Mediterranean Investment Initiative
Initiative pour l'Investissement en Méditerranée

Measures to enhance and guarantee

# Investment in the Mediterranean

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GROUPE Caisse des Dépôts

IPEMED
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Caisse de Dépot et de Gestion

*The analyses developed in the report engage solely their authors and do not represent the official position of the founders of 2IM*

# PREFACE

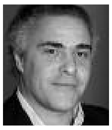
The Mediterranean Investment Initiative (www.2IM.coop) is a project led by Caisse des Dépôts (France), Caisse de Dépôt de Gestion (Morocco) and the Institut de prospective économique du monde méditerranéen since March, 2009. By bringing together thirty public and private, investors from European countries, South and East Mediterranean countries, Gulf States, but also development multilateral institutions, the Initiative had as objectives to establish a shared diagnosis on opportunities and obstacles to investment in the Mediterranean region, to identify financial and legal tools to enhance the pace of investment and to formulate concrete proposals so as to encourage business opportunities.

The proposals formulated within the framework of the Initiative, contained in this report, fit into a dual vision. In the long term, the aim is to establish a comprehensive vision whilst in the short term is to propose operational solutions. The long term vision consists in setting up a global financial architecture based upon a development financial institution to direct investment into projects that will build economic structure in the SEMCs over the long-term, rather than into speculative sectors. The time is now ripe to gradually establish a flexible and ambitious financial architecture specific to the region and akin to the Bretton Woods institutions: a Bank, a monetary fund, a guarantee agency, etc.

**Radhi Meddeb**
President
of IPEMED

In the short term, the aim is to remedy the shortcomings in the legal regimes governing investment security in the region and to set up instruments and tools for financing infrastructure and SMEs. If it is to attract investors, the Mediterranean region needs to enhance its business climate and improve investor perceptions of the region. It also needs to endow itself with financial tools that will allow it to overcome the difficulties in financing infrastructure and SMEs.

Time has come to establish a real euro-Mediterranean partnership to accompany the historical moments the Mediterranean region witnesses and favors its emergence as a complementary and competitive region where solidarity is the rule in the context of globalization. Measures proposed within the Initiative do certainly contribute to it.



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## SUMMARY



## LIST OF ACRONYMS

**ABD** u African Development Bank
**AFD** u French Development Agency
**AFESD** u Arab Fund for Econo - mic and Social Development
**BRIC** u Brazil India China
**CDC** u Caisse des Dépôts et Consignations
**CDG** u Caisse de Dépôt et de Gestion
**CDP** u Cassa depositi e prestiti
**EC** u European Commission
**EIB** u European Investment Bank
**ENP** u European Neighborhood Policy
**ENPI** u European Neighborhood and Partnership Instrument
**EU** u European Union
**FDI** u Foreign Direct Investment
**FEMIP** u Facility for Euro-Mediterranean Investment and Partnership
**IDB** u Islamic Development Bank
**IFC** u International Finance Corporation
**IPA** u Pre-Accession Assistance
**MIGA** u Multilateral Investment Guarantee Agency
**NIF** u Neighborhood Investment Facility
**OECD** u Organization for Economic Cooperation and Development
**SEM** u Small and Medium Enterprises
**SEMC** u South and East Mediterranean Countries
**UfM** u Union for the Mediterranean
**WB** u World Bank

## INTRODUCTION

# Measures to enhance and guarantee Investment in the Mediterranean

THE MEDITERRANEAN Investment Initiative (2IM) was launched on 13 March 2009 as a partnership between Caisse des Dépôts, CDC (France), Caisse de Dépôt et de Gestion, CDG (Morocco) and the Mediterranean Economic Foresight Institute (IPEMED). The aim of 2IM is to bring together public and private investors with a view to identifying ways and means of increasing the pace of investment in the South and East Mediterranean Countries (SEMC) and of improving the business climate there. Since 2009, 2IM's main focus has been on three key topics:

- How to forge closer links between economic operators across the Mediterranean region so as to speed up the emergence of an integrated economic area in the region.
- The need to build confidence among economic operators throughout the region, using the twin pillars of shared responsibility and shared decision-making.
- The need to provide a secure investment environment so as to enhance the region's attractiveness and its resilience to economic and financial turmoil.

**THE FIRST SECTION OF THE REPORT GIVES AN OVERVIEW OF THE CURRENT SITUATION OF INVESTMENT WHILE THE SECOND SECTION OUTLINES PROPOSALS AIMED AT STEPPING UP THE PACE OF INVESTMENT IN THE REGION.**

FOLLOWING 2IM'S LAUNCH, avenues for further exploration were identified and two working groups, legal and financial, were established. The intention was that these would formulate proposals for legal and financial tools based on a shared diagnosis of the region's weaknesses and advantages. The working groups' findings were submitted to and debated by the 2IM steering committee, composed of representatives of AFD, EFG-Hermès, OECD, PROPARCO, SFI, as well as founding members CDC, CDG, CDP and IPEMED. They were also examined in a series of workshops held as part of the 2IM second plenary meeting on 25 February 2010 in Rabat (Morocco) organised by CDG. More recently, they were outlined in a presentation to KfW in Brussels in September 2010.

This report brings together the recommendations of the financial and legal working groups, as set forth in separate, multi-author reports.

**Financial group**

- *Investment in the Mediterranean: Current Situation and Ways Forward,* Guillaume Almeras & Abderrahmane Hadj Nacer, March 2009.
- *Tools for Stepping up Investment in the Mediterranean,* Michel Gonnet, September 2010.

**Legal group**

- *Overview of International Legal Mechanisms for Protecting Foreign Investment in the Mediterranean,* Sabrina Robert-Cuendet, April 2010.
- *Proposals for Enhanced Investment Guarantees in the Mediterranean Region*, Eric Diamantis, July 2010.

THE KEY FINDINGS OF THE Commission on the Financing of Co-Development in the Mediterranean, chaired by Charles Milhaud, were also included in this report. The report contains two sections. The first section gives an overview of the current situation of investment in the region and the main barriers to investment. The second section outlines proposals aimed at stepping up the pace of investment in the region. Two approaches are suggested: a long-term approach that seeks to endow the region with a fully-fledged financial infrastructure based around a dedicated financial institution; and a short-term, operational and pragmatic approach involving measures to guarantee and secure investments in the region durably, and the creation of tools to channel financing into two key sectors: infrastructure and SMEs.

# Current situation of investment in the Mediterranean

THE CURRENT INVESTMENT situation in the Mediterranean region presents a highly contrasted picture. On the one hand, the SEMC enjoy certain advantages that enabled them to continue tapping foreign direct investment (FDI) and maintain growth rates in excess of 3% even at the peak of the crisis. On the other hand, the Mediterranean continues to have one of the starkest investment deficits in the world, particularly in the areas of infrastructure and SME financing.

The region stands out for the sheer volume of its investment needs for the coming ten years, estimated at a minimum of around €250bn: €100bn for energy, €110bn for urban development (water, drainage, waste treatment, urban public transport), €20bn for logistics (ports, airports, motorways), and €20bn for enterprise development support, bearing in mind the 50 million jobs the SEMC need to create between now and 2020.

**THE REGION STANDS OUT FOR THE SHEER VOLUME OF ITS INVESTMENT NEEDS FOR THE COMING TEN YEARS, ESTIMATED AT A MINIMUM OF AROUND €250BN.**

Furthermore, although the SEMC had caught up to a certain extent as regards FDI attractiveness (FDI was hovering around €45bn in 2006), by 2009 the global economic crisis had sent FDI into retreat (a 72% fall in Morocco, and 50% down in Israel, Lebanon, Tunisia and Turkey)[1]. An improvement in FDI is not completely off the cards, however, given the cyclical nature of FDI trends in the region. The SEMC came through the global financial and economic crisis with growth rates of more than 3% intact, at least in the short term. For Turkey, for example, the IMF is forecasting 2011[2] growth at somewhere in the range of 3-7%.

Moreover, according to HSBC, two countries in the region – Turkey and Egypt – *"stand alongside Colombia, Indonesia, Vietnam and South Africa as high growth potential countries, with the potential to join the ranks of the BRIC"*[3].

WHILE MULTILATERAL and bilateral international donors have stepped up their financial injections into the region, investments continue to lag far behind what is needed. The SEMCs' own investment potential, meanwhile, is constrained by the imperative of fiscal responsibility as prescribed by the World Bank. At the same time, the Mediterranean region offers genuine advantages in terms of population size, dynamism, and comparative resilience to the financial and economic crisis that affected the European Union countries so severely.

The total population of the member countries of the Union for the Mediterranean will reach 874 million by 2030 and exceed 900 million in 2050[4]. The Maghreb and Egypt will each be home to 130 million people by 2020. Given this upturn in the very building blocks of economic power – population size and level of education (witness the BRIC example) – population size could in time become a major advantage for the region.

The first section of this report offers a brief overview of FDI and financing by a number of investment financing providers in the Mediterranean. The main obstacles to investment will also be outlined in this section.

## Overview of investment financing in the Mediterranean

ACCORDING TO Mediterranean Investment Project Observatory (ANIMA-MIPO), the number of new FDI projects announced in the SEMC is on the rise again, with 581 projects identified in the first three quarters of 2010 compared with 542 in total for 2009 (a 43% increase). The total value of the new projects came to €20.4bn at 30 September 2010, compared with €28.6bn in 2009. The average value of an investment project was €35m in 2010, compared with €50m in 2009. Growth is also being seen in joint venture creation: 362 new joint ventures were set up in the first three quarters of 2010, compared with 303 in total for 2009. **CHART 1**

Turkey and Israel together are attracting more investment than all of the other countries put together. Syria and Lebanon registered clear-cut growth, with FDI mainly directed to the banking sector. Syria's banking sector was opened to foreign investment to a maximum of 60% in early 2010. Total announced FDI in Syria came to €2.2bn in 2010, compared with €0.9bn in 2009.

(1) Milhaud Commission report – May 2010.

(2) Idem.

(3) IPEMED NEWS, September 2010, article by Akram Belkaid, editorial advisor.

(4) Source: FAOSTAT, © FAO Statistics Division 2009, 13 August 2009.

In the Maghreb, announced FDI came to €3bn in the first three quarters of 2010, compared with an annual average in excess of €8bn since 2003. Tunisia scored highest on the number of FDI projects announced, with 92 in the first three quarters of 2010, compared with 78 for 2009 as a whole.

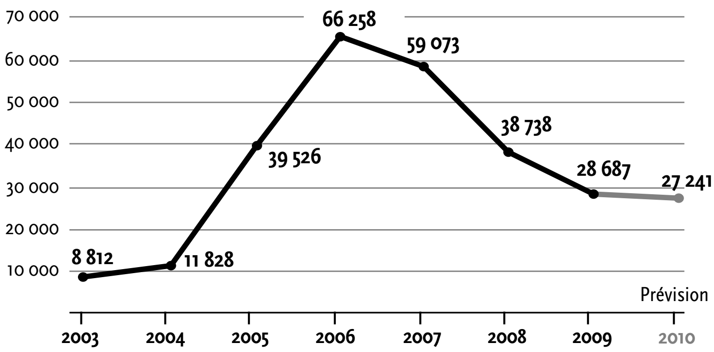
EUROPEAN CORPORATIONS continued to lead the pack in 2010, with 30-40% of the total number of FDI projects announced. This notwithstanding, there is a trend towards greater diversity of origin, with emerging countries now accounting for 30% of the total number of announced FDI projects. The Gulf States, on the other hand, are in retreat somewhat owing to the financial crisis and real estate bubble. **CHART 2**

The SEMC also receive large-scale investment financing from international multilateral and bilateral funding agencies. According to the Milhaud Commission's report, the total financial flow to the region in 2009, aid and loans alike, came to around €20bn.

The region's most important multilateral partner is the European Union, with €2bn in aid and €5bn in loans granted by the European Investment Bank (EIB). The Agence Française de Développement (AFD – French development agency) is the largest bilateral donor, with total commitments to the region in excess of €1bn. **TABLE 1**

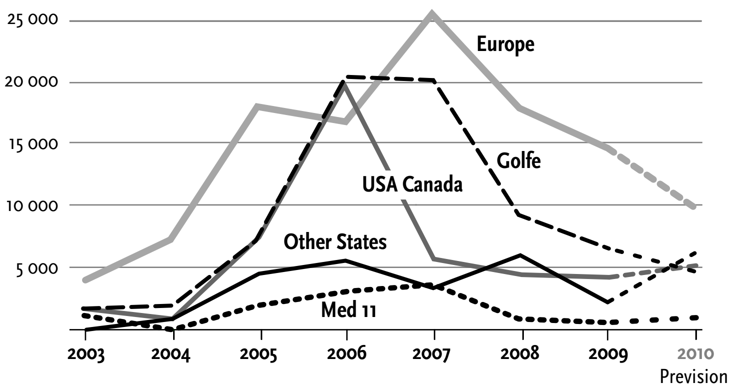
Below is a more detailed overview of investment inflows in the region.

CHART 1 **Trends in net new FDI** € millions




Source : Anima-Mipo

CHART 2 **Net announced FDI per region of origin** € millions




Source : Anima-Mipo

TABLE 1 **Multilateral financing per donor** € millions, 2009

| Donor | Amount |
|---|---|
| European Union | 2,206.80 |
| European Investment Bank | 5,009.00 |
| World Bank Group | 3,954.40 |
| EBRD | 416.00 |
| African Development Bank | 948.20 |
| IDB and AFESD | 956.40 |
| Other institutions | 805.50 |

| Donor | Amount |
|---|---|
| France | 1,292.80 |
| USA | 1,183.80 |
| Other States | 2,192.90 |
| Arab and Islamic Funds and States | 462.20 |
| **Total** | **19,428.00** |

Source : Milhaud Commission report

## The European Union (EU) is the region's largest funding provider.

THE EU ACTS mainly via its European Neighbourhood Policy Instrument (ENPI), the Facility for Euro-Mediterranean Investment & Partnership (FEMIP), managed by the European Investment Bank (EIB), and, since 2008, through the Neighbourhood Investment Facility (NIF). The ENPI's total allocation amounted to €12bn for the period 2007-2013, which represents an increase on previous years.

ENPI credit financing mainly goes to bilateral projects (country-specific cooperation projects). Loans are also issued to the two ENPI regions (South and East), as well as to regional and cross-border initiatives and mechanisms.

