The Cost of Dubai World's Excesses

Mohsin Khan explains how Dubai World's problems might imperil the future of Islamic bonds, hamper borrowing in the Gulf, and fuel demands there for more transparency.

Edited transcript, recorded December 8, 2009.

Steve Weisman: The financial difficulties of Dubai World shook the financial markets all over the world in November. Mohsin Khan, senior fellow at the Peterson Institute for International Economics, is here to discuss the repercussions and causes of the financial crisis at Dubai World. This is Steve Weisman with Peterson Perspectives at the Institute. Welcome, Mohsin.

Mohsin Khan: Thank you very much, Steve.

Steve Weisman: Mohsin, what exactly happened in November with Dubai World?

Mohsin Khan: What happened really was that one of Dubai World's holding companies—Dubai World is a holding company—Nakheel, which is a construction company, found it very difficult to meet its debt obligation coming due on December 14. And that led to this standstill [agreement] proposed by Dubai World on its entire debt through May of 2010.

Steve Weisman: How much debt?

Mohsin Khan: Dubai World has about $26 billion worth of debt. The note coming due on December 14 is only is $3.5 billion. It's an Islamic bond.

Steve Weisman: The total debts outstanding for Dubai World were in the range, I think, of $60 to $80 billion, a tiny fraction of global debt. But as with Lehman Brothers or other crises, it did shake up the financial markets temporarily. Why?

Mohsin Khan: Partly I think it has to do with the fact that it was a surprise. It came as a surprise for two reasons. One, the surprise was that, in fact, Dubai World supposedly enjoyed the full support of the government of Dubai, which in turn enjoyed the full support of the government of Abu Dhabi—its very wealthy neighbor or fellow Emirate. That was a surprise. The second surprise was the timing. The debt of Dubai World was really coming due in May of next year; May 30 was the next big payment. Nakheel had to, in fact, pay its creditors on December the 14 and the next round was coming up on May 30 of 2010. So, why now? Why go through with this? Of course you have people saying, "Well, they knew all along that there was a problem and that this was coming." But I think that's sort of—in my view—sort of ex post rationalizing. Now, I think the world was really surprised, both by the fact that it was Dubai and the fact that the timing was so sudden.

Steve Weisman: Everybody thinks of the Gulf countries and the Emirates—Dubai is one of seven Emirates in the United Arab Emirates—"Oh the Gulf, they've got a lot of money from oil." "They have a lot of smart people." "They're spending it sensibly no doubt." Tell us a little bit about why Dubai got into this situation.

Mohsin Khan: I'm not sure we can actually say they weren't spending it sensibly, to cover the entire group of Gulf countries or even the Emirates that make up the United Arab Emirates. There was—it's true—a lot of easy money around, for the last couple of years. There was a construction boom, which sounds familiar to people here. Very large investments were taking place in construction. And when the bubble burst, you had the classic situation where Nakheel the construction company was stuck with a lot of large, unfilled, unfinished buildings. And it had at the same time—whose value was falling day by day—it had these debts. It borrowed a lot to finance these debts, basically, and it found itself in deep trouble.

Steve Weisman: And another aspect of this was that people expected either the Central Bank of the Emirates or Abu Dhabi—the rich neighbor—to come in and help Dubai. Why didn't that happen?

Mohsin Khan: Well, that's a very interesting question, Steve. As I said earlier, one big surprise was why did [the] Dubai government come in and announce a standstill instead of saying, "No, we'll support the debt of Nakheel and also of Dubai World."? All along people have assumed—I think all market analysts assume—that behind Dubai stood Abu Dhabi, the rich neighbor, the rich Emirate. The ruler of Abu Dhabi is the president of the country. The ruler of Dubai is the prime minister of the country. These are the two big Emirates. Abu Dhabi is oil rich, extremely wealthy. They could very easily support them.

Well, what happened was for the last few weeks, when there's been some chatter about what's happening with Dubai, Abu Dhabi did not come out and say clearly that they would kind of support [Dubai]. In fact, they said nothing at all, and that made people more and more nervous. Then when the standstill was announced, I think people didn't quite realize just what kind of a contagion it might create. And it did create some, because credit default swaps with Abu Dhabi went up and there was actually no reason why they should. People began to wonder about Qatar, another country here in the Gulf that is extremely wealthy too. I would say that Qatar is probably one of the wealthiest countries in the world. Questions were raised about Kuwait and so on. So there is a contagion effect that has occurred from Dubai, which is unfortunate because Dubai is a special case. Dubai has very little oil. It depends on services—financial services and, of course, it's built itself up as a tourist hub. It doesn't have oil or gas, like the others do, that can stand them in good stead in bad times. Dubai did a lot of borrowing in the financial markets. But one thing to remember is of course, not all of their borrowing was foreign. They were borrowing from local banks. They were borrowing from Abu Dhabi banks. The biggest loans they've had are from two state-owned Abu Dhabi banks. Very recently, they got a $5 billion loan from two Abu Dhabi state-owned banks a day before they announced that, in fact, they were going to have a standstill. So it's still a bit of a mystery.

