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# *Contents:*

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# FINANCIAL INTEGRATION IN THE FOUR BASINS: A QUANTITATIVE COMPARISON

**Sergio ALESSANDRINI**
University of Modena and Reggio Emilia, **Italy**
sergio.alessandrini@unimore.it
**Elisa VALERIANI**
University of Modena and Reggio Emilia, **Italy**
elisa.valeriani@unimore.it

**Abstract**

*The intention of the following paper is to present some stylized features of the financial integration of the four basin regions composed by the Baltic Sea, Black Sea, Caspian Sea and Mediterranean Sea regions. It discusses the developments, trends and features of the International Investment Position (IIP) in the regions. Using volume based indicators we compare and identify the gaps in them, whilst distinguishing between the EU e non-EU members and providing an overview of the asymmetries and the convergence as a result of the integration in the different financial markets. After reviewing the trends, the final chapter points to those areas that need further efforts to achieve greater regional integration.*

**Keywords**: international financial integration, convergence, asymmetries, current account openness, FDI, financial development, portfolio investment

**JEL Classification**: F15, F21, F33

## 1. Introduction[2]

Starting from the 1990s, the European Union undertook a set of reforms addressed to complete the full liberalization of the capital transactions between the member states and the third parties. The purpose of the agreement was to accomplish the full financial integration of the European capital markets alongside the same principles of the common market for good and services[3]. In 2004, the Wider Europe and the European Neighbourhood Policy (ENP) projects proposed a '*comprehensive prudential regulatory framework for the financial services area*'[4], aimed to reinforce the undergoing benefits of the capital account liberalization in the partner countries.

The original conceptual framework suggests, in combination with the achievement of the internal market and the implementation of the Economic and Monetary Union (EMU), that over time more financial integration will promote the stability of financial markets. Furthermore the new asset will enhance the overall economic performance with financial innovations and organizational improvements.

Moreover, the main benefit of the financial integration consists in the development of the financial sector, promoting deeper and more sophisticated domestic financial markets. Thus, banks and financial institutions may increase the financial alternatives for borrowers and investors[5].

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[2] This paper falls within EU4SEAS, *The EU and sub-regional multilateralism in Europe's four sea basins: Neighbourhood, Enlargement and Multilateral Cooperation,* research project funded by the European Union's Seventh Framework Programme (FP7/2007-2013) under Grant Agreement no.225382 (visit www.eu4seas.eu for further information)

[3] European Commission, *Capital Market Liberalization*: *The Single Market Review Series, Subseries III, Dismantling of Barriers*, (August 1996).

[4] European Commission, *Communication from the Commission, European Neighbourhood Policy, Strategy Paper.* (2004), 15-16. "It will be key to the creation of business and the promotion of investments that these countries ensure that companies are able to operate on a level playing field. In combination with the above measures, access to European financial markets should, over time, add to the stability of partners' financial markets and help enhance their overall economic performance. The further liberalising of capital movements will provide new opportunities."

[5] For a critical analysis of the benefits of capital liberalisation see Stiglitz, Josef E. 2004. Capital-market Liberalization, Globalization, and the IMF. *Oxford Review of Economic Policy,* Vol. 20, No. 1: 57, in particular the different impact between FDI and short-term capital flows.

## 2. Two questions

The following paper attempts to compare the patterns of the international financial integration, it addresses some specific theoretical issues and aims to benchmark the four basin regions. The four sea basin regions are composed by groups of countries with different institutional and economic characteristics.
The four sea regions are the following:

- **The Baltic Sea region:**
  EU: Estonia, Latvia, Lithuania, Denmark, Finland, Sweden, Germany, Poland;
  Non EU: Russia, Belarus.

- **The Black Sea region:**
  EU: Bulgaria, Greece, Romania;
  Non EU: Turkey, Georgia, Russia, Ukraine, Moldova, Armenia, Azerbaijan.

- **The Caspian Sea region:**
  EU: none;
  Non EU: Iran, Azerbaijan, Russia, Kazakhstan, Turkmenistan, Georgia, Armenia, Turkey, Uzbekistan.

- **The Mediterranean Sea region:**
  EU: France, Greece, Italy, Slovenia, Spain, Malta, Cyprus;
  Non EU: Turkey, Lebanon, Syria, Israel, Egypt, Jordan, Libya, Tunisia, Algeria, Morocco, Bosnia and Herzegovina, Croatia, Montenegro, Albania, Serbia, Macedonia.

Some countries are overlapping among the groups: Russia and Turkey have borders in three basins, whilst Azerbaijan, Armenia, Georgia and Greece belong to two basins.

Once defined the purpose of the study, it is significant to answer the following two main questions. The first one relates to the theoretical models of financial integration.

The standard economic theory suggests that the liberalization of capital flows, in particular long-term capital flows, and financial development are important policy instruments; as a matter of facts, they provide a favourable support for the integration of neighbouring countries on a regional scale. In this regard, capital flows play a crucial role, in terms of fostering accelerated growth, technical innovation and enterprise restructuring[6]. In recognition of these potential benefits, governments undertook widespread capital account liberalization over the past quarter-century.

In the 1990's, capital account liberalization played an important role in the market reforms introduced by governments in the transition economies[7]. The countries that adopted policies of capital account liberalization attracted a large amount of foreign capital; their financial system developed enhancing more complete, deeper and better-regulated financial markets. Additionally these nations gained credit to foster the transition and the economic growth.

There are two main channels through which financial integration promotes financial development. First, financial integration implies that a new type of capital is available from neighbouring countries. In addition, new and more capital inflows allow these countries to smooth consumption, to deepen financial markets, and to increase the degree of market discipline.

Second, financial integration leads to a better financial infrastructure, which mitigates information asymmetries and, as a consequence, reduces problems such as adverse selection and moral hazard[8]. Financial

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[6] *See* Prasad, Eswar S., Rogoff, K., Wel, S., and Kose, M. Ayhan. 2003. Effects of Financial Globalization on Developing Countries: Some Empirical Evidence, *IMF Occasional Paper No. 220,* Washington: International Monetary Fund (2003). and Edwards, Sebastian. "Thirty years of current account imbalances, current account reversals, and sudden stops". *IMF Staff Papers* (2004): 51 (Special Issue), 1.

[7] Capital account liberalization is considered an important precursor to financial integration. See Kose et al. "Financial Globalization: A Reappraisal". *IMF Staff Papers* (2009): Vol. 56, No. 1, 8.

[8] *See* Schmukler, Sergio L. "Financial Globalization: Gain and Pain for Developing Countries". *Federal Reserve Bank of Atlanta Economic Review, Second Quarter* (2004), and the criticism of Stiglitz, Josef E. "Capital-market Liberalization, Globalization, and the IMF". *Oxford Review of Economic Policy* (2004): Vol. 20, No. 1, 57. See also Massad, Carlos. *Capital Flows in Chile: Changes and Policies in the 1990's in Financial Globalization and the Emerging Economies*, (J. A. Ocampo, S. Zamagni, R. Davis and C. Pietrobelli ed., 2000), 219-233.

integration is a market driven process. According to this aim, the legislative and regulatory framework has been adapted and addressed at lowering legal regulatory impediments and at reducing the transaction costs of the domestic financial markets[9].

The second question is addressed to the empirical measurement of the financial integration. The enquiry requires a quantitative analysis to understand the openness of the capital markets and the evolution of the financial integration among the basins.

The definition of 'financial integration' considers two broad categories of indicators: quantity or volume-based indicators and price-based indicators. The former set is used to investigate the extent to which investors have internationalised their portfolios. In financially integrated markets investors increase their holdings of non-domestic assets in order to benefit from the international diversification.

Price-based indicators measure discrepancies in asset prices on the basis of their geographical origin. In a perfectly integrated market, prices of assets with similar characteristics should be the same or at least largely influenced by common area factors.

In this paper we approach the comparison using volume-based indicators.

## 3. Financial integration in the four basins

### 3.1 The evidence and the practices

The liberalization of capital flows is a general feature in almost all countries of the four basins, even though its degree of openness and its timing has been the subject of specific policy decisions. Most neighbouring countries undertook a series of market reforms and adjusted their monetary policies to enable a higher openness of the capital account over the decade. Only seven countries decided to lift all capital controls according to the *acquis communaitaire* and became full members of the European Union (EU).

The non-EU partners adopted a broad variety of different exchange rate regimes and capital liberalisation policies, even though the integration policies of the EU had the explicit aim of removing legal barriers on capital cross-border transactions[10] and promoting the financial integration in the single currency area.

Only four partner countries opted for pegging the euro with currency board arrangements (Bulgaria, Bosnia) or conventional fixed peg arrangements (Macedonia, Croatia). The large majority of partners opted for a fixed peg agreement anchored to the US dollar (Belarus, Jordan, Kazakhstan, Lebanon, Morocco, Russia, Tunisia, and Turkmenistan) or to the SDR as Libya. Other countries decided to pursue a more flexible approach and introduced a crawling peg system with a composite basket of currencies, such as Iran. Others managed a float system as Turkey, Ukraine, Algeria, Egypt, Moldova and Romania. See the annex for a further detailed analysis of the foreign exchange regimes.

