FINANCIAL CRISIS: CREATIVE DESTRUCTION & OPPORTUNITIES FOR DIFC

DIFC ECONOMICS

Dubai International Financial Centre

Overview

- The risk of a global financial meltdown has been avoided for now thanks to massive government rescue plans and guarantees
- Volatility will persist for the months to come with bad and good news while the banking sector remains under strain
- Conjunction of financial crisis, housing bust and credit crunch portends deep recession in the US and UK. The US stimulus package has been delayed by political squabbles and is unlikely to produce effects before mid-summer.
- Emerging markets and the GCC have been so far more resilient, but the shock have been too strong to be offset by purely domestic factors.
- Oil prices will remain depressed with negative effects on public finances and infrastructure projects
- The Gulf and DIFC could be among the long term gainers in the adjustment process, if economic governance and transparency are improved and a more coherent set of policy responses and structural reforms is framed over the next weeks and months.

Analysis of Global Situation

- Despite a historic coordinated intervention of all major central banks and a series of unprecedented, wide ranging and extensive government intervention, the financial sector remains fragile and a return to normality is slow. Damage assessment is still underway and new heavy losses are revealed every quarter.
- Authorities, financial intermediaries and corporations are bracing for at least three quarters of deep recession and widespread weakness until end 2009 as the credit crunch spreads to the real economy. Almost every month forecasts have been corrected sharply downwards. World growth in 2009 is forecast to be barely above zero.
- Lower consumption, cuts in investment projects and corporate downsizing in the wake of sharply reduced credit availability will in all likelihood prevail until the deleveraging comes to an end and trust in financial markets is restored.
- At present nobody can be sure for how long markets will remain dysfunctional, what results the stimulus packages will produce, over what time frame, and what future imbalances might cause.

Recent IMF Forecasts

- The **world economy** is coping with the most severe shock to mature financial markets since the 1930s.
- On an annual basis, **global growth** is expected to moderate from 5.0% in 2007 to 3.4% in 2008 and 0.5% in 2009.
- **Advanced economies** will suffer a deep recession, -2.0% in 2009 (a downward revision of 1.7% compared to a month ago).
- **Emerging economies** have thus far been able to hold on, but global trade, on which most of them rely, has suffered one of the most severe quarterly blows in history. Their real GDP growth is expected to slow from around 8% in 2007 to 3.0% in 2009 (revised down from 6.1% in the October WEO) on the optimistic assumption that export push will be replaced by domestic demand.
- These figures essentially indicate that the world is facing a **simultaneous recession never experienced in peace time**

Global growth comes to a halt

DIFC

All regions affected...

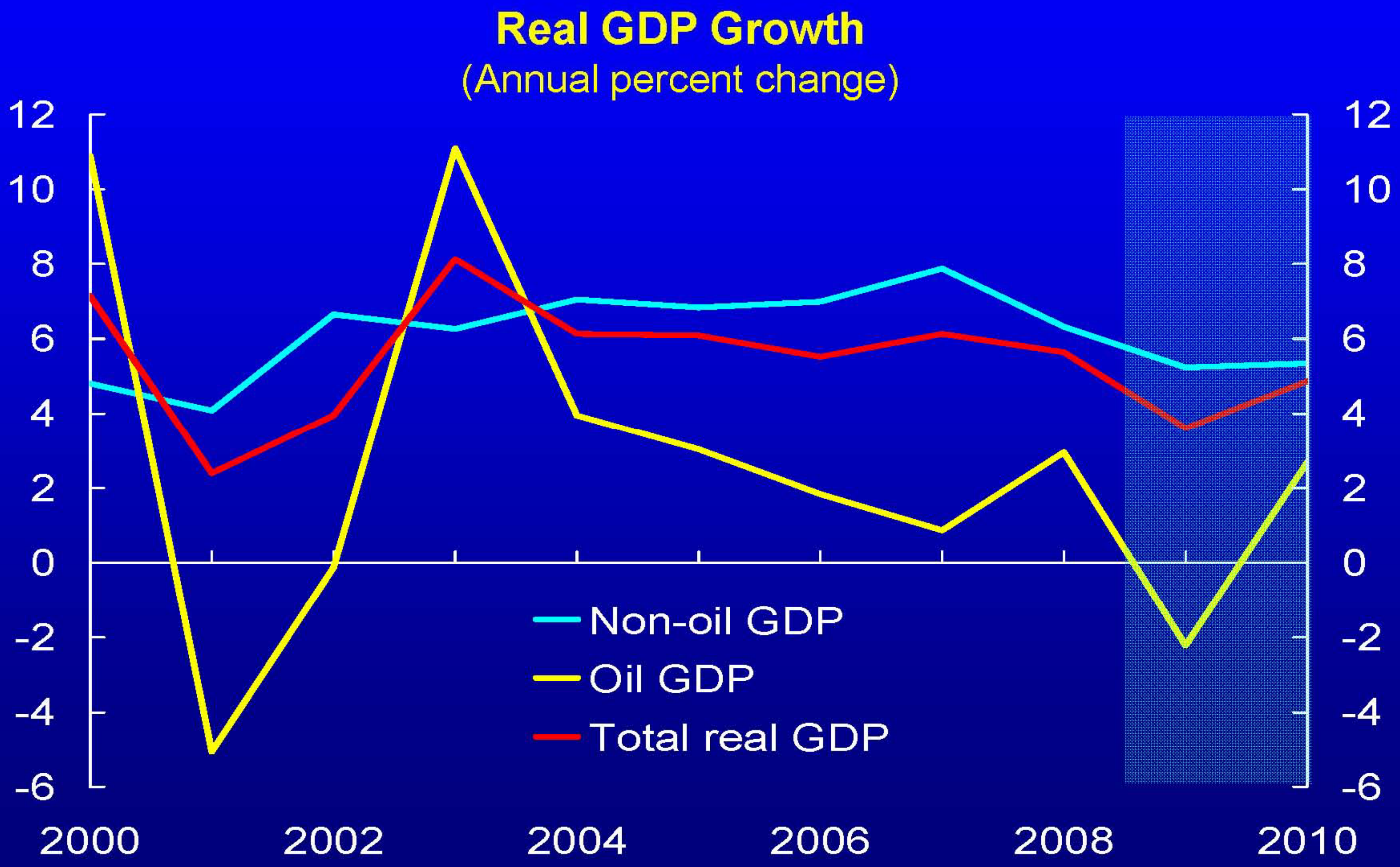
Overview of the World Economic Outlook Projections

(Year on Year)

