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Financial Openness and Financial Development in the South Mediterranean Sea Countries: Institutional Approach and Calculation of Development Thresholds

By
Samouel BEJI[1]

Abstract:

The central theme of the paper is the financial development issue in a context of financial globalization for the south Mediterranean sea (SMS) countries. The choice of this theme is motivated by the importance of the economic development and the growth in these countries, who are usually the subject of political instabilities, and are distinguished by weak political institutions. Our aim in this paper is to point out that the financial openness in the conditions of the SMS countries would be prejudicial for its financial development. In contrast, the financial openness would be beneficial for the financial development in the presence of the adequate legal and institutional development. This is our main hypothesis.

To do so, we used an econometric panel error-correction model with non-overlapping data for the period 1980-2005. The model links financial development indicators to institutional and legal indicators, in order to calculate institutional thresholds. The actual state of the institutional and legal environment in the region would not allow them to ameliorate the efficiency of their financial systems. Then, it's not recommended, if we trust on the results founded, to operate a financial openness. Instead of opening the "financial frontiers", it's better to prepare this transition by an improvement of the institutional and the legal environment.

Keywords: *financial development, institutional development, financial globalization, capital account liberalization, sequence of liberalization*

1. Introduction

The issue of the paths to follow in order to realize the financial development for the developing economies and even for the developed ones has not finished provoking reactions, suggestions and polemics. So what makes this debate interesting? If we trust on the works of McKinnon (1973); Shaw (1973) and for the recent studies of Greenwood and Jovanovic (1990); Bencivenga and Smith (1991); Roubini and Sala-i-Martin (1992); King and Levine (1993); Levine (2004) we conclude that the financial development is prominent for the growth and the economic development. Although the fact that this question has not yet been distinct concerning the effectiveness and especially for the sense of the causality between the two concepts.

After the beginning of the vast wave of the financial globalization which accompanied a larger movement of globalization, we attend, since the end of the eighties, to many attempts of the developing countries to insert the globalized

[1] PhD student, teaching assistant and CEPN member at the University of Paris XIII (France)

financial sphere. This trend is explained by the thought on the benefits of the openness and the exchange on a large scale. Following the example of the commercial liberalization, the policymakers in that period thought that the financial integration would be advantageous for the economic development. Nonetheless, the financial crises episode for many developing countries, threw doubts about the advantages of the financial liberalism and the trust on the financial integration, yet defended strongly by the "Washington Consensus" ideas. Since these countries already engaged on reforms plans in order to abolish the restrictions on capital movements and to liberalize their financial systems.

In the same way for the decision makers of economic policies in these emergent countries, this understood that the financial opening is not like the commercial liberalization. They also understood that the financial liberalization requested a number of economic, financial and almost institutional and political prerequisites, to do so. The question was then, how to liberalize instead of to liberalize or not, in order to realize the financial development and so the economic development.

These crises attracted the attention on the necessity to be doted by an adequate frame for the financial openness. Furthermore, it's necessary to proceed by steps and by following progressive plan to avoid the risks of speedy openness. The examples of South Korea, China, Malaysia in Asia and the Chili for Latin America defend the idea of the sequencing and the importance of the gradualism in the process of the financial openness. Indeed, these countries opted for an exclusive and alternative way of financial openness, different from the globalized version recommended by the International Financial Institutions (IFI). This "protected" financial openness avoided them to live the mishaps of the other experiences of financial globalization.

This analysis lead us to express the same interrogations for the case of the South Mediterranean Sea countries (SMS), given the need to the economic development for these countries on one hand, and their specificities in the other. The aim of this paper is to try to define an alternative path for the SMS countries, given their features, to realize the economic upswing via the financial development, while avoiding the drawbacks experienced by the other developing countries in the nineties.

The rest of the paper is organized as follow; the second section is dedicated to a highlight of the general situation of the financial systems for the countries of the region. The third section present the theoretical framework of the new concept of financial development based on the quality of the institutional, legal and political environment. The forth section is an econometric analysis utilizing a panel encompassing 10 south Mediterranean countries over the period 1980 to 2005 in order to study the long term effect of capital account openness on financial development, after controlling of the level of institutional and legal development.

The econometric study encompasses also a study of the sense of causality between the financial openness and the financial development, as well as a test whether we have to operate a commercial liberalization before the financial openness. The final section represent concludes remarks.

2. Analysis of the Financial Development Situation in the South Mediterranean

The governments of the SMS countries started since the last two decades, reforms of their financial systems under the influence of the Structural Adjustment Plan (SAP). The aim of these reforms is to create the ideal conditions for the development of banks and financial markets, for more active participation and more

important role in the economic growth process. Concerning this, there exists significant differences for the financial development levels among the countries of the region. Even if we consider that the development level evoked remains under who observed in the other developing countries, especially in Asia.

Following the study made by Hoskins (2003) on the state of financial development in the region, we can set a classification of SMS countries through their degree of financial development. The indicators selected are : Ratio of money plus quasi money to GDP, ratio of M1 to M2, domestic credit to GDP, deposit/lending spreads, deposit and lending rates, deposit money bank assets to GDP, deposit money bank assets by asset in % of total assets, ownership of commercial banks by number of banks, ownership of commercial banks by equity, stock market capitalization and number of shares listed.

High level	Middle level	Low level
Israel Jordan Lebanon	Algeria Egypt Morocco Tunisia Turkey	Libya Syria

Source : IMF

There exist several reasons explaining the specific nature of the financial systems in the region. The political and economic instability caused partially by the difficult situation of security, may be one of the plausible reasons. This uncertainty damage the level of trust, shrink consequently the lending activity and then all the activity of investment. These risks are reflected in the low level of sovereign credit ratings for countries in the region.

The late development of the financial and banking sectors are partially explained by the existence of other sources to finance the economy. For example, the high yields of the energy sector in some countries (especially Algeria and Libya) shrank the development of the banking sector. Because they represent a main source of financing for the economy. It substitutes then the banking finance and reduces its development.

