

MENA'S Economic Renaissance: Shua'lat for Islamic Finance At Islamic Funds world 2006

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MENA's Economic Renaissance: Shua'lat for Islamic Finance

Agenda

- Global economic developments and prospects
- MENA and the GCC economic and financial renaissance
- Sustaining the boom and achieving sustainable growth
- Mainstreaming the nascent Shari'a compliant finance market
- DIFC/DIFX role in creating a regional market for Shari'a compliant FS



Global Economic Prospects

- World economic growth has been exceptional since 2003; dominated by US growth with strong contribution of Asian emerging market economies
- **US growth underpinned by strong policy responses:**
 - Monetary policy easing
 - Expansionary Fiscal policy
 - Strong defense and security expenditures
- **Outlook increasingly uncertain:**
 - US growth engine faltering: decline in residential investment growth, job creation
 - US twin deficits: current account and budget are unsustainable
 - Adjustment will require both demand switching through US\$ depreciation and reduction in domestic aggregate demand/ increased saving



Global Economic Prospects (Cont'd)

- Monetary tightening to combat higher inflation and international payments imbalances: US rates higher than expected over 2006-2008
 - Monetary policy tightening in EU and Japan along with (a) end of Fed tightening and (b) strong Asian currencies, will imply a weaker US\$
 - Equity markets forecasting slower growth
 - Breakdown of Doha Round talks: increased protectionism, bilateralism and RTAs
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- US growth prospects in 2007: $2\frac{1}{2}$ to $2\frac{3}{4}$ helping correct current account deficit



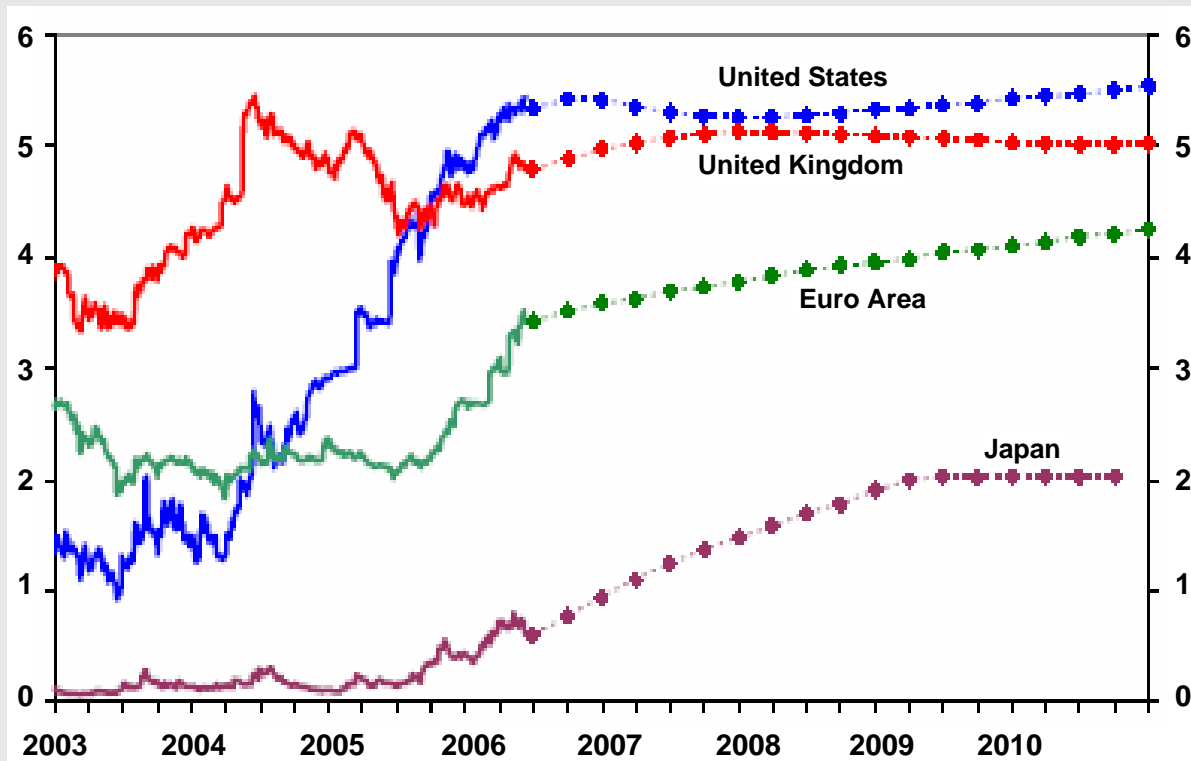
Real GDP growth rates (percent change, year-over-year)

Country/region	2004	2005	2006	2007
Industrial countries	3¼	2¾	2½	2¼
United States	4¼	3½	3	2½
Canada	3	3	2¾	2½
Japan	2¼	2¾	2¾	2
Western Europe		1½	2	2
Britain	3¼	2¼	2¼	2¼
Euro area	1¾	1½	1¾	1¾
Germany	1½	1	1¾	1½
France	2	1½	1¾	1½
Italy	1	0	¾	1
Spain	3	3½	3	2¾
Other euro area	2¾	2¼	2¼	2½
Developing countries	7½	6½	6	5¾
Asia	8¼	7¾	7¼	6½
China	10	10	9	8½
India	7½	7½	7	6½
Other Asia	6	5	4½	4¼
Latin America	5½	4¼	4	3¾
Central and Eastern Europe	6½	5	5	4½
Commonwealth of Independent States	8½	6¾	6½	6
Russia	7¼	6½	6	5½
Middle East	5½	5½	5	4½
Africa	5½	5	4½	4¼
World (WEO weights)	5¼	4½	4¼	4

Source: M Mussa, Institute for International Economics.