The capital account liberalisation policies have been also mixed: the Baltic States proceeded towards the accession to the EU, whilst the Caspian and Mediterranean countries lagged behind.

This paper adopts the annual data published by the IMF's Annual Reports on Exchange Rate Arrangements and Exchange Restrictions (AREAER)[11] in order to obtain a comparable measure of capital account restrictions for the 17 EU members and 29 non-EU countries. The AREAER data are suggested by the majority of studies on capital account liberalization, due to the several advantages from an institutional point of view, or a de jure measure. They provide a consistent measure of restrictions on capital account transactions as well as foreign exchange arrangements and they are available on an annual basis across a wide range of countries. Their main disadvantage is that such 'rule based' data generates a simple 'on-off' indicator, which indicates neither the relative degree of capital restrictions, capital mobility nor the degree of legal restrictions enforced.

However, the recent empirical research tried to overcome these shortcomings. For example, Chinn and Ito[12] proposed a composite index (KAOPEN) that incorporates information either about restrictions on capital account transactions or on current account transactions and exchange rate arrangements. The index highlights positive values when the level of restrictions is low, whilst negative values are displayed when the countries have a higher intensity of capital controls.

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[9] Nevertheless, evidence in Europe has demonstrated that in a context of perfect financial integration, frictions are likely to persist. See European Central Bank, *Financial Integration in Europe*. (European Central Bank, April 2009), 12.

[10] The EU Banking Directives (1977, 1988), the Financial Services Action Plan (1999), the White Paper (2005).

[11] Among others, de-jure measures based on information on the AREAER have been developed by Quinn 1997, Johnston and Tamirisa 1998, Miniane 2004, Chinn And Ito 2002, 2008.

[12] Chinn, D. Menzie *et al*., *Capital Account Liberalization, Institutions and Financial Development: Cross Country Evidence*. (NBER Working Paper No. 8967, 2002)

Figure 1 shows the performances of the countries which adopted the Euro or pegged their currencies to Euro during the period of observation that lasted from year 2000 to year 2007. The diagram illustrates that these nations had the best growth of financial integration (KAOPEN index higher than 1,50) if compared to those that opted for other policies. Instead those countries that pegged their currencies to US dollar or SDR or other composite baskets (in particular the Black Sea and the Caspian Sea regions) had a lowest growth of financial integration, with negative KAOPEN indices. Not surprisingly, countries with pegged their rates to the EU had considerably higher financial integration, confirming the conventional discipline. When the national rules converge to EU norms, regional financial integration improves substantially with greater participation of domestic banks and private investors.

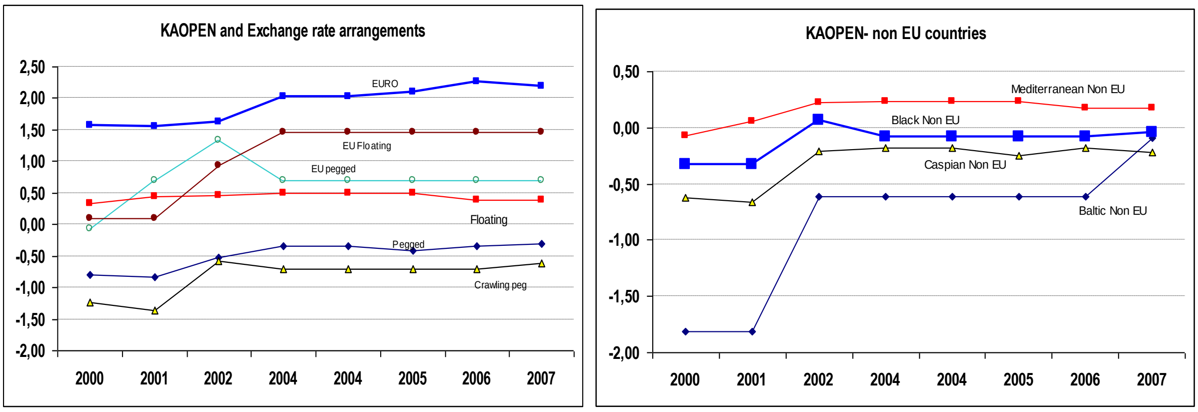


**Figure 1**. Capital Account Openness (KAOPEN) and Foreign Exchange Regime

These are, of course, simple observations. However, it is possible to suggest how much financial integration was due to the introduction of euro (the highest level) or the pegging to euro. In particular the Baltic Sea region shows the best experience, not only for the large concentration of EU members, but also for the 'Russian factor', which has been supported by the institutional liberalization of the capital accounts in the most recent years and the consequent convergence, as shown in the right side of Figure 1. Also in the Mediterranean countries, as capital controls have been progressively eased in recent years, the financial integration has increased significantly with positive values of the index[13].

The history of the European Union and of some individual countries has recognized the importance of financial cooperation, which has been institutionalized in three regions: the EIB, FEMIP for the Mediterranean (the oldest and the largest), the Nordic Investment Bank (with the extension to the three accession countries in 2005), the Black Sea Trade and Development Bank (the smallest). Only the Caspian Region has not yet received due attention. The level of regional cooperation has increased over time, adding new projects on the portfolio and increasing the resources to the planned needs.

However, the financial resources are limited and the total asset exposure is only a small fraction of the entire capital flows in the regions. Consequently, over time the resources have been properly addressed on selected projects of mutual interest, from energy, to transport, to environment, to SMEs. Additional factors have contributed to the increasing flows of funds to the bordering regions: in particular the capital liberalization combined with the market deregulation. As a result, the savings of the EU economies had the possibility to finance investments in the neighbouring partners, to differentiate the risk and attain a more efficient allocation of capital. However, capital outflows have also less desirable side-effects. In a context of incomplete structural reforms, as in the Mediterranean and Caspian Sea regions, the international capital flows carry considerable risks which could magnify the underlying macroeconomic and structural weaknesses.

To sum up, the empirical evidence shows that capital flows are influenced by many factors, some of them belong to a general scale, whilst others involves only specific countries. A few examples of factors that affect the capital flow are: the liberalisation of international capital transactions; regulatory reforms of capital markets;

[13] Müller-Jentsch, Daniel, *Deeper Integration and Trade in Services in the Euro-Mediterranean Region: Southern Dimensions of the European Neighbourhood Policy.* (Washington, D.C., World Bank and European Commission, 2004); Lagoarde-Segot, *et al.* "The Capital Markets of the Middle East and North African Region. Situation and Characteristics", *Emerging Markets Finance & Trade* (September–October 2008): Vol. 44, No. 5, 68.

improvements in the macroeconomic performance of countries; rapid progress in communication technologies, and privatisation and structural economic policies.

### 3.2 The domestic perspective

The financial market integration plays a special role in neighbouring emerging or transition countries. It is widely known that the financial market is one of the most important elements of the transition, as it is the central institution for transforming savings into investments and thus generating long-term economic growth.

Previous studies have shown that the financial integration can be analysed from two different perspectives.

The first one, the domestic perspective, financial markets in neighbouring countries still remain underdeveloped and rudimentary; an example of this trend is clearly shown in Table 1.

**Table 1**. Domestic financial integration

| | GNI per capita PPP | | Market capitalisation of listed companies (% of GDP) | | | Domestic credit to private sector (% of GDP) | |
|---|---|---|---|---|---|---|---|
| | 2000 | 2009 | 2000 | 2007 | 2008 | 2000 | 2008 |
| EU Baltic | 16.790 | 27.051 | 72,6 | 69,0 | 27,0 | 55,6 | 105,2 |
| Non EU Baltic | 5.615 | 13.790 | 7,5 | 58,0 | 39,4 | 11,1 | 34,9 |
| EU Black Sea | 9.357 | 17.683 | 32,0 | 55,5 | 17,7 | 22,2 | 68,8 |
| Non EU Black Sea | 3.510 | 8.337 | 11,2 | 36,2 | 16,0 | 11,4 | 35,9 |
| EU Caspian Sea | 0 | 0 | 0,0 | 0,0 | 0,0 | 0,0 | 0,0 |
| Non EU Caspian Sea | 3.758 | 8.582 | 6,3 | 25,6 | 13,6 | 10,9 | 21,2 |
| EU Mediterranean Sea | 19.297 | 27.990 | 66,6 | 91,7 | 30,4 | 94,3 | 138,5 |
| Non EU Mediterranean Sea | 5.524 | 11.144 | 12,3 | 53,9 | 27,7 | 35,9 | 48,9 |
| Euro Area | 23.275 | 33.193 | 86,9 | 85,0 | 37,9 | 97,9 | 126,4 |

The Baltic Sea basin has the highest average level of GNI per capita compared with the other regions, followed by the Mediterranean Sea basin. The difference between EU and Non EU member states, measured by the standard deviation, is also lower in the Baltic Sea basin then in the Mediterranean, with the highest differences in the Black Sea basin. The ranking remains essentially the same if we look at the two other indicators of financial development: the Market capitalisation of the listed companies and the Share of lending to private sector.

