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# Dubai financial crisis: causes, bailout and after

## A case study

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### Abstract

This paper explains the circumstances that led Dubai to the current financial crisis that still lingers. It analyses the steps taken at various stages by the city state to ameliorate the situation including the bailout help the UAE Government eventually granted. It spotlights the role international rating agencies played in aggravating the situation and demands that their activities be brought under regulatory nets now being strengthened across the world in the context of ongoing global meltdown. Finally, it warns of challenges Dubai may be facing in years ahead and what could be done to pre-empt them. The argument is cast with a backdrop of the economic position of UAE in the Middle-East and happenings at the global level in the arena of finance – mainstream and Islamic.

**Keywords:** Islamic finance; Global meltdown, Dubai crisis; Rating agencies; financial architecture.

### Introduction

The financial crisis that originated from the property sector of the US economy took little time to cover the financial firmament across countries. The global melt down as it is now called pales even the Great Depression of

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1930s in terms of its range, depth, damage caused and complexity. Its rise and ebb have been unique. It seems to be on a path of recurring revival threatening in some cases the collapse of an entire economy as of Greece.

In earlier crises like that of 1930s, the standard remedy was attempting the revival of effective demand by putting money into the hands of people through initiating public works easing the unemployment situation: banks collapsed like card houses. Today the story is different. Banks have become too big to fail. Huge sums from taxpayers' money are being spent as oxygen to keep them alive. Thus, the slogan of capitalism becomes: *profits are private, losses public*. The expenditure on bailouts does little to expand effective demand. Unemployment continues to rise. Distributional inequalities tend to aggravate.

Islamic finance has recently won much praise from the bankers, experts, scholars and jurists for remaining resilient and stable during the current global crisis. Indeed, they all claim that the crisis has helped prove the vitality of the Islamic system compared with its mainstream counterpart. They ignore the relative position of the two systems. Islamic finance is no more than a candle facing the sun: the ratio of market assets held by the two is no less than 1:100, and is presently on the rise. Furthermore, Islamic finance stays risk averse, short-term and liquidity oriented. For these and other reasons the system has not yet developed enough pipelines to connect with the ongoing crisis. Nonetheless, some Islamic banks did come to grief in recent months. Examples are Investment Dar in Kuwait, Islamic Bank in Qatar, Gulf Finance House in Bahrain, the Emirate Islamic Bank of UAE and Dubai World<sup>1</sup>.

The U.A.E. has a unique political structure that gives much economic independence to the individual emirates. An understanding of the set up may help to appreciate the treatment of the Dubai crisis and what followed thereafter.

## **2. Dubai in U.A.E. politico-economic structure**

The U.A.E. came into existence in 1971 after the United Kingdom announced the ending of its treaty relationship with the seven Crucial Coastal States that were under its protection since 1892. Abu Dhabi, Dubai and Sharjah are the three largest constituents of the country. Each one of its emirates is governed by an Emir who controls its administration. Each Emir manages independently the resources of his unit. The Federal Supreme Council (FSC) consisting of these Emirs is the highest constitutional authority in the United Arab Emirates; it holds both the executive and legislature powers.

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<sup>1</sup>. For details see Rashid Siddiqui (2010): *Cross-sell of Islamic finance, Islamic Finance Report 2009*, Project Finance International of Reuters. Taqi Usmani also supports this view

The Emir of Abu Dhabi, the largest oil (petroleum) producing Emirate, was elected President of the U.A.E., and the Emir of Dubai, a commercial centre and a major oil producer was appointed as the Vice-president and Prime Minister. The legislative authority called the Federal National Council (FNC) plays only an advisory role. Its members are appointed by the FSC to serve for a term of two years.

A notable feature of the Middle-East countries is that they are mostly run by personal decision-making processes. The development of modern democratic institutions with sufficient autonomy have been slow to develop<sup>2</sup>. This is why sufficiently detailed, regular and reliable data on many vital national variables for these economies is often missing. Their economic policies thus defy worthwhile analyses. The U.A.E. is in a better position: Available data is adequate to show that its vast natural resources in oil and gas next only to Saudi Arabia and Iraq, abundant supply of cheap skilled and unskilled labor from abroad, business friendly environment and socio-political stability have contributed handsomely to its economic growth and prosperity.

