The Future of Capital Markets in the Middle East

DIFC Knowledge Series 7 – MENASA Capital Markets

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Agenda

Changing Economic & Financial Geography

The Financial Crisis & Lessons Learnt

Financial Structure of the Middle East

Debt Markets as a Cornerstone for Development Strategy

Future of Capital Markets

Role of the DIFC

Changes in Economic Geography…

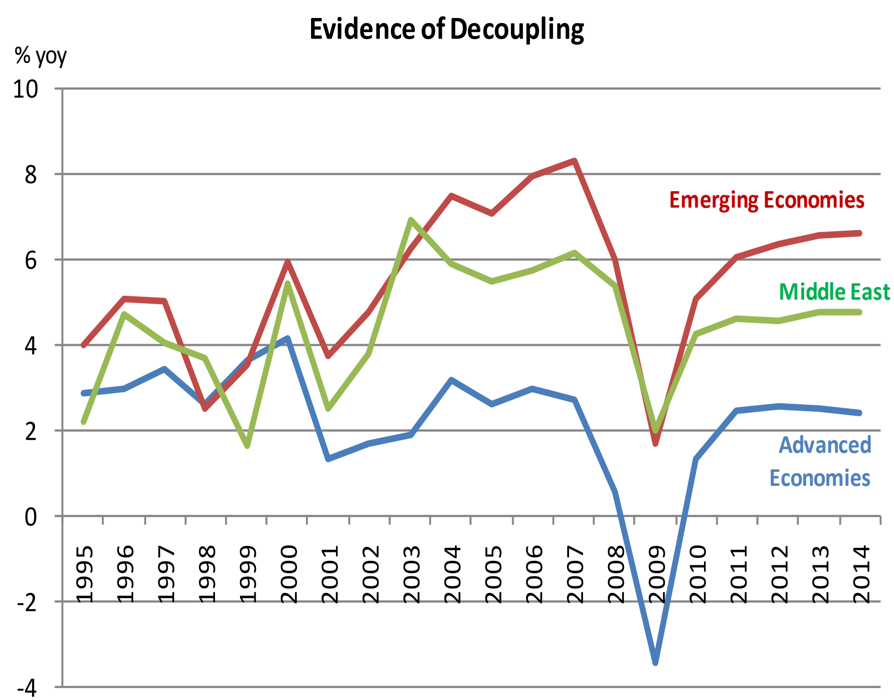
World economy is expected to grow at 3.1% yoy in 2010 (2009e: -1.1%); GCC growth is forecast at 5.2% in 2010 (2009e: 0.7%)

- As 2008 ended, global growth was falling off a cliff (post-Lehman tsunami)
- At the close of 2009, global activity was rebounding, albeit at a relatively modest pace compared to the alarming decline in 2008Q4- 2009Q1

Global Output Growth

percent, q/q saar

	08Q3	08Q4	09Q1	09Q2	09Q3
Mature Economies	-2.5	-6.9	-8.5	-0.1	1.9
United States	-2.7	-5.4	-6.4	-0.7	2.2
Euro Area	-1.6	-7.4	-9.5	-0.5	1.7
Japan	-4.0	-10.2	-11.9	2.7	1.3
Emerging Economies	1.5	-5.5	-5.4	7.5	7.5
Latin America	2.2	-7.4	-10.7	-0.5	6.0
Emerging Europe	-0.8	-6.9	-19.3	2.9	5.8
Asia/Pacific	2.2	-4.0	3.1	13.0	9.0
World	-1.6	-6.6	-7.8	1.6	3.1

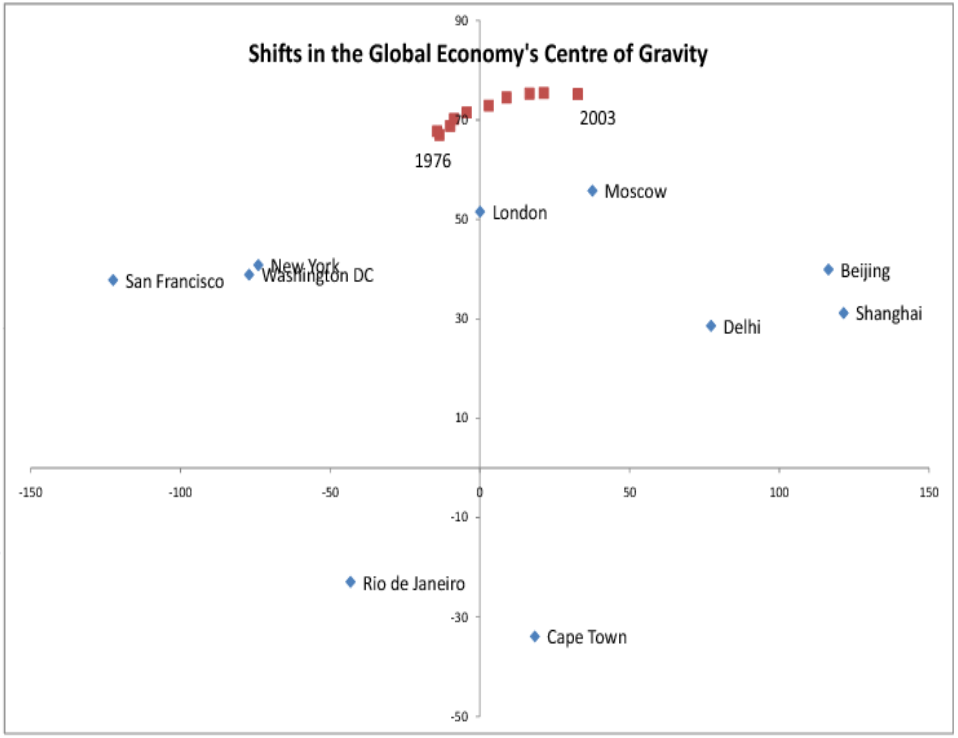


Source: Institute of International Finance Global Economic Monitor Jan 2010, IMF Database, Oct 2009