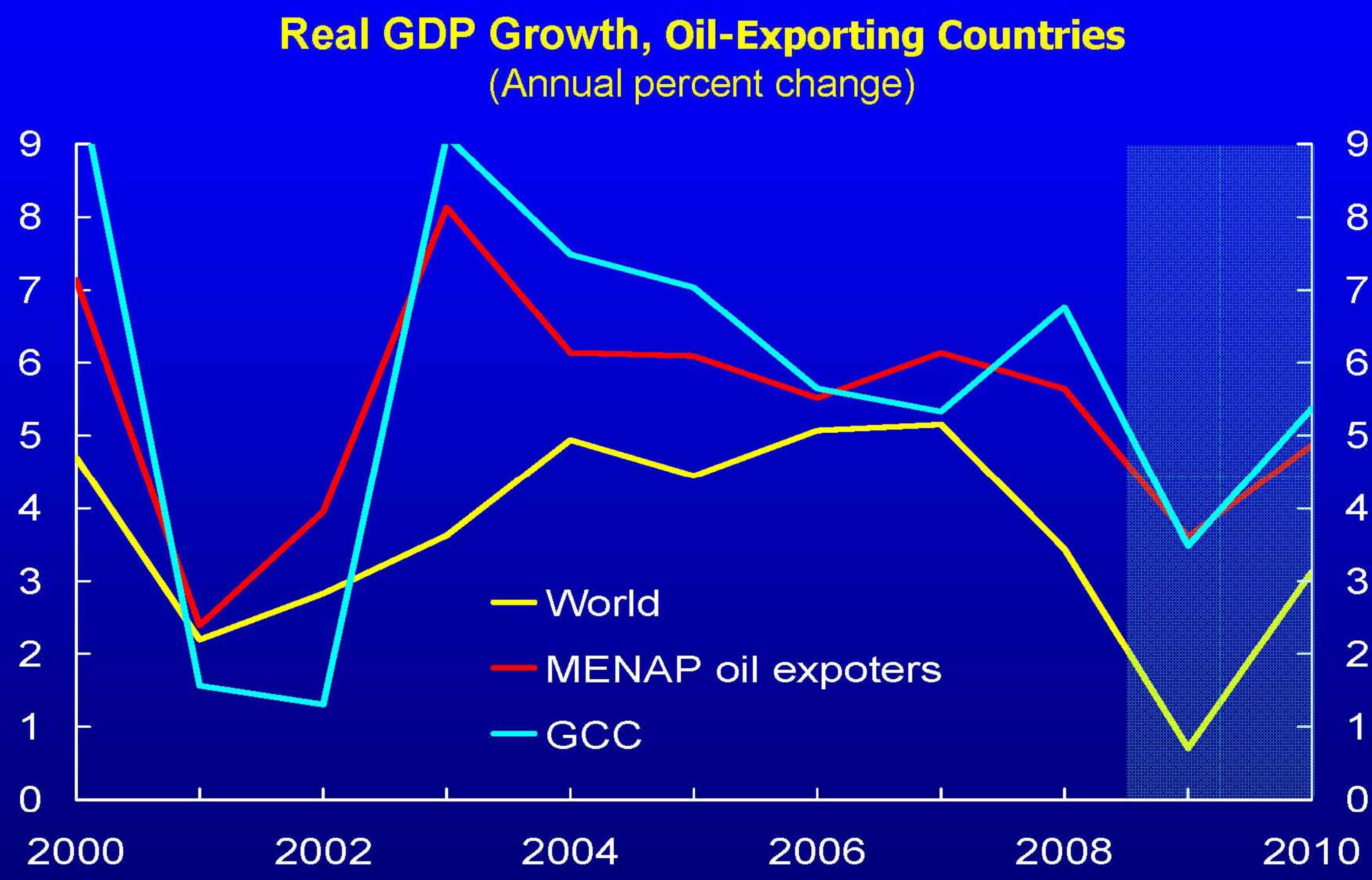
			Projections		Difference from Nov. 2008 WEO Projections	
	2007	2008	2009	2010	2009	2010
World output	5.2	3.4	0.5	3.0	-1.7	-0.8
Advanced Economies	2.7	1.0	-2.0	1.1	-1.7	-0.5
United States	2.0	1.1	-1.6	1.6	-0.9	0.1
Euro Area	2.6	1.0	-2.0	0.2	-1.5	-0.7
Emerging and Developing economies	8.3	6.3	3.3	5.0	-1.8	-1.2

Global economy heading for major downturn

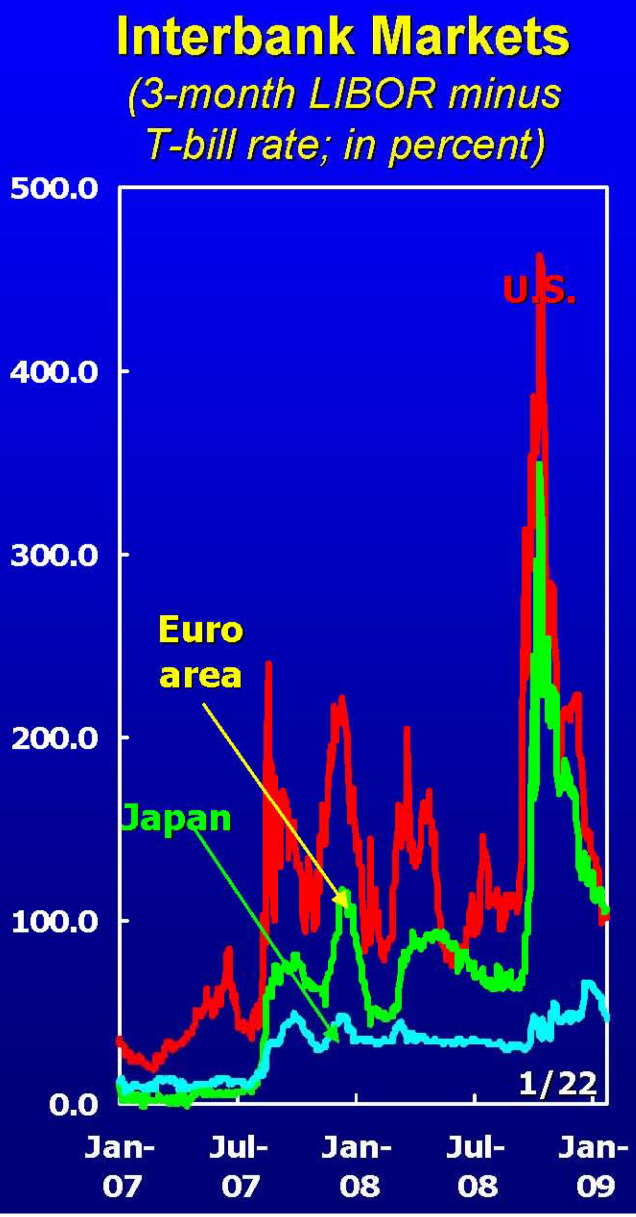
Growth in MENAP oil producers is expected to slow...

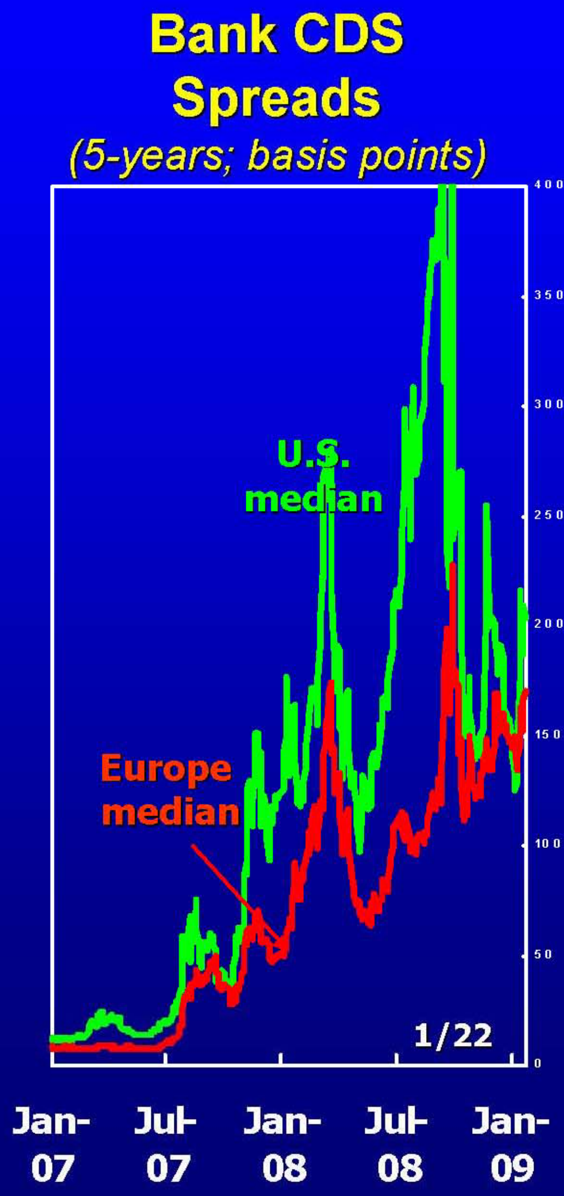


Growth in oil producers is expected to slow…



Global financial system slowly coming back from the brink





27 Things you may not have known about banking crises

Systemic Banking Crises: A New Database, IMF Working Paper, Nov 2008

1. In 55 per cent of cases, the banking crisis coincides with a currency crisis.
2. Bank runs feature in 62 per cent of the crises.
3. Banking crises are often preceded by credit booms, in 30 per cent of the cases.
4. Non-performing loans average about 25 per cent of loans at the onset of the crisis.
5. Macroeconomic conditions are often weak prior to a banking crisis.
6. Extensive liquidity support is used in 71 per cent of crises.
7. Peak liquidity support tends to be sizeable and averages about 28 per cent of total deposits.
8. Blanket guarantees are used in 29 per cent of crises, often introduced to restore confidence even when previous explicit deposit insurance arrangements are already in place, lasting for an average of 53 months.
9. Prolonged regulatory forbearance - where banks, for example, are allowed to overstate their equity capital in order to avoid the costs of contractions in loan supply - occurs in 67 per cent of crises.
10. In 35 per cent of cases, forbearance takes the form of banks not being intervened despite being technically insolvent, and in 73 per cent of cases prudential regulations are suspended or not fully applied. Existing literature on forbearance shows it is counterproductive, with banks taking on additional risks at the future expense of the gove11. In 86 per cent of cases, government intervention takes place in the form of bank closures, nationalizations, or assisted mergers.
12. 51 per cent of crisis episodes have experienced sales of banks to foreigners.
13. The more bank closures there are, the higher the fiscal costs.
14. A blanket guarantee, however, reduces the instances of bank closures.
15. Bank restructuring agencies are set up in 48 per cent of crises.
16. Asset management companies are set up in 60 per cent of cases to manage distressed assets.
17. In 76 per cent of episodes, banks were recapitalised by the government, mostly with cash, government bonds or subordinated debt.
18. Recapitalisation programs are usually accompanied with some conditionality.
19. To the extent that debt relief schemes are discretionary, they run the risk of moral hazard as debtors stop trying to repay in the hope of being added to the list of scheme beneficiaries.
20. Average net recapitalisation costs to the government amounts to 6 per cent of GDP.
21.On the bright side, recapitalisations tend to be associated with lower output losses.
22. Monetary policy tends to be neutral during crisis episodes, while fiscal policy tends to be expansive.
23. Average fiscal costs, net of recoveries, associated with crisis management average 13.3 per cent of GDP.
24. The average recovery rate is just 18 per cent of gross fiscal costs.
25. Real GDP losses average 20 per cent relative to trend during the first four years of the crisis.
26. There is a negative correlation between output losses and fiscal costs: the higher the fiscal costs, the smaller the loss of output
27. Inflation and currency devaluation help reduce the budgetary burden and thus have been a feature of the resolution of many crises in the past.