UAE has been among the fastest growing economies in the world. Its GDP crossed \$270 billion mark in early 2009 even as subsequently recession in construction slowed growth and the economy is not estimated to expand more than 2% in the year 2010. The size of the economy is third in the Middle-East and its per capita income rank is fourth in the world higher than several leading West European economies. The services sector at 44% is the leading contributor to her revenues.

**Table 1: GDP indicators for the U.A.E. Economy 2004 – 2008**

| Years                                  | 2004      | 2005      | 2006      | 2007       | 2008       |
|--|-----------|-----------|-----------|------------|------------|
| GDP (constant prices, annual % change) | 9.7       | 8.2       | 9.4       | 7.7e       | 6.6e       |
| GDP per capita (USD)                   | 27,594.83 | 32,391.58 | 38,613.42 | 42,274.57e | 45,228.31e |
| Inflation rate (%)                     | 5.0       | 6.2       | 9.3       | 8.0e       | 6.4e       |
| Current Account (billions USD)         | 10.34     | 24.32     | 35.94     | 42.78e     | 49.51e     |
| Current Account (in % of GDP)          | 10.0      | 18.3      | 22.0      | 22.6e      | 23.0e      |

Source: IMF - World Economic Outlook Database

Note: (e) Estimated data

<sup>2</sup> For, example the participation of citizens in the political activities is non-existent in the U.A.E. Ever since the creation of the federation in 1971, the FCS has not made any changes in its principle of power delegation within the federal government.

The U.A.E. is a highly urbanized country. And, Dubai is the biggest city followed by Abu Dhabi which is the largest contributor to the U.A.E. revenue. The GDP of Dubai rose from \$46 billion to \$82 billion in 2008 averaging 18% growth a year. The economy was initially raised on petrol-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 2008 when the tide of global crisis hit this tiny outpost. Interestingly, researchers find no significant relationship between the monetary and real sector growth rates in the U.A.E.<sup>3</sup>. It was the fast dwindling demand for luxury houses and tourism services that crashed the economy. Banks came to grief as a result of recession in construction industries not because of financial overdoing. .U.A.E. is comparatively a modern westernized country in the region For example, alcohol is freely available and ladies are not obliged to cover their head.

### **3. The debacle**

The debacle started with the booming real estate industry of Dubai going bust around the middle 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.

Government of Abu Dhabi and the Central Bank of U.A.E. stepped in the nick of time with a \$10 billion bailout offer for the state run Dubai World which had got stuck in a mire of billions of dollar debt. 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, 2009; 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 it coming and hailed the UAE move to address the crisis. For failure to help could presumably threaten the cohesion of the UAE.

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<sup>3</sup> See Mohamed Shihab (2000): Economic Development in the UAE, PP. 249-259 posted on the internet

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.

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 though feared the unemployment of her workers the crisis could cause, but the overall feel there was that a mountain was being made out of molehill. The Finance Minister of the country pointed out that in the first place the [Rupee] amount involved was small and in the second, the exposure of the Indian banking system to Dubai was limited. The statement largely reflected the sentiment in the Asian countries.

In any case, the US\$ 10 billion bailout only provided some breathing space to Dubai World; its long run debt position remained precarious. It was only a couple of days back – May 20, 2010 – that the company reached a deal *in principle* to restructure US\$ 23.5 billion in debt with the core lenders holding 60% of the exposure. The proposal offers repayment over a five or eight year period and allows lenders to take on additional options. The deal has no new financial support from the government and must still be approved by banks outside the core negotiating panel. Naturally, this is not an entirely welcome position for Dubai World but under the circumstances they could not probably hope for the better<sup>4</sup>.

