Dubai Storm: Crossing the line of Control

(Dr. Nikhil Saket, Senior Assistant Secretary, ICAI, New Delhi)

Introduction

The Dubai Debt Crisis 2009 has been called by economists a consequence of real estate bubble burst when on November 26, 2009 Dubai proposed to delay repayment of its debt which includes delay in the payment of $ 60 Billion debt on Dubai World, the investment vehicle for the emirates for 6 months.

It had taken loans from many financial institutions for developing Dubai. It spent a lot of amount on developing real estate and now there are not enough buyers of those properties because of global recession. Due to this the Company is not in a position to repay its loan instalments. Since all those loans have been guaranteed by Dubai Government, Dubai Government has requested the lenders to extend time for redemption. Total liabilities of Dubai World are $60 Bn. It is not such a big amount to have a big impact on the world economy. As far as India is concerned, real estate sector and banking sector have some exposure there, though not big enough to have much impact. But in case those Indians who are working there, lose their jobs, then Indian job market may feel pressure. UAE is big importer of Indian items, our exports may also suffer a bit.

Dubai, which was once considered to be the world's fastest growing city (emirate), is one of the worst targets of present global financial crisis. All the sectors have badly affected. However development and real estate sectors have suffered more than any other. Engineering jobs are in real danger as many state owned developers like Nakheel, Tameer, Tatweer, Samaa Dubai and Emaar have to pay millions to the contractors and consultants. Ongoing projects are being closed due to the unavailability of funds.

Dubai World, the flagship investment company owned by the Government of Dubai and/or Dubai's ruler Sheikh Mohammed bin Rashid al-Makhtoum, announced a standstill on its debt repayments, with specific reference to a $4 billion bond payment that Nakheel, a Dubai World property development subsidiary, is due to pay in December.

By all indications Nakheel and also Emaar, another state-owned property developer, were perilously close to insolvency if they hadn't already crossed the line. Nakheel had shelved development of the second and third Palm Island projects and Emaar, developer of the world's tallest building Burj Dubai, was trying to get itself acquired by Dubai Holdings.

Mark Mobius of Templeton Asset Management has warned that a default by Dubai World could trigger defaults – especially of state-owned companies – in other markets and could lead to a 20 per cent drop in emerging markets overall. Dubai's slump may be deeper and more protracted than anyone expected, but Dubai's rulers have never ceased to astound with their imagination and audacity.

Dubai's debt troubles have exposed the fallacy of it's once much –vaunted "model" of raising shining cities in the desert with foreign residents, finance and labour. They have also set in train a power shift towards Abu Dhabi. Dubai's population rocketed to 1.5 million, as white collar professionals from around the world took plum jobs in a country marketed as a liberal enclave in the Gulf sun. An army of Asian workers was hired to construct the glitzy projects, drawing accusations of slave labour from right's groups, while Dubai's own citizens dwindled to a small minority, bringing strains as cultural values mixed warily.

Dubai's economy: Vital Facts

Dubai is part of the United Arab Emirates, seven city-states which have separate ruling families, separate budgets, but security, immigration and foreign policies in common. Abu Dhabi has nearly all the UAE's oil. To keep up, Dubai from the 1950s on diversified its economy into ports, trade, services and finance, largely successfully. But its liquidity-fuelled real estate and tourism binge in the last decade may have been one step too far.

- Contrary to the general assumption that Dubai's economy is totally driven by oil and gas, it is a fact that oil sector only comprises less than 6% of the economy of Dubai.
- In fact, Dubai's portion of natural gas revenues in the United Arab Emirates is only about 2%. Dubai's oil production is estimated to be about 240,000 barrels per day.
- The other largest contributing sectors of Dubai economy are Real estate and construction (22.6%), trade (16%), (15%) and financial services (11%) (all are 2007 figures).
- It is true that Dubai's economy was built on the back of Oil Money but Dubai's oil reserves have diminished significantly and are expected to be exhausted in 20 years.
- Dubai has one of the most unique and unusual economies in the world. Dubai has numerous free zones including Jebel Ali Free zone, Dubai Maritime City, Dubai Internet City and Dubai Maritime City, Dubai Internet City, and Dubai Media City.

