The Arab Economies: Monetary and Financial Implications of the Euro- Currency*

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ملخص

الانعكاسات المالية والنقدية لليورو على الاقتصادات العربية

تقدم هذه الورقة تحليلاً شاملاً للانعكاسات المالية لليورو على الدول العربية ذات الاقتصاد المتنوع وغير المتنوع. وتهدف لمناقشة قنوات الاتصال المالية والنقدية المختلفة والتى يمكن من خلالها للتكامل النقدى والأوروبى بعد اتخاذ اليورو كعملة موحدة، أن يؤثر فى الاقتصاد العربى. ووجود علاقات عميقة بالفعل بين الأوضاع المالية في أوروبا والعالم العربى والتى من المتوقع تزايدها وتقويتها بعد إدخال اليورو، سوف يكون فى مقدمة العوامل التى تؤثر وتشكل الأسواق المالية وسياسات سعر الصرف والاستثمار الأجنبى المباشر واحتياجات النقد الأجنبى.

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1- Introduction

This paper explores the financial and monetary implications of the introduction of the euro on Arab Oil[1] and Non- Oil producing countries.[2] It aims at a discussion of the financial and monetary channels of transmission, through which monetary, financial, and economic integration in the European Union (EU) achieved after the introduction of the Euro will affect the Arab region. The Arab region is particularly poised to benefit from the EU's monetary and financial integration. This is not only due to geographical proximity, but also due to the extensive financial relationships, which are expected to intensify as a result of greater monetary integration in the EU. The Arab region is composed of two heterogeneous groups of countries: The first with a very concentrated export and production structures, while the second enjoys a more diversified structure. Thus, the financial implications of the introduction of the euro will vary across Arab countries, depending on each country's financial patterns, and factor endowments.

The Euro is expected to promote balance of payments transactions in euros. Central banks usually hold foreign exchange reserves to pay for their international financial transactions. Increased financial transactions with the euro area will prompt Arab central banks to shift significant portions of their reserves into euros. This will serve the main purpose of reducing capital flows transaction costs.

The European Central Bank's (ECB) mandate is to keep inflation rates in the euro area at relatively low levels, thus, the case of an Arab exchange rate peg to the euro, or to a basket of currencies where the euro is given the highest weight, to reflect the financial patterns between the two regions becomes a plausible scenario. Also, the currency denomination of external debt dictates the currency denomination of foreign exchange rate

reserves, since servicing of the debt is usually in the same currency. Currently, most Arab debt is denominated in United States (US) Dollars; however, the creation of an integrated EU debt market will be an important factor favoring the use of the Euro as an exchange rate anchor and for the denomination of Arab debt.

The EU's financial market, which emerged after the introduction of the Euro, has presented the Arab economies with a wider and more liquid bond and stock markets then the eleven old and segmented financial markets. Thus, the Arab region is particularly poised to benefit from the emergence of an integrated financial market in the EU.

This paper is divided as follows. Section 2 discusses the EU-Arab financial integration, and capital account transactions. Section 3 explores the implications for foreign exchange reserves. The implications on Arab exchange rate policies are highlighted in Section 4. Section 5 highlights the implications for the Macro-economic policy formulations in Arab countries. Section 6 outlines the impact of the introduction of the Euro on Arab financial markets. In Section 7, the use of the Euro in foreign direct investment is discussed. Finally, Section 8 concludes the main findings of the paper and presents some policy implications.

2- EU-Arab Financial Integration and Capital Account Transactions

With the exception of perhap`s Lebanon and Egypt, most Arab capital markets are still relatively closed and still impose various restrictions on the flow of capital. The GCC capital accounts have been fully liberalized, but various restrictions still remain on the flow of capital between GCC and non-GCC Arab countries. Shafer (1995) has argued that while countries initially tend to raise barriers to capital flows, whenever a financial crisis

is looming in the horizon, the literature focuses on the ineffectiveness of additional exchange control, and in today's developing world none of the developed world's financial markets maintain any barrier on the flow of capital. Hakim and Neaime (2000) have argued that financial restrictions might have benefited the Arab region, which did not feel the financial heat emanating from the East-Asian financial crisis.(3) However, more integration within the Arab region will still offer foreign investors the diversification they want, and the shield required to absorb intentional financial shocks. The gradual Arab integration with the EU financial markets will come at a later stage, when these markets become more liquid and mature. They would have achieved the level of financial governance necessary for enhanced integration. It is therefore, imperative to quickly move towards enhanced integration of capital markets within the Arab region which is poised to more benefit and better compete with other emerging and developing financial markets for capital flows from the EU. The structural changes in the EU financial markets, which occurred after the introduction of the Euro, have increased the pressures on Arab financial markets to quickly remove the intra-regional barriers to the flow of capital. This region will benefit considerably from a more liquid and integrated financial market in the short-run. Complete and full integration with the EU financial market could come at a later stage, but it should somehow preserve the unique-diversification potentials that the financial markets of the region are now offering to international investors.(4)