Furthermore, according to the classic view of the financial repression authors like McKinnon (1973), Shaw (1973), Roubini et Sala-i-Martin (1992) and Levine (1997) the net involvement of the State in the financial sectors (especially in Algeria, Syria and Egypt) bothers the emergence of competitive and efficient systems. The governments, according to this view, set the lending and deposit rates arbitrary, without consideration to the scarcity of resources on the financial markets, deal out the credits to the public companies, or use them to finance its deficit, as it involves the extraction of implicit tax calling "the inflation tax". This situation cause, according to these authors, the rise of non performing credits and prevents financing the private sector, who would offer better investment opportunities. Competition in the banking systems is also bothered by the settlement of barriers on entry by local and foreign banks in many countries. The limited competition leads to limited innovation on the banking sector and then restricts the transformation of short term deposits to long term loans.

The quality of banking governance and corporate governance, represent also an important factor explaining the current level of financial development in the region. For the banking sector, the experts of the IMF consider the government involvement and the restrictions on competition as the cause of the lack of innovations

in the lending activity. So it hinders the skills formation in credits attribution and forecasting risks. On another hand, and according to an institutional view, the weakness of the judicial system makes difficult the enforcement of the lenders rights. So it hinders the banking financing as the bankers couldn't turn to law to recover the collateral in case of bankruptcy or insolvency.

Furthermore, banking regulation and supervision doesn't reach the level of international standards, involving a rise in savers risks concerning banks quality and performance[2]. Even if these remarks on the judicial and legal system are relevant to relate the current situation of financial development in these countries, it would be better to be more moderated concerning the government involvement in the banks management. Since, resorting only to the market doesn't inevitably allow the best resources allocation.

The banking and financial markets in these countries are naturally imperfect, as well as all the financial and banking markets in general. For the case of these countries, the weakness of the institutional and legal system is due to a lack of transparency needed to a good markets functioning. The government involvement in this case is justified. Further, in the beginning of any development process, the State intervention is often requested to guide and lead the functioning of banks and financial markets. We can refer, to illustrate our point of view, to the case of some European countries, such as France or Italy who had pursued a government intervention policy in the financial system, since the end of the World War II until the end of the seventies. These countries collected the benefits of this strategy by realizing the most important growth rates in that period, thanks to the protection of their financial systems.

We notice at this level of analysis, that financial reforms initiated in the SMS countries are the outcome of the Structural Adjustment Plans which are the direct consequence of the desire to spread the liberal convictions of the "Washington Consensus". These ideas are related by the International Financial Institutions, themselves controlled by the USA and the EU (by habit, the IMF is always directed by an European and the World Bank by an American). We can have a doubt then on the real possibility of these institutions to well manage countries that they don't necessarily know enough about them, given the fact that the features and specificities of the emerging and developing countries are different from the industrialized ones. Moreover, it's interested to the developed countries to help emergent economies to realize the financial integration, in order to well profit from the investment opportunities existing in these countries.

The globalization would be "forced" then to them. The imposition of the globalization movement can be clearly illustrated in its financial wing called, financial globalization. Since it targets one of the economy's pillars, which represent the national sovereignty. This is a real danger for the developing economies. It represents n economic threat, like demonstrated by the phase of the financial crises in Latin America and East-South of Asia. But also an institutional threat, since the financial globalization is recommended by the international financial institutions that apply it through a standard way and measures that are not necessarily adapted to the social and economic reality of these countries. Then, it's obvious that this movement gives rise to distrust and creates autonomy reactions against it.

The importance to be doted by a favorable legal and institutional environment seems then to be essential to reach a high level of financial development and so to

[2] Hoskins. I (2003) : art. op, cite. P : 14.

realize the hoped economic development and growth. Hoskins (2003) notice the "bad" quality of the legal and institutional environment as the main reason that prevents the SMS countries to reach that aim. Indeed, the majority of experts and analysts interested by the financial development issue in the region notice the importance of a good governance, and institutions high quality to enhance the effectiveness of the financial systems.

Furthermore, in a context of globalization featured by markets integration and general adoption of privatization companies' policy, it's necessary to reinforce regulation and supervision frameworks. In general, the institutional environment and the banking systems have to be more friendly and more favorable to do business as noted by Hoskins (2003) : " Weak judicial and legal systems make it difficult for financial institutions to enforce contracts. This includes weak bankruptcy laws and procedures, unclear land and collateral ownership rights, as well as difficulties in recovering collateral when necessary.

Improvements in these areas will also facilitate the development of deeper capital markets which at present remain undeveloped"[3] and then make them capable to resist to the violent waves of the financial globalization. It is within this same framework that belong this work, since the aim is to demonstrate that the financial globalization applied to the SMS countries does not automatically generate progress, growth and wealth. In the next section, we will try to study the real link between the legal, institutional environment quality and the financial development, by studying the economic literature on this point, and the theories concerning that link.

3. The Link between the Financial Development and the Institutional Development

The link between the financial openness and the financial development is not free of ambiguity. Indeed, in order to profit from the capital account liberalization, the financial systems have to be strengthened by a developed legal and institutional framework. Specifically, the economies where the legal and judicial system don't guarantee the property rights, or don't look after efficiently the enforcement of financial contracts, suffer in general from a lack of incentives to lending activities and the settlement of financial transactions. Lenders and borrowers legal rights, the credibility and transparency level of laws organizing the financial sector are the main factors that govern the financial sector in an economy, and give or not incentives to turn to the financial system.

According to this, Claessens and al (2002)[4] and Caprio and al (2004)[5] founded that more lenders are protected by an efficient judicial system, deeper is the financial system. By considering the effective level of legal and institutional development, we can then surround the ambiguity between the financial openness and financial development. Indeed, we can adopt the hypothesis that the financial development can be the outcome of the financial openness, only if the whole economy reaches a reasonable level of institutional and legal development.

