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Lagarde's damning verdict on Europe's banks: 'stop dragging out reform'

Exclusive

By Anthony Rowley

The head of the International Monetary Fund has made a dramatic intervention in the debate over the health of the European banking sector, saying the problems are the result of their failure to follow the US in carrying out tough reforms in the wake of the global financial crisis.

In an exclusive interview with *Emerging*

Markets, Christine Lagarde said she was concerned by "market trepidation around one Italian Bank, one German bank and questions around some of the more southern European countries' banking systems".

Last week shares in Germany's Deutsche Bank fell sharply amid concerns over whether it could survive the impact of a \$14bn fine by US authorities, while Monte dei Paschi, Italy's third-largest bank, has been ordered by the European Central Bank to reduce its holdings of bad debts.

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Lagarde: problems need to be addressed

Record world debt much worse than IMF numbers — \$162tr says IIF

By Anthony Rowley

If you thought the colossal volume of world debt revealed by the IMF yesterday at \$152tr was scary, look away now. According to the leading trade body representing global banks, the Institute of International Finance, the figure is much worse, at \$162tr, or 243% per cent of world GDP.

The new number, which goes up to June 2016, was revealed to *Emerging Markets* by Hung Tran, executive managing director of the IIF, and trumps the IMF total which was generated on a new database that covers 130 countries covering the 15 years to the end of 2015.



Tran: borrowers could be 'in trouble'

Tran added that if bank debt is added in, global debt soars even higher to an enormous \$216tr, or 327% of GDP. Even though bank debt is in the form of loans to the non-financial sector and "washes out," it still represents "loan contracts"

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Nigerian finance minister slams 'hypocrisy' in climate finance

By Owen Sanderson

Kemi Adeosun, the finance minister of Nigeria, has attacked the "hypocrisy" of Western governments in stopping developing countries accessing development bank finance for coal power.

"We're being blocked from coal because it's not green, and there's some hypocrisy in that," said Adeosun. "We had an entire Western industrialisation that was built

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FINAL WORD

Jim O'Neill

IIF

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and should be included in the global total, he said.

Victor Gaspar, director of the IMF's Fiscal Affairs Department, warned that the record levels of debt could lead to a "financial crisis" in the absence of pre-emptive fiscal and other measures to deal with the situation.

INTEREST RATE RISES

Gaspar told *Emerging Markets* that despite the record debt levels he was "not worried" about possible market reaction to further rises in the US Federal Reserve's interest rates. However, the IIF's Tran said there were causes for concern.

Debt service costs had risen, even in the face of record low interest rates, because of the "sheer scale" of global debt, said Tran. And, if interest rates rose, either because of Fed action or an increase in "inflation expectations" borrowers were going to find themselves in trouble, he said.

That will add to the "headwinds" that are already slowing the global economy and that in turn will restrict growth further and raise the level of non-performing loans and financial sector distress, Tran added.

Around two thirds, or some \$100tr, of the figure quoted by Gaspar represented private sector debt while the rest was in the public sector, where overall debt had now reached 85% of GDP. "Excessive debt is a major headwind against global recovery and a risk to financial stability," the IMF official said. "Rapid increases in private debt often end up [causing] financial crises [and] financial recessions are longer and deeper than normal recession."

Private debt, he noted, "is concentrated in advanced countries and a few systemically important emerging market economies". In advanced economies, "which were at the epicentre of the global financial crisis, deleveraging has been uneven and in many cases private debt had continued rising. Public debt has also surged in these countries, partly due to the migration of bad debt of the private sector into the government balance sheet."

According to the IMF's latest Fiscal Monitor, "low nominal growth is a major driver behind slow deleveraging in advanced economies." Fiscal policy "can do more to restore growth and stability," Gaspar suggested. "Targeted fiscal intervention in the form of government-sponsored programmes to help restructure private debt can be very effective, particularly in China."

Fiscal policy "cannot go it alone" Gaspar added. "Policy frameworks that include monetary, fiscal and structural measures [can lead to] an eventual sustainable downtrend in government debt to GDP ratios".

China's bad debt problem: a reckoning is coming

By Elliot Wilson

A new crisis is brewing in China, where debts at leading corporates and banks have risen to unsustainable levels, threatening domestic and global economic stability and increasingly the likelihood and regularity of future shocks.

At the heart of the problem sits the toxic brew of non-performing loans (NPLs) within China's 4,000-plus central, state, and city-level banks, some of the country's leading private sector economists have told *Emerging Markets*.

According to government data, the banking industry's NPL ratio was 1.75% at the end of June 2016. But independent voices say this drastically underestimates the problem. "The real rate is far higher than the official data suggests," says Xiang Songzuo, chief economist at Agricultural Bank of China. "China's commercial banks readjust and redefine what counts as a bad loan at will. The real NPL ratio is between 7%-8%."

Francis Cheung, chief China strategist at Hong Kong-based investment bank CLSA, believes the true ratio of bad loans to all lending in the country is even higher, "around 15%", or 10 times higher than official estimates," he says.

CLSA's Cheung reckons that a quar-

ter of all firms listed in mainland China do not make enough profit to pay their interest expenses.

China has attempted to tackle the issue. Earlier this year, it re-opened its securitized bad debt market. In September, the government kick-started a debt-to-equity swap reform with Beijing-based Sinosteel paving the way, swapping Rmb27bn (\$4bn) of its debt for equity convertible bonds.

But this redistributes corporate debt rather than solving the problem, and could undermine the wider banking sector. Société Générale has warned that large-scale SOE debt restructuring could plunge the country's banks into crisis

GOING UNDER

Experts say the government will ultimately be forced to let some SOEs, and even a few non-systemic banks, fail.

"The state will be forced to let some companies go under, and the banks will just to absorb the losses, says Ag Bank's Xiang. "The biggest eight steel firms have total outstanding loans of Rmb3tr, and 30% of those loans will go bad in the next year or two. The coal sector is even worse off. When they fail — and they will — it's probably that more than a few smaller



Xiang: 'The real rate is far higher than the official data suggests'

local banks will go under as well."

China's cautious policymakers are presented with a dilemma. They can either act to dissolve its most troubled SOEs, thus raising the prospects of a Lehman-like banking crisis, or to continue to roll over debt, thus increasing the chances of China suffering a long, Japan-like stagnation.

Either way, a reckoning is coming. "High debts raise the chances of China seeing a serious shock, at least once a year," says CLSA's Cheung. "It was the domestic A-share crisis last year; next year, he tips prices in the property sector, which have surged in recent quarters, to crater, "dampening consumer sentiment, and causing a surge in bank NPLs. Debt levels are making China's economy fragile."

Nigeria

Continued from page 1

on coal-fired energy, and that's the competitive advantage that's been used to develop Britain, certainly, where I grew up."

She continued: "Now Africa wants to do it, we get 'it's not green, you can't do it, you should go do solar and wind', which is the most expensive power form... Those who started it should lead. Those who have been doing it for 200 years should not tell us not to do it."

Her remarks were partly in reference to the reported split between the African Development Bank and the World Bank over partial risk guarantees.

In spring 2015 the AfDB set up a partial guarantee with Nigerian Bulk Energy Trading, but, according to NBET's president, the World Bank declined to support the facility because it financed coal. The AfDB extended further risk guarantee facilities to NBET and the Nigerian power network TCN in July this year, again without the World Bank's involvement.



Adeosun: West is being unfair

But the debate is far wider than that.

Many of the investment banks which signed agreements to stop financing coal power in the wake of the Paris agreement carved out lending to developing or emerging economies. BNP Paribas and Société Générale, for example, pledged no new lending to coal in high income countries, while HSBC pledged no new lending to projects with a carbon inten-

sity of more than 850g per kilowatt hour — but put in place a lower cap of 550g for richer countries.

Adeosun's views were echoed by Professor Paul Collier, also part of the panel session of infrastructure in developing countries, and by Anders Borg, former finance minister of Sweden and chair of the World Economic Forum.

Collier said: "What's the sensible and ethical way to close the coal industry? Start with richest and finish with poorest."

He asked Adeosun whether she would commit to closing coal if rich countries did it first, and she replied: "Of course, because it would be fair."

Jonathan Taylor, vice president of the European Investment Bank, pointed out that the West was now at least being consistent — the EIB's guidelines for new lending use the same 550g cap as HSBC, which according to Taylor, virtually rules out coal.

But, challenged on the EIB's back book by Borg, he acknowledged that around 20% of its energy project portfolio was still coal-fired.

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OUT OF THE WOODS

Seen and heard in the corridors of the Annual Meetings

• **/It takes tow** Outside the World Bank building, a hefty DC policeman strides up to shifty looking (and equally chunky) type stapling fliers to a lamp-post, ready to do some admonishing. Yet the man is merely advising motorists to park elsewhere while the conference is on, and he backs off. "Has anyone had their car towed here," *OOTW* asks the cop. "Yeah, mine, few years ago," he replies with a grimace. "Found my car parked up outside the Treasury building six hours later."

• **/Who's the boss?** Are the Bretton Woods Twins running short of willing moderators at this year's conference? It was tempting to think so after seeing IMF supreme Christine Lagarde asked to hustle a seminar on technology and innovation, while a panel headed solely by World Bank bigwig Jim Yong Kim and chief economist Paul Romer had no moderator at all. Attendants found themselves in the unusual position of yearning for Richard Quest.

• **/No soup for you!** An invitation to a \$1,000-a-head 'finance-and-fintech' event organised by the vigorous-sounding Caribbean-Central American Action arrives by email. Nine hours spent discussing Caribbean banks in a dimly lit hall, anyone? Perhaps not. But CCAA director Gwendolyn adds a kicker. Registration is free for journalists, she said, but lunch is not. *OOTW* turned up anyway – one of only two members of the Fourth Estate to bother – and nicked a cookie. Fight the power!

• **/Public censure.** Oxford University's Paul Collier is often described as a 'thoughtful economist' who eschews sweeping statements. At an infrastructure panel, he wondered aloud why African sovereigns would indent themselves by paying crazy yields of "10% or more". Nigeria's finance minister Kemi Adeosun, seated alongside the ruddy-faced academic, pointed out that Nigeria paid 6.8% for its latest Eurobond. "Whatever, whatever", Collier replied, flapping his arms around and looking mildly alarmed.

• **/No logo/IMF ueber alles** Spotted outside the conference: a group of fortysomething tourists being photographed in front of the IMF logo: some gurning; others mid-jump. A German couple then tarry a while with their young son, who correctly identifies the flags of Russia and Belgium. "And which is the best country," Daddy asks of his progeny. The boy pauses then lights up. "Deutschland, Deutschland, Deutschland", he cries, while his parents hustle him away.

Rising nationalism threatens Turkish growth

By Virginia Furness

Terrorism, a military coup attempt, and a sovereign downgrade have failed to deter dedicated EM investment in Turkey, but deteriorating growth prospects and increasing nationalism may threaten its long term outlook, according to leading economists.

On Tuesday Turkey slashed its forecasts for GDP growth this year to 3.2% from an earlier forecast of 4.5%, putting it in line with the IMF's real GDP projection of 3.3% for 2016 and 3% for 2017 that it issued this week.

While many expected revised growth numbers, investors are starting to question the effectiveness of government and central bank policy to stimulate growth. In addition, Turkey's increasingly nationalist stance is threatening to undermine investor confidence.

"The impression I get from speaking to locals and the corporate community is that there is a significant fear factor," said Viktor Szabo, a senior investment manager at Aberdeen Asset Management in London. "It's not just the usual uncertainty but the ongoing purges, it is poisoning business relations. Turkey needs FDI but despite noise about ease of access to local markets, it is very difficult to do business there."

Turkey's relationship with trading

partners, particularly Europe, is complicated. Relations on both sides cooled substantially in the wake of Turkey's failed coup attempt on July 15. The European community was shocked by Turkey's move to round up thousands of military personnel and by the associated talks to reintroduce the death penalty.

The EU issued a statement to say the measures taken were "unacceptable" and that they were "concerned" by Turkey's decision to declare a state of emergency. This was recently extended by President Recep Tayyip Erdogan's administration. Turkey was in turn dismayed by Europe's response.

While both sides have proceeded with a relationship of mutual suspicion regarding the immigration deal, anti-terrorism laws and visa-free travel, the relationship could deteriorate further should Turkey reintroduce the death penalty, something which analysts say cannot be discounted.

In addition, now the likelihood of EU membership is waning, analysts are concerned that Erdogan's increasingly errant and nationalistic policies may further impact the business environment, as well as relationships with European partners.

"The prospects for EU membership



Erdogan: fear factor

have long provided an important policy anchor," said Markus Schneider, senior EM economist at Alliance Bernstein. "Yet with EU accession firmly on hold post-Brexit, this anchor is likely to weaken again and risks alienating Turkey from its European counterparts."

While Turkey's move to extend by 12 weeks the state of emergency declared post-coup has alarmed some, Schneider points out that Turkey has used its powers of decrees exclusively to counter the threat of domestic terrorism, and not for any other policy measures. "They have been relatively disciplined so far," he said.

Colombia faces downgrade threat after rejecting peace deal, tax reforms in doubt

By Lucien Chauvin

The Colombian government's stinging loss in its referendum on a peace deal with Marxist rebels could complicate a long-anticipated tax reform to boost revenue. Meanwhile, the value of Colombian assets have fallen on fears the shock result could lead to a ratings downgrade.

President Juan Manuel Santos's government, and most political and economic analysts, were banking on a solid win in the October 2 referendum for the peace agreement signed a few days earlier with the Revolutionary Armed Forces of Colombia (FARC). It would have ended 52 years of war and, according to the government, lasting peace would have added one point annually to GDP growth.

A slim majority of Colombians saw things differently, with the "no" camp receiving 50.2%, a victory of approximately 54,000 votes.

The huge blow to the Santos government, which spent four years negotiating the 297-page agreement, could undermine a revenue-raising tax reform that should go to Congress on October 10. The stakes of the reform are high, with failure to improve revenue potentially leading to a downgrade in its creditworthiness by rating agencies.

Previously, financial markets had largely ignored Colombia's peace process, but the

country's currency and sovereign bonds slumped this week in response to the shock vote. The peso weakened from Cp2,868 per dollar before the vote to Cp2,960 early on Tuesday, while the government's dollar bonds were down between 1.5 and 2.5 points in secondary markets. JP Morgan said on Monday that "the market will likely price in the risk of a downgrade to Colombia's rating".

The tax reform has been in the works for months. It includes three large areas, increasing value-added tax (VAT), reducing and simplifying corporate taxes and eliminating loopholes to reduce tax evasion. The details have not been released, but the reform should include a three point increase in the VAT to 19%.

REWORKING THE NUMBERS

Finance Minister Mauricio Cárdenas said while the final numbers are still being worked out, he believes that a reduction in capital expenditures in the 2017 budget and increased revenue from the tax reform would allow the government to comply with its fiscal rule.

"Tax reform, together with the 2017 budget, will reaffirm Colombia's fiscal sustainability. Fiscal consolidation is going to reassure Colombia's BBB rating," he said before the referendum.

The referendum results means the government is going to have to work much harder to get Congress to go along.



Cárdenas: referendum a serious blow to reforms

"The failure of the referendum is a serious blow for the government and particularly President Santos himself. The key risk is that he starts to face more resistance in Congress as other political players try to take advantage of his weakened position," said Adam Collins, Latin American economist at London's Capital Economics.

Ramón Aracena, chief economist of the Institute of International Finance's Latin America Department, agreed that Santos is now in precarious position. "The capacity of the government to implement a required tax reform for next year is diminished, because the Santos government has no political capital now to push forward the reforms," he said.

Argentina bond spree spreads to Europe amid hefty demand

By Olly West

Argentina took a further step in its reintegration to global markets on Wednesday, selling €2.5bn of euro-denominated bonds as the search for yield continues to benefit emerging market sovereign issuers.

In its first visit to the euro market in 15 years, Argentina raised €1.25bn of five year bonds and €1.25bn of long 10 year notes.

Mauricio Macri's economic market-friendly government has become a darling for fixed income investors — even has it had to increase its primary fiscal deficit expectations for 2017 from the 3.3% it promised in January to 4.2%.

The need to finance the fiscal deficit means that such market access is crucial for finance minister Alfonso Prat-Gay, who has opted to take a slow but steady approach to reducing the deficit in order to avoid a short-term shock to the economy.

So far, bond investors — starved of yields in developed markets — have been accommodating.

"The gradualist approach to fiscal consolidation is the safest one politically, and has been facilitated by very accommodating markets," said Gustavo Cañonero, former chief EM economist at Deutsche Bank and now partner at Grupo SBS, the Buenos Aires-based asset manager and investment bank.

"If Treasury rates were not at 1.5% we would not have had the option of being gradual."

After announcing initial price thoughts of 4.5% for a new bond maturing in 2021 and 5.625% for a new 5.625%, bookrunners BBVA, BNP Paribas and Credit Suisse attracted some €725bn of demand. This allowed the leads to tighten guidance several times before launching each tranche at €1.25bn at final respective yields of 4% and 5.125%.

"It is very smart of Argentina to diversify their funding sources given the amount of debt they have to raise," said the head of EM bond syndicate at one bulge bracket investment bank. "My only surprise is that they did not raise even more."

The Argentine government has already captured \$19.25bn of dollar denominated bonds on two different occasions this year, after reaching an agreement with holdout creditors in April. Bankers say the euro market was a natural area for expansion, while there are rumours that the sovereign is contemplating the issuance of a Panda bond.

Funding needs for 2018 could be as much as \$15bn equivalent, depending on the success of the government's tax amnesty.

In another show of investor appetite not just for yield and Argentine credit risk, but also for Argentine currency risk, mortgage lender Banco Hipotecario also announced a bond deal on Wednesday.

The bank is planning to raise \$300m of peso-linked three year bonds via Deutsche Bank and Santander. The bond will be placed on Thursday.

Tanzania's Ndulu: 'We are the champion of financial inclusion'

By Olivier Holmeyer

Tanzania's relentless push to digitise, and expand, access to financial services has produced a level of inclusion unseen anywhere else in Africa, the country's central bank governor Benno Ndulu has told *Emerging Markets*.

Much of the financial community still looks to Kenya as the role model for modern, accessible banking services, owing in large part to the stellar rise of M-Pesa, a phone-based money transfer and microfinance company launched there just nine years ago and now used by the vast majority of the country's adults.

But Ndulu said Tanzania had caught up with, if not overtaken, its northern rival, and was now on course to deliver near universal financial coverage to its population.

The governor said that eight out of 10 adults in Tanzania would have access to formal financial services by next year, either through a traditional bank account or thanks to a mobile money operator. A decade ago, more than half of the population was still excluded from the financial sector, and over a quarter relied on informal forms of banking. Five years ago, when Kenya's mobile banking sector was

already booming, virtually no such transactions were taking place.

Now, things look very different, and progress is happening fast. "We are the champion of financial inclusion," said Ndulu. "The big push is in technology."

Because virtually all adults in Tanzania, even in remote areas, now have a mobile phone, or access to one through a friend or family member, the prospect of full inclusion is no longer a distant one.

One advantage Tanzania has over Kenya is that rather than depend on a single innovative business to expand financial coverage, it has fostered a competitive landscape, where various firms fight for a piece of the country's unbanked population.

Ndulu said Tanzania had avoided a situation in which M-Pesa has a *de facto* monopoly, as in Kenya, instead ending up with five such companies — with all the advantages that brings for consumers. "As a result, the rates are lower," he said.

And the technology is more flexible in Tanzania, too. He says: "In Kenya, if you hold an M-Pesa account and I hold an Airtel account [another mobile money operator], you have to go to an agent, get cash or buy e-units to pass the money across from one to the other. In Tanzania you can easily transfer it directly. We are the first in the world to have done this."



Ndulu: big push in technology

That is, he says, because the Tanzanian central bank, under his impulse, has been more willing to take risks, allowing innovation to take place unregulated, then monitoring how the changes play out on the ground, and only afterwards regulating the new technology, if necessary. Most other central banks would regulate before allowing new financial services to be offered to the public, Ndulu added.

Underlying his attention to financial inclusion, and the technological means of achieving it, Ndulu, who won *Emerging Markets' Central Banker of the Year for Africa* award in 2009, said: "My legacy, more than anything, is in tech."

More than inflation reduction or any other project he has worked on, helping to guide the growth of technology has been the core pride of his tenure, he said.

Ndulu is a year away from completing his second, and final, five year mandate as governor.

Rate market divergence can only go so far — EIB

By Craig McGlashan

Fears that the interest rates set by the world's four major currencies will continue to diverge are overplayed, according to a senior official at the European Investment Bank.

"While diverging rate paths in different geographies are not impossible, large international rate markets are so intertwined, that in reality there seems to be a limit to the extent that global rate markets can move in completely different directions," Bertrand de Mazières, director general, finance at the European Investment Bank told *Emerging Markets*.

The central banks responsible for setting rates for the world's four core currencies have never been so far apart in their policies since the financial crisis of 2008. The US Federal Reserve is in a rate rising cycle — albeit a very slow one — the Bank of England is embarking on another round of quantitative easing, the European Central Bank has added corporate bonds to its purchase programme and the Bank of Japan is attempting to control not just short term interest rates but long term ones too.

The BoJ's attempt to steepen the Japanese government bond curve by keeping 10 year interest rates at 0% — an initiative introduced in September dubbed "yield curve control" — led to

speculation that domestic Japanese investors might be tempted to refocus their purchases into onshore securities, possibly dampening demand for bonds from issuers outside the country.

But the interconnectedness of the global markets makes this an unlikely prospect, according to German development bank and major bond issuer KfW.

"The Japanese capital market is a strategic market for us and all groups of investors play an important role in our funding activities," Günther Bräunig, member of the KfW executive board in charge of capital markets, told *Emerging Markets*.

"Retail investors look for yield enhancement via Uridashi bonds, which are usually foreign exchange or Nikkei-linked, and the low yield environment fuels demand for these products. Institutional investors in Japan are very professional and look for portfolio diversification in all respects. Yield differentials therefore only play a limited role when it comes to their decisions."

SELL THE RUMOUR?