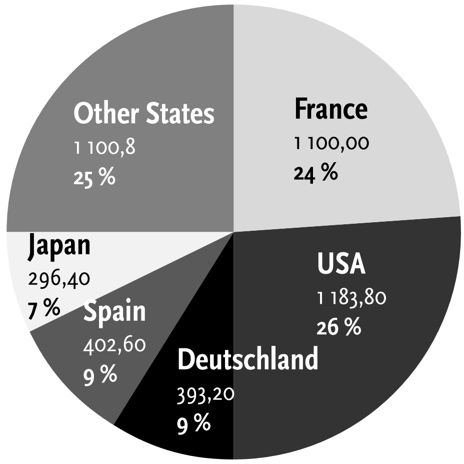
For the period 2007-2013, FEMIP has a budget envelope of €8.7bn to finance EU guaranteed loans, and €2.2bn to finance non-guaranteed loans for enterprise development and financing infrastructure meeting the priorities defined within the framework of the Union for the Mediterranean.

The NIF focuses mainly on infrastructure funding, and has a budget envelope of €700m for the period 2007-2013. Member States have been asked gradually to match the EU contribution so as to optimise lending leverage. As of the end of 2009, projects totalling €4.3bn were financed in this framework, with a contribution of around €74.8m by the NIF.

By way of comparison, the Instrument for Pre-Accession Assistance (IPA), which provides funding to potential candidate countries such as Turkey, has a budget envelope of €11.5bn. The report underscores that the ten South Mediterranean countries (205 million inhabitants) received €887m or €4.30/inhabitant under the ENPI in 2009, compared with €921m received by the IPA eligible countries (87 million inhabitants), or €10.50/inhabitant.

CHART 3
**Bilateral funding per country**
€ millions, 2008

Source : Milhaud Commission report




### Other multilateral institutions provide funding that partially meets the region's needs

Infrastructure; SMEs, investment guarantees

WORLD BANK GROUP (WB) invested a total of €4bn in the region during 2008-2010, broken down as follows: energy 25%, private sector financing 25%, and transport and water 25% each. International Finance Corporation (IFC), the World Bank subsidiary dedicated to private industrial financing, invested €860m in equity and loans in the region in 2009. The Multilateral Investment Guarantee Agency (MIGA) guarantees investments in the region against selected political risks. Its commitment to the region in 2009 came to €497m to cover investments in Syria and Turkey. The World Bank also operates in the region via two funds:

- the Global Environmental Facility (GEF) via a programme called Sustainable Med launched in 2009 with an $800m budget,
- and the Clean Technology Fund, which is planning to provide $750m to finance projects under the Mediterranean Solar Plan.

AFRICAN DEVELOPMENT BANK GROUP (ADB) has increased its financing to the region, with a focus on Egypt, Morocco and Tunisia. In 2009, its total commitments came to €948m mainly in the areas of transport, energy and industry.

THE ISLAMIC DEVELOPMENT BANK (IDB) issued concession loans in 2008 totalling €567m with a main focus on Tunisia, Morocco and Turkey, notably to finance infrastructure, human development and private sector projects.

THE ARAB FUND FOR ECONOMIC AND SOCIAL DEVELOPMENT (AFESD) financed projects totalling €400m in 2008, with a clear preference for the energy sector.

**THE ENPI'S TOTAL ALLOCATION AMOUNTED TO €12BN FOR THE PERIOD 2007-2013.**

### Bilateral funding is substantial in the region, totalling €4.4bn in 2008

FRANCE IS THE REGION'S biggest provider of funding after the USA. AFD manages most of France's commitments to the region, providing €853m in 2009. AFD's subsidiary PROPARCO provides capital and credit financing. AFD's total commitments to the region in 2009 came to €1.1bn, with Turkey, Morocco and Tunisia the main beneficiaries. AFD provides private sector financing in the region mainly via its ARIZ fund and the Mediterranean Investment & Support Facility. France, Germany and Spain provide 42% of the development assistance received by the region. **CHART 3**

### Sovereign investors play a leading role in the region, mainly in the area of enterprise creation

IN 2008, KFW MADE a total of €150m investments of its own. CDC launched Averroès I in 2003 and Averroès II in 2009, and plans to invest €50-80m in start-ups. A joint project by CDC (France), CDP (Italy), CDG (Morocco) and EFG-Hermès (Egypt) and EIB led to the launch of the INFRAMED fund, which aims to provide long-term funding to infrastructure projects. The INFRAMED partners provided the fund with an initial endowment of €400m, and plans are afoot to increase that to €1bn. Further information on the fund is contained in the second section of this report.

### Joint initiatives are underway aimed at better targeting investments, streamlining the project approval process, and better sharing out risk

AFD, KFW AND EIB have signed an agreement that seeks to "harmonise their methods of intervention in the region and co-finance projects"[5]. The same is also being done by donor private financing subsidiaries via European Financing Partners (EFP), enabling donors to finance projects using the single-window principle.

### Most of the funding made available to the region comes from three donors and goes to three countries.

TURKEY, EGYPT and Morocco "capture 53% of the available aid"[6] and the EU, EIB and the World Bank are the main donors, "providing 60% of the total aid" to the region.[7]

## Main obstacles to increased investment in the Mediterranean

THE INVESTMENT situation on the ground in the Mediterranean is highly complex, with factors stemming from the disparate nature of the region's economies coming into play: two economies rely on oil exports (Algeria, Syria), three have close links with the EU (Algeria, Morocco, Tunisia), five have more or less close links with the Gulf States or the rest of the world or both (Egypt, Lebanon, Palestine, Jordan, Israel), and Turkey is a special case unto itself. The same heterogeneity is seen in the countries' links with the EU, as shown by their trade with the bloc: some 50% of Algeria, Morocco and Tunisia's trade is with the EU, whereas for Egypt, Lebanon, Palestine, Jordan, Israel and Syria, the figure is around 30%.[8]

Another factor is the remarkably slow progress in Euro-Mediterranean economic integration. Of the multiple challenges and obstacles faced by the region, we have chosen to dwell on five main investment obstacles identified in the report prepared by Guillaume Alméras and Abderrahmane Hadj Nacer. We believe these to be crucial to the future of the region, since they "cover the entire gamut of investment financing instruments"[9]:

- FDI volatility and the region's capacity to attract FDI over the long-term
- Sharp currency fluctuations: euro vs. dollar?
- Inadequate SME financing
- Structural need for infrastructure financing
- Negative perceptions of the business climate.

### FDI volatility and the region's capacity to attract FDI over the long-term

IN 2000-2007, the SEMC managed to close the FDI gap, partly by seeking out diversified sources of FDI. The European countries are no longer the sole investors in the SEMC: the Gulf States, Turkey and the Asian countries are investing increasingly in the SEMC, to serve local and export markets alike. Moreover, the SEMCs' output is becoming ever more sophisticated, research and innovation are taking hold, and companies are attracted by local specialists who cost less to employ than their European counterparts. FDI fell in 2008 and 2009 owing to the world financial and economic crisis.

According to the Mediterranean Investment Project Observatory (ANIMA-MIPO), "*2010 saw a continuation of the trends recorded in 2009. Foreign companies are once again giving the green light to investment projects as reassuring economic forecasts are released for the Mediterranean countries (4% growth for the Arab countries in 2010 according to the IMF), but the projects are smaller in scale and carry less risk.*" Although the Mediterranean countries did not emerge unscathed from the crisis, they did manage to resist by redeploying their value chains and thanks to near-shoring by European companies coming under increased competitive pressure. European companies have also stepped up their quest for new sources of growth on what have become increasingly dynamic and less distant markets.

NEVERTHELESS, the Mediterranean's share of FDI remains inadequate. "*FDI flows into the Mediterranean region account for less than 5% of global FDI"[10]. There are two reasons for this: FDI volatility and the incapacity of the SEMC to build a durably attractive image.* **TABLE 2**

Guillaume Alméras and Abderrahmane Hadj Nacer argue that the following reasons explain the impact of FDI in the region: "*Whereas the task for*

(5) Report of the Commission on financing of co-development in the Mediterranean, chaired by Charles Milhaud.

(6) Idem.

(7) Idem.

(8) "Crisis and ways out of crisis in FEMIP Mediterranean partner countries", FEMISE, 2010.

(9) "Investment in the Mediterranean: current situation and ways forward", Guillaume Almeras & Abderrahmane Hadj Nacer, March 2009.

(10) Report of the Commission on the financing of co-development in the Mediterranean, chaired by Charles Milhaud.

*the SEMC was to attract the capital they needed, FDI has tended to be passively suffered rather than actively managed; investment projects have led to increased economic activity, but the trickle-down effect has frequently been meagre. According to ANIMA-MIPO estimates, job creation directly attributable to FDI in the SEMC (2 million jobs in six years) has been well below the level required, and, more importantly, has been falling off in recent years (101,000 jobs in 2006, 86,000 in 2007, 76,000 in 2008) owing to a lack of sufficiently dynamic industrial policies.*

*Much of FDI, notably in the energy sector, uses foreign labour and equipment and leads to exports of raw or almost raw materials, thereby creating little in the way of local added value. In the construction and public works sector, ... FDI is creating increased supply in a narrow middle and high income segment mainly made up of outsiders (expatriates, second homes for diasporas). Parts of the local population and local professionals are falling prey to an eviction effect (lack of quality real estate, land price inflation).*

*FDI can also cause large-scale capital flight, making it tempting to resort to a more closed strategy. The example of Algeria is illustrative in this regard. By way of comparison, countries such as China, India, South Korea (the principle of "filtered" openness), Thailand, and, very recently, Brazil, have implemented more nuanced and selective strategies with respect to FDI"*[11].

TABLE 2 **Share of Mediterranean countries in world FDI**

| | Total PM | World | % MC |
|---|---|---|---|
| **IDE 1995-2005** | 10.978 | 741.045 | 1,48% |
| **IDE 2007** | 55.748 | 2.099.973 | 2,65% |
| **IDE 2008** | 54.867 | 1.720.873 | 3,19% |
| **IDE 2009** | 32.437 | 1.114.189 | 2,91% |

Source : UNCTAD, Data Base 2010

Their main conclusion is that the SEMCs' capacity to attract FDI has to be placed within a larger picture – that of their openness to the EU and to non-EU partners – with two main characteristics highlighted:

- An influx of FDI from the EU and the Gulf States (before the crisis) seeking to use the SEMC as a production or hosting platform (tourism, real estate) for mainly external markets;
- Business flows are developing in parallel between the SEMC themselves and with new non-EU markets. This is leading to modest inwards investment with a greater focus on local markets and a strong manufacturing slant.

FEMISE[12] MAKES the following four points about FDI:

- The contribution of FDI to economic growth in SEMC depends on whether the country in question has opted to improve its business climate, privatise its economy and liberalise its market, or whether it has decided to continue with a tightly regulated model. Bearing this in mind, a distinction needs to be drawn between countries with a pro-active FDI policy such as Egypt, Tunisia, Morocco and Jordan, where foreign companies play a quantitative role in economic growth, and countries that are not as aggressive about attracting FDI either because of their already sizeable economic clout (Turkey) or because they have significant financial resources or savings at their disposal (Algeria, Syria, Lebanon).
- FDI has become a key factor for economic growth. That being said, FDI's contribution to dynamic growth, job creation and economic balance between territories is not so clear.
- FDI can buoy growth over the long-term if host countries have the capacity to absorb over time the technologies that FDI brings.
- A mechanism similar to the ASEAN Comprehensive Investment Agreement is needed so as to foster the emergence of Mediterranean-based industry champions capable of occupying an important place in the global manufacturing architecture.

THE MILHAUD COMMISSION underscores the need for SEMC on the receiving end of FDI to foster a high degree of domestic saving and investment and to provide clear regulatory and legal environments conducive to attracting investment. Measures along these lines could have a multiplier effect on FDI and encourage source countries to transfer the technology and know-how needed to preserve or enhance their competitiveness in the countries where they've invested.

## Sharp currency fluctuations: euro vs dollar?

THE WORLD FINANCIAL crisis did not leave the SEMC unscathed. It still has the potential to upset their monetary balance. Any Euro-Mediterranean partnership needs to take this aspect on board also. We are not calling specifically for consideration to be given to establishing a single currency in the region, although this continues to be a long-term objective. Such a move would require States to agree to relinquish a degree of sovereignty and to coordinate fiscal and tax policies.

A number of pressing issues worthy of consideration arise in connection with how the region's

(11) "Investment in the Mediterranean: current situation and ways forward", Guillaume Almeras & Abderrahmane Hadj Nacer, March 2009.

(12) "Crisis and ways out of crisis in FEMIP Mediterranean partner countries", FEMISE, 2010.

economies are aligned with either the euro or the dollar. One of the consequences of the crisis was a drop in revenue owing to reduced external demand; reduced capacity among migrants to remit earnings to their home countries due to increased host country unemployment, reduced tourism, and reduced FDI. The domestic growth seen over the past few years undoubtedly contributed to the overall growth registered in the SEMC, partly thanks to increased private consumption. However, domestic growth alone cannot compensate for the drop in exports. Moreover, the SEMC are suffering the fallout from increased raw material prices, which among other things are eroding purchasing power substantially.

Some of the SEMC import from the EU and pay in euro, whereas their exports to the rest of the world might be priced in dollars. The currency wars are likely to cause a scissors effect, endangering these countries fragile economic growth through no fault of their own.

The matter of whether or not the SEMC should consider pegging their currencies to the euro deserves consideration therefore, although this goes beyond the scope of this report. Sticking to investment matters, Euro-Mediterranean monetary cooperation could be developed in two areas:

- Protecting long-term investor financing against exchange risks;
- For some projects, allow public and private investors from the SEMC to access euro financial markets under optimal conditions: in this way, the EU could "compensate" its partners for the strength of the euro against the dollar by reducing the cost of raising funding.

THE AIM WOULD be to create a network of central banks of the countries in question so as to foster investment and reassure investors in times of crisis that could undermine the SEMCs' macroeconomic fundamentals and perhaps provoke pressure on their currencies.

