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Debt Hamstrings Recovery

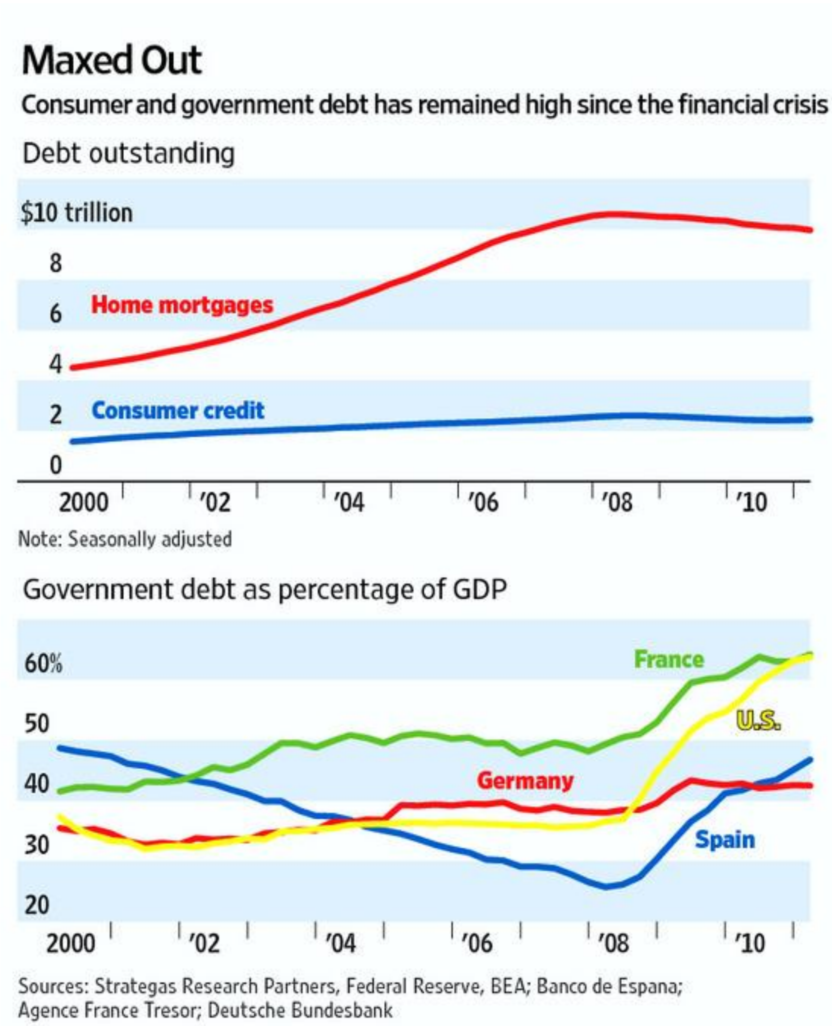
Inability of Nations, Consumers to Get Out of Hock Weighs on Global Economy

By TOM LAURICELLA

The Federal Reserve is just days away from ending one of the major steps to aid the U.S. economy—but the effort has done little to solve the original problem: The government and individuals alike are still heavily i debt.

WSJ's Francesco Guerrera reports U.S. consumer debt has skyrocketed by 37% over the past 10 years and is in part responsible for the economy's slow recovery. Photo: Joe Raedle/Getty Images

Around the globe, the inability of governments and households to reduce their debt continues to cast a shadow over Western economies and the financial health of individuals. Today, U.S. consumers have more mortgage and credit-card debt than they did five years ago, and the U.S. budget deficit is worsening. At the same time, European governments are having to throw billions more euros at Greece to keep it afloat.



The repercussions are likely to play out for years to come in the form of patchy economic growth, further government market intervention—such as last week's decision by oil-consuming nations to release more oil onto the markets—and frequent financial-market swings.

The fundamental problem is that reversing the trend of piling on the debt requires some combination of cutting spending, growing income or the economy, and inflation. But wage growth is stagnant and home prices, which underpin much of the debt problem, are still falling.

Meanwhile, in a vicious circle, businesses aren't hiring or investing because they know consumers are tapped out. Banks, for their part, are hoarding cash, being stingy with new loans.

Unlike the aftermath of typical recessions, simply lowering interest rates hasn't been enough to get growth back on track, economists say. Central-bank efforts have boosted financial markets in the short term—raising stock prices and significantly lowering interest rates—but they have been unable to push people and governments to whittle down debt.