Emerging Markets: Changing Economic Geography

Emerging markets have contributed 2/3 of global growth since 2002.

- The world's economic centre of gravity in 1976 was a point West of London, somewhere towards the middle of the Atlantic Ocean.
- But in the 30 years since then, that centre of gravity has drilled 1800 km - one third of the planet's radius - deeper into the Earth's crust, away from the US & towards the East.
- Interestingly, evidence shows **geographical shift accelerated in 1991 & 2001 - each time the US was in recession!**
- In less-turbulent times, between 2002 and 2007:
  - ✓ China's average contribution to world economic growth approached 66% that of the US;
  - ✓ China and India's together, almost 85%;
  - ✓ East and Southeast Asia's, more than 130%.



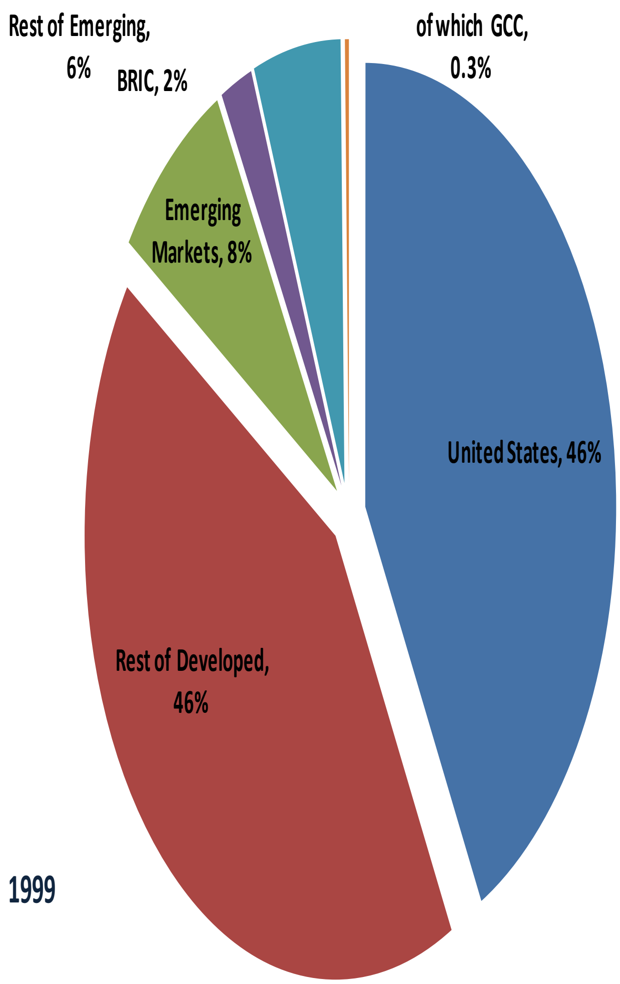
Source: Quah, D (2009): "The Shifting Distribution of Economic Activity", London School of Economics, Oct 2009.

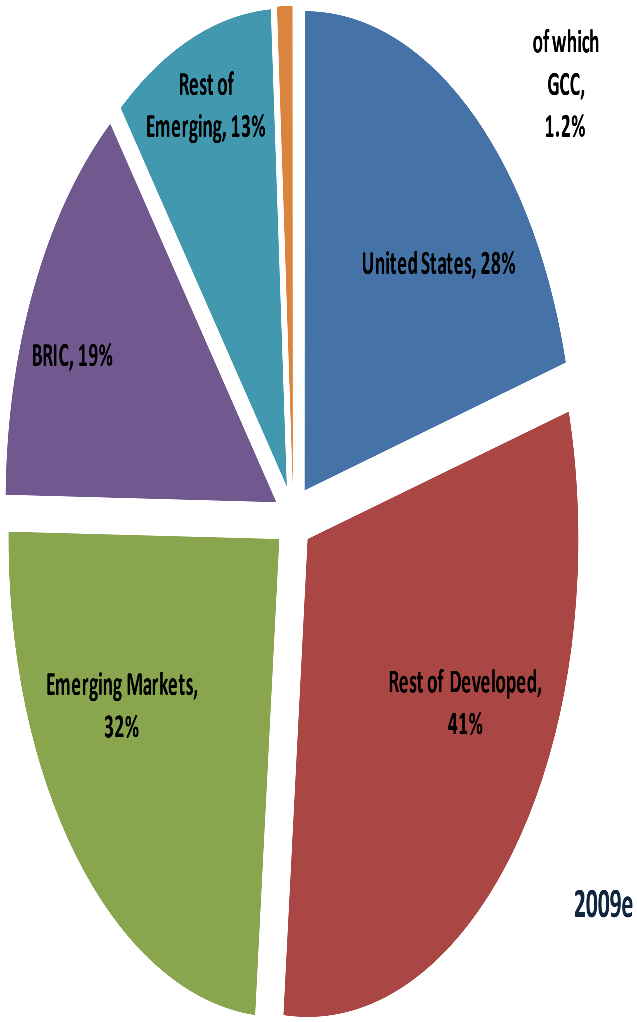
Emerging Markets: Changing Financial Geography