But yield differentials do have a big impact in other areas.

This week, the Republic of Italy, despite concerns over the health of its banking sector and a constitutional reform referendum in early December



De Mazières: there seems to be a limit to the extent that global rate markets can move in completely different directions

was able to sell a €5bn 50 year bond, its longest dated benchmark ever.

Less than five years ago, many in the market were concerned that Italy would have to join Greece, Ireland and Portugal in seeking a bail-out.

But nearly 370 investors placed more than €18.5bn of orders for Italy's issue this week, suggesting that either the buy-side is comfortable that Italy's problems are not as bad as a few years ago — or, more likely, that the effects of quantitative easing have trumped all other concerns and have forced investors to grab yield where they can find it.

That proved true after rumours surfaced shortly after Italy priced its bond that the ECB might consider tapering its bond buying programme — which dented the price of Italy's new bond in the secondary market. The ECB swiftly denied the claims.

Air Astana IPO to rekindle investor love for Kazakhstan

By Elliot Wilson

Kazakhstan is struggling to convince global investors to put their capital to work in the Central Asian state after being hit by low oil and commodity prices, rising spending and low growth.

Investors and bankers say the clearest path to putting Kazakhstan back on the investment map will be via a series of sizeable stock listings of leading Kazakh firms, planned for the months ahead. The procession will be led by Air Astana, which is planning a dual initial public offering which could net the national flag carrier Air Astana upward of \$500m, bankers said.

The IPO, which is unlikely to be completed before the first half of 2017, will likely see shares sold in the Kazakh capital Astana, and on a second bourse, with London seen leading the pack, ahead of Hong Kong and Singapore. Air Astana is owned 51% by sovereign wealth fund Samruk-Kazyna, with the rest controlled by Britain's BAE Systems.

"They should raise between \$500m and \$1bn," said one banker involved in discussions with the Kazakh government. "But it all depends on timing and execution. If they get it right, it will transform how the global investment community views Kazakhstan."

Astana's image among global investors has been hit hard by last year's devaluation of Kazakhstan's currency, the tenge, and by a series of scandals undermining Kazakh firms listed abroad.

Other IPOs planned for 2017 and 2018 include domestic energy major KazMunaiGas, uranium producer Kazatomprom, and railway monopoly Temir Zholoy. The sale of one or all of those major state firms will go a long way to raising the \$6bn the government is targeting to help Astana fill a yawning hole on its budget, caused by the longstanding decline in resources prices, and to meet its social security spending needs.

Officials also pointed to the importance of the "One Belt, One Road" project, a \$4tr-plus project to link China with Europe overland, via Central Asia, Russia and the Middle East. Janet Heckman, country director for Kazakhstan, at the EBRD, said OBOR was "critical to everything we are doing in Kazakhstan, especially now you are seeing commercial corridors being built through Iran and Pakistan, and increased shipping transiting the Caspian Sea, all of which is part of OBOR".

Michael Sauer, chairman of Almaty-based investment bank Visor Capital, said Chinese investment was transforming the region's economic prospects. "Some of these economies are just a few billion dollars," he said.

"Add in a few billion from the various Chinese lending institutions, such as the \$40bn Silk Road Fund, and you're already adding a few percentage points to economic growth. This is where the growth is going to come from in Kazakhstan and around Central Asia in the years to come."

GCC to keep borrowing to finance reform despite rising oil price

By Virginia Furness

Gulf countries are not planning to reduce their international capital market funding requirements despite a rise in the oil price following the Organization of the Petroleum Exporting Countries (Opec) cutting production last weekend. Instead, Gulf Corporation Council countries are maintaining their funding targets, determined to use the money to drive through much needed fiscal reform.

While higher oil prices may aid the GCC's bid to balance its budget and improve investor sentiment towards the region, they will not mean that the reform agendas will be set aside, according to Jarmo Kotilaine, chief economic advisor to the Bahrain Economic Development Board (EDB).

"There has been such a squeeze in oil sector investment and the government is aware that tables can turn very quickly," said Kotilaine. "Nonetheless, all GCC countries have developed the view that markets have changed for good. This will drive fiscal reform and government restructuring. But we are also seeing new, innovative ideas of how to use oil better and differently."

After months of refusing to cut production, Opec signalled its intention to support the market, and agreed to reduce output to between 32.5m and

33m barrels per day, and the price rally may help reduce fiscal deficits.

In a June report, the IMF estimated that the cumulative fiscal deficits of the GCC and Algeria was projected at almost \$900bn during 2016-21.

Low oil prices have exacerbated Bahrain's fiscal deficit which was estimated

to be 12.5% of GDP earlier this year and the kingdom is committed to a programme of fiscal and structural reform, and to balance its budget by 2020, which is echoed elsewhere in the Middle East, most notably Saudi Arabia. It has so far raised \$3.35bn in the international markets this year.

GCC countries have raised more than \$24bn in the capital markets this year and with Saudi Arabia due to print a \$10bn-\$15bn deal this month, and Kuwait touting a near-\$10bn bond, issuance volumes will hit the highest ever annual levels. Luckily for the GCC, such large funding needs have been met with strong investor demand as the hunt for yield pushes the buy-side down the credit spectrum.

GROWTH SLOWDOWN

Bahrain's GDP growth slowed to 2.9% in 2015, according to the IMF's World Eco-



Healthcare in Bahrain: diversified growth

nomie Outlook published this week, and the government has maintained an expansionary fiscal stance since 2009 resulting in budget deficits and rising debt, which was exacerbated by low oil prices.

Investors appear undeterred by these metrics however and poured orders of \$6bn into the \$2bn dual tranche 12 year conventional bond and 2024 sukuk on Tuesday. Bahrain, rated BB/BB+, had a difficult start to its funding year after it was forced to cancel a reopening of both its 2021s and 2026s in February after a shock move by Standard & Poor's to downgrade the sovereign to junk.

Kotilaine of the Bahrain EDB said that more than 80% of Bahrain's GDP now came from the non-oil sector, representing a big shift for the kingdom. Bahrain is seeing growth in private healthcare, transportation and construction and has an infrastructure investment pipeline worth in excess of \$30bn, according to Kotilaine.

The time has come for local African capital markets, says MEFMI

By Lucien Chauvin and Thierry Ogier

South and east African countries need to co-operate on developing local capital markets and pool central bank resources if the region is going to find a way out of the many cycles of crisis it has endured.

Local capital markets will need to be developed if these countries are to free themselves from a dangerous over-reliance in aid and grants and funnel investor cash looking for high yields into the many infrastructure projects in the region in need of finance.

Speaking on the fringes of the IMF annual meetings this week, Caleb Fundanga, executive director of MEFMI, a grouping of southern and eastern African countries, is encouraging members to move on policy reforms that would allow for the advancement of a regional capital market.

"We have to develop an African capital market. It is an idea whose time has come because there is no reason why we should be investing in low yield paper from OECD countries," he said. "It is going to be a hard sell, but we have to start now if we want to find a way out of these cycles of crisis."

Fundanga said a lack of capital markets blocked access of African countries to available cash. "There is a lot of

money today and we have many projects that offer very high yields. We need to get policies in place so investors can look to us to place capital," he said.

Fundanga is not alone in pushing the need for capital market development. The African Development

Bank (AfDB) has launched its own financial capital market initiative to create a more vibrant capital market that will support development in the region.

Charles Boamah, AfDB vice president of finance, said countries had traditionally relied on official flows, grants and other types of support that were declining or, at best, stagnant.

"You now have to look at other sources to finance your development. Aid and grants still have a role to play. So we put on sharp focus the need to rely more on capital markets, to channel savings into profitable development projects. It is going to grow in importance," he said.

POOLING RESOURCES

Powell Mohapi, chief economist at the



Fundanga: 'we have to start now'

Lesotho Central Bank, said capital market development was on the agenda, but there were a series of other steps countries were working on to link up.

The 14 members of the Southern African Development Community have implemented a regional payment system and Mohapi said the next initiative was central banks potentially pooling

resources to address crises.

He said a potentially game-changing idea would be an agreement among the 14 countries to jointly finance infrastructure.

Investors, however, remain sceptical about capital market development if reforms are not put in place first.

Thomas Konditi, president and CEO of GE South Africa, said capital markets would be a catalyst, but it was necessary to work on a reform that could help navigate the existing strong headwinds.

"It is important to first look at how much capital is tied up in inefficiency or is misdirected. If you tally how much revenue is coming in and where capital is, you could redeploy resources to focused areas and keep the needle moving today," he said.

Brazil markets tune in to Apprentice star's shock win

By Thierry Ogier

The meteoric rise of a neophyte politician in Sunday's local polls in Brazil may have a strong impact over the 2018 presidential election, according to investors and analysts.

João Doria, the new mayor-elect of São Paulo, Brazil's largest financial centre, came out of nowhere to clinch a surprise first round victory just over a month after the impeachment of Dilma Rousseff.

Financial markets applauded the triumph of the conservative, pro-privatisation Doria who once anchored a local version of Donald Trump's *Apprentice* TV show, over the outgoing leftwing mayor Fernando Haddad, who belongs to Rousseff's workers' party (PT). The Bovespa stock exchange rose 1.9% on the result in spite of a negative external environment.

In the longer term, the surprise outcome of the São Paulo election is a clear boost to Geraldo Alckmin, the governor of São Paulo, who will become one of the main presidential contenders at the 2018 presidential election.

"Alckmin has come out on top. As of this moment, he is the obvious candidate of his party [PSDB]," says Monica de Bolle, a Brazilian fellow researcher at the Peterson Institute for International Economics. Alckmin was the only leader of the PSDB who supported Doria, a mix of socialite and businessman, while others snubbed him.

"He is not a traditional politician, he is someone from outside. This may tell you that the 2018 election may look a bit similar," says Ramon Aracena, the Latin America chief economist at the Institute of International Finance (IIF). The anti-corruption probe known as *Java Jato* which has exposed links between some large companies and politicians in the Petrobras scandal, had a "big impact" on the results, he said.

Within weeks, two former finance ministers of the PT governments were questioned by the police. One of them — Antonio Palocci — has been detained and former president Luiz Inacio Lula da Silva was charged with corruption.

"The PT has lost a lot of ground, maybe in more than 300 cities. People do understand what is going on there, and they are punishing those who are perceived to be corrupt. They are giving a reward to those who are perceived not to be corrupt, especially those who do not belong to the political establishment," he says.

"Brazilian politics are shifting towards the centre-right. This trend might be further accentuated in 2018," said David Fleischer, a political scientist in Brasília. This may strengthen the momentum for economic reforms that the current administration is currently trying to push through, including a cap on public spending.

World Bank unveils tools to unblock infrastructure logjam

By Phil Thornton

The World Bank will today unveil an initiative that its chief financial officer Joaquim Levy believes will unlock billions of dollars of private finance needed to fill the yawning infrastructure investment gap.

He will use a meeting of the Bank's Global Infrastructure Facility (GIF) to launch new tools, guarantees and indices to help attract private investors that are sitting on huge quantities of assets but which are nervous about investing in emerging and frontier market economies.

The demand for infrastructure for the developing world alone runs over hundreds of billions of dollars a year. While most governments face budgetary constraints, the 10 largest pension funds alone hold \$2tr of assets, the 10 largest insurance companies hold \$4.5tr and the 10 largest sovereign wealth funds, \$5tr.

Increasing infrastructure investment is a crucial part of the strategy of Jim Yong Kim, the bank's president, to hit his two goals of eliminating poverty and reducing inequality. However, despite the array of potential projects, investors have been wary of the risk involved.

"We have to create a better system that doesn't exist today for asset and wealth managers to be able to get into this. So this is the strategy that the bank is building with a lot of partners," Levy told *Emerg-*

ing Markets in an interview.

He said the GIF, which was launched with a big fanfare last year, would aim to tackle three logjams. The first was what he called "upstream" challenges that include a lack of information for potential investors. "Facilitating the flow of information is essential for asset managers who cannot spend an enormous amount of time to get acquainted with this new space," he said.

To meet this challenge the Bank will today unveil details of a project assessment tool that will provide independent assurance for emerging and developing country governments on the quality and completeness of their projects' preparation.

REFINANCING RISK

It will also expand on the instruments such as guarantees that it provides to challenge what he called the "midstream" challenges to finance infrastructure and manage the risk involved. "We are working to develop new instruments to address not only political and institutional risk but refinancing risk, and exchange rate risk," he said.

Lastly the Bank will tackle the barriers discouraging investors from putting money into infrastructure. It is looking to establishing a "downstream financing window" and use credit enhancements to mobilise private capital



Levy: new funds to de-risk projects

and a new infrastructure debt index in collaboration with Morningstar, the research company, to enable investors to track performance of the asset class.

Another initiative that Levy will announce today aims to encourage governments to sell existing infrastructure and use the proceeds to fund new investment. "This frees finance for greenfield projects, which is something that is difficult for private investors, by recycling brownfield assets."

He said infrastructure investment would offset the recent sharp slowdown in trade growth. The World Trade Organisation said last month trade volumes would grow just 1.7% this year — the slowest pace of trade and output growth since the financial crisis of 2009.

Green finance pushes the boundaries as controversial issuers eye SRI bonds

By Owen Sanderson

The green bond market is going from strength to strength, with volumes on target to more than double in 2016 to \$100bn — but at the cost of bringing some firms involved in clearly polluting industries to the market.

NGOs such as the World Wildlife Fund have called for stricter standards to help the market fulfil its potential.

Earlier this year, Mexico City Airport issued a green bond, successfully convincing investors that the goal of a "carbon neutral" airport, using solar energy and energy efficient buildings, could overcome the inherent environmental costs of the aviation industry. The issue achieved the top environmental rating of "GB1" from Moody's.

But Pemex, the Mexican state oil company, had to pull a planned issue which would have financed work to upgrade its pipelines and cut leaks, among other projects. At least six airlines have also considered green deals to finance upgrades to more efficient aircraft, according to Sean Kidney, chief executive of the Climate Bond Initiative, speaking at a World Bank Civil Society session on Tuesday.

Other oil companies may yet decide to brave the market — Kidney declared he would be "thrilled" if Total, the French oil company, were to issue a deal to fund its transition to renewable energy, even if the credit quality of the bond was based on Total's oil reserves.

Controversial issuers which have been pitched green financings include the major tobacco firms, which have a clear route to reducing their environmental impact through agricultural practices — but little chance of ever having their bonds bought by ethically-driven investors.

COMMON STANDARDS

Meanwhile, the World Wildlife Fund, one of the earliest green bond investors, has called for a common standard for the market, and a focus on actual, verifiable environmental improvements, rather than promised future improvements.

"Green bonds are crucial for the future of a sustainable economy, but not everything labelled 'green' fulfils its promise," said Jochen Krimphoff, sustainable finance specialist for WWF. "There must be robust standards to ensure that people get what they expect. Vigorous, credible, fully de-



Kidney: 'thrilled' by Total deal talk

veloped and widely accepted industry standards for green bonds are urgently needed to sure that the market thrives and the sustainable economy grows."

Green bonds are typically ordinary bonds backed by promises from the issuer to deploy the proceeds of the issue on green projects. An external agency usually verifies that the promises are credible, and an issuer can deliver enough information about the use of proceeds to satisfy investors. But an issuer cannot be forced into default by a failure to fulfil its green promises, and cannot be sued by investors on these grounds.

According to green bond specialists, only the UK's Green Investment Bank has issued debt with hard covenants on green use of proceeds, which can be used by investors in the courts to force green commitment.

EMERGING MARKETS

MANAGING EDITOR

Toby Fildes toby.fildes@globalcapital.com
+44 7580 154 001

ASSOCIATE EDITOR

Phil Thornton +1 469 901 2847

ON-SITE REPORTERS

Lucien Chauvin +1 469 901 2813
Paolo Danese +1 469 996 792
Virginia Furness +1 469 901 2967
Craig McGlashan +1 469 901 2857
Thierry Ogier +1 469 901 2863
Anthony Rowley +1 469 901 2832
Owen Sanderson +1 469 901 2849
Oliver West +1 469 901 2860
Elliot Wilson +1 469 901 2868

CONTRIBUTORS

Lucy Fitzgeorge-Parker, Rashmi Kumar

PHOTOGRAPHER

Gerald Hayes +1 469 901 2883

VIDEO

Dave Lamb +1 469 9012 869

HEAD OF OPERATIONS

Sara Posnasky +1 469 954 0122

PRODUCTION EDITOR

Vicki Robinson

HEAD OF SPONSORED PROJECTS

Annabel Nason

SPECIAL PROJECTS EDITOR

Phil Moore

MANAGING DIRECTOR

John Orchard

DIRECTOR

Ruth Beddows ruth.beddows@globalcapital.com
+44 20 7779 7386

PUBLISHER

Oliver Hawkins oliver.hawkins@globalcapital.com
+44 20 7779 7304

DEPUTY PUBLISHER

James Andrews james.andrews@globalcapital.com
+44 20 7779 8074

ASSOCIATE PUBLISHER

Henry Krzymuski henry.krzymuski@globalcapital.com
+44 (0)20 7779 7303

ASSOCIATE PUBLISHER

Melissa Roach mroach@globalcapital.com
+44 (0)20 7779 8276

AMERICAS PUBLISHER

Kevin Dougherty +1 646-629-6355

LATIN AMERICA PUBLISHER

Soledad Contreras M: +44 (0) 7408 865 672

CENTRAL ASIA PUBLISHER,

Mine Helimoglu +90 5324131686

PUBLISHER, MIDDLE EAST & TURKEY:

Adil Jilla of MEIAC ajilla@meiac-uk.com
ASSOC. PUB., MIDDLE EAST & TURKEY
Kaersi Jilla of MEIAC k.jilla@meiac-uk.com
(UK): +44 (0) 797 384 310 (Dubai): +971 4 4548690
Shatha Tower, Office No. 1906, Media City PO Box.
502118, Dubai, UAE

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Telephone: +44 (0)20 7779 8888

Directors: John Botts (non-executive Chairman),
Andrew Rashbass (CEO), Sir Patrick Sergeant, The
Viscount Rothermere, Colin Jones (Finance Director),
David Pritchard, Andrew Ballingal, Tristan Hillgarth,
Paul Zwillenberg

Washington DC office:

Crescent Room, One Washington Circle Hotel
1 Washington Circle, NW
Washington DC 20037

Hotel Front desk: (202) 872 1680

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QATARI BANKS 





Brexit flexit: Britain hopes EMs will be at front of trade deal queue

Britain has made striking free trade deals one of its signature policies following the Brexit vote. Emerging markets will no doubt be keen to sign up but the reality is that such deals will take years to sign off

By **Phil Thornton**

From the combative exploits of Sir Francis Drake in the sixteenth century to the more pacific overtures by modern entrepreneurs such as Sir James Dyson, Britain has seen herself as a premier trading nation.

But the shock vote on June 23 that started the process for the UK to leave the European Union has left trading partners in emerging and developing worlds unclear about where the UK stands.

The role of smaller and poorer nations has become more important in the wake of a warning in September by US president Barack Obama, who said that US/UK trade relationships could “unravel”.

The Japanese government made an even more specific and stark threat, using a 15-page open memo to the UK government to warn that its firms could pull out of the country if they no longer had access to EU markets.

The idea that freedom from the constraints

of a Brussels-led trade negotiation system would free Britain up to strike deals with emerging markets — and perhaps revive that buccaneering tradition — were central to the victorious pro-Brexit campaign.

Prime minister Theresa May used her first major event in the public arena last month to hail Britain’s proud history as a trading nation. Speaking ahead of her meeting with Chinese president Xi Jinping at the meeting of G20 leaders in Hangzhou, she said: “As the UK leaves the EU I’ve set out our ambition to be the global leader in free trade.”

But like her clarion call that “Brexit means Brexit”, that statement of intent over Britain’s future status as the world’s premier trading nation asked more questions than it answered.

May has sought to seize the initiative, holding informal discussions about future free trade deals after Brexit with the US, Australia and India at the G20 summit, the first major global policy meeting since the

June 23 vote by Britons to leave the EU.

But now that three months have passed since the vote, many analysts say turning that vision into reality will be a different matter. “So much of what the UK and the rest of the world are going to have to go through, particularly in terms of trade, is yet to be decided and it is this uncertainty that will prove to be the biggest problem in the next couple of years,” says David Lea, senior analyst for western Europe at Control Risks, a global consultancy.

“There is a lot of negotiating to be done and while people are apparently quite confident about how that is going to go and expressing their opinion in very strident and confident terms, really nobody knows.”

CLOSER BONDS

Some of the larger emerging economies and particularly those that are fellow members with the UK of the Commonwealth have made equally positive noises.

Australia has emerged at the front of the queue. Its prime minister Malcolm Turnbull said in Hangzhou that his government had already been engaged in discussions with the UK about what the free trade arrangements may look like after Brexit.

“Australia is determined to provide

“*The pressure will be on the UK to agree trade deals and agree them quickly*”

—David Lea,
Control Risks

Britain with all the support and assistance that we can,” he said. “We are such great friends, such strong allies. [There] couldn’t be two countries with closer bonds.”

One of New Zealand’s top trade negotiators is flying to London to support officials in the newly minted Department for International Trade headed by Liam Fox. Singapore, Mexico and South Korea seem keen.

However, analysts such as Andrew Kenningham, senior emerging markets economist at Capital Economics, are not convinced that verbal promises will be followed by hard negotiation any time soon. Australia’s trade minister has since put a timeline of 2.5 years after the UK leaves the EU.

“These things go very, very slowly and many emerging markets have a big backlog of other things they are working on in terms of trade policy, so their thinking on this issue will be almost minimal in somewhere like India,” says Kenningham.

While there is nothing to stop Britain and emerging countries starting to negotiate a trade deal while the UK is still a member of the EU, it will be hard to strike any meaningful deals until it is clear what relationship Britain will have with the rest of Europe.

However, it is clear that — Brexit or not — there is huge potential to exploit and expand the UK’s trade network.

Although the share of UK exports to non-EU countries has risen in the last two decades, sales to the rest of Europe, which has enjoyed anaemic growth for the last eight years, still make up 44% of all exports. Eight of the top 10 markets for UK exports are in the EU (and the eurozone) with Switzerland and China completing the list.

