Macro & Markets
Perspectives on the OIC World

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Content

An unprecedented crisis in modern history

- **USD 12t** public **"**mopping up" bill[1] (equal to nearly **20%** of the global GDP)
  - Includes capital injections, liquidity support and debt guarantees
  - UK has to-date spent **82%** of GDP on its rescue package
- G20 on course to run highest budget deficit since WWII
- A **USD 1.9t** of once available credit has dried up – (A reduction equal to half of money borrowed in 2007)[2]
- The global GDP is forecasted to grow the slowest in **60 years** (-1.1%)[3]
- OIC investment growth to **more than halve** to 6% (from 16% in 2007)[4]

However, the roots of the crisis have not yet been addressed

Source: (1) Telegraph 08 Aug 2009; (2) NYT 20 Feb 2009; (3) IMF World Economic Outlook Oct 2009; (4) IDB 17 Jan 2009

“Clearly as religious leaders we want to say that the **root problem is human greed**, which is not specific to any one nation or even to the governing class or any one religion.”

- *International group of Christian and Muslim leaders*

Source: Middle East Online, October 16, 2008

How the crisis will impact the OIC World

- **OIC not "decoupled" from developed markets but affected through contagion**
  - Trade and capital market flows remain the key sources of linkages to the rest of the world
  - Regional trade ties may develop between OIC and fellow emerging markets as traditional export partners face recessionary phases

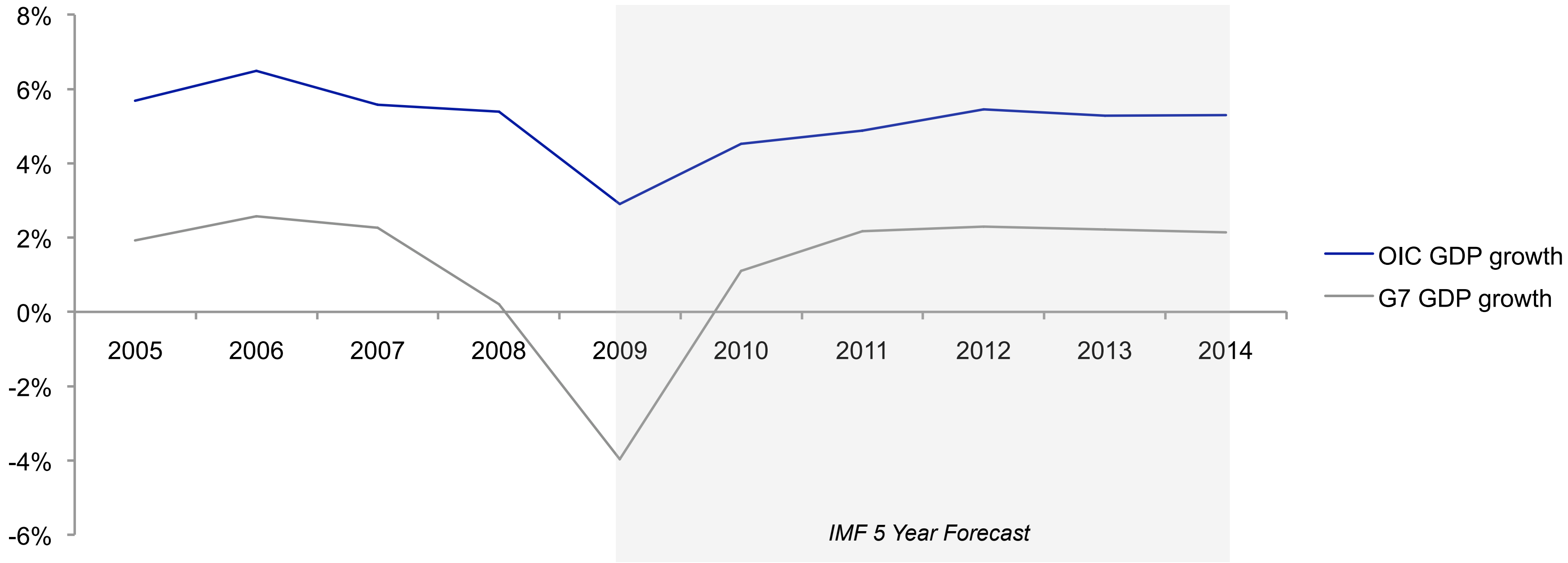
- **Emerging markets are projected to benefit from access to capital flows**
  - OIC countries will benefit from emerging market association but in a tiered structure based on "ease of doing business" and corporate governance metrics
  - Wealthy hydrocarbon economies (e.g., Saudi Arabia, Abu Dhabi, Kuwait, Qatar) are perceived as sources of capital and are taking a larger stage on the global scene – GCC net foreign assets over $1t (110% of regional GDP) [1]
  - Crisis may spur inward and OIC market focus of SWF and reserve managers towards real economy investments, developing infrastructure and business sectors

