



**THE COMMITTEE FOR A  
RESPONSIBLE FEDERAL BUDGET**

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# Understanding the S&P Downgrade

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AUGUST 10, 2011



# THE COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

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Since 2003, the Committee for a Responsible Federal Budget has been housed at the New America Foundation. New America is an independent, non-partisan, non-profit public policy institute that brings exceptionally promising new voices and new ideas to the fore of our nation's public discourse. Relying on a venture capital approach, the Foundation invests in outstanding individuals and policy ideas that transcend the conventional political spectrum. New America sponsors a wide range of research, published writing, conferences and events on the most important issues of our time.

# Understanding the S&P Downgrade

## Introduction

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On Friday, August 5, the Standard and Poor's (S&P) credit rating agency downgraded the long-term credit rating of the United States from AAA to AA+, issuing the country's first downgrade from a major rating agency. The downgrade was issued in part because of the country's high level of debt and the failure of recent legislation to control it. More significantly, though, the downgrade resulted from increasing questions over the nation's political capacity to enact further deficit reduction in light of the recent debate.

Policymakers need to heed this warning and enact more aggressive deficit reduction that results in stabilizing the debt. Failure to do so will result in higher borrowing costs, less budget flexibility, lower longer-term economic growth, and ultimately a fiscal crisis.

## How the Ratings Work and Where the U.S. Stands

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The job of a credit rating agency is to assess the credit risk, and therefore credit worthiness, of a given bond issuer. Though these agencies typically review the worthiness of private firms, they also look at state, local, and federal governments – including the U.S. government.

In the U.S., there are three major credit rating agencies: S&P, Moody's, and Fitch Ratings. In addition, several smaller "Nationally Recognized Statistical Rating Organizations" rate the U.S.'s credit-worthiness.

In assessing the riskiness of several debt instruments, agencies will generally give bonds a grade, with AAA (Aaa for Moody's) being the highest, followed by AA+ (Aa1), AA (Aa2), AA- (Aa3), A+(A1), A (A2), A- (A3), BBB+ (Baa1), BBB (Baa2), and so on. Everything rated BB+ (Ba1) or lower is considered a "junk" bond, or a

FIG 1. UNITED STATES' CREDIT RATING BY AGENCY

Rating Agency	Grade	Outlook
Standard & Poor's	AA+	Negative
Moody's	Aaa	Negative
Fitch	AAA	Stable
Egan-Jones	AA+	Developing
Japan Credit Rating Agency	AAA	Stable
Rating and Investment Information	AAA	Stable

very risky investment. In addition, the rating agencies usually assign bonds an “outlook” of either positive, negative, or stable, depending on whether the next move is likely to be an upgrade, a downgrade, or no change.

Currently, 13 major countries are rated as AAA by the S&P, meaning that they have an “extremely strong capacity to meet” their financial commitments. The U.S., until recently, has always held a AAA (Aaa) rating as well from each certified bond agency. That changed in mid-July of 2011, when a small rating agency known as Egan-Jones reduced the country’s rating to AA+ on fears of a growing debt burden.<sup>1</sup>

On August 5th, S&P followed suit, becoming the first major certified agency to downgrade U.S. long-term debt securities. They also put the country on a negative outlook, warning that a further downgrade could come if the fiscal situation continues to deteriorate or the political system continues to deadlock. As S&P has explained, the difference between AAA and AA+ is actually quite small; instead of an “extremely strong capacity,” all AA ratings represent a “very strong capacity to meet its financial commitments.” Still, the implications could potentially be serious, and the downgrade represents a black mark on the U.S. political system.<sup>2</sup>

While S&P chose to downgrade the U.S. in light of the recent debt negotiations and ensuing deal, Moody’s decided to affirm the country’s Aaa outlook after having put the U.S. on review; still, they put the country on a negative outlook and warned that failure to adopt further fiscal consolidation measures could lead to a downgrade in or before 2013. Fitch has yet to affirm its AAA rating one way or the other, having only stated that they are completing a review of the U.S. credit rating by the end of the month.<sup>3</sup>

1 Andrew Ackerman and Mark Taylor, “Rater Egan-Jones Cuts U.S. Debt,” *Wall Street Journal*, 18 July 2011.

2 Standard & Poor’s, *United States of America Long-Term Rating Lowered To ‘AA+’ On Political Risks And Rising Debt Burden; Outlook Negative; Understanding Standard & Poor’s Rating Definitions*.

