WHEREFORE ARABIAN SWFs?

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Context: Where MENA is coming from and where it is going

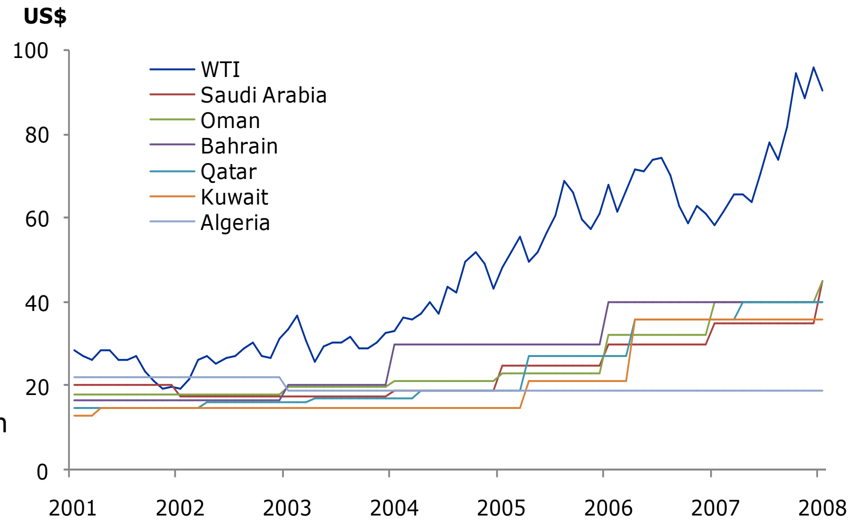
- **The 1990s: a "lost decade"**
  - Dismal average GDP growth of 3.6%
  - Job creation at 2.5%
  - Unemployment ~15% in 2000; 2x global average
  - Among youth, unemployment > 20%; 35% under 25 yrs
  - 100mn jobs needed by 2020 to absorb labor force growth (World Bank, 2004)

- **This decade: a "renaissance" of sorts?**
  - Oil boom leveraged to tackle old problems in new ways
  - Regional GDP growth now at 6-7%
  - Job creation > 4% during 2002-2005
  - MENA unemployment now down to 12%
  - World Bank has revised *down* its estimate for job creation needs, 68mn by 2010
  - Sustainability of higher job creation rates is now key

- **A quiet transformation is certainly underway**
  - Reforms across the region, e.g. MENA OECD and more
  - Oil revenues being deployed for structural diversification
  - *Saudi Arabia*: An estimated US$600bn in domestic investment in pipeline over 20 years, incl. 20 universities
  - *Algeria*: Launched US$120bn development plan and is using record reserves to pre-pay external debt

- **Prudent budgeted oil price assumptions**
  - The GCC average, US$45 remains well below WTI, despite doubling since 2002.

MENA budgeted oil price assumption[1]



[1]Source: MEED, Bloomberg, Pantera.

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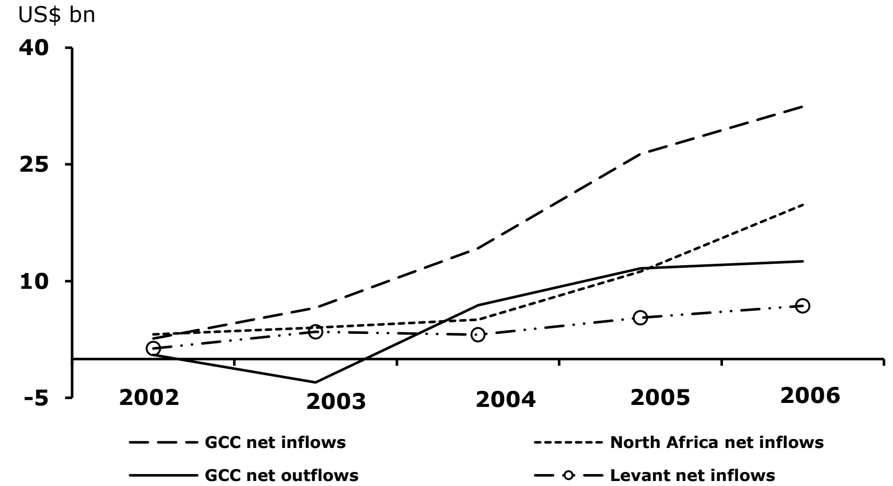
Investment is the main driver of change, and SWFs are playing a part

