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Vulnerable nations' fury at climate finance betrayal

By Olly West and Lucien Chauvin

Officials of the world's most vulnerable nations are growing increasingly anxious that they will not receive their fair share of money dedicated to sustainable development — even though these countries are often at the forefront of climate finance innovation.

As Hurricane Matthew sends a devastating reminder of how unprepared many countries are to deal with climate events, small island states warned that the money pledged for climate change is not yet ending up in the hands of those that need it most.

Although officials and experts recognise the achievements of last year's Paris agreement, financing "is too slow relative



Adams: climate finance bureaucracy 'unacceptable'

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EM leader kicks back against Western anti-bank rules

Exclusive

By Lucien Chauvin

The United States and Europe must reconsider their "anti-bank" regulation in order to deliver the boost to world economic growth that ultra-low interest rates have failed to produce, Peru's president said.

In an interview with *GlobalMarkets*, Pedro Pablo Kuczynski accused Western policymakers of forgetting basic economic theories about



Kuczynski: policies have to change if we want growth

Continued on page 3

Fears of 'unsustainable' EM bond market as Fed rate rise looms

By Olly West and Virginia Furness

Emerging market bond markets are vulnerable to further interest rate rises in the US, analysts have told *GlobalMarkets*, warning of an alarming disparity between a hot market and declining credit quality.

Moritz Kraemer, global chief ratings officer at Standard & Poor's, said that "as long as the debt accumulation goes on, the bigger the risks will be when rates do rise".

Many investors claim to be calm ahead of an expected 25bp hike from the Fed in December — despite the severe sell-offs that followed the Fed's announcement it would begin tapering in 2013, and its previous rate hike at the end of 2015.

And if fundamentals do not improve, the market remains susceptible.

"Worries about Treasury rate rises
Continued on page 3

Failure to borrow for infrastructure 'makes absolutely no sense'

By Owen Sanderson and Anthony Rowley

The failure to invest in infrastructure when interest rates are negative in Europe is a terrible waste of opportunity, one of the world's leading investors said yesterday. "I know the politics are tricky,

but economically it makes no sense," said Mohamed El-Erian, chief economic adviser at Allianz.

The topic has dominated discussions across the IMF and Institute of International Finance meetings this week, as

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FINAL WORD

Elvira Nabiullina

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EM bonds

Continued from page 1

are absolutely not misplaced,” said Paul Tregidgo, vice chairman of debt capital markets at Credit Suisse. “No matter how much expectations are managed or how well hikes are telegraphed, there is such a complex set of considerations that investors have to be prepared to move quickly.”

Until it is clear that economies are growing again, “EM markets are going to continue to be buffeted around by one factor or another”, Tregidgo said.

A report from S&P this week showed that nine of the largest 20 emerging market sovereign issuers — measured by amount of debt outstanding — had negative outlooks from the agency. Just two had positive outlooks.

At the same time, global monetary easing continues to drive a search for yield that is permitting broad bond market access even for the riskiest of credits. Ecuador, for instance, raised \$1bn of notes due 2022 in September, paying a whopping 10.75% of interest.

“As spreads tighten, we are seeing weaker credits issuing in EM, and it is starting to feel unsustainable,” said Sarah Glendon, head of emerging market research at Gramercy.

“What seems distorted to me is that spreads suggest that a lot of EM names are getting stronger rapidly, but — in Latin America at least — there are very few fundamental stories markedly improving.”

STAMPEDE TO THE EXIT?

But it is an EM-wide problem. Kraemer said that the sovereigns that relied on foreign funding were most at risk. “The Philippines and China, for example, but South Africa and Turkey do [rely on foreign funding] big time,” he said. “These are the sovereigns that might be caught in the crossfire when rates increase in the US.”

Another EM fund manager said he was not worried about an immediate hike, but by the prospect of the indication of a more aggressive tightening cycle.

“In the worst-case scenario, there’d be a stampede to the exit,” Kraemer said. “That is why the process is as gradual as it can be.”

When the Fed has previously signalled a tightening in monetary policy, local currency debt has suffered even more than hard currency. This could exacerbate the issue.

“EM has a very big debt problem, a domestic debt problem,” said Robert Waldner, chief strategist at Invesco. “We need a long period of deleveraging, where countries work down debt levels.

“In that period we’re going to see defaults and deflation, and that makes for a hard time. Growth is slowing; debt is growing. It is not a crisis, but it’s an on-going EM headwind.”

Infra

Continued from page 1

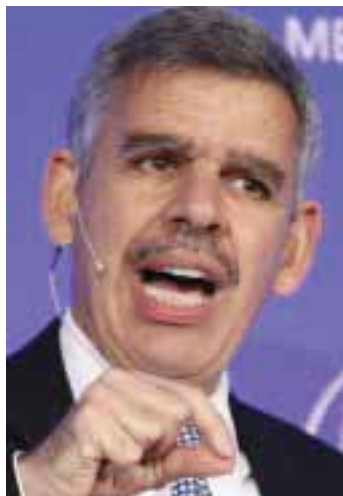
everyone from bankers to investors to finance ministers looks for ways to boost growth — and offer higher returns to savers.

Larry Summers, the Harvard economist and former US treasury secretary, advocated more infrastructure spending — even when there was a risk funds would be spent inefficiently — as it was better than nothing. He pointed out that even wasteful spending, such as in wartime, still stimulated the economy.

He was responding to the claim that the congressional district of Hal Rogers, chair of the House Appropriations Committee, had some of the finest infrastructure in the world.

But while Summers might be relaxed about money going missing, spending money on infrastructure efficiently, particularly in emerging markets, is still a crucial concern. Emerging markets need infrastructure for basic power, water, transport and communications — not just because economies need stimulus.

Asian Development Bank (ADB) president Takehiko Nakao told *Global Markets* it was revising upward the estimate it produced several years ago that Asia would need \$8tr of infrastructure investment in the current decade. “We need more money for infrastruc-



El-Erian: strike while the rates are low

ture development — power, roads, railways and communications.”

The organisations that do the hard grind of finding and funding individual projects, particularly public institutions like the multilateral development banks, want careful controls.

Just by their presence, though, some of the biggest infrastructure headaches go away.

NO WASTE

Joachim von Amsberg, vice president, policy and strategy, at the new Asian Infrastructure Investment Bank (AIIB), said: “Developing countries are almost defined by weak institutions or insti-

paradigm in which banks are operating”.

Kucyznski, 77, is not a traditional politician spouting hollow rhetoric. He not only has a degree in economics from Princeton University, but also was a top manager in Peru’s Central Bank in the 1960s and returned as finance minister in the 2000s. In between, he held key positions at the World Bank and IMF, and served as CEO of banking, investment and mining firms.

His government is bucking the trend in the region with a package of reforms to spur the economy to expand at a sustainable rate of 5% annually over the coming years. Peru’s GDP expanded by 4% in the first half of the year and the expectation is for it to finish the year at that rate. The ultimate goal is to get many more people into the banking system.

WEB OF RED TAPE

In late September Congress approved special powers that will allow the administration to rule by decree for 90 days on five large areas, ranging from

tutions not serving public good, which are a natural source of risk in these areas, but those same governments are our shareholders, so some participants see our participation in deals as mitigating the risks from government, even if we don’t do an explicit guarantee.”

Even developed market infrastructure investing has to confront government risk to projects. Cressida Hogg, head of infrastructure at the Canadian Pension Plan Investment Board, which has C\$22bn (\$16.6bn) deployed in infrastructure investments of a planned C\$40bn, flagged public private partnership (PPP) rules.

“You don’t want to constantly reinvent the wheel,” she said. “When governments re-did Australian and UK PPP frameworks, everything went back up in the air and you had to re-understand everything you understood before.”

Bill Winters, chief executive of Standard Chartered, said the world was getting towards a better leverage model, based around different parties taking different parts of the risk in a public and private infrastructure collaboration — separating out, for example, political risk, and short and long term economic risk.

But he also warned that regulation is a challenge. “No financial institution is encouraged to take long term complex illiquid unrated types of risk,” said Winters. “That’s led to a real lack of standardisation. That means the brain damage to get your arms around some of these infrastructure investment can’t be justified in terms of volume.”

economic reform to security. While other countries in the region are increasing taxes, the Kucyznski government has opted to lower them to stimulate growth from the private sector.

The plan calls for lowering the value-added taxes by one percentage point, to 17%, reworking income tax to cap the total pressure on corporates at 33%, and creating special categories for small and medium enterprises to get them into the formal economy.

“The tax change will allow small enterprises that are outside the system to join in with much lower taxes for a period of 10 years so that they formalise and have access to bank credit, which will be a big source of growth down the road as the programme matures,” he said.

Bank credit in Peru is about 50% of GDP, which is low for the region. In neighbouring Chile bank credit is roughly equal to GDP. The Association of Banks reported in August that there were just over 213,000 outstanding mortgages in a country of more than 30 million people.

Kucyznski

Continued from page 1

the impact of bank-created money on growth. “It is the first day of class in any textbook on monetary economics,” he said.

He said that the implementation of Dodd-Frank, the US financial rulebook, and what he called the “anti-bank” policies of Europe, would consign the two largest economic blocs to slow growth. “These policies have to change if they want to return to growth,” he said.

He also attacked the new unconventional monetary policies being followed by the central banks of the US, eurozone, the UK, Switzerland and Japan. “I don’t think that central bank policy is very important at the moment, because it has very few tools left,” he said.

His comments echo a warning earlier in the week by IMF managing director Christine Lagarde who told *Global Markets* that said monetary policy was “being stretched thin” and was “clearly transforming the

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OUT OF THE WOODS

Seen and heard in the corridors of the Annual Meetings

• **/Mimidigits** Spotted at the IIF's shindig at the Ronald Reagan building: a store selling T-shirts urging America's bewildered populace to "Vote Trump" and "Make America Great Again". The spaced-out store attendant inside said he'd sold just two this week, adding that they only had the offending item in a small. Alas, there were no Trump-branded gloves for those afflicted with teeny tiny hands.

• **/Crisis of timing** A major talking point at the IIF yesterday was the "flash crash" that sent sterling plunging in value by up to 10% on Friday. One British attendee though seemed less interested in the geopolitical ramifications of a currency crash, and far more engaged in when the event had happened. "I have a very, very, bad feeling I was using an ATM at that point," he wailed. Please send donations for his flight home to *OOTW*. Make it out to cash please.

• **/Half-hearted for Hillary** Another endorsement for the Democratic candidate for US president — though this time, one that's unlikely to get many flocking to the polls on November 8. *Annual Meetings Daily*, the weirdo daily modeled on *GlobalMarkets*, has endorsed Hillary Clinton. But talking about damning the former Goldwater Girl with faint praise. "Since it is isn't a crime to support Mrs. Clinton on account of her gender, we endorse her partly on that score," the AMD's editors said. Oddballs.

• **/Penny wise, pound foolish** The IFC's 60th anniversary celebration was a sumptuous event, concluded with CEO, Philippe Le Houérou, issuing a book on the multilateral's venerable history and flamboyantly cutting a ceremonial cake. Yet there was a notable absence of faces at the event. Where was everyone? Two staffers muttered to *OOTW* that they hadn't been invited — and nor had most of their colleagues. Perhaps the IFC, which recently posted its first ever loss, is trying to save a bit of dough?

• **/Priti poor** When a political initiative gets immediate breathless support from Britain's far-right political outfit UKIP — and no one else — it probably should be quietly shelved or thrown in the garbage bin. Priti Patel, a former Conservative Party press officer and now UK Development Secretary (and professional agitator) called yesterday for "radical reform" of the World Bank in order to "end aid dependency and achieve maximum impact for UK taxpayers". Oh Priti. Learn some decorum.

• **/Too many clucks** The IMF cafeteria seemed keen to offer hungry delegates a "Taste of Jamaica" at lunch on Saturday, serving up a melange of meat, rice and veg. But the Jamaican delegation was left seriously unimpressed. "You call that jerk chicken," one said loudly and publicly. "I call that rotisserie chicken with herbs". To be fair, it was a little on the stewy side, though *OOTW* — who's rather less discerning — still approved.

• **/Celebrity spotters** A brace of tourists sidled up to *OOTW* on the sodden DC streets, keen to know why so many of the sights they'd come to peer at were barricaded off. On being informed about the identity of the IMF and its *raison d'être*, their eyes got big. "Will Obama be there," one asked. When a negative prognosis was delivered, their faces fell. What — Christine Lagarde and Tim Geithner not good enough for you?

VTB first on the block as Russia embarks on mass state sell-off

By Elliot Wilson and Virginia Furness

Slow-growing Russia is looking to aggressively patch up the yawning holes in its budget by pushing through a series of big privatisations of state-run corporate giants in the months ahead, senior officials said.

Talking exclusively to *GlobalMarkets*, Russia's deputy finance minister Sergei Storchak said: "Privatisation is something we are working on. It is important that the government is making decisions in this field but there are hesitations. We want to reduce the role of the state in the economy."

First up in the fire sale, as Russia looks to top up a rapidly-depleting rainy day fund, will be VTB Bank, 60.9% owned by the government, and Russian shipping giant Sovkomflot. Two other assets set to be placed on the slab are oil firms Rosneft and Bashneft, both hit hard by US and European sanctions.

"Sovkomflot will be sold; VTB will be sold," Storchak said, adding: "VTB considers themselves purely Russian but they've become as global as many of the international banks." Another high-ranking official in the Russian government corroborated the information, adding that the state would likely sell a minority stake in VTB, but pursue a "majority or total" sale of Sovkomflot, not before early 2017.

The deputy finance minister said Russia would continue to pepper the market with sovereign bonds in the months ahead. A \$1.75bn, 10 year Eurobond was completed in May, \$1bn of which was sold to foreign investors, with another \$1.25bn to be raised from the global capital markets by end-2016.

Storchak said Russia would more than double its capital-raising capacity in 2017. "We need to be permanently in the market. I was happy with the outcome of the [May] bond, but I would prefer it to be business as usual. It was a lot of administrative work and the allocations were a headache. Next year we have a bigger figure in [mind]. We will be looking to raise \$7bn in the markets."

DAMPENING INFLATION

Meanwhile, Ksenia Yudaeva, first deputy governor of the Bank of Russia, pointed to a raft of legislation designed to tamp down inflation, free up capital onshore, and reinvigorate the sluggish economy, which is tipped by the IMF to shrink by 1.2% this year, before growing 1% in 2017.

"We are introducing measures designed to inject long-term momentum into the economy," Yudaeva told *GlobalMarkets*. "We need a thriving onshore base of major institutional investors, which means cre-



Yudaeva: strengthening financial supervision

ating and supporting insurance firms and pension funds. It means strengthening financial supervision and regulation, and making our capital markets deeper and more sustainable."

Although inflation remained on track to fall to 4% by end-2017, Yudaeva said Russia had little choice but to continue to tap global capital markets for fresh funding. "We are running out of money in one of our reserve funds, so we will have to borrow more in order to finance our future budget deficits. This is one of the reasons why we have to return to the international debt markets — there is no other choice."

The Reserve Fund, which peaked at \$142.6bn in 2008, fell to \$32.2bn in August, a month-on-month decrease of 16%, as the government rushed to swap foreign currency into roubles to cover the deficit.

'A dollar is a dollar' – battle cry for African integration

By Lucien Chauvin and Thierry Ogier

African countries must focus on trading with each rather than running into trade barriers in their attempts to sell agricultural produce to highly regulated American and European markets, policymakers told *GlobalMarkets* yesterday.

"One of the biggest costs is logistics, because the further you go to the market the more expensive it becomes," said Zambian Finance Minister Felix Mutati.

"So why don't you deal with the guy next door, minimising your costs and, therefore, improving your margins," he said. "A dollar is dollar. And you need to earn that dollar in the most cost effective way."

He called for trade and infrastructure integration on the continent, telling *GlobalMarkets* that governments needed to take greater advantage of opportunities offered by regional markets. He said that if countries boosted inter-regional trade to 20% it would help transform economies.

Mutati, a former trade minister in his new post only a few weeks, said his government was encouraging farmers to look more toward the Democratic Republic of Congo than Europe to export.

"Instead of dealing with all the barriers of selling beef or sugar to Europe, we

could sell food to people in the DR Congo who want it. We can sell a live goat or chicken, not worrying about all these phytosanitary barriers," he told *GlobalMarkets*.

He said that while copper would remain a key component of Zambia's economy — copper represents 60% of exports earning — there were options for agriculture and other sectors to sell goods to bordering countries.

BORDERLESS DREAM

Malado Kaba, Guinea's finance minister, said the goal should be a borderless region. She said nations were small, so "we need to integrate to create economies of scale." Also in West Africa, the Benin finance minister Romuald Wadagni praised the progress made by the Economic Community of West African States (ECOWAS), which plans to implement a common external tariff.

The big integration trend right now is in power, where countries are deregulating the industry and interconnecting power systems.

"Things have been getting better in the power sector. The sector has been unbundled, power price structures have been reformed and are now cost reflective. It is a sector that is poised to grow. It reminds me of what happened in telecom 20 years ago," said Admassu Tadesse, president and CEO of PTA Bank, active in 20 countries.



Mutati: 'look to DRC not Europe'

A major undertaking is construction of a 500kV power transmission line through Kenya, Tanzania and Zambia. These three countries form a kind of a "missing middle" for regional power integration. Once the 2,300km line is finished it will mean interconnection from Egypt down to South Africa.

Tanzania earlier this week announced part of the project, with a tender for construction of a 414km line that would connect it to Kenya. The \$310m project is jointly funded by the Tanzanian government, the African Development Bank (AfDB) and the Japan International Cooperation Agency (JICA). It should be finished in two years.

"This is the kind of initiative that the future of Africa will be built upon," said Mutati.

Stephen Dhieu Dau, finance minister from South Sudan, said pooling resources to add energy, telecom and transportation infrastructure "not only enhance trade, but creates employment options".

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Success is a journey

'Deutsche Bank could learn from us' — Ukraine hails reform agenda

By Virginia Furness

After several years of economic and political crisis, radical reforms at the National Bank of Ukraine are helping the country that was once known as the "breadbasket of Europe" to grow again.

Since taking office as deputy governor of Ukraine's central bank in 2015 Dmytro Sologub has worked towards creating an advanced "modern institution" devoid of corruption, inefficiencies, and unnecessary personnel.

"Deutsche Bank could learn from us," he said.

Corruption in the upper echelons of decision making has been a pervasive problem in Ukraine, and no less in the central bank. But Sologub believes that by creating a streamlined institution with a proper pay structure, this can be stamped out. In the last year and a half, headcount has been reduced from 12,000 people to 5,200.

"Low pay creates adverse selection problems, and it leads to corruption because people have to have other sources of income," he said. "Ukraine is not unique in this but endemic corruption is penetrating a lot of activities and the central bank is trying to combat this with transparent policy."

Ukraine is becoming a more transparent place to do business, he said, noting that the energy sector is now receiving more investment because of it. Sologub looks to Romania as a role model regarding its efforts to eliminate corruption, and its ability to create a conducive business environment.

While he acknowledges that the National Bank of Ukraine has ground to make up, he is already looking ahead to how Blockchain and a cashless economy could improve Ukraine's financial system. "In three to four years we will look very different," he said.

Remarkably, the central bank has wrestled back sky rocketing inflation which it has managed to reduce from 43% last year to 12% this year. The target over a three year period is 5%.

"Our main aim in 2017 is to preserve financial stability, and help economic growth to recover to 2%-3%. It was a very severe crisis and we are slowly emerging from it. But we are realistic that you can't lose part of your territory and your biggest trading partner and expect full recovery." Exports from Ukraine to Russia have fallen to 7% from around 30%.

In February 2015, Ukraine floated the hryvnia, which plunged sharply. Sologub says he faces a large ideological problem because goods providers are too focused on exchange rates, and view any devaluation against the dollar as a direct reduction in spending power.

Sologub oversaw a radical cleaning up of Ukraine's banking system. Law enforcement agencies have created a problem for the sector due to corrupt officials enabling delays, and bribery. He terms the first stage "the clean-up". Over the past year or so, some 83 banks were closed, leaving around 100. "Ninety percent of those were really fraudulent," he said.

Brics bank carves 100% green niche with first loan rollout

By Thierry Ogier

The New Development Bank (NDB) will start disbursing its first loans by the end of the year, Paulo Nogueira Batista Junior, the vice president of the so-called BRICS bank said yesterday. A second bond issue is scheduled for early next year in China.

The NDB was officially launched last year by five large emerging market countries (Brazil, Russia, India, China and South Africa) amid a great deal of scepticism in the West. The first disbursements on five projects that have already been approved.

"The five projects approved by the board total \$811m in commitments, one in each of the five founding member countries. They are all projects in the renewable energy area," he told *GlobalMarkets*. "Disbursements on all of them will be made during the last quarter of this year."

The bank is hiring personnel to increase its staff from the current 65 to 300 in two years. All of its member countries, some of them hit by recession or a severe financial crisis, have contributed equally to the initial \$750m capital of the bank in January.

The NDB has issued its first bond this summer and raised the equivalent of

\$450m. "It is a green bond in RMB. For now, we are 100% green on the assets and on the liability size," he said. The five year bond in RMB yielded 3.07% and was three times oversubscribed, he said.

Nogueira said a second local currency denominated bond will be issued in India in the first quarter of 2017. "They are very interested in local currency lending," said Takehiko Nakao, president of the Asian Development Bank (ADB).

Nogueira added: "The NDB is focusing on using local currency in its funding and in the loans, so that they do not generate foreign exchange issues, and we started with the RMB."

AIIB 'NO THREAT'

He has denied that China has showed less interest in the NDB following the launch of the Asia Infrastructure Investment Bank (AIIB). "China has enough resources and its strategic vision allows it to work simultaneously with us and with the AIIB. AIIB is a very much China-led. It has veto power over the AIIB, none of our countries has a veto power in our bank," he said. "Our green bond issue was to a large extent due to the support of the Chinese central bank and the Shanghai municipal government."

Green bonds have been growing very rapidly in the international capital markets



Batista: targeting renewable energy

lately in several parts of the world, in line with the increasing concern with environmental issues. "Bond proceeds will be fully allocated to projects that are considered green," said Nogueira Batista.

The Brics bank expects to get an international credit rating from one of major agencies next year.

The bank, which was originally crafted as an alternative to the World Bank, has put a strong focus on green infrastructure. "Our goal is to achieve in the next five years at least two thirds of our commitments [placed] in sustainable renewable infrastructure energy, like solar energy, wind farms, et cetera, and contribute to environment related issues," he said.

SDR reform key to monetary system overhaul

By Anthony Rowley and Paolo Danese

The entry of the renminbi into the IMF special drawing rights (SDR) on October 1 is stirring up debate for a revised role of the currency, with some suggesting reform of the SDR could lead to a more stable international monetary system.

One achievement for the agenda targeting broader use of SDR, also sanctioned by the leaders at the G20 summit held in China in September, was the first SDR bond priced by the World Bank.

"It was important to see that the World Bank's IBRD issued a landmark SDR500m bond in the Chinese market last month, a first in 35 years," said IMF deputy managing director Zhang Tao at a seminar on Thursday.