Stylised Facts on the Aftermath of Severe Financial Crises

C. Reinhart & K. Rogoff (2008)

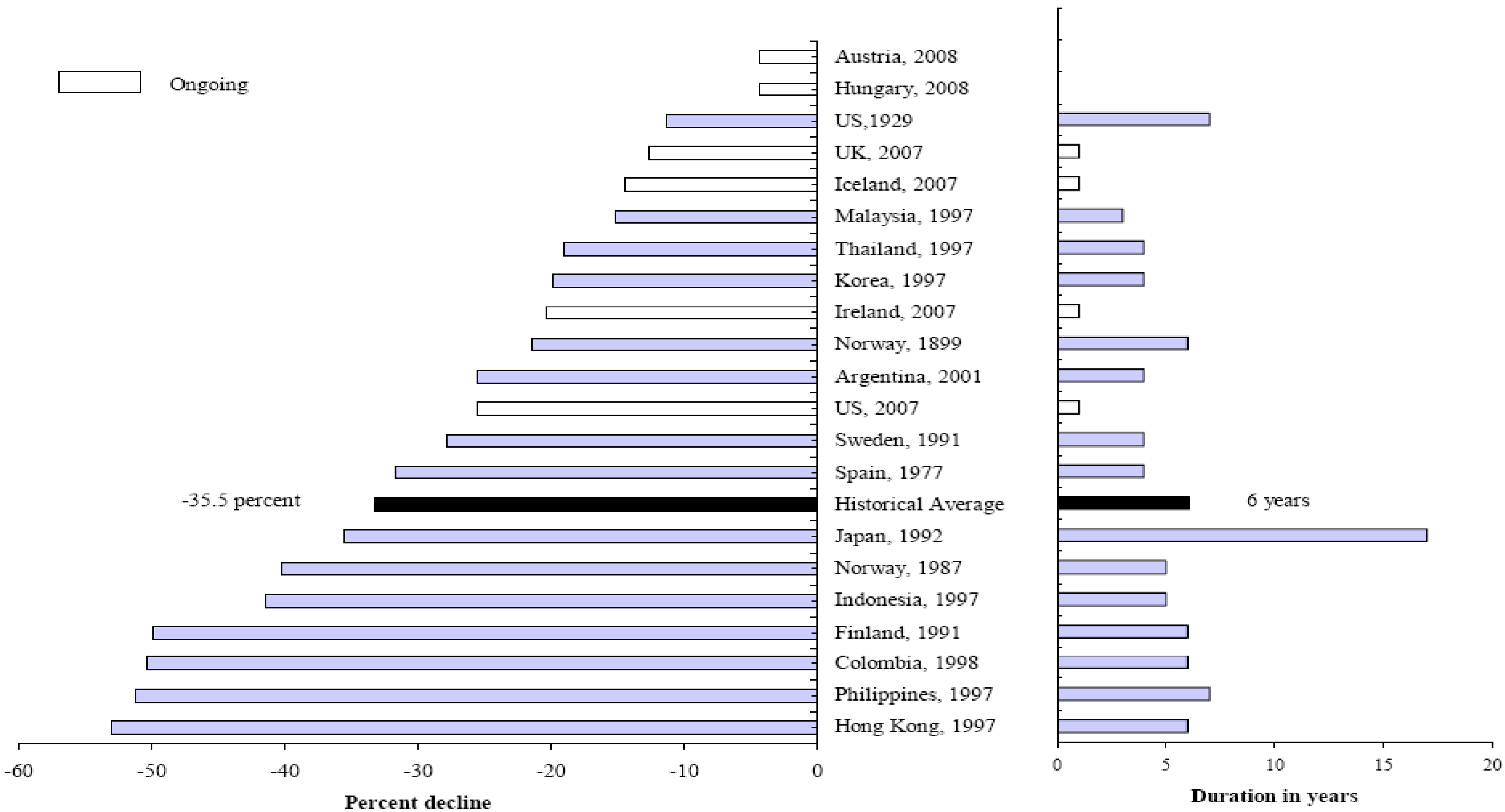
1. ***Asset market*** collapses are deep and prolonged. Real housing price declines average 35 percent stretched out over six years. Equity price collapses average 55 percent over a downturn of about three and a half years.

2. ***Aftermath of banking crises is*** associated with profound declines in output and employment. Unemployment rate rises an average of 7 percentage points over the down phase of the cycle, which lasts on average over four years. Output falls (from peak to trough) an average of over 9 percent, although the duration of the downturn, averaging roughly two years, is shorter than for unemployment.

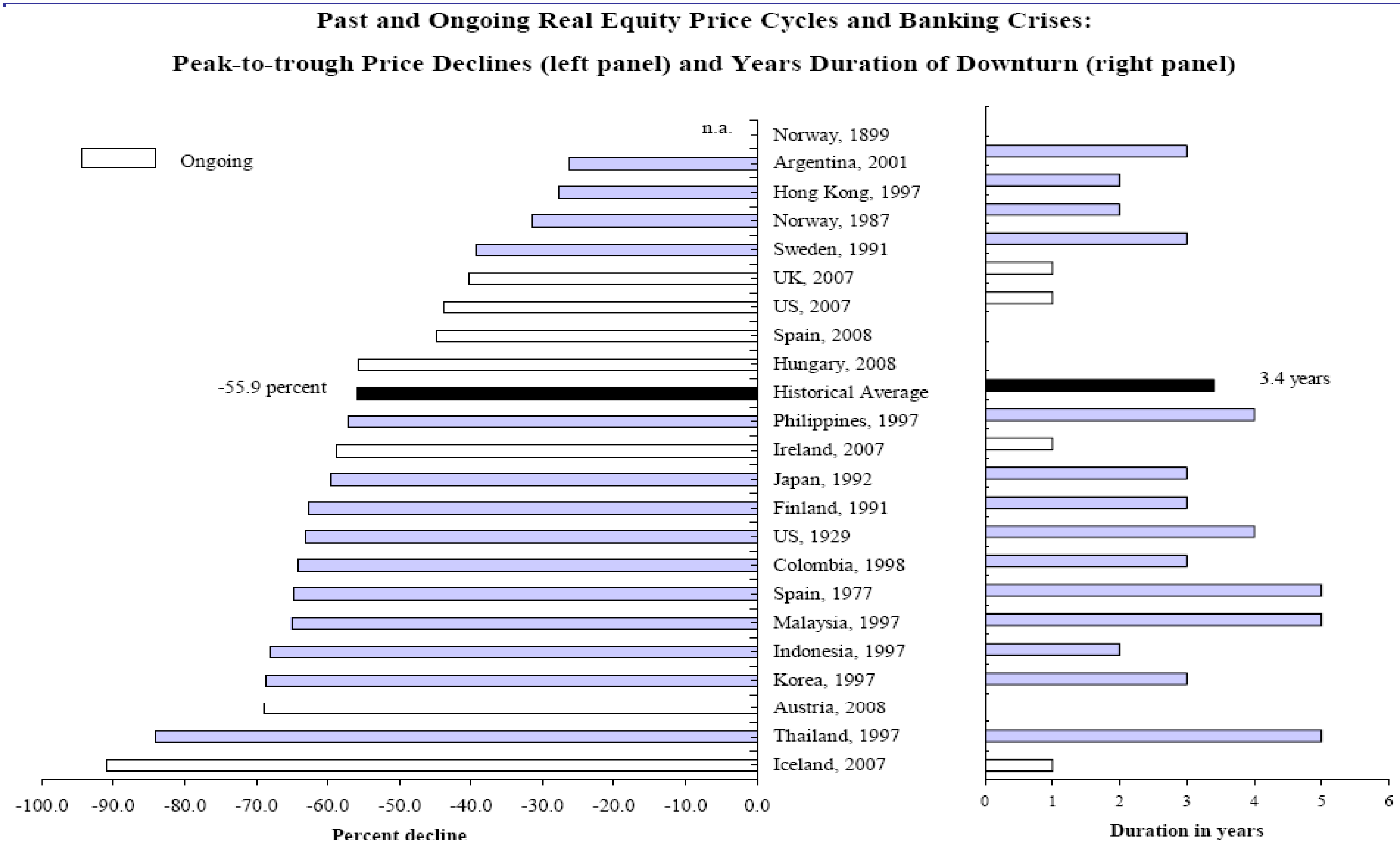
3. ***Real value of government debt tends to*** explode, rising an average of 86 percent in the major post–World War II episodes. Main cause of debt explosions is not the costs of bailing; the big drivers of debt increases are the collapse in tax revenues as a result of recession.