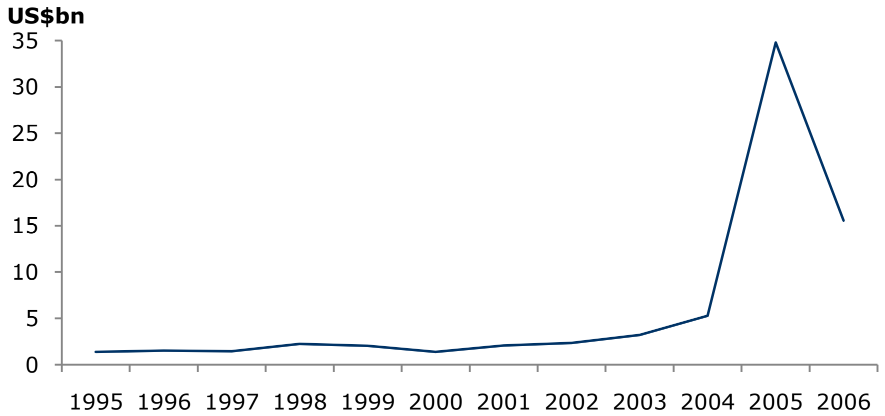
- **Net FDI inflows: US$58.7 bn (2006) a 37.7% increase oya**
  - GCC both a source of high net inflows and net outflows
  - *Saudi Arabia*: Highest net inflows (US$18bn) *Kuwait*: Highest net outflows (US$7.9bn) in MENA in 2006
- **Unprecedented intra-regional flows**
  - The GCC invested $60bn over 2002-06 in the rest of MENA[2]
    - This represented 13% of the 2006 GDP of MENA, exc. GCC
  - In contrast, the GCC invested $300bn over 2002-06 in the US
    - This represented 2% of 2006 GDP in the US
- **Intra-regional investment[3] is clearly growing**
  - At US$17.6bn in 2006 *vs* < US$5.0bn before 2004
  - Kuwait, Saudi Arabia and UAE accounted for 69% of outward intra-regional investment in 2006
  - Highest recipients in 2006: Lebanon, Egypt, Jordan, Tunisia and Saudi Arabia

MENA net FDI inflows and outflows[1]



Note 1: The Levant comprises Iraq, Jordan, Lebanon and Syria
Note 2: UNCTAD reports FDI on a net basis (capital transactions' credits less debits between direct investors and their foreign affiliates). UNCTAD reports both net increases in liabilities (inward FDI) and net increases in assets (outward FDI) with a positive sign, unlike balance of payments data. A negative UNCTAD net FDI outflow figure represents a disinvestment (one of the three FDI components - equity capital, reinvested earnings and intra-company loans - is negative and larger than the others)

MENA intra-regional investment[3]



[1]Source: UNCTAD, Pantera. Latest available data is through 2006.

[2]Source: IIF

[3]Source: Inter-Arab Investment Guarantee Corporation. Data is on an approval basis, not on a balance-of-payments basis. Inter-Arab investments refer to private and licensed investment flows conducted by Arab investors from one Arab country or more into another Arab country that depicts both private and pure public or government investments, based on their nationality. Latest available data is through 2006.

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MENA economic outlook: Decoupling, anybody?

- **Relatively sheltered; growth could ease but should remain robust overall**
  - Boom has led to CA and fiscal surpluses, low debt, high FX reserves and NFA
  - GCC growth led by investment, not consumption, in contrast with previous cycles. Infrastructure development is filling deficits from past two decades.
  - The non-oil sector, major engine of growth in the GCC, is not export-oriented
  - Egypt likely to be the most vulnerable to an acute G3 slowdown given merchandise and services trade links. GCC inflows should continue to support reform-driven growth

