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A Cautious Arab Macroeconomic and Energy Investment Outlook : One Crisis May Conceal Another

Impact Assessment and Policy Recommendations

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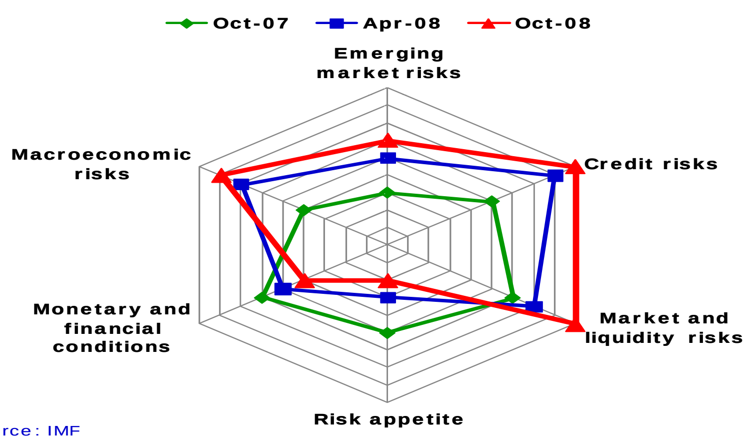
Outline of presentation

- One crisis may conceal another…
  - The credit market crisis
  - The oil market crisis
- Impact on the Arab macroeconomic outlook
- Impact on the Arab energy investment outlook
- Conclusions and policy recommendations

1. One crisis may conceal another…

A quick look at the IMF's Stability Map shows that for almost a year and a half the global financial and economic systems have been under tremendous stress



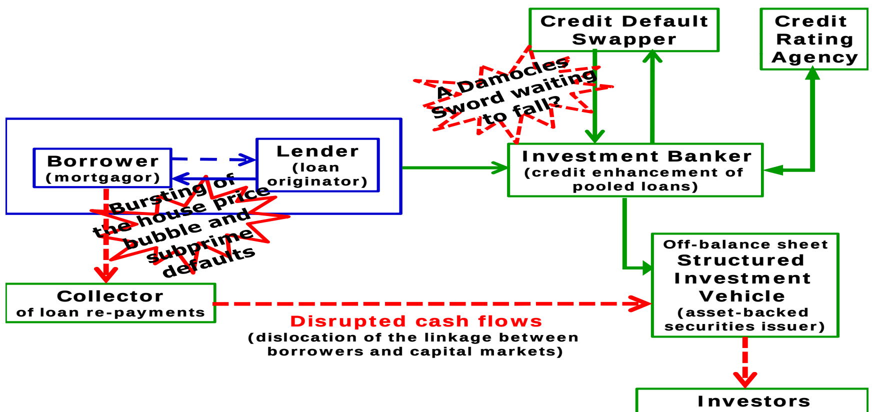
Source: IMF
Note: Closer to center signifies less risk, tighter monetary and financial conditions, or reduced risk appetite

1.1 The credit market crisis

At the origin…The brave new world of financial asset securitization

- In the old-fashioned world of banking
  - Loans were originated by Banks or Savings & Loan
  - Kept on their books
  - Monitored by them until maturity
- In the sophisticated world of securitization
  - Investment bankers buy in bulk loans sourced by brokers
  - Pool and slice them into structured collateralized obligations
  - "Enhance" them to get investment-grade from CR Agencies
  - Move them off-balance sheet and sell them to investors

How much blame should we put on securitization magic when the true culprit may be closer to (US) home!