Term Structure of Interest Rate Expectations

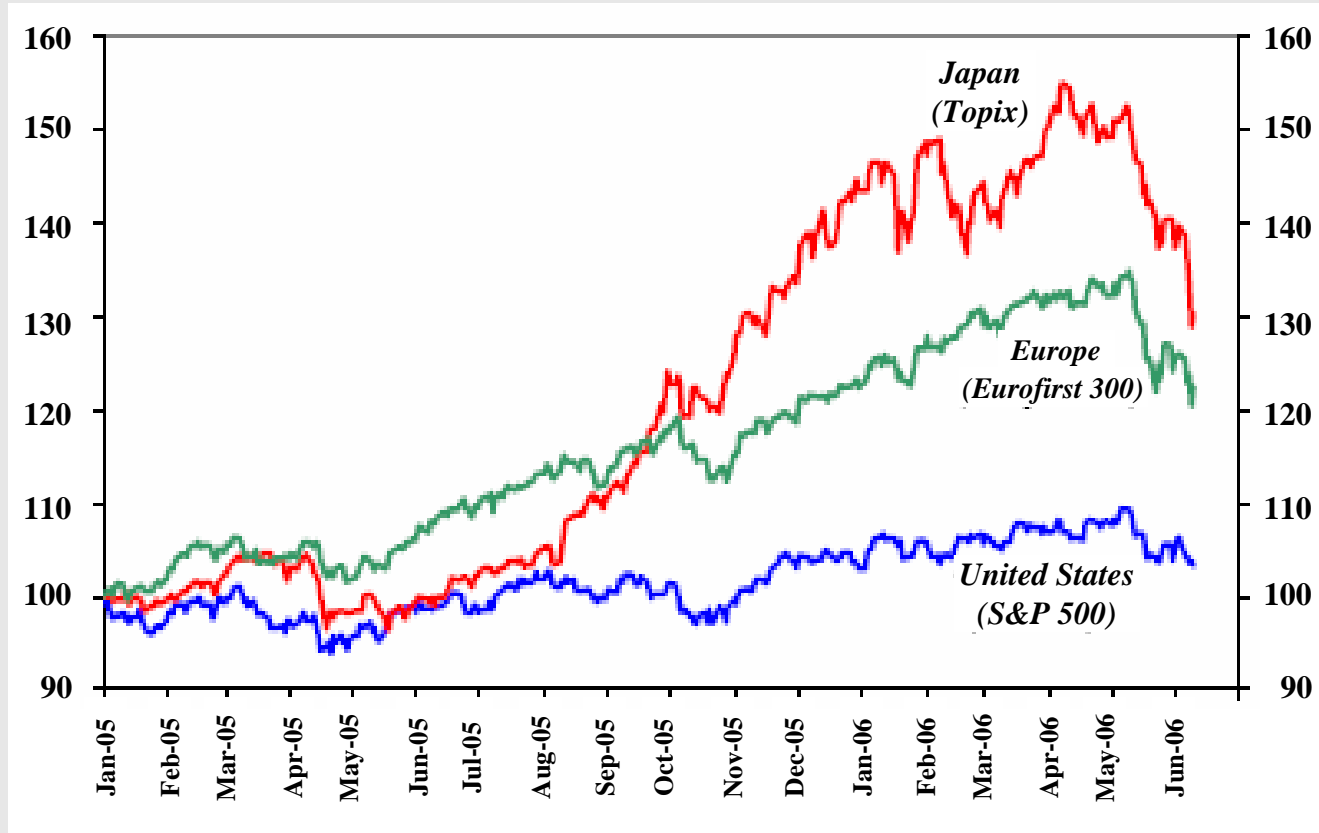
(In percent, 3-Month LIBOR Futures Strip)



Source: Bloomberg LP

Global Trends & Prospects

Global Equity Market Performance (Rebased, December 31, 2004 = 100)



Source: Bloomberg LP

Major Global Risks remaining!

- World Oil Supply and price volatility
- Geopolitical Conflicts
- Global Terrorism
- Opportunities and Challenges for Growth in China
- Protectionism and Trade Liberalization
- The Dollar and the Twin Deficits
- Environmental Accords
- World Health Conditions: Asian bird flu



A MENA Economic & Financial Renaissance?

- MENA has achieved above average growth rates sustained by
 - Favorable global developments (high growth, low inflation and interest rates)
 - Accommodating monetary policies leading to high money and credit growth rates, and financing real estate and financial market booms with spectacular gains and excess returns in equity and debt market instruments
- Growth boom has been investment led with increased infrastructure investment leading to ↑ in absorptive capacity and ↑ in productivity growth
- Accumulation of international reserves with high current account balances, leading to a doubling of international reserves between 2002 and 2005
- Inflation higher, but limited pass-through of higher oil prices to consumers



A MENA Growth Resurgence and Economic Renaissance?

- Average real GDP growth 6.2% over 2003-2005 vs. 4% in 1998-2002
- ↑ Labour flows to oil exporters → ↑ remittances to labour exporting countries (Egypt, Jordan, Lebanon, Morocco)
- Current account surpluses of \$250/\$300 billion or about 25% GDP
- C/A surpluses recycled back into regional economies
- Oil producers policy reaction has been fiscally conservative: $\frac{2}{3}$ of higher oil revenues have been saved
- Fiscal position of GCC remains in surplus for an oil price in the range of \$35-\$38
- Real exchange rate appreciation in oil producers
- Positive demographics sustaining labour & output growth
- Surge in Shari'a compliant banking & finance



Middle East: A Favourable Economic Environment

Real Oil and Non-Oil GDP Growth for Oil Exporters (Annual change; in percent)

	1998–2002 Average	2003	2004	2005	2006
Non-Oil					
Oil exporters	4.5	6.4	6.3	7.0	6.5
Algeria 1/	3.6	5.9	6.2	5.1	5.7
Azerbaijan	4.2	15.2	13.5	8.4	9.6
Bahrain	4.4	8.3	8.6	9.0	8.0
Iran	4.7	6.6	5.9	6.3	5.3
Kazakhstan	7.7	8.9	8.4	11.0	8.9
Kuwait	6.1	10.0	5.3	6.8	6.9
Libya 2/	3.4	2.2	4.1	4.6	4.0
Oman	4.4	5.8	8.0	6.0	6.3
Qatar	4.9	11.8	4.0	8.3	8.0
Saudi Arabia	3.2	3.7	5.0	8.6	8.0
Syria	4.1	3.6	6.0	5.1	5.5
United Arab Emirates 2/	7.0	10.8	9.9	7.8	8.1
Oil					
Oil exporters	1.6	10.3	4.0	4.3	4.6
Algeria	3.4	8.8	3.3	5.6	3.5
Azerbaijan	20.0	0.7	2.5	65.3	54.2
Bahrain	7.3	1.1	-11.5	-7.5	0.3
Iran	0.6	7.7	3.4	2.5	4.9
Kazakhstan	16.8	11.4	15.3	2.2	3.4
Kuwait	-2.7	19.8	7.7	11.3	5.2
Libya 2/	-1.5	25.4	5.5	1.6	6.9
Oman	2.1	-5.9	-3.2	-1.5	5.9
Qatar	9.8	6.3	13.5	3.4	6.5
Saudi Arabia	-1.8	17.2	6.7	2.2	2.6
Syria	-3.4	-6.6	-11.3	-4.3	-5.8
United Arab Emirates 2/	-1.3	13.6	2.9	8.4	2.5

Source: IMF MECA Outlook, May 2006

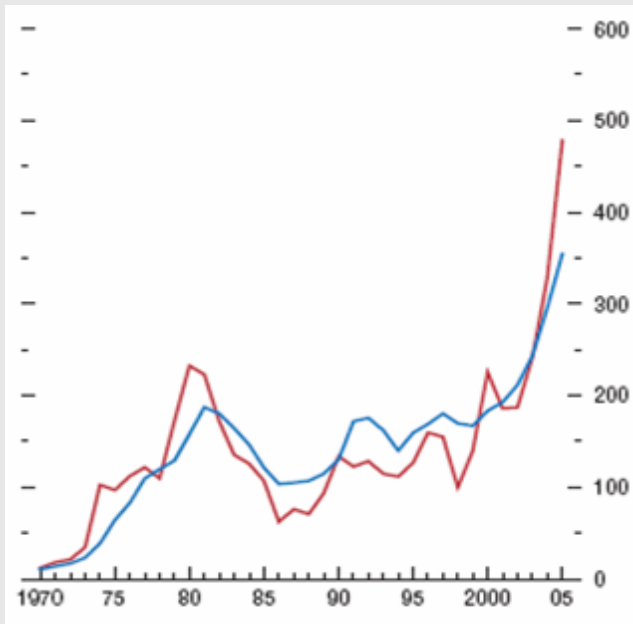
Increase in Wealth and Permanent Income

- Value of oil wealth of oil exporters increased by an estimated **\$40 trillion** between 1995 and 2005
- Permanent Income increase of some \$850 billion at a Real Rate of 3%
- Sharply rising oil prices have resulted in enormous increases in export earnings and current account surpluses for oil producing countries
- Current account surpluses running at **20-25% of GDP** much of which is being recycled back into regional economies
- Real exchange rate appreciation
- Rise in prices of non traded goods & services
- Increased liquidity resulted in an investment driven boom, as witnessed by:
 - Real estate boom and asset price appreciation
 - Stock market boom
 - Credit market boom

