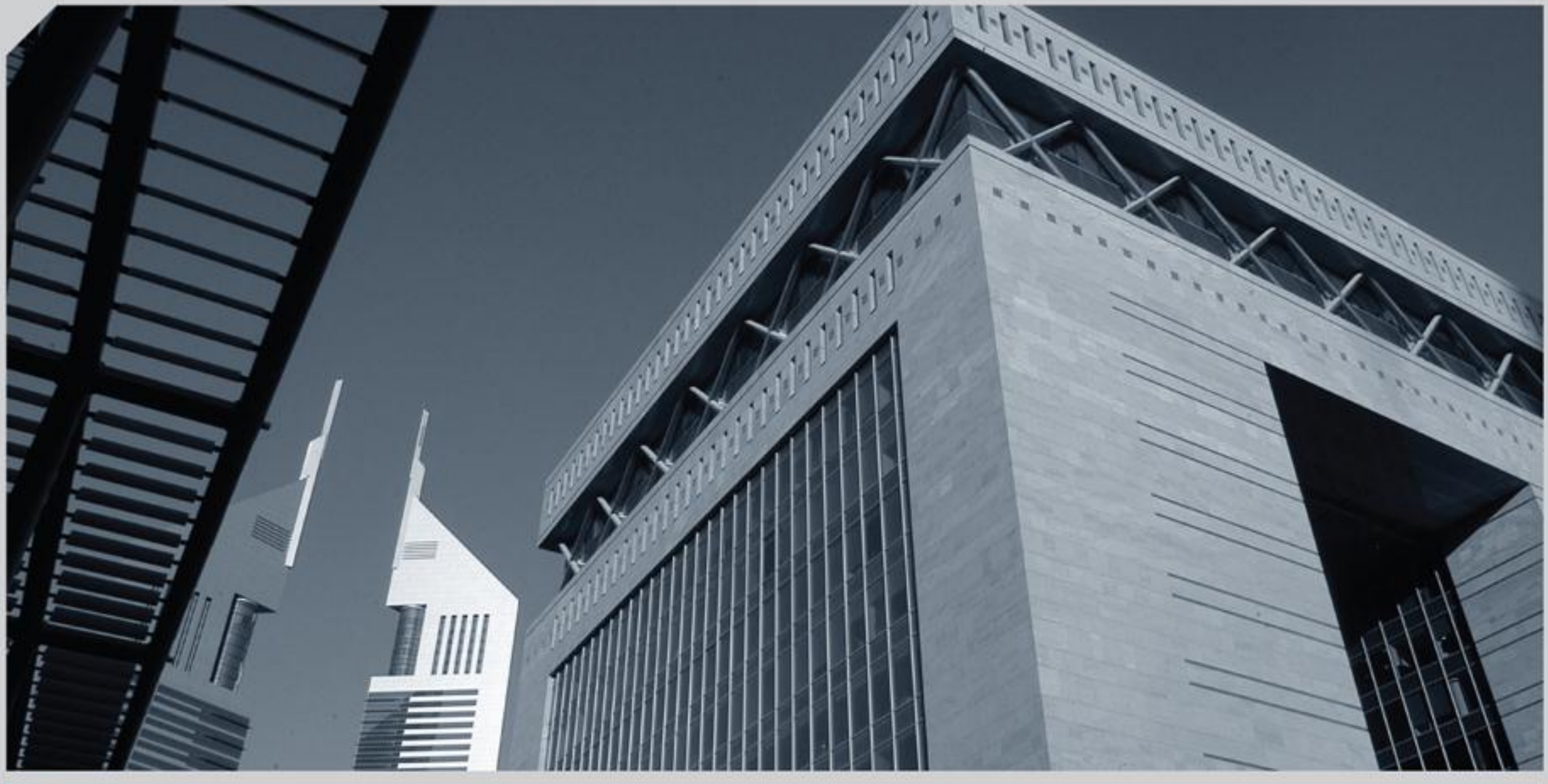

Local Bond Markets as a Cornerstone of Economic Development Strategy