The increasing trend towards economic integration among countries in both the goods and capital markets has meant that countries are now drawn into closer ties. This growing dependence has paved the way for a change in behavior and thinking in these countries so that they can adjust to financial

integration.[5] If one wants to truly appreciate the type of financial relationships that can be seen evolving between Europe and the Arab region, probably the best parallel for prophecy is the Latin American region. The ample empirical and theoretical evidence presented in the finance literature in support for capital flows liberalization during the late 1970s and early 1980s prompted some Latin American and Asian countries to liberalize their financial policies. Among those countries, Argentina, Chile, and Uruguay were the first to open up their economies to international competition. Uruguay started this process in 1974, and soon after Argentina and Chile followed suit in 1975. Columbia, Mexico and Peru focused on liberalizing the movement of capital. East-Asian economies fared far better than Latin American countries in terms of economic growth and employment, after the financial liberalization program, which was introduced in the early 1980s. Spectacular growth rates have been realized at a time when economists have linked the latest East-Asian crisis to the fast liberalization, which took place in these countries.[6] Other countries in the Arab region have closely been watching and judging these developments. These countries have been reluctant to liberalize their current and capital accounts despite the vast support for such programs, and the prospects of enhanced growth in the region.

A successful movement toward full capital account convertibility requires a cautious removal of financial barriers in a context of sound macroeconomic fundamentals. As Arab financial markets become more integrated with the EU financial markets, they may experience increased volatility of cross-border capital flows. One way of reducing capital account volatility without imposing additional controls would be to avoid excessive reliance on short-term flows: being highly volatile and sensitive to changes in international financial conditions. Some

Arab countries have already started to implement the adjustment measures to benefit from the competitive environment imposed by the globalization of the EU financial markets.

3. Implications for Foreign Exchange Reserves

Since the euro meets the criteria of a reserve currency, it may rival the dollar and have a major impact on Arab central banks foreign exchange reserves Here, a fundamental issue involves the euro stability in purchasing power as a reserve asset. To this end, a country could expect stability in the purchasing power over imported goods and services of that part of its reserves held in euros.(7) The dollar's dominance of official international reserves is greater than US weight in the world's economy seems to justify. Estimates show that the dollar accounts for over half of official reserves, more than twice the US share of global output.(8) The dollar dominance has been due mainly to the unrivalled depth and liquidity of its financial markets. Given the overweighing of the dollar in current portfolios, central banks will most likely shift some of their dollar assets into euros (Alogoskoufis and Portes 1997).

Arab central banks may now shift to the euro, as returns on dollar assets are likely to be much lower than in recent years. Some analysts believe that the US equity prices are already overvalued and that there is evidence that foreign investors' interest in the US stock markets is declining (see OECD 1999, p.8). The dollar and the US stock market are closely linked as soaring share prices have attracted foreign capital and so contributed to an artificial appreciation of the dollar. Thus, fears of a decline in US equity prices would lead to a sharp drop in the dollar, inducing central banks to reduce their dollar reserves. Table (1) indicates that in both Lebanon and Egypt, the dollar is still the main denomination of foreign exchange reserves, however, after the introduction of the Euro, Arab central banks

will find it more attractive to convert major portions of their reserves into euros. This is not only justified by portfolio diversification considerations, but also for the purpose of reducing capital flows transaction costs.

