COMMENTARY | Looking a lot like California

CHOICES APPEAR BLEAK IN GREECE'S HEAVY DEBT

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PIIGS is an acronym for the most troubled of the European Union economies — Portugal, Ireland, Italy, Greece and Spain.

The weakest of these is Greece, a country whose recent socialist government profligacy has even exceeded ours on a per capita basis. Greece is in imminent danger of defaulting on its sovereign bonds.

Greece is the first of what may be many economies to have reached the point of no return. The country cannot service its current debt and pay for government programs, nor can it borrow more to push debt service into the future.

The country's condition looks a lot like California's, except that California is much larger. California is over 20 percent of the U.S. total population and constitutes a similar percentage of U.S. gross domestic product. It is the eighth largest economy in the world, if measured separately from the U.S.

Greece represents about 3 percent of the EU's population and GDP.

But watching how the EU deals with the Grecian debt situation may tell us how to deal with California's extreme debt situation — or, maybe, how not to.

A country with a sovereign currency would normally deal with excessive deficit spending by inflating away the debt through the devaluation of its currency. Sound familiar? It should. It has been Washington, D.C.'s course of action since Woodrow Wilson. Among other reasons, the U.S. created the Federal Reserve in 1913 to enable this behavior.

This temporary measure, which can buy time for a permanent solution, is not available to Greece because it is part of the European Union so it can not unilaterally devalue. It's also not available to California as long as it's part of the U.S.

BLOOMBERG NEWS FILE PHOTO

The more than 2,400-year-old Parthenon temple sits atop the ancient Acropolis in Athens, Greece.

There is serious discussion of a bailout by the rest of the EU. Greece, as a sovereign country, ultimately makes the decision as to what happens.

The Greeks have three choices:

- Take the bailout, if offered, and make the drastic budget cuts and tax increases that will keep them in the EU and work out their debt. This would mean a protracted recession/depression.
- Default on the debt and enter a recession/depression for an even longer time. They would not be able to count on any new debt financing from any other

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country.

- Leave the EU and create, then deflate, their own sovereign currency. This would amount to practical default on their debt.

The moral hazard issue may preclude the EU, and especially Germany (the strongest EU economy), from bailing out Greece. After all, the remainders of the PIIGS are fragile also. Ireland could legitimately ask why it wasn't being bailed out. If Spain fails, it is too big for even Germany to bail out.

There is also the problem of contagion in this interconnected world. You can bet there are a lot of derivatives related to all EU debt and especially the PIIGS.

If the Greeks are allowed to default, and with the bulk of their debt in three countries, the consequences could be disastrous to EU credit creation. If the Greek debt is written off and other countries' sovereign debt is given the required mark-to-market treatment, it would destroy the balance sheets and, therefore, the viability of the European banking system.

Prior to this crisis, credit risk was not often factored into first world sovereign bonds. We now know that sovereign debt from EU countries is no longer "safe."

Another "gift" from fiscally irresponsible governments buying votes with deficit spending on socialistic benefits.