In addition to the legal environment quality which is important to realize the financial development, we notice in the recent economic literature the emergence of

[3] Hoskins. I (2003) : art. op, cite. P : 16.
[4] Claessens. S ; Djankov. S ; Fan. J et Lang. L : « Expropriation of Minority Shareholders in East Asia », Journal of Finance, P : 21.
[5] Caprio. G ; Laeven. L et Levine. R (2004) : « Governance and Bank Valuation », mimeo, University of Minnesota, P : 2.

another important factor, considered as the natural complement of a good institutional structure. It's the concept of social capital approximated by the level of trust and cooperation among individuals.

a. The Importance of Social Capital

Fukuyama (1997) considers that: « Social capital can be defined simply as the existence of a certain set of informal rules or norms shared among members of a group that permits cooperation among them. The sharing of values and norms does not in itself produce social capital, because the values may be the wrong ones... The norms that produce social capital...must substantively include virtues like truth-telling, the meeting of obligations, and reciprocity »[6]. For Bowles. S and Gintis. H (2002): « Social capital generally refers to trust, concern for one's associates, a willingness to live by the norms of one's community and to punish those who do not »[7].

The social capital is a concept borrowed from sociology, related to the benefits taken by individuals via their adhesion to communities and associations (Bourdieu, 1985) or the extend and quality of human relationships in a society and its potential to be enhanced (Coleman, 1990). In this context, a high level of social capital leads to the exclusion and the punishment of all who deviate from a set of social conventional standards.

The relationship between social capital and financial development attracted the attention of few economists. Comparing to the studies on the link between social capital and economic development. Only the studies of Guiso . L, Sapienza. P and Zingales. L (2000) ; Hong. H, Kubik. J. D and Stein. J. C (2001) ; Calderon. C, Chong. A and Galindo. A (2001) had clearly analyze the link between the two concepts, via empirical studies connecting indicators of social capital and financial development indicators.

The existence's intuition of a link between social capital and financial development is the result of the fact that a financial contract between a lender and a borrower needs a giver level of trust to be accomplished and to its clauses to be respected. Since in a financial contract, the lender transfer an amount of money at the date t to the borrower, in the hope to recover it at t+1 in the future. In order to avoid an opportunist behavior, another clauses comes complete the contract, like collateral requirement.

However, in several cases and given many factors, the collateral system looses its effectiveness because of the lack of the system of regulation adopted (like the difficulty to the lender to access to collateral in case of the borrower's insolvency) or a lack in the system of contracts enforcement. Even, in the case of a strict application of laws, the financial contracts are intrinsically incomplete. It involves that no contract can guarantee completely the refund of a loan. It involves too, that even if the law is strictly respected, the trust will have an important role to play in defining the financial market deepness, given the fact that a financial contract is basically incomplete.

Furthermore, trust is more important in the economies where legal rights of lenders are less protected and judicial system is weak. Hence, a high level of trust would favor the settlement of financial contracts between individuals and then contribute to the development of financial markets. Moreover, the respect of financial

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[6] Fukuyama, F. (1997), "Social Capital," Tanner Lecture on Human Values, P : 378-379 cited in Durlauf, N. S et Fafchamps, M. (2004) : « Social Capital », NBER Working Paper Series 10485. P : 4

[7] Bowles S et Gintis. H (2002) : « Social Capital and Community Governance », Economic Journal 112, P : 422, cited in Durlauf, N. S et Fafchamps, M. (2004) : art, op. cite. P : 5.

contracts is not necessarily due to the threat of legal punishment, but it's an issue of mutual trust among different market participants. Indeed, if the debtor don't respect his commitment and don't repay his debt in the future, the use of financial contracts will be shrank and even involves, in case of generalization of the phenomena, to a high insolvency and risk to weaken the whole banking sector[8]. Hence, the trust level can be considered as a significant factor of development or banking distress et could even explain the differences between financial systems and economic development between countries.

However, like noticed by Baudassé, T. and Montalieu, T. (2004), the importance of social capital in the financial transactions and relationships can take more specific aspects[9]. Since the lender in case of contracting a credit is in a situation of information asymmetry compared to the borrower, as the later is more informed about the eventual earnings and the feasibility of the project. In the aim of avoiding this asymmetry information, M. Ferrary (2003) suggests two methods.

The first has a Cartesian nature. It's the "instrumental risks appraisal". It consists to evaluate the solvency of a debtor relating to objective data and information. For an individual credit, it consists to check and study some borrower's features, like the age, the job, the income, the banking history... For the firms, it consists to check the accounting records and the evaluation of some financial management elements. The second method is more subjective. It's the "social appraisal of the financial risks". It consists to create with the borrower informal relationships thanks to it, the lender would be able to know more personal and subjective information about the borrower.

This personal information is about the borrowers' honesty and also about the feasibility and the soundness of the projects. So, these information would never been known by the lenders otherwise. In these approach, the banker will have a : "...strategy of social infiltration depends on which social network underlies the business that he wants to evaluate.

When a social network is geographically-based (for example, the area around the branch), the successful financial counsellor should frequent places where his potential clients socialize in order to find individuals who have information and to learn the local actors' reputation"3[10]. To illustrate his idea, Ferrary (2003) refers to the example of the French restaurants in Paris, managed in majority by businessmen originating from a region in southern France. This situation incited a Parisian bank to enrol a financial counsellor from this community, because he knows more than another about them.

In theory, the social capital approximated by the trust level is positively linked to measures of breadth and size of the financial sector, and negatively linked to measures of its efficiency. To understand this conjecture, we have to come back to the initial of the financial intermediary operation. This operation links a deposer who is the lender to a debtor who is the borrower, via a financial intermediary. In this process, the deposers and the lenders are both exposed to a problem of optimisation that appears some risks.

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[8] Calderon. C, Chong. A et Galindo. A (2001): « Structure and Development of Financial Institutions and Links with Trust: Cross-Country Evidence », Inter-American Development Bank, Research Departement Working Papers N°444.

[9] Baudassé. T et Montalieu. T (2004) : « Le capital social : un concept utile pour la finance et le développement ». Document de recherche N°25 du Laboratoire d'économie d'Orléans. P : 11.