But the issuance alone was but a first step. "There is a long way to go to achieve global risk diversification, Chinese financial reform, renminbi internationalisation and improved stability of the international monetary and financial system," said Zhang.

Broader use of the SDR is being hailed as a possible cure for some of the ills affecting the international monetary system (IMS), by pushing central banks to hold more diversified reserves, for example. The dollar currently accounts for over 60% of global foreign currency reserves, according to IMF data.

Another important step will be the inclusion of more currencies in the SDR, but the RMB entry as the first emerging markets currency was a positive sign, Bernard Snoy, president of the Robert Triffin International Association (RTI), told *GlobalMarkets*.

"With the RMB inclusion in the SDR, China itself is staking ownership and taking its share of responsibility for the functioning of the IMS," Snoy said.

IMF managing director Christine Lagarde, noted as much in a press conference on Thursday. "[RMB inclusion in the SDR] certainly anchors the Chinese economy in the group of large, international, open economies in the world."

RETURN TO KEYNES

But SDR sceptics abound. "In nearly ten years of managing foreign currency reserves, I have not once heard or mentioned the SDR as a useful reference," said a senior central bank official attending the annual meeting. Eisuke Sakakibara, former Japanese ministry of finance official said he saw little future for the SDR.

"I just don't share the view that the SDR is important and that it needs to be enhanced," he told a panel. "I don't think need for SDR has increased, as long as we have freely traded currencies like euro, dollar, yen that's enough."

Despite the doubts, Snoy said it would be for the IMF to set itself the highest goal: to eventually create so-called Multilateral



Zhang: issued SDR500m bond

Drawing Rights (MDR), inspired by the Bancor first theorised by Keynes. "This would be a currency of the IMF, with the IMF acting as the world central bank," said Snoy.

While such a goal was far into the future, intermediary steps were possible. The SDR itself, despite its limited circulation, could be a useful springboard, especially if non-public sector institutions, such as commercial banks, were to follow the World Bank's example by issuing SDR bonds and increasing the liquidity of the market.

"The SDR should be used more actively by the public sector, and the IMF could already reform SDR allocations," said Snoy. "Reforms could also look to enable the IMF to issue more SDRs, acting as a lender of last resort."

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Global tightening threatens Africa investment push

By Thierry Ogier

Poor access to finance is threatening to jeopardise the project investment programmes of many African countries, leading policymakers have told *GlobalMarkets*.

"We need to access longer maturity resources," said Malado Kaba, finance minister of Guinea. "We have very important investment needs. We have a mismatch between our long-term needs and short-term resources," she said. "Guinea is a poor West African country that has suffered the double blow of the Ebola crisis and the collapse of commodity prices."

Investment programmes have supported economic growth in countries like Ethiopia, Guinea and Cote d'Ivoire, but they may become at risk if access to capital does not improve, a senior World Bank official has warned.

"The tightening of financial conditions is certainly affecting our countries," said Albert Zeufack, Africa chief economist of the World Bank, in an interview with *GlobalMarkets*. "There is an issue with the perceived risk for Africa. There is empirical evidence that the perception of risk in Africa is always exaggerated," he said.

"If you look at sovereign bond spreads, they have shot up in the past six months. Countries like Ghana now have spreads above 1,300bp, this is

extremely high. It is limiting fiscal space. For us it is a worry because the last thing we want is for countries to stop investing. The issue of access to capital for infrastructure is critical."

PENSIONS FUNDS

He said there was more than \$3tr in sovereign funds that were getting close to a zero interest rate. "Pension funds have a lot of liquidity across the world in a low interest rate environment," he said.

"These resources can be converted into longer term maturities to finance infrastructure in Africa. There is evidence that the return on investment in infrastructure in Africa is actually very high. It is comparable to other international bank loans," he said.

The World Bank has been using more guarantees to help African countries address the issue of risk. "Although we know there is serious tightening on the international financing landscape, we hope countries will continue these investments in infrastructure and this would be likely to keep growth at higher levels," he said.

The World Bank has just slashed its 2016 growth forecast by almost half to 1.6% (from 3% in April) mainly due to the "terrible situation" in the continent's largest economies in Nigeria, South Africa and Angola, which account for



Zeufack: 'there is empirical evidence that the perception of risk in Africa is always exaggerated'

60% of Sub-Saharan GDP. "This is worrisome because this is the lowest level in more than two decades. It is even lower than population growth. For the first time in two decades, income per capita is going to grow at a negative rate," said Zeufack.

Declining commodity prices have crippled the economy of many countries. Others economies that are dependent on agriculture have been hit by "one of the strongest *El Niños*" and drought in southern Africa, said David Hedley, Africa economist at the Institute of International Finance.

There also risks ahead. Countries that are more vulnerable to a rise in US interest rates are those that have a high volume of capital flows in their balance of payments, according to Zeufack, such as Kenya, Nigeria and South Africa.

MENA public sector job reform crucial to overcome oil crisis

By Olly West

Oil-producing Middle Eastern nations must embark on radical reform of public sector labour markets in order to diversify their economies and overcome the slump in oil prices, the World Bank said yesterday.

As research shows that countries with higher male unemployment rates are more likely to send fighters to so-called Islamic State (Daesh), economic development needs to be inclusive and raise employment levels, Shanta Devarajan, the World Bank's chief economist for MENA, told *GlobalMarkets*.

"These countries are trying to diversify their economies to reduce their dependence on oil," said Devarajan. "I do not think you can do that without reform of the public employment programme."

Public sector wages are so high, and there are so many people employed in the state sector, that it is very difficult to develop a competitive private sector, said the economist.

Bruno Versailles at the IMF's Middle East & Central Asia department said these countries were facing "a new reality". "They will have to transform their economies. The government cannot give so many public sector jobs, and there needs to be a re-orientation of growth to the private sector, he said.

Data from the IMF show that all Gulf countries increased their dependency on oil from the start of the century until crude prices hit their peak in 2014. Between 2011 and 2014, oil accounted for more than 90% of fiscal revenues in Saudi Arabia, and more than 80% in Bahrain, Kuwait and the UAE. The World Bank now expects growth to fall by more than half to 1.6% in 2016, and prospects for a rebound look tepid if reforms do not arrive.

In some nations, progress has begun on the public employment side: Algeria has announced a freeze in public salaries. These moves go in the right direction, but are mostly "tiny steps", says Devarajan.

With the rise of extremism in the region, countries need to act fast. Unemployment — in particular among young males — is one of key factors encouraging radicalisation and driving recruits for ISIS. The higher the rate of male unemployment in a given country, the greater the propensity for that country to send fighters.

Economic development is therefore crucial. "We need economic development of a particular kind — development that brings inclusion. That is the key," said Devarajan. "If you want to reduce that level of extremism, you need to work on stimulating employment via private sector job growth."

As well as the human cost of the conflict, violent extremism has had a devastating effect on Syria and Iraq's economies. The UN estimates investments of \$150bn-\$200bn will be needed to bring Syria's GDP back to pre-conflict levels. In Iraq, the non-oil economy contracted by 14% in 2015.

Chile pledges to cuts deficit levels... as it goes on a borrowing spree

By Lucien Chauvin

Chile has pledged to reduce its deficits despite unveiling plans to tap sovereign bond markets for as much as \$10.5bn next year.

Finance minister Rodrigo Valdés told *GlobalMarkets* that while Chile's gross debt was still low, it was time to bring the fiscal deficit in line. "I am worried in the sense that we cannot continue increasing debt at this pace for too long. We cannot have these deficits for too long," he said.

The fiscal deficit for the A+ ranked economy will likely be 3.2% of GDP this year, an increase from the initial forecast of 2.9%. It was 2.2% last year. The government is forecasting GDP to expand this year by 1.75%, increasing to 2.25% in 2017. Fitch said that Chile's sluggish 1.9% growth in the 2014-2016 period was the second lowest in its A rated class.

The government has not decided on the breakdown of debt for next year, but the minister said that while there would be some paper placed on the international market it would rely more on local debt because interest rates are low and the country has a deep financial sector.

The government's approach to the

debt is part of a larger effort to continue unwinding the fiscal stimulus in place since the start of the commodity slowdown. The 2017 budget will increase by 2.7%, the slowest increase in 14 years. Valdés said the government has aimed for a neutral fiscal stance this year and that will continue in 2017.

PRIVATE PENSION REFORM

A number of major issues could impact the government's projections, including the need to conclude salary negotiations with public sector workers and come up with an agreement on its pension system.

Total spending on wages is around 20% of GDP, which makes the negotiations critical to government plans. A point that could work in the government's favour is a decline in inflation. Annual inflation rate in September was 3.1%, safely within the 2%-4% target. The Central Bank has responded all year to lower inflation by keeping the benchmark interest rate unchanged at 3.5%.

Tougher will be the negotiation on the country's pension system. Chile's private pension system, adopted in 1981, has been a model for the region, but it is now widely disparaged by Chileans. President



Valdés: 'we cannot have these deficits for too long'

Michelle Bachelet has announced some changes, but the government hopes to come to broad agreement with stakeholders on deep reforms to the system. Chile's private pension funds have around \$160bn of assets under management.

Valdés said Chileans across the board are not satisfied with the system, with the vast majority saying that they are not receiving enough from their pension fund when they retire.

"We hope to come to an agreement to improve the system in the next few months. We are very aware that we need to find ways to make the system more friendly and with greater risk sharing," he said.

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Alain Bifani: 'Lebanon's economy will not be derailed'

By Olivier Holme

Lebanon, though profoundly shaken by the civil war that has engulfed neighbouring Syria since 2011, is working hard to mitigate the impact of the conflict on its economy, the director general of the country's finance ministry has said.

"We clearly face a very difficult situation," Alain Bifani told *GlobalMarkets*, "but there is no risk that the economy will be derailed."

Speaking of the country's institutional resilience to hard knocks, Bifani said: "There are tensions: on the fiscal front, it's tough, the economy is not growing as it should, nor is it creating jobs as it should. But at the same time, the social net is working, more or less. We have been able to absorb a huge shock."

Lebanon, which has a population of just 4.5 million, has taken in more than 1.5 million Syrian refugees. That has taken its toll: since 2010, when Lebanon's GDP grew by 8%, annual growth has oscillated between just 0.9% and 2.2%, according to the World Bank. The Syrian war also triggered a political crisis, with Lebanon's main parties fighting over which side to support in the conflict. As a result, the country has been left without a president for two years.

Bifani sought to remain positive despite all this. He pointed to strong central bank reserves — \$40bn as recently as the end of August — and the endurance of the country's civil service. The education system, for example, has managed to incorporate hundreds of thousands of Syrian children.

When asked whether this has been the hardest test in his career, Bifani, who has worked at the finance ministry for the past 16 years, said it was hard to say. "I don't remember a period that was easy," he said. "Lebanon is in a permanent state of crisis. I think we've become experts at managing crises."

"We've had everything: we've had war, we've had blockades, we've had periods without a president, without a government, we've had political assassinations, we've had internal conflict."

Lebanon went through a civil war of its own in the 1970s and 1980s — a conflict that scarred the country and produced a generation of bankers and politicians used to working through deep, seemingly irresolvable challenges.

Bifani said one of the keys to handling these challenges was to invest in the future. He spoke enthusiastically of plans to update Lebanon's crumbling infrastructure, ranked 101st in the world by the World Economic Forum.

"The road works have now been launched," he said. "Investment into railways, ports, electricity, water quality are next in line."

Over the next five years, Lebanon intends to spend \$2.5bn billion on infrastructure, Bifani said. "That will compensate a little for the slowing growth of the economy. But more importantly, it will give us services we desperately need."

Philippines declares itself 'open for business' to China

By Elliot Wilson

The Philippines is planning a radical overhaul of economic focus and development, the country's finance minister has told *GlobalMarkets*, starting with a rapid pivot toward China, and a push to cut red tape, slash poverty rates, and suck in fresh foreign investment capital.

Carlos Dominguez said the first major foreign policy step under president Rodrigo Duterte, who took office in June, was to rebuild the nation's ragged relations with China. "We are rebalancing our foreign relations toward China," he said in an exclusive interview. "Under the last administration [of former president Benigno Aquino] our relations with China were rather adversarial."

Pointing to the July arbitration case that ruled against China's claims of dominion over the majority of the South China Sea, Dominguez said the country was now ready to enter into "serious negotiations" with China and Vietnam, to determine sovereign maritime borders once and for all.

Détente, he added, would "open up new doors to investment from China. As a concrete first step, we are joining the Asian Infrastructure Investment Bank, which China is fostering and promoting. What

we are saying is that we are open for business with everyone, including China."

LEVEL PLAYING FIELD

Dominguez also promised to help build a government focused on the needs of the people and the business sector. President Duterte, he said, would in the next few days "call for a constitutional change to open up the entire economy to foreign investors and foreign capital, including power plants, natural resources, banking, and telecoms, which [Duterte] is particularly keen to foster competition in." Only land ownership, still a cultural sensitive issue, would remain off limits for foreign investors.

The focus would be on "creating a level playing field for all businesses, local and foreign", and on slashing red tape at local and central levels. Duterte, he added, planned "to cut the amount of time it takes to secure a permit to start a company to as little as three days", echoing the business-friendly legislation he enforced as mayor of Davao, a city on Mindanao island.

Infrastructure would remain a key focus on the new administration, Dominguez insisted. He said the government would open its chequebook in



Dominguez: slashing red tape

order to focus on the kinds of infrastructure projects, including telecommunications masts, power plants, highways, schools, and hospitals, which would help raise development levels, reduce inequality and slash poverty rates, which have not fallen in 10 years.

"Expansionary fiscal policy will be a key focus for this government," he pledged. "Therefore, we plan to increase overall government debt by two to three percentage points during this administration, in order to free up fresh domestic investment capital. That means freeing up P\$165bn (\$34bn) in new spending this year alone." The Philippines' public debt-to-GDP ratio stands at 45%, on a par with its sovereign peers, but far lower than in the developed world.

Green bond standards 'not a burden' to EM entrants

By Craig McGlashan

Organisations driving forward the burgeoning green market should ignore claims that more onerous reporting standards and other initiatives may prove too high a barrier to entry for emerging market or small corporations to enter, according to Arunma Oteh, treasurer of the World Bank.

"If we're going to tackle the climate change pressure that we face in the world, we have no choice," she told *GlobalMarkets*. "I think the world realises it. My experience of talking to some issuers is that they're very excited that there are standards that can help people better understand what they're doing in this market."

"I don't think we need to reduce the standards so that others can enter this market. We've had some very successful issuances by other types of institutions, other than supranationals."

Isabelle Laurent, deputy treasurer and head of funding at the European Bank for Reconstruction and Development, believes that those organisations involved in crafting the Green Bond Principles — a set of guidelines on issuing green bonds — must be wary of ensuring that the market is just as attractive for small corporations or poor countries as it is for supranationals with vast resources, for whom sustainability is built into their very being.

"Quantitative reporting can be very different for many issuers, so the Green Bond Principles have to be minded to strike the right balance between ensuring the integrity of the green bond market and that money goes to projects that are going to have significant impact, but reporting should not be too complex and costly that many issuers will be deterred," Laurent told *GlobalMarkets*.

"We have a large team of environmental specialists, because sustainability is part of who we are and we're required to assess it for every project. So that's a very different dynamic."

On development participants are united against a regulatory aspect on governing what is green, however.

"Regulation is an awkward one because people's views on green are different and change over time," said a head of funding at a major international institution, who did not want to be named. "For instance, at one time biofuels were seen to be the future, but now people are not so sure."

GREEN GOVERNMENT

So far, no governments have sold green bonds. But France has confirmed it will issue one in 2017 and, in the emerging markets, Nigeria has also looked into the possibility.



Laurent: GBP need to strike the right balance

By tapping the green bond market, such countries may be able to find demand from investors that would not normally take part in their bond issues.

Spanish development bank Instituto de Crédito Oficial has sold two social bonds — a similar product to a green bond, except with a social rather than environmental focus.

Even among investors without a specific focus on environmental or social securities, the green bond product is starting to raise interest.

"I've been to various investor meetings in the US east coast over the last few days and it's interesting how often they have brought up the topic of green bonds and want to understand them," said EBRD's Laurent. "These are not strictly speaking green investors, but it appears to be part of their focus."

Exclusive

'There is embedded risk in everything we do in life' — CME chief's world view

From Brexit to the impact of a likely rise in US interest rates, Terry Duffy CEO of Chicago Mercantile Exchange, offers a 360 degree view of risks and opportunities for financial markets in the US, Europe and emerging economies. By Toby Fildes

GlobalMarkets: *European markets appear afraid of a Trump presidency. But how are US markets viewing the November elections?*

Right now, the polls are going to be like an equity market — they're going to fluctuate dramatically over the next several weeks.

In the long view, I don't think the markets are going to be affected by whether Trump's elected or not. There are a lot of other fundamental factors outside the President's everyday activities that make markets go up and down, no matter who's in that office.

It takes several years to set policy. So until that takes effect, the markets will have a wait-and-see attitude.

We've just had major legislation called Dodd-Frank, so from the financial markets side, we've already had all the regulatory changes I think we're going to see for a long time.

GlobalMarkets: *What does Brexit mean for the derivatives industry in Europe?*

I still think London will be a central place in Europe for financial services. Brexit was just as much about border laws as it was against anything else with the Union. I think other nations are looking at the same thing. So maybe you'll see some changes within the Union. In the short term, there will be uncertainty to deal with.

But it's really difficult to see how it's going to be damaging completely towards Europe or the US. I think people will realise this is more political than economic.

GlobalMarkets: *How optimistic are you about the performance of markets over the next three to six months?* The broader markets, especially the US markets, are trading on basically all-time highs. A lot of this has to do with Fed policy. People have nowhere to go but the equity markets today to get some kind of return on their money.

This interest rate policy is, in my opinion, flawed. In the US, we have a \$20tr national debt; then we have \$6.5tr of mortgage debt or home debt; we have \$1.3tr of credit card debt; \$1.2tr or \$1.3tr

of student loan debt, plus auto loans and everything else.

I'm trying to figure out who is going to be borrowing money to stimulate the economy when they're already in debt. The policy, to me, appears to be putting more people in debt, not growing the economy.

And that blends to the equity markets. I'm not saying the market's going to sell off. But unfortunately, when you get to levels — and this is my 36 years' experience in the marketplace — whether they're all-time highs or all-time lows, they normally have a pretty good snap, one way or another.

GlobalMarkets: *What would you have done differently?*

I think the Fed has confused the marketplace. In the US, we've had a zero interest rate policy since 2008, 2009. The message that was delivered over the last several years is that we wanted to see

some of the biggest institutions in the world. If they were to fail, not too many other institutions would be standing.

One of the things people don't understand is that we don't, as central counterparties or clearing houses, introduce risk to the system. We manage the risk that people bring to us.

So as long as we continue to do the right things to manage that risk, that fear should be allayed.

GlobalMarkets: *Is it a starting gun for a wave of consolidation of exchanges?*

From our standpoint, I think it's business as usual and it's not going to have any effect on how we operate CME Group.

Will there be more consolidation? Time will tell. But regulators have gotten very difficult. They've already blocked a few other major transactions. Australia and Singapore — that did not

"China says it's growing at 6.5% or 7%. That is hard to refute, but at the same time, it's hard to validate"

certain economic factors happen before we moved rates.

Well, those things have all happened and yet they didn't do anything with rates. That confuses the market.

In my opinion, you could've easily taken the rates to 1% or 2% to 3%. Stop penalising savers and retirees. Give them a return on their money.

I personally believe you would have stimulated the economy a lot more by encouraging savers to start spending some money than trying to make people that already have too much debt spend more money.

GlobalMarkets: *In light of recent regulator comments on the merger plans of London Stock Exchange and Deutsche Börse, how concerned should the market be that clearing houses are becoming too big to fail?*

The market is not understanding that very well. The equation of clearing houses being too big to fail is if their three or four biggest clients fail. We're talking

go through; the Canadians blocked the sale of the Toronto Exchange.

So there's a lot of concern about some of these entities going forward, rightly or wrongly. I'm not saying it's right, but that's just been the pattern over the last several years.

We're growing our business in many different ways. It doesn't mean we have to buy another entity. But at the same time, if there was something that could add value, we're always keeping our eye out.

GlobalMarkets: *Which emerging markets are most interesting to you?*

Well, it's hard to say what's an emerging market any more.

We own a small piece of the BM&F exchange in Brazil, and we like that investment.

I personally believe that emerging markets in general won't have the explosive growth they've had in the past, but it doesn't make them bad investments either.

China says it's growing at 6.5% or 7%.



That is hard to refute, but at the same time, it's hard to validate. So I still think we could have a little disruption around the world.

I don't mean to sound like a pessimist, because I'm not. It's been ultimately very good, globally.

But my biggest concern is some of the things that have happened outside the financial markets, whether it's terrorist attacks in Paris, or in San Bernardino, California.

The financial markets have literally shaken them off, where historically they would have said that these events can't be good for the future of markets and priced their impacts differently.

GlobalMarkets: *Are we coming to the end of the great regulatory phase for derivatives?*

Yes, in the US, we have. Basel III is still out there — that's one of the things internationally we're concerned about, because it's going to raise the cost of business even more.

Look at the leverage ratio — money sitting in clearing houses that banks have no access to, that they still have to account for in their leverage ratios — to us it makes absolutely no sense.

The problem with markets is there's always inherent risk. A lot of people would like to see them become riskless. But if you're going to have a riskless business, whether it's banking or a bakery, you're probably not going to be successful.

There is embedded risk in everything we do in life. And I think we have to be careful not to overburden these markets to a point where they don't allow economies to grow, because that's when nobody will have a chance. **GM**



Credit check: World Bank chief's five year challenge after election rumpus

Jim Yong Kim faces a challenge in driving through his reform agenda in his second term amid criticism of his performance so far — and of the election system that handed him another five years in the top job

By **Phil Thornton**

Maybe it is because it carries the title of president that the race to become the next head of the World Bank appeared to echo the other, frenetic presidential election process in the United States.

The process to choose the head of the giant multinational lender began a full 12 months before the term of the incumbent Jim Yong Kim expired in July 2017. But there the comparison ends: while almost 20 people put themselves forward to fight for the right to run for the White House just one person came forward for the Bank — Kim.

The decision on whom to appoint to the top jobs at the two intergovernmental bodies that oversee global financial problems, known as the Bretton Woods sisters — the Bank and the International Monetary Fund — has become more political in the wake of the global financial crisis and recession that

hit emerging and developing economies.

Although Kim's current term carries on until July next year, the news that the man known as JYK had already started sounding out shareholders for an extension during the summer of 2016 sent shock waves through Washington's north western quadrant.

"It really blindsided a lot of people, myself included, who were sure this would not come up until the April 2017 meetings," says Lant Pritchett, senior fellow at the Center for Global Development and a former economist at the World Bank for 17 years.

The news has stoked up simmering concerns over the way that the head of the World Bank is chosen, as critics feared that JYK's proactive campaign would close off a debate about the selection process.

Luiz Vieira, co-ordinator of the Bretton Woods Project (BWP), a civil society network that monitors the Bank, says that Kim was probably keen to avoid the possibility

of Donald Trump, a critic of globalisation, becoming president and having the power to block Kim's re-election.