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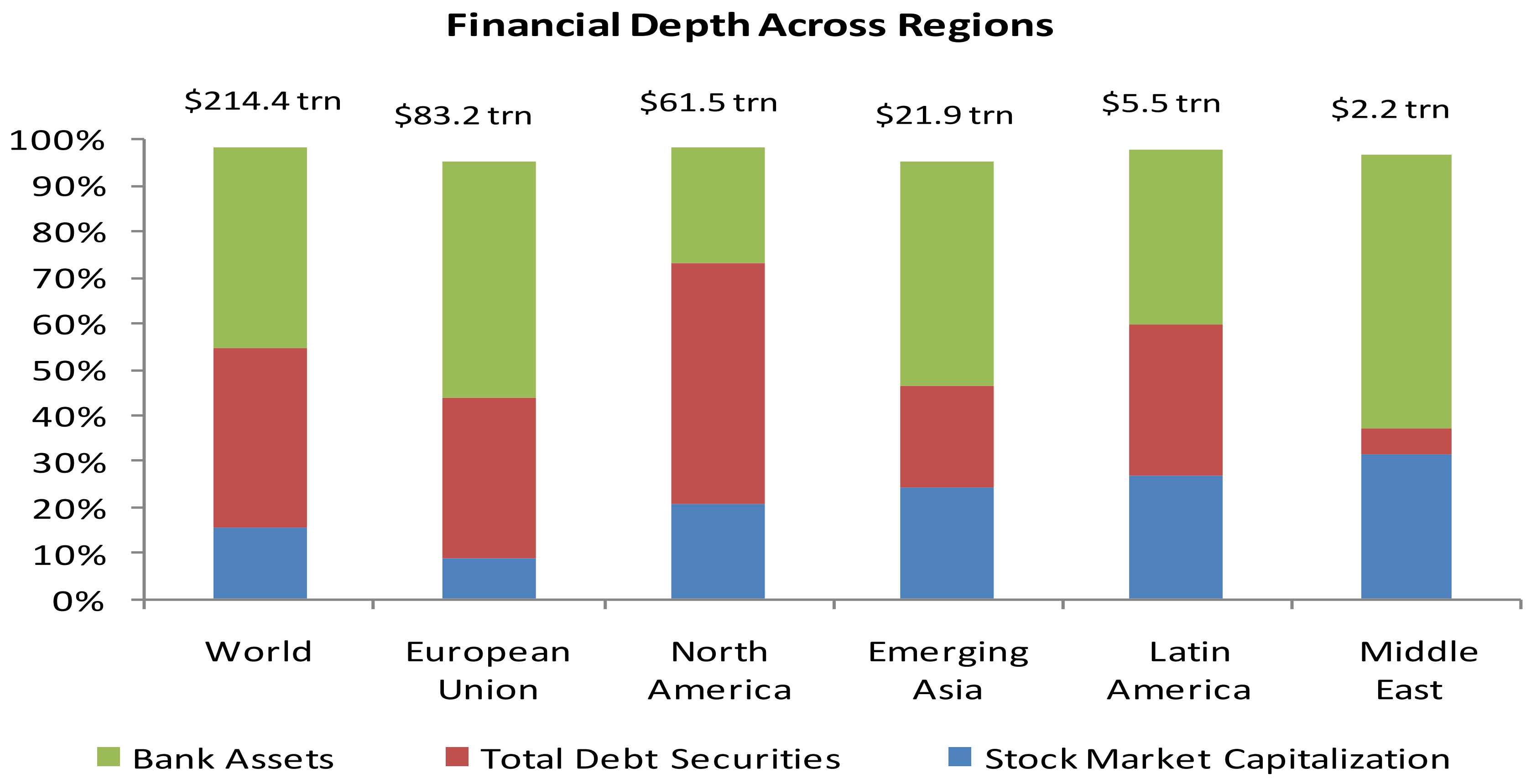
DIFC Dubai International Financial Centre