APICORP Research – Compiled and "structured" from different sources

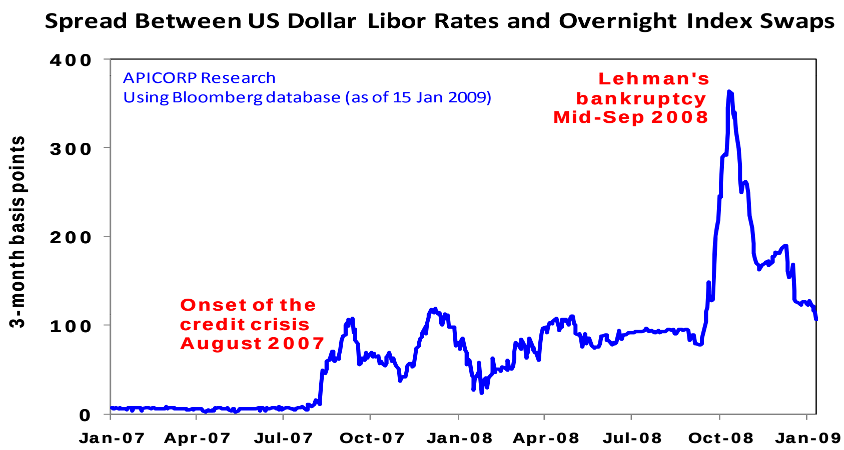
Whatever the case, the credit crisis has highlighted much broader issues

- Underpricing of risk and massive credit expansion
- Excessive use of leverage by investment banks and hedge funds
- Looming problems in the credit derivative market (credit default swaps)
- Significant risk management weaknesses and vulnerabilities

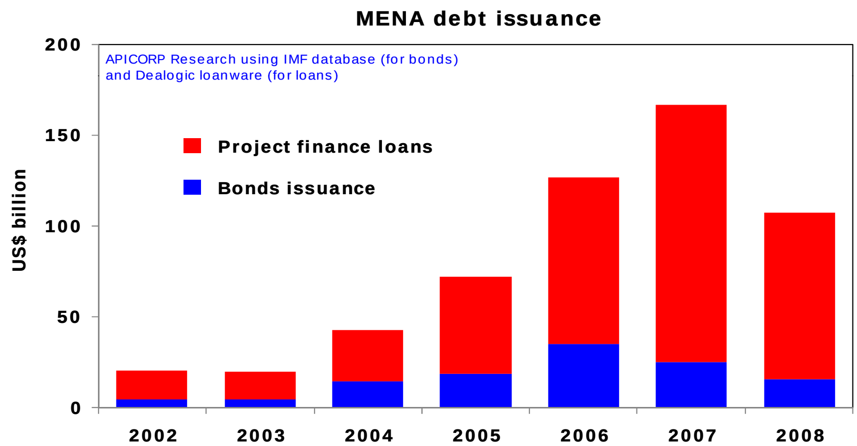
Drastic and decisive actions have been taken to support financial institutions, prevent further failures and restore confidence

- **Central banks…**
  - Extending liquidity provisions beyond conventions
  - Aggressively easing monetary policies
- **Treasuries…**
  - Bailing out shaky financial institutions
  - Purchasing troubled assets from banks
  - Guaranteeing interbank lending
- **Sovereign Wealth Funds…**
  - Taking shareholding in banks

To little avail… Despite risk spreads trending towards their pre-Lehman levels, interbank markets have remained largely frozen



The credit crisis has led to a contraction of capital inflows to the Arab / MENA world that is likely to have lasting effects



1.2 The oil market crisis

Oil market dislocations: Until the summer of 2008, limited potency of OPEC[a] and CFTC[b]

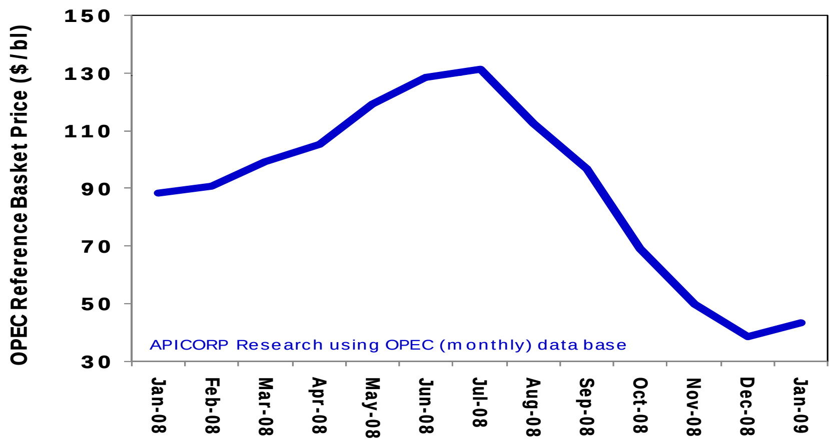
- Large scale involvement of investment banks on behalf of (passive) commodity investors reduced the scope for arbitrage between the physical and futures markets
- Neither OPEC's traditional policy instrument (output adjustment) nor CFTC's (FSA) supervisory and regulatory measures could help set boundaries

