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Governments Behaving Badly

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Barely a day goes by without prominent mention by the news media of Europe's current fiscal troubles, with a special focus on the debts of the PIGS nations (Portugal, Ireland, Italy, Greece, and Spain). Certainly, most of these countries have lacked fiscal discipline and are now fighting against market forces that their own policies have set in motion. However, are these countries' actions different than what we have witnessed in the past, or even different than what we have witnessed in our own country?

It should not surprise any of us that governments have been promising, then borrowing, then spending, and then defaulting for thousands of years. One of the earliest noted defaults was a group of Greek city-states defaulting on loans in the 4th century B.C. Even during the heady days of European colonialism France defaulted eight times and Spain six times between 1500 and 1800. No fewer than eight U.S. states have defaulted on their bonds, and the 1900s saw increased default activity worldwide. Throughout history there have been hundreds of sovereign defaults occurring on every continent except Australia and, thankfully, Antarctica.

There are two primary solutions to a sovereign default. One solution is for a government to inflate its way out of the debt by debasing its currency. This was the preferred method in Greek and Roman antiquity as well as in Norway (1918), Germany and Greece (1923), Japan (1945), Argentina (1989), and Turkey (1994). However it has been more common recently to solve the default through a negotiation between the sovereign and its creditors. Ultimately this is likely what will happen in Europe since it is in the interest of all parties to do so. Germany, a relatively strong European economy and one built on exports does not want to see some of its biggest customers and neighbors unable to function. Weaker countries like Greece will need access to future financing but will almost certainly see their standards of living fall as they finally have to repay at least a portion of what previous generations and governments have spent. All of this negotiating and wrangling is being brought to us in real time before our very eyes courtesy of a 24 hour news cycle.

It is often suggested that "globalization" is to blame for several current economic ills including government fiscal weakness. This is not a new or even recent phenomenon. Over 500 years ago the great explorers Columbus (heading west) and da Gama (heading east) sailed with establishing global commerce as a primary goal. Markets have at least to some degree been globalized ever since. With trade and global capital flows have come defaults, but they are a normal, if undesired, part of the marketplace. Defaults are essentially the market regulating and moderating a government's fiscal actions when citizens have been either unable or unwilling to do so. Rather than being feared, this process can be viewed as a healthy and necessary step to continued global economic growth.