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Dubai's Debt Troubles: Beginning of the Next Leg Down?

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Most of us have heard that Dubai World is asking for a six month delay in paying back its debt. The debt was supposedly backed by the Dubai government, so Standard & Poor's considers this a default of the Dubai government.

Dubai World Island, formed of manmade islands. Planned to be a residence for 12,000 people. (Dubai Travel Guide)

It is a little early to see how the Dubai situation will play out, but it seems to me that there is a significant chance that the Dubai situation will mark the beginning of the next leg down in the downward recessionary spiral and world debt unwind. Oil prices are likely to drop, so few are likely to notice that oil ultimately plays a major role in the continuing debacle.

Dubai by Itself

The Dubai situation is complicated, which is part of the reason why the restructuring of Dubai World's debt took the world by surprise. Dubai World, the conglomerate behind a huge number of commercial and residential buildings, is the one whose debt is being restructured. The amount of the restructured debt for Dubai World is only about $60 billion, so by itself, is insignificant compared to the size of the world economy. The government of Dubai backs the Dubai World debt. If one includes the government of Dubai, total debts are about $80 billion, which is still not a huge amount compared to world assets.

Dubai doesn't have much oil. It also doesn't have much water, or much arable land either. It is a major financial center, and would like to expand in that role. But without a growing world oil supply (or at least growing Middle-East oil supply), it is difficult to see how continuing growth might happen. Dubai's property values have dropped in the past year and vacancies are a significant issue.

If one knows about peak oil, it is pretty easy to see where Dubai World is headed, over not too long a timeframe. The energy intense plan it has put together is not sustainable for very long. Except for financial services, Dubai does not have much to sell. Financial services generally depend on growth, and in particular growth in debt, but this does not seem really sustainable either, unless extracted resources can provide the needed growth--something that seems increasingly less likely.

Bailout for Dubai?

Based on the above description, a bailout for Dubai is at best a temporary band-aid. Dubai is part of the United Arab Emirates (UAE), and Abu Dhabi is the senior partner in the UAE. Unlike Dubai, Abu Dhabi has significant oil reserves and has a huge sovereign wealth fund. According to the Independent:

> As with Iceland, the Ukraine, Hungary and many other states, Dubai can and should be saved. The damage is containable. Aid must come from Dubai's partners in the United Arab Emirates, especially oil-rich Abu Dhabi; from the Gulf Cooperation Council, dominated by Saudi Arabia; and from the IMF. Abu Dhabi's sovereign wealth fund alone is worth about $700bn, the biggest in the world. So the funds are there to organise some sort of rescue; the political will must be found.

So there seem to be funds available. But the question is: will others really want to put more money into what is fairly clearly a sinking ship, especially if one understands the world oil situation?

In the absence of a bail out, the interest rates of the whole region are likely to go up, and this may put more pressure on Abu Dhabi or the Gulf Cooperation Council. But if there is a bankruptcy, the assets may become available very cheaply. This countervailing incentive may ultimately win--we don't know yet.

Also, the amount of bailout that is needed may be less than $60 billion. If the bailout applies only to the bonds whose date is currently being extended, the funding requirement could be as little as $22 billion.

Parallels to Dubai

One can think of quite a few parallels to Dubai. The fact that there are so many parallels is what makes it easy for the fallout from Dubai to spread widely.

Subprime

In some ways, Dubai World is equivalent to the sub-prime housing market for the US--one of the most vulnerable spots in a downturn. There is a huge amount of debt involved. The real estate owned by Dubai World uses a huge amount of energy to make an inhospitable location desirable. It is in a vulnerable location, not unlike the distant suburbs, favored by those buying homes with sub-prime mortgages in the US. In some ways, Dubai World is a "canary in a coal mine." One wonders how far Las Vegas is behind Dubai.

Commercial Credit

To some extent, what we see in Dubai World is part of the commercial credit crisis that is occurring in many parts of the world. Too many commercial buildings have been built in areas where they are not needed. Prices have dropped, and vacancy rates have risen. The buildings were built with debt, and now there is serious question now whether this debt can be repaid.

Multi-Layered Debt

Before the crisis hit, everyone seemed to believe that someone was responsible was guaranteeing Dubai World's debt. Dubai was guaranteeing Dubai World's debt, but who is guaranteeing Dubai's? If another organization (such as Abu Dubai) is guaranteeing Dubai's debt, are they also guaranteeing Dubai World's debt?