[10] Ferrary. M (2003): « Trust and Social Capital in the Regulation of Lending Activities », The Journal of Socio-economics, Vol.31, P : 683 cited in Baudassé. T and Montalieu. T (2004) : art. op, cite. P : 12.

The risk of the deposers is that the financial intermediary adopts an opportunistic behaviour, given the high and sometimes prohibitive monitoring costs. The lenders confront the risk that borrowers won't repay the credit. In these two cases (opportunistic behaviour of the financial intermediary and the insolvency of the borrower) the initial owner (the deposer) couldn't recover his funds. The importance of these risks and their impacts on the deposers decisions depend of a several factors, especially in an institutional dimension. Inside this institutional dimension, trust (or social capital) is very important. A low level of trust could exacerbate these risks. Since in this case, the borrower is more risky to get insolvent than in case of a high level of trust. That's why we notice that in countries where trust is not a shared feeling between individuals, the financial market is nor large, neither deep.

The deposers and lenders are influenced by the trust in their partners when they establish the finance agreement. The deposers loose the control of their funds when they leave them to the financial intermediary, and lenders loose a partial control of their funds when transferring them to borrowers. If the trust level is low in an economy, the deposers would doubt that bankers (financial intermediary) will properly treat their funds. Similarly, lenders would have doubts about the solvency of the borrowers. This situation would restrict the extension of credit activity, and discourage the use of banks by savers. So it slows automatically financial market's activity, even for the whole economic activity.

Concerning the financial markets efficiency in case of low trust level, the theoretical conclusions stay the same. Indeed, financial intermediaries are facing high marginal costs in countries where risks are high. These costs are partially transferred to borrowers and lenders via high interest rate margins, like noticed by Angbazo (1997) and Pong Wong (1997). Then, if financial risks are exacerbated by low trust level, the efficiency proxies like interest rate margins are expected to be negatively correlated with trust level.

b. Law and Finance Theory

A prolific economic literature noticed the incidence of financial development on growth. Levine, R. and Zervos, S. (1998) showed that the development of banking sector and financial markets is a good proxy of economic development in general[11]. For a microeconomic point of view Demirguc-Kunt and Maksimovic (1998), and also Rajan, R. and Zingales, L. (1998)[12] showed in their studies that financial institutions are crucial for firms and industry's expansion.

Although the existence of discords among theorists about this question, it seems to be clear the reliance of a positive relationship between financial development and growth. This link fixes more than issue about the financial development state in many countries. Indeed, what makes some countries reach growth and economic development by financial development and other no? The law and finance theory gives more than an explanation about this question and fix the issue of the legal and institutional environment to explain the differences between financial developments[13].

[11] Levine. R and Zervos. S (1998) : « Stock Markets, Banks and Economic Growth », American Economic Review, 88, P : 542.

[12] Rajan. R. G ; Zingales. L (1998) : « Financial Dependance and Growth », Chicago University and NBER, P : 26

[13] Beck. T et Levine. R (2004) : « Legal Institutions and Financial Development » in Claude Menard, Shirley. M (eds) Handbook of New Institutional Economics, Kleuver Dordrecht, The Netherlands, P :

The first part of this theory argues that where the legal and judicial system is strong, respect rigorously the property rights, investor rights and protect contracts between individuals, savers are more encouraged to turn to banks and then finance the need of firms to invest, contributing by the way to the expansion of capital markets. The absence of that legal framework wouldn't allow investor to access to private financing and so hinders financial development.

The second part of the law and finance theory argue that the different legal traditions born in Europe during the last centuries, expanded after to all over the world by conquests, the different colonization waves and herding phenomena explain the differences seen today concerning investor protection laws, the application of financial contracts and then the differences between financial development levels, if we trust the first part of that theory.

La Porta and al (1998)[14] were interested by laws governing the investor protection, the quality of enforcement of these laws and the property concentration in 49 countries. Their analyses lead to three main results. First, laws are different although they give a set of adequate rights to investors. In particular, the common law legal tradition countries would protect more effectively investors than French civil legal tradition. German civil law and Scandinavian one take a middle rank between them. In addition, there isn't evidence confirming the existence of privileged category of investors. Evidence show, rather, that common law legal tradition protects all kinds of investors.

This result corroborates the hypotheses of La Porta and al (1998) about the investors range's multiplicity of rights in the presence of multiple legal traditions. These rights are induced by laws and not inherent to the equities themselves. Second, the enforcement of laws is different according to the countries. Indeed, the laws enforcement is more rigorous in German civil law and Scandinavian countries. The laws enforcement is also accurate in common law countries, but less rigorous in French civil ones. The quality of laws enforcement, on the contrary to laws themselves is improved with the income level.

Third, evidence supports the hypothesis that countries develop substitutes to bad investor protection systems. La Porta and al (1998) argue that : " Some of these mechanisms are statutory, as in the case of remedial rules such as mandatory dividends or legal reserve requirements. We document the higher incidence of such adaptive legal mechanisms in civil law countries.

Another adaptive response to poor investor protection is ownership concentration. We find that ownership concentration is extremely high around the world, consistent with our evidence that laws, on average, are only weakly protective of shareholders. In an average country, close to half the equity in a publicly traded company is owned by the three largest shareholders.

Furthermore, good accounting standards and shareholder protection measures are associated with lower concentration of ownership, indicating that concentration is indeed a response to poor investor protection"[15].

4. Empirical Analysis of conditions to the financial development in a financial globalization context

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[14] La Porta. R ; Lopez de Silanes. F ; Shleifer. A et Vishny. R W (1998) : « Law and Finance ». Journal of Political Economy 106, P : 1151.

[15] La Porta. R ; Lopez de Silanes. F ; Shleifer. A et Vishny. R W (1998) : art. Op, cite. P : 1152.

The model studied in this paper is largely inspired by the model of Ito (2005) which is practiced for a panel of emerging countries, with a special attention to the region of South-Eastern Asia[16].

