Local Bond Markets as a Cornerstone of Economic Development Strategy

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24th January, 2010
Agenda

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DIFC Economic Note # 7 by Nasser Saidi, Fabio Scacciavillani & Aathira Prasad

Introduction

Bond and Sukuk Market Development 2003-09

Importance of Debt Market Development

Policy Recommendations

Role of the DIFC in Debt Market Development
• In the Middle East, capital markets are dominated by bank assets and equities
• Debt securities make up just 5.6% of the Middle Eastern capital markets

International Bonds Outstanding

Bond financing in MENA is tilted towards sovereign issuers, as opposed to a relatively more balanced distribution in other regions.

<table>
<thead>
<tr>
<th>(in USD bn)</th>
<th>Sovereign</th>
<th>Corporate</th>
<th>Financial Institutions</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>All countries</td>
<td>2113.5</td>
<td>2813.7</td>
<td>20186.2</td>
<td>25881.0</td>
</tr>
<tr>
<td>Developed countries</td>
<td>1598.7</td>
<td>2562.8</td>
<td>19503.7</td>
<td>23665.2</td>
</tr>
<tr>
<td>Developing countries</td>
<td>477.8</td>
<td>214.0</td>
<td>512.1</td>
<td>1203.9</td>
</tr>
<tr>
<td>Africa &amp; Middle East</td>
<td>43.7</td>
<td>35.7</td>
<td>82.3</td>
<td>161.7</td>
</tr>
<tr>
<td>Asia &amp; Pacific</td>
<td>57.2</td>
<td>89.8</td>
<td>208.3</td>
<td>355.3</td>
</tr>
<tr>
<td>Latin America &amp; Caribbean</td>
<td>206.0</td>
<td>55.5</td>
<td>97.0</td>
<td>358.6</td>
</tr>
<tr>
<td>Bahrain</td>
<td>1.1</td>
<td>-</td>
<td>5.1</td>
<td>6.2</td>
</tr>
<tr>
<td>Kuwait</td>
<td>-</td>
<td>-</td>
<td>3.2</td>
<td>3.2</td>
</tr>
<tr>
<td>Oman</td>
<td>-</td>
<td>-</td>
<td>1.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Qatar</td>
<td>4.4</td>
<td>5.9</td>
<td>3.3</td>
<td>13.6</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>-</td>
<td>1.9</td>
<td>7.8</td>
<td>9.7</td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>8.8</td>
<td>14.4</td>
<td>42.5</td>
<td>65.7</td>
</tr>
</tbody>
</table>

Source: BIS Quarterly Bulletin, Sep 2009
Bond Market Development 2003-09

• Bond issues have risen dramatically since 2003, but as in the rest of the world, 2008 recorded a dip in the number and size of issues.

• Total issuance in 2009 shows a significant pick-up in issues post-Ramadan.

Source: Bloomberg, Reuters, DIFC Economics
Sovereign Issues Dominate in 2009

Conventional Sovereign Issues formed 72.4% of debt issuance*

- Conventional Corporate, 21.6%
- Sovereign Sukuk, 5.81%
- Corporate Sukuk, 0.26%
- BH, 3.4%
- KW, 11.6%
- OM, 3.5%
- QA, 29.9%
- UAE, 24.0%

* data as of Nov 22, 2009

Source: Bloomberg, Reuters, DIFC Economics
The Emergence of the Sukuk Market

Issuance of Sukuk dampened in 2008 and 2009 compared to 2007

- Sovereigns and government-related issuers were the most common Sukuk issuers – for funding programs amid declining economic activity, fiscal deficits and lower commodity prices.

- Share of US dollar-denominated Sukuk dropped from 85% in 2002 to 10% of issuance in 2008; Speculation of GCC currencies de-pegging directly led to a shift in currency choice

- Malaysian ringgit was the top currency choice in 2009

- Among the GCC countries, Bahrain dominated the number of Sukuk issues in 2009 while Saudi Arabia raised the maximum value of issues
Comparison of Bond Returns

- The impact of the Lehman tsunami on the markets is clearly evident.
- Emerging market returns are catching up; outperformance of lower-rated, higher-yielding bonds in 2009

**Bond performance: Global vs. Emerging Markets**

**Bond market returns took a hit post-Lehman**

Source: Bloomberg, Reuters, HSBC-DIFX indices, DIFC Economics
Underdeveloped Debt Markets in MENA

The markets in the MENA region are still underdeveloped:

- Lack of breadth, depth and liquidity,
- A small investor base
- Absence of a clear legal & regulatory framework
- Lack of credit rating culture
- Unsatisfactory market transparency
- Lack of benchmarks
- Lack of long maturities
- Lack of a broad spectrum of institutional investors
- Absence of a derivatives market for managing interest rate and credit risk.