Past and Ongoing Real House Price Cycles and Banking Crises:

Peak-to-trough Price Declines (left panel) and Years Duration of Downturn (right panel)



Sources: Reinhart and Rogoff (2008b) and sources cited therein.

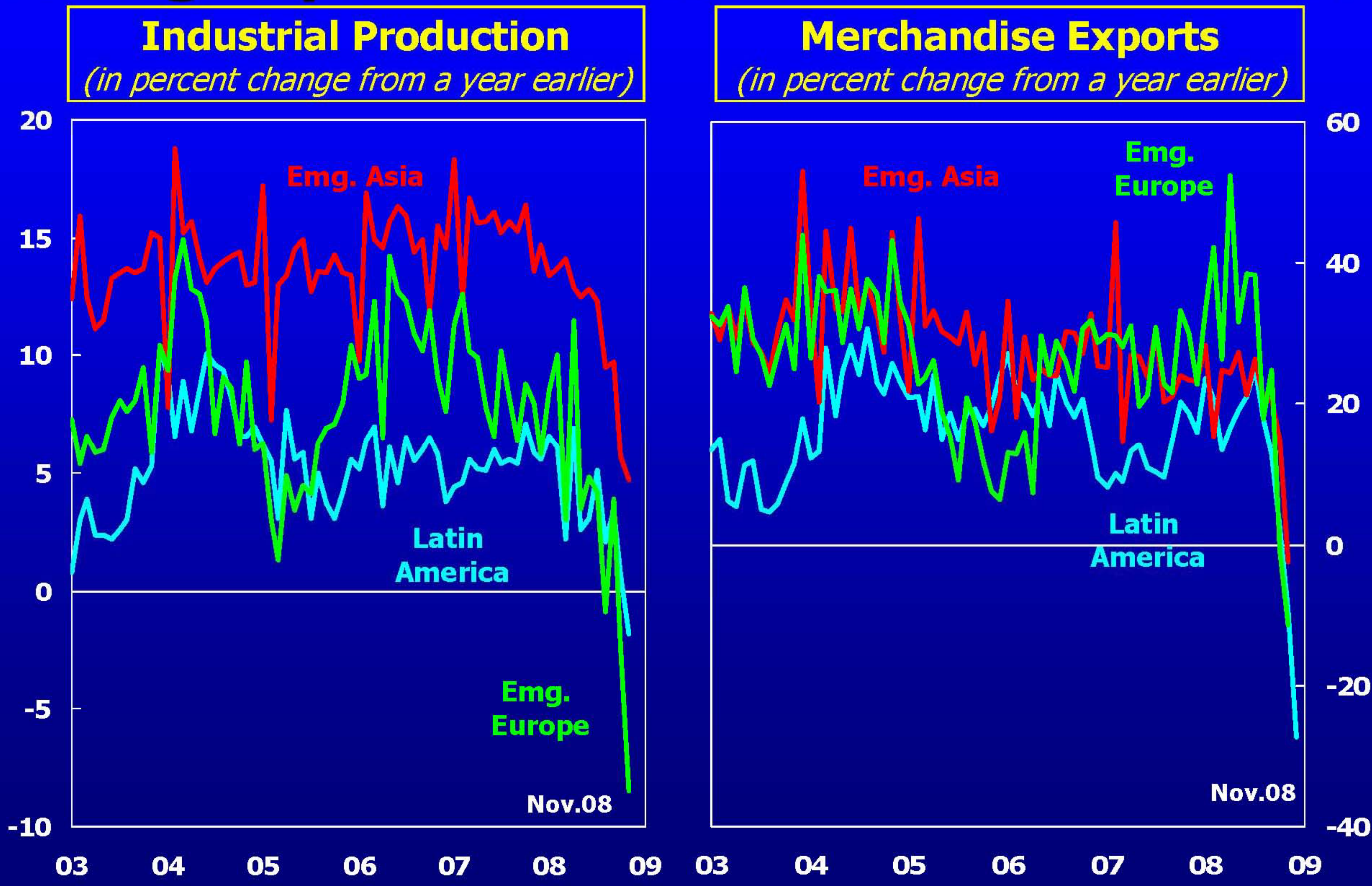


Sources: Reinhart and Rogoff (2008b) and sources cited therein

Contagion and Decoupling

- Hopes of containing the contagion hinge on the stimulus to domestic demand in large emerging markets such as China, India, Brazil, Mexico, Korea, GCC.
- China's successful fiscal expansion in response to the East Asian financial crisis of 1997–98 spent heavily on infrastructure projects for which there was strong local demand.
- If we look at the 2000-01 recession, export growth in the major EMs dropped off precipitously, falling in Brazil from 15% in 2000 to 6% in 2001, from 39% to -3% in Russia, from 22% to 4.5% in India, and from 28% to 6% in China.
- However domestic consumption cushioned part of the drop
- The lesson of the late 1990s has been learned and today most EM display a much sounder policy mix: this is likely to be the case for China, India, Brazil, Russia and GCC
- Also the financial sector in large EM has not suffered large losses from exposure to toxic assets

Emerging economies' growth slowed by falling exports and industrial Production…



Resilience in Emerging Markets

- A slowdown in external demand will not be enough to force a hard landing in EM growth, but could force a sudden adjustment in the export sector with factory closures and widespread layoff.
- While hot money inflows have turned to outflows in many EMs, a hard-landing is unlikely unless FDI drops drastically.
- In several EMs, financial markets are clogged, and this will cause growth to fall sharply in the near term. However, if policy actions in the US and Europe help to unfreeze markets, there is a good chance that most EMs will escape a severe contraction.
- The key factor to watch will be large infrastructure projects and the effects of stimulus measures aimed at boosting domestic consumption in the Ems.