In what coming, we will study the long term effect of capital openness on the financial development in a model controlled by the level of institutional and legal development. The model is specified in the equation (1) :

fdi t fd-i5-t = γ0+ ρfdi5-t + γ1 καορεν;_5 + γ2Li + γ3 (Li kaopeni5-t) + x;_5 τ+Ui

FD is a measure of financial development; KAOPEN is a measure of financial openness; X is a vector of economic control variables; Li is a measure of legal, institutional development.

a. The presentation of the model variables

In this model, the vector X who represents the economic control variables consists of: the log of per capita GDP in terms of Purchasing Power Parity, the inflation rate, and the trade liberalization as measured by the ratio of the sum of imports and exports relative to GDP. The Log per capita GDP is here represented, because there is a large part of literature which attribute the financial development to an economic frameworks development, associated to an increase in the yields in a given economy.

The inflation rate is included, because it may influence the economic decisions, mainly concerning the financial investment. Indeed, a high inflation rate would be able to discourage the use of financial intermediation, and foster the investment in real assets such as real estate[17]. Finally, trade openness is included as a control variable ad hoc. The relationship between financial trade and financial openness will be better explained later. Financial openness is measured by Chinn-Ito index (KAOPEN).

Regressions were made for each of the four financial development indicators (FD): BLRBA, DCBS, DCPS and SMKC respectively banking liquidity ratio of banking assets, domestic credit granted by banking sector to GDP, domestic credit to private sector ratio of GDP, and finally stock market capitalization of listed companies to GDP. The first three indicators are related to the banking sector development, while the last is related to the capital markets development.

The legal and institutional indicators used in this study are measures of the general level of institutional and legal development. The LEGAL indicator represents this general level. The CONCOR, RUL and VOA represent respectively control of corruption, rule of law and voice and accountability. These 3 last indicators are included in the LEGAL indicator and are extracted from the database made by Kaufmann. D, Kraay. A and Mastruzzi. M (2006)[18]. This database is updated until 2005 of the same database constructed by Kaufmann. D, Kraay. A and Zoido-Lobaton. P in 1998. The Kaufmann. D, Kraay. A and Mastruzzi. M database belongs

[16] to. H (2005) : « Financial Development and Financial Liberalization in Asia : Thresholds, Institutions and the Sequence of Liberalization », The North American Journal of Economics and Finance, Vol 17(3).

[17] That's why, the IFI care mainly about controlling the inflation, when they undertake reforms plan in a given economy.

[18] Kaufmann. D, Kraay. A et Mastruzzi. M (2006) : « Governance Matters V: Governance Indicators for 1996 to 2005 », www.worldbank.org/wbi/governance/govmatters5.

to a set of databases gathered by the World Bank in response to the grown interest shown by research on the theme of governance and its role in development.

This database contains governance indicators on 213 countries covering 6 dimensions of the governance:

- Voice and accountability ;
- Political stability and absence of violence ;
- Government effectiveness ;
- Regulatory quality ;
- Rule of law ;
- Control of corruption.

In order to avoid endogeneity problems associated with short term cyclical effects, the model is specified as a panel error-correction model with non-overlapping data. Data are sampled only every five years between 1980 and 2000, and the five-year average growth of the level of financial development is used as the dependent variable and the "initial conditions" for time-variant explanatory variables, including the initial level of the financial development indicator, for each five-year panel. The regressions are made for 10 south Mediterranean Sea countries (Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Syria, Tunisia and Turkey)

Before showing the regressions results of the first model, we have to clarify that for data we have, the institutional and legal indicators are invariables over time. Like shown by Wei (2000) for the corruption indexes, this kind of institutional indicators may induce a bias in the regression results. In the aim to avoid this problem, it's advisable to use averages for sub periods. In addition, the introduction of these factors as independent variables of time, probably, doesn't pose problems for the study. Because the features represented by the legal and institutional variables evolve very slowly over time.

Furthermore, the aim of this study is to focus on the effect of the financial openness on the financial development, and not the effect of the legal and institutional development itself. In other words, rather than study the effect of the legal and institutional development on the financial development, the objective here is to see how the effect of the financial openness is modified by the quality of the institutional and legal environment. Thus, the temporal variations of legal and institutional variables are not critical in this study.

Following the same approach of Ito (2005), the use of five year windows allows us to minimize the effect of financial bubbles that financial development indicators may unintentionally capture. But the use of five years as the length of each window is still arbitrary. That's why we changed, like tested by Ito, the length of Panel intervals. When the length of the window is changed to four as well as six years, the estimation results are qualitatively intact.

b. Presentation and Interpretation of the regression results

The regression results of the specified model in equation (1) are reported in the following table 1 and table 2.

Table. 1 : Financial Development, Financial Openness, Institutional and Legal Development (LEGAL : General Development of the Legal and Institutional Environment)

	BLRBAt-	DCBSt-	DCPSt-DCPSt-	SMKCt-SMKCt-
Financial openness (t - 5)	-0.1617276 (0.1390694)	0.0334736 (0.0775546)	-0.0001281 (0.0432938)	-0.1180724 (0.0455673)
LEGAL	-1.473957 (1.221656)	-0.6400825 (0.6779895)	-0.0886744 (0.3533887)	-1.35862 (0.4469413)
Interaction : LEGAL*Financial Openness (t-5)	0.295587 (0.2496302)	0.3051935 (0.1368052)	0.0193313 (0.0830774)	0.4079559 (0.1109774)
Financial Deepening (t-5)	1.413549 (0.2769219)	0.061207 (0.019675)	0.5786786 (0.2352529)	1.209521 (0.3765764)
Log per capita GDP (t-5)	1.04379 (0.6156936)	0.5318692 (0.3708727)	-0.0925022 (0.1972445)	-0.048572 (0.1951229)
Inflation (t-5)	0.0089444 (0.0213185)	0.028908 (0.0118197)	-0.0066787 (0.0066008)	-0.0043489 (0.0060746)
Trade Openness (t-5)	-0.7631034 (1.184826)	-1.269429 (0.717984)	-0.0547659 (0.3645377)	-0.0096942 (0.3403386)
Constant	-8.780528 (4.762831)	-3.945675 (2.832618)	0.5651485 (1.510498)	2.730059 (1.455797)
R2	0.66	0.58	0.44	0.66

Point estimates from OLS. Standard deviations are between parentheses. Dependent variable is the average annual growth rate over a five year period. The financial deepening variable represents the initial state at the beginning of every period of 5 years of the dependant financial development variable.