[a] OPEC: Organization of the Petroleum Exporting Countries
[b] CFTC: U.S. Commodity Futures Trading Commission

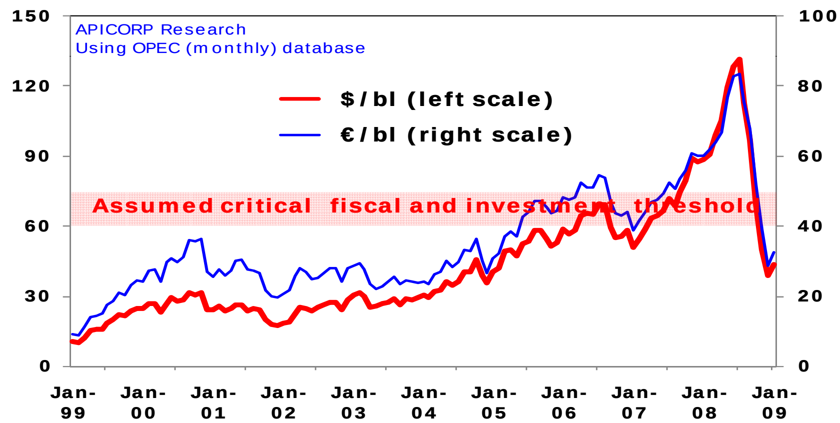
Before the "speculation vs. fundamentals" controversy quieted down OPEC and CFTC were pressured to take actions and stabilize the markets

- OPEC…
  - While OPEC Secretariat had continued to put the blame on speculative activities in the futures markets
  - Saudi Arabia moved to cushion the physical market with extra crude
- CFTC…
  - While CFTC economists continued to dismiss claims that speculation has driven up prices on the Nymex
  - CFTC focused on swap dealers and commodity index traders in a move to improve transparency and control

With some success: The 2008 Summer bubble did burst... But oil prices have fallen steeper than expected and much lower than desired

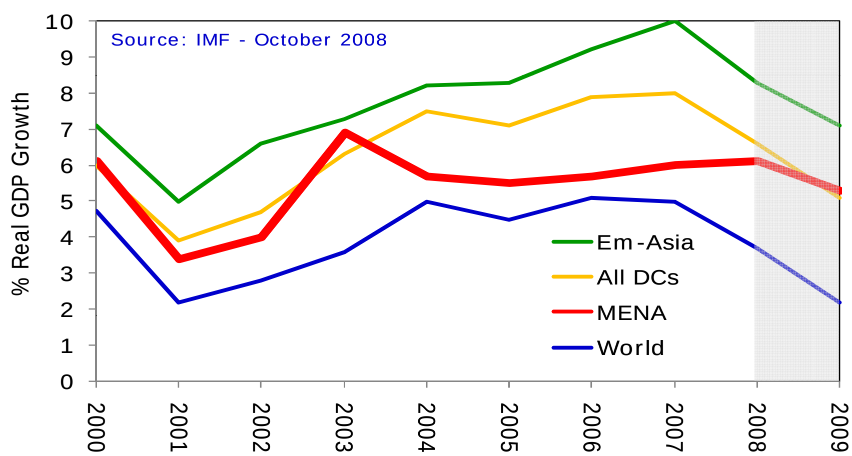


Assuming prices have reverted back to fundamentals, OPEC will find it harder, in face of collapsing demand, to drive up prices to the critical fiscal/investment threshold of $60-70/bl