Creane, Goyal et.al. (2004) underscore six broad themes identifying more specific drawbacks in:

- Monetary policy
- Banking sector
- Nonbank financial sector
- Regulation and supervision
- Financial openness
- Institutional environment
Local Debt Markets: Cornerstone of Development Policy

Potential drivers of MENA Debt Market:

- **Finance infrastructure** and development projects in the region
- **Corporate Debt:** Well functioning debt markets will help reduce dependence on bank finance at a time when the banking sector is in a process of deleveraging
- **Government Debt:** Diminish macroeconomic and financial vulnerability from energy price fluctuations by providing governments with an alternative source of funding to smooth out volatile revenues
- **Enable monetary policy** by providing central banks with a market to conduct open market operations & control liquidity
- **Mortgage Markets:** cornerstone of housing finance
- **Local currency bond markets are a cornerstone of development strategy**
Why Local Currency Market Development?

Developing debt markets in local currencies would allow to:

- Deal with currency mismatching & exchange rate risk
- Absorb volatile capital flows and reduce financial instability
- Provide institutional investors instruments that offer safe and stable long term yields in local currency
- Develop a stable source of capital to fund public and private ventures
- Provide Central Banks an effective monetary policy tool: open market operations feasible => help maintain an inflation target without a peg to a major currency
- As a by-product, debt market would:
  - enhance transparency in pricing and intermediation,
  - facilitate constant monitoring of macro-economic expectations,
  - ensure disclosure of information and periodic communication regarding public policies.
Role of Central Bank & Ministries

- Ministry of Finance (MoF) has key role as the developer and executor of the state budget and sovereign borrower for the country
- Fiscal authorities have to consider how important projects will be funded; choices on how to fund projects – domestically, internationally, bond or loan market - will impact the level of market development.
- The Central Bank **role as monetary authority** => operate in the market to inject or withdraw funds using market mechanisms
- The Central Bank is the designated **fiscal agent of the government** => conduct the sale of securities; may also maintain and operate the securities depository
- The Central Bank as **a regulator of the banking system** => involve in the creation of a liquid yield curve => allow banks to price their assets more accurately
- The Central Bank could boost the market if banks were required to hold a **minimum percentage of their statutory liquid reserves in government paper**
- **Establishment of a repo market** could facilitate open market operations and also facilitate banks / participants to manage their own liquidity flows
Policy Recommendations

• Government **bond issuance across the maturities spectrum** (eg. 1, 2, 5, 7, 10 and 30 years) can provide the building blocks for a yield curve. ("market breadth")

• The issuance must be conducted **systematically over a number of years with appropriate pre-announcement** of auction dates, size & characteristics of the issue etc.

• The calendar interval should be conveniently spaced with **three objectives** in mind:
  
  ✓ creation of a critical mass of tradable paper ("market depth")
  
  ✓ avoid the drying up of longer dated maturities
  
  ✓ prevent concentrated refinancing activity from straining markets’ absorptive capacity.

• Issuance must be **large and liquid enough to be traded actively** by a number of agents; features should maintain consistency across maturities ("market liquidity")

• **Primary market could be activated through an auction mechanism** once the Authorities establish a Primary Dealer system

• To allow for maximum liquidity and participation, **bonds and Sukuk can be either listed on exchanges as well as traded in OTC markets.**
Role of DIFC in Debt Market Development

- The DIFC has put in place a **financial platform incorporating international best practice and characteristics**:
  - Legal and regulatory infrastructure embodying international best practice
  - Multi-currency Trading platform and Settlement System
  - Transparency and disclosure are predominant criteria for issuers, with timely flow of information
  - Sound insolvency and creditor rights regime
  - Experienced debt market participants (e.g. GBSA)
- NASDAQ Dubai is a fully integrated electronic regional securities exchange that operates to international standards and is strategically located in the DIFC.

The Asset Classes traded on NASDAQ Dubai
Development of Debt Markets is a Policy Imperative

- Debt markets required for financing for Infrastructure & development projects
- Monetary Policy: tool for central banks to conduct monetary policy and control liquidity
- Fiscal Policy: essential tool for deficit financing & to smooth volatility of revenues
- Corporate finance: diversify from reliance on bank financing
- Real estate & housing finance
- Pension funds & assets for expatriate population
- GCC bond market attractive to international investors:
  - backed by the region’s energy commodities reserves, accumulated private and public wealth & political stability.
  - value of the GCC fixed income securities would be underpinned by strong fundamentals: positive growth prospects, economic diversification, shift of the epicenter of the world economy
  - Safe haven & hedge against episode of extreme risk aversion.
  - Boost after the launch of a common currency in the Gulf: new international financial architecture
Thank You!
Q&A