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The determinants of international financial integration in the MENA area

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Abstract

The degree of International financial integration has considerably increased over the last two decades and has become a topical area of research. This study aims to offer some insight into understanding this phenomen in the MENA area. Several explanations are considered and discussed such as trade openness, the level of development, the financial market development, the inflation rate, fluctuations in the exchange rate, the financial crisis of 2008 and the tax policy. Overall, the results provide strong evidence in support of our choice of drivers of international financial integration.
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Keywords: International financial integration; External debt; MENA region.

1. Introduction

Over the last two decades, a considerable number of articles have recognized and proved the financial integration of the world's major stock markets (see for example, Kaminsky and Schmukler, 2002; Bekaert and Harvey, 2000 and Kim and Singal, 2000).Several studies also provided an array of indicators to proxy for international financial integration even though none of these definitions can be generally accepted or considered as a benchmark (Edison, Levine, Ricci, & Slok, 2002; Prasad et al, 2003; Vo, 2005a; Von Furstenberg, 1998).Vo (2005b) also offers other international financial concepts where its measures involve testing correlations between different macroeconomic variables.

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Recently, the Middle East and North Africa stock markets (MENA) have been emphasized in the literature because they have been considered as one of the most promising investment opportunities in the world. .

Prior studies focusing on the integration of stock markets in MENA nations with those in the rest of the world is very limited. Neaime (2002) using the Engle-Granger (1987) co-integration approach, test for the integration of MENA markets with world stock markets over the period 1990 to 2000. He finds a weak integration among the MENA markets (Morocco, Egypt, Jordan and Turkey) and strong integration between MENA markets and developed markets (U.S., U.K. and France).

The main purpose of this paper is to empirically investigate the determinants of international financial integration in MENA countries. But first of all, it is important to identify suitable quantitative variables to proxy for international financial integration. In this paper, we use External debt as a proxy for international financial integration.

We rely on a model considering a number of economic and devilment indicators including level of development, international trade openness, financial market development, exchange rate, inflation, and country risk as key elements to explain financial integration in MENA countries.

This study will clearly enrich the existing empirical literature on assessing the determinants of international financial integration. We will use external debt to proxy the international financial integration in the MENA region and over a period of 7 years (2006-2012).

The remainder of this study is outlined as follows: Section 2 provides a brief summary of the relevant literature. Section 3 presents the empirical model to test the determinants of the financial integration. Section 4 summarizes and concludes the paper.

2. Literature Review

Theoretically, Von Furstenberg (1998) is amongst the very first authors to investigate the prerequisites for international financial integration.

Literature on the reasons as to why investors prefer domestic assets in their portfolio mainly fall into different explanations and several authors have focused on determinants of international financial integration-capital controls, such as Alesina et al. (1994) and Melisi-Ferretti (1995), Epstein and Schor (1992), Obstfeld (1998).

Grilli and Milesi-Ferretti (1995) examined the economic effects and structural determinants of control of movements of capital and by using a panel of 61 developed and emerging countries. The results obtained in this study show that there is no strong correlation between the restrictions on the capital account and economic growth.

Lemmen and Eijffinger (1996) used a continuous measure for capital controls and concluded that inflation rates, government instability and investment are key determinants of capital controls in the European Union.

On the other hand, De Gregorio et al (1998) analyzed the relationship between financial integration, financial development and economic growth on a wide range of developed and emerging countries. The cross-sectional estimation for several indicators of financial development and financial integration over the period 1960-1993, indicates that there is a positive relationship between the degree of financial integration, deepening of the financial system and growth Economic. Additionally, the author concluded that the benefits of financial integration on economic growth come from the deepening of the financial system.

The study of Agenor (2001) tried to identify the key political conditions that allow countries to exploit the gains while minimizing the risks associated with international financial integration. The author claimed that prudent macroeconomic management, adequate supervision and prudential regulation of the financial system, greater transparency and a better ability to manage risk in the private sector, are important conditions to face sudden potential reversals in short-term capital flows. In addition, the study showed that the promotion of financial integration have important implications for the reform of the international financial system.

In a slightly different way, Lane and Milessi-Ferretti (2003) explains financial integration by removing barriers to the movement of capital and investment. They studied the dynamics of international financial integration using data on the portfolio of foreign assets and liabilities for a set of industrialized countries. They claimed that the studied variables (such as trade openness, GDP per capita and market capitalization) helped to explain the long-term variation of the degree of international financial integration.

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