- **Short term impact of the crisis will be felt on multiple fronts**
  - Severe hit to the wealth of certain nations e.g. Gulf SWFs losing 20-30% of book value[1]
  - Low oil prices and falling trade volumes (inter and intra OIC) will affect export revenues (50% of OIC export earnings generated from trade with non-OIC developed countries) [2]
  - Reduced FDI, aid, and remittance earnings will hurt developing OIC nations more
  - "Flight to safety" capital flows will impact once-universal access to capital and corporate borrowing costs

Source: (1) IIF 28 Sep 2009; (2) IDB 17 Jan 2009

Despite crisis halving OIC GDP growth, outlook remains positive due to strong fundamentals

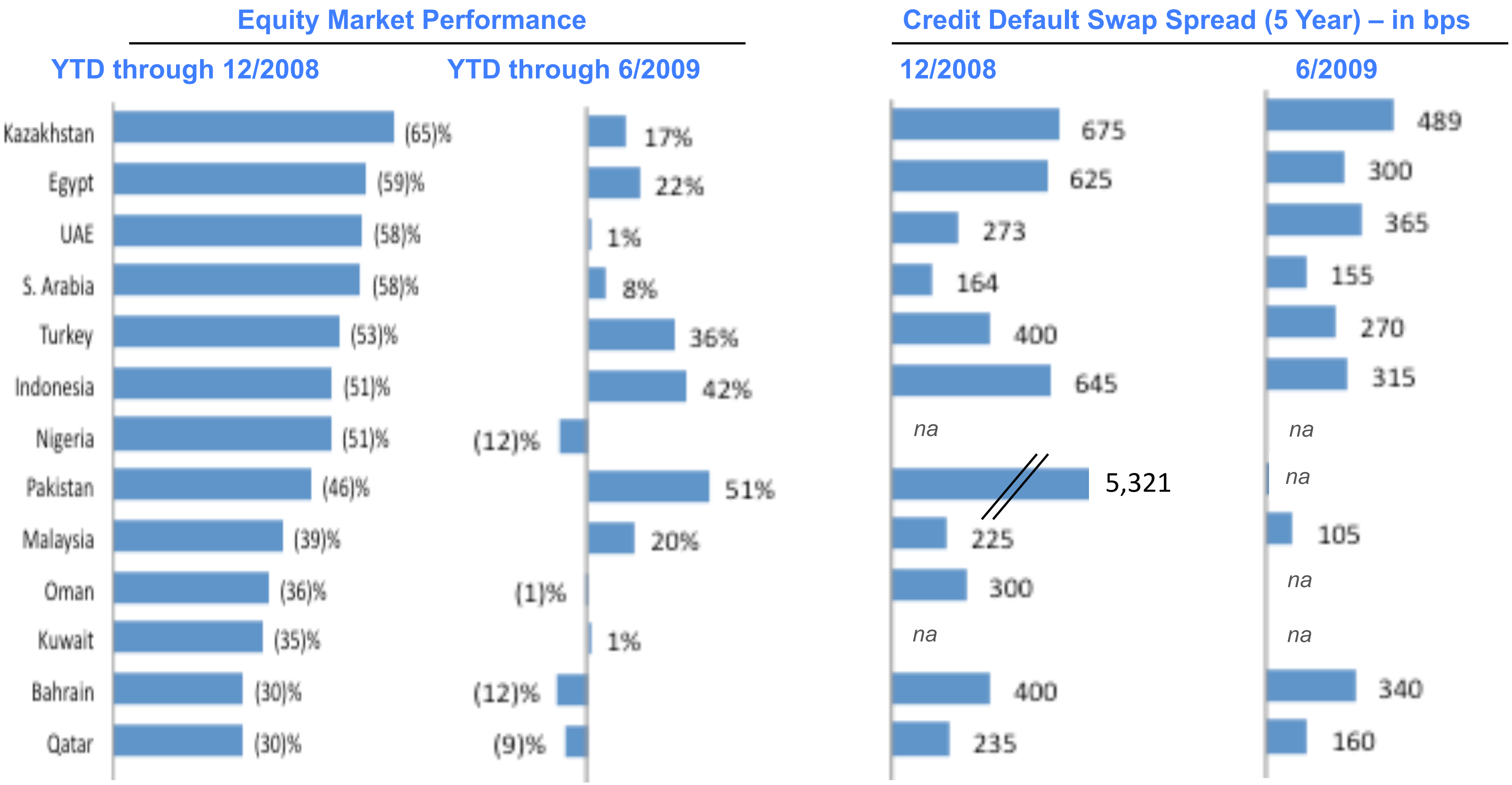
Crisis caused OIC average GDP growth to fall from 5.4% to 2.9%



