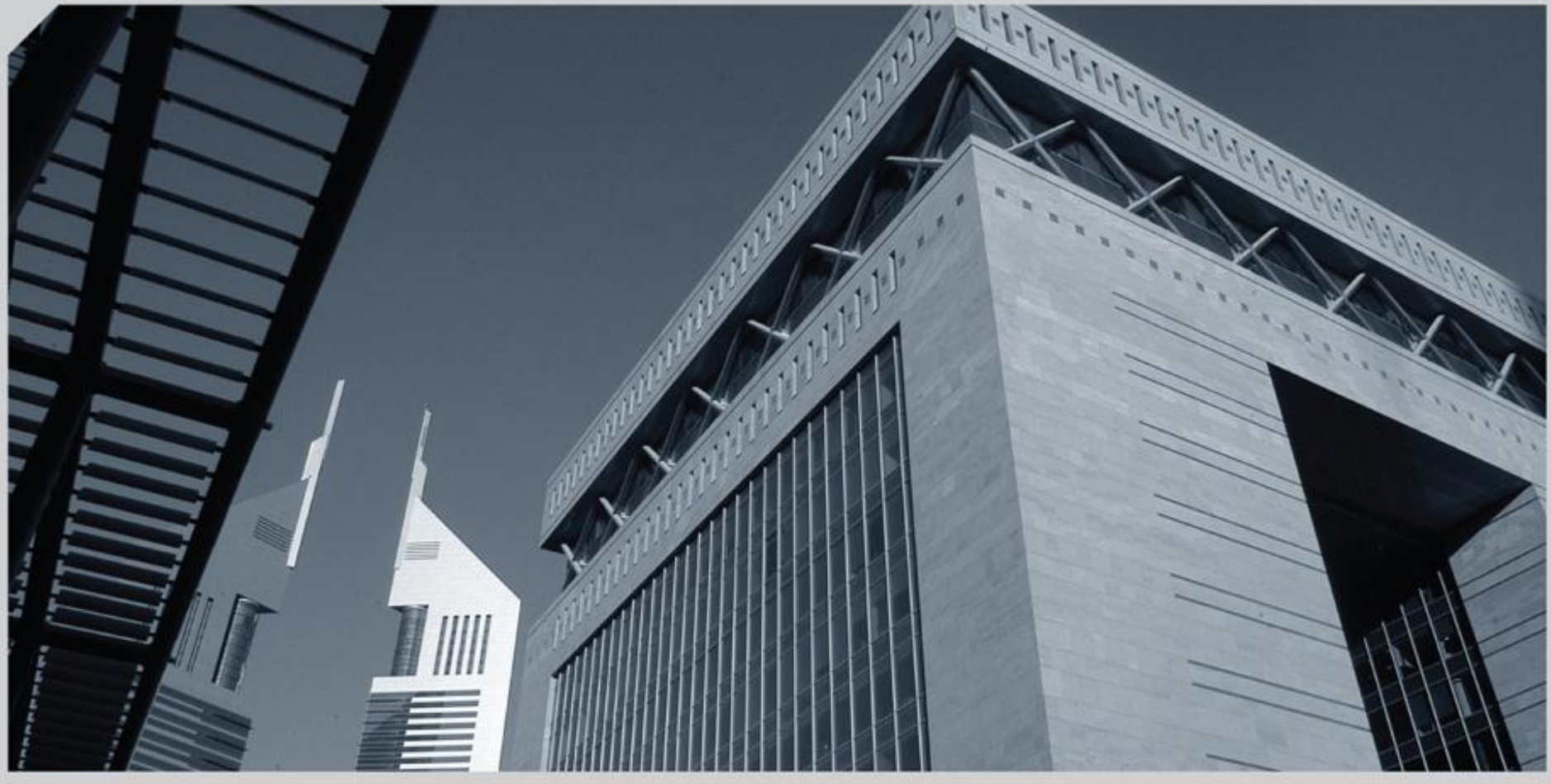

Breaking Down Barriers to Investment: Developing Bond & Sukuk Markets

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Dubai International Financial Centre

Agenda

Financial crisis and sudden stop in capital flows

GCC & MENA affected despite strong economic fundamentals and prospects

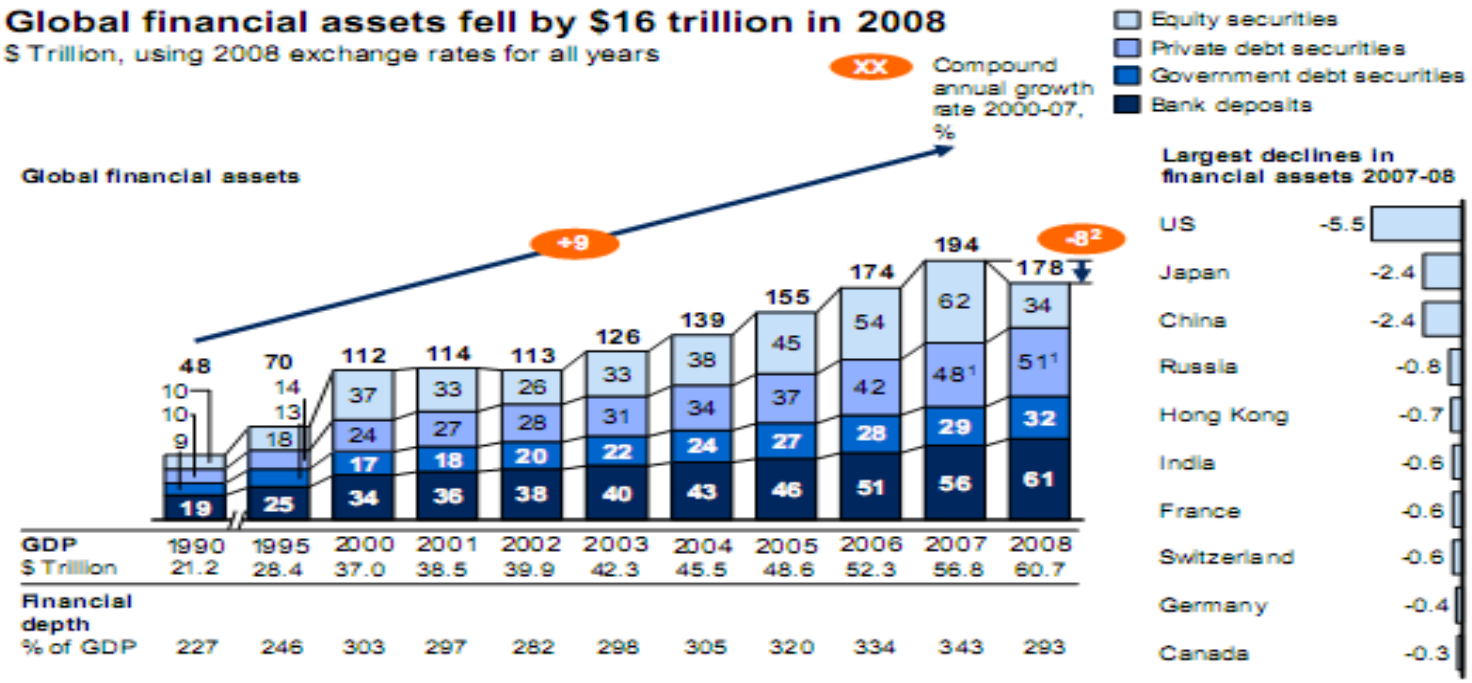
Taking advantage of markets dislocation and new financial market architecture

