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"Euro-Arab Financial Relations and Intermediation of Long-term Investment"

by

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# Euro-Arab Financial Relations and Intermediation of Long-term Investment

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1. Since the early seventies, the long-term structural surpluses which many countries, predominantly the Arab oil-producers, have developed in their balances of payments have posed new problems and challenges to the international financial and monetary systems.

The Euromarket financial intermediaries that handle the funds generated by these surpluses not only have to face a multiple risk situation (a maturity risk, a currency risk, and a country risk), but also the new and delicate problem of investing funds on behalf of public agencies. The situation is further complicated by the fact that since the end of World War II the predominant form of long-term international investment has been direct capital investment on the part of multinational corporations, rather than financial investment as had been the case in the pre-war period.

As is known, a large part of these surplus funds was directed to the Euromarkets and placed in short-term deposits. This solution was viewed by many as temporary: the surpluses had developed suddenly with the sharp rise in petroleum prices and the funds had to be immediately invested in some way. Short-term deposits were considered a stop-gap which would give the investors time to evaluate other investment opportunities which would lead to a greater diversification and longer maturity of their holdings. Though this has taken place to a certain extent, existing evidence shows that the greater part of the surplus funds generated by increased oil prices is almost permanently being held in short-term deposits on the Euromarkets. This does not necessarily reflect the investors' preference for this type of investment, but rather the almost complete lack of credible alternatives. The sheer magnitude of the surpluses makes it very unlikely that a significant proportion could be invested in long-term capital assets such as securities and equity participations in corporations based in the oil-importing countries. Political and legislative obstacles have also

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discouraged recourse to this option.

Furthermore, because the industrialized countries have generally been more willing and able to readjust their balances of payments to this new situation than have the less-developed, oil-importing countries (including some Arab countries), the latter have therefore had to bear the greater part of the burden deriving from the oil-producers' structural surpluses. The oil-poor LDCs debts on the Euromarkets, incurred to finance their large payments deficits, have in fact risen very sharply since 1973.

2. This state of affairs certainly does not favor the Arab world as a whole, nor the oil-producers in particular, for a variety of reasons.

Inflationary pressures and widely fluctuating exchange rates have made international financial markets increasingly unstable. The surplus funds deriving from oil sales and invested in short-term assets are exposed to the risks inherent in such a situation. In order to protect their investments, investors are pressed to frequently change the composition of their portfolios, and this in turn leads to further tensions and instability on the markets.

Secondly, a large part of the surplus funds are eventually utilized by developing countries whose financial soundness is becoming increasingly questionable, raising the risk of insolvency. True, it is the financial intermediaries who underwrite these risks; however, the ultimate lenders will also suffer the consequence of a situation in which the quality of the final debt increases the fragility of the system as a whole, a system where no lender of last resort is available.

Thirdly, deposits on the Euromarkets are not always sufficiently protected against political interference, at a time when the utilization of economic instruments to achieve political aims is becoming more and more widespread. Both aspects were underlined by the recent situation involving Iran, and the fact that an agreement has now been reached does not imply that this weapon will not be used in other circumstances, against other countries.

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Finally, the development of the Arab East as a region is in no way enhanced by this pattern of utilization of surplus funds. Even the income derived from these financial investments is in most cases reinvested along the same lines, and hence the financial wealth derived from oil exports is for the most part 'alienated' from the region. Optimistically this could be viewed as a way of employing funds until a viable model for economic development, which could be sustained even without oil, is found. A pessimistic interpretation is that a real and valuable, but depletable resource, oil, is being traded off for paper assets which have no organic link with the countries to which they legally belong, and which are moreover exposed to the cold currents of international political and economic instability.

3. In recent years numerous proposals for a better utilization of the OPEC surpluses have been put forward. However, not all of them have sufficiently taken into account the interests of the Arab oil-producing countries and of the Arab East as a region.