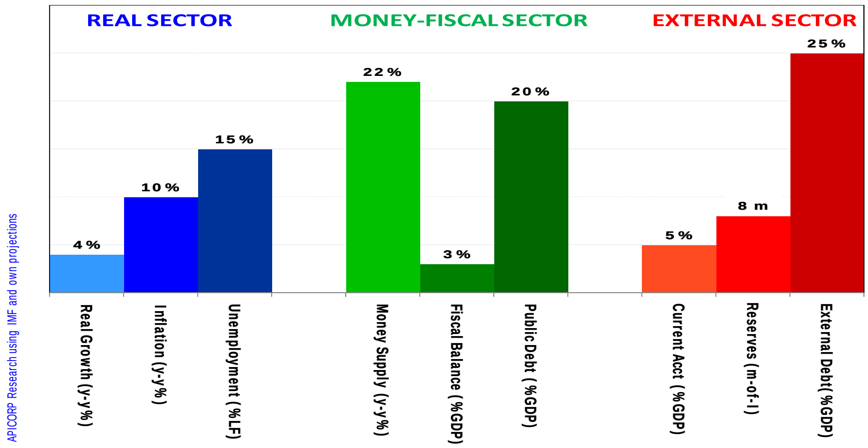


2. Impact on the Arab / MENA macroeconomic outlook

It took some time to the IMF to recognize the spill over of the credit crisis to the real economy. It has corrected its Oct 2008 global growth down sharply, but left MENA's growth prospects largely unchanged



Against scarce / high-cost credits and falling oil prices our 2009-2013 Arab / MENA forecast points to a below-trend economic growth but a still positive outlook for the non-real sector



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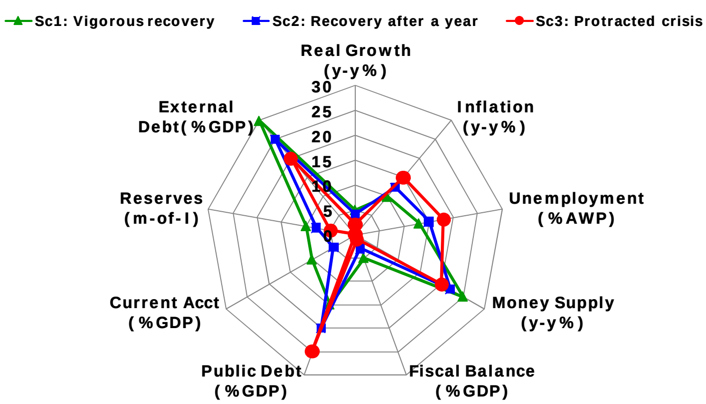
Whatever the scenarios, however, inflation and unemployment will remain major concerns of policy-makers in the region



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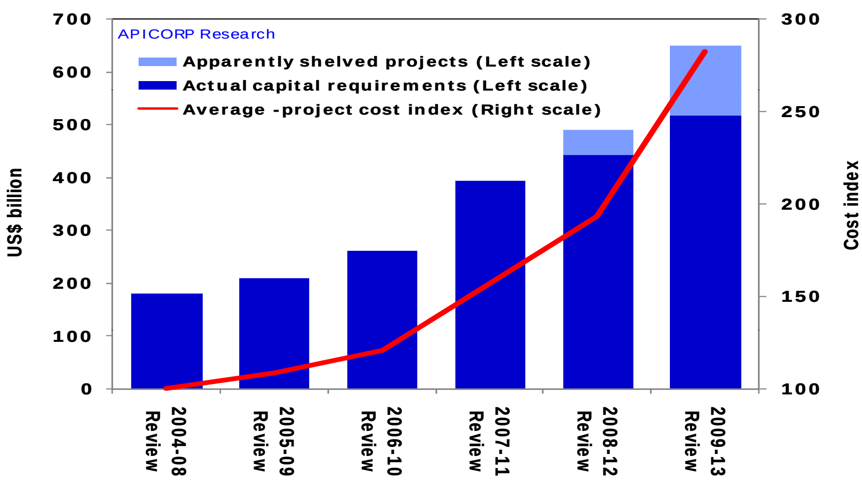
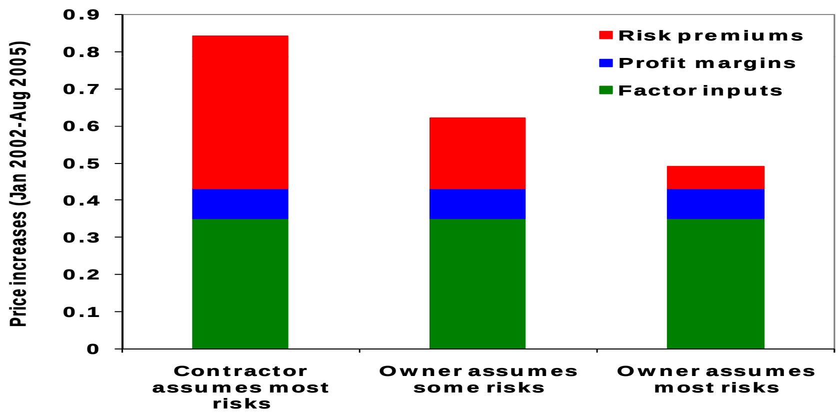
3. Impact on Arab/MENA energy investment outlook

