The Theoretical Considerations of Financial Markets Integration: the Case of Arab Countries

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Abstract

The main goal behind this study is to analyze the concept of financial markets integration. The study concentrates on the Arab countries and presents the possibility of its application on these countries. This study was conducted to examine the financial markets integration from a theoretical point of view including the factors standing against the financial integration, efforts of Arab countries in addition to the risks and benefits related to this integration process. The results indicate that the financial integration of Arab countries is low and more efforts have to be spent for the real integration to be achieved. Financial markets integration is considered as an important tool to support the development of trade and capital movement both inside Arab countries and internationally.

Keywords: Law of One Price (LOOP), Financial Markets Integration (FMI), Greater Arab Free Trade Area (GAFTA), International Monetary Fund (IMF)

1. Introduction

A significant amount of research over the last three decades has concentrated on the financial market integration issue, and how to measure this integration. The “financial markets integration” as a term refers to financial economics area of research that covers several features of interrelationship across financial markets. Different schools of thoughts have been developed to measure the financial market integration. Some have concentrated on the investment restriction as indicators of integration; others have used the correlation of the local market return with the world return as a measure of integration.

In general, financial market integration could be considered as a status where there are no impediments or barriers, such as transaction costs, legal restrictions, tariffs, taxes and all types of controls against the mobility of portfolio equity flow or the trading in foreign assets. In the case of financial market integration, all assets with the same level of risk generate the same return across all different markets.

Different schools have been developed to measure the financial market integration. In general, the law of one price (LOOP) is the common factor for most of these schools. When taxes and transaction costs are not taken into account, identical securities should have the same price across all markets where such securities are traded. In other words, if two or more markets are integrated then the identical securities should be priced identically within both markets (Oxelheim, 2001). When stocks in all markets are being affected by the same risk factors and the same risk premia, implies that financial markets integration is existing.

2. Literature Review

Stulz (1981) defined financial markets as being integrated “if assets with perfectly correlated returns have the same price, regardless of the location in which they trade”. A fully integrated market is defined as a situation where investors earn the same risk-adjusted expected return on similar financial instruments in different national markets, (Jorion and Schwartz, 1986, p.603) which means arbitrage profit will not be achieved. In other words, if the risk of an identical financial instrument is traded on the same price in different markets, then it will be a sign of integration between these markets. However, if there are stronger domestic returns depend on world market shocks; a financial market is considered to be more integrated. This definition highlights not only the openness of financial markets but also measures the extent to which shocks are transferring across markets. The transmission of a shock requires both the capital itself flows across markets and the removal of barriers in order to take advantage of potential market opportunities (Fratzscher, 2002). It is very well known that, when a financial market is fully integrated, both the country's economy and the given market will not be isolated from any external influence.

The technology and communication rapid development and the widespread of using the internet have been strongly contributed in making financial markets practically and institutionally more integrated. These tools enable agents, traders, investors and all participants in financial markets to have the access to information, and therefore facilitating the management of their portfolios more efficiently.

Other important tools relating to the removal or as a minimum, the diminishing, of government restrictions that includes transaction taxes, legal restrictions and all types of controls against either the interest rates or the movement of capital. All of these points and steps have been known as "the liberalization process". However and as per Akdogan mentioned in 1995, these improvements that took place in developed countries in 1970s and 1980s, continued during the 1990s in most developing countries, and many countries are still implementing improvements.

Various points of view are offered concerning the benefits of financial markets integration. According to Haluk Akdogan (1995, pp. 62-65) these points of view are:

- When financial markets are integrated, the market risk (systematic risk) becomes a specific risk (unsystematic risk), and this kind of risk can be diversified or eliminated away by considering the security as a part of diversifiable portfolio.
- Relying on the competitive auction-model, when there are no barriers and impediments to the movement of capital, financial markets integration will perform effectively through the balanced allocation of the world's resources. Moreover, moving from capital market where capital is relatively rich to another where capital is relatively limited; the capital will seek out higher returns to investment. These features of capital markets lead the competitive auction-model to perform more effectively to economically balance the market.
- Some researchers have discussed whether the corporate financial strategies depend on the existence of an integrated financial market or not. In case of an integrated market, firms can increase their capital with lower costs than firms do in a fragmented market. In addition, decisions like capital budgeting for firms usually depend on their contribution to the international capital. The marginal cost of capital of a firm uses international sources is lower than a firm that uses only local resources.

