

framework to protect the masses from the financial crises that are perpetuated by greed in absence of adequate statutory and institutional controls on the functioning of the financial institutions.

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The rise and fall of Dubai

Aastha Gupta

In his book "Manias, Panics and Crashes: A History of Financial Crisis", Charles P. Kindleberger provides an extensive historical account of financial crises analyzed within Minsky's framework. It starts from an autonomous shock to the economic system that alters profit opportunities; the shock can either be the outbreak of war or a bumper crop or a technological advancement or an oil shock, which creates a feeling of buoyancy and leads to a reordering of investment priorities. Consequently, there is an investment boom which may result in 'euphoria' and 'overtrading' i.e, positive (and even outlandish) expectations driving up future prices, followed by more investors entering the market to speculate and earn profits. But the boom may subside by itself

when expectations of its subsidence are caused by the inability of a few investors to repay, which sets in motion a stampede for liquidity. This rush back into money triggers panic, seizure of credit and eventually crisis.

Dubai exemplifies a similar boom-bust phenomenon. The economy was steered by the speculative excess and over accumulation of the boom, which was the outcome of the growth strategy followed by its ruler Sheikh Mohammed bin Rashid-al-Maktoum. The objective behind such a strategy was to transform oil-poor Dubai from an Arab backwater into a global city, so that by the early years of this century, it had become a global hub: the largest international financial centre between Singapore and Europe. But with the current financial crisis, the ensuing contraction in aggregate demand all over the world has led to an inevitable crash that was followed in Dubai. This became clear by the sudden announcement of the state-owned conglomerate, Dubai World, on 25 November, 2009 that it would suspend payments on its \$26 billion debt- these loans involved payments to bondholders of the world's biggest sukuk or Islamic bond issue. It is the presence of this instrument that has thrown serious doubts on the Islamic financial system, particularly, when it was believed that this segment was relatively unaffected by the ongoing crisis.

Dubai is one of seven small states that make up the United Arab Emirates (UAE), and in terms of the size of its economy, it is second to Abu Dhabi (which has most of the oil reserves). Although the economy of Dubai was originally built with the might of oil, but with a significant decline in its oil reserves, revenues from this sector currently account for less than 6% of its

total revenues. Thus by late 1980s, Sheikh began the process of transformation by adopting a strategy to diversify the economy away from oil and a shift to trade, finance, tourism and shipping as engines of growth. Hence, exemptions from corporate taxes, import and export duties were given to international companies which were accompanied by an absence of restrictions on the movement of funds, tax-free incentives and an easy hiring of labor. For instance, the Jebel Ali Free Zone (JAFZ), an industrial area surrounding the port 'Jebel Ali' in Dubai, was established during this period to lure foreign investors. The combination of a huge port and a tax-free industrial zone enabled Dubai to become a major entrepôtcentre and became a transshipment zone serving the Gulf region.

As a result of its continued growth, Dubai owned a world-class air carrier in Emirates Airlines and an iconic seven star hotel 'Burj al-Arab' within a decade. The subsequent decade saw its emergence as a global financial hub of the developing world. It was during the early years of this decade (i.e. 2000s) when the Government created holding companies that spanned the public and private sectors, namely, 'Dubai Holdings', 'Dubai World' and 'Investment Corporation of Dubai', each include several property developers with significant interests in trade & services. All of them pursued business activities designed to achieve profits for private sector investors and were encouraged to buy companies around the world.

The huge expansion seen in Dubai's economy during the period 2002-07 has been partly funded from an increase in borrowing from abroad; Dubai-based corporations became the major borrowers in international capital

markets, at the same time, the UAE banking system also procured loans, although it had adequate capital and remained profitable until mid-2008. These vast sums were borrowed to finance rapid growth, especially in real estate, which heightened the exposure of the financial system to consumer and real estate loans. This was further propelled by strong speculative increases in the value of stocks and real estate that created an uncertain future for asset prices. In view of this, acceleration in the growth of credit to the private sector was observed, which in turn, raised risks from the increase in non-performing loans. Consequently, loans-to-deposits ratio of the banking system rose continuously.