DIFC-MIGA bond Sukuk programme and investment initiative

Developing local debt markets: an imperative

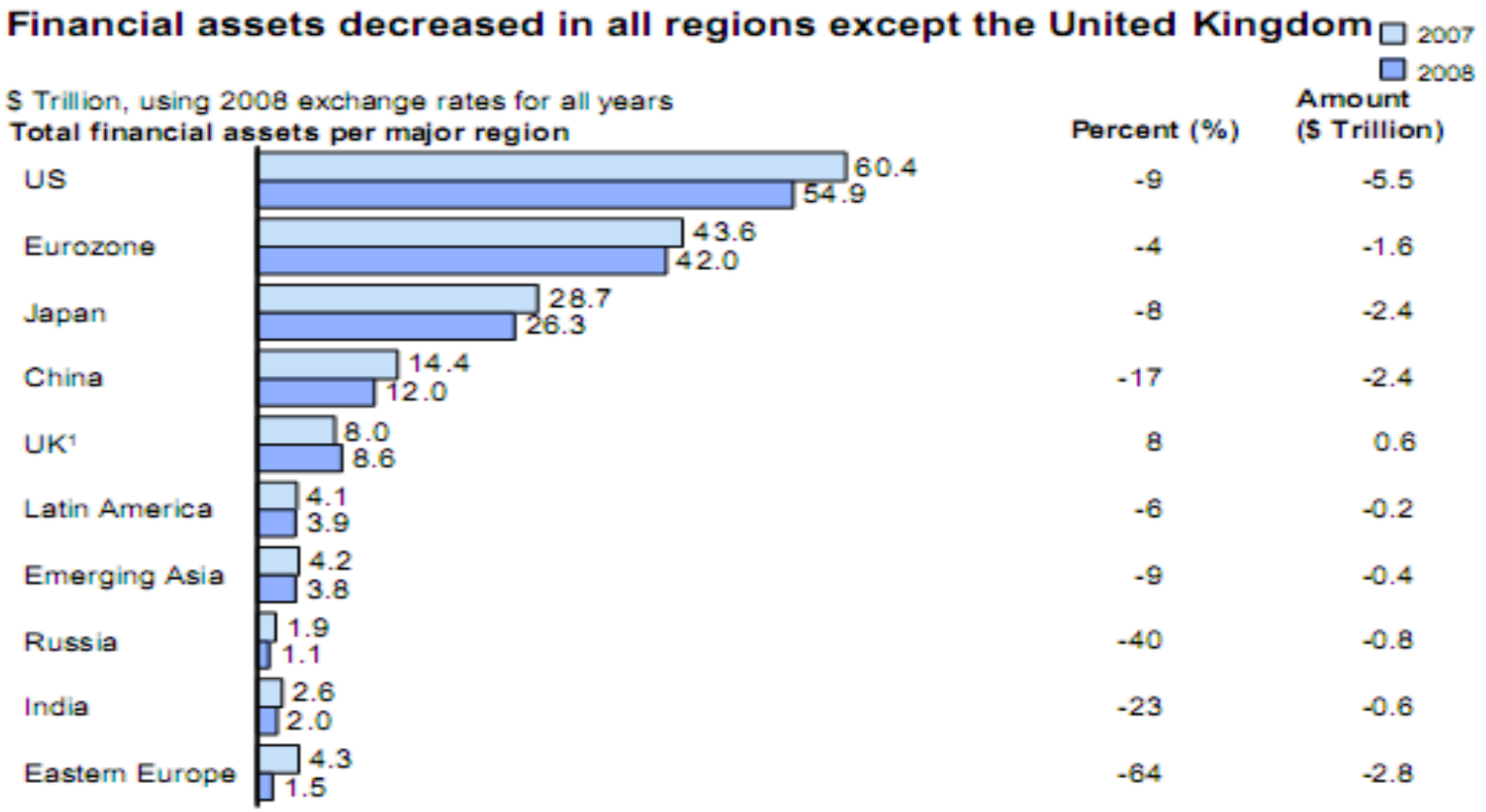
Repercussions of the Crisis

By end 2007, after almost 3 decades of buoyant growth the total value of global financial assets reached a peak of $194 tn, corresponding to 343 % of GDP, but by the end of 2008 this figure had fallen to $178 tn.



[1] Excludes debt write-downs of $0.28 trillion in 2007 and $0.98 trillion in 2008.
[2] In current exchange rate terms the drop in global financial assets would have been $22 trillion in 2008, or 11 percent of global financial assets.
Note: Figures may not sum due to rounding.
SOURCE: McKinsey Global Institute Global Financial Assets database; Bloomberg