## Inadequate SME financing

THE CREATION OF SMES is crucial to the economies of the SEMCs, since it offers the key to solving their jobs crisis. In 2009, the Maghreb had more than two million small and medium enterprises (SMEs), of which 1.2 million were based in Morocco, 410,000-430,000 in Algeria, and 450,000-490,000 in Tunisia[13]. The Maghreb alone needs to create around a million jobs a year for the next 20 years if it is to keep unemployment from rising above its current level.

The economic growth measures put in place by the SEMCs lack a number of important tools for financing SME creation: guarantees, insurance schemes, local currency loans, exchange risk coverage, and direct equity investment. We have identified two sources of financing that could solve the issue of SME capital financing: private equity and financial markets.

**THE CREATION OF SMES IS CRUCIAL TO THE ECONOMIES OF THE SEMCS AS IT HELPS SOLVING THEIR JOBS CRISIS.**

PRIVATE EQUITY. Like many other emerging countries, the SEMC continue to suffer from an inadequate supply of bank-sourced investment credit instruments. Local banks tend to be poorly equipped to meet the long-term financing needs of businesses. A more specialised array of financing instruments is needed for the financing of enterprise creation and expansion, as is direct access to financial markets, so as business do not have to rely on the products offered by banks alone.

The region's businesses resemble a pyramid: at the apex, one sees a small number of major companies, which capture the bulk of FDI. These businesses create much of the region's added value and inject capital into the economy, but they do not create enough jobs. At the base of the pyramid, one sees SMEs, informal undertakings, and very small enterprises (VSEs). These create large numbers of jobs but fall outside the ambit of private equity. Financing instruments for this group are totally lacking. For the segment sandwiched between the two, investment capital could play a pre-eminent role.

Private equity is undergoing rapid growth in the South and East Mediterranean. Following a learning curve period in 1990-2000 when funds achieved zero returns on investment and ploughed money into their own business development (training of specialists, fieldwork to identify projects, learning about local specificities, building local regulatory frameworks, finding partners), there are now around forty different private equity firms managing around 150 different funds.

According to a 2008 study by Anima[14], "*320 capital investment funds, of which 181 are based in Israel, have been identified in the SEMC and in Southern Europe … Together, these 320 funds have $40bn in targeted endowments and $31bn in leveraged capital.*"[15]

A number of funds are operating in the early stage segment in Egypt (EFG Hermès, IT Ventures) and Turkey (iLab Ventures, Golden Horn

(13) Afkar review, issue 24.

(14) ANIMA Med Funds: overview of capital investment in the MENA region, September 2008.

(15) "Investment in the Mediterranean: current situation and ways forward", Guillaume Almeras & Abderrahmane Hadj Nacer, March 2009.

Ventures, Isgirisim). A number of countries have start-up funds dedicated to the early stage segment in promising economic sectors: ITC (Morocco and Tunisia).

However, in the report they published in 2009, Guillaume Alméras and Abderrahmane Hadj Nacer stated that despite the emergence of a well-anchored private equity capital sector in the SEMC, the sector, owing to its relative youth, is lacking in certain areas such as the initial phases of enterprise development.

Private equity needs to work harder to help what are frequently family-owned SMEs scale up and expand to become more profitable and more international. For although private equity firms have succeeded in scooping up large sums in recent years ($15bn over three years), they have not been investing enough (15-20% of fund assets).

Another problem concerns investment fund exits. A study by the Moroccan association of capital investors (AMIC) brings together exit data for 29 investment exits by Moroccan funds over recent years. The average gross IRR is 26% for the projects in question. Net IRR after management costs, profit sharing and exchange risk is still at an acceptable level for private European investors (around 15%; other examples mention high multipliers at the time of resale of undertakings, in the region of 2.5 to 3).

It is important for IRR requirements not to be excessively high; the return on these investments is necessarily below that of some stocks or speculative real estate investments. This point needs to be made forcefully: development capital, which finances non-listed SMEs, is by its very nature incompatible with a rapid exit speculative approach: industrial value creation is only possible in a medium term perspective.

**THE MAGHREB ALONE NEEDS TO CREATE AROUND A MILLION JOBS EACH YEAR FOR THE NEXT 20 YEARS TO KEEP UNEMPLOYMENT FROM RISING.**

PRIVATE EQUITY IS clearly has excellent potential to finance enterprise creation in the region, provided that underlying constraints are addressed: (i) the region's negative image; (ii) the need for a stable regulatory framework with a regional dimension if possible, so as to channel savings in a sustained manner into the business sphere; (iii) the need to diversify resources (fund subscribers), because to date, without the major donors (EIB, IFC, ADF-Proparco, etc.), very few funds could have got off the ground; (iv) the risk of the current financial crisis being used as a pretext for inappropriate decisions (higher taxes on funds, restrictions such as in Algeria, etc.); (v) exchange risks (funds subscribed in euro or in dollars, revenues in local currencies), bearing in mind that techniques for protecting against exchange risks are still very much in their infancy and that profitability can only be reliably known at exit, meaning the date and exchange rate are in the realm of uncertainty; (vi) continued efforts to enhance manager and human resource quality; (vii) the need for a clear separation from traditional banking activities (lending, account management) so as to avoid conflicts of interest.

Finally, it is important to have a local presence on the ground, in each country of operations: it is simply not feasible to "source" projects from the North. There is no particular need however to delocalise European fund management teams to the South; "Maghreb" funds are becoming more and more common, and the Middle East is attracting local and regional funds. That being said, regional professional forums are an excellent tool for fostering experience and best practice sharing.

Many European governments (Spain, France and the UK, for instance) offer tax incentives to private equity: governments to the South of the Mediterranean, which sometimes view private equity as excessively profitable and needing to be taxed or controlled in one way or another, could usefully draw on the experience of the Northern countries.

CAPITAL MARKETS. The MENA region accounts for only 5.6% of the global capital markets[16]. Some of the SEMCs have, however, achieved notable capital market success stories, among them the Amman Stock Exchange. In terms of the number of listed companies (262), Jordan compares well with countries much larger: its market capitalisation comes to 200% of total GDP, with 50% participation by non-residents.

Casablanca Stock Exchange is building ties with the Union of Arab Stock Exchanges, and also with African countries such as Côte d'Ivoire, Senegal, and Gabon. Casablanca Stock Exchange is a service provider to Libreville Stock Exchange, and cooperates closely with Côte d'Ivoire and Senegal.

Yet the dynamism seen in some SEMC stock markets is not reflected in massive investment in enterprise creation. The stock exchanges in the SEMC offer limited corporate financing as a complement to the already sparse offering elsewhere on the market.

Several factors common to all of the region's countries explain the under-development and shallow reach of the region's stock markets. "*Some of the factors behind this pertain to the relatively*

(16) "Crisis and ways out of crisis in FEMIP Mediterranean partner countries", FEMISE, 2010.

*short history of stock market mechanisms in many of the SEMCs, and to the ingrained habits of local business people at the helm of family owned undertakings who are not accustomed to the reporting and transparency obligations imposed by the capital markets. That being said, as early as 1992, some 35 of Jordan's largest corporations were financing more than 50% of their investments via share issues.*

*The relative weakness of the financial markets is also due to the weak institutional investment environment, and specifically to the under-development of the insurance sector, both in terms of quantity and size: Egypt has 21 insurance companies, of which three plus a reinsurance company control 70% of a market that is no larger than 2% of GDP (Jordan's insurance sector is the largest in the region at 2.5% of GDP). In Algeria, the insurance market accounted for 0.6% of GDP in 2005, despite the existence of 16 insurance companies (seven of which are public)"*[17].

A way of deepening the region's capital markets and enabling the SEMCs' stock exchanges to carry out their role to the fullest extent could be to unite them into a network. They could also establish relations with countries outside the region with a view to listing their companies and handling deals originating there in accordance with the one-stop-shop principle. Another approach could involve creating common indexes. Examples of cooperation already exist, such as the Union of Arab Stock Exchanges, a body whose aim is dialogue and coordination.

**THE DYNAMISM OF SOME SEMC STOCK MARKETS IS NOT REFLECTED IN MASSIVE INVESTMENT IN ENTERPRISE CREATION. THEY OFFER COMPLEMENTARY CORPORATE FINANCING TO SEMS.**

HOWEVER, the members of the Union of Arab Stock Exchanges do not have the same concerns and do not view themselves as reformers. A number of stock exchange operators in the region are favourable to the establishment of a network of Mediterranean stock exchanges with variable levels of coordination between the member exchanges. The aim would be to work towards regulatory convergence, but also to enable the same asset to be listed on several exchanges. The creation of a network would also be a way of offering a shared platform for institutional investors, who tend to be put off by the narrowness of national markets.

Another way of deepening the capital markets would be to create an index of Mediterranean stock exchanges, although it would have to be designed and run by an internationally recognised independent body.

Regardless of how it's done, the region's capital markets must be deepened so as to provide local enterprises with non-bank sources of financing. It would also give additional investment opportunities to investors, harness local savings, and offer guarantees to FDI host countries on the durability of FDI and its contribution to the host countries' economies.

## Structural need for infrastructure financing

THE SEMC COUNTRIES' investment needs are gargantuan. Two recent studies put at $150-200bn the infrastructure financing needs of the SEMCs over the coming five to fifteen years:

The EIB estimates that over the next ten years, the South Mediterranean countries alone will need to invest $100bn in energy, $110bn in urban development (water, drainage, waste processing, urban transport), $20bn on logistics (ports, airports, motorways), and $20bn on enterprise development support.

McKinsey, for its part, identified a pipeline of projects for the next five years totalling $200bn in nine sectors in eleven SEMCs. Taking an equity average of 25-40% and a private sector stake of 15-20% for most of the projects, the private capital need comes to $30-40bn ($7.5-16 in equity).

It has to be noted that the donors and funding agencies operating in the region will not be able to provide that level of financing, even despite their increased profile. The amount of financing they can provide will be well below what is needed (€20bn in 2009).

Apart from aid and loans from the Northern countries and multilateral funding providers, much of the financing will have to come from public and private, national and international investors from across the world. Investors need an ad hoc regime to make investment in the region attractive and to commit to long-term investment projects.

Clearly, the task of attracting investment capital into projects involving deferred revenue (maturity in the order of several decades) and moderate returns on investment (in the region of 4-7%) is fraught with difficulty. Above and beyond investment, the main challenge stemming from the financial crisis is that of increasing lending, but this raises equity requirements for banks (Basel III). Added to this, the resulting liquidity risks on banks' balance sheets induce them to accord preference to projects in less risky zones.

Based on these considerations, coordination and the right policy choices become indispensable. The current lack of cooperation between the

(17) "Investment in the Mediterranean: current situation and ways forward", Guillaume Almeras & Abderrahmane Hadj Nacer, March 2009.

SEMCs is hampering any efforts to design methods of coordination that would lead to the creation of the kinds of financing modalities required by a whole host of infrastructure projects.

The description of the current situation set forth in the report of Guillaume Alméras and Abderrahmane Hadj Nacer reveals that some of the SEMCs have large numbers of infrastructure projects that have yet to be priority ranked in terms of size, timeliness and even importance criteria.

The SEMCs indeed are characterised by burgeoning infrastructure projects, whereby each individual country completely ignores the projects underway next door. This makes for competition between the countries at the regional level, most strikingly in the logistics sector.

This lack of coordination systematically boils down to the considerable financing requirements. "*A way to estimate them is to reason in terms of gross fixed capital. Taking the latter in the various SEMCs as a base level and assuming that … to meet the investment requirements in housing, infrastructure, industrial development, education and training, etc., it should be at 30% of GDP, the additional investment requirement comes to $200bn for the first year for all of the SEMCs together. This is a realistic figure, bearing in mind that Morocco alone is planning public investment totalling €100bn over the coming five years*"[18].

Clearly then, prioritising among projects is the only way to meet the necessary goal of mobilising the requisite resources. The prioritisation process could be inspired by the priority objectives of the Union for the Mediterranean (depollution of the Mediterranean Sea, sea and land highways, Mediterranean solar plan) and could be given a regional dimension (South-South, South-North) by ranking the projects in terms of risks and also by adopting innovative criteria such as environmental impact and trickle-down effect.

## Negative perceptions of the business climate

THE MEDITERRANEAN REGION hosts a system of 317 bilateral investment treaties (BITs) signed by and between the countries of the region[19]. The protections afforded by those treaties almost always include the following: national treatment,

- Most favoured nation treatment,
- Fair and equitable treatment,
- Guarantees in the event of expropriation,
- Guarantees in the event of losses,
- Freedom of transfer,
- Umbrella agreement,
- Full and total protection and security.

As well as substantial protection, the treaties afford procedural guarantees that make it possible for an investor to refer a dispute with a host State to an international arbitration tribunal. Recourse to arbitration can be limited in certain cases; nevertheless, in the Mediterranean region the arbitration mechanisms of reference are the ICSID mechanism, the UNCITRAL arbitration rules and the ICC arbitration rules. Some treaties refer to less well-known and more specific mechanisms such as the Cairo or Istanbul Regional Centre for International Commercial Arbitration, the International Arbitration Centre of the Austrian Federal Economic Chamber, the Stockholm Arbitration Tribunal, or the Arab Investment Court in the Arab countries. Referring a dispute to one of the two main arbitration institutions, ICSID or ICC, is extremely costly for the parties. Hence, SMEs find themselves excluded from the system, which is really only an option for large-scale investors.

Nevertheless, compared with other regions of the world, the Mediterranean region from Mauritania to Turkey and including Israel and Jordan offers a lower return on investment, or at least a higher risk, even though there are subtleties from country to country. Investment in the region is also more complicated to structure owing to the diversity of the national investment frameworks.

EUROPEAN INVESTORS, who continue to be the region's main investors, allocate barely 3% of their FDI to the SEMC, compared with US and Japanese companies that direct on average 20% of their FDI to their Southern neighbours. Other investors in the region focus essentially on oil and gas (North American investors) and real estate assets offering relatively short-term returns (Gulf States). Many investors say that this is because long-term investments in the region are perceived as risky. This also explains why private investment funds authorised by their statutes to invest in the region are so few and far between. In fact, in recent times there has been an increase in applications for financial guarantees covering breach of contract risks for contracts involving public and semi-public partners in Southern countries, and risk of host countries reneging on their financial commitments.

(18) "Investment in the Mediterranean: current situation and ways forward", Guillaume Almeras & Abderrahmane Hadj Nacer, March 2009.

