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ANALYSIS OF THE ADVANTAGES OF DEVELOPING A LOCAL CURRENCY BOND MARKET IN UNITED ARAB EMIRATES

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ABSTRACT

United Arab Emirates (UAE) has emerged as a major economy to be reckoned among the emerging economies. UAE in general and Dubai in particular is transforming itself as a major financial hub of the world and the cornerstone of the Islamic finance market. Fund raising through Bond markets in UAE are in the initial stages of development. However, most of the bonds issued by the different Emirates, Government related entities and Private companies are in US Dollar. This is mainly because UAE has a system of currency peg against the USD, which keeps the currency rate largely constant. This therefore removes the currency fluctuation risks and gives enough liquidity for the USD based bonds.

However, there exist a lot of opportunities and advantages if the Government and other UAE entities start issuing the bonds in the local currency (UAE Dirhams), which is the case with most of the other economies of the world. This paper aims to highlight the rationale of developing a local currency bond market (LCBM) in UAE.

Keywords: Local Currency Bond Market (LCBM), Monetary Policy, UAE Dirham (AED), USD peg

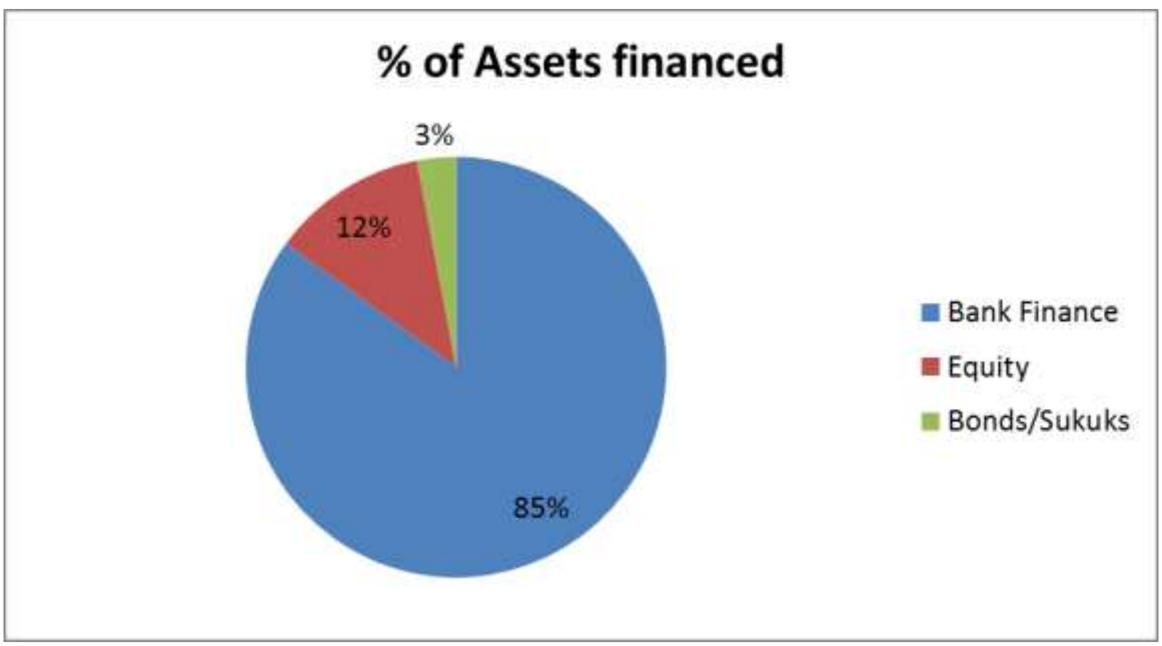
Introduction

United Arab Emirates is the second largest economy in the Middle East region and one of the fastest growing emerging economies of the world. The country is globally re known for its significant growth and transformation in the past few decades.

Over the last decade, UAE has invested significantly in infrastructure development like constructing world class airports, ports, roads, metro, and tourist attractions. The iconic world class projects like Palm Islands, Burj Khalifa are real testimonies to the success of the economy. The growth especially in Dubai was driven by the investment growth which in turn helped the trade and tourism sector to flourish. The investments were mainly by Government related entities (GRE), which developed some world class infrastructure and real estate projects.

How the Projects were funded?

In this backdrop let's analyze how the major projects were funded. The projects were mainly financed by the UAE Banks and the contribution of equity and bond funding was relatively minimal. Nearly 85% of the total projects are financed by Banks, while the contribution of Equity and conventional Bond funding or Islamic sukuks is at 12% and 3% respectively. UAE has more than 50 commercial and Islamic Banks serving the credit needs of the economy.



SCOPE FOR FURTHER DEVELOPMENT OF BOND MARKETS

Excessive reliance on the Bank finance to fund long term projects can create issues for the Banks and to the economy. Infrastructure projects are often long term in nature and have longer breakeven and payback periods. This in turn can lead to Asset Liability mismatches among the Banks, creating liquidity issues and more vulnerability to the external environment. It is in this context, that the scope for further deepening of the bond markets becomes paramount. Currently UAE has an evolving bond market which mostly comprises of the bond issuances by some of the Emirates, Public sector companies; Govt related entities, Banks and Private sector. However bulk of these borrowings is denominated in USD.

WHY BOND ISSUANCES ARE DENOMINATED IN US DOLLARS

The advantages of issuing USD denominated bonds for UAE entities are mainly the following

* No currency risk as the UAE Dirham (AED) is pegged against the US Dollar
* Issuances in USD also create the much needed liquidity in the bond markets. As large segment of investors are foreign entities, they prefer issuances which are in USD.