Demographic dynamics and real economy investment opportunities will see OIC markets benefit from capital inflows

Source: IMF, World Economic Outlook Database, October 2009

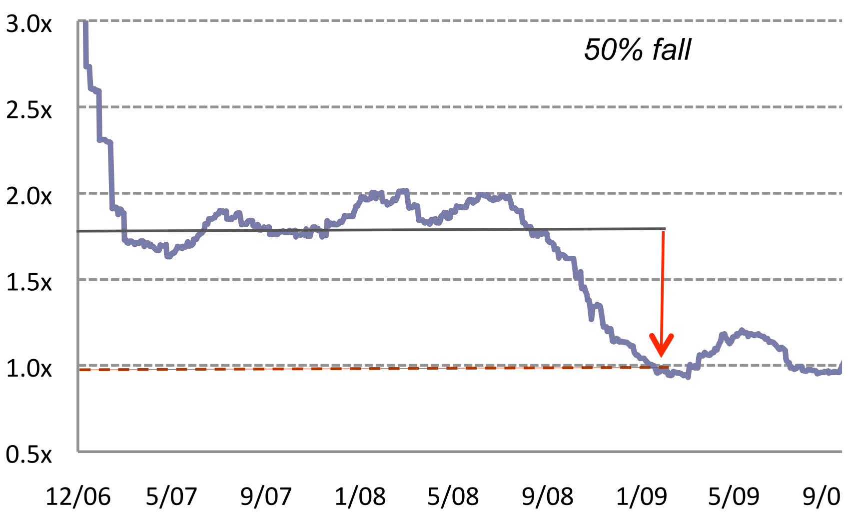
OIC equity markets are recovering from 2008 losses with narrowing of CDS spreads indicating lowered risk premiums