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009(E)
World Market Cap	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
United States	46%	47%	50%	47%	45%	43%	39%	36%	31%	33%	28%
Rest of Developed	46%	45%	41%	42%	44%	44%	44%	44%	41%	41%	41%
Emerging Markets	8%	8%	9%	11%	12%	13%	16%	20%	28%	26%	32%
BRIC	2%	3%	3%	3%	4%	4%	6%	9%	17%	15%	19%
Rest of Emerging	6%	5%	6%	7%	7%	9%	11%	10%	11%	11%	13%
of which GCC	0.3%	0.3%	0.4%	0.9%	0.9%	1.3%	2.5%	1.3%	1.7%	1.6%	1.2%

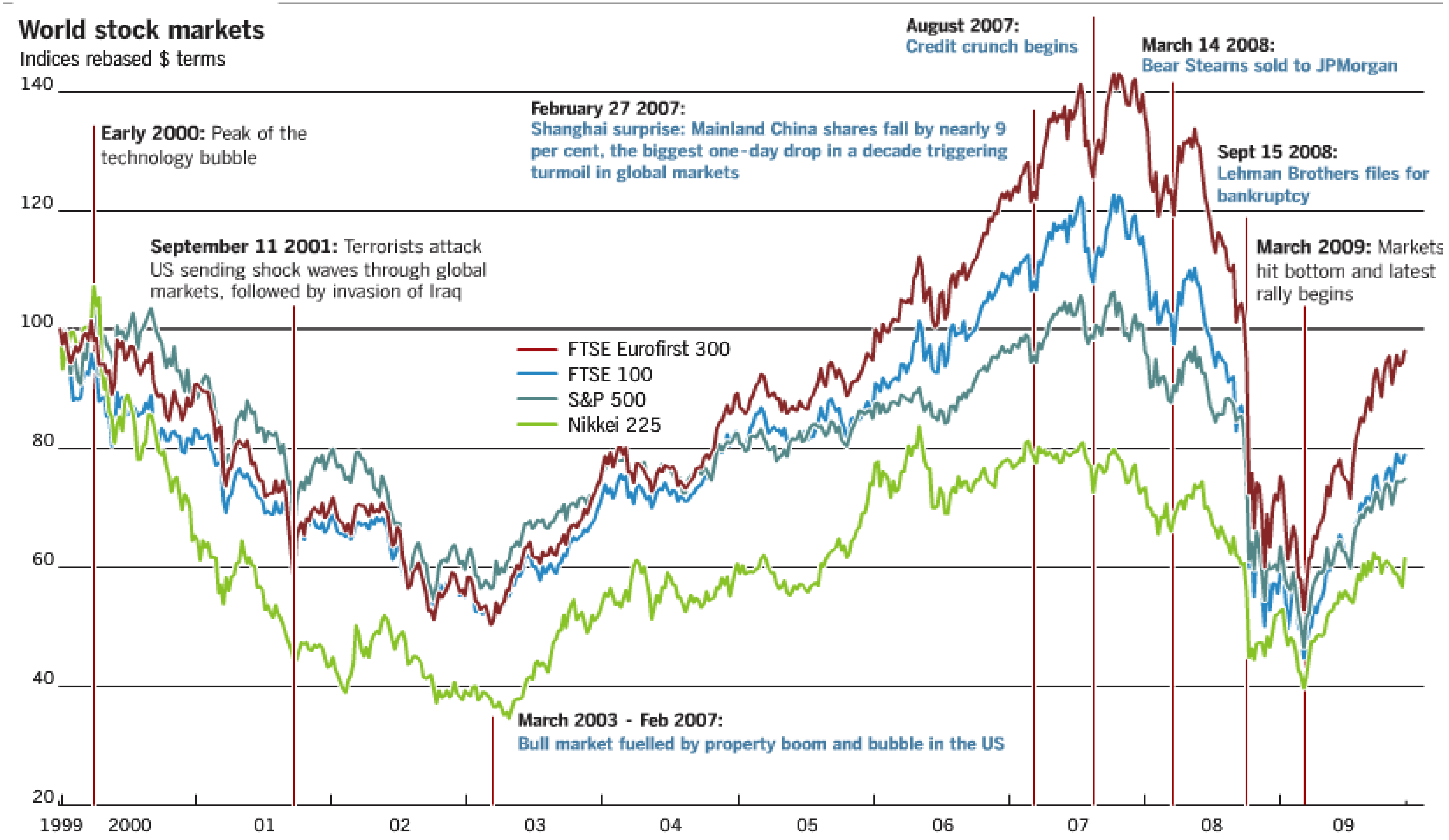
Source: Standard & Poors.