Dubai World: Snap Shot

- Dubai World is an investment company that manages and supervises a portfolio of businesses and projects for the Dubai government across a wide range of industry segments and projects that promote Dubai as a hub for commerce and trading.
- Chairman of this company is Sultan Ahmed bin Sulayem.
- Dubai World was established under a decree ratified on 2 March 2006 by Sheikh Mohammed bin Rashid Al Maktoum, Vice-President and Prime Minister of the United Arab Emirates and Ruler of Dubai. He also holds the majority stake in Dubai World.

- Dubai World's assets range from stakes in Las Vegas casino company MGM Mirage to London-traded bank Standard Chartered Plc and luxury retailer Barneys New York through asset-management firm Istithmar PJSC.

Major Reasons: Seeds of Trouble

- Due to the ongoing global financial crisis of 2008-09, Dubai's real estate market experienced a major downturn. This lead to the slowing economic climate.
- It was declared in an international press council by Mohammed al-Abbar who is senior aide to Dubai's Ruler and UAE's Vice-President/Prime Minister, Sheikh Mohammed bin Rashid Al Maktoum and who serves as the Director-General of Dubai's Department of Economic Development, and Chairman of Emaar, one of the world's largest real estate companies in December 2008 that, Emaar had credits of US$ 70 billions and the state of Dubai additional US$ 10 billions while holding estimated 250 billion in real estate assets.
- By early 2009, the situation had worsened with the global economic crisis taking a heavy toll on property values, construction and employment.
- As of February 2009 Dubai's foreign debt was estimated at approx. USD 100 billion, leaving each of the emirate's 250,000 UAE nationals responsible for 400,000 USD in foreign debt.
- A longer-term assessment of Dubai's property market showed depreciation; some properties lost a much as 64% of their value from 2001 to November 2008.
- It contributed to the failure of key businesses, declines in consumer wealth estimated in the trillions of US dollars, substantial financial commitments incurred by governments, and a significant decline in economic activity.
- In recent years, Dubai has expanded with ambitious, eye-catching projects like the Gulf's palm shaped islands and the world's tallest skyscraper in hopes of becoming a tourist-friendly Middle Eastern metropolis. In the process, though, the state-backed networks nicknamed Dubai Inc. have racked up $ 80 billion in red ink. The emirate may now need another bailout from its oil-rich neighbour Abu Dhabi, the capital of the United Arab Emirates.

Extent of its problems

In 2000, Dubai Financial Market (DFM) was established. It was established as a secondary market for trading securities and bonds, both local and foreign. During that time the Government decided to diversify Dubai's economy from a trade-based, but oil-reliant, economy to one that is service and tourism-oriented has made real estate more valuable. The orientation towards tourism and service led the economy towards Real Estate Boom and the result was appreciation in the property prices from 2004-06.Dubai became a centre of large scale real estate development projects and this led to the construction of some of the tallest skyscrapers and largest projects in the world such as the Emirates Towers, the Burj Dubai, the Palm Islands and world's second tallest, and most expensive hotel, the Burj Al Arab.

The emirate has said it has $80bn of debts; though some analysts say the true figure could be double that. Dubai World, the state-owned holding company whose bail-out plans triggered the current crisis, has liabilities of about $60bn, though only part of that is debt. The main problem is its real estate subsidiary Nakheel, which has huge bonds coming due, including an Islamic bond for $3.5bn in December. It appears to have little cash flow to meet payments - as well as relying on debt, it also sold most developments off-plan, with new developments now on hold.

At the most basic level, fears that exposed banks will have to write down losses, and that both Dubai and Abu Dhabi may have to sell worldwide assets, has hit prices everywhere. At an "animal spirits" level, the disclosure of significant unforeseen problems in Dubai has refocused attention on where else might have hidden "black holes". The health of sovereign debt worldwide, already seen as the major financial issue for the next decade is also being reexamined.

Dubai is still seen as the premier place to do business in the Middle East and beyond. It is a preferred base for not just Arab but Pakistani, Iranian and even Indian businesses, due to the wider region's political uncertainty. Its reputation for liberal attitudes helps. But events have damaged its reputation for economic competence, which the emirate's rulers will now have to work hard to restore.