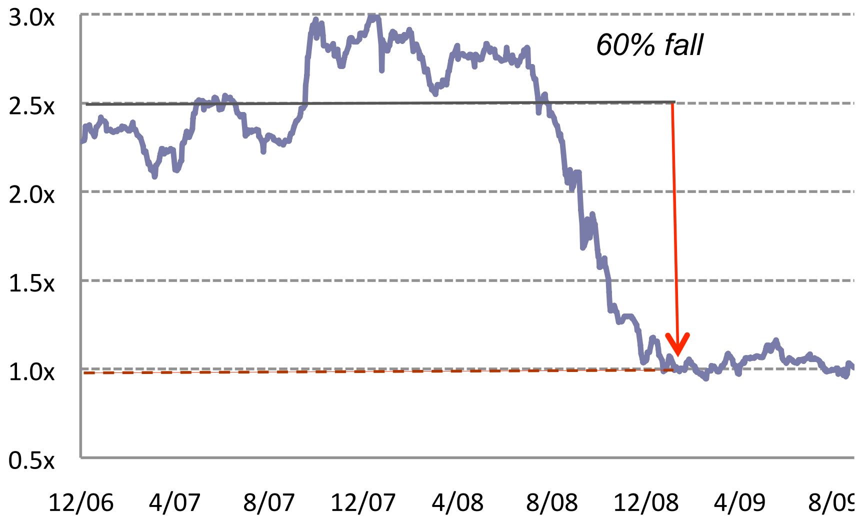
Source: Bloomberg

OIC banking sector valuations have halved but are recovering

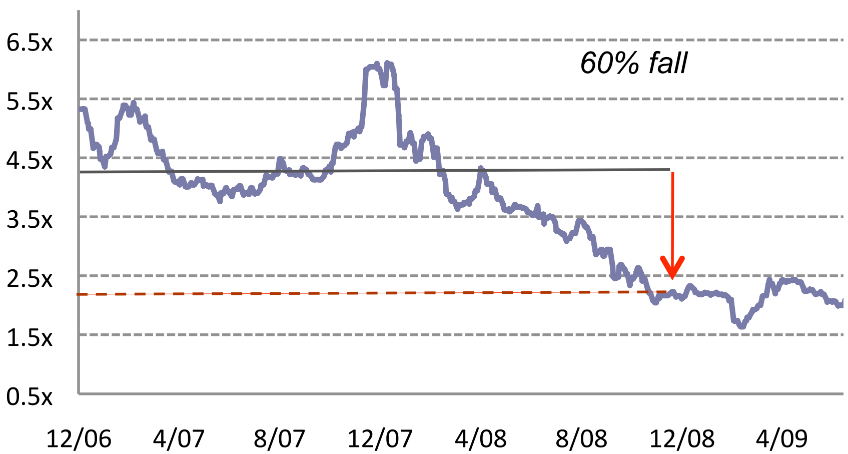
Bahrain – P/B



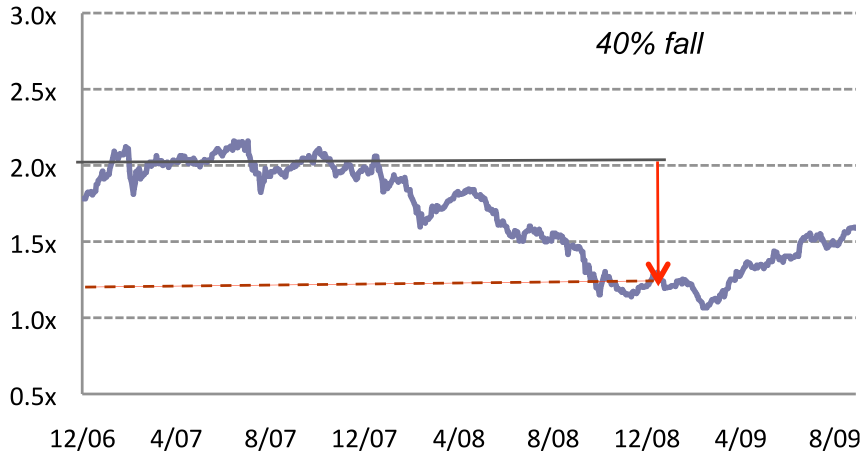
UAE – P/B



KSA – P/B



Malaysia – P/B



Source: Bloomberg

Impact of current crisis on select OIC economies

Saudi Arabia

– Saudi conglomerates Saad Group and Algosaibi default on $22b of debt that affected 120 banks. Debt restructuring underway.

+ Government spending is a key driver of economy as lending to private sector is at a 9-year low. Specialised credit agencies to disburse $400b over 5 years.