Our 2009-2013 review points to potentially higher capital requirements with the upside likely to be capped by the shelving of a substantial number of projects



In addition to changes in scope/scale, higher capital requirements have so far resulted mainly from higher EPC costs



Source: Merrow (2006), IPA, Inc. [transposed]

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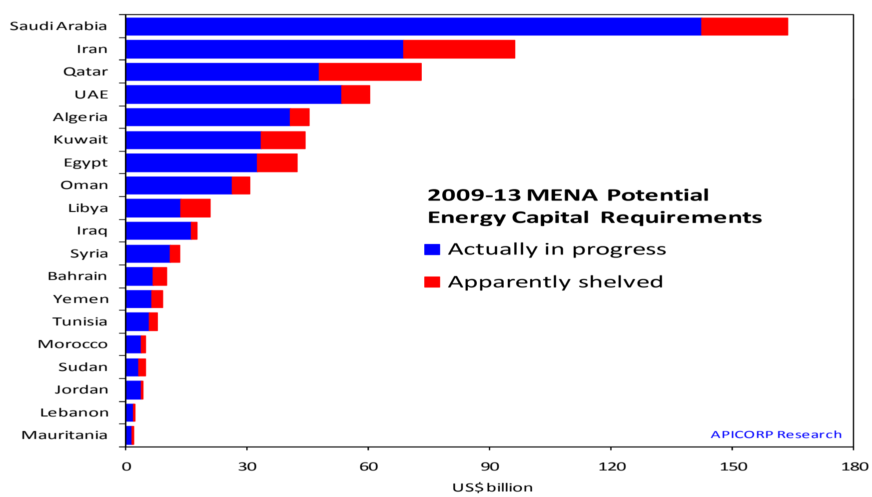
The geographical pattern reflects both the distribution of hydrocarbon resources and each country's circumstances



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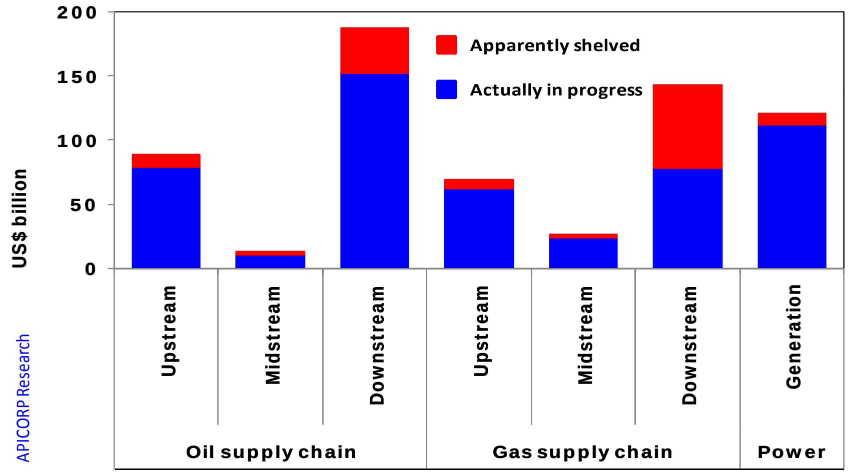
The sectoral pattern, which is dominated by the refinery link of the oil supply chain, highlights a maximum shelving in the gas-based industry



More significantly, the overall capital structure has shifted much more to equity