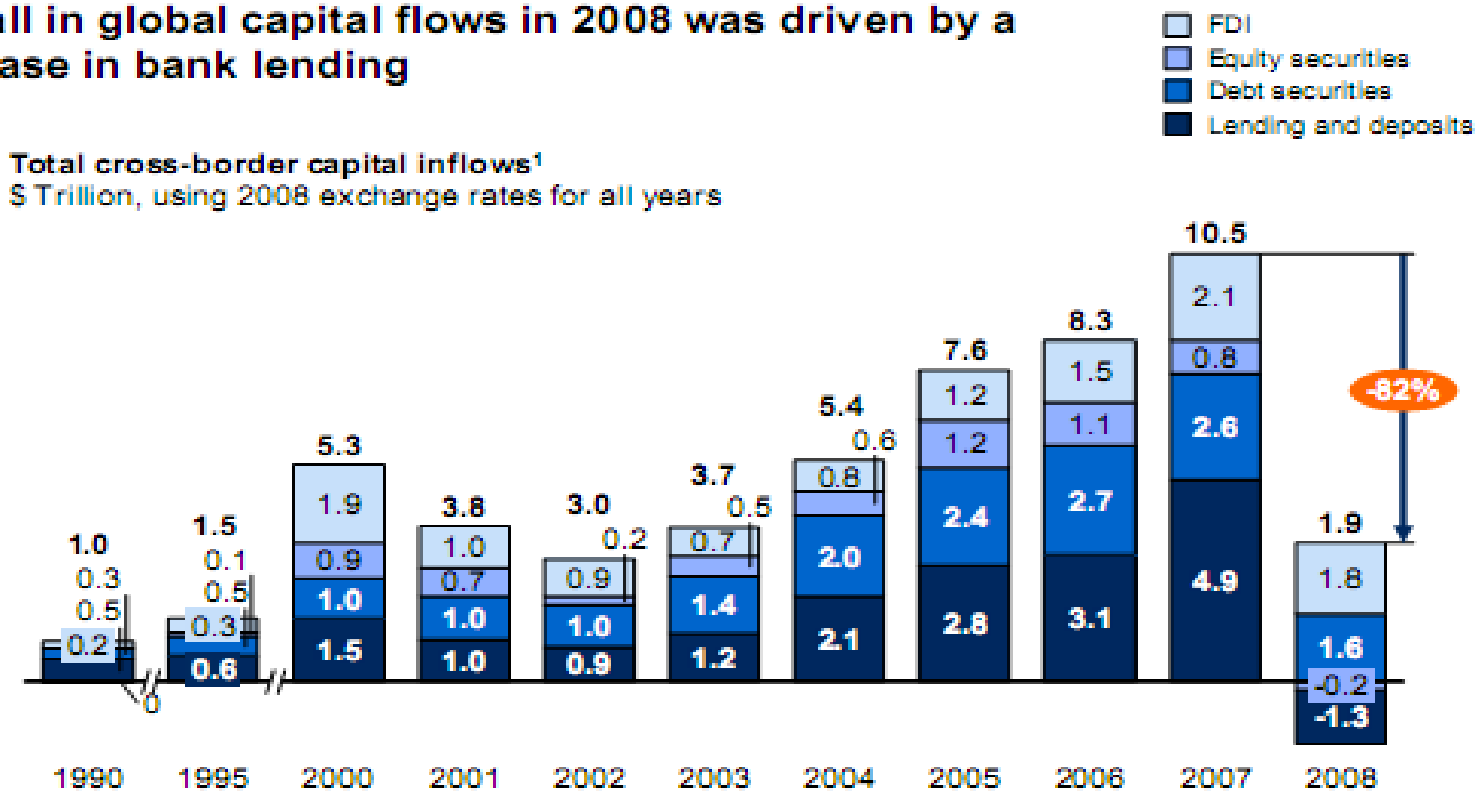
Setback in Financial Markets



¹ Assets increase primarily due to an increase in international financial institution debt, reflecting a surge of securitization activity in response to the Bank of England's accepting securitized assets as collateral for repurchase agreements.
Note: Figures may not sum due to rounding.
SOURCE: McKinsey Global Institute Global Financial Assets database

The Lehman Tsunami

The fall in global capital flows in 2008 was driven by a decrease in bank lending



% of global GDP	1990	1995	2000	2001	2002	2003	2004	2005	2006	2007	2008
	4.7	5.4	13.5	9.4	7.8	9.9	13.3	15.9	17.3	20.7	3.1

[1] Capital inflows represent net purchases by foreigners of FDI, equity, and debt securities, as well as deposits and loans to local banks.

Note: Figures may not sum due to rounding.

SOURCE: McKinsey Global Institute Cross-Border Capital Flows database

GCC & MENA Were Hit Despite Healthy Growth & Prudent Policies

- **The seizure of financial markets in late 2008, halted abruptly a long term process of increasing capital flows to Emerging Markets.**

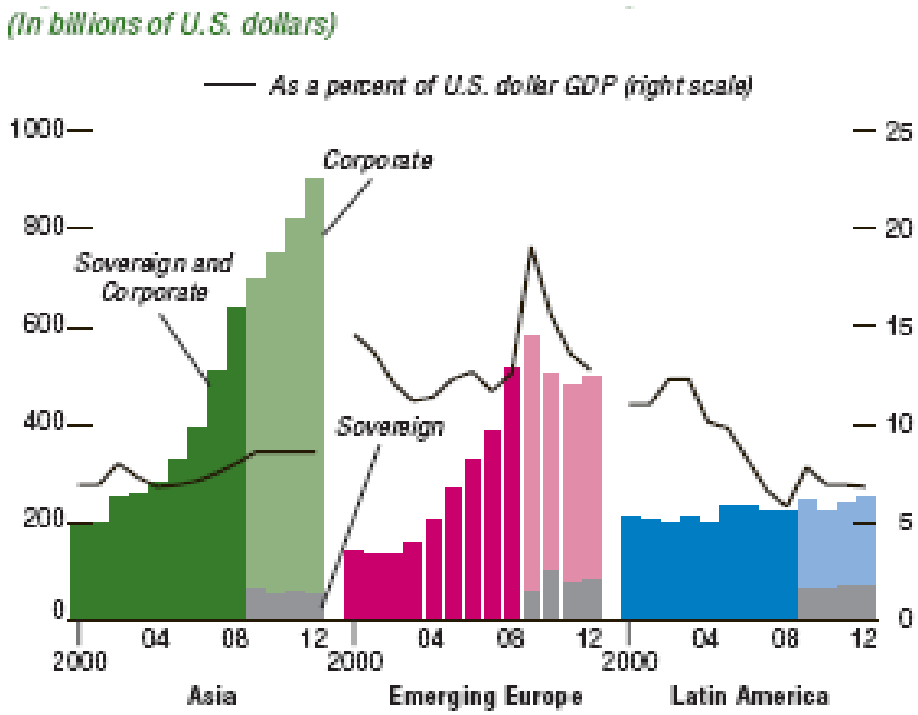
- **Cross-border capital flows, (FDI, purchases and sales of foreign equities and debt securities, and cross-border lending and deposits) fell 82%in 2008, to just $1.9 tn from $10.5 tn in 2007.**

- **Relative to GDP, the 2008 level of cross-border capital flow was the lowest since 1991. Most of the decline came from bank lending, which created a spate of severe liquidity crises**

- **GCC/MENA region was hit as well despite strong economic fundamentals and prudent policy stance.**

- **The area most severely affected was trade finance, which despite being a low risk activity, suffered a spectacular retrenchment causing one of the most severe quarterly decline in global trade in history.**

External Debt Refinancing Needs in Emerging Markets



Sources: Bloomberg L.P.; IMF, International Financial Statistics and World Economic Outlook databases; and IMF staff estimates.

Note: Amortization of medium- and long-term debt on the year and short-term debt outstanding at the end of previous year. Corporate debt includes financials.