Steve Weisman: Why did Sheikh Khalifa, who is the president of the United Arab Emirates, not come to the rescue of his cousin—I think you said—Sheikh Mohammed in Dubai?

Mohsin Khan: Well, it's difficult to say what's going on. It's a family matter—very difficult to know.

Steve Weisman: A family matter with global financial repercussions.

Mohsin Khan: And that is true. But not as global as some people have made it out to be, Steve. The fact of the matter is that Abu Dhabi has now said, "We're going to look at this on a case by case basis." This is, we're not going to give a blanket guarantee to Dubai World's debt. The interesting thing is it would be strange for Abu Dhabi to now say, "We guarantee Dubai World's debt" when the government of Dubai is saying that Dubai World is a private corporation, and [Abu Dhabi] doesn't have to guarantee their debt. It's a private corporation and the shareholders of that are the government, yes, but investors and creditors will lose if this firm goes—if this big company goes under; so will the government. So if the government of Dubai—which is the owner of Dubai World—is saying "This is a private corporation," it's more difficult than for Abu Dhabi to come in and say, "Ah, but we'll support it." So I think there's a sort of a waiting game—if you like—being played out here. That being said, there are a lot of people making out that somehow this is a sort of double dip coming. There may be a double dip in the Gulf, certainly. I mean, growth in the United Arab Emirates would be lower and so and so.

Steve Weisman: You mean this could lead to a further repeat of the economic downturn?

Mohsin Khan: That's correct. But not for the world at large because we're talking about very small amounts and in the limit. I mean, $80 billion is the total debt of Dubai and that doesn't have to be paid off until 2012/2013; that's the maturity of the debt. Eighty billion is nothing compared to the assets that Abu Dhabi has. People estimate it has anywhere from eight to ten times that amount in assets. People also forget that the debt of Dubai is $80 billion but the assets are $75 billion. Now of course, $25 billion of those are in land and real estate, etc., whose values fall and they're illiquid. But they still have assets so yes, you might say there's negative net worth but it's not by much.

Steve Weisman: Has this chapter been resolved?

Mohsin Khan: My own feeling is that this will get resolved very soon. The interesting question that comes up is what's going to happen on December 14 with this Islamic bond coming due? Because that raises a whole new set of issues. You know an Islamic bond would be—this would be probably the first time that an Islamic bond is defaulting. And certainly, the first default in the United Arab Emirates of any bond. The default of an Islamic bond creates a number of legal issues [for] both Islamic law and, in fact, UK law because these bonds are governed by UK laws. However, an Islamic bond has to be backed by a real asset, like a building or a ship or something like that. However, the ship or the building or the real asset is located in Dubai. And it's an interesting question as to whether, in fact, if the UK law says "Fine, the creditors can have the real asset now," which is what they would want. The fact of the matter is, it would then go to the Dubai courts, to see whether they could have the assets that are underlying this bond—which are unfinished buildings and villas, etc., in Dubai.

Steve Weisman: So they're not out of the woods.

Mohsin Khan: No, they're not out of the woods, because I think these things still have to be played out, but—

Steve Weisman: But the global economy is not imperiled.

Mohsin Khan: I don't think the global economy—I mean, there are some doomsayers who would say that this is a sign that, you know, we're going into a worldwide recession again. I think that's just stretching it tremendously because that's not going to happen; this is a small thing. And as I said before, Abu Dhabi can easily take care of this problem.

Steve Weisman: A small thing but an interesting thing.

Mohsin Khan: It is very interesting. There are a lot of issues there. I mean the second consequence it will have, I think—which I should mention—is that it's going to do two things. One, it's going to create a problem with Islamic bonds in the future. A number of companies and corporations—including the World Bank for that matter—were issuing these kinds of bonds. It's going to be more difficult now. People are going to want to know where exactly the asset is. And in fact—in the case of default, which nobody ever worried about before—in the case of default, can we recover this asset? That's one thing that's going to be it. The other thing is it's going to be more difficult for corporates in the Gulf to be able to borrow abroad; banks are going to be much more reluctant. And the third, if I might mention, is that I think that should push these guys into more transparency and communications. I heard a wonderful story about this, the head of Barclay's Capital in Dubai—who have credits outstanding in Dubai, not just Dubai World but Dubai in general, of close to $2.5 billion, including too Dubai World, that's a part of it—heard the news while driving home in the car on the radio, that a standstill had been announced. I mean, big creditors were not informed. Nobody was informed. This was just the night before—

Steve Weisman: It's an astonishing lack of transparency.

Mohsin Khan: Absolutely. And I think people are going to call for much more transparency now whenever they put their money into these kinds of assets.

Steve Weisman: Mohsin Khan, thank you very much for walking us through an interesting, complex situation.

Mohsin Khan: Thank you very much, Steve, for having me.