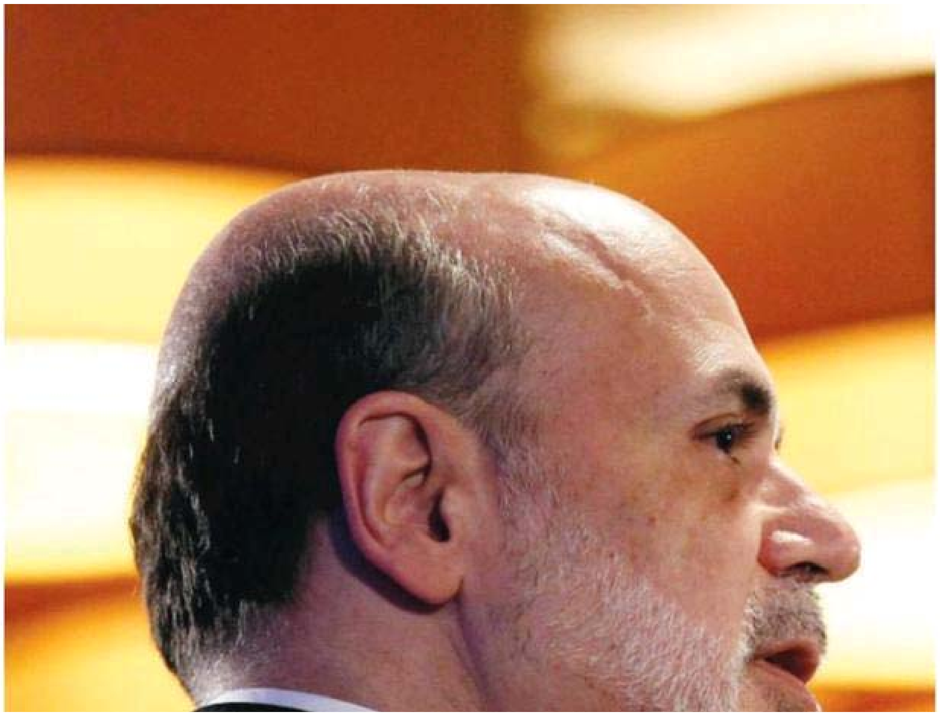
Bernanke warns of 'severe disruptions'



Ben Bernanke, chairman of the Federal Reserve, speaks about fiscal sustainability at the Committee for a Responsible Federal Budget annual conference in Washington, D.C., on Tuesday. Kevin Lamarque, Reuters

Tim Shufelt, Financial Post · Jun. 15, 2011 | **Last Updated: Jun. 15, 2011 3:04 AM ET**

With the public debt level in the United States lapping at the country's debt ceiling, the U.S. economy is quickly running out of breathing room.

And unless the political deadlock in Washington. D.C., is broken and the borrowing limit lifted, the result could be default, panic and even a sequel to the global economic meltdown, according to U.S. officials at the highest levels.

Federal Reserve chairman Ben Bernanke added urgency to the debate on Tuesday, warning that anything resembling credit default could cause "severe disruptions in financial markets and the payments system."

Inaction could "create fundamental doubts about the creditworthiness of the United States, and damage the special role of the dollar and treasury securities in global markets in the long term," Mr. Bernanke told a budget conference.

President Barack Obama made his own plea, calling U.S. credit the "underpinning of a global financial system.

"We could actually have a reprise of a financial crisis, if we play this too close to the line," Mr. Obama said.

But increasingly the rhetoric favours a showdown between Democrats and Republicans, many of whom have begun to ruminate on the merits of delaying interest payments on treasuries for a few days.

But even a so-called "technical default" could result in economic calamity, said Michael Gregory, senior economist at BMO Capital Markets.

"This will be a credit event and one that I'm afraid will permeate the entire global financial system," he said. "Experimenting with that when global financial markets are already sensitive about debt issues is risking too much in terms of a significant market reaction."

The United States federal debt hit the current legal maximum of US$14.3-trillion in mid-May. Since then, the Treasury Department has paid the federal bills through cash reserves and shuffling money between accounts.

But there are limits to creative accounting, and the Treasury set a deadline of Aug. 2, the point at which Congress will either have to have raised the debt ceiling or default.

The Obama administration is seeking an increase to the ceiling of about US$2.4-trillion, enough borrowing capacity to defer the issue until at least after the federal election next November.

"The administration does not want to have to come back next summer and revisit this heading into the election," said Tad DeHaven, a budget analyst at the Cato Institute. "So it's an opportunity for Republicans to beat him over the head."

Republican leaders have argued that borrowing increases should be matched by spending cuts in order to reduce the US$1.4-trillion deficit.

The world's biggest ratings agencies are certainly trying to encourage the two parties to hammer out an agreement in the coming weeks.

They have warned that any default could imperil the country's coveted AAA rating, the mark of superiority that makes U.S. treasuries the safest, most stable investments of their kind in the world.

Fitch Ratings agency recently said U.S. treasury bonds could be labelled "junk" if the government misses payments by Aug. 15.

It's difficult to imagine those are empty threats, Mr. Gregory said. "The U.S. has a pretty ugly debt and deficit dynamic; there's no question it's spiralling out of control. If the U.S. was anybody else but the U.S., they would have been downgraded a long time ago."

One big concern, he said, was that U.S. politicians will simply be unable to hammer out an agreement in time, with Aug. 2 triggering an abrupt downgrade.

But even more alarming is that some Republicans have warmed to the idea that a short deferral of interest payments would not have great market implications and would be a way to force fiscal reforms.

Chalk that up to political posturing, however, Mr. DeHaven said.

"They're going to raise the debt ceiling; we've been down this road before. The only questions are when and under what terms," he said. "Neither party is going to want to get tagged with an economic collapse."

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