Dubai has shocked investors by asking for a debt standstill at Dubai World, the government’s flagship holding company that has developed some of the world’s most extravagant real estate projects.

The move raised the spectre of default in the Middle East’s trading hub just as early signs of economic recovery have emerged. During the boom, Dubai rode the wave of easy credit generating phenomenal economic growth but was badly hit by the global credit crisis.

Dubai’s surprise move angered some investors who had been reassured by local officials for months that the city would meet all obligations on its $80bn (£48bn) of gross debt in spite of recession and a real estate crash.

“Investors view this as shockingly bad news,” said Rob Whichello of BNP Paribas. Two hours after announcing it had raised $5bn from two Abu Dhabi banks, the department of finance asked for a standstill until May 30 on all financing to the heavily indebted Dubai World and its troubled property unit Nakheel, which is due to pay back $4bn on an Islamic bond on December 14.

Dubai also launched a restructuring of the government holding company, which oversees ports operator DP World, the UK-based P&O Ferries and troubled investment company Istithmar. Nakheel, the developer behind the city’s Palm Islands that boast celebrity owners such as David Beckham, has had to shed thousands of staff and left contractors out of pocket as local property prices halved and credit dried up.

A symbol of Dubai’s pre-crunch excess, the government company has had to cancel plans for the world’s tallest tower and a constellation of reclaimed islands, as collapsing cash flow left the developer on the brink.
The government’s announcement came after the local stock market had shut and on the eve of the Eid holidays, during which most offices will be shut until December 6.

“This will destroy confidence in Dubai, the whole process has been so opaque and unfair to investors,” said Eckart Woertz, economist with Dubai’s Gulf Research Centre.

A spokeswoman for the department of finance said the government intended to ask all bondholders to extend until May. But the government said no decision had yet been made on how to deal with investors insisting on repayment in December.

The gaping size of Dubai World’s $22bn debt problem has been apparent for a year. But the government’s level of support has been clouded by politics and a lack of clarity on how much it could raise from international markets and the oil-rich capital of the United Arab Emirates, Abu Dhabi.

Bond markets reacted sharply to the news with investors demanding higher premiums to hold debt from the region. In London trade it cost about $460,000 annually over five years to insure $10m worth of Dubai government debt against default, compared with $360,000 on Tuesday. Prices rose for its neighbours with Abu Dhabi protection $100,000 more than on Tuesday.

Standard & Poor’s and Moody’s Investors Service immediately downgraded the ratings of all six government-related issuers in Dubai following news of the repayment delay and left them on review for possible further downgrade.
Moody’s cut ratings on some government-related entities to junk status, while S&P cut ratings on some entities to one level above junk.

S&P said the restructuring “may be considered a default under our default criteria, and represents the failure of the Dubai government (not rated) to provide timely financial support to a core government-related entity.”