Dubai's $59 billion default sends tremor through global financial system

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Dubai's announcement on Wednesday that it would be delaying by "at least" six months the maturity date of $59 billion in bonds issued by the city-state's largest state-owned company, Dubai World, has sent global shares tumbling. The market reaction to Dubai's massive debt default is partly explained by the exposure of European and Asian banks to DP World and its tourism subsidiary, Nakheel.

The real reason for the falls, however, is that Dubai's apparent insolvency confirms that default by hyper-indebted government borrowers is now a real risk right across the globe, especially in the Middle East and Eastern Europe. Such a default would not only mean an immediate worsening of the already brutal post-crash conditions suffered by millions of workers in defaulting countries, but would usher in a second, and probably worse, phase in the global financial crisis.

A note published by Bank of America strategists warned of the possibility of a major sovereign default. "One cannot rule out—as a tail risk—a case where this would escalate into a major sovereign default problem, which would then resonate across global emerging markets in the same way that Argentina did in the early 2000s or Russia in the late 1990s," the note said.

An editorial in today's *Financial Times* noted that while markets were not expected to return to the panic of September 2008, because the financial sector had state backstops, "fearful investors have started to worry about how safe sovereign debt is," citing Ireland and Greece as two examples.

The Dubai meltdown represents only a small sum in terms of total global indebtedness. Nevertheless it indicates that despite talk of global economic recovery, the world remains on a knife-edge. Attempts at reassurance by British prime minister Gordon Brown indicate that financial and government elites are already fearful. Brown this morning acknowledged the risk that Dubai posed to the global economy but, with careful understatement, told reporters "I think we will find this is not on the scale of the previous problems we have dealt with."

Market falls on news of the Dubai crisis were sharpest in Japan, where a number of banks (including Mitsubishi UFJ and Semitoro Mitsui) are directly or indirectly exposed. Japanese shares plummeted 3.2 percent yesterday—the market's largest one day decline in 8 months. A 2.9 percent fall in Australia the same day reflected the fact that a Dubai World subsidiary, stevedoring company DP World, carries one third of Australia's sea cargo. In New York, the share index opened 2 percent down and only partially recovered those losses. Forty-four billion British pounds has been wiped off the London market, the largest single day loss since March. Shares in UK bank HSBC fell 7 percent. HSBC is reported to have lent Dubai $17 billion. Other UK banks with a Dubai exposure are Standard Chartered, Citigroup UK, Lloyds and Royal Bank of Scotland, an institution now majority-owned by the UK government, which has received more bailout money ($67 billion) than any other bank in the world.

Dubai World accounts for three quarters of the $80 billion borrowed by Dubai's state-owned companies to fuel the emirate's property boom. That boom—which came to an end when property values halved in a period of weeks from October 2008—was an expression of the global elite's fantasy of endless wealth, with Dubai's ruling family creating a desert playground for the global rich. Its most notable features were the world's tallest building, a giant indoor ski slope and a series of vast man-made islands in the shape of palm trees and stars. Dubai World, which manages billions in construction projects, also used its foreign borrowings to diversify into global transport, especially ports and shipping. DP World is the largest port operator in the Middle East.

It is testimony to the anarchy and irrationality of the global financial system that although the scale of the Dubai crisis has been apparent for months, the government's default announcement still caught global markets unawares. Banks had apparently assumed the existence of an implicit government guarantee of DP World's debt, if not by the Dubai government, then by Dubai's sister emirate, oil-rich Abu Dhabi. But there was no guarantee—Dubai World is a limited liability company owned by the Dubai government. The expectation that Abu Dhabi would rescue foreign investors was just idle hope.

Along with worldwide share market falls, the immediate effect of the Dubai default has been a surge in the insurance costs for national borrowings, especially by poorer countries. That cost is represented in the price of credit default swaps (CDS) on government bond issues. Greek CDS costs in particular have skyrocketed, raising fears that Greece, with public debt levels at a staggering 130 percent of GDP, will follow Dubai within weeks. CDS costs for Hungary have also soared since Wednesday, and there have been CDS price increases of about 11 percent for Malaysia, South Korea and Qatar.

These developments are by no means unforseen. Rather, the Dubai default is a lit match for ready-to-burn tinder, namely global sovereign debt levels. The key response of capitalist institutions to the global financial crisis has been to transform the toxic debts and unsustainable borrowings of private institutions into public debt via bail outs, guarantees and other stop-gap mechanisms. According to new estimates by Moody's, the credit rating agency, the total stock of sovereign debt worldwide will have risen by nearly 50 percent between 2007 and 2010 to $15.3 trillion.

This ballooning of sovereign debt has been so fast and so immense that there is little chance of debtor governments, mired in unemployment and low growth, repaying either in the short or long term. As borrowing costs increase because of the perception of increased default risk (also called 'long tail' risk), the situation for indebted countries becomes worse. Global funds available for such borrowings are also drying up. While Greece, Hungary, Latvia, Estonia and Turkey are at the top of the global watchlist, default is also an eventual likelihood for the United States, which has public debts of $12 trillion. The key difference between the United States and smaller states, in this regard, is that the US is currently deemed by its bondholders, including the Chinese government, as 'too big to fail'.

The Dubai default also pierces claims that allegedly well-managed and well-regulated national portions of the world economy can escape the effects and aftershocks of the financial crisis. Government and the corporate press have claimed that Australia, for example, is immune. But it is now likely that DP World's Australian ports—a substantial piece of that country's infrastructure, currently worth $1.5 billion—will have to be sold in the near future. Early reports indicate that there is unlikely to be strong interest and there may be no buyers. Few local companies have funds of that scale to invest in what is now, in the context of an uncertain future for global trade, a very risky asset.