(19) IPEMED report on the current situation of international legal mechanisms to protect foreign investment in the Mediterranean, Sabrina Robert-Cuendet, April 2010 "*The countries concerned are the EU member states: Germany, Austria, Belgium, Bulgaria, Cyprus, Denmark, Spain, Estonia, Finland, France, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, the Czech Republic, Romania, the UK, Slovakia, Slovenia, Sweden; and the non-EU Mediterranean countries: Albania, Algeria, Bosnia-Herzegovina, Croatia, Egypt, Israel, Jordan, Lebanon, Morocco, Mauritania, Monaco, Montenegro, the Palestinian Authority, Syria, Tunisia, Turkey and the Arab League. We also included the agreements concluded by Libya, which is an observer rather than member of the Barcelona Process*".

Moreover, the existence of legal instruments whose aim is to guarantee investment security does not seem to be having any significant impact on regional risk perceptions: the protections afforded by the legal framework on investments are complex (different national regimes, the large number of bilateral investment treaties and conventions concluded under the aegis of the League of Arab States, the Arab Maghreb Union, and the Organisation of the Islamic Conference) and lack precision (the role of the most favoured nation clause in extending the applicability of clauses from one investment protection treaty to another; differences in jurisprudence from one arbitration tribunal to another, which are costly to investigate (higher transaction costs since every investment in the region requires individual analysis on this particular point); costs and time spent settling disputes and enforcing decisions handed down).

The overall image conveyed by the region when it comes to protecting investments compares unfavourably with that of NAFTA, which has a system that allows investors to plan investments based on protection standards that are identical throughout the region.

**THE EXISTENCE OF LEGAL INSTRUMENTS AIMING AT GUARANTEEING INVESTMENT SECURITY DOES NOT SEEM TO BE HAVING ANY SIGNIFICANT IMPACT ON REGIONAL RISK PERCEPTIONS.**

MANY DIFFERENT stakeholders can offer investment guarantees: national agencies dedicated to protecting foreign and sometimes domestic investments (e.g. COTUNACE in Tunisia), development agencies (e.g. AFD), multilateral institutions: banks (World Bank, African Development Bank, Islamic Development Bank, SFI, EIB), and guarantee agencies (MIGA, Compagnie Interarabe de garantie des Investissements, Société Islamique d'Assurance des Investissements et de Crédit à l'Exportation).

However, the financial guarantees offered by these bodies would be no match for the scale and timeframe of the region's investment needs over the coming twenty years. They are costly to obtain and not always perfectly adapted to projects below $50m (in terms of cost, conditions for activation and the multiplicity of stakeholders involved). Projects under $50m are becoming increasingly numerous, and their sponsors are frequently medium sized companies. Nor are they suited to projects lasting more than 15 years.

Moreover, while political risk (non-convertibility, non-transfer, expropriation, war, terrorism and civil disturbances, breach of contract by the State or public enterprises) can generally be covered by national guarantee agencies subject to the constraints outlined above, this is not the case of a number of other classes of risk that play an important role in any investment decision.

Systemic risks such as devaluation or currency depreciation tend not to be covered, and political risk coverage tends not to extend (notably on matters of sovereignty) to local banks that could be involved in project financing in local currency, thus contributing in certain cases to mitigating currency risk. There are financial instruments that can limit this type of risk in major projects, but, beyond considerations as to cost, they only apply to projects involving convertible currencies with a satisfactory track record.

Moreover, the existing institutional guarantee mechanisms generally do not offer comprehensive political/commercial risk protection, even despite the high demand for such a guarantee, particularly from SMEs. Trials involving separating out political and commercial risks have already been carried out (and also with respect to EU guarantees of EIB loans outside the EU and guarantees for project financing), but there is no structured mechanism available on an ongoing basis because the issue of who will pay compensation to investors or banks if a guarantee is activated has yet to be settled.

FINALLY, it is necessary for the various financial guarantee mechanisms, including those available on the private sector (for coverage periods that are generally shorter and under less stable terms than with public instruments) to be coordinated since the level of coverage (not all cover debt and equity alike and some instruments require a counter-guarantee by the host-State), eligibility, costs and procedures are rarely identical.

Argentina's experience has convinced many major investors of the need to strengthen the efficacy of investment protection mechanisms, particularly in the light of how long it takes to settle investor-State disputes and issues with secure enforcement guarantees. 1

# Proposals for the financing of investment in the Mediterranean

IT IS SCARCELY NECESSARY to belabour the fact that so many structural projects require funding that's above and beyond the capacity of donors and SEMCs to provide. Likewise, the financial and economic crisis has shown that any country's FDI attractiveness can be vulnerable to turmoil. Bearing this in mind, the aim of our proposals is to make use of all of the available tools and instruments to identify and bring to bear additional advantages that have gone unnoticed hitherto.

Our proposals fit in to a dual short-term and long-term vision. In the long term, the aim is to establish a comprehensive financial architecture based around a development financial institution dedicated to the region. The aim will be to direct investment into projects that will build economic structure in the SEMCs over the long-term, rather than into speculative sectors.

In the short term, the aim is to remedy the shortcomings in the legal regimes governing investment security in the region and to set up instruments and tools for financing infrastructure and SMEs.

TIME IS NOW RIPE TO GRADUALLY ESTABLISH A FLEXIBLE AND AMBITIOUS FINANCIAL ARCHITECTURE SPECIFIC TO THE REGION ARTICULATED AROUND AN MEDITERRANEAN DEVELOPMENT BANK.

**LONG-TERM VISION.** The considerable financing needs of the SEMCs mean new opportunities for the long-term emergence of an integrated financial area in the Euro-Mediterranean region. The time is now ripe to gradually establish a flexible and ambitious financial architecture specific to the region and akin to the Bretton Woods institutions: a Bank, a Monetary Fund, a guarantee agency, etc.

Europe needs to look for growth drivers in its immediate environment as its demographic slowdown and sluggish productivity gains shunt the continent onto the sidelines. With the emergence of new powers in the form of Brazil, India and China and the severity of the crises underway in peripheral eurozone countries, Europe could find itself with reduced capacity to influence the international regulatory system. For their part, the SEMCs are not in a position individually to face up to monetary risks, long-term FDI bottleneck risks, or export risks.

The CONVERGENCE study carried out in 2010 by IPEMED demonstrated that an albeit fragile process of economic convergence between the North and South Mediterranean is now underway. Massive investments by major European corporations in low added-value activities are gradually being complemented by the development of integrated productive systems in various sectors, both high and low tech. The arrival of new companies attracted by the success of their commercial partners or competitors could amplify this trend. In some industrial and service sectors, most of the leading world corporations are already present in the region.

More generally speaking, a new stage in the process appears to be consolidating. Companies that are aware of the resources of the South and East Mediterranean countries have been setting up shop there since the beginning of this century with high added-value activities that, if they attain a critical mass, could pull the SEMCs into a virtuous development circle that would benefit the entire region. European corporations would preserve their competitiveness in industry and services, and the SEMCs would receive a strong economic boost. Complementarities between North and South could then be exploited via win-win partnerships.

**SHORT-TERM VISION.** Our proposals are focused on means of securing investments and tools for financing infrastructures and SMEs, notably via partnerships. The issue of securing and guaranteeing investments in the Mediterranean region is crucial owing to its cross-cutting nature.

If it is to attract investors, the Mediterranean region needs to enhance its business climate and improve investor perceptions of the region. It also needs to endow itself with financial tools that will allow it to overcome the difficulties in financing infrastructure and SMEs.

We are in favour of implementing a stable regional legal framework to give the region enhanced visibility and reassure international and local investors. Investors need a harmonised legal regime of investment protection and investor dispute settlement guarantees for strategically identified projects. The aim of having a single regional international agreement with the customary provision on protection of investments, although laudable, is not achievable in the near term. A regional treaty on investment protection would raise legal and political hurdles that could not be resolved swiftly. Therefore, the speediest option would appear to involve the elaboration under the auspices of the general secretariat of the Union for the Mediterranean of a draft framework agreement setting forth a uniform legal environment (with some sections being optional, if necessary) on the protection of investments in the Union for the Mediterranean States, and a mechanism for recourse to arbitration.

As concerns infrastructure, only an Infrastructure Guarantee Fund initiated by the European Union based on a list of UfM-approved investments would be capable of meeting the financing needs of the SEMCs. Projects with a regional dimension should be given priority, as this is a way of favouring structure-creating projects that foster South-South and North-South integration and share out the burden of project costs. When it comes to SME funding, the Guarantee Fund seems to be the best way of achieving as diverse a source of funding as possible.

**TO ATTRACT INVESTORS, THE MEDITERRANEAN REGION NEEDS TO IMPROVE ITS BUSINESS CLIMATE AND INVESTOR PERCEPTIONS OF THE REGION.**

THERE ARE A number of guarantee funds at the national level in the North and South alike whose aim is to foster the establishment and development of SMEs by bringing together public and private stakeholders. EIB plays a key role here, alongside other international mechanisms such as World Bank Group/MIGA with its universal vocation and broad spectrum going from SMEs to infrastructure. Another example is the inter-Arab investment guarantee organisation, which is based on the MIGA model, or the mechanisms offered by the Northern and Southern countries (Hermès / AFD / BFPME Tunisia, etc.). The Mediterranean enterprise development initiative offers a comprehensive approach that could lead to the creation of a Guarantee Fund initiated by the EU. Additionally and more specifically, we propose the creation of a Guarantee Fund for SMEs that would be replenished by the regions and focused on clusters.

## Long-term vision: a financial architecture for enhanced integration in the Euro-Mediterranean financial area

WE PROPOSE THE GRADUAL implementation of an ambitious financial architecture of variable geometry specific to the region, based around a Mediterranean development bank. The Bretton Woods institutions would be used as an inspiration: a Bank, a Monetary Fund, an investment guarantee agency, a harmonised regional investment protection framework, dispute settlement mechanisms, etc. Only in this way will it be possible to remedy the shortcomings identified in the region by the Mediterranean Investment Initiative.

This kind of architecture is needed so as to:

- Support and invigorate investment right at the outset of enterprise creation.
- Develop the region's capital markets and encourage convergence between them.
- Strengthen and broaden export guarantee instruments.
- Provide a comprehensive, shared and concerted framework for investment protection.
- Guarantee greater monetary stability in the region.
- Bring together existing initiatives and help reinvigorate investment.
- Create conditions conducive to the long-term transformation of migrant savings into investments.

### A development financial institution specific to the region

THE MILHAUD COMMISSION'S report mentions three options with a clear preference for option 2, which calls for the establishment of a financial institution based on existing structures. Option 1 calls for the establishment of a development bank from scratch whose capital would be held by the countries and public and multilateral bodies of the North and the countries of the South and East of the Mediterranean. This option was not retained because obtaining an AAA rating would be extremely costly in initial capital. Option 3 calls for the establishment of a Mediterranean public financing facility in the form of a subsidiary of public bodies acting as long-term investors. This option was viewed as second rate and would only be considered as a last resort, because by its very nature a facility of this type can only harness limited amounts of financing which would be incommensurate with the immense funding needs of the region.

Option 2 was chosen because it calls for the establishment of a financial institution dedicated to financing co-development in the Mediterranean. One way to achieve this could be through the creation of a subsidiary of EIB for the Mediterranean. Its capital would be open to the UfM member States and to the EU, the Gulf States, the World Bank or the African Development Bank. The institution would need to have an AAA rating in order to have the requisite financial capacity and effectiveness.

We believe strongly that a Mediterranean-focused development financial institution could bring the region unquestionable added value:

- Its creation would send out a strong signal to investors. It would help restore confidence in governments, banking systems and industrial partners. Its mere existence would offer security to savings and investment flows.
- It would facilitate the shift from an investment fund approach to a cross-cutting, regionally integrated and sustainable development approach.
- It would facilitate the transformation of idle liquidity into long-term resources and foster stability and monetary anchoring.
- Even if it contributed only modestly to project financing, the involvement of a Mediterranean development institution would have a catalyser effect by encouraging commercial banks and other equity investors by reassuring them as to project feasibility.
- It would be focused on key functions aimed at raising the level of economic development of the region and financing SMEs and the private sector more generally.
- It would help improve the calibre of projects by bringing to bear expertise and a capacity to identify and evaluate risk that is largely lacking in the region.
- Finally, only a regional development financial institution would be capable of funding cross-cutting, ambitious projects such as high speed rail networks, power inter-connections, international highways, etc. Until now, the Arab Fund for Economic and Social Development has been the only body financing such projects, but its resources are somewhat limited.

An institution of this type would serve as a bridge between public sector and private sector. The States and national and international public institutions participating in it would have a significant leverage effect on the institution's public and private assets thanks to their credibility and public governance function. They would be placing their might behind a region-wide innovation effort based on a strategic vision for economic development and integration in the Mediterranean.

**A MEDITERRANEAN-FOCUSED DEVELOPMENT FINANCIAL INSTITUTION COULD BRING THE REGION UNQUESTIONABLE ADDED VALUE.**

Looking to how the World Bank has created at the global level a set of instruments for identifying private sector projects, financing and underwriting them, and training people to carry them to fruition, the Mediterranean region needs to establish a development bank specific to its region that would gradually endow it with these same instruments. The Mediterranean development bank should be given an even broader mandate that would include the innovation roles of a business bank, particularly business incubation, so as to give new impetus to economic and industrial development in the South Mediterranean countries.

THE MEDITERRANEAN development bank would carry out four essential functions for the region:

- Support for private sector projects, particularly SMEs: identification of projects, but also the role of business incubator, supporter of private initiatives, promotion of projects in areas earmarked as strategic – a framework for action inspired by the effective strategies seen in East Asia;
- Transformation of short-term financial resources into medium- and long-term financial resources for investment.
- In a relative near-term perspective, a role in investment-related training and experience sharing with a view to strengthening the financial systems of the Southern countries and fostering North-South and South-South exchanges. This would necessitate the harmonisation of accounting standards and a substantial improvement in States' statistics functions so as to ensure the availability of harmonised statistical data from national statistics institutes;
- In the longer term, a role as investment guarantor via a Mediterranean Guarantee Fund for Investment and Exports (MGFIE).