Around the world, we have all kinds of governmental entities responsible for huge amounts of sovereign and sub-sovereign debt. Much of the sub-sovereign debt is not doing well. We have this in the US, with the government guaranteeing the debt of all kinds of organizations, from nuclear electric power generation to housing lenders to the FDIC to the pension guarantee fund.

There are also states and cities with huge amounts of debt, supposedly guaranteed by insurance companies--but certainly those insurance companies don't have enough assets to handle more than a tiny percentage of defaults. Many states and cities are having serious problems with tax collections. Federal bailout funds have been helping for a time, but they won't help indefinitely. How does all this work out?

Islamic Debt

Dubai World is not the only Middle Eastern organization with debt restructuring. Earlier this year we read:

> A sukuk default by Kuwait's Investment Dar and debt restructuring at Saudi conglomerates have shaken confidence in the $1 trillion Islamic finance industry, fanning debate about investors' protection and investors' rights.
>
> Billed as safer than traditional banking due to requirements for assets to underpin deals, Islamic bond holders worry they may not have any more legal safeguards than conventional counterparts in case of default, or perhaps even less, partly due to the untested nature of the process.

So if this default isn't the first--it is really the third in a row of what was supposed to be a safer way of lending--the default raises questions about lending in general in the Middle-East. If countries in the Middle-East are using this type of financing for some of their new oil investment, this default is likely to mean that interest rates will be higher, and funds less available, if they want financing in the future.

Debt of Emerging Economies

Dubai is an emerging economy. Recently, investors have been less worried about defaults of these economies, based on costs for insuring against debt defaults. But now, the default of Dubai raises the issue of how secure the debts of these emerging market economies really are.

Some of these emerging economies are oil producing nations, so might be thought to be safer, but the Dubai situation begins to raise questions. Some oil producing countries that come to mind with potential debt problems include Mexico, Angola, Brazil, Kazakhstan, and Russia. If there is increased concern about the debt of these countries, loans are likely to be less available, and interest rates higher. This is also true for loans related to oil investment, even if the loan is to a company within the country, rather than the country itself.

Debt of Countries (or smaller organizations) that Have Excessive Debt

The Dubai situation brings to mind the fact that there are quite a number of countries--not necessarily emerging markets--with high levels of debt, that may not be able to pay back the debt either. Examples include Japan, Italy, Greece, Hungary, and the Ukraine. States like California come to mind as well.

If Dubai defaults (or even if it doesn't), what is the fallout potential?

Direct Fallout

The direct fallout potential of a debt default by Dubai seems to be relatively small. There are a number of European banks that may have to recognize losses on these bonds, but the amount of exposure is likely to be manageable at least according to BBC. Some banks have already had their equity shored up, in recognition that problems such as this are still "hiding" somewhere. For example, the Royal Bank of Scotland has had its equity shored up by the Treasury's Asset Protection Plan. But if the equity of some banks is reduced once they are forced to recognize losses on the bonds, these banks may cut back on future loans, to keep their ratios of loans to equity within acceptable bounds.

There are also some investments of Dubai World outside of Dubai. For example, Rembrandt tells me that Dubai World is one of the largest investors in the industrial region "tweede maasvlakte" in the Netherlands, and that Dubai World has a 30% share in the consortium for a new container terminal which should start operations in 2013 in Netherlands. A default by Dubai World could have an impact on investments such as these.

There might also be some derivatives relating to the default of Dubai (or Dubai World) that would need to be paid.

Indirect Fallout

The indirect impacts are the big concern. Some of these indirect impacts are likely to happen, *even if* Dubai is bailed out, because the Dubai incident points out that the world is still vulnerable to credit issues--contrary to the assuring statements that governments and major newspapers recently have made.

Higher Interest Rates and/or Stricter Underwriting Standards

Which borrowers might be subject to higher interest rates (or stricter underwriting standards)? Looking at the "Parallels to Dubai" list above, the Dubai problems suggest that debt problems may be much more widespread than is currently contemplated in the pricing of loans.