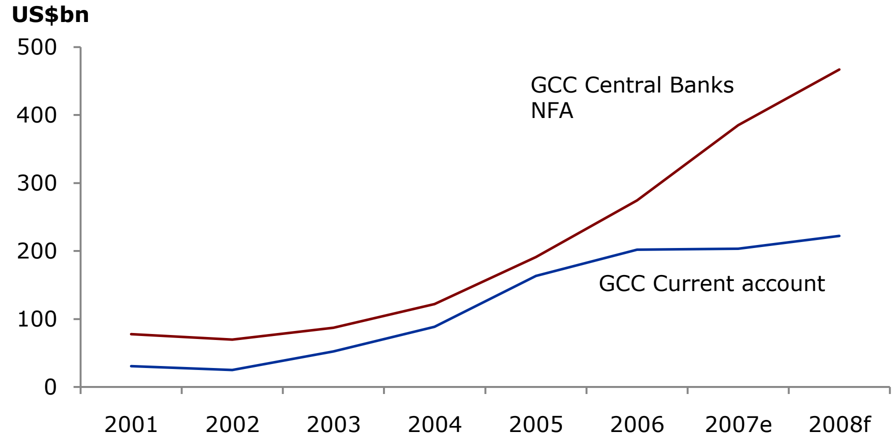
- **Does this imply no risk? No.**
  - A correction is still likely in some segments of the real estate market
  - Can you import enough human capital?
  - Increasingly strained GCC monetary policies linked to USD pegs; risk of further USD weakness
  - High inflation could entrench expectations, damage competitiveness and investment outlook
  - Geopolitical risk, practically perennial…

- **Direct impact of subprime crisis is manageable**
  - S&P survey: aggregate exposure of GCC banks < 1% of their total assets
  - Some debt issuance postponed due to tightened market conditions
  - Stock markets are still dominated by domestic retail investors. Recent pull-back by global institutional investors will likely be of a temporary nature
  - Indirect impact: oil prices might recede from recent highs if global growth slows. Low budget breakeven prices and accumulated surpluses will cushion

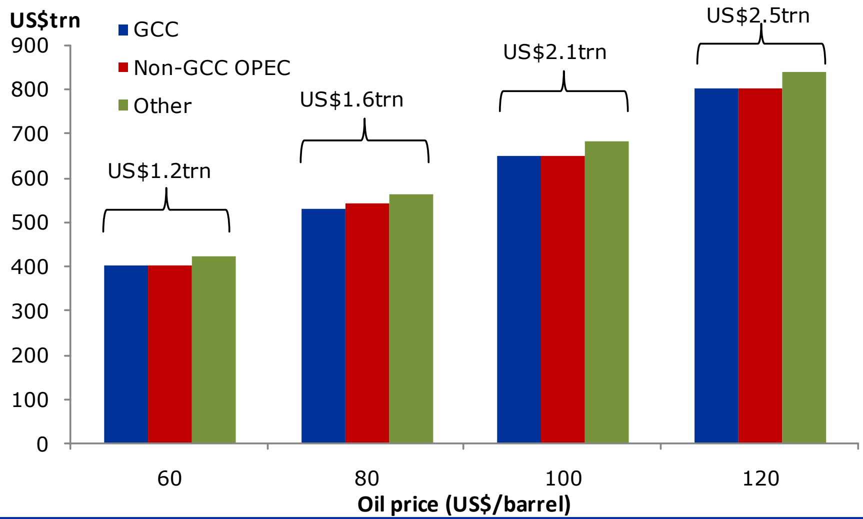
Sovereign Wealth Funds: Destined to grow

- **Oil prices & sustained CA surpluses driving foreign asset accumulation**
  - Petrodollar recycling through both "absorption channel" and "capital account channel"
- **How large?**
  - IMF estimates SWFs hold US$2-3trn in assets
  - Merrill Lynch estimates AUM will reach US$7.9trn by 2011
  - IMF projects AUM will reach US$6-10trn by 2013
  - Morgan Stanley projects SWFs to reach US$12trn in size by 2015
  - Standard Chartered projects SWFs' assets to reach US$13.4trn over the next decade