**Supporting the private sector, particularly SMEs**

BESIDES NEEDING a source of funding for SMEs, the SEMCs need to create more SMEs. That being the case, the primary function of the Mediterranean development bank should be to help them do this by acting as:

- A business incubator;

- A provider of support to enterprise creation in sectors identified by each country as strategic and thus to be structured over the long-term;
- A body that would identify projects that are viable and mature; this will require the bank to develop the capacity to calculate economic risk and to rate projects;
- A provider of investment and loan guarantees.

Currently, these functions are lacking within the national banks of the Southern countries and within the EIB and other multilateral bodies, which lack sufficiently close day-to-day contact with SMEs to be able to genuinely support their development. A Mediterranean development bank created by the countries of the South and North would fill that gap by providing a trusted grassroots body that would support and promote the private sector.

**Transformation of resources from short-term into long-term**

THE SOUTHERN COUNTRIES have liquidity in abundance. They need to be able to transform their local savings and migrant remittances into long-term investments in credible and structure-giving projects. Here again, the Mediterranean development bank would transform a portion of the highly liquid migrant remittances into long-term savings that would be used either to finance or to guarantee the financing of productive investments. At present, the Southern banks are failing to secure this kind of transformation, with a few exceptions such as in Morocco. The Mediterranean development bank would need to build partnerships with private trans-Mediterranean consortia with a view to collecting migrant remittances. It would enjoy the credibility stemming from its public ownership and its AAA rating in discharging the task of transforming remittances into long-term resources.

**THE MEDITERRANEAN DEVELOPMENT BANK WOULD TRANSFORM A PORTION OF THE HIGHLY LIQUID MIGRANT REMITTANCES INTO LONG-TERM SAVINGS.**

**Strengthening skills and exchanging experiences**

ONE OF THE FUNCTIONS of the development bank could be to encourage exchanges of experience. According the bank a mandate for fostering experience exchange and offering investment advice would help build public sector capacity, which in turn would contribute to the development and proper management of investment in the Mediterranean region. Sharing expertise is not something that comes naturally to public authorities, although that is less the case in the private sector. There are, however, technical assistance instruments that have been put in place by international financial institutions, the United Nations and the European Commission, as well as by national bodies, that seek to support public sector efforts in the area of investment in the North, South and East of the Mediterranean. The Mediterranean development bank could draw these various strings together and create a region-wide facility on their basis. A network for training and pooling and sharing investment experience would be set up within the bank. The network would be financed by the national agencies responsible for promoting investment.

Among the roles incumbent on the network of agencies and the Mediterranean bank would be the following:

- The organisation of a forum for the exchange of information and for promoting self-assessment of the service's technical and economic performance, etc.
- The identification of best practices in the area of supervision of contracts involving private sector participation: cost/benefit analysis to inform decisions on public or private service providers, the utility of contracting services out, mechanisms for contract drafting and follow-up, etc. Best practices would be established and promoted on the practical basis of experience exchanges via exchange forums.
- Advice to local authorities: eventually, the bank could offer its investment expertise to local authorities. This service would be remunerated: in the same way that multinationals receive advice from the top business banks, local authorities need to have access to a paid service involving high calibre assistance. Advisory services would be rendered by consultants and seconded public servants, with the Mediterranean bank ensuring a constant turnover of high calibre advisory staff.

The network would be used to collate an initial document database for the use of national agencies. The resultant MedStat would fast turn into precious tool for the Mediterranean bank and for States. It would enable the exchange of experience on financial aspects, as well as on sector-specific projects (environment, energy, transport, etc.) and economic foresight.

**A guarantee function via the creation of a Mediterranean Guarantee Fund for Investment and Exports** (MGFIE)

PROCEEDING ON the basis of the principle of variable geometry, countries that so desire would set up within the Mediterranean bank a Mediterranean Guarantee Fund for Investment and Exports (MGFIE). The idea would be to remedy the shortcomings of the existing guarantee instruments, both national and international. Those shortcomings are essentially as follows:

- The guarantee systems tend not to be compatible (MIGA competes with Coface, etc.), so that investors have no way of escalating the risk of high cost (no reinsurance);
- The guarantee systems are not regional in scope and cannot be used to pool risk across a number of States, even for shared projects;
- They lack the capacity to deal with crisis situations, and are incapable of providing fixed rate investment convertibility guarantees.

WHY COVER INVESTMENTS and exports alike?

- The Southern countries need an instrument that will cover their risks related to exports to North and South alike. But export credit insurance is very costly, not always available in all Southern countries, and not always flexible. The bodies and mechanisms that Southern exporters have recourse to (ADB, IDB, Société arabe de garantie des investissements, etc.) do not always have the professional capacities or the range of services available that operators need so as to cover their risks. This shortcoming in expertise and range of services translates into a higher cost of service, since these bodies frequently prefer to increase their fees if unable to estimate the risk precisely or to reinsure it under acceptable terms.
- The Northern countries need to be able to secure their investments in the South against political risk, exchange risk, sovereign default risk, and risk of default on an arbitration enforcement ruling. Hence the proposal to couple these risk coverage needs by establishing a fund for investment and export risk coverage.

Compared with the World Bank's MIGA, which is based in Washington and has no specific mandate for the Mediterranean, the fund would have the advantage of covering investment and exports on the one hand, and of building proximity and therefore trust among the partners on the other hand. It would serve to regulate investment and export flows within the region: securing investments against risks, limiting windfall strategies, notably with respect to relocations from North to South, reduction of the cost of insuring against export risks, etc. All of this would apply equally to trade and investment along the North-South, South-North and South-South axes alike.

**A MEDITERRANEAN GUARANTEE FUND FOR INVESTMENT AND EXPORTS (MGFIE) WOULD REMEDY THE SHORTCOMINGS OF THE EXISTING GUARANTEE INSTRUMENTS.**

THE ADVANTAGES OF THE MFGIE would be as follows:

- It would help establish an integrated economic area in the Mediterranean; it would involve the public and private sectors, the North and the South, and would involve the Gulf States too;
- It would be established in a progressive and pragmatic manner. It could begin by covering a limited number of countries, demonstrating its efficacy, and then take in a greater number of countries with the attendant higher yields. As regards investment, it could initially focus more specifically on projects of general interest to the region, such as environmental investments;
- It would be profitable: like with most other large insurers of investments and/or exports, the return on the capital provided by the States in the form of their initial guarantee endowment would be taken from the insurance premiums paid by operators;
- The participation of States, and notably the Northern States, would give it (i) sufficient financial wherewithal to cover its risk exposure, and (ii) access to reinsurance at competitive terms;
- Its dimension and its expertise would enable it (i) to estimate risks precisely; (ii) to offer a complete range of guarantee services required by operators. Its risk rating function would be accessible to the private sector at affordable prices. It would enable the determination of guarantee rates that could be used by other national and international bodies, and would make re-quotations possible;
- It would help overcome the bilateral approach to North-South economic relations in the Mediterranean, even if this means sacrificing the traditional support provided by States (particularly in the North) to their foreign trade. This would open up avenues for establishing a genuine and coordinated Mediterranean trade policy, particularly among the European countries.

THE MEDITERRANEAN development bank could also carry out two other crucial functions so as to complete the financial architecture:

### Mediation and arbitration: establish an international dispute settlement centre in the Medterranean (CIRDIEM)

OPERATORS wish to be able to have recourse to international law, particularly mediation and arbitration. An "International Centre for International Investment and Export Dispute Settlement in the Mediterranean" (CIRDIEM) could be created for this purpose. The MFGIE could make its services conditional upon any disputes being referred to CIRDIEM. Willing States would undertake via an international agreement to ensure the arbitration centre should meet the highest possible standards (the quality of its arbitration judges determines the credibility of an arbitration centre).

Operators already have a number of arbitration centres available to them, notably ICSID, the Cairo Regional Centre for International Commercial Arbitration (CRCICA) and the Dubai International Arbitration Center (DIAC). CIRDIEM would have its own set of advantages:

- It would have a region-wide presence and a purely Mediterranean mandate. The signing of an international agreement establishing CIRDIEM would represent a political commitment to an international dispute settlement system that would be common and shared rather than distant and imposed from outside. This would make the centre an invaluable political and economic negotiation instrument for the region;
- It would have the efficacy and responsiveness of a body that would fast become the instrument of reference for local operators;
- The possibility of tariff equalisation to enable access to mediation and arbitration services for SMEs (from the South, but not only), who can rarely afford such services.

It could be created from scratch or based on an existing body. For example, the CRCICA could be used as a basis, and turned into the reference arbitration body for the Mediterranean region. The way in which it would later become part of the Mediterranean bank would need to be defined at a later date. It could also be envisaged that the Mediterranean bank would serve as an ad hoc regional court of justice of last instance.

**The function of giving impetus to prioritising innovation and business incubation**

IN KEEPING WITH its mandate as a business bank, the Mediterranean development bank would set itself the goal of innovation and financial engineering. It would need to be fairly flexible in its operations to be able to adapt and respond to identified needs. In enterprise support, for instance, it would need to be able to support companies at all stages of their development: start-up, establishment, development, transmission, etc. The bank's business incubation function would be particularly important: besides supporting projects identified by economic stakeholders, the idea would be that the bank would actively innovate by establishing enterprises and offering turn-key products.

THE MGIE FUND WOULD SERVE TO REGULATE INVESTMENT AND EXPORT FLOWS WITHIN THE REGION.

Possible services include project hosting (creating nurseries to facilitate partnerships and experience exchanges), technical assistance for all aspects of a project (commercial, technological and industrial, legal and regulatory, financial, human and organisational), and financing (feasibility study, then project per se). Seed funds and incubators could be established in each individual country based on identified needs and opportunities. By way of example, the development of oil-related sectors and wheat production could be encouraged in Algeria.

As far as the capital and governance of the Mediterranean development bank are concerned, the proposal is to have equal participation by the public sector, the private sector, and the Arab sovereign funds.

- The private sector stakeholders (North and South) would be harnessed to collect savings via North-South consortia;
- The public sector stakeholders would provide savings guarantees, enable the transformation of savings into long-term resources, provide backing for borrowing by the bank, and set up the guarantee mechanisms. The public sector stakeholders would include:

  - Multilateral financial institutions, notably the EIB, to help finance major infrastructure programmes or take stakes in investment projects;

  - National development financing institutions (AFD, KfW, etc.) and willing States from North and South, the list of which would be expected to become longer as the bank demonstrates its efficacy. Involvement by a State would mean de facto acceptance of the bank's activities in its territory and with respect to its enterprises, with a view to securing integration into a regional financial area in which each State will have helped define the common rules, instead of countries having to fight for their role in the international arena or conducting their international affairs in a dispersed manner.
- Sovereign funds, notably those based in the Gulf, would also contribute to the development of a Mediterranean region with real potential, where they could usefully invest their resources.

THE BANK'S CAPITAL would reach 10 billion euro in five years, of which a quarter could be provided by the EIB (0.5 billion euro per year). With ten billion euro in capital, the leverage effect in terms of raising funds would be much more considerable than that of the banks specifically dedicated to the Mediterranean today.

## A practical and operational vision: tools and measures to guarantee and invigorate investment in the Mediterranean

OUR PROPOSALS FOCUS on ways of securing investments and tools for financing infrastructure and SMEs, particularly via partnerships.

### Securing and guaranteeing investments for major priority projects

THE MATTER OF SECURING and guaranteeing investments in the Mediterranean is crucial because of its crosscutting nature. It is of utmost importance that the legal framework governing investments in the region should be clarified, so as investors can enjoy a harmonised legal regime for investment protection and guaranteed settlement of Investor/State disputes on the basis of a body of integrated case law and within reasonable timeframes. This clarification of the legal regime should be accompanied by the creation of a specific system of financial guarantees against political risk and certain economic risks, some of the cost of which could, under certain circumstances, be borne by the public authorities.

**WE NEED TO INSTALL A CLEAR AND EFFECTIVE LEGAL SYSTEM DEDICATED TO THE PROTECTION OF STRATEGIC INVESTMENTS IN THE MEDITERRANEAN.**

*A clear and effective legal system dedicated to the protection of strategic investments in the Mediterranean.*

**A legal system for the protection of investments under UfM auspices**

AS WE HAVE SEEN, although the region has numerous instruments affording legal protections to investments, their great number and complexity offer no clear-cut comparative advantage to the region as a whole in terms of making it more attractive. On the contrary, they add considerably to the cost of conducting analysis and to transaction costs. Moreover, the absence of a uniform body of case law interpreting the provisions of these instruments and the lengthy and costly nature of dispute settlement procedures creates a climate of legal uncertainty that impairs investment activity.

The solution therefore would be to foster harmonised protection of investments.

The conclusion of a regional treaty on the protection of investments that would create an identical legal framework across the region (or with easily identifiable differences, perhaps with optional or alternative provisions) is doubtless the most satisfactory solution from the intellectual standpoint. However, the establishment of a general regional treaty on the protection of investments raises a number of legal and political issues that would take an inordinate amount of time to resolve in view of the urgency of the region's investment needs.

This is why it would make sense initially to focus efforts to simplify the investment protection system on the category of strategic investments, i.e. long-term, structure-giving investments covering groups of countries in the region, as identified by the UfM (for example, a protection instrument such as the energy charter treaty was used as a basis for protecting investments in that sector). At the same time, we could continue to strive to foster longer-term harmonisation between the national legal systems of the region's countries, but in another framework.

**A regime offering clear legal protection at the regional scale**

THE IDEA IS TO OFFER a harmonised framework that would ensure the long-term viability of projects carried out under the auspices of the UfM, and to secure investments into the Southern countries' infrastructure. Essentially, the treaty in question would set forth the rights and obligations of investors in the context of investment projects under consideration. It would need to contain the usual clauses found in investment treaties, namely:

- Definition of investment / investor;
- Admission or preliminary establishment;
- Fair and equitable treatment;
- Non-discrimination, national treatment, MFN;
- Expropriation and compensation;
- Free transfer of capital;
- Settlement of disputes (State / State and investor / State).

The issue of investor nationality and if the treaty is applicable to investors from outside the UfM needs to be given special attention.

The protections afforded must not be less than those existing by virtue of other instruments. The treaty should offer a streamlined and uniform framework for investment in accordance with most recent best practice in international treaties and jurisprudence on these matters. The legal framework could possibly serve as a model for other sectors and regions.

