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THREDGOLD
ECONOMIC
ASSOCIATES

The TEA Company
A Professional Speaking and
Economic Consulting Company
1366 S Legend Hills Drive, Suite 150
Clearfield, Utah 84015
801-614-0403

www.thredgold.com

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A Shot Across the Bow

Written by Jeff Thredgold, CSP, President, Thredgold Economic Associates

Financial developments within Greece of recent weeks should be considered “a shot across the bow” for similar smaller nations such as Portugal, Spain, and Ireland. Such a warning shot regarding high debt levels should also be taken seriously by larger nations, including the United Kingdom and the United States.

The nation of Greece is facing a financial crisis, tied in part to the short-term impact of the deep European and global recession just ended. Unemployment is flirting with 10.0%. At the same time, the implication of living too long above its financial means is now coming home to roost.

Investor concerns about the quantity and quality of debt issued by the Greek government, known as sovereign (or national) debt, have risen sharply in recent weeks. High debt levels as they relate to the nation's gross domestic product (GDP) have heightened the issue of potential default, or at least the painful reality of the sharply declining value of Greek debt securities.

Sovereign debt defaults are infrequent, but can and do occur. The past 15-20 years have seen Russia default on its debt, Mexico face a debt crisis (to be assisted by the U.S.), various Asian nations face major debt and currency issues, and more recently Argentina default on its debt (*The Wall Street Journal*).

Greece is currently running a budget deficit estimated at 13% of GDP. Such a massive deficit runs contrary to the mandates of “euro zone” membership, which limit annual budget deficits to no more than 3% of GDP. Talk is cheap, with no real means of enforcement to such requirements.

In the years prior to the establishment of the euro zone, a smaller European nation could move to devalue its currency as a temporary means of boosting exports, thereby improving its economic performance. Such an option is not now available to Greece or other euro zone member nations as monetary policy is conducted on

an aggregate basis by the European Central Bank.

Dominos

The greatest threat regarding the current Greek debt solvency debate is the possible domino effect involving other nations. A Greek default on its debt, or a painful plunge in the value and marketability of Greek debt securities, would likely be followed by similar debt issues for other nations. Such a domino or cascade effect would be difficult to stop once the process had begun.

**THE U.S. SIMPLY CANNOT
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CONSEQUENCE**

The role of stronger European nations in lessening financial market anxiety regarding Greek debt is being hotly debated in Berlin and Paris. Germany and France, the two most dominant members of the euro zone, have announced a support package for Greece, the details of which are under discussion.

Any financial support or limited debt guarantees provided by the stronger euro zone players would be most unpopular with their own citizens. At the same time, economic and financial conditions imposed on Greece by Germany and France as part of a support package would be opposed by a large and politically strong Greek public sector work force and strong trade unions. Strikes and public protests are already part and parcel of Greek life today in regard to proposed cuts in government spending.

At the same time, any financial support provided for Greece by the Germans and the French would effectively be seen as a similar level of support, if necessary, for Spain, for Ireland, and for Portugal, with Italy and Belgium possibly not far behind. Needless to say, the Germans and the French are extremely wary of such “moral” guarantees of financial assistance.

An IMF Role?

The Germans and the French could elect to stay relatively silent and let the International Monetary Fund (IMF) step in to support Greece. However, the German/French position is likely to be one of letting Europe solve its own problems, without outside influence and interference.

The fact that the Germans and the French see the IMF as an institution dominated by the U.S. only adds to their reluctance to have the IMF highly involved in the Greek situation. The Greek people are also likely to oppose extensive IMF involvement in their financial problems as the IMF usually requires highly painful austerity steps (meaning sharp cuts in public spending, with even higher unemployment rates) as a condition of financial support.

Larger Nations?

Current sovereign debt issues at play in smaller European nations should be a wake up call for London and Washington DC. While political leaders in the U.K. and the U.S. see no real chance of similar financial market anxiety regarding U.K. and U.S. debt levels, caution is advised.

Note the chart below. Unprecedented annual budget deficits lead to a rapidly expanding sovereign debt. The U.S. simply cannot afford to run massive and irresponsible trillion dollar budget deficits for years to come without consequence.

The possible domino effect is real. Financial markets function effectively when confidence levels of investors are high. Investors are willing to buy debt securities

issued by corporations or municipalities or nations if they feel highly confident in the repayment ability of the issuer.

Investors must also feel highly confident in their ability to easily sell such securities into viable financial markets at any time at reasonable prices. Rising sovereign debt levels, combined with rising interest costs to service such debt, can and will eventually ravage investor confidence.

As noted before, if you earn \$60,000 annually but spend \$90,000, life is good, with plenty of extras. If the following year you earn \$70,000 but spend \$100,000, life is also good. However, you are dependent upon someone to believe in your ability to repay borrowed money. You are also subject to higher and higher financing costs.

When potential lenders (or investors) eventually ratchet up the price of credit, or suspend access to any additional credit, life is no longer so good. At that point, the creditors can make many painful demands to reduce your “quality of life” and enhance their ability to be repaid.

Such is true at your house and mine. Such is true for corporations and municipalities that issue debt. Such can eventually be true for various nations... Greece today...and possibly the U.S. tomorrow.



“TEA”ser

Everything is funny as long as it is happening to someone else.

—Will Rogers



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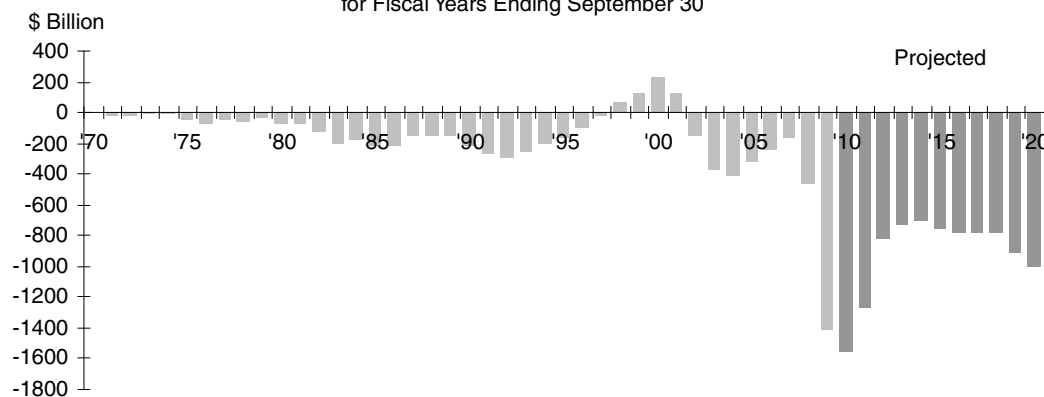
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Thredgold Economic Associates
1366 S Legend Hills Drive, Suite 150
Clearfield, Utah 84015
www.thredgold.com

Graphics and layout by Kendall Oliphant
Research assistance by Shawn Thredgold

Federal Budget Surpluses or Deficits

for Fiscal Years Ending September 30



Source: Office of Management and Budget