Dubai's success was also intensified by its involvement in re-exports. As a transshipment centre, it imports billions of dollars of goods that are subsequently sold mainly in Iran and Russia. This, in turn, has attracted Iranian investments and thousands of Iranian residents.

Another crucial factor responsible for the recent boom is the huge inflows of capital and labor. This aspect can be described with the exchange rate mechanism. The UAE maintains an exchange rate pegged to the US dollar, so that 1\$ = 3.67 Dirham. Between 2005 and mid-2008, Dubai's GDP grew by an annual average rate of 7.8% in real terms, while its inflation rate doubled from 6.2% to 12.3% during the same period, very little of this growth is attributed to oil income since Dubai produces scanty oil. These high inflation rates along with the strong growth rate of the economy called for a tightening of its monetary policy. However, as the credit crunch hit the US economy, it eased its monetary policy and reduced the interest rates, so that dollar

became less attractive in currency markets leading to its depreciation against a basket of major global currencies. Simultaneously, the UAE continues to stick to Dirham's peg to the dollar, thereby causing a decline in its currency against other currencies. This made UAE exports cheaper and competitive, particularly for Dubai since its re-exports also got a boost. But the country's trade with non-dollar zone (like Yen or Euro) became expensive leading to the impact of 'imported inflation'. In addition to this, UAE's tight monetary policy accompanied by an open capital account further reinforced the above process and this, in turn, added to the already high rates of inflation.

Negative real interest rates provided another stimulus to the economy. This was in consequence of high inflation rates, which exceeded the nominal interest rates, so that the cost of borrowing became essentially free. It can be interpreted like this – debt secured today will be devalued by say 5% in a year's time or that the cost of repayment will be 5% lower in real terms. In such a situation, saving is discouraged and the prices of precious metals & other commodities face an upward pressure as people seek out alternate stores of value. This makes real estate an important source of investment. Since the rental costs go up due to rising prices, buying property becomes more attractive. This also provides an explanation of the sustained nature of Dubai's property boom and a persistent rise in private sector's credit

A continuous upsurge in oil export prices in 2007 and an incessant growth of the UAE economy led to the speculation on a revaluation of the Emirati Dirham. This triggered large capital flows into the economy,

which exacerbated credit growth and inflationary pressures. In Dubai, the outstanding stock of credit to the private sector rose further and a vast speculative bubble in real estate, stocks, and bonds was thus generated. Its success became all the more illusory when it constructed the tallest building in the world and the most expensive luxury hotels, complexes and shopping malls. In contrast, other economies of the Gulf have huge oil deposits, for instance, Abu Dhabi currently has oil reserves estimated at over \$65 billion annually. They have been less integrated with the world economy and were more sober during the boom years.

This hedonistic expansion of Dubai was hugely based on global integration, be it trade or financial flows or the movement of people. An integral part of its strategy of encouraging foreign investors was to use Dubai as the Middle Eastern base for their activities in Asia and elsewhere, so was the implementation of much more liberal policies towards dress, drink and other matters of personal norms than other states in the Gulf (including those in the UAE), which proved to be a remarkable success.

The global crisis that began with the decline in real estate values in the US inevitably hit the Gulf's most globalized economy. Dubai's fall began with the outflow of capital, as investors needed money to cover their losses in the US market, and they foresaw that emerging markets would be deeply affected by the recession. Hence the greatest advantage that Dubai enjoyed over the past six years – its interconnectedness with the global economy – has come back to haunt them. From then on, the collapse of non-tradable sectors, especially real estate and construction, was immediate.