= Outlook: very positive with AA rating due to strong fiscal position. Net foreign assets at SAMA rose by $378b during 2003-08

UAE

– Dubai's SWF entities under pressure due to debt-fuelled spending and property price correction forced the merger of the two biggest home lenders

+ Dubai government issued $20b emergency bond to provide loans on a "commercial basis" to troubled government-related entities

= Outlook: Some sector stabilisation underway for Dubai, however Abu Dhabi is largely unaffected with AA ratings and unabated spending on 2020 vision

Kuwait

– High profile losses of Kuwait's Gulf Bank ($1b on derivatives exposure) and defaults from Global Investment House ($200m) and Investment Dar ($100m sukuk)

+ Government introduced unemployment benefits for citizens of private sector and reformed sponsorship system bringing new dynamism to labour market

= Outlook: stable on large oil savings with AA rating however alignment between parliament and monarchy is key

Malaysia

– Malaysia's diversified and globally connected economy was impacted by recessionary trading partners

+ Government launched massive $16.5b stimulus package equivalent to 9% of GDP (largest relative to GDP in Asia)

= Outlook: stable with A rating due to budget deficit outlook but recovery assisted with diversified economic base and strong fundamentals

Source: IIF 28 Sep 2009; EIU Country Report Jul 2009

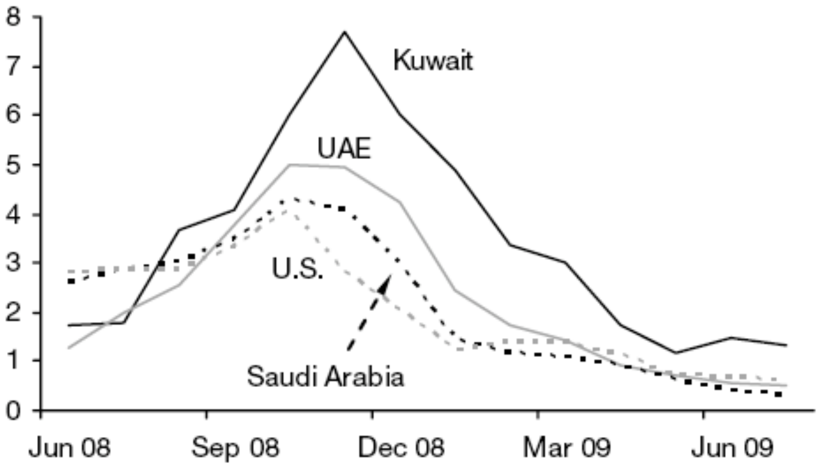
Policy responses of the GCC economies

Policy Response to the Global Finacial Crisis

	Deposit Guaran.	Liquidity Support	Capital Inject.	Equity Purch.	Monetary Easing	Fiscal stimulus
Bahrain		x			x	
Kuwait	x	x	x	x	x	
Oman		x		x	x	
Qatar		x	x	x		x
S. Arabia	x	x			x	x
UAE	x	x	x		x	x

Interbank 3 Months Deposit Rates

percent



Source: Saudi Arabian Monetary Authority

- **Financial contagion reaches the Gulf**

  Extraordinary measures adopted to ensure normal functioning of financial markets and reputation of certain hubs as financial centres

  E.g. UAE central bank guarantees all 24 local bank deposits and inter-bank lending and required a $14b fund to boost liquidity in 2008

- **Monetary easing has lowered funding costs**

  Authorities are taking proactive action in restoring confidence and stability to prevent a downward spiral

  Governments are also using fiscal stimuli spending on social sectors and infrastructure to cushion the downturn

  E.g. Saudi Arabia $400b package over 5 years

Source: IIF 28 Sep 2009

Key challenges looking ahead

OIC MENA

- **Steep decline in oil prices**

  $147 (May 08) to $50 p.b (Dec 08) swing will pressurise fiscal balances of oil-exporting countries

  Key challenge of raising productivity levels of non-hydrocarbons sector through structural reforms is underway which has boosted region's resilience to future oil price shocks
- **Financial contagion exposure**

  Exposure to derivatives, defaulting family-conglomerates, real estate downturn and 50% stock market collapse have required heavy government support

  Governments have ensured swift and robust crisis policies to normalise banking system activities
- **Troubled local businesses**

  Tightening of credit markets has seen 4x increase in borrowing costs and cancellation of a quarter of commercial and infrastructure projects

  Governments need to resort to directly inject capital flows via funds given policy rates are now near zero

