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Transforming Finance in the Middle East and North Africa

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Abstract

This paper argues for a transformation of finance to support the economic and social transformation of the Middle East and North Africa. The paper first documents the existing financial system in the region. The system is heavily skewed toward banking, relative to non-banking services, such as stock and corporate bond markets, with significant heterogeneity across countries. Second, the paper discusses the stance of macroeconomic policy in the region, which has had important implications for the destination, profitability, and quality of bank lending and the limited evolution of the financial system. Third, the paper explores the impact of technology on financial development, with particular attention to prospects for the development of fintechs. Entrenched incumbency of banks has limited the role of non-bank operators in fostering market contestability and fintech development. The paper is a call to the authorities and policy makers in the Middle East and North Africa to break with the status quo and business as usual. It underscores the need for a "moonshot approach" focused on establishing the foundations of a new digital economy and its role in promoting a well-functioning and inclusive financial economy to support the development needs of the region.

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I. Introduction

Nearly nine years after the Arab revolts, the Middle East and North Africa (MENA) region is at a crossroads.[2] Throughout the region, citizens have again taken to the streets—in Algeria, the Arab Republic of Egypt, Jordan, Kuwait, Lebanon, the Islamic Republic of Iran and Iraq. Although the triggering events of the protests vary from country to country, as does their intensity, the fundamental cause in all is a pervasive distrust of government. Young people in MENA countries are in despair and lack confidence in the ability of governments to improve livelihoods.

These protests signal the need for transformative economic and social changes to spur economic growth and create the hundreds of millions of jobs needed to employ the young people who will enter the labor market over the next several decades. Yet little has been done to address those needs. Nearly all governments have failed to implement the deep structural reforms required to transform these dysfunctional economies, which are characterized by rent-seeking, into modern economies which are more diversified and innovative, and which also recognize the salutary impact of fair competition and genuine private enterprise (Arezki et al. 2019). This paper argues for a transformation of finance to support the economic and social transformation of MENA.

But before we proceed further, it is appropriate to ask why finance for MENA? The literature on the nexus between finance and growth has documented strong evidence for the key role that a well-developed financial system can play in fostering growth, employment creation

[2] The paper covers the countries within the MENA region as categorized by the World Bank. MENA includes most of the non-European Union Mediterranean countries. Non-European Mediterranean countries include the Syrian Arab Republic, Cyprus, Lebanon, Israel, the West Bank and Gaza, the Arab Republic of Egypt, Libya, Tunisia, Algeria and Morocco. Table 1 provides relevant statistics on the financial systems of individual countries in the latter group.

and poverty alleviation (see Senbet, 2019; Levine and Zervos, 1998). Financial systems, both banking and non-banking services, provide multiple functions beyond just savings/resource mobilization. In fact, the available evidence indicates that the multiple functions, such as risk sharing, information production, price discovery, governance/monitoring, payment systems, etc., are channels for linking financial development with economic development. It is with these in mind that a "reality check" is conducted on the existing financial system and its contribution to sustainable development in MENA.

The current financial system reflects the oversized role of the state in the economy and its crowding-out effect on small and medium-size enterprises (SMEs). The system is heavily skewed toward banking relative to non-bank services, such as stock and corporate bond markets, with significant heterogeneity across countries in the region. The macroeconomic policy stance, including overvalued exchange rates, has had adverse implications on the destination, profitability and quality of bank lending and hampered the evolution of the financial system, including non-banking services. Rather we observe entrenched and dysfunctional banking that mainly channels credit to the government sector but does not perform the vital intermediation role in private credit provision.

Entrenched incumbency of banks is quite worrisome, since it stifles innovation that is needed to develop a financial system that is dynamic, inclusive, and innovative that also leverages advancing technology. In particular, it has limited the role of non-bank operators in promoting market contestability and in developing fintechs, which are growing rapidly even in low-income countries, such as those in Sub-Saharan Africa. In general, these are barriers to the development of well-functioning financial systems that help spur economic growth and employment creation.

To overcome the current challenges and seize the opportunity to leapfrog, the region needs to embrace the technological tide transforming the global economy while embracing clean energy development. This transformation calls for dual transition: (a) *decarbonization* of the economy—moving away from the use of fossil fuel as the main source of energy toward renewable energies; and (b) *digitalization*—digital transformation of traditional activities and the advent of new digital activities (See Arezki, 2019 and Arezki et al. 2018). To achieve the transition, MENA needs hundreds of billions of dollars of investment in quality projects, including in renewable energy and telecom sectors. MENA should aggressively join the global momentum for the use of clean, renewable energy (e.g., wind, solar, geothermal) to combat climate change. Likewise, it should aggressively develop the digital infrastructure that is also essential for the development of a digitized financial economy.

Because the availability of public funds is limited and debt levels are reaching dangerous levels,[3] countries in MENA must undertake upstream reforms, including those pertaining to the macroeconomy and competition needed to attract private investment. There is a real opportunity for developing countries, including MENA, to tap into trillions of dollars of "frozen assets" invested in low-yielding, even money-losing, instruments in advanced economies. To attract these funds from advanced economies, MENA must transform its financial system to more effectively channel both foreign and domestic savings into transformative investments at home. MENA needs to unleash the power of the rising pent-up domestic and regional demand to build productive systems that will drive investment and employment creation (Arezki, 2019).

[3] Of course, debt levels are insufficient indicators of debt sustainability and distress. Debt servicing costs are also key determinants. In fact, in more recent years, as emerging and low-income countries were able to access private credit markets, debt servicing costs shot up. Thus, it is the totality of debt levels and debt service costs which is key in determining debt sustainability and/or distress.

Specifically, MENA countries need to take two actions: (a) vigorous enforcement of competition policies especially in the financial system, and (b) adjustment of the macroeconomic policy stance, including exchange rate adjustment. That will not only potentially increase the volume of credit, but also foster efficient allocation of credit and other sources of finance, including non-bank services, toward productive activities that are value enhancing for the private sector, as well as the overall economy. These two anchors are at the center of the analysis that follows.

The remainder of the paper is organized as follows. Section II documents the existing financial system in MENA. Section III discusses the impact on the macroeconomy on the financial system. Section IV explores the prospects for fintech in MENA. Section V concludes with a call to break with the status quo and adopt a "moonshot approach" focused on the foundations of the digital economy in MENA that supports a well-functioning financial system that is inclusive and innovative.

II. The State of Play: The Financial System of MENA Economies

The lack of diversification of MENA economies reverberates on their financial systems. Indeed, MENA economies are poorly diversified and follow a rent-seeking model. The region's vast reserves of fossil fuel create rents for oil exporting countries. Oil importers in the region are also indirectly benefiting from the vast wealth of exporters through foreign direct investment, aid and remittances. Besides oil as a source of rent, the lack of market contestability, in the form of barriers to firm entry and exit, in both importers and exporters generate rents and favors incumbent firms whether they are state-owned enterprises (SOEs) or politically connected firms. As with the rest of the economy, finance, especially the banking sector which dominates the financial systems, is also subject to entrenched incumbency and stagnation.

MENA is not among the most financially developed banking system in the developing world.[4] Indeed, when it comes to financial development proxied by the share of credit extended to the private sector over GDP, MENA is in middle of the pack of developing regions. As shown in Figures 1 and 2, MENA average credit to the private sector stands at 57 percent of GDP—also about 60 percent for non-European Union Mediterranean countries—while East Asia, the top performing region, stands at 152 percent. There is, of course, significant heterogeneity within MENA countries. The Gulf Cooperation Council (GCC) countries have significantly higher degree of banking sector development than both oil importers and non-GCC oil exporters (see Figure 2).

Stock and corporate bond markets in MENA are significantly underdeveloped relative to the rest of the developing world. Indeed, when it comes to assessing the development of these two markets, proxied by stock market capitalization and corporate bond issuance, respectively, both as a share of GDP, MENA's position is toward the bottom of the pack of developing regions. As shown in Figures 3 and 4, stock market capitalization stands at around 42 percent of GDP in MENA—27 percent in non-European Union Mediterranean countries—while East Asia stands as the top performing region, at 179 percent of GDP. There is, of course, significant heterogeneity within MENA, with the GCC experiencing much higher level of capitalization than both oil importers and oil exporters outside GCC (See Figure 4). Similarly, when it comes to the development of corporate bond issuance, MENA trails other developing regions and so do non-European Union Mediterranean countries (see Figure 5). Moreover, there is significant heterogeneity with MENA, with the GCC having much more developed corporate issuance

[4] This is similar to the findings in the context of Africa. See, for instance, the NBER volume publication by Allen, Carletti, Cull, Qian, Senbet, Venzuela (2018). They measure the development gap based on the benchmark financial development line computed from out of sample (other peer countries). The measure of the actual development gap for MENA relates both inclusion and development gaps.

compared to oil importers and oil exporters outside GCC, with the latter having near none. Overall, MENA's financial development gap is not just relative to the more advanced countries, but also other peer developing countries. The development gap is across the board – stock markets, corporate bonds, and even banking in terms of private credit provision.