Some Major Concern

- Dubai World, the heavily indebted United Arab Emirates conglomerate behind plunging global markets, is refusing to sell off its assets cheaply; the group has categorically refused in recent months to sell several properties and investments at low prices.
- Dubai's second largest property developer Deyaar recently announced that it would be putting at least 25 per cent of its projects on hold. The outlook is grim.
- Several real estate properties have already dropped in price by up to 50% and we have not even seen the full extent of the global financial crisis. Analysts forecast much steeper forecasts ahead. Dubai's economy diversified away from oil towards real estate and tourism making it extremely vulnerable to today's market conditions.
- The Dubai construction boom is expected to come to an imminent halt with many partially finished projects littering the landscape as investors walk away from the off plan deposits in the wake of the ongoing crash in property values. It remains to be seen how much of this excess supply will eventually be reclaimed by the desert as many foreign investors in off plan Spanish properties are painfully experiencing.
- More than half of the construction projects in the United Arab Emirates, worth $582 billion, have been put on hold, according to the market research firm, Proleads. Some projects are still going ahead, thanks, in part, to the $10 billion bailout from the UAE's capital, Abu Dhabi. But, many workers are unemployed and stuck there.
- Worker advocacy groups - including the United Nations International Labor Organization - have increased pressure for wider protection covering the hundreds of thousands of unskilled construction workers who flooded regions of the Gulf during the building boom and now face the fallout from leaner times.
- The demands include ending the illegal-but-common practice of companies holding workers' passports, effectively blocking their chances of looking for other jobs under the country's sponsorship system.
- The economy is in a bad state as the banks have stopped lending and the stock market has plunged 70%. The economic despair is evident everywhere as luxury hotels are three-quarters empty. Shopkeepers in newly built malls are reporting a substantial drop in sales. Houses and cars are for sale too almost everywhere.
- There has been a drop in property sale too, so half of all the UAE's construction projects, which are worth about $582bn (£400bn), have either been put on hold or totally cancelled, thus there is a huge trail of semi finished towers on the outskirts of the city stretching into the sandy desert.
- The Dubai crisis has lead to a big cause for worry and a panic situation too, in the financial market as banks and financial firms lost in markets across the world. Economic slowdown will affect the sales force too, in huge measures and the biggest casualty are going to be the Indian labour force which will be directed affected by the Dubai financial crisis.
- Perhaps the global financial crisis will prove a blessing in disguise for Dubai. Greater global regulation and higher taxes could lead to an exodus of the financial industry to

offshore locations. The Dubai International Financial Centre is uniquely well qualified to fill this role.

- Indeed, nothing would fill up the offices, apartments and villas faster than an influx of refugees from the global financial crisis.
- Of course, the falling office and housing rents of recent months will also boost the appeal of Dubai to the banks and financial institutions. Housing remains the biggest single cost item for employees and has become prohibitively expensive, although financial service companies do normally operate in high cost locations.
- The United Arab Emirates (UAE) has total debt amounting to $184 billion at the end of 2009, according to estimates by Bank of America –Merrill Lynch, which said the region faces a heavy redemption schedule schedule until 2013.
- The lack of official debt data may add up to uncertainty and cause higher risk premium of the 184 dollar UAE debt Dubai hold 88 billion while Abu Dhabi amounts for 90 billion. The debt servicing cost will be higher than these estimates as their numbers only include the principle payments.
- Royal Bank of Scotland Group under wrote more loans than any institutions to Dubai World. The state company seeking to reschedule debt. While HSBC holdings has the most at risks at the United Arab Emirates according to JP Morgan Chase & Co.
- But the performance of the Dubai Financial Market Index, the main indicator for the emirate’s stock market, tells a different story. It peaked about 6,000 points two years ago then began to fall, tumbling sharply during the global credit crunch late last year and dropping below 1,500 points. It closed its latest trading day on Wednesday at 2,070.89, up more than 40% from the start of year, but still down by two-thirds from its all-time high.
- Dubai has an estimated debt mountain of $80 billion, as large as the emirate’s entire gross domestic product. Dubai World’s group debt of $59 billion comprises three quarters of the total.
- Some analysts say that: The core reason for the Dubai Financial mess up is that Sheikh Mohammed’s decision to invest all his wealth as well as Dubai govt fortunes in Real estate markets in United states through a foreign investment arm of Emaar, which claimed to be the second largest property developer in US, which ultimately went bankrupt due to recession and filed for Chapter 11. Chapter 11 is a chapter of the United States Bankruptcy Code, which permits reorganization under the bankruptcy laws of the United States. (Chapter 7 governs the process of a liquidation bankruptcy, while Chapter 13 provides a reorganization process for the majority of private individuals

