

The Economic Reboot

September 2011

I must warn you, the below is a horror story. It may only be fiction; just the Armchair's over active imagination. Do not read if you dislike horror. Do not read if you want to sleep at night. Again, DO NOT READ if you want to sleep at night. You have been adequately forewarned.

Contagion. That's what a good many are focused on when talking about Greece. How can this one small country be so important? Its GDP is probably little different from that of Houston, TX. Why would the default of one tiny economic ant be of any consequence whatsoever?

The most obvious concern if Greece defaults is, what happens to banks in the EU who are holding Greek sovereign debt? Well, of course those banks will have to write down that debt, meaning they may not be capitalized well enough to meet regulatory standards. "So what?" you might say. "Those banks made bad loans. Banks do that all the time and recover. Why is it so much more dire this time?"

European banks may hold a great deal of Greek debt, but it has been suggested American banks have written a good amount of credit default insurance on that debt. Think of AIG, the credit insurance black hole that almost took the world economy down. Well, the game AIG was playing has not stopped. Now American banks, and likely some European ones, are playing a newer version of it. They have sold insurance against a Greed default. (A typo worthy of retention.) They have sold insurance on all sovereign default risk.

So if Greece defaults, then some American banks will have to take it on the chin, sharing the pain with their European counterparts. One would think, "Okay, the system can surely handle Houston, TX going bankrupt. Big deal! There should be more than adequate capital in the banking system to handle this." Yes...but for contagion.

As *Merriam-Webster* defines it, contagion is an influence that spreads rapidly. The most serious contagions are those that can't be stopped because we don't have a cure. So how would tiny Greece infect the giant global economic system? Unfortunately, it could be quite simple.

If Greece defaults, then interest rates on sovereign debt have to rise. New default risk has been identified. Sovereign debt may not be as safe an investment as previously believed. So all of a sudden, the cost of borrowing has to rise. Well, what do you expect Ireland and Portugal to do? Prove they are of stronger fiscal and moral character than the Greeks? It would seem likely they too would default to maintain internal sovereign harmony.

Opps! We've had another default; so more risk is now apparent, which means the cost of borrowing has to rise again. Then, the next weakest balance sheet country, maybe Spain or Italy, who knows about those Eastern Europeans, has to pay more for their debt. And guess what, if one of those countries can't handle the debt burden and interest costs, then it defaults. There goes the cost of borrowing again, and here comes the next weakest sovereign balance sheet, another default, another rise in the cost of borrowing and on and on and on, until....

What is the until? It's what the Armchair calls the "economic reboot." You see, as the contagion spreads, the confidence in money starts to fall. For example, if these countries in Europe default, they

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are likely going to leave the Euro and start anew with their own currencies. But what will those new currencies be worth and why?

Is the IMF going to say, “Yeah, we think the new Greek drachma is worth X”? Well, how do they determine what X is? Does Greece adopt a gold standard? It would seem highly unlikely that they have much gold to back their currency. How about an oil standard? Here too Greece doesn’t have any oil to back a currency. In order to have a currency the world will accept, it has to be backed by something other than “we have a printing press that can print it.”

So what of the new Irish pound or Portuguese escudo? What will they be worth? And what will the new Spanish peso and Italian lira be worth? And what will become of the Euro and a global economic system that has been built around it and the dollar?

If banks in Germany and France are worried about having to mark down their Greek debt, what happens if they have to mark down their Portuguese, Irish, Spanish and Italian debt? Can banks survive such a loss of capital? And where will they get new capital since it would seem likely they have all invested in each other? Could each bank’s capital base contain capital from the others?

And how much will the American banks have to come up with to settle claims by the Europeans who bought insurance against default? And what of America’s sovereign debt service capability after the cost of capital rises? How can the Fed mandate low interest rates for two years? Doesn’t Mr. Market have a say in what investors require for their risk? And what of economic activity after the cost of capital rises?

Once these countries start defaulting, who is going to take those drachmas, pounds or pesos of uncertain value? Who is going to take Monopoly money for the goods it produces? There goes trade with these countries. Let’s not forget, America’s biggest export market is Europe! And as trade with these countries stops, the global economy slows down, and as the global economy slows there is less earnings spread around the system to pay back other debt, which then defaults and on and on and on...until a great deal of the global economic systems stops dead in its tracks.

The PC on-button doesn’t work. The operating system is so antiquated it can’t boot up. Applications don’t run without an operating system. The hard drive is so fragmented it’s frozen. Virus upon virus has infested the system. No more patches can fix it. It’s time for a reboot. What happens in this reboot?

Well to begin with, global commerce will have slowed to a crawl because no country, no company, and no individual has any idea what currency is worth. So how can Saudi Arabia sell its oil? What are they going to get for it? And how can Chile sell its copper? How are the producers of natural resources going to get paid? And how do the transporters of natural resources get paid? And how does labor get paid? And what labor is needed when the global economy has shut down? And what’s labor going to do when there are no jobs much less any worthwhile way of paying them?

Where will confidence in currency even exist, and why? And how can any economy “work” without confidence in a means of exchange? Just because everyone can print more money to “paper over” the problem, will that add confidence to the system, confidence to currency?

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Has anyone been through a hurricane before? Remember the Katrina and Haiti photos and stories? For those in Houston, we just have to go back to our hurricane Rita experience. Sheer chaos takes hold, even in a civil society, when there is no gasoline or anything in the grocery store.

This is the horror story central bankers, corporate bankers, governments, economists, investors and pretty much everyone doesn't want to think about. This is the story no one wants to consider, no one wants to tell. It's like the government knows a giant asteroid is set to hit the earth, destroying massive amounts of life. Does it tell citizens or does it just keep busy hoping for change that will forestall the inevitable? Why do you think the five most powerful Central Banks in the world are now trying to "paper over the problem" by flooding European banks with dollars?

This is the story likely being told to the Greeks. But, can we expect the citizen voters in Greece to sacrifice greatly for the good of a few banks? Can we expect the common man in Greece to understand the contagion risk? And can we expect the Greeks and others to happily sell or pledge national assets at a huge discount to satisfy German and French banks, and any others caught up in this circle of debt and currency manipulation?

This is the story they are going to tell the BRIC countries. "Rescue us or you will be toast, too!" Without confidence in currency, without a means of exchange how will China even conduct business?

Fiction? Maybe, but maybe not. A horror story, absolutely.

Anything's greatest weakness can be found by first understanding its greatest strength. Over the last thirty years, the global economy has expanded astronomically. Prosperity around the world has risen. An amazing interconnected system has developed to inspire all sort of innovation as well as execute and deliver it to societies around the globe. ***But this interconnectedness makes us interdependent.*** So now if one little link in the bicycle chain breaks, the bicycle may no longer work, and we don't just have a simple bicycle economy.

Like we should have known before Lehman's fall, ***systemic risk grows the more complex a system gets.*** And our current global interconnected and interdependent economy is pretty darn complex. Greece is one bicycle chain link. If it breaks, the bicycle may just stop working. As the Armchair has been suggesting for a while...

When the Enron Ponzi scheme collapsed, banks came in to save the U.S. gas and power industry. When the Wall Street Ponzi scheme collapsed, governments came in to save the financial services industry. But who is going to save us if the government Ponzi scheme collapses? Is this the twilight of modern sovereignty?

I warned you about reading this potential economic nightmare. Nighty night, sleep tight!



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