Agenda

Local Bond Markets as a Cornerstone of Economic Development Strategy
DIFC Economic Note # 7 by Nasser Saidi, Fabio Scacciavillani & Aathira Prasad

Financial Depth Across Regions

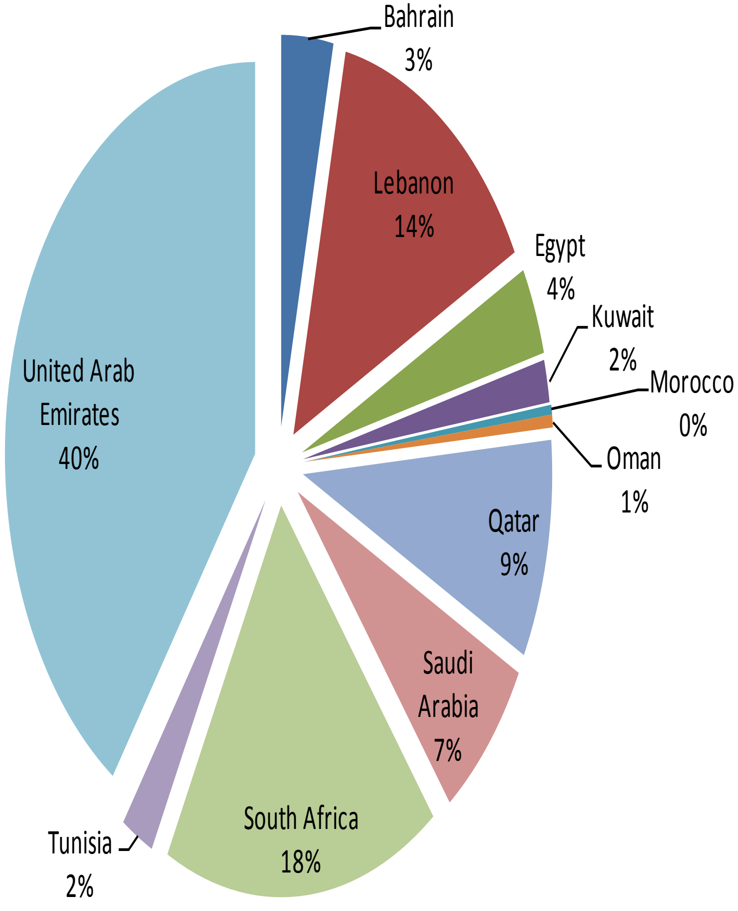
- In the Middle East, capital markets are dominated by bank assets and equities
- Debt securities make up just 5.6% of the Middle Eastern capital markets



