Forbes

Fighting Debt with Debt

By Bob McTeer **March 5, 2012**

My house is under water, for sure

My car is upside down, you bet

But I'm getting me a consolidation loan

And finally getting out of debt

Bob McTeer

Well, it may be hard to borrow your way out of debt, but sometimes it buys time, and time is money. One of the few major contributions to the European debt crisis is the ECB's lending to European banks. Long-term low-interest loans help the banks themselves as well as put them in a position to buy European sovereign debt, an excess of which is the main problem. It buys debtor countries some time to become less so. It goes a long way toward making the European debt crisis a condition that doesn't portend disaster tomorrow.

The second round of ECB lending attracted some 800 European bank borrowers, reportedly more than participated in the first round because of more relaxed collateral requirements. Oddly, those collateral requirements are established, not by the ECB, but by the national central banks. We may quibble that those are anything but riskless assets for the banks, but what national bank regulators are going to downgrade and mark down their own sovereign debt to fail their own banks? In other words, Italian banks can buy Italian government debt, and both debtor and creditor, and even the bank regulator, have an incentive to treat them as sound if "held to maturity."

Cries of hyper-inflation resulting from "printing money" are already being heard. While some increase in inflation cannot be ruled out, the more likely outcome will be similar to the U.S. experience. The combination of TARP's injection of capital into the banking system and the Fed's loans to banks and debt purchases brought similar predictions of hyper-inflation. It didn't happen because circumstances increased the banks desire to hold excess reserves and those reserves were never translated into multiple money expansion as would have been likely under normal circumstances. The Fed's actions may not have been sufficient to stimulate the economy sufficiently, but they were necessary to prevent a contraction precipitated by banks trying to get

more liquid. The good news is that money has to be spent to cause inflation and it must be created to be spent. The bad news is that money has to be spent to stimulate the economy and feed a vigorous expansion and it must be created to be spent. There is no reason to expect the outcome to be different in Europe under similar circumstances.

The American experience in the Depression also demonstrated the folly of "mopping up" excess bank reserves that the banks themselves did not consider excess under the extraordinary circumstances.

Another disaster that didn't happen in the U.S. case is a precipitous decline in the foreign exchange value of the dollar, and for similar reasons. Money not created is not going to be spent on other currencies. The dollar may be called weak, but it's no weaker than it was prior to the financial crisis and the actions taken to deal with it. It's instructive, I think, to note that the Euro actually strengthened following this second round of ECB lending.

I know all this sounds like heresy, but the key is to keep counterfactuals in mind. What is seen is not much improvement. What is not seen is disaster averted—for now.