#### **4. Sukuk under scanner**

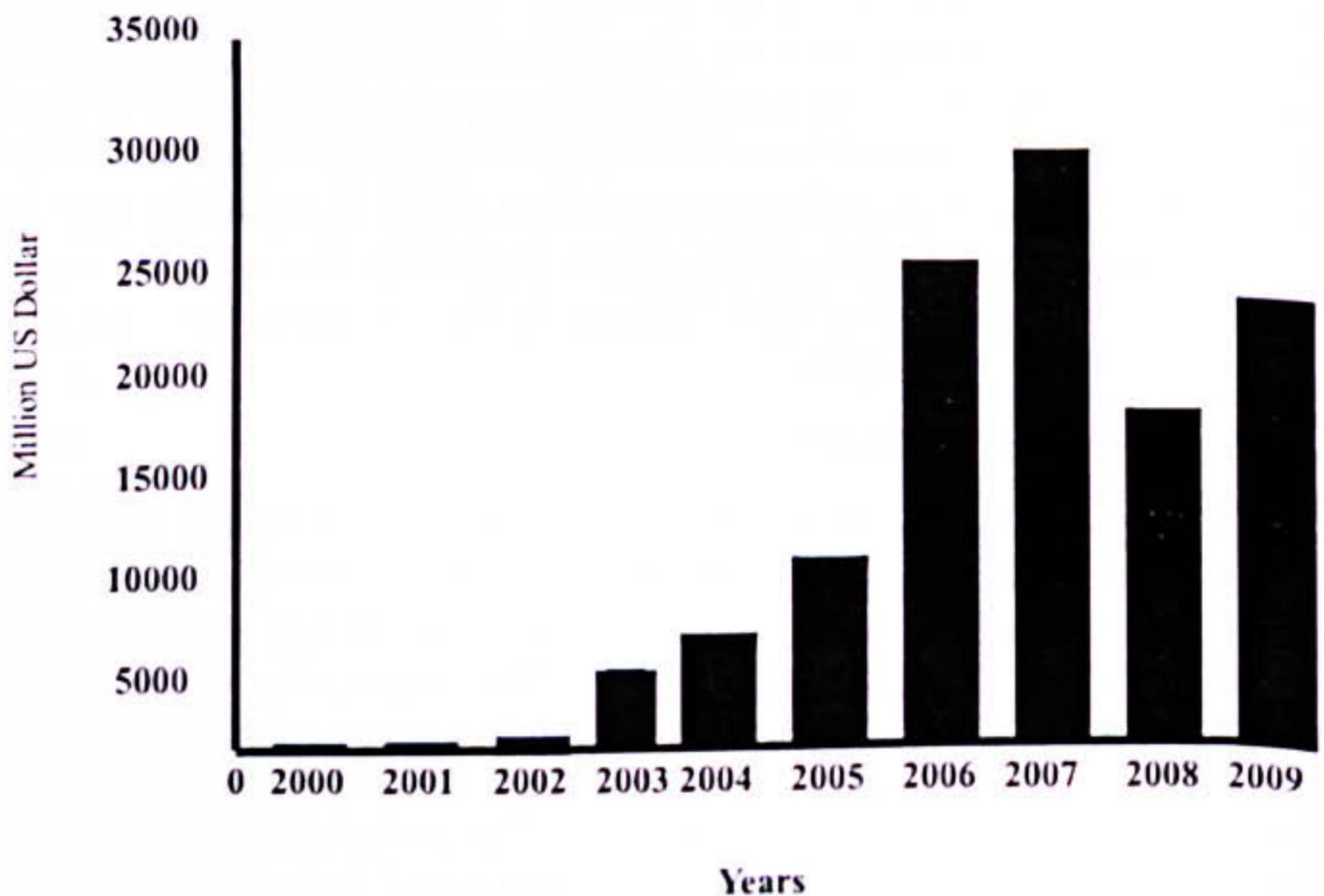
As indicated above, the involvement of Sukuk – the Islamic bonds – in the fiasco was tiny. Still, most comments, including some from the sober academics, contained disproportionate voicing of alarm and warnings on the role of the Islamic bonds in Dubai turmoil. One reason why sukuk attracted the attention of the market probably was that it was the sukuk payment due on December 14 that 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 the

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<sup>4</sup> See news item *Dubai World in US \$23.5 billion debt deal with lenders* The New Straits Times, Friday, My 21, 2010, page B8.