There are some risks directly linked to increasing the integration of financial markets. Jain and Bhanumurthy, (2005) have stated that the volatility risk and surprising reversals in the flows of capital in the context of highly open capital accounts may stand for a significant cost.

The risks that cross-border the financial transactions can create for countries with relatively easily broken financial systems and week regulatory and supervision structures. Favorable shocks may attract large amounts of capital inflows; encourage consumption and spending at stages that are unsustainable in the long term, forcing countries to over-adjust to adverse shocks as a result of unexpected capital reversals. Unfavorable macroeconomic effects may take place due to the large capital inflows made by financial openness, including rapid expansion in monetary, real exchange rate appreciation, broadening current account deficits, inflationary pressures (resulting from the effect of capital inflows on domestic spending).

Some disconnections could be generated by financial integration, which in turn may raise the risk. In other words, chain of reactions in the formation of expectations could be caused by failure in one part of the system which could have an undermined effect. Tumpel-Gugerell (2010) stated that, the financial isolation which is the opposite of financial integration is not the logical answer to such a risk.

Misallocation of resources could be a reason of the large growth in the financial system. The theory of the relationship between financial market integration and its effect on growth is always positive has been questioned by a number of researchers and academies. When there is a reasonable sized financial market, this leads to an efficient allocation of resources and therefore, promoting economic growth. However, a decrease in the growth marginal contribution could be resulted out of the large growth in this market.

The size of financial system could exceed certain limits in some cases; the effect of this increasing size of market on growth could end up with negative results. Actually, very complex financial products might be created when the financial system grows in a way exceeds certain limits. In other words, in case of integration among financial markets, it would be possible to end up with huge sized financial system and therefore a new merged financial market. Allocating the sources over this market might not be efficient due to political, social, economical or any other reasons that might prevent and stand against the efficient allocation of resources. Therefore, the integration in this case might lead to an unorganized and instable financial market.

3. Arab Financial Integration Overview

3.1 Factors Standing Against Arab Financial Markets Integration

To facilitate and clarify the reasons standing behind the interrupted process of Arab financial markets integration, the region's countries were classified into three sections: Oil countries (Two third or more of their exports consist of fuel natural resources); countries with poor natural sources (one third and even less of its exports is natural resources), and an in-between group where fuel exports comprise between one and two-thirds of their exports), Hoekman and Messerlin (2002). Based on the previous classification, three main reasons are presented below to justify the important role behind the relatively unsuccessful process of integrating Arab financial markets:

- The Arab world has a limited economic size. Moreover, the Arab countries that are members of the GAFTA "Greater Arab Free Trade Area" have a GDP less than Spain's one. Egypt is the only Arab country that has a population of more than 80 million. Compared to Europe, there are four European community (EC) member states having more than 60 million people and two states only have less than 5 million of population. The Arab countries limited market size is a vital factor of the failure of all efforts towards a regional economic integration since the 1950s. Another influential economic force works against financial integration of Arab markets is the relative similarity of Arab countries to each other and therefore the existence of competition between them in the same markets. Nearly half the Arab countries are either rely heavily on oil exports or oil rich countries. As the basic reason for trade is to benefit from the endowments differences (comparative advantage) between trading parties, therefore, limited prospected benefits are suggested out of this regional integration. Offsetting this is the fact that Arab countries show a wide range of GDP per capita, starting from less than USD 500 in Yemen to USD 17,000 in Emirates and Qatar. Such large differences in income generate a motivation to include product differentiation in trading in order to respond and reach the different income levels and tastes. However, these differences compared to the small markets involved appear too broad to be an influential force for a better regional trade. The previous leaves the production sharing possibility or trading processing type, where energy, water or labor and intensive parts of the production process is carried out in countries where such factors are available. East Asia, Central Europe and North America are using this type of trade which has become important. However, increasing the efficiency through for example, reducing the transaction costs, are pre-conditions for such a trade type.
- "Inter- industry" is a point deserves focusing and especially because of its domination on the exports of a majority of countries. This is based on the existence of specialized products, with countries generating different products using diversified tools. If the comparative advantage of a certain country with a limited variety of products is very strong, such kind of trade could be associated with a concentrated structure of export. "intra-industry" trade is the complementary of "inter-industry" trade, including the different kinds of similar products or the exchange of raw materials and goods that support the production chain (importing goods and raw materials and exporting the goods ready for consumption). In the industrial and high income countries in general, intra-industry trade represents a large and growing share of total country trade.

