Deal with debt loads or despair: observers

Stan Honda, AFP, Getty Images

Trader Jason Blatt reacts to the market correction on the floor of the New York Stock Exchange on Monday.

Tim Shufelt, National Post · Aug. 9, 2011 | **Last Updated: Aug. 9, 2011 5:10 AM ET**

Those trying to steer the global economy away from disaster need to abruptly change course and confront their monumental debt burdens, or risk sustained market chaos.

From superficial deficit reduction in the United States to futile bailouts in the eurozone, the global debt crisis is being mismanaged by politicians and bankers on all sides, judging by the relentless slide in stock markets. The culprit is political gridlock.

That's what led to the U.S. debt downgrade, which ended a 70-year streak of top-notch credit and sparked a stampede to exit equity markets, said Alex Jurshevski, founder of Toronto-based Recovery Partners and an expert in sovereign restructurings.

Now, having been stripped of one of its most powerful assets, U.S. legislators are trying to come to grips with how to quell the panic.

Their counterparts in the eurozone are attempting the same feat. Both sides are failing, Mr. Jurshevski said.

"You're dealing with a very cumbersome decision-making process that I believe is unable to come to the correct decisions in the short period of time needed to avoid a huge train wreck."

There are measures that could go some way toward calming markets and giving investors some assurance. But the fixes that are currently on the table won't suffice, Mr. Jurshevski said.

In the United States, a starkly divided Congress recently tabled a deficit-reduction plan that failed to address the concerns of ratings agencies. That plan was a product of the debt-ceiling debacle, which itself amplified fears of U.S. fiscal doom.

"The legacy of that was a hit on business and consumer confidence, and a downgrade reinforces that," said Michael Gregory, a senior economist at BMO Capital Markets. "The U.S. economy is worse off for what U.S. politicians have done. They can blame each other, but it's the fault of them all."

Standard & Poor's cited dysfunction in Washington as justification for its subsequent downgrade. And the impasse produced reasonable doubts that the United States could confront its debt problem and end its recent habit of running trillion-dollar deficits, Mr. Jurshevski said. Similarly, battle lines in the eurozone are getting deeper, with growing opposition among much of Europe to additional bailouts and bond-buying programs.

Many analysts insist the way to limit contagion and contain the crisis is to allow some sort of debt restructuring, where bondholders have to take a hit. "Instead of facing that reality ... they chose to bail them out and kick the can down the road a couple of years," Mr. Jurshevski said.

Despite the hundreds of billions of euros thrown at the Greek problem, for example, the country's debt burden has actually increased, he explained. However, some analysts raise the possibility that there is no real solution to the deteriorating global debt crisis, at least not one that can be imposed through governance.

"This is a case in which markets have to heal themselves," said Don Coxe, strategy advisor to BMO Capital Markets.

Greece's failed finances pale in comparison to the growing possibility that contagion will claim either Spain or Italy, or both. Together, the two countries account for nearly 30% of the eurozone's GDP, while Italy has the world's thirdlargest publicly traded bond market, he noted. "If it costs that much to save Greece, they can't afford Spain or Italy."

The great fear is that debt worries will seep into the world's banking system and produce the kind of credit freeze witnessed after Lehman Brothers collapsed in 2008.

As of yet, credit creation in the United States isn't showing any real symptoms. But interbank lending in Europe is beginning to slow, with financial institutions proving ever more reluctant to lend to one another.

"Once again, we're back to the banking system," Mr. Coxe said. "This is capitalism's weakest point."

The credit trends emerging in Europe prompted the European Central Bank to extend its bond-buying program to Spanish and Italian debt on Monday, purchases of which could reach ¤850-billion ($1.2trillion). That price tag is sure to heighten political tensions, Mr. Gregory said. "This has all the hallmarks of going down to the wire, just like the debt ceiling debate," he said. "And that will create more volatility."

In the United States, intense scrutiny will be directed at the bipartisan committee charged with identifying US$1.5-trillion in additional spending cuts this year, he said. That committee may also consider the Bush-era tax cuts, which are set to expire at the end of 2012. "Politically, someone has to say, 'Yes, let's raise taxes,'" Mr. Gregory said. "We all know how difficult that will be in Congress in an election year."

tshufelt@nationalpost.com