However, it is the role of the Bank and of the United States, its largest single shareholder, in seemingly throwing their weight behind Kim's candidature that has really riled Bank watchers. After the news broke, the Bank moved to launch the process and gave just three weeks for nominations and then another "two to three weeks" for interviews for the shortlisted candidates.

Vieira says this contrasted with the months the Bank took to hire Paul Romer to replace Kaushik Basu as its chief economist ahead of the Indian scholar's retirement in July. "It is the lack of transparency, lack of accountability, the speed of the process," he says.

"Surely for an institution that's very process oriented and goes around the world talking about the benefits of open merit-based processes and about good governance, the contrast between the Bank's approach and what it preaches is quite stark."

NO CONTEST

On September 14 the Bank announced that only JYK had come forward. Observers blame the US for the lack of a contest. The Treasury put out a tweet shortly after midnight on the day the nominations opened, throwing its weight behind JYK for a second term. "Obviously the US government doesn't want to have debate," says Jacob Kirkegaard, senior fellow at the Peterson Institute for International Economics (PIIE).

In the days after the US announcement, 19 major shareholders indicated they would support Kim including China, France, Germany, Japan, Pakistan and the UK. Since those accounted for 51.54% of the votes the game was over before a speech was given in anger.

"They could have waited until the nomination period closes to say which of the nominated candidates they were going to support," says Pritchett. "How inappropriate is it to declare which candidate you support before the closure of the nomination period? Patently they were trying to deter there being other nominations."

Vieira at BWP, which has long called for a genuinely open-minded, merit-based and transparent process to select a new president, is angry that once again the opportunity for a non-American candidate to argue their case has been lost.

He conceded that the election of a president from an emerging or developing country would be "no panacea", especially as the winning candidate would inevitably come from what he calls the establishment elite of their relevant country.

"Would this change necessarily imply radical change in what the Bank does?" he asks. "No, but it would be a step in the right direction and if they had a merit-based transparent process, that would be much more in line

with the development ethos of the institution and what they preach to others."

Kim's behind the scenes lobbying was revealed by the World Bank Staff Association, which has in the past complained about Kim's running of the Bank after its private letter to the executive directors of the Bank was widely leaked.

"At the World Bank Group we preach principles of good governance, transparency, diversity, international competition and merit-based selection," they wrote. "Unfortunately, none of these principles have applied to the appointment of past World Bank Group presidents.

"Instead, we have accepted decades of back-room deals which, 12 times in a row, selected an American male. This must change."

MANAGEMENT SHAKE-UP

As the dust settles on the election process, attention will turn to what Kim will do with his second term that will take him to 2022. For many observers it is hard to answer that question without looking at the president's record in the initial four years of his first term in office.

There is no doubt that Kim was dealt a bad hand in terms of the unexpected challenges thrown up by natural and human-made disasters. The turmoil in the Middle East following the Arab Spring and the rise of Daesh were followed by the outbreak of Ebola in Africa and of the Zika virus in Latin America. This has coincided with a shift in emphasis and financial resources away from traditional development work — investing in infrastructure or country-based programmes to deal with poverty — to thematic issues such as pandemic preparation, climate change and dealing with refugee problems.

This transformation was at the heart of a shift from a focus on country-by-country issues to the creation of 19 global practices on issues ranging from agriculture to water that cut across national boundaries and pre-existing managerial responsibilities.

Health was one of those and, as a former director at the World Health Organization, Kim was praised for his swift and effective interventions on those issues.

"Obviously the World Bank has been a bigger player in health issues and that goes to his credit," says Kirkegaard at the PIIE. "Perhaps it is the fact that the Bank should be more active on health issues as is the case now and lives undoubtedly have been saved as a result."

However, the restructuring triggered anger and protests among the Bank's 15,000-strong workforce as the plan involved cutting \$400m of costs that included taking out levels of management.

The World Bank Staff Association says its annual employee engagement survey has, for two years running, made it "painfully clear" that the World Bank Group

is experiencing a crisis of leadership. Four out of five staff say that they clearly understand and embrace the institution's overall goals. However, in stark contrast, only one in three understands where the senior management team is leading them. "Even fewer believe that our senior management creates a culture of openness and trust," it says.

Kirkegaard says that one should not overplay the reaction of staff to the restructuring of an organisation that many people have seen as a sluggish bureaucracy and which has inevitably led to people seeing their jobs reorganised and their colleagues made redundant.

"There are lots of things that need to be changed at the World Bank — many to do with staffing that will naturally upset them — so that is not in itself an argument against a second term," he says.

His concern is that there is little to show from the reorganisation in terms of action on the ground or signals as to the strategic vision for the Bank. "This was supposed to be a big McKinsey-style turnaround and do things dramatically different, yet at end of day there is not much to show for it," he says.

The reorganisation had a false start. After being created in July 2014 the global practices were reorganised into three groups with education, health and social protection and labour global practices going into one group, areas such as energy, environment and water going into another and a third taking poverty and less core issues such as finance and markets.

Pritchett says that of the leaders put in place at the 17 initial global practices only nine were still in place. "Whether the global practices were a good idea or bad idea, it hinged on being able to recruit the kind of people who could make it work," he says. "Within two years you had a 50% turnover rate." The Bank declined to comment.

Pritchett says that Kim had "picked the battle to fight" but did not have the "management wherewithal" to follow it through and make sure that the ideas worked. "Now he is in a worse position because he used whatever political and organisational capital he had and didn't actually follow it up and make sure it worked."

A spokesperson for the Bank said: "The original structure of 17 global practices has today been retooled to 14. In the years since their establishment, a number of movements have occurred in the leadership — two senior directors have gone on to become country directors, others have rotated into other positions within the organisation, and two have retired."

Since the changes were first implemented, the Bank has delivered a record level of lending outside of a financial crisis. Demand for lending from the World Bank has risen to levels never seen outside a financial crisis, climbing to more than \$160bn between the 2013 financial year and 2016.

In the bag (just)

The shareholder vote	
Country	share of vote (%)
Argentina	0.81
Benin	0.07
Brazil	1.84
Chile	0.46
China	4.62
Colombia	0.45
France	392
Germany	4.19
Indonesia	1.02
Japan	7.15
Kenya	0.15
Mexico	1.44
Netherlands	2.00
Paraguay	0.08
Pakistan	0.54
Peru	0.36
Rwanda	0.07
South Korea	1.64
Uruguay	0.18
UK	392
US	16.54
TOTAL	51.54

Current as of September 15, 2016

“what they say”



"There are lots of things that need to be changed at the World Bank — many to do with staffing that will naturally upset them — that is not in itself an argument against a second term"

—Jacob Kirkegaard, *The Peterson Institute for International Economics*



"The contrast between the Bank's approach and what it preaches is quite stark"

—Luiz Vieira, *Bretton Woods Project*



A visionary leader has to reaffirm the Bank's commitment to focus on the big national development issues"

—Lant Pritchett, *Center for Global Development*



Although the changes were implemented by Kim, there has been a move under his predecessor Robert Zoellick to restructure the Bank. He was concerned that it took 25 individual decision points before loan approval, which pointed to an institution that was process-heavy and overloaded.

FIVE MORE YEARS

Given that it is highly unlikely that the restructuring will be altered again, the issue for the president will be how to use the remaining 5-1/2 years of his term.

One of the key challenges remains how the Bank should position itself within the development universe where the vast majority of flows of capital come from private investors while new players such as the China-led Asian Infrastructure Investment Bank are becoming significant players.

Kirkegaard says that the Bank must accept that it will become a niche player. "Private sector flows will dominate to such an extent that the World Bank will be able to help through its institutional capacities to channel such private flows towards most of the productive uses in a way that is environmentally sustainable and ensure that other types of degradation don't take place," he says.

However, civil society groups believe that the Bank has a long way to go on those types of issues even with the \$61bn of lending that it makes every year.

The Bretton Woods Project has been a longstanding critic of the environmental impact of the Bank's projects and is worried by the Bank's review of its safeguard policies, which it fears will lead to a weakening of protections of human rights and environmental standards.

Civil society groups believe that the Bank will weaken standards further to compete with rivals such as the AIIB — although both the Bank and the AIIB insist that they will continue to maintain high standards.

Vieira at BWP believes that the review of safeguarding standards is a "good test case"

of the president's next term. He says the Bank must do a much better job of engaging communities affected by its lending.

"It should allow them to participate in the process of design and implementation," he says. "The idea of inclusion of civil society is the key to making the Bank better able to develop policies that are pro-poor equitable.

"If I was to have only one demand, it would be to improve that consultation process with affected communities and that would entail being able to take action to safeguard their rights."

The Bank may move away from the big ticket projects as the AIIB steps up its lending programme. The Asian unit has approved half a dozen loans so far while its business plan for 2016 sees lending of \$1bn.

Kirkegaard says it should use its existing institutional strengths and assets to pioneer better responses to phenomena such as the explosion in the use of so-called big data — giant datasets that may be analysed computationally to reveal patterns, trends and associations.

"The World Bank is in a position of an institution that can set standards and bring governments together," he says. "It has legitimacy in large parts of the developed and developing worlds. It is to Kim's credit that the Bank has been moving in that direction but mastering this increasingly important part of development policy will be key to how relevant it will be in five years' time."

At the same time there is a debate going on among Western countries over whether agencies such as the World Bank should retreat from a vision of national development into a narrower approach that focuses on the poorest of the poor.

Pritchett at CGDev, who is also a professor of international development at Harvard, says the World Bank can look for an enhanced role as governments look to set aside broader issues of national development such as fostering productive economies and capable governments.

"Western countries want the World Bank to scale back its vision and define development down and I think we need a leader who can define development up," he says.

"A visionary leader has to reaffirm the Bank's commitment to focus on the big national development issues: how countries are going to become productive and prosperous — not just 'not poor' — and how governments are going to get rid of the scourge of corruption and deliver the services their citizens want."

Kim is likely to come out fighting after the endorsement of the executive board as shown by his launch of the World Bank's new paper on poverty on Monday [October 3].

But whatever happens over the next five years it is almost certain that the debate over the selection process for the head of the World Bank will not go away and may intensify. The World Bank Staff Association points out that the United Nations, which was formed at the same time as the Bank, has a selection process that is "guided by principles of transparency and inclusivity and explicit diversity objectives".

The issue is certain to come to a head in 2022 when both Kim and Christine Lagarde, the head of the International Monetary Fund, come to the end of their second terms.

Kirkegaard says that the decision to allow Christine Lagarde to remain as head of the IMF so cementing the unbroken control by Europe of that job for the last 70 years was probably a significant factor behind the US's decision to insist on Kim staying at the Bank.

"You could argue it sets up for change in 2022 as it seems likely to me that the IMF will get a non-European head after Madame Lagarde's second term," he says.

That will give emerging markets five years to unite behind a strong candidate — something they have failed to do since the jobs came up for election. "Is that good for the World Bank as an institution? Will it come out strengthened as a result of those five years? I doubt it." **GM**

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OPINION

Goodbye Great Britain

The last round of IMF lending to developed market countries (before the European sovereign crisis) was 40 years ago — when Britain was locked out of the capital markets and had to go cap in hand to the Fund

By Richard Roberts

On September 28, 1976 — 40 years ago last month — Denis Healey, Chancellor of the Exchequer, arrived at Heathrow on his way to the International Monetary Fund's annual meeting. As he waited in the VIP lounge, gin and tonic in hand, he learned that the sterling crisis that had started in March had blown up again. Healey headed back to the Treasury and announced that Britain intended to apply to the IMF for a record \$3.9bn loan.

The purpose of the borrowing from the IMF was to replenish Britain's foreign currency reserves to boost confidence in the pound and therefore to stop the run.

It was by no means Britain's first such borrowing. In June of that year, Britain had received a six-month

“
Private lenders were naturally reluctant to lend to the British government



\$5.3bn credit facility from the central banks of the other G10 countries that had stabilised sterling over the summer. With \$1bn drawn from that facility, the British government owed foreign creditors a total of \$19bn. Most of this borrowing was not a pressing problem, being medium or long-term. But the central bank credit was due for repayment on December 9, at which point Britain's foreign exchange reserves would be down to \$2.5bn.

So what? Since June 1972 the pound had been floating, so in theory, the currency was free to find its equilibrium level. But there was the thorny matter of the \$5bn equivalent of volatile 'sterling balances' held by foreign central banks — much more than Britain's foreign exchange reserves.

If a run really got going sterling could go through the floor, destabilising the fragile post-OPEC oil price shock international economy and triggering drastic British policy measures. *The Wall Street Journal's* advice to investors to get out of sterling was headlined, "Goodbye Great Britain".

Under the circumstances, private lenders were naturally reluctant to lend to the British government.

Since May there had been a 'buyers' strike' in the Gilts market. This was a problem; the Labour administration was running a massive budget deficit to stimulate demand because of the recession, and this meant heavy public borrowing. But the Gilt buyers had no confidence in government economic policy and potential buyers were convinced that Britain's interest rates would have to rise — meaning a capital loss.

Unsurprisingly, the international capital market was also firmly shut to British borrowings — the leading US international monetary official even fretted with colleagues about a British default.

The IMF was the only source of funds to replace the central bank credit upon repayment. But this meant IMF conditionality — which was exactly what the markets and even some members of the British Cabinet were hoping for.

An IMF mission arrived in London on November 1, checking in at Brown's Hotel, Mayfair, under false names. The negotiations took six weeks, three times the customary period, and featured an unprecedented personal intervention by its managing director, Johannes Witteveen.

At one point, the Labour Cabinet rejected the proposed conditions for the loan — significantly reduced



Chancellor Denis Healey: struggling to defy the markets. Below: heading to board Concorde before hot-footing it back to the Treasury

public expenditure and borrowing — but reality took hold eventually.

The growing likelihood of a loan — with IMF fiscal and monetary discipline the price — plus a hike in Britain's interest rate to a record and stratospheric 15%, led to a shift in outlook in the Gilts market. All of a sudden, buyers became keen to invest before the closure of the loan led to a rate cut and a leap in bond prices; the Gilts strike was over.

Britain's loan application was filed on December 15, six days after the repayment of the central bank credit, in the meantime sterling was safeguarded by emergency swap arrangements.

The loan was approved by the IMF Executive Board on January 2, 1977.

Possessed of the IMF's 'Good Housekeeping Certificate', Britain was able to return to the international capital market. On January 24, the Bank of England announced a \$1.5bn seven year Eurodollar loan from a syndicate of 13 British, American and German banks.

Every financial metric improved substantially in 1977, reflecting adjustments made both before and as a result of the IMF borrowing.

In the event, less than half of the standby credit was drawn and repayment was made well ahead of schedule. By then sterling was well on its way to becoming a North Sea petrocurrency, posing a new problem — not devaluation, but overvaluation.

The British and Italian standbys of 1977 were the last of three decades of post-war IMF facilities for European countries. Henceforth, its client base was the developing world.

Until Greece, Ireland and Portugal from 2010, but that is another story. **GM**

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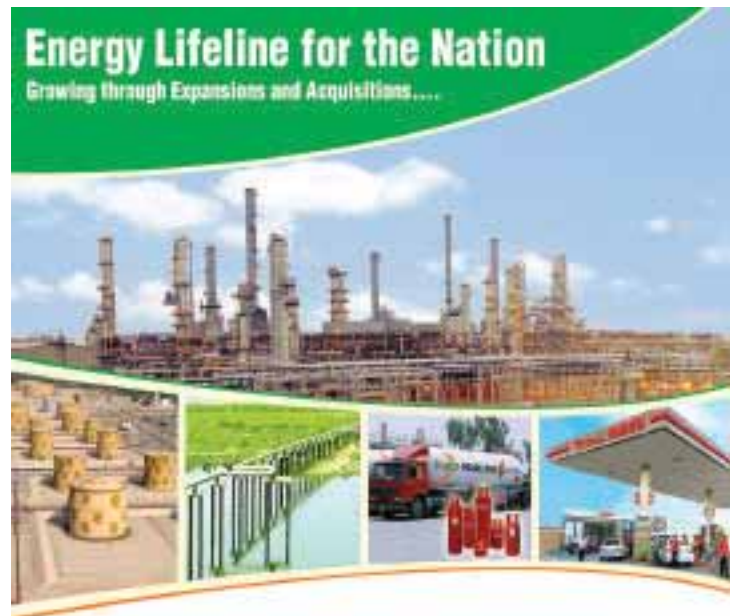
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Pakistan has seen a visible economic turnaround over the last three years, due to the successful implementation of a comprehensive programme of economic revival to enhance economic growth and achieve sustainable development.

Key areas of reform under implementation include: fiscal consolidation through improved public financial management and tax administration; energy sector restructuring including capacity enhancement; divestment through strategic private partnerships and strengthening of regulatory frameworks

Macro-economic performance remains robust, with a steadily rising growth of 4.04% in FY2014-15, 4.71% in FY 2015-16, expected to accelerate to 5.7% next year. The fiscal deficit has been reduced to 4.6% in FY2015-16 from 8.2% in FY2012-13. Foreign exchange reserves have crossed \$23bn. The central bank's policy rate stands at a multi-decade low of 5.75%.

Pakistan has entered the lower middle income country status, with a per capita income of \$1,561 in FY2015-16. The country has also successfully completed a \$ 6.64bn Extended Fund Facility programme with the IMF recently.

We have lengthened the maturity of the domestic debt portfolio and are continuing to diversify our financing sources.

Pakistan re-entered the international capital markets in 2014 after a gap of seven years by issuing Islamic Sukuk for \$1bn and Eurobonds worth \$2.5bn in 2014 and 2015 and is launching another Islamic Sukuk issue in October 2016.

Under a successful divestment programme, amounting to over \$1.1bn, shares in the banking and oil and gas sectors have been divested and strategic sale of a power company has been carried out.

Pakistan Stock Exchange continues to outperform its regional peers over the last four years and has recently been included in the Emerging Markets Index by Morgan Stanley Capital International.

Pakistan's economic turnaround has been duly recognized by credit rating agencies, international develop-

ment partners, think-tanks and independent economists. Moody's as well as Fitch have raised our economic outlook from negative to stable, while Standards & Poor's revised its rating from stable to positive. The IMF in its global economic outlook has added Pakistan in the list of emerging economies.

“ The China Pakistan Economic Corridor (CPEC) with an investment of \$46bn is a testament to Pakistan's rising potential ”

Financial sector reforms have improved access to finance, especially for small and medium enterprises through implementation of the National Financial Inclusion Strategy and legislative measures including establishment of credit bureaus, the deposit protection fund and strengthening of legal rights of lenders and borrowers.

The China Pakistan Economic Corridor (CPEC) with an investment of \$46bn is a testament to Pakistan's rising potential and the government's commitment to use this opportunity as a game changer for the country in the coming decade. Twenty five industrial zones are being established on the three routes of CPEC. The CPEC projects include investment of \$34bn in the energy sector and \$12bn in building roads, highways, railways, ports and airports.

With a track record of pursuing prudent economic policies, Pakistan is emerging as a favorable destination for foreign direct investment, offering opportunities in regional trade, telecommunications, the financial sector and exploration of natural resources such as oil and gas.

Pakistan's economy:

A frontier market that was flirting with insolvency just three years ago, is now in rude health. Investment is flooding into Pakistan from China, the West and the Gulf, attracted by high returns, rising stability and an economy underpinned by strong growth figures and a pro-business government

Pakistan's economy is on a tear, growing at its fastest pace since the bubble years of the mid-2000s. According to projections from the International Monetary Fund, the economy is set to grow by 5.0% in 2017, up from 4.7% in 2016 and 4.0% in 2015. Emerging markets-focused investment bank Renaissance Capital tips gross domestic product to expand by an average of 4.4% a year over the four years to end-2017, against a median of 2.8% over the five years to end-2013.

At every level, there are signs of marked improvements in one of South Asia's most vibrant markets. Global institutions, attracted by the high yields on offer, are snapping up Pakistan securities listed at home and abroad.

China is pumping billions of dollars into vast infrastructure projects that will open up the country's northern borders, allowing locally made goods, from cotton and textiles, to raw and produced food products, to potash and fertiliser, to be shipped overland, into Central Asia and Russia, and beyond.

Deepening markets

Pakistan's efforts to widen and deepen its capital markets, and to foster the creation of an innovative, knowledge-based economy, are gaining traction. The country is rapidly becoming a key provider of niche IT services, with upstart companies in Karachi and Lahore bursting with freelance software coders, programmers, and application developers. The primary equity capital markets are returning to action. An initial public offering completed in September by Loads Limited, saw the auto parts maker raise \$20m from local and foreign investors; more stock sales are expected in the months ahead.

Economic return to form

One can point to a host of reasons for Pakistan's economic return to form, but four in particular stand out.

First, there is the impact the IMF has had, since agreeing to lend \$6.6bn to the country in September 2013. Back then, Pakistan's fi-

nances were in a perilous state, weighed down by low growth, a widening fiscal deficit, and dwindling foreign reserves that barely offered a month's worth of import cover. A slew of natural disasters had rocked the country, including the floods of 2010 and a series of earthquakes in Balochistan province in 2013. The US Federal Reserve's decision to taper its bond-buying programme from the middle of 2013 had sucked foreign capital out of emerging markets, hitting Pakistan hard.

The IMF's three year credit line, which Pakistan exited in August 2016, paying off its debts in full and on time, was a necessary measure for a hard-hit government. "Pressure from the Fund", London-based Capital Economics said in a research note published August 1, had been a "factor behind the improvement in Pakistan's fiscal position, with the government accepting a need to reduce energy subsidies and increase its revenue base".

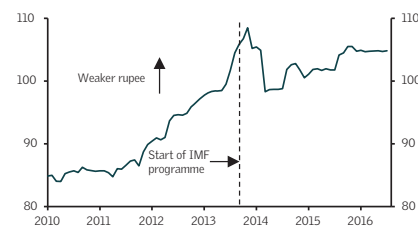
Economic management

But it takes two to tango, and the turnaround in Pakistan's fortunes have been as much to do with the government's far-sighted decision making and scrupulous economic management, as they have with the IMF's gentle prodding.

One of the country's perennial frailties in the past was that it spent too much money and earned too little, in part due to an underdeveloped taxation system. Since 2013, Pakistan has taken deliberate and decisive steps to beef up its tax collection structure, raising additional revenues from high-net-worth individuals (some of whom were paying lower levels of overall tax), and tackling corruption at source. Renaissance Capital tips the tax-to-GDP ratio to rise to 14.5% by end-March 2020, from 11% five years earlier. Rising government income — which has been aided by low global oil prices, benefiting the energy-poor economy, has helped narrow the fiscal deficit, from 8.4% of GDP in 2013, to 4.3% in 2016 and 3.6% in 2017, using RenCap's projections.