International Bonds Outstanding

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

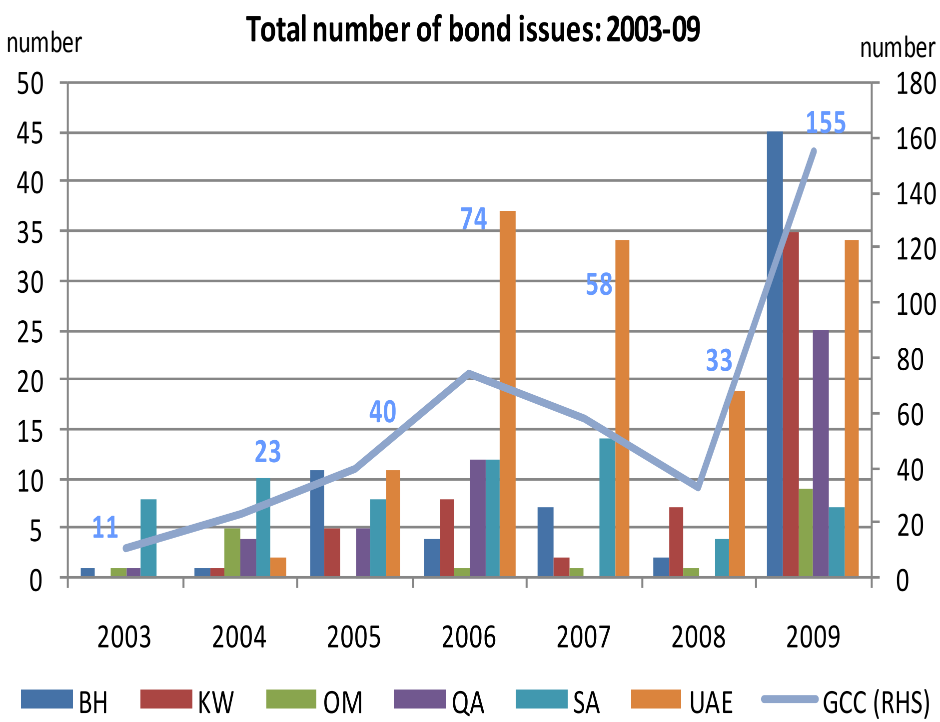
(in USD bn)	Sovereign	Corporate	Financial Institutions	Total
All countries	2113.5	2813.7	20186.2	25881.0
Developed countries	1598.7	2562.8	19503.7	23665.2
Developing countries	477.8	214.0	512.1	1203.9
Africa & Middle East	43.7	35.7	82.3	161.7
Asia & Pacific	57.2	89.8	208.3	355.3
Latin America & Caribbean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