OIC Asia

- **Attracting private capital flows**

  "Flight to safety" saw funds withdraw to liquid safe holdings – short term net capital inflows projected to decline by 60% to $562b in 2009 but will recover

  Normal credit lines to SMEs could be curtailed, reducing the ability to undertake trade financing
- **Weakened export-earnings prospect**

  Steep falls of up to 27% (from 2007 peak) in prices of major non-oil commodity exports will affect earnings of less-economically developed and export reliant nations

  Regional trading partners need to be sought to cushion the projected export growth fall from 8.3% (2008) to 2.6% (2009)
- **Impact on poverty**

  Falls in remittance flows and official grants are projected to drastically fall given recessionary environments of OECD economies

  Extreme poor projected to increase to 130m requiring $38b spending to raise to poverty line level. Alternate welfare mechanisms are required e.g. microfinance initiatives

Source: IIF 28 Sep 2009; IDB 17 Jan 2009

Islamic finance can contribute to post-crisis financial architecture along two fronts

Conceptual Benefit

- **Debt as a least preferred form of financing**
  - Investment orientation, not debt culture
  - Sale of debt prohibited
- **Inherent equity orientation and bias**
  - Model is built around participatory financial structures rather than penalising equity holders
  - Benefit of risk-reward alignment
- **Linkage to real economy**
  - Transactions are asset-backed
  - Prevent inverted "pyramid of debt" beyond the asset value
- **Risk-sharing not risk-shifting**
  - Prohibition of uncertainty and speculation in contracts
  - Short-selling and exotic derivatives (e.g. CDS and CDO) not permitted
  - "Narrow" banking principles and "full reserve" banking

Direct Impact

- **Islamic finance taps sources of Islamic savings and fund portfolios**
  - OIC world SWF assets of $1.8 trillion can supply much needed capital[1]
  - As much as one-half of Muslim world's savings will be in Islamic financial institutions by 2015[2]
- **Islamic finance as a tool for corporate competitive differentiation**
  - Islamic finance affinity to reach out and tap OIC export markets
  - Provides source of cross-border line financing

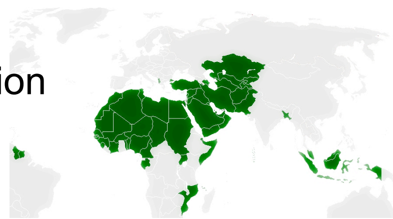
Source: (1) estimated from SWF Institute 26 Oct 2008; (2) UNCTAD Report 24 Sep 2008

Several practices from the Islamic banking sector are relevant to the conventional sector following the crisis

1. Increased emphasis on asset-based financing
2. Limits on the sale of debt and preference for equity financing
3. Greater transparency in transfer of debt and linking to origin
4. Introduction of “Ethical Supervisory Boards”
5. Evolving financial architecture to be based on separation of risk-free and risk-bearing accounts
6. Prioritizing research and development with two-way transfer of best practices

Concluding Thoughts

- **The crisis has started a global power shift that will re-define the drivers of future growth**
  - OIC world is positioned as the next frontier for growth
  - Capital inflows for OIC markets with robust governance structures
- **The crisis also provides an opportunity to develop regional trade ties and consolidation efforts**
  - Recessionary environment of traditional OECD export partners will foster greater regional trade partnerships
  - Distress mergers and attractive valuations may pave the way for economies of scale consolidations, e.g. in overbanked Gulf markets
- **OIC markets continue to remain full of opportunity, with attractive potential and dynamics**
  - 1.6 billion consumer market – $6,000 GDP per capita
  - 5.9% average GDP growth rate (2003-07)
  - OIC world SWF assets have become a major source of capital
- **Islamic finance will get favorable tailwinds, given the continuing troubles of the conventional banking system**
  - In-built mechanisms to prevent excessive leverage or speculation
  - Growing Islamic asset pools can be tapped for competitive differentiation
  - Emerging trend of “debt to equity” rotation



Source: IDB 17 Jan 2009

Islamic finance should reach out with a demonstrable model to the conventional banking industry

"He who receives an idea from me, receives instructions himself without lessening mine. He who lights his candle at mine, receives light without diminishing me.”

– Thomas Jefferson

Thank you