Global markets for luxury goods and services also shrank. Real estate sector in Dubai, both commercial and residential, has seen values drop up to 50% since August 2008 and the twin issues of debt & falling property prices would act as an impediment to its recovery. Jumeirah Lake Towers (JLT) serves as a convincing example of the intensity of the property meltdown; it is a landmark development of 87 towers supposed to provide housing & offices for residents and workers, but is now largely empty. Local banks are also heavily exposed to this sector. A spectacular plunge in the property prices accompanied by a shrinking population as expatriates flee from mortgages & consumer debt has complicated the bank's problems and confounded their risk-management models.

Due to contraction in the volume of world trade in goods and services because of the credit crunch, the trading and shipping industries have also been hurt. But these sectors still offer a ray of hope for Dubai's embattled economy as it has certain key advantages of a good geographical position, logistical infrastructure and very low custom duties, so that it continues to be a significant gateway for goods for the rest of the region. The main port Jebel Ali remains one of the main drivers of the Emirates' economy. No other city in the Middle East either has the infrastructure to act as a services hub for the rest of the oil-rich region or the ability to compete with Dubai in the years ahead. This may give Dubai's economy some benefit amid the turmoil since these hydrocarbon-fuelled economies are expected to rebound from the global downturn faster than other areas.

Despite the financial turbulence that has

beleaguered the world economy, the latest GDP figures of Dubai show that the economy continued with its upward trend in 2008. According to the Department of Economic Development (DED), its GDP grew by 5.7% from 2007 to 2008. But these figures indicate a sharp denial in the fourth quarter of 2008 as the recession struck home. From the second half of 2008, the economy sank and the current account balance became sharply negative. This explains that being a small, globally integrated hub, Dubai felt the full blow of the crisis. All the principal drivers of its economy into which it diversified – trade, real estate, retail, tourism, and finance – have suffered. The rate of expansion in the services industry too has slowed down as the tourist arrivals have plummeted. Wages are also falling around the region and the situation is even tougher for the manual workers who slogged on the now-desolate construction sites. Many projects have been stalled or even abandoned that several workers have been sent home on unpaid leave. It was on 25 November 2009 when the state-owned conglomerate, Dubai World, unexpectedly declared that it would suspend payments on its \$26 billion debt. The loans involved a \$4.05 billion repayment on a \$3.52 billion sukuk (Islamic bond). Abu Dhabi has already offered some assistance by lending \$10 billion loan to its debt-laden neighbor, part of Dubai's \$20 billion package launched in 2009. The Federal Finance ministry has also deposited about Dh50 billion with banks across the country. This has helped in averting the debt meltdown and improving the outlook of the region to some extent.

To conclude, the ambitious city of Dubai is one of the biggest casualties of the global credit

crunch. Strong federal support for all the UAE banks may help its economy in managing the current situation, but broader questions of speculative growth and irrational exuberance in housing and real estate sectors remain. Global capitalism is at a point where it must deal with the consequences of the previous phase of worldwide over-accumulation in these areas. As real estate prices continue to fall in the US, default and dispossession continue to increase. At the same time, the multiplier effects of the collapse of the construction sectors are still working their way through the global economy. This crisis has not only questioned the optimistic discussion of global recovery, but has also shown how this can affect the developing world.

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Latin American crisis and Comparative Lessons from it for Eurozone crisis

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In 1981-83, the world economy suffered a steep recession. Just as the great depression made it hard for the developing countries to make payments to their foreign loans-quickly causing an almost inevitable default, the great recession of early 1980s also sparked a crisis over developing countries debt. The crisis began in August, 1982, with Mexico announcing its central bank running out of foreign reserves, and that it could no longer meet payments on foreign debt. In response, banks in industrial countries, largest private lenders to Latin America, started cutting off new credits and demanding payments on their earlier loans. The result was widespread inability of developing countries to meet prior debt obligation and a generalized default.

The crisis was mainly based on the debt build-up phenomenon. So the reasons underlying the crisis were mainly the factors that led to debt build up, which were as follows:

- There was collapse of Bretton woods system, which was accompanied by the re-emergence of international capital markets and an increase in international commercial banks. Also, in