The indicators show two different aspects of the financial divide between EU and non-EU members, and between regions. Where the process of financial liberalization is more advanced, as for the stock exchange, the gap is much smaller. But where national restrictions prevail on the harmonization to international rules, as in the commercial banking system, the gap is much wider and more resistant over the decade.

The share of private claims on GDP can help to access the degree of financial liberalization and financial deepening. Table 1 indicates that the gap in financial deepening has been reduced during the decade, but it still remains considerably high, one third in average of the euro area. Moreover, the differences among the countries or region are also very important: a low 20-35% in the Caspian and Baltic region, with the predominant presence of Russia, compared to a 50% in the Mediterranean region which has a relatively well developed commercial banking system.

Instead, for the market capitalisation index, the differences disappeared during the decade as a result of the improvements of the corporate governance of the listed companies and the government policies. Financial activities have been boosted by increased listings of companies, mostly made possible through privatization of state-owned enterprises. In addition, the growth of their economies has been higher than the EU, and the attractiveness of these new stock markets has grown considerably in size and volume. For example, the Egyptian equity market is one of the most developed in the Mediterranean region with 306 listed companies in 2009 (down from 1148 in 2002).

The data is very respectable compared to the listed companies in the Stock exchanges of Turkey and Russia, which performed 315 and 333 respectively. The cumulative result is that the average capitalisation index in the four regions increased to 50-60% in 2007 from 10-15% in the Nineties, compared to the high 80% of the Eurozone. Therefore, considering the good performance of their markets, some of these countries have been included in the MSCI composite index[14]. According to the classification of markets and the accessibility measures that reflect the international investors' experience and excluding the Eurozone countries, twelve countries are defined as frontier markets[15]; other four as emerging countries, and one, Israel, as developed market.

In a context of large differences in volume and in scale, the international financial integration has provided additional resource to supplement domestic savings and has increased the competition in domestic financial systems. On the way to adapt their rules and regulations to the new environment, all countries had to face several pressing problems and resistances that may concern the economy in general and the development of a national financial intermediation system.

Some of these problems have an institutional nature, as the low profitability of the economy and its industries, the lack of a common corporate and economic culture or the inadequate protection of the minority shareholder rights during the privatisation phase. And on more than one occasion, the monopolisation of some sectors of the economy had a significant and negative influence in the financial markets.

### 3.3 The international perspective

The second outlook is called the international perspective. According to the international perspective the main contribution of integration is the source of financing, with the traditional tripartition of international capital flows: (1) Foreign direct investment (FDI) which are flows between firms and their foreign subsidiaries or foreign partners and may be the result of earnings of the same foreign subsidiary that are retained abroad; (2) Portfolio investments, which are private transaction in equity securities and debt securities between banks and financial intermediaries; (3) Debt instruments, which are financial flows between financial intermediaries and firms and governments which supports trade and investment activities.

All indicators of cross-border transactions from the IMF of the BIS suggest an ever increasing interdependence within the countries of the four basins and the EU.

For the analysis we use the database of Lane and Milesi-Ferretti (2000-2007)[16] last updated on 2008. According to the authors' methodology, international financial transactions are divided into broad categories: portfolio equity investment, FDI, foreign exchange reserves, and debt. The debt category includes portfolio debt securities and other instruments, such as loans, deposits, and trade credits.

The following analysis took in consideration stocks, which is typical for such kind of structural analysis, instead of flows. The net external position, given by the difference between total external assets and total external liabilities, measures the net creditor or debtor position of the four regions vis-à-vis the rest of the world. Therefore, the net external position is similar to the IMF definition of 'Net International Investment Position', which is the measure of the cross-border financial net flows (over time) plus the changes in the value of the holdings of these

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[14] MSCI, *MSCI Global Market Accessibility Review*, June 2010.

[15] Frontier markets: Estonia, Lithuania; Kazakhstan; Romania, Bulgaria, Ukraine; Croatia, Lebanon, Jordan; Serbia, Slovenia, Tunisia. Emerging markets: Russia, Turkey, Egypt, Morocco; Developed markets: Israel and the Eurozone countries.

[16]The database *"External Wealth of Nations" Dataset, 1970-2007* is available on line at http://www.philiplane.org/EWN.html.

assets. We used the Lane Milesi-Ferretti database because the IIP statistics diffused by the IMF do not yet cover all neighbouring countries of the four basins.

From the elaboration of data we can derive a number of broad trends or stylized facts.

### 3.4 Two big trends

The pattern of international financial integration has changed significantly over the decade. It seems that the direction of capital flows is no longer a one-way, top-down element of the European pyramid of external relations. There are some partner countries with the highest level of assets close to the highest liabilities' level, resulting in almost flat net position. On the other side, there are other partner countries with increasing unbalances, positive or negative. The traditional characterization of capital-rich and capital-poor no longer follows the EU's external borders, so as to emphasize the traditional separation between the North and the South that has governed the debate during the Seventies.

Today the role of financial intermediation will hold for both: not only supplementing the domestic savings as proposed by the traditional European institutional literature, but mobilizing the accumulated financial resources in some countries or 'swapping' assets and liabilities in order to diversify the risk.

In presenting the data, we divide countries into four basins. In addition in order to identify the EU members within each group, we subdivide the Four Seas groups in EU e non EU. The separation is necessary in order to remark the different institutional character of the country and its association with the foreign exchange regime.

The indicators follow the definition proposed by Lane and Milesi-Ferretti (2003)[17] for measuring the International Financial Integration as a stock to GDP ratio:

Eq. (1) IFI = (FA + FL) / GDP

where FA (FL) denotes the stock of external assets (liabilities). This ratio is a volume-based measure of international financial integration.

The indicator can also be expressed as a difference between gross foreign assets and foreign, as defined by the net external position, and GDP.

Eq.(2) NEP = (FA - FL) / GDP

Figure 2 plots the IFI ratio, as a weighted average, for each of the four groups of countries over the period 2000-2008. Since most of the adjustment of the liberalization of the capital accounts were implemented rather quickly in the Nineties, the share of capital flows has finally stabilized at a ratio between 1,0 and 1,5, while continuing to increase in the euro area.

For the non-EU economies, we notice a deceleration of the financial integration that stops in 2004 with a resumption of bilateral flows that led these countries to overcome the initial levels of integration. The financial crisis of 2008 has dissolved the progress achieved in a decade. The development is however not comparable to the strength and the speed of financial integration within the European Union, with a ratio three time higher than the GDP.

This is, of course, consistent with the theory of financial harmonisation pursued by the European Union since the end of the seventies: no doubts that the international financial integration has increased markedly, particularly among the EU economies. While the trend towards increased international asset trade has been visible since the early 1970s, it has accelerated in the mid-1990s with the implementation of the three stages of the EMU (Economic Monetary Union). Total assets of the Euro Area increased from 6.590 billion USD to 19.239 billions in 2008. The IFI ratio increased from 210 to 300% of GDP. In the EU, the increase in cross-border asset holdings has been strong for both debt and equity instruments (the latter including FDI and portfolio equity) and in other debt instruments.

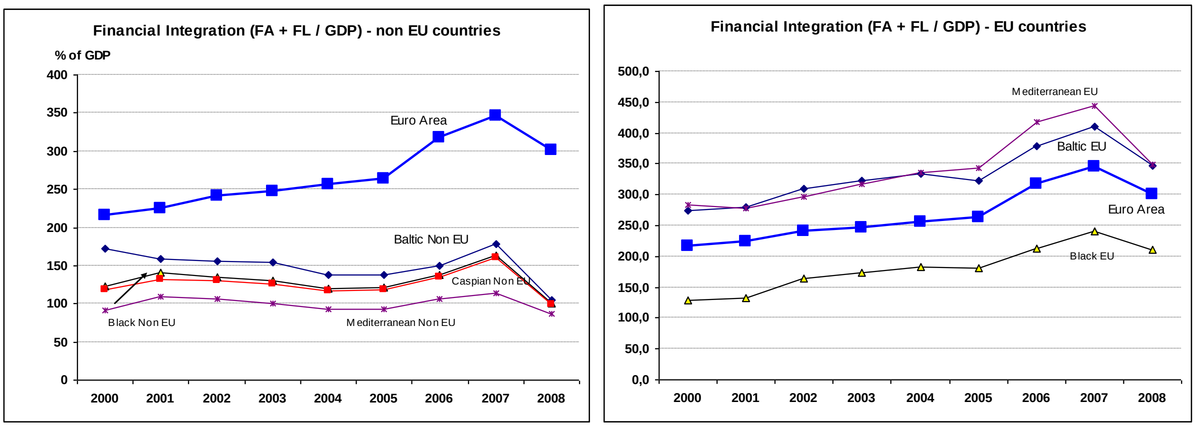
The situation is completely different in the non-EU countries. We observe a general increase in cross-border equity holdings, particularly FDI, but the overall stock of debt instruments on GDP (debt assets and debt liabilities) has decreased over the decade. The pattern appears similar for the four basins, even though we notice

[17] Lane, Philip R., and Milesi-Ferretti Gian Maria, "The External Wealth of Nations: Measures of Foreign Assets and Liabilities for Industrial and Developing Countries". *Journal of International Economics* (2001): Vol. 55, 263.