Tectonic Financial Geographic Shifts: 1999-2009



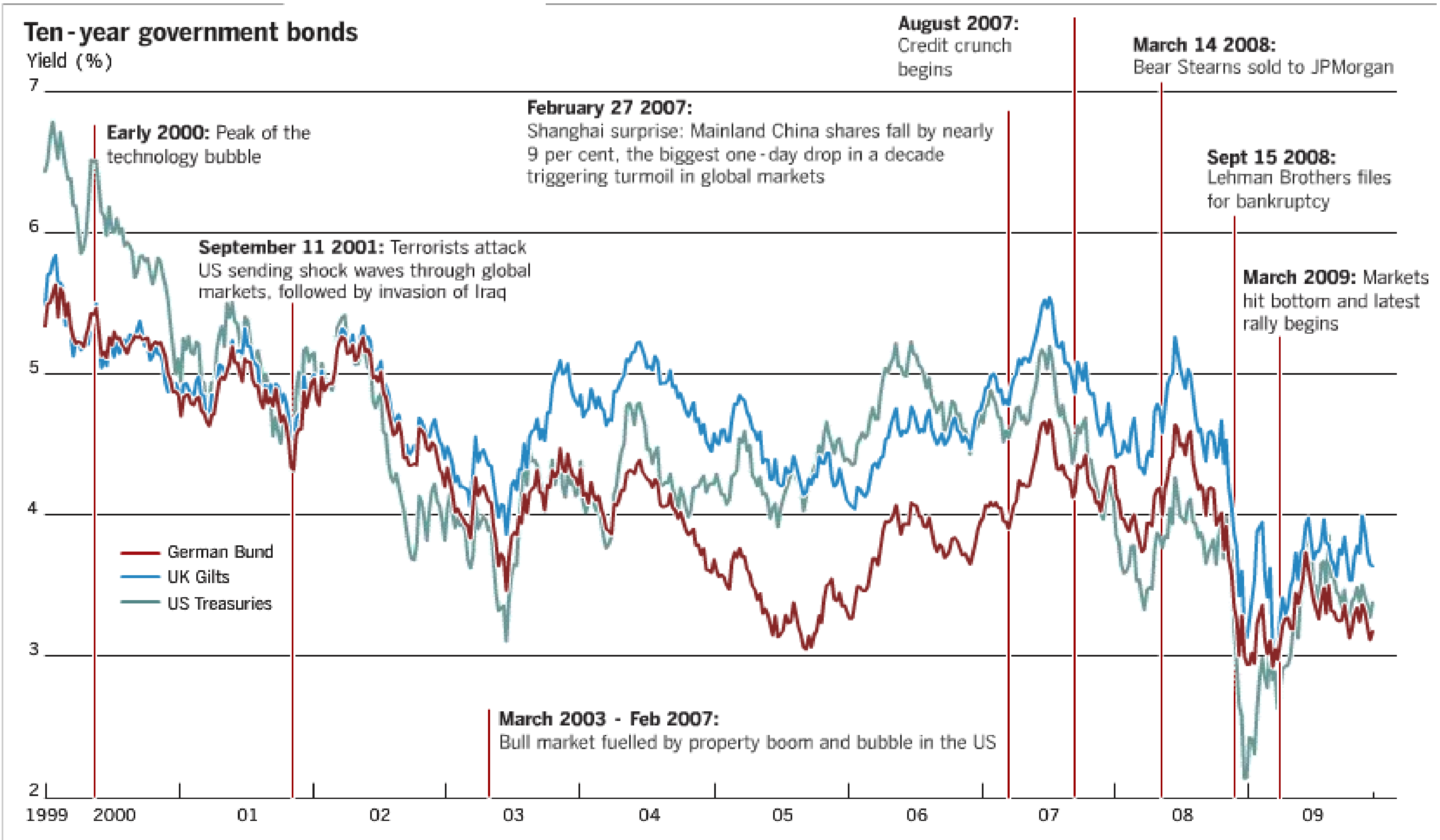


Observers Did Not Notice: The Equity Decade That Was



Source: Financial Times

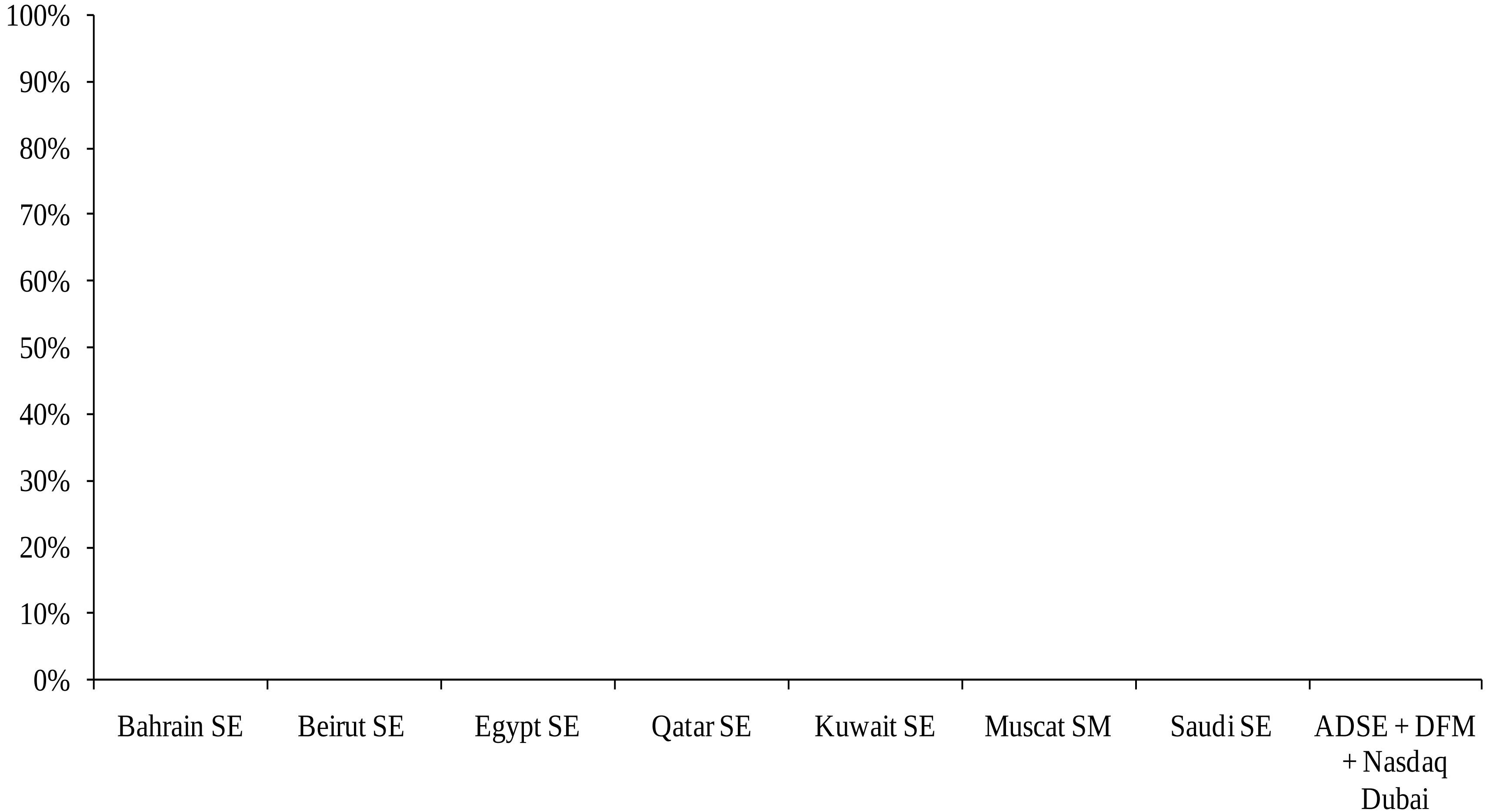
Observers Did Not Notice: The Bond Decade That Was



Source: Financial Times

Nascent ME Equity Markets; ∑GCC= $677 ≈HK $690

Market Capitalisation (as a % of 2009 GDP) of select stock markets in the region



