

Losing the Economic Battle

The global debt apocalypse approaches.

BY DAVID SMICK

On the issue of public debt, Washington is experiencing what psychologists call “learned helplessness.” The financial news is so relentlessly terrible that people have become numb to it and assume nothing can be done to regain control over our fate.

Today the world’s public and private debt exceeds an incredible 300 percent of GDP. We are at risk of succumbing to an ugly, downward, global mark-to-market in asset prices. Yet the discussion in Washington fails to reflect the immensity of the threat.

Some money managers have a theory that this mark-to-market process has been under way for some time. Stage One was the 1990s Asian crisis. Global financial markets concluded that Asia’s debt was dangerously high and its banks’ balance sheets not reflective of reality. Global traders pounced. Interest rates soared, equity markets plummeted, banks failed, and currencies collapsed.

Stage Two is happening in Europe today.

Stage Three will eventually hit the United States. Washington policy-makers seem confident America’s public debt risk is years away. They believe that the U.S. economy, with the dollar the reserve currency, enjoys some immunity from these concerns. The central bank, moreover, can buy bonds to keep interest rates from rising in response to growing debt. Yet these are risky assumptions.

A year ago, senior European offi-

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cial never dreamed they’d be in their current mess. Greece represents only 3 percent of the Eurozone economy. Bailout tricks and clever central bank interventions were supposed to calm nervous markets. That happened, but didn’t last. A powerful global financial market brought officials to their knees. Today, many European policymakers can’t believe America is risking a similar outcome. True, as a means of protection the Fed itself will try to manipulate credit markets by keeping long-term interest rates artificially low. But global financial markets will simply penalize bank stocks, a phenomenon that may result in a credit contraction and double dip recession.

The larger danger is that ballooning debt reaches a tipping point beyond which financial markets conclude the debt cannot be repaid without instigating political chaos. That is Europe’s predicament today. Markets realize that the austerity policies needed to bring the debt under control are making the task of debt reduction impossible, as tax revenues plummet.

Some analysts, including Criton Zoakos, argue that the global economy has reached a “point of no return.” Debt suffocates growth, which destroys equity values (particularly financial stocks), which diminishes lending, investment, and consumption. Falling tax receipts lead to even more debt. Optimists argue not to worry. The world since January 2008, they say, has been undergoing an important period of public and private deleveraging. Growth will resume once deleveraging is completed.

If only life were that simple! Global indebtedness, according to

Zoakos, has actually *increased* by 17 percent since the beginning of 2008. Nations have enacted generous bailout and stimulus programs while growth has averaged an anemic 1.2 percent.

With the world having fallen into a giant liquidity trap, monetary policy has been ineffective. Because of the growing slack in the economy as the developing world joins in the global slowdown, the central bankers couldn’t inflate their way out of today’s debt problem through bond purchases even if they wanted to.

What the Greek situation has shown (debt 120 percent of GDP before the crisis and 170 percent today after reforms) is that austerity without a strategy for vigorous economic growth is a recipe for failure. But Washington’s political environment is so poisonous, bipartisan fiscal compromise seems impossible.

Washington is overflowing with tax reform policies, proposals to bend the cost curve of entitlements, and ideas for smart infrastructure spending. There even seems to be a beneath-the-surface bipartisan consensus to move forward on these items, which probably won’t happen short of a stock market crisis that forces Congress to act.

Yet these reforms may not be enough. Policymakers also need to reform today’s slow-to-lend, too-big-to-fail banks. Here’s an important question: Should governments and central banks continue to try to prop up the value of the assets on bank balance sheets even though those values are unsustainable? This losing battle has already contributed to global public debt-to-GDP ratios that boggle the mind. We may be saving our banks, but we’re losing our economy.

Like a giant bow wave building up on each side of the vessel, the growing debt is threatening to swamp the entire world economic ship. A feeling of helplessness has taken hold at the precise moment policymakers need to be audacious. The numbers behind presidential candidate Herman Cain’s 9-9-9 plan may not add up, but his gut instinct is on the mark. America needs radical reform on the issues of both growth and debt. ♦