Table (1) Currency Composition of Foreign Exchange Holdings, end 1998 (percent of total)

Country	EU[1] Currencies	USD	Yen	Other
Egypt	**7.2**	**80.1**	**3.9**	**5.8**
Lebanon	**4.1**	**95.6**	**0.1**	**0.3**

Sources: Chaffour, J., and L., Stemitsiotis (1998): "The Impact of the Euro on Mediterranean Partner Countries," Euro paper No 24, The EC 1998. [1]EU currencies are the French franc and the Deutche mark

4- Implications on Exchange Rate Policies

The introduction of the single currency in the EU will indeed affect the exchange rate relationships between Arab countries and the Euro area. Arab countries will no longer have to compete with Spain and Portugal, which used to devalue their currencies against their major trading EU partners to stimulate their exports and attract Foreign Direct Investment (FDI). However, countries in Eastern Europe, might still resort to such policies, and might divert trade and FDI from countries in the Arab region. In fact, the increased use of the euro in Arab countries may circumvent and dampen the effects of capital diversion.

In 1976, nearly 42 Developing countries had a dollar peg, however, in 1996 only about 15 countries have maintained this peg (see Table 2). This declining trend is expected to continue especially in the Arab region, due the emergence of the euro as an alternative anchor currency to the dollar.

Table (2) Exchange Rate Policies in Developing Countries (Number of Countries)

Exchange Rate Regime	1976	1986	1966
Pegged Regime	86	67	45
US Dollar	42	25	15
Flexible Regime	11	28	52
Managed Float	4	13	21
Independent Float	1	11	29

Source: World Economic Outlook, IMF, 1997

With the exception of Egypt, which follows a managed float to the dollar, most Arab countries are still under a dollar peg or a peg to a basket of currencies weighted heavily towards the dollar, at a time when more than half of their external trade and international financial transactions are with the EU (see Table 3).

Table (3) Exchange Rate Arrangements of Arab Countries

Currency Pegged to		More Flexible Regime	
US Dollar	Basket of Currencies Weighted Towards the US Dollar	Managed Float To the US dollar	Independent Float
Iraq Jordan Oman Syria UAE Yemen	Bahrain Kuwait Saudi Arabia Qatar	Egypt Lebanon	-

Source: World Economic Outlook, IMF (1998).

In deciding upon an exchange rate regime, several factors should be taken into account. The literature on exchange rate policies focuses on some characteristics that determine whether a country would be better off, in terms of its ability to maintain

sound macroeconomic policies with a fixed or a flexible exchange rate arrangement. In general, the larger and the more diversified an economy is, the less attractive is a fixed exchange rate regime. Most Arab economies, especially GCC countries, are relatively small and have a very low degree of diversification in both their exports and production structures, for instance, oil exports in some GCC countries amount to 80 percent of total exports. These countries, therefore, tend to experience greater fluctuations in foreign exchange earnings, often as a result of oil-specific shocks. Thus, the adoption of a pegged exchange rate regime should reduce and dampen the disruptive effects of larger exchange rate fluctuations.

Fischer (1977) and Flood (1979) have argued that the choice of an exchange rate regime should account for the types of shocks impinging on a given economy (see also Mansoorian and Neaime 2001). It is shown that a fixed exchange rate regime is generally superior, if the economy is relatively closed and the shocks are predominantly of a domestic origin. On the other hand, if shocks originate abroad, then a flexible regime would be more preferable in the case of a more open economy. With the exception of perhaps shocks to the price of oil, most shocks in the Arab region originate at the domestic level. This is mainly due to the fact that Arab economies are still closed and isolated from international financial shocks. The optimal regime in the region is a pegged arrangement that would stabilize macroeconomic performance by minimizing fluctuations in GDP, consumption and inflation.

Another strand of the exchange rate literature emphasizes the central bank preferences in terms of the trade-off that exist between inflation on one hand, and employment and GDP growth rates, on the other. In this framework, and given high inflation rates a pegged exchange rate, by providing a clear and

transparent anchor, can help establish the credibility of a stabilization program It also provides the right signal to international investors that any capital invested domestically will not loose its purchasing power. Lebanon has been actively using a pegged exchange rate regime to the US dollar since the early 1990s. The results of this policy were very successful in attracting foreign capital, whether in the form of FDI, or in the form of short-term investments in government treasury bills. This has put Lebanon at the forefront of Arab countries attracting foreign capital to the region. In addition, pegged regimes can sometimes help to discipline a country's fiscal and monetary authorities. This is particularly relevant for Arab countries that do not have the same capacity as advanced economies to draw a wedge between fiscal and monetary policies. In this framework, a pegged exchange rate regime constrains the authorities in the use of seigniorage as a source of revenue.

