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Dubai Debt Debacle Rattles Markets, Confidence

In Dubai, massive banners advertising available space adorn the sides of nearly every building. Hundreds of cranes that just last year were working around the clock now stand idle all day. Unfinished sky scrapers seem almost as common as completed ones. And workers who were recently flooding in from around the globe are now beginning to leave.

The Emirate of Dubai, one of seven sheikdoms that form the United Arab Emirates (U.A.E.), has been badly damaged by the economic crisis. Property prices have collapsed, losing half of their value. The low-interest debt-fueled extravaganza in the desert fiefdom is screeching to a halt, at least for now.

Dubai World, a massive state-owned conglomerate responsible for many of the emirate's audacious real estate projects, announced last week that it was seeking a six-month freeze on about $60 billion in debt repayments. The government-run company will be restructuring around half of the debt so far, officials stated Monday. One of the firm's construction arms, Nakheel, asked the Dubai stock market to suspend its $5 billion worth of Islamic bonds until it could "fully inform the market."

Following the announcement of the debacle, commentators and some analysts became worried that the crisis could set off a "tsunami" or even a "domino effect" that would roil world markets again. The announcement was compared to everything from Argentina's default in 2002 to Lehman Brothers' collapse last year. Stock markets around the world dropped sharply as investors tried to figure out what it all meant.

"One cannot rule out — as a tail-risk — a case where this would escalate into a major sovereign default problem, which would then resonate across global emerging markets in the same way that Argentina did in the early 2000s or Russia in the late 1990s," explained analysts for Bank of America after the news broke. Other banks issued similarly dramatic warnings, while even the Obama administration announced that it was "monitoring" the situation.

With the potential for a default on the debt, rating agencies including Moody's and Standard and Poor's immediately stepped in and downgraded several Dubai state entities. The debt restructuring "may be considered a default under our default criteria, and represents the failure of the Dubai government (not rated) to provide timely financial support to a core government-related entity," said S&P. The cost of insuring Dubai debt also soared, as did protection for Abu Dhabi debt.

The U.A.E.'s central bank, meanwhile, pledged to support national financial institutions and local branches of foreign banks with increased "liquidity" (fiat money). But finance officials in Dubai warned Monday that the government was not responsible for the company's debt. "Creditors need to take part of the responsibility for their decision to lend to the companies," declared the director general of

Dubai's Department of Finance. "The company received financing based on its project schedule, not a government guarantee."

It turns out British banks, some owned by taxpayers, were particularly exposed, with some estimates claiming they own as much as $50 billion worth of Dubai debt. American banks were left relatively unscathed, though Citibank does have some investments in the emirate. Speculation abounded about whether the government would end up stepping in to bail out its company, or whether Abu Dhabi, the richest emirate in the U.A.E., would offer some assistance. But so far, Abu Dhabi has only pledged to selectively support some of the debts — not extremely reassuring to the market that had assumed an implicit government guarantee existed because of the nature of the conglomerate.

The reactions to the debt issue have been varied. Economist Max Keiser, who predicted the collapse of Dubai earlier this year, warned that the debt announcements mark the beginning of "phase two" in the global economic crisis. Though the amount of money involved was not excessively large by proportion, Keiser explained that after the massive losses already weathered by European banks, all new write-offs take on added significance, cutting into "the bone of the global financial system."
"These governments are at the end of their tether in their ability to keep shoveling more fiat currency onto the bonfire," he noted during a televised interview with *Russia Today*, calling British Prime Minister Gordon Brown and economic chief Alistair Darling the "Beavis and Butthead of the global finance markets" for organizing the government takeover of Royal Bank of Scotland, which is reported to have significant exposure to the troubled Dubai debts.

Euro-Pacific Capital president and Senate candidate Peter Schiff said the Dubai debt announcement essentially amounted to a default, but that world markets had overreacted because investors were overly fearful about a "contagion." The state firm does have real assets like properties, after all. Schiff also noted that he did not think the situation was going to be a cause for a capital flight from emerging markets.

But even after announcing some of the restructuring details on Tuesday, which many analysts were optimistic about, the long-term consequences of the debacle for Dubai and possibly the region will not be good. "This will destroy confidence in Dubai, the whole process has been so opaque and unfair to investors," proclaimed Eckart Woertz, an economist for the Gulf Research Centre in Dubai who warned that the emirate may lose its status as the regional financial hub. "There is terrible damage to its ambitions in the financial field from how it handled this."

The situation has also negatively affected the U.A.E. and the whole Gulf region, with stock markets across the Arabian peninsula continuing to drop sharply into Tuesday. UBS bank analysts predicted that Middle Eastern projects will have a harder time accessing foreign capital, while other analysts and reports also discussed the possible repercussions for U.A.E. and other regional markets.
"While an efficient market should be able to distinguish between Dubai's creditworthiness and that of the individual Gulf Cooperation Council members — Saudi Arabia, Bahrain, Qatar, Oman, Kuwait and UAE — we believe that the Dubai World announcement is a shock to investors and unhelpful to GCC entities that would attempt to tap the capital markets any time soon for larger issues," said UBS analyst Michael Bollinger in a report released by the Swiss bank.

Some of Dubai World's projects include palm-tree shaped islands and the world's tallest building, among other extravagant developments. Dubai has become world famous for some of its bombastic undertakings, including an indoor ski slope with real snow and a group of man-made islands shaped as an atlas of the world's countries. One of Dubai World's subsidiaries sparked controversy in the United

States when it tried to buy American ports, while other parts of the firm have invested in everything from casinos in Las Vegas to property in Britain.

Dubai is indeed a unique place. With its combination of a relatively free economy (in some ways) and almost nonexistent taxes, investors were bound to pour money in. A strange version of capitalism — complete with debtors prisons and massive state-owned companies — created a surreal city that was awash in wealth, for a time at least. Indeed, it has become one of the most prosperous places in the Middle East. But now, the situation has deteriorated. Officials are actually confiscating foreign news papers that report too harshly on the debt situation.

But no matter what happens when the pieces finish falling, it will likely take time before investors regain trust in Dubai. However, this problem should not be blamed on “super capitalism,” as some disingenuous commentators have attempted to do. First of all, Dubai World is a state-owned entity. In addition, artificially low interest rates by central banks around the world led to huge amounts of malinvestment around the world, much of which resulted in a global property boom that happened to blow up with particular ferocity in this odd desert sheikdom.