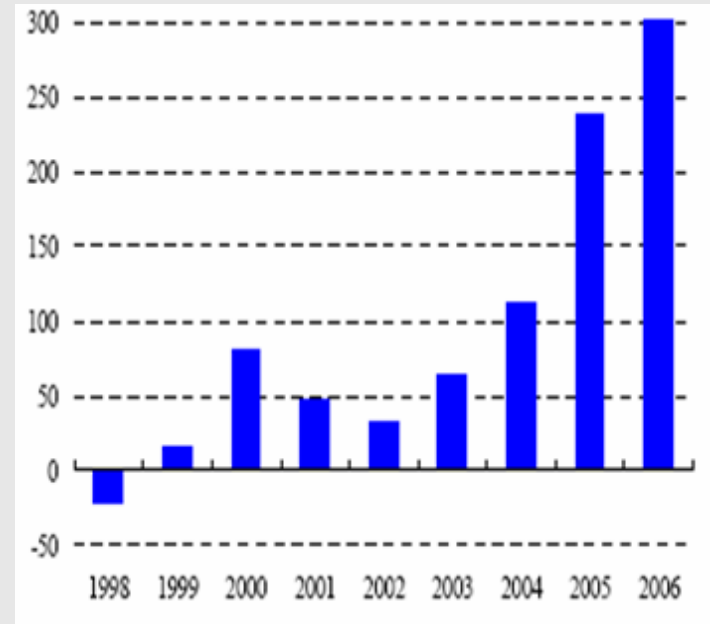


Higher Oil-Related Inflows Led to Stronger External Positions for Oil Exporters with Current Account Surpluses running at 20-25% of GDP

OPEC Imports and Oil Exports (Billions of USD)



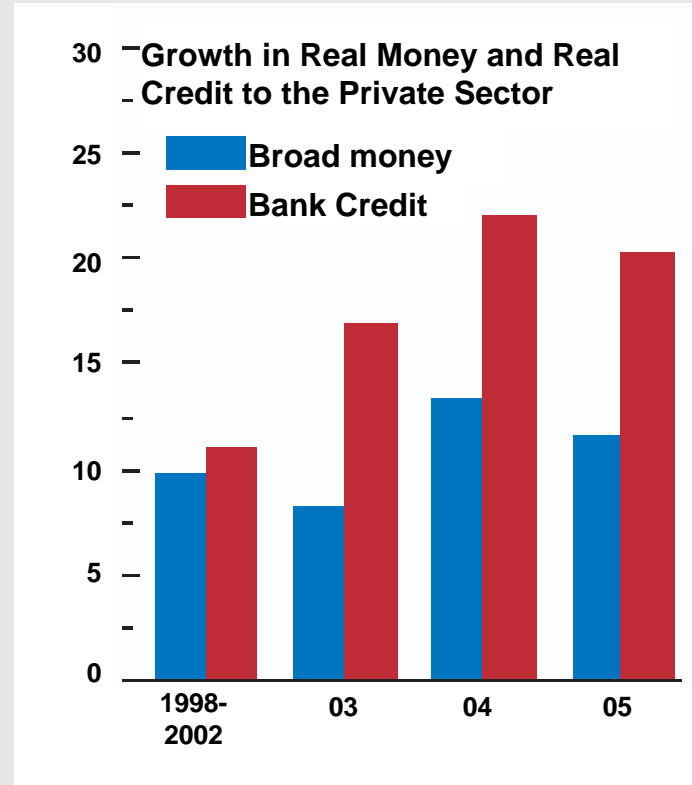
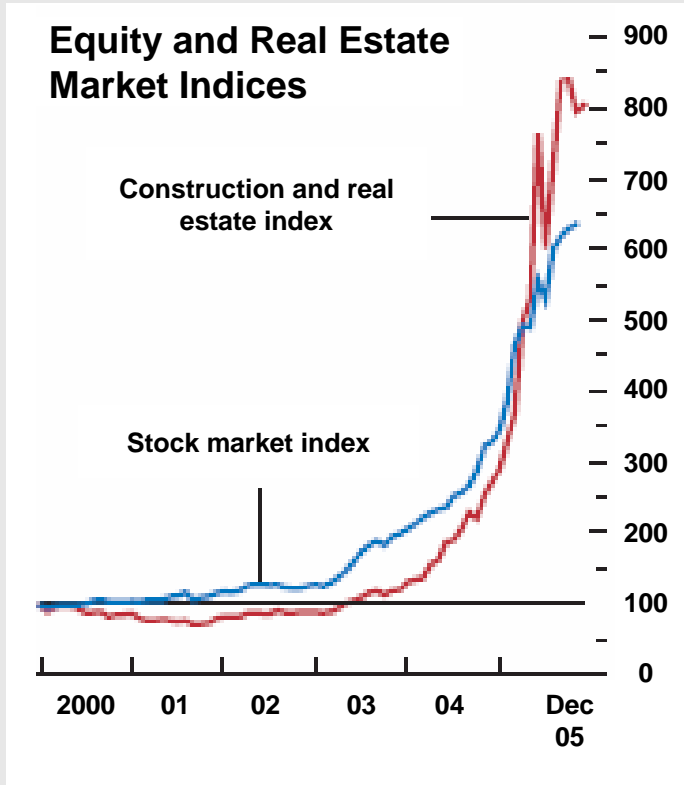
Current Account Balance for Oil Exporters (Billions of USD)



Source: IMF World Economic Outlook Report, April 2006/ IMF Staff Estimates & Projections

