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Abstract

Morocco has engaged important structural reforms aiming at establishing the basis of a strong and durable economic growth. These reforms have enabled for the reinforcement of overall macroeconomic stability, the improvement of business environment and trade openness, combined with the liberalization of key productive sectors.

The financial system, mainly the banking sector, was placed at the hearth of this reforms dynamics, with due regard to its key role in terms of growth reinforcement and economic catch up. Thus, in addition to the privatization of public banks, restructuring of some specialized financial institutions and the development of equity and bond markets, the Moroccan financial sector has seen a deep change of its regulatory and institutional framework to bring it in line with international standards.

Being the main component of the Moroccan financial system (nearly 60% of financial assets), the Moroccan banking sector has a diversified structure which compares favorably with some emerging countries with a level of higher financial development like Mexico or South Korea. This diversification is followed by an increasingly reinforced financial depth and solidity compared to regional average.

Whereas the Moroccan financial sector currently stands as one of the most structured and developed systems in the South-Mediterranean area, the new challenges rising ahead, in particular with the entry into force of prudential rules within the framework of Basle II as well as current and future engagements within the framework of financial services liberalization, put into the agenda the issue of its adaptation to global market forces and competition to tackle the challenges of transition and convergence.

In parallel to the efforts engaged at the domestic level in the area of financial system modernization and deepening, it is worth to say that a significant role falls to the European Union in terms of sustaining the process of real and normative convergence. The new business opportunities such as offshore banking services, represents a powerful factor of attraction of resources resulting both from financial co-operation and FDI. The positive effects of these additional resources on Morocco's socio-economic fundamental are clearly significant as it would enhance the pace of the process of convergence towards European standards and thus reinforce the credibility of European Union engagements in favor of the ongoing reform process in Morocco.

The purpose of this paper is to draw up the main aspects of financial system reforms in Morocco during the last years. Then, a comparative analysis with some Southern Mediterranean countries and Central and Eastern Europe will be carried out to appreciate most relevant developments. Lastly, an attempt to identify benefits and costs of the adjustment of the Moroccan financial system will be undertaken and a number of suggestions, based upon some successful experiences, will be made in order to accelerate the pace of Moroccan financial sector convergence towards European Union standards.

Part One: Reform Process of the Moroccan Financial System

1- Macro-economic Stability: A Prerequisite to the development of the Moroccan Financial Sector

In keeping with the general trend in emerging economies, the macro-economic situation in Morocco has significantly improved. General indicators of solvency and external liquidity have been reinforced following the maintenance of a current balance surplus, the lightening of the impact of external debt and the increase in external net assets.

There has been an upturn economic growth of 5% on average over the last five years. Alongside this marked evolution, economic activity has become less volatile and relatively less subject to climatic changes. In fact, the contribution of non-agricultural sectors has increased over the last few years. It leveled at 5.9% in 2006 on account of the recovery of sectors such as construction and public works, tourism and transport as well as the emergence of promising sectors such as information technology, food processing industry, electricity and electronics industry.

The positive impact of this sustained growth, coupled with active measures taken to promote employment, is clearly noticeable in the unemployment rate which dropped down to 9.8% in 2007 from 12.5% in 2001 in spite of a decreasing activity in the sector of agriculture.

The macro-economic stability has been further consolidated with an inflation rate of around 2%, a budget deficit of less than 3%, and a balance of payment surplus of about 2%. As to the rate of the treasury's direct debt, it has decreased by ten points off the GDP from 2001 through 2006 to rest at 57.4%. The current process of fiscal reform and the modernization of administration should result in efficient management of the state's finances. This further enhances budgetary discipline and widens the maneuvering scope of public authorities by gearing their intervention towards promoting the business environment and developing the infrastructure of social services.

In addition to the downturn of external debts, the structure of external public debt shows signs of improvement and offers favourable financing conditions with less exposure to risks arising from currency exchange. Most liabilities towards foreign creditors are debts granted on a medium term range. A break out of creditors by type reveals that commercial banks have a limited leverage in comparison to bilateral or multilateral creditors.

Economic and social progress, as well as political stability, have positively impacted the country's image abroad. This was confirmed by the "Investment Rank" awarded to Morocco by the Fitch Rating Agency in April 2007. The positive impact is also noticeable in successful launches on financial markets. In fact, the two major bond issues carried out on the international market of debt, the first of which was used towards the early repayment of the London Club debt, were well received by the international financial community.

2- Main Features of Financial Reform

On the eve of implementing reforms, the Moroccan financial system had a segmented structure where the state was bureaucratically omnipresent through specialized financial entities and a monetary policy based on techniques of quantitative regulation. This was at a time when financial markets were marginally scaled and not sufficiently equipped with diverse instruments that could otherwise enable them to finance the economy in an adequate manner.

To address these inadequacies, considerable reforms have been undertaken since 1990 with the aim of putting in place a viable modern financial system that can ensure efficient mobilization and allocation of savings through economic channels. Approaches include reforming the banking sector, financial markets as well as monetary policy and exchange. These reforms are aimed at making interventions more consistent and Morocco's financial system more competitive.