The coefficients in which we focus on these regressions are those related to the financial openness, the legal variable and the interaction between them. The regressions are made of every indicator representing the financial development. The BLRBA represents the banking liquidity, DCBS is the proxy of the importance and the weight of the banking sector in the economy by measuring the quantity of domestic credits granted. DCPS is the variable that measures the share of loans granted to the domestic private sector, and finally SMKC is the financial development indicator which measure the stock market capitalisation of listed companies.

Table 1 reports the estimations with LEGAL representing the legal and institutional general development as dependant variable. Financial openness is supposed to act directly and interactively on financial development by controlling the legal and institutional general development. Indeed, the total effect of capital account openness can be showed as:

Total effect of financial openness = ((γ1 + γ3L) Lis the mean of the legal development level.

If we focus, for example, for the banking liquidity to banking assets ratio, we find that the total effect of an increase by one unit of financial openness is the loss of 0.735 percentage of financial development (in this example approximated by the BLRBA ratio). In the case were the LEGAL mean for all the period is -1.947. Thus, the capital account openness can lead to a higher or lower level of financial development, depending of the legal and institutional development level.

Table 2 clarify this point. Indeed, the first line of the table reports the total effect of one unit increase in financial openness, on every financial development indicator. And there are 4 indicators : BLRBA, DCBS, DCPS and SMKC. The second line of the table reports the average level for the institutional and legal development for all the countries on all the period. While the third line reports the legal development threshold level, from where legal, financial openness starts "production" of financial development.

Table 2: The total effect of one unit increase in financial openness on the financial development level

	BLRBA	DCBS	DCPS	SMKC
Total effect of financial openness	-0.735	-0.56	-0.037	-0.91
L (LEGAL)	-1.947			
Legal development threshold	0.547	-0.109	0.0066	0.289

By way of example, and for the sake of comparison we can evoke the case of Thailand who knew a little increase in its financial openness index, but due to its high level of the LEGAL index (measuring the legal and institutional development), it's expected to have a growth rate of 1.2% of its stock market capitalization.

Table 3 shows the regression results made on every component of the LEGAL index ; CONCOR, RUL and VOA which represent respectively the level of corruption control, rule of law and voice and accountability taken distinctly and in interaction with the financial openness index. From the results shown by this table, we can notice that via the different regressions made, those with the DCBA indicator are the most demonstrative of the importance to be doted by a developed legal and institutional system. This result is important when we know the place and the weight of the banking systems in the countries in which we interest. The banking system in the majority of the region's countries is merely confounded with the financial sector1, which means that its development is equivalent to the development of the whole financial sector, and denotes its responsibility in the growth and accumulation process.

Also, another observation emerges from the reading of the regression results table. It's the fact that financial openness coefficient taken alone is negative, and it continues to be negative even when we make it in interaction with the legal, institutional development indicator. That notices that financial openness wouldn't bring financial development without a reasonable level of legal and institutional development level. That reasonable level in not yet reached by the countries of the region 1 Elsewhere, the stock market data are inexistent for some countries of the region (Syria and Libya especially) for many years.

Table. 3 : Financial development, financial openness, legal (components of LEGAL : Corruption control CONCOR, rule of law and institutional development ' RUL, voice and accountability)

	BLRBAt - BLRBAt-5	DCBSt - DCBSt-	DCPSt - DCPSt-5	SMKCt - SMKCt-5
Financial openness(t-5)	-0.148 (0.162)	-0.0563 (0.0723)	-0.046 (0.043)	-0.114 (0.0616)

CONCOR	-0.209	-0.491 (0.254)	-0.289 (0.15)	-0.405 (0.197)
Interaction : CONCOR*Financial Openness	0.185 (0.0946)	0.239 (0.0844)	0.03 (0.048)	0.121 (0.071)
Financial deepening (t-5)	1.25 (0.256)	0.0649 (0.152)	0.518 (0.193)	0.485 (0.372)
Log of per capita GDP (t-5)	0.841 (0.644)	0.742 (0.313)	0.062 (0.182)	0.145 (0.249)
Inflation (t-5)	0.002 (0.022)	0.0255 (0.0101)	-0.0073 (0.0058)	-0.003 (0.007)
Trade openness(t-5)	-0.436 (1.267)	-1.669 (0.587)	-0.3 (0.324)	-0.034 (0.447)
Constant	-7.001 (4.88)	-5.278 (2.357)	-0.528 (1.376)	1.262 (1.863)
R2	0.63	0.7	0.58	0.46
	BLRBAt - BLRBAt-5	DCBSt-DCBSt-5	DCPSt-DCPSt-5	SMKCt-SMKCt-5
Financial openness (t-5)	-0.103 (0.175)	-0.066 (0.0922)	-0.0026 (0.0475)	0.018 (0.0391)
RUL	0.117 (0.786)	-0.377 (0.402)	-0.331 (0.228)	-1.097 (0.24)
Interaction : RUL*Financial Openness (t-5)	0.2 (0.0266)	0.335 (0.136)	0.0055 (0.0755)	0.402 (0.0844)
Financial Deepening (t-5)	1.251 (0.262)	0.0436 (0.0163)	0.679 (0.22)	1.4 (0.312)
Log per capita GDP (t-5)	0.706 (0.610)	0.42 (0.333)	-0.0553 (0.178)	-0.221 (0.157)
Inflation (t-5)	0.000456 (0.0241)	0.0355 (0.0125)	-0.004 (0.0064)	-0.0022 (0.0051)
Trade openness (t-5)	-0.155 (1.225)	-0.89 (0.607)	-0.08 (0.313)	0.179 (0.265)
Constant	-6.055 (4.63)	-3.109 (2.539)	0.267 (1.363)	4.219 (1.208)
R2	0.63	0.59		0.78
	BLRBAt-BLRBAt-5	DCBSt-DCBSt-5	DCPSt-DCPSt-5	SMKCt-SMKCt-5
Financial openness(t-5)	-0.097 (0.152)	0.183 (0.0885)	0.0128 (0.046)	-0.107 (0.0611)
VOA	-0.186 (0.573)	0.175 (0.3)	-0.035 (0.182)	0.327 (0.234)
Interaction : VOA*Financial openness (t-5)	0.035 (0.136)	0.211 (0.075)	0.0145 (0.0416)	0.098 (0.0503)
Financial deepening (t-5)	1.264 (0.257)	0.0512 (0.0172)	0.542 (0.235)	0.427 (0.351)