Edwards (1996) argued that the choice of an exchange rate regime depends on the level of independence and credibility of the central bank and its GDP and inflation targets. Most Arab central banks are mere agents of the various governments, and they are in no way independent from political pressure, and perform the main function of financing their respective government. Thus, the low inflation target is always traded- off with the high GDP growth target. For these reasons, and although fixed exchange rate regimes have somehow lost their popularity, Arab central banks might be inclined to choose to peg their currencies to the euro to reap the benefits of a low inflation euro area Mundell (1961) and MeKinnon (1963) have argued that the choice of a nominal exchange rate anchor should take into account the following considerations. First, of course, the anchor should qualify as a store of value and a unit of account; in this context, both the US dollar and the euro quality

as the preferred peg for Arab countries, Second, the trade patterns and the share of external trade relative to GDP, existing between the two areas. Obviously, the euro takes the lead in qualifying as the preferred anchor for the Arab region as more than 40 percent of Arab trade is with the EU, when it is only at 15 percent with the US (see IMF, Direction of Trade Statistics, 1999). Finally, to what extent are the two regions subject to symmetric shocks, shocks that can be absorbed by increased factor mobility. Neither the US, nor the euro area, is subject to the same shocks as those observed in the Arab region. This is because of the relative closeness of the current and capital accounts of Arab countries vis-à-vis not only the euro- area but also most countries of the world. But efforts in the Arab region are now devoted on liberalizing the various accounts of the balance of payments with the EU. The benefits from this should be considerable.

5. Implications for Other Macro-economic Policies

Table (4) indicates that the US dollar dominates the denomination of Arab foreign external liabilities, where on average 50 percent of total debt is denominated in the US dollars followed by the Euro currencies.

Table (4) Currency Composition of Total External Debt of Arab Countries, 1996-1998

Country	1996			1997			1998		
	Euro[1]	USD	Yen	Euro	USD	Yen	Euro	USD	Yen
Egypt	30.9	35.8	12.3	28.7	39.1	11.6	29.2	37.2	12.5
Jordan	16.1	29.5	22.3	14.8	30.4	21.6	16.1	30.4	23
Lebanon	8.9	65	0	12.9	61.9	0	8.1	37.7	0
Oman	0	61.4	13.1	0	64.1	11.3	0	65	8.2
Syria	2.9	82.7	3.1	2.7	84.8	2.8	2.8	84.8	3.1
Yemen	1.3	23.1	5.1	1.7	56.5	7.3	1.6	58.2	7.3

Source: World Bank, Global Development Finance, 2000. [1]EU currencies are the French franc and the Deutche mark

With the introduction of the euro, some Arab countries would want to diversify their external liabilities by shifting to the euro. In addition, the current trading patterns between the two regions is also another factor pushing Arab countries in that direction. Jordan is the most striking case; only 1.6 percent of its exports are with the US, while 37.8 percent of the debt is dollar-dominated (see Table 5). This clear mismatch raises some doubts about the already existing debt management policies in those countries. Anchoring their currencies to the euro without altering the currency denomination of their foreign debt may prove to be inadequate and painful especially if the dollar appreciates(9). The adequate strategy would be an anchor to the euro, coupled with a gradual shift in the denomination of foreign debt. Instead of having the US dollar dominate the denomination of foreign liabilities, the euro should take the lead in the denomination of Arab foreign liabilities (10). Ideally, the respective debt denomination weights should match those dictated by the existing trade patterns, and the currency-denomination of foreign debt should be taken into account when establishing a peg to a basket of currencies and deciding up the weights given to the various currencies involved in the basket(11).

Table (5) Country- Distribution of Trade and Currency-Distribution of External Debt

Arab Country-End 1997	% of Exports to		% of Imports from		% Total Debt	
	US	EU	US	EU	US	EU
Egypt	11.43	41.47	13.06	38.2	39.1	28.7
Jordan	1.62	12.1	11.45	37.84	30.4	14.8
Lebanon	6.18	22.92	9.18	47.45	61.9	12.9
Oman	3.63	3.00	7.6	32.96	64.1	11.3
Syria	0.66	55.39	3.33	27.65	84.8	2.8
Yemen	0.16	8.14	7.29	24.65	56.5	1.7

Sources: The World Bank, Global Development Finance, 2000. Direction of Trade Statistics, Yearbook, IMF 1998.