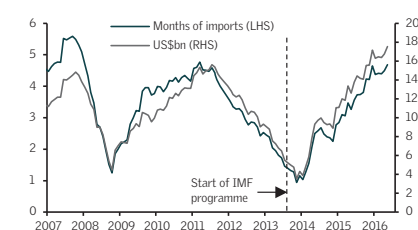
Alice Mummery, an emerging markets ana-

Pakistan rupee



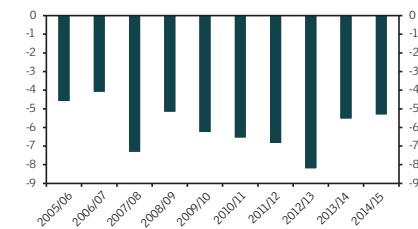
Source: Thomson Datastream

Foreign exchange reserves



Source: Thomson Datastream

Pakistan budget balance (% of GDP)



Source: CEIC

powering ahead

lyst at the Economist Intelligence Unit (EIU), points to the country's increasing economic and financial solidity. "Macroeconomic stability has firmed up, with the rate of economic expansion remaining relatively healthy," she says. "Moreover, underlying fundamentals point towards a robust growth outlook in the coming fiscal year. An expected improvement in the primary sector will bolster growth and private consumption in 2016/17, while continued infrastructure development will help to enhance the business environment in the medium-term."

China

That brings us to the second point working in Pakistan's favour: China. Between now and 2030, China is planning to pump \$46bn into local infrastructure projects, building new roads, ports, rail lines and air terminals, laying gas and oil pipelines, and installing new coal and nuclear power plants (see page xx). Some of these projects, all part of the so-called China-Pakistan Economic Corridor (CPEC) are designed expressly to provide China with an easier way to transport goods into and out of the country overland, cutting costs and risks by bypassing the Malacca Strait.

But they also stand to benefit Pakistan's economy. New power plants lead to fewer blackouts, while also enabling businesses to meet deadlines and avoid delays and stoppages. New highways and townships should bring wealth and development to Balochistan, allowing it to compete for investment and projects with richer, eastern provinces such as Sindh and Punjab. Some of the new power plants are already coming online, boosting both electricity production and manufacturing, says the EIU's Mummery. In June 2016, the IMF noted that real growth levels were being supported by "large-scale manufacturing and buoyant construction activity", as well as rising private-sector credit growth, much of which is a direct result of capital flowing into Pakistan, from China, to be channelled into CPEC-related projects.

Fresh impetus

The economy has benefited in recent quarters from an influx of global institutional capital that has flooded in from global investors keen to profit from higher-yielding securities and assets across the emerging world. Pakistan has been a major beneficiary of that process, sucking in capital from Europe, North America, the Gulf states, and Southeast Asia this year.

But perhaps the biggest positive impact on the domestic economy in recent years has come from within. Pakistan's government, from Premier Nawaz Sharif to Finance Minister Ishaq Dar to Planning, National Reform and Development Minister Ahsan Iqbal, have managed

to inject fresh impetus into the economy, while husbanding the country's precious natural and financial resources.

Privatisation push

At the IMF's urging, the government from late 2013 kicked off a far-reaching privatisation plan, designed to sell large or majority stakes in failing government-controlled enterprises that cost the state an estimated \$6bn a year. Progress, while slow at times, has been made. A notable success was the sale, in April 2015, of the government's entire stake in the country's largest private-sector lender, Habib Bank, which netted the state \$1.02bn. Privatisation minister Mohammed Zubair noted at the time that around 75% of the orders for shares in Habib Bank were placed by investors and funds based outside the country, boding well for future privatisations.

The government has also earmarked another 68 state-owned firms, including loss-making enterprises such as Pakistan International Airlines (PIA) and Pakistan Steel Mills, for sale — though that process hit a snag in April 2016, when parliament passed a law that would allow PIA, the nation's flag carrier, to be converted into a joint-stock company, but not to cede full control to outside investors. In June 2016, the IMF said Pakistan's authorities had shown desire and willingness to "continue working towards reforming public-sector enterprises, and putting them on a sustainable financial path".

Improving numbers

Wherever one looks, the country's finances look healthier than they have been in years. Foreign reserves, which had fallen to critical levels in 2013, stood at \$16bn as of April 2016 — against

\$13.5bn in April 2015 and \$9.1bn as of April 2014 — with total liquid FX reserves, including net reserves held by banks, at \$20.8bn. Exports are set to rise next year, too, driven by the sale of basic goods (pure woven cotton, crude petroleum, linen and rice) as well as services such as IT and entertainment products. Most of the nation's exports still head to the likes of United States, China, Afghanistan, Germany, and Britain — though that list is set to develop as the northern frontiers are opened, allowing Pakistan to export more goods to Russia, Iran, the United Arab Emirates, and Central Asia.

New power plants will encourage more capital to flow into major industrial projects, boosting growth and employment levels. Government projections tip the mining sector to expand by 7.4% this year, with the construction industry growing 13.2%, and manufacturing output up 6%. Electricity and gas production and distribution is forecast to grow by around 12.5% a year for the foreseeable future, benefiting from a flood of investment from major Chinese state firms.

The EIU's Mummery tips manufacturing to continue to grow apace, benefiting from rising electricity output, and the State Bank of Pakistan's decision to cut interest rates in order to boost growth. She also points to "strong expansion" in the tertiary sector, which she expects to grow 5.7% in the 12 months to end-March 2017, against 4.3% the previous year. Growth across the tertiary space, she added, was "broad-based, with all six components — trade, transport and communication, finance and communication, housing, government services, and other services — performing well. The general upwards trend across services bodes well for the economic growth outlook, as the tertiary sector accounts for close to 60% of total [economic] output."

Pakistan: key economic indicators by year

	2012	2013	2014	2015	2016E	2017E
Real GDP growth (%)	3.8	3.7	4.1	4.0	4.7	5.0
Investment (%/gGDP)	15.1	15	14.6	15.5	15.2	15.7
Inflation (%)	11	7.4	8.6	4.5	2.9	5.2
Fiscal balance (%/GDP)	-8.6	-8.4	-4.9	-5.2	-4.3	-3.6
Foreign exchange reserves (\$ billion)	10.8	6.2	9.1	13.5	18.1	20.8
Import cover (months of import)	2.7	1.5	2.2	3.4	4.2	4.6
Net foreign direct investment (\$ billion)	0.9	1.3	1.7	0.9	1.3	2.6
Total public debt (%/GDP)	63.3	64.2	63.7	63.6	66.1	64.2

Sources: IMF; Unctad, Renaissance Capital

E = Estimated

China leads the way

Chinese investment has transformed Pakistan as an FDI destination. With the number of terror attacks falling and the northern borders about to be opened up, Pakistan will become a major trading nation in the decades ahead, further boosting inflows of investment capital

If there is a theme that dominates foreign direct investment (FDI) in Pakistan — and is likely to continue to do so for the foreseeable future — it can be summed up in one word: China.

For years, China has been investing in the rising South Asian economy, pumping in \$47.4m in the financial year to end-June 2011, and double that amount \$90.6m two years later. But it was in 2013-2014 that China became a true power-player in the country, investing just shy of \$700m into Pakistan, most of which was used to buy coal mines, build power plants and beef up infrastructure around the increasingly influential blue-water port city of Gwadar. And the investment has continued: in the 24 months to end-June 2016, Chinese enterprises pumped another \$850m into the country.

China's focus has been timely — the inflow of capital from a handful of sovereigns has waned in recent years. FDI from British business interests has tumbled since the global financial crisis, while American investors actually withdrew \$66m from Pakistan in 2015-2016, as funds sought to benefit from rising US interest rates. The United States' financial engagement has been "steadily trending downward" since 2007, when American interests channeled

\$1.4bn into the country, notes Alice Mummery, an emerging-markets analyst at the Economist Intelligence Unit.

But a host of other countries continue to direct capital into the country, most notably Norway, Hong Kong (used as a proxy investment conduit by mainland Chinese firms), and the United Arab Emirates, which has a long and strong trading relationship with Pakistan. In December 2015, UAE-based energy firm Al Motahaden Petroleum Refineries agreed to build a \$500m grassroots refinery in the northwestern province

CPEC — the Grand Plan

At the heart of the mainland's burgeoning interest in the country is the China-Pakistan Economic Corridor (CPEC). This grand and far-reaching plan is designed to help China bypass the chokepoint of the Malacca Strait — which it views as being controlled by US interests — by shipping goods such as oil, gas, and raw and natural commodities, into and out of the country via Pakistan.

To that end, China is planning to spend \$46bn between now and 2030, on a vast road

“ Power projects as well as rail and road networks are the two sectors that will draw the lion's share of FDI in the years to come ”

of Khyber Pakhtunkhwa.

But it is China that will, more than any other sovereign nation, define the country's financial and economic relationship with the world in the decades to come, generating the majority of the capital flowing every year into Pakistan.

and rail transport network connecting Gwadar and the southern trading metropolis of Karachi, with western China, via Pakistan's two great northern cities: Lahore, and the capital Islamabad. When complete, the Karakoram Highway connecting China's Xinjiang province with Pakistan's province of Gilgit-Baltistan will be one of the world's highest paved commercial routes, and a modern-day engineering miracle. China-controlled enterprises are also digging new coal mines, laying oil and gas pipelines stretching from the Indian Ocean to mainland China, and building much needed infrastructure, from a new international airport in Gwadar, to renewable energy projects in the east of the country.

“Under the CPEC initiative, China will dominate rising foreign direct investment in Pakistan,” notes Farrukh Sabzwaria, director of regional equities sales at Credit Suisse in Singapore. “China's share of total FDI being channelled into the country rose 33% in 2015-2016, up from just 6% three years ago. Power projects as well as rail and road networks are the two sectors that will draw the lion's share of FDI in the years to come. And while it is still early days, we are also beginning to see growing Chinese interest in ac-



Karakoram Highway Tunnels

amid FDI surge

quiring assets in the cement sector and electricity transmission and distribution space.”

Strategic location

Total inward foreign direct investment hit \$1.90bn in 2015-2016, against \$923m the previous year. Early data from the current fiscal year suggests that domestic FDI is set for another stellar year. Data projections from the Pakistani government and the International Monetary Fund tip the total stock of new FDI as a share of economic output to increase from 0.5% in 2015-2016, to 0.8% in 2016-2017, and 1% in 2017-2018, and to continue to rise thereafter, until at least 2020. According to data from the central bank, China accounted for 28% of net FDI in the first half of 2016, and more than half of all net inward foreign investment in both 2014 and 2015.

Nor are these figures a fluke — or the net result solely of China’s aims of improving local infrastructure in order to ship goods to and from African, Latin American, and Middle Eastern markets, quicker, cheaper and more efficiently.

Pakistan has in recent years quietly transformed itself into a place where emerging-world and developed-world investors feel at ease. Terror attacks continue, as they do in many other nation states. But fatalities have fallen sharply in recent years. The number of domestic deaths attributed to terror attacks peaked in 2009 at 11,704, according to the South Asia Terrorism Portal, a widely respected data intelligence and analysis source.

Since then, it has fallen steadily, to 3,182 in 2014 and 2,403 in 2015 — and to just 740 through the first nine months of 2016. If the current year winds down without a sudden spike in violence, it stands to be the least violent 12 months for Pakistan in more than a decade. The China-driven CPEC project is also aimed at boosting domestic security by bringing wealth and development to the resource-rich western province of Balochistan, as well as the unsettled tribal regions in northwestern Pakistan.

Business support from the very top

But if stability is crucial to the country’s appeal among foreign investors, it is Pakistan’s place on the map, and the clear and unalloyed support for the business community among elite political circles, that looks set to continue to suck investment dollars, euros and Chinese renminbi into the country.

Soon after Nawaz Sharif was re-elected prime minister of Pakistan in 2013, the government issued a new and much-heralded Investment Policy, designed with the express intent of boosting flagging inflows of foreign capital.



Chinese President Xi Jinping, centre, with Pakistan’s President Mamnoon Hussain, left, and Prime Minister Nawaz Sharif on display in Islamabad, Pakistan

Planners and legislators in Islamabad set out a series of clear and bold aims, including: to boost the average annual long-term economic rate of growth to between 7%-8%; to provide ample employment for an increasingly young and urbanised population; and to boost the economy’s competitiveness rankings.

But it is in the world of FDI that Pakistan has demonstrated the reach and range of its ambition and long-term potential. 2013’s Investment Policy tipped total inflows of foreign capital to reach \$4.6bn by 2017, and thereafter, to average out at around \$6.5bn a year. “Assuming average annual GDP growth of 5%, the FDI stock would account for 20% of GDP, which is close to the current global average,” the policy stated.

Multiplier effect

Pakistan hasn’t quite achieved those outsized goals. But it would take a brave person to dismiss the country’s chances of hitting those figures over the next few years. The CPEC corridor will open up the country’s northern borders, allowing Pakistan-made goods to be transported overland to growing markets in the Middle East and Central Asia. That should boost revenues and earnings in key sectors, notably textiles, cotton spinning, fertiliser, potash, natural gas, fresh fruit and vegetables, and coal. More capital is also likely to flow into a country bursting with talented software designers and programmers.

Better infrastructure, from new rail lines and highways, to reliable and functioning transmission grids, to a growing network of mobile telecoms masts, will also, experts say, suck in a torrent of investment capital in the years ahead. Credit Suisse’s Sabzwaria notes that, so long as Pakistan remains at the heart of China’s regional ambitions, “the economic benefits for the domestic economy are innumerable.” He adds: “The prospects of better energy availability should eventually have a multiplier effect on manufacturing growth.”

One last infrastructure-related investment points not just to China’s influence in the country, but to Beijing’s long-term global ambitions — and how they will affect everyone. In June 2016, the new China-led multilateral, the Asian Infrastructure Investment Bank, signed a \$100m loan with the Asian Development Bank, to fund the construction of a 64km stretch of highway linking Lahore with Islamabad. During the signing event — which marked the first time the Manila-based multilateral had co-financed a project with the AIIB, ADB vice president Wencai Zhang noted that it was imperative that Pakistan “grasp the opportunities presented by its strategic location. Investments in transport and connectivity... and other regional co-operation initiatives, can put Pakistan’s economic development on an upward trajectory.” Wise words indeed.

Corridor of Opportunity

Pakistan is set to become one of the world's great economies, benefiting the \$46bn China-Pakistan Economic Corridor, which will link Beijing with the Indian Ocean overland for the first time. An influx of Chinese — and global — capital will boost growth and foreign direct investment, buoy the construction sector, and help transform Pakistan from a nation of separate and often fractured provinces, into a single, co-ordinated, consolidated country

The China-Pakistan Economic Corridor (CPEC) is, by any measure, one of the first great new engineering projects of the 21st Century. In its scale and ambition — and in terms of its ability to transform one economy (Pakistan's) while boosting another's ability to reach global markets with its goods and services (China's) — it could be compared with the Panama and Suez canals, or with another historic transport system, China's 1,500-year-old Grand Canal.

By 2030, China plans to have spent \$46bn in Pakistan: forming new roads and rail lines, upgrading others, and building new power plants that use oil, gas, coal or nuclear as their primary energy source.

Gwadar transformed

In Gwadar, on the Indian Ocean, a \$2bn special economic zone is springing up, modelled on China's commercial trade zones. Once a sleepy little coastal town, Gwadar's officials are dredging a deep-water port and building a new, \$230m airport able to accommodate wide-bodied Airbus A380 and Boeing 777 passenger jets.

The American author Robert Kaplan noted in his book *Monsoon: The Indian Ocean and the Future of American Power*, that Gwadar had the potential to be

transformed into Pakistan's answer to Dubai, boasting a financial and commercial hub, an export processing zone, a world-class airline hub and direct access to major shipping lanes.

And Gwadar will just be the tip of the spear. A new westerly overland route will link the port city with Quetta, capital of the Balochistan province. Two other highways will cleave the country in two as they head north from Karachi, though Sindh and Punjab provinces, to Lahore. All of these routes will then coalesce, before heading north again, a single, four-lane highway threading its way through Pakistan-controlled Kashmir until it reaches the border with China, 3,000km from the Indian Ocean. Goods will then be shipped overland, through Xinjiang, to Beijing, Shanghai, and Hong Kong. In all, nearly \$6bn will be spent on building new highways over the next decade and more.

Little wonder both Nawaz Sharif, Pakistan's prime minister, and Ahsan Iqbal, minister of planning, national reform, and development, have described CPEC as a "game-changer" for the country. If all goes to plan, it will allow goods and services to flow into and out of China, without needing to pass through the chokepoint of the Malacca Strait.

Energy sector boost

One of the biggest beneficiaries will be the energy sector. Pakistan has long struggled to maintain a steady supply of electricity to homes and businesses across the country. Many larger enterprises fund their own power units, or risk losses whenever the state or local power grid fails. This problem should ease as Chinese funding washes through the industry, easing energy bottlenecks.

Nearly \$34bn is set to be spent over the next 10 years, building power plants, laying oil and gas pipelines, and building out the domestic generating grid. By 2030, an additional 10,400MW of additional power will have been added to the

network. New coal-fired power plants are planned at Port Qasim (costing \$1.8bn), in Sindh (\$1.3bn) and at Muzaffargarh, near Multan, in the heart of the country's cotton-growing region (\$1.9bn). An 870MW hydropower project is being built in Khyber Pakhtunkhwa province in the far north of Pakistan, at a cost of \$1.8bn; another dam, budgeted at \$1.5bn, is set to be laid across the Jhelum river in Punjab. A host of renewable projects, including a giant solar park in Bahawalpur, will channel clean power to homes and businesses in the east of the country.

Elsewhere, China is helping to build coal mines as well as six new nuclear reactors. An integral

Total planned spending on the China-Pakistan Economic Corridor, by China

Sector	Total spend by 2030 (\$ billion)
Energy	33.79
Roads	5.9
Rail	1.6
Mass transit in Lahore	0.66
Gwadar Port	0.04
Total	45.69
China-Pakistan fibre optic network	

Source: Government of Pakistan, USAID

part of the jigsaw will see Pakistan construct a 700km pipeline to import liquefied natural gas from China, further helping to ease energy shortages. And another major transport upgrade in the years ahead will involve the installation of a high-speed rail line set to connect Karachi with Lahore. An extension will then link Lahore with a dry port in Peshawar. A six-lane, 1,240km highway linking Karachi with Lahore, is on track to be completed in 2017, while Pakistan is also planning to build new, or upgrade existing, light rail lines in the country's six largest cities.

Trade between the two countries is already flourishing. In a May 20 research note, the emerging markets-focused investment bank Renaissance Capital pointed to China's "rising importance as a trading partner with Pakistan". It added: "China accounted for about 10% of Pakistan's imports in 2010, and 13%-14% in 2014", noting that in 2015, that figure had jumped sharply, to 17%.

The new economic corridor should also open up Pakistan's northern borders, boosting domestic imports and exports, and channelling more global corporate and institutional investment into the country. It will become easier to transport Pakistan-made goods — fresh produce, apparel, and commodities — overland, through China and beyond. Planning Minister Iqbal believes that by breaking down borders and creating new trade routes, Pakistan can become a "bridge" linking South Asia with China and Central Asia. "We will be able to carve out a large economic bloc of about 3 billion people living in this part of the world," he adds. "[That is] nearly half the planet."

One Belt One Road

As times goes on, CPEC will become indivisible from China's 'One Belt, One Road' project, a gargantuan and massively ambitious plan to recreate the old Silk Road by linking Beijing overland with Europe, via South and Central Asia, Russia, and the Gulf states. In the words of Wang Yi, China's foreign minister: "If 'One Belt, One Road' is like a symphony involving and benefiting every country, then construction of the China-Pakistan Economic Corridor is the sweet melody of the symphony's first movement."

New infrastructure will also help to boost two-way business between Pakistan and the Middle East. Bilateral trade between the United Arab Emirates and Pakistan, which hit \$9bn in 2014, is set to grow exponentially in the years to come, as commercial routes expand and flourish.

Realising potential

By joining up the country's infrastructure, and bringing wealth and development to western regions such as Balochistan and Waziristan, Pakistan's will be in a position to realise its huge potential. The wider economy will be in a strong position to benefit, too. On June 10, the International Monetary Fund said domestic economic growth would hit 5% in the fiscal year to end-March 2017, up from 4.6% the previous year, aided, by an "expected pick-up of investment related to the China-Pakistan Economic Corridor". It added that the CPEC would keep activity in the construction sector "buoyant" for years to come.

The main ratings agencies agree with this prognosis. Pakistan has impressed global investors and regulators by paying off a \$6.4bn loan from the IMF in full and on time. The final payment of \$102m was cleared on August 5, with the IMF's Pakistan mission chief, Harald Finger, noting the "significant progress" Pakistan had made toward "strengthening macroeconomic and financial stability" and for creating solid foundations for a higher rate of sustainable and inclusive growth.

Vision 2025

A business-friendly government in Islamabad, China's determination to create new trade paths linking Beijing with the Indian Ocean, and Pakistan's Vision 2025 agenda, should see this ambition achieved. Under the 2025 plan, the goal is to transform Pakistan into one of the world's top 10 trading nations by mid-century, propelled by a strong and inclusive economy, democratic governance, a modernised public sector, and food and energy security. Add to this a well-crafted and concerted push to encourage entrepreneurship, connectivity, and an innovative and competitive knowledge economy.

Going forward Standard & Poor's tips gross domestic product to expand by an average of 4.5% in the

Axis of power and transport



Source: Hindustan Times

three years to end-2018, "supported by strong services and construction, the spillover effects of rising remittance inflows, improving energy (gas and electricity) supplies, lower oil prices, and higher investment". The CPEC corridor, it adds, will be a major driver of investment, helping to boost per-capita income by an average of 2.5% a year over the same period.

The IMF meanwhile expects Pakistan's economy to grow by 4.5% in 2016 and 4.7%, with the inflation rate coming in at 3.3% and 5% respectively, aided by low global oil prices. One of the most impressive data points here is the current account deficit, set to come in at just 1.0% in 2015 and 1.5% in 2017 — benefiting from low energy prices, a booming and inclusive economy, and a widespread belief

that Pakistan's economy is heading in the right direction.

CPEC win-win

CPEC, in short, stands to be a win-win for everyone. It will fund Pakistan's full integration with the global economy, linking the rising South Asian economy with China, Europe and the Gulf states overland, for the first time in decades. In a research notes issued on June 16, Moody's noted that, over time, the China-Pakistan Economic Corridor would "bolster growth through investment in transportation and power generation infrastructure", bolster both the manufacturing and construction sectors, and lead to a fresh influx of foreign direct investment from across the world.

Tapping Pakistan's

Pakistan has long been considered an energy-poor nation. But oil, gas and coal finds, offshore and onshore, and major new port facilities and pipelines stretching the length of the country, could be set to transform the South Asian sovereign into a major energy player of the new century

Energy has long been Pakistan's curse. This is a country whose large and rising population (the country had 195 million people as of October 2016, according to government data, making it the world's sixth most populous country) has long presented its government with a complex challenge: to tap new sources of hugely valuable energy where little, if any, had historically existed.

There is carbon here in spades. Pakistan boasts 754 billion cubic metres' worth of gas, placing it 28th in the list of the world's largest sovereign producers of natural gas. It has rather less oil, at least in comparison to other countries in the region, placing it 52th on the global list.

Coal, though, is another matter. A recent find in the desert district of Tharparkar, hard by the border with the Indian province of Rajasthan, may ultimately generate up to 185 billion tonnes of anthracite and lignite coal. If that find yields anything near its earliest estimates, it would vault Pakistan overnight from a 'resource-poor' nation into the energy-producing major leagues.

