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In the Wake of the Dubai Financial Meltdown: More Contraction, more Defaults, more Brushfires

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The Dubai virus has been contained. There won't be another financial system meltdown. But the lessons of Dubai are hard to ignore. Global shares started tumbling at the first whiff of trouble; no one bothered waiting for the details. Someone yelled, "Fire" and the panic began. It's a good indication of how jittery investors still are.

Surprisingly, the dollar remained relatively flat throughout the crisis, hovering between \$1.49 to \$1.50 per euro. That's good news for the big banks and brokerage houses that are betting on the carry trade. If Dubai flops, the dollar will get stronger, and they'll lose a bundle. Market analysts predict that the zero-rate dollar is now funding over \$1 trillion in one-way bets. It's a risky business which could lead to another disaster.

Dubai World's call for a debt moratorium triggered an immediate shift away from emerging markets which rely on cheap credit to fund their projects. Credit spreads have widened on countries throughout Eastern Europe and the developing world. Investors are skittish and want to see how much red ink is on business balance sheets. The possibility of a sovereign default is more likely now than ever before. Even if Dubai escapes the chopping block, others won't be so lucky.

For now, risk-aversion is the name of the game. Even before Dubai blew up, 3-month T-Bills had slipped into negative territory while the 2 year Treasury fell to record lows. That means that investors aren't buying the "green shoots" hype. They've pulled their savings from money markets and stuffed it into government bonds, still the safest bet around. Here's a clip from the New York Times:

> "Trying to prevent a run on its banks, and financial turmoil that some fear could spread globally, the United Arab Emirates said on Sunday that it would lend money to banks operating in Dubai, amid concerns about excessive borrowing around the world.
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> The central bank's move was an attempt to head off the kind of crisis of confidence that froze credit markets last year and brought the global economy to the brink of failure, threatening everyone from hedge fund billionaires to retirees who had their savings in supposedly safe investments." ("Arab States Move to Stifle Dubai Crisis", Vikas Bajaj and Graham Bowley, New York Times)

The financial system is so fragile that a default on a paltry \$60 billion can send the dominoes skittering through world markets. That sounds like a system on its last legs.

From the New York Times again:

> "Central bankers and government officials around the world will be watching nervously for signs that the fears of contagion are contained or spreading as markets open in Europe and New York. They are looking to see if investors begin pulling money not just from companies and banks connected to Dubai, but also from other countries that may have taken on more debt than they can afford to repay.
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> Already, investors fled the stocks last week of banks with outstanding loans to the tiny emirate and its investment arm, Dubai World. Now, analysts will be watching to see whether investors flee highly indebted companies too.
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> While Dubai is not big enough to directly ignite financial repercussions outside the Mideast, the main fear is that investors could flee risky markets all at once in search of safer havens for their money — much as they did in September 2008, when the failure Lehman Brothers heightened worries about all financial institutions, regardless of their strength.
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> Those fears were allayed only after the United States announced a huge bank bailout, and began guaranteeing a variety of borrowing that slowly helped credit markets begin functioning again. That many of these measures remain in place could help contain any possible contagion from Dubai now."

The Times is full of it. The "fears were never allayed" because the system was never fixed. Instead of nationalizing underwater banks and forcefully reducing leverage in the financial sector, the Fed provided a blanket guarantee on all types of toxic garbage. That helped calm the markets, but the deeper problems still remain. There's been no new regulations and Wall Street's gigantic looting operation has continued without pause–only now–every-time a deadbeat developer misses a payment in some far-corner corner of the earth, all hell breaks loose. The way it's shaping up, central banks and finance ministers will be spending all their time putting out fires. That's because the so-called "new architecture" of the financial markets–including securitization and complex debt-instruments–doesn't work. We already know that, because the system collapsed. Remember?

Whether Dubai muddles through or not, there's more pain to come. The world's economies are now strung together with trillions of dollars of counterparty deals that are traded outside of any regulated index. No one knows who is sufficiently capitalized and who isn't. It's one big guessing game. On top of that, credit is tightening and rolling over debt is getting harder. That means more volatility, more uncertainty, and more Dubais ahead. No wonder public confidence in government is in the dumps.