Middle East Surging Asset Markets

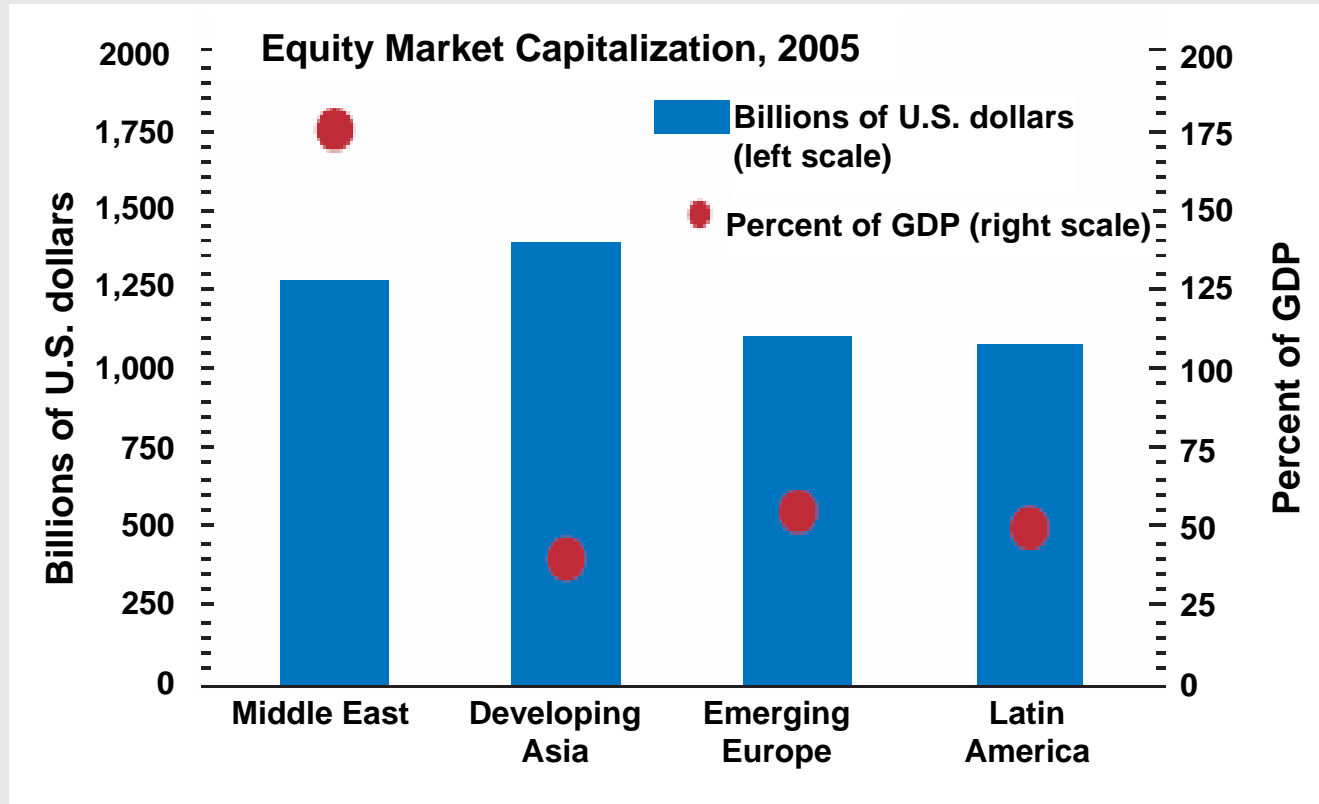
Oil-related revenues have fueled growth in bank credit and asset prices.



Source: IMF World Economic Outlook April 2006

Middle East Surging Asset Markets

Regional equity markets have grown similar in size to other emerging market regions.



Source: IMF World Economic Outlook April 2006

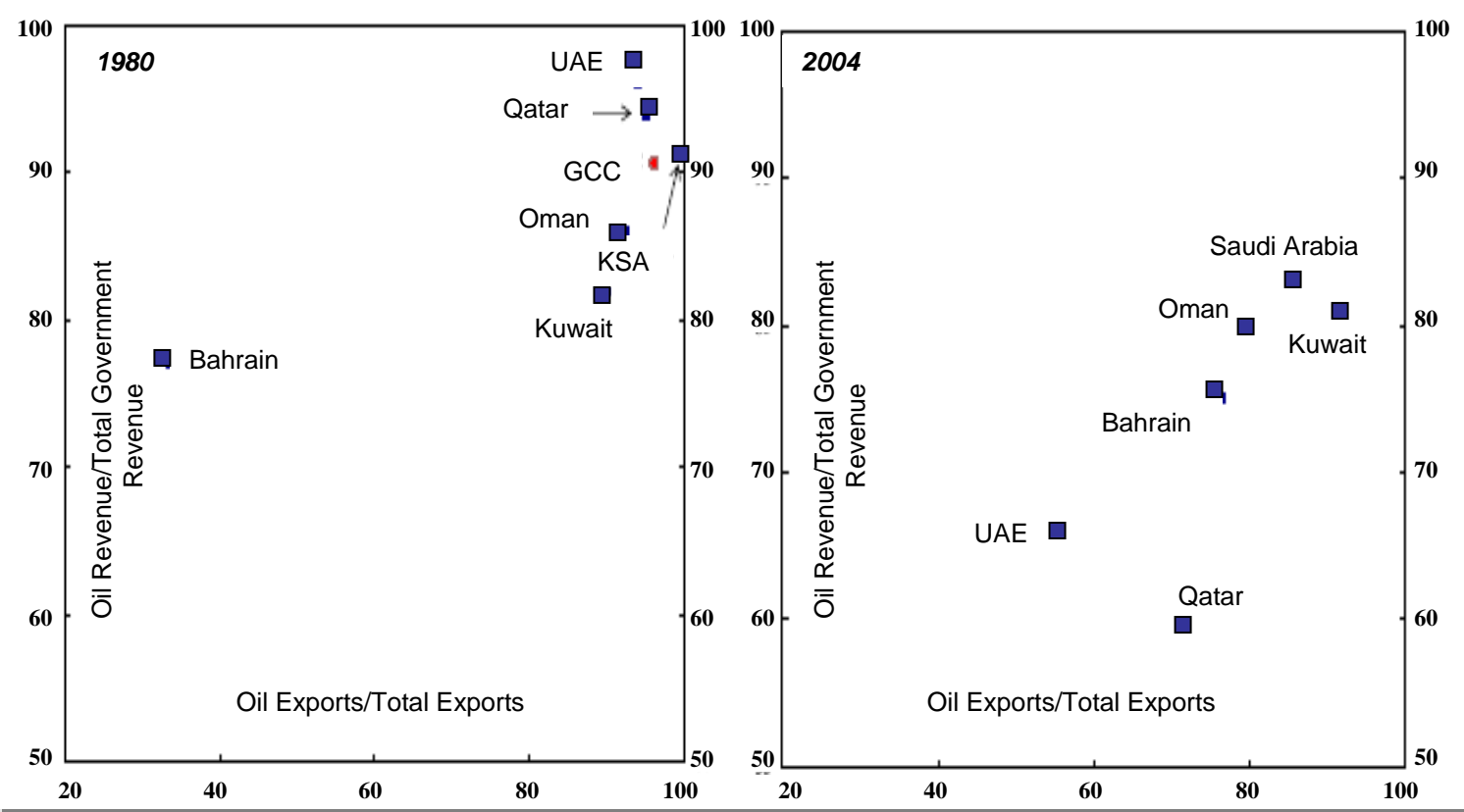
MENA: A More Favourable Economic Environment

- Oil price shock likely to be permanent than earlier episodes of 1973- 1974 and 1979-1981.
- In comparison to previous oil booms, region characterized by:
 - Increased focus by regional governments of spending on long-term economic development
 - Sizeable infrastructure developments around the region with an estimated value of projects planned or under development in GCC & Iran in excess of USD 1 trillion.
 - Greater intra regional trade & investments. Surplus funds recycled to rest of region through FDI. (DP, EMAAR, Etisalat)
 - Significant increase in external portfolio flows. (BIS)
 - Regional governments pursuing economic diversification with diminishing contribution of oil to GDP. Region's economies are diversifying at a rapid pace and this should help offset any weakness in the hydrocarbon sector.
 - Wealth repatriation as a result of high returns on investments in region and higher barriers abroad post 9/11