In addition, when choosing an exchange rate anchor, Arab countries should also take into account their foreign liabilities and the currencies in which they are denominated. This is because any pressure to devalue their respective currencies versus their anchor will instantaneously lead to a revaluation of its debt servicing. Thus, any gains in competitiveness resulting from devaluation will soon be wiped out by the excess burden of the servicing of its external liabilities. This argument holds especially for high indebted Arab countries, and will complicate their potential peg to the euro since most of their debt and its service is still denominated in US dollars (see Table 5). Therefore, any volatility in the euro dollar exchange rate might pose difficulties for these countries in the short-run. However, as more and more of the Arab debt is converted to euros, the case for a peg to the euro will become much more robust. Therefore, exchange rate volatility will be expected to affect Arab countries with substantial external debt, like for example, Syria, Jordan, Yemen, and Lebanon and to a lesser extent Egypt. If these countries shift their exchange rate peg to the euro, they will experience, in the short run at least, a mismatch between the currency denomination of their debt being in US dollars and the euro anchor (12).

The Scenario is quite different for oil producing Arab countries First, those countries have little or no external debt, thus the issue of a mismatch between the currency composition of their foreign debt and that of their potential exchange rate anchor is not relevant. Second, the heavy reliance of those countries on oil exports to various countries with no specific region or country as a main trading partner renders their choice of a currency peg somehow free from trade considerations which impose themselves on the non-oil producing Arab countries. Third, the factor that might insight those countries to peg their

exchange rate to the euro, besides the fact that about half of their external trade is with the EU, is the potential increase in the role of the euro as an international currency in international financial markets in general, and in the quotation of raw materials, mainly in the denomination of oil contracts in particular. The increased role of the euro in international trade and financial markets will not occur immediately but will be gradual and perhaps slow. As the euro gains ground on the international level its use in the quotation of oil contracts will become more and more justified.

Moreover, most oil-producing Arab countries rely on oil revenues to finance their current expenditures. Since all these revenues are denominated in US dollars, the US dollar peg is somehow presently justified. But taking into account the trading patterns of those countries, the euro peg might once again jump to the forefront as a justifiable peg. It is, thus, expected that those countries will continue with their dollar peg in the medium run and will be inclined to shift to a euro peg only after oil contracts start to be denominated in euros. However, this will be linked with whether the euro will assume a leading role on the international financial scene, and whether it will challenge the dollar international role, which started after the Bretton Woods conference.(13)

6. Implications for the Arab Region Financial Markets

The advent of a fully integrated bond market in Europe may incite Arab governments to increasingly tap the Eurobond market for obtaining government credit. The trend for these governments will be to move away from the traditional sources of finance (e.g. foreign bank loans), since a well-integrated and liquid bond market is expected to reduce borrowing costs and enhance the benefits of issuing government bonds. In a later stage, it is expected that firms operating in the Arab region will also start to issue corporate bonds benefiting from reduced

borrowing costs and a large base of investors.[14] In fact, and until the introduction of the euro, Arab governments and firms have preferred to issue bonds denominated in Us dollars. This was the case because the US market has always offered a vest spectrum of liquidity services and a wider range of financial and derivative instruments. Not to mention, of course, the large size of investors operating in that market.

Increased financial integration with the euro area is expected to bring considerable benefits to the Arab region. The euro has created a deeper and more liquid capital market and is now offering lower borrowing costs for Arab countries wishing to raise funds through euro- denominated financial instruments. Moreover, EU financial institutions and brokerage houses will be willing to diversify their portfolios by tapping Arab financial markets which will benefit from portfolio capital inflows.

Table (6) Portfolio Investments in the Arab Region (Millions of US Dollars)

Country	1993	1994	1995	1996	1997	1998
Egypt	0	10	2	1233	1813	494
Jordan	0	0	11	25	70	11
Lebanon	0	1	34	122	89	147
Oman	0	26	5	25	38	10
Syria	0	0	0	0	0	0
Yemen	0	0	0	0	0	0

Source: The World Bank, Global Development Finance, 2000.

However, this process has been extremely disappointing so far, as Table 6 indicates portfolio investments in the Arab region have historically remained at extremely low levels. Given the relative closeness of their economies, Syria and Yemen have not had any portfolio investments for the last seven years. Egypt has done relatively well and was able to attract considerable amount

of portfolio flows during the last five years. This can be attributed to the considerable efforts devoted lately on the privatization of government entities and on enhancing the efficiency, depth, and liquidity of the Egyptian stock market.

