

## A financial sandstorm

*The global consequences of Dubai's debt problems.*

For years, Dubai strove to capture the imagination of the financial world, projecting its young financial centre as a "global gateway" for capital. Last week it succeeded in grabbing attention. Its announcement that it would delay repayment of the debts of Dubai World, a vast government-owned conglomerate, swept through global markets like one of the blinding sandstorms that occasionally afflict the emirate, obscuring the gleam of its skyscrapers.

Like those storms, Dubai's announcement was so damaging because it reduced visibility. Investors had assumed that the Dubai government was willing to rescue the indebted conglomerates it sponsors, and that Abu Dhabi, its well-heeled neighbouring emirate, was willing, in turn, to rescue Dubai. In particular, they had looked forward to the full and timely repayment of a \$3.5 billion Islamic bond issued by Nakheel, a Dubai World subsidiary, on December 14th.

Dubai's failure re-awakened a number of dormant fears in investors. Some worried about banks that had lent heavily to the region. Others wondered if Dubai was carrying far more than the \$80 billion or so in debt that it has owned up to. The announcement reminded investors that tacit sovereign guarantees may be worthless. Earlier in November, for example, Ukraine's state railway firm, Ukrzaliznytsya, failed to repay part of a syndicated loan, and its energy firm, Naftogaz, restructured its debt.

More fundamentally, Dubai's wobble raised the spectre of a sovereign default. Dubai's government is not technically on the hook for Nakheel's debts. But the government's hesitation in saving its national champions nonetheless demonstrates its fiscal limits.

Elsewhere, governments have emerged from the crisis burdened by debt. Both Greece and Ireland are carrying heavy public liabilities denominated in a currency (the euro) that they cannot print. Doomsayers worry that the world has escaped from the financial frying pan into a fiscal fire.

These wider fears are easy to exaggerate. Despite its self-aggrandisement, Dubai is not yet important enough to bring down the global financial system. Its troubles moved markets last week partly because so many traders were on holiday. Other investors were looking for cues to sell after the long rally in markets since the spring. By Monday November 30th, the principal stock indices were shaking off the dust and venturing upwards again.

But the damage Dubai has done to itself is no passing storm. An emirate that has spent so much money and hired so many flaks to cultivate its image and inspire confidence saw much of that work undone in a single 200-word statement announcing the debt standstill.

Had it announced the restructuring a few months earlier, with the ground properly laid, investors might have taken it in their stride. Those who lent to Dubai World at a premium can have no complaints if the risks for which they were compensated turn out to be real. And a standstill may buy time for the deeper restructuring that Dubai World undoubtedly needs. It is better to weed out the bad businesses within the group rather than cross-subsidise them to save face.

But Dubai had led investors to expect that publicly traded instruments, such as sukuk, or Islamic bonds, would be honoured. And the government offered no satisfactory explanation for its sudden change of stance. Thus even as markets slumped, political speculation mounted. A week earlier, Sheikh Mohammed bin Rashid al-Maktoum, Dubai's ruler, had sidelined three of the men who ran "Dubai Inc" in the boom years. Perhaps, then, the standstill was the result

either of a power struggle within the ruling circles of Dubai, or between Dubai and its neighbour, Abu Dhabi.

Abu Dhabi's conservative rulers have mixed feelings about their brash, go-getting neighbour. They may have asked why they should rescue Dubai from the consequences of its own prodigality. Or why they should resuscitate bankrupt Dubai firms that will compete with Abu Dhabi's own national champions? At the weekend, a senior Abu Dhabi official told Reuters that it would "pick and choose" which of Dubai's entities to help.

But many investors in Abu Dhabi bought into the Dubai boom. They will lose money if the bust turns into a protracted slump. And of the banks most exposed to Dubai, several have headquarters in Abu Dhabi. Thus the central bank of the United Arab Emirates has made it clear that it will provide liquidity to any bank, foreign or domestic, operating in the United Arab Emirates. Dubai is not yet a gateway to the financial world. But it can open the door to all sorts of trouble in its neighbourhood.

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