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DAILY GLOBAL COMMENTARY

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Dubai's Latest Mega-project – A Massive Default?

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Over the past few years, Dubai has built a reputation not just locally but worldwide. As the fastest growing of the seven emirates making up the United Arab Emirates, it has become known for its astonishing creations – the largest manmade islands (three at latest count), one of the world's largest ports, and the Burj Dubai – the tallest manmade structure in the world. Unfortunately, its latest creation is not receiving the same kind of oohs and ahhs. The announcement on Wednesday requesting a six-month payment freeze on the $59 billion in debt issued by Dubai World, a state-run conglomerate behind all this grand development, made markets shudder at another prospect – the largest sovereign default since Argentina in 2001.

While technically this week's announcement does not yet constitute a formal default, international markets are treating it like one. Credit default spreads have broadened to what one analyst called "Icelandic" levels, investors have cut back positions and headed for the safety of the US$(?), and everyone is reconsidering just how safe some safe bets are. If a shamelessly-wealthy Gulf country could potentially default, what about countries with rising debts, huge deficits and shaky recoveries?

The complexities of the UAE's governmental structure make the situation difficult to grasp at first glance, but the problem can be captured by a few basic points. First, Dubai is the second-largest emirate in the UAE next to Abu Dhabi, but Abu Dhabi is also the power of the national government and has been challenged by Dubai's meteoric rise. Next, the UAE has a sovereign wealth fund estimated at one half-trillion dollars in case of emergency, so money is clearly available at the national level to bail out Dubai if that route is chosen. Lastly, the national government wants to emerge from this situation with international markets assured that a state-run entity has the backing of the government and will be subsequently subject to reform and accountability. Taken together, these points plus an appreciation of the politicial undercurrents suggest a scenario that avoids outright default.

In our base case, Abu Dhabi offers support from a national level so Dubai World can meet its financial obligations and implement some debt restructuring, all in exchange for ownership of significant Dubai-owned assets – Emirates airlines has been suggested in recent reports. In addition, Abu Dhabi forces Dubai World to restructure its business model from the dysfunctional "build it and they will come" ideal. These conditions would satisfy Abu Dhabi's emirate-level interest in retaining dominance while also securing the national interest of retaining some international market confidence, all while avoiding a formal default. We will be monitoring events for key markers suggesting this scenario is playing out – replacement of Dubai World board members by more technocratic people favored by Abu Dhabi, the transfer of Dubai's assets, and a general humbling of the indebted emirate in a way that places Abu Dhabi firmly in charge.

However, it would be irresponsible to not also mention what worries us looking forward. Aside from the off-chance that Dubai and Abu Dhabi are unable to converge on a cohesive recovery, what are the chances that Dubai World is just the first of more possible defaults to come? Since the UAE does not release public debt figures and estimates are sketchy at best, there is a chance that another public company could announce an excessive financial burden and a need for bailing out. This applies not just for the UAE but for any of the fast-developing Gulf countries experiencing an asset bubble collapse. With widening credit default spreads throughout the region and even into emerging Asia, any entity dependent on the recent flood of cheap money to roll over its debts could easily find itself out of options. Few would be as singularly vulnerable as Dubai World, but a significant default could set forth a vicious cycle of contraction and collapse that could take a number of victims.

The first sign of things to come could be as early as the first week in December, when Gulf markets re-open from the Eid al-Adha holiday (Dubai World announcing its debt postponement plans just before Eid celebrations was in all likelihood not a coincidence). This will mark the first chance for officials to state positions and make confidence-building claims, with the further interest of calming international markets. Between that time and the December 14 due date for Dubai World's next debt payment, we expect to see a concrete plan laid out for bailing out the conglomerate and some pressure taken off the credit markets. However, if no settlement can be reached, it would not surprise us if another major entity started talking about restructuring or a debt freeze before year-end – and not necessarily a company in the UAE.