3 Moody’s, *US Aaa Confirmed, Negative Outlook Assigned*; Daniel Bases and Walter Brandimarte, “Fitch keeps US AAA rating, review ongoing,” *Reuters*, 3 August 2011.

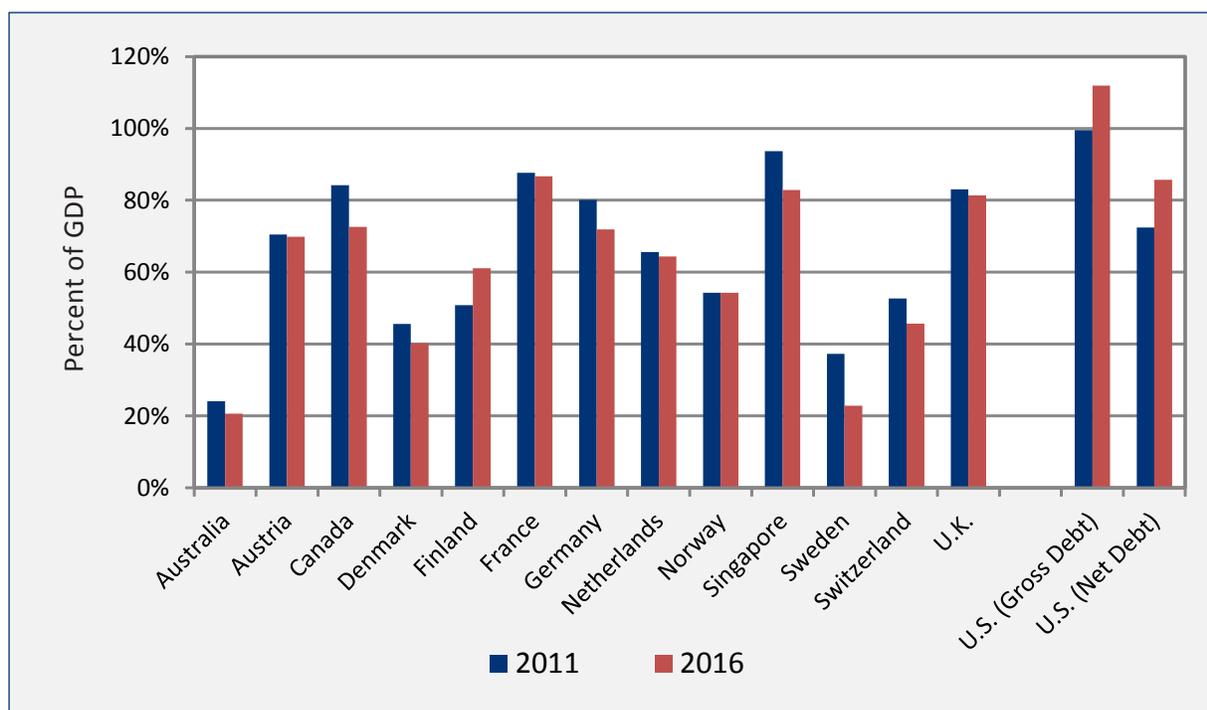
# Reasons for the Downgrade

In its recent release, S&P pointed to a number of reasons for downgrading America's long-term debt rating, including our dismal long-term fiscal outlook, the failure of the recent debt deal to produce sufficient savings which would stabilize the debt by mid-decade, and most importantly the weakening "effectiveness, stability, and predictability of American policymaking and political institutions" when it comes to addressing fiscal issues.

In terms of the U.S. debt burden, S&P views the country's high and growing debt-to-GDP ratio as an increasing problem. According to their estimates, the country's total net debt burden (including states and localities) will rise from 74 percent of GDP at the end of 2011 to 79 percent at the end of 2015 and 85 percent at the end of 2021.<sup>4</sup>

Compared to other AAA-rated countries, the U.S. faces perhaps the most severe fiscal situation. According to the International Monetary Fund, General Government Gross Debt in the U.S. is higher than any other country.<sup>5</sup> More importantly, all of the AAA countries, save Finland, are projected to have a stable or lower debt in 2016 than in 2011 – while U.S. debt will continue to grow.