Three axes have been introduced in the banking sector; namely the restructuring of the legal framework governing these institutions (principle of universal bank, protection of depositors, surveillance of the banking system), the consolidation of prudential regulation in compliance with international norms (solvency, liquidity, risk management, etc..) and the deregulation of banking activity (rate decontrol and mandatory job reduction). At present, reforms are geared towards a further consolidation of the jurisdiction of the central bank and securing its independence as well as extending its control to all banking activities and setting a close coordination with all the controlling authorities of the financial system.

Reform of financial markets has been implemented gradually. For the year 1993, this reform involved the modernization of the Casablanca Stock Exchange and the setting up of stock trading firms and real estate investment organizations as well as a control entity, called the CDVM, the securities market watchdog. In 1996, the stock exchange reform was stepped up further through the computerization of the quotation system, the dematerialization of securities, and the setting up of a central depository as well as a customers' guarantee fund. For the years 2006 and 2007, the initiated reforms aimed at upgrading the security system of transactions.

As to the insurance sector, a gradual liberalization of tariffs relating to certain lines of business has been undertaken and some extensive reforms have been initiated. These reforms aimed at developing institutional savings and ensuring the sector's compliance with the content of ratified free trade agreements.

Alongside these ongoing reform projects, measures have been taken at the level of monetary policy. These measures include the recourse to indirect instruments of regulation (Open Market, resumption of liquidity, advance on calls for tenders, etc.) and the implementation of new Bank al-Maghrib charters that allow more autonomy to monetary authorities and inhibit clashes of interest involving budgetary policy and monetary policy.

In keeping with the increasing opening up and the gradual integration of the national economy in its regional and international context, significant progress has been made in the process of exchange liberalization initiated in 1993.

In addition to setting up an exchange market in 1996, a gradual liberalization of capital account was initiated and new measures were adopted in 2007. These measures particularly included easing the terms of investment for Moroccan banks operating abroad. The duration of this investment has been increased to five years and their liberalization has been brought up to 10% for the OPCVM portfolios. Foreign Direct Investment could amount to MAD 30 million. Insurance companies no longer need prior authorization for foreign investment that account for 5% of their assets.

On the whole, the prospects of these reforms are promising. The volume of credit granted by the banking sector has remarkably increased to rest at 72% of the GDP against 51% in 2001. This is indicative of a further consolidation of this sector's leverage in financing the Moroccan economy. Besides, the banking sector has contributed to the birth of large- scale financial conglomerates comprising the entire range of financial services and increased the number of international transactions. The capitalization of an already modernized stock exchange market has significantly gone up over the last few years, from 24.5% of the GDP in 2001 to 97% in 2007.

3- Performance Benchmark of the Moroccan Financial Sector Compared to some countries in the Euro-Mediteranean Region

Following the various reforms undertaken over the last two decades, the have resulted in an increased efficiency of this system. When compared to financial systems of some emerging and developing economies, the system nonetheless shows gaps that undermine the role that financial intermediation in financing the economy.

On the basis several indictors, the following section seeks to offer a comparative appraisal of the performance of the Moroccan financial system, with special focus on the banking sector.

This comparative analysis, albeit not exhaustive, attempts to delineate the remarkable progress some of countries of the region have made and raise questions about the discrepancy in performance between Morocco and these countries.

3.1 Relatively Satisfactory Performance Indictors

<u>Size of the Financial System and Quality of Banking Assets</u>

As to credits granted by the Moroccan banking system, the part of loans set in terms of GDP percentage has consistently increased. It reached 59% in 2006 against 51% in 2001 before rebounding to 72% in 2007. This ratio is by far superior to the average of the MENA region (58%) and clearly above the average of some countries in Central Europe (around 30%) but lags behind the average of the Euro-Zone (109,6%).

In addition to factors relating to the scale and growth dynamics of these economies, the discrepancy in performance could be ascribed in terms of European standards to the selectiveness of lending institutions that have to compete fiercely for the lowest possible risks or to the reluctance of certain banks to grant loans to small and medium size enterprises. Another factor that accounts for this discrepancy is the financial system's preference for investment in public debt securities, particularly those of the liquid kind, wherein the quality of signature ensures virtually risk free operations.

The quality of assets within the Moroccan financial system has been substantially upgraded. There has also been considerable progress in the collection of doubtful debt following the newly set legal framework. In 2007, the ratio of delinquent debts was brought down to 7.7% of the portfolio of bank loans against 10.7% in 2006[1] and 15.9% in 2005.

Despite this outright deceleration of the portfolio of doubtful debts, their level is still superior compared to that of emerging countries in Europe where the rate has significantly decreased in keeping with the level in the Euro-Zone (3 %). Progress made in the Czech Republic with 4.3%, Poland with 7.1% and Slovenia with 2% is ascribed to change in the classification of debts and the transfer of part of doubtful debts carried by banks according to a deliverance plan.

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[1] The low quality of bank assets particularly involves public banks. Otherwise, the ratio of these delinquent debts rests at 7.4% following 9.6% in 2005.