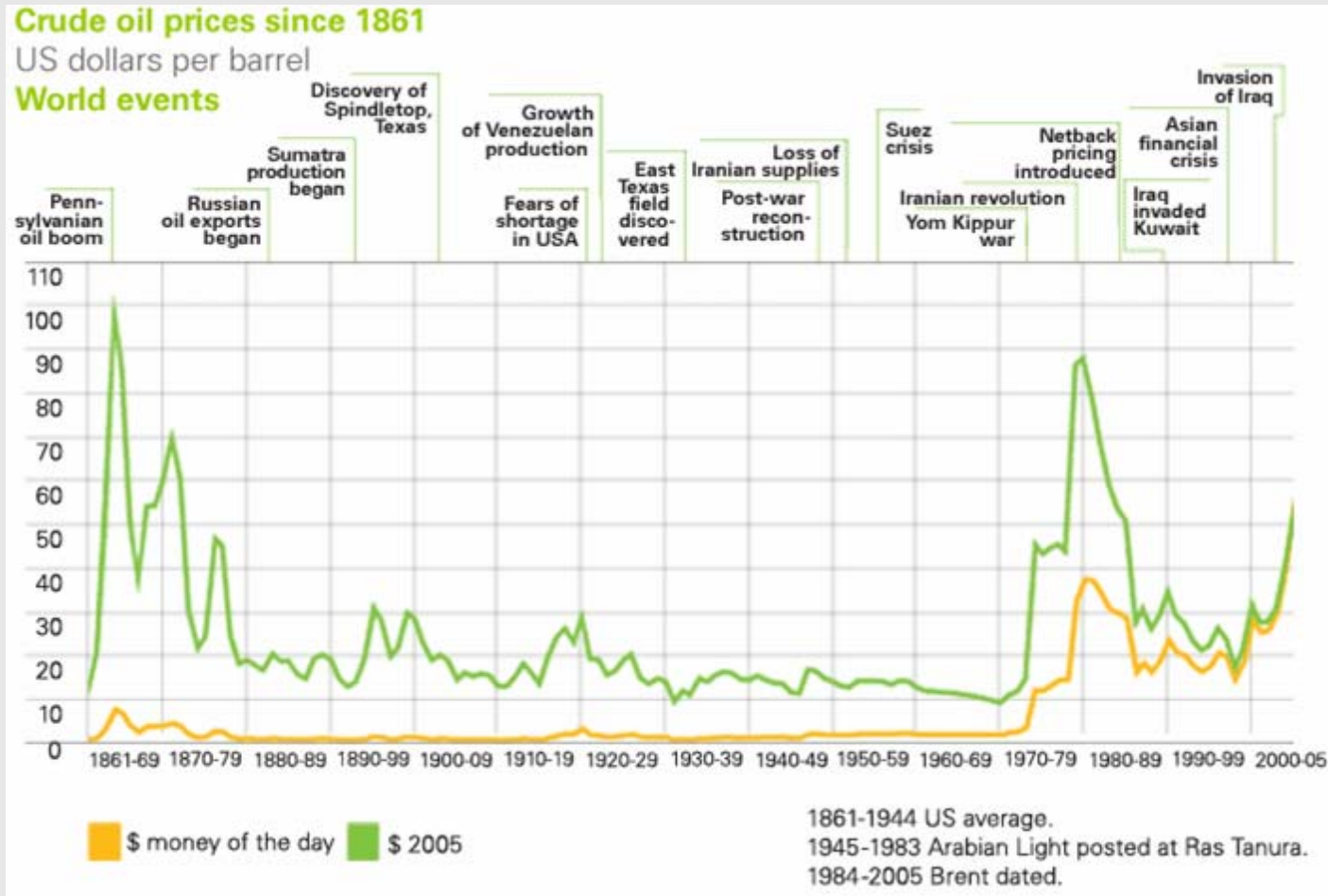
Region Less Reliant on Hydrocarbon Sector

GCC Countries: Oil Dependency 1980- 2004



Source: National Authorities

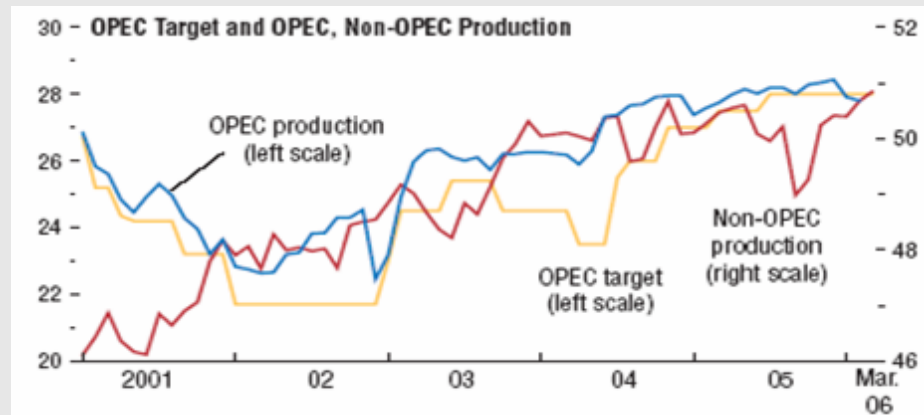
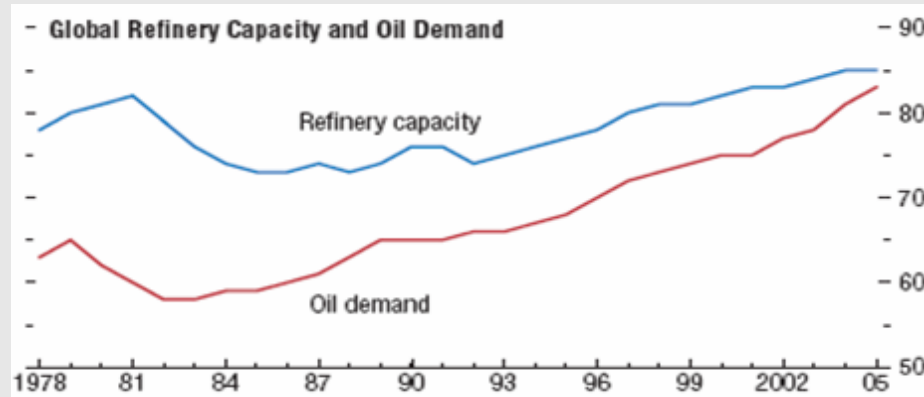
Crude Oil Prices