Intra-industry trade type is concentrated more on fuels than for other products such as consumer electronics. There are several kinds of fuel products, and many possibilities to produce diversified fuel and oil based products and goods, such as chemical products. The intra- industry trade potential is supported by the fact that chemical and oil markets are monopolized enough to help the limited number of firms that are specialized in such a field to follow the policy of achieving maximum profits through segmentation of markets and differentiation of products. It is important to mention that economies of scale is the main driver of intra-industry which make specializing in similar but differentiated goods and exchanging it by other countries a profitable trade.

- Many types of agreements were discussed and negotiations about the regional trade took place over the Arab long history, starts from bilateral agreements to shrink taxes on a specific number of products to the special programs that intended at creating common market of Arab countries. Many of these contracts and agreements have not been active, and most of them were never effectively implemented, to end up with a very limited and unbalanced regional trade compared with other areas.

  Some Examples of these agreements include, the agreement signed in 1953 which aims at organizing the movements of goods trade among the Arab League states; the agreement between Iraq, Jordan Syria and Egypt that took place in 1954 to set up the Arab common market; the agreement that was signed between eighteen Arab countries in 1981 to promote and smooth the progress of intra-Arab trade.

  Indeed, political objectives are typically there and have gains and weigh overcome the economic costs. Despite the fact that it is not easy to allocate the suitable weight to each part of the equation, ensuring the achievement of net gains out of the regional integration is the challenge. Additionally, it is important to recognize that any political gains tend to collapse over time as principal objectives are achieved. Therefore, even if the benefits and economic costs did not change, continuous plans are required to make up for the decreasing value of political gains.

  *“For Arab integration efforts to be successful there must be sufficiently large domestic coalitions that favor it over all alternatives“(*Galal, 2000).

  The regional integration arrangements inability to reach and keep a positive overall cost-benefit balance could be the reason behind the new born of several agreements or later died ones.

3.2 Arab Efforts

Efforts of Arab countries have started with the establishment of the Arab League. The Arab League was established in Cairo in 1945 by Egypt, Yemen, Lebanon, Saudi Arabia, Iraq, Syria and, Jordan. The memberships have continued to increase during the 20th century second half, with 15 more Arab countries and 4 observers.

The Arab League is wealthy in resources, with massive reserves of natural gas and oil. Fertile lands are available and especially in Sudan, particularly in the south, the area that is known as the Arab world food basket. The tourism industry which is considered one of the fastest growing fields in the region has not been affected by the instable situation. Egypt, Lebanon, UAE, Tunisia and Jordan are among the top Arab countries in that sector. Telecommunications is another industry that is steadily growing in the Arab League. In less than a decade, Arab companies such as Zain, Etisalat and Orascom have successfully managed to compete globally as worldwide power players.

Member states of the Arab League economic achievements are considered low in the history of the League. Other Arab organizations, such as the Gulf Corporation Council (GCC), have accomplished more than the League has achieved. However, they have created several economic and financial projects lately which were supposed to be completed soon. Arab Gas Pipeline is one of these projects, which hopes to transfer Iraqi and Egyptian gas to Jordan, Syria and Lebanon, and then to Turkey and Europe. The project when created was planned to be completed by year 2010. Greater Arab Free Trade Area (GAFTA) is another project which was supposed to be completed by year 2008.

On the other side, Zank (2009) stated that *"It would be wrong to state that there has been no progress at all at Arab integration. The Arab League, founded in 1945 by seven states, comprises by now 22 countries and it has not been without effects".*

The economic development in the League of Arab states shows a good diversity. Comparing the oil rich countries such as Kuwait, KSA, Bahrain, UAE, Oman and Qatar and the poor countries such as Djibouti, Comoros and Mauritania we find a significant difference between them. For instance, the richest Arab and world country, Qatar, GDP per capita is higher than that of Mauritania by 73 times.

