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The Dubai Debt Debacle: Likely Impact on South Asia

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Abstract

This paper focuses on the ongoing debt crisis in Dubai and other recent economic setbacks in the United Arab Emirates (UAE), and assesses their likely impact on South Asia. Owing to the region's lower exposure to Dubai World's over-leveraged debt, the impact on South Asia's financial markets is likely to be limited. However, South Asia's real economies, particularly those related to remittances, could be adversely affected as Dubai's real estate bubble bursts and the UAE counts the impact of the financial crisis. The real downside risk for the South Asian region, nevertheless, is the sustainability of the dubious 'Dubai model' which has been emulated in the Gulf neighbourhood and one that absorbs a large number of South Asia's surplus manpower.

Background

The equity markets around the world rattled following the recent announcement by Dubai World, a state-owned investment conglomerate of the UAE, of a six-month standstill on its US$59 billion debt. However, investment bank UBS thinks that Dubai, one of the sheikhdoms of the UAE, may owe more than the estimated US$80 billion to US$90 billion in liabilities assumed by investors.[2] Dubai World's investments span a wide range of areas – transport and logistics, dry docks and maritime, urban development, and financial services. Its debt deferment plan has led to a jump in the Gulf region's default swaps.[3] Some analysts even fear that this might escalate into a major sovereign default problem, which would then resonate across global emerging markets in the same way it did in Argentina during the early 2000s or in Russia during the late 1990s.[4]

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2 "Dubai Debt May Be Higher Than $80 Billion", UBS says (http://www.bloomberg.com/apps/news?pid=20601087&sid=aXGrvyOI6IWs&pos=3).

3 The Bonds of Dubai World's property unit, Nakheel, mature on 14 December 2009. Dubai contract climbed 120 basis points to 438 basis points. Credit-default swaps across the region rose sharply, with Saudi Arabia climbing 11.5 basis points to 86.5 and Qatar rising 5.5 basis points to 99. Contracts linked to Abu Dhabi rose 34.5 basis points to 134.5, according to London-based CMA (http://www.independent.ie/business/world/dubai-debt-crisis-rattles-confidence-in-persian-gulf-borrowers-1954263.html).

4 "Dubai Crisis May End in 'Major' Default", BofA says (http://www.bloomberg.com/apps/news?pid=20601087&sid=a8RD8uqjoLCQ).

Like the Lehman Brothers in the United Sates, could Dubai be the canary in the coal mine for heavily indebted countries? It is too early to predict such a gloomy picture considering the fact that the UAE is one of the world's leading hydrocarbon producers, and it has a stock of US$75 billion foreign exchange reserves, and not to mention the fact that the Abu Dhabi Investment Authority (ADIA), UAE's sovereign wealth fund, has estimated assets of approximately US$800 billion. However, investors are alarmed by the problems in some Eastern European economies, and even in more developed economies, particularly countries that have higher debt-gross domestic product (GDP) ratio, following Dubai's debt crisis. Moreover, the crisis in sovereign debt gives an indication that the current financial crisis is far from over.

Abu Dhabi, the capital and the largest of seven sheikhdoms that make up the UAE, has been reluctant to bail out the Dubai World, the corporate face of the Emirates, frustrating investors who had assumed the sheikhdom's debt was quasi-sovereign. Nevertheless, Dubai World announced last week that it was in talks to restructure its debt. With the current debt crisis, the Emirates' financial strength faces a huge setback following a series of losses owing to the global financial turmoil. In February 2008, the Abu Dhabi government injected US$20 billion in Dubai to ease its liquidity problem. The real estate market in Dubai has seen a 20 to 50 percent drop in its property prices. In addition, the ADIA may have lost over US$125 billion since the financial turmoil hit the United States in fall 2007.[5]

Likely Impact on South Asia

The fallout of Dubai World's default risk and other recent setbacks in the UAE could affect South Asia through two channels. The first is through the direct financial linkages between Dubai World and South Asian (mostly Indian) banks and other institutional investors. There could be some spillover effects to the regional equity markets, notably Indian and Pakistani bourses, largely owing to the global investor's sentiment following Dubai's debt woe. Secondly, the region's real economies could be affected adversely due to significant economic relations between the UAE and South Asia. India-UAE non-oil bilateral trade stood at US$29 billion in 2007-08. Dubai Ports World, a part of Dubai World, runs five container terminals in India that accounts for 40 percent of India's container traffic. It has operations in Pakistan too. More importantly, the UAE is one of the leading destinations for South Asian low and semi-skilled manpower.