Source: BP Review

World Oil Supply and Demand

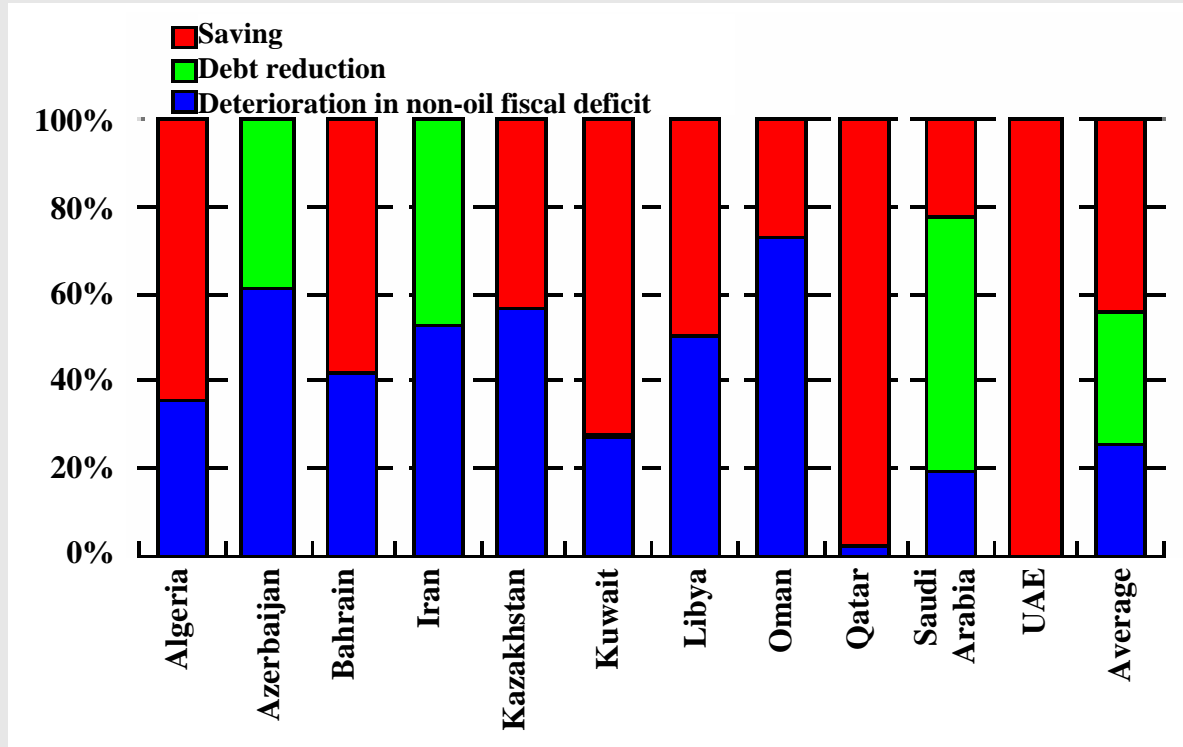
World Refinery Capacity, Spare Capacity and Production (Millions of barrels a day)



Source: IMF World Economic Outlook April 2006

Current Account Surpluses of Oil Exporters Recycled Back Into Regional Economies: Use of Additional Oil Revenue, 2003-2005

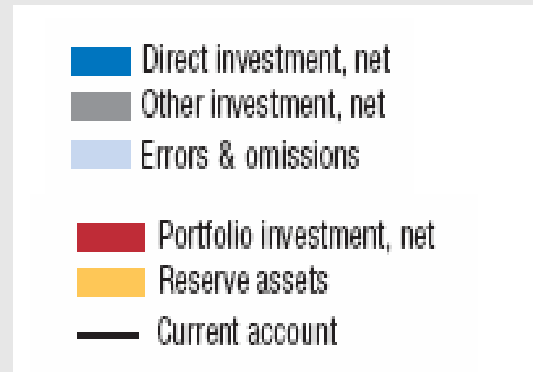
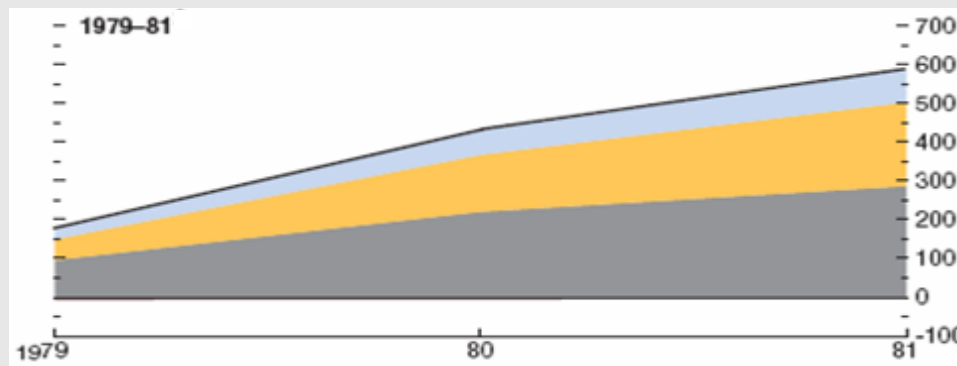
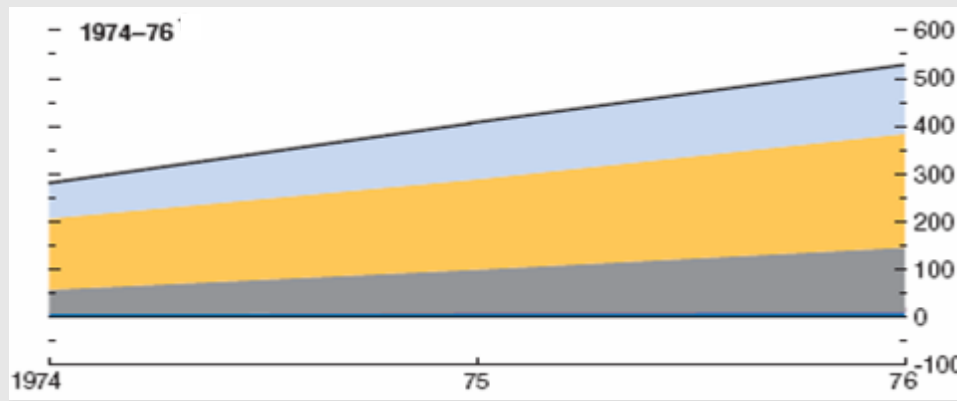
(In percent, base year = 2002)



Source: IMF Staff Estimates and Projections.

How Does Current Oil Price Shock Compare with Previous Episodes?

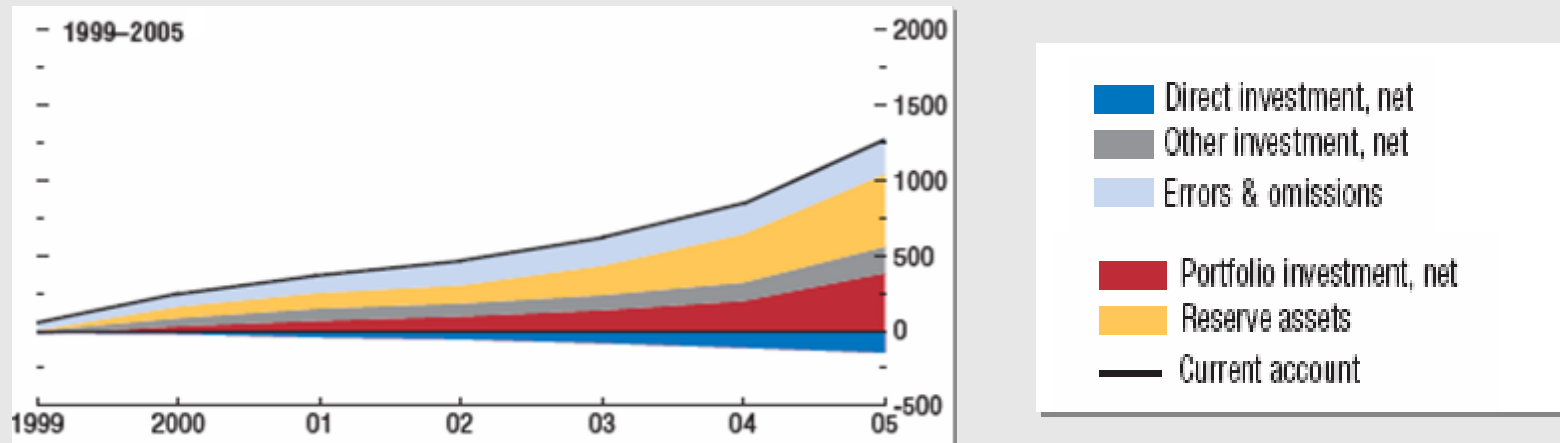
Fuel Exporters' Cumulative Current Account Balances and Capital Flows (Billions of 2005 U.S. dollars, cumulative)