Sovereign (governmental) debt default has receded from concern recently, especially for emerging nations. If Dubai can have debt problems, when it is in the oil-rich part of the world, and a major financial hub, this raises questions on many types of sovereign debt, for countries not as well situated. And if sovereign debt can have problems, this raises also questions on sub-sovereign debt--all of the debt of organizations whose debt is guaranteed by governments, but is not governmental debt itself.

The problems with commercial real estate are also highlighted. In some places, it may be a very long time until occupancy rates get to acceptable levels, and values of buildings get back to historical levels.

Interest rates everywhere are likely to rise, according to the Vancouver based Citizen's Bank:

> "Perhaps the financial effect of this specific problem will be contained locally and will not infect the greater global economy," it [Citizen's Bank] said.
>
> "However, one effect of this event will be that the cost of money just got a lot more expensive for everyone. Credit guidelines will be tightened again by all banks, not just those who are affected by Dubai; this will make it more difficult for consumers and businesses to borrow at all, never mind the interest rate. It would not be an understatement to say that Dubai is driving everything in the market at the moment."

And of course, the cost for insuring against debt default is likely to rise, also, since there is greater perceived risk of default.

Pressure on Governments to Rein in their Debt

With interest rates rising, and with an example that sovereign debt default can occur, there is likely to be greater pressure on governments to stop the rapid rise in borrowing seen in the past year. Of course, if there are limitations on the additional debt by governments, it will also becomes more difficult for governments to bail out banks and other organizations that need assistance. This will increase the likelihood that major banks will fail and cannot be bailed out, as happened in Iceland.

Pressure on federal governments may also lead to pressure on more local governments. If federal governments cannot continue to borrow as much, it will be hard for them to bail out local governments.

Rising Gold

If debt looks risky, investors will look elsewhere. Gold especially is likely to be bid up. There isn't a lot of it, but many governments and investors will want to buy gold, to avoid what appear to be unsafe currencies.

Increased Volatility in Currency Exchange Rates

My guess is that initially, investors will flock to US Treasuries, and the dollar will be bid up in value. Then US Treasuries will not be perceived as safe, and investors will shift to other currencies, perhaps the Canadian dollar or the Euro. Eventually, I wonder whether there will need to be a change to the international currency system to reduce the volatility. This might involve less free exchange among currencies.

Unwind of the "Carry Trade"

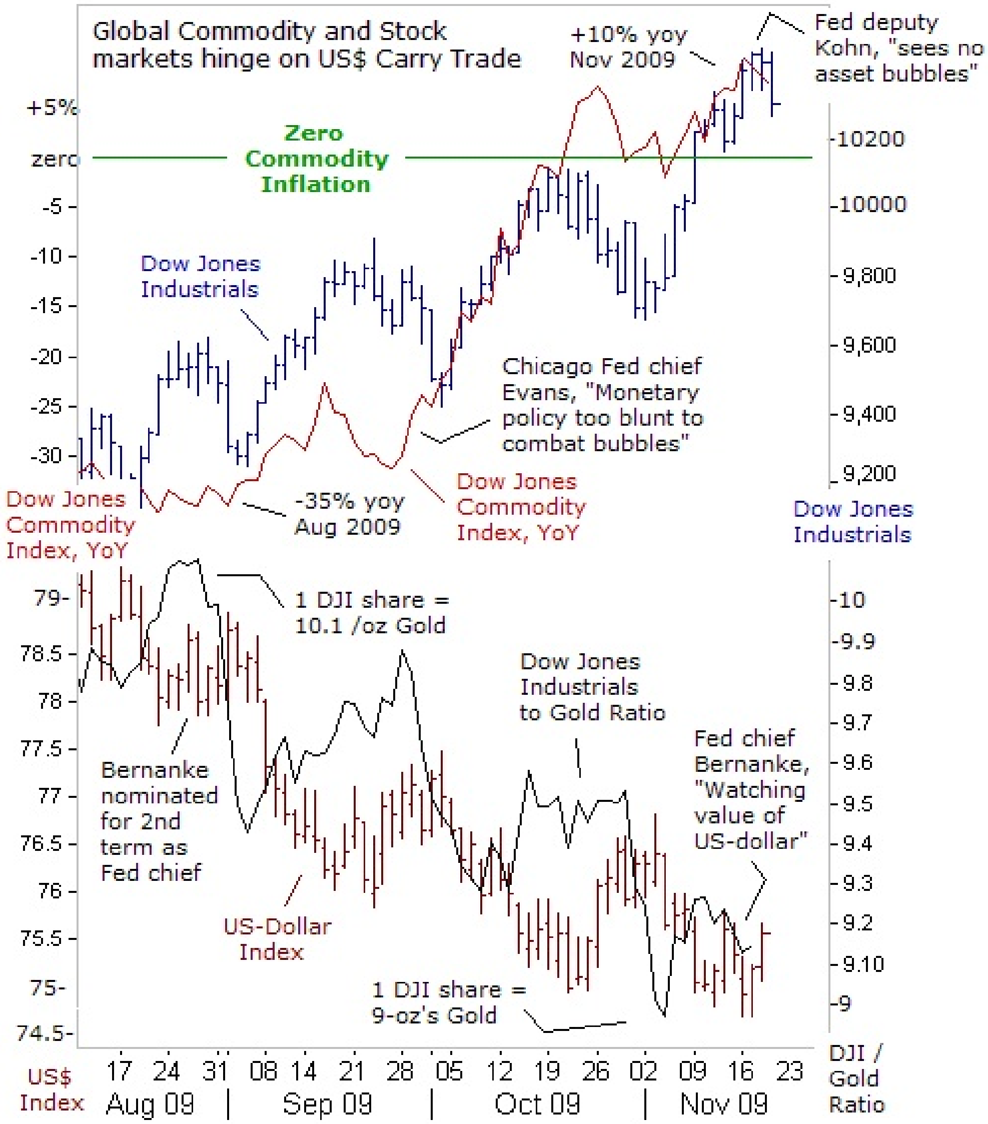
A number of individuals have been writing about what appears to be an increasing "carry trade," with interest rates near zero in many countries. What happens with "carry trade" is investors borrow money in one currency, and invest it in bonds or stocks using another currency. There are many currencies which can be borrowed at low interest rates now, which might be suitable. The dollar, when it was falling, would be especially desirable, because the continuing decline relative to other currencies would give investors a second opportunity for gain.