Coal would help diversify the country's energy mix. Pakistan is heavily reliant on natural gas and

oil to meet its primary energy requirements. The country's gas deficit currently runs at between 2 billion and 4 billion cubic feet per day, depending on the season and the time of day. Total local crude oil production, meanwhile, has long lagged: Pakistan currently has to import around 87% of its oil needs, mostly from the United Arab Emirates and Saudi Arabia.

In recent years, the pressures surrounding this energy deficit have eased, thanks largely to the medium-term decline in oil prices, which remain below \$50 as of early October. In July 2016, the State Bank of Pakistan estimated that the country's oil import bill fell to \$7.67bn in the 12 months to end-June 2016, against \$12.17bn over the same period a year ago, and \$14.8bn the year before that, when oil prices were still trading at north of \$100 a barrel.

Foreign investment push

But oil prices will return eventually to normality, again eating into Pakistan's budget. And that is one of the main reasons why the current government, under Prime Minister Nawaz Sharif, is so keen to encourage foreign corporates to invest in

the country's energy network: laying new oil and gas pipelines, digging new coal mines, fleshing out the national transmission and distribution grid, finalising new renewable energy projects and digging for more oil and gas.

The latter focus will be key to its energy future. Pakistan is looking for new ways to transport oil and gas into and out of the country. One of the biggest projects is the Turkmenistan–Afghanistan–Pakistan–India Pipeline, a vast conduit for natural gas that is being partly financed by the Asian Development Bank. It will, when completed, pump gas overland from the Caspian Sea to India, via northern Pakistan, when it becomes operational in 2020. Another major gas pipeline running from Iran to Pakistan is also under construction. Pakistan's government is also preparing the groundwork for a new oil pipeline stretching from the growing port city of Gwadar, on the Indian Ocean coast, to western China.

In September 2016, Finance Minister Ishaq Dar said that three south-north pipelines, stretching from Gwadar to western China, were under construction, with the first set for completion by the end of 2016. "The second," the finance minister added, "would be a parallel north-south pipeline built [with] Russian investment, while the third pipeline is planned between the towns of Gwadar and Nawabshah" in the easterly province of Sindh.

Exploration investment

But perhaps the biggest step-change — one that will reverse the country's energy fortunes — involves the state's determination to transform Pakistan into a major focus for oil and gas-related exploration investment. Already in 2016, Pakistan's Ministry of Petroleum and Natural Resources has announced plans to offer 32 exploration blocks to oil and gas companies operating in the country. That augments the list of 46 new blocks that have already been sold to oil exploration firms. A host of supplemental agreements — 70 in all, covering 94 leases — have been handed to smaller oil explorers, with the aim of boosting localised onshore production.

In September 2016, Shahid Khaqan Abbasi, Minister of Petroleum and Natural Resources,



Turkmen President Gurbanguly Berdimukhamedov, left, shakes hands with Afghan President Ashraf Ghani, second left, Pakistani Prime Minister Mohammad Nawaz Sharif, second right, and Indian Vice President Hamid Ansari during a ceremony in Ashgabat, Turkmenistan.

wealth of oil and gas

told Pakistan's National Assembly that the oil and gas sector had received investments totaling \$15.3bn since the start of 2013, adding that the country had made 82 oil and gas discoveries over the same period.

Analysts are impressed by what they are seeing. "Lucrative policies on gas pricing, stability resulting from improving law and order, and vast arrays of unexplored territory, have created attractive propositions for exploration and production companies, who are well positioned to deploy the excess cash on their books," notes Farrukh Sabzwaria, director of regional equities sales at Credit Suisse in Singapore. "Oil & gas exploration has made up 30%-40% of foreign direct investment over the past few years — and four multinationals are firmly entrenched, and should continue to bring in FDI for exploration and development activities." In other words, Pakistan, once a minnow in the fields of energy production and exploration, is well on its way to becoming a major player in the field, thanks to far-sighted government policy.

Producer and conduit

A host of major infrastructure projects completed or in the final throes of completion, will also boost the country's ability to act as both a conduit for oil and gas passing through its territory, and as a major producer of energy in its myriad forms. The country's first-ever liquefied natural gas terminal, able to handle up to 400 million cubic feet of LNG a day, was

“ Pakistan, once a minnow in the fields of energy production and exploration, is well on its way to becoming a major player in the field, thanks to far-sighted government policy”

completed in March 2015 in Port Qasim, east of Karachi. Another four LNG terminals are set to be completed, enabling Pakistan to import up to 2 billion cubic feet of gas a day, by the end of June 2018, while LNG processing facilities are also being targeted for completion by end-2016 and July 2017 in the Balochistan district of Sui. Those two projects will boost the country's LNG processing capacity by 1.8 billion cubic feet of gas per day.

And In July 2016, the government in Islamabad said it would revive the vast \$6bn Khalifa Coastal Refinery in Balochistan, which was shelved by its co-investor and co-owner, the Emirate of Abu Dhabi, under the previous Paki-



Sections of gas pipes are seen at the start of construction on a pipeline to transfer natural gas from Iran to Pakistan

stani government. Pak-Arab Refinery, one of the country's largest corporations, and a joint venture between the Pakistani government and Abu Dhabi, which owns 40% of the project, will aim to produce 250,000 barrels of oil a day, once the refinery is working at full capacity.

Then there are the pipelines, which will further boost the country's ability to process and conduit oil and gas — and to make it far easier to channel much-needed power to domestic businesses. If all goes well, the country's perennial energy deficit, and the problem of regular blackouts

PSO import 3.75 million tonnes of gas a year from the Gulf state.

A host of oil and gas majors are also working to tap new oil reserves in the country, or boost their presence in Pakistan's burgeoning energy services sector. Major foreign players operating onshore include Hungary's MOL Group, Vienna-based OMV, and Italy's Eni, along with oil field services specialists Schlumberger, Halliburton and Baker Hughes.

Local players also becoming increasingly powerful, diversified, and international, most notably Oil and Gas Development Company Limited, which boasts a primary listing on the Pakistan Stock Exchange, and a secondary listing on the London Stock Exchange, and domestic oil exploration pioneer Pakistan Petroleum.

Huge untapped reserves

Then there are the country's untapped reserves of carbon. In November 2015, petroleum ministry advisor Zahid Muzaffar said Pakistan's total oil and gas reserves, including unexplored offshore wells and fields, were greater than all Central Asian states combined. If true — and given that Central Asia includes one major gas producer, in Turkmenistan, and one major oil produce, in Kazakhstan — it would place Pakistan's energy sector and the wider economy in a highly promising position.

Pakistan has a huge and still largely underexplored offshore basin, which many believe to be as carbon-rich as the Niger and Nile deltas in Africa, and the Mahakam delta in Indonesia. The country also claims to possess major reserves of exploratory shale gas, another rich and economically viable source of both energy and future wealth. Energy was once Pakistan's curse. Now, it may well turn out to be its blessing.

and brownouts, which hamper the economy and crimp companies' ability to operate at maximum efficiency levels, will become a thing of the past.

Major foreign players

In recent years, the Pakistan government has signed deals with a host of foreign oil and gas explorers, producers, consultancies and commodity traders, with the aim of increasingly professionalising its energy sector. In December 2015, Pakistan State Oil (PSO) handed a five year contract to Shell and Geneva-based global commodity trader Gunvor, to supply it with LNG, running to the end of 2020. Another, 15 year contract with Doha-based Qatargas will see

Banking on growth

Pakistan's banking sector is in its best shape for years, as bad loan ratios fall, capital adequacy and profits rise, and new legislation allows lenders to process a logjam of bad assets that has long bedevilled the system

Much like the wider economy, Pakistan's banking sector is in its healthiest state in years. Financial inclusion is on the rise, as people in less-developed regions secure access to basic deposit and savings services via new bank branches, digital banking platforms and mobile phones.

Underlying credit quality is improving, notably at the country's largest lenders, led by Habib Bank, MCB Bank, National Bank of Pakistan, United Bank, and Allied Bank. For years, non-performing loans (NPLs) had hobbled a financial sector that struggled to eliminate a backlog of soured loans, many disbursed to struggling corporates in important but slower-growing industries such as textiles.

The banking sector's ratio of bad loans to total lending fell to 11.7% at the end of March 2016, according to data from the State Bank of Pakistan (SBP), down from 12.4% a year earlier, and the lowest level since 2009. Capital adequacy, meanwhile, has emerged in recent years as one of the industry's most prominent

success stories, having risen from an average of 14.9% in 2013, to 17.3% at the end of 2015, according to the central bank. Total assets across the banking sector hit Rs14.3tr (\$137bn) at end-March 2016, according to data from the finance ministry, against Rs12.1tr a year earlier. Solid banking industry data is supported by a strong macroeconomic environment and record high foreign exchange reserves, underpinning stability in the FX market.

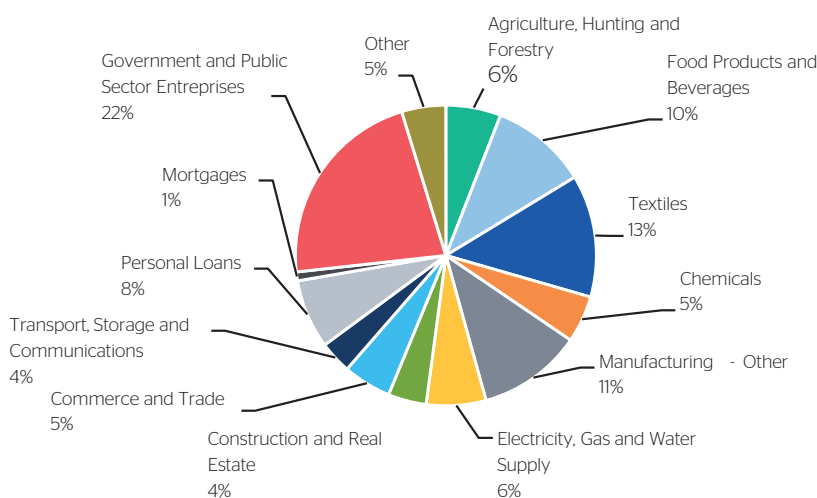
Top performers

Little wonder that, in February 2016, Credit Suisse rated Pakistan's banks the best performers in Asia in the three years to end-2015. The nation's total stock of bank credit is also on the rise, according to data from investment bank Renaissance Capital, rising 7.6% year-on-year in 2015, to Rs4.2tr. Credit Suisse is also positive. "Our long-term outlook on the sector remains positive, with likely acceleration in credit growth from 2017 led by drawdowns on [major Chinese-led] energy and infrastructure projects, as well as higher private sector borrowing from

the cement, consumer and energy sectors," says Farrukh Sabzwari, director of regional equities sales at the Swiss bank in Singapore. "This should help drive credit growth by a compound rate of 16% over the four years to 2020, with average annual profit growth rising by 18% over the same period."

Poorly directed lending remains a challenge for both bank chiefs and financial regulators. Alice Mummery, an emerging markets analyst at the Economist Intelligence Unit, notes that, while non-performing loan ratios had fallen sharply in recent years, bad loans remained concentrated in a few key industries — notably textiles, which accounts for 9% of GDP, 40% of jobs, and more than 50% of the nation's exports, according to data from the All Pakistan Textile Mills Association. And while textiles accounted for 13% of all outstanding bank lending at end-March 2016, according to data from Moody's, the industry also accounted for 26% of all troubled or soured loans. NPLs are far lower in the construction sector and the fast-growing media, entertainment, and information technology world.

Pakistani banks' loan book composition as of March 2016



Source: State Bank of Pakistan

Momentum regained

The central bank's determination to keep rates low is also helping to boost credit growth. Interest rates, which last peaked at just shy of 14% in 2009, have been inching down for years. But since Nawaz Sharif was re-elected to the position of prime minister in 2013, campaigning on a platform of growth, jobs, low inflation, and innovation, the banking industry has really regained its momentum.

Ashraf Mahmood Wathra, installed as governor of the central bank in April 2014, has continued to stimulate spending by pushing rates lower. The SBP cut its main policy interest rate by 25bp to 5.75% in May 2016 — the lowest in 44 years — citing the need to keep credit and macroeconomic growth high, and inflation low. Concerted efforts to convert lower rates into higher credit growth are bearing fruit. Loans to the private sector rose by 5.5% on an annualised basis in October 2015, 8.6% in February 2016, and 8.8% in May 2016, according to central bank data. According to government data, Rs460.6bn credit was disbursed to private-sector enterprises



Credit: Mohsin Jaffery, Flickr

in 2015-2016 compared to Rs223.8bn last year registering an increase of 106%.

“With the lowest banking penetration in frontier markets, and a loan-to-deposit ratio below 50%, we see plenty of scope for [private sector lending] to safely accelerate,” Renaissance Capital noted in a May 2016 research report. The investment house added that robust private sector focused lending was being boosted by an influx of capital to the China-funded infrastructure projects that make up the \$46bn China Pakistan Economic Corridor (see page 12).

In its report, RenCap said the domestic economy compared to Turkey in the 1990s — adding the proviso that modern-day Pakistan boasts far better inflation figures and fiscal deficit numbers. It said Pakistan would continue to benefit from “rising bank lending [and] capital inflows”, as well as robust economic growth and a “broadly stable currency”.

New laws

A raft of new laws recently passed by legislators is also expected to augment the banking sector’s underlying strength. In June 2016, the Senate Standing Committee on Finance passed a bill that allows for the creation of corporate restructuring vehicles, which can take over failed domestic firms and make them financially and operationally viable. The restructuring outfits will be licensed and regulated by the Securities and Exchange Commission of Pakistan.

The law will allow banks to resolve problematic assets in a timely manner, while making it easier for judges to approve the forced liquidation of corporate assets. Restructuring specialists will reorganise and liquidate distressed companies, and sell banks’ non-performing assets at a discount. “With fewer problem assets, banks will increase lending to the private sector,” Moody’s said in a June research note. The long-term aim is to create a thriving onshore market for distressed debt, which will suck in capital from debt resolution investors and agencies from around the world.

An extra clause was later tacked on to the legislation, which penalises anyone who defaults on their debts despite being in a position to meet their obligations. Anyone found guilty of breaking this so-called ‘foreclosure clause’ can be jailed for up to seven years, while borrowers in

deliberate default will be prohibited from securing bank loans for up to 10 years. Pakistan’s National Assembly passed the additional amendments in August.

In a later research note, published on August 11, Moody’s drew up a list of domestic lenders that are, it believes, best placed to profit from the new rules. Karachi-based state run commercial lender National Bank of Pakistan, the ratings agency said, would “benefit most from these amendments, given its higher stock of problem loans”, which stood at 20% of gross loans at end-March 2016. Habib Bank, United Bank, MCB Bank and Allied Bank also stood to benefit from the new rules, the ratings firm added, given their “high exposure to collateralised corporate lending”. Moody’s rates all five lenders B3 with a stable outlook.

Financial inclusion push

Pakistan’s banking system faces two more revolutions in the years ahead, both of which stand to benefit domestic lenders, foreign banks operating onshore, and any institution looking to invest in either the financial services industry or in the wider economy.

The first is financial inclusion. Just 13% of adults have access to a bank account, one of the lowest levels in the developing world, according to data from the World Bank. Put another

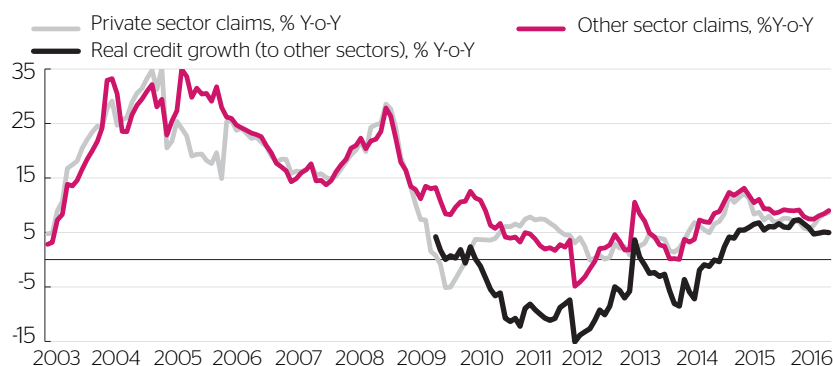
way, it means that more than 100 million citizens have no access to even a simple deposit account. Just 5% of women have access to a bank account, compared to an average among South Asian countries of 37%. Drilling down, 2.9% of adults have a debit card, while less than 1% actually make use of them. Just 1.4% of the country’s 195 million people receive their weekly or monthly wages by having them deposited into an account. The Washington-based independent policy and research outfit CGAP estimates that Pakistan has just five ATMs and nine commercial bank branches per 100,000 adults, against a global average of, respectively, 34 ATMs and 12 branches.

Authorities in Islamabad aim to change this utterly over the next few years. In May 2015, the government launched its National Financial Inclusion Strategy — in basic terms, a roadmap that will allow the country to meet a list of specific targets by 2020. These include: ensuring that at least half of all working-age citizens, including women and young adults, have access to a bank account; and boosting the total share of bank lending disbursed to small and medium sized enterprises, to 15%. On September 23, Finance Minister Ishaq Dar said Pakistan was working closely with the Financial Action Task Force, a global body working to boost the integrity of the international financial system, to reach out to remote areas, and to meet the needs of the country’s most financially excluded people.

Digital progress

But in other ways, notably when it comes to digital banking, Pakistan is far ahead of the curve. Six percent of adults have a mobile bank account, accessible via a simple cellphone. That may seem a low share by Western standards, but it compares healthily to South Asia’s average of 2%. A host of foreign and local lenders, including Habib Bank and Bank Alfalah and London-based Standard Chartered, have announced plans in recent months to expand their digital presence across the country: another sign that Pakistan’s banking sector is facing a strong and healthy future.

Bank lending growth to the private sector, to ‘other sectors (including private sector)’ and real growth



Sources:IMF, Bloomberg, Renaissance Capital

A 21st century look to

Pakistan's capital markets are back in business after a few lean years, with M&A deal volume and the Karachi Stock Exchange at record highs, and investors chasing yield in a country now promoted to MSCI 'emerging market' status. Rules passing through parliament are expected to underline the country's reputation as a great place to do business

Pakistan's capital markets have long played a crucial role in mobilising domestic resources and channeling them effectively. In recent years, capital market activity has yo-yoed: one good year followed by a middling one pursued by another good one.

But there is little doubt that activity is headed in an upward direction, benefiting from a burgeoning and increasingly stable economy, a major influx of fresh capital from key partners such as China and the United Arab Emirates, and a raft of new laws designed to foster broader and deeper onshore capital markets.

2015 Securities Act

Perhaps the most influential recent piece of legislation is the 2015 Securities Act, which set out, first, to demutualise the country's three stock exchanges, and second, to unite them as the Pakistan Stock Exchange (PSE). The new, unified bourse incorporates global benchmarks, such as the International Organization of Securities Commission's rules governing securities regulation, market manipulation, and investor protection. It also aims to boost public confidence in the markets, by forcing companies to provide full financial disclosure be-

fore any public offering, and to comply with any and all existing and future regulations.

Futures Market Act

Another key piece of legislation is the Futures Market Act, which is currently wending its way through parliament. It contains dedicated provisions that will regulate the derivatives and futures market, benefiting from an additional layer of oversight provided by the capital markets regulator, the SECP. A Futures Market Bill, currently being implemented, is also set to formalise rules and regulations that define how stock exchanges, central depositories, clearing houses and securities brokers and advisers operate. Lawmakers are also finalising a comprehensive Capital Market Development Plan, set to be introduced by 2018. This will outline how everything is regulated onshore, from equities to debt and commodities to derivatives, while also defining expected levels of corporate governance, disclosure and transparency.

The full impact of this avalanche of new legislation will likely not be seen for a number of years. Pakistan's financial space was not ungoverned or unregulated before, but laws were all too often old and archaic — and long overdue for an upgrade.

(The Securities Act 2015, for instance, replaced the Securities and Exchange Ordinance, which was passed all the way back in 1969).

21st Century force

The new rules are designed to transform Pakistan's capital markets into a 21st Century force in South Asia.

But the short-term benefits are also already being felt. The Karachi Stock

Exchange hit an all-time high of 40,541 on September 30, and is up 24% through the first nine months of the current year, making it one of the best performers in Asia. Trading volumes have risen each year since 2013, benefiting from new rules introduced by the current pro-business government, under the aegis of Premier Nawaz Sharif and Finance Minister Ishaq Dar — and from guidance and direction provided by the International Monetary Fund.

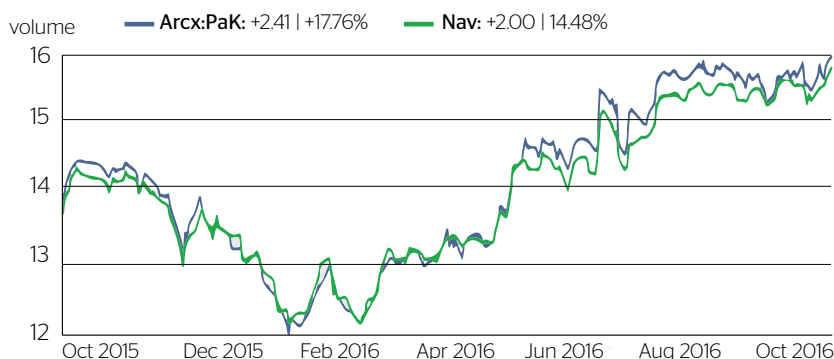
"Reforms," notes Farrukh Sabzwaria, director of regional equities sales at Credit Suisse in Singapore, "have given more teeth to the capital markets regulator, and we have seen the SECP flex its muscles through broker audits. This has been appreciated and was a key reason why Pakistan was able to seal an upgrade to MSCI Emerging Markets status" from frontier market status, as it did in June 2016.

Global investor love

There are good reasons why global investors love Pakistan, a list that includes: new and capital markets-expanding legislation; the influx of capital from key sovereign partners; and in recent years, a sharp fall-off in the number of domestic terror attacks. It is little wonder then that the Global X MSCI Pakistan has been one of the best-performing exchange-traded funds across the emerging-markets space in recent years. The ETF is up 19.44% over the current year to end-September 2016, during which time the iShares India 50 ETF has gained 8.28%, and the iShares MSCI China ETF has lost 22.68%.

Domestic equity capital market issuance in Pakistan has risen from just \$8m in the first nine months of 2013, to \$543m over the same period in 2014, and \$1.16bn in 2015, according to data from Dealogic. Key transactions completed over that period include the much-vaunted \$1.02bn privatisation of the nation's largest private-sector lender, Habib Bank, completed in April 2015. That deal is viewed as a trailblazing sale, in that it marked Pakistan's largest-ever privatisation, and provided ample proof that the government was se-

Global X MSCI Pakistan ETF PAK



Source: Morningstar

global capital markets

rious about divesting stakes in many of the country's largest and most troubled state-run firms. A flurry of smaller initial stock offerings have also peppered the markets in late 2015 and 2016, from the likes of Karachi-based Hi-Tech Lubricants, Mughali Iron & Steel, and TPL Properties.