It appears that South Asian, notably, Indian financial institutions' exposure to the Dubai World is not large. Available report indicates that Bank of Baroda and the State Bank of India have US$200 million and US$50 million exposures respectively to the troubled Dubai World. Some Indian real estate companies may also have some business links with Dubai. *Reuters* reports that at least one Indian real estate company has an exposure of US$9.6 million through a joint venture with Dubai World's property developer unit, Nakheel. The country's total exposure will be available to the public once the Reserve Bank of India's (RBI) enquiry on it is conducted. The Sensex, India's flagship equity index, joined the tumble in bourses around the world but recovered following the RBI and the Finance Ministry's intervention in the market that played down the issue viewing that the fallout from the Dubai debacle on India would be limited.

[5] The Straits Times, 13 February 2009.

There could be some adverse affects in terms of remittance flows in the South Asian region as the UAE counts the total cost of the ongoing financial meltdown. In recent years, oil price hikes had fuelled Emirates' growth that made it one of South Asia's leading labour destinations. An estimated 5.3 million Indians live in the Gulf and, of them, 31 percent are in the UAE. Indians alone constitute 40 percent of Dubai's population and account for 10-12 percent of India's inward remittances. Remittances have emerged as a key driver of economic growth in South Asia, particularly in Bangladesh, Nepal, Sri Lanka and Pakistan. The UAE constitutes the third largest source of remittances for Bangladesh and Sri Lanka. For Pakistan, it is fourth largest source of inward remittances. The major setback for South Asia's manpower export is Dubai's plunging property market that absorbs most of the foreign labour. Construction and real estate account for almost 50 percent of Dubai's GDP. Major property developers are abandoning their expansion plans in the city. For instance, Emaar Properties, the biggest developer in the UAE, abandoned a merger with three real estate units of Dubai Holding, halting the expansion into the world's worst-performing property market, viewing that the transaction was no longer economically viable.

As the UAE pays the huge toll of the ongoing financial turned wholesale economic crisis, it is likely that the growth in this sector will slow down and this could, in turn, markedly decelerate the manpower export in this country from South Asia.

All that Glitters is not Gold

Despite the recent setbacks, the UAE and the Gulf region would continue to cash in on the benefits of windfall gains from its hydrocarbon resources. A McKinsey Global Institute study conducted in 2008 revealed that, at an oil price of US$70 per barrel, the Gulf's oil export earnings will add up to over US$6 trillion over the next 14 years and at US$100 a barrel will mount to almost US$9 trillion. However, for the region, the issue is not so much the accumulation of petro-dollars as much as the productive utilisation of those dollars. Nevertheless, despite the Gulf's recent boom, it could not hide its pitfalls. For instance, apart from Dubai's heavily reliance on debt, productivity is another issue that should worry the UAE's long-term growth. Productivity growth in the Middle East, except in Qatar and Bahrain, remains very low, if not negative. Labour productivity in the UAE grew -0.9 percent in the period of 2000-2008.

Moreover, the problem in Dubai will have some ripple effects in the Gulf. For the rest of the Gulf, Dubai has been an economic model that developed an open economy and showed an entrepreneurial spirit well beyond oil. However, like the United States, Dubai too proved that there is a limit to growth with an over-leveraged finance. Taking the lessons from Dubai, the other Gulf countries could be more cautious in developing luxurious real estate projects or putting their petro-dollars in speculative investments. For them, another worry is the current economic conditions of the United States. As the UAE and most Gulf economies' large chunk of foreign exchange reserves are invested in the United States treasury and their currencies are pegged with the United States dollar, they may not find the world's largest economy a safe haven anymore. All these factors may adversely affect the economic outlook and the economic expansion of the UAE and the other Gulf states.

The debt and other economic crises in Dubai may have limited impact on India considering the latter's giant economy and growing economic opportunities in the country. However, other South Asian countries such as Bangladesh, Pakistan and Nepal that have become remittance economies of late depending on external labour markets heavily, particularly the Middle East, may face difficulties to send their surplus labour to the region.

Dubai may be one of the world's largest gold trading hubs and may soon be home to the world's tallest building. However, with an economy whose boom relies heavily on debt, it has to face the day of reckoning once it is forced to walk towards the darker side of its business cycle. Its oil-rich neighbour, Abu Dhabi, can afford to bail it out more than once thanks to its huge stock of black gold, but for a sustained economic growth, the city-state needs to follow or invent a better model. Apart from over leveraged-finance, South Asia, particularly Pakistan, Bangladesh and Nepal have another lesson to learn from the current global economic crisis and Dubai's debt woes. They should focus more on domestic economic reforms so that their surplus labour need not rely excessively on overseas markets for employment.

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