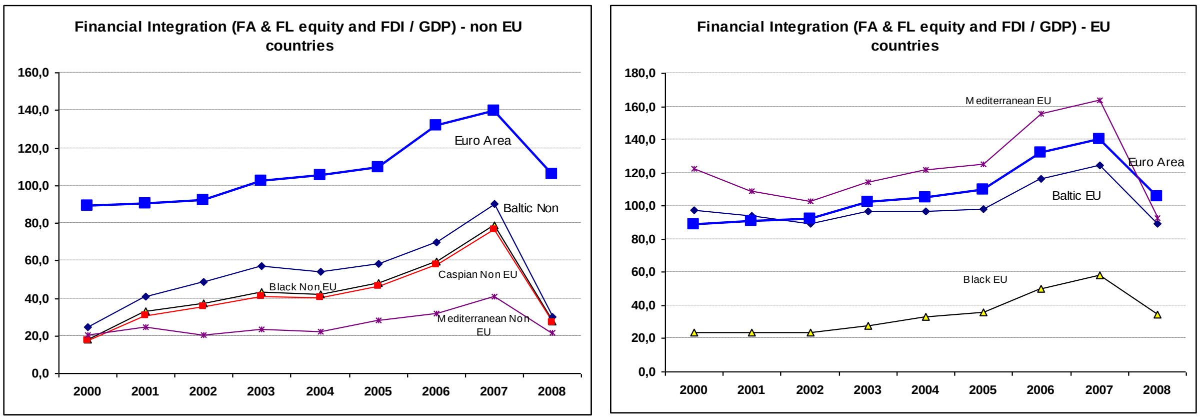
Lane, Philip R., and Milesi-Ferretti Gian Maria, "International Financial Integration". *IMF Staff Papers, Washington: International Monetary Fund* (2003): Vol. 50, Special Issue, 82.

important differences in term of intensity. The non EU Baltic economies have the highest IFI index for FDI and Portfolio equity instruments, 90% of GDP in 2007, while the lowest 50% is reported by non EU Mediterranean countries. Furthermore, all four Neighbouring regions show a common trend towards a smaller share of debt instruments, which is also converging to 50% of GDP.

**a.** Gross capital flows




**b.** Gross Portfolio Equity and Foreign Direct Investment




**c.** Gross Other Investment (Portfolio Securities Debt and Other Investment)

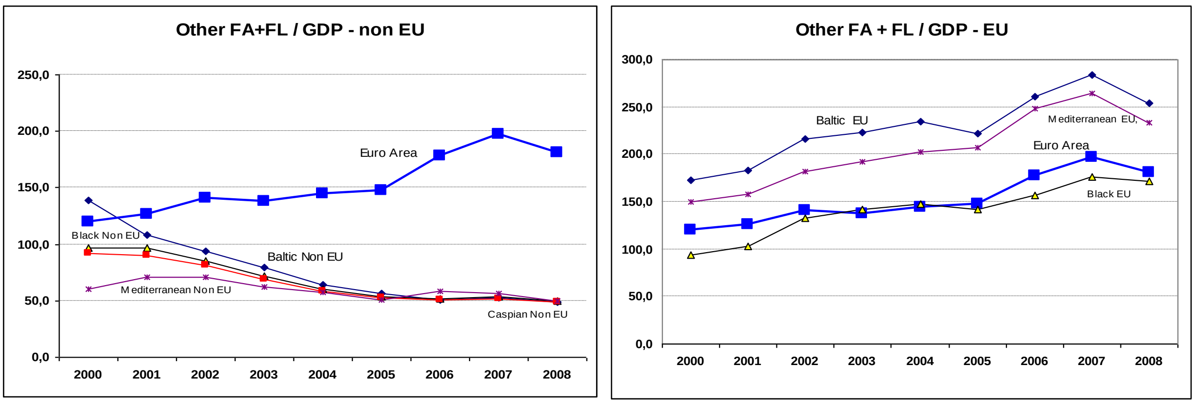



**Figure 2.** International Integration Index (Gross position)

Clearly, factors such as the increase in trade linkages, the reduction in capital controls, the foreign exchange regime, advances in telecommunications, and the increased availability of information are important in driving the acceleration of international financial integration in the four regions, but the trends (in particular those referring to other investments) underscore the deep difference that separates the European economy and that of neighbouring countries.

However, the structure and the quality of capital stocks has improved, in the sense that FDI has become the most dynamic source of net capital flows in all regions. The 'Russian factor' is relevant here. In fact, the non-EU Baltic countries double their advantage on the Mediterranean region, while considering the relative size to GDP, and they are also more integrated than the EU Black Sea countries. During the decade FDI seems the most desirable type of flows, in that it tends to be more long-term and less easily reversible, as well as often incorporating new technology and other know-how. Additionally we can notice that the announcement of the ENP project in 2004 has contributed positively in accelerating the FDI inflows in all regions.

Moreover, there is another fundamental trend concerning the convergence effect of a deeper integration. The EU imbalances, displayed in Figure 3 as Net External Position (NEP), have increased during the decade after the accession of the Eastern and Nordic countries, while for the non EU partners the convergence was the main effect of the European integration project until the disruption caused by the financial crisis in 2008. The Euro Area consolidated its position of net exporter of capital, with a net negative position near to 20% of GDP. Non EU Mediterranean decreased their net debt position from 35% to 19% of GDP, while the non EU Baltic region (Russia, for clarity) shifted from a net positive position to a negative one since 2004.

These trends confirm that the evolution of the neighbouring countries may be different from the other emerging market economies, which on the contrary, suffered the contraction of external capital flows during the same period. In this perspective the favourable expectations of the international lenders to the Baltic region, and Russia in particular, differ from the relative contraction of external financing (in particular bank loans) affecting the Southern Mediterranean region. These convergence patterns were interrupted by the financial crisis of the summer 2008. In fact, the net creditor position in 2008 in the three regions (Baltic, Caspian and Black sea) is essentially due to the contraction of portfolio liabilities of Russia.

Instead, for the EU economies the imbalances increased, with a positive net position for the Baltic region (net position of Germany) and a deterioration of the Black Sea region (Greece) and Mediterranean Region (Spain).

Which are the largest creditors and debtors, relative to their GDP levels? Even though richer countries tend to be creditors (Germany, with a net position of 25% of GDP in 2007 from a - 7% in 2001 and France, with a net creditor position of 10% of GDP), the correlation is less evident. Russia has been net creditor before 2004 and becomes net creditor again in 2008. Syria, Iran and Libya are creditor with net foreign credits higher than 30% of GDP (230% for Libya). In the Caspian region the foreign assets accumulated by the governments during the decade of high oil and gas prices now exceed the total foreign debt and inward FDI in countries like Azerbaijan, Turkmenistan and Uzbekistan, with an average net external position higher than 30%. Iran too, has a net positive position.

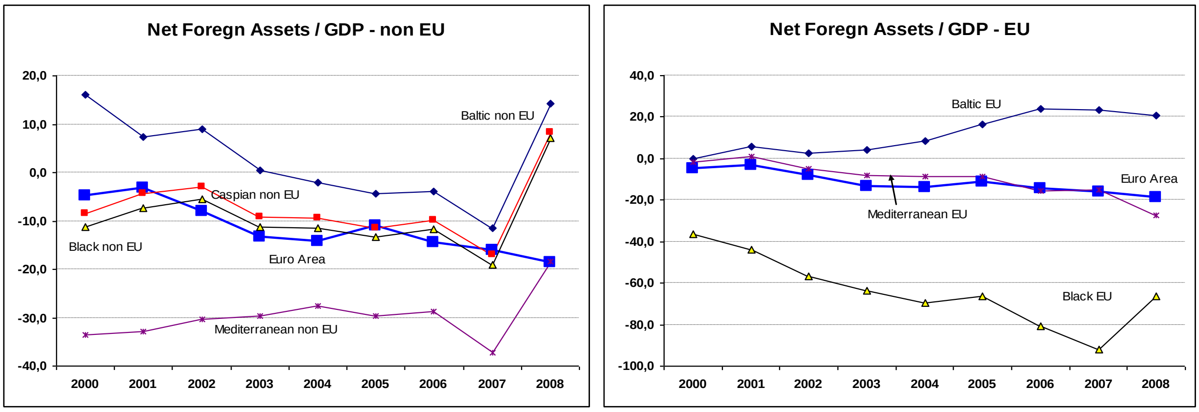
Several neighbouring countries have successfully build up foreign assets and funds that help mitigate the impact of the economic setback in the industrial countries, even though the longer-term goal of economic diversification remain elusive. This is partly because the countries in the Mediterranean and Caspian basin depend on wealth from natural resources. Furthermore, they lack of the sound institutional framework that would support the creation of a more diversified and sustainable economy.

