

The intrinsic unimportance of Dubai World and the important wider message it conveys By Willem Buiter November 29, 2009 6:08pm Dubai is not systemically significant. If its troubles open our eyes to the likely imminence of the start of the final leg of the journey from household default through bank default to sovereign default, it may do some systemic good, by alerting fiscal policy makers to the vulnerability of their nations' fiscal-financial positions, and by educating citizens and voters to the urgency of deep fiscal burden sharing.

Dubai again

On Thursday, 26 November 2009, Dubai World, a 100 percent Dubai state-owned holding company asked for a six-month moratorium on debt service on debt guestimated to be somewhere around \$60 billion. One of the companies in Dubai World's portfolio, the property developer Nakheel, also announced a debt service delay on the same day.

According to Wikipedia, the companies managed by Dubai World include: Dubai Ports World, the third largest port operator in the world; Economic Zones World; Nakheel, known for residential estate development projects such as the Palm Islands, the Dubai Waterfront, The World and The Universe Islands; Dubai Drydocks; Dubai Maritime City; Dubai Multi Commodities Centre; Istithmar World; Kerzner; One & Only; Atlantis, The Palm; Island Global Yachting; Limitless; Leisurecorp; Inchcape Shipping Services; Tejari; TechnoPark; P&O Maritime; Discovery Gardens and Tamweel.

Dubai World is therefore a veritable smorgasboard of companies in fields of activity likely to have been especially badly hit by the North-Atlantic financial crisis and the world-wide downturn that followed it. You don't want to touch property, construction, shipping, docks, ritzy tourism and global acrobats with a barge pole during a major cyclical downturn. Nakheel was at the acme of property development pushed to excess, competing with God, nature and the Netherlands by constructing islands, which it hoped to sell to gormless rock stars and European football geniuses. Dubai World and Nakheel have both requested a six month deferral of debt service. Dubai World has also requested a restructuring of its debt.

A sufficient number of creditors of Dubai World is likely to go along with the standstill and restructuring request to avoid a formal default. Nakheel is more complicated. Property values in Dubai have fallen by more than 50

percent from their peak, the company is geared up to the eyeballs and its cash flow position is said to be unspeakable. It would make sense under normal circumstances for the creditors to put Nakheel into default and take control of and liquidate its assets to minimize their losses. However, Nakheel's assets are mostly in Dubai - land and structures, finished and unfinished. We don't know what creditor rights, especially foreign creditor rights are worth in Dubai. Will legal judgements reached in London be enforceable in the courts of Dubai? The jurisprudence of internationally traded sukuk (Islamic bonds), which comprise part of the debt involved, has not been fully tested before.

The value of real estate in Dubai is of course, highly uncertain. If Sheikh Mohammed bin Rashid al-Maktoum's gamble pays off and Dubai becomes the main financial centre of the Middle East, a key entrepot for international trade and travel, and a tourist destination for the world's affluent, property values will recover and ultimately exceed their previous peak values. If it proves impossible to create and maintain on the Arabian Gulf, stuck between Saudi Arabia and Iran, an outpost of global financial capitalism, an enclave of economic and social liberalism, conspicuous consumption and hedonism, underpinned by the rule of law and run by expatriates that make up 80 percent of the population or more, then the sand and ruins of Dubai may soon rival those of Babylon. It's an interesting bet. I would need pretty good odds to take it.

The position of the creditors is stronger vis-a-vis Dubai World, because Dubai World and its subsidiaries other than Nakheel have many assets outside the jurisdiction of Dubai. These can be attached more easily by the creditors should a formal default occur.

The sovereign guarantee delusion

Of the estimated \$80-\$90 bn Dubai owes to the rest of the world, probably between \$50 bn and \$60 bn is owed by private companies like Dubai World and Nakheel. The rest is sovereign debt. To put things in perspective, when Lehman Brothers went into bankruptcy protection, it owed more than \$600 bn. We are talking systemically small beer here.