These proposals can be grouped under three broad categories:

a) proposals aimed at improving the existing system, on the assumption that oil surpluses will continue to be invested primarily in the form of official reserve assets deposits on the euromarkets, and intermediated by the latter

b) proposals directed toward the creation of alternative channels of intermediation at the official level, involving off-market operations.

c) proposals based on the hypothesis of "privatisation" of funds within the Arab countries (through the development of Arab financial markets), and an intermediation of these funds through links between the Arab financial markets and other international financial markets.

The first category includes a wide array of proposals aimed at reducing the present instability in international monetary relations. Some of these proposals have, to a certain extent, been implemented. The creation of regional currency areas, such as the European Monetary System, was conceived mainly as a means of bringing about convergent behavior in the monetary variables of the EC member countries (inflation rates, exchange rates, etc.) with respect to the currencies of other countries and vis-a-vis the US dollar in particular. Other proposals such as the one calling for a 'substitution account', were advanced in conjunction with events which had led to a widespread desire among almost all monetary authorities to diversify their reserves away from the dollar. Also included in this first category are the proposals put forward in the context of the current debate over the necessity of imposing more stringent controls on the international banking system. These controls would oblige private banks to be more cautious in their lending policies, would assign to international monetary organizations the task of providing support and surveillance, and might eventually lead to the creation of a global lender of last resort.

Not included in this category are all the numerous proposals advocating the issuing of especially designed financial assets, or the introduction of mechanisms for the indexation of existing assets. These proposals would fall into the second category if these assets were to be offered off the market specifically to oil producing countries. If, instead, they are offered on the market, they cannot possibly be restricted to a particular class of buyers, and are therefore to be considered a normal consequence of technological progress in the financial system. As a matter of fact, indexed assets and assets denominated in various currency baskets have been offered on the markets in past years without in any significant way altering the general situation.

4. In the second category, we may include the various types of recycling operations, based on bilateral or triangular agreements, actually implemented or merely proposed.

The special issue of US government bonds offered to Arab countries, Saudi Arabia in particular, in December 1974, and the issue of DM denominated bonds in a bilateral agreement between the Bundesbank and SAMA, are examples of the former type of oepration.

An example of the other type is the proposal put forward by the former Governor of the Bank of Italy, Guido Carli, in association with Prof. Ezio Tarantelli. They propose that the industrial countries offer to the Opec countries special bonds indexed to the nominal rate of increase of GNP of the issuing countries. Thanks to this mechanism, oil-importing countries could obtain the resources to finance their own growth notwithstanding their oil deficits; and at the same time they would have every interest in seeing that a high nominal rate of GNP growth was the result of low inflation and high real growth. The oil exporting countries would acquire an interest in the same result, because this would increase the "real" yield of their investments. Growth in the OECD would make it possible to finance and stimulate growth in the non oil-importing LDCs via an increase in export credits and/or development aid from the industrialized countries.

It should be noted that the logic behind the Carli-Tarantelli approach is basically the same as that inspiring the system for indexation of oil prices proposed by Saudi Arabia and discussed by the Opec members in the latter half of 1980.

Along the same lines, there are the proposals for the emission of bonds denominated in European Currency Units (ECU). These would initally be offered by individual EEC member countries and eventually in a more distant future, by Community institutions themselves.

5. The proposals included in the first and second categories are to be considered as complementary, not as alternatives. However, even in combination, they will not completely satisfy the needs and expectations of the holders of surplus funds.

In the short run these proposals might substantially contribute to the strengthening of financial relations, thereby reducing the risks today connected with the investment and intermediation of surplus funds. Off-market operations might help to shift at least part of the risk burden from the banking system to governments, and in this case the final debtor might be selected according to criteria more in line with broad political imperatives.

However, none of these proposals can eliminate the risk of economic reprisal motivated by political conflict; quite to the contrary, this danger might even be increased in the framework of bilateral relations at the official level.

Finally, neither the first nor the second category of proposals solves the problem of "alienation" of surplus funds from the countries to which they belong. Quite to the contrary, they are all based on the assumption that the structural surpluses of the oil producing countries should be utilized to finance growth in the oil-importing countries.

It should be noted that the problem of "alienation" of surplus funds is strictly connected to the issue of increasing the absorption capacity of oil producing countries. A solution to these problems would benefit both oil-exporters and oil-importers. In fact, the problem of long-term structural surpluses exists only in as much as the oil-producing countries do not find sufficient domestic outlets in productive investment for their oil income.