Source: Zawya, IMF Database; Data as of Jan 24th 2010

Lessons Learnt (?) from the Financial Crisis

•**Contagion & Spillover effects**:

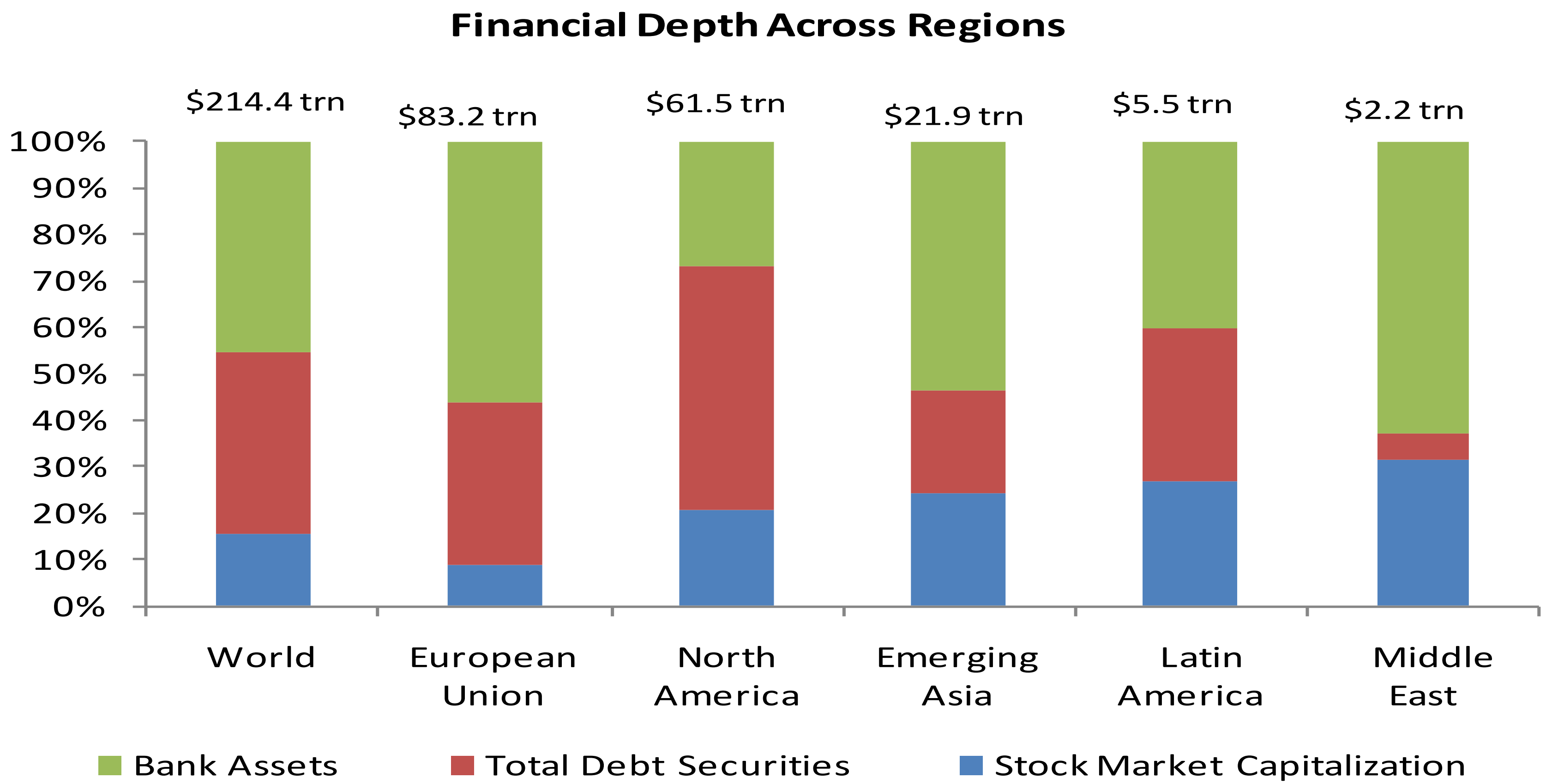
•Nearly two-thirds of the increased financial stress in MENA EM countries after the Lehman shock is attributable to direct or indirect spillovers of financial stress in advanced economies (IMF WP/10/8, K Moriyama, Jan 2010)