France became net debtor in 2008, with a remarkable contraction of the value of FDI. The EU largest net debtors are Spain, with a NEP index higher than 80% (from a 24% in 2000), Greece (more than 100%), while Italy remains more or less stable at 21% of its GDP. Indeed, in addition to the level of development (measured by the GNI), several other factors—including demography, the size of public debt and FDI flows, and natural resources endowment—influence significantly the net external position of the four basins.

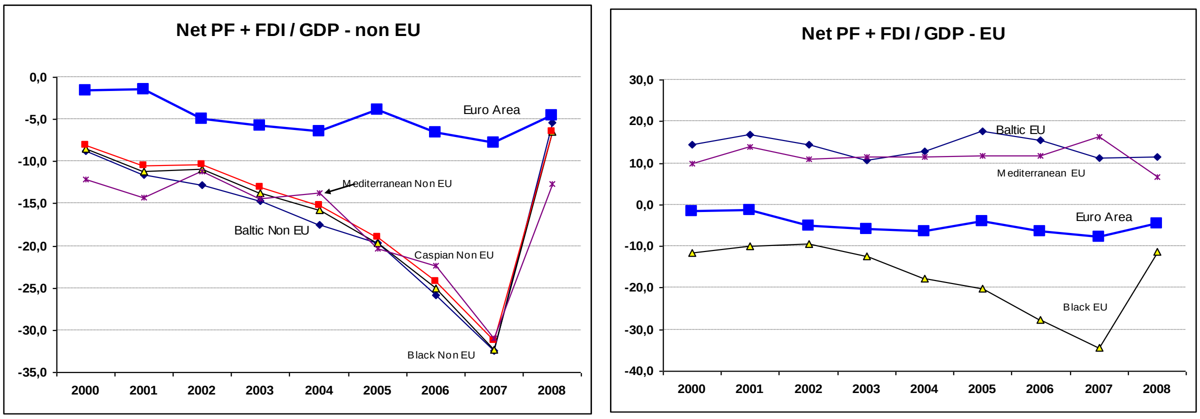
From the perspective of private capital flows the asymmetries between EU and non-EU have increased during the decade, with a negative net external position higher than 35% of GDP in all regions and with only five capital exporting EU countries (Denmark, Germany and Sweden) in the Baltic Sea, Italy and France in the Mediterranean Sea. Among the neighbouring countries only Libya is a net investor (Portfolio Investments). For the non-EU Mediterranean countries and Baltic region, the downward trend in their external position was reversed in 2008, primary because of a deterioration of Russian Federation (contraction of inward FDI) and the stability of the Caspian ad Black sea. For the Baltic the improvement in 2008 is due to the contraction of foreign investments in the same year.

The comparative look for the net debt position (debt assets less debt liabilities, Figure 3 c) shows the common convergence to lower level of external exposure, around 10% of GDP, while in 2000 the non EU Mediterranean countries were exposed by more than 30% of their GDP. Here, the shift from indebtedness to FDI has been made possible by the instruments of the first pillar of the Euro-Mediterranean partnership within the Barcelona Process. Instead, the financial integration within the EU has encouraged a credit boom and over-borrowing which have increased the unbalances in the Black sea basin (Greece in particular and Romania), the Mediterranean (again Greece and Spain), in contrast with the Baltic Sea basin that is near the balance or in net creditor position.

**a.** Gross capital flows




**b.** Gross Portfolio Equity and Foreign Direct Investment




**c.** Gross Other Investment (Portfolio Securities Debt and Other Investment)

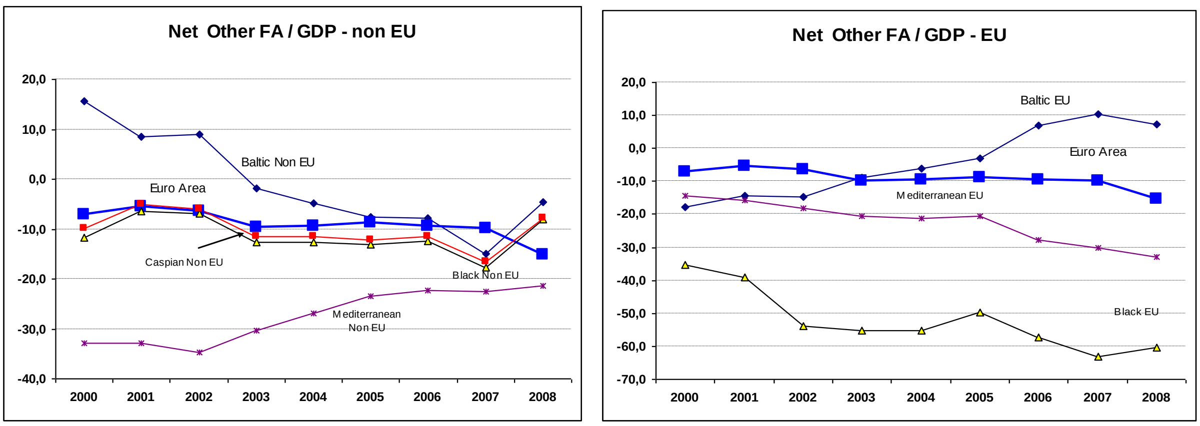



**Figure 3.** Net External Position Index

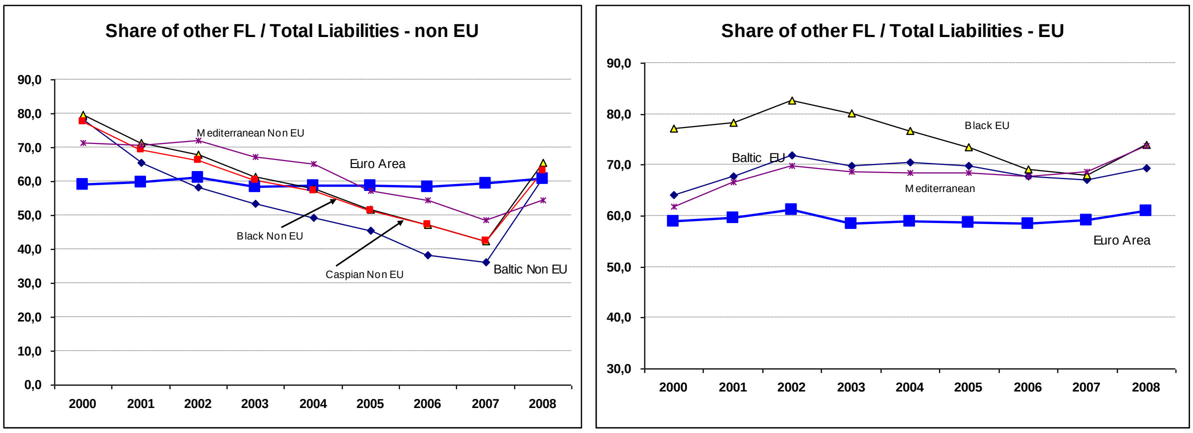
### 3.5 Opportunities and risks for neighbouring countries

The large increase in cross-border equity, direct investment holdings, in the shifting patterns in international borrowing and lending in the non EU partners can be viewed positively, as factors reducing the vulnerability of the neighbouring markets to external shocks. Equity liabilities (including FDI) now account for about 40% of total external liabilities as a whole, compared to 20% of EU countries. Only the non-EU Mediterranean countries, while showing a gradual growth of private capital inflows, remained below 33%, offsetting the difference with a greater share of financial loans.

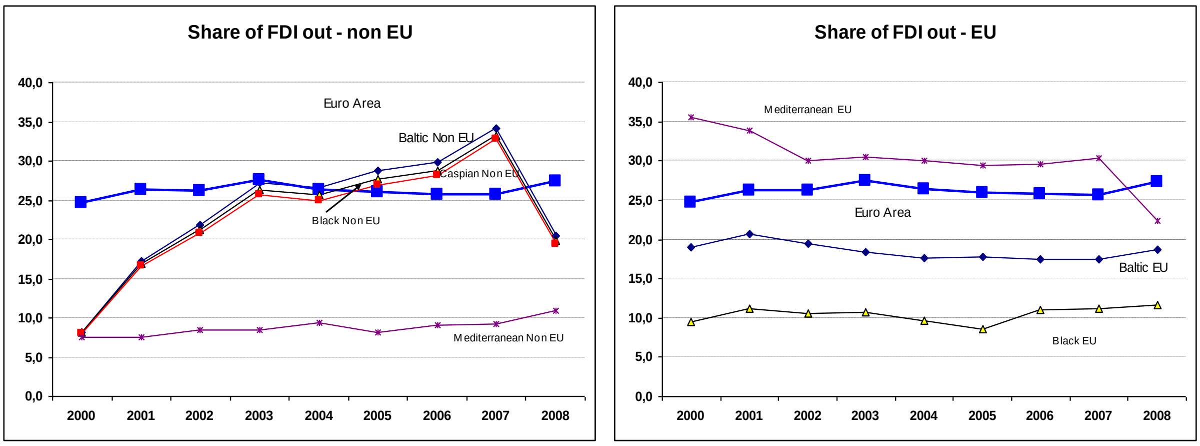
Financial integration also relates to the foreign assets. From this point of view, it appears an important systemic innovation, i.e. the growth of the outward FDI (Figure 4 b), which is enhanced by the removal of legal restrictions and the increased integration of the economies. This aspect concerns in particular two basins: the Baltic and Black Sea, which are interconnected by the foreign investment activities of the Russian firms. The critical aspect in these financial relations is the lack of dynamism of the Mediterranean countries, with a share of direct investment of less than 10% of their foreign assets.