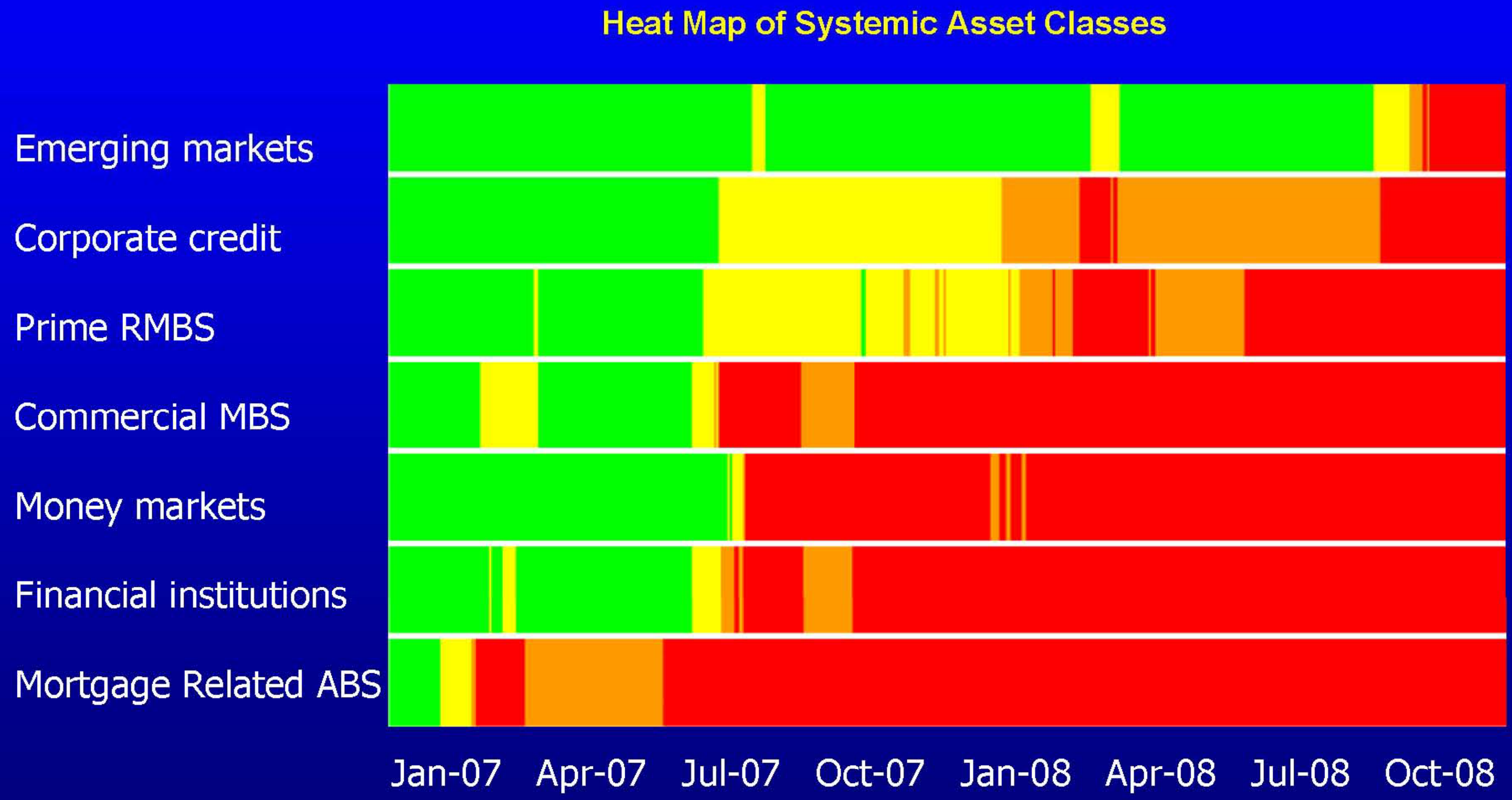
MENA - Limited Repercussions

- **MENA, especially the Gulf region, has not been as severely hit by toxic assets and financial turmoil thanks to**
  - Profitable domestic markets
  - Small stock of outstanding securitised/structured products
  - Limited expertise in managing structured investment products
  - Regulatory/prudential requirements limited exposure to sub-investment grade investments & instruments
  - Growing importance of and compliance with Shari’a
  - Ample liquidity from the increasing net capital flows (due to high returns) and from oil exports
  - Fiscal discipline and sizeable stock of foreign assets
- **However the drop in oil price will cloud the outlook and put strains on public finances and current accounts**

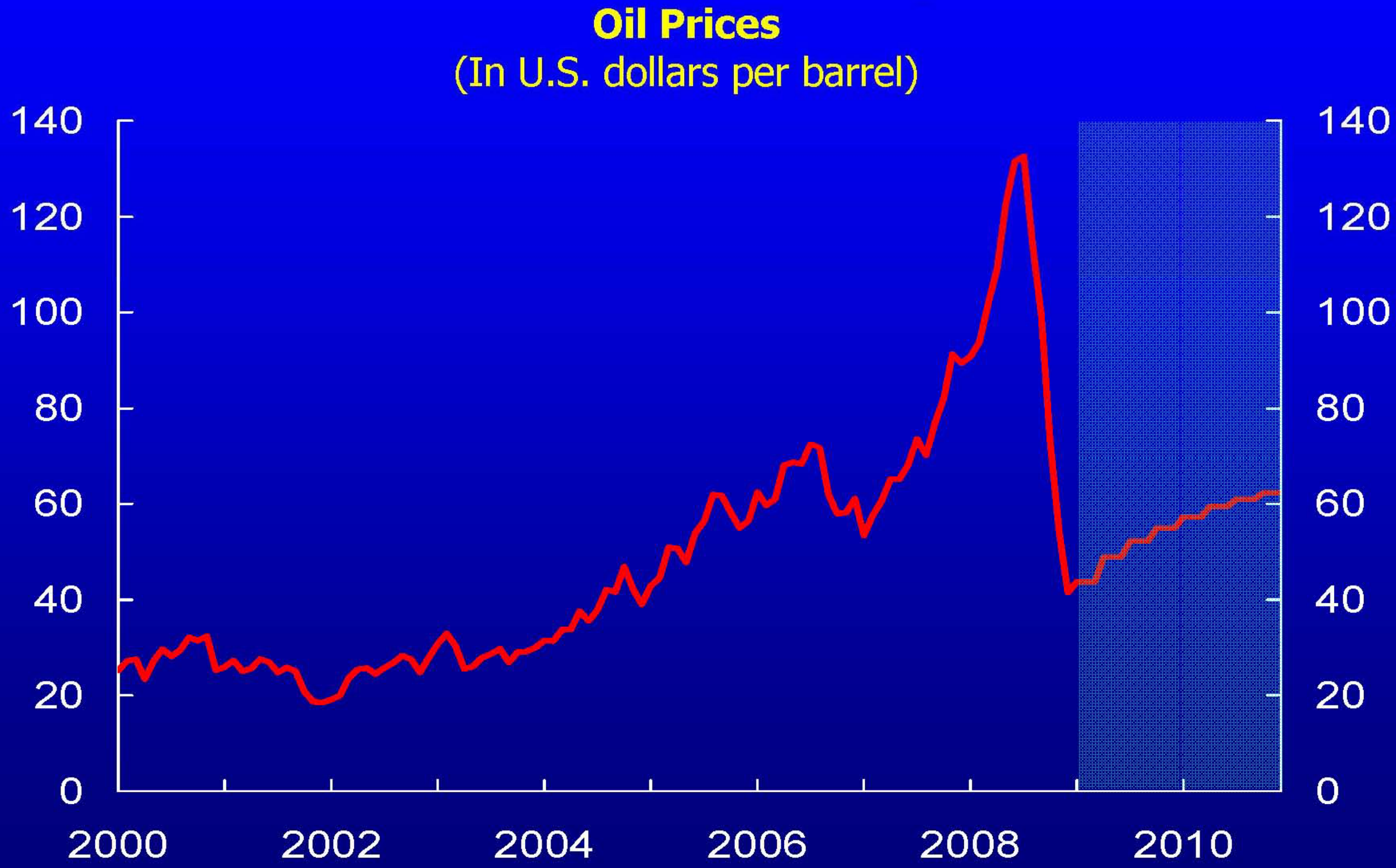
MENA Vulnerability through Real Sector channel

- In addition to oil prices, the following real sector economic transactions may increase MENA vulnerability to the crisis:
  - Decline in International Trade
  - Decline in Tourism
  - Decline in Foreign Direct Investment
    - Countries with ties to Europe are most vulnerable including Tunisia, Morocco and Egypt
  - Decline in Remittances affecting labour exporting countries