Some Lessons:

1. Strengthen Corporate Governance, Transparency & Disclosure
2. Strengthen Financial Sector Regulation & Regulatory Capacity
3. Design & introduce Financial Safety Net
4. Strengthen Market Resilience
5. Institutionalise and Build Economic Policy Capacity
6. Engage in design of new International Financial Architecture, Policy & Regulation
7. Develop Local Currency Money and Debt markets

Financial Depth Across Regions: undeveloped ME Markets

- 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



Source: IMF Global Financial Stability Report, Oct 2009

Why Local Currency Market Development?

Developing debt markets in local currencies would allow to:

- Deal with currency mismatching & exchange rate risk
- Provide Central Banks an effective monetary policy tool: open market operations feasible => help maintain an inflation target without a peg to a major currency
- 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
- 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.

Local Debt Markets: Cornerstone of Development Policy

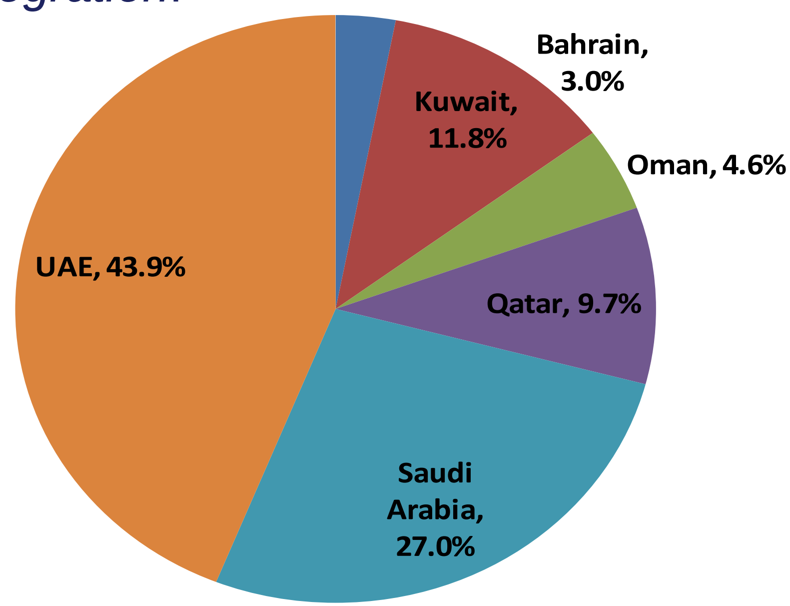
Potential drivers of MENA Debt Market:

- **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

Infrastructure Investments in the GCC

- Massive infrastructure investment by GCC countries has been a major factor & contributor to recent (2003-2008) economic growth, productivity gains, increased private sector investment and diversification
- Infrastructure spending continued despite the financial crisis: helped stabilize economies, avoid contagion effects from credit crunch & sustain growth.
- For the GCC it is imperative to accelerate the pace on infrastructure & network projects that foster *regional integration*:
  - ✓Integrated Transport Systems (Road-Rail-Air-Water)
  - ✓Electric grid
  - ✓Pipelines
  - ✓Telecommunications &Fiber Optics
- As of Jan 18, 2010, MEED Projects estimates value of projects planned and underway in the GCC at $2.26trn



