



Could Dubai World's Debt Default Spark a Crisis in the Middle East and Beyond?

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When Dubai World announced late in November that it wanted a six-month delay on payments on \$26 billion in debt, the financial markets were thrown for a loop. The Dow Jones Industrial Average quickly fell 155 points, or 1.5%, European stocks dropped and oil prices plunged. The Dubai story is still unfolding -- the emirate's stock exchange fell for the third consecutive day on December 9 after Moody's downgraded the ratings of six government-linked companies -- though some investors believe Dubai does not provoke as much fear as other corporate collapses over the past couple of years. Is this response overly sanguine? Or are Dubai World's problems somehow different or less severe?



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Certainly, the numbers are big enough to put the crisis in the major leagues. Dubai World, the emirate's investment vehicle, has debts totaling about \$59 billion. Were it to default, it would be the largest government default since the approximately \$100 billion Argentine debt crisis of 2001. "Dubai, like Iceland, has become a metaphor for the ... excesses of the past few years," says Wharton management professor [Mauro F. Guillen](#), director of the Lauder Institute.

Whether Dubai's problems are a last gasp of the most recent financial crisis, or a harbinger of new ones to come, is far from clear. Wharton finance professor [Jeremy J. Siegel](#) believes Dubai World will turn out to be "a very minor affair" for the world economy and financial markets. "It doesn't mark any sort of new shoe dropping, or the start of some emerging-market crisis, or the start of some domino situation at all," he says, arguing that the world is emerging from the last crisis fairly well.

Wharton finance professor [Richard J. Herring](#) cautions, however, that Dubai is just one of many countries that have spent heavily because low interest rates made borrowing easy. "So far, the market has tossed it off as a minor restructuring," Herring says. "This may be true, but it may also be the tip of an iceberg that extends to many countries that pegged their currencies to the dollar and kept interest rates too low for local conditions for too long."

Renegotiating Debt

Dubai World has said it is seeking new terms only on the debt of its real estate subsidiary, Nakheel, while its other operations, including the city's port facilities, remain healthy. Many experts say Nakheel's problems evoke a sense of déjà vu. Like the financial crisis that started in the United States, it involves real estate, heavy borrowing and overconfidence -- or carelessness -- arising from an assumption that the government would back the company financially if it got into trouble. Dubai World is negotiating with its creditors, a process expected to take at least until the end of the year, and government officials have insisted the firm will not default.

Unlike Abu Dhabi, capital of the United Arab Emirates, Dubai does not sit on vast oil reserves. As a result, the ruling family has resorted to heavy borrowing since the 1950s. The basic strategy has been to build Dubai into a regional hub for commerce and tourism, and as a magnet for the wealthy. Dubai World is a government-owned holding company formed in 2006, and is said to have 50,000 employees spread among at least 100 cities around the world. Its largest subsidiaries are Nakheel and DP World, one of the world's largest port operators.

Under Dubai's ruler, Sheikh Mohammed bin Rashid al-Maktoum, Dubai World has engaged in extraordinary amounts of real estate development, including symbols such as a man-made island shaped like a palm tree, mostly with borrowed money. But the worldwide economic downturn has reduced revenues. Construction has stopped on many buildings, and many completed ones are largely empty.

"Dubai is a classic bubble," Herring says, arguing that low interest rates caused real estate prices to soar the same way they did in the U.S. "When the price of oil fell from record highs, the revenue estimates from many of these ambitious projects had to be slashed, and so prices had to fall."

As in the U.S., the real estate frenzy was fueled by cheap money and a sense that values could only go up. But there was another factor: Lenders were eager to pour money into Dubai because of what they saw as Dubai World's implicit financial backing by the Dubai and Abu Dhabi governments. While loan documents apparently stated there was no government guarantee, many lenders seemed to think the situation was like that of Fannie Mae and Freddie Mac in the U.S., the two government-authorized mortgage firms. When Fannie and Freddie ran into trouble in 2008, the government did step in to help, protecting the firms' business counterparties. "The interesting thing was the [Dubai World] creditors -- how in the world did they lend to a company without really looking at its cash flow carefully?" asks Wharton finance professor [N. Bulent Gultekin](#).

Reassessing Risk

Despite similarities to the U.S. crisis, the Dubai crisis comes at a time the world is better equipped to withstand a financial shock, according to Wharton finance professor [Richard Marston](#). "This is a very different circumstance," Marston says, adding that "market participants have been through the wringer and have reassessed risk."