Increased two-way EU-Arab liberalization will not only increase allocative efficiency within Arab financial markets, as the experience of the developed economies shows, but will also provide Arab investors with greater opportunities to diversify their portfolios and reduce risks. The increased efficiency gains in the allocation of savings and investments, and increased potentials for portfolio diversification in the region will contribute to higher and sustainable Arab growth rates, and might gradually alleviate unemployment problems.[15]

Some but not all-Arab countries have started to implement varying degrees of institutional reforms of their monetary and fiscal instruments, as well as their banking systems. Arab countries that have already liberalized their capital accounts have achieved greater reliance on indirect monetary instruments, such as the T-bill rate. In Egypt and Lebanon, the Treasury bill rate and the discount rate exert an overwhelming influence on deposits and lending rates, and reforms of the financial sector have been under way for nearly a decade. Most interest rates have become market determined and the government's preferential access to financial resources overwhelmingly curtailed. In Bahrain, Kuwait, and Oman, the same could be said about efforts devoted to liberalizing interest rates.

Significant efforts have also been undertaken in the Arab region to reform and strengthen the banking system. The capital base of banks operating in Egypt and Jordan has been enhanced considerably to meet international standards set by the Basle minimum of eight percent. In the last few years, Lebanese commercial banks have started regaining quickly their leading

role in the region. With more stringent enforcement of prudential regulation, these banks have seen their capital base rising steadily. The same could also be said about the banking systems of Kuwait, Bahrain and Saudi Arabia. These countries have recently developed a well-established system of supervision based on international prudential standards. Yet, there is still a lot to be done in terms of financial and capital account liberalization. Saudi Arabia, Oman, and Syria need to remove the restrictions on foreign direct investment. Egypt need to remove all the restrictions imposed on resident deposits abroad, and on resident and nonresident account convertibility. Not surprisingly, countries with the highest levels of financial restrictions have to be quicker in implementing the financial liberalization agenda. Lebanon and Bahrain have the least financial restrictions to remove, followed by Jordan and Kuwait. Syria, however, will be facing the greatest challenge.

Arab Stock markets have fared relatively well during the last decade. Increased liquidity, transparency and depth of these markets have attracted foreign portfolio investments seeking portfolio diversification. In addition, privatization reforms, which were implemented in the last few years, and the liberalization of some Arab stock markets contributed significantly in attracting foreign capital. The Egyptian stock market for instance experienced a significant increase in its market capitalization from USD 4 billion in 1994 to USD 24 billion in 1998. The Saudi Stock market did not fare as well, with a market capitalization of about USD 50 billion, its growth has been relatively disappointing (see Table 7). This is because its liquidity is low and the Saudi government still owns a considerable number of firms operating on the stock market.

Various Arab financial restrictions still exist in the face of EU portfolio flows, and the removal of these restrictions, will

improve and enhance liquidity in these markets. GCC flock markets are still close to foreign investors; even non- GCC Arab countries face restrictions on portfolio investment in these stock markets. Increased liberalization with the EU is expected to attract investments into the region for diversification purposes.

Table (7) Arab Stock Market Capitalization (Millions of US Dollar)

Market	1994	1995	1996	1997	1998
Amman Stock Market	4626.2	4724.2	4556.4	5456.2	5862.7
Bahrain Stock Market	5129.3	4706.8	5019.4	7825.8	6771.8
Saudi Stock Market	38693.3	40904.0	45855.8	59378.3	42630.6
Kuwait Stock Market	10967.3	14400.0	20599.8	27244.6	18423.9
Beirut Stock Market	..	..	2391.1	2904.5	2425.5
Egypt Stock Market	4258.8	8074.2	14184.8	20875.7	24381.4
Total	**63675.0**	**72809.2**	**92607.3**	**123685.0**	**100496.0**

Source: Arab Monetary Fund, 1999.