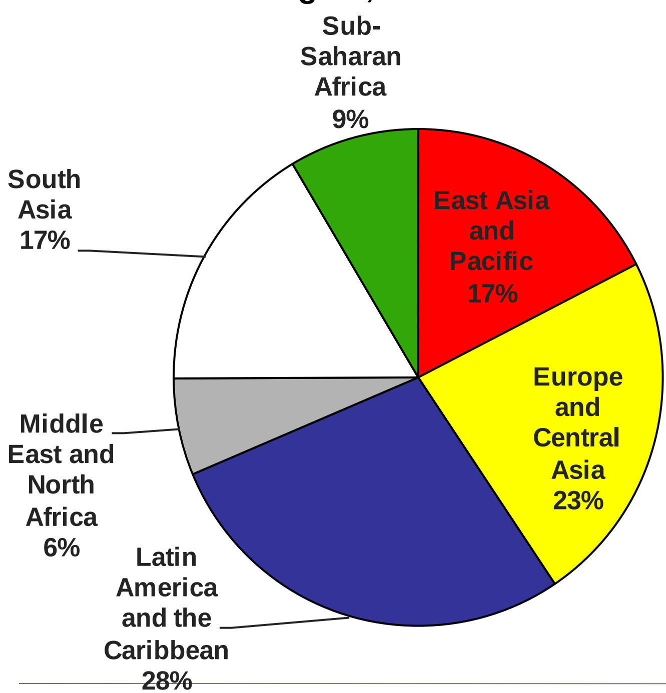
Source: MEED Projects

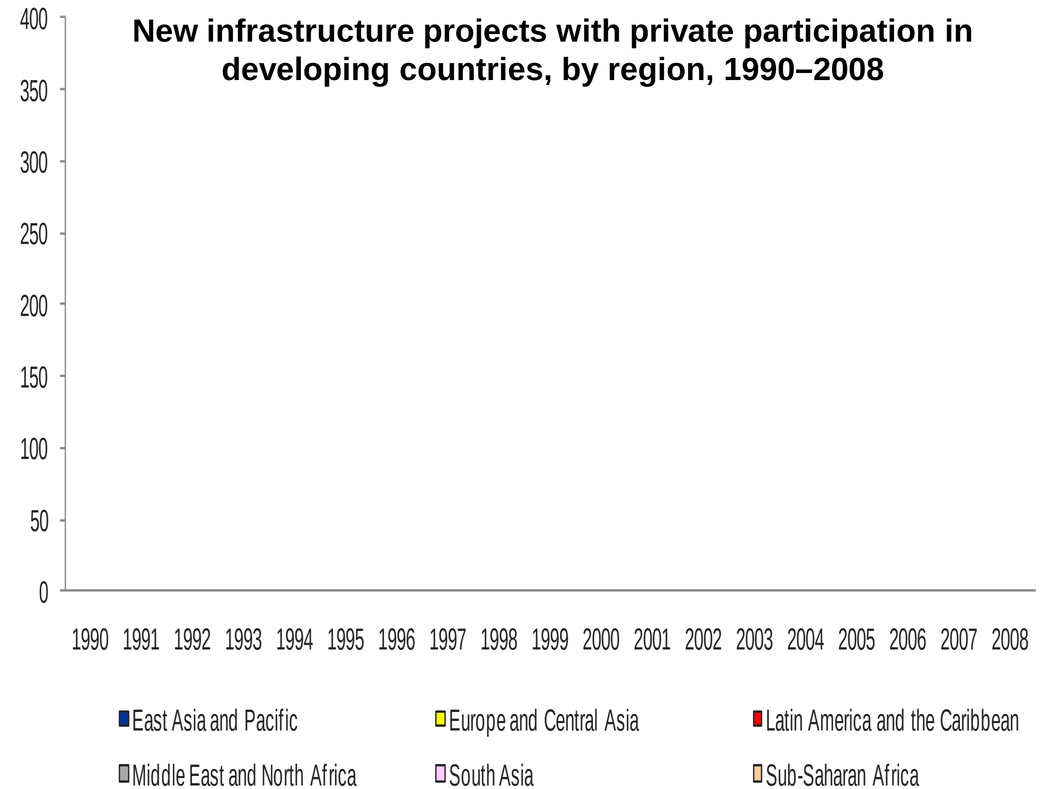
Future of MENASA Capital Markets I: PPP

Private Partnership projects in infrastructure:

- In 2008, 10 infrastructure projects (investment commitments of US$2.4 bn) with private participation reached financial or contractual closure in the MENA.
- Infrastructure projects implemented in previous years had additional commitments of US$3.6 bn, bringing total investment in 2008 to US$6 bn.

Investment commitments to infrastructure projects with PP in developing countries, by region, 2001-08





Source: World Bank and PPIAF, PPI Project Database

Future of MENASA Capital Markets II: SOE privatisations

State-owned enterprises (SOEs)

- Over the past two decades, close to one trillion USD worth of SOEs have been privatised in more than 100 countries, 80% per cent of which in OECD member countries.
- In the MENA region, the privatisation process has been rather slow due to: Lack of political will, overstaffing, low pace of job creation in private sector etc.
- Some of the ***Preliminary Findings*** of the Stocktaking Report on Corporate Governance of State-Owned Enterprises in the Middle East and North Africa Region (OECD-Hawkamah):
  - ✓ State enterprises dominate many economies in the region, accounting on average for more than 40% of the local production.
  - ✓ Public sector employment accounts for 32% of the total employment in the region compared to 27% worldwide and only 13.5 % in the OECD countries.
  - ✓ SOEs in MENA are prominent in energy, infrastructure and network industries, such as air travel, electricity, gas and water supply, oil and telecommunications.
  - ✓ In the MENA region the value from recent SOE privatisation deals nearly tripled to reach US$11 billion (16 % of the total) in 2006, and the number of transactions grew from 21 to 33. Egypt was the clear regional leader in this area.