Quite the opposite has been the case. The lowered cost of borrowing has enabled individuals and governments to delay taking measures to change the way they spend and save.

Given the difficulties of paying down debt, "you have to get comfortable with the idea that it's going to take a long time for the markets to adjust and the economy to get back on solid footing," says Tom Luster, director of investment-grade-bond research at Eaton Vance Investment Managers.

Carmen Reinhart, a senior fellow at the Peterson Institute for International Economics, has said that the experience of past financial crises suggests the unwinding of debt on average takes seven years, with debt ratios not coming down significantly until three years after a crisis.

"The issue with debt is you can't get rid of it quickly and you can't get rid of it nicely," Ms. Reinhart says.

Ms. Reinhart looked at 15 post-World War II financial crises and found that seven involved a double-dip back into recession. She says the current economic weakness highlights a feature of the post-financial-crisis landscape that investors and businesses need to become accustomed to: "The ability to absorb shocks that you normally could withstand…is much more limited," she says.

"If your household is already feeling the weight of an underwater mortgage…you're going to feel differently about adding more debt to absorb the cost of gas," Ms. Reinhart says.

Since the autumn of 2008 there have been repeated attempts by central banks and governments to cushion the blow of the debt-cutting process. In the U.S., efforts included the Fed's first round of so-called quantitative easing, in which the Fed essentially printed money through purchases of more than $1 trillion of mortgage-backed securities. There have been multiple rounds of stimulus by the federal government. The European Central Bank, along with the Bank of England, also employed quantitative easing.

This week the Fed is set to end its second round of quantitative easing, known as "QE2," which pumped $600 billion into the financial markets since last autumn. All told, the Fed has flooded the markets with roughly $2 trillion since August 2008.

Yet U.S. consumers have 37% more credit-card, auto and other nonmortgage debt than a decade ago, before adjusting for inflation, according to the Fed. That is down 6% from its peak of $2.6 trillion hit in September 2008, but most of that decline took place within the first 12 months. Over the past year, consumer credit has been essentially flat at around $2.4 trillion.

The news is especially grim when it comes to mortgage debt. Nearly 23% of mortgages are underwater, according to data compiled by J.P. Morgan Chase. Meanwhile, there is still more mortgage debt outstanding than there was five years ago, roughly $9.9 trillion, according to the Fed. The result is consumers find it harder to tap home-equity credit lines or sell their houses.

Pumping money into the financial system "doesn't stop the need for the private sector to heal itself," says Dominic Wilson, chief global-markets economist at Goldman Sachs Group Inc. "We're still facing the headwinds of an economy that is struggling to get on its feet without stimulus."

On the fiscal front, the outlook is worsening. The U.S. government debt-to-GDP ratio will hit 100% this year, up from 62% in 2007, according to the IMF

The core of Europe is seeing fiscal balances worsening as well. Germany's debt-to-GDP ratio is expected to be 80% this year, up from 65% in 2008. France will reach 88%, up from 64%, according to the IMF.

The Congressional Budget Office last week forecast that the amount of government debt will reach its highest point relative to the size of the economy since just after World War II.

This environment is a stark contrast to the so-called "Great Moderation" of the late 1980s and 1990s when economic ups and downs were shallower. That economic resiliency "had a lot to do with increased ability to access the credit markets," says Jason DeSena Trennert, chief investment strategist at Strategas Research Partners. "Without the benefits of that cushion…the volatility of economic growth is going to be greater."

The uneven economic performance is translating into frequent sharp reversals of sentiment in markets. Goldman's Mr. Wilson says it is most evident in the short-term bond markets.

"It's definitely a start-and-stop flavor for the markets," says Mr. Wilson.

Another effect is that interest rates could stay exceptionally low for much longer than would usually be the case, says former World Bank official and author Liaquat Ahamed, whose book Lords of Finance examined monetary policy in the 1920s and 1930s. He notes rates have been essentially zero in Japan since 1995 and that during the Great Depression, the Federal Reserve cut the discount rate to below 2% in 1934 and it held at those levels until the mid-1950s.

History shows "that when people have borrowed too much, they stop borrowing and interest rates stay very low for a very long time," he says. "So you can forget about investing in bonds."