



Global Views

Goodman on Debt, Default, and the EU

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Every Debt has its Day

Almost defaulting is all the rage these days. Both sides of the Atlantic seem determined to walk themselves to the edge of fiscal abyss all the while looking up at the heavens shrugging their shoulders and saying, "Us, what could we do, it's not our fault." For today let's leave aside the colossal idiocy that is the U.S. Congress and focus on the colossal idiocy that is the E.U. After all, what's more fun than taking on grandstanding about currency, lying about sovereign debt, and national and international institutions doing anything but their job. You might want to take a moment to remove any sharp objects before we move along. Ready?

Know Your International Currency: Euro Edition

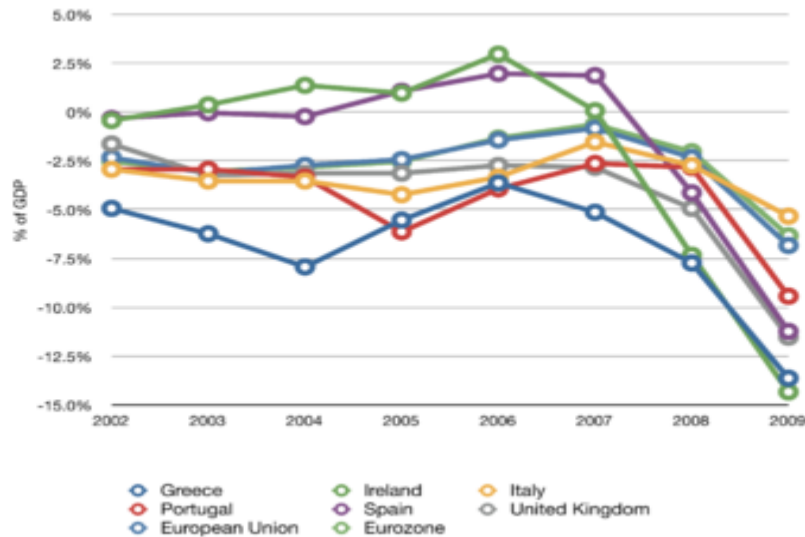
It's become common place to blame the adoption of the Euro for the bind that the PIIGs increasingly find themselves in. Woe is them the story goes. If only they had their own fiscal policy to implement they wouldn't be faced with this bailout or default bind. Evil, evil European Central Bank how could you possibly do this to them? And, as with most popular story lines, it's a complete crock. It's the equivalent of being afraid of the dark, buying a ticket to a movie, and then freaking out when the lights go down.

It was with good reason that when the EU was established it required deficits of less than 3% of GDP and a debt ratio of less than 60% of GDP. There wasn't so much of that good reason when the ECB allowed countries to gleefully disregard those requirements. Greece and Ireland specifically dug themselves into the holes that they're in (and lied about how deep they were), despite being told when they joined the EU that no ropes would be available to help them climb out.

But They Gave Us the Shovel!

And that's the crux of the matter. Joining the EU unquestionably drove foreign investment to the PIIGs. Way back in 2005 the European Central Bank looked at Ireland, Greece, and Portugal and saw that adopting the Euro led to a 25% increase in lending. Of course the study also said that the banking sectors of those countries remained sound. Well, 1 outa 2 ain't bad. When lending and foreign investment shoot up, GDP shoots up, so government borrowing shoots up. Then the financial market collapses along with everybody's economy. So the logical thing to do is.....you guessed it, keep borrowing, but hide and lie about it as the graph of government borrowing as a percentage of GDP on the next page (or on the highly technical

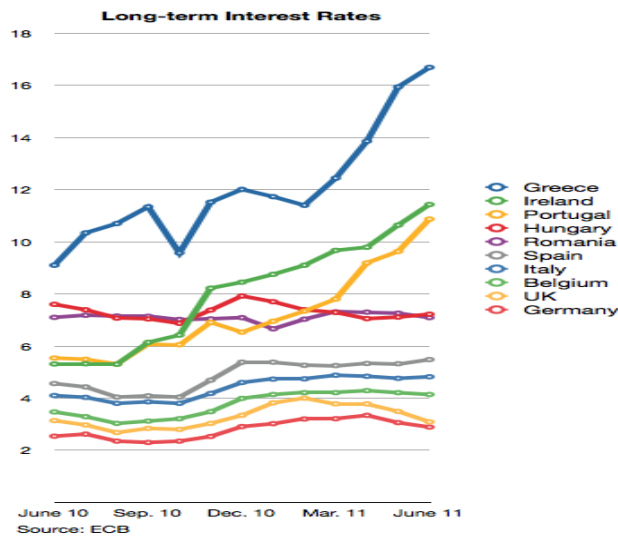
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webpage of Wikipedia) shows. And then when it comes time to pay the loans, blame the Euro for not being able to inflate your way out.

That’s What the Money is For

So, first we had Ireland, then Portugal and now Greece (with Italy on the horizon) trying to borrow and lie (lie is such a strong word, it sounds so much better when we say massage the numbers) their way out of trouble, but the music stopped. What happens now? Well there’s a little known mechanism for dealing with entities that can’t pay their obligations. They freaking default. It happens, although granted in the developed world it’s rare. But, guess what, that’s why interest rates soar as you can see over on the left (it should be noted that the pretty picture from ECB data cuts off before Italy began to become infected by the contagion). So, you invested in Greek or Irish debt, and now there’s a chance they might be forced to default, well as Don Draper would say, “That’s what the money is for!!



It’s Broke and You Bought It

Look, nobody wants dramatic financial turmoil. But, when it happens the markets are supposed to be equipped to deal with it. Defaults happen. They especially happen when countries flaunt rules, and the bodies overseeing them (I’m looking at you European Central Bank) don’t enforce those rules. Sure adopting the Euro means you can’t inflate your way out, but it’s not like this comes as a shock to anybody who invested in the debt in the first place. It isn’t the damn currency’s fault. It’s the borrowers fault for overextending and lying about it. It’s the ECBs fault for ignoring the very debt limits it had established. And finally, its investors faults for not pricing in risk correctly. Besides at the moment there’s something kind of quaint and refreshing about a country on the edge of default because it doesn’t have the money to pay. That’s like so two years ago, nowadays it’s all about defaulting when your government can’t stop fighting with itself like two squirrels and an acorn. But, that is obviously a story for another day.