7- The Use of the Euro in Foreign Direct Investment

It is expected that European FDI to the Arab region will be substantiated and enhanced, as a result of the creation of one integrated financial market The Arab region is poised to benefit from the EU financial integration, if it is successful in moving quickly towards more financial liberalization with the Euro-area. Otherwise, FDI might quickly be diverted to Eastern Europe, if financial reforms in the Arab region are once more delayed. Arab countries should pursue appropriate economic policies, good governance and sound banking, as well as, have a well- defined and effective legal system. A case in point is Lebanon and Egypt, which with relatively low capital flows and exchange restrictions, have benefited from massive net inflows in the last few years, while Syria, Bahrain, Yemen and the UAE with relatively more restrictions have had the least (see Table 8). Also, it is empirically observed that GDP growth rates in countries, which have maintained high controls on their capital

account transactions, have remained considerably lower than in countries with less restrictions. It is also observed that FDI have fostered technological transfers, which increase productivity and competitiveness.

Table (8) FDI Inflows to the Arab Region (Millions of USD)

Country	1987-92	1993	1994	1995	1996	1997	1998
Bahrain	58	-5	-31	-27	47	26	10
Egypt	806	493	1256	598	636	891	1076
Jordan	21	-34	3	13	16	361	223
Kuwait	7	13	-	7	347	20	-10
Lebanon	2	7	23	22	64	150	230
Oman	103	142	76	46	75	49	50
Qatar	10	72	132	94	35	55	70
Saudi A.	-35	1369	350	-1877	-1129	2575	2400
Syria	67	176	251	100	89	80	100
U.A.E	52	401	62	399	130	100	100
Yemen	198	897	11	-218	-60	-138	100

Source: UNCTAD, World Investment Report, 1999.

If these financial reforms are not implemented early enough, EDI and other types of capital flows from non-EU countries will choose the Euro area instead. FDI from Japan and the US might be prone to redirect their flows to the EU as opposed to the Arab region. Japanese and US firms might be attracted by the higher growth prospects in the EU, and by the creation of an integrated and liquid financial market which is expected to reduce transactions costs of equity and acquisitions and minimize borrowing costs of EU subsidiaries of branches of foreign companies. South-South financial integration should be a priority. The integration of Arab's financial markets should be implemented as a first step towards enhanced South-North financial integration. (16)

8. Conclusions and Policy Recommendations

Economic and Monetary Union in Europe will create a new global financial architecture. The international financial system will never be the same again as three of the G-7 countries have discarded their monetary identities in favor of the single currency. Overall, the euro is a new currency of global importance and the dollar will have to coexist with the euro and the yen, and will have to share its role as an international currency.

This paper has shown that the main channels of transmission through which the euro will affect the Arab region will be the monetary and. financial channels. The euro constitutes now a legitimate currency anchor for non- oil producing Arab countries in the short-run. For GCC countries, however, the prospects of a euro anchor will be highly correlated with the role the euro will be playing on the international financial scene, in general, and the quotations of oil contracts and oil derivatives in particular. Also, the unification of the EU financial markets and the creation of a large and liquid bond market is now offering the Arab region new prospects to diversify their foreign exchange holdings, their portfolio holdings, and their foreign external liabilities.

GCC countries have little or no external debt thus the issue of a mismatch between the currency composition of their foreign debt and that of their potential exchange rate anchor is not relevant. The factor that might insight those countries to peg their exchange rate to the euro, is the potential increase in the role of the euro as an international currency in international financial markets in general, and in the quotation of raw materials, mainly in the denomination of oil contracts in particular. The increased role of the euro in international financial markets will not occur immediately but will be gradual

and perhaps slow. And as the euro gains ground on the international level, its use in the quotation of oil contracts will become increasingly justified. Moreover, most oil-producing Arab countries rely on oil revenues to finance their current expenditures. Since all these revenues are denominated in US dollars, the US dollar currency peg is somehow presently justified. It is, thus, expected that those countries will continue with their dollar peg in the medium run and will be inclined to shift to a euro peg only after oil contracts start to be denominated in euros. However, this will be linked with whether the euro will assume a leading role on the international scene and whether it will challenge the dollar international role, which started after the Bretton Woods conference.