Consequently, all neighbouring economies have dramatically reduced the share of debt to their external liabilities to level well below the EU average, thus clearly reducing the risks of financial crises by linking more closely the return on external liabilities to domestic economic performance. However, as shown in Figure 4, the financial crisis of 2008 reversed the good performance of the previous years.

**a.** Share of Other Foreign Investment over total Foreign liabilities




**b.** Share of outward FDI over total Foreign Assets



**c.** Share of inward FDI over total Foreign Liabilities

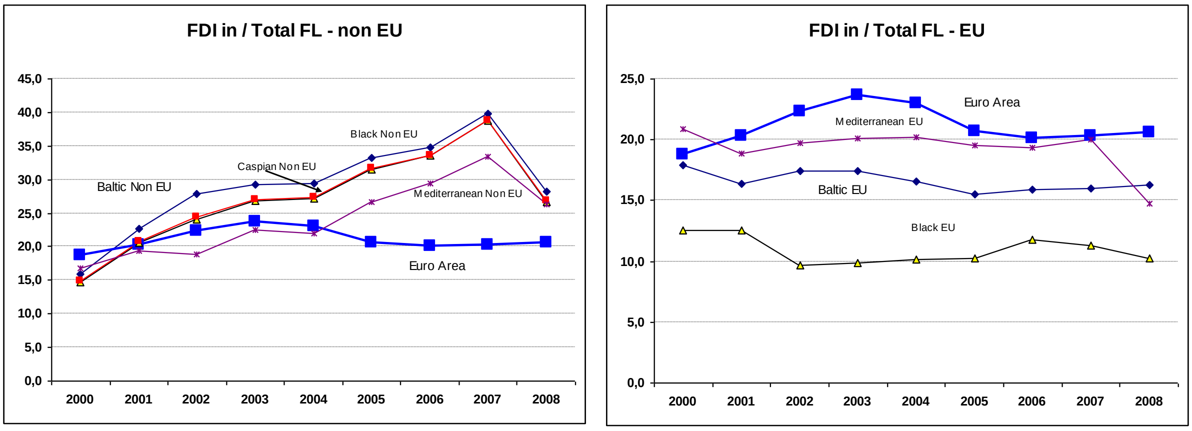



**Figure 4**. Share of FDI and Indebtedness

## 3.6 Stock market capitalisation

In terms of their stock market capitalisation, the Mediterranean and Baltic Sea Regions are in a better position compared with the other two regions. Particularly, Egypt, Jordan, Morocco, Croatia, in the Mediterranean basin and Russian Federation in the North show a clear upward trend between 2003 and 2007 (Figure 5).

Nevertheless, the stock market capitalisation still remains considerably below the relevant values of developed economies in Tunisia, Algeria, Turkey, Syria, Belarus and in the Caspian basin. Because the stock market is of relevance in financing enterprises, further efforts especially to attract foreign investors can be very important.

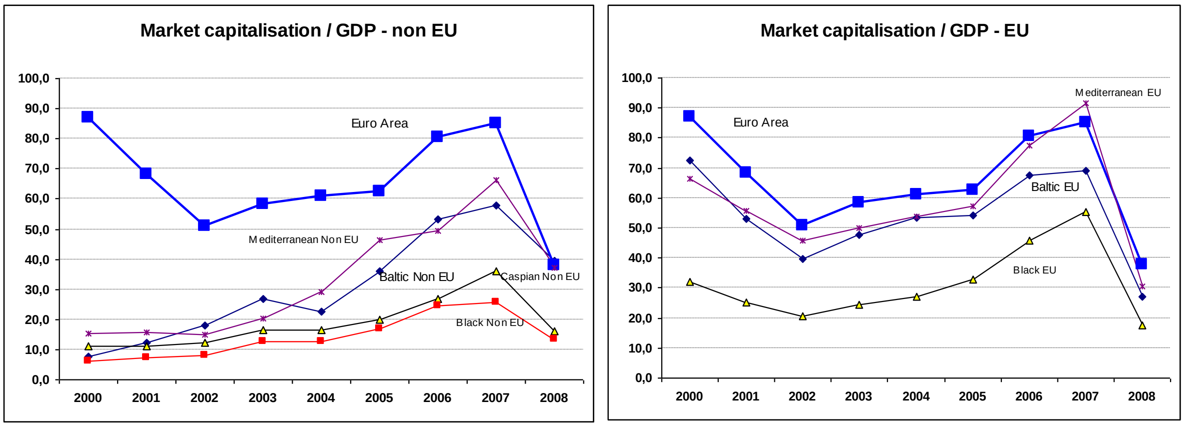



**Figure 5**. Stock Market Capitalisation in the 4 Seas 2000-2008, in percentage of GDP

## 3.7 Reserves

To conclude, this paper deepens the topic of International reserves, which are the liquid external assets under the control of the central bank. In this case we notice a great asymmetry between the EU and the non EU regions. Not only the reserves-GDP ratios are ten time larger in non EU countries but the ratios increased substantially during the decade, 30% of GDP in the Mediterranean basis and 35% in the Baltic region (Russia in particular).

In a period of greater flexibility of the exchange rates, it is debatable this huge accumulation of reserves in line with the predictions of the buffer stock models, such as the adjustment costs, the volatility of foreign trade, the exposure to volatile short-term inflows of capital[18].

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15 Calvo, Guillermo. *Capital flows and capital-market crises: the simple economics of sudden stops*. (Journal of Applied Economics, 1998) 1: 35–54.

The 'social cost' of these reserve was estimated by Rodrik (2006)[19] through the spread between the private sector's cost of short-term borrowing abroad and the yield that the Central Bank earns on its liquid foreign assets. The estimated spread is between 3 to 7 percent, undoubtedly very high especially for capital scarce economies. Therefore, it can be suggested that the central bank either curtail the size of reserves accumulation or invest the excess reserves for more profitable returns in term of employment (Mediterranean basin) and growth (Baltic basin).

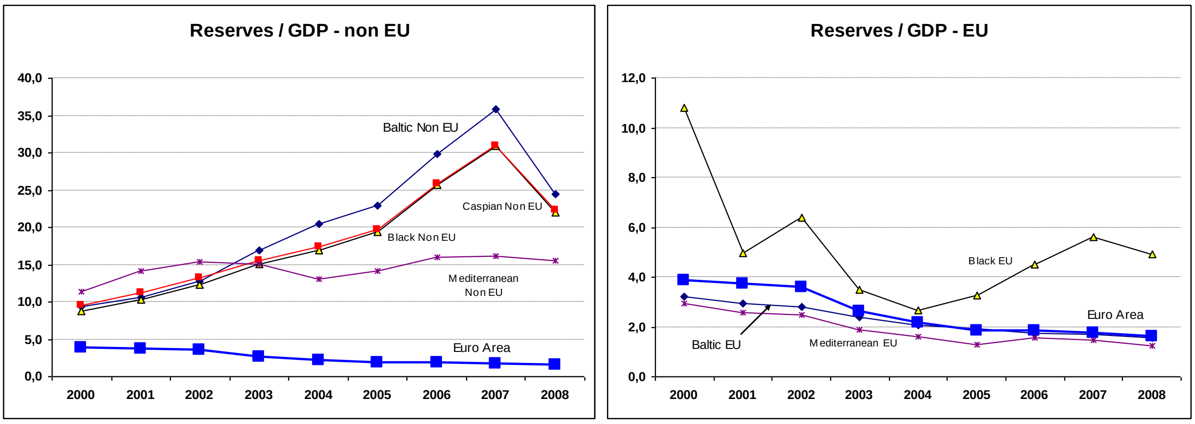


**Figure 6.** Stock of International Reserves in the 4 Seas 2000-2008, in percentage of GDP

## 4. Conclusions

The experience of the South Mediterranean countries suggest that, despite the improvements in the FDI inflows and in deeper financial integration to some countries (Morocco, Tunisia, Egypt, Jordan), its sectorial destination does not always correspond to the real needs of the recipient economies. Excluding privatizations and investments in oil and gas concessions, foreign promoters invested only 1% of GPD. These results are disappointing when confronted with the 'ritual' declarations to stimulate local production capacity and to create additional employment and revenue.

Therefore the essential policy issue is not simply to deepen the financial integration of the neighbouring countries into the global market. Rather, it refers to other specific objectives that can be achieved by competitive and dynamic sectors or industries. In this regard, financial integration becomes the instrument, as well as the incentive, to diversify the composition of export. Moreover it improves the performance along the competitive advantages, which are more likely to benefit from investment and innovation.