Log per capita GDP (t-5)	0.648 (0.623)	0.207 (0.345)	-0.13 (0.19)	0.165 (0.229)
Inflation (t-5)	0.0043 (0.0219)	0.0279 (0.0118)	-0.007 (0.006)	-0.0027 (0.007)
Trade openness (t-5)	-0.284 (1.16)	-0.604 (0.611)	-0.0141 (0.338)	0.346 (0.402)
Constant	-5.631 (4.715)	-1.375 (2.617)	0.87 (1.455)	0.906 (1.766)
0.63		0.7	0.44	0.5

Point estimates from OLS. Standard deviation are between parentheses. Dependent variable is the average annual growth rate over a five year period.. Financial openness is measured by the Chinn-Ito index (KAOPEN). The financial deepening variable represents the initial state at the beginning of every period of 5 years of the dependant financial development variable. As was the case for the LEGAL indicator, we report on a table the thresholds from which financial openness start "production" of financial development for the region's countries.

Table 4: Total effect on financial development indicators growth following a one-unit increase of the financial openness indicator

	BLRBA	DCBS	DCPS	SMKC
Total effect of financial openness	-0.169	-0.083	-0.049	-0.127
L(CONCOR)	-0.113			
Legal development threshold	0.8	0.235	1.53	0.942
	BLRBA	DCBS	DCPS	SMKC
Total effect of financial openness	-0.12	-0.092	-0.003	-0.014
L(RUL)	-0.0804			
Legal development threshold	0.515	0.197	0.472	-0.044
	BLRBA	DCBS	DCPS	SMKC
Total effect of financial openness	-0.122	0.0289	0.0022	-0.178
L (VOA)	-0.73			
Legal of development threshold	2.77	-0.867	-0.88	1.091

The analysis results of table 4 confirm the financial development state typology, made at the beginning of the paper. Which inform us that there is a ranking of countries according to the degree of financial development. Indeed, the financial openness is detrimental for almost all the region's countries, given their actual legal and institutional environment quality.

The case of the VOA indicator which represents the democratic degree of the

political institutions is an exception. Indeed, for that indicator, it's possible to benefit from the financial openness, to improve the quantity of credits to private sector, and even credits granted by banking sector (DCPS and DCBS).

However, when we focus on the average level of that indicator for Israel (0.908), we can doubt that it influence the global average level of the region, which exceed the threshold level (The global average level for whole region is -0.73, while it would be enough to have respectively -0.867 and -0.88 to realize an increase in the distribution of credits by banking sector, and the allocation of credits to the private sector. In addition, the threshold level is reached only by Israel and Jordan, with respectively (0.908) and (-0.326). While, for Libya and Syria, the levels are respectively (-1.583) and (-1.485) which are largely below the threshold level (-0.867 for the DCBS indicator and -0.88 for the DCPS level).

This classification according to the legal and institutional development reminds us, the one made depending on the financial development level, in page 3 of this paper. So it is clear to note that if a country comes to building legal, judicial system reliable and credible institutions, it has more opportunities to benefit from globalization and the benefits of financial openness. Elsewhere, Israel is the more financially "opened" country, and where the financial system is the more liberalised among the region's countries. In this case, we can doubt that, the high financial development level of this country, is the main reason of its openness and its financial integration. In other words, we have to check, if it's the financial development who leads to financial openness and not vice versa. That's what we will try to answer to in what following.

c. Test of the reverse causality between financial openness and economic development

One may wonder, in light of recent findings, whether it is the financial development that brings the country to pursue policies of liberalization and financial openness rather than the reverse. If we can show that the inverse relationship between financial development and financial openness is not relevant, it may be considered that countries can achieve the development of their financial system by deciding in a exogenous way to liberalize their financial systems or not.

In the aim to test this hypothesis, we changed the equation of the first model, swapping places of KAOPEN indicator and measures of financial development (BLRBA, DCBS, DCPS, SMKC). The dependent variable is, hereafter, the level of growth over 5 years of the financial openness indicator, whereas exogenous variables are now indicators of financial development and their interaction with the variable LEGAL. The model is as follows:

Equation (2)
kaopen; -kaopen;_5 =^0 + ^kaopen;_5 +^fd;_5 +φ2 v + ψ^ν xfo[_5) + χ[_5φ +

The coefficient of interest in this regression is φ1. If we find that it's significantly positive, it means that the regressions found above suffer from a form of simultaneity and that financial development led to the financial openness.

The results of equation's (2) regression show that through the various measures of financial development, as well as various indicators of legal and institutional development, the estimated coefficients are for the most part not statistically significant or significantly negatives. Indeed, over the 16 estimated coefficients (4

indicators of financial development BLRBA, DCBS, DCPS, SMKC for 4 legal and institutional development indicators LEGAL, CONCOR, RUL, VOA) we found only three φ1 significantly positive. These 3 factors are related to the financial development according to the BLRBA indicator. However, we found above in the context of the first equation regressions that coefficients different from the values expected, were all relating to the BLRBA indicator.