But while the US (17%) and Germany (8%) make up a quarter of exports, outside the top 10 no country is the source of more than 2% of exports [see table].

And many of those countries sell many times that share to the EU as a whole — the UK may make up 4% of Hungary’s trade but the EU is worth almost 60%. Other than China, the largest emerging markets are India with 1.6% and Russia with 1.5%.

CHINA: ‘MUTUAL TRUST’

Among those emerging economies likely to see benefits from a new free trade deal, the largest and most interesting is China, which is the UK’s sixth largest trading partner with 3.5% of British exports and which sends 2.6% of its exports to Britain.

Premier Xi told May in Hangzhou that China wanted to continue to promote “even more stable, better” relations with Britain’s new government.

While the two countries should continue to promote co-operation in the areas of

investment, energy, infrastructure and finance, Xi added: “Both sides should increase political mutual trust, expand common interests and appropriately handle disputes.”

This was widely seen as a reference to May’s surprise delay to a decision on whether to back a \$24bn nuclear project at Hinkley Point in the west of England, to be built by French firm EDF with the help of \$8bn from China, which would then go on to build further plants.

Kenningham at Capital Economics says it highlights the tensions that both emerging markets and the UK will encounter as they look to strike third-nation trade deals outside the EU.

“The UK may want to offer even freer access to foreign direct investment. But you run into issues as we’ve seen with the Hinkley Point nuclear plant,” he says.

“The agenda that one part of the government has advocated is absolute free trade, but I think in reality that will run into all

sorts of objections within the UK government before you can get around to negotiating with other countries.”

Lea at Control Risks points out that the UK will be in a weaker bargaining position than some major emerging market powers. “The pressure will be on the UK to agree trade deals and agree them quickly,” he says.

“So I suspect they will not be driving too hard a bargain, and the rebalancing of power in the global economy will make emerging markets think now is a good time to do a trade deal with the UK in terms of getting markets for primary products and semi-manufactures.”

He says the major Asian powers such as China and Japan will have the resources to negotiate a wide ranging deal but it will be of such a size and scope that it might take years to sign off. The trade deal between Canada and the EU took six years to negotiate and has still not been ratified after two years.

He says it is more likely the UK will target

The queue

UK goods and services exports by destination, 2013 (£bn)

Destination country	Goods	Services	Goods & services	Share of UK goods & services exports
1 US	40.6	49.5	90.1	17.6%
2 Germany	30.5	12.2	42.7	8.3%
3 Netherlands	25.8	9.8	35.6	7.0%
4 France	21.3	10.9	32.2	6.3%
5 Ireland	18.9	7.8	26.7	5.2%
6 China	13.2	4.2	17.4	3.4%
7 Belgium	14.0	3.0	17.0	3.3%
8 Switzerland	6.1	9.7	15.7	3.1%
9 Italy	9.0	5.9	14.9	2.9%
10 Spain	8.8	4.7	13.5	2.6%
11 Japan	4.8	5.0	9.8	1.9%
12 Australia	4.3	5.4	9.7	1.9%
13 Sweden	5.9	3.8	9.6	1.9%
14 India	6.1	2.0	8.0	1.6%
15 Russia	5.4	2.3	7.6	1.5%
16 Hong Kong	5.6	1.9	7.5	1.5%
17 Canada	4.0	3.5	7.5	1.5%
18 South Korea	5.2	1.5	6.7	1.3%
19 Singapore	4.2	2.3	6.5	1.3%
20 Norway	3.3	2.9	6.2	1.2%
21 Saudi Arabia	3.4	2.4	5.8	1.1%
22 Turkey	4.1	1.3	5.3	1.0%
23 Denmark	2.9	2.4	5.3	1.0%
24 Poland	3.9	1.3	5.2	1.0%
25 South Africa	2.6	1.9	4.5	0.9%
26 Brazil	2.7	1.2	3.9	0.8%
27 Luxemburg	0.2	2.8	3.1	0.6%
28 Czech Republic	2.0	1.0	3.0	0.6%
29 Greece	1.5	1.3	2.8	0.6%
30 Malaysia	1.6	1.0	2.7	0.5%
Total: top 30 countries	261.8	164.8	426.6	83.4%
Total: other countries	45.0	39.7	84.7	16.6%
World total	306.8	204.5	511.3	100%



Brexit means Brexit

From left: international trade secretary Liam Fox, foreign secretary Boris Johnson and Brexit secretary David Davis

some of the smaller emerging economies such as Mexico, Singapore and Sri Lanka that have already voiced their interest.

“There will be pressure on the UK to show progress early and I think it will want to demonstrate a few early successes,” says Lea at Control Risks. “They may look to some relatively friendly countries who have a commitment and try to seal those early.”

Smaller emerging markets will not be in such a strong position. “It will be an additional burden for many EMs, especially smaller ones,” Kenningham says. “Their capacity to negotiate trade agreements is quite limited.”

And according to Richard Baldwin, professor of international economics at the Graduate Institute of International and Development Studies in Geneva, there is less to play for. “For emerging markets exporting mostly manufactured goods, there’ll be little change,” he says.

ARTICLE 50

However, a lot will come down to what type of trading relationship Britain can agree with the rest of the EU. Negotiations on that can only start when the UK triggers Article 50 of the Lisbon Treaty and can take up to — but not longer than — two years.

Given that, Kenningham says emerging markets simply will not have the option of negotiating a deal until that process ends. “These things go very, very slowly and many EMs have a big backlog of other things they are working on in terms of trade policy so their thinking on this issue will be almost minimal in somewhere like India.

“Certainly I think it will be difficult for them to achieve very much even in the long term and impossible to achieve anything in the short term.”

The key issue will be the precise legal relationship between the UK and the EU and what access that gives traders and investors to use

Britain as an entrepot for the rest of Europe.

Those talks will be tied up in the poisonous issue — for domestic UK politics — of finding a trade-off between the UK’s desire to maintain access to EU markets and its need to satisfy its citizens’ demand to control immigration.

According to Malcolm Barr, an economist at JP Morgan, there are good reasons why the UK’s interests may be best served by setting out a goal to remain within the European Economic Area (EEA) — known as the “Norway option” as that is what the Nordic non-EU country has done.

“Leaving the single market implies an enormous step change in the UK’s trading relationships with the EU,” he says. “Starting from the standpoint of staying in the EEA at least has a pre-existing legal form which can be drawn upon.”

This would enable the UK to either use the flexibility over migration already allowed for in the EEA, or negotiate additional protocols to make additional UK controls over migration more explicit.

However, David Davis, head of the UK Department for Exiting the EU, appears to favour an exit based on a new set of bilateral agreements with the EU — sometimes referred to as the “Swiss option”.

Liam Fox has said he would prefer a free trade agreement with the EU rather than be part of the EU custom union, which he says could restrict the UK’s ability to negotiate lower tariffs with other trading partners.

Quite how seriously he will be taken by UK exporters and potential trading partners remains to be seen, however. In early September the international trade secretary told activists that Britain was “not the free-trading nation it once was. We have become too lazy, and too fat on our successes in previous generations.”

He added: “Companies who could be contributing to our national prosperity — but choose not to because it might be too difficult or too time-consuming or because they can’t play golf on a Friday afternoon — we’ve got to be saying to them if you want to share in the prosperity of our country you have a duty to contribute to the prosperity of our country.”

His remarks did not go down well with British businesses, with Richard Reed, co-founder of Innocent Drinks (and a high-profile Remainer), calling Fox “a complete fraud” while Chuka Umunna, a Labour member of parliament, branded him a “complete disgrace”.

But away from the mud-slinging of UK politics and the long negotiations in dark Brussels’ committee rooms, the outcome will make a big difference for emerging markets, says Baldwin at the Graduate Institute. “For nations like India, which use the UK as an entry way into the EU market Brexit is a problem,” he says. “If the exit option chosen involves Single Market access, then all is well,

if not, the UK-India agreement won’t help.”

Tata Motors, the Indian giant, owns Jaguar Land Rover (JLR), one of the UK’s biggest car brands. Outside the EU trading system, UK-based carmakers could lose preferential tariffs and customs treatment that could make conducting business in Britain more costly.

In a statement issued immediately after the Brexit vote, JLR said: “There will be a significant negotiating period, and we look forward to understanding more about that as details emerge.”

However, Baldwin says that for most emerging markets, which export mostly manufactured goods, there will be minimal impact. “If UK agrees an EEA-like agreement, there’ll be little change for EMs.”

MOOD MUSIC

Since all existing trade agreements become void the moment the UK leaves, poor countries in particular will be anxious to know that the preferential treatment they have under the EU’s Everything But Arms (EBA) programme will be maintained. Under EBA, 49 least-developed countries (LDC) gain full duty-free and quota-free access to the EU for all their exports with the exception of weapons.

Kimberly Elliott, a senior fellow at the Center for Global Development in the US, says the UK’s parliament will need to pass legislation to replicate this. The UK will also need to come up with its version of the EU’s Generalised System of Preferences (GSP), lowering tariffs for the least developed countries without also lowering tariffs for rich countries. Change needs checking

But it will be the countries above the LDC threshold with bilateral deals with the EU that may be worried. “The UK will have to renegotiate these and I suspect the problem for developing countries is that these will be well behind in the queue behind the EU, US and Canada,” she says.

“The best outcome in the short run would be if the UK early on passes EBA and GSP with reasonable rules of origins and as broad a coverage as possible, so low income countries are covered from day one and they can then negotiate beyond that.”

Given the timescales involved in trade deals, it may take years if not decades to see clearly whether Britain has used its freedom from the joint EU trade bloc to recreate the network of trade deals it once enjoyed.

Given the political imperative it is likely that the UK will push for deals and emerging markets will seize the opportunity to get a deal on better terms with one of the major economies.

But it is hard to predict the nature of that relationship even 10 years ahead. As David Lea says: “The most important influencing factor is not going to be the UK’s attitude but the overall tone, flavour and mood music of the international trade regime that is in place then.” **EM**

“I suspect the problem for developing countries is that [they] will be well behind in the queue behind the EU, US and Canada”

—Kimberly Elliott, Center for Global Development

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Asian green bonds blossom with



The Asian green bond market has gone from being a minnow a year ago to dominating global issuance, proving that the product is here to stay. But with no real pricing advantage and the investor base still largely traditional, there is plenty holding back a shift towards growth and sophistication

By Rashmi Kumar

Phenomenal, fast growing, exciting. These are just some of the words market watchers have used to describe the development of the green bond market in Asia. And if the numbers this year are anything to go by, they are not wrong in their thinking.

According to Dealogic, 28 green bonds have been sold in Asia Pacific this year as of September 5, 2016 — a vast jump from the four sold during the same period in 2015. In volume terms, the numbers have risen from \$1.42bn to \$22.4bn.

At the heart of this growth are China and India. China has accounted for \$19.09bn of volumes so far in 2016, with India ranking second with \$1.29bn of deals. And more green notes are widely expected from both countries before the year is out.

“China is by far the largest regional influence on this market with India potentially

matching it over time,” says Ricardo Zemella, managing director, head of DCM and syndicate for Asia at ING Bank. “Overall, Asia’s relative high growth and need for infrastructure make the region fertile ground for green financing.”

The green market received a big fillip in early September at a meeting of the G20 members in China — an event where the most populous country in the world made the fight against climate change its core agenda. On September 4, the US and China outlined plans to expand their efforts on climate change, including formally adopting the international climate change agreement reached in Paris in December 2015.

The agreement will hopefully encourage other nations to formally adopt the Paris pact and work towards making the environment cleaner and more sustainable — eventually leading to the sale of more green debt across the globe. But whether Asian countries will be eager to rush in remains a question.

“There are still a number of relatively poor Asian economies where many people live from one day to the other and sustainability does not score high on their priority list,” says Martin Wehling, head of debt origination for Asia Pacific at DZ Bank. “So there are various government initiatives to push a sustainable economy and sustainable usage of resources. However, we have seen a lot of changes among Asian market participants over the last 18 months, from governments, regulators, exchanges, issuers and investors alike.”

TOP DOWN

Asian countries generally have taken a top down approach to developing the green market. The People’s Bank of China (PBoC) in December 2015 laid out guidelines for green debt issuance by financial institutions. At the end of last year, the National Development and Reform Commission (NDRC) released guidelines for corporate issuance of green bonds.

India too has taken conscious steps, having set itself an ambitious objective of building 175 gigawatts of renewable energy capacity by 2022, requiring an estimated \$200bn in funding. To that effect, the Securities and Exchange Board of India put together a green bond framework in January 2016 following a public consultation.

Both countries have seen a mix of domestic and international issuance. In China, the

China, India in the lead

first mover was Shanghai Pudong Development Bank, which sold a Rmb20bn (\$4.3bn) onshore bond in January. Offshore, Bank of China sealed a landmark \$3bn green deal in July, which was at the time the fifth largest green issuance globally and Asia's largest international green trade.

India meanwhile saw the first onshore issuance from Yes Bank in February 2015. The maiden international bond meanwhile came from the Export-Import Bank of India, which blazed the trail for other financial and corporate names to follow.

South Korea too has seen action this year having seen no green issuance in 2015. The Export-Import Bank of Korea returned in February having been Asia's first green issuer in 2013. It was followed by Hyundai Capital Services this March with a \$500m deal. The Japanese market, however, which last year saw two green notes worth \$839m, had recorded no deals as of September 5.

The fact that a chunk of issuance has been from names in the financial sector or from policy lenders has not gone unnoticed. "This is a normal trend and was the way the green bond market also developed in Europe," says Wai-Shin Chan, HSBC's Asia Pacific director for climate change strategy. "For corporates, it is good to have a list of projects they can fund that is green. Given knowledge about green bonds is still not very high, it is easier to sell a green bond from a very credible financial institution rather than a corporate that people may not know."

ELUSIVE BENEFITS

That's not to say the market has not welcomed some corporates. Hong Kong's Link

Reit, China's Zhejiang Geely Holding Group and Aboitiz Power Renewables from the Philippines have sold green debt. In India, the likes of Greenko Power have laid the foundation for corporates.

"The green concept is relatively new for south Asia but we are seeing lots of interest from corporates with enquiries on the format, the assets to be applied etc. So going forward we could see a surge in issuance," says Shyam Saraf, vice-president, capital markets group for south Asia at MUFG.

One of the biggest challenges holding back issuance is pricing, say market watchers. On the primary front, issuers have typically sold green debt in line with their traditional bonds, driven by a couple of factors.

For starters, the majority of the Asian issuers sell their notes in Reg S format. But most of the green dedicated investors are in Europe and the US. With US accounts already shut out, that leaves European green investors. But given their assets are typically in euros, their involvement in dollar deals tends to be limited, say bankers. As a result, there is little price tension to prove beneficial to issuers.

"The benefits of pursuing a green bond remain elusive from a strict pricing perspective," says ING's Zemella. "A bond issuer embarking on such a path derives value from the signal it provides the market: they are investing their time and efforts in embracing sustainable financing standards and doing 'the right thing' towards the environment. Pricing benefits will come with time as the asset class develops and standards become more consistent across geographies."

UNDER PRESSURE

Frank Kwong, head of primary markets, Asia Pacific at BNP Paribas, says he is seeing a shift to project bonds and renewable power as companies transition from using coal to cleaner energy.

"Philippines is a growth market where there will be development bank and private capital involvement to finance such projects and this can be done using green bonds. So we are expecting a lot more supply," he says. "We've been pitching green bonds to issuers as we feel that the timing is right and it makes sense to finance projects using green bonds. A lot of Asian issuers have CSR objectives which can involve green investors."

Vicky Münzer-Jones, a Singapore-based partner at law firm Norton Rose Fulbright, reckons the interest in selling green debt — despite no pricing advantage — stems in part from a fear factor of being left behind.

"There is anecdotal evidence that there is a deeper market for green bonds; you may not be able to put a price on it but there is a bigger pool of investors to tap and that's the way the market is going to move," she says.

It has not been easy to get here, however, and the way forward will also be a challenge. Putting the framework into place was something the market had been working on for years. And even now, the main challenge is the different approaches and thinking behind what is green and what is not.

Here, parties like the International Capital Markets Association (ICMA) have come into play with the body putting together guidelines for green bonds. ICMA's guidelines focus on transparency and accountability, according to its Asia Pacific chief representative

“what they say



"The benefits of pursuing a green bond remain elusive from a strict pricing perspective"

—Ricardo Zemella, ING



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"There is some concern in Asia about the shades of green as there is fear that the process of getting a green tick is too easy" — Russell Baines, Westpac



"Buying green bonds just because it is green is not a prudent choice ... we will buy the non-green bonds and still engage with the issuer to get a better understanding of their social and sustainable footprint." —Alex Struc, Pimco



Boosting sustainable development

In July New Development Bank (NDB) held its first green bond roadshow in Shanghai. Kundapur Vaman Kamath (left), president of the NDB, and Chen Siqing, vice chairman and president of the Bank of China (the lead manager on the deal)

Mushtaq Kapasi. He says that it is about the right reporting disclosure standards and then the body gives the market the freedom and flexibility to decide how green a product it wishes to buy.

“The market is now at a stage where either issues have been ironed out or people agree to disagree about having different standards,” he adds. “And that is healthy — so long as we’re adhering to the principles, it’s up to the market to accept or not accept whether something is sufficiently green or not.”

DIFFERENT SHADES OF GREEN

The concept of getting independent third party verifiers for green bonds has gathered momentum, with issuers increasingly needing verifiers. However, there is now increased competition with numerous verifiers aggressively pitching to issuers.

“There is some concern in Asia about the shades of green as there is fear that the process of getting a green tick is too easy,” says Westpac’s head of DCM and syndicate, Asia, Russell Baines. “Products may be labelled green but it raises a question of how sustainable the use of funds actually is. Feeding back into the requirement for a deeper market to get to a self-sustaining size — the hope is that the market doesn’t branch off into a little bit of green, very green etc as we see growth in issuance.”

There is help at hand, however. Sweden’s SEB Bank and Germany’s GIZ have a strategic alliance (STA) to educate those in the green industry. Their partners in Asia include India and China. “At the heart of the STA is the idea that we want to provide a lot of knowledge and transfer the profound expertise our partner SEB has through technical workshops offered to key public and private stakeholders in our partner countries,” says Yannick Motz, who manages the Emerging Markets Dialogue on Green

Finance at GIZ.

This might well serve the Asian market, which still has numerous challenges to overcome if it wants to grow further. The absence of green dedicated investors is a big hurdle and is one that is unlikely to be remedied in the near future. This is because the green bond market in Asia is caught in a chicken or egg situation — green investors will set up shop if there is more critical mass in the market but the mass can only be reached with more buy-side activity.

“The main tangible benefits of green bonds are not in enhanced seniority or security but the use of the proceeds and transparency via additional reporting,” says Alex Struc, an executive vice-president and portfolio manager at Pimco. “While investment grade companies can just borrow for general corporate purpose green bonds with specialised annual reporting offer additional transparency on how the proceeds are used.”

But Pimco has a strict policy when it comes to investing in green debt. “Buying green bonds just because it is green is not a prudent choice,” added Struc, who also co-heads Pimco’s ESG effort. “If the cheapest to deliver happens to be other than green debts of the issuer we like, we will buy the non-green bonds and still engage with the issuer to get a better understanding of their social and sustainable footprint.”

EDUCATING INVESTORS

The Hong Kong debt market got a boost in July with Link Reit becoming not just the first green issuer from the city but also the first property developer to go green. The path to its trade was a long one, with the issuer first holding investor meetings in July 2015 but delaying its deal due to volatility.

“Capital markets conditions change every day,” says Hubert Chak, Link Reit’s director of finance. “After Brexit and the

market reaction and then the Fed meetings minutes, it led to a situation where 10 year Treasuries were at historical lows so we started to look at the market closely. Our objective was to get low cost, green bond investors and push out the overall maturity of our debt portfolio.”

Doing a green bond was something suggested by bankers close to the issuer as a way to finding a new investor pool. In addition, as a Reit, the issuer had stable income — something investors liked. “We faced two challenges,” says Chak. “One was with educating investors. Some investors had already invested in Hong Kong and Asia and part of their mandate is to invest in companies that take efforts in sustainability — these were the light green bond investors.

“And then we had dark green or dedicated investors that only buy green bonds and have a check box for what is green and what is not. They are very strict on what they can invest in but they are not familiar with Asian companies. So in July 2015 and 2016 we had to educate them on our background and history.”

Its debut green outing stemmed from the fact that Link put together a sustainable framework about five or six years ago as a way to think about the community and its stakeholders.

Chak adds that that there was no benefit on issuing a green bond from a pricing perspective but there was no disadvantage either. The company had to incur some documentation cost but Chak says it was quite “immaterial” considering the amount raised.

“For companies looking to issue green bonds, it is really important to start planning early. I’m not saying that we are very forward thinking but companies should take efforts on sustainability and energy saving as ways to manage your projects well. It’s not something you can do within months; it’s a long term commitment.”

It was this focus on sustainability that drove National Australia Bank to become the first green bond issuer from Australia in 2014, selling a \$300m deal. Its head of capital financing for Asia, John Barry, says: “We attracted new to NAB debt investors and SRI investors, were able to extend the tenor of our funding mix by issuing a seven year green bond and managed to highlight our commitment to financing the transition to a low carbon economy.

“Since our inaugural deal, the Australian green bond market has continued to evolve, attracting new issuers, new investors and new green bond formats so it’s good to know that we had a role to play pioneering the development of the green bond market.”