FIG 2. GROSS DEBT AMONG AAA RATED COUNTRIES AND THE UNITED STATES



Source: International Monetary Fund *World Economic Outlook* (April 2011).

Note: Smaller AAA countries excluded are Hong Kong, Luxemburg, The Isle of Mann, Lichtenstein, and Guernsey.

4 Standard & Poor's, *United States of America Long-Term Rating Lowered To 'AA+' On Political Risks And Rising Debt Burden; Outlook Negative*.

5 Since the unique role of trust funds makes U.S. gross debt not strictly comparable to other countries, it may be worth looking at its "net debt" which nets out obligations between government accounts and between higher and lower levels of government. U.S. Net Government Debt is not only on the high end, but it is higher than many AAA countries' gross debt levels.

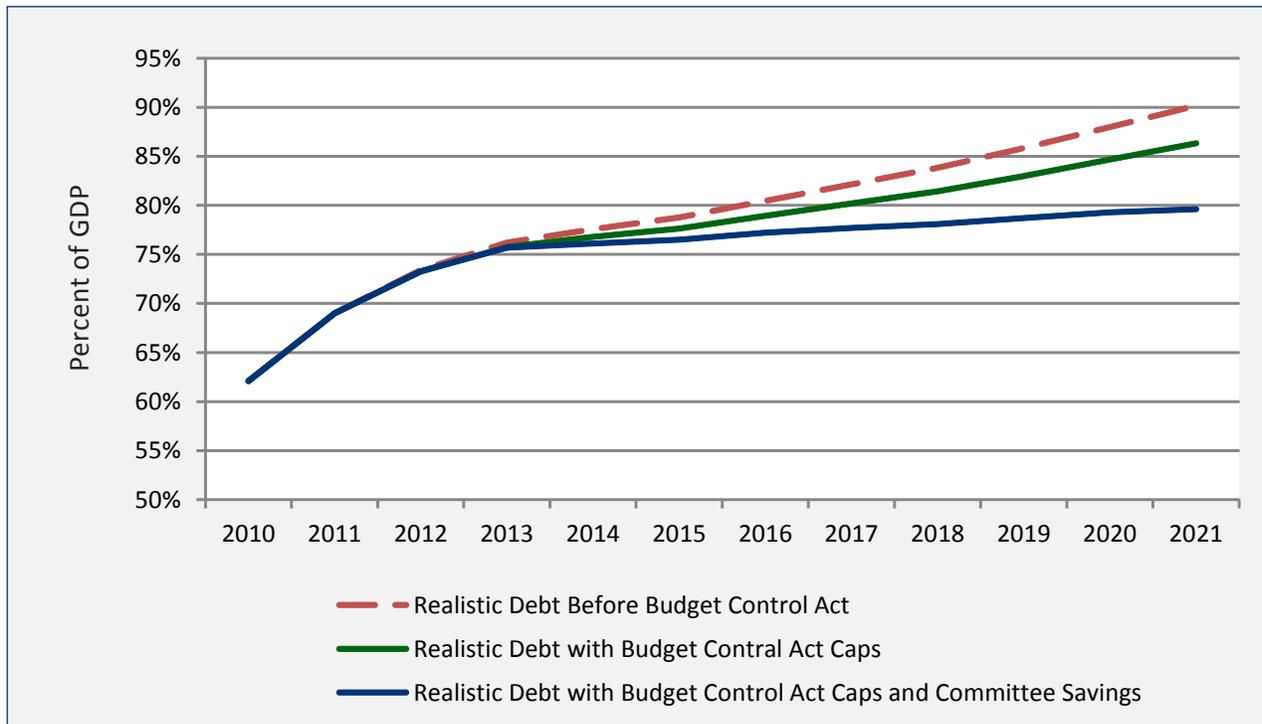
Secondly, after months of working toward a comprehensive debt reduction deal, lawmakers agreed on only modest savings under the recently-enacted Budget Control Act (BCA), compared to what is needed to stabilize the debt. That plan included over \$900 billion in savings coming mainly from discretionary spending caps along with a special process – a special joint committee of 12 lawmakers – to identify another \$1.5 trillion in deficit reduction (backed up by an automatic sequester of \$1.2 trillion if additional savings do not materialize).

