Working towards better integration in the Mediterranean Financial Area

CONTEXT AND CHALLENGES

In its study for the French Caisse des Dépôts (CDC), McKinsey Company assessed public projects in the pipeline over the next 5 years as totalling €200 billion in nine activity sectors in 11 SEMCs (excluding Turkey and including Libya), i.e. €40 billion per year for 5 years. The EIB has also estimated needs over the coming ten years in the sole South of the Mediterranean €100 billion in the energy sector, € 110 billion for urban planning (water, sanitation, waste treatment and urban transport), € 20 billion for logistics (ports, airports and highways), and €20 billion for supporting company development to contribute to the 50 million jobs that SEMCs need to create before 2020.

Funds from current stakeholders taken together, i.e. South and East Mediterranean countries, local banks, multilateral institutions for funding development and private stakeholders, are insufficient to cover these needs. Investment remains low in the region and private investment even more so, particularly when it comes to investing in infrastructure for the long term, which is perceived as too risky for the profitability expected. Gross fixed capital formation (public and private investments) related to gross domestic product is below 25% in the Middle East and North Africa (MENA), compared to 40% for East Asia and the Pacific. Savings available locally are currently rarely mobilized by standard financial systems, because the region is characterized by low intermediation rates and limited development of its financial markets.

UFM'S PROPOSITIONS FOR ACTION

Faced with the scale of investment needs in SEMCs, new opportunities for Euro-Mediterranean cooperation are emerging. This is a convenient moment because: (1) Europe needs to identify growth areas in its immediate environment; (2) SEMCs cannot individually find the resources to deal with monetary risk, market risks, risks of long-term FDI and risks of exports.

The proposal is to progressively put in place, adopting the variable geometry principle, an ambitious financial architecture specific to the region and centred around a Mediterranean development bank. This architecture would be inspired by the Bretton Woods institutions: a bank, monetary fund, agency to guarantee investment, standardized regional framework for protecting investments, mechanisms for settling disputes, etc. This is the only appropriate format to address the deficiencies identified in the region by the "Mediterranean Investment Initiative" (2IM – www.2im.coop), jointly led by the CDC (France), the CDG (Morocco) and IPEMED.

An architecture of this type is necessary to:
1. Support and revitalize investment during the initial stages of business creation.
2. Develop capital markets in the region and encourage their connection.
3. Strengthen and extend export guarantee measures.
4. Offer an overall and common framework for securing investments.
5. Guarantee greater monetary stability in the region.
6. Federate existing initiatives and participate in revitalizing investment.
7. Create conditions for the long-term transformation of migrant savings.

The adversity of the current situation calls for progress to be made to create the conditions needed to break with a procrastinating market and weak growth.
At the very least, and in the absence of such decisions, three actions need to be taken immediately by public powers:
- **Set up a Guarantee Fund for infrastructures.**
- **Set up a Guarantee and Support Fund for SMEs.**
- **Put together a working group around the UFM's General Secretariat to continue the work done by the 2IM initiative and its teams and so rapidly formulate and adopt concrete propositions.**

It is only by taking decisions of such kind that the private sector will be able to take over from public action, extend securely to encompass all countries in the Union for the Mediterranean, and innovate, and that the Private Public Partnership will be in a position to give maximum leverage to the resources available.

Facts

1. The importance of investment capital and capital markets. Like many other emerging countries, SEMCs still offer insufficient banking options for investment credits; banks are often ill equipped to provide long-term investment to economic stakeholders. They focus on short-term investment and their demands for guarantees are exorbitant for SMEs. To complete the range of banking available, more specialized funding channels are needed for creating and developing businesses and giving them direct access to capital markets. A capital investment economy is now established in SEMCs, yet because it is relatively recent, it remains incomplete, especially for the early development stages of businesses.

When it comes to capital markets, several SEMC stock markets are ignored, though dynamic, with their action resulting in far-reaching connections. Capital markets have high potential in the whole region. In this domain, Europe is absent: no major European stock market acts for SEMC markets; no index has been defined for the Euro-Mediterranean.

2. SEMCs have mostly caught up in FDI. From 2000 to 2007, SEMCs for the most part made up for their lagging behind in FDI and there is no reason to think that the crisis will sustainably inverse trends observed up to 2007. Some SEMCs have thus joined the countries in the world that proportionately receive the most FDI for their economic size (source: UNCTAD 2006 ranking).

The result is that in some SEMCs, investment efforts are largely left to foreign investment (e.g. Jordan). FDI is increasingly looking towards heavy industry, either for exports or to satisfy fast-growing domestic markets. Despite the crisis, several SEMCs are now reaping the fruits of efforts they have been making for several years.