Doing a green bond was in line with the bank’s broader ESG credentials. In 2010 NAB became the first Australian bank to be certified as carbon neutral. And in 2015 it committed to undertake low carbon financing activities of A\$18bn over seven years. **EM**

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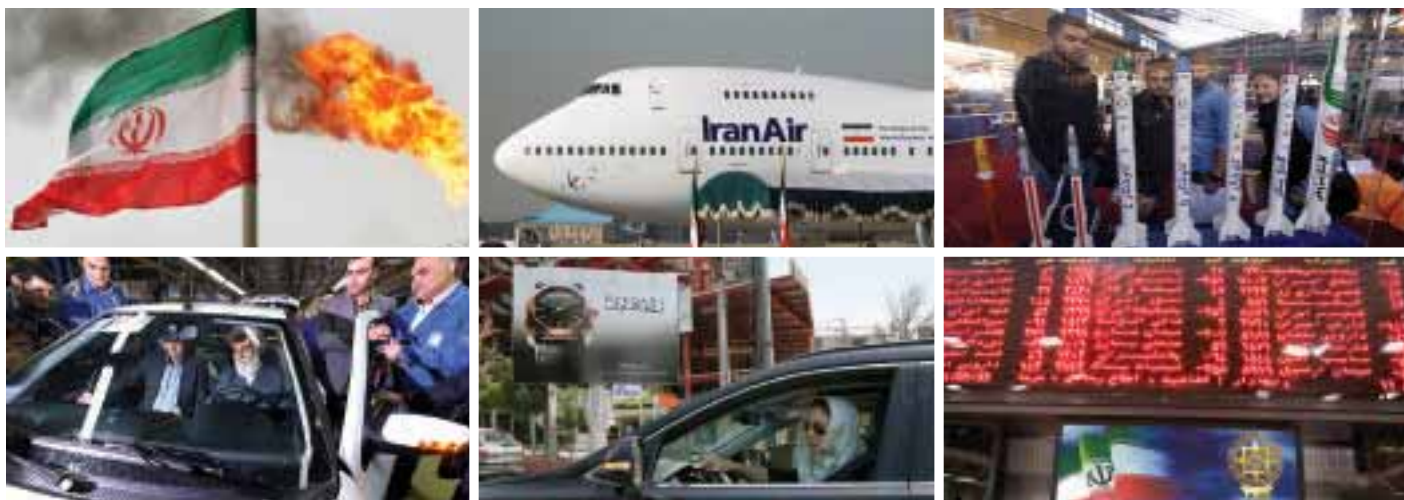
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After the hype: a slow start to Iran's new era

Investors have rushed to Iran in the 18 months since the Western powers agreed to lift sanctions but blocks on US banks and a creaking domestic financial sector have crimped growth prospects

By **Elliot Wilson**

In a low interest world hot for yield and desperate for the next big thing, Iran would seem to have it all. Solid rate of growth? Yes. Ample reserves of a high-value commodity? Oil — yes. Large, educated populace, keen to earn and build a better future? Yes, yes, yes.

Any casual observer leafing through the business pages of the world's media over the past 18 months would be forgiven for assuming that Iran's long term economic and financial success was a done deal. The July 2015 Joint Comprehensive Plan of Action, in which the five permanent members of the UN Security Council plus the European Union agreed to eliminate sanctions on Iran in exchange for the country destroying its stockpile of medium enriched uranium, fomented much hope in the country's future — and an awful lot of hype.

Some of this was well directed. Despite being pinioned by US-led sanctions for the past 37 years, the Islamic Republic of Iran boasts the world's 18th largest economy (in nominal terms) and the 26th largest in terms

of its relative purchasing power. The United Nations reckons it to be the world's 26th largest consumer market thanks largely to the youthful nation's obsession with spending. "Iran is a very significant market with a highly diversified economy and a large and well educated populace," notes Charles Robertson, global chief economist at investment bank Renaissance Capital. "It ticks a lot of the boxes that usually attract investors."

Since the 2015 nuclear agreement, which remains on track, investors and corporates have swarmed to the Persian Gulf to view the country's potential first hand. Sometimes that results in more than mere glad handing. In January, Iran placed a \$27bn order for 118 Airbus planes, later reduced to 112. Boeing is hoping to sell a fleet of jetliners to state-run Iran Air. Renault, which has run a joint venture with the government-owned IDRO Group since 2004, has pledged to double capacity and market share. In June another French carmaker, PSA Group, said it would revive a long-dormant alliance with another local automaker, Iran Khodro, investing €400m (\$450m) and aiming to produce 200,000 vehicles a year by 2018. Another French giant, Orange,

struggled to keep pace with promise. In Iran's case, it faces a host of problems, some interconnected and localised, others entirely unrelated and formed far from the country's shores.

One is the sheer weight of positive publicity that Iran's opening up has garnered. It is easy, when thinking of its potential in the abstract, to forget just how far this nation had slipped behind — and how much catching up it has to do. "There was a buzz around Iran in the wake of the nuclear agreements," notes Ramin Rabii, chief executive officer of Iranian investment firm Turquoise Partners Group. "That has calmed down a great deal. It will take longer for Iran to open up and realise its potential than was originally assumed. It won't be quick."

Foreign equity investors have been quite slow to put their money to work onshore. Tehran Stock Exchange's (TSE) main index, TEDPIX, has had a solid year, rising 24% in value through to September 19. But this has been driven, Turquoise Partners noted in its August 2016 Iran investment report, by "falling interest rates rather than the effect of foreign portfolio inflows".

At the start of the year, RenCap's Robertson tipped foreign institutional investors to pump \$1bn into locally listed securities during the course of 2016. He now says: "I'd be surprised if the total amount was even \$100m. I didn't expect it to be such a challenge. I assumed foreign investors would be more comfortable" trading in Tehran. The TSE is reckoned to contain 50 sanctions-compliant stocks that are "safe" investment targets for foreign funds.

Yet as is so often the case when it comes to the hype surrounding recently opened or rapidly growing frontier markets, reality has

The next big thing?

Iran's economic forecasts (fiscal year ends March 20)

Metric	2016/2017	2017/2018	2018/2019
Nominal GDP (\$ billions)	386	409	440
Real GDP growth (%)	4	3.7	3.8
Crude oil exports (barrels per day, million)	1.8	2.1	2.2
GDP per capita (purchasing power parity, \$)	17,888	18,591	19,473

SANCTIONS STILL HURT

Analysts say what Iran lacks is the comforting presence of a major global custodian bank capable of calmly settling billion dollar trades. There is no State Street or JP Morgan operating in Tehran, no Citi or HSBC — nor is there likely to be so long as US financial sanctions remain in place.

US banks remain outlawed from doing business in the country while European lenders are prohibited from completing dollar transactions processed through the US financial system. “As a consequence, fund managers are saying it is too complicated for them to buy into the market,” notes RenCap’s Robertson. There are two ways to invest in onshore equities: via a local fund or using a Tehran-based broker and a foreign trading and investment code secured from the Securities and Exchange Organisation.

Then there is the lack of interest in Iranian stocks even among adventurous fund managers, who, while desperate for yield, are happy to find it in other, more accessible and better regulated emerging and frontier markets, from Mexico to Russia and Colombia to India. Yields on local bonds may be nudging the 25% mark while the simple process of depositing funds in a local bank account can generate real returns of 20%.

But that does not make the process of getting money into and out of the country any easier. All share trading has to be settled by the Central Securities of Depository of Iran, a system that is, notes one local investor, “fraught with risk”. And no one wants to be accused by The US, at this stage of the opening-up process, of breaching sanctions and slapped with a hefty fine. Little wonder even frontier investors have decided for the time being, to give Iran a wide berth.

The problem of the country’s lack of financial infrastructure doesn’t stop there. Iran’s banking sector is in a terrible state. Failed or soured loans account for 15% of total bank lending, according to figures from Fitch Ratings, far above the international average of around 4%. In March 2016, the financial authorities unveiled a raft of proposals to strengthen the financial sector ranging from plans to launch a maiden sovereign Eurobond to the launch of a bad bank designed to sluice a huge backlog of toxic loans out of the system.

Again, many of these problems are a net result of the grinding effect of sanctions. There are a few well run local lenders — Tehran-based Middle East Bank is one. But too many have spent recent years extending loans to companies run by individuals with impeccable connections but little financial acumen or willingness to meet their financial obligations.

Analysts say change can and will only come from outside, in the shape of more foreign lenders setting up shop in Tehran and second-tier cities and providing a more

worldly financial education to local banks and bankers. A few foreign and semi-foreign lenders already have onshore operations including Hamburg-based Europäische-iranische Handelsbank, Germany’s DZ Bank, Belgium’s KBC and Geneva-based Hinduja Bank (Switzerland). Austria’s Erste Bank is also preparing to set up a representative office.

But most of these are either small private banks or smaller European lenders offering a simple, bare bones set of services such as letters of credit. “These are tiny, small banks,” notes Turquoise Partners’ Rabii. “We need large global banks to come back into the country. Only then will we see large flows of capital entering and leaving the country. That will happen but not for another two to three years. Until then Iran will struggle to have ‘normal’ banking relations with the outside world.”

There is much to admire about Iran — and many reasons to believe in its future. The World Bank expects economic output to expand by 4.2% in 2016 and 4.7% in 2017. Middle East Bank CEO Parviz Aghili tips the growth rate to average out at “somewhere between 5% and 8% over the next 10 years. If China managed to have 25 years of double digit growth, there is no good reason why Iran should not have a similar growth rate.” Much of this additional growth will stem from the natural resources sector space: Iran boasts the world’s fourth largest proven stocks of oil, at 157.8bn barrels, according to the *CIA World Factbook*.

And as sanctions ease, domestic capital markets should broaden and deepen. Investors hope to see a host of industries ranging from petrochemicals to cement to mobile telecommunications liberalised and deregulated, creating a slew of listings by increasingly powerful corporate vehicles. A good start, bankers say, would be the break-up and listing of the sprawling state-run concern Persian Gulf Petrochemical Industries.

In an ideal world, this would help Tehran Stock Market become one of the region’s more influential bourses. “I believe it will be the best performing stock market over the next five to 10 years,” says Turquoise Partners’ Rabii. “The quality of listed companies on the bourse will continue to improve. As sanctions ease, the price earnings ratios will rise from seven times forward earnings at present to 11 or 12. Stock values will rise, dragging in more foreign investment.” In time, investors say, Iran’s leading corporates will eye dual listings in cities ranging from New York to Shanghai via London, Dubai and Hong Kong.

FRIENDS REUNITED

One final question: who are Iran’s sovereign friends now and down the line? Through the sanctions era, Tehran’s hardliners have made much of their enmity with

the US and UK, yet less clear is whom they like and admire. So convoluted and conflicted are Iran’s relations with the wider world that its leaders, from the clerics to president Hassan Rouhani on down, may not know.

Many of Iran’s strongest ties are with European nations including France, Germany, Switzerland and Italy — the latter a constant voice urging mediation with the country even during the wilderness years. Closer to home, there are Iraq, Turkey and the United Arab Emirates, each crucial in its own way to Iran’s hopes of becoming a major regional export and trading hub.

Elsewhere, the picture becomes more blurred. Iran may rail against the Anglophone reaches of the West but it needs Britain and America onside for a host of reasons, from financial to commercial to political. Then there’s the world’s rising economic giant, China. The Asian country, says Middle East Bank’s Aghili, “is ahead of everyone else” but only because Chinese businessmen “took advantage of their monopolistic position in the recent past and badly treated their Iranian counterparts. Now they are concerned that they may lose the market and have become over aggressive.” Adds Rabii at Turquoise Partners: “The Chinese tried to take advantage of Iran during the difficult times and that left a bitter taste in our mouths. The perception of China among Iranian businessmen is not positive.” **EM**



“It will take longer for Iran to open up and realise its potential than was originally assumed. It won’t be quick”

—Ramin Rabii,
Turquoise Partners

“Fund managers are saying it is too complicated for them to buy into the market”

—Charles Robertson,
Renaissance Capital

Ranking**Largest stocks listed on the Tehran Stock Exchange by market capitalisation**

Name of Company	Sector
1 Bank Melli	Banking
2 Ansar Bank	Banking
3 Fajr Petrochemical	Energy
4 Mellat Bank	Banking
5 Parsian Bank	Banking
6 Pasargad Bank	Banking
7 Saderat Bank	Banking
8 Tejarat Bank	Banking
9 Chadormalu	Mining
10 Khouzestan Steel	Manufacturing
11 Mobarakeh Steel	Manufacturing
12 Ghadir Investments	Diversified
13 Gol-E-Gohar Iron Ore	Mining
14 MTC	Telecoms
15 Iran Khodro	Autos
16 IRI Marine	Shipping
17 MAPNA	Construction
18 ITC	Telecoms
19 Mobin Petrochemicals	Energy
20 INC Industries	Aviation
21 Omid Investment Management	Financials
22 Parsian Oil & Gas	Energy
23 Jam Petrochemical	Energy
24 Khalij Fars	Defence
25 Isf Oil Refinery	Energy
26 Tamin Petrochemicals	Energy
27 Saipa	Autos
28 Beshahr Investments	Financials

Source: TSE



Yield starved investors turn blind eye to risks for Erdoland

Investors have returned in force to higher yielding markets and assets this year, with Turkey one of the big beneficiaries. The risks, though, are building as Erdoğan's grip on the country tightens

By Elliot Wilson

The events of July 15 in Turkey are now well known. Yet while the eyes of the world have focused on president Recep Tayyip Erdoğan's diatribes and defiance since the failed coup, a far larger problem has quietly come into view: the increasingly fragile state of Turkey's economy.

On September 7, the customs and trade minister, Bulent Tufenkci, tipped economic output to expand by between 4% and 4.5% in 2016. To most analysts, that target seems far out of reach. Gross domestic product expanded 3.1% year-on-year in the three months to end-June, according to the official statistics agency Turkstat. Private investments

contracted 1.6% on an annualised basis over the same period, with corporate spending on machinery and equipment down 5.3%, the sharpest drop in two years.

Sales of passenger cars, another key economic indicator, have been on a downward trend since 2011. But they have slumped alarmingly this year, with sales falling 29% and 13% year-on-year in, respectively, July and August. An August 2 note by Capital Economics noted that a "decline in consumer confidence" had caused household spending to "weaken sharply at the start of the third quarter".

PRE-COUP PAIN

In truth, notes Roxana Hulea, emerging

market strategist at Société Générale, an economic slowdown was already happening "long before the coup took place". She points to the "compound effect of a number of issues" including: economic sanctions imposed by Russia following the downing of a Russian jet over the Turkey-Syria border last November; the stalling of a series of long planned and much needed economic reforms; and a tourism sector battered both by the coup and a series of devastating terror attacks in Ankara and Istanbul.

The loss of momentum in the tourism space is a grievous problem for regions on the Black Sea and Mediterranean coasts. Foreign arrivals fell 36.7% year-on-year in the key month of July, according to figures



**Ali Fuat Taşkesenlioğlu,
General Manager**

Halkbank General Manager Ali Fuat Taşkesenlioğlu has stated that in 2016, Halkbank aims to achieve a 17-percent increase in deposits and a 16-percent growth in assets and loans. If Halkbank is able to achieve its objectives on specified dates, what impact will these objectives have on profit and asset quality?

We will continue to work in line with our 2016 targets without compromising our mission to provide continuous support to Turkey. The operations we are carrying out have allowed us to move closer to the 2016 goals we set for ourselves. We became one of the main drivers of real sector growth during this period and we continue to add value to Turkey's economy by providing the necessary capital and strategic support. Halkbank's total assets for the first half of the year rose to 200.4 billion Turkish lira. Total deposits, meanwhile, reached 130.5 billion Turkish lira. Halkbank's total loans in the first half of 2016 amounted to 183.4 billion Turkish lira, while net profit rose to 1.57 billion Turkish lira. Halkbank has maintained its leadership position in SME loans also in May by increasing its share to 13.4 percent, calculated based on the size of cash loans allocated to SMEs.

According to Halkbank, "confidence and stability prevail in the Turkish economy." What kind of opportunities create this affirmation on the local market? What is the role of Halkbank in supporting and financing Turkey's mega projects?

Turkey's economy is economically reliable and stable due to its strong production potential, competitiveness in export, and employment capacity. Our bank consistently sustains the operations that carry Turkey forward through its strong financial position, high asset quality, and risk management. We believe that corporations can make great contributions to the sustainability of our long-term economic development goals, and therefore we continue to increase commercial and corporate loans.

Ensuring continuity of investments in major companies in the corporate segment is the basis of economic stability in rapidly developing countries like Turkey. When we focus on the direct impact of these companies on the economy, it appears that their contribution to gross domestic product is more than 10 percent. In recent years, our country has witnessed significant progress in this regard. Halkbank in particular, but all other Turkish banks as well, have the privilege of being a part of the largest projects in the history of the Republic by generously supporting them.

It is often mentioned that SMEs are the backbone of the Turkish economy. As Turkey's leading SME bank, what does Halkbank do to ensure that small businesses have sufficient access to competitively-priced funds? How do the protocols that Halkbank signed with the World Bank and the European Investment Bank help to generate new funding opportunities for SMEs?



> Productive Turkey's Bank

Halkbank attaches great importance to low-cost funds at convenient terms provided from abroad. Thus, we are constantly in talks with the European Investment Bank and the World Bank as well as, to institutions like the French Development Agency and the Council of Europe Development Bank. In December, we signed a new €200-million loan protocol with the World Bank for the financing of SMEs and large enterprises. The loans under the Protocol are made available to large enterprises that are in a business relationship with micro-enterprises, SMEs, and SMEs that employ fewer than 1,000 people.

Lastly, while we provided \$500 million in financing through the issuance of bonds on international markets, we also did syndication agreements amounting to \$175 million and €477 million. The aforementioned bond issuance was the first issuance in Central and Eastern Europe and the Middle East and Africa and the Emerging Markets after the Brexit. These agreements that we have made give us strength in our efforts to increase sustainable competitiveness in the real sector. Our efforts to accelerate the access of SMEs and micro-enterprises to financing as well as to strengthen the supply chain through financing large enterprises in a business relationship with them will continue. We are committed to remaining a pioneer in the development of this field in Turkey and to supporting the development of our country's investment and trade.

Halkbank has announced that it will postpone its 2015 plans to create a participation banking unit. Is Halkbank still determined to stick to its long term plan of establishing Islamic banking operations in Turkey?

Halkbank will establish a participation bank. We have not dropped it at all, but rather we have simply chosen to re-evaluate our future plans. We have therefore decided not to apply for permission to operate at this time and have legally informed the authorities regarding the withdrawal of the establishment license. Once we identify how we can create the most efficient operating strategy, we will re-apply for the establishment license for participation banking.

2015 was another important year for Halkbank in terms of international growth thanks to the expansion of the branch network in Macedonia and the purchase of 76.76 percent of the shares of Serbian Cacanska Bank. Are you satisfied with the performance of Halkbank's international operations? What are Halkbank's plans to develop its overseas operations?

We intend to increase our effectiveness and our brand value overseas. In line with our expansion strategy in neighboring countries, we are taking steps to become one of the major players in the sector. In the last two years, operating as Halkbank A.D.

Skopje, we increased our branch numbers to 34 from 21 in 16 Macedonian cities and our number of employees to 430 from 275. During this same period, we raised our loan amount to €335 million from €92 million while our deposits increased to €336 million from €89 million. As a result of these developments, our bank in Macedonia became the 5th largest bank in the sector as its asset size amounted to €490 million. After the capital increase in 2015 that our bank operating under the name Halkbank A.D. Beograd, formerly Cacanska Bank, experienced in Serbia, we now own 82.47 percent of shares. We are interested to expand to other Balkan countries.

One of the most crucial developments of this period was the start of operations of our representative office in Singapore following the completion of registration procedures. We are confident in the consolidation of our relationships with international corporate investors and correspondent banks through this office, especially in the Asia-Pacific Region. We believe that having a representative office in Singapore, a country that stands out with a strong potential for stable growth, will make a huge contribution to our journey towards becoming a global bank.

Right after the double shock caused first by Brexit and then by the terrorist attacks that hit Istanbul Ataturk Airport, Halkbank announced immediately that it will issue new bonds. How has the changed approach of international investors and creditors to Turkey affected the financing strategy of Turkish banks? How is Halkbank's funding profile evolving? Are you satisfied with the bank's capital and liquidity position?

Despite some plans and attempts to disrupt Turkey's steady progress, we unremittingly continue to work on projects that we believe will benefit our country. Despite these attempts, which we now believe are over and done with, the banking sector has continued its regular activities without any damage and no problems have surfaced thanks to measures taken by interested institutions, the Central Bank in particular, regarding the maintenance of the efficient functioning of financial markets. Our country is a very safe haven for investors and there are no negative elements that can unsettle the markets. By virtue of this trust and reputation, during the past few weeks, we provided for our country an important fund through Eurobonds as well as syndicated loans amounting to approximately \$1.20 billion. Receiving response from 225 finance institutions, a figure more than four times greater than the issuance demanded by the U.S., Europe, Asia, and the Middle East, is a testament to the power of Halkbank and Turkey on international markets. The issuance performed extremely successfully and has shown that any attempt to disrupt the perception of our country will be shot down. ■

Company data

■ Total assets (June 2016):	200.4bn Turkish lira
■ Net profit (1H 2016 v 1H 2015):	1.57bn vs 1.23bn Turkish lira
■ Equity (End 1H 2016 v 1H 2015):	209.8bn vs 18bn Turkish lira
■ Cost to Income ratio (End 1H 2016 v 1H 2015):	45.6% vs 41.2%
■ Core Tier I ratio (End 1H 2016):	12.8%



"Global investors are complacent about what's happening in Turkey"

—Roxana Hulea, Société Générale

"In my view, most of the flows draining into emerging markets are by investors who know little about the emerging world"

—Guillaume Tresca, Crédit Agricole

from the tourism ministry, and by 30.3% through the first seven months. "Given how many dynamics have been working against Turkey in recent years, it's actually surprising that we didn't see a slowdown before," adds Hulea. "But we are probably going to see a significant slowdown in economic growth going into 2017.

This will spell trouble for Turkey and in many ways. Inflation is projected by the International Monetary Fund to come in at 9.8% this year and 8.8% in 2017. The Fund tips economic growth to slow to 3.4% in 2017 from 3.8% this year, one of the factors that will lead to a widening of the current account deficit from 3.6% to 4.1%. The government's longstanding plan of a steady annualised level of 5% inflation and 5% economic growth seems as far away as ever.