The new developments in the euro-area financial markets will have important implications on the financial conditions in the Arab region, both in terms of interest rate volatilities and in terms of the magnitude and stability of capital flows. These structural changes have increased the pressures on Arab financial markets to quickly remove the intra-regional barriers to the flow of capital. This region will benefit considerably from a more liquid and integrated financial market in the short-run. Complete and full integration with the EU financial market could come at a later stage but it should somehow preserve the unique-diversification potentials that the financial markets of the region are now offering to international investors. These countries would have by then achieved the level of financial governance necessary for enhanced integration. It is, therefore, imperative to quickly move towards enhanced financial integration of capital markets between GCC and non- GCC Arab countries to benefit and better compete with other emerging and developing financial markets for capital flows from the EU. With the exception of GCC countries, which have already integrated their financial

markets, most financial markets of the Arab region are still segregated. Thus, future efforts should be devoted towards enhanced financial integration within the Arab region, and Arab governments should take into account the sequences, magnitudes, and relative speeds of opening-up before embarking in any financial liberalization programs.

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ENDNOTES

1) The Arab oil producing countries produce and export oil, and due to their oil endowment their economies are not diversified. These are mainly countries of the Gulf Co- operation Council (GCC): Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

2) The Arab non- oil producing countries have more diversified economies and are: Egypt, Jordan, Lebanon, Syria, and Yemen.

3) According to the IMF, the East-Asian Financial crisis did not result from liberalization of the current account but rather stemmed from the macroeconomic stances adopted, the institutional setting created and the sequencing pursued in opening the capital accounts in these countries.

4) Geographical proximity with the EU has had a negative impact on the Arab region's financial markets after the introduction of the euro). What is emerging with the introduction of the euro is a fully integrated financial market with great growth potentials. The Arab

region has to implement swiftly the reforms needed to better compete with the euro market in attracting foreign capital in the short- run. Then, in the medium and long run, Arab -EU financial integration should be enhanced to reap the benefits of the newly created euro financial market and its important growth potentials. Arab countries with relatively liberalised capital accounts are Egypt, Jordan, and Lebanon while, countries still maintaining significant restrictions on capital account transactions are Saudi Arabia, Kuwait, Oman, and Syria.

(5) See Goldstein and Shari 1982a, and Quirk and Evans 1995, for a comprehensive analysis of the effects of economic integration on Less- Developed Economies.

(6) For a complete discussion of the impact of financial globalization on less developed countries see Neaime (2000), and Mansoorian and Neaime (2000).

(7) This stability would protect such a country only from price changes in its imports owing to exchange rats changes, and not from price changes owing to inflation in the exporting countries of the euro zone.

(8) This extra demand for the dollar as the world's main reserve currency has made it even easier for the US to finance its current account deficit.

(9) A peg to the euro also means a crawling peg with the euro or even also a managed float regime (adjusted peg) with target the euro.

(10) While a euro peg is expected to protect Arab considerable trade flows with considerable trade flows with the EU from the trade related effects of currency fluctuation, it will leave them exposed- depending on their degree of international financial integration- to changes in the euro- area interest rates. To maintain the euro peg Arab monetary policies will most likely have to increase domestic interest at least in the short run. Higher interest rates will increase the costs of domestic debt services and might lower domestic GDP and aggregate demand. The negative impact of higher interest rates on Arab's domestic economies could be dampened by increased EU capital flows to the region.

(11) Pegging the respective Arab currencies in real terms to a trade weighted basket of currencies where the euro should be given the highest weight should be dictated by the extensive trade patterns between the Arab region and the EU.

(12) Benassy- Quere (1997) argued that one important factor behind the latest financial crisis in Asia was that East Asian countries exchange rate policies which were not in line with the distribution of trade by partner country, and with the currency distribution of foreign exchange reserves and foreign external liabilities.

(13) As Arab countries move to a turn peg they will start to benefit from a currency link to a larger and more diversified turn area than Germany or France, with the potential for reduced exposure to demand shocks transmitted through the exchange rate. Moreover, the extent to which the volatility of the euro-dollar and euro- yen affects the competitiveness of Arab countries that peg to the euro, will depend on how close an approximation the euro is to a country's effective exchange rate basket

(14) A deeper and more liquid EU bond market is expected to enhance hedging opportunities against fluctuation in the underlying yields.

(15) Some concerns should, however, be raised about the prospects of capital outflow from the Arab region to the EU, as a result of increased financial liberalization, and as Arab financial markets react to financial shocks or domestic financial and monetary policies. Circumventing the possibility of capital outflows is rooted in prudent fiscal and macroeconomic policies and a sound financial system in Arab countries - Both of which are necessary in preserving the confidence of both domestic and European investors.

(16) Incentives should be directed towards the implementation of financial and economic reforms to render the region attractive for EU FDI, as well as, FDI from non-EU countries.