3. SEMCs do not have the systems needed for providing more export guarantees. Most SEMCs, like their Northern neighbours, provide their national companies with aid for exports and setting up abroad. Sometimes certain types of company are targeted, frequently in technology. These guarantees remain limited in number and the financing purposes covered, since local banks still frequently set conditions whereby access to hard currency credit requires constituting local currency deposits that are prohibitive for SMEs. In SEMCs, public guarantees are generally almost exclusively focused on covering the non-payment of exports and are a long way from guaranteeing every stage of an entrepreneur's international development. In comparison, western systems successively cover: market prospection (covering part of costs of prospection undertaken but not amortized due to insufficient sales), pre-financing of exports, exchange rate risks linked to export contracts, fulfilment of contracts and their payment, guarantee of supplier credit, guarantee of immaterial goods (e.g. patents, brands, etc.), guarantee of mobilizing credits started abroad, guarantee of documentary credits, and political risk that is likely to hit investments.

4. Legal guarantees of investments judged to be insufficient. All Mediterranean countries have adopted laws or national codes on foreign investment (source: Anima 2010). 582 bilateral treaties for protecting investment have been adopted, including 73 treaties concluded between countries in the region (although only a third are in force) (source: OECD 2010). Some free trade agreements concluded by countries in the region also include dispositions relating to investment protection. Most countries in the region are also part of regional organizations, some of which foresee specific investment guarantee regimes (Organization of the Islamic Conference, Arab League, Arab Maghreb Union) completed by an international court of arbitration (Arab League) and/or an investment guarantee agency (Arab League, Organization of the Islamic Conference). Twelve states have signed the Washington Convention that constitutes the ICSID.

However, it emerges from a number of reports, in particular by the OECD and UNCTAD, as well as interviews with certain investors in the North of the Mediterranean and the Gulf states, that expectations regarding investment protection in the region are high. The experience of the Argentinean crisis in particular and the administrative measures that followed have convinced investors that it is important to set up a legal framework for protecting and promoting investment making it possible to quickly and efficiently neutralize or compensate political or systems-related risks.

5. SEMCs' monetary stability – a true challenge. The global financial crisis also hit SEMCs, who saw their currency resources diminish (e.g. drop in transfers, less FDI and a drop in exports). This crisis could threaten their monetary and financial stability. Some SEMCs receive imports from the EU paid for in Euro while most of their exports to the rest of the world are in Dollars. A scissors effect will emerge with a currency war that risks endangering economic take-off in these countries.

Regional economic integration is difficult to envisage without a degree of financial stability between the different currencies involved, even before a free trade principle can be applied to all categories of goods. The question of linking SEMCs' currencies to the Euro needs to be posed.

Propositions

1. A NECESSARY PROJECT'S COORDINATION. A multilateral body needs to be entrusted with guiding, coordinating and supervising public actions and commitments within projects chosen by the UFM. An obvious choice for this body could be the UFM's Secretariat. Donors would make their expertise available and could directly pilot the public side of European funding. Other public and private investors could also be called on, including from outside the region. An operational structure would need to be created which would be the contracting party, responsible for labelling projects, legally and financially engineering them and running them. It would act on behalf of the Secretariat and could be attached to it, and would liaise with donors and investors grouped around projects. These investors, from different public and private backgrounds, could be associated to a Trust, which would itself designate the structure as its trustee. The main advantage of this type of set-up is that it could run the projects in a single way, within a multilateral framework, while bringing together different investors to finance them.

2. A DEVELOPMENT BANK SPECIFIC TO THE REGION. Like the EBRD set up from 1989 in Eastern Europe, a Mediterranean development bank could bring undisputable added value to the region:

- Firstly, its creation would give out a strong signal to investors. It would contribute to restoring confidence within governments, banking systems and industrial partners. Its simple existence would create conditions of security for savings flows and investment.
- It would make it possible to move from an investment fund logic to one of regionally integrated, sustainable cross-cutting development, and would give out the image of a region that sticks together and is committed to constructing and defending its common future.
- It would help transform unproductive cash balances into long-term funding and encourage conditions of stability and monetary anchorage.
- Even with a modest role in project finance, intervention from the Mediterranean bank would have a catalyst effect, encouraging commercial banks and other capital stock investors by giving reassurance on the feasibility of projects.
- Like the EBRD in Eastern Europe, the bank would have to provide essential functions aimed at upgrading the region's economies and financing SMEs and the private sector.
- It would contribute to improving the quality of projects by lending expertise and identifying and assessing risks, which are largely lacking in the region.
- Lastly, only a regional development bank would be capable of carrying cross-cutting, ambitious, mobilizing projects such as: TGVs in the South, electricity interconnections and cross-border motorways. Until now, only the Arab Fund for Economic and Social Development has financed projects of this kind, with limited resources.