The stock exchange market has witnessed some positive developments with a market capitalization of 97% of the GDP in 2007 and a steady increase in volume of transactions. It ultimately accounted for 60% of market capitalization in 2007. However, this market shows a high degree of concentration since the ten highly rated companies represent 90% of the capitalization market. These figures compare favourably with those of Europe's emerging economies where capital markets are comparatively less developed with a capitalization market of about 30% of the GDP on average.

Nonetheless, the performance of the stock exchange market in Morocco is still below that of countries of the MENA region, namely Jordan (a capitalization market of 208% of the GDP and a transaction ratio of 72%) and Asian emerging economies. Furthermore, the capital market still cannot play an active bridging role in financing Moroccan companies, as indicated by the low volume of bond issues and the capital's market concentration on a limited number of big companies (MAD 4.1 billion in 2006). Likewise, the volume of stock issues of negotiable debt securities mainly involve certificate deposits and warrants of financing firms (90%), which is indicative of the low recourse of non-financial firms to capital market.

Efficiency and Stability Indicators

With regard to profitability indicators, the return on equity for Moroccan banks across the board, was around 17% in 2006; a ratio that compares favourably to that of some emerging economies in Europe such as Slovenia with 17.5% and Lithuania with 17.2%. However, this ratio remains below that of EU countries; namely Germany with 9.4%, Italy with 13.1% and Portugal with 15.6%. The discrepancy in return can be partly ascribed to a much higher risk level for an emerging country like Morocco. This situation is attested to by a wider interest margin that represents 76% of the Net Banking Product against 44.2% in France, 41.3% in Germany and 61.4% in Spain.

Although the financial context is characterized by an ever-increasing competition and a decrease in interest rates that considerably reduces the intermediation margin, Moroccan banks still have a reasonable margin to maintain a level of profitability, especially that a great part of collected deposits does not earn an interest and that the prospects of elaborating modern banking activities will ensure a steady revenue.

In addition to their high profitability, Moroccan banks are relatively efficient, with an operating ratio of 48% in 2006. This ratio is below that of French banks with 62%, Italian banks with 60%, Spanish banks with 55.5%, and even below the ratio of Polish, Czech and Hungarian banks (between 55 and 60%). The cost control must be qualified in a context where salaries in the banking sector are low.

In keeping with the trend of emerging economies, the Moroccan banking sector features a reasonably high degree of concentration since the three leading banks represented a total of about 64.4% in global assets in 2006;[2] which gives them a firm foothold on financial markets. The situation is relatively less pronounced in the French banking sector with a ratio of around 43% and 48% for its Italian counterpart. However, the degree of concentration featured by the banking sector in Morocco is less pronounced than that of countries of Central Europe, namely the Czech Republic with 87% and Slovenia with 63%. In spite of the high concentration level of this sector, there are several small size and cooperative based banks in these countries.

The Moroccan banking system also features a satisfactory 11.5% ratio of equity capital for 2005, a ratio that is similar to that of many countries of Eastern Europe and the European Union. This level is indicative of a solid national banking system that is in compliance with prudential rules set by international standards.

Capital structure of Moroccan banks is characterized by a strong presence of foreign banks, especially French ones. Major banks include *BNP Paribas*, *La Société Générale, Credit Agricole Indosuez* whose interventions up to the end of 2006 represented respectively 65%, 51.9% and 52,7% towards the capital of BMCI*, SGMB* and *Credit du Maroc*[3]. Other foreign banks are involved but with minor interventions.

This trend is similar to the one developing in Europe's emerging economies, a trend that is characterized by a withdrawn public sector and a strong foreign presence. Foreign investors have actively taken part in the process of bank privatization and own on average about 70% in total assets of East European banking system. It must be stressed that these foreign participations go in tandem with setting up European firms on the PECO[4] markets on the eve of their joining the European Union.

The number of bank holders in Morocco is certainly on the increase, but it remains comparatively low. Statistics for the year 2006 show that only 30% of the total population has bank accounts against 98% in France, and 1 automatic teller machine per 7300 inhabitants compared to France with 1 machine per 2400. Opportunities to develop this sector and increase its business activity are readily available.

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[2] The five leading banks represent 80% of total assets.

[3] These are three national banks BMCI (Banque Marocaine du Commerce Intérieur) SGMB (Société Marocaine Générale de Banque, and CDM (Crédit du Maroc)

[4] Countries of Central and Eastern Europe (Pays d'Europe Centrale et Orientale)

3.2 Morocco's Challenges of Developing and Converging its Financial System.

The Moroccan financial system can be a major player in the catch-up dynamics to which Morocco has subscribed. The system's further involvement in financing productive sectors would be a key vector to increase the opportunities offered by association and Free Trade Agreements that bring Morocco closer to The EU, the US, Turkey as well as to Arab countries (Tunisia, Egypt, Jordan) under the Agadir Round.

Consolidating Competitiveness in the Banking Sector

Consolidating competitiveness in the banking sector is necessary to enhance the development of financial intermediation and sustain stability of the financial sector as a whole. This also means modernisation of the public banking system, its opening up to foreign capital and development of service products to break away from the heavy dependence of revenues generated by credit intermediation. A healthy, competitive and transparent environment could be a major factor in facilitating SMEs' access to banking services and reducing their related costs.