M&A record

Nor has the mergers and acquisitions market been a slouch. In July 2016, the Dutch foods giant Koninklijke FrieslandCampina said it would spend \$700m to buy a 51% stake in the Pakistan food-to-fertilisers firm Engro Corporation. The previous month, Turkish conglomerate Koç Holding said it would buy local consumer goods firm Dawlance Premium Home Appliance, for \$258m. M&A transaction volumes through the first nine months of 2016 totalled \$1.01bn, according to Dealogic, a record high.

And in August 2016, Chinese multinational power generator Shanghai Electric said it would spend \$1.6bn to buy K-Electric, the utility that provides power to Karachi, the country's most populous city. That deal will mark the biggest private-sector investment in Pakistan's history. Shanghai Electric is buying the utility from its previous owners, UAE-based Abraaj Capital.

China has become the biggest sovereign investor in Pakistan, and plans to pump \$46bn into a series of giant domestic infrastructure projects over the next 15 years.

Sovereign borrower leads the way

Pakistan has also been busy raising capital in order to cut debts and build an economy fit for the 21st Century. In September 2015, the South Asian sovereign issued a \$500m 10 year international Eurobond that was three times subscribed, a deal completed in a tough and turbulent market. Then in December, the Islamic Republic of Pakistan closed a \$300m 18-month loan, its fourth such international commercial loan in less than 24 months, and the country's largest ever syndicated financing.

This year also started off with a bang. In April, the sovereign again dipped into the loan market, borrowing \$408m, with eight banks and institutional investors joining sole bookrunner Credit Suisse. The bullet loan started out as a \$150m facility, which was increased thanks to interest from institutional investors. The funds were used to support the country's balance of payments, and to pay for crude oil imports. Finally, in the last week of September, the government hired five lenders — Citi, Deutsche Bank, Dubai Islamic Bank, Noor Bank and Standard Chartered — to arrange a roadshow spanning the Middle East, Europe, and the United States. A sale of 144A/Reg S US dollar five year notes was set to follow, along with — if all goes well — a sukuk.

Multilateral activity

Also in late September, the new Beijing-led multilateral, the Asian Infrastructure Investment Bank (AIIB), announced a \$300m loan to fund the expansion of a hydropower project in northern Pakistan, co-financed by the World Bank. The AIIB in June also signed a \$100m loan with the Asian Development Bank, to fund the construction of a 64km stretch of highway linking Lahore with Islamabad. AIIB president Jin Liqun said the projects put the multilateral "well on the way" to meeting its 2016 external lending target of \$1.2bn.

Privatisation to take off

Going forward, one of the government's main ambitions will be to sell shares — or divest an outright majority — in many of the nation's largest and best known, but often also overstaffed and debt-laden, corporations. High on the list are Pakistan International Airlines (PIA), Pakistan Steel Mills, and Pakistan Railways. All are ageing, short of modern equipment, overmanned, and crippled by debts — a problem alleviated each year by an injection of state capital.

The current government, under Premier Sharif, wants to change this. Its aim — to sell shares in its biggest corporations, thus boosting governance, slashing debts and headcount, sucking in fresh global investment capital, and installing the profit motive — echoes that of many successful emerging markets, from India to Poland to Mexico. True, the process has been slow at times, due to political squabbling about what should be privatised, and whether firms should be partially



Credit: Raja Islam, Flickr

divested or sold outright.

A notable example of this internal conflict arose in April 2016, when parliament passed a law allowing PIA to be converted into a joint-stock company, but not permitting it to be sold in its entirety to the private sector.

But overall, the outlook is positive. In three years to end-September 2016, the government's Privatisation Commission raised \$1.7bn by divesting shares in local assets and corporates. Dealflow was led by the sale of Habib Bank, and by divesting shares in National Power Construction Corporation, United Bank, Allied Bank, and Pakistan Petroleum.

Privatisation deals are likely to continue to pepper the market going forward, dragging in much-needed foreign exchange, and continuing to press home the message to foreign investors: that Pakistan is open, welcoming, transparent, and a great place to do business.

Top 20 Pakistan Any Involvement M&A 2014-2016 YTD

Target	Target Industry Group	Deal Value \$ (m)	Acquirer	Acquirer Nationality
Engro Foods Ltd (51%)	Food & Beverage	707	Koninklijke FrieslandCampina NV	Netherlands
Dawlance Premium Home Appliances Co	Consumer Products	258	KOC Holding AS	Turkey
Lafarge Pakistan Cement Ltd (75.86%)	Construction/Building	218	Bestway Cement Ltd	Pakistan
China Three Gorges South Asia Investment Ltd	Utility & Energy	125	International Finance Corp-IFC	United States
Habib Bank Ltd (Stake%)	Finance	122	CDC Group plc	United Kingdom
United Bank Ltd (10.3%)	Finance	120	Bestway Holdings Ltd	United Kingdom
Bank Alfalah Ltd (15%)	Finance	65	International Finance Corp-IFC	United States
Daraz.pk (Stake%)	Computers & Electron-	56	CDC Group plc	India
PICIC Asset Management Co Ltd	Finance	40	Habib Bank Ltd	Pakistan
Lafarge Pakistan Cement Ltd (12.0705%)	Construction/Building	35	Bestway Cement Ltd	Pakistan
Grange Power Ltd (51%)	Construction/Building	30	China Western Power Industrial	China
Hascol Petroleum Ltd (15%)	Oil & Gas	28	Vitol Group	Switzerland
Masood Textile Mills Ltd (24.36%)	Textile	28	Shanghai Challenge Textile Co	China
National Power Construction Corp Ltd (88%)	Utility & Energy	25	Mansour Al Mosaied Co Ltd	Saudi Arabia
DH Fertilizers Ltd	Chemicals	20	Pakrab Fertilizers Ltd	Pakistan
COSCO SAEED Karachi Pvt Ltd (20%)	Transportation	19	China COSCO Shipping Corp Ltd	China
China Sunec Energy (Pvt) Ltd (90%)	Utility & Energy	16	Shanghai Brilliant Elevator	China
Noon Pakistan Ltd (51%)	Agribusiness	12	Fauji Fertilizer Bin Qasim Ltd	Pakistan
Engro Powergen Ltd (4%)	Utility & Energy	8	CMEC Thar Mining Investments	United Arab Emirates
Security General Insurance Co Ltd (9.59%)	Insurance	6	Adamjee Insurance Co Ltd	Pakistan

Source: Dealogic

LOCAL MARKET EXPANSION NEXT ON AGENDA AS ARGENTINA GOES GRADUALLY

Argentina's return to international bond markets this year broke many records, and its after-market performance has been equally stunning. It has also changed investors' concerns. Previously preoccupied with court rulings, an unpredictable government, legal technicalities and a curve comprising an assortment of complex instruments, bondholders now are looking at more conventional credit issues and can enjoy a normalised dollar curve with several liquid points. The buy-side is now assessing inflation and inflation expectations, GDP growth and FDI, and — crucially — progress on the fiscal deficit.

All the while the government is trying to be as transparent as possible and the turnaround in communication with the market could not have been more dramatic.

GlobalCapital sat down with the finance secretariat's chief of cabinet, one of the DCM bankers that worked closely on the record breaking trade and local and international investors to discuss the next steps on Argentina's comeback trail.



PABLO QUIRNO,
CHIEF OF
CABINET, FINANCE
SECRETARIAT,
MINISTRY OF
TREASURY AND
PUBLIC FINANCES,
ARGENTINA



MATTHEW DUKES,
DIRECTOR, LATIN
AMERICA DEBT
CAPITAL MARKETS,
DEUTSCHE BANK



JUAN SALERNO,
ARGENTINA CHIEF
INVESTMENT
OFFICER, COMPASS
GROUP



LIONEL MODI,
CHIEF INVESTMENT
OFFICER, ORIGENES
SEGURO DE RETIRO



SANTIAGO CUNEO,
PORTFOLIO
MANAGER AND
STRATEGIST,
RVX ASSET
MANAGEMENT



OLIVER WEST,
MODERATOR,
GLOBALCAPITAL

GM: Let's take a moment to look at how far Argentina has come from when Mauricio Macri won the elections to where it is today. Pablo, what have been the most important achievements so far?

Pablo Quirno, Ministry of Treasury & Public Finances: You'd have been surprised if I'd have told you 10 months ago that we would be in the place we are today and we are very happy with where we are. Ever since the lifting of the cepo within the first 10 days of the administration, we have been pursuing an agenda of transparency, openness and consensus building that takes into account both the social and political environment. One of the first things we tried to solve was the holdout situation, which required some very tough months of opening up and convincing our counterparties that we were good faith negotiators.

In just four months we were able to solve that problem and re-open international capital markets for Argentina.

This was very important not only because we were able to solve a problem that has haunted us for many years, but also because accessing capital markets is part of our plan to reinsert Argentina into the international community.

The re-opening of capital markets is also allowing us to pursue an agenda of gradualism in terms of fiscal convergence, which coincides with our need to build consensus and to take into account the social and political impact of our plans.

Socially, we realise the importance of protecting our population as the administration put tariff adjustments in place. On the political side, we are trying to be very transparent and to build consensus with Congress and governors alike. This has allowed us to reach a lot of political agreements in these 10 months that we think will improve the lives of many people in Argentina.

I would also highlight our application for OECD membership, the fact that we're going to have the presidency of the G20 in 2018 and the first IMF article IV consultation in 10 years. These all show we are on the path to normalising our relationships with the international community.

GM: Matt, you were in the thick of it when market re-opening happened. How do you assess the job that Argentina has done on the bond market side of things?

Matthew Dukes, Deutsche Bank: The speed at which Argentina was able to address its outstanding debt issues the moment President Macri came into office is truly impressive. The negotiations with the holdouts, the new issue and the lifting of the injunction all happened just four to five months after the new administration took office. It was an extremely impressive feat and the bond issue itself will, I'm sure, win all the various awards, having set all sorts of records for biggest EM deal, biggest EM order book and so on. But it was much more than just a bond transaction, when you think about how the deal allowed the country to put its difficult recent past behind it and look forward to realising its potential.

A lot of people were anticipating that Argentina would re-open bond markets, but perhaps they were not anticipating the simply staggering numbers. The deal size was \$16.5bn and the order



book reached \$70bn. After that, Argentina was able to return to the market and take advantage of very strong funding conditions to raise an additional \$2.75bn of capital in late June. So far in 2016 there has been roughly \$20bn of issuance from the sovereign and \$30bn in total Argentine issuance. When you consider the additional \$10bn that provinces, corporates and banks have raised, you can see that the sovereign did exactly what it set out to do: re-open bond markets for other issuers. The speed at which all of the provinces tapped international bond markets, in addition to the opening of the corporate and the bank sector, was very important.

Argentina is now the second highest source of EM bond deals by volume for 2016 year-to-date. The speed at which the country has turned itself around in the eyes of markets from where it was just a year ago is remarkable and exactly what the administration wanted to do. And being able to attract capital back into the country will have a direct impact, as Pablo said, on people's lives here.

As far as Argentina and bond markets go, the door is wide open. Investors still remain optimistic. There's been a significant rally in the bonds of both the sovereign and the sub-sovereign issuers. Even after that rally, investors still see reasons for optimism, as do the research teams of many banks. People see continued upside in Argentina, which is pretty exciting when you think about what the country will be able to achieve as an issuer going forward.

Particularly interesting — and we've already seen YPF issuing in Swiss francs and the sovereign has very recently issued in euros — is that you will begin to see Argentine issuers be able to diversify their funding sources to other markets. There is an exciting opportunity for Argentina to continue to do very interesting things in international capital markets.

GM: We'll get on to the diversification point shortly. Santiago, from the buy-side, how have you viewed this transformation of Argentina from offering double digit yields to sub-6% for a 10 year? Is the buy-side fully buying into the Argentina story?

Santiago Cuneo, RVX Asset Management: Argentina was certainly too cheap for some time. Investors knew that the problem was the country's relationship with the markets and bondholders. If you had looked at the numbers of the country, without knowing its identity, you would have said it was no worse than certain neighbouring countries that have far higher ratings and trade at lower yields. In that sense, I guess a lot of improvement was telegraphed: it was clear that there would be significant upside once the default was cured.

Recently I was meeting colleagues on the buy-side and at one of the rating agencies, and their worries have changed completely. What worried people before is no longer a worry, meaning that investors and rating agencies are now paying more attention to the fiscal accounts. Although the ministry has set a path to solve the fiscal imbalance towards 2019, it is perhaps not

clear to everyone exactly how it will increase tax revenues or reduce expenditure. I understand from the point of view of the policymaker that the objectives have to be varied, that they must view everything through the lens of politics and must bear in mind next year's elections. But this can create conflicts in the short run with what bondholders want to see, so I'd say that the policy mix is perhaps creating some doubts.

Lionel Modi, Orígenes Seguros: I have a question for Matt. As a local investor, and speaking as an Argentine living in Argentina, I'd like to ask how the external market perceives the amount of money that our country was able to successfully place? Does it look like an excessive amount, and do you see more appetite for more Argentine debt?

Dukes, Deutsche: There are two ways to approach it: from a fundamental perspective, and from a technical perspective. Fundamentally, and I'm sure Pablo can comment on this, the Argentine economy remains extremely under-levered. If you consider the amount of debt, and the ratios, in the public and private sector, there is clearly significant capacity to incur the additional indebtedness. From that perspective, I can safely say that the market did not view the incremental debt that Argentina raised as excessive.

On the technical side of things, there were also quite a few factors in Argentina's favour. These supported the recent deals and will continue to be supportive of future issuance. Number one is that Argentina had been out of the market for a very long time and going into the transaction most investors were very much underweight on Argentina, so there was significant capacity for investors to increase their weighting. That is on a relative basis. On an absolute basis, after the transaction Argentina took on a very substantial increase in its weighting in the EMBI index, which is the most significant index that investors track. Real money investors tracking the index therefore had the necessity to increase the weighting on an absolute basis as well. Not only are investors going from underweight to market-weight or overweight, they are also increasing their absolute exposure because Argentina becomes a much more significant component of the index. Furthermore, going into the second quarter of this year, markets saw a significant turnaround. Oil prices hit a floor, which was positive, and there was a shift in interest rate and central bank policy globally that provided good tailwinds for the transaction.

In addition, there was a lot of anticipation for the deal. The buzz surrounding the issuance definitely created momentum, despite all the issues that were happening in the background — the technical default and the negotiations with holdouts that were going on concurrently. Investors, particularly first-time investors in Argentina, were excited to be in the deal; it was viewed as a very historic transaction. All of those things led the bond transaction in April to be such a big success.

As we've seen, as a follow-on from that, fund flows into EM continue at a rapid pace — in particular since the Brexit vote — which has added fur-



MATTHEW DUKES,
DEUTSCHE BANK

ther momentum into the emerging markets debt asset class. Globally, we are in an ultra-low rate environment and investors are looking for assets that offer attractive yields. Relative to other countries within emerging markets, if you look at fundamentals, relative value, and particularly the upside that's available in Argentina for investors, it remains a very interesting investment opportunity — even after bond spreads have rallied 200bp, or in some cases even more across the Argentine curve.

From a market technicals perspective, there are certainly things that could affect this. The market will certainly be paying very close attention to the Fed's decision on rates in December, as well as what the ECB decides to do in Europe and other forthcoming global political events. These are all factors that could potentially slow down some of the rally that we've seen and calm some of the positive sentiment. But you have to look at things on a relative basis and within the stories that investors are following very closely in emerging markets, Argentina certainly remains near the top of the list in terms of the upside potential that is available.

GM: Argentina has certainly been fortunate so far with market conditions. Pablo, are you confident — given your funding needs — that you will be able to withstand a potential correction in the market?

Quirno, Treasury: I'd also like to address the issue of the fiscal deficit, how we're going to get there and any doubts the market may perceive. There are obviously queries in terms of how we're going to achieve what we've laid out. It is remarkable that we've been able to gain so much credibility in these 10 months, but we need to keep looking ahead and continue to demonstrate that we're doing what we've said we will do. It is very important for us to earn that credibility and trust from every party. We predicted a 4.8% fiscal deficit for this year back in January and we're comfortable that we're going to reach that.

Looking ahead we see the path to fiscal convergence as very important.



We will face challenges but we believe that the team that president Macri has put together will be up to those challenges. When we have setbacks, we find solutions. Take, for example, the gas tariff setback from the Supreme Court. It was very important for us to ensure that we abided by that ruling and we have put together the processes to overcome that setback. There have been some temporary delays in the way we will reduce the subsidies, which basically account for about 50% of our deficit reduction going forward, but we are receiving support from — and have the credibility of — the market. Managing the political and socioeconomic balance is something we have to be able to do. Obviously investors want the deficit to come down fast, but if we do it too fast there will be a social imbalance we need to take care of. This is why our access to capital markets is so important.

Just to return to the tariff situation: we have put together, through the public audiences system, a new way of reducing the gas tariff subsidies in such a manner that gas prices will be at market price by 2019. That was not part of the plan when we announced the gas tariff process back in April. In hindsight we had to adjust our processes and rebalance what we wanted to achieve and we're going to get to the same place as before.

Regarding access to financial markets, 2016 was a year of transition. There were many challenges to resolve — and many we still face — but we feel that our 2017 financing needs are very doable and that from 2018 onwards access to capital markets should not be an issue. The projected fiscal deficit for 2017 gives financing needs in the order of \$18bn, net of amortisations, and that is something that Argentina could certainly raise between external and domestic markets. And that \$18bn figure does not take into account any money coming from the tax amnesty, which is a wild card. However much the tax amnesty raises, we can subtract that from the \$18bn of net financing needs, and it is difficult to say that we won't be able to do that.

Juan Salerno, Compass Group: Regarding this \$18bn, what do you think will be the proportion of local versus offshore funding?

Quirno, Treasury: One of our priorities is to develop local capital markets. Very soon we will be presenting a package of laws to Congress that includes a capital markets reform law, a netting and derivatives law and a new mutual fund law. We will try to address the current system's tax asymmetries, put tax incentives in place and create a long term savings plan for people. For this framework to work and thus to develop the market, we need the macro stability that we are trying to achieve by reducing inflation. For this reason it is very difficult to assess how much is going to come from local versus foreign demand. What we do know is that as we develop our local markets our dependency on external capital markets will decrease.

Salerno, Compass: We have seen dollar and now euro issuances;



JUAN SALERNO,
COMPASS GROUP

can we expect a longer curve in pesos?

Quirno, Treasury: One of our goals is to put together yield curves as references for both corporates and provinces. We are developing our dollar curve and are trying to develop our peso curve too. In August we began with a A\$6.8bn (\$448m) five year peso CER bond issuance.

Modi, Origenes: In fact just yesterday (September 26) you announced a new five year Tesoro bond.

Quirno, Treasury: Yes, and through weekly tenders we've been able to move from CER, to fixed rate 18 months, to fixed rate two years. And now we'll issue a fixed rate five year peso. The reason we have not developed the peso curve so much already is that it was very expensive to do so until inflation began to fall. Now that we have had two months with average inflation at 1%, we think that appetite is there to build our curve, and we're starting to do this.

Dukes, Deutsche: This is a pretty exciting development. Given Argentina's financing requirements for next year, having the ability to attract international investors into the local market would certainly help to enhance the level of demand. There is already a high level of sponsorship from international investors for Argentina in the hard currency markets, but we know that there are accounts that also want to add exposure in the domestic market. To the extent that market conditions continue to be favourable, international investors will look to participate and to extend the curve, as we typically see happen in local markets. International investors tend to play in the longer parts of the curve in local markets and as long as we continue to see a reduction in inflation and inflation expectations, they should find it an enticing prospect. The reset of global central bank policy in the last few months and the inflows that we have seen into EM local currency debt funds should also work in favour of the peso market, and we are currently seeing a very good opportunity for local currency debt issuance in general. As the government continues to develop that curve and if global liquidity conditions

remain so benign, there should be very interesting opportunities for Argentina.

GM: Pablo, do you have any particular targets in terms of international participation in the onshore market?

Quirno, Treasury: No, not really, we don't break it down that way. We will be offering an attractive proposal for the whole investor community, and if demand comes from abroad then great. Obviously it will take longer to grow the local capital market, because the critical mass in the local saving market is still not there. But as we improve our macro conditions we will see a larger proportion of demand coming from locals. In the meantime we will build the curve for foreign investors as well.

GM: Santiago, coming from a US-based fund, how do you view potential foreign participation in the local market?

Cuneo, RVX: In general, I believe investors are quite reassured that the exchange rate is going to behave. It is clear that price inflation is a priority for the government nowadays. One possible worry is that the exchange rate still looks overvalued, and the dollar is cheap, which could have some effect on local currency investments in the future. The overvaluation of the peso could also be a worry on the growth front, because Argentina needs investment-led growth. Although it is clear that some sectors — such as alternative energy — are going to be successful anyway, the economy also needs more competitiveness in the industrial sector, for example, where costs have to be reduced. The way I see it, much like Brazil, Argentina is at a crossroads in that we have had good news — at least in the eyes of investors — on the political front, but now we are waiting for some deliverance.

If global liquidity conditions continue as they are then that is good news, because it provides the government with time and allows it to obtain cheaper financing for this transition. Similarly, if commodity prices are stable or even find an upside bias, then even better. These are the things investors are looking at, but I agree that they are recognising that Argentina has upside, particularly on a relative value basis.

GM: Lionel, I know you've been talking to some of your international counterparts about the local curve. Is the local market deep enough for them?

Modi, Origenes: That is a very good point. Recently I started holding meetings with funds that have come from abroad. One of their main concerns about taking that first step into the Argentine market is that they do not feel comfortable with the lack of depth of local capital markets. That is an area on which we are closely working, in particular with the finance ministry, to find a channel to capture private savings and develop, once more, real money demand for long-term assets both in equities and fixed income.

Nowadays, the two big institutional investors in Argentina are insurance companies and mutual





LIONEL MODI,
ORÍGENES SEGURO DE RETIRO

funds. Mutual funds are mostly related to transactional cash management coming from the corporate sector, so insurance companies are the only ones that remain able to properly take risk. There is a big gap that has to be filled with either a private pension system, or an alternative pension system, or a different saving mechanism. This would allow a mass of private savings to take different risk. The main intermediary in Argentina, the one that can capture private savings and turn them into long term investments, is the banking sector. There is no asset management industry nowadays able to fill that gap.

This is a concern that foreign investors continuously talk about. As you can see from other Latin American countries, where sometimes up to half of local debt is in foreign hands, these investors need someone who has a negative correlation with them. That gives them the knowledge and comfort that when they want to lower their positions or sell bonds, there is someone with real money who can take that asset and give them the opportunity to reallocate their portfolios. That is the big picture. At the moment in Argentina, the total amount of assets under management dedicated to long term investments is around \$10bn-equivalent at most. This needs to be doubled or tripled in the next four to five years.

Salerno, Compass: I agree with Lionel. As we mentioned earlier, Argentina is an unleveraged economy, not only in terms of government debt but also in terms of the industries. For example, the banking sector and the mutual funds industry are very unlevered, and the mutual fund industry is mostly made up of transactional funds. Ever since the nationalisation of the pension funds, in Argentina we have been lacking a big player to arbitrage the liquidity premium in the local markets. As of the beginning of this year, we have seen foreign investors trying to buy local debt — but with the condition that they have an exit deal for these positions.