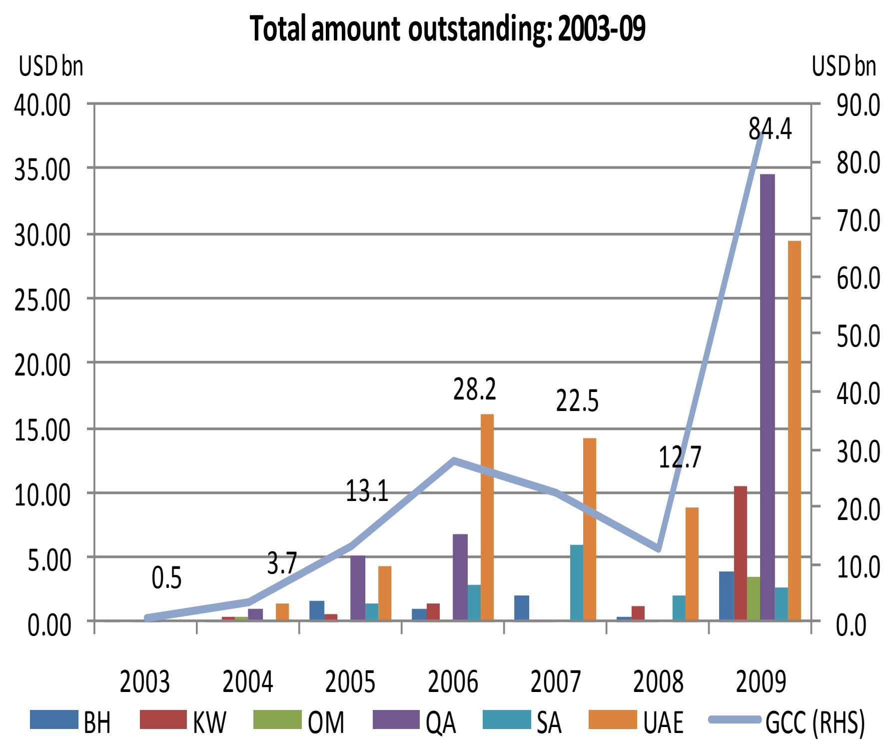


Source: BIS Quarterly Bulletin, Sep 2009

Bond Market Development 2003-09

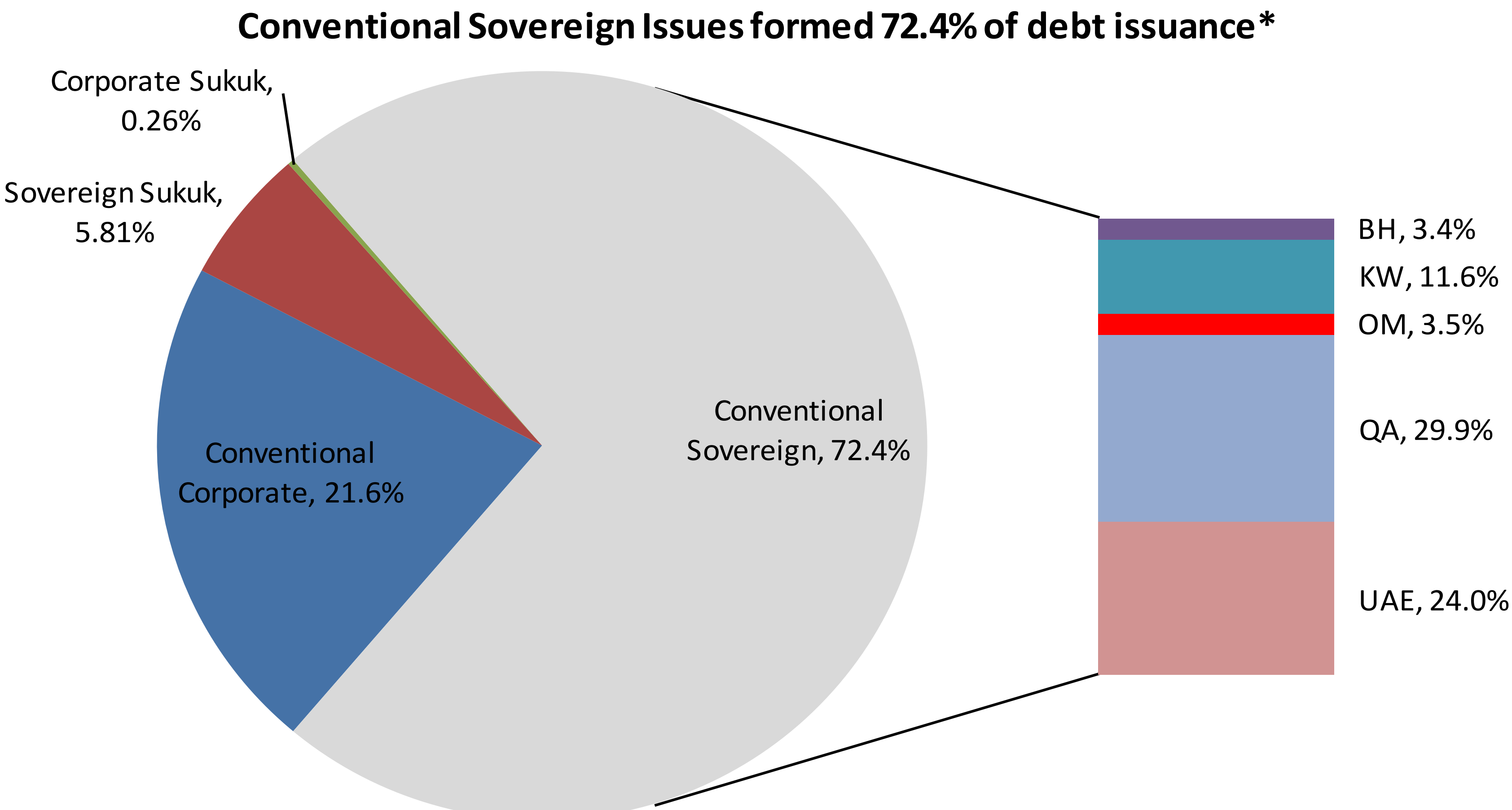
- Bond issues have risen dramatically since 2003, but as in the rest of the world, 2008 recorded a dip in the number and size of issues.
- Total issuance in 2009 shows a significant pick-up in issues post-Ramadan.