The second concern is the increasingly tenuous grip the sovereign has on its much prized investment grade credit rating. Fitch rates Turkey's long term foreign currency sovereign debt BBB-, the lowest rung on the investment grade ladder, with a stable outlook.

But on July 18, Moody's put the country's Baa3 rating on review for a downgrade. The July putsch might have failed but, the ratings agency warned, the fact that it took place at all reflected "broader political challenges" and left credit risks at "elevated" levels. In a research note published on July 27, SocGen said its base case scenario was for Moody's to downgrade Turkey's foreign currency debt by one notch to Ba1 — junk status — within the next 12 months due to waning growth and "institutional deterioration", an abstract way of aligning the various negative factors that are conspiring to undermine and hamper Turkey's manifest potential.

Moody's duly obliged, cutting its rating from Baa3 to Ba1 on September 23, joining S&P which rates the sovereign BB.

Many of these factors coalesce around the nation's increasingly repressive president. SocGen analyst Hulea believes the move toward greater autocracy under Erdoğan, a process that has accelerated since July,

"negatively impacted Turkey's investment grade rating".

ERDOLAND

To Guillaume Tresca, senior emerging market strategist at Crédit Agricole, Erdoğan "will become even more authoritarian. Every day, he is more and more like [Russian president Vladimir] Putin and he saw the coup as an opportunity to clean the Gülenists out of the system. Turkey is becoming 'Erdoland', just as Russia is all about Putin."

Analysts have also, post-coup, been left wondering whether the global investor community has overestimated the true level of domestic stability. Moody's on September 5 said the credit profiles of most big non-Turkish firms operating in the country, including consumer goods firms Nestlé, Unilever and Philip Morris International, were likely to remain largely "unaffected by [domestic] political uncertainty". Yet Crédit Agricole's Tresca believes investors have simply chosen to ignore the perils that exist in a brittle country low on confidence and which bows to the whims of an increasingly autocratic patriarch.

That could change quickly in the months ahead. In Turkey, the position of president is a ceremonial one, where the cutting of ribbons not the shaping of laws is the order of the day. Erdoğan wants to alter that, emasculating the role of the prime minister and transforming his office into a powerful executive presidency in the American — or better yet, the Russian — mould.

Yet that can only happen by rewriting the constitution, which requires the president either to win an up-or-down vote, via a single-issue referendum, or to secure a two-thirds super-majority for his ruling AKP party in the Turkish parliament. Many believe Erdoğan is more likely to consider the latter option, leveraging his high popularity ratings in the wake of the coup to declare another general election in the months ahead. "His popularity could give him the parliamentary super-majority he craves," says Crédit Agricole's Tresca. "If he calls a poll, it would likely take place in the last two months of the year or early in the first quarter" of 2017.

Erdoğan, ever the astute politician, will be aware of the dangers of treading this path. Turkey's electorate have trudged to the polls twice in the past 14 months; few would embrace a third vote, called merely to increase one man's control over them.

He will also be aware of the wave of good luck that Turkey has ridden for much of the year. The banking sector remains in robust shape, boasting in the main low levels of non-performing loans and high levels of capital adequacy. "I can't see a danger on the horizon in that space," says Credit Agricole's Tresca. "The only near term threat would

be if the government attempted to revive a flagging economy by pressuring banks to lower rates in order to boost credit growth."

LUCKY TIMING

The Turkish government was also fortunate that, on the night of July 15, the wider populace emerged onto the street to fight those who sought to re-assert the military's longstanding domestic dominance by toppling the man who had done so much to clip their wings.

The coup also happened at a generally favourable time for emerging markets. Investors in search of cheap equities and high yields have returned in force to higher yielding markets and assets this year. Billions of dollars have been sucked into emerging market funds, pushing share valuations in the likes of Russia to all-time highs. In Turkey, the Borsa Istanbul 100 index is up 7.5% through the year to September 14, while 10 year sovereign bonds are paying out more than six times their US equivalents.

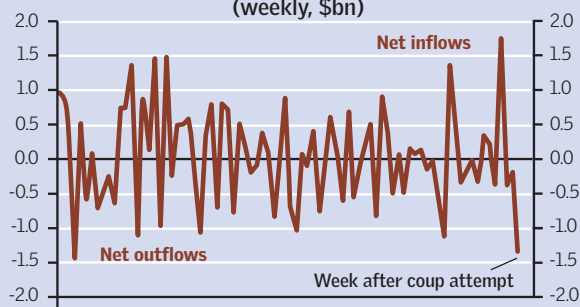
Had the coup taken place in a less benign time for emerging markets, "the [negative] impact on assets would have been stronger", notes SocGen's Hulea. "What helped was that global appetite was quite resilient at that point — plus the way the central bank and other ministries reacted was very positive. There was a lot of good and regular communication between government and investors and analysts."

Turkey then needs to cross its fingers and hope that investor appetite continues to favour higher yielding markets and assets. "Global investors are complacent about what's happening in Turkey," notes SocGen's Hulea. Adds Crédit Agricole's Tresca: "In my view, most of the flows draining into emerging markets are by investors who know little about the emerging world. These guys can leave very rapidly if the political risk rises again — if, for example, there are new snap elections or an unofficial rewriting of the constitution. Long term investors such as European corporates could well be put off by rising political uncertainty."

That, in the end, could be the factor that convinces Turkey's president not to go through with yet another general election. Instead, he could focus on pushing through the reforms Turkey desperately needs, from boosting productivity and liberalising the state railway system to improving labour market flexibility and deepening the country's capital markets. "Predicting Erdoğan is tricky at the best of times," says William Jackson, a senior emerging markets economist at London-based Capital Economics. "There is a state of emergency in place which allows him to amend various powers in legislative and administrative branches. Given that, I would wonder if new elections are really necessary at the moment." **EM**

Stressed

Turkish banks' net borrowing from banks abroad (weekly, \$bn)





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Palestine: Finance & Banking

OVERVIEW

A Robust & inclusive banking system

Resilience is hard-wired into the Palestinian economy's DNA. In the West Bank and Gaza, businesses are forced to be innovative and creative as a result of the restrictions that the political situation has imposed on them.

Despite adverse regional circumstances, notably declining foreign donor aid in recent years, the Palestinian economy has managed to keep growing, with the World Bank forecasting 3.5% GDP expansion in 2016. The Bank has lauded the achievement of the Palestinian Authority (PA) in reducing the fiscal deficit in the past decade, cutting it by 15 percentage

points to 10% of GDP even while external financial support has fallen at a faster rate.

The PA's fiscal deficit (before grants) narrowed in 2015 to 11.7% of GDP with expenditure growth of 6% — mainly driven by spending on transfers and goods and services — offset by strong revenue growth of 9%.

The biggest challenge, though, is the decline by almost 50% in foreign support to the PA in the past three years, which has left the budget under severe strain and the pensions system close to collapse, the (World?)Bank says. Aid in 2015 dropped by almost 30% relative to the previous year and was less than what was needed to

cover the deficit, leading to a \$650m financing gap. The PA resorted to accumulation of arrears and domestic borrowing to cover the gap. The lower donor support has been responsible for a slowdown in West Bank growth to 2.8% in 2015, about 2.5% lower than 2014. The Israeli government's decision to suspend the transfer of Palestinian taxes in early 2015 is another factor that has contributed to a severe liquidity squeeze.

The situation differs between the West Bank and Gaza. Reconstruction efforts have provided a boost to the Gaza economy where real GDP growth is estimated to have reached 5% in 2015,



ensures economic resilience

driven by strong growth in the construction sector as well as retail and wholesale trade.

Despite an adverse political environment, the Palestinian Authority has sought to attract investors and address key economic reform measures such as the new Movable Assets Law, which allows machinery to be used as collateral in case of default.

NEW VISION

Some of the most prominent Palestinian companies and investors are looking to revive the economy, launching in late August 2016 a “new vision for the revival of the Palestinian econo-

my” blueprint, backed by leading businesses including Paltel, the telecoms group, Padico, an industrial conglomerate, the Bank of Palestine and the National Beverage Company. This is to recommend tackling specific socio-economic challenges and promote investment in specific sectors, then identifying whether these should be tackled by government or the private sector or both. These sectors include agribusiness, water, power infrastructure and tourism.

The banking sector meanwhile remains a stalwart source of support for the Palestinian economy. Palestinian banks have maintained upward trends in growth in assets, deposits and

also lending, with a more focused strategy on financial inclusion to reach all segments of economy activity in the country via policies safeguarded by the Palestinian Monetary Authority (PMA).

“The key stabilisation factor is the health and stamina of the financial and banking sector in Palestine,” says Hashim Shawa, chairman and general manager of Bank of Palestine (BoP).

A new IMF report issued in August 2016 stresses the importance of maintaining correspondent banking relations with international

Continued on page III

and Israeli banks to maintain financial stability and flow of trade and confidence in the market.

"We see the role of our bank and all banks as crucial in maintaining the health of the financial system," says Shawa. "The onus in a place like Palestine remains on the banking system to adapt to challenges and provide creative solutions to help sustain this economic resilience. Our bank has adapted skillfully to these challenges. During the latest Gaza war we kept our ATM machines fed with cash at great risk to ensure customers were able to purchase essentials during ceasefire periods. This is a commitment we uphold seriously."

The bank also helped industries whose factories had been destroyed to rebuild them in post-war Gaza with softer loan terms. It continues to undertake similar interventions even during periods of calm and business as usual as the need is great. The strategy has paid dividends, with enhanced customer loyalty, with discipline in loan repayment and with credit history records that are reflected in low NPLs. "We stand by our customers in times of great need; they stand by us all the time," says Shawa.

Inevitably, Palestine often suffers from imposed exogenous incidents and unpredictability. That forces banks to respond. "We have adapted to the interplay between flexibility and resilience," says Shawa. "But the hallmark of our ability to cope is the predictability and the fundamentality of our stringent banking regulations."

PMA RESTRICTIONS

The PMA's role in underscoring economic and financial stability is critical. The PMA does not conduct a comprehensive monetary policy typical of a central bank, such as setting an inflation rate target and the concomitant interest rate, as a result of the absence of a national currency.

"It is well known that the PMA works in a highly risky environment, which prevents it from fully carrying out its tasks like other central banks, especially with regard to developing and implementing monetary policy and the relationship with Israeli correspondent banks," says PMA governor Azzam Shawwa.

The PMA has nonetheless been able to deploy some major monetary policy instruments such as the required reserve ratio and put in place the appropriate analytical and informational framework for setting monetary policy.

As Shawwa points out, the PMA has been collecting and analysing critical economic and financial data, developing the appropriate instruments and econometric models for economic and financial data analysis and forecasting, and conducting and disseminating essential studies and reports (including a quarterly Inflation Report, quarterly and annual Economic Report and an annual Financial Stability Report).

"In spite of the adverse economic and political climate, the PMA continues to make steady strides towards ensuring the stability, efficiency and robust growth of the financial system in various ways," says Governor Shawwa.

These include developing the appropriate regulatory and supervisory measures for banks, money changers (is this right?) and specialised lending institutions legally controlled by PMA (specifically risk-

FACING FACTS

Political risk: territorial discontinuity as a result of Israeli occupation and oppressive practices (blockades, checkpoints, etc.).

Foreign exchange risk: posed by the absence of a national currency and dealing with three currencies in circulation, ILS, USD and JOD.

Unstable government revenues: partly because of heavy reliance on donors aid and occasional Israeli government withholding of custom revenues due to Palestinians.

Regional instability.

Credit risk: arising mainly from loans to the government and its employees.

Restrictions on the shipment of excess Israeli shekel cash accumulated at the Palestinian banks: the mechanism in place allows shipments on a monthly basis limited to NIS 300m in addition to the exceptional shipments by prior approval of the Israeli side. The PMA monitors liquidity closely and takes necessary measures to step in to handle any liquidity issue facing banks.

The issue of noncompliance by the Israeli side with important provisions of the Paris Economic Protocol under the Geneva Accords: especially regarding maintaining normal relations between the Palestinian and Israeli banks. This is occasionally indicated by threats by some Israeli banks to cut off correspondent relationships with the Palestinian banks.

based inspections and business continuity in line with Basel standards).

The PMA has established a state-of-the-art credit bureau covering borrowers' credit records facilitating and safeguarding bank loans' expansion, which helps drive the economic development process. It has also instituted the Palestine Deposit Insurance Corporation, which covers over 93% of the depositors and spurred both public deposits and savings.

The PMA has developed an efficient payments system that ensures the smooth settlement, growth and automation of interbank and customer transactions. It is broadening its regional and international relationships network by, among other things, concluding various technical cooperation and assistance agreements with other central banks in the region and beyond and with international financial institutions, including the IMF and World Bank.

In close collaboration with the IMF and ECB, the PMA is drafting the new Central Bank law affirming PMA's independence and potential role in the formulation and implementation of an appropriate monetary policy, specifically when the essential prerequisites are fulfilled for the issuance of a Palestinian national currency.

MODERNISING BANKS

The PMA also has a role to play in encouraging banks to invest in technology and to service the SME segment of the economy. "The PMA's strategy is to enforce and encourage banks to provide modern banking services and to use technology and advanced systems to provide these services," says Governor Shawwa.

For example, the PMA has implemented country-wide systems that provide the core infrastructure for the banks to provide e-services. The first was the RTGS system (branded as BURAQ), which provides the core and backbone of the payments system among banks. In addition, the PMA has also implemented a clearing house system which provides automated check clearing processing.

In this context, PMA also initiated a project during



PMA governor Azzam Shawwa identifies the key challenges facing Palestinian banks and financial institutions

2016 to implement electronic cheque clearing, which will adopt the necessary technology in check truncation and clear cheques electronically without the need to exchange the paper cheques. The PMA also implemented the National ATM switch which connects all the ATM networks in the banks in one domestic network, which reduced transaction cost and enhanced the retail payments system's efficiency.

The PMA mandates all banks to provide e-banking services to their customers through secured web services. They must also have business continuity arrangements in place including, but not limited to, disaster recovery sites, alternative sites and remote access, coupled with business continuity policies and procedures.

IN FOCUS: PALESTINIAN SMEs

The PMA has paid particular attention to the SME sector in view of its key role in the development of the national economy, the creation of job opportunities, alleviation of rising unemployment, diversification of income and fostering of entrepreneurship. To that end, it is carrying out the responsibilities assigned to a technical committee established in 2013 in order to enhance SME capabilities, including implementing the recommendations of the Fourth Banking Conference, 2013, which aims to empower SMEs, enhance their capabilities and facilitate their access to finance and credit.

The PMA has put in place a number of measures and regulations:

- Special lending institutions under the PMA supervision umbrella (besides banks and money changers), given that these institutions account for a significant credit to SMEs.
- Making efforts to support SMEs by facilitating their access to financing and credit sources. Consequently, the PMA adopted several incentivising measures, including waiving the requirement of an advance cash payment of 10% of SMEs' outstanding debt bal-

This requires banks to invest internally in technology to integrate with these systems, and their services were changed to become more technology dependent and less paper-based.

Palestinian banks are supportive of the PMA's efforts. "We are fortunate to have a regulatory body in the PMA that has created a safe working environment for banks to work in Palestine based on adherence to international standards and creation of custom made regulations to fit the local environment," says BoP's Shawa. "This approach has provided a safe and professional working environment for banks, protecting the sector from possible upheavals and insulating it from international financial crises."

The PMA has adopted local AML and CFT regulations in addition to adhering to international AML standards, with constant reviews of the implementation of these practices within the sector supported by international bodies.

"The PMA has also encouraged banks to focus on financial inclusion and promoting cashless transactions, activities that Bank of Palestine is well immersed in with our own financial inclusion and electronic banking programmes," says BoP's Shawa.

Regulatory oversight is a key aim of PMA policy. "Palestinian banks are complying with Basel II capital requirements," says Governor Shawwa. "All banks meet the minimum capital adequacy ratio, which is 12% as stipulated in the PMA regulations; the average capital adequacy ratio for all banks is about 17%. Meanwhile, in 2015 the PMA asked banks to raise the paid-up capital to \$75 million by end-2017."

The PMA has recently implemented Basel II requirements on the Palestinian banking sector subject to a parallel-run period with Basel I requirements. This implementation is being done in collaboration with the World Bank. The PMA plans to gradually adopt Basel III capital and liq-



Future PMA building

uidity requirements in the mid-term.

All Palestinian banks meet the minimum liquidity requirements stipulated by the PMA regulations both on cash ratio of main currencies — NIS, Jordanian Dinars, USD and the euro (3% for each currency and 6% for all currencies together) – and the legal liquidity ratio (25%). Stress testing results revealed that all banks have passed all the liquidity shock tests.

ISLAMIC BANKING

Developing full Islamic banking is also part of the PMA's plans. The PMA recent licensed a new third Islamic bank, which will start operations in 2016.

The PMA has focused strongly on combatting money laundering and countering terrorist financing. It began its Anti Money Laundering/Combating Financing of Terrorism (AML/CFT) efforts in 2004 by establishing the Financial Follow-up Unit (FFU). The

PMA became an observer member in the Middle East and North Africa Financial Action Task Force (MENAFATF) on money laundering in 2006 and a full member in 2015.

In 2007, the PMA issued the AML Decree Law no. 9/2007, which was developed with technical assistance by the IMF and in line with international standards for combatting money laundering. The law stipulated the establishment of the National Committee for Anti Money Laundering (NCAML) and the FFU as the executive engine for its anti-money laundering national apparatus.

In 2015, also with technical assistance from the IMF, Palestine issued the AML/CFT Decree Law no. 20/2015, which adopted the revised recommendations on AML/CFT after major challenges in the underlying legal infrastructure were overcome.

These efforts have received the support of the PA. At end-December 2015, the Presidential Decree Law no. 14/2015 was issued to implement UN Security Council resolutions on criminalisation and combatting the financing of terrorism.

The NCAML/CFT issued regulations for the financial and non-financial sectors to comply with the law. These sectors include banks, money changers, micro-finance institutions, securities firms, insurance companies, mortgages and non-financial businesses and professions such as jewellers and gold merchants.

Concentrating on corruption as a main driver for money laundering and to comply with revised recommendations in this regard, the NCAML signed a Memorandum of Understanding (MoU) with the Anti-Corruption Commission and issued regulations to the financial sector regarding Politically Exposed Persons (PEPs).

In 2013, the FFU signed MoUs with different national entities (the ministries of interior and national security, national economy, finance, justice and transportation in addition to the land authority) and regional counterparts to facilitate the flow of information and better coordinate AML/CFT efforts.

The PMA is actively seeking technical assistance especially from the IMF in the implementation of the AML/CFT laws and evaluation of progress made so far to qualify for MEANAFATF evaluation, tentatively slated to occur in 2024. ■

ance when rescheduling a non-performing loan, and exempting banks from the 2% risk reserve requirement on facilities granted to SMEs to motivate banks to expand SME financing.

- Coordinating with the Ministry of National Economy to allow banks and specialised lending institutions to access information on companies and institutions registered with the Ministry, issuing the law on Movable Assets Registry, which would reduce onerous lending preconditions for business; allow such assets to be on loan collateral; and expand access to facilities through mortgage and registry of the enterprise's assets pursuant to the Law.
- Planning for the development of an SME credit scoring system, which takes into account PMA policy to promote SME access to sources of finance. Also PMA has launched a SME database with comprehensive information on SME debt finance portfolios. The database allows users access to a number of analytical and supervisory reports, which contribute to better control of the sector and help develop SMEs' capacities and access to financing sources.
- In 2015, the PMA and the World Bank Group jointly established a Credit Guarantee Facility aimed at reviving the private sector in Gaza by enhancing access to bank credit, especially establishments which sustained heavy damages due to the Israeli-Gaza hostilities around mid-2014.
- The PMA took necessary measures to amend the provisions of Clause 32 of the 2010 Presidential Decree no. 3 on Banking Law, in order to create a legal mechanism by which it becomes permissible for banks to enquire about deferred cheques drawn on customer accounts in order to verify the creditworthiness of customers and enterprises.



BANKING

Bank of Palestine grows its footprint at home and abroad



Mr. Hashim Shawa, Chairman/GM Bank of Palestine

Bank of Palestine (BoP), Palestine's largest financial institution, has made a habit over its 56-year history of defying the odds. Operating out of the West Bank, the lender has grown into the most widespread branch network in Palestine, with assets of over \$4bn.

Listed on the Palestine Exchange since 2005, the bank is also profitable, reporting a 7.25% increase in net profit to \$24.4 million for the first six months of 2016 compared to the previous year. Gross income of \$82.49m was 19.2% higher.

The bank's chairman and general manager Hashim Shawa points out that BoP has now crossed the \$4bn threshold of total assets with 65 branches spanning all of Palestine. It continues to be Palestine's leading bank in terms of presence and branch network and sustained growth in all financial indicators across its operations.

"Our revenue drivers stem first from this sustained pursuit of strategic presence in urban and rural areas, providing wider access to finance and transacting services. With fast-growing demand on banking products in unbanked regions and traditional centres of commerce and an emerging youthful population, our strategy aims to satisfy the world standard of a maximum of 10,000 customers per branch," says Shawa.

As such, the bank aims to continue expanding its branch network, not only in pursuit of business but also in fulfilment of a financial inclusion mandate to all customer segments and all regions.

The scale of operations is necessarily broad. BoP is engaged in retail, corporate, micro & SME financing and diaspora banking operations – the latter a significant theme given the large numbers of Palestinians who reside outside Palestine's borders.

BoP is also the sole agent for issuing and acquiring Visa and MasterCard in Palestine with over 5,900 point of sale merchant terminals nationwide. It is also involved in large project finance loan syndications. It adopts a holistic sustainability strategy and has worked with the International Finance Corporation (IFC) to develop a stringent risk management and governance structure.

MSME SUPPORT

Revenue enhancement has benefited from segmentation and provision of niche services coupled with financial and non-financial advisory services to grow

our customer segments. "The bank has continued to focus on financing and supporting micro, small and medium sized enterprises (MSMEs), given the fact they are the engine of growth in an emerging economy like Palestine where 87% of the Palestinian workforce is employed," says Shawa.