We are finding local markets very attractive because, as I said, without a big player in the market, we could continue to see this arbitrage in terms of spreads. But we need a lot of development, and I think the role that ANSES (the state pension fund) may be able to play could be

important here. If they can sell now, or if they can trade a portion of the shares and bonds in their portfolio, then it is an opportunity to give to the market the liquidity that we need. In this sense we need more than just a private sector approach; the public sector approach can also work to give liquidity to the market.

These new issuances coming from the Treasury are also good news for local players and for foreign investors too, because they need larger sized issues that we have not had until now.

GM: Do you think there is appetite locally to extend the government's peso curve?

Salerno, Compass: I do think that appetite is growing. At the beginning of this year, when the central bank raised rates dramatically, local players were more inclined to place their savings in the Lebac (peso-denominated notes issued by the central bank) curve for the short term. Now, as inflation is coming down and the central bank is relaxing rates, investors are beginning to look at other markets like the equity markets, the medium and longer term dollar curve, the floaters and the CER-linked bonds. There has been an improvement in markets locally, but we are going to see this improvement much more clearly towards the end of the year when rates move down dramatically.

Dukes, Deutsche: An additional market that I'd mention — and one that bears a lot of resemblance to a local transaction but that is structured in an offshore format — is the global peso. YPF took advantage of this market earlier in the year and we would expect to see other Argentine issuers take advantage of this demand dynamic. In the event that a local currency curve is developed, there is an opportunity for these issuers to take advantage of the demand that exists today from international investors. There is captive demand for Argentine peso assets, so the global local currency instruments are another alternative available right now to certain borrowers and that we expect some to take advantage of, if supportive underlying trends in Argentina continue.

Salerno, Compass: I'd also like to make a point regarding the provinces, which is a different universe, and maybe a riskier one than that of government risk. They have their own financial needs and we are seeing that these provinces are issuing debt in dollars abroad. As we manage a local fund orientated to the provinces, we are trying to get an idea of how the management of these issuances is working in terms of the financial risk. Although we have seen some changes in terms of each province's management, previously there have been some disappointing years regarding how they manage their finances. This is a challenge for the government and for the provinces: how they finance their needs and, more importantly, how they spend this financing.

Quirno, Treasury: It is important to highlight that we are addressing this issue in our dialogues with the governors, which have been very open and have allowed us to reach several agreements

during the year. One of these was to give money from federal taxes back to the provinces, an agreement that has been instrumental in getting the governors and provinces to work with us. As part of that, we are having a lot of conversations regarding the new fiscal responsibility law, which allows us to have discussions aimed at standardising policies going forward and ensuring that the financing that is being raised is geared to infrastructure projects rather than provincial deficits. Many of these provinces have not received this kind of money for the last 10 years and in some cases they don't even have the use of proceeds readily available. We're making sure that the provinces that issue will be financing infrastructure needs, not current needs.

GM: How close has your dialogue with the provinces been as they've been issuing?

Quirno, Treasury: As part of the consensus-building process we have had very open dialogue both with congress and provincial governors. Amid the normalisation of all the issues that we have faced, we have made an effort to build consensus in such a way that we've been able to pass very important legislation out of Congress, where we don't have a majority in either chamber: the Holdouts Resolution Law, the SME Law, the Historical Reparation's Law for Retirees and Pensioners, the capital repatriation, and hopefully the PPP law, which was approved by the Senate last week and will go to the Lower House in the coming weeks. They realise that by having a common agenda we will be able to achieve the goals of the whole country.

Modi, Orígenes: Do you have any monitoring process for provincial debt issuance?

Quirno, Treasury: Through the Treasury Secretariat we have a formal authorisation process meaning that we have to approve each time a province wants to issue. But it has been more a case of advising them on going to market and the things they should be looking for given the expertise that we have within the Finance Secretariat's office. We are not a big brother telling them what they can or can't do. Part of the conversation with the provinces and governors is the fiscal responsibility law, and the need to have an agreement that financing going forward will be for infrastructure projects in each provinces.

Dukes, Deutsche: I would also add that the government has done a very good job of managing the process of the provinces coming to market, in particular with regards to how the issuances have been staggered. Each one requires a marketing process, a roadshow and price discovery. As you can imagine, price discovery for Province of Buenos Aires or the City of Buenos Aires is relatively straightforward, but as you get to some of the less frequent issuers it is important to have extensive discussions with investors to find out the right clearing level. Managing and staggering that process



was important. We certainly had some feedback from investors that there was a little bit of province fatigue, which is natural and understandable given the amount of issuance that came through. But at the end of the day the \$6bn or so of issuance from provinces was very well received and if you look at the secondary market performance of the provincial deals it has overall been very good. I take my hat off to the team for orchestrating the access of the provinces into the international market and ensuring it was done in a professional manner that gave investors the time to do their credit work and provide the feedback necessary for each transaction to be successful.

Cuneo, RVX: Sometimes investors can only base their opinion about certain credits on the past. Argentina carries the burden of its past, which explains why risk perception is higher than in other countries. On the topic of the provinces, to some extent there is concern among investors that provinces could be thinking that the government will bail them out if anything goes wrong, rather than thinking about the best way to use the proceeds in a manner that generates solvency. These provinces are not used to having such amounts of dollars; for some provinces this is a lot of money. Some investors worry that there is a risk of the provinces thinking: we have all this debt that we are supposed to use for public works, but rather than doing our homework on the fiscal

that he sees Mexico as the limit of the kind of debt ceiling that Argentina could have, with debt-to-GDP at around 50%, because Mexico handles that percentage with no problem.

But Mexico has a greater component of domestic currency denominated debt, and in light of Argentina's experience in 2001, investors may be worried that Mexico and Argentina's situations are not the same. So just to answer the earlier question of how much domestic currency financing Argentina can have: as much as possible, in my view.

I don't want to spoil the party and it is probably too early to get overly worried about these things, but they are worries that are lurking.

GM: Pablo, in terms of the currency mix of sovereign debt, is the government setting any targets?

Quirno, Treasury: No, we are keeping our options open and receiving a lot of reverse enquiries, which is how we ended up visiting the euro market this week. There is a financing plan to meet and we'll be flexible in terms of where we are going to source that, keeping in mind the idea of developing the curves in the currencies we want to issue in. The priorities are our needs and investor appetite. As I said before, there is a wild card that we're not yet considering, which is the tax amnesty, so we need to maintain flexibility.

Dukes, Deutsche: What is the latest timeline for when you expect progress on the tax amnesty?

Quirno, Treasury: There are several deadlines. There is an early bird deadline on December 31. October 31 is the deadline for cash from Argentines, which needs to be kept for six months in a special account. Then there are two bond alternatives: one is due September 30 and the other one is December 31. The final opportunity is March 31, but the penalty if you miss the December deadline goes from 10% to 15%, so — given that we expect most people to declare very close to the deadline — we expect the bulk of it to come near year-end.

GM: On the subject of keeping your options open, we know Argentina is on a euro roadshow at the moment, but are there other currencies you're considering? There have been rumours about a Panda bond.

Quirno, Treasury: Yes, there have been rumours. We'll look at different pockets of demand and the Panda market may be one that we'll target.

Dukes, Deutsche: In terms of the external financing, dollars is clearly the starting point in terms of the depth and liquidity it provides. Euros would be the second as a place to look for diversification and additional liquidity. But there are other interesting markets to consider. As we discussed earlier, YPF was in the Swiss franc market recently, and was — interestingly — able to buck the trend of what is traditionally sold to Swiss investors. The sizes are smaller in Switzerland but there is the potential for diversification there as well.

The Panda bond market is an interesting one, and one in which we have seen sovereigns issue in recent months. Korea and Poland have issued, and others are looking. Given the relationship Argentina has with China — I understand the minister has visited China recently — and the economic relations between China and Latin America, there is certainly an interesting opportunity for Argentina in that market as well. Right now Argentina appears focused on its key markets; for the other markets it is really a function of investor appetite and timing. We always keep our eyes peeled for opportunities and provide them to the team here.

One development that could be particularly interesting is that, although we often hear that certain markets are only open to investment grade issuers, or have some sort of other limitation, I believe that Argentina will be able to push the envelope in this respect because of the excitement around its story.

We think there will be many opportunities for Argentina to diversify going forward, and we will be identifying those as they become available.

GM: Santiago mentioned issues lurking in the background but I'd like to ask the local funds what issues they are focussing on in terms of Argentina's credit risk.

Salerno, Compass: We have elections next year and this is an important issue to consider. They will be legislative elections so it will perhaps be a little bit difficult to make an assumption on what counts as a victory for the government or not. Political risk continues to linger. It is not at the same level of the risk that it was under Kirchnerism, but the new Peronist opposition can still pose a risk to the government's plans. Another thing to take into account are the social demands that Pablo mentioned at the beginning and how these will affect salary adjustments next year. Much will depend on whether they are going to take into account forward-looking inflation or past inflation.

On the fiscal accounts side, as the Treasury has adjusted the goal to a 4.2% primary fiscal deficit next year, we will be looking at how this is going to develop during the next year.

But for next year the key issue is political. If the government has a good election it would surely trigger another bullish moment for local debt.

Modi, Orígenes: Besides the social and political environment, the one thing I'm looking at every day is inflation and interest rates. Yesterday the president of the central bank announced the new methodology, which will be working for the following year, and made some statements about the inflation targeting that they will be putting into place. I'd like to point out that the markets, until recently, did not really expect the government to be able to meet its inflation targets. But inflation rates have really slowed down and now we've seen investors demanding long term fixed rate bonds in Argentine pesos. For that reason a very important test will be the end of the year. If inflation doesn't continue to roll down maybe that confidence — and that investment idea of



PABLO QUIRNO,
MINISTRY OF TREASURY
AND PUBLIC FINANCES

adjustment we could use it to pay these current expenditure needs. During the previous administration, provinces were unable to save money for infrastructure because it was all captured by public servants. This is one of the risks that investors are assessing.

Secondly, I think there is a danger of a sort of Dutch disease — not in the sense of selling commodities but in the sense of all these capital inflows providing a supply of foreign exchange that is keeping the dollar too cheap in the long run. Moving away from the provinces but on the issue of dollars coming in, finance secretary Luis Caputo has said



SANTIAGO CUNEO,
RVX ASSET MANAGEMENT

trying to lock in fixed rates for longer periods and favouring local currency over hard currency — could be challenged. I will definitely be looking closely at inflation rate figures and of course the pace of monetary policy, in terms of interest rate reduction.

For me the bottom line of all this is growth in the economy. Most of the fiscal figures are arranged in a way that growth is necessary to lower some ratios, so growth and inflation will be really the most important things to look at.

Salerno, Compass: To add to Lionel's comment: what kind of growth can we expect to see in the next few years as we shift from consumption-driven growth to investment-related growth? My concerns and questions are related to the long term approach to growth in Argentina. I cannot know if society is ready for this investment-driven approach right now and for this fiscal tightening over the next few years. It is something that we are going to find out, but it is definitely a challenge.

GM: When people look superficially at the numbers, one topic they often talk about is FDI and how it has not increased as fast as some expected. Has it arrived at the pace you expected?

Modi, Orígenes: To be honest we haven't seen a strong FDI figure for a long time and of course we were all expecting changes. Beyond the financial sector, which is arguably one of the current administration's biggest achievements, we probably were expecting more FDI to have arrived by this point. Everyone is expectant, but of course the approval of projects can take a long time. The public sector is stepping in to make the first step in terms of developing and building a better institutional environment for that. But it is fair to say we Argentines had probably been expecting a little bit more by now.

Salerno, Compass: I would agree with that. We have seen announcements of more than \$45bn for the next few years but we would like to see that in place. They are long term investments, so they do not come quickly. It is worth mentioning that

Argentina has really been on the sidelines from an FDI perspective versus other Latin American countries, so I think there's a lot to do but there is also a lot out there to capture.

Quirno, Treasury: There is an obvious lag between when FDI is announced, when it arrives, and when it starts to generate growth. If we'd said 10 months ago that we would already have announcements of \$46bn of FDI for the next four years then people would have thought we were crazy. We have very high aspirations.

Modi, Orígenes: It is also a learning process for investors.

Quirno, Treasury: It is a learning process for everyone. More than that, it's a re-education process. A whole generation of people who started working 12 years ago — most people under 35 years old — have not experienced this framework or system. So it requires re-education for them, for Congress, for us, for the public sector putting the projects together, and for the investor community. That adds to the lag, but the important thing is that we are committed to putting the necessary frameworks in place.

Through that, we are gaining the trust and confidence from investors and from other countries. We have been able to rebuild relationships with the international community: China, the USA, France, Germany, Italy, Spain, Brazil, Russia and others. That is also attracting investors back to Argentina. Much like with inflation and fiscal convergence, it is a process. We are confident that FDI is kicking in. Take the example of the renewable energy tender earlier in the month: we were seeking bids for 1,000MW of energy and we received 6,300MW of bids from 123 participants. The appetite is there, and that competition will allow us to have better energy prices than what was expected six months ago.

GM: What are the main messages that investors should be taking away about the Argentina story?

Quirno, Treasury: The central message is that we are continuing to put together an agenda of consensus building and fiscal gradualism that will allow us to achieve our growth potential. That is the key. From the Finance Secretariat's office, our priority is to develop our local capital markets. We need to match, through local capital markets, the real project needs that Argentina has. Our country has huge infrastructure and energy needs and a buoyant agribusiness market, for example. These are all opportunities and we need to pave the way for these projects to flourish.

GM: Santiago, what are the principal issues to look at in Argentina in the next year?

Cuneo, RVX: I have a macroeconomic bias, so I would say again that I'd like to see Argentina working without this fear of floating the exchange rate. I understand that now we are in a transitional period, but personally I am afraid that the inflationary targets are too ambitious. I don't

think that what is happening in Brazil — where the real is too strong — is right, and Argentina is suffering the consequences. High interest rates are taking their toll on industrial activity. Overall, relative prices still need to change in Argentina, particularly public service prices. If we are too ambitious on the inflationary front we will cause too much damage to the real economy. I guess eventually the government will have to be more neutral in the FX market, so as to avoid the appreciation of the peso — which is going to continue because the priority in the short run is disinflation. Eventually, a floating exchange rate will reassure investors with macro worries that there is this tool of macro adjustment that can be used if necessary. They also want to see that the pass-through has been reduced, much like in other Latin American countries like Mexico or Chile. That is what Argentina has not been too accomplished at in the past, and to me this will be the next level of achieving a more stable, more solid macroeconomic system.

GM: Let us finish up by bringing the discussion back to the market. Matt, as we've heard, Argentina has done very well this year. But it is never going to be easy to raise \$15bn or whatever Argentina needs to raise next year. From a bond market perspective, what does the issuer need to keep in mind?

Dukes, Deutsche: First and foremost, Argentina has a very strong team of financial market veterans who know markets and how to spot opportunities. That is the most important thing. For us bankers, it makes our jobs easier because Luis Caputo, Santiago Bausili and Pablo know how to take advantage of the ideas, reverse enquiries etc. that we can provide to them. That is going to be even more important next year. The April transaction was without a doubt historic and record breaking but, as I laid out earlier, there were quite a few tailwinds leading up to the transaction in terms of investor positioning and so on. Investors now are more overweight Argentina; we do not know their exact positioning but they are certainly more overweight Argentina than earlier in the year.

Next year will be much more about timing, monitoring not just what is happening in Argentina but also the other factors that tend to influence EM debt markets: macro issues, central bank policy, commodity prices. At the beginning of this year, market conditions were not good, with only a select group of EM issuers able to access markets. The improvement in conditions by April was very opportune for Argentina. So avoiding those types of periods of volatility, and identifying when the conditions are most supportive for issuance, is very important. That is where Argentina will be able to maximise its funding at the tightest possible yield or concession to their curve, and that will be the strategy going forward. They need to be savvy in terms of finding those windows and accessing them as quickly as possible to take advantage of the demand. With the team they have in place, they certainly have the experience to deliver on that.



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Government goes gradual in search for fiscal recovery

Mauricio Macri's government is having to find a fine balance between fiscal consolidation and suffering too much short term economic and political damage. Markets appear willing to finance gradual change, and economists back the government's strategy, but improvements need to come quickly

By Olly West

There are still signs of the way things used to be in Argentina. Upon arrival, a customs form asks you to declare your personal mobile phone. You can still find menus in pizzerias in Buenos Aires that have handwritten prices that have been crossed out several times and replaced by higher numbers as inflation drove prices at a faster pace than they could produce new menus.

Such menus are becoming ever less common, but some of the effects of the previous administration will possibly be permanent. Entire apartment blocks that have been built without gas, for example, because electricity was so cheap thanks to the Kirchner government's subsidies that there was no need for gas.

In other ways, the country is very different: visitors no longer change hundred dollar bills on street corners to gain a far more favourable rate than they can at a cash machine.

This is reflective of the new government's medicine for the economy, where some measures have had an immediate impact, but other issues will take longer to fix. Float-

ing the exchange rate and settling with holdouts — thus regaining international capital market access — were obvious short-term improvements.

But inflation, although now slowly reducing, went up during the early days of Macri's government before it went down — partly as an inevitable consequence of floating the currency.

And reducing the fiscal deficit is also going to be a slower process than originally expected: in September's budget, the government said its expectation for the 2017 primary fiscal deficit had changed from 3.3% to 4.2%. Still, the government has at least recognised the issue.

"The nucleus of the macroeconomic problem was an enormous fiscal deficit that was being financed by money printing or the central bank's reserves," says Camilo Tiscornia, director at economic and financial consulting firm C&T Asesores in Buenos Aires. "The new government had to stop this and lower inflation."

To do this Argentina has had to raise debt, and lots of it — \$16.5bn in April, \$2.75bn in July and €2.5bn in October. While a chunk

was used to settle with holdout creditors, the issuance has also allowed the government to make a gradual fiscal adjustment.

"Politically, this makes a lot of sense, and you could argue that it also makes economic sense," says Tiscornia. "Closing the fiscal deficit too quickly could have worsened the recession."

THIS TIME IT'S DIFFERENT

Given Argentina's patchy history with foreign currency debt, the eye-watering numbers have inevitably raised some worries. But economists are confident that previous mistakes are not being repeated.

"The most important difference this time is that government debt held by private investors is barely 10% of the GDP," says Tiscornia. "Additionally, I believe the president is committed to fiscal balance, a conviction not shared by previous presidents."

One thing is having a plan; another is being able to execute it. Again, the history books are somewhat scary: no non-Peronist president has completed a full term since 1928. With legislative elections due in October 2017, Macri and his finance minister Alfonso Prat-Gay are treading a fine line between keeping the economy going and applying painful tightening treatment.

But again, there is a surprising level of positivity among local commentators.

"Although Argentine society remains quite difficult — demanding on social and economic matters — the last 10 years have demonstrated that the old way of doing



Clearing up

On the terrace of the Kirchner Cultural Center in Buenos Aires during Argentina's Business and Investment Forum in September

things will get us nowhere and was not sustainable," says Gustavo Cañonero, partner at Buenos Aires-based asset manager and investment bank Grupo SBS. "My feeling is that most people are giving the new administration the chance to try to do things more normally."

Cañonero says he has some sympathy with the government. Although, to Wall Street hedge fund managers who'd never been south of Miami, Argentina may have appeared a disaster on the way to a Venezuela-scale crisis, the economist admits there was "no sense of crisis" in the country before the presidential elections in October 2015.

This makes it harder to persuade the population that hard-hitting economic reforms are needed, even though economists could see that Argentina was using international reserves to pay for consumption and subsidies, and was heading for economic disaster.

"It is difficult to say to a population, 'look you didn't know it but we were bankrupt'," he says. "The government is being very careful with the message it's delivering, and has done better communicating on some issues — like the devaluation — than on others, such as the gas tariff corrections."

In August, the Supreme Court ordered the government to reinstate subsidies that it had tried to remove on gas prices as part of its efforts to cut spending and revitalise an energy sector in desperate need of investment. This decision directly led to the adjustment in the 2017 budget deficit target.

"The government's political capital is so important, says Jan Dehn, head of research at Ashmore. "It cannot afford to make the kind of mistakes that it did with the energy subsidy reduction."

In some cases, argues Cañonero, the government's measures have been clearly beneficial for the population, but it has not made this message clear.

"The budget implicitly shows that the cost of public investment is much lower than before, meaning they can do much more with the same money," he says. "Perhaps the gov-

ernment could have done better to communicate that."

GDP TO ACCELERATE

The need for the government's economic policy to be broadly accepted meant that many were disappointed when second quarter GDP numbers came in below expectations, falling by 3.4% on annual terms.

But Edward Glossop, Latin America economist at Capital Economics, argues the numbers were not as bad as they looked. He points out that the main reason for the

contraction was an 11.9% quarter on quarter drop in exports.

The government's finance team is extremely confident that growth will begin to pick up in 2017 and this optimism is shared by independent analysts.

"I don't want to paint a too positive picture because the GDP numbers aren't good, but without the export drag it is not actually that bad," says Glossop. "Moreover, I'd tentatively say that it looks like the worst of the downturn could be over."

Tiscornia says there are several differences between the first and second half of the year that suggest economic activity will rebound. Among these are the stabilisation of the Brazilian economy, a stronger agro sector expecting a record maize harvest and the reduction in interest rates — which hit 38% earlier in the year.

Finally, Tiscornia says his firm tracks tenders for public works, and that he noticed an increase — from around 20 per month to more than 100 — as of April.

"Given the time these processes take, we will probably start to see the effects of this soon," he says.

If the economy does begin to deliver benefits, it should reinforce support for government policy, says Cañonero. On top of growth, another crucial factor is inflation.

Prices in Argentina gained just 0.2% in August — down from 2% in July. Restaurant owners fed up of rewriting their menus are not the only ones happy at the news: central bank president Federico Sturzenegger has been able to reduce his 2017 target for inflation — which reached 47% earlier this year — to below 17%.

"Lower inflation would be a clear indicator of success and there has been an important reduction in recent months that has improved the social mood," says Cañonero.

THE FDI FRONTIER

For a sustainable improvement, however, investment needs to arrive not just from portfolio managers into bond markets but from foreign direct investors. Dehn at Ashmore

says that whether FDI arrives or not is the "big question".

"After extreme populism for 15 years, at the moment the government's job is to roll back the excess demand," says Dehn. "But to not do this too far, which would be political suicide. They need the supply-side to pick up: that is why FDI is so important."

The nature of direct investment means that it was never going to come as quickly as portfolio flows have done, so any sense of disappointment that numbers have not picked up is premature, say economists.

Firstly, says Tiscornia, this year's headline statistics will not be that useful for indicating progress.

"Under the previous government, because multinationals could not extract dividends from the country, they would account for that money as a capital expenditure," he says. "This inflated the investment statistics, and means that if this year's FDI numbers are flat versus last year's, in reality there has been an increase."

But the most important factor is the gradual re-education process that companies have to undertake.

"Investment is a slow process and we can see this through our clients, who are mainly large multinational companies," says Tiscornia. "They have to sell Argentina to their headquarters and convince them it is a good place to invest again."