If there are sudden changes in the relativities of the various currencies, it doing "carry trades" will suddenly become much more risky, and hence less desirable. This is especially the case the currency which has been borrowed begins to rise in value relative to other currencies, because then the cost to pay back the loan suddenly rises. For example, if the US dollar is being used for carry trade, and it starts rising instead of falling, this could lead to an unwind of these exposures.

Another push toward unwind of the carry trade may come from the perception that the investments being purchased with the borrowed funds, especially if they are in emerging markets, are more risky than originally assumed.

Lower Stock Market Prices

One can make a case that the rise in stock market prices around the world in the past few months has been financed by loans at close to zero interest rates, including carry trade debt. To the extent that interest rates rise (or debt becomes less available), this will tend to deflate such a bubble. Also, if the carry trade starts to unwind because of currency volatility and other issues, this will mean less money available for investment in stock markets, and will further reduce prices.



Graph by Gary Dorsh from Gold News.

Besides the unwind of the bubble caused by debt at near 0% interest rates, there will also be the issue of lower profits by stock companies, because of lower sales (due to lack of availability of debt for would-be buyers to purchase the products sold by the companies).

Lower Commodity Prices

If debt rates are higher, and credit is less available, demand will drop further for discretionary items, such as new cars, furnishing for homes, and expensive food, including meat. With lower demand, prices will drop for commodities including oil, natural gas, uranium, and some types of food.

Lower Investment in Oil, Natural Gas, Uranium, and Farm Equipment

With (1) lower commodity prices, (2) more volatile prices because of changing exchange rates, and (3) higher interest rates, there is likely to be less investment in a large number of items, including oil, natural gas, uranium, and farm equipment. One reason for the lower investment will be lower profits (because of the lower prices), leaving less funds for reinvestment.

Layoffs, More Recession

With debt less available, individuals, businesses, and governments will be buying fewer goods and services of all types. The people working in sectors that would have been providing these goods and services will find themselves without jobs, or with reduced hours.

Timing

All of this will not necessarily happen at once. Initial analyses are likely to show that even in the case of a Dubai default, losses can easily handled by the system. It will only be as higher interest rates and tighter lending standards start working their way through the system that the impact will really start being felt. Within three months, I would expect impacts to start being felt fairly widely, if my view of the situation is right.