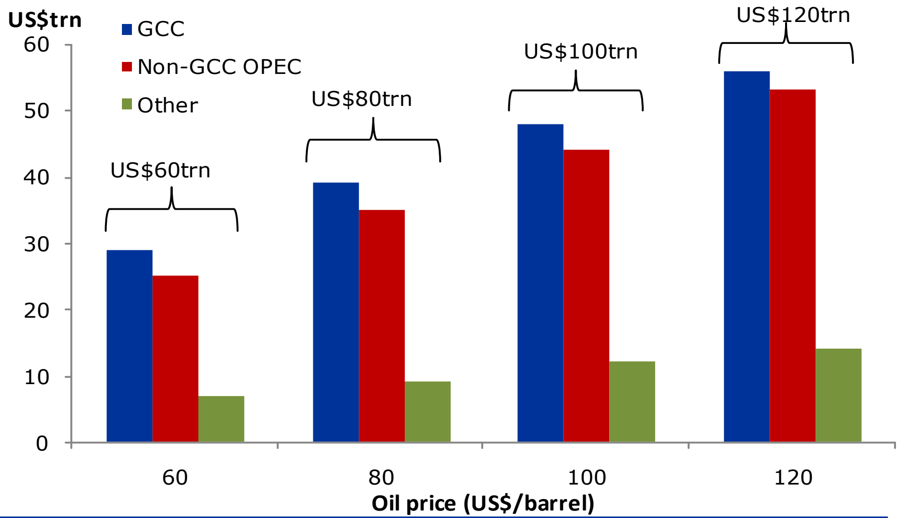
Aggregate GCC current account, CB NFA[1]



Market value of annual flow of oil exports[2]



Market value of proven oil reserves stock[2]



[1]Source: IMF, IIF, official statistics, Pantera.

[2]Source: Morgan Stanley.

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What are SWFs? A heterogeneous group

- **They differ in objectives**
  - *Stabilization funds:* Insulate budget & economy from commodity price swings
  - *Savings funds:* Facilitate savings & intergenerational transfer of equity, dampen Dutch disease effects
  - *Reserve funds:* Decrease opportunity cost of holding reserves through portfolio allocation
  - *Development funds:* Finance socio-economic projects & policies
  - *Contingent pension reserve funds:* Cushion against hidden government pension liabilities

- **Different investment profiles imply differential financial market implications**
  - Macro stabilization requires liquid investments while savings funds have longer-term horizons
  - CB reserves tend to be less diversified than SWF portfolios
  - SWF growth will likely support risky assets, including equities; use of external managers likely to increase
  - Passive CB-like SWFs likely to support EUR through diversification
  - Savings funds likely to support EM currencies

- **Macroeconomic impact of SWFs**
  - Can strengthen *public finances* if robust framework & control/monitoring mechanisms in place
  - Can influence *monetary conditions* through repatriation of returns (Fx appreciation) or injection of liquidity into domestic assets
  - Can boost *balance of payments* and external stability
  - Can support global *financial markets* through revenue allocation, enhancing liquidity & stabilizing times of stress – *the SWF put*
  - Can enhance *development* and *growth*, especially in EM investments

Are GCC SWFs the big bad wolf?

- **They are big**
  - Estimates of AUM vary, but all are large
  - KIA established in 1953, ADIA established in 1976 (same year as Canada and Alaska funds)
  - SWF growth reflects a secular shift in global activity & wealth
- **But they are not bad**
  - We seldom used to hear about them because they have not tended to destabilize markets
  - Blurring of government and private sphere is not new, nor unique to the GCC
    - e.g., 98% of land under development in UAE owned by government or semi-government entities (Nakheel, Dubai Properties, Emaar); significant stakes in banking, cement, utilities, industrial, telecom firms
    - Possibly *more* competition not *less* (e.g., new Dubai LCC)
  - Strategic objectives are being achieved through other means
    - Borse Dubai, ADSM deals to develop domestic capital markets
  - Being new should not imply bad regulation -- the GCC is fully cooperative...
- **...and nothing happens at full moon**
  - Cycles of alarm are the only constant
    - KIA acquisition of 20% of BP in 1988, and reaction of UK Monopoly & Mergers Commission
  - Now widely recognized that DP World port take-over treatment was overblown
  - UAE is the US's most important non-oil trading partner in the Arab world
  - SWFs now actively involved in consultations with multilateral bodies
  - ~50-80% of SWF assets externally managed & large portions of direct investments involve no control rights
  - While more transparency is desirable, recipient countries should show that scrutiny is clear and objective
  - Market efficiency is a two-way street
  - The GCC and the US will remain staunch political allies for the foreseeable future