Source: IMF World Economic Outlook April 2006

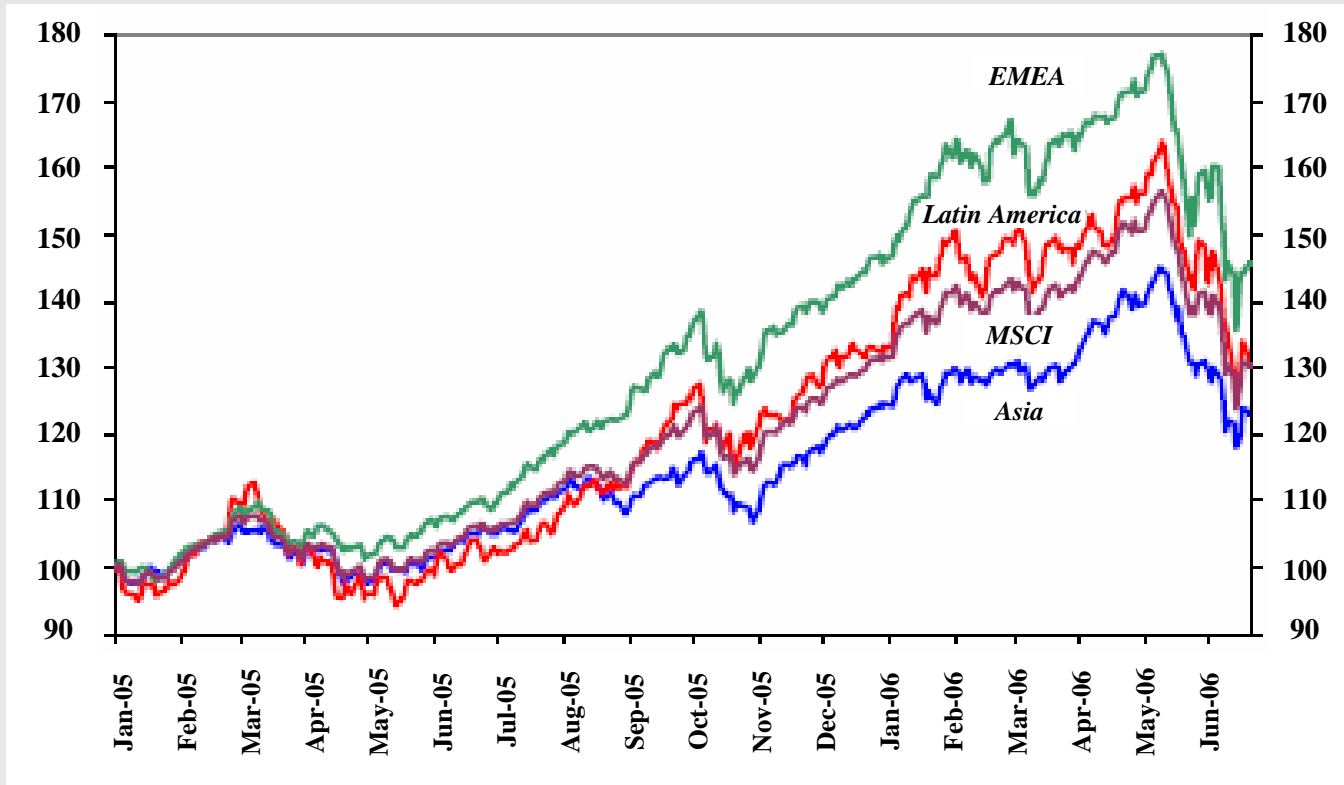
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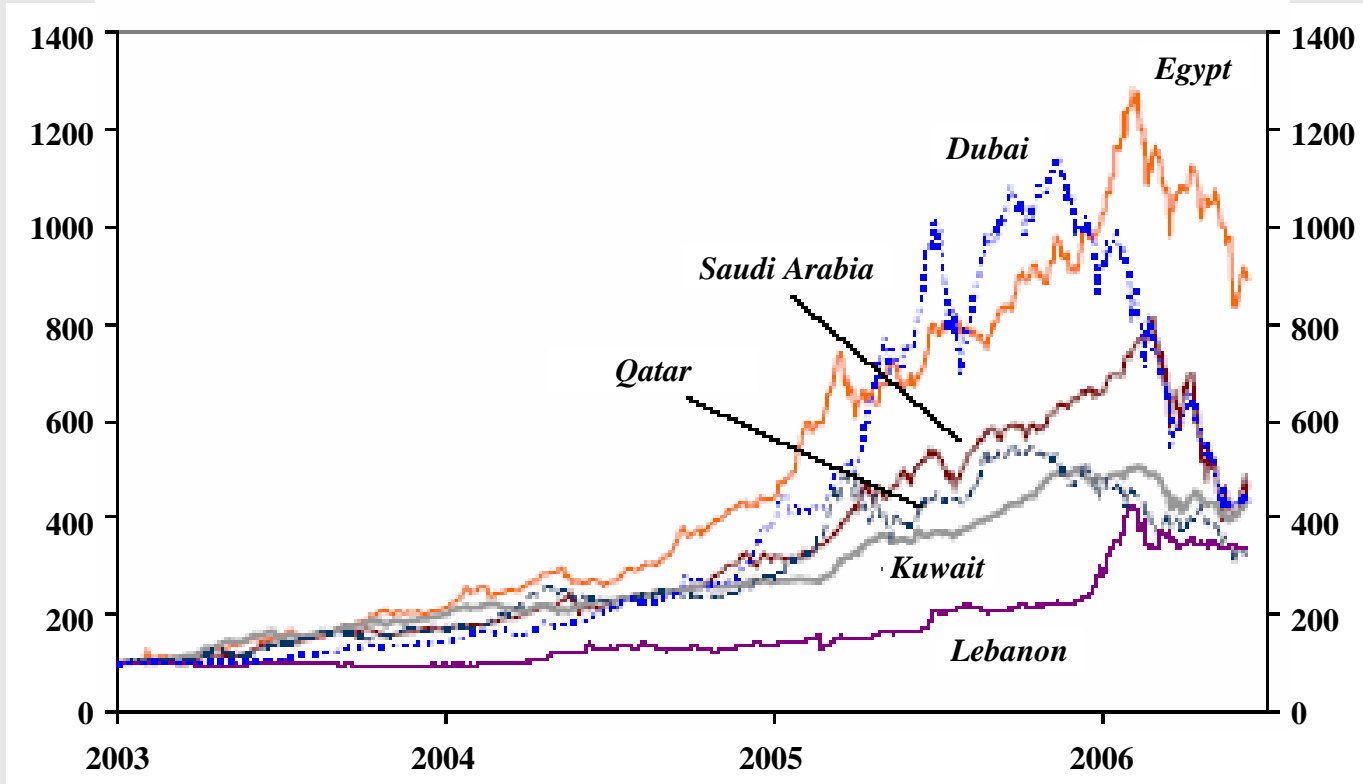
Source: IMF World Economic Outlook April 2006

Emerging Markets: MSCI Equity Performance (December 31, 2004 = 100, local currency performance)



Source: Bloomberg LP

GCC Equity Markets in Perspective (1/1/2003 = 100)



Source: Bloomberg LP

MENA Sustaining the Boom?