Foreign bank competitiveness could incur costs in the short term; but its effects on the local financial system would be on the whole positive and would instigate a dynamic within the economy, as seen in various emerging countries in Europe and Asia.

Enhancement of Financial Markets

Liquidity is a key factor in consolidating financial markets. Despite a noticeable increase, Moroccan stock exchange liquidity is far below the average recorded in emerging countries, and does in no way compare to the current level in developing countries. This consolidation is guaranteed by improving liquidity of capital markets, through widening investor spectrum and consolidating transparency to ensure participation.

Hence, action is needed to consolidate financial markets. As a matter of fact, liquidity surplus of the banking system hinders efficient pricing. It negatively impacts interbank market and decreases activity of secondary markets of bonds, with the prevalence of a practice of withholding bonds until maturity.

Increasing Transparency and Reinforcing Information Systems

Increasing transparency and consolidating information system mainly involves speeding up the process of compliance with the basic principles of Basel II, notably the one related to the operational and financial economy of watchdog agencies. In addition, watchdog agencies would be more efficient with greater coordination at the national level (official exchange of information among regulatory entities) and the development an efficient information system of risk management.

To this effect, the project implementation of a risk terminal by Bank Al Maghrib, which will be operational by January 2009, would contribute to the consolidation and modernisation of existing infrastructure through globalising information, improving access rate to finance banking, and particularly through reducing credit rate. The advantages of such a project also include boosting economic growth and maintaining financial stability, as well as securing a good rating of Morocco.

Part II: Costs and Benefits of Adjusting the Moroccan financial System: What role for Regional Integration?

Adjusting the Moroccan financial system can not be carried out in isolation. On the contrary, it should go hand in hand with the consolidation of the democratic process as a whole, regarded as a major factor for stability, equity, distribution and sharing. Such a process represents by far the development platform for the productive system through the eradication of situation rent, the promotion of transparency, and the emergence of a new economic elite composed of innovative entrepreneurs.

The question of adjustment is also at the heart of the controversy of financing. It is a common concern for all South Mediterranean economies that committed themselves to opening up to other economies and regional integration. However, economic adjustment, the core of this integration, is facing some difficulties due to the slow and divergent dynamics of convergence.

1. Facts Relating to Regional Integration and the Convergence Process of South-Mediterranean Countries

The reality of Euro-Mediterranean regional integration contrasts with the ongoing dynamics in some regional poles in Asia and America, which are presently enjoying a booming intra-regional exchange, alongside a massive influx of Direct Foreign Investment. This is not the case with South-Mediterranean countries, despite efforts made in the last ten years through the launch of the Barcelona Process. The integration inadequacy of the South-Mediterranean region is characterised by weak intra-regional trade, resulting from insufficient transport infrastructure, limited diversification of productive structures, competitive rather than complementary nature of economies within the region, and heterogeneous national legislations.

A Slow Process of Convergence

Despite efforts to set up of a Euro-Mediterranean zone of shared prosperity, the speeding up of economic adjustment and investment optimization, the Mediterranean economic space is still marked by different national growth and development rates.

The analysis of PI 311 in PPA data between 1990 and 2004[5] shows relatively divergent evolutions among countries of the region. This period witnessed relatively weak economic growth in North African countries, and fast economic take-off in the 15 member states of the European Union, as well as in the economies of Eastern European countries.

As a matter of fact, two of the 15 EU countries enjoyed unprecedented success. Ireland achieved spectacular adjustment results as it moved from 78% of PI 311 (PPA) of the 15 EU countries in 1990 to 126% in 2004, while Luxemburg extended its share from 150% in 1990 to 170% of PI 311 (PPA) of the 15 EU countries in 2004. These countries benefited from the considerable development of their financial markets, thanks to the exceptional dynamism of international stock exchange markets and the massive influx of Direct Foreign Investment, particularly in the IT sector.

In the same context, Estonia, Hungary, Poland, Slovenia and Bulgaria have succeeded in reducing the gap in relation to the European average, registering a growth rate of income per inhabitant higher than that of the 15 EU countries between 1997 and 2004, having already registered a lower rate between 1990 and 1996. This dynamics followed years of efforts towards economic stabilisation, structural transformation and extensive reforms on the eve of joining the European Union (setting up institutions, new market mechanisms, exchange reorientation, restructuring and privatisation of public enterprises, improvement of the business environment, etc.).

As to North African countries, they have been unable to start the process of economic take off and to sustain national standards of living. Hence, between the years 1997 and 2004, the four North African countries achieved an annual average growth rate of P11B (PPA) of 2.4%, against a mere 0.9% between 1990 and 1996; that is to say, an improvement of 1.5 points between the two periods.

Morocco, for instance, has been involved since the nineties in a reform dynamics, aiming at the stabilisation of the macro-economic context, the improvement of the business environment, the consolidation of competitiveness of the national productive apparatus and the launch of ambitious programmes to develop infrastructure. These reforms have yielded positive results, with the P11 BH (PPA)[6] reaching an annual average growth rate of 1.8% between 1997 and 2004, against 0.7% in the years 1990-1996; that is to say, an increase of 1.1 points.