As a result, prices of debt securities such as various types of bonds have adjusted in recognition of the potential for defaults, making the financial markets less sensitive, Marston adds. "The market has recently been through hell and it's on the lookout for risk. It's anticipating risk. It is in a much better position to absorb a Dubai default if it does indeed occur."

While the assumed government backing of Dubai World is similar to the Fannie and Freddie cases, the scale is much smaller, he adds. A Dubai World default would not have worldwide consequences. Had Fannie and Freddie gone down, it would have undermined confidence in U.S. Treasury securities, causing a worldwide financial tsunami.

Dubai World is government owned, so the firm's problems raise questions about whether other countries' government-run investments are headed for trouble. Some observers have been questioning the influence of sovereign wealth funds -- huge, often secretive investment pools run by governments in countries like Abu Dhabi, Norway, China, Singapore and Saudi Arabia. Critics worry that unsafe bets by such funds could further destabilize the financial markets and world economy. Is Dubai World an early warning of problems with those funds?

Probably not, notes Gultekin. While it is true that sovereign wealth funds are used to invest financial reserves, such as the wealth from oil revenue, "most sovereign wealth funds are very prudent. They don't take major risks." Dubai World, though connected to the government, is different from a sovereign wealth fund because it is not being used to diversify the nation's resources but, instead, to borrow money to create resources. "Dubai doesn't have oil and gas wells, so the emirate is really dependent on this strategy of turning themselves into a hub for tourism and doing business," Gultekin says.

Greek Tragedy?

Still, some experts point out that Dubai's problems show what can happen when governments get deep into debt, as many have in response to the recent financial crisis. "People are concerned about debts in general that have been built up during the [world economic] crisis," says Marston. "There has been a very big jump in government debts around the world."

Two countries at especially high risk are Italy and Greece. "In itself [the Dubai crisis] doesn't matter very much," says Wharton finance professor [Franklin Allen](#). "But as a precursor to what may happen in the next few months or years, it is very important. There is a lot of talk about whether Greece may have

serious problems or not." Greece has a lot of debt, most of it held by lenders outside the country, meaning a debt crisis in Greece would affect other countries, Allen says.

In the worst case, which Allen says is unlikely, a crisis starting in Greece, Italy or elsewhere could shake financial markets' confidence, causing values of debt instruments to plunge around the world, as they did during the Russian default crisis of 1998. "A small default by the Russians caused an enormous crisis," Allen recalls.

On December 9, stock markets around the world fell after Fitch Ratings downgraded Greece's government debt to its worst level in a decade. The government has faced harsh criticism since it revealed that its debt is twice as large as was previously disclosed, and has reached more than 12% of GDP. After the downgrade, the Greek prime minister George Papandreou promised in a news conference to "do whatever it takes to control the huge deficit." He added, "We are not the new Iceland, just as we are not the new Dubai."

It will likely be some time before Dubai's fate becomes clear. Abu Dhabi could still come to Dubai World's rescue, and the creditors may agree to restructure the debt.

Gultekin believes problems arising from Dubai World will for the most part be contained in Dubai rather than affecting the region, largely because Dubai is the most highly leveraged country in the area. Saudi Arabia and Abu Dhabi have oil wealth, Qatar has natural gas wealth and the other emirates are not big economic players. "It was really Dubai that was the most daring and commercially active in the region," Gultekin says.

Despite the problems with Dubai World's real estate empire, other parts of the business are doing well, says Guillen. "Dubai has been thriving because of the war in Iraq," he notes. "It's a major port for transshipment." Ultimately, Abu Dhabi is likely to help out, but with strings attached that will leave Dubai with less autonomy, Guillen says. "It's a pity, because had they been a little more cautious they would be in better shape now."

Even if Dubai's troubles deepen, there may be a silver lining. Gultekin predicts that Dubai World's lenders will supply funds needed to complete real estate projects that have stalled, because the buildings will be more valuable finished. He notes that Florida suffered a burst real estate bubble in 1926, but that the excess building eventually drew people to Florida from around the U.S. and eventually made the state an economic powerhouse. "A similar thing will happen in Dubai," he adds. "Their ego is a bit bruised.... They will have to be a bit more realistic."

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