In explaining its downgrade, S&P expressed concern that the plan leaves open too many details which brings into question whether they will materialize. Even assuming the special joint committee succeeds, S&P concludes that the BCA “falls short of the amount that we believe is necessary to stabilize the general government debt burden by the middle of the decade.”

This is consistent with our finding that federal debt held by the public will still rise to 86 percent of GDP by 2021 if the discretionary caps are adhered to and 80 percent of GDP if the special joint committee is also successful. While this is an improvement from the 90 percent of GDP we had projected under CRFB’s Realistic Baseline before the deal, it is far from sufficient to stabilize the debt, let alone put it on a downward trajectory as a share of the economy.<sup>6</sup>

It should be noted that before they officially released, S&P had erroneously projected net debt of 81 percent of GDP in 2015 and 93 percent in 2021, as opposed to 79 and 85 percent, respectfully, because they had been using the wrong discretionary “baseline.” Their final numbers resulted in about \$350 billion less debt by 2015 and roughly \$2 trillion through 2021. Despite this, S&P concluded that a downgrade was still warranted.<sup>7</sup>

FIG 3. DEBT PROJECTIONS BEFORE AND AFTER PASSAGE OF BUDGET CONTROL ACT



6 Committee for a Responsible Federal Budget, *CRFB’s Long-term Realistic Baseline*.

7 Standard & Poor’s, *Standard & Poor’s Clarifies Assumption Used On Discretionary Spending Growth*.

Indeed, the most important factor in S&P's downgrade was its lack of faith in the U.S. political system's ability to reach consensus on future deficit reduction measures. As S&P explains:

“[T]he downgrade reflects our view that the effectiveness, stability, and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenges to a degree more than we envisioned... we have changed our view of the difficulties in bridging the gulf between the political parties over fiscal policy, which makes us pessimistic about the capacity of Congress and the Administration to be able to leverage their agreement this week into a broader fiscal consolidation plan that stabilizes the government's debt dynamics any time soon.”<sup>8</sup>

Looking at the recent debate over the debt, S&P concludes that “the differences between political parties have proven to be extraordinarily difficult to bridge.” They also conclude that new revenues, or more than minor changes to other entitlements, will be quite difficult to enact, making the chances of stabilizing the debt slimmer still.

They find that the difficulty in reaching consensus on fiscal policy will not only make debt reduction difficult, but also divert attention from “the debate over how to achieve more balanced and dynamic economic growth.”<sup>9</sup>

## Immediate Effects of Downgrade

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The direct effect of the downgrade is still largely unknown, but signs suggest it may not be all that precipitous, at least in terms of the effects on interest rates. It is important to understand that this downgrade represents only a single notch reduction – from “extremely strong” to “very strong” – from one of the three major rating agencies.

Moreover, one of the largest potential risks – that money market funds will dump Treasuries en masse – is relative small since recent financial regulations assign any bond rating above AA- with a zero risk-rating and require all U.S. Government Securities to be counted as “First Tier Securities” regardless of their rating.<sup>10</sup>

AllianceBernstein recently conducted a study of past downgrades from other countries, looking at changes in interest rate spreads. They found little change for countries downgraded to AA+. They did conclude that the reaction could be more severe in the context of an existing crisis, but that the special features of the U.S. would likely insulate it from these issues. According to the authors, their analysis “suggests only a limited impact on US market yields...thanks to a combination of America's safe haven in times of crisis and the fact the world is several years into an economic rebound.”<sup>11</sup> Indeed, to the extent a downgrade leads to increased global economic uncertainty, it could actually reduce U.S. interest rates due to a paradoxical “flight to quality” whereby the U.S. still offers the most abundant supply of safe assets – even absent the AAA rating.