Add to this the fact that, one year ago, nobody was expecting Mauricio Macri to win the elections, and it is hardly surprising that foreign direct investors have not rushed in.

"Businessmen were convinced Daniel Scioli would win," says Tiscornia. "This means that most companies were not prepared for such an improvement in conditions, and this adjustment takes time."

But the investment has to come, whether from foreign or local companies. Cañonero says it needs to increase from 17%-18% of GDP to 22%-23%, but that this will easily take four or five years.

"Unfortunately there is an urgency to see growth as soon as possible," he says. "The economy's main problem is a lack of productivity growth and competitiveness, and investment is needed to achieve this."

The good news is that markets have, so far, been willing to finance Macri's agenda and — if bond spreads are anything to go by — are giving him the benefit of the doubt regarding fiscal consolidation.

The customs officer at Ezeiza airport had zero interest in this journalist's mobile phone declaration, and even his taxi driver colourfully told him that he was willing to take some short term pain to repair the long term damage of the previous administration.

If these are signs that the Argentine population is as willing to embrace the new as bond investors are, maybe this time it really is different. **GM**

“
The government's job is to roll back the excess demand. But to not do this too far, which would be political suicide. They need the supply-side to pick up: that is why FDI is so important”

—Jan Dehn, head of research, Ashmore

Caputo confident on growth as markets finance change

Exclusive interview



Luis Caputo had been head of LatAm trading at Deutsche Bank and JP Morgan, but he'd never done a deal as important as the one facing him at the start of 2016. Few — if any — bankers ever do. Argentina's finance secretary, known in the market as "Toto", led the nation's negotiations with holdout creditors, achieving a faster and cheaper resolution than most expected. This has left Caputo confident that the government will be able to do just as good a job in tackling the outstanding issues facing the economy

By Olly West

GlobalMarkets: *Did you imagine 10 months ago that you would make such swift progress and have, in terms of financing, a relatively hiccup-free start?*

Everything went pretty much as we expected. We firmly believed that we would reach an agreement with holdouts sooner than the market had expected. The way the issue was resolved also helped a lot: the idea that we would decide to pay in cash had not been on anybody's mind here or in the US, but this ended up being a key part of the deal.

Paying in cash was crucial firstly because it meant we had to issue much less debt; essentially we were able to materialise the haircut and save \$7bn or \$8bn. Furthermore, paying cash ensured that we placed the new bonds in the right hands. It would have been a total mess to give new bonds to the holdouts, as they are not natural holders. Placing the bonds with the right investors meant our curve has traded far better than everybody thought.

What did come as a surprise was the level of demand, but it was a good thing as it allowed us to sell the bonds to funds that we knew would be long term bondholders and were not there for a short term trade.

Since the issue, we have been sending the messages that the market wants. Foreign investors are probably more optimistic than locals, and they value all the changes we are implementing and trying to implement. Furthermore they recognise the time bombs that we have been able to diffuse.

There are additional aspects that perhaps do not receive as much attention, such as our commitment to recognising institutions, which is a huge change. We respect not just US law but also Argentine law. The central bank is now independent. For the first time in so many years we have credible statistics, which is of vital importance. All this should be normal, but after so many years of not being able to rely on these factors it has been a big change. So we are not just talking about the economic front but also the institutional aspect. When I was dealing with the hold-

outs, it was clear to me how things work when the different powers work independently as they should.

All in all, there has been a huge change in the past nine months. We are going to be growing in 2017 for the first time in five years with no FX restrictions. Just a few months ago we were in default and now our bonds trade at the lowest yields in Argentine history: it is almost hard to believe. Just a year ago we were at risk of heading towards economic crisis, and now it feels like we are in a completely different country. It is difficult not to feel optimistic about the future.

GlobalMarkets: *Now that bond market access is very much re-established, what are the main priorities regarding financing?*

Our number one priority is to develop local market capabilities. Argentina has a very small, undeveloped local market. It is very important not because we want more people speculating in our markets, but because we want more small and medium sized companies to have access to long term financing in pesos. External markets are open and the sovereign, the provinces and large companies have access to those, but small and medium sized companies do not. Developing local savings and local market capacity will enable us to connect projects with money, which will be positive for productivity. A lot of people talk about FX rates as a way to increase productivity, but there are many ways to do it and improving the cost of financing is one of them. Another compelling reason to develop local markets is to avoid external shocks, because as it stands we depend too much on external financing.



Resolving the difficult issues

Caputo in February after meetings at the office of a court-appointed mediator with US holdout creditors in New York and next to finance minister Alfonso Prat-Gay during a hearing to present a draft bill to approve the landmark deal

GlobalMarkets: *How do you plan to go about developing local markets?*

The reform of the capital markets law, which will be sent to congress in the next 30 days, will be very, very important. One of the options for the repatriation of money as part of the tax amnesty is the possibility of not paying a fine if you invest for five years in local closed end funds. This is a useful shortcut to gain critical mass for the next five years, and will hopefully also be a way to educate people on these new instruments. The hope is that in five years from now these people decide they like what they did and will continue in the market. There will also be new products for people to invest in. It's a matter of educating people, changing the laws, creating new products and giving the right incentives.

GlobalMarkets: *We know that in 2017 Argentina will again have large amounts of debt to raise. Do you therefore fear a correction in financial markets?*

It is a challenging amount but less challenging than what some people say. We have to roll over debt with the private sector and multilaterals, and we have to finance the deficit. However, we are not taking into consideration in our budget, for instance, the money that will eventually arrive from the repatriation of capital. This could lower our financing needs substantially. We still see a lot of appetite for Argentine risk, we receive a lot of reverse enquiries, and I believe that unless the world collapses we should not have a problem raising financing.

Sometimes, in fact, the more problems the wider world faces, the more money comes to Argentina. Markets now are more mature than when I was on Wall Street and then everything was either risk-on or risk-off. In the old days, an event like Brexit would have been really bad for everyone. But it actually ended up benefiting us, firstly because people looked for countries heading in the right direction and also because investors had to look for higher yielding credits like Argentina. From our side I do not think we can do much more to show that we are conducting the right policies.

GlobalMarkets: *In the medium term, post-2017, how much external financing is going to be required?*

After 2017 the amount will become much lower due to lower maturities and a lower fiscal deficit. The main challenges from a financing perspective will have been 2016 and 2017.

GlobalMarkets: *Let's talk about issues on bond investors' minds. Last week's budget changed the expectation for the primary fiscal deficit. Has this changed your expectations for fiscal consolidation in the medium term?*

It will just delay the convergence to fiscal equilibrium, probably by a year. If you look closely at the budget, it is essentially what we had forecast minus the adjustment required by the Supreme Court ruling to reverse the increase in energy prices. This is a ruling that we clearly had to obey. With respect to the ultimate path we take, this will only be a delay. We understand more than anyone that we cannot finance six percentage points of GDP every year with debt. We are not considering not adjusting our deficit; on the contrary we are just taking a more gradual approach because we believe that's the right medicine for our economy.

Argentina is coming out of a recession, and if you apply a brutal adjustment to that then you will most likely make things worse, collect less money, and then see an even larger deficit. In order to make the adjustments we need the economy to start picking up, and that is what is going to happen now. Once growth starts accelerating then the government will have more capacity to make the adjustments that everybody wants. But when the economy is heading downwards, making a brutal adjustment doesn't work.

GlobalMarkets: *You sound very confident that next year the GDP growth will pick up. I am exceedingly confident. There is no doubt in my mind, literally, that growth will arrive. What is also encouraging is that there is no doubt in the opposition's mind, either. In fact*

they think the economy will grow even more than what we forecast. There will be growth in 2017 and even more growth in 2018.

GlobalMarkets: *Now that you've completed perhaps the most obvious tasks, which some see as the "low-hanging fruit", what is the main message you're offering to investors?*

I would certainly dispute that what we have done is take the low-hanging fruit. Take the lifting of the FX restrictions. When we did that there were probably only two people in the country — minister Prat-Gay and myself — who were convinced that it would go so smoothly. The same people who act like it was an easy task are people who at that time were saying that the exchange rate would shoot to 20 pesos to the dollar. *(Editor's note: It's now just above 15.)*

With the holdouts, expectations were for a 15% haircut and that we would take a year. In reality we resolved the issue with a 40% haircut in just three months. The way I see it, if we were able to resolve those very difficult issues in a much better and faster way than everybody predicted, then we should have gained the credibility to keep tackling the issues that remain and that are not quite as complicated.

GlobalMarkets: *Finally, Jack Lew, US treasury secretary, was in town this week. Did he have any words of advice?*

It was an excellent meeting. We have a very good relationship with the US Treasury. In fact we feel very strong support from not just the US but European countries and most others. It is clear to us that the world wants Argentina to do well. It was an honour to have Mr Lew here, and was also very useful because he reinforced that we are working on a bilateral tax agreement. This is very important for us, because there have been rumours that people could hide in the US, which clearly is not going to be the case. It was a short but very positive meeting that again reflects the support that we are receiving from pretty much the whole world. **GM**

“
“If we were able to resolve those very difficult issues in a much better and faster way than everybody predicted, we should have gained the credibility to keep tackling the issues that remain and that are not quite as complicated”

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No industry for old men: a renowned banker's personal history of, and polemic on, modern banking

Two Lives: A Financial and Social Memoir

By Stanislas Yassukovich Austin Macauley Publishers Ltd, £9.99

Review by Graham Bippart

Stanislas Yassukovich's *Two Lives: A Financial and Social Memoir*, in which he recounts his own life, as well as the lives of his father and the Eurobond market (of which he was a progenitor) might be a first of its kind. It is a bond man's — and bond market's — *Bildungsroman*, as well as a polemic against the state of banking and a klaxon sounding the end of capitalism as we know it.

The man needs little introduction in the Eurobond world. One of high finance's *éminences grises*, he formed and was managing director of the European Banking Co — one of the first pan-European investment banks — served as deputy chairman of the London Stock Exchange, chairman of the Securities and Futures Authority and finally chairman of Merrill Lynch in Europe. Yassukovich is therefore something like a living monument to Euromarket history.

Two Lives is peppered with tales of the kind of innocent luxury found in F Scott Fitzgerald, its prose reminiscent of that author and, strangely, Anthony Trollope. Yassukovich refers several times to both authors, and their styles have clearly influenced his. "We sealed our brief interlude with a chaste kiss," he writes of an encounter during his brief tenure with the US Marines.

He skillfully sets bijoux from the history of banking in their geopolitical, and sometimes social, contexts, intermingling them with the shaggy dog stories he admits to loving. Anecdotes from his coming of age, his family history, and the life of his "heroine", the Eurobond market, are often richly and entertainingly told.

Their telling gives a clue to how the author perceives his own life, as well as his distaste for the present and future of banking. For it is his love of detail — of the smell, touch and sound of a memory and its inherent personal value — that imbued his professional life. And this texture is just what seems to be missing from modern life, with its immediacy, distance between counterparts, and haste. *Two Lives* is very much not hasty.

His detailed narratives, from youthful galas in Long Island to brief vignettes of military history, to specific financial deals and even the temperaments of old Russian soldiers, have the charm of tales told by a man who has lived in a more tactile world than our own.

Capturing the dizzying speed of technological advance in finance, he writes: "It is as though I had helped paint the animals in the caves at Lascaux, and now watched a nature film on television," about them.

The line is telling, for it is the passivity of the modern financial world that Yassukovich sees as threatening its downfall.

The rot began a long time ago, according to Yassukovich. The original fall began with "the age of accommodation" that began in the 17th century for spawning "a plethora of devices to obtain money on commodities and transactions that never were". This familiar sounding cocktail resulted in a 1763 meltdown

in Amsterdam and Hamburg.

Yassukovich has similar harsh words for the Big Bang of 1986, which he saw as "a turning point in the wrong direction".

There are few things Yassukovich likes about the modern banking world.

If the first half of the book is a narrative of a structured, purposed life, the second half is about that life, set in a narrative spinning out of control.

Covenant-lite loans are a "breakdown in basic banking principles"; regulators no longer have the ability or talent to be immersed in their markets enough to reg-



ulate them; attempts at self-governance are legally unenforceable and futile; 'reputation' and 'responsibility' have no real meaning in the modern corporate culture; savers have no choice but to put their money with institutions that have no sense of the duty of ownership.

Other laments are stranger. Yassukovich is devoted to the idea of good breeding, as regards his own "pedigree" and his lifelong hobby of all things horses. He bemoans the lack of it as contributing to the downfall of modern culture: "It is... inconceivable that breeding should have obvious consequences for animals but not for humans and to so claim is an example of human arrogance."

Few of Yassukovich's readers are likely to be convinced by this reductive logic, which pops up throughout the memoir in variations. "Breeding" in animals is meant to produce certain traits often at the expense of others, such as speed in exchange for lungs that tend to bleed. Specific traits can be bred in a single generation because, after centuries of intentional inbreeding, the gene pool is shallower. Few would extol the Habsburgs' in-house approach to legacy maintenance. It led to the famously inbred Charles II of Spain, whose pathologist declared after his autopsy that "he

had one testicle, black as coal, and his head was full of water". And the downfall of the City as he sees it certainly has nothing to do with its diversification, as implied late in the book.

But *Two Lives* offers much, despite these faults. Yassukovich's telling of his own career is run through with a distinct moral ribbon that doesn't fade much in a younger reader's eye.

"Many of the negative evolutions in corporate structure, ill-conceived business models, management deficiencies, poor and conflicted regulation can be ascribed to a failure by shareholders to behave respon-

Yassukovich's telling of his own career is run through with a distinct moral ribbon that doesn't fade much in a younger reader's eye

sibly, and exercise the rights of ownership," he writes.

It is an important complaint, and one he's made before. In 2005, Yassukovich took to the pages of *The Spectator* to make a prescient warning to the finance industry.

In 'Whatever happened to shame?', Yassukovich aimed a volley of accusations at the financial sector and its regulators that would prove perfectly true in the years that followed, including regulators levying insignificant fines and settling cases without admissions of guilt.

"So the regulators' ultimate sanction has become a nuclear option, impossible to use," Yassukovich wrote.

He also warned of a loss of faith in the financial system. Individual savers have no choice but to put their money with a few giant institutions operating in a culture of impunity.

"A lack of confidence in the integrity of the financial system eventually translates into a crisis of confidence in capitalism as a whole," Yassukovich warned in that article. "The City cannot prosper in moral isolation from the general public. Unless it rediscovers the difference between right and wrong — as a concept separate from technical compliance with written rules — it risks damaging the entire economic system on which its prosperity depends."

Sadly, the author seems to have lost hope in the strength of his invective. In *Two Lives*, he laments: "Following the current meltdown in the world's geopolitical and financial fabric merely reminds one how lucky one was to have lived out its last moments of sanity."

Two Lives is a compendious, but deeply knowledgeable and entertaining read. One must hope it is picked up by the generation Yassukovich fears is already damned. **GM**

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What's happening Sunday October 9

Don't Miss

Euro50 Group & CIGI Breakfast Meeting The Eurozone after Brexit

Location: The Willard Room

Willard Intercontinental Hotel, 1401 Pennsylvania Ave NW, Washington, DC



8:00

Registration

8:15

Introductory remarks: **Edmond Alphandéry**, Chairman of the Euro50 Group

8:30-8:40

Opening remarks:

Nouriel Roubini, Professor of Economics at Stern School, NYU; Chairman of Roubini Macro Associates

8:40-9:00

Keynote speech:

Philip Lane, Governor, Central Bank of Ireland

9:00-10:00

Discussion panel

Guest Speaker: **Paul Tucker**, Chair, Systemic Risk Council, Harvard University; Former Deputy Governor of the Bank of England

Panelists: **René Karsenti**, President, International Capital Market Association (ICMA); **Athanasios Orphanides**, Professor of Global Economics, MIT Sloan School of Management; Former Governor of the Central Bank of Cyprus, **Mahmood Pradhan**, Deputy Director, European Department, IMF, **Domenico Siniscalco**, Vice-President and Managing Director, Morgan Stanley; Former Minister of *Economy and Finance of Italy*; **Nicolas Véron**, Senior Fellow, Bruegel; Visiting Fellow, Peterson Institute for International Economics

10:00-10:45

Questions and Answers with Guest Speakers and Panelists

10:45-11:00

Concluding remarks: **Domenico Lombardi**, Director of the Global Economy Program,

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The Federation of Egyptian Banks Reception in the Crystal Room at the Willard InterContinental



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Highlight

10.00am – 10.30am

**One on one with Christine Lagarde
and Michael Lewis**

A conversation between IMF Managing Director
Christine Lagarde and financial journalist and best-
selling author Michael Lewis on topical issues.

Michael Lewis is the author of *The Big Short* and
Boomerang, both set in the global financial crisis,
and *Liar's Poker*, a Wall Street story based partly on
his experience as a Salomon Brothers bond salesman
Location: IMF HQ1 Atrium



5.00pm – 7.00pm

Reception

Hosts: The Executive Board of KfW Bankengruppe

Location: The Metropolitan Club, RED Lounge, 170101 H Str

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Climate

Continued from page 1

to the needs”, according to Jean-Paul Adam, minister of finance, trade and the blue economy in the Seychelles. Adam told *GlobalMarkets* there were “still shortfalls” in terms of the financing that has been pledged.

“Flows of this finance to the most vulnerable countries are slow and in some cases non-existent,” he said. “The bureaucracy around access to climate finance is unacceptable.”

Procedures and paperwork to access finance from the Green Climate Fund (GCF), the UN’s initiative to bring climate finance to developing countries, are a particular frustration.

“The bureaucracy around access to climate finance is unacceptable.” —Jean-Paul Adam

“Progress has been slow and at this stage is disappointing,” said Timothy Antoine, governor of the Eastern Caribbean Central Bank. “We are concerned about the potential for us not to get our fair share because of the hurdles that are constantly being put before us.

“Are we going to receive parity and are we going to hold them accountable for the promises that have been made?”

Small island nations naturally face human resource constraints, which makes it “very difficult to deal with a fund that is not clear with how it will prioritise its action,” said Adam of the Seychelles.

“Small island states have no indication that they will receive any form of priority in terms of funding, even though they are often the ones most at risk,” he said.

“There is also no clarity in terms of the types of projects that should be put forward in principle.”

TEAMING UP

So concerned are the world’s most vulnerable countries that finance ministers from the Climate Vulnerable Forum (CVF) mobilised to form the Vulnerable 20 Group (V20) a year ago.

“There is really an expectation that clarity will be provided [regarding the \$100bn], partly because — for developing countries that are resource constrained — it is not actually a lot of money in the grand scheme of things,” said Matthew McKinnon, project manager of the CVF.

“Estimations from macroeconomists say we will need to reprogramme trillions of dollars in order to really deliver on the Paris Agreement.”

Lord Nicholas Stern, author of the landmark Stern Review in 2006, told *GlobalMarkets* that the Paris agreement had been “remarkable” and that its speed of implementation was “extraordinary”. But he insisted that the world was “still not doing enough” to combat climate change.

After addressing the annual finance ministers’ meeting of the Commonwealth, which contains 21 of the 50 most vulnerable states in the world, Stern said that small islands were particularly vulnerable.

“Hurricane Matthew has illustrated the issue, and the access of islands to funding that enables them to invest in a resilient development story is very important,” he said.

THE final word

Recovery must be backed up by reforms

The Russian economy has bottomed out. A long period of protracted recession is over and the third quarter of this year demonstrates sequential economic growth. It is worth noting that it happened faster than we expected a year ago.

As we implement our policies on this matter we have a positive view of the ability of the Russian economy to get “back to normal”.

The shocks we faced were harsh. The Russian economy passed through a period of high volatility in financial markets, with uncertainty and pessimism over the economic situation in general. Today the situation has significantly improved and looking back, we can identify two important lessons that we have learned.

First, if you are forced to make a complicated decision involving potential political risks, and it is inevitable, you should make it earlier rather than later. The rapid transition of the exchange rate in Russia to a floating regime allowed the Russian economy to cope with shocks much faster and smoother than other countries that were faced with the same problems but delayed the decision to set their exchange rates free.

Second, the actions of any central bank are, alone, not enough to encourage economic growth on a sustainable basis. The Russian economy has to start large-scale reforms to overcome structural barriers.

So, what is happening in the Russian economy now? Inflation has decreased sharply from 15.7% a year ago to 6.4% now. We foresee inflation at about 5.5%-6% by the year-end. Therefore we are confident in our ability to reach our 4% inflation target by end-2017 and maintain inflation at that target level thereafter.

Inflation expectations have been declining. We hope that inflation expectations will be anchored at the target level once we have proved that inflation can be maintained at 4%.

The structure of the Russian economy changes to tradables from non-tradables further to changes in relative prices as expected. At this juncture, most changes and positive output growth are seen in the sectors competing with imports, such as food processing, chemicals, domestic tourism and traditional export industries such as mining and agriculture. Yet we also observe a growing number of cases where Russian producers, which had been producing for the local market before, are exploring export opportunities.

Yet, we are not satisfied with the level of achievements in our economy.

Despite recent positive developments, we still expect Russian GDP to contract by about -0.3% to -0.7% this



year. Thereafter, we expect a modest recovery, with economic growth at 0.5% to 1.0% in 2017, and 1.5% to 2.0% in 2018-19.

A level of 1.5% to 2.0% is probably the upper limit of potential growth of the Russian economy now, and it could be inhibited by internal factors. Some of them are objective by nature (e.g. negative demographic trends), others are related to imperfect or unreasonably excessive regulations and weak institutions.

We are facing a complex set of negative factors that could be overcome by designing and implementing structural reforms.

I will mention only those that could foster rapid and sustainable economic growth in Russia. First, pro-competition policies, de-regulation and de-monopolisation in the economy. This will require significant reduction in direct and indirect state interventions in the economy, leaving much more room for private entrepreneurship.

Second, labour market reform aimed at increasing mobility of the labour force, would reduce wage pressures on the

Russian economy and make it more efficient and flexible.

Third, a medium-term fiscal consolidation programme and a new fiscal rule that should be approved quickly. These would stabilise the real exchange rate and reduce fiscal uncertainty.

Though the structural reforms are crucial for the Russian economy, there is a particular role for the Central Bank in promoting economic growth.

First, we must achieve the inflation target and maintain the inflation rates close to 4%. Investments

are almost impossible while inflation is high.

Second, the Bank of Russia’s monetary policy will remain moderately tight to lower inflation expectations and stimulate savings.

It means that interest rates (including the key rate) in the economy will exceed inflation by several percentage points.

To ensure high savings rates and set up conditions for their transformation into investments it is important to protect household deposits against inflationary depreciation. On the other hand, for businesses it is vital to have interest rates higher than inflation and to be able to utilise bank loans rather than rely solely on price rises.

Positive real interest rates are the new reality for the Russian economy. It allows all economic agents — banks, companies and national government — to improve their productivity, increase efficiency and reduce costs to achieve sustainable growth despite any unfavourable external economic conditions.

“**If you are forced to make a complicated decision involving potential political risks, and it is inevitable, you should make it earlier rather than later**”

Elvira Nabiullina, head of the Central Bank of Russia

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