Tables 1 and 2 consist of the gross domestic product (GDP) of the Arab League countries (table 1) and the world regions (table 2) based on the purchasing power parity (PPP) in US dollars. If not indicated, otherwise, the figures are based on 2009 and 2010 data published by the International Monetary Fund (IMF).

4. Results and Discussions

The Arab organizations and institutions seem to be having good names but the question is to what extent they are performing with their objectives and goals.

In general and from a theoretical point of view, in spite of the efforts mentioned, the degree of Arab markets integration remains low. A sharp criticism was directed to the Arab world by foreign researchers such as:

"At best level and among large sections of the population there was a pronounced pan-Arab "we-feeling"" (Kramer, 1993).

"*The Arab experience shows factors such as language or common identity do not bring about integration. They might be helpful, but they become secondary in the face of structures and of interests created by them"* (Zank, 2009).

It is important to note that implementing the objectives and goals of the current institutions efficiently would be the way towards an integrated Arab financial market. A serious action has to be taken by the Arab leaders' starts by supervising these organizations and watching its performance closely before setting up any new organization.

5. Conclusion

This study presents and analyzes literatures related to financial markets integration. Financial markets integration is considered as a tool to support the development of trade, both inside Arab countries and internationally. Arab markets will become more attractive for foreign capital inflows as well as domestic capital inflows. Easier internal Arab access to companies could be provided by liquid financial markets in addition to providing them with the home base needed to expand across the Arab region and abroad.

Financial stability can improve with integration. The public sector can finance its needs at lower cost. Integration represents a support to the society through financing the economic challenge that is facing the Arab world.

Factors standing against integration are mainly: the small sizes of Arab markets, Concentration and diversification of products in addition to the political issues where no major Arab country seems to be willing to take over the lead of this integration process.

The Arab efforts are mainly included in the institutions established and agreements signed since the establishment of the Arab League in 1945. Some of these institutions are active to a limited extent and some are not. We believe that more attention should be given to the Arab institutions established in order to achieving the goals and objectives of its establishment. Moreover, a serious of actions has to be taken regarding the forgotten signed agreements and unjustified delayed projects.

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Table 1. GDP by country

Gross Domestic Product	GDP (PPP) USD B		GDP (PPP) USD per Capita	
Country	2009	2010	2009	2010
Algeria	240.809	252.189	6,884.79	7,103.61
Bahrain	28.275	29.663	27,214.13	26,807.51
Djibouti	1.996	2.104	2,481.99	2,553.34
Egypt	468.997	498.176	6,114.38	6,367.43
Iraq	111.343	115.33	3,564.83	3,598.92
Jordan	33.175	34.617	5,547.65	5,658.79
Kuwait	133.822	138.099	37,849.43	38,293.26
Lebanon	55.036	59.906	14,267.87	15,330.96
Libya	86.128	96.099	13,599.27	14,878.24
Mauritania	6.317	6.676	2,034.55	2,099.64
Morocco	145.419	152.619	4,586.87	4,773.45
Oman	73.902	78.1	25,635.21	26,197.69
Qatar	128.255	149.995	78,260.41	88,232.51
Saudi Arabia	593.875	619.826	23,271.85	23,742.69
Sudan	92.977	98.969	2,376.90	2,465.96
Syrian Arab Republic	99.403	105.324	4,938.85	5,107.93
Tunisia	95.521	100.048	9,154.06	9,488.51
United Arab Emirates	180.824	186.908	36,843.15	36,973.44
Republic of Yemen	58.135	63.329	2,454.29	2,595.70
Arab League	2,634.23	2,787.98	307,080.47	322,269.58

Source: *International Monetary Fund (IMF), source does not provide data for the compound Arab League.*

Table 2. GDP by Region

Gross Domestic Product	GDP (PPP) USD B		GDP (PPP) USD per Capita	
Country Group Name	2009	2010	2009	2010
World	70,040.55	74,004.25		
Advanced economies	37,391.55	38,746.65	36,931.10	38,055.56
European Union	14,772.54	15,150.67	29,689.30	30,366.98
Emerging and developing economies	32,649.00	35,257.60	5,702.23	6,082.00
Developing Asia	16,129.34	17,801.44	4,564.17	4,983.05
Latin America and the Caribbean	5,959.29	6,354.21	10,612.68	11,188.14

Source: The reported figures are taken from 2009 and 2010 estimate of the IMF published report for 2009 and 2010.

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