Future of MENASA Capital Markets III: FOEs

Family owned Enterprises

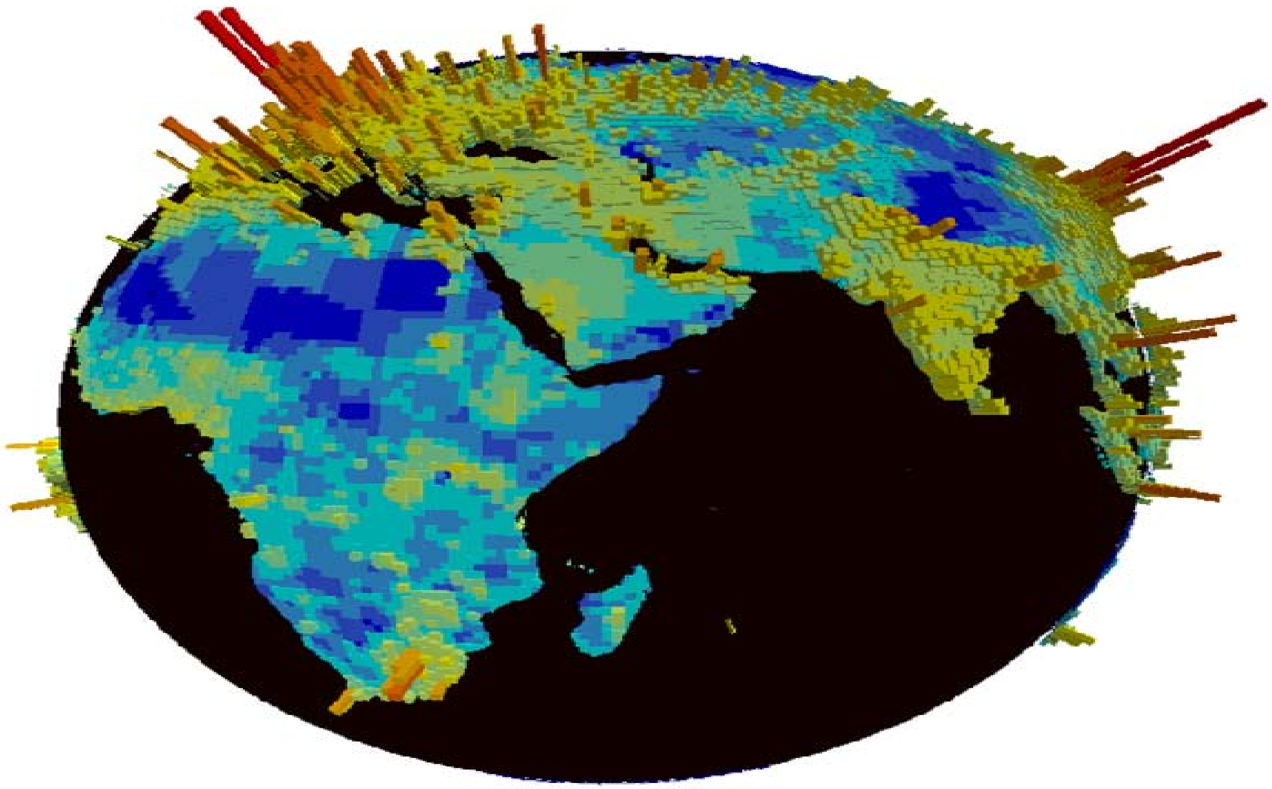
- Families represent more than 90% of MENA businesses; major source of job creation in coming decade
- Families and FOEs must become 'institutions' in order to survive
- Families/entrepreneurs should actively promote development of financial markets to:
  - ✓ Meet challenge of increased economic openness and globalization
  - ✓ Reduce risk through diversification and divestment of family assets
  - ✓ Exit strategy: solution to successor problem and equity in family inheritance
- According to a recent Ernst & Young Business survey on the state of family business in the ME:
  - ✓ Half the regional family businesses surveyed agreed that going public was important to their survival.
  - ✓ Only 20% are planning to take their company public while 20% oppose the idea and the remaining 60 per cent are not committed.
- **Hawkamah – IFC Initiative** provides Corporate Governance Assessments and Corporate Governance Advisory Services for Families in Business and Families going for IPO.

Transformational Role of the DIFC

- **DIFC has achieved critical financial mass:**
  - ✓ Provides market infrastructure for GCC bloc to emerge as economic and financial hub for MENASA region
  - ✓ Provides comprehensive platform for listing, IPOs, privatisation, project finance, securitisation
  - ✓ Lower access barriers to financial services
  - ✓ Lead integration of financial markets: DFM + Nasdaq-Dubai
  - ✓ Develop Regional Debt Market
  - ✓ Build payment system infrastructure for $ and Euro payments
  - ✓ Greater harmonization of laws & regulations across UAE and wider GCC
- **Change in Global Economic Geography requires accompanying change in Global Financial Geography**

Snapshot of economic globe over Europe-Africa-ME-Asia

(Nordhaus & Chen, 2009)



Thank You!