Dubai World Goes Bust

Edwin M. Truman explains how the Dubai-based investment fund went from being a beneficiary to a casualty of the global credit bubble.

Edited transcript, recorded December 1, 2009.

Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics. Edwin Truman, senior fellow at the Institute, is one of the world's leading experts on sovereign wealth funds. He's here to talk about the shaky turmoil surrounding the Dubai World situation. Thanks for joining us, Ted.

Edwin Truman: My pleasure.

Steve Weisman: Readers of the financial pages are watching the resolution of the fund that's known as Dubai World. What is Dubai World and why do we care?

Edwin Truman: Dubai World is a holding company, which is largely owned by the government of Dubai, but it's a separate entity. It has many pieces: one major piece [operates] port facilities around the world. Another piece is a subsidiary that builds real estate investment in Dubai, which is the principal problem. A third is a sovereign wealth fund called Istithmar.

Steve Weisman: Americans remember when Dubai Ports sought ownership of port facilities several years ago. That was blocked on political/national security grounds. But that's not the fund that's in trouble now—

Edwin Truman: It is a component of Dubai World. Dubai World, as a huge holding company, has a number of these subsidiaries and some of these subsidiaries have taken on large debts, and those debts are coming due, and they apparently didn't have the cash flow to service or roll over those debts. And so that's why they called for a moratorium to renegotiate the terms of the debts.

Steve Weisman: How did they get into this trouble?

Edwin Truman: I think it's part of the global credit boom, so they are a beneficiary and then a casualty of the global credit boom, which brought down many financial institutions around the world or shook many financial institutions around the world. They took on too much credit and expanded too fast, including in the construction business there in Dubai, also other places around the world. And basically, their cash flow couldn't handle the debt and so they have to ask for restructuring.

Steve Weisman: They built, as everyone was following it now can see, a lot of kind of pleasure palaces, commercial complexes, luxury hotels, indoor ski resorts in the desert, artificial islands. What were they thinking?

Edwin Truman: Dubai has developed itself or saw itself as the financial hub of that part of the world. As they often put it, between Singapore and Frankfurt, there's no financial hub. So they were trying to build themselves up as a major financial hub. They already had been very successful with their ports operations and they were then into, basically, the real estate business.

And in some sense, the collapse is not any different than the general collapse of commercial real estate in the United States, except that this country, which is only slightly larger than Rhode Island, at one point apparently had one quarter of the construction cranes operative in the world operating there. So when the crash came from the world and around the world, everything stopped. But they had in fact stopped a lot of their construction and put many of their plans on hold and then were hoping, I guess, that they'd have enough cash flow to service the debts and be able to get restarted again. But obviously, things caught up with them.

Steve Weisman: Dubai, as you said, is a country. But it's actually a part of a federation of seven emirates known as the United Arab Emirates and Abu Dhabi is the big cheese in that emirate circle. Is Abu Dhabi or is the central bank of the United Arab Emirates inclined to bail out Dubai?

Edwin Truman: I think we actually don't know. This is a complicated process. The United Arab Emirates as a country is only 38 years old. Its confederation only got put together finally in its current form in the early 1970s. And so they're feeling their way. The central bank is located in Abu Dhabi. It has advanced some credit to institutions in Abu Dhabi and banks around the United Arab Emirates in general. The problem is that there is a certain amount of reluctance to bail out, to use that term, Dubai and these somewhat very grandiose plans.

And it's a bit like, if we want to put it in American context, asking Texas to bail out California, and that doesn't actually go down very well on this political system. Even if in the end, Texas, through the federal system in our case, might end up bailing out California. But it hasn't happened yet and so I think there's some tension between those two city states in terms of what they were doing. And the view, with some reason, has to be that in some of it, that Dubai was being profligate with its money.

Steve Weisman: Right. I mean the analogy is that Texas, which has run a pretty tight ship fiscally, is not in the kind of bad shape that California is in, with large civil service, university, public expenditures. Also, isn't there some discomfort in the rest of the Gulf and in the Arab world with the sort of materialist activities there?

Edwin Truman: Yes. I think there are some tensions there and it's again, a young country in a part of the world which until recently hasn't operated by the standards that we, in our cultural way, apply to other countries. And it's not as if Abu Dhabi after all also hasn't had a huge building boom. It's just been relatively more restrained than in Dubai. And I think that's part of the issue, that the country, their region as a whole—especially with the run-up on oil prices through the last decade—has done very well.

Steve Weisman: They still have oil so they still have funds. Do they have the resources in the Gulf and in the emirates to bail out this situation without it spreading like a contagion?