6. The third category of proposals, when viewed as complementary to the others, is of particular interest in that it promises to provide a solution to the problems left unresolved by the other schemes.

This third approach involves the creation and development of Arab financial markets capable of intermediating surplus funds on a private basis, i.e. through institutions whose functions and operative criteria are those typical of private banking systems.

The mechanism underlying such operations would be more or less the following. Surplus funds would initially be invested by the official institutions of the oil-producing countries on the Arab financial markets. These Arab markets would then allocate resources in accordance with their functions and their own operative criteria, which would presumably be different from those of the governments themselves. It must also be assumed, however, that the official Arab monetary institutions will in some way intervene, introducing regulations to influence the structure and behavior of the developing markets.

A first question mark is: what currency will be utilized to denominate official deposits on the Arab markets? Surplus funds are initially made up of Western currencies, mostly US$.

A first possibility is that dollars be placed as such in deposits at banking institutions in countries different from the surplus holder's country of origin, but belonging to the Arab financial circuit. These might be banks in Lebanon, Bahrain, Jordan, or other countries; or institutions created expressly for this purpose, perhaps along the lines of the Basle Bank for International Settlements.

We believe that this hypothesis would create conditions significantly different from those of the present situations, whereby official Arab institutions place their funds directly on the Euromarkets. Immediate control over the surpluses would in no way exclude the possibility of investing according to Euromarket criteria, but would open up the possibility of employing the funds in different ways. In other words, new financial options would be opened: old ones would not be closed. These new options might affect the geographical distribution and the conditions of loans, both in terms of maturity and of cost.

A second hypothesis is that the official monetary institutions of the oil exporting surplus countries stimulate the growth of unofficial institutions within their own countries, providing them with financial resources denominated in the national currency, and at the same time opening the door to investment abroad. The net result would be a decrease in the accumulation of official reserves, and an increase in private capital outflows from the oil-exporting countries. A policy of financial deepening would thus come to play a crucial role in favour of the development of Arab economies, creating conditions more conducive to an increase in the absorption capacity of the oil producers and the Arab East in general.

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Some countries in the region seem already to be actively pursuing such a policy.

This second hypothesis will probably become more relevant in the longer run: in the short run it involves the risk of creating excessive inflationary pressures and stimulating speculative investment rather than fixed capital accumulation.

7. If we assume that a growing share of the surpluses will be processed through the Arab financial markets according to one or the other of the two hypotheses mentioned above, what would the implications be for relations between the Arab and the European financial markets?

We think that a development along these lines might offer numerous advantages. Firstly, Arab financial intermediaries might establish a presence of their own on the European markets (as they are already doing to an increasing extent) and operate with considerably greater flexibility and scope. Thus, they might invest in the acquisition of industrial assets or equity participations, both in order to diversify their financial portfolio and in order to gain a minority or controlling interest in specific corporations. Until now, this kind of investment was seriously hindered by the official nature of the potential or actual Arab investor, which created a negative reaction in public opinion. Nevertheless, some investments of this sort have been made and the experience has proved to be largely positive. Furthermore, we might expect a sharp decrease in nationalistic reactions if the investor appears to be a private financial institution not immediately connected to the will of any government.

It is indeed evident that if the investment came from a private institution (private both legally and in its investment criteria) the resistence to a growing penetration of Arab capital would lose its political grounds. The result would be an increase in investment alternatives which would affect both the demand and the supply of financial assets, because all of the private operators would have an interest in the introduction of innovations.

This kind of integration might not develop spontaneously. It is necessary that governments provide an appropriate legal environment, geared to ensure a maximum of capital mobility, eliminating the danger of nationalisation and protecting the possibility of divestment.

At the same time this process of integration, in contrast with other proposals, would not need specific mechanisms to guarantee against exchange risks or inflation. Any guarantee of this kind would necessarily limit the investor's freedom in portfolio choices, which should be complete.