It would particularly need to include a dispute settlement body that would give access to fast-track justice at a reasonable cost and in accordance with a uniform body of jurisprudence. The matter of uniform jurisprudence is of particular importance to enhancing perceptions of risk in the region. There are many ways of achieving this, including drawing on the expertise of the existing arbitration centres using the treaty on the energy charter as a model, for instance. All that is needed is for there to be an integrated supreme arbitration body that is capable of acting as court of cassation (review limited to law and to manifest errors of judgement, with specific consideration given to coverage of costs, so as to ensure that the procedure is swift and to avoid lengthy delays).

THE ADOPTION OF A CLEAR and comprehensive legal framework for the protection of investments carrying the UfM stamp of approval would have two types of advantages:

- The direct advantage of improving the perceived attractiveness of the region,
- An indirect advantage involving reduced transaction costs (costs of analysis and investment and export guarantee costs) and easier access to financial markets (bond issuance, securitisation or equity searches), particularly for the financing of major projects and/or the establishment and financing of investment funds dedicated to the region – markets could be a way of structuring long-term investment financing by having market financing, guaranteed commercial debt and/or public debt in the first 15-20 years (seen as the most risky), and then financing in later years using local commercial banks as a matter of priority.

These advantages would be further boosted by the establishment of a revamped system for allocating financial guarantees.

**The investment protection regime needs to be put in place as a matter of urgency**

A NUMBER OF OPTIONS could be considered as regards the legal means available for setting up the investment protection regime.

One option, that of adopting a straightforward declaration enshrining principles derived from international practice in the area of investment protection and then appending this to each government contract for approved projects, should be ruled out from the outset. Since such an approach would not impose anything binding on States or investors in the event of a dispute, it would effectively add nothing to the existing instruments and would simply render the current system even more complex than it already is.

A second option, which would involve organising a diplomatic conference with the aim of concluding a multilateral regional treaty, should probably also be ruled out, particularly in view of the time that would be required to bring such an endeavour to fruition.

There is however a third option, that appears feasible for rapid implementation. It would involve preparing under the auspices of the secretariat general of the Union for the Mediterranean a draft agreement defining a uniform legal framework (that could include optional sections) for the protection of investments bearing the seal of approval of the UfM. The document in question would be submitted for ordinary ratification by States that wish to host such projects, along the lines of the Cape Town Convention on International Interests in Mobile Equipment.

**MUCH OF THE FINANCING WILL NEED TO COME FROM INVESTORS OF ALL SHADES, PUBLIC AND PRIVATE, INTERNATIONAL AND LOCAL ALIKE.**

## Financial tools for infrastructure and SME financing

WE RECOMMEND five financial tools for the financing of infrastructure and SMEs in the Mediterranean region:

- An infrastructure guarantee fund to be initiated by the EU based on a list of investment projects bearing the UfM seal of approval.
- An SME guarantee fund to by endowed by the regions and focused on clusters.
- Modernisation of the financial markets to ensure better harnessing of local savings and their transformation into long-term investments for the SEMC (infrastructure/SMEs).
- The mobilisation of public and private stakeholders from the North and South of the Mediterranean to put together joint initiatives on information sharing and collaboration.
- The establishment of a North/South Mediterranean Union of credit insurers to act as an interface between credit insurance companies from North and South.

### Infrastructure guarantee fund initiated by the EU based on a list of UfM approved investment projects

APART FROM transfers and aid from the North and other regions of the world to the SEMC, much of the financing will need to come from investors of all shades, public and private, international and local alike. Clearly, the task of attracting investment capital into projects involving deferred revenue (maturity in the order of several decades) and moderate returns on investment (in the region of 4-7%) is fraught with difficulty.

Above and beyond investment, a key challenge, exacerbated by the financial crisis, is that of increasing lending, but this raises equity requirements for banks (Basel III). Added to this, the resulting liquidity risks on banks' balance sheets induce them to accord preference to projects in less risky zones.

A guarantee instrument would thus appear to be an ideal vector for focusing public resources, one that would cause the committed resources to multiply beneficially. Such a tool would need to be compliant with the restrictions on State aid and subsidies (WTO community law / OECD export credit rules). It would also need to be based on a clear body of case law and reasonable processing timeframes.

**A GUARANTEE INSTRUMENT APPEARS TO BE AN IDEAL VECTOR FOR FOCUSING PUBLIC RESOURCES CAUSING THE COMMITTED RESOURCES TO MULTIPLY BENEFICIALLY.**

At the practical level, an effort needs to be made to rank projects in order of priority. This is the sole way of achieving the goal of concentrating the resources.

The priority ranking should be carried out on the basis of the priority objectives of the UfM (depollution of the Mediterranean Sea / sea and land highways / Mediterranean solar plan), and it should have regional dimensions (South-South / South-North).

A pitfall to be avoided would be that of using country risk as a key selection criterion. That being said, it would be useful to develop a system for rating projects for risk but also for their level of innovation, the extent to which they contribute to building economic structure, their environmental impact, or their trickle-down impact on the broader economy.

The following infrastructure could be deemed priority:

- **Energy:** the production, transport and distribution of electricity, the transport and distribution of gas, renewable energy;
- **Transport and telecommunications:** airports, air transport, port infrastructure, sea transport, roads and highways, bridges, railways, telecommunications;
- **Environment:** water and drainage, solid waste disposal and processing, anti-pollution measures, irrigation;
- **Human and social capital:** construction of hospitals and clinics, construction of schools and technical and vocational educational establishments, social housing.

A key prerequisite for the success of any UfM approval label would be to ensure that projects are selected from as broad a base as possible so as to avoid projects being selected from a very narrow base. More generally, the selection process should be swift, and based on technical, legal and financial expert assessment, with as little red-tape as possible.

*An adapted tool*

REGIME. The scope of the guarantee could go beyond political risks to cover some economic and financial risks too.

- Many operators already have provision in place to cover political risk. By way of example, MIGA covers four main risks and is gradually making provision for a fifth (the last in the list):
  - Refusal of transfer and non-convertibility (excluding devaluation);
  - Expropriation (direct and indirect);
  - Armed conflict and civil disturbances (including terrorism and sabotage);
  - Breach of contract (by a State or a State entity);
  - Sovereign non-compliance with financial obligations.

- A selection of economic and financial risks guaranteed would be determined à la carte depending on the project.
  - Already therefore, the following would appear to be priority topics for consideration:
  - Coverage of non-equity loans;
  - Payment risks in situations whereby the private partners have complied with their contractual obligations (cf. concessions);
  - Liquidity risk (beyond 15 years).

The issue of exchange risk coverage (local currency/convertible currency) requires further analysis: covering exchange risk in the framework of the existing mechanisms would bring about significant additional costs. Whereas only private stakeholders would be exposed to construction risk, the new scope of guarantee under consideration could be extended to selected operating risks in the case of concessions. This guarantee mechanism would apply not only to international investors, but also to local banks and investors so as to harness local savings.

The mechanism would need to be based on and fit in with existing international and national guarantee systems (co-guarantee/counter-guarantee). It could lead to better coordination of relevant instruments.

Specific guarantee mechanisms could be established based on this better coordinated basis with the help of sovereign entities or international institutions in the case of certain UfM approved investment projects. The practical specifics such as the upper limit per country or per project, the amount of premiums, the guarantee rate (a single rate or a country/project-specific rate) would need to be determined by the participants of the proposed guarantee fund.

The matter of contributions to the guarantee fund from countries outside the region (Gulf States/USA/China, etc.) should also be addressed. A straightforward principle could be adopted: any company whose country of origin contributed to the financing of the guarantee would be eligible to benefit from the system.

THE MATTER OF CONTRIBUTIONS TO THE FUND FROM COUNTRIES OUTSIDE THE REGION (GULF STATES/USA/CHINA, ETC.) SHOULD ALSO BE ADDRESSED.

Finally, the entire process would enable the examination of projects and a swift decision following negotiations with private partners on the basis of straightforward and transparent rules.

AN EXPANDED SUPPLY of investment guarantee instruments alongside a redefined and enhanced common legal framework for the protection of investment should logically lead to a significant reduction in the cost of risk premiums. The quantum of premiums as a function of the risks covered could be kept at a high level (MIGA currently charges 2% of the amount covered for all long-term political risks). The reduction of the cost of risk coverage would however continue to be an objective in providing investment security. This would happen concomitantly with the broadening of the scope of risks covered and the creation of innovative mechanisms based on the existing resources of the fund and closer coordination between its operators.

There would be further scope for reducing the costs assumed by project proponents in securing their investments by allowing for contributions from sovereign entities and international institutions to the payment of insurance premiums for selected UfM-approved investments. This avenue deserves exploration so that if it were to be taken up, it would be in conformity with OECD and WTO rules.

EXTENT. If a decision were to be made to establish a regional UfM infrastructure guarantee mechanism at the initiative of the EU, guarantees to UfM-approved investment projects could be structured in two phases (purely illustrative at this stage):

- An initial financing phase (0-15 years):
  - The equity would be provided by the Northern countries with the possible participation of the Gulf investment funds;
  - Debt mainly provided by banks from the North, co-financed by regional development banks such as the EIB and other willing IFIs, together with loan guarantees from loan guarantee agencies, in full conformity with applicable international rules.
  - Involvement of a yet-to-be-created infrastructure guarantee community fund.

- A refinancing phase (15/25 years):
  - Refinancing as a matter of priority by local banks: the financial risk would be lower (debt largely amortised and revenue flows validated by 15 years of operations). Moreover, refinancing in local currency would eliminate the exchange risk from project financing;
  - Consideration of securitisation of bank debt in phase 2 by local financial players, with shares to be sold to local savings account holders;
  - Possible partial guarantee of securitisation transactions by the yet-to-be-created infrastructure guarantee fund. This would enable local financial institutions to target local savings account holders and enable the latter to contribute to the long-term development of their country by purchasing secured bonds in the second phase of a project's life-cycle.

## SMEs guarantee fund endowed by the regions and focused on clusters

LOCAL BANKS HAVE a short-term focus, are mainly geared to large enterprises, and demand guarantees that SME managers are frequently unable to provide. This explains why the East and South Mediterranean has the highest rate of self-financing (more than 2/3) among all of the major geographical regions of the world.

One of the reasons for this state of affairs frequently and justly evoked by banks is the lack of transparency stemming from family ownership, and the absence of the necessary skills both within the SMEs and within the banks themselves to deal with SME financing issues. Closer sector-specific analysis reveals that the existing capital financing mechanisms in the form of venture capital funds and guarantee funds exclude certain sectors that are deemed too high a risk, as well as certain key stages in SME development such as start-up, the second round of financing during expansion, the exit of venture capital funds after 5-10 years presence, etc.

Clearly, technical assistance both to SMEs themselves and to local players (investment banks and funds) is required in order to carry out expert assessment of applications and then offer specific training to all of the relevant players in each of the countries.

THE AIM OF ANY initiative must be to encourage banks to increase their volume of lending and to facilitate investments by local and international investors by using mechanisms that are as straightforward as possible so as to encourage banks and entrepreneurs to take them up.

One of the initiatives launched within the framework of the UfM is the Mediterranean Enterprise Development Initiative (MEDI). Its aim is to foster steady and sustainable economic development in the Mediterranean. MEDI is an initiative of Spain and Italy, with the support of the EIB.

Our proposal is to establish an SME guarantee fund endowed by the regions and focused on clusters. Clearly, the global economic and financial crisis carries the risk of States turning inwards in a quest for national solutions. In the face of delocalisation, renationalisation of certain economic activities no longer seems so far-fetched.

However, globalisation is the driving force behind the creation of co-development zones that are mutually profitable for all participating countries (NAFTA / Mercosur, China-Japan-South Korea-SE Asia).

If Europe is to compete with these regional entities, it needs to open up to the SEMC. The aim is to establish a new economic zone of investment and consumption capable of competing with these new economic blocs. Technology transfers are not only a way of building export platforms; they will also serve to establish new consumer markets in the SEMC, with the attendant jobs- and wealth-creation in North and South alike.

An initiative that would contribute to that goal would involve establishing a fund bringing together the regions of Europe (Italy, France and Spain initially) in partnership with the regions of the South and East Mediterranean with a view to creating a specific instrument for supporting enterprise creation and development, with a priority focus on clusters. Here once again, the aim is to concentrate resources for better efficacy, and also to tie enterprise creation and development to spatial planning and regional development objectives.

**AN EXPANDED SUPPLY OF INVESTMENT GUARANTEE INSTRUMENTS ALONGSIDE A REDEFINED AND ENHANCED COMMON LEGAL FRAMEWORK FOR THE PROTECTION OF INVESTMENT SHOULD LOGICALLY LEAD TO A SIGNIFICANT REDUCTION IN THE COST OF RISK PREMIUMS.**

Crucial to this initiative would be the bringing together of the European regions in a guarantee fund in partnership with local banks and international operators such as the EIB, the national Caisses des Dépôts, AFD, etc.

Apart from guarantees, technical assistance would be provided to entrepreneurs and banks for expert assessment of applications. A partnership with local banks from the South enabling them to increase their lending capacity to SMEs would be one of the key features of the initiative. The following operational principles could apply (expert assessment to be analysed further):

- For Fund capitalisation of €10m, the objective would be a multiplier of 3, or an investment of €30m;
- Assuming a guarantee upper limit of 50%, the maximum amount of loans generated by the Fund would be €60m;
- The Fund could apply a loan duration of 3 years (each start-up guarantee provided by the Fund would expire in its third year);
- The €60m total would therefore be multiplied by 3.33 to yield a maximum loans generated total of €200m.

Eligibility criteria would need to be determined, although conceivably, guarantees would be tied to specific activities or specific categories of entrepreneurs such as beginners, women, specialists in innovative technologies, or rural dwellers. There could also be a focus on currently neglected phases such as start-up or second round of financing, necessary for the development of existing SMEs. These new guarantees would stand alongside existing guarantees (counter-guarantees), the aim being to pool risks.