Revenue enhancement has equally benefited from segmentation and provision of niche services coupled with financial and non-financial advisory services to grow its customer segments. "The Bank has continued to focus on financing and supporting micro, small, and medium sized enterprises (MSMEs), given the fact they are the engine of growth in an emerging economy like Palestine, where 87% of the Palestinian workforce is employed," says Shawa.

Accordingly, the bank has established a specialist MSME unit to help low income business owners develop their businesses across Palestine including rural areas. "As these businesses grow, Bank of Palestine continues to work with them, responding to their growth and changing needs with more sophisticated products and advisory services," says Shawa.

This segmentation has helped diversify BoP's asset quality with the dedication of \$200m to finance SMEs, and the percentage of MSME lending grew to 19% from total loan portfolio balancing exposure to corporate, retail and government lending. The IFC estimated the financing gap for the MSME segment in Palestine at around \$900 million, providing ample room for more MSME focus at the bank.

"Our targeting of MSMEs and women has proven an astute decision given the high degree of credit discipline within these segments that are eager to obtain financing and ensure creditworthiness. This duet of resilience and discipline has managed to keep our non-performing loan ratios at approximately 1.4% at half-year 2016," says Shawa.

BoP continues to develop its products and services to meet various client needs with continued enhancement of the bank's credit card holders experience, creating additional treasury services, rigorous savings campaigns and a push towards more plastic card business utilising the widespread POS presence with new premium cards on offer.

The bank has just signed an agreement with Royal Jordanian airline for a cobranded card allowing cardholders to earn air miles with RJ every time they use the card. "With a push towards electronic banking, we will continue to promote the recently established e-commerce and mobile banking platforms," says Shawa. "The bank in partnership with its subsidiary PalPay® has launched the first mobile application e-bank allowing customers to pay their bills and transfer funds to a friend using a registered mobile number at the bank. This has helped the bank service more customers electronically, and especially with mobile accessibility on the rise.

In its efforts to maintain high liquidity ratios above the current 14.5% and strong capital adequacy, BoP has

finalised an agreement with IFC to receive a \$50m subordinated loan, which will help it in meeting its obligation to achieve growth and expansion targets.

The bank will continue its growth strategy of expanding its branch network at home and opening representative offices in key international markets, it's evident that the bank's ambitions do not stop at home or in the region.

Additionally, the bank has recently finalised two important strategic banking acquisition deals helping its growth strategy. The first deal was a merger deal whereby the Palestine Commercial Bank, a local commercial bank, was successfully merged with the Bank of Palestine in a share swap of 3:1 in favour of the BoP share. This merger will increase the paid up capital of BoP by \$10m, strengthening its capital adequacy to a comfortable \$195m in paid-up capital, a reality that will allow its market position to become dominant across all operational indicators.

"The merger deal was well received by the market and the regulators and was done with the determination to grasp an opportunity to grow and consolidate resources," says Shawa.

ISLAMIC BANKING

The second deal was the acquisition of an additional 31% stake in the Arab Islamic Bank (AIB). This share acquisition allowed BoP to become a majority shareholder in an Islamic banking operation in Palestine, holding 51.98% of AIB shares. Although AIB will remain an independent subsidiary, this determining block will allow BOP to provide Islamic banking solutions to a growing segment of the population who require such Islamic banking services, complementing BOP's strength in traditional banking services.

The driver for this deal was simple: the market share of Islamic banking in Palestine is only at 10% while the real potential is at 25%, an indication of a promising market opportunity and a window to provide Islamic financial inclusion to a segment of the population desirous of sharia compliant banking services.

SUPPORTING THE DIASPORA

Bank of Palestine is growing in both geography and size with a corresponding increased sense of mission. Since starting in Gaza in 1960 and despite the early years of forced closure post the 1967 occupation of Palestine, the bank resumed operations in 1981 with a stronger determination to serve all Palestinians inside and outside the geography of Palestine.

"The determination by the founders of the bank at the time instilled into our DNA a responsibility to carry on with this mission," says Shawa.



Corporate Headquarters, Bank of Palestine, Ramallah Palestine

Bank of Palestine Board Members, Sibos Geneva 2016

The bank set up its first presence in the West Bank in 1994 in the aftermath of the Oslo Peace Process to gain a foothold in the entire geography of Palestine. With an expanding branch network across the West Bank and Gaza, Shawa argues it was only natural that the bank, the carrier of the national name of the country, would take its brand to the GCC region. The bulk of the Palestinian people as a result of their history of past wars and resulting displacement reside outside of their natural homeland.

“More than 7.62m Palestinians live outside Palestine while 4.75m reside within the West Bank and Gaza. The need to connect with this sizeable diaspora community compelled us to establish a dedicated diaspora unit and an international strategy starting with a representative office presence in key hub markets,” says Shawa

This international expansion will help BoP gain the trust of its customers and offer its services to millions in the GCC area acting as an economic bridge that will not only connect Palestinian expats in the region to their homeland, but will equally help showcase investment opportunities to international investors leveraging the legacy and stamina of the bank at home.

“Our first such representative office opening was at the Dubai International Financial Centre (DIFC) in the heart of the Gulf Region serving not only the 1m Palestinian residents in the extended GCC region with bank accounts at BOP and increased resultant business registration,” says Shawa.

This is one of the bank’s most significant milestones since its establishment in 1960. “This key step of being

part of the international financial community was made possible by the support of the Palestinian government, the Palestinian Monetary Authority, the Dubai Government, the DIFC Authority, our stakeholders and our customers and employees,” he says. “Our presence at DIFC will strengthen the Palestinian financial and banking system. This international expansion will help us gain the trust of our customers and offer our services to millions in the GCC area acting as an economic bridge that connects Palestinian expats in the region to their homeland, leveraging many shared values.”

INTO SOUTH AMERICA

BoP is also planning to be the first Arab and Palestinian bank to have a footprint in Latin America via a planned presence in Chile, where a sizeable Palestinian population lives.

Many people questioned the logic of the bank’s intention to open its second representative office in 2017 in Santiago, Chile. But Shawa points out this was not only natural but an important milestone in its international representative office strategy. Chile is home to 500,000 Chileans of Palestinian origin with evolving connections with their original home, Palestine. Santiago De Chile is also a recognised hub for the Latin America region with approximately 1m Palestinian diaspora spread in the continent.

“Being the first Arab bank and Palestinian bank to open a representative office in Chile, we help bring Palestine and the Middle East region closer to the burgeoning community of Palestinian diaspora and Latin

Americans in the entire region who are challenged in their connectivity to Palestine by physical and cultural distances,” says Shawa.

The bank is never only commercially oriented towards these important connections. “We feel a sense of responsibility and we invest in a holistic relationship through a sustainable partnership involving knowledge transfer, joint projects and Community based interventions involving culture, sport, arts and music. Such foundational partnerships with the diaspora communities helps first to serve our human mission and in due course our commercial mission. When we serve the diaspora community nearby in the Levant and GCC and more importantly in the furthest corners of the planet in Chile and Latin America we feel a sense of mission achieved, and our values served across the divide of time and distance,” says Shawa.

Shawa remains optimistic despite the many challenges facing his country. “At Bank of Palestine we remain buoyant about Palestine and its economic potential,” he says. “The country remains endowed with a young population with 70% of the population under the age of 34 years, with an economy that is nascent and rich with ample opportunity for future development of both the country’s human and physical resources. As such, we want to be innovative applying FinTech and electronic banking in future strategies, engaging more youth segments and providing new products using all platforms of customer care with, humanity and agility.” ■

INCLUSION TOPS THE AGENDA

BoP has been the leader in Corporate Social Responsibility (CSR) in Palestine dedicating 6% of its net profit to community & human development. This ties in with a broader commitment to financial inclusion.

Palestine is unique as it is divided, because of the remaining military occupation of key regions, and accessibility from the hinterland to the town centres is difficult. Therefore financial inclusion has a physical value as well as a virtual value. As a result the bank implements financial inclusion through branch presence in remote villages, virtual presence via electronic banking and content via programmes targeting segments of the most unbanked. In addition to working with the micro enterprise segment, the bank has focused on key unbanked segments of the population, mainly women through innovative approaches and partnerships with world bodies.

Women are a key target demographic for the bank. “We started with women because women suffer from a high 37% unemployment and only 20% of bank accounts in Palestine are owned by women, while studies have shown that more than 60% of women-owned businesses in Palestine have unmet financing needs with a strong desire by women to launch their own businesses,” says the bank’s chairman and general manager, Hashim Shawa.

The bank has created its flagship “Felestinya” women’s programme to change this reality and achieve financial inclusion. The programme focuses on economic and social empowerment

for women both at the bank and in the market place, with a target of reaching 1,000 women per year, providing key financial awareness sessions for them. The programme uses novelty interventions such as the Mini-MBA in partnership with the IFC, which has enabled the creation of a skillset training programme for six months on business and leadership skills.

The Felestinya programme for women also features loans without collateral and accepting gold as collateral from women. Results have been outstanding in both the marked jump in the number of women who bank and resultant business registration. In recognition the bank was awarded Best Bank in the Middle East for Financial Inclusion by emefinance presented in 2015 and became a member of the Global Banking Alliance for Women (GBA) and a signatory of the

Women’s Empowerment Principles (WEPs).

The bank was included in July 2016 as a member of the Global Alliance for Banking on Values in recognition of its value system and work in financial inclusion.

Next on the bank’s financial inclusion agenda is the youth segment. With youth unemployment at 50% and with entrepreneurs not having early stage financing, Bank of Palestine has stepped in to create a bridging mechanism to support investing in aspiring entrepreneurs. The bank, along with several like-minded partners, has established a \$10m Ibtikar Fund (pictured above). The objective of this fund is to invest selectively in Palestinian early stage innovative ventures focusing primarily on the ICT sectors. While this intervention is a start in this youth segment, the bank plans to unveil more programmes in 2017.

SOVEREIGNS ROUNDTABLE PANELLISTS

**RICARDO ADROQUE,**
HEAD OF EMERGING
MARKETS DEBT
GROUP, BARINGS,
BOSTON**JEAN-DOMINIQUE
BÜTIKOFER, HEAD
OF EMERGING
MARKETS FIXED
INCOME, VOYA
INVESTMENT
MANAGEMENT,
ATLANTA****PABLO GOLDBERG,**
MANAGING
DIRECTOR,
PORTFOLIO
MANAGER
AND SENIOR
STRATEGIST,
EMERGING
MARKETS,
BLACKROCK**ED PARKER,**
MANAGING
DIRECTOR, FITCH
RATINGS, LONDON**THOMAS
ROOKMAAKER,**
DIRECTOR, FITCH
RATINGS, HONG
KONG**SHELLY SHETTY,**
SENIOR DIRECTOR,
HEAD OF LATIN
AMERICAN
SOVEREIGNS, FITCH
RATINGS, NEW
YORK

EM: Over the last 12 months, has there been a disconnect between EM credit quality in and the performance of EMD?

Parker, Fitch: Yes. From a top-down perspective, in contrast to the positive sentiment in the market this year, 2016 is going to be a year of record sovereign ratings downgrades for Fitch. Already, there have been 20 downgrades, 17 of which are EM. Moreover, we have 17 EM on Negative Outlooks, signalling that further downgrades are likely.

The deterioration in credit fundamentals signalled by our sovereign downgrades suggests that the positive market sentiment this year to a large extent reflects investors' search for yield. It is also a reflection of the rebound from the pervasive pessimism we saw among investors following the taper tantrum over three years ago.

One partial explanation is that quite a few of the downgrades we've seen have been for smaller countries that have a lower weight in EM indices. Nevertheless, there is a very clear pattern across our ratings of downgrades and negative actions.

The disconnect between credit quality and the performance of Emerging Market Debt mirrors what we have seen in some developed economies where yields are at record lows, even though there are still very high levels of government and debt.

Shetty, Fitch: Downward ratings pressures have clearly intensified across the Latin American region. We have downgraded Brazil thrice over the last year, most recently in May with a downgrade to BB with a negative outlook. We downgraded Bolivia in July, and assigned negative outlooks to Colombia in July and Ecuador in August. We have also downgraded Suriname,

**PHIL MOORE,**
MODERATOR

which has been affected by the commodity shock, from BB- to B+.

We now have five sovereigns with a negative outlook, including Colombia, Costa Rica, Brazil, Ecuador and Suriname, and only one on a positive outlook. This is the Dominican Republic, which is B+ positive.

Rookmaaker, Fitch: Globally, we've seen as many downgrades this year as we did in 2011, which was the year of the European debt crisis, when a number of investment grade countries were downgraded.

But in Asia we haven't seen as much downward pressure on ratings. The two countries we now have on negative outlook are Japan for idiosyncratic reasons, and Sri Lanka, which we downgraded with a negative outlook in February because of deterioration in the fiscal sphere and pressure on the external front.

Asia looks relatively strong compared to other regions. Economic growth is still relatively high in the region and most of the Asian countries are net oil importers, although Malaysia, Indonesia and Mongolia are relatively big commodity exporters. Another consideration is that in Asia, external financing requirements are generally quite low compared with the other big emerging markets, which helps in times of stress.

Goldberg, BlackRock: It's true that in terms of ratings, we are currently seeing a negative credit cycle of the intensity of the one we saw during the global financial crisis. We don't think this is necessarily warranted, but it has been anticipated by spreads. Remember that we had been living through a bear market in EM for three years between 2013 and 2015.

Very early in the year we felt that EM had become oversold, which paved the way for the first part of the rally, which was a decrease in risk aversion.

The second phase of the rally had to do with fundamentals. As EM currencies started to recover, we began to see a disinflationary process in many EM countries, particularly in those where central banks had been tightening monetary policy.

Another reason we have become more bullish about EM was the bottoming-up we saw in commodity prices, with OPEC starting to talk about stabilising oil prices, which is another fundamental support for EM.

So we had a bottoming of the growth cycle, some rally in currencies and a reduction in risk aversion. Putting all these together, our fair value models are justifying the rallies we've been seeing.

I wouldn't agree that this rally has been accompanied by no improvement in fundamentals, but we are in a very different growth environment to what we saw prior to the global financial crisis and the taper tantrum. We're in a more mature environment for global growth which is driven by lower rates, which means the search for yield will stay very much alive.

Adroque, Barings: My overall view is that there have been some fundamental changes in EM



RICARDO ADROQUE
BARINGS, BOSTON

over the last decade. At the very least, EM have demonstrated their capacity to withstand what has been a fairly negative global environment in terms of outflows from EM, depreciating currencies and declining commodity prices. Given such a negative global environment, the resilience that EM have been showing is very encouraging.

So investor appetite is not necessarily being driven by the search for high yields, but by the expectation that it is unlikely yields will need to go any higher.

EM: What are the main macro drivers of the weakening of sovereign credit quality?

Shetty, Fitch: In some ways, the Latin American region has become more resilient in the sense that we haven't had a traditional balance of payments and currency crisis. FX flexibility, inflation-targeting regimes and the overall credibility we've seen from Latin American policymakers have all been positive.

That said, the region is still affected by the aftershocks of the commodity downturn which has been transmitted through FX rates, asset prices and even sovereign borrowing rates. The main effect of all these influences is that we're seeing fairly subdued economic performance across most countries in the Latin American region.

It looks as though 2016 will be a second consecutive year of economic contraction in Latin America, with recession not just in Brazil and Venezuela but also in Argentina and Ecuador. We're expecting a contraction in regional GDP of more than 1% this year, before a recovery to around 1.5% in 2017 with positive growth in all countries in the region except Venezuela.

There are downside risks to our growth projections, largely because commodity prices are unlikely to recover dramatically and we could still see bouts of international volatility. More importantly, the domestic drivers of growth are still fairly uncertain.

There was positive spill-over during the past decade from a very good commodities price

environment, which translated into increases in investment, credit growth and consumption. Now that commodities prices have fallen, this has been replaced by a negative spill-over with investment contraction in some countries, slower credit growth and consumers feeling the headwinds from deteriorating labour markets.

In most cases, negative ratings actions in Latin America are being prompted by the growth challenges we've seen in some of these countries or fiscal and debt trajectory issues. In some cases we have also highlighted external vulnerabilities, such as the high current account deficit in Colombia, and the erosion of external buffers which is the case in Bolivia.

EM: How is the commodities shock affecting Sub-Saharan Africa?

Parker, Fitch: Sub-Saharan Africa is one region where we have seen a lot of negative actions since 2014. The main reason for that has been low commodity prices, and if they were to fall further or fail to recover from where they are now, we will continue to see stresses building up in a number of countries there.

In quite a few of these countries we have seen a build-up in debt levels, stemming from fairly aggressive capital expenditure programmes. In the boom years there was fiscal loosening and an increase in public debt. Now that the economic and commodity cycle has turned, we've seen growth slowing, deficits increasing and debt service burdens rising.

EM: A year ago, investors were nervous about the likely impact on EMD of a tightening of US monetary policy. Today, are EM less vulnerable than they were to rising US rates? If so, why?

Goldberg, BlackRock: One of the things that made us more bullish about EM in early January was more dovish central banks around the world. This is important because the strength of the dollar was leading to high currency volatility which had an impact on inflation and in turn meant that some EM countries had to tighten monetary policy. So the stability of the dollar was a very important change in the fundamental picture of EM.

Our analysis shows EM spreads tend to cushion the impact of higher US long rates on EMD performance. This is not the case, however, if the movement in rates is sharp and sudden – like in the taper tantrum. Given the current level of US yields, an active management of duration appears increasingly important.

Bütikofer, Voya: We have to split the answer in two; the impact of capital flows and the debt dynamic.

First, could a G7 interest rates normalization derail capital flows to EM, as investors repatriate part of their investments? How sticky are these flows, especially ETF flows, given the current chase for yield?

In short, we think the overall vulnerability of EM to capital outflows has reduced. The reality is that most EM countries have significantly lengthened their debt profile over the last decade with less reliance on external funding. As such, most EM sovereigns are now more immune to capital outflows and roll-over risk than they have been in the past. However, the current account financing still remains an issue in certain emerging markets. Turkey is one such example, given its reliance on capital flows. However, despite market volatility and nervousness over the summer, its solvency was not at risk and the market stress was short-lived and well managed by the Central Bank of the Republic of Turkey.

In addition, we do not expect the EM private sector high leverage to challenge sovereign creditworthiness. While this debt roll-over risk has yet to be tested, large EM corporates are proactively lengthening their debt maturity profile and lowering their average cost of funding. This is a positive evolution and should reduce countries' balance of payments vulnerabilities. Secondly, could an abrupt outflow put EM currencies and spreads under renewed pressure threatening sovereign debt dynamics?

We expect that a rise of G7 yields would only have a marginally impactful on debt dynamics and credit metrics of emerging countries. EM sovereigns have benefited significantly from the long-term decline of their cost of funding as global liquidity has increased. We think that EM Central Banks have more ammunition compared to DM Central Banks to loosen their monetary policy. This would improve further their overall debt dynamic. In a world where the pace of global growth has slowed, as long as orthodox EM fiscal policies remain, we don't foresee a rapid worsening of sovereign debt dynamics on the back of higher yields in the US. We do not exclude that steeper G7 yield curves may lead to some curve steepening, affecting long-dated maturities. However, this does not necessarily result in a deterioration of their credit metrics overall.

Adroque, Barings: Generally I would say that EM are less vulnerable to a rise in rates than they were a year ago. That may change, given that there is still a tail risk that the US may hike rates twice, and but possibly even more aggressively.

At the same time, the dependence of EM on portfolio flows has lessened quite significantly. A year ago, when EM were more dependent on portfolio flows, it may have made more sense to be concerned about a US Fed rate increase. This year, a Fed hike would certainly be negative from a flow perspective, but it has become less of a concern given that many EM have reduced their current account deficits.

EM: Given that EMD is such a heterogeneous asset class, are some economies considerably more vulnerable to these flows than others?

Adroque, Barings: Of course, some countries

have remained more dependent on portfolio flows than others. Countries that have smaller local markets and lower levels of reserves, for instance, as well as more recent issuers in the international markets, are most at risk. Some of the African economies with very small domestic markets come to mind. But by the same token, those markets also tend to offer higher yields.

Other countries that could be affected more negatively are those with the most stable economies that today are trading at a very small spread to US Treasuries. Chile is one example of a country that may be more vulnerable in the event of a sell-off in US Treasuries.

Argentina, a new issuer in external markets, may also be more at risk in the event of a US rate hike. However, for the time being, the amount of debt that Argentina has issued in international markets makes this less of a concern.

Parker, Fitch: We don't expect US rates to rise either very sharply or to very high levels.

This means that the absolute level of US rates



ED PARKER,
FITCH RATINGS

should be manageable for most markets. But especially if rates started to rise more quickly than is currently being priced in by the market, we may see another bout of financial market volatility which in turn could lead to a reduction in capital inflows.

It is the countries with large external financing requirements that will be most exposed in the event of a drop in capital inflows to EM or a sharp increase in risk premiums.

Of the large EM, Turkey stands out as one with large external financing needs. It has a persistently large current account deficit, although this has fallen to around 4% of GDP this year due to lower oil prices. But we would expect the current account deficit to drift up again in 2017 and 2018.

Turkey also has high short-term debt and amortisations relative to foreign exchange reserves.

We have seen quite an extended lending boom in Turkey, with a rise in credit to GDP and the loan-to-deposit ratio in the banking sector. Quite a bit of the borrowing has been in foreign cur-

rency, so there are some warning signs there.

That said, Turkey has had no problem at all in financing its current account deficit and rolling over its external debt throughout the last decade in spite of the stress tests of the global financial and eurozone crises, as well as numerous domestic shocks.

Rookmaaker, Fitch: Countries like Thailand, China and India all have relatively strong external balances. If you're a net creditor you're much less vulnerable to general EM turmoil arising from Fed policy normalisation or whatever.

EM: On the subject of Asia, another common concern this time last year was the outlook for China, and the implications that a sharp slowdown in China would have for the broader EM universe. Have these concerns receded?

Rookmaaker, Fitch: The market indeed seemed concerned a year or so ago about growth in China. But growth has remained relatively strong. In the last quarter it was 6.7% y-o-y, and we expect growth of 6.5% in 2016, before coming down to 6.3% in 2017 and 5.8% in 2018.