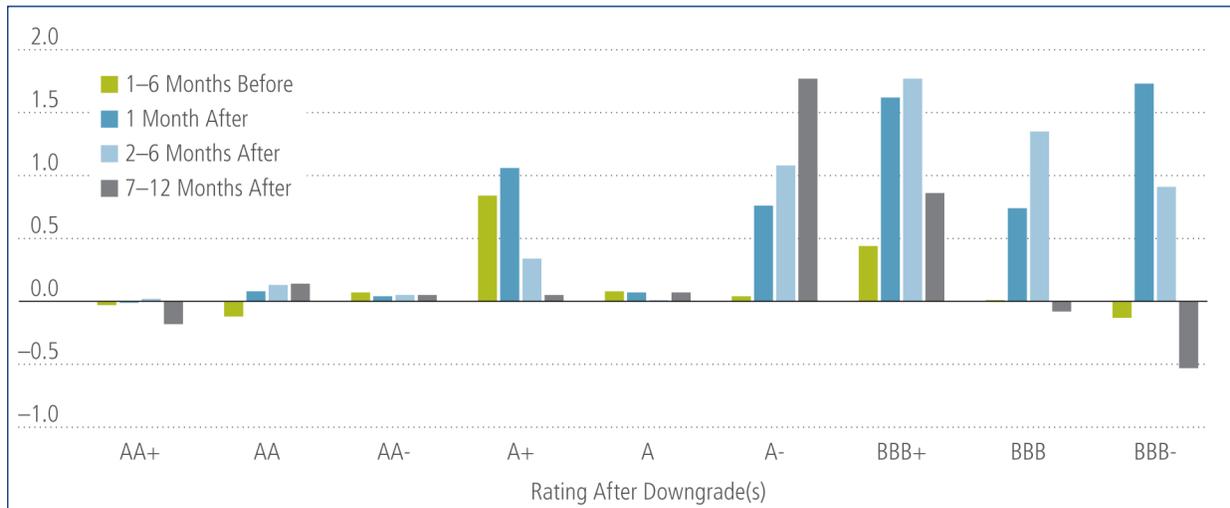
8 Standard & Poor's, *United States of America Long-Term Rating Lowered To 'AA+' On Political Risks And Rising Debt Burden; Outlook Negative*.

9 Ibid.

10 Wells-Fargo, *Understanding the Consequences of a U.S. Debt Downgrade*.

11 AllianceBernstein, *When "Risk-Free" Isn't Risk Free: The Impact of a US Treasury Downgrade*.

FIG 4. PERCENT IMPACT OF RATINGS DOWNGRADES ON SPREADS



Source: Chart from AllianceBernstein, *When “Risk-Free” Isn’t Risk Free: The Impact of a US Treasury Downgrade*.

While the immediate impact on U.S. Treasury interest rates could be small or even negative, the recent downgrade could have substantial spillover effects. For one, the downgrade may contribute to a further weakening of an already fragile economy. By reducing market confidence, it can impact investing, hiring, and even consumption.

As a narrow example, one need only look at the stock market – where the Monday following the S&P downgrade saw the biggest drop in the Dow Jones Industrial Average since the financial crisis in 2008, falling more than 600 points. Other factors certainly played a role in the market’s response – including worries over debt levels in Europe, the strength of the euro, economic indicators of the U.S., and statements from central banks around the world. However, at a time of significant economic volatility and uncertainty, S&P’s downgrade of U.S. debt is clearly not helping assuage concerns over both the U.S. economy and the federal government’s fiscal health.

In addition to a potential stock market spillover, a downgrade in U.S. Treasury bonds could spell trouble for other types of debt. On Monday, S&P downgraded the rating of a number of organizations backed by the U.S. government, including Fannie Mae, Freddie Mac, 10 of the 12 Federal Home Loan Banks (the other two already had AA+ ratings), and the Farm Credit System, which could make it harder for some of these organizations to issue debt.<sup>12</sup>

In addition, the U.S. downgrade has already lead to downgrades for a number of municipal bonds at a time when many state and local governments are struggling. On Tuesday, S&P downgraded over 11,000 debt issues from state and local government that are tied to federal finances. Though these downgrades represent just 1 percent of the \$2.9 trillion municipal bond market and S&P recently reaffirmed that many state and local governments can still maintain AAA credit ratings, further downgrades could certainly occur.

