"Fairy Tale" Economics: "Sovereign Debt Default is Impossible"

By Matthias Chang
Global Research, March 25, 2014
Future Fast Forward

Region: USA
Theme: Global Economy

What prompted me to write the present article is because some central bankers have been spewing nonsense, and because if many out there don't use common sense, they will suffer enormous financial losses.

Anyone who agrees that there can be no sovereign defaults has a fickle memory or no memory at all. Additionally, they have also forgotten the economic dogmas spread by Nobel Laureates, central bankers, financial advisers etc. which alas turned out to be fairy tales. And it was only just five years ago.

People do have short memories.

Before we get to the bottom of the impossibility of sovereign defaults, let's examine some other "impossibilities" often touted by the so-called economic experts, those that have the "magical" alphabets behind their names – PhD, especially from Ivy League universities. I prefer to call these so-called experts "Phony Donkeys". No doubt there are exceptions, but not many.

Home Mortgages – safest kind of lending

It is often said that home mortgages have minimum risks in that defaults are so miniscule that they count for nothing. This is indeed true in the good old days of "old fashion banking". Let's take the statistics from America since whatever happens in America impacts globally.

In the period from 1991 to 2004, banks suffered losses amounting to only 0.15 per cent on home mortgages. Do the maths. For every US$1 Million, the bank lost US$1,500. Therefore, it is very safe to finance home mortgages. In fact, in the fourth quarter of 2004, it went as low as 0.08 per cent (Source: Federal Reserve).

Fast forward to 2009 – If you are applying for a mortgage loan, you would be strip-searched and examined with a magnifying glass by a banker to determine whether you are in fact credit worthy.

What changed? The banks were churning out "Frankenstein Financial Products" to be traded as "CDOs", "Synthetic CDOs" etc. Some of these products were derived from mortgages called "Liars' Loans". Mortgages were packaged into "sophisticated financial products" which in turn were sliced and diced into other financial products. They called it "securitisation"! People forgot that the mortgages were not originated in the manner as before in the good old days of conservative banking. Such good "old fashion banking" was boring. So, the new generation of bankers decided to inject some excitement – innovations to the financial sector. In essence, it was just a slight variation to the good old Ponzi schemes of yesteryears.

This was the "new reality" created by the financial sector. Everything was hunky-dory. But, it was a grand illusion.

Today we called the resulting fiasco that shocked the world as the "Subprime crisis". It brought the banks, the global banks to its knees and triggered the global financial tsunami. Governments have to bail out the financial sector via their central banks and took over the toxic assets.

Central banks are now carrying the toxic assets in their balance sheets.

The lesson to be taken from the above is that what may be true in one era may be false in another, a fairy tale in fact. Everything should be examined in context.

Sovereign Risks

Only an idiot would assert that there can be no sovereign risk of default, especially in the case of countries that can print their own currencies (digitally or otherwise) such as the USA.

The economic theory touted is that because a country can print its own currency, it can never be bankrupt and therefore cannot default. Q.E.D.

It is contended that central banks can keep printing monies to bail out the banks and pay government debts without any repercussions. One need not be a rocket scientist with a string of PhDs to figure out the flaw in this economic theory. Common sense is enough to expose this economic mumbo jumbo. The principal practitioners of this heresy are the current central bankers. This is Voodoo economics!

The Flaw

Common sense tells me that if a country can print money to pay its debts, then why in the first place was there the necessity to borrow?

The central bank could just print and print money to finance all manner of development projects and operating expenditures. There is no necessity to have any income tax, as we are told that income tax is levied to enable the government to pay its expenses and when in deficit, to pay for the debts it has incurred to finance the deficit. And if printing was such an easy solution, the world would not have experienced hyperinflation, when money had to be carried by the wheel-barrow to trade and cigarettes were more valuable than the currency in the country suffering from hyperinflation.

The Myth

It is therefore a myth to say that the US treasury bonds are the safest assets as there are no risks of default. Uncle Sam will always honour its debts. It will never default. This blind faith was nurtured over the years, especially post World War II when the US became a superpower and was engaged in the Cold War with the Soviet Union and China.

The experience of the US in itself demolishes the argument that a country can print all the monies it needs to get out of debt and to avoid a default. The monetary policies of the FED especially Quantitative Easing (QE) exposes the fallacy of the "Printing Money Theory". Otherwise, why have the drama of "to taper or not to taper"? If printing toilet paper money is not a problem, why stop QE? Why taper in December of 2013?

Kinds of Default

There are essentially two types of defaults.

- Don't pay the debt – tell the creditors to "piss off"; or
- Inflation – printing money (digitally or otherwise).

The example of the first kind of default is when Argentina refused to pay its debts. A more recent example is when Iceland told its foreign bankers to piss off and prosecuted the bankers for fraud!

The US is the leading example of the second kind of default.

However, we must not forget that the US had defaulted before but in another way. It used to be that the US Dollar was backed by gold and anyone holding a US Dollar could demand that it be exchanged for gold at the agreed rate of US$35 per oz of gold.

Immediately after World War II, America was the creditor to the world, but after the ruinous wars in Korea and Vietnam, the US became the biggest and baddest debtor in the world to the extent that it had insufficient gold to support the US Dollar. The default was triggered by President De Gaulle of France who on realising that there were insufficient gold in Fort Knox to back all the US$ in circulation demanded gold in exchange for the US$ France held in reserves. Initially, the gold was given to France, but President Nixon realised soon enough that should other nations follow suit, the value of the US$ would collapse as there were insufficient gold for exchange / redemption purposes.

And so in 1971, Nixon declared that US$ would no longer be redeemable in gold. From that day onwards, the US$ became a pure fiat currency. The rest of world followed the Pied Piper. Gold was referred to as the "Barbaric Relic".

But, for the fact that the US being a nuclear superpower was able to compel subservience to the Dollar Emperor, the value of the dollar would have plummeted to zero or near zero! This in itself exposes the inherent flaw in the "Printing Money Theory". It was military might that compelled countries to accept the US$ as the global reserve currency.

The End Game

The US$ confidence game was supported by two other pillars besides nuclear weapons.

The second was the "Petro-dollar". The US was able to impose, with the connivance of OPEC led by slavish Saudis, that oil must be traded in US$ in exchange for military protection against coups. I have in the past written exhaustively on this issue and will not repeat myself in this article.

The third was the US treasury bonds. It was touted as risk free and the best asset to own in the world. Because of the propaganda that the US can never default on its bonds, holders of US$ were seduced to participate in the financial con game. The psychology behind this gambit is simple. It preys on the human nature of greed and the misperception of "easy money".

The tag-line was and still is "Just invest in US$ to earn safe and easy returns".

Today the world is drowning in a cesspool of US$100 trillion of debt. US$ toilet paper is floating and circulating everywhere and soon enough, it will only take someone and or a country to declare that the US Emperor has no clothes to trigger the collapse of the US$ financial system.

When that happens, and it will be soon, no amount of US$ bills printed in whatever denomination would be accepted as payment for goods and services and in settlement of debts! The threat of nuclear wars by the US
and Israel ring hollow. If Iran is not intimidated what more Russia and China who themselves are nuclear powers.

The beginning of the end of the present system is already taking place as several countries have begun to trade in currencies other than the US$. The tide will turn when oil is no longer traded in US$. It is as simple as that!

The "Printing Money Theory" would be buried for good. I am not sure whether it would Rest in Peace (RIP) or Rest in Shame (RIS).

Articles by: **Matthias Chang**