Growth over the last decade has been mainly investment-intensive and credit-driven, which is a model that is not sustainable in the long run. The level of corporate debt is still rising, and more and more forms a drag on growth. At the same time, we are also seeing some rebalancing of the economy towards more consumer-driven growth.

One reason why we expect to see a gradual slowdown rather than a hard landing is because we believe the authorities have a relatively strong capability to manage the economy. Most lenders and borrowers are either state-owned or heavily influenced by the government, which reduces the risk of a sudden loss of investor confidence. The financial system in China is also largely funded by deposits, which form a relatively stable source of funding.

While the authorities seem to recognise the importance of dealing with the debt issue, the government's high growth targets are not consistent with deleveraging the economy, so there is a mixed signal there.

There is significant exposure in Asia to a risk of a severe slowdown scenario in China, not least because trade linkages are relatively strong. For example, Korea sends 25% of its exports to China and another 30% or so to other Asian countries. There are also countries with large banking system exposures to China, like Hong Kong and Macau.

Investors also often use the Korean won as a hedging proxy for the yuan, which means that in times or turmoil there is also potentially a very strong linkage between the currencies of Korea and China.

Parker, Fitch: Clearly Chinese demand has a knock-on effect in terms of commodity prices and global risk sentiment. If we think back to August or December last year and February

this year, when we had episodes of heightened concern over the global economy and EM, much of it stemmed from fears about the risk of a hard landing in China. If we see fresh concerns about a slowdown in China we would expect that to affect EM.

China has also been a very large provider of finance to EM, particularly to the resource exporters of Africa. So far, we haven't seen any signs that China is retrenching from that position, but if there were a change in Chinese policy regarding international financing this would spill over to Africa.

Goldberg, BlackRock: At the start of the year, we saw signs that the Chinese stimulus was starting to filter through the economy and the pace of the slowdown in China started to taper. The People's Bank of China also became much better at communicating its strategy on the renminbi, which helped reduce uncertainty and anchor EM currencies. As long as the RMB was under pressure, it would have been difficult for other RM currencies to recover.

Adroque, Barings: The impact of the slowdown in China's economy has already been felt in EM, primarily through lower commodity prices over the last two years. Given that China is one of the biggest, if not *the* biggest, importer of commodities in the world, it has already benefited from weaker commodity prices — specifically, lower commodity prices have led to a transfer of resources from emerging markets to China. As such, it's not surprising that China has not yet suffered a hard landing.

At the same time, we think China now has the resources to avoid a hard landing. In China, politics and the economy are closely intertwined, which we believe significantly reduces the risk of a hard landing in the short term. So we do not expect to see a significant economic problem in China.

If economic problems do arise, we believe the country's political system will likely be able to resolve them. We don't see concerns regarding the political system in China creating significant risks.

EM: Political risk continues to impact a number of EM. Russia, Turkey, Brazil and South Africa are all recent examples. What is the outlook for political risk in the EM universe?

Parker, Fitch: There are always downside risks from political news flows in EM.

In the countries you mention, those risks have probably increased over the last year, although maybe less so in Russia where it is a couple of years since western sanctions were imposed. I'd say that political risk has settled down, but given Russia's relations with the west there is always the chance of a further flare-up in geopolitical risk.

In Turkey, political risk has increased over the last couple of years, which was confirmed in the coup attempt in July and the response

of the authorities. The scale of the purge since the coup generates uncertainty over the capacity of the government and checks and balances. Other adverse events include the spill-over from the Syria conflict and the terrorist attacks on Istanbul and Ankara which are having a negative impact on tourism where revenues are down 40% y-o-y in the first half of 2016.

In South Africa, we've also seen some increase in political risk. As in Turkey, there has been a long term deterioration in governance levels and some increase in corruption. But more immediately there are now tensions between finance minister Pravin Gordhan and President Zuma which is knocking confidence. If we were to see Gordhan being ousted in circumstances which signalled that the country was moving in the direction of fiscal loosening, it would be likely to have an adverse effect on the economy and creditworthiness.

There is also the uncertainty over the ANC leadership contest in 2017 which is driving an intensification of the internal battles within the party.

We've seen closely fought elections in many African countries, leading to some hold-up in economic adjustment programmes. In some cases we've also seen some disputed results which have yet to play out, which may increase the risk of political and economic destabilisation in some of those countries.

Rookmaaker, Fitch: I'm often asked about political risk by investors. For example, if there is a change of government we are often asked how we view the potential for policy change from a risk perspective. We explain that we focus more on policy implementation rather than personality. For example, I've had a lot of questions recently about the new central bank governor in India.

Another political risk is violence and terrorism. For example, there has been a lot of political violence in Bangladesh in recent years because of the polarisation between the two main political parties.

It's an over-simplification, but in some respects the Bangladeshi economy rests on two pillars – one is remittances which account for 7% of annual GDP and the other is garment exports which account for 12%. So these are very important for the economy, and if foreign investors in the garments industry decide to move their business elsewhere, it would mean that one of those pillars would be taken away which would disrupt the growth model. So from a ratings perspective, that could have a significant impact.

Another topical example of geopolitical risk in the region is Korea. Whenever there is news about North Korean missile tests, reporters call me and ask if we are going to downgrade South Korea as a result. Since such tensions tend to build up and calm down again we try to rate through this tension cycle, but we do factor this geopolitical risk into our analysis and ratings.

EM: Are investors adequately paid for these risks?



JEAN-DOMINIQUE BÜTIKOFER
VOYA INVESTMENT MANAGEMENT,
ATLANTA

Bütikofer, Voya: This is a question researchers and investors have been struggling with for years. How do you model or realistically quantify the political risk premium inherent in financial assets? We know from experience that increased political uncertainties impact investor confidence and market volatility. However, EM have always had to deal with political uncertainties and risks. In some respects these risks have risen over the last 18 months.

EM spreads implicitly embed some political risk premium but these premiums differ based on whether a country is high yield or investment grade. Instead of trying to quantify the political risk premium, we try to assess the second derivative impact on the fundamentals of an economy. For example, how will declining consumer confidence impact growth or how will fiscal behaviour impact sovereign credit metrics? This has to be assessed on a case by case analysis basis and in some respects we think investors may have been a bit too complacent given recent events

Adrogué, Barings: The EM universe is vast, and whether investors are being compensated for risks varies from country to country.

In the case of Russia, we don't think investors are being adequately compensated for political risk. There, bonds are still trading very close to where they were prior to March 2014, and the world has changed since then. In our opinion, the type of risk investors are facing in Russia should be considered higher today than it was prior to March 2014.

In Brazil, political risk is closer to being priced in. The news in Brazil is actually more positive than it has been, and now that the impeachment procedure has played out, Brazil could have two years of political stability.

In Turkey, while it is true that President Erdogan is in control, we are somewhat concerned about the political direction in which the country is headed. Given this potential political risk, we do not think investors are being fully compensated.

Finally, in the case of South Africa, we think investors are in most cases being compensated

for political risk. Following the most recent municipal elections in which the ANC gained a slim majority, the country appears to be evolving politically toward a more open, democratic system. This evolution should create a much more stable environment over the long term.

In the short term, volatility will likely increase due to the in-fighting within the ANC. But looking ahead two to three years, the prospects for political stability in South Africa are looking much better.

Goldberg, BlackRock: Political risk differs considerably from one market to the next. For example, the political risk you're taking in Argentina is whether the normalisation of the political environment will lead to a normalisation of the economy. Will growth rise and inflation fall fast enough to sustain political support for a more market-friendly environment?

In Venezuela, you're taking a significant amount of political risk, but you're getting paid a pretty hefty coupon for it.

In South Africa, investor sentiment was improving and then we had the tension between Zuma and Gordhan.

In Turkey, there was a lot of political risk and markets sold off to the extent where perhaps investors are now being adequately paid for that risk.

So it is a different story in each market, which is why we are so adamant about the need for selectivity in EM.

Parker, Fitch: The key issue for us is the impact of this political risk on economic performance and public finances. So far in Turkey we've seen growth holding up reasonably well. The government deficit remains low, at 2% of GDP, and the public debt/GDP ratio continues to decline, which has been keeping Turkey at investment grade, although we assigned a negative outlook to our BBB- rating in August.

Another country that has been affected by political change is Poland, where Fitch has taken a more constructive view than some other market participants. We have affirmed our A- rating since the Law & Justice Party came to power at the end of last year.

There was some concern about its policies on institutional reform, but we don't expect to see significant spill-overs from this into the economy. We think Poland will continue to grow at a good pace, the government is committed to keeping the budget deficit below 3% of GDP, and has backed away from a conversion of Swiss franc mortgages in a manner that could be damaging to the banking sector. So we don't see the political change last year in Poland leading to a significant deterioration in the country's economic prospects or creditworthiness.

Shetty, Fitch: Against the backdrop of slower growth and some political pressures given the low popularity ratings of several leaders in the region, the challenge is how to cope with the fiscal pressures that are emerging.

Obviously a lot of people are talking at the moment about politics in Brazil. As to its impact on the economy, we expect another contraction this year and then a cyclical recovery coming about next year driven by improving confidence indicators and a more market-friendly policy approach.

That said, the sustainability of this uptrend in confidence indicators depends on the progress that the government is able to make in terms of passing measures that consolidate the outlook for public finances and growth. Yes, we see signs of bottoming out and stabilisation, but we're still expecting fairly subdued growth of about 1% in Brazil in 2017.

EM: More broadly, are we seeing more of a commitment to structural reform in Latin America?

Shetty, Fitch: I think that policymakers in several countries in the region are coming to the same conclusion, which is that growth rates could be much more moderate than in recent years in the absence of structural reforms.

Clearly, we are seeing a number of new governments in the region emphasising the need to improve productivity and private investment in order to boost growth prospects because they're not going to benefit from the tailwinds of higher commodity prices. We will need more structural reforms if we need domestic demand to become an engine of growth.

This applies to several countries. Since 2013, Mexico has been implementing quite important reforms, but their effect will only be felt over the medium to long term, and their effectiveness will also depend on the ability of the government to strengthen the rule of law. The Mexican government has been able to make steady progress on oil sector reform despite low oil prices, and in the electricity sector there have been reforms designed to attract private investment. This in turn will translate into lower costs for the manufacturing sector over the medium term.

I think Brazil is rightly focused now on fiscal measures and other initiatives to strengthen the public finances. But the new economic team has also been sending out some encouraging signals about reducing state interventionism and eliminating the requirement to have minimum participation by Petrobras on pre-sal projects. They have also been giving signals about attracting more private investment in the infrastructure sector which is very much needed.

Elsewhere in the region, Colombia is becoming much more focused on its 4G infrastructure projects which have now reached the implementation stage. Colombia also has a long-term opportunity arising from its peace deal which should help boost the agricultural sector and improve efficiencies in the wider economy.

In Peru, as well, the new government is emphasising the need to boost growth through reducing labour informality and boosting investment and growth among SMEs and moving faster on infrastructure projects.

So I think a number of countries are making it clear that the way to reverse the decline in potential growth will be through productivity-enhancing structural reform. As in any region, the impact of these reforms will only be felt in an incremental fashion and in the medium term. But it has been encouraging to see that policymakers are becoming more focused on the structural reform issue.

EM: What progress is being made in terms of structural reforms elsewhere in the EM universe?

Rookmaaker, Fitch: In India, we're seeing more structural reform being implemented than expected. When Modi was elected in May 2014 his government immediately started to roll out reforms, not all of which proved easy to implement – especially the big ticket ones. But we've seen notable progress recently with the passing in the Upper House of the bankruptcy act and the goods and services tax (GST).

There has been a lot of progress but starting from a low base. The weakness of the business environment in India is reflected in the World Bank Doing Business Indicators. Of all the countries in the triple-B category, India has ranked the lowest in this respect. The fiscal position is also weak compared with its peers, and continues to constrain India's sovereign ratings.

But India is still a positive story in the sense that growth is relatively high and structural reforms are being implemented. The same goes for Indonesia, where reforms started later and were difficult to implement at first, but since September last year we have seen an acceleration in the ambitious reform process. Some of these reforms are minor but others are making a significant improvement to the business environment.

Goldberg, BlackRock: I don't see a great commitment to structural reform in EM. But this is not unique to EM. It is challenging to implement structural reforms anywhere in the world. They tend only to be introduced *en masse* when countries experience a severe crisis, and we are not seeing crises similar to those of previous EM stress that have acted as an impetus for reform.

But we have seen reform in Argentina, and in Colombia we are seeing a push for tax reform. In Mexico there has been progress on reforms surrounding Pemex. In Brazil we need to see some fiscal consolidation.

In Asia, there has been some progress on structural reforms in Indonesia. In India there has been quite a lot of hype over reform, and in China the pace of reform is still an open question.

EM: Thomas mentioned earlier that Asia has been relatively unaffected by the wave of sovereign downgrades we've seen in 2016. Elsewhere in the EM world, where are the good news stories in terms of growth?



SHELLY SHETTY
FITCH RATINGS

Shetty, Fitch: From a ratings perspective, we're not really seeing any positive momentum in the region partly because the economic recovery projected for next year is so subdued. Fiscal challenges have not been completely overcome and debt dynamics are stable at best and in several cases still deteriorating a little.

The exception is the Dominican Republic, where we've seen resilience in domestic drivers of growth such as tourism and business services. We've also seen a reduction in external vulnerabilities with a decline in the current account deficit. They have also gone through an election cycle and it appears that fiscal discipline has been maintained.

In some of the smaller Central American countries, where we have seen a positive terms of trade shock, the picture is rather more mixed. In these countries we've seen more resilient growth, lower inflation, a reduction in current account deficits and savings on energy costs, which has been supportive of fiscal accounts. However, in several cases, structural constraints limit the upside in terms of ratings.

Parker, Fitch: In the EMEA region, we've had two upgrades in this year. We upgraded Hungary back to investment grade and we also upgraded Serbia to BB-. Central and Eastern European economies are generally much better placed than Africa. They are gainers from lower commodity prices and have benefited from the return to growth in the Eurozone and from the lower financing costs flowing through as a result of quantitative easing.

Also, in most countries in the region we haven't seen private sector credit booms as most have been in a deleveraging cycle since the global financial crisis. So Central and Eastern Europe is the brightest spot in the EMEA universe.

EM: How are investors positioning themselves to protect against economic and political risk, and to benefit from some of the more positive dynamics affecting EMD?



PABLO GOLDBERG
BLACKROCK

Goldberg, BlackRock: As the rally has started to mature, we assume that investors can no longer expect to generate returns in EM by playing the beta. Today you need to look for the good alpha stories, which means you need to be selective and focus on active management, both in terms of credit selection and duration.

I don't think we're yet at the stage where we can expect massive appreciation in EM currencies, so local market selection should be based on tactical allocations.

In terms of looking for asset classes that give you alpha, we think EM corporates may be a good source of return.

The markets we like at the moment include smaller African names, Indonesia and Russia. There are also some crowded trades that need to be monitored closely. Argentina is one example. Venezuela and Brazil are others.

Bütikofer, Voya: Investors are attracted to EM fixed income for various reasons. The asset class has grown significantly in size and depth over last decade. It offers investors many diversification opportunities and various sources of returns; however each comes with its own set of embedded risks.

Over the last decade, EM debt was sold as a convergence to DM story, with higher growth leading to improved fundamentals, ratings upgrades, lower risk premiums and strong returns. The latest EM ratings downgrades have not forced us to revisit the long-term EMD investment case, but we strive to diversify as much as possible across EM quasi-sovereigns, corporates and selected domestic bond markets. Nevertheless, the aforementioned risks keep us vigilant and focused on underlying fundamental drivers while monitoring closely momentum and the catalysts of investor flows. These inflows create a positive dynamic for EM countries restoring both consumer and investor confidence. The result is often lower credit risk premiums and stronger currencies which further contribute to an improvement in fundamentals.

In order to benefit from this positive dynamic, we try to blend contributors to performance

not over-relying on one single position thereby avoiding concentration risk. After such an amazing spread compression and currency performance, carry may be the most stable source of returns for the next three to six months. We expect investor risk appetite to remain highly correlated to the upcoming Fed policy, the outcome of the US election and the extent of continued financial market momentum.

EM: We talk about emerging markets as though they are a homogenous asset class? Isn't it possible to find pockets of value in such a diverse asset class?

Bütikofer, Voya: Yes, but in today's low yielding world, the reality is that everyone is chasing any high yielding asset class, credit or instruments. The ETF-isation of the latest inflows into EMD has led to lower differentiation across credit and issuers. So we agree that some countries, currencies and corporate sectors that previously underperformed are now showing better value than others; but the question is, are they offering enough upside given their risk premium and will this liquidity-driven rally continue or are we facing the risk of a reversal?

We are somewhat cautious given the strong year-to-date performance, but we recognize that since the G20 meeting in January, global central banks and finance ministries have been committed to global financial markets stability, which should help confidence. While investors may be worried about the lack of global growth and trade prospects, we see this central bank commitment and support as beneficial for EM countries.

This means that EMD as an asset class is a hold rather than a sell.

In EM, we recommend long-term investors take a diversified approach to EMD. In our EM diversified portfolio we are overweight EM credit to capture carry and further potential spread contraction while hard currency denominated external debt — sovereign, quasi-sovereign and corporates — make up the core of the portfolio. Despite underperformance in 2014-15, we think EM local rates and some currencies offer some interesting opportunities. But as currencies contribute a lot to the overall portfolio volatility, it's a tactical positioning trade rather than a five year buy-and-hold strategy.

In terms of my favoured markets, we have been big believers in the Argentina turnaround story for nearly a year now. We have been in the trade from the beginning but it is gradually becoming a consensus trade so we now have to question how much of the positive story is already priced in and what are the upcoming risks.

In Russia the risk premium has declined significantly and at these levels it no longer yields as much as we might like.

Last, there remain opportunities in Sub-Saharan and African countries but they come with considerable idiosyncratic risks. One has to pay very close attention to macro fundamentals, politics and credit dynamics in each country.

Adroque, Barings: We see many potential opportunities across the EM universe, including in sovereign hard currency debt, corporate debt and local debt (sovereign debt issued in local currencies). One area I would highlight is EM corporates, which have fared well in spite of the depreciation in their countries' currencies, the weakness in commodity prices and the persistently negative headlines surrounding the asset class.

In fact, corporates have performed very well. In terms of spread, EM corporates have come down significantly versus their local sovereigns. Contrary to what the Bank for International Settlements and the IMF have said over the last two years — that corporate debt was high risk because it was dollarised and therefore vulnerable to currency depreciation — corporates have performed well.

Given that currencies appear to have stabilised, and even assuming that the Fed will raise interest rates, we don't envision a significant increase in corporate defaults or a large sell-off in the corporate market. Overall, we are quite constructive on the asset class.

In general, when investing in EM, selectivity and active management are critical as performance can vary significantly. Something we track in order to assess the attractiveness of certain issuers is the spread of EM corporates against the debt of the sovereigns in which they operate. Using this analysis, we have found that for the most part, Latin American corporates have done very well.

EM: Is the universe of liquid available instruments open to you increasing, and is it providing enough diversification in terms of geographies, sectors, currencies and maturities?

Adroque, Barings: Yes. While the local currency corporate market is still relatively small, across asset classes and geographies the EM universe as a whole offers a large pipeline of opportunities from which to seek attractive risk-adjusted returns.

EM: What would your favoured trade be today?

Adroque, Barings: Across all of Barings' EMD strategies, we believe rigorous, bottom-up analysis is critical to identifying the most attractive opportunities as they emerge across the asset class. That said, I currently see potential benefits in a diversified portfolio of local rate bonds, partially currency-hedged, in markets that have already experienced currency depreciation as a result of rising inflation and interest rates. These markets could include Malaysia, Indonesia, Brazil, Colombia and South Africa where currencies now appear cheap to fair value.

It's also important to note that opportunities in EM can appear and fade quickly. As such, it is critical to have a comprehensive understanding of the countries, sectors and issuers that make up the asset class before investing in its debt.