Moody's Investors and S&P rating agencies 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. Dubai suspended the operation of the agencies in the Emirate as a response. Rating agencies could have presumably shown a little restraint in their declarations. 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 – and the payments are heavy - 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 designs 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.

A reference to Sukuk remaining under scanner during recent years may not be irrelevant in the present context. The controversy around the instrument continues to rage ever since Taqi Usmani, one of the leading jurists of today, cast cloud about its being Shari'ah compliant in most cases (85%). One consequence was that experts tend to sermon in whatever adversity



**Figure 1:** Growth of sukuk over the period 2000 – 2009. Source: WEIF Foundation: Special Commemorative Publication 2010

they find the presence of sukuk. Dubai crisis has been no exception. The suspicion detracted from the rising popularity of the instrument as Figure 1 above shows<sup>5</sup>

Some analysts looked at the Dubai turmoil 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 out. Sukuk market remained calm and unaffected by the turmoil 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 Western rich countries. This demand may not be picking up for quite sometime. The future is quite uncertain, if not bleak. The emirate must proceed with caution.

## 5. Concluding remarks

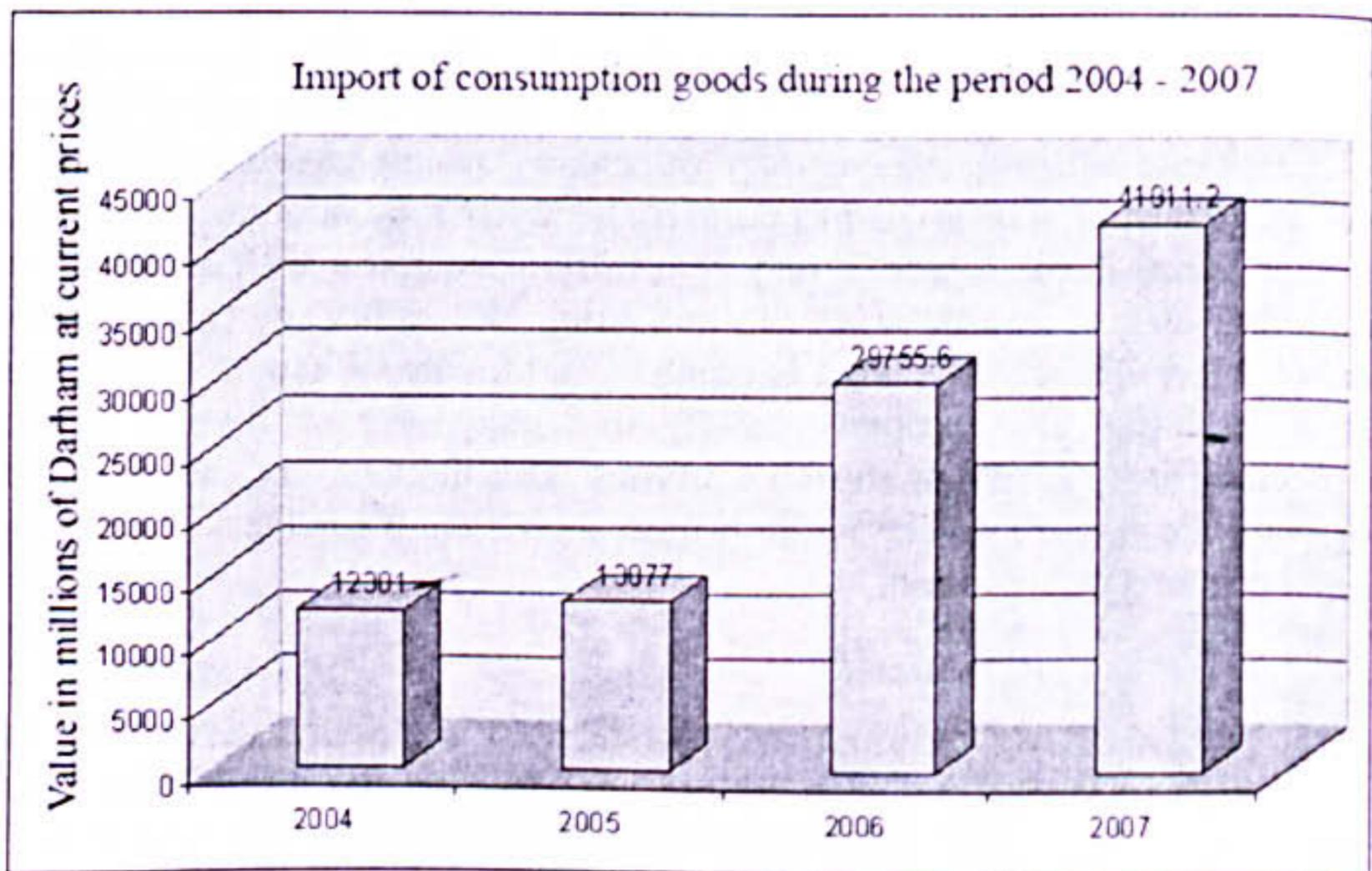
The U.A.E. has been remarkably stable on the politico-economic front from its very inception. The overall growth rate has been high though fluctuated with the rise and fall in international oil prices. The U.A.E. is one of the richest economies in the world. It has fine infrastructure and has spent lavishly to promote human development, especially through education and