The fact that these private companies that owe the rest of the world some \$60 bn or so mostly have but one shareholder, the government of Dubai, and that the government of Dubai is merely another manifestation of the

al-Maktoum ruling family, is neither here nor there. The liabilities of Dubai World and of Nakheel are not sovereign liabilities or sovereign-guaranteed liabilities. The shareholder (the al-Maktoum family aka the government of Dubai) will decide on ordinary commercial principles whether to provide additional financial support to these companies.

If the shareholder of Dubai World and of Nakheel believes that a further capital injection makes commercial sense, it will inject additional capital (assuming it can find the financial resources to do so). If, as I suspect is the case with Nakheel, the company is so deep under water that injecting additional shareholder capital would be throwing good money after bad, the company will not be financially supported by the shareholder. That's how financial capitalism works. It's called hard budget constraints.

In making a decision as to whether it makes commercial sense to extend financial support to Dubai World and to Nakheel, two considerations will play a role: (1) the impact of a default by either entity on the future ability to borrow of companies owned by the same shareholder and on the future ability of the shareholder to borrow in his capacity as sovereign, and (2) the impact of a default on the wider economy of Dubai.

As regards access to future borrowing, there is no better credit risk, from an ability to pay perspective, than someone who has just defaulted on all of his obligations. What better borrower than someone without any debt outstanding? A prior default may of course provide information about (a signal of) future willingness to pay.

Given the over-the-top reaction of creditors and the western media (including the Financial Times) to the possibility that the Dubai and Abu Dhabi sovereigns might not stand behind the debt of Dubai state-owned companies, it is clear that a debt deferral or a debt default by Dubai World or by Nakheel would indeed be news for a number of market participants. They will have learnt that only sovereign debt is debt of the sovereign and that only sovereign-guaranteed debt is debt guaranteed by the sovereign. A simple lesson but a useful one.

So in the future they will lend to Dubai World or Nakheel or to other state-owned companies in Dubai on terms that

reflects the likely absence of sovereign support, should these companies get into difficulties. Those terms are likely to be rather less favourable than terms extended earlier on the belief (wishful thinking) held at the time, that debt of state-owned companies is sovereign guaranteed. The notion that companies from Dubai, state-owned or not state-owned would not have access to the international markets for an extended period of time following a debt deferral, debt restructuring or debt default by Dubai World or Nakheel is ludicrous and counterfactual to a vast range of historical experience.

The impact of a debt deferral, debt restructuring or debt default by Dubai World and Nakheel on the wider economy of Dubai would be minor. Most of the damage has already been done. Construction has ceased on many of Nakheel's crazier projects. Property values have collapsed. With a population that is more than 80 percent expatriate, the main effect on employment will be felt by the non-native Dubai population, and by their countries of origin, who will be getting lower remittances and who may have to absorb returning expatriates.

Even if the government of Dubai were to feel morally inclined to make good the losses of its creditors (a strange and unlikely state of mind in any rational economic being, admittedly), it probably does not have the financial means to bail them out. The Dubai sovereign is likely to be in such bad shape that Dubai World is simply too big to save.

Even though the government of Dubai may well turn out to have empty pockets, the ever-optimistic foreign creditors of Dubai World and of Nakheel have not yet come to the end of their list of potential sovereign Santa Clauses. No, Abu Dhabi is either morally bound or will be impelled by inexorable commercial logic to bail out either Dubai World and Nakheel, or the Dubai sovereign, or both. As if, as my daughter (16) would say.

The seven Emirates that make up the UAE don't have joint and several liability for the sovereign public debt issued by each of the seven Emirates. So Abu Dhabi is under no legal or moral obligation to bail out the Dubai sovereign, even assuming the Abu Dhabi sovereign has the means to do so. A fortiori, the Abu Dhabi sovereign is under no legal or moral obligation to bail out private companies in Dubai or anywhere else, including Dubai World and Nakheel.