WHY UAE SHOULD DEVELOP LOCAL CURRENCY (AED) BASED BOND MARKETS?

Despite the advantages of borrowing in a foreign currency as discussed above, there exist many compelling reasons for the country to develop local currency bond markets (LCBM). These are the following

1. Strengthening Monetary Policy

This is among the most important reasons why UAE should develop a Local Currency Bond Market. As the country has pegged its currency against the USD, it is directly affected by the monetary policy in USA. UAE Central Bank’s ability to control the monetary policy of UAE is constrained by the peg.

Interest rates in US and in UAE cannot be very different due to this system. If the rates vary much, the investors will get arbitrage opportunities of borrowing in one country and investing in the other. This therefore raises significant challenges before the UAE Central Bank in conducting its monetary policy independently of the US. An active Local currency bond market will be a tool which will help the Central Bank to conduct monetary policy functions and liquidity management.

2. Avoiding Dollarization of the liabilities

If the borrowings are made in the foreign currency it leads to a dollarization of the liabilities. This implies that the issuing country has no control over the currency in which the liabilities are raised. On the event of any external macro-economic shocks, the volatile capital flows can dry up and the USD reserves can fall drastically. This thus exposes the country to potential instability in case of an unfavourable economic or geo political situation. Though Japan and US are amongst the top highly indebted countries of the world, their borrowings are entirely in their own currency which protects them from external shocks

3. Reduce the Excess dependency on the International Investors and encourage local investors

The bond issuances happening in UAE in US Dollar, is highly influenced by the global investor sentiment. The foreign investor appetite for UAE Bonds can dry up if there is a challenging macro-economic condition in their countries or if there are other better investment opportunities. This can become a major challenge for the companies based in UAE in difficult times.

If AED based bond market was active, it could have attracted investment from investors within UAE. The residents in UAE would have been subscribers to the bond issuances by Government or top rated corporates. This would thus protect the economy from external macro-economic shocks and would help the economy to be more resilient to global economic events. This is also another reason why the Government should develop Local currency bond market even though it may not need to borrow itself.

4. Reduce the Excessive dependency of the Companies on Banks for sources of Finance

As discussed earlier, the most major source of Finance for the companies in UAE are from the 50 plus Banks operating in the country. This also results in the concentration of Bank assets in certain sectors like Real estate due to its importance in the economy. In most of the advanced economies, the Bank finance is not the most important source of Finance for companies. Companies approach the debt markets, equity markets etc for long term fund raising.

If an active Local Currency Bond market was existent, it could have significantly helped the borrowers to diversify their sources of Funding apart from the Banks. This also would have helped the Banks to limit the excessive reliance of the companies on its finance. Thus it would contribute to the macroeconomic stability in UAE.

5. Development of Insurance, Pension Fund Industry in UAE

Presence of a Local currency bond market can offer a significant boost to the Insurance and pension fund industry in UAE. These industries, which are a key component of any developed economy, desperately need long term investment options due to the nature of their business. Currently, the Life insurance market is underdeveloped in UAE because of the absence of long term investment options for the Insurance companies. The only active component of the insurance industry in UAE is the motor insurance which often doesn't have long term investable surplus. The investable surplus of the Insurance companies can be invested in the AED based bond markets if it was present.

6. Absence of Government Issuances forces Banks to invest in Private bonds, thus increasing the Credit Risk before Banks

Currently, the Federal Government of UAE doesn't issue any bonds which can be treated as the benchmark sovereign paper. This is because the Federal Government is resource rich and doesn't need to resort to the borrowings. This is one of the reasons why the Debt to GDP ratio of UAE still remains very low at 17%.

But the absence of Government bond issuance poses an additional challenge before the Banks. The Banks are forced to make their investments in bonds issued by Private or semi government entities. This often adds to the exposure to the same entity as same company could have taken finance from the Banks. So this often leads to additional credit risk for the Banks.

7. Local Currency Bond market would help in effective implementation of Basel III norms.

UAE Banks are moving closer to implementation of Basel III norms on Capital Adequacy by 2015. With this UAE will become one of the few nations in the world to have moved to Basel III norms by 2015. But the effective implementation of Basel III norms hinges also on the presence of an LCBM.

Basel III norms specify high levels of liquid assets to help the Banks withstand risks as arising out of sudden shortages in liquidity. Among the list of the most liquid assets, the most prominent is the Government issuances. Currently as the Government issuances are insignificant in UAE, the Banks are forced to do the investment in the bonds of Corporates and other institutions. The liquidity and quality of these investments can undergo major challenges during major economic challenges like the recession witnessed in 2009.

8. Yield curve development which will facilitate better pricing of loans by the Banks

The absence of an active AED based bond market results in the absence of a yield curve for the different maturities. This thus poses a major challenge before the Banks as how to price the long term loan offerings. It has to be noted that the USD yield curve cannot be considered as a proxy for the AED yield curve due to the major differences in the economic factors of US and UAE.

Conclusion

The analysis indicates the significant advantages that would accrue to the UAE economy, Banks and Companies in case of an active Local Currency Bond market. This would help to deepen the debt market, help Banks in effectively doing their Asset Liability Management, reduce the excessive dependency on Banks and more importantly empower the Central Bank to effectively undertake the monetary policy despite of the USD peg.

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