III. The Macroeconomy and Finance in MENA

In MENA economies, the boundary line between what is public and private is blurred. This complicates the emergence of a genuine private sector in MENA. Moreover, economies in MENA are subject to what is known as the "missing middle". That is, the segment of medium-size firms, which is typically an engine of growth and job creation, is missing. In other words, MENA economies typically have bi-polar labor markets where individuals are either employed in the informal private sector or the public sector, including state-owned enterprises (SOEs) and large politically connected firms. The public labor market segment is often rigid in contrast to the informal sector, creating a duality which is unsustainable. This phenomenon is endemic to the financial system as well, which is concentrated and dominated by banks which primarily lend to SOEs and politically connected firms. Indeed, in many MENA countries, SOEs and politically connected firms often have privileged access to credit, especially from public banks.[5] Figures 7 and 8 show that MENA and non-European Union Mediterranean countries have the highest share of bank credit to SOEs of all developing regions. Among MENA subgroups, oil importers have, on average, the largest share of credit going to SOEs, followed by the GCC and oil exporters outside GCC (see Figure 8).

[5] See for instance Rijkers, Freund and Nucifora (2017) in the case of Tunisia under Ben Ali.

Such bias in the orientation of bank lending toward SOEs and connected firms reflects both the shortage on the supply and demand for credit toward SMEs. The demand and supply for credit are obviously interlinked. On the supply side, not only do SMEs find it difficult to get funding, they can find it hard to compete, including for public contracts, with SOEs and other connected firms, whose easy access to credit allows them to operate inefficiently — or even at a loss, in turn adversely impacting banks through non-performing loans. In addition, the limited capability of small firms to grow and adopt new technology also limits the demand for credit by SMEs. Overall, bank lending bias toward SOEs and politically connected firms impedes the development of competitive and well-functioning banking systems. Banks have distorted incentives against performing their vital functions of intermediation through private credit provision and helping allocate resources to their best productive use.

The banking sector is also highly concentrated. Figures 9 and 10 show that MENA—and the non-European Union Mediterranean region--has the highest concentration rate of all developing regions in the world. Among MENA sub-groups, non GCC oil exporters have the highest concentration ahead of oil importers and GCC countries (see Figure 10). Increasing competition would help reduce concentration and help lower interest spread, the interest rate charged by banks on loans to private sector customers minus the interest rate paid by commercial or similar banks for demand, time, or savings deposits. In turn, more competition can promote mobilization of domestic savings and increase financial inclusion, including of the informal sector. High level of concentration is often associated with abuse of dominant position and collusive behavior, including even when there is foreign bank participation. Foreign banks are often limited to serving import activities and do not compete with domestic banks directly. The presence of public banks can also lead the regulator to deviate from its role to ensure

contestability. At worst, it would be an invitation for incumbent operators to collude and segment markets.

Many countries in MENA have a fair portion of banks publicly owned (La Porta et al. 2002; Cull et al. 2018). Syria, Iraq, the Republic of Yemen, and Libya have their entire banking systems as state owned. Algeria, Tunisia and Egypt have a significant segment owned by the state. GCC countries, Lebanon, Jordan and Morocco do not have a public bank segment. State owned banks and the blurry nature of the frontier between the public and the private sectors are conducive to a disproportionate amount of non-performing loans (NPLs) on bank books. Notwithstanding the measurement challenges, Figures 11 and 12 show that MENA, and more so the non-European Mediterranean region, have a relatively high rate of NPLs. Figure 12 shows that oil exporters outside GCC (countries with the most state-owned banks) have the highest rate of NPLs, followed by oil importers and GCC countries. Credits in arrears, including toward SOEs, is often not included in NPLs in some countries, and hence banks do not have to make provision for them.

In addition, the stance of macroeconomic policy limits the role of finance in spurring economic growth. A tendency toward fixed or strongly managed and overvalued exchange rate favors import dependence, consumption-based model at the expense of private investment in domestic productive systems (Ilzetzki et al. 2019; World Bank, 2004; Elsherif and Mohieldin, 2018).[6] Moreover, there is lack of capital market integration at the regional level, including of payment systems. Most countries lack currency convertibility and have strict capital controls limiting the prospects for investment and ability to borrow. This restriction includes banks that borrow in foreign currency and makes it difficult to fund projects which are potentially bankable.

[6] For recent assessments of exchange rate misalignment, see individual country IMF Article IV Reports and External Balance Assessment on the International Monetary Fund's website.

Capital market integration can help alleviate low levels of stock market development, both in terms of depth and liquidity provision, as documented earlier. In fact, initiatives for regional integration of markets should be at the top of the financial sector development agenda. Capital market integration is also an avenue to fund large-scale cross-border projects, as well as helping the region to integrate into the global financial economy. Lack of harmonization of exchange rate and monetary policies is a hindrance to regional integration.

MENA countries tend to adopt policies for overvalued exchange rates that drive interest rates higher.[7] This distorts bank lending behavior towards holding government bonds and crowding out the private sector. In particular, banks typically hold large excess reserves—capital reserves held by banks in excess of what is required by regulators—in treasury bonds at relatively high rates, and hence reporting relatively high profitability with little risk taking (see Gray et al. 2014). Moreover, oil exporters sterilize excess liquidity through auctions to issue high interest paper, creating additional opportunities for banks to benefit from high interest rates at minimal risk. That macroeconomic policy stance creates artificially high profitability without managing risk in the credit provision to the private sector. Therefore, such counterproductive macroeconomic policies hinder, rather than promote, the development of a well-functioning banking system. In particular, this system sustains banks that do not perform their fundamental functions as informed agents in the economy in the monitoring of credit risk and allocation. In short, this leads to a dysfunctional banking system that is devoid of efficient intermediation and lacks private credit provision, impeding allocation of resources to best economic use and value creation.

[7] The presence of capital controls is a limiting factor. That said, countries experiencing influx of foreign exchange typically raise interest to tame inflation or repurchase and term auction deposits to soak up excess liquidity.

Further, MENA macroeconomic stabilization policies have been harmful to the banking system in the build-up of public debt, including debt acquired through SOEs which receive favored treatment relative to the rest of the economy. MENA countries typically delay the stabilization of their economies until it is inevitable. The period of boom from high oil prices in the 2000s, where both oil exporters and importers had run important spending programs, was followed by a buildup of debt. They had to resort to significant adjustment in terms of internal and external deficits following the synchronized slowdown that started in 2011 in the wake of the Arab revolts and the persistent decline in oil prices that started in 2014. The macroeconomic stabilization policies consisted of exchange rate devaluation (e.g. Egypt) and/or cuts in consumer subsidies and tax increases. Inflation has been stubbornly high, forcing central banks in many countries to hike interest rates sharply.

The stubbornly high inflation has often been one of the ramifications of the monetization of deficits to which the authorities in many MENA countries have commonly been resorting. That monetization of deficits, coupled with government guarantees and "below the line" borrowing by the web of SOEs (also channeled through public banks), has an important implication beyond inflation especially in terms of the dangerous rise in public debt. To limit a detrimental effect on the financial system, macroeconomic stabilization should be sustained. To do so, authorities should ensure competitive neutrality of all SOEs in commercially oriented activities. That is, SOEs should receive the same treatment as private operators in terms of transparency standards, debt, tax treatment, subsidies. Accompanying this, there should be a moratorium on monetary financing.[8] Moreover, it is necessary to monitor the evolution of government guarantees and below line financing which lead to a piling up of public debt.

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[8] See Arezki et al. (2019) for a fuller discussion of competitive neutrality and corporate governance for SOEs.

A rising government debt makes it difficult for MENA to respond to adverse economic developments and to finance growth-enhancing investments. Lack of transparency is especially acute in infrastructure lending, where collateral, liens, and other terms and clauses hidden in contracts are often not fully revealed. While hidden debt may be appealing to a few leaders who use it for their personal gain, it adds to the real economic burden and jeopardizes the future of younger generations, who become more frustrated in turn. Debtor and creditor governments around the world need to act more responsibly and commit to transparent terms for infrastructure lending. The citizenry ought to be fully informed about the contingent liabilities that governments are making on their behalf.

IV. Fintech and Financial Inclusion in MENA

As documented earlier, the MENA financial development and inclusion gaps are enormous. Moving forward, business as usual is unacceptable. Finance is dynamic and it is now being rapidly fueled by advancing technology and digitization around the globe. Hence, MENA must innovate to move in pace with an increasingly fast, dynamic, and complex financial world. The innovation opportunities are now widely available around the globe, and private sector initiatives are moving faster than an enabling policy space. One recent and remarkable development, that is spreading rapidly at a global level in view of growing need for digital financial services, is fintech.

Fintech refers to the integration of technology by financial firms in order to improve their use and services to consumers. Fintech typically implies the unbundling of the offering of services and the creation of new markets for these firms. Fintech should serve the improvements of

financial systems, especially payment solutions which are the cornerstone of trade. Indeed, a digital economy depends on payment systems that are not just easy to use and widely available, but also trustworthy. Developing effective mobile payments, such as Kenya's M-PESA system, the first ever instance of fintech that requires no financial intermediary like a bank, will be crucial for ensuring that digital platforms for ride sharing, on-demand tasks, and other services can thrive.

In fact, fintech startups in Africa and around the globe are mobilizing mass market access to a wide range of financial services - savings, credit, insurance, and other digital products. They have actually become instruments for innovative financial inclusion which is key for inclusive development. It should be recognized that financial development alone will not ensure financial inclusion, and hence MENA should welcome the fintech movement for its impact on mass livelihoods through inclusion (Senbet 2019).

Outside the GCC, with the exception of Lebanon, and to a lesser extent Jordan, which have relatively advanced payment systems, the quality of digital financial services in the MENA region currently lags most of the rest of the world. That is despite the presence of banks which are supposed to facilitate payments. Figures 13 and 14 show that MENA, and the non-European Union Mediterranean region, is among the developing regions with the lowest level of cashless payments. Figure 14 also points to the fact that oil exporters outside GCC is the subgroup within MENA with the lowest level of cashless payments behind oil importers and the GCC.

The concentration of banks and their dominant role in the financial system of MENA have ended up limiting financial innovation. MENA regulatory frameworks need to catch up with the rapid pace of financial innovation. An ongoing debate is what regulatory standards should be used for financial services which are under different institutional jurisdictions. This

issue is relevant, because digital financial services are activities spanning the domains of banks and telecommunications. Who and how should such services be regulated (banking regulator or telecom regulator, or both)? The issue was recently taken up by a global financial inclusion task force with the main conclusion being that regulation should be functionally, and not institutionally, based (Center for Global Development, 2019). That is, regulation should be similar across providers (banks as well as non-banks) as long as these institutions provide services which are functionally equivalent, so that equivalent services (functions) are treated the same from a regulatory standpoint.[9]

In the case of MENA, banks *de facto* have monopoly over payment systems and have power and incentives to lobby the regulators against awarding new licenses for payment solutions to non-bank operators. The regulators in turn view themselves as guardians of the public (i.e., the banks). This stifles financial innovation and hampers the emergence of fintechs in the region. Governments will, thus, need to develop an approach to regulation that encourages, rather than stifles, innovation. For instance, excessively tight regulation of entry and licensing requirements of mobile network operators discourages them from enhancing access to payments services by their mobile phone subscribers. Moreover, regulatory policies should not protect the vested interests against new entrants with innovative technology-driven services.

To be sure, ensuring confidence through their mandate on financial stability, especially in financial systems, is essential; but regulation must be balanced with policies to boost

[9] The principle of functional regulation, rather than the providers of those functions, is relatively a new phenomenon and not much understood. See Senbet (2019) and the recommendations of the global financial inclusion task force (Center for Global Development, 2019). For a theory of optimal bank regulation, as well as the linkage between deposit insurance and financial development, see John, Saunders, Senbet (2000) and Cull and Senbet (2005), respectively.

competition, so that startups can easily enter the market and test new ideas. There needs to be more space for more start-ups to emerge. In this respect, policy makers should look to China which has allowed non-bank operators to provide payment solutions, instilling competition and challenging what were then inefficient (and often state-owned) banks dominating the landscape, not unlike in MENA today. That policy has allowed China to leapfrog in the use of credit cards and embrace secure mobile centric payment solutions, including those provided by digital platforms, such as Alipay which has reached 1 billion users. Also, East Asia presents a good example of how contestability in the financial sector and other key sectors, such as telecom, has allowed the region to break from the middle-income trap (see Arezki, Fan and Nguyen, 2019).

In spite of the dominance of banks in the financial system, the level of financial inclusion in MENA is relatively low. As mentioned above, banks in MENA have tended to lend to governments and politically connected firms rather than serving individuals and SMEs. The absence of available collateral, due to insufficiently developed or non-existent mortgage markets in the region, reinforces the bias that banks typically have in lending at high rates and free of risks to governments by holding excess reserves in treasury bonds. Foreign banks have typically served to finance import activities and, hence, do not challenge the status quo. Figures 15 and 16 show that MENA, and the non-European Union Mediterranean region, is among the developing regions with the lowest level of financial inclusion. Figure 16 also shows that the GCC countries unsurprisingly perform better in terms of financial inclusion, followed by oil importers and non-GCC oil exporters which are both far behind.

Thus, a competition policy enforcement in key sectors, such as finance and telecom, should be at the top of the agenda for authorities in MENA if they commit to allowing fintech to transform finance through more inclusivity and break away from stagnant growth.[10]

V. Needed: A Digital and Finance Moonshot for the Middle East and North Africa[11]

The digital economy holds the promise of a new way forward, but it is still in its infancy, and young people face obstacles in putting technology to productive use. Although the internet and hand-held devices are ubiquitous throughout the MENA region, they are currently used for accessing social media, rather than for launching new enterprises. There are success stories to be sure (Arezki, Belhaj and Shah, 2019). One is Careem, the ride-sharing company that operates in more than 90 cities across 13 countries, and it was purchased by the U.S. ride-sharing giant Uber. Another is Souq, the e-commerce platform that Amazon bought for more than $500 million. These achievements demonstrate the enormous potential for digital commerce in the region. But it is small—too small in a region where 66 percent of the population is younger than 35.

To achieve such an ambitious agenda, countries must mobilize political support and stir the public imagination. They cannot do that if they continue the traditional incremental approach to change. Without a full-blown effort, a generation of MENA youth will be condemned to unemployment or low-productivity, low-wage employment. And the technological gap between the MENA region and the rest of the world will continue to widen.

[10] It is worth mentioning here that, as MENA countries commit to the development of well-functioning and inclusive financial systems, they should also invest in the development of commensurate capacity for risk-management and governance. Finance and financial innovation have become increasingly complex, and they will continue to do so in the future, requiring talented financial manpower, as well as financial regulatory capacity.

[11] This section draws from Arezki and Ghanem (2017).

MENA countries must undertake what might be called a ‘moonshot’, an all-out effort to achieve a goal named after the massive US effort in the 1960s to land a man on the moon. President John F. Kennedy’s 1961 decision to pursue this objective unleashed an extraordinary collective national effort that achieved its seemingly impossible goal in mid-1969.

A MENA moonshot would involve a collective commitment to achieve parity with advanced economies in information and communications technology by 2022. MENA countries would seek to equal or better OECD countries in terms of their level of access to the internet, capacity to transmit data (bandwidth) and the number of financial transactions carried out electronically.

The effort to create modern telecommunications and payments systems will require specific and bold goals, firm deadlines and cooperation among all elements of society, including the private sector. Some of the needed elements are in place already. Young people in MENA are digitally savvy in many ways. They are active on social media and they are heavy users of mobile phones. Mobile phone penetration in the region is among the highest in the world.[12]

But that is about as far as it goes. The quality of internet service in most MENA countries is poor and few people have access to it. Only in Sub-Saharan Africa and South Asia is there a lower per capita level of broadband subscriptions, and MENA users have a limited amount of bandwidth per subscriber.

[12] This is welcome news in view of the fact that the current financial development indicators are uniformly low for MENA relative to peer developing countries. The penetration can help bridge the gap if the youth are appropriately incentivized to be financially entrepreneurial. Fintech entrepreneurs are a case in point.

Digital finance is almost non-existent. The poor quality of internet and payments systems hinder the development of a modern economy that creates quality jobs for its citizens, particularly the younger generation which lacks productive employment. In fact, with an enabling digital infrastructure, and the appropriate policies accompanying it, the youth themselves can be part of the solution through a variety of private initiatives enabled by technology solutions. They will not just be job seekers but also job creators through a variety of entrepreneurships enabled by the new environment (e.g., fintech entrepreneurs).

But digital infrastructure cannot be brought up to speed without overhauling the region's regulatory apparatus. Regulators too often see the world through a prudential lens – pre-disposition to limit risks, but blind to catalyzing innovation or encouraging competition. Excessive risk conservatism can be value destructive in a similar fashion as excessive risk. This requires regulatory capacity in balancing risks and rewards of innovative activities. Allowing new firms to enter either the telecommunications or financial industries would lower prices and increase quality. But in both sectors, incumbents and regulators make entry difficult and retard innovation.

Unlike countries in Latin America or Central and East Asia, which have aggressively pushed competition and liberalization in the telecommunications sector, MENA countries have pursued a very gradual approach to change. As a result, Latin American and Asian countries, which a decade ago had internet speeds and usage comparable to MENA, have not only far surpassed the Arab world, they rival advanced economies.

Unnecessarily tight and invasive regulation has so retarded the growth of digital payments in the region, especially in North Africa, that much poorer countries in East Africa

outperform MENA in terms of the diffusion of mobile money. Policy makers should study China and Kenya's model of light but effective regulation, which has fostered the rapid growth of the mobile centric payment systems, Alipay and M-Pesa, respectively.

The moonshot digital and financial system is a bold vision. Accordingly, authorities in MENA should set three bold goals and plan to accomplish them rapidly, say within four years:

- *First*, they should create a modern broadband internet that covers all countries, including those that are lagging economically.
- *Second*, they should develop an infrastructure that supports digital money transfer through mobile devices and the internet but also that enables technology solutions for a wider range of digital financial services, including savings, credit, insurance, e-commerce, etc.
- *Third,* they should develop an infrastructure that supports integration of financial systems in the region and that collectively leverages advancing technology and digitization.

As documented earlier, MENA financial systems are malfunctional in their intermediation functions, both in banking (low private credit provision) and non-bank services (thinness in stock markets).There is a growing recognition of financial integration in other regions, particularly in Africa. The prime example is the regional stock exchange in Abidjan, Côte d'Ivoire (BVRM - Bourse régionale des valeurs mobiliéres), which serves the West African Francophone countries. More recently, the East African Community (EAC), comprising five countries, has taken important steps towards harmonizing the regulatory environment for financial integration. The integration momentum is fueled by the new historic free trade agreement which calls for

integration in services, including finance. Several members of MENA are signatories to this agreement.

To foster integration, all MENA countries should consider harmonizing their investment and trading laws, as well as accounting standards, including promotion of convertibility of currencies. The added benefit of financial integration is to help unlock foreign investments in deeper financial markets and integrate MENA into the global financial economy. Moreover, regional stock exchanges can be an avenue for privatizing state-owned enterprises and enhance the depth of the stock markets. Moreover, privatization through stock exchanges has other potential benefits, including improved corporate governance, price discovery, and diversity of ownership of the economy (Senbet, 2019).

To facilitate modern broadband internet and payments systems, authorities face twin challenges[13]:

- They must encourage new entrants and promote competition.
- In a region that has been dominated by public banks, they must build trust in the integrity and security of digital finance in a private market.

As President Kennedy's 1961 decision galvanized the United States, a 2018 MENA moonshot could unite authorities and young people behind a common goal. A common goal to transform the ways in which governments, companies, international financial institutions,

[13] The recommendations are mainly focused here on financial technology and not other important ingredients for financial development. The financial development gaps cannot just be bridged by technology alone and will require supportive financial regulation. In fact, innovation can occur without technology – as it has for centuries (e.g., another Kenya success story – Equity Bank). See Senbet (2019).

foundations, civil societies and even foreign governments conduct business and collaborate. It would transform MENA economies and help to ensure that millions of the region's young people can find the good jobs they deserve.

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Appendix

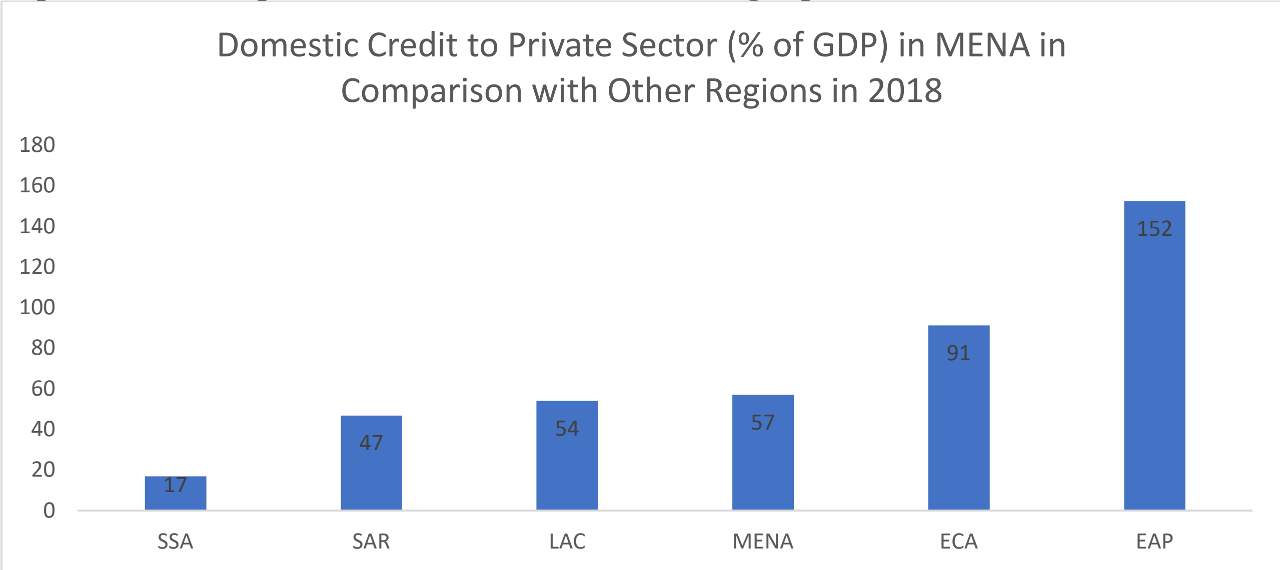
Table.1 Summary of financial development in non-European Mediterranean countries

Country/Region	Domestic Credit to Private Sector (% of GDP) in 2018	Stock Market Capitalization to GDP (%) in 2017	Corporate Bond Issuance Volume to GDP (%) in 2015	Credit to Government and State-Owned Enterprises to GDP (%) in 2016	Bank Concentration (%) in MENA in 2017	Bank Nonperforming Loans to Total Gross Loans (%) in 2016	Made Digital Payments in the Past Year (% Age 15+) in 2017	Borrowed from a Financial Institution or Used a Credit Card (% age 15+) in 2017
Syria	..	..	..	..	79.7	..	..	..
Cyprus	139.6	12.3	..	17.6	76.0	36.7	65.5	24.9
Lebanon	..	22.0	1.6	68.8	38.7	4.9	27.1	22.6
Israel	66.5	65.0	0.9	9.4	64.9	1.6	86.0	78.8
West Bank and Gaza	49.9	25.2	..	..	100.0	2.2	8.2	7.2
Egypt, Arab Rep.	25.5	13.8	..	70.7	59.3	..	5.9	8.8
Libya	17.6	..	..	24.4	85.2	..	20.8	8.4
Tunisia	68.0	20.5	..	14.1	37.2	..	19.1	11.7
Algeria	25.1	0.2	..	37.5	67.0	12.1	15.6	5.0
Morocco	85.3	56.8	1.0	22.3	74.3	..	8.7	2.6
Average	59.7	27.0	1.1	33.1	68.2	11.5	28.5	18.9

Sources: World Development Indicators as of December 2019; Global Financial Development as of October 2019; Global Financial Inclusion as of October 2018.

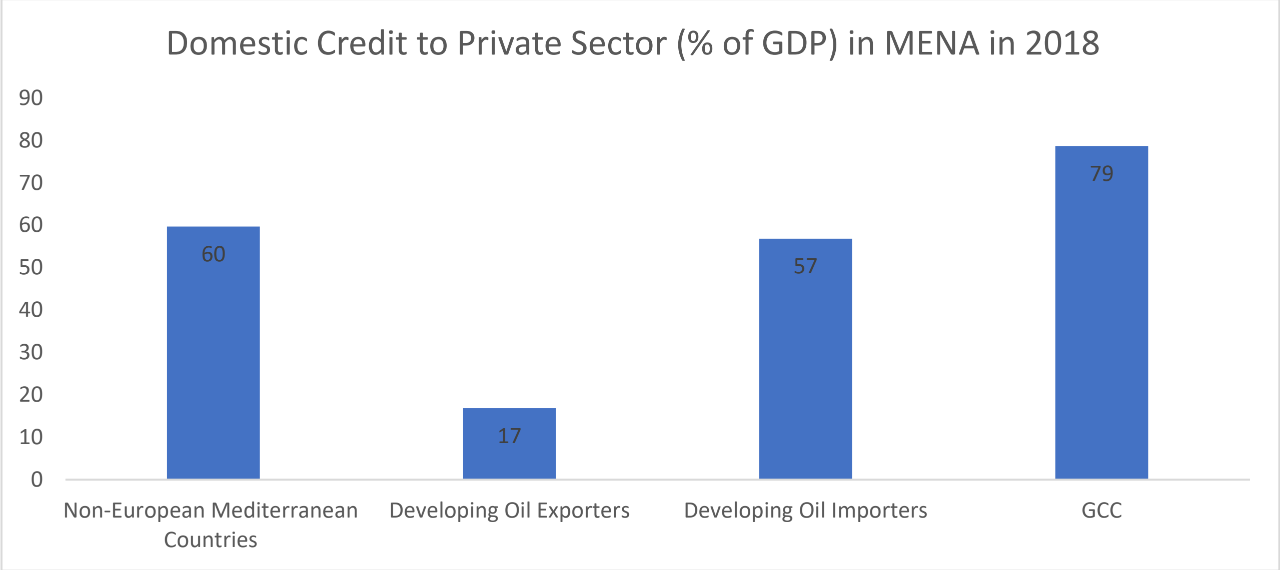
Note: Non-European Mediterranean countries include Syria, Cyprus, Lebanon, Israel, West Bank and Gaza, Egypt, Libya, Tunisia, Algeria and Morocco.

Figure 1. Banking in MENA vs. rest of the developing world



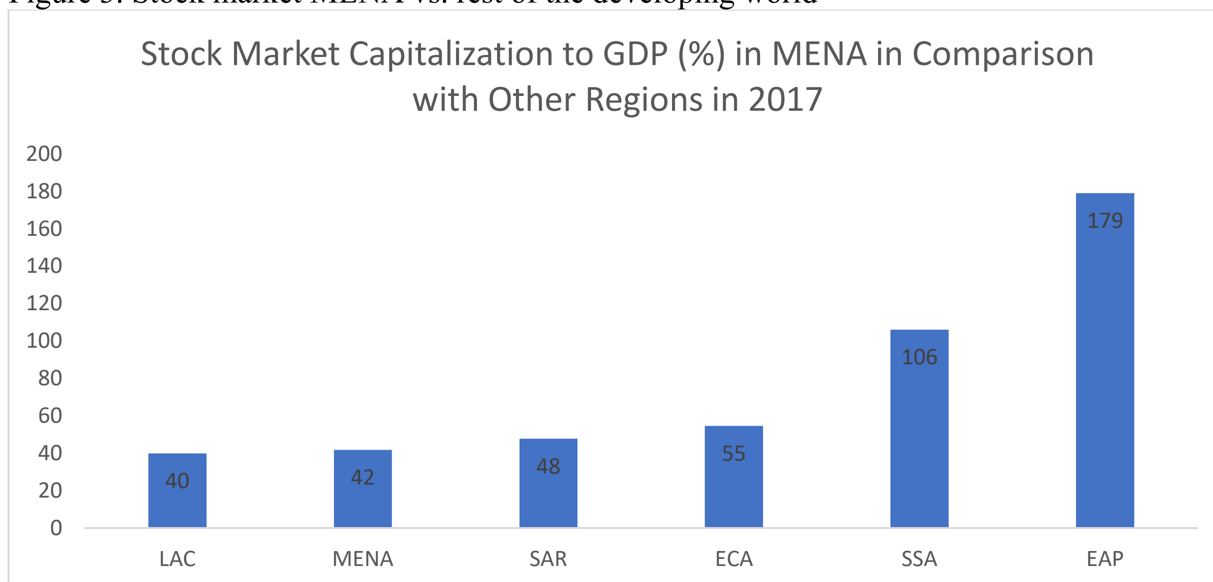
Source: World Development Indicators as of October 2019.
Notes: EAP stands for East Asia and Pacific region. ECA stands for Europe and Central Asia region. MENA stands for Middle East and North Africa region. LAC stands for Latin America and the Caribbean region. SAR stands South Asia region. SSA stands for Sub-Saharan Africa region.

Figure 2. Banking within MENA



Source: World Development Indicators as of October 2019.
Notes: GCC countries are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and UAE. Developing Oil Exporters include Algeria, Iran, Iraq, Libya, Yemen, Rep. Developing Oil Importers include Djibouti, Egypt, Jordan, Lebanon, Morocco, Tunisia, West Bank & Gaza. Non-European Mediterranean Countries include Syria, Cyprus, Lebanon, Israel, West Bank and Gaza, Egypt, Libya, Tunisia, Algeria and Morocco.

Figure 3. Stock market MENA vs. rest of the developing world



Source: Author's calculations based on the data from Global Financial Development as of October 2019.
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Figure 4. Stock market capitalization within MENA

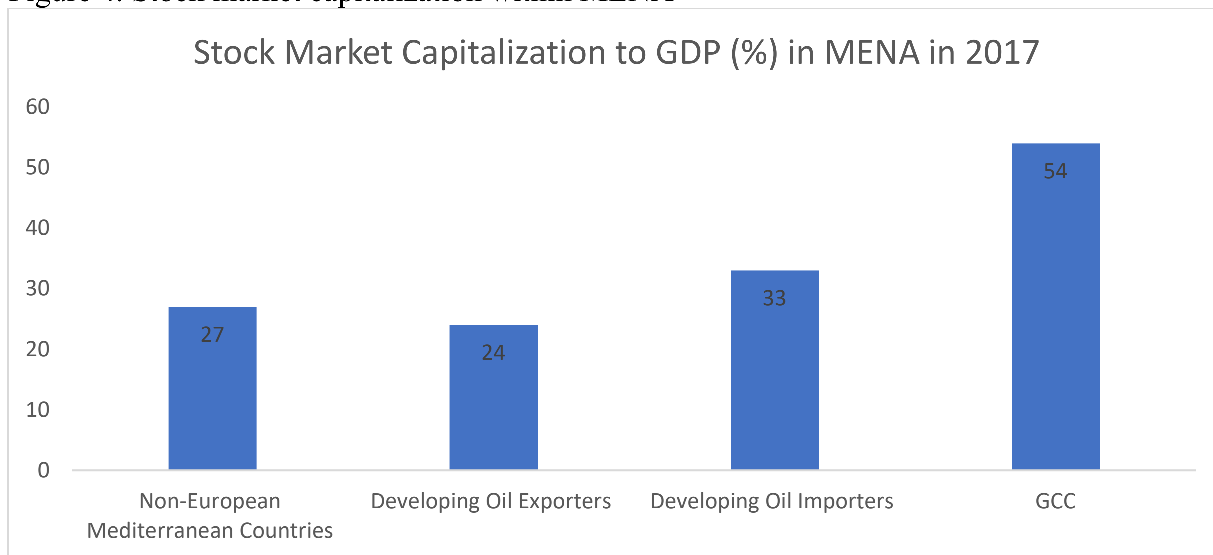

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Figure 5. Corporate bond issuance: MENA vs. rest of the developing world

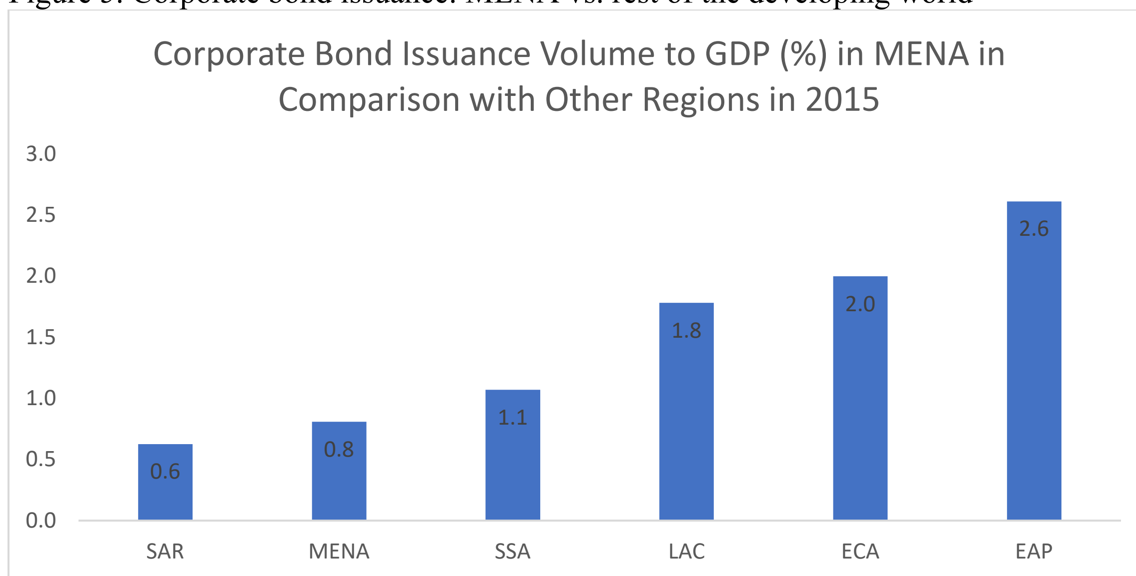

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Figure 6. Corporate bond issuance within MENA

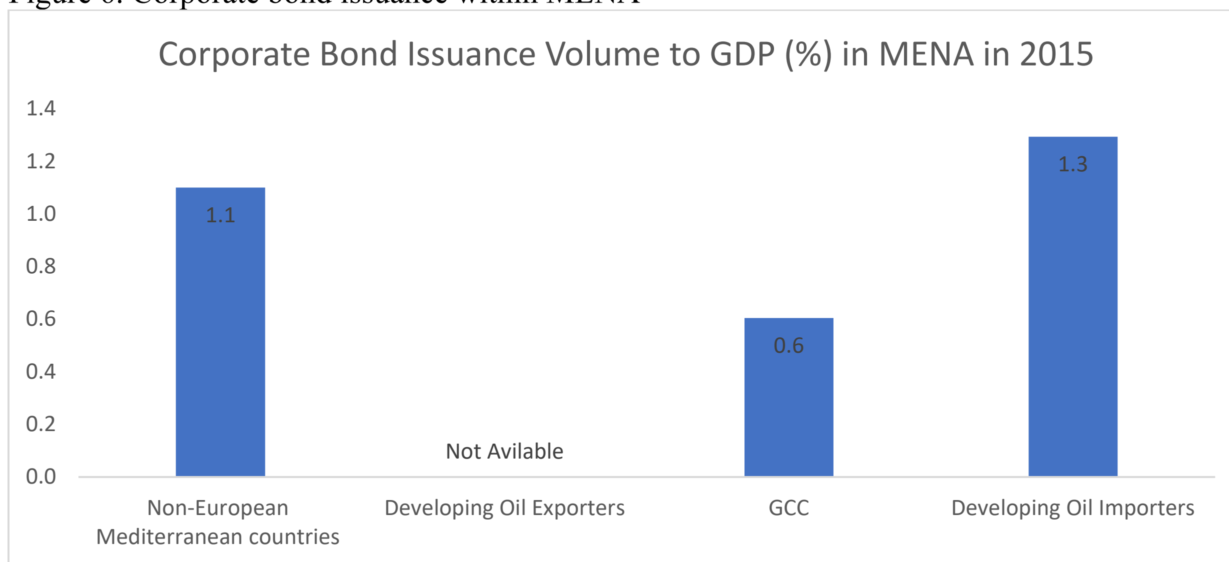

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Figure 7. Credit to the public sector: MENA vs. the rest of the developing world

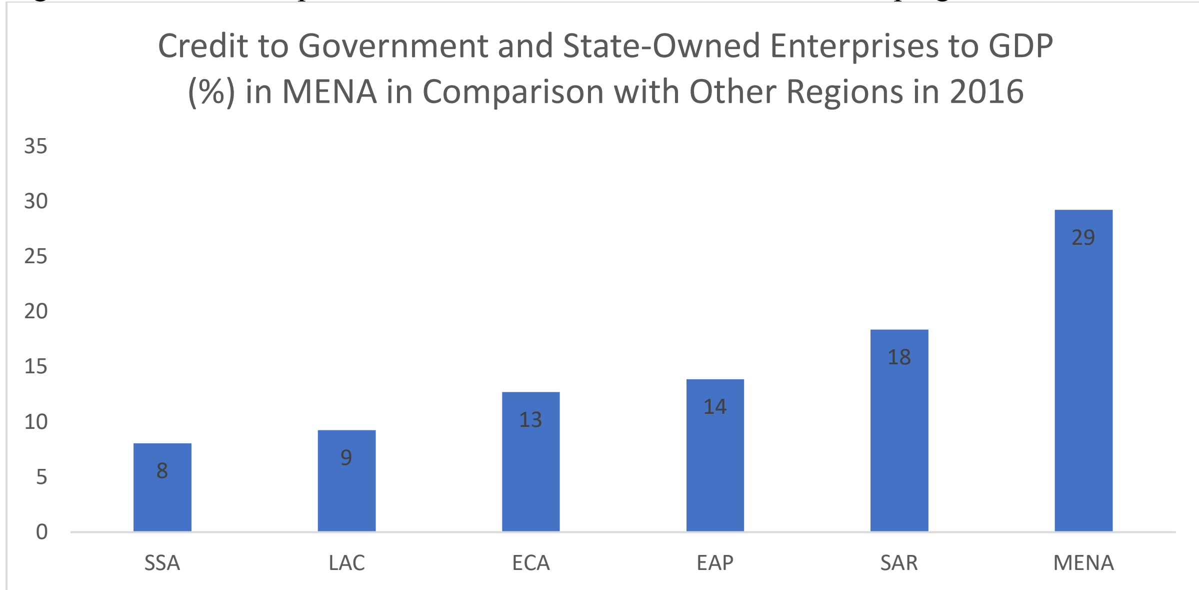

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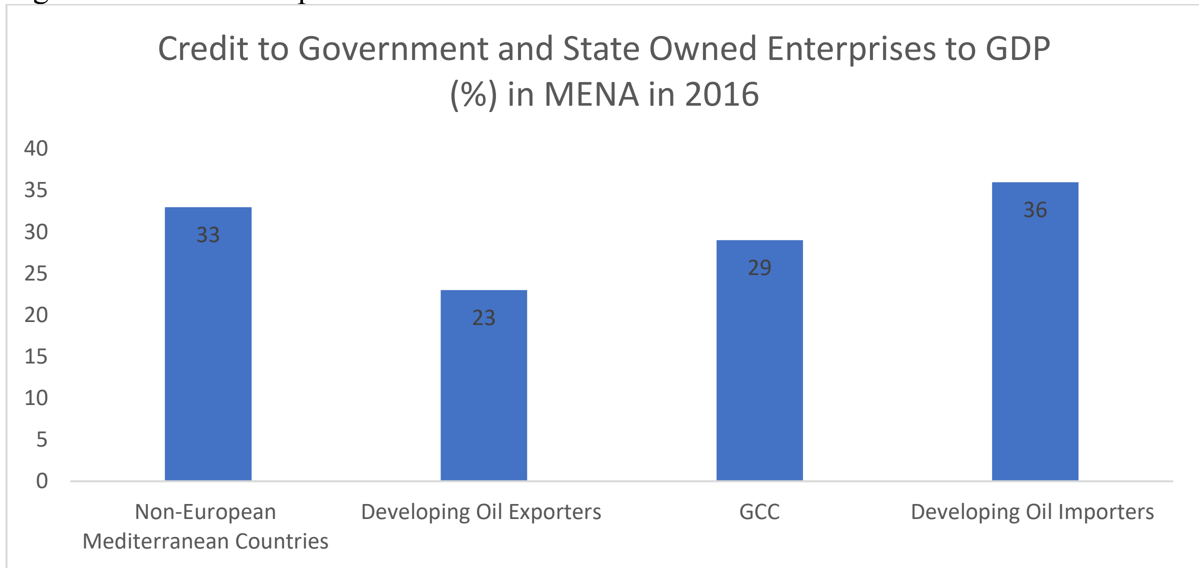
Figure 8. Credit to the public sector within MENA



Source: Global Financial Development as of October 2019
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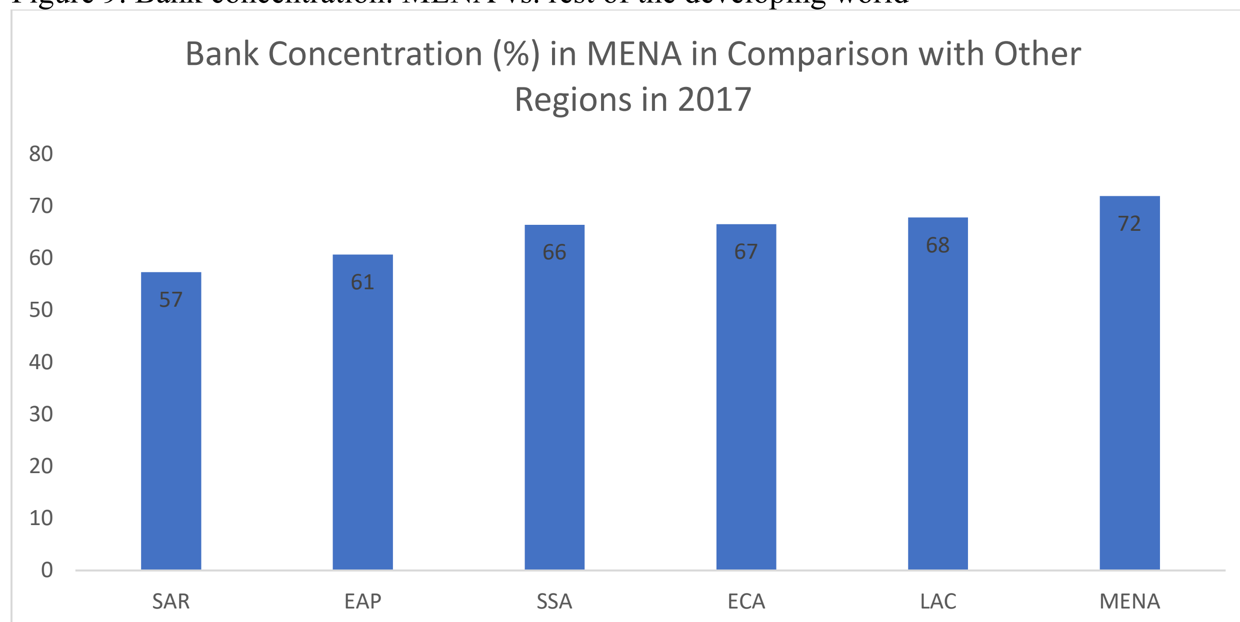
Figure 9. Bank concentration: MENA vs. rest of the developing world



Source: Author's calculations based on the data from Global Financial Development as of October 2019
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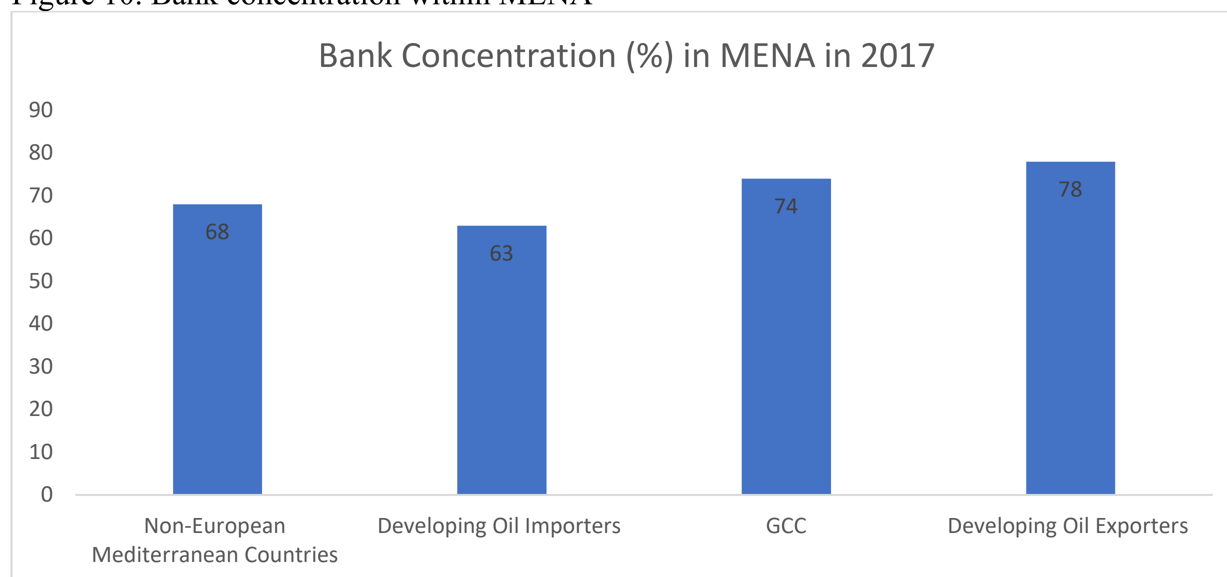
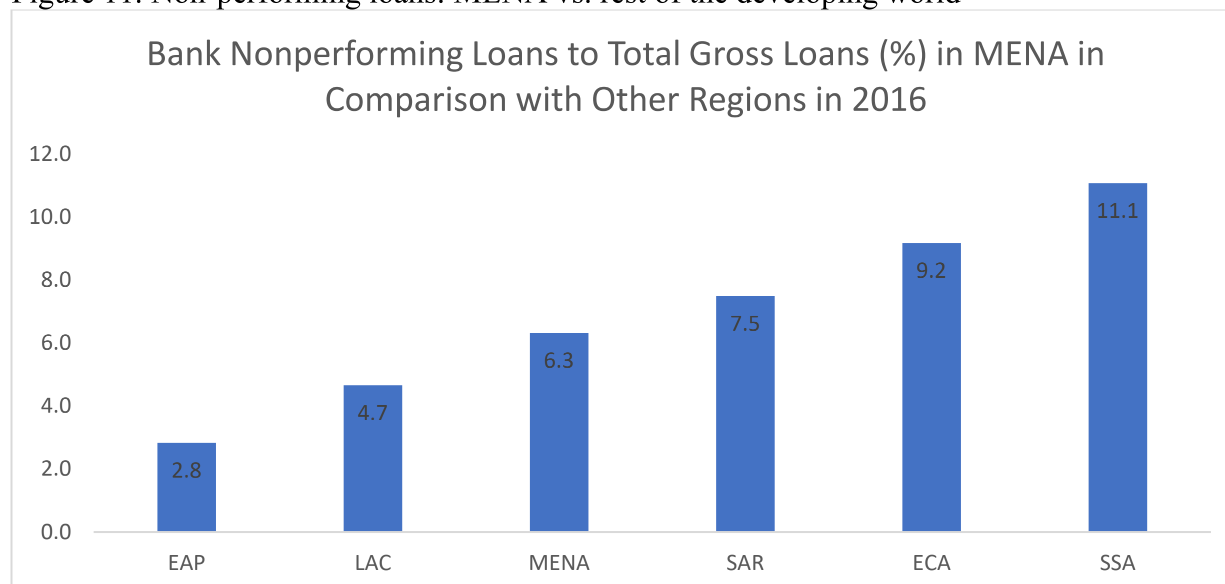
Figure 10. Bank concentration within MENA



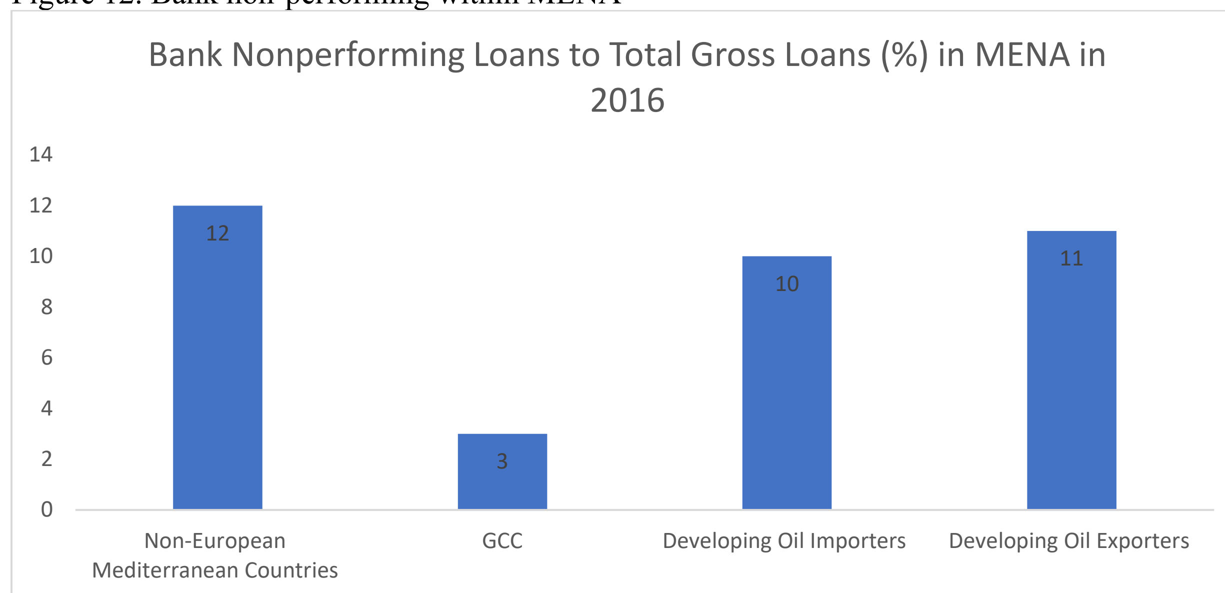
Source: Financial Development and Structure Dataset (updated September 2019)
Notes: GCC countries are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and UAE. Developing Oil Exporters include Algeria, Iran, Iraq, Libya, Yemen, Rep. Developing Oil Importers include Djibouti, Egypt, Jordan, Lebanon, Morocco, Tunisia, West Bank & Gaza. Non-European Mediterranean Countries include Syria, Cyprus, Lebanon, Israel, West Bank and Gaza, Egypt, Libya, Tunisia, Algeria and Morocco.

Figure 11. Non-performing loans: MENA vs. rest of the developing world



Source: Author's calculations based on the data from World Development Indicators as of October 2019
Notes: EAP stands for East Asia and Pacific region. ECA stands for Europe and Central Asia region. MENA stands for Middle East and North Africa region. LAC stands for Latin America and the Caribbean region. SAR stands South Asia region. SSA stands for Sub-Saharan Africa region.

Figure 12. Bank non-performing within MENA



Source: World Development Indicators as of October 2019
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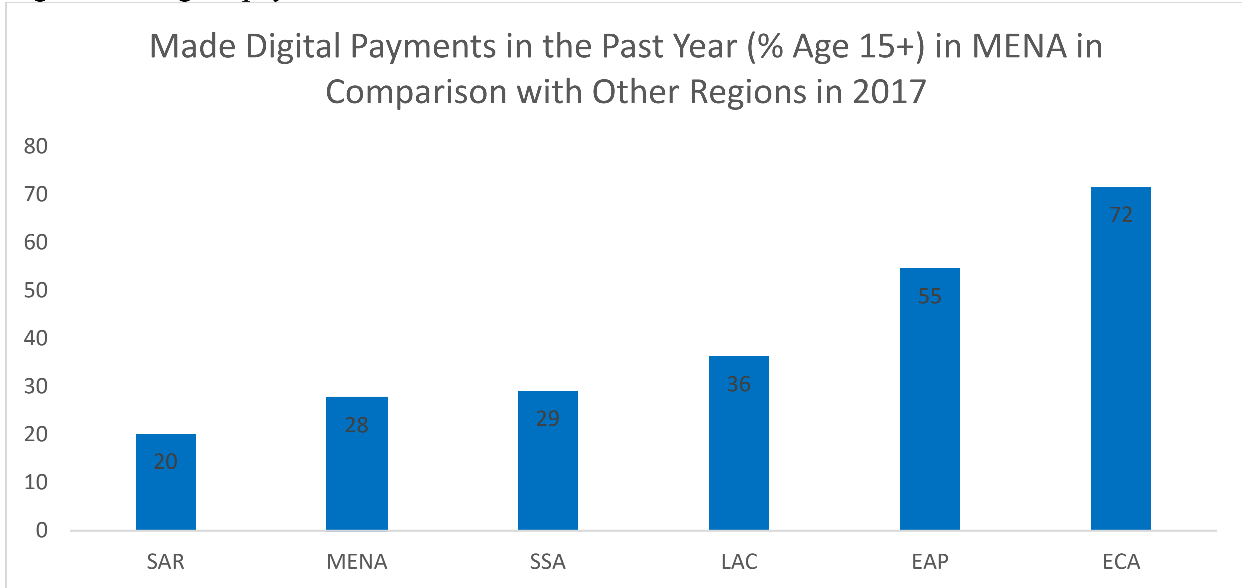
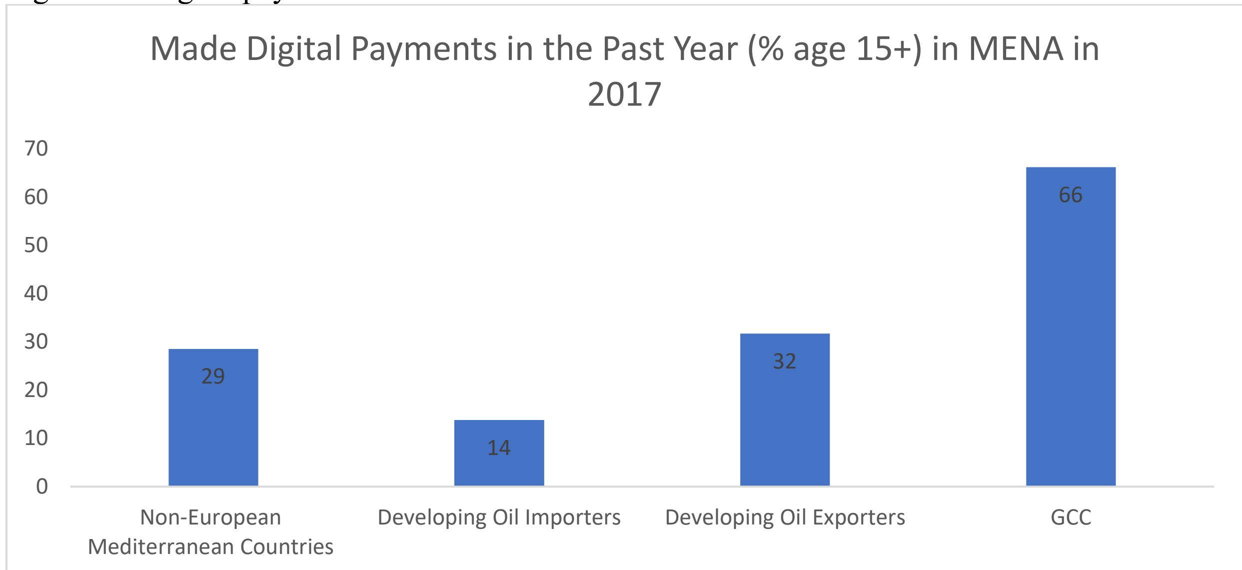
Figure 13. Digital payments: MENA vs. rest of the world



Source: Global Financial Inclusion as of October 2018
Notes: EAP stands for East Asia and Pacific region. ECA stands for Europe and Central Asia region. MENA stands for Middle East and North Africa region. LAC stands for Latin America and the Caribbean region. SAR stands South Asia region. SSA stands for Sub-Saharan Africa region.

Figure 14. Digital payments with MENA



Source: Global Financial Inclusion as of October 2018
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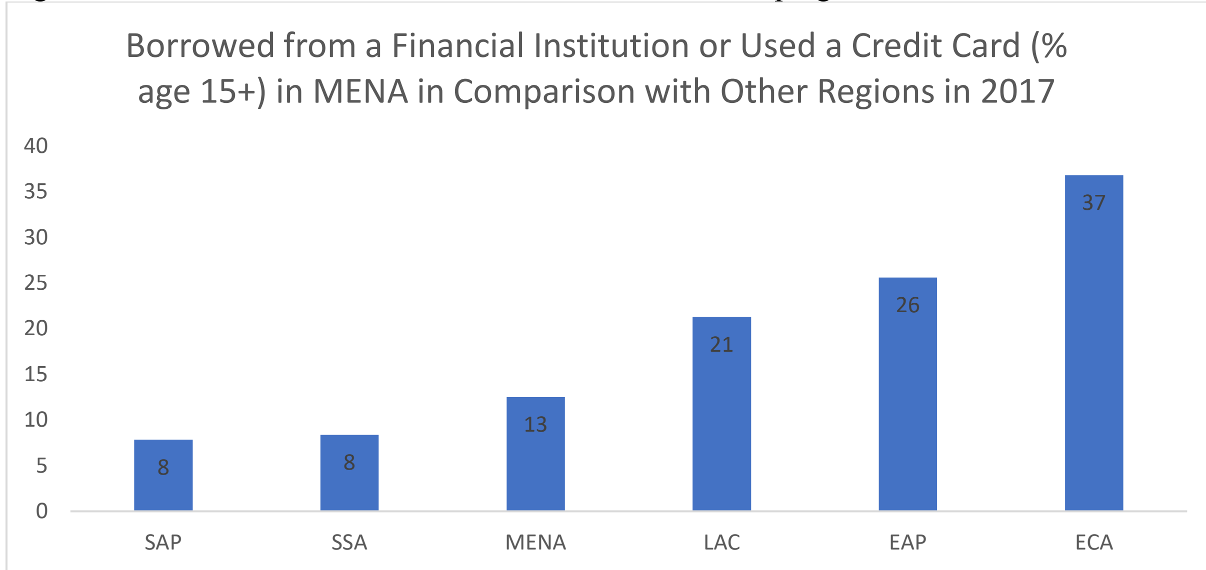
Figure 15. Financial inclusion: MENA vs. rest of the developing world



Source: Global Financial Inclusion as of October 2018

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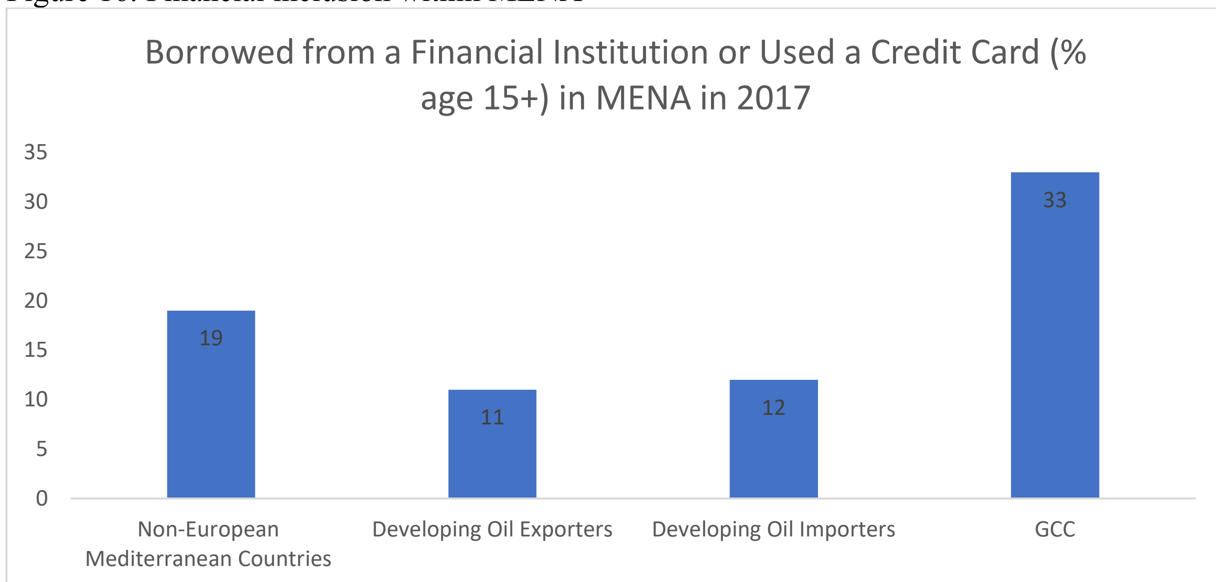
Figure 16. Financial inclusion within MENA



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