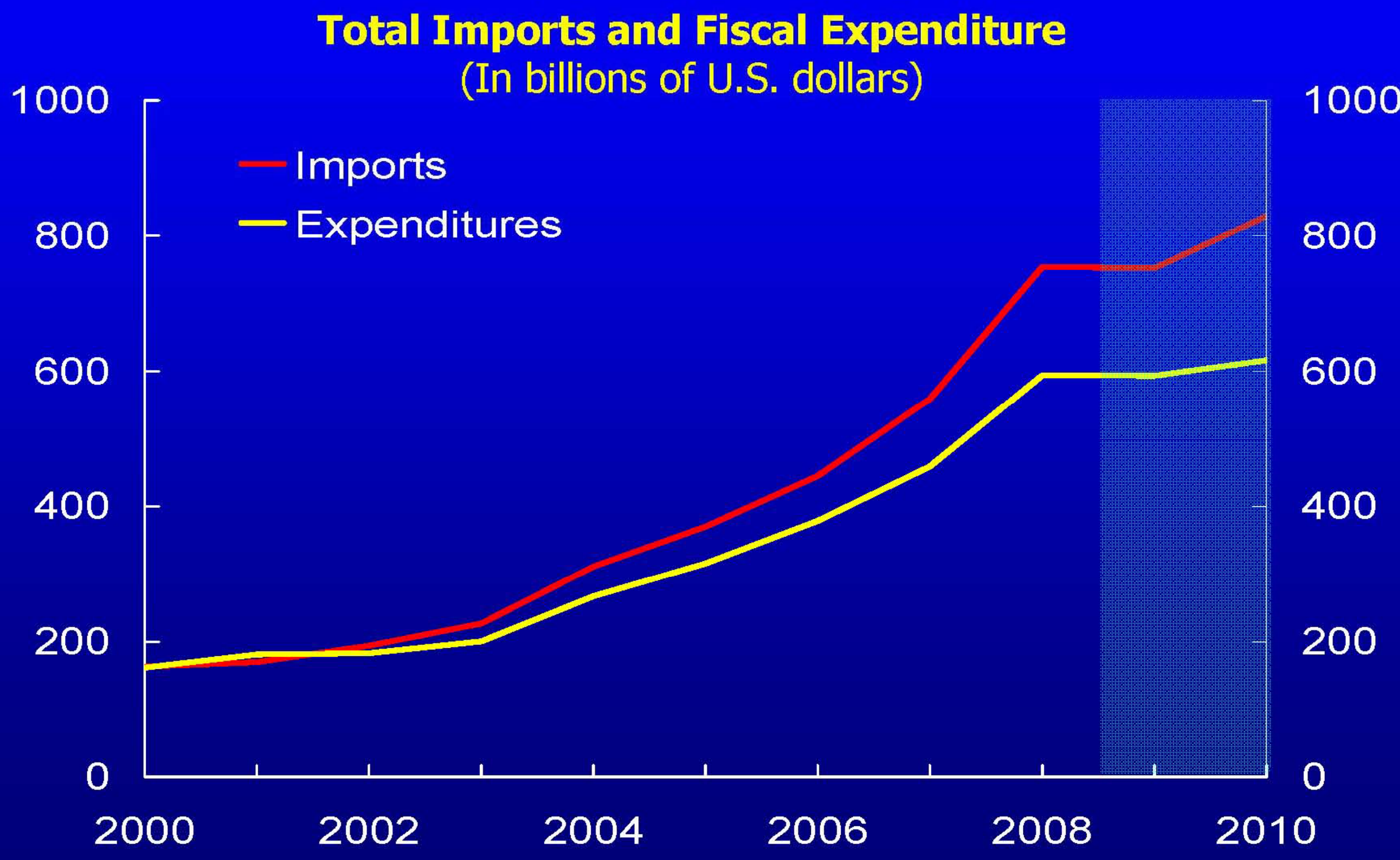
And the spread of the crisis to emerging markets will continue



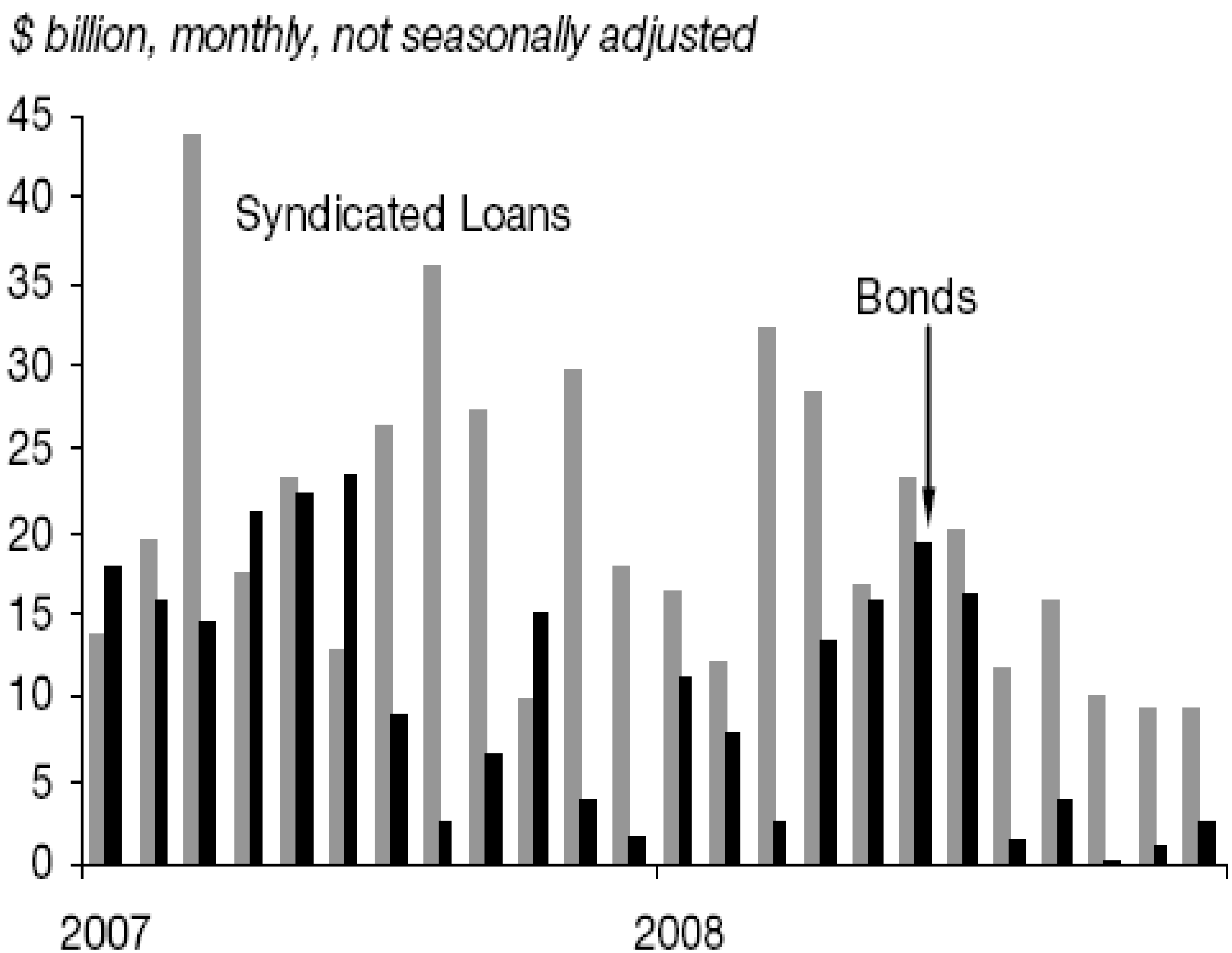
The slump in global demand has led to a collapse in commodity prices



But governments likely to maintain spending



International Issuance by Emerging Markets



Source: Capital Flows to Emerging Markets, IIF, Jan 2009.

GCC in the turmoil

- **Although the real economy in the UAE and the Gulf has not been seriously affected yet, contagion lurks and complacency would be fatal**
- **So <u>the governments must show that they are ready to act decisively</u>. A clear communication policy backed by actual data should stress that**
  1. **The public and private sector in the GCC have enough resources to offset adverse conditions and contagion effects**
  2. **The main infrastructure and development projects will continue as planned despite the financial crisis because funding is unaffected**
  3. **The authorities will take a series of measures aimed at cushioning the financial intermediaries and improve project management, resources allocation, data disclosure, and governance of corporations**