- **Financial fragility induced by an unprecedented leverage is likely to severely affect the emerging markets because their refinancing needs will compete with the huge increase in public debt of developed countries.**

- **Countries that do not have solid domestic debt markets face greater refinancing risk.**

Financial Atrophy Induced by Government Rescues

- The aftermath of the financial crisis has made western financial intermediaries reluctant to lend to emerging markets and to a large extent has made them reluctant to lend to anybody!
- Recent policy measures and interventions creating perverse effects: central banks shower banks with liquidity at (almost) zero interest rates, which banks can invest in (in principle, zero risk) an increasing supply of government bonds → no incentive to lend to private sector
- Effectively, western financial intermediation is taking money from one branch of government (the central bank) and lending it to another (the Treasury) pocketing the spread in interest rates, at the expense of the tax payer.
- This atrophy of the leading financial institutions presents the Emerging Markets with a once in a lifetime opportunity: grow local currency debt and money markets

Shift in Economic Geography

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

- We are witnessing a major shift in global economic geography: by 2013, GDP of emerging and developing economies will account for 51% of global GDP, in purchasing power parity (PPP) terms, overtaking advanced countries for the first time since the 19th century.

- In 2008, the Asia-Pacific was the leading region for foreign direct investment (FDI), accounting for 33% of global FDI projects. For the first time, Dubai became the number one city in the world for FDI, usurping London, Shanghai and Beijing.

- The challenge is to sustain the shift & create an investor friendly environment with regulation and governance trusted by the public. Three areas should be given priority:
    - Political Risk
    - Structural reforms
    - Financial Market Infrastructure

New Equity Market Geography

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	30-Jun-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%	29%
Rest of Developed	46%	45%	41%	42%	44%	44%	44%	44%	41%	41%	39%
Emerging Markets	8%	8%	9%	11%	12%	13%	16%	20%	28%	26%	31%
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%	12%
of which GCC	0.3%	0.3%	0.4%	0.9%	0.9%	1.3%	2.5%	1.3%	1.7%	1.6%	1.5%

Source: S&P

Importance of Debt Markets

- **Well-functioning and liquid fixed income security markets contribute greatly to the efficiency and stability of financial intermediation.**

- **Market depth and liquidity reduce transaction costs, provide an efficient channel to allocate resources to productive uses and improve risk allocation by all financial intermediaries.**

- **Debt markets are basis for active monetary & fiscal policy.**

- **Deep local currency bond markets allow open economies to better absorb volatile capital flows, provide institutional investors with instruments that satisfy their demand for safe and stable long term yields, reduce financial instability associated with asset price bubbles, and grant a stable source of capital to fund public and private ventures under the constant scrutiny of markets.**

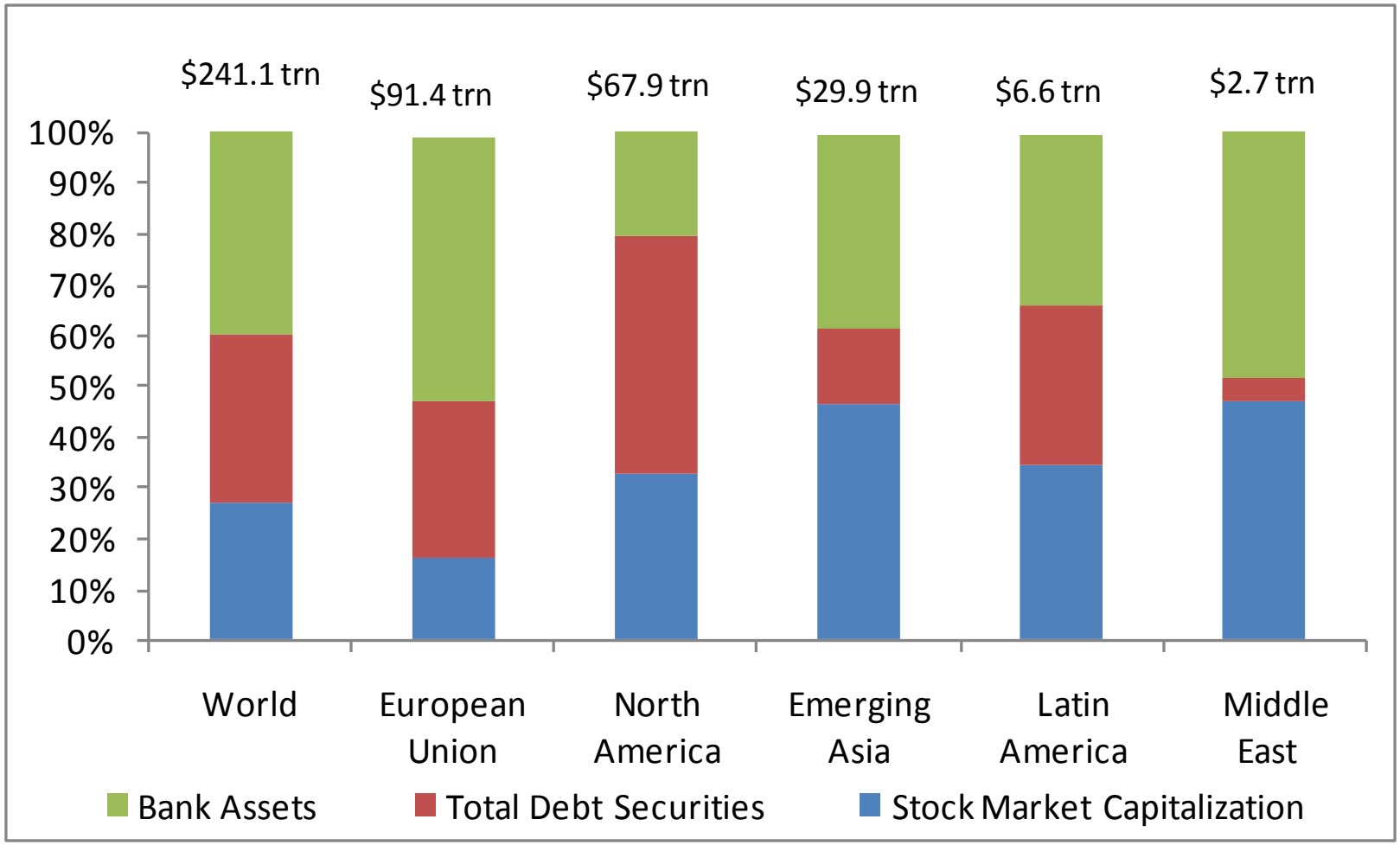
Developing Debt Markets: an imperative

- **Banking system has been main source of financing. Need to reduce:**
  - Currency mismatch
  - Asset/liability mismatch
- **MENASA/GCC countries need long-term finance:**
  - Diversify sources of government & corporate finance
  - Housing and Real Estate
  - Infrastructure projects & public works
- **Debt Markets can and should be used to raise long-term financing:**
  - Both the private and government/public sectors
  - Both Local and International issuers
  - Local and International currencies
- **Develop:**
  - Government Debt Market
  - Corporate Debt Market including convertible debt
  - Conventional and Sukuk