12 Standard & Poor’s, *Ratings On Select GREs And FDIC- And NCUA-Guaranteed Debt Lowered After Sovereign Downgrade*.

# Potential Medium and Long-Term Effects of Downgrade

Although the immediate effects of this downgrade could be relatively small, the medium and long-term effects could be severe. As S&P and Moody's have both warned, failure to put our fiscal house in order could result in further downgrades in the next couple of years. In fact, of the 10 other countries that have lost their AAA rating, 8 have seen an additional rating downgrade, including 5 which never recovered their AAA rating. Among those who have recovered their rating, it took an average of about 13 years – the shortest being for Canada, which recovered the rating in just under 10 years.

The consequences of further downgrades from S&P, downgrades from other agencies, or even a long-sustained AA+ rating could be serious. Currently, U.S. Treasuries dominate the bond market both domestically and internationally. Were this to change, even gradually, it could cause substantial upward pressure on interest rates.

The consequences of permanently lower ratings are reflective of the consequences of higher debt – since lower ratings function as a market signal that the United States may be unable to continue financing its debt in perpetuity.

FIG 5. COUNTRIES THAT HAVE LOST A AAA RATING FROM S&P

Country	Year Lost	What Happened After the Downgrade?
Australia	1986	Fell as low as AA in 1992 before regaining AAA rating in 2003
Canada	1992	Fell as low as AA+ before regaining AAA in 2002
Denmark	1983	Fell as low as AA in 1989 before gradually regaining AAA in 2001
Finland	1992	Fell as low as AA- in 1993 before regaining AAA 2002
Ireland	2009	Fell many times to a low of BBB+ as of April 2011
Japan	2001	Fell as low as AA- in 2002, recovered to AA in 2007, fell back to AA- in 2011
New Zealand	1983	Fell as low as AA- in 1993, rose to AA+ in 2009
Spain	2009	Fell to AA in 2010
Sweden	1993	Regained AAA rating in 2004
Venezuela	1982	Fell to as low as CCC+ in 2002, rose to its current level of BB- in 2006

Source: Standard & Poor's, *Sovereign Rating and Country T&C Assessment Histories*.

From a fiscal perspective, higher interest rates mean higher interest costs – and thus more debt. According to the Congressional Budget Office, a permanent 1 percent increase in projected interest rates would increase the deficit by \$1.3 trillion over the next decade – erasing nearly all the savings which are to be identified by the special joint committee under the BCA. Using that rule of thumb, even just a 0.1 percent increase in interest rates, compared to what CBO projects them to be, would increase deficits by \$130 billion, requiring more tax increases and spending cuts than would otherwise be necessary and reducing overall budget flexibility in the future.<sup>13</sup>

Higher interest rates could also trickle throughout the entire economy and “crowd out” important growth-creating investments while reducing the size of the nation’s capital stock and slowing economic growth in the process.

And most seriously, further downgrades could cause a market panic which could in turn lead to a fiscal crisis. Such a crisis may be unlikely now due in part to the unfortunate state of other countries, but its prospects could become a more serious threat over time. If a U.S. debt panic occurred, it could have widespread repercussions throughout the global financial markets and could potentially throw the world back into a severe financial crisis. Such a situation should be avoided at all reasonable costs.

## Conclusion

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The recent S&P downgrade of U.S. debt should not be a cause for immediate panic, but it should be a wake up call that we are running out of time to get our debt under control. Continued failed efforts to put our debt on a stable to declining path, continued unwillingness to take on entitlement and tax reform, and the growing gulf between the political parties on fiscal issues will continue to feed lack of confidence in the federal government and the economy more broadly. Absent a serious plan to bring the debt under control, the consequences could be dire.

In the coming months, all eyes will be on the new special joint committee formed by the BCA. To avoid further downgrades from the rating agencies – and more importantly to put our debt on a sustainable path – this committee must “Go Big.” Specifically, the committee should be looking to double or triple its target from \$1.5 trillion to \$3 to \$4.5 trillion in order to put the debt on a downward path. And it must take serious steps to control the long-term growth of Social Security, Medicare, and Medicaid while recommending pro-growth tax reform which puts both our economy and budget on a better path.

Change comes about either through leadership or crisis; the time for leadership is running out.

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<sup>13</sup> Congressional Budget Office, *Budget and Economic Outlook: Fiscal Years 2011 to 2021*.