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<sup>5</sup> The view that Shari’ah compatibility of sukuk remains controversial was endorsed also at the recently concluded WEIF Conference in Kuala Lumpur. See their special commemorative publication 2010 entitled *Ensuring sustainability in the Muslim world: Empowering people, leveraging resources*.

health care. The global crisis essentially had impact on Dubai segment of the economy and the Emirate has eventually been able to tide over the situation even as her worries have not yet entirely ended<sup>6</sup>. Presumably, there are a few generic lessons that the developing Muslim countries may learn from the recent happenings in Dubai.

1. Consumption expenditure per head in U.A.E is very high even if allowance were made for high incomes. Semi-official reports indicate that daily per capita consumer spending in the UAE stands at 27 dollars while average spending in the rest of Arab countries is 3.5 dollars per day. Note also that personal loans grew by 11% during the last three months of 2009. The phenomenon is set to expand even more, especially in view of existence of parties that are ready to fuel these unnecessarily lavish spending trends. This cuts into the investible savings and fuels inflation that touched 10% last year. Like most Arab nations, there is no income tax in the U.A.E. However, there seems to be a case for considering the feasibility of levying an expenditure tax in the Emirate. It can have a simple structure, with suitable exemptions. It will curb *israf* (wasteful expenditure) and release larger funds for economic development<sup>7</sup>.



**Figure 2:** Import of consumption goods

Source: Ministry of Planning and Economy Abu Dhabi

<sup>6</sup> Nakheel is facing cancellation of contracts even after the recent debt restructuring deal. IFIS: Weekly News letter, May 24, 2010.

<sup>7</sup> It is suitable for Gulf countries because their populations are small and economies are not very complex yet.

2. Most of the consumption goods (85%) are imported from the Western countries involving huge outflow of money (See Figure 2). There is a strong case for increasing trade among Muslim nations. The efforts of WIEF seem to be bearing fruit: the intra-nation trade has gone up recently from 10% to 20% of the total. This can be pushed up substantially only through promoting mutual investment in producing substitute goods. A blue print for that can be prepared.
3. Finally, Islamic financial institutions need diversification to move from the present short-term commercial financing towards long-term investment facilities. In this connection the air of doubts and controversy around sukuk must be cleared. It is gratifying to note that the IFSB is organizing a one day Seminar on Sukuk Development next month (June 2010) in London just to address this issue.

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