This invites us to believe that the choice of the indicator itself is the problem rather than the reliance of the regressions made. This leads us to conclude that the regressions made on the conditions under which the legal and institutional development influences the financial development do not suffer from problems of simultaneity. The other equally important fact that draws from these results is that financial development does not necessarily lead to financial openness.

In other words, a country that is making steady progress in the use of its financial system is not obliged to open its "financial borders", since the achievement of financial development is not necessarily a step before the financial openness. In many cases, it is rather the opposite that is suggested. Financial development achieved in a given economy should not be quickly delivered to an international competition suddenly and in a not gradual manner.

The example of South Korea represents a benchmark. We should proceed by steps in the process of financial liberalization and openness, in order to benefit from financial globalization and the opening up to international competition. This is what economists call the "gradualism" or "sequencing".

d. The importance of the sequencing

According to McKinnon (1991), the capital account openness must be the latest in a long series of liberalization and should only take place once the liberalization of trade has been completed. Nevertheless, the theoretical merits of this claim were not always confirmed by the empirical work dealing with the issue. Thus, Haggard and Maxfield (1993) have shown that trade liberalization is a prerequisite for the financial openness while Leblang (1977) found no effect of trade liberalization on financial liberalization.

Aizenman and Noy (2004) have discovered a two-way relationship between the financial openness and trade liberalization, although they have found that financial openness leads to trade liberalization rather than the reverse. Tornell and al. (2004) have shown that financial liberalization has always followed the liberalization of trade during the last two decades.

In what follows, we will try to test the hypothesis that trade liberalization is a prerequisite for financial openness. To do so, we used the following model :

$$KAOPENt = \xi 0 + \xi 1KAOPEN5\text{-}t + \xi 2\ TRADEOPEN5\text{-}t \quad + Z1\text{-}t\ \ /\ t\ 5\text{-}\Theta + vt$$

Where: Zt-1 / t-5 is the vector of macroeconomic variables control; the budget deficit, international reserves and GDP per capita. The choice of the first two variables is justified by the fact that they represent the determinants of capital controls. The variable of per capita GDP is incorporated to reflect the level of development of the economic system. Because these variables are supposed to monitor the general trend of macroeconomic variables, they are included as average on sub 5 years.

Trade openness is represented here by the variable TRADEOPEN which is the reciprocal of the weighted average of burdens imposed on imports and exports. This

variable measures the de jure open trade because the variable KAOPEN also represents the de jure financial openness. Unlike the ratio sum of exports and imports relative to GDP, which is a variable of the de facto open trade.

We will also test the existence of an inverse relationship between trade liberalization and financial openness. In other words, we will see if the financial openness leads to trade liberalization by the regression of this model :

TRADEOPENt =ξ0 +ξ[TRADEOPENt5 +ξ2 'KAOPEN5-t +Z1-t/t5-Ξ + wt

In order to avoid the problem of two-way causality, in both types of regressions, we use a non-overlapping panel data analysis as in the other regressions. Although the difference with the other analyses is that the macro variables are included as the five-year average. Thus, both KAOPEN and TRADEOPEN are included as the initial conditions of each five-year panel. In the empirical results, we focus on the coefficients ξ2 and ζ2 to see if the trade openness can be a precondition for financial opening, or the reversed causality is true. Table 5 summarizes the results of estimating both models.

Table 5: Determinants of Capital Account and Trade Openness

	KAOPEN	TRADEOPEN
Financial openness (t-5)	0.773 (0.133)	26.149 (9.093)
Trade Openness (t-5)	0.0158 (0.007)	0.698 (0.217)
Average Budget Deficit (t-1/t-5)	0.0135 (0.0751)	0.404 (2.346)
Average Total Reserves (t-1/t-5)	0.00000363 (0.0717)	-12.017 (5.344)
Average GDP per capita (t-1/t-5)	-0.0803 (0.272)	13.452 (16.701)
Constant	2.11 (1.82)	-30.05 (121.812)
R2	0.67	0.96

Standard deviations are between parentheses. Budget surplus, total reserves, and GDP per capita are included at the average over t-1 through t-5. KAOPEN and TRADEOPEN are estimated in first differences.

The first column of the table shows that none of the macroeconomic variables control (fiscal deficit, total reserves and GDP per capita) has a significant coefficient. However, the coefficient of initial market opening is significant and confirms the hypothesis which states that trade liberalization is a necessary condition for the success of the capital account openness. Nevertheless, the results of the second column of the table belie the empirical results found in earlier studies conducted on the link between trade liberalization and financial openness. Because for all the countries subject to our study, it appears that there is an inverse relationship between the capital account openness and trade liberalization.

4. Conclusion

The issue of financial development in emerging countries continues to attract interest, the reactions of the community of economists and mainly continues to

generate controversy. Indeed, the classical economists seem to believe in the benefits of free trade and its applicability for the financial field. Another piece of the economic literature, especially from neo structuralists economists refute this idea and instead believe in the benefits of protectionism, particularly in the financial field. The aim of the study undertaken in the context of this paper was to show an objective risks that may incur today countries south Mediterranean sea countries (which represent similar features to all developing countries, excepting the case of Israel), by insertion in a globalized financial sphere.

We deliberately used the term risk, because the governors and other economic policy makers in these countries seem rather brought to the financial openness forgetting the preconditions necessary for its accomplishment. Indeed, it appears from the results of this study that for all indicators of financial development, the current state of legal and institutional development can not ensure an improvement in financial systems activity and efficiency. It is therefore not advisable in view of these results to pursue an aim of financial openness before realizing these prerequisites.

This conclusion, that we come in the end of this study, seems not to be taken into account by the region' countries (for example, Tunisia had already planned to institute soon, the full liberalization of the Tunisian Dinar). Rather than opening the financial "borders", the best way would be to prepare the groundwork for such a choice, by improving the quality of the legal and institutional environment. But it seems that in logic of "wild" financial globalization, the States, especially, in the developing world, have lost so much flexibility and autonomy in the pursuit of their beneficial goals. They are obliged to follow the proposals and dictates of the international financial institutions, already at the mercy of a few private interests.

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