Abu Dhabi, which sits on most of the oil reserves of the UAE, has the financial means to bail out both the state-owned companies of Dubai and the Dubai sovereign. I don't see any commercial case for the Abu Dhabi sovereign to bail out Dubai World and Nakheel. Indeed, it would be much more attractive for the Abu Dhabi authorities to have Dubai World and Nakheel go into receivership and to cherry pick the good assets at liquidation prices. Abu Dhabi will probably bail out the Dubai sovereign should it come to that - as well it may. They are, after all, family, and it would give Abu Dhabi major leverage over its reckless cousin.

The fact that the central bank of UAE (which covers all seven emirates and does not take any important decision without the consent of the most important of these, Abu Dhabi) bought \$10bn worth of sovereign Dubai debt earlier this year, and the placement of \$5bn worth of sovereign Dubai bonds with two Abu Dhabi banks hours before the announcement of the Dubai World/Nakheel debt standstill, suggest that holders of Dubai sovereign debt are safe as long as Abu Dhabi's pockets remain deep enough. As the Abu Dhabi sovereign wealth fund, the Abu Dhabi Investment Authority, has an estimated \$627 bn in assets, the ability to play rescuer is certainly there. But there is little chance of Abu Dhabi forking out to make whole the creditors of Dubai World and of Nakheel.

So as regards bail-outs that is pretty much the end of the road. Perhaps the unsecured creditors of Dubai World and Nakheel can appeal to the Vatican to mount a bail-out in the name of inter-faith dialogue. After all, the Vatican has some prime property right in the heart of Rome which it could offer as collateral for a bond issue earmarked for supporting those who took a gamble on Dubai. I wonder how much the re-development rights of the Sistine Chapel would be worth?

The issue will come to a head no later than December 14, 2009 when a 14.7 bn UAE dirham (\$3.52 bn Islamic bond or sukuk) matures and comes up for payment. To all intents and purposes this sukuk, although formally asset-backed, is only partially secured debt. Like many Islamic financial products that obey the letter but not the spirit of Islamic finance, it has been engineered to mimic the economic (contingent pay-off) features of a conventional debt instrument while maintaining the formal trappings of

Sharia-compliance (partial ownership in a debt and in an asset). Capital protection is achieved through a legally binding commitment to repurchase the asset by the issuer of the debt. Over the life of the debt, the issuer pays a rent to the holder. This rent can be benchmarked to a market interest rate, like Libor, or be at a fixed interest rate.

The Nakheel sukuk has a fixed interest rate of 6.345 percent per annum.

It is secured against assets constituting two plots of land Nakheel is developing in Dubai. When the sukuk was issued in 2006, that land was valued at \$4.22 bn. With property prices down by 50 percent or more, the value of the assets backing the sukuk could be anything between nothing and \$ 2 bn. I am reminded of a tv ad about property investment that appeared on US television when I last lived in the US in the early 1990s. A couple is driving around in an arid, God-forsaken piece of South-West USA desert, looking for the all-singing, all-dancing lake-front development they had bought into. In the end the exasperated wife turns to the husband and barks: "I wonder what cactus goes for on the open market?"

The wider economic impact of Dubai World's financial distress The first thing to note is that the losses have already been made. In the case of Nakheel, pointless marble has been overlaid on redundant bricks piled on top of unnecessary concrete poured on marginal land that was ludicrously overvalued. In the case of Dubai World and its other subsidiaries, many often intrinsically valuable foreign assets were purchased at the top of the last boom, at prices that had become detached from their fundamental values. Debt issued to extract this imaginary wealth will now have to share in the collapse of the value of the assets, unless someone else is kind enough (stupid enough?) to shoulder these losses. The debt kerfuffle is a debate about who will bear these losses that have already been incurred - the shareholders, the creditors or the sovereign (the ruling family, the tax payers in Dubai and the beneficiaries of Dubai public spending). There is a further debate about the wider systemic consequences of different ways of distributing these losses.