MENA Region	Actual US$ billion	Capital Structure	Equity	Debt
Oil supply chain				
. Upstream	79	15%	100%	0%
. Midstream	11	2%	100%	0%
. Downstream	153	29%	35%	65%
Gas supply chain				
. Upstream	62	12%	90%	10%
. Midstream	24	5%	100%	0%
. Downstream	79	15%	40%	60%
Power link				
. Generation	112	22%	25%	75%
Total Investments	520	100%	54%	46%

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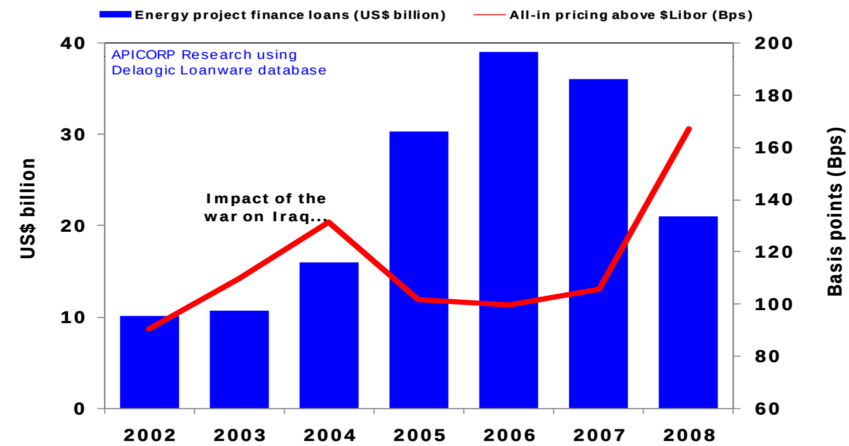
With wider risk spreads, shorter maturities and constrained availability, securing the appropriate amount and mix of debt will be considerably more challenging and costly



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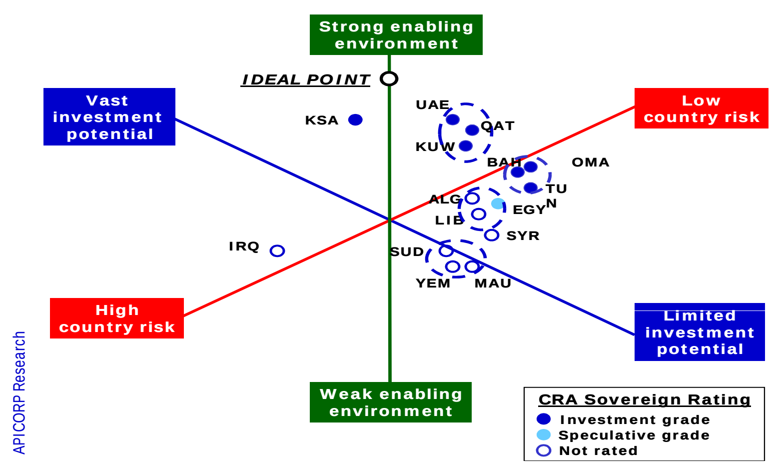
The best policy response to higher risk aversion, and the resulting higher capital cost, is to reduce perceived risks. Our *Perceptual Mapping*, shows that the task will be considerably more challenging outside the GCC area



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4. Conclusions and policy recommendations

Conclusions

- The financial crisis has broadened and spread to gradually engulf the Arab / MENA world
- Current trends in the credit and oil markets have combined to augment downside risks for
  - The Arab / MENA macroeconomic outlook, which may deteriorate substantially
  - The energy investment outlook whose potential is likely to be capped further

Policy recommendations

- **Make up for shrinking foreign capital inflow by:**
  - Reallocating internally the capital invested offshore by State Funds (Stabilization Funds & Sovereign Wealth Funds)
  - Supporting mainstay Pan-Arab Financing Institutions with short term liquidity and standing ready to recapitalize them
  - Reinforcing existing Development Funds (or creating new ones)
- **Minimize the cost of funding economic stimulus spending** by tapping domestic capital markets
- **Review investment strategies** to exclude from any "option to wait" infrastructure energy projects
- **Improve the investment climate,** promote investor confidence and reduce perceived country risks