[5] Data for comparison is available up to 2004

[6] GDP per inhabitant in PPP of the Moroccan economy, corresponding to the period between 1998 and 2004, was corrected from the results obtained by the new national accounting system of 1993, 1998 base.

Nevertheless, these results are not enough to address the income gap per inhabitant which separates Morocco from the 15 EU member states. Morocco's P11BH (PPA) was 15% lower than that of the 15 EU member states in 2004. The demographic factor is partly responsible for this result, as the population increased by a yearly average of 1.4% from 1997 to 2004, a relatively high figure if compared to that of other countries of the region. As to the Moroccan active population, it went up at a steady rate (1.4% per year). Nonetheless, the Moroccan economy has not benefited from such rapid accumulation of human capital to speed up its growth rate. Despite witnessing a drop, the unemployment rate remains high (9.7% and 9.8% in 2006 and 2007 respectively), especially in urban areas and amongst the young.

All in all, the Moroccan economy should maintain a growth gap of 4 points in relation to the 15 EU states, to start a more rapid convergence process by 2012, while a growth gap of 6 points would position the Moroccan economy on a convergence trajectory similar to that of the PECO. This scenario is likely, based on the achievement of a new growth level (non agriculture-based P11B higher than 5% in the last five years), and the consequent substantial improvement of P11B/inhabitant estimated at around 41% in the last ten years (10% between 1998 and 2002 and 20% between 2003 and 2007).

Elements Reflecting the Importance of Endogenous and Exogenous Hindering Factors

The slow pace of the convergence process in South-Mediterranean countries is due to a range of hindering factors at different levels. Such factors are related to the belated demographic transition and its impact on the job market, education and training, the limited benefits from the commercial opening carried out in the Euro-Med partnership scheme. Moreover, the inadequate running of national productive systems impacts on innovation and risk taking, in addition to the high cost incurred by the upgrading of productive tools and the modernisation of infrastructure.

(i) Belated Demographic Transition and its Effects on Employment

Despite being on the increase, demographic transition was late in comparison with other emerging countries in Asia and Latin America. The current increase in the progression rate of active population coincides with the most critical phase of commercial opening featured in the framework of association agreements.

According to FEMISE forecasts, and in case the current activity rate in South-Mediterranean countries remains unchanged, around 20 million jobs should be created between now and 2010, and around 34 million jobs by the year 2020. Hence, tensions in the job market, which neither immigration nor recruitment in the civil service could contain, will persist in the future.

In addition to the difficulties caused by the job market, education costs in these countries, whose share in GDP is far higher than in other developing countries (around 6% against approximately 3% on average in Asia and in Latin America), do accentuate the problem. Moreover, inappropriate job qualifications further undermine the benefits expected from such expenditure.

(ii) Limited Benefits of Regional Integration

The effects of regional integration did not result in a sufficient appropriation of benefits consequent to a development process led by Europe in particular. The setting up of a development dynamic specific to South-Mediterranean countries has not materialised yet.

Patterns of economic specialisation in the region have witnessed profound changes which may lead to a reallocation of production factors. Such factors could give more credibility to partnership, in view of the powerful leverage that commercial integration would have over the diversification of exchange, the emergence of economies of scale and intra-sector specialisation. The slow movement of productive specialisation is one of the main factors behind the portioning of South-South exchange. Such compartmentalisation prevents these economies from achieving sufficient economic maturity that attracts foreign investment.

The weakness of Foreign Direct Investment is compensated by European financial aid which remains disproportionate in relation to the massive financial aid granted to Central and Eastern European countries on the eve of their joining the EU, first in a 1 to 3 and then a 1 to 8 rate. The case of Mexico in the ALENA[7] framework is very revealing. This country, which has become the privileged destination for FDI, witnessed a substantial increase to reach an average of around $18 billion during the period 2005 and 2007, 60% of which comes from the USA.

Hence, the problem of financing partnership remains unsolved in the sense that it does not really contribute to economic take off of South-Mediterranean countries that have opted for economic opening. Consequently, it is worth noting that despite the increase of Morocco- EU exchange in the preceding years, Morocco's share in EU's global commerce remains relatively stable (0.7% in 2006 against 0.75%in 2000). In addition, the increase in imports coming from the EU caused a hole in the commercial deficit of our country with the European partner and reached the figure of around ***MAD 28 billion in 2006 against MAD 24 billion in 2005.***

[7] Nafta. (North American Free Trade Agreement)

Similarly, the fiscal loss of earning on import duties ensuing from the Association Agreement with the EU increased by around MAD 6 billion just for the period from ***January to December 2007[8], that is to say, around €530 million.*** The implicit cost of this tariff dismantling is disproportionate in relation to the financial aid granted to Morocco in the framework of the national indicative budget over the period ***2007-2010*** amounting to ***€654 million***

(iii) ***A Less Homogeneous Productive System and Financing Circuit***

Although proceeding at variable degrees, the operating mode of the productive systems in the majority of the countries of the region neither favours innovation nor encourages taking risks. This is clearly reflected in the fragmentation of the industrial fabric and absence of complementariness between the various actors of the productive system, generally characterized by family businesses, who call for external financing, be it from banks or financial markets, and finance their activity mainly through their own capital.