Despite the weaknesses of the domestic financial markets, foreign investors could increase the chances of domestic enterprises to realize trade and investment opportunities through partnership, networking and exchange of information on best practices.

To understand the factors behind the financial integration and the necessary policy measures, we need to look at the role represented by the institutions in setting the legal environment and the regulations which promote the financial market development. The increased information costs, which reduce the overall levels of business investment, are an effect of the weak performances of the financial institutions. The benefits, as well as the incentives, from the integration cannot be limited to the markets for goods and services, which are the main goals of all FTA project.

Financial cooperation, rather than financial integration, is still seen as a tool for targeted assistance to partner countries. The financial resources that are allocated by the EU in supporting the financial Institutions are still marginal compared to the overall external financial flows towards the partner countries. In three basins the financial cooperation is assisted and promoted by regional Financial Institutions supported by EU member states: FEMIP in the Mediterranean, the IEB, the Black Sea Trade and Development Bank, the Nordic Investment Bank. It is obvious that the institutionalization of financial cooperation is in itself an incentive, but at the same time is not the only condition for the success of economic integration with the neighbouring countries.

Financial integration needs the presence of foreign banks which are expected to strengthen the economic relationships among the EU and the partner countries or among the partner countries. Financial integration needs

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[19] Rodrik, Dani, "The social cost of foreign exchange reserves, International Economic Journal". *Korean International Economic Association* (2006): 20(3), 253.

also a more open attitude from the central authorities, which include also the reconsideration of the exchange rate regime, since recent experience shows that countries that anchored their currencies to the Euro at the end they obtain better results in term of growth and stability.

# ANNEX
# FOREIGN EXCHANGE REGIMES IN THE FOUR SEA BASINS

## THE BALTIC SEA REGION

**EU**: Estonia, Latvia, Lithuania, Denmark, Finland, Sweden, Germany, Poland;
**NON EU**: Russia, Belarus.

**Estonia** joined the IMF on the 26th of May 1992 and it was included in the ERM II on the 28th of June 2004 pegging its kroon to the euro tightly to the central rate. The euro will replace the kroon on the 1st of January 2011.

**Lithuania** joined the IMF on the 29th of April 1992 and it was included in the ERM II on the 28th of June 2004. Currently the litas is pegged to the euro at the rate of 3.4528 to 1. Euro was expected to replace the litas by January 1, 2010, but due to the current rate of inflation and the economic crisis, this date will be delayed for another three years until 1 January 2013.

**Latvia** joined the IMF on the 19th of May 1992 and it was included in ERM II on the 2nd of May 2005. The lats are so pegged to euro and they float within 1% of the central rate, Ls 0.702804 = €1. Latvia had originally planned to adopt the euro as its official currency on 1 January 2008. It is now expected that Latvia will introduce the euro in 2012 at the earliest, although the head of the National Bank of Latvia has suggested that 2013 may be a more realistic date.

**Denmark** joined the IMF on the 30th March 1946 and it has been included in ERM since 13 March 1979. Denmark negotiated special 'opt-outs' of the Maastricht Treaty that allowed the country to preserve the krone while most other members of the European Union adopted the euro in 1999. The krone is now pegged to the euro via the ERM II and the Denmark Nationalbank keeps the exchange rate within a range of ± 2.25% against the central rate of EUR 1 = DKK 7.460 38, a narrower one of that provided by the ERM II of ±15%.

**Finland** joined the IMF on the 14th of January 1948, the European Union in 1995 and the Eurozone in 1999. The Finnish Markka was replaced by the euro in 2002. The euro has a floating exchange rate. However, since central banks frequently intervene to avoid excessive appreciation or depreciation, this regime can be also called managed or dirty float.

**Sweden** joined the IMF on the 31st of August 1951. The exchange rate of the Swedish krona against other currencies has historically been dependent on the monetary policy pursued by Sweden at the time. Since November 1992 a managed float regime has been upheld. By simply choosing to stay outside the ERM II, the Swedish government is provided a formal loophole avoiding the theoretical requirement of adopting the euro.

**Germany** joined the IMF on the 14th of August 1952. It adopted the euro in 1999.

**Poland** joined the IMF on the 12th of June 1986 and it became a full member of European Union on the 1st of May 2004, which means that Poland is obliged to introduce the euro, which will replace its current currency, the zloty, though not at any specific date and only after Poland would be able to meet the necessary stability Maastricht criteria. Poland at the moment is not able to join the ERM II and it still uses a floating regime even if more flexible.

**Russia** joined the IMF on the 1st June 1992. It adopted a floating exchange rate with no predetermined path: ruble has no explicitly stated nominal anchor; Russian monetary policy is conducted monitoring various indicators.

**Belarus** joined the IMF on 10th of July 1992. In 2008 Belarus claimed it would have abandoned pegging the Belarusian ruble to the Russian ruble saying goodbye to currency integration after renewed tension with Russia caused by another pricing dispute over Russia's gas supplies to Belarus.
The National Bank of Belarus decided to maintain the Belarusian ruble's stable exchange rate against the U.S. dollar as the sole monetary policy benchmark.

## THE BLACK SEA REGION

**EU**: Bulgaria, Greece, Romania;
**NON EU**: Turkey, Georgia, Russia, Ukraine, Moldova, Armenia, Azerbaijan.

**Bulgaria** joined the IMF on the 25th of September 1990. It signed the EU accession treaty on the 25th of April 2005. Bulgaria meets three and fails on two criteria in order to join the eurozone. It derogates on the price stability criterion, which envisages that its inflation does not exceed that of the three EU member states with the lowest inflation (Malta, the Netherlands and Denmark) by 1.5%. Bulgaria's inflation in the 12 months to March 2008 reached 9.4%, well above the reference value of 3.2%, the report said. Bulgaria has not yet joined ERM II. As the current lev was fixed to the Deutsche Mark in par, the lev's peg effectively switched to the euro, at the rate of 1.95583 leva = 1 euro, which is the Deutsche Mark's fixed exchange rate to euro.

**Greece** joined the IMF on the 27th of December 1945. It acceded the European Union on the 1st January 1981, the ERM II in 1999 and it adopted the euro in 2002.

**Romania** joined the IMF on the 15th of December 1972. It acceded the European Union on the 1st of January 2007. Currently, the leu is not yet part of ERM II but plans to join in 2010-2012. The Romanian monetary authority are now managing a floating exchange rate regime influencing the movements of the exchange rate through active intervention in the foreign exchange market in order to create the condition to meet the ERM II as soon as possible.

**Turkey** joined the IMF on the 11th March 1947. As it has been negotiating EU membership since 2005, it adopted a loosely floating exchange rate regime for its lira managed with the support of EU and it introduced inflation targeting.

**Georgia** joined the IMF on the 5th May 1992. The country has been IMF supported since after the August military conflict with Russia in 2008. The IMF programme determined the immediate monetary tasks as securing sufficient banking-sector liquidity, exchange-rate stability and adequate level of foreign-currency reserves. The Fund now states that the monetary authorities remain committed to implementing a flexible exchange rate regime for the lari, as advocated by the IMF as a longer term strategy. This reduces the need to intervene in the foreign currency markets, even if moderate intervention to stabilise the exchange rate can be defended.

**Ukraine** joined the IMF on the 3rd September 1992. Hryvnya has been the national currency of Ukraine since 1996. Initially, the foreign exchange rate was UAH 1.76 =

USD 1.00. Following the Asian financial crisis in 1998 the currency devaluated to UAH 5.6 = USD 1.00 in February 2000. Later, the exchange rate remained relatively stable at around 5.4 hryvnias for 1 US dollar and was fixed to 5.05 hryvnias for 1 US dollar from 21 April 2005 until 21 May 2008. In mid-October 2008 rapid devaluation began with the hryvnia dropping 38.4 % from UAH 4.85 for USD 1 on 23 September 2008 to UAH 7.88 for USD 1 on 19 December 2008.

**Moldova** joined the IMF on the 12th of August 1992. Moldova currently aspires to join the EU and has implemented the first three-year Action Plan within the framework of the European Neighbourhood Policy (ENP). The Moldovan leu was established on 29 November 1993, following the collapse of the Soviet Union and the creation of the independent republic. The National Bank of Moldova (NBM) maintains a floating exchange rate regime of the Moldovan leu. The rate is calculated by the NBM as the arithmetical mean of the weighted average of buying and selling exchange rates of deals contracted on the Moldovan foreign exchange market between 12:30 of the previous day and 12:30 of the reporting day.

**Armenia** joined the IMF on the 28th May of 1992. The modern dram came into effect on 22 November 1993, at a rate of 200 rubles = 1 dram (1 USD: 14.5 AMD). The dram is not pegged to any other currency and it flows independently on the market.

**Azerbaijan** joined the IMF on the 18th of September 1992. In 2007 the National Bank appreciated the exchange rate against the US dollar along smooth path. Starting March 2008, the authorities fixed the value of the manta vis-à-vis to euro/US dollar composite. The weights of the manat currencies in the composite are regularly changed to increase the weight of the euro. Thus, effective March 2008, the classification of de facto exchange rate arrangements has been changed from a crawling peg to a crawling band arrangement.