Edwin Truman: I think that question is going to be the nature of the deal. And my guess, which is only a guess at this point, is that the creditors of Dubai World will not be asked to take a write-down and therefore absorb material losses, but will be asked to stretch out their obligations.

Steve Weisman: And those creditors include financial institutions and other entities where?

Edwin Truman: Principally as far as we know, some of them are based actually in Dubai. And indeed, Dubai was setting itself up as a financial center. So in some sense, it was saying to financial institutions from around the world: you want to get in on the ground floor, come here to Dubai and by the way, lend us some money.

But it looks like the predominance of the exposures—or a large fraction of the exposures—are British-based institutions: Standard Chartered, Hong Kong and Shanghai and some of the British-based institutions, which historically have had a lot of their activity in the Gulf. You can be sure that all major financial institutions around the world had a piece of the action. Now, they will have to go through it just like any other big restructuring.

Steve Weisman: To what extent is that jeopardizing the stability of the financial system the way the collapse of Lehman Brothers did last year?

Edwin Truman: That's my point. I suspect it's not going to be a collapse. It's not as if they're going to liquidate Dubai World. They may end up having to liquidate in some sense this real estate. But I suspect they have enough resources so that if they stretch out the payments of their obligations, they will be able to meet the obligations, presumably perhaps even at a higher interest rate. So this is a restructuring-rescheduling mode rather than a write-down.

But I think the real risks are two. One is, this is a government-owned operation and the government seems to be stepping back from its responsibilities. That raises issues about similar entities around the world thinking about what if the Treasury had walked away from Fannie Mae and Freddie Mac, for example. They weren't even government-owned but they were perceived as being government-backed. So that issue is a bit of a problem and investors around the world are saying, "Well, where do we see similar kind of—"

Steve Weisman: And where else do they see a similar thing?

Edwin Truman: One answer is in Russia. And other places where the government is pretty heavily involved. Then in other parts, perhaps other parts of the Middle East itself, where they have a pretty heavy involvement of the government. But if they can say it can happen in Dubai, then it can happen elsewhere. So it increases the nervousness and the anxiety of investors and so measures of risk aversion have gone up.

Steve Weisman: And this has affected countries that have already gone into debt for whatever reason—stimulus programs and deficit spending—in Eastern Europe or other parts of the world?

Edwin Truman: Yes, to the extent that it is a story about excessive leverage. There are other places around the world that have run up their debts, whether in Eastern Europe or some parts of Latin America or other parts of the world or Europe itself. Because we're still going through a global deleveraging process—we have transferred some of the debt to the government's balance sheet—but basically a global deleveraging process. What this proves at least to me is that even if we're largely through this crisis, there are going to be a number of aftershocks and this is just one. And there will be no doubt several more before we will treat the economic and financial crisis of 2007–2009 as history.

Steve Weisman: Ted, a last question raising the subject of sovereign wealth funds with which we started. You have produced some very important studies of this whole concept of countries using their reserves to set up these investment funds, which are called sovereign wealth funds. How big of a part of that phenomenon is this Dubai World situation?

Edwin Truman: The sovereign wealth funds, like almost any investor going into this crisis who wasn't a hundred percent in cash, took their losses—paper losses. On average, they lost 20 percent or 30 percent on their portfolios. Any diversified investor of the world, that happened.

That's what happened to Harvard and Yale endowments. And the sovereign wealth funds in the Middle East have, we assume, suffered similarly and in particular, Istithmar, which is the one that is under the Dubai World—they actually have two others in Dubai—it has had some troubles with its investments. And there has been some turnover in their management and some questions about their judgment and worse over the course of this year. So they certainly have been hurt.

One particular problem, which is somewhat indicative of the general Dubai problem, is that these entities operating in this part of the world don't yet fully play by what I would call Western standards of transparency and accountability. Now, they're pulled from the West onto these kinds of firms. So for example, in the case of Istithmar, on my scoreboard for sovereign wealth funds, its score is at the bottom. We know something about their investments. They own a piece of Barneys Department Store,—luxury store. But we don't really know much about their size and their strategy and what their objectives are, and how they've organized themselves. So they get a low score on my scoreboard for sovereign wealth funds.

Steve Weisman: Will this crisis change that for some of these funds?

Edwin Truman: I think likely. I would think that crises like this can have two effects. They'll say, "Gee, we have to be more secretive because we'll get into trouble." But when they get this kind of problem and when you had the Asian financial crisis and the Mexican crisis, the result was that countries had to commit themselves to providing more data, more consistently, more regularly to investors. In some sense, Dubai has surprised its investors. If they're going to recover their place in borrowing and [remain] active in the financial markets, they probably will have to have a more transparent operation going forward.

Steve Weisman: Ted, thanks very much.