MENA Debt Markets are still in infancy

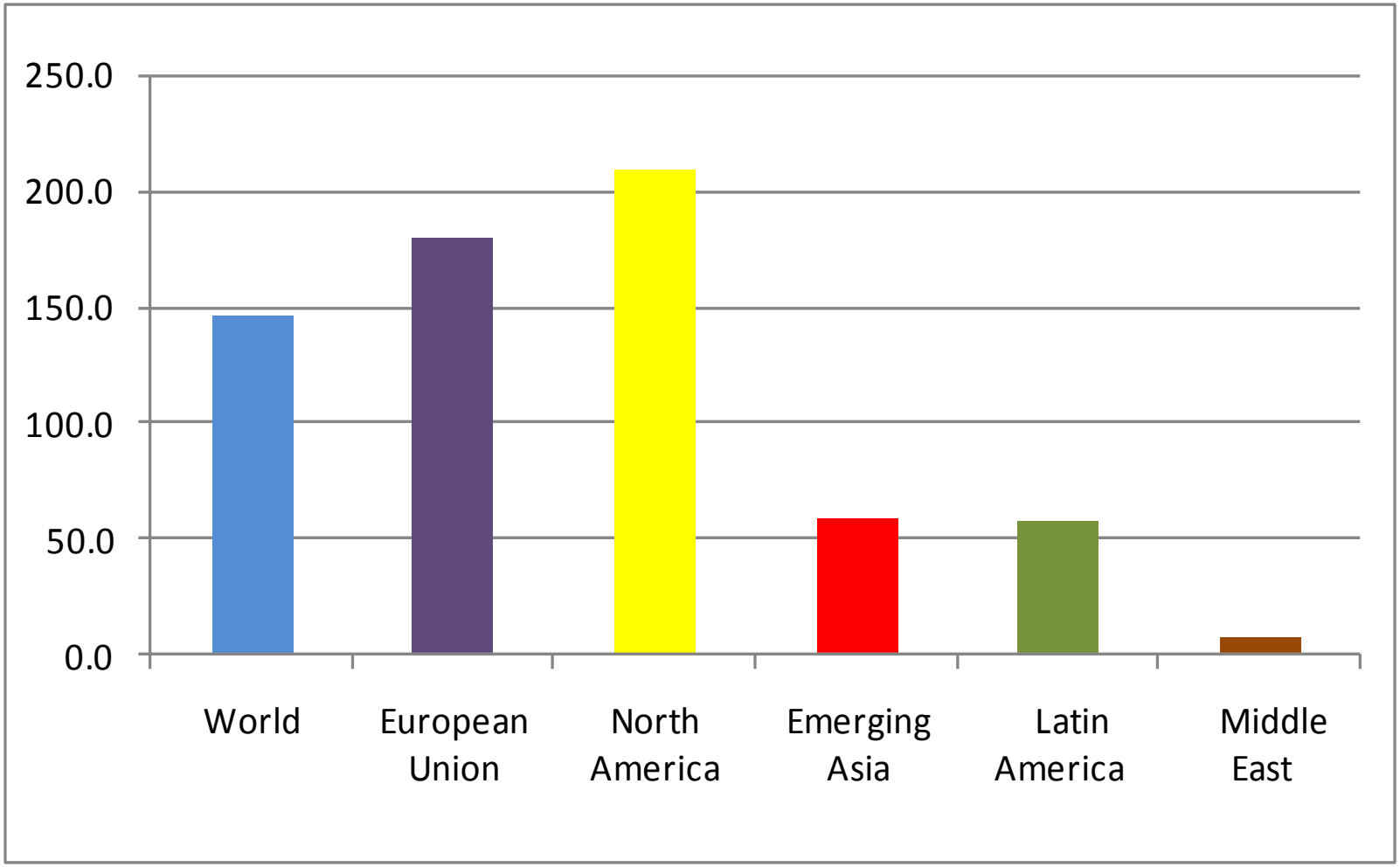
- Financial depth across the region shows the relatively low dependence of the Middle East on debt securities as of the end of 2007. According to end-2007 data from the International Monetary Fund, the world capital markets consist of an average 33.3% bond instruments, 27% equities and 39.7% bank assets
- In the Middle East region, the capital market is dominated by equities and bank assets, which together make up 95.5% of finance. Debt securities make up just below 5% of the Middle Eastern capital markets.
- The bond market in the MENA region remains the weakest among the world's regions in terms of financial intermediation. Bond financing is tilted towards sovereign issuers, as opposed to a relatively more balanced distribution in other regions

Financial Structure Across Regions, 2007



Source: IMF Global Financial Stability Report, April 2009

Total Debt Securities, 2007 (as % of GDP)



Source: IMF Global Financial Stability Report, April 2009

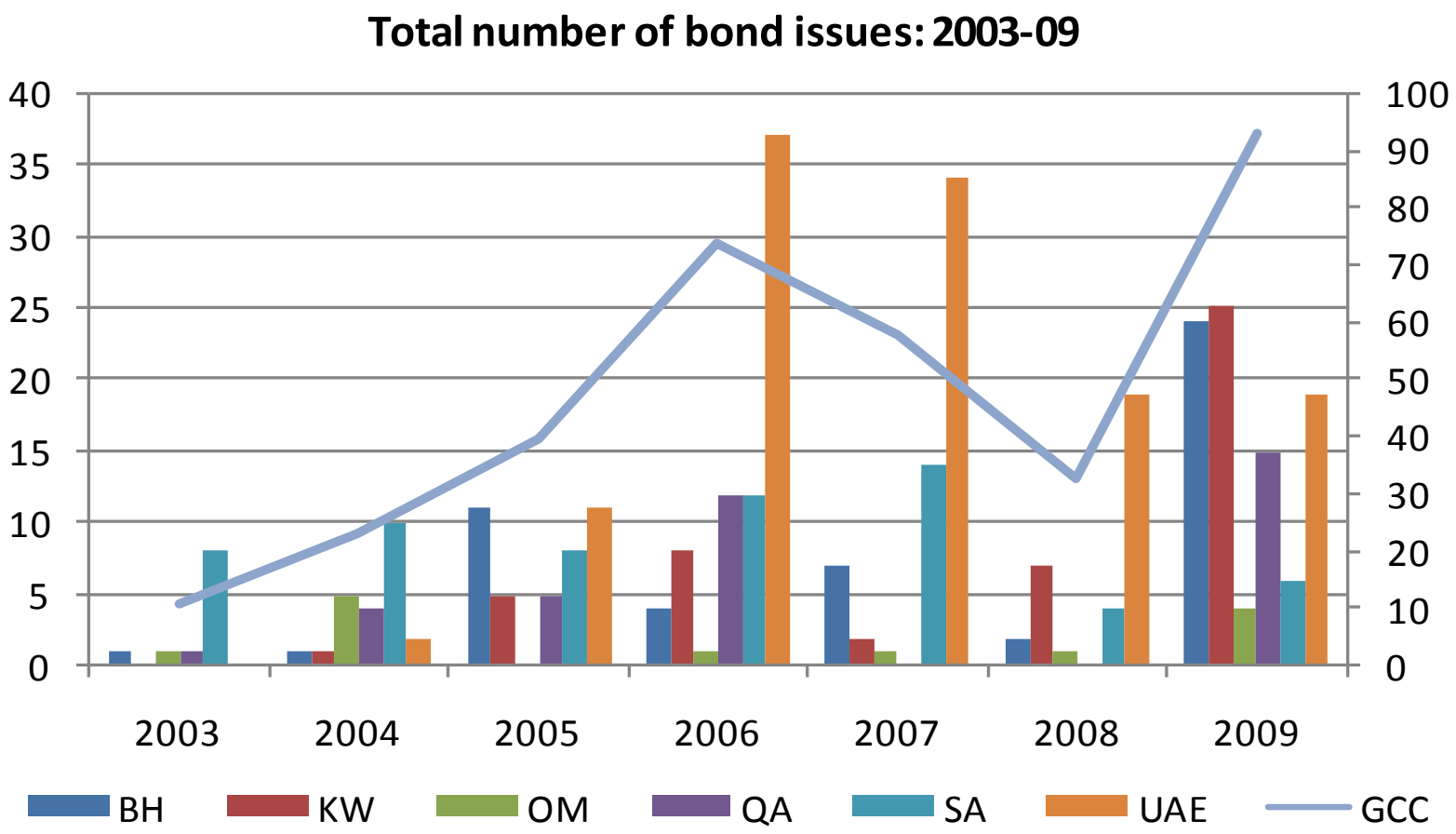
Debt Market has Emerged as an Attractive Alternative