Crisis impact

Buying real estate is a major commitment that people will be reluctant to undertake at a time of global financial turmoil and the absence of buyers would have an inevitable impact on prices. Credit also tends to tighten under such circumstances, although it could be that the UAE Central Bank decides this is the point at which lower interest rates become essential for economic well being. For usually the peaking out of interest rates marks the bottom of a down cycle in property.

Stocks from Tokyo to New York were haunted by concern that banks were exposed to state companies in Dubai, whose rise from a desert backwater into the business hub of the world's top oil exporting area lured expatriate cash and executives.

"While it is a setback, I think we will find it is not on the scale of previous problems we have dealt with," British Prime Minister Brown told reporters in Port of Spain. "The world financial system is stronger now and able to deal with the problems that arise."

French Prime Minister Francois Fillon said the Gulf had the resources to ensure the world would not sink into a second round of turmoil, but Russian premier Vladimir Putin said the saga showed how hard it is to shake off a crisis that has lasted two years.

In the United States, administration officials said the Treasury Department was closely monitoring the situation in Dubai, while Canadian Finance Minister Jim Flaherty said the Group of Seven industrialized nations has had discussions about Dubai's credit issues and was monitoring consequences.

Japanese Finance Minister Hirohisa Fujii raised the prospect of a G7 joint statement on currencies in Tokyo after the Dubai debt worries pushed the Japanese yen currency to a new 14-year high against the dollar. But no such statement has been issued and the yen retreated from its earlier highs.

But the prospect of a bailout did little to allay concerns among investors, already worried the global economy may not be recovering quickly enough to justify a near doubling of prices for emerging market stocks and many commodities since March.

Bank exposure

The Dubai news raised fears that some major banks could face yet more write downs in addition to those already triggered by the global financial crisis in 2008.

The costs to insure the debt of some big U.S. banks against potential default rose between 10 and 20 basis points. But HSBC, Europe's biggest bank and the one with more loan exposure to the UAE than any other at around $15.9 billion, said it was not concerned.

JP Morgan said it was less concerned about global banks' direct exposure to Dubai World and was not worried about Abu Dhabi, which is sitting on hundreds of billions of dollars." We are more concerned about the spill over effect within the UAE," it said in a note. "It remains unclear if the Dubai government will support the liabilities of government related entities."

India and Dubai

Reserve Bank of India governor D Subbarao said: "We should not react to instant news like this. One lesson that we learnt from the global financial crisis is that we must study the developments and measure the extent of the problem and hence study the impact on India"

The Reserve Bank of India plans to ask banks to furnish details of their exposure, if any, to Dubai World, the government-owned company which is reeling under liabilities of $ 59 billion and has sought to delay repayment of its debt obligations.

State Bank of India, Bank of Baroda, ICICI Bank and Axis Bank are some of the banks that have a presence in Dubai.

Exposure in the Middle East

Scrip	Current Mkt Price (BSE,in Rs.)	% change
Voltas	168	0.2
Simplex Infra	523	-0.5
Punj Lloyd	202	-1.9
Gammon India	233	-2.2
Omaxe	93	-2.3
L & T	1587	-2.7
Nagarjuna Con	154	-4.5
Bank of Baroda	521	-4.6

Source: Times of India, November 28, 2009

- As far as India is concerned real sector and banking sector have some exposure there, though not big enough to have much impact. But in case those Indians who are working there, lose their jobs, then Indian Job market may feel pressure. UAE is big importer of Indian items; our export may suffer a bit.