Source: Bloomberg, Reuters, DIFC Economics

Sovereign Issues Dominate in 2009



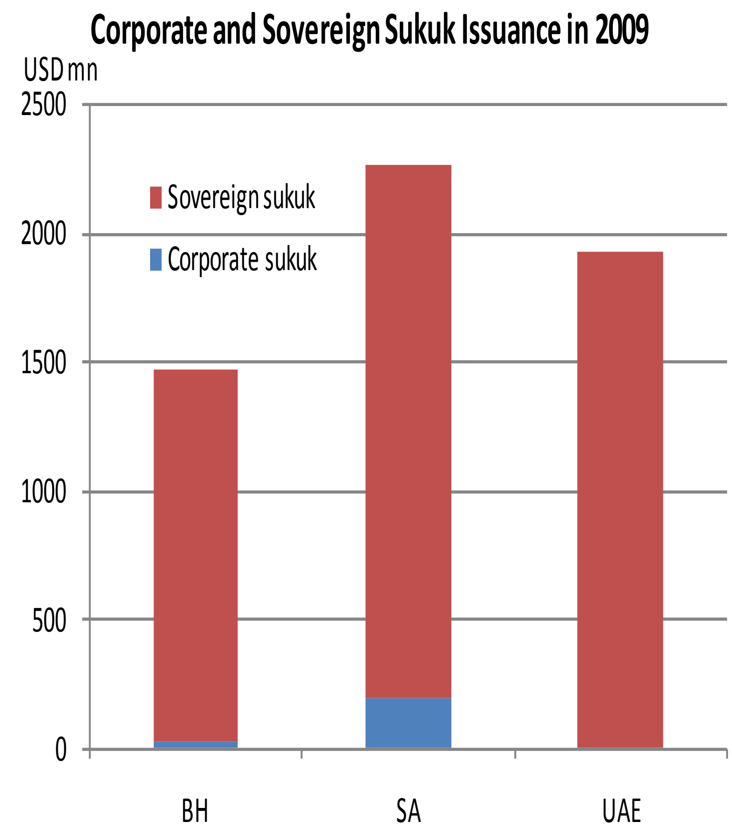
* data as of Nov 22, 2009

Source: Bloomberg, Reuters, DIFC Economics

The Emergence of the Sukuk Market

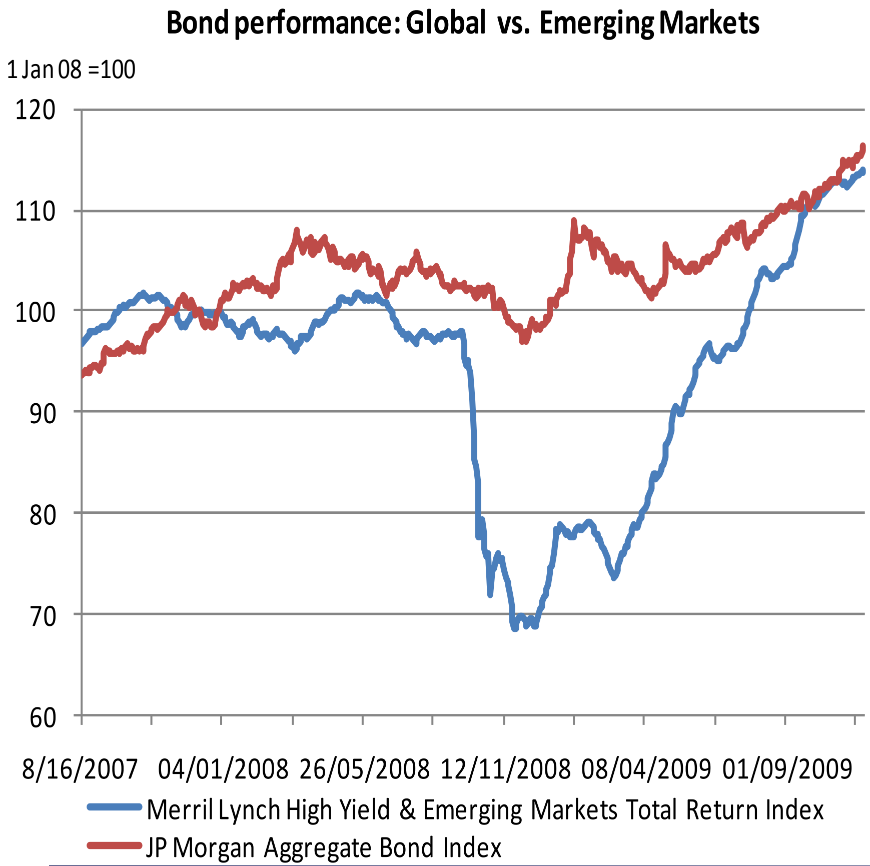
Issuance of Sukuk dampened in 2008 and 2009 compared to 2007