- **Bonds have been rarely used, in large part because until very recently they were deemed unnecessary in a region flush with capital and hydrocarbon wealth. Funds for large projects were available through banks and government coffers.**

- **The reversal in hot money flows, losses in the region's equity markets post-Lehman, and the prohibitive cost of long-term borrowing has been a powerful reminder over the vulnerability of relying on external finance. With precarious sources of external finance GCC countries are tapping the pool of wealth in the region and foreign capital looking for relatively safe investment.**

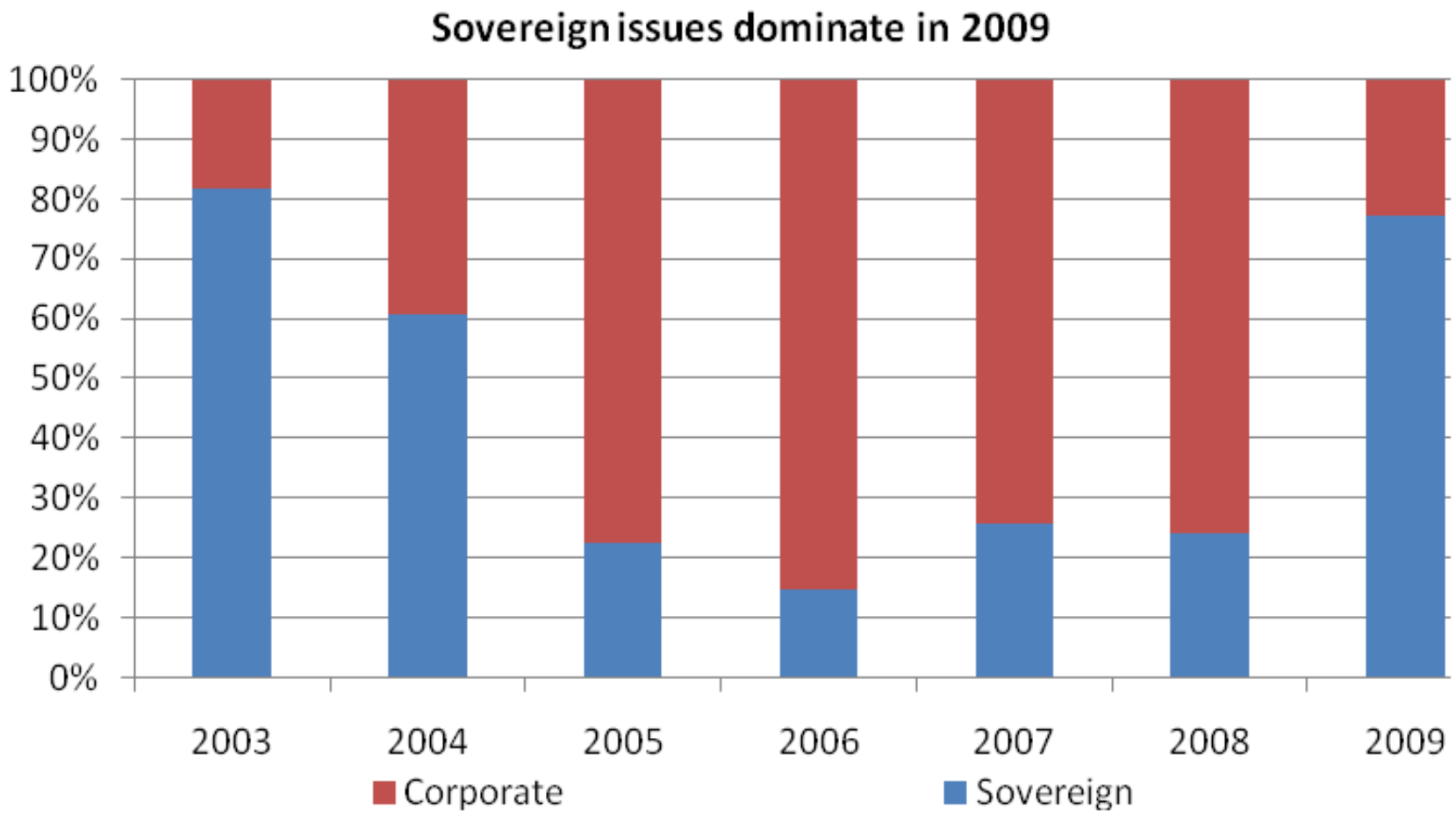
- **Activity in the debt market has substantially increased post-crisis to match the governments' commitment in infrastructure projects and public works.**

