The world's next economic hot spot?

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Jeffrey Born, professor of Finance and Insurance Photo by Craig Bailey.

(PhysOrg.com) -- A bailout by neighboring emirate Abu Dhabi has apparently stabilized Dubai's financial crisis. But the longer-term economic impact—on Dubai and other nations—could grow more serious.

Professor of Finance and Insurance Jeffrey Born says the possibilities range from a prolonging of the recession in some Western economies—especially the United Kingdom—to a more serious credit crisis for Islamic economies.

When people think of Dubai, they think of extravagance. Can you give us a brief historic perspective on the financial rise of the United Arab Emirates?

On an area of the Arabian Peninsula on the south coast of the Persian

Gulf lie seven sheikdoms that formed a confederation known as the United Arab Emirates (UAE) in 1971, when a 100- year protective treaty with Great Britain expired. Dubai is the second-largest emirate and it takes its name from the major port city located on the Gulf. The confederation members use a common currency, the UAE dirham, but each has its own legal system and constitutional monarchy. Oil, discovered in the early 1960s, accounts for 25 percent of the UAE's total GDP, which rose to $206 billion in 2008. For comparison, when formed, the UAE had a GDP of approximately $1.5 billion. Linkage of the UAE dirham to the U.S. dollar has led to significant inflation, but nonetheless, real growth rates have been amongst the highest in the world since the mid 1970s, and the creation of OPEC.

Dubai World is the investment conglomerate that many blame for the current economic crisis*. What is their role in the downfall?*

Dubai World [DW] is a royal family-controlled holding company that is the vehicle for development in the Dubai Emirate and its efforts to diversify the economy. For example, DW is a 50-50 partner with the MGM Mirage in the $8.5 billion "City Center" development in Las Vegas that has had significant troubles, and DW bought the New York City-based retailer Barneys for $850 million in 2007. Amongst its subsidiaries is the real estate development company Nakheel, which is best known for its palm tree- shaped housing development in the Gulf that can be seen from space.

It was the announcement by this subsidiary that a scheduled repayment of $4.1 billion of Islamic Bonds would not be made—and that neither the emirate nor the emir planned to rescue DW—that triggered the crisis. At the last moment, the largest emirate, Abu Dhabi, announced that it would loan $10 billion to Dubai (which would then loan funds to DW in order to pay off the debt) to avert the collapse of the holding company.

There has been speculation that Dubai might face a double-dip recession in 2010. What does this mean for the region? For the West?

Notwithstanding the successful debt repayment, DW is going ahead with plans to ask lenders for a “stand-still” (no accrual of interest) on nearly $26 billion of real estate-related debt. In the short run, this is causing real estate investors to look toward Abu Dhabi as a safer haven within the UAE, which will almost certainly depress values in Dubai even more. With real estate development accounting for about a quarter of GDP in Dubai, continued softness in real estate will no doubt extend or worsen the recession. United Kingdom-based banks have made large loans to DW, increasing concerns about an already fragile financial system there and perhaps extending their recession even longer. Japan, China, and the U.S. are the major exporters to Dubai (and the UAE), and further belt-tightening may reduce the speed at which these economies rebound. But Dubai is a very small market. Our exports amount to just $1.4 billion out of a total of more than $1.8 trillion annually.

How is the crisis in Dubai affecting the rest of the world today, and what might its impact be longer-term?

The short-term response to the DW crisis was to create the second “flight to quality” in less than 12 months. Nervous international investors dumped risky assets, converted their funds to U.S. dollars and bought U.S. Treasury securities. The flow of funds toward the U.S. caused the dollar’s value to rise and yields on short-term U.S. government bonds to plummet. Now that the crisis is subsiding, the capital is flowing back out of the U.S., causing the dollar to give up some of its recent gains and Treasury yields to rise slightly.

Long-term, the near-default of an Islamic Bond has caused investors worldwide to contemplate the riskiness of these securities. Under Islam, as applied to finance, borrowers and lenders are more like “partners,” and payments to investors (not referred to as 'interest') are not guaranteed. Any disputes would almost certainly be adjudicated locally. Thus, the huge growth in Islamic debt that has taken place in the past decade may slow substantially, to the detriment of many Islamic economies.

Is Dubai, in the well-worn phrase of the day, too big to fail?

It is impossible to know the full extent of borrowing that has taken place in Dubai, but estimates are that the amount (including DW) exceeds $100 billion—roughly three times the GDP of the emirate, making it one of the most leveraged states in the world. With small and rapidly dwindling oil and gas reserves, Dubai needs to be successful in its efforts to transform itself or its income levels could fall.

U.S. firms such as EMC, IBM, and Microsoft have a large presence in Dubai, UK-based banks have made large loans to DW, and the debt securities have been popular investments of oil-rich countries in the region. With so many powerful and vested economic interests in Dubai, some form of bailout was virtually assured. The Abu Dhabi funds appear to come with significant "strings" attached, signaling a slow-down in what has been very rapid growth area in the world.

Provided by Northeastern University

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