Take the worst-case scenario where the debt, all \$60bn of it, is worthless. The wealth loss would, through the wealth effect on consumption, reduce consumer expenditure by no more than 5 % of \$60 bn per year, or \$3 bn. That's spread

out fifty-fifty between Dubai and the rest of the world. Nasty, but of no systemic significance.

The marginal propensity to consume of the creditors of Dubai World and of Nakheel may well be lower than that of the cash-strapped Dubai sovereign. Bailing out the creditors would then weaken global demand. Are any systemically important banks likely to be materially affected by this? The exposures of major western banks reported in the press are gross exposures only. They don't allow for any measures to hedge their exposure that the banks holding the debt may have taken since they acquired it. I would be surprised if any western bank were to take a solvency-treatening hit because of the Dubai storm-in-a-teacup. If the opposite were to be the case, I believe the regulators/supervisors will, finally, be ready with prompt corrective action and special resolution arrangements to mitigate the impact of these losses on the banks' ability to engage in continued financial intermediation.

Sovereign default: coming to a sovereign near you?

The massive build-up of sovereign debt as a result of the financial crisis and especially as a result of the severe contraction that followed the crisis, makes it all but inevitable that the final chapter of the crisis and its aftermath will involve sovereign default, perhaps dressed up as sovereign debt restructuring or even debt deferral. The Dubai World and Nakheel debt standstill and possible default is of systemic significance only because it may well be a harbinger of future sovereign financial distress, in Dubai and elsewhere.

From Dubai to Iceland, Ireland, Greece, Hungary, Italy, Portugal, Spain, Japan, France, the UK and the USA, the sovereign debt burdens have been at current levels during peacetime only on the way down from even higher public debt burdens incurred during wars. Watching the public debt to GDP ratios rise to levels likely to reach or exceed 100 percent of GDP by 2014 is deeply worrying, especially with structural primary (non-interest) deficits as high as they are. The political economy of fiscal burden sharing, inside nations and between nations, will be a major field of enquiry for economists and political scientists during the years to come. I am pessimistic in that regard about countries characterised by deep polarisation and political gridlock. This includes nations as different as Greece and the USA.

It is clear that nations whose public debt is mainly denominated in domestic currency and whose central bank is either not very independent or can be made dependent by the government of the day are likely to choose inflation and exchange rate depreciation over default as a way out of fiscal-financial unsustainability. That category would include the USA and, to a lesser extent, the UK. Because the ECB faces 16 national governments and national ministries of finance, the power and independence of the ECB are much greater vis-a-vis any Euro Area member state than the power and independence of any central bank facing a single national government and Treasury. That is regardless of the formal independence criteria laid down in laws, treaties or constitutions.

The practical implication of this is that the ECB will not monetise the government debt and deficits of small European Area member states. Only Germany can really push the ECB around, partly for historical reasons, partly because it is the largest and most powerful Euro Area and EU member state and partly because of the geographic reality that the ECB is on its territory - in the final analysis the German government can order a siege of the Eurotower ... For small peripheral European nations, the threat of sovereign insolvency is therefore a real one, unless EU fiscal solidarity can be relied upon to bail them out. When Ireland was about to be swept away by a wave of global financial mistrust triggered by the Irish government's decision to guarantee effectively all liabilities of its banks, the then German Finance Minister Steinbrück made the amazing statement (which he obviously had not checked with his coalition partners, his Chancellor or his voters) that the Eurozone countries would not let one of their own go into default.

The year that has passed since then has made this implicit commitment to a Eurozone, let alone an EU cross-border sovereign bail-out rather less credible. All EU sovereigns are, to varying degrees, in fiscal dire straits. We may well see in the next few years the first sovereign default by an old EU15 country since Germany defaulted on its debt in 1948. If the travails of Dubai wake us up to that possibility, they will have done some good. Sovereign defaults are not acts of God. They are the result of choices. If we continue to play the political game in a business-as-usual mode, there could be quite widespread sovereign debt restructuring throughout the advanced industrial world. If we grow up, we can avoid the worst.