3. A GUARANTEE FUND FOR FINANCING INFRASTRUCTURE. Initiated by Europe, and capable of associating traditional political risk guarantee actors, this kind of Fund is an ideal way of concentrating public resources and leveraging the resources used. The Fund is particularly suitable for projects with differed income and relatively low yields, and would provide guarantees for energy projects (e.g. production, transport and distribution of electricity and gas), renewable energy, transport projects, telecommunications, environment (water and sanitation, waste treatment, removing pollution, etc.) as well as human and social capital (e.g. hospitals, teaching establishments and social housing). Alongside traditional political risks, it could cover liquidity risks beyond a fixed maturity, and thus encourage long-term project funding.

4. A COMMON EURO-MEDITERRANEAN FUND FOR GUARANTEEING EXPORTS. This kind of Fund – one of whose functions could be to ensure greater coordination between national export guarantee agencies in the region – would provide structures in SEMCs active in this domain with complementary resources to: extend the range of their services; improve their reinsurance conditions and, for long procedures, receive advances to help them swiftly compensate their business clients in whole or in part; and work more with local banks, which in SEMCs tend to rarely promote export guarantees.

5. AN SME REGIONAL GUARANTEE FUND WITH A PRIORITY FOCUS ON CLUSTERS. This Fund would complete the Mediterranean Business Development Initiative (MBDI) launched by Italy and Spain along with the EIB. It would put European regions (Italy / Spain / France to start with) in partnership with regions South and East of the Mediterranean to set up a concrete instrument to support business creation and development:

- based on a territory principle, with a priority focus on clusters and competitiveness poles, the Fund would be able to mobilize all actions in place in North and South (research / universities / start-ups / capital investment / major enterprises / SMEs, etc.);
- it would provide strong technical assistance to accompany business applications and would be well placed to encourage the multiplication of genuine cluster funds, attracting both local capital and international investments (from Europe, the Gulf, etc.).

6. Revitalizing capital markets by encouraging connections. The challenges of developing capital markets are: to allow companies to access non-banking resources; to find more numerous outlet possibilities for investors; to mobilize local savings; and to provide warrantees to countries receiving direct foreign investments on the sustainability of the funding and its contribution to the receiving economies. Reciprocally, foreign investors would be able to develop in more secure conditions. The first achievements in SEMCs show the way.

7. Given their considerable investment needs, and at a time when South and East Mediterranean Countries public budgets are highly constrained by the financial and economic crisis, it is inevitable that governments in the region will turn to Public Private Partnership (PPPs) both for infrastructure projects and financing SMEs. These mechanisms, which are not yet common in the region, could be promoted by developing and adopting a standardized regional PPP framework. This would have the advantage of (1) providing investors with greater legal clarity and more transparent transactions; (2) ensuring a reasonable allocation of risk between private operators and public authorities; (3) mobilizing local private operators; (4) strengthening states' institutional capacity to control and manage PPPs; and (5) developing innovative long-term finance schemes, which are crucial to infrastructures projects.

8. A regional investment framework in the Mediterranean possibly based on the following principles:

- Multilateral standards for dealing with investment recognized by states in the region;
- Multilateral standards for investor behaviour applicable in states in the region;
- Flexibility that would allow all states, via a declaration system, to remain in a multilateral system and at the same time highlight certain clearly identified characteristics or provide reinforced protection to certain categories of investment;
- Establish a Mediterranean Investment Secretariat (MIS) responsible for supervising implementation of the multilateral agreement.

This type of multilateral framework would allow investors to rely on protection guarantees clearly identified for each country and offering a standardized regional framework. It would also allow states to highlight specific characteristics while still valuing the debate within a multilateral forum on the negative and positive effects that these characteristics have on investor behaviour in their respective economies. Lastly, in addition to this multilateralism of investment protection, an Investment Tribunal should no doubt be created to seek greater efficiency and more coherence with tribunal law, plus an investment guarantee agency. No guarantee is serious without efficient sanctions of the violation of the rule of law and without prompt compensation for prejudice of the investor or the state receiving the investment. As well as its main role, the investment guarantee agency could also be at the centre of an exchange of experience and debate between the region's states on improvements to introduce national legal frameworks for protecting and promoting investment. In any case, the existence of a legal framework for investments that is seen to protect would result in less costly insurance cover for political risks in existing systems.

This kind of framework could be implemented pragmatically via country membership on a case-by-case basis and/or based on projects promoted.

9. Implementing the propositions. This work needs to be taken further by the Union for the Mediterranean's authorities to rapidly reach concrete propositions. The lines identified need continued exploration and to be made into concrete propositions to submit to the governing bodies of the Union for the Mediterranean.

A working group should be set up without delay to adopt the 2IM's team and approach, bringing members of civil society who have already worked on these subjects together with experts from UFM member states. The Secretariat will organize a working programme for them with the aim of rapidly drawing up the expected propositions.

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