Special Report 2011/06

What if AAAmerica gets downgraded?

Long-standing concerns about the sustainability of US fiscal imbalances have finally led to the first 'negative outlook' for the AAA-rating of US sovereign debt by S&P. Will other rating agencies follow? And what would be the impact of a downgrade? While an actual downgrade is only a medium-term risk, and its immediate impact may be limited, time is running out for Capitol Hill.

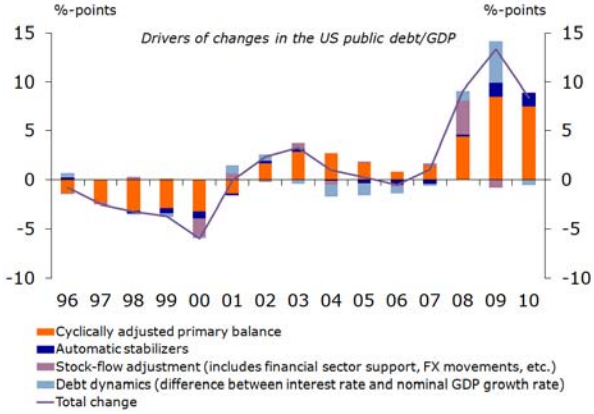
S&P pulls the trigger

On April 18, 2011 Standard and Poor's (S&P), one of the major rating agencies, sent a shockwave through the global financial markets by cutting its outlook on the US sovereign debt from *stable* to *negative*. This was the first time[1] that S&P placed US debt on negative outlook, which means there is a 1/3 chance of a downgrade of the US sovereign rating in the next 2 years. In justifying this dramatic move, S&P noted that "*there is a material risk that US policymakers might not reach an agreement in how to address medium- and long-term budgetary challenges by 2013*". However, S&P did not tell us anything that we didn't already know. After all, the market for US treasuries is highly transparent and concerns about the skyhigh US budget deficit have been elevated for quite some time. Immediately after S&P's surprise announcement, the 10y US treasury yield jumped 8 basis points, but within four hours it had returned to its previous level.

How did the US get here?

The US public finances have worsened considerably since the inception of the crisis. Figure 1 shows that the US public debt has been on the rise since 2007 for a host of factors. The biggest contribution has come from a surge in budget deficits amid the crash in the housing market and the significant shrinkage of the bloated financial sector.

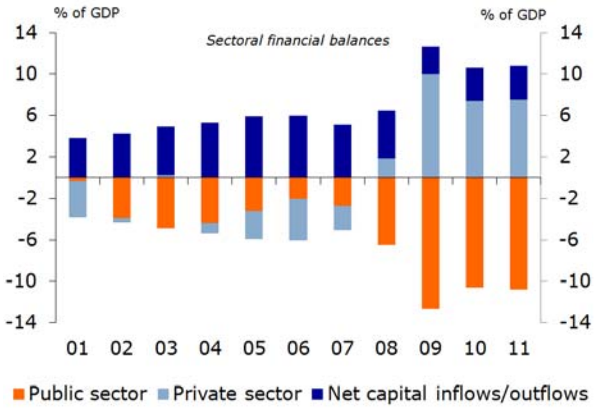
Figure 1: Rising debt



Source: OECD, Rabobank

Looking at the US sectoral financial balances, we can see that the deleveraging process in the private sector following the plunge in asset prices and the deterioration in labour market dynamics have forced the public sector to releverage in order to overcome a repeat of the Great Depression (see figure 2). The overstretched US households needed to repair their balance sheets after amassing colossal amount of debt in the go-go years of the past decade. As a result, the personal savings rate, which dropped to close to zero before the crisis, surged thereby leading to a massive fall in the household debt-to-income ratio (from 130% in 07Q3 to 116% in 10Q4).

Figure 2: Deleveraging and releveraging



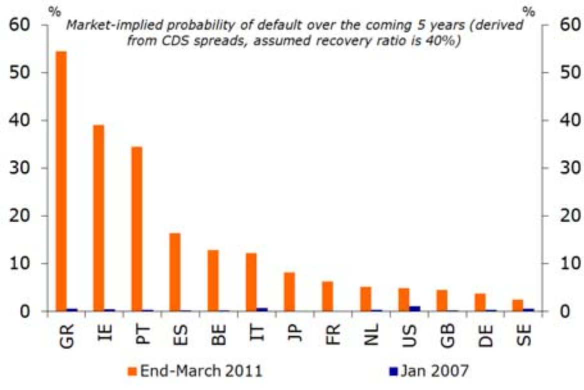
Source: IMF, Rabobank

[1] Other rating agencies made similar moves in the mid-1990s.

