AEGON Asset Management

Monthly outlook – December

Dubai(ous) – all that glitters is not gold

The tables have turned: how to destroy a financial reputation

Last week, the state-owned company Dubai World (which has debts of around USD 59 billion) shocked the international markets by asking for a six-month repayment holiday, when it told its creditors to kindly wait until 30 May 2010 before exercising their claims. As we all know, Dubai World holding is the owner of the Dubai-based Nakheel corporation, the projects of which included the property development of the "Palm Islands". Bonds issued by Nakheel were due to mature on 14 December this year, when domestic and international investors alike had unanimously expected the company to repay the price of the securities in full.

The situation was further exacerbated by the fact that, following the announcement, the US markets closed for Thanksgiving, while in the Muslim state of Dubai the Eid al-Adha (Festival of Sacrifice) is still underway. Together with the Eid Al-Fitr that follows the month of Ramadan, Eid al-Adha is the most important religious festival in the country. This means that on this year's 49th week the equity markets of the United Arab Emirates were only open on the last day of November and the first day of December, and were only set to reopen on 6 December. By dawn on Tuesday the story had taken another turn, as Dubai World Holding announced the rescheduling of around USD 26 billion of its debts. The rescheduling applied exclusively to the holding's companies known as Nakheel World and Limitless World. All of this is partly reassuring, since according to the announcement the financial situation of the remaining subsidiaries, including the world's third largest dock operator, Dubai Ports World, continues to be stable. It was also mentioned that the rescheduling would be carried out in several stages, and that the Islam bonds (or sukuks) issued by Nakheel, accounted for USD 6 billion of the debts affected by the rescheduling. These events raised serious questions with regard to the emirate's ability – and, more importantly, its willingness – to settle in full the debts of state-owned corporations on time in the future.

Dubai's situation is not easy at the moment, as not even the emirate is immune to the global economic crisis. It's a little-known fact that the oil, which was discovered in 1966, will run out within 20 years according to the most likely estimates, and even today the oil business only accounts for 6% of the country's GDP. In a forward-looking move, in the 1980s and the early 1990s Dubai took a strategic decision to become one of the largest world-class tourist destinations on the planet. The tourism-related infrastructure developments, initially financed from oil revenues, bore fruit over the years, and this was accompanied by skyrocketing property prices. At the same time, with the beginning of the 2000s, borrowing by the seven "states" making up the United Arab Emirates, and especially the loans of Dubai (which account for two thirds of the EAE's total debt) began to rise at a dramatic rate. By the second quarter of 2009 the EAE's debts totalled USD 123 billion, which is four times the figure for 2005. The greatest cause for concern is the high loans-to-GDP ratio, which has risen from 23% to 51.3% in the space of four years. What this amounts to is nothing other than a mammoth investment financed by a vast and constantly growing credit bubble. When the crisis hit, however, tourism fell back considerably, and property prices have fallen by 50%

over the past 12 months. After six years of economic growth, the country has been in recession since the second half of 2008.

The debts of the city state, which was regarded by some as the last word in over-the-top extravagance and luxury, total USD 80 billion according to the official figures. However, it is far more likely that Dubai's implicit and explicit liabilities could be as high as USD 200 billion, or 250% of GDP.

Naturally, these highly negative events are also reflected in the CDS (Credit Default Swap) levels, which serve to quantify the level of uncertainty with regard to repayment of the state debt. In Dubai's case the CDS levels literally shot up, which has also substantially pushed up the CDS levels of the other states in the region, as well as other developed and developing countries (including Hungary). It is especially interesting to note that the tables initially turned in Hungary's favour: Dubai's 5-year CDS level stood at 647 points on 27 November, which was 407 points higher than Hungary's 5-year CDS, which at that time was 240 points. However, the chart clearly shows that the October 2008 situation reversed, since Hungary's CDS point value, in the great panic, exceeded Dubai's by 148.5. In other words, investors considered a default by Hungary to be more likely. An additional impact is that Moody's and Standard & Poor's downgraded all of Dubai's state-owned companies, putting several companies in the "junk" category. The world's stock markets, and particularly bank securities (e.g. Barclays, Deutsche Bank, Royal Bank of Scotland, ING, UBS), were hit hard by the announcement. This comes as no surprise, since almost 40% of the United Arab Emirates' overall debt portfolio is associated with the United Kingdom, 9% each with Germany, France and the United States of America, 7% with Japan, 4% each with the Netherlands and Switzerland, 2% with Austria, 1% with Belgium and the remaining 15% with other countries.