Clusters would not be limited to the high-tech sector bringing together researchers, engineers, entrepreneurs and investors in a Silicon Valley type arrangement. They would also be closely involved in defining local development projects, such as in the following few examples:

- Competitiveness clusters in Sweden based on cooperation between universities and enterprises (example: Kista, which brings together more than 600 enterprises working in the new technologies and telecommunications sectors);
- Clusters in Spain, which bring together enterprises of different sizes in a given sector and in a

given geographical region, not necessarily with R&D as a primary focus;

- Production-oriented clusters such as those in Italy, or in France's local productive services (SPL) set-up. These are networks of enterprises that pool their resources and develop complementary facets of their businesses in a given region with a view to achieving economies of scale (plant / commercial development / HR / training/innovation, etc.). Their success is based on the large numbers of frequently competing and constantly innovating companies involved (major companies/SMEs);
- Seven development clusters identified under Morocco's "Emergence II" plan (automotive / aeronautical / food industry and seafood / crafts / textiles / on-board electronics), with an objective of 22 international standard integrated industrial platforms;
- Tunisia's industrial strategy through 2016 for the creation of clusters in key sectors of the economy:
  - Enhancement of existing sectors (textiles-garments / leather and footwear / food industry / mechanical manufacturing / electrical manufacturing / construction materials industry / phosphates industry);
  - Encourage the emergence of new sectors (electronics / automotive and aeronautical parts / technical plastics / pharmaceuticals and paramedical / ITCs and service centres);
  - Prepare for the future (mechatronics / biotechnology / environment, etc.).

TECHNOLOGY PARKS are sprouting up across the Mediterranean region: three in Egypt, one in Jordan, four in Morocco, two in Syria and five in Tunisia. Algeria also has technology park projects underway in the petrochemicals and pharmaceuticals industries.

The advantage of this approach is that it focuses resources in specific zones and enables coordination of existing activities with necessary future steps (start-up, venture capital, loans, and all forms of access to financing). It covers all forms of enterprises (large, small and medium), and urban and rural areas alike:

- It is jointly organised with public and private stakeholders in a given area.
- It creates links between higher education and business.
- It encourages research and industry to work side by side.
- It enables operational project management.
- Finally, it strengthens North-South experience sharing, co-investment in Southern countries, and technology transfers.

**A SPECIFIC GUARANTEE TOOL WOULD CLEARLY BE CONDUCIVE TO DEVELOPING A NETWORK OF SPECIALISED FUNDS THAT WOULD CONNECT UP THESE ENTERPRISE AND INDUSTRY CLUSTERS IN THE MEDITERRANEAN WITH THEIR EUROPEAN COUNTERPARTS.**

A SPECIFIC GUARANTEE tool would clearly be conducive to developing a network of specialised funds that would connect up these enterprise and industry clusters in the Mediterranean with their European counterparts, with SME development serving as a focal point. France's DGCIS (directorate general for competitiveness, industry and services) signed with UBIFRANCE in January 2009 a convention on the internationalisation of the country's competitiveness clusters.

Such a guarantee fund approach would also fit in well with the EU's seventh framework programme for technological research and development (FP7), given the large number of Southern countries that are eligible for FP7 (Algeria, Egypt, Jordan, Lebanon, Libya, Morocco, Palestinian Authority, Syria, Tunisia, as well as Turkey as an associated country).

## Harnessing local savings for long-term investment in the SEMC

Infrastructures, SMEs

*The creation of long-term products for institutional and private investors*

INTEGRATION BETWEEN the stock exchanges of the Southern and Eastern countries continues to be worthy of consideration. The development of common indexes, and, once the market achieves sufficient depth, of trackers, is something that could be promoted on an operational basis.

Cooperation is already emerging between various stock exchanges in the South (recent example of a Tunisian company carrying out its IPO simultaneously in Tunis and Casablanca). The Casablanca stock exchange is pursuing a strategy aimed at seeking closer ties with Sub-Saharan Africa, so as to turn it into the region's enterprise financing centre.

For the near term, we favour national solutions based on the premise that successful solutions will spread by contagion into neighbouring countries.

One of the common weaknesses in the region's financial markets is the very low presence of institutional investors, be these insurance companies, health insurance funds, or retirement funds (less than 3% of GNP compared with 37% for Brazil, 28% for South Africa or 7% for Mexico).

The task of developing the market will require the harnessing of local savings to a greater extent than is the case today, and this can only be done by creating products that foster the kind of long-term saving that does not as yet exist in the region (life insurance in Morocco is five years). The extreme example is Syria, where 40% of bank liquidity is idle because of the dearth of investment products offered by the central bank (legislation on securitisation has been voted but is not yet in place).

The priority therefore is to create fully fledged bond markets the national level and to make them attractive for local investments. There are economic players who wish to invest in a long-term perspective, but the tax conditions are not sufficiently attractive, and products such as payroll saving accounts and security savings accounts simply do not exist.

**THE CREATION OF LONG-TERM PRODUCTS FOR INSTITUTIONAL AND PRIVATE INVESTORS.**

Morocco's Ministry of Finance undertook in 2010 to take steps to foster long-term saving. The aim is not so much to stabilise savings at around the 30% mark, but rather to achieve a shift away from short-term instruments in favour of long-term instruments. A programme contract is to be signed with insurance companies calling upon them to invest 200 million dirhams in the capital markets, with the aim of doubling that amount within five years. A draft law on securitisation was recently approved by the Council of Ministers, opening up the door to a new form of financing. Clearly, this stands to benefit the real sector of Morocco's economy immensely.

THE IDEA OF PRE-ALLOCATING a portion of long-term savings towards the financing of infrastructure and SMEs is worthy of consideration. Banks in the region do not engage to any great extent in infrastructure or SME financing, thus a partnership with a view to encouraging such activities would be of the essence. Morocco's CDG plays a key role in this area in its own country, and could serve as an example for other countries in the region.

Tunisia's recent decision to establish a "Caisse des Dépôts" (deposits bank - Caisse) ties in well with the objectives outlined above. The objectives of the Caisse are threefold: to trade on and help modernise the financial markets, to finance infrastructure and to finance SMEs.

Investment projects for the financing of infrastructure and those carried out in the framework of the EU-initiated guarantee fund could be structured across two phases:

Although it is necessary to create innovative financial instruments such as bonds, it is also important to address the needs of individual savings account holders and their lack of trust in the banking system. It is this lack of trust that explains their aversion to long-term instruments, and indeed their aversion to holding bank accounts in the first place.

THE "*LIVRET A*" tax incentivised savings account in France for the financing of social housing has been immensely successful since it was created, thereby demonstrating the efficacy of such products. Depending on the country, funds collected under such instruments could be directed into long-term investment in areas deemed to constitute a national priority, such as SME and infrastructure financing. Consideration could also be given to creating a savings product made up of shares in SMEs.

Consideration should also be given to harnessing migrant remittances, despite the significant drop therein following the financial crisis. Some 85% of migrant remittances go to subsidise family budgets (health, education, etc.), and that looks set to remain unchanged, but there is scope to increase the share allocated to non-real estate investments, which currently is less than 3% of total migrant remittances. An attractive and secure product needs to be created so as to reduce the still large proportion of undeclared remittances and encourage higher banking penetration, which continues to be a key objective (40% in Morocco, 15% in Algeria, 15% in Egypt). Such a pro-active move would not just concern traditional migrants: it would also seek to bring on board second and third generation EU residents of Maghreb origin interested in investing in the countries of origin of their parents by putting some of their savings into new and secure products.

AN INITIATIVE bringing together banks from the North and South of the Mediterranean would be the only way to reach bank clients from North and South and lay the groundwork for a common banking market.

One of the key objectives would be to increase bank penetration in the South, reaching out in particular to the beneficiaries of migrant remittances. A cross guarantee-based joint offering could then be created targeting migrants from the South residing in the countries of the North, as well as students, young graduates and entrepreneurs from the South seeking to open a bank account, obtain a loan or invest in the countries of the North.

*The Caisse des Dépôts' initiative for the creation of a club of long-term investors, and the creation of "Caisses des Dépôts" in the South and East Mediterranean countries*

THE CAISSE DES DÉPÔTS' initiative for the creation of a club of long-term investors bringing together public and private operators sharing the same vision is an interesting operational avenue for exploration that should be introduced to new partners from North and South.

The establishment on 26 May 2010 of InfraMed infrastructure fund, the UfM's first financing instrument made up of Caisse des Dépôts, Cassa Depositi e Prestiti (CDP), European Investment Bank (EIB), Caisse des Dépôts et de Gestion Morocco (CDG) and Egyptian bank EFG Hermès is a concrete example of how the initiative could be implemented. The InfraMed Fund is set to play a central role in channelling investment into infrastructure in the South and East Mediterranean countries. The Fund includes two local compartments: one dedicated to Morocco and the other to Egypt.

With an initial €385m endowment (€150m from Caisse des Dépôts and CDP, €50m from EIB, €20m from CDG and €15m from EFG-Hermès), the Fund is expected ultimately to harness €1bn.

INFRAMED Infrastructure will provide funding for urban, energy and sustainable transport infrastructure. It will mainly invest in new projects meeting basic criteria in terms of environmental protection, social impact, transparency and tendering, with a view to investing with a longer-term perspective than traditional private funds specialising in infrastructure.

Two local funds have been established to finance projects in the same sectors as those selected by INFRAMED. These are the InfraMaroc and InfraEgypte Funds, each of which will amount to 20% of INFRAMED's commitments with a minimum of €100m. Investments in Morocco will be looked after by CDG and those in Egypt by EFG-Hermès. InfraMaroc Fund will have an endowment of 100m dirhams. Its target size is 3 billion dirhams, including a minimum commitment from CDG totalling 550m dirhams. The main target country is Morocco, with other Maghreb countries accounting for up to 20% of the Fund's commitments. The Fund will target companies whose activity is largely centred on the development, operation, construction and/or possession of infrastructure assets.

**THE CAISSE DES DÉPÔTS' INITIATIVE FOR THE CREATION OF A CLUB OF LONG-TERM INVESTORS BRINGING TOGETHER PUBLIC AND PRIVATE OPERATORS SHARING THE SAME VISION IS AN INTERESTING OPERATIONAL AVENUE.**

The experience of INFRAMED and its local segments such as InfraMaroc shows that entities capable of harnessing and managing savings in a secure manner, attracting tax breaks and investing on the financial markets in a long-term perspective, are increasingly emerging as a high-performance economic model.

Interestingly, the recent global economic and financial turmoil has seen renewed interest in the "*Caisse des Dépôts*" model. Public financial institutions of this kind with their own resources and no connection to national budgets need to be allocated a long-term investor role.

This is due to the generally accepted fact that private markets can only develop if there is a public "catalyst" that takes charge of creating a structural framework in the country concerned. These kinds of missions involve three main thrusts: working to modernise financial markets; financing infrastructure; financing the economy with a priority focus on SMEs. In addition to this, most countries would also give consideration to ways of financing social housing and local authorities.

Two countries in the region have made the decision to establish a *Caisse des Dépôts*: Mauritania's ministry of finance began as of 2009 to look at ways of harnessing the deposits of public bodies, of the social security and retirement funds, and of the national savings account, to the task of developing the country: housing, enterprise creation, local authority infrastructure, etc. The aim is to establish a "Caisse des Dépôts et de Développement" (a development-oriented *Caisse*).

More recently, on 25 June 2010, Tunisia officially announced the creation of a *Caisse* to be focused on modernising the financial markets and financing infrastructure and SMEs. The aim is for the *Caisse* to be operational by 1 January 2011.

At this point in time, when such matters are still at the gestation stage, there is a real opportunity to extend the core membership of the club of long-term investors beyond the current partners of the *Caisses*.

The club under consideration needs to be first and foremost a venue for exchanging best practices and business proposals. It was with this aim in mind, that in October 2010 the CDG launched the very first international forum of *Caisses des Dépôts*.

Aside from acting as a venue for considering issues of common concern, the club needs to have a shared vision and to use that vision to come up with innovative investment tools, as the example of Inframed Infrastructure shows.

With a view to expediting this process, the existing nucleus of CDC/CDP/CDG could set up as a consortium dedicated to supporting the establishment of *Caisses des Dépôts*, with a view to putting their vast experience at the service of States keen to avail themselves of it. Support services could be provided to States in such areas as institutional matters (governance, risk management and control, investment doctrines), training in matters related to long-term investment, or the performance of specific expert assessments (e.g. secure management of savings, PPP, financial structuring of infrastructure investments, or urban planning and social housing policy).

A number of countries, including Syria, have already expressed their interest in such an initiative. Algeria and Egypt would also benefit immensely from such a facility.

## Mobilising public and private stakeholders from North and South to develop joint strategies on information sharing and collaboration

### Capital investment

AT ONE END OF THE SCALE, one finds major corporations that create added value and attract international investors but do not create sufficient jobs (around 100,000 in direct job creation and 300,000 in indirect job creation). At the other end of the scale, one finds very small enterprises (VSEs) whose financing needs range from €50-100K. Between the two, there is ample scope for capital investment in the SME segment. This segment accounts for the bulk of a country's enterprises and the bulk of its job creation.

Analysis of the 2007 Medfunds report shows that while private equity has succeeded in bringing in large amounts of liquidity over the recent past (€15bn over three years), it has not invested sufficiently (15-20% of total fund subscriptions).

Private equity has only recently matured in a number of countries (Morocco, Tunisia, Egypt, Turkey, and others). Following a period of learning and investment in HR, selection of partners and selection of projects, returns on investment have gone from zero (0+) in 1999-2000 to satisfactory levels today.

For second generation funds (an AMIC study based on exit data for 29 investments of Moroccan funds over recent years), the average return on investment is 26% gross for the projects invested (compared with 11-13% in Europe). Even allowing for management costs and exchange risk, the 26% gross rate yields a net of 15%.

**PRIVATE MARKETS CAN ONLY DEVELOP IF THERE IS A PUBLIC "CATALYST" THAT TAKES CHARGE OF CREATING A STRUCTURAL FRAMEWORK IN THE COUNTRY CONCERNED.**

Exit figures are currently satisfactory. However, although the invested volumes are quite large, there still subsist difficult segments where investment needs are far from being met and where intervention by government or international institutions such as the EIB is indispensable. In terms of the enterprise creation sequence, one could mention the start-up phase and the second round of financing for companies in expansion. It is also important to note that investment should not be confined to the high technology sectors alone: traditional sectors such as food and agriculture, which create much larger numbers of jobs and contribute to balanced regional development, should also be prioritised.

Another outstanding issue concerns how to fuel the secondary market, which remains largely underdeveloped (speculative overvaluation has been observed on some markets). The good news is that, notwithstanding its shortcomings, venture capital has a key role to play in non-speculative economic development based on value creation by high calibre local teams operating close to their markets, and that those teams are now in place.

