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# Dubai turmoil before and after the bailout: Note

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## **Abstract**

*This note explains the circumstances that created the recent economic turmoil in Dubai. It analyses the consequences of the bailout the government ultimately enforced. It questions the role rating agencies play in such crises and suggests regulation of their activities. Finally, it warns of challenges Dubai is likely to face in years ahead.*

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The Government of Abu Dhabi and the UAE Central Bank stepped in the nick of time with a \$10 billion bailout offer for the state run Dubai World which had recently got stuck in billions of dollar debt mire. Of the allocated amount, \$4.1 billion was meant to take care of the World's immediate debt obligations comprising Islamic bonds (sukuk) of Nakheel - the property development arm of the company. The amount was falling due on December 14, the very day support was pledged. Nakheel has since met its obligation within the stipulated time limit. The remaining \$5.9 billion of the pledge was earmarked to help meet the obligations to trade creditors and contractors of the World. Contrary to what some perceived, it was not an unexpected step; many, including the IMF, could see and hailed the on coming UAE move to address the crisis. For failure to help could have even led to the disintegration of the UAE.

Dubai World had rather abruptly asked for time from its creditors until end of May 2010 to repay their loans of about \$59 billion. The announcement caused a quiver in the global financial markets. The element of suddenness resulted in a failure of reaction to distinguish delay from default. The bailout announcement calmed the nerves reassuring investors, financial and trade creditors, employees, and common people that the government will always act to uphold the market principles and globally acceptable business practices. Stock markets in no time turned their tails up. US dollar looked up against the Yen; The Euro climbed them both. Asian credit default swaps tightened and the risk appetite got boosted.

Dubai economy was initially raised on petro-dollars, but the fast dwindling oil reserves of the emirate made her take to diversifying the economy. The emirate decided to develop service and tourism sectors: it positioned itself as an international finance, trading and sports centre. High rise buildings, grand hotels, and luxury resorts soon dotted the land all around. Property prices were on gallop until the close of 2006. Then the tide of global crisis reached this tiny outpost also. The debacle started with her booming real estate industry going bust at the start of 2008. Exuberance in a promising market had created excess supply: property prices crashed – the average fall being around 40% of their value in 2009 alone: sales were slowing, profit margins were vanishing. The abrupt declaration on November 26 by Dubai government asking the creditors to reschedule repayment put the financial world in panic. Shares went tumbling across the world.

The reaction was sharper in the West as boom in the emirate was heavily financed by foreign funds, especially the European banks like RBS and Standard Chartered. Developing countries did not express much concern. India feared though the unemployment of her workers the crisis could cause, but the overall feel was that mountain was being made out of molehill. Her finance minister observed: first the [Rupee] amount involved was small; second, the exposure of the Indian banking system to Dubai was limited. The statement largely reflected the sentiment in the Asian countries.

Sukuk – the Islamic bonds – have been under cloud since the time Taqi Usmani questioned their Shari’ah compliance in most cases (85%) slowing down their popularity. One consequence is that experts tend to sermon in whatever adversity they find the presence of the sukuk. Dubai crisis has been no exception. Most comments, including some coming from the more sober academic world, contained disproportionate voicing of alarm and warning on the role of the Islamic bonds in Dubai turmoil.

One reason why sukuk attracted the attention of the market in the fiasco was that their payment due on December 14 was the centre of the time-resetting negotiations: Islamic bonds so to say triggered the crisis. The government announcement of its intention to enforce payment rescheduling immediately led both Moody’s and Standard services to heavily downgrade the Islamic sukuk along with bonds of various government related entities in Dubai. A more realistic approach could not have missed the point that the amount due on sukuk was no more than 6 -7% of the total money involved and failure had not yet taken place. Rating agencies could have shown a little more restraint in their decisions. They wield enormous power in the global bond markets: they can literally make or unmake a government not by actual downgrading but by merely announcing the intention to do so. There are increasing murmurs in financial circles as to why these agencies are allowed to continue rating debt issues? As the bond issuers themselves have to pay for the evaluation exercise, there candidly is scope for the ratings moving in tandem with the payments. It is not very clear what rules of conduct these agencies follow, who design these rules and who oversees their observance: There is presumably a case for setting up regulatory frameworks for the rating agencies even for establishing separate ones for Islamic bonds.

Some analysts looked at the Dubai fiasco from a historical angle. To them, the seeds of Dubai turmoil were sown the moment Sheikh Mohammad took the decision to invest his wealth as also of the emirate in the US real estate markets through the foreign arm of Emaar – the second largest property developer on the scene. The company ultimately went bankrupt extending in the process the US subprime crisis to the emirate. The American connection links well with Washington and Abu Dhabi putting pressure on Dubai to join the ‘international community’ in taking a tougher line on Iran, one of main trade partners of the emirate. Dubai has also decided to enact immediately an insolvency law on the US-British model to provide protection to local companies like the World from its creditors. Abu Dhabi may also be looking for some

concessions from the emirate in return for providing her the bailout. It may, for instance, seek concessions on trade with Iran and on the future of Emirates Airline. Here is in operation economics to meet political ends or precisely, the political economy of the region.

Sukuk was not *the* issue in Dubai crisis as some have tried to make it. Sukuk market remained calm and unaffected across countries including the leading one in Malaysia. The emirate was in part a victim of global meltdown and was in part overtaken by unguarded optimism and mismanagement. The crisis has compromised her reputation as an economic power house in the region it may find difficult to retrieve. It also faces the daunting task of restructuring the remaining \$22 billion of Dubai World's debts. More importantly, what is going to be the fate of its huge investments sunk in high value property mostly in anticipation of foreign demand, especially from the West. This demand may not be picking up for quite sometime. The future is quite uncertain, if not bleak. The emirate must proceed with caution.

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