- Dubai's debt woes have got Bollywood producers and distributors worried as the city is a significant contributor in the West Asian market for Hindi films. Dubai market generates 40-45 percent of the overseas collections for Bollywood films.

- 50 lakh Indians who work in the gulf, the Malayalee diaspora alone account for more than 20 lakh and they bring more than 25 percent of the state's GDP as remittances.

.

- Dubai economy accounts for roughly one third of UAE's GDP and this could mean that a little over 3 percent of India's total exports could be at risk, post crisis.
- Indian stock market lost over 600 points in initial trade, but recovered sharply and ended the day with a 223 point loss as reassuring sentiments expressed by corporates and commerce ministries as also

Positive Outlook

Richard Thompson, editor of the Middle East Economic Digest, says the region is starting to react to the economic downturn. Dubai has moved to stabilize its economy with its $20 billion sovereign bond program. For the short term, it should be sufficient to meet the city's refinancing needs this year and lend stability to the economy.

CONCLUSION

The real question, therefore, is the price Abu Dhabi will demand to bail out its imprudent neighbour. The price is likely to be political as well as economic -- that is to say Dubai may lose some of its independence as well as having to part with an equity stake in some of its major assets.

The United Arab Emirate's central bank has allayed concerns about local banks, saying these lenders have raised their capital and proved themselves by weathering the global financial crisis. The key to Dubai's future lies undoubtedly in its relationship with its neighbour Abu Dhabi, run by the Nahayans, cousins of Dubai's Maktoums. While Dubai has no oil, Abu Dhabi sits on one tenth of the world's oil deposits and has built up a massive sovereign wealth fund estimated at $900bn. Abu Dhabi is the immensely rich powerhouse of the 7-member United Arab Emirates.

The Emirate evidently expanded too fast and ran up heavy debts by embarking on vanity projects of doubtful financial viability, such as the 810 metre-high Burj Dubai skyscraper – the highest in the world -- and the artificial islands built in the shallow waters along its coast, to provide room for miles of luxury villas. These, in particular, could be vulnerable to a rise in sea-levels due to global warming. In view of the hot and humid climate in the Gulf, Dubai's emphasis on high-class tourism may prove to be a mistake.

Its real advantage, however, lie in its location - as an international trading and financial hub between East and West - and in the quality of the people who have chosen to live and work there. These assets are bound to see it through. The tragedy of the black hole in Dubai's finances is that it has dealt a blow not only to its own reputation but to that of the United Arab Emirates -- and beyond that to the Arab Gulf as a whole. One might even go so far as to say that it has dealt a painful blow to the entire Arab world. The debt crisis in Dubai also pushed up debt insurance costs for other sovereigns in the Gulf, wealthy region Western firms had turned to for help at the height of the credit crunch, and at some major U.S. banks

Dubai is still seen as the premier place to do business in the Middle East and beyond. It is a preferred base for not just Arab but Pakistani, Iranian and even Indian businesses, due to the wider region's political uncertainty. Its reputation for liberal attitudes helps. But events have damaged its reputation for economic competence, which the emirate's rulers will now have to work hard to restore

It is a hope to return to boom times and to complete a skyline of half-finished buildings - a hope that now seems distant.

****

References

- Dubai – A lesson in why Transparency Matters" Article from Wall Street Journal.
- "Abu Dhabi's Silence Raises the heat on Dubai" Article From the New York Times.
- " Stocks Slumped on news that Dubai's government - backed investment firm risked a $60 billion default Article from statribune.com
- Caught in Deserted Storm : The Economic Times
- Dubai's No Great Sheikh- The Economic Times
- RBI to ask banks for details of exposure to Dubai World : Business line
- Dubai's response hold key to finance hub status : The Economic Times
- Market cuts losses after Govt allays Dubai Team : Business line
- Dubai world scare , a trigger for correction : Business line
- Dubai: First domino of new crash? Business line
- Fear floats at Dubai : All at sea : The Times of India
- Blog.taragana.com
- www.foxnews.com
- www.docstoc.com
- www.bfinance.com