- Central challenge is to use oil wealth and demographic dividend to create economic & financial incentives for sustained growth
- Economic reforms, diversification and state divestment & privatisation.
- Growing private sector participation in infrastructure across MENA countries.
- Infrastructural Developments: estimated value of projects planned or under development in the Gulf exceeds USD 1 trillion.
- Greater regional economic integration: GCC Monetary Union in 2010, lower trade barriers Greater Arab FTA
- With economic diversification and liberalisation attractive prospects exist across many sectors.



Middle East: A Favourable Economic Environment

Projects Planned and/or Currently Underway in the Region *(Millions of USD)*

	UAE	Bahrain	Kuwait	Qatar	KSA	Oman	Iran	Iraq	Total Value
Oil & Gas	32,633	1,110	26,228	59,725	44,605	9,860	54,845	10,155	239,161
Construction	264,501	21,740	170,375	36,326	83,349	10,135	4,275	14,180	604,881
Industry	15,980	2,705	2,130	5,030	10,585	3,450	5,335	1,218	46,433
Power	16,970	1,305	5,632	6,303	23,115	2,610	11,613	2,680	70,228
Petrochemicals	6,350	1,000	4,270	9,720	55,002	7,250	20,240	175	104,007
Water & Waste	2,035	1,070	2,380	1,173	5,500	2,140	560	50	14,908
Total Value	338,469	28,930	211,015	118,277	222,156	35,445	96,868	28,458	1,079,618

Source: Data as of May 2006, MEED Projects

MENA Policy Challenges

- Undertake and maintain economic and financial policy reforms
- Adjustment to higher oil prices: increase pass-through, reduce subsidization and create social safety nets
- Invest in infrastructure and human Capital
- Invest in and Accelerate pace of Regional Economic Integration to create markets: infrastructure, policy harmonization, institutional structures
- Management and Governance of oil wealth: develop MENA financial markets and undertake FDI
- Divorce oil wealth and its management from fiscal policy
- Monitor and manage balance sheet risk of banking and financial system resulting from exposure to real estate and asset markets
- Focus on Financial Market development for economic growth and development



MENA Growth Prospects remain strong

MENA Real GDP Growth

(Annual change; in percent)

	1998-2002 (Average)	2003	2004	2005	2006f	2007f
MENA	3.60	6.20	5.50	5.70	6.10	5.60
<i>Of which</i>						
GCC	2.50	8.50	5.90	6.80	7.10	6.90
Maghreb	3.50	6.60	5.00	4.00	5.80	4.90

Data are at factor cost (2000 prices).

Sources: Data provided by country authorities; and IMF staff estimates and projections.



MENA Renaissance is Shua'lat for Islamic Finance

- Strong Macroeconomic fundamentals & Demographic factors underlying growth in demand of Shari'a compliant financial services
- However, mainstreaming and creating a market for Shari'a compliant financial services is critical
- DIFC/DIFX role in creating a regional market for Shari'a compliant FS



Growth of Islamic Finance Dependent on Building Markets

- Challenge is access to Shari'a compliant FS: only 20% of Muslim population in GCC buys Shari'a FS
- Greater Standardisation & regulatory & legal alignment
- Adoption of Shari'a compliant CG
- Improvement & harmonisation of Shari'a regulatory compliance process
- Issuance of tradable Shari'a compliant financial instruments
- Creating liquidity for a secondary market for Shari'a compliant financial instruments
- 'Lender of last resort' function
- Creating "breadth, depth & liquidity"
- Set-up Corporate Governance framework for Shari'a compliant institutions and FS



Shari'a compliant finance: product availability

- Funds generally mandate or institution focused: limited development of retail collective investment instruments
- Despite popularity, retail real estate funds have limited accessibility
- Sukuk funds have yet to take off: supply remains limited and institution focused
- Alternative investment instruments including derivatives and hedge funds are untested, nascent and require Shari'a compliance assessment and approval



Prospects for Islamic Finance

Sukuk:	US\$ 15 billion
Islamic Assets:	US\$ 500 billion
Islamic Funds:	US\$ 350 billion
Annual Growth Rate:	20% p.a.

- Shari'a compliant institutions now account for about 25% of banking & financial system in UAE, Bahrain.
- Malaysia leading the way.
- Oversubscription of Sukuk to date indicative of demand and huge potential.
- Opportunity for Islamic structured products to support project financing needs
- Opportunity for structuring leasing transactions relating to oil & gas, aviation, marine & cargo among others
- Prospects within Shari'a- compliant securitization
- Opportunities within real estate investments, REITS and mortgage market

Source: various

Shari'a compliant finance: product availability

- Overall size estimated at some US\$850 billion made up of (in descending order):
 - Morabaha transactions
 - Shari'a compliant funds
 - Retail Finance products
 - Sukuk



Islamic finance requires sound financial markets

Common Harmonized Framework
& Policy

Institution Building

Market Structure Reform

Instrument & Financial Technology

Legal & Regulatory Infrastructure

Resulting in growth based on market creation not transaction related!



DIFC & Shari'a compliant Finance

- DIFC aims to be the global market for Shari'a compliant finance
- DIFC has set clear procedures for authorising Shari'a compliant institutions
- DIFC/DFSA/DIFX have streamlined listing of Shari'a compliant financial instruments
- DIFC has set-up an Islamic Finance Advisory Council (IFAC)
- Aim is to provide the main regional platform for a secondary market in Sukuk and Shari'a compliant funds
- DIFC is home to largest ever Sukuk issue US\$3.4 billion
- Creation of a Government Sukuk market:
 - Financing infrastructure
 - Mainstreaming as public finance instrument
- Creation of Shari'a based mortgage market to support housing finance



DIFC Investment Funds Regime

Collective Investment Law- DIFC Law no. 1 of 2006

- DFSA issued legislation to regulate the managed funds industry within the DIFC.
- Legislation permits both the domicile of funds in DIFC and or distribution of existing foreign funds (both public and private funds).
- Flexible legislation permits a variety of recognised investment vehicles
- Regulation of fund operators rather than fund, leaving room for product innovation.
- Permits the operation of various types of funds including but not limited to: property funds, Islamic funds, hedge funds, private equity funds, fund of funds.
- Permits appropriate delegation and outsourcing
- DFSA funds regime in compliance with IOSCO Principles for Collective Investment Schemes.



The DIFC Investment Trust Law- DIFC Law no. 5 of 2006

- Legislation permitting setting up Collective Investment Funds in the form of an Investment Trust.
- Rules to permit the operation of REITS within the DIFC have also been introduced.
- REITS have become the most favoured method for attracting public ownership in property investments.
- They provide a convenient form for listed and tradable property ownership with transparent pricing and liquidity.
- Under these Rules it will be possible to issue REITS for the first time in this region, utilizing the facilities of the DIFX. It will add a significant new dimension to the UAE's property market.



Shari'a compliant Funds: building capacity

- Asset management industry has to build Shari'a compliance capacity: knowledge, people, funds
- Asset management industry has to establish a geographical presence in MENA region
- Asset management industry has to develop compliance capacity: Shari'a, legal and regulatory aspects
- DIFC intends to become the major hub and capital market for Shari'a compliant financial services and instruments



MENA's Economic Renaissance: Shua'lat for Islamic Finance

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