Strange as it may seem, the current state of the market with all of its shortcomings, is likely to attract both international and local investors (family businesses). The latter are likely to be attracted away from the short-term appeals of real estate investment, which used to be more lucrative but which has its limits and risks as shown by the current crisis.

WHAT WILL BE THE determinants of success? A network of venture capital investment companies from North and South has coalesced around Euromed Capital Forum. This could serve as a catalyst and think-tank for improving the legal framework and attracting new investments. Information outreach and the establishment of an institutional information focal point on venture capital in the South and East Mediterranean is a pre-requisite.

Clearly, institutional investors are seeking to increase their venture capital exposure (according to the EMPEA / Coller survey), but weighing up the various factors they tend to privilege China, India and South America instead of the South and East Mediterranean, which suffer from a low profile. There is thus demand on the part of potential investors for more comprehensive information and more detailed benchmarks.

The lack of Midcap experience in emerging countries among potential investors means they have an all the greater need for information on country situations and on the detailed performance of each fund. Improved databases, corporate communication per asset class and region, and the identification of high-calibre, reliable teams are becoming key factors in geographical decisions.

We propose working with independent bodies to build databases/an observatory on existing funds in the Euromed zone comprising such data as fund size, performance, and portfolio typology. Annual web-based communication events by the observatory and an annual flagship event could turn this into an invaluable tool for all investors interested in the region. The forthcoming Euromed Capital forum to be held in Cairo in April could be used as an occasion to launch such an observatory officially.

A yet-to-be-defined working programme could be articulated around three priorities:

## 1. Legal and tax environment stability

**VENTURE CAPITAL HAS A KEY ROLE TO PLAY IN NON-SPECULATIVE ECONOMIC DEVELOPMENT BASED ON VALUE CREATION BY HIGH CALIBRE LOCAL TEAMS OPERATING CLOSE TO THEIR MARKETS.**

VENTURE CAPITAL has always evolved and developed in a pre-defined legal framework. Morocco has yet to create such a framework. Any country that wants to foster long-term financing needs to work on tax transparency and particularly on ensuring stable rules of the game. Yet currently, these are subject to change almost on an annual basis.

The aim of legislative harmony across the region, however desirable it may be, appears unattainable. Therefore, the benchmarks that guide investors need to have the effect of encouraging countries to ensure legal stability.

Investment capital, which should not be conflated with other more short-term or speculative instruments (LBO, hedge funds), has proven its economic growth and job creation potential, and hence its potential to generate revenue and tax for the State. A simplified and stabilised regulatory framework should also attract a portIon of local savings (family office or capital markets) into long-term investments that in the past were less lucrative than real estate but that create value for the economy.

A final role of the yet-to-be-created observatory could be to disseminate best practices as far and wide across the region as possible.

## 2. Foster new teams and new funds

SO AS TO ATTRACT investors into all segments capable of contributing to the development of the South and East Mediterranean economies, development capital must not just focus on the high technology sector but also target the food and agriculture industry and the traditional sectors in general, where job creation potential is much higher.

New funds need to be created and new teams trained. Investors have become ever more demanding in view of the increasingly stringent regulatory constraints, and also because of the large number of past project failures in the region. These are a liability for the region compared with other regions of the world.

Creating new teams and funds requires lengthy financial engineering efforts of around 18 months. In addition, it is costly to recruit and train fund managers, to structure a fund, and to get fund-raising started (€200,000-300,000 to get a fund off the ground).

Hence the crucial importance of financing. Local banks are only beginning to move into the sector, but they themselves require training in this new activity. This is the reason for the proliferation of training initiatives financed by international institutions (European Commission, AFD, KfW, etc.).

Capital investment funds already present in the region are the best placed to carry out these tasks and set up financial engineering companies. A possible solution could be to have external public and private partners (international and local) take stakes in the financial engineering companies under consideration.

A capital investment fund setting up this kind of financial engineering company would invest in the management company once it was established (for a €100m fund, the rule is that the management company would take a €1m stake). Regardless, it is clear that public support for such private sector initiatives is indispensable.

Mention deserves to be made of the Moroccan government's initiative to set up public/private funds over the period 2009-2015 with a total potential budget of 1.05bn dirhams. In the pilot phase, the State will set up two public/private funds both focused on development capital and LBO with a total public budget of 350m dirhams. These funds will be managed by private professional operators selected via an expression of interest tender. The target date for establishing the funds is the end of the second quarter of 2010 at the latest.

With a view to encouraging private investment, the State adopted a number of incentive measures, including the retrocession of a portion of its earnings to private shareholders.

Tunisia's current efforts to structure its system of SME financing and simultaneously establish a holding entity under the auspices of the SME financing bank and a *Caisse des Dépôts* deserve close attention.

**3. Establishment of regional emerging markets funds of funds with specialists in long-term financing**

FOR MANY YEARS, the development of investment capital in the South and East Mediterranean has required a familiarity with the situation on the ground, and in particular the local business situation. This meant having national teams in each country.

This requirement was all the more important for the absence of clear regulation and the gaping disparities from one country to another. Having national teams in each country is no less important today.

Whereas investment in the region is more risky than in a developed country, return on investment is also much higher. Growth in the South and East Mediterranean countries is going to take place on the back of enterprises meeting demand on national, regional and export markets. Growth sectors will range from high technology goods to consumer products as a new middle class with new consumption habits emerges. This favourable economic context in what continues to be an uncertain environment requires a regional approach, hence the need for regional funds of funds.

A fund of funds managed by professional multidisciplinary teams with in-depth knowledge of the region and its stakeholders would be able to identify experienced teams and create new management teams in each of the countries concerned. This would enable risk diversification per country; predefined strategies would be followed (minority vs. majority/ young or mature enterprises, etc.).

Such a diversified portfolio would doubtless be of interest to new investors in the region, since it would spread their risk across several countries and more than one fund.

International bodies and local banks (even family offices) would be more than willing to become involved in such an initiative insofar as it would enable new and emerging local teams to get into place with as a safety net the high standards of governance provided by the management teams of the fund of funds.

Subscribers to the fund of funds would be able to invest directly in the selected primary funds alongside the fund of funds.

**VENTURE CAPITAL SHOULD NOT BE CONFINED TO THE HIGH TECHNOLOGY SECTORS ALONE BUT ASLO FOOD AND AGRICULTURE, WHICH CREATE MUCH LARGER NUMBERS OF JOBS.**

## North-South Mediterranean Union of loan insurers

Like their Northern neighbours, most SEMC offer their national business community mechanisms to support exports and investment abroad. Some countries target specific sectors, such as high tech. The guarantees on offer are limited however, both in terms of quantity and in terms of the financing covered. Local banks, meanwhile, make access to foreign currency loans contingent on companies depositing large sums of local currency, which very often rules out SMEs.

In the SEMC, public guarantees tend almost exclusively to be limited to insurance against default on payment for exported goods. They do not, by any yardstick, cover the totality of the needs of enterprises exporting to international markets. The guarantee systems in the Northern countries, by contrast, offer sequential coverage: market prospecting (coverage of part of the cost of prospecting incurred if sales are insufficient to recoup that amount), pre-financing of exports, exchange risk inherent in an export contract, contract execution and payment, supplier credit guarantee, guarantees with respect to intangible assets (patents, brands, etc.), guarantees with respect to repayment of accounts receivable arising abroad, guarantees for documentary credits, and guarantees with respect to political risk exposure.

A Mediterranean Union of credit insurers would be tasked principally with promoting cooperation between operators by doing the following:

- Encouraging the harmonisation of financial statement disclosure regulations;
- Creating networks of existing sources of information to enhance information reliability;
- Involving trade missions, banks and other institutions in data collection and forging links between operators;
- Organising co-insurance to spread out risk and enhance services to operators;
- Fostering expertise pooling and building on synergies;
- Working to establish a debtor black list;
- Facilitating unpaid debt recovery.

GENERALLY speaking, needs and requirements are considerable, and there is no scope for increasing either private or public resources. The only solution therefore, is to optimise resources. There is a shared responsibility to take action on the part of the Northern and Southern countries. The consensus is that the guarantee fund instrument offers the best approach and the greatest leverage effect.

The EU needs to come up with an initiative for the creation of an infrastructure-specific guarantee fund, using as a starting point the investment priorities set forth in the relevant UfM documents. The recently established secretariat in Barcelona would be the ideal institution to manage such a fund. An instrument of this kind is the only way of financing the vast majority of the projects identified, notably when it comes to bank lending.

This should not be seen as excluding the kinds of initiatives that Northern countries could elect to become part of with respect to specific projects: the regions guarantee fund could be given its initial momentum by Italy and France. Its focus on clusters would make it possible, once the initiative has been launched, to forge links between the regions of the North and those of the South.

THE MODERNISATION of the South's financial markets is obviously a task for the authorities in each of the countries concerned, with a strengthened South-South cooperation dimension if at all possible. Modernisation is expected to lead to local savings being directed into job-creating investment projects (SMEs, infrastructure) via secure long-term investment instruments, that will benefit the countries' economies.

Thus, the emergence in the Southern countries of *Caisses* is likely to accelerate the entire process: such *Caisses* will quickly turn into major market players and long-term investors, attracting in international and local private operators.

The success of all of the actions outlined above will depend on the credibility of the reforms undertaken and the level of confidence they instil. High levels of investor confidence can only be achieved via the creation of a clear and stable legal environment. Only this will lead local (institutional and private individual) and international players to commit themselves to the market for the long-term. Principles of good governance must at all times stand to the fore.

State intervention, although indispensable in the current times of crisis, is only legitimate to the extent that it attracts and supports the activity of private operators, both lenders and investors. This is the pre-requisite sine qua non for private initiatives to develop and flourish, as illustrated by Euromed Capital Forum in the area of investment capital.

**STATE INTERVENTION, ALTHOUGH INDISPENSABLE IN THE CURRENT TIMES OF CRISIS, IS ONLY LEGITIMATE TO THE EXTENT THAT IT ATTRACTS AND SUPPORTS THE ACTIVITY OF PRIVATE OPERATORS, BOTH LENDERS AND INVESTORS.**

In terms of governance, while the Funds will benefit from support from the European Commission (infrastructure guarantee fund) or regions yet to be identified (SME specific funds to be financed by the regions), they will need to be sufficiently open to allow a maximum number of institutional and private investors from the UfM countries and other international investors to participate financially.

Investors and donors will need to have voting rights proportional to their contributions. Beneficiary SEMCs should also entitled to contribute to decisions on the granting of guarantees and financing to one project or another. This kind of involvement is crucial to ensure that the SEMCs take ownership of the projects, which in turn will have to have a regional character. Moreover, involving the SEMCs will send out a strong signal in favour of the new mode of parity North-South governance enshrined in the founding principles of the UfM. The new governance approach marks an important political step forward compared to the Barcelona process. At the very least, it will need to be implemented at the level of expert assessments, which must absolutely not be imported from the North to the South.

THERE IS ALSO a need to coordinate with existing initiatives: several funding agencies and bilateral and multilateral investors are already involved in the financing of major projects in the Mediterranean region. Despite the financial contributions of the EU and the other funding agencies in the region, the infrastructure and SME financing needs of the SEMCs are immense. The instruments proposed in this report are an addition to the initiatives underway, and are not intended to compete with them. In the area of infrastructure financing, for example, we accorded preference to instruments specific to projects with a strong regional dimension that have already been preliminarily examined by the North and South jointly and to which the countries in question have committed already.

The variable geometry principle that applies to regional projects more than to purely bilateral projects is another project selection criterion. Our proposals on SMEs seek to increase the role of local banks. We highlight the need for local banks to be less risk averse by supporting SMEs at the start-up and development phases. We also propose tools aimed at securing SME financing via the financial markets and via local authorities. 1

# CONCLUSION

THE SOUTH AND EAST Mediterranean countries have immense financing needs with respect to major, structure-giving investment projects. There are resources out there, but, with few exceptions, public resources are becoming scarce and private resources, including those of the South and East Mediterranean countries, tend to be invested in short-term instruments or in regional blocs with stronger growth rates or lower risk factors.

THE MEDITERRANEAN REGION is seen as an agglomeration of different legal and economic systems with few real ties between them. It is true that legal systems and standards differ from country to country; intra-regional trade comes to less than 8% on average of the region's total trade. The overall investment image of the region is harmed too, making it a less attractive investment destination than other regions of the world. The investment protection instruments traditionally used in the region are not equal to the task of reducing perceived risks to a level sufficiently low to trigger the kinds of investment volumes required by the region.

**AN IMPROVED LEGAL AND FINANCIAL FRAMEWORK FOR INVESTMENT SHOULD BE ENOUGH TO KICK-START THE PROCESS OF REALLOCATING CAPITAL AT REASONABLE COST TO PROJECTS DEEMED OF STRATEGIC VALUE.**

IT IS THEREFORE NECESSARY to revamp the legal and financial framework governing the protection of investments by (i) putting in place an international treaty that would create a specific legal protection regime for UfM project at the level of the region (or, at the very least, at the level of those countries opting in to the treaty), with provision on a dedicated dispute resolution body capable of developing a clear body of case law, and (ii) the creation of a system of financial guarantees of greater volume, greater risk coverage and easier access, based on pooled public resources and private financing.

GUARANTEEING INVESTMENTS will not be enough however: also needed are efforts to harmonise in other areas, particularly in the areas of commercial law (e.g. law on sureties, law on public-private partnerships, etc.) and technical and regulatory standards, and continued concerted action in the area of fiscal policy.

MORE GENERALLY, there is a need for enhanced sharing of information and expertise between the countries of the region, North and South alike, particularly in the area of PPP negotiations. States, when affording legal security to investors, must have a proper understanding of the scope of the guarantees afforded, and there must be balanced negotiation of investor-State contracts.

THERE ARE OF COURSE other measures that need to be adopted, particularly with respect to strengthening the transformative role of banks and capital markets, improving labour productivity, and so forth. That being said, an improved legal and financial framework for investment should be enough to kick-start the process of reallocating capital at reasonable cost to projects deemed of strategic value. Such projects include structure-giving investments in energy, water and transport, and also the creation of investment funds dedicated to the region that will benefit SMEs too. 1

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