This weak dynamics of the productive system affects a financial system characterized by a strong apprehension of risk and resorts mainly to public debt financing. As a matter of fact, despite progress in the field of financial liberalisation, the financial system in the region remains inappropriately oriented towards the main component of the economic fabric of these countries; that is, Small and Medium-sized Enterprises.

Furthermore, in addition to a shortage of discountable productive projects, the majority of financing mechanisms destined to enterprises (notably capital risk), either from national or international bilateral and multilateral agencies, are underused. The European Bank of Investment, through the FEMIP[9]fund, set up in 2002 and dedicated to South and East Mediterranean countries, has had trouble readjusting its portfolio to for SMEs, a portfolio composed essentially of loans granted to leading public sector institutions that have strong capital intensity. If we take the case of Morocco, we find that the projects financed by FEMIP reached the figure of €1040 million over the whole period of 2002-2006, 67% of which were allocated to infrastructures, notably in the fields of energy and transport, against 4% for capital risk and 3% in the form of credit lines.

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[8]According to the Moroccan Customs and Excise Office.

[9] Multilateral Investment Fund for the Middle East (Facilité Euro-méditerranéenne d'investissement et de Partenariat)

2. Benefits and Costs of Convergence of the Moroccan Financial System

The convergence process of the Moroccan financial sector has been very beneficial as it offers undeniable opportunities, especially in relation to the supplement of economic growth. Such an act induces a more efficient intervention in the field of financing the economy. This convergence is nonetheless without price. On the one hand, an accelerated financial opening up increases vulnerability to exogenous shocks; on the other hand, the necessary adjustment of some components of the national financial system would incur substantial cost.

Ostensible benefits

The opportunities related to the deepening of the Moroccan financial sector are clearly visible. They target both the development of competitiveness in the segment related to the financing of SMEs and the positive effects with respect to knowledge and know-how transfer. A further modernisation of the financial system would offer substantial margin of progression for economic growth. The potential of growth of the Moroccan banking sector is particularly promising. In connection with this, banking loans in our Morocco contribute with a mere 58% of the national GDP against 110% in the Euro-zone countries. The contribution of bank deposits in the Moroccan economy show the same potential growth.

The Moroccan market is interesting case study mainly because the rate of banking services is weak, while its earning power is high with an intermediation margin higher than that in Western Europe. Moroccan banks benefit from a safer regulatory framework and enjoy the emergence of a middle class, whose needs regarding insurance, complementary retirement and health are substantial.

In addition, the development of private financial institutions, particularly foreign ones, constitutes a crucial factor to the efficiency of the financial sector on the whole. This will contribute to the consolidation of governance and competitiveness, favour the emergence of new job skills that would oppose the restrictive nature of classical intermediation and allow the diversification of financing instruments and the development of forward markets. Hence, a better risk appreciation and an easing of obstacles related to financing SMEs, remains by far the main component of the national productive fabric.

This fact is confirmed in Middle-Eastern countries, where the most productive banks (capitalisation ratio, profitability, quality of credits) are private banks and particularly foreign capital banks. The experience of PECO and other Latin American countries equally shows that the presence of foreign banks increases the efficiency of national banks, the quality of legislation and banking control.

In addition, the implementation of liquid market of large-cap stocks would encourage the transformation of saving capital into a source of financing especially in a context that controls inflation. BEI recent commitment to finance infrastructure projects in some important public enterprises shows the existence of important long-term investment opportunities for the financial system. Such projects involve the National Electricity Office (ONE) and the Moroccan Highway Office (ADM). The latter partakes of the framework of a future trans-Mediterranean Axis in the prospect of reopening the frontiers with Algeria, especially in the transport sector, one of the weakest links of regional integration.

It is also important to note that normative convergence of national economy, particularly the financial sector, towards the European standards would be a support factor for partnership credibility. This has been demonstrated through the case of PECO as well as in other emerging economies like Mexico, where industrial relocations have secured a self-maintained process and where industrial Foreign Direct Investment is conducted in tandem with that of financial services.

Which are not exempt from economic and financial consequences, or even social

The opportunities presented above are not without risk. Several variables must be taken into consideration in the equation of convergence and the greater integration of the Moroccan financial system within the network of international finance.

Among these variables, there is the risk that greater financial opening up could result in transfers of domestic savings. While this risk can be played down since greater opening up will provide new opportunities for national financial institutions to optimise their business dealings, it is still necessary to improve transparency and prudential regulations in order to safeguard the stability of the financial system.

On the other hand, recent events in several emerging nations (Mexico, South-East Asia, Argentina) show the extent to which the pursuit of external financial opening up increases the risks of financial crises spilling over (as in the example of the American sub-prime crisis which affected the entire world economy).

The growth of international banking transactions and the greater role played by international investment funds, even though most of the latter have opted for strategies of safe and long-term investment, could be a destabilising factor by dramatically reversing a position, especially with regard to small emerging economies. This risk of international financial troubles spilling over is greater since, unlike periods of international financial crisis, notably since the 1990s, which are caused by macroeconomic problems, more recent crises are the result of institutional deficiencies still present in emerging financial systems such as Morocco’s.