## THE CASPIAN SEA REGION

**EU**: none;
**NON EU:** Iran, Azerbaijan, Russia, Kazakhstan, Turkmenistan, Georgia, Armenia, Turkey, Uzbekistan.

**Iran** joined the IMF on the 29th December 1945. Starting November 2007, the rial gradually depreciated against a composite of currencies, including the euro, the US dollar and the yen. Thus, effective January 2008, the classification of the facto exchange rate arrangement has been changed from conventional pegged arrangement to a crawling peg.

**Kazakhstan** joined the IMF on the 15th of July 1992. The tenge has remained within a 2% band as result of official actions. Thus, effective October 2007, the classification of the facto exchange rate arrangement has been changed from managed floating with no predetermined path to a conventional US dollar pegged arrangement.

**Turkmenistan** joined the IMF on the 22nd of September 1992. The redenomination of the manat currency was completed in January 2009 and the central bank remains committed and has intervened regularly on the foreign exchange market to support the new exchange rate and satisfy the increased demand for foreign exchange from commercial banks.

**Uzbekistan** joined the IMF on the 21st of September 1992. Since April 2007, the sum has been depreciating vis-à-vis the US dollar within a 2% crawling band, while the Central Bank of Uzbekistan’s one-sided interventions have resulted in steady reserve accumulation. As a result, the exchange rate arrangement has been reclassified, effective April 2007, from a conventional pegged arrangement to a crawling peg.

## THE MEDITERRANEAN SEA REGION

**EU**: France, Greece, Italy, Slovenia, Spain, Malta, Cyprus;
**NON EU**: Turkey, Lebanon, Syria, Israel, Egypt, Jordan, Libya, Tunisia, Algeria, Morocco, Bosnia and Herzegovina, Croatia, Montenegro, Albania, Serbia, Macedonia.

**France** joined the IMF on the 27th of December 1945. It is a founding member state of the EU and it adopted euro in 2002.

**Italy** joined the IMF on the 27th of March 1947. It is a founding member state of the EU and it adopted euro in 2002.

**Spain** joined the IMF in the 1958. On the 1st of January 1986 Spain joined the European Communities and later in 2002 it adopted the euro.

**Slovenia** joined the IMF on the 14th December 1992. Slovenian tolar was included in ERM II on the 28th June 2004. On 1 January 2007, the tolar was supplanted by the euro.

**Malta** joined the IMF on the 11th of September 1968 and the ERM II on 2nd of May 2005. The euro replaced the Maltese lira as the official currency of Malta on 1 January 2008 at the irrevocable fixed exchange rate of 0.429300 MTL per 1 euro.

**Cyprus** joined the IMF on the 21st of December 1961and the ERM II on the 2nd of May 2005. The Cyprus pound was replaced by the euro as official currency on 1 January 2008 at the irrevocable fixed exchange rate of CYP 0.585274 per EUR 1.00.

**Lebanon** joined the IMF on the 14th of April 1947. The exchange rate peg to US dollar provides a strong nominal anchor and remains the lynchpin of financial stability. Maintenance of the peg is essential in light of the government's high debt and debt service obligations in foreign currency, and the substantial currency mismatches of corporations and households, owing to widespread loan dollarization. Under the IMF's exchange rate arrangement classification system, Lebanon falls under the category 'stabilized arrangement' since its *de facto* peg has not been formally announced. The recent increase in the real exchange rate reflects both a strengthening of the U.S. dollar and sustained domestic inflation.

**Syria** joined the IMF on the 10th of April 1947. Since August 2007 the official rate has been pegged to the SDR (Special Drawing Rights), a reserve currency created by the IMF to reduce the pressure on gold and the U.S. dollar in international transactions, with a wide margin. The currencies pegged to SDR derive their value from a currency basket consisting of the U.S. dollar, the Japanese yen, the British pound, and the euro. Thus, the classification of the de facto exchange rate arrangement has been changed, effective September 2007, from a conventional pegged arrangement to a pegged exchange rate with horizontal bands.

**Israel** joined the IMF on the 12th of July 1954. The new sheqel was introduced, replacing the old sheqel on January 1, 1986 at a rate of 1,000 old sheqalim = 1 new sheqel. Since January 1, 2003, the sheqel has been a freely convertible currency. This makes the sheqel one of only twenty or so world currencies for which there are widely available currency future contracts in the foreign exchange market. It is also a currency that can be exchanged by consumers in many parts of the world.

**Egypt** joined the IMF on the 27th of December 1945. The pound has appreciated by about 4% vis-à-vis the US dollar since August 2007. As a result, the de facto exchange rate arrangement has been reclassified, effective August 2007, from a conventional pegged arrangement to managed floating with no predetermined path for exchange rate.

**Jordan** joined the IMF on the 29th of August 1952. Since October 23, 1995, the dinar has been officially pegged to the IMF's Special Drawing Rights (SDR). In practice, it is fixed at 1 US dollar= 0.709 dinar most of the time, which translates to approximately 1 dinar = 1.41044 dollars. The Central Bank buys U.S. dollars at 0.708 dinar, and sells U.S. dollars at 0.710 dinar.

**Libya** joined the IMF on the 17th of September 1958. From February 1999 to December 2001, Libya maintained a dual exchange rate, with the official rate pegged to a Special Drawing Right (SDR) at the rate of 1LD=.608 SDRs. State import agencies effected transactions using the official rate. Since 2001, the Libyan Dinar has been unofficially pegged to the U.S. Dollar (allowed to float within a specified band). With a 50% devaluation of the official rate in 2002, the two rates were effectively unified. A further 15% devaluation took place in June of 2003. In June of the same year, Libya agreed to the terms of IMF Article IV consultations, which called for, among other things, advanced import requirements and an end to the 15% exchange tax and subsidy.

**Tunisia** joined the IMF on the 14th of April 1958. The dinar has been very stable against a euro/US dollar composite. Thus, effective May 2006, the classification of the de facto exchange rate arrangement has been changed from managed floating with no predetermined path to a conventional pegged arrangement.

**Algeria** joined the IMF on the 26th of September 1963. Algeria's current exchange rate regime is a managed float, of which the IMF approves. Algeria does not subscribe to the IMF's Special Data Dissemination Standard but began participation in the less stringent General Data Dissemination System in April 2009.

**Morocco** joined the IMF on the 25th of April 1958. The exchange rate regime, under which the dirham is pegged to a basket of currencies composed essentially of the Euro, has served Morocco well, contributing to macroeconomic stability, and particularly to price stability.

**Bosnia and Herzegovina** joined the IMF on the 14th of December 1992. The convertible mark was established by the 1995 Dayton Agreement and replaced the Bosnia and Herzegovina dinar, Croatian kuna and Republika Srpska dinar as the currency of Bosnia and Herzegovina in 1998. *Mark* refers to the German mark, the currency to which it was pegged at par. Since the replacement of the German mark by the euro in 2002, the Bosnian convertible mark uses the same fixed exchange rate to euro that the German mark has (that is, 1 EUR = 1.95583 BAM).

**Croatia** joined the IMF on the 14th of December 1992. The country is a candidate for the EU membership. The main reference currency for kuna was the German mark, and later the euro. A long-time policy of the Croatian National Bank has been to keep the fluctuations of the kuna exchange rate with the euro in a relatively stable range. The country has been on the path of accession of the EU and it plans to join the European Monetary System.

**Montenegro** joined the IMF on the 18th of January 2007. Montenegro is a potential candidate for membership in the EU. The country presented its official application in 2008, hoping to gain EU candidate status in 2010, though it has already adopted the euro as sole currency.

**Albania** joined the IMF on the 15th of October 1991. It formally applied for EU membership on 28 April 2009. The cautious monetary policy has proved to be successful in keeping inflation low in recent years, well within the informal 3 ± 1% inflation target range. Albania's exchange rate regime is an independent float, although the Bank of Albania occasionally intervenes in the foreign exchange market with the aim of smoothing temporary fluctuations and accumulating the necessary reserves.

**Serbia** joined the IMF on the 14th of December 1992. The dinar exchange rate is under a managed floating regime with no pre-determined path and the Central Bank has taken preliminary steps towards inflation targeting preparing the transition to full-fledged inflation targeting.

**Macedonia** joined the IMF on the 14th of December 1992. As an EU candidate country, the Former Yugoslav Republic of Macedonia is taking part in the instruments of the pre-accession strategy, such as a Stabilisation and Association Agreement and the accession partnership, which defines specific priorities for which progress is to be made in view of further EU integration. An economic dialogue is held annually. In the context of the pre-accession fiscal surveillance procedure, each year the country notifies the Commission of key data on public finances and submits annually a pre-accession economic programme. This, together with an assessment prepared by Commission staff, is the basis for the multilateral dialogue between EU Member States and candidate countries. The Commission's annual Progress Report, usually published in the autumn, assesses progress in meeting the Copenhagen accession criteria.

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