What does all this portend for the future? First of all, resolving the situation of Dubai, despite the great initial fright and the relatively quick reassurance that followed, will be a time-consuming process. It is clear from the above that this is less of a local problem, than a new epicentre of global financial disruption. Those countries in the region that already have strong fundamentals (Abu Dhabi, Kuwait, Qatar and Saudi-Arabia) will have less difficulty weathering the current situation. Others – including countries that are outside the region but which have a large deficit and state debt (e.g. Central and Eastern Europe, and certain Balkan nations) – may come under greater pressure in the future.
Finally, two important lessons can be learned from Dubai, both of which should be taken to heart. (1) In the long term, economic growth based on borrowing on such a scale cannot be permitted in any country. (2) Regardless of the unprecedented scale of global economic stimulation, this cannot be used to simply paper over every problem, many of which remain with us to the present day. Conclusively, investors would do well to bear in mind that last Wednesday's announcement from Dubai is not necessarily the last financial impact of the protracted global economic crisis.

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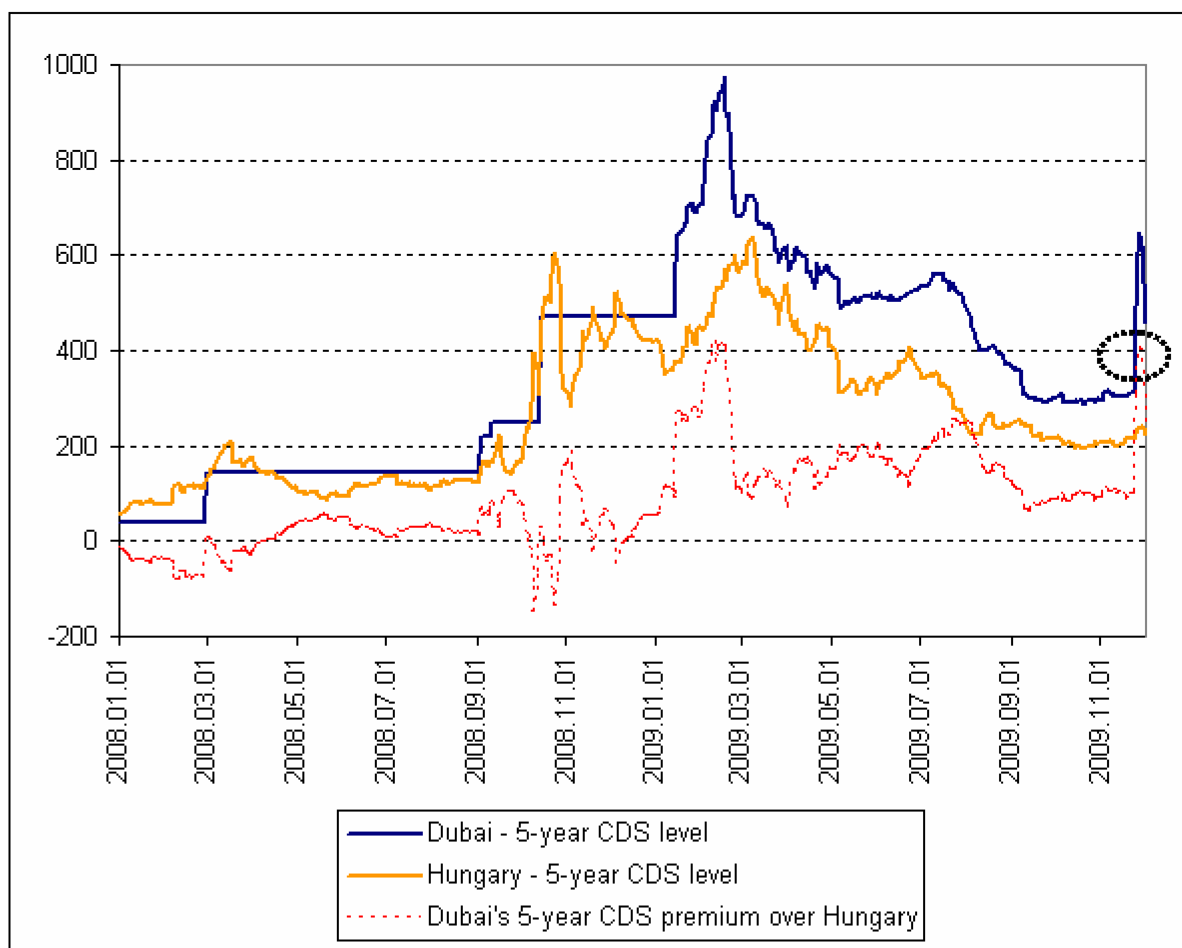
5-year CDS level of Dubai and Hungary from the beginning of 2008 to the present



Source: Bloomberg

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