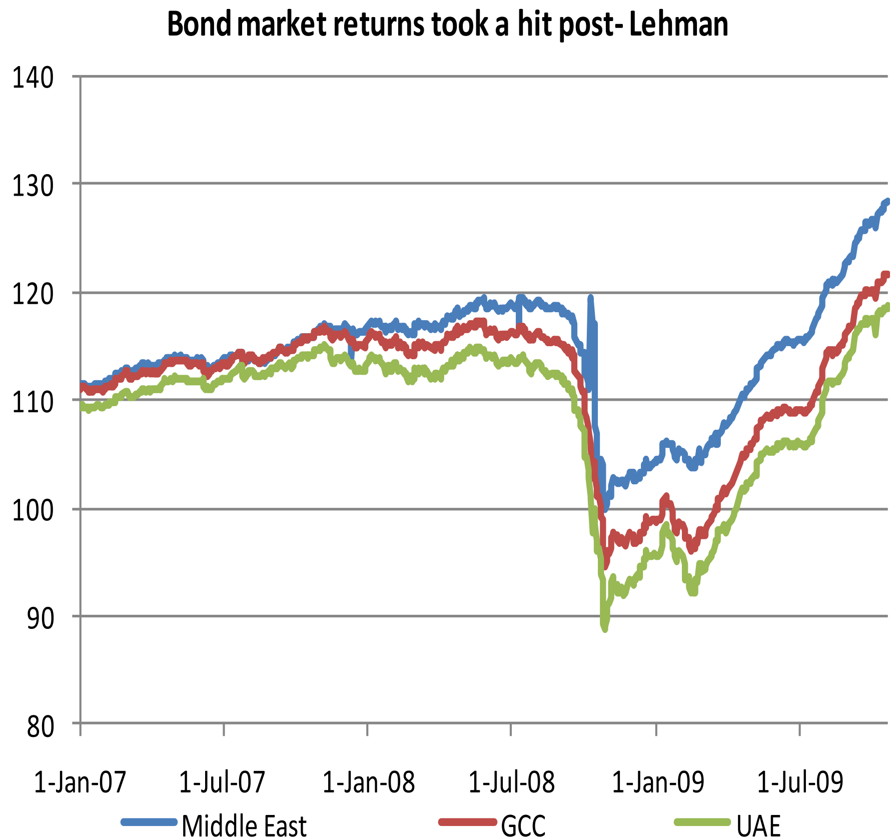
- Sovereigns and government-related issuers were the most common Sukuk issuers – for funding programs amid declining economic activity, fiscal deficits and lower commodity prices.
- Share of US dollar-denominated Sukuk dropped from 85% in 2002 to 10% of issuance in 2008; Speculation of GCC currencies 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





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 <u>minimum percentage of their statutory liquid reserves in government paper</u>
- **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

Main Cash Market | Bond Market | Sukuk Market | Structured Products | Derivatives Market

NASDAQ Dubai's Debt Market

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