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What's happening Thursday, October 6



10.00am – 11.00am

Seminar: **The governance gap: why does half the world distrust government and what can we do about it?**

Speakers: **Adnan Khan**, Research and Policy Director, International Growth Centre; **Winnie Byanyima**, Executive Director Oxfam International; **Edmund Malesky**, Professor of Political Science, Duke University; **Kyle Peters**, Interim Managing Director and COO and Senior Vice-President, Operations, World Bank
Moderator: **Clare Short**, Chair, Cities Alliance, Former Secretary of State for International Development, UK
Location: World Bank Group MC Building, Jim Wolfensohn Atrium

10.00am – 11.30am

Seminar: **How can South Asia's firms better compete?**

Speakers: **Indrajit Coomaraswamy**, Central Bank Governor, Sri Lanka; **Annette Dixon**, Vice-President, South Asia Region, World Bank Group; **Kim Elliot**, Senior Fellow, Center for Global Development; **Anabel Gonzalez**, Senior Director, Trade & Competitiveness, World Bank Group; **Rubana Huq**, Managing Director, Mohammadi Group, Bangladesh; **Pravin Krishna**, Professor of International Economics and Business, Johns Hopkins University
Moderator: **Anubha Bhonsle**, Journalist
Location: World Bank Group MC Building, MC 13-301

10.00am – 11.30am

Seminar: **Fiscal policy in the new normal**

Speakers: **Mitsuhiro Furusawa**, Deputy Managing Director, IMF; **Brad Delong**, Professor, University of California, Berkeley; **Bill Morneau**, Finance Minister of Canada; **Ludger**

Schuknecht, Chief Economist, German Ministry of Finance; **Arvind Subramanian**, Chief Economic Adviser to the Government of India
Location: George Washington University, Jack Morton Auditorium

11.00am – 12.30pm

Seminar: **Human capital summit: investing in the early years for growth and productivity**

Speakers: **Jim Yong Kim**, President, World Bank Group; **Louis Paul Motaze**, Minister of Economy, Planning and Regional Development, Cameroon; **Daniel Kablan Duncan**, Prime Minister, Cote D'Ivoire; **Jimmy Morales**, President, Guatemala; **Ato Abdulaziz Mohammed**, Minister of Finance and Economic Cooperation, Ethiopia; **Sri Mulyani Indrawati**, Minister of Finance, Indonesia; **Gervais Rakotoarimanana**, Minister of Finance and Budget, Madagascar; **Muhammad Ishaq Dar**, Minister of Finance, Pakistan; **Amadou Ba**, Minister of Economy, Finance and Planning, Senegal; **Samia Suluhu**, Vice-President, Tanzania
Moderator: **Julie Gichuru**, TV Host, Africa Leadership Dialogues
Location: World Bank Group MC Building, Preston Auditorium

12.00pm – 1.00pm

Seminar: **CNN debate on the global economy**

Speakers: **Christine Lagarde**, Managing Director, IMF; **Mark Carney**, Governor, Bank of England; **Wolfgang Schäuble**, Finance Minister, Germany; **Yi Gang**, Deputy Governor of the People's Bank of China
Moderator: **Richard Quest**, Anchor, CNN
Location: IMF HQ1 Atrium

12.30pm – 2.00pm

Seminar: **Identification for development: harnessing the power of digital solutions**

Speakers: **Paul Romer**, Chief Economist, World Bank; **Tara Nathan**, Executive Vice President, Public-Private Partnerships, MasterCard; **Ajay Bhushan Pandey**, CEO Unique Identification Authority of India (UIDAI); **Sri Mulyani Indrawati**, Minister of Finance, Indonesia; **Justin Forsyth**, Deputy Executive Director, Partnerships, UNICEF; **John Guisti**, Chief Regulatory Officer, GSMA
Location: World Bank Group, MC Building, MC2-800

1.00pm – 2.00pm

Seminar: **Integration in the Americas: views from the Pacific Alliance and Argentina**

Opening: **Jim Yong Kim**, President, World Bank Group
Speakers: **Alfonso Prat-Gay**, Finance Minister, Argentina; **Alfredo Thorne**, Finance Minister, Peru; **Jose Antonio Meade**, Finance Minister, Mexico; **Mauricio Cardenas**, Finance Minister, Colombia; **Rodrigo Valdes**, Finance Minister, Chile

Moderator: **Josefina Townsend**, Newscaster, Lima, Peru

Location: World Bank Group MC Building, Preston Auditorium

3.30pm – 5.00pm

Seminar: **From risk to reward: accelerating business engagement globally in pursuit of the SDGs**

Speakers: **Gavin Wilson**, CEO, IFC Asset Management Co; **Mark Malloch-Brown**, Chair, Business and Sustainable Development Commission; **Hendrik du Toit**, CEO, Investec Asset Management; **Helen Hai**, CEO, Made in Africa Initiative; **Laura Alfaro**, Warren Alpert Professor, Harvard Business School; **Amy Jadesimi**, Managing Director, Lagos Deep Offshore Logistics Base
Moderator: **Jane Nelson**, Director of the Corporate Social Responsibility Initiative, Kennedy School of Government, Harvard University
Location: IFC Building, IFC Auditorium

Seminar Pick

2.30pm – 4.00pm

Seminar: **Borrow without sorrow: managing debt in a volatile global economy**

Speakers: **Jan Walliser**, Vice-President, Equitable Growth,

Finance and Institutions, World Bank; **Mauricio Cardenas**, Minister of Finance and Public Credit, Colombia; **Pravin Gordhan**, Minister of Finance, South Africa; **Moritz Kraemer**, Global Chief Ratings Officer Sovereigns, Standard and Poor's; **Liliana Rojas Suarez**, Senior Fellow, Center for Global Development; **Apisak Tantivorawong**, Minister of Finance, Thailand
Moderator: **Francine Lacqua**, Anchor, Bloomberg Television
Location: World Bank Group J Building, J B1-080



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4.00pm - 5.15pm

Seminar: Asia in the evolving international monetary system

Speakers: Barry Eichengreen, George C. Pardee and Helen N. Pardee Professor of Economics and Professor of Political Science at the University of California, Berkeley; Eisuke Sakakibara, Aoyama-Gakuin University in Tokyo, former Vice Minister of Finance, Japan; Andrew Sheng, Distinguished Fellow of the Asia Global Institute at the University of Hong Kong; Dr. Duvvuri Subbarao, former Governor of the Reserve Bank of India; Perry Warjiyo, Deputy Governor of the Bank Indonesia
Location: George Washington University, Jack Morton Auditorium

5.00pm - 6.00pm

Seminar: Great expectations: the test of multilateralism

Moderator: Clare Short, Chair, Cities Alliance; former Secretary of State for International Development, UK
Speakers: Shaolin Yang, Managing Director, World Bank Group; Lars Hendrik Roller, Economic and Financial Policy Adviser to the Federal Chancellor, Germany; Sherpa for Germany's G20 Presidency; Joachim von Amsberg, Vice-President for Operations Policy and Strategy, Asian Infrastructure and Investment Bank; Ray Offenheiser, President, Oxfam USA
Location: World Bank Group MC Building, Preston Auditorium

OfNote

10:00am

Roundtable: The Outlook on Indian Markets. India's economic outlook in light of the recent reforms enacted by Prime Minister Modi's government.
Host: US India Business Council (USIBC)
Speaker: Dharmakirti Joshi, Chief Economist, CRISIL Limited
Location: 1615 H St NW, Washington, DC
RSVP: Ketan Thakkar (kthakkar@usibc.com)

ExtraCurricular

Institute of International Finance (IIF) 2016 Annual Membership Meeting

Location: Ronald Reagan Building and International Trade Center, Washington, DC

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Frontier Markets Location: Atrium Ballroom A

8.00am - 9.15am

Opportunities and Challenges: Edwin Gutierrez, Monish Mahurkar, Mthuli Ncube, Jean-Charles Sambor, Sonja Gibbs (moderator), Jitania Kandhari, Monish Mahurkar

9.15am - 9.45am
Zambia

9.45am - 10.15am

Sri Lanka: Indrajit Coomaraswamy

10.15am - 10.45am

Papua New Guinea

10.45am - 11.30am

Egypt: Tarek Amer, Amr El Garhy

11.30am - 12.15pm

Lebanon: Saad Andary

1.30pm - 2.15pm

Paraguay: Carlos Fernandez Valdovinos, Santiago Pena Palacios

2.15pm - 2.45pm

Ghana: Johnson Asiamah

2.45pm - 3.25pm

Kenya: Patrick Njoroge

4.00pm - 6.30pm
IIF View of the World: Staff Presentations:

Brexit Location: Atrium Ballroom A

1.30pm - 2.30pm

UK Outlook: Stephanie Flanders, Rain Newton-Smith, Stewart Wood, Sara Eisen (moderator)

2.30pm - 3.30pm

EU/UK: What Next for the Relationship?: Steven Maijor, Barney Reynolds, Kristen Silverberg (moderator); David Wright, Anthony Browne,

3.30pm - 4.30pm

In Conversation

4.00pm - 4.30pm

Journalist roundtable: Martin Arnold, Ed Conway, Simon Nixon, Ben White

4.30pm - 5.30pm

Impact on the Financial Sector: Frederic Drevon, Simon Gleeson, Rupert Harrison, Andrew Large (moderator), Davide Serra

5.30pm - 6.30pm

The Future of the EU: Vladis Dombrovskis, Reza Moghadam, Kay Swinburne, Vittorio Grilli, Hans Kundnani,

4.00pm - 6.30pm
IIF View of the World: Staff Presentations:

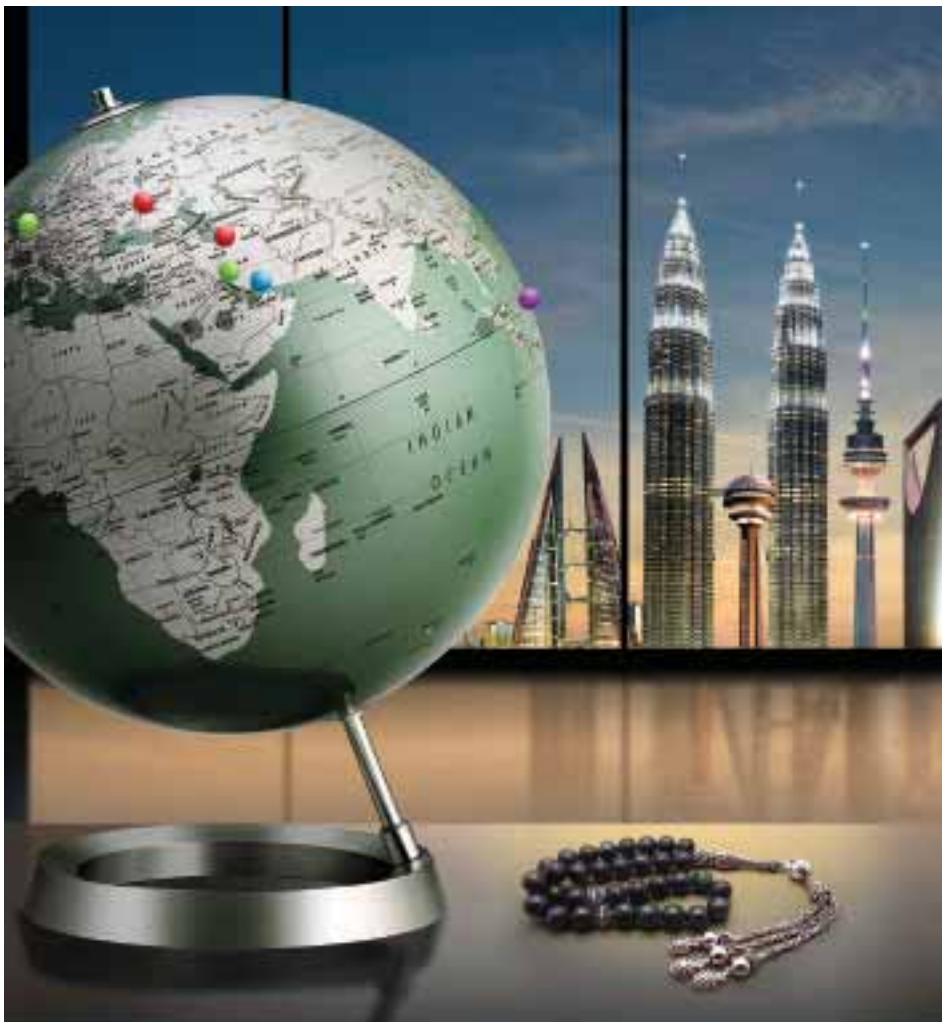


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THE final word

The \$40bn investment in AMR that could save \$100tr

By Jim O'Neill

Two years ago I was tasked by the then UK Prime Minister David Cameron to lead an independent global review into antimicrobial resistance (AMR) — the worsening problem of drug-resistant infections. As a result of increasing rates of resistance our antibiotics, as well as antimalarial and antiretroviral drugs, are already becoming less effective, and in some cases completely ineffective.

This is exacerbated by too much unnecessary use of antibiotics in both humans and animals, while at the same time many people who are in most need of these drugs do not have access to them. At a low estimate, 700,000 people already die every year from AMR. This is not just a future health threat — it is already a medical emergency in many parts of the world. To make matters worse, we are not creating anywhere near enough new drugs to combat this problem — no new class of antibiotics has been developed in decades. The medicine cupboard is bare.

The problem of resistance has been recognised by scientists for as long as we have had antibiotics, but it is clear to me that if the world is to tackle this threat we need much more focus on this problem from global finance and economic development ministries. This has been a focus of my review since we began, when we explored the human and economic costs of resistance if we do not take action now. We estimated that by 2050 the yearly death toll could rise to a staggering 10 million people every year, with a cumulative cost to world GDP of around \$100trn. To put this in context, this cumulative loss is larger than the world economy is today.

In a study published recently, the World Bank confirmed our estimates of the future economic impact, suggesting it could cause damage to the world economy on par with the 2008 financial crisis. While this kind of impact may seem like a stretch, the risks and cost of AMR become easier to grasp — and more startling still — when one realises how much modern medicine is reliant on effective antibiotics. Without antibiotics to control infections, hip replacements, gut surgery, chemotherapy and caesarean-sections would all become either highly risky or impossible.

G20 AGENDA

It is clear that this is an economic threat and needs to be on finance ministers' agendas as they are going to be



faced with picking up the bill if these costs come to be realised. Not to mention the terrible human cost of inaction that is already affecting far too many people across the world. I have advocated the G20 focussing on this issue since I began this work and was very pleased to see the detailed recognition of AMR in the September communiqué. The role the G20 gave to the OECD will also be critical in developing proposals to tackle the market failures for new antibiotics and diagnostics, to be agreed at next year's G20.

AMR is a problem for all parts of the world — bacteria do not respect borders and the world is more linked today than it ever has been. However, a common misperception when I started this review was that AMR is a problem for the "rich world". This is far from the truth — the biggest burden is, and will continue to be, felt in low and middle-income countries, as is sadly true for many infectious disease threats. This is why it also needs to be at the top of the development agenda. As one example, you only need to look at the terrible impact that drug-resistant TB is having already — around one third of the current 700,000 deaths from AMR every year are due to resistant TB. This is a disproportionate problem for many low and middle-income countries, which face the damaging triple burden of TB, HIV/AIDS and Malaria.

If the policies to develop new drugs and use the ones we have better are successfully delivered, we can stay ahead of this critical health threat and avoid huge economic costs. The total cost of my proposals is around \$40bn over 10 years. Investing \$40bn over a decade to save a \$100tr cost seems to me like one of the best investments that could be made.

We have made exciting progress this year on AMR but without the continued support and collaboration of governments, industry and international NGOs we will not deliver the change needed to avert this threat. The G20 has committed to come back to this problem in 2017 and in two years a UN taskforce will report back to the Secretary General, providing great opportunities for further progress. We are not static observers of history — we must act now to help secure the health of future generations.

Jim O'Neill is Chair of the Review on Antimicrobial Resistance.

Embattled Mercosur to suspend Venezuela amid attempts to boost regional trade

By Thierry Ogier

Mercosur, Latin America's Southern cone customs union, has threatened to suspend Venezuela's full membership on December 1 if it does not meet the group's requirements, including the democratic clause.

"We are in a stand-by position. Time will come," said Santiago Peña, Paraguay's finance minister, in an interview with *Emerging Markets*. "There is a date [that has been set]. They need to comply... If there is no progress, Argentina will probably take over [the rotating presidency] in January," he said.

Venezuela, which joined Mercosur in 2012 thanks to the pressure of Brazil and other countries, now finds itself isolated as most other countries in the region have conservative governments that are blaming Nicolas Maduro's economic policies for the economic collapse of the oil-rich country and for subsequent widespread shortages.

"We want to see improvement for the Venezuelan people, because we have witnessed what has happened in recent years. We want to see progress in Venezuela. It depends on the government to make that progress," said Peña. Venezuela has also been accused of violating human rights, which is in breach of Mercosur's democratic clause.

Paraguay first denied the right to Venezuela to assume the rotating presidency of Mercosur a few months ago, and it was later joined by Brazil and Argentina. "Venezuela needs to meet all the legal requirements," Peña said. "There has been no sign that it intends to do so."

TOUGH NEIGHBOURHOOD

In 2012, Venezuela also forced the suspension of Paraguay from the regional grouping after the impeachment of its left wing president Fernando Lugo.

"We did approve Venezuela's admission in Mercosur at the time. We do have enough authority to raise our voice because we have put the rule of law above political consideration," said Peña.

"It is a tough neighbourhood we have, and it is not going to change," he said, in a reference to a 19th Century war when the landlocked country was crushed by a triple alliance between Brazil, Argentina and Uruguay.

While trade between Brazil and Argentina has fallen by almost 50% in five years (to \$21bn per year), according to the Buenos Aires-based consultancy Abeceb, Paraguay, a small landlocked country, has described itself as a champion of free trade. "The current economic situation in the region is reminding us that we need to integrate. The lack of integration is a reason why South America is growing less than Asia," Peña said.

Meanwhile, Arturo Valenzuela, a former US assistant secretary of state, has argued that there is too much pessimism in Washington regarding Mercosur.

"I think there is a significant change taking place in Mercosur on a whole range of ideas, including economic issues that are very important.

Lagarde

Continued from page 1

"This is not to say that all banks are in a difficult situation in Europe but some of them really need to be addressed," she said.

"These institutions need to be managed because one of [them] is of systemic importance, and it is a very large institution — a complex one too. I think the authorities are aware that measures have to be taken. They are disposing of certain assets and considering disposing of further assets and strengthening the structure of the bank [concerned]."

Lagarde said the big difference between the US and Europe was that the US took "very abrupt and heavy duty measures to fix the financial sector, to fix the banks back in 2009 and to deal with the non-performing loans and the lack of capital".

US authorities "went heavy" on reform "whereas the Europeans did not do that and did not deal with non-performing loans as promptly as the US and did not take [such] hard-line measures. The financial sector, which was the big weakness of the financial crisis, was addressed head on and very promptly by US authorities whereas it was not the case in Europe. I think the Europeans are dragging things."

'STRETCHED THIN'

Lagarde said that zero or negative interest rates were "transforming the paradigm in which banks are operating. She said monetary policy was "being stretched thin". "If [this situation] lasts for a long time it is going to question the current business model not only of banks but

"There are populist voices around in various countries, and not just in the United States, calling for withdrawing behind borders, limiting the flow of goods and services, hindering the flow of people"—Christine Lagarde

also of insurance companies and pension funds. This is a very substantial issue."

She said that "a lot of good things have been done in the financial sector in terms of improved regulatory environment, improved supervision, better co-operation between regulators and supervisors".

"When we look at the banks there is clearly a stronger capital structure and more buffers. We have 'living wills' in place and we have in many instances bailing-in mechanisms that have been framed. Those are the positives since the global financial crisis."

But, she said, "with interest rates at the zero lower bound or less than zero lower bound [that] is clearly transforming the paradigm in which banks are operating. The second factor which has changed is the development of the non-bank financial sector or shadow banking sector."

The IMF head meanwhile expressed concerns to *Emerging Markets* over what she called the trend toward "reversal" of the process of globalisation.

This is affecting "the relatively free and unencumbered flow of goods and services [based on] existing international trade arrangements. There are populist voices around in various countries, and not just in the United States, calling for withdrawing behind borders, limiting the flow of goods and services, hindering the flow of people."

leading view

The great policy rotation

By James McCormack

The shift in policy emphasis toward greater fiscal easing in many advanced economies could support economic growth in the short term, but may be accompanied by financial market disruption. With markets so closely linked to the policy backdrop, investors should be sensitive to the risks ahead.

Policy settings at the European Central Bank and Bank of Japan, and the Bank of England's post-referendum initiative, indicate that continued monetary easing outside the US is a certainty in the coming months. This is despite policymakers and markets' increasing awareness of the unintended consequences of negative interest rates and recognition that the benefits of easing are more evident in financial asset prices than the real economy. The first of these considerations has resulted in policies becoming increasingly complex, particularly in Japan. A widely drawn conclusion, based in part on central bank officials' admissions that additional easing offers diminishing returns, is that monetary policy is running out of options.

The international policy community is building a consensus that stronger growth requires current easy-money conditions to be maintained (except by the Fed) and supplemented by greater fiscal stimulus. The G20 leaders' communiqué following the Hangzhou Summit tellingly listed "potential volatility in the financial markets" as the leading downside risk to the global economy, ahead of commodity prices, weak trade and investment, slow productivity and employment growth.

Recognition of financial market volatility as the key global risk — when markets are being driven intentionally by central bank actions — point to a clear continued accommodative bias to monetary policy.

In its July World Economic Outlook, the IMF sounded decidedly Japanese, making reference to the need for demand support and structural reforms "without leaving the entire stabilisation burden on the shoulders of central banks".

In Europe, the fiscal requirements of the Stability and Growth Pact are effectively non-binding for the time being, as shown by the Commission's recommendation in July to impose no fines on Portugal or Spain after the Council found that neither country had taken sufficient action to correct excessive deficits. This reflects the political realities of today's Europe, where anti-EU sentiment is high, and most evident on issues surrounding security and migration, and the imposition of fiscal austerity.

THE THREE T'S

The absence of much debate on the traditional "three T's"



of fiscal expansion (timely, targeted and temporary), probably because they are already agreed, provides further confirmation of the growing acceptance of pending fiscal easing. The consensus seems to be that the right time is now, the best target is infrastructure spending, and whether it is temporary depends on how long central banks can keep interest rates lower than GDP growth, which is a reasonable proxy for the return on infrastructure investment.

There is plenty of evidence that monetary policy has not been as effective as desired at raising inflation and supporting economic growth in recent years. The most compelling is the

degree to which "unconventional" policies have become accepted as necessary and rolled out with less surprise and impact over time. But there is no reason to believe that traditional fiscal policy will not work, at least in the short term, if large spending projects that contribute directly to GDP are undertaken, as is currently contemplated.

There are two reasons why financial markets could react

unfavourably to successful fiscal expansion. First, there may be concerns that a return to stronger economic growth would weaken the case for continued monetary easing. Even without an immediate pick-up in inflation, a growth spurt could call into question the justification for maintaining exceptionally easy money. Second, a "fiscal deflation" is possible, whereby an investment-led surge in growth contributes to higher prices and wages. Investment is typically more trade intensive than consumption spending,

and employment related to trade usually commands higher wages. This also lends to the view that co-ordinated fiscal policy is most advantageous, as there can be cross-border growth support.

Successful fiscal scenarios would conflict with the understanding that policy interest rates will remain "lower for longer" and that inflation is improbable into the medium term. Given how widely accepted these tenets are, and the degree to which market positioning is aligned with them, what may turn out well for the real economy might be considerably less positive for financial markets.

The final risk with the turn to fiscal stimulus is that it does not work. Fiscal expansions are ultimately intended to be displaced by private sector growth that, once spurred by public spending, gains its own traction. A much less appealing result is a quick return to lower growth but with higher government debt when public spending has run its course. In that scenario, it would not only be Japan's "three arrows" that other advanced economies emulate.

James McCormack is global head of the sovereign and supranational group at Fitch Ratings

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