Thus, the cost of dismantling a tariff policy entails an ongoing risk for national companies already excluded from financing networks, and difficulties in having access to structural updating programmes. The vulnerability of companies, especially small and medium-size enterprises, facing the daunting challenge of competing against European imports may cause a drift into the informal sector, with all the consequences this would have for economic, social, and political stability. This would undermine Morocco's efforts to reintegrate the informal sector into the formal sector through tax incentives and institutional, financial and accounting mechanisms.

Equally important, the privatisation and modernisation of financial systems can sometimes result in dramatic adjustments of human resources within financial institutions. These institutions may review staffing and recruitment plans, in an effort to improve their productivity and streamline their workforce. This fairly significant social issue would also be added to the overall cost of opening up. This trend has already been observed in Poland (131.000 to 122.000 employees between 2002 and 2004 respectively before rising up in 2005 and 2006 to 129.100) and in the Czech Republic (from 39.493 in 2002 to 37.540 in 2005 before rising to 38.232 in 2006).

The adjustment of the financial system raises once again the issue of the financial viability of retirement pension funds. Lingering tensions on the job market, fed by voluntary retirement and the drop in actual job creation in the public sector, have created daunting challenges relating to the financial viability of these funds. Besides the effort to modernise these funds, which may turn out to be costly and achieved at the expense of other priority programmes, notably in the social and infrastructure sectors, the transition toward a capitalist regime of investment of retirement fund reserves, could be an alternative approach to address current limitations.

Finally, it should be noted that the significant opening up of the financial sector in favour of majority holding within national banks entails new challenges in terms of financial regulations and control. The complex relations between head-office and subsidiaries make the task all the more daunting, and necessitate the consolidation of the institutional capacity of regulatory bodies, to counter the threat of weakening their authority, and to prevent any financial damage to the domestic financial system.

But the reduction of which requires a greater involvement of European partners

Regardless of the contingencies relating to opening up and attendant costs, the costs and benefits balance still points in favour of greater liberalisation of the Moroccan financial system in order to overcome the convergence challenge. The experience of Spain and Portugal confirms this much. These countries have managed to rapidly absorb the impact of opening up and to establish their respective economies on a very competitive basis. But these success stories should not eclipse the major contribution made by the European Union to the dynamics of the two countries, notably through structural and cohesion funds and the massive influx of private investment.

In this sense, sharing the cost of opening up with European partners is reasonable and legitimate, to improve the stability of the Moroccan economy in its entirety, and foster the emergence of a platform for mutual prosperity that can be an essential instrument in dealing with the problem of migration at the gates of Europe. Given these circumstances, the nature and volume of the European Union's prospective financial contribution to our country should be increased, so as to induce the resumption of community assets, following the dispositions that PECO enjoyed while preparing to join the EU.

In conclusion, it is necessary for Europe to rethink and redraw its strategic borders in light of today's political and economic realities that are unrelated to those born out of the Treaty of Rome. This is in the interest of Europe as well as countries in the South-Mediterranean, which are essential partners in reducing migratory influx. Many challenges lie ahead, but the EU's experience, articulated around the Franco-German axis, shows that, today, economic cooperation can give shape, around new wider partnerships, to a Euro-Mediterranean community driven by a spirit of solidarity and based on historical and cultural ties.

3. Regional Financial Integration: A Possible Course towards Convergence

Regional financial integration has become a necessity, in that it promotes sharing available resources for investment and commerce, the best possible diversification of financial risks, and the consolidation of regional economic growth in the medium term.

The level of development attained by the Moroccan financial system allows it to play a key role in financial systems, particularly in the Maghreb region. Thus, in order to guarantee an efficient allocation of savings among countries, the development of regional cooperation, which would enable the organisation of the allocation of savings at the regional level, would benefit both investors and operators in the region.

Successful experiences which corroborate the feasibility of regional financial integration

The example of regional experiences in financial integration is useful to South Mediterranean countries. Indeed, the case of the European Union (EU) shows that gradual financial integration can be profitable, even in the case of the heterogeneity of economic conditions and regulations within different member states.

To this end, the EU adopted a plan of action for financial services and worked on the coherence of regulations in the financial domain (the Lamfalussy process) which aimed to set common objectives, establish the best possible regional practices and to transpose them to the national level, following adaptations as necessary, and to define specific timelines for the achievement of set objectives.

On the other hand, the financial and monetary integration process underway in countries belonging to the Gulf Consultative Council (CCG) highlights the fact that financial integration can also have very beneficial effects when applied to countries with similar resources and economic structures. Such experience highlights the importance of political will in the integration process, to lessen tensions that may arise from the dilution of national sovereignty within an international context.

That nevertheless requires several prerequisites

Given successful experiences, financial integration in the Maghreb, which may concern other economies in the Machrek such as Jordan and Egypt, or even economies in the Gulf, has several prerequisites and should ideally follow these stages:

• Consolidating macroeconomic stability and adjusting the macroeconomic context to strengthen the capacity of national economies to absorb external shocks.