Of course, if we move towards a diffusion of market mechanisms for allocation we must assume that these mechanisms are able to produce efficient results. The intermediation of surpluses through Arab private institutions inevitably implies that these institutions underwrite part of the risks which today are born by the institutions of the importing countries. It is not possible to seek a reduction of these risks through particular government guarantees without essentially undermining the whole meaning of developing Arab financial markets.

8. A second advantage of the development of Arab financial markets is that the "private investors" we are discussing might not be only Arab banks but also - perhaps even predominantly - financial companies set up as joint ventures between Arab and European banks. This kind of "private investor" might achieve greater solidity in its financial operations, reducing to a minimum the dangers connected to a lack of information. (We might just recall how difficult it is to assess country risks).

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As far as the risk of political interference is concerned, this kind of cooperation would allow for maximum anonimity of the investor, thus minimizing the risk. The importing country would be unable (and most likely unwilling as well) to say which part of the operations carried out by a specific private investor originates from a deposit of reserve assets from a specific government. At the same time the "private investor", i.e. the joint venture, would legally be a resident of an Arab country - preferably an oil-producing country or a minor producer such as Bahrain - and out of reach of political interference.

The third advantage of such a course of action is to create favorable conditions for increased economic cooperation within the Arab East. Our assumption is that a leading role would be played by institutions located in oil importing Arab countries, such as Lebanon or Jordan. It is very likely that this would open the door to productive investment in these countries, thereby increasing the overall absorption capacity of the Arab East.

However, we must realistically assume that this development would not by itself immediately provide a solution to the problem of "alienation" of surplus funds. If we assume that the private intermediaries will operate according to private criteria, it is unlikely that they will initially allocate a large share of their financial resources to investment in the region. At the same time it is certainly true that the development of Arab financial markets, both autonomously and in cooperation with European Banks, might become a very important instrument in pursuing the goal of Arab regional development.

This development might be encouraged within a process of integration between Arab and European financial markets by creating, alongside the joint ventures we discussed above, bilateral or multilateral financial institutions specializing in financing long-term projects of a regional interest.

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A network of Euro-Arab financial joint ventures with different specializations might be utilized to encourage European enterprises, to which European banks normally cater, to consider investing in the Arab East. These kind of initiatives might move alongside the existing official financial institutions for interarab financial cooperation, and engage in co-financing operations. In this way additional entrepreneurial capacity would be mobilized to locate and develop economically sound projects of regional interest.

With regards to Italy, we can suggest some possibilities in sectors in which our enterprises are very competitive at the international level. Thus, joint ventures between Italian and Arab banks might take a leading role in the development of natural gas resources, where ENI has a technological advantage in underwater gas pipelines, thanks to the experience gained in laying the Transmediterranean pipeline from Algeria to Italy. Large infrastructural projects of regional importance might be studied in connection with the large number of engineering firms operating in our country. Finally, manufacturing investment might be encouraged in some sectors where economies of scale are important and plants must be designed to cater for the whole market of the Arab East. One such sector where Italian industry is internationally strong is automobiles and trucks.

A "private" approach to this kind of regional project might be welcome because it would allow for the location of certain activities in the non oil-producing countries.

The need to engage cooperatively in investment schemes of regional importance stems directly from the long-term goal of increasing absorptive capacity - a goal which could never be reached if we restrict our considerations only to the oil-exporting countries within the Arab East.

It is clear that in the long run the prospects of regional economic cooperation in the Arab East are influenced by political developments. It is possible that political tensions and conflicts would lead to a situation where it would be unfeasible to undertake most investment projects of a regional character. At the same time, these same projects might become politically less sensitive and less vulnerable if they were underwritten by private financial institutions located in countries which, for a variety of reasons, would reduce the danger of politically motivated interference.

9. Eight years after the initial appearance of large-scale structural surpluses in international payments, it has become clear that the problem is here to stay. A satisfactory solution has yet to be found, and most probably there is no single solution which might be entirely satisfactory by itself. In a complex context in which solutions have to be found exploring different paths at the same time, an effort to diversify and deepen the long-term cooperation between Arab and European unofficial financial institutions might open some very interesting opportunities.