Bond issuance in the Gulf



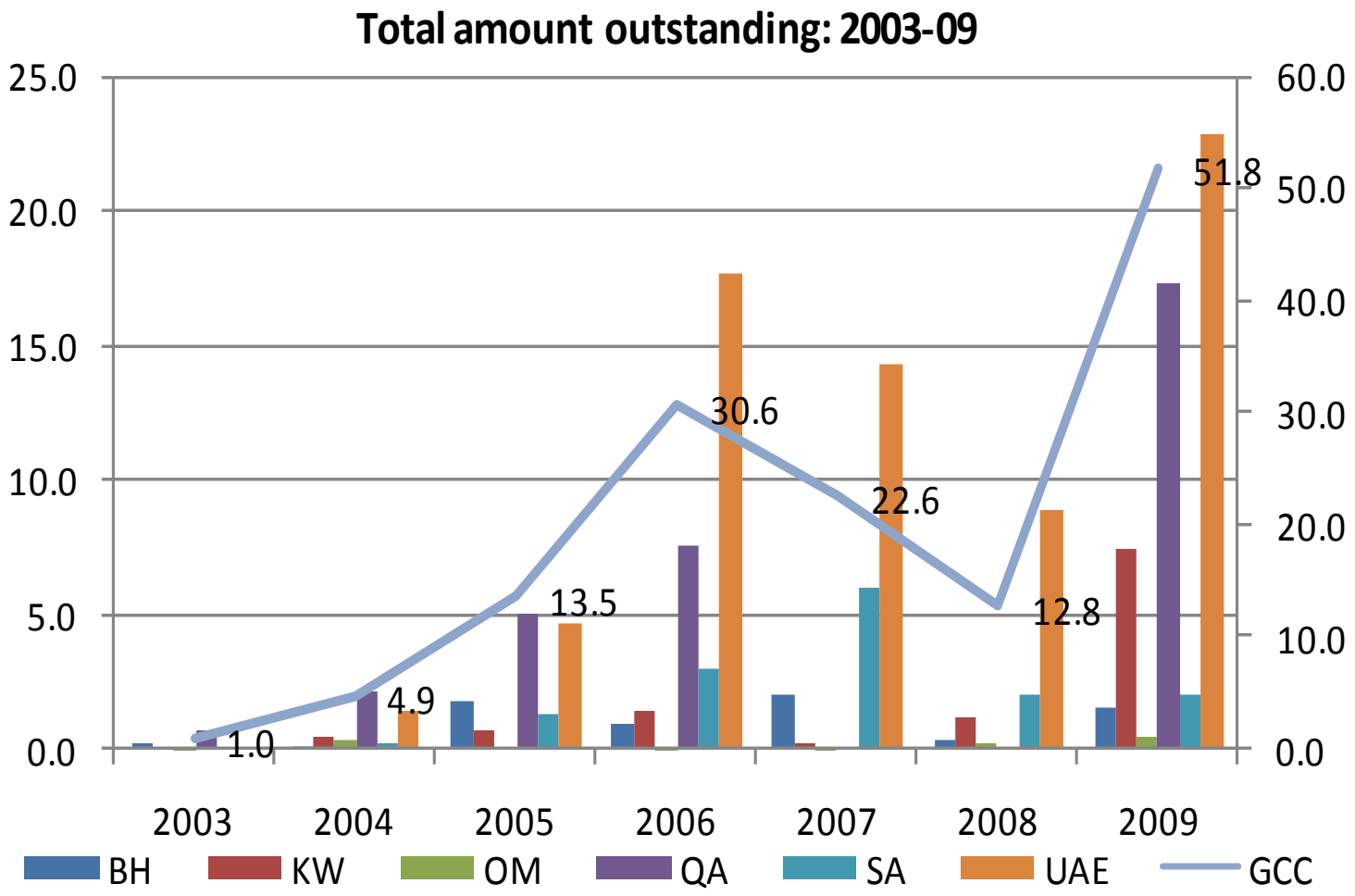
Source: Bloomberg

Bonds Issuance by Type



Source: Bloomberg

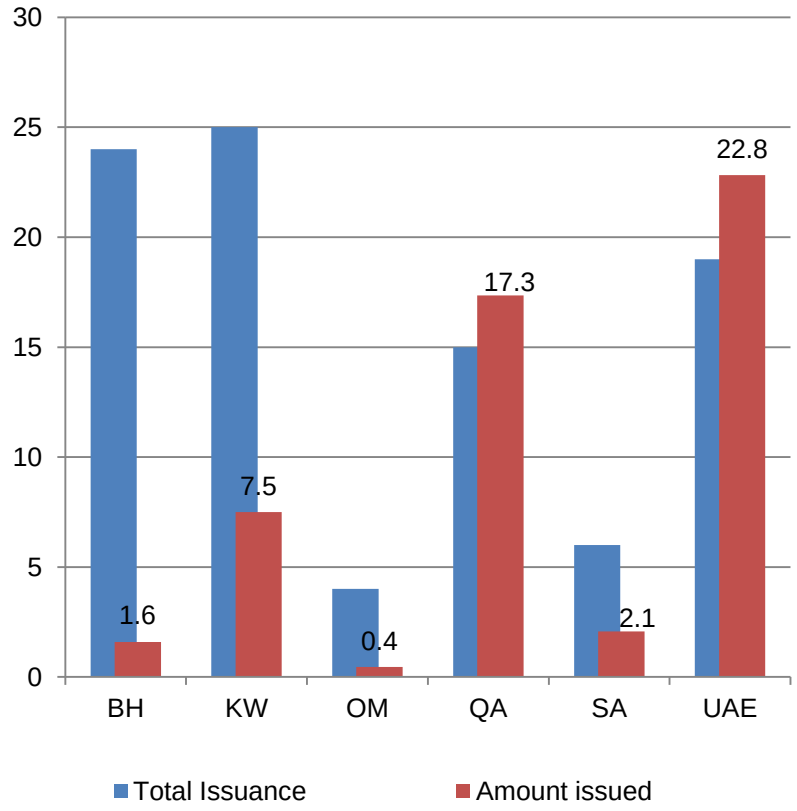
Stock of Bonds Outstanding in the Gulf



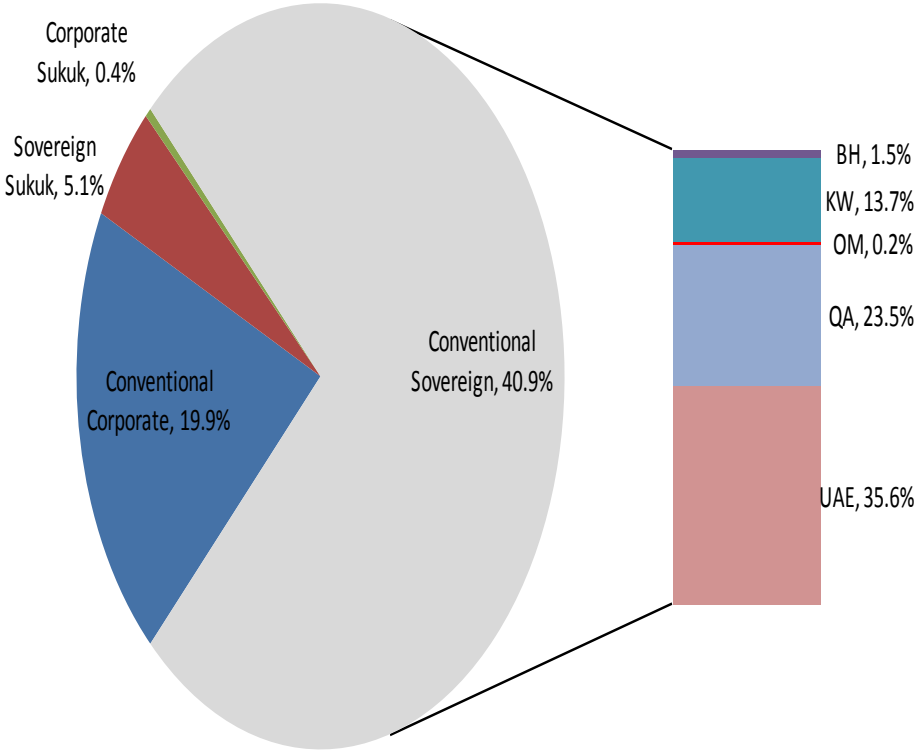
Source: Bloomberg

New Issuances in 2009 and Breakdown by Type

Issuances in 2009: By number and amount of issuance

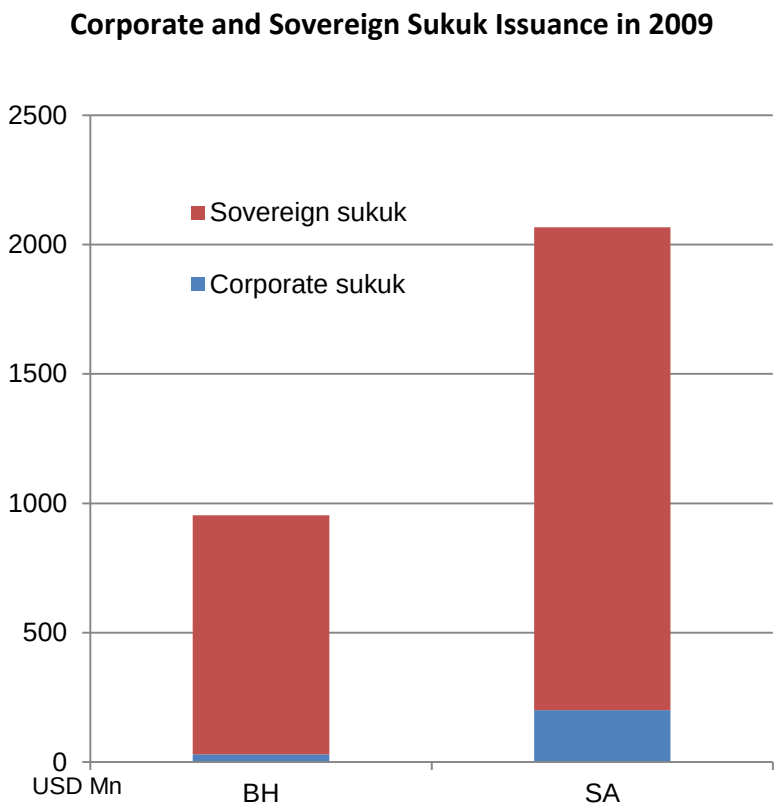


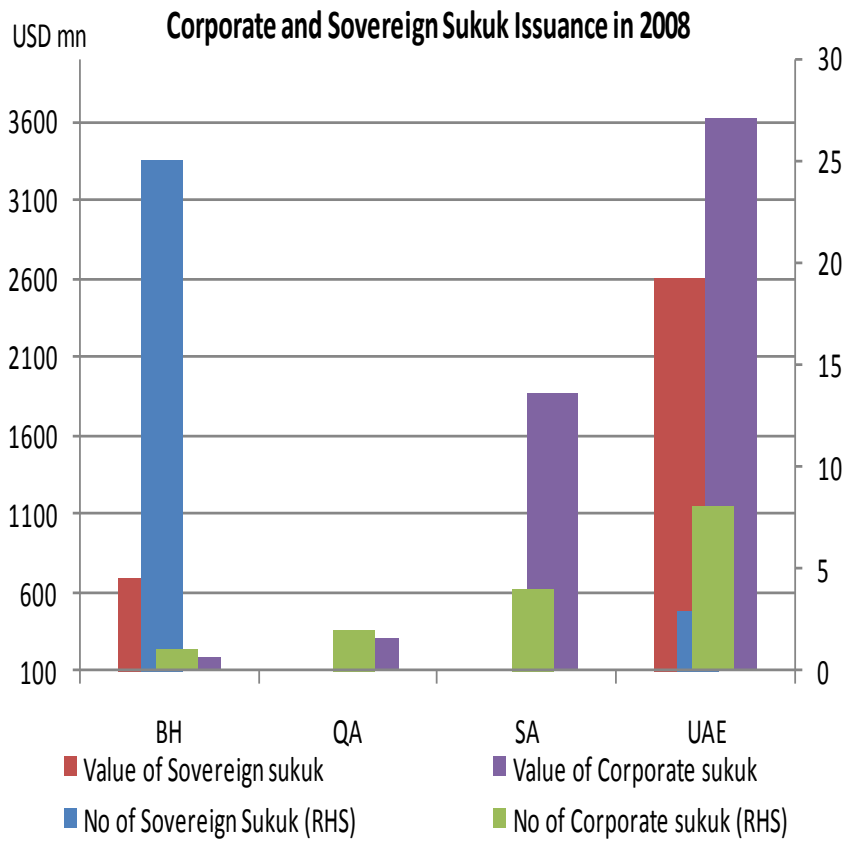
Conventional Sovereign Issues formed 40.9% of debt issuance till end-Aug09



Source: Bloomberg

Sukuk Issuances by Type





Source: Bloomberg

DIFC-MIGA Programme

- Cooperation on MIGA's Arab Investment Initiative will be comprised of three main components:
  - Arab Investor Survey
  - Arab Investment Portal
  - Regional Dissemination and Launch Events

- Mutual cooperation in promoting foreign direct investment and cross border financing in the region

- Cooperate in promoting guarantees for coverage in line with MIGA's guidelines and eligibility requirements to include, among other:
  - Foreign Investments, including equity, shareholder loans, and shareholder loan guaranties
  - Capital market bond & Sukuk issues and asset securitisations
  - Corporate & Sovereign investors/issuers

Developing Debt Markets: a Regional Imperative

- Witnessing the emergence of a GCC based Bond/Sukuk market

- Developing Regional Debt Markets is an imperative:
  1. Finance Infrastructure, Development Projects and Public Works
  2. Sever the link between energy revenues and capital spending
  3. Enable Public Debt Management & active Fiscal policy
  4. Enable Monetary policy: OMOs, REPOs, Swaps…
  5. Increase capital mobility & deepen organized financial markets
  6. Support and Enable Regional & GCC Economic & Financial Market Integration

- DIFC-MIGA programme will help boost FDI and development of bond & Sukuk market

Thank you!