• Reducing threats to financial stability through consolidating prudential and control regulations, and harmonising the protection of the financial system.

• Harmonising payment systems and their convergence according to international norms (BRI) in order to provide access to services and payment networks which meet the needs of all economic operators.

• Harmonising financial information and contracts, so that the transition to international financial reporting standards (IFRS) and to international accounting standards (IAS) enables better risk assessment.

• Gradually liberalising capital accounts. The gradual lifting of restrictions to capital movement and foreign currency control, coupled with appropriate safeguarding mechanisms, could boost competition and allow investors and enterprises to have access to regional and international capital markets.

• Improving regional co-ordination by sharing information between national control bodies, within and outside the region.

Towards a greater integration of the two shores of the Mediterranean

These prerequisites will help in achieving greater Euro-Mediterranean integration based on a proactive approach aimed at speeding up the convergence pace of partners south of the Mediterranean. Besides security and cultural issues, integration must also entail greater cooperation in strategic fields, such as setting up competitive poles, inter-company cooperation, and cooperation in the energy, water, and environment domains.

This would reposition the region in the new configuration of the world economy in terms of exchange, production and investment.

To this end, setting up innovative mechanisms and institutional instruments, designed for productive investment, notably in small and medium-size companies as well as infrastructure, is an absolute priority. Such mechanisms will ensure a better integration of countries of the region into European funding networks, and can be deployed on three main fronts: (i) implementing a specifically Euro-Mediterranean action plan, focused on a limited number of issues, to complement the existing financial cooperation platform, (ii) combining the requirements of short-term economic adjustment with long-term support to economic development, (iii) consolidating the capacity of partner countries with regard to issues linked to funding.

Such new dimension to regional integration would be an effective means of overcoming shortcomings observed in previous Euro-Mediterranean approaches to integration. One possibility would be to look beyond a basic business rationale and move towards a productive logic to face up to the challenge of convergence as well as the many challenges of globalisation.

Equally relevant, the European Union’s financial contribution must be increased. In this respect, the European Union Neighbourhood Policy (EUNP) for the period 2007-2013 ought to be reviewed quantitatively and qualitatively. Funds made available are quite limited if compared to funds allocated to Candidate Countries prior to joining the EU (4 Euros per inhabitant for countries south of the Mediterranean, against 35 Euros per inhabitant for Candidate Countries (PECO)), and are further stretched by the intense competition from countries of the CET, notably the Ukraine.

Conclusion

Considered the most successful country in the South-Mediterranean region, the Moroccan financial sector witnesses on-going progress in terms of conditions of access to bank funding, funding costs, bad debt servicing, stocks and shares transaction costs, improvement of regulation and control bodies, and modernisation of information systems. This trend is equally positive for the improvement in direct finance operations: significant increase in listings, increase in transaction volume, and improvement in floating capital, notable increase in public calls for savings bonds.

It is clear that progress made by Morocco in the modernisation and the development of its financial system, which allows for more efficient funding of productive sectors, is outstanding if compared to other countries of the region. However, more effort is required to reach the best European standards, as occurred with new member countries of the European Union.

Thus, the whole issue of regional integration needs to be reviewed in terms of coherence, efficiency, and credibility. The commercial facet of integration, crucial as it may be, remains insufficient in itself to create momentum towards convergence, which would allow the Moroccan economy to better integrate into European production and trade networks. Besides the high cost of opening up and the scarcity of resources available for financial cooperation, the limited Foreign Direct Investment (excluding privatisation) in our country, as opposed to the massive industrial delocalisation towards Eastern Europe, should be highlighted.

Restructuring the national productive system and fine-tuning the areas of specialisation of national companies has contributed to a real international investment dynamic, notably from Europe, which has in turn enhanced the appeal of bank capital, with all the positive fallout in terms of skill and technology transfer. To this end, concrete action should be taken at the domestic level as well as at the regional and South-Mediterranean level.

At the domestic level, the parameters of change should be focused on improving funding conditions, especially for small and medium-size companies. This entails a greater range of funding terms to better manage risk, the consolidation of opening up and competition, while improving and safeguarding the Moroccan financial system’s capacity to respond to internal and external crises. This further entails improving the capacity to mobilise savings, the integration of the informal sector, and the incitement to institutional savings.

At the regional level, better support from the European partner is necessary to lessen the costs of opening up. Active support would foster a movement towards progress, which would be profitable to both parties. The expertise acquired by the Moroccan banking and insurance sectors, the level of its credit quotation and its reinforced presence in the North and West African markets, place it in the best position to act as the link between European financial centres on these markets, specifically within the medium-sized financial services niche (between 100 and 500 million dollars).

This convergence is also justified by the importance of investment by Arab Gulf countries in Morocco, which often transits through European financial centres. The creation of a "golden triangle" would ensue, benefiting all parties concerned.

Furthermore, a reinforcement of South-South financial integration would allow national financial systems to develop sufficiently to face exterior competition while consolidating their appeal to international financial flow. The establishment of a network of vibrant Pan-Oriental stock markets, which would combine European financial expertise, South-Mediterranean potential and investment from Arab Gulf countries, would result in a generally positive situation for the whole region.