The analysis shows that the US government's expansionary fiscal policy may have been necessary given the private sector's weakness. Nevertheless, the resulting rise of public debt has placed the country's public finances in the spotlight.

In fact, the cost of fighting the recession is only part of the problem. Due to entitlement programs, the US faces growing structural budget imbalances. The income from payroll taxes will not be enough to deal with the costs of the ageing population and the rising costs of health care. Projections by the Congressional Budget Office suggest that Social Security may run out of money in 2043, and Medicare as soon as 2017. Admittedly, investors still seem to be giving the US government the benefit of the doubt even though it is the only AAA-rated country that has no credible medium-term plan to restore debt sustainability. The market-implied probability of default derived from CDS spreads show that investors are little concerned about the US public finances (see figure 3). To be sure, a further rise in the public debt ratio and the resulting increase in debt servicing costs can suddently shift sentiment.

Figure 3: Who's afraid of a US default?



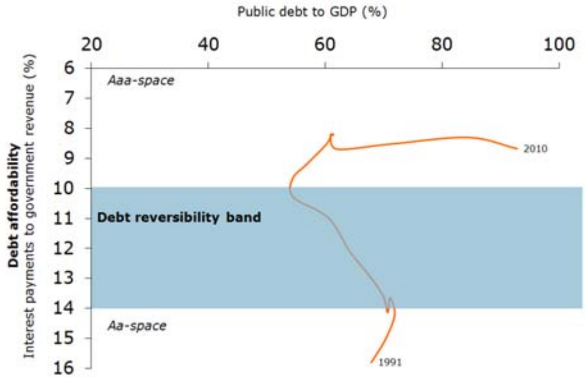
Source: Bloomberg, Rabobank

What about Moody's?

Now that S&P has set a time schedule for a possible downgrade, should we expect a similar move by Moody's? To assess the likelihood of a rating downgrade by Moody's, we must look at three important criteria:

- **Debt affordability** (the ability of the government to service its debt).
- **Debt reversibility** (the ability of the government to restore debt affordability by combining discretionary fiscal adjustment and nominal growth).
- **Debt financeability** (the ability of the government to raise large amounts of debt without triggering large increases in its cost of funding).

Figure 4: Moody's Aaa-monitor



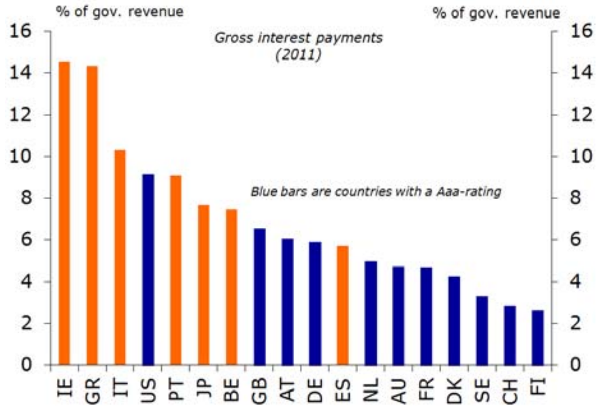
Source: OECD, Moody's, Rabobank

Moody's Aaa-monitor, which shows the position of a government, year by year, on the basis of its debt/GDP ratio and debt affordability (interest payments/revenue ratio), nicely encapsulates all three criteria in one single chart (see figure 4). The horizontal axis measures the debt/GDP ratio. The vertical axis measures debt affordability. This axis is inverted, so that a downward trajectory over time means a gradual deterioration of debt affordability. The slope and curvature of the curve provide a crude indication of a government's degree of debt financeability. A steep curve indicates that a rise in debt is accompanied by a rapid deterioration of affordability – typically through an associated increase in interest rates (which makes the curve bend). The shaded area represents the debt reversibility band