GCC Outlook: Macroeconomic Projections

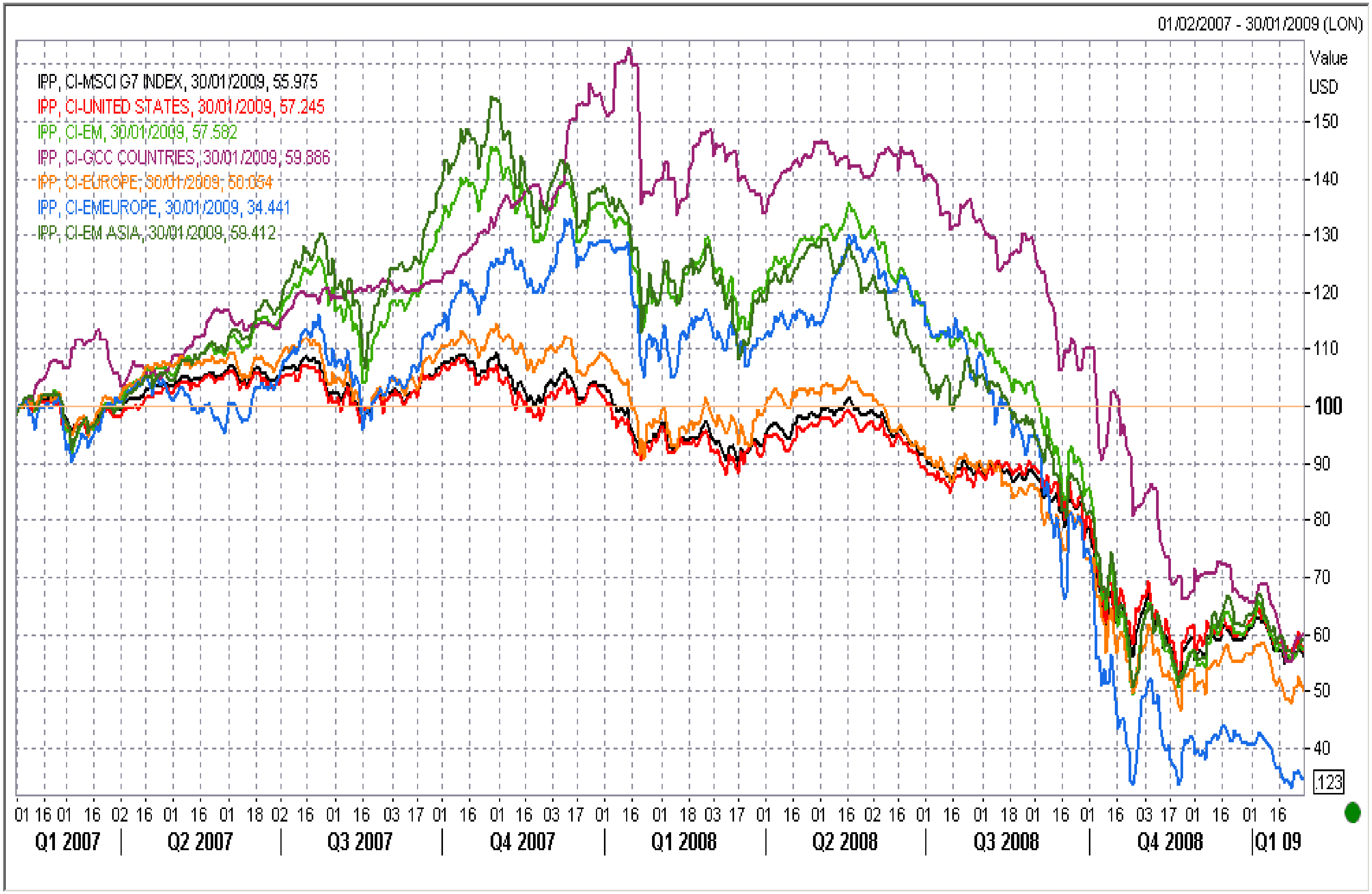
	2007	2008f	2009f
Oil Price (Brent; $/barrel)	72.6	99.1	55.6
GCC			
Nominal GDP ($ bn)	821	1,065	906
Real GDP growth (%)	5.5	5.7	3.6
Hydrocarbon	1.1	4.2	1.3
Nonhydrocarbon	7.9	6.1	4.4
Inflation (%)	7.0	12.0	7.6
Current account bal. ($ bn)	206.3	321.4	47.9
(% GDP)	25.1	29.3	4.6
Fiscal balance (% GDP)	19.2	21.9	4.7

f = IIF forecast

	2007	2008f	2009f
United Arab Emirates			
Nominal GDP ($bn)	201	258	216
Real GDP growth (%)	6.1	5.8	3.1
Hydrocarbon	-1.2	3.0	-0.2
Nonhydrocarbon	8.7	6.5	4.2
Current account bal. ($ bn)	36.3	52.7	13.3
(% GDP)	(18.1)	(20.4)	(6.2)
Fiscal balance (% GDP)	26.7	28.1	11.7

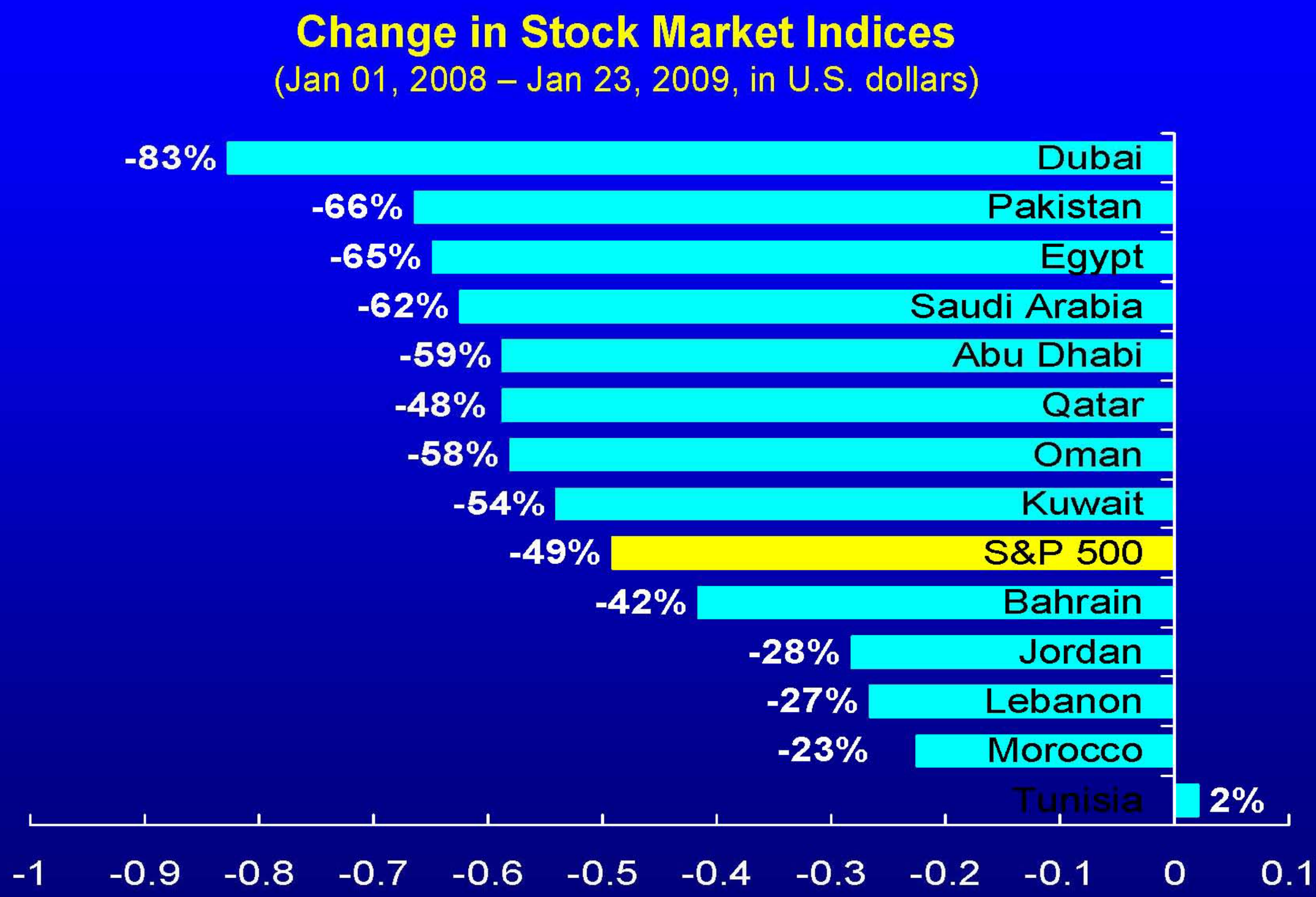
Source: IIF Report on GCC, Dec 2009

G7 & Emerging Market Equity Performance



Source: Reuters, DIFC Economics.

Asset price corrections deepen further



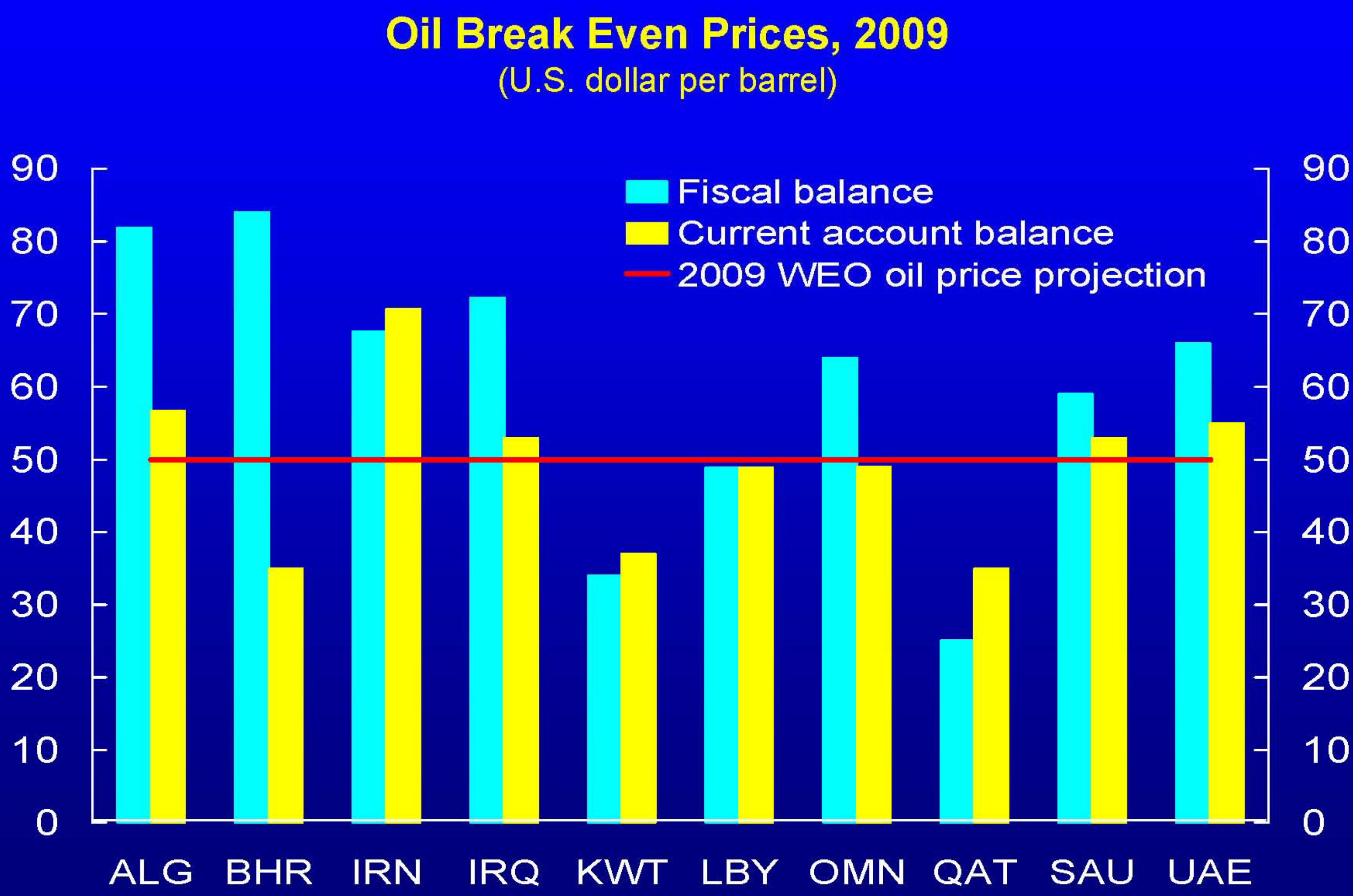
Policy measures in the GCC

- Bahrain cut the repo rate by 25bp and the overnight rate by 50bp
- Kuwait cuts the repo rate by 100bp and the discount rate by 125bp. A series of other measures included 1bn USD investment by KIA in local stock market, liquidity injections, increase in the loan/deposit ratio, extensive deposits guarantee.
- Qatar has instructed QIA to buy 10-20% of local banks' capital
- KSA reduced its repo rate by 50bp (but left unchanged the reverse repo rate), and set up a 36bn USD liquidity facility (only 2-3 bn have been used) and reduced reserve requirements from 13% to 10%.
- UAE guaranteed all deposits (including interbank) and set up a 50bn AED emergency liquidity facility (little used so far), while the government deposited 70bn AED in local banks. The repo rate was reduced to 1.0% effective 19 January 2009

Banking sector in GCC

- GCC Banks remain well capitalized and profitable, with NPL below 5% of the total. Vulnerability will emerge as growth rates decline.
- Liquidity problems were caused mostly by an outflow of speculative capital betting on a currency revaluation and by the seizure of international money markets
- While cost of wholesale funding has increased, the region has no shortage of capital and its creditworthiness is solid
- However, IIF estimates that international banks have provided between 20% and 50% of project financing with the highest share in the UAE. In June 2008 foreign liabilities of the UAE stood at USD 88 from 23 billion at end 2005.

Oil prices do not recover as expected



Overall Implications for the DIFC

- Negative:
  - The world financial sector will undergo a period of extensive retrenchment, restructuring and recapitalisation, and regulatory reform uncertainty
  - Organic growth cannot be taken for granted; a process of consolidation of banks and financial institutions -- including in the UAE and the Gulf -- will affect the number of current employees in the DIFC => Growth can come only as a result of expanding market shares
  - Cost cutting and consolidation will continue throughout 2009; some of our clients might decide to close their offices at the DIFC as the deal flow stagnates or drops
  - IPO activity has stalled, although M&A and restructurings might pick up
- Positive:
  - The GCC remains one of the few areas where capital is still available and banks are strong, so it is likely that a sizeable portion of the global restructuring might involve GCC institutions
  - Emerging markets companies will be seeking investors outside the traditional financial centers
  - Investments by SWF in top global banks will increase the visibility of the Gulf in the boardrooms
  - Regulatory environment is perceived as being rather conservative
  - The crisis should speed up the launch of the GCC GMU and single currency

DIFC needs a shift to a pro-active role

- DIFC strategy cannot be primarily aimed at providing office space for companies
- Constant contacts should be maintained with governments and policy makers in the GCC and the DIFC region. Business proposals need to be developed and marketed aggressively
- A concerted effort (seminars, fora) should be made to attract Free Zone companies to seek financing at the DIFC.
- A series of heavy and mostly unnecessary regulatory measures are likely to be taken in the US, UK and EU affecting hedge funds and private equity. We could develop an efficient regulatory environment to draw these entities to the DIFC
- DIFC needs to become a policy adviser to the Dubai and UAE governments on the benefits of fostering the right environment for banking & financial markets, project financing, mortgage market and fixed income markets.

DIFC needs a shift to a pro-active role

- **Policy action is required:**
  - **By UAE CB and Government in order to achieve a 'soft landing' for the UAE**
  - **By Dubai Government and DIFC**

- **Policy action must address three main areas of vulnerability and risk:**
  - **Real estate market**
  - **Banking & Financial Markets & Institutions**
  - **Government finances and debt management**

UAE Measures to enhance liquidity and stability

DIFC

1. Central Bank REPO and SWAP Facilities
2. Central Bank Guidelines for Dealing with Corporate Difficulties
3. Government Guaranteed Bank Securities
4. CB and liquidity for Shari’a compliant institutions
5. Establishing an Emirates Bond Fund (EBF).
6. CB/MOF facility for lending to SMEs
7. Establish a Debt Management Unit
8. Establish the Emirates Deposit Guarantee Corporation (EDGC)
9. Establish an Emirates Mortgage Guarantee Corporation (EMGC).
10. CB Soft Loan facility for Bank M&A

Dubai/DIFC Strategy need updating

DIFC

- Dubai Strategic Plan 2015 is increasingly out of date and needs to be revised. We must offer the Dubai government to redraft it based on solid research, analysis and statistical data.
- DIFC can become the public finance adviser to Dubai government
- The need to boost trading volumes is critical to the survival of the DIFC; listing of stocks, derivatives and bonds must be the overriding task for the next 12 month.
  - Stocks can be attracted by facilitating dual listing of companies (e.g. MOUs with other Stock Exchanges) and by launching a market with lighter listing requirements such as AIM
  - A fixed income market cannot be developed without a decisive boost from the government and the central bank. A lobbying effort must be launched with the objective of starting a medium term plan for government securities issuance (and possibly government entities) in conventional and Islamic securities.
  - DIFC should develop a programme for Infrastructure and Public Works to be financed through Bond & Sukuk issues
- Fixed income securities are required both to stream line the Dubai Inc. exposure and to offer a liquid market in view of the GCC currency union. Missing this opportunity would be a fatal mistake.
- Insurance market and Takaful products need to be given a more decisive boost
- Efforts to establish DIFC as a center for captives should be stepped up

DIFC Areas for Action

1. Develop Bond Market to serve Governments and Corporates of the region, including Dubai
2. Engage with Sovereigns and International Financial Institutions, including WB, EDB, ADB, AFDB, ISDB to issue securities in the DIFC. IFC will be issuing a Sukuk out of DIFC.
3. Launch DIFC-MIGA guarantee programme for sovereign/corporate bond issues
4. Promote RAPID payment system to serve DIFC region
5. Legal infrastructure for market completeness and growth:

   (a) Securitisation; (b) Securities lending
6. Merge DIFX and DFM to provide breadth, depth, liquidity and multi-currency
7. Set up an Second tier market (AIM) designed for small and midsized companies (SMEs), with simplified listing rules and minimal ongoing obligations
8. Actively attract companies from the FZs and regional countries such as India to list securities
9. Promotion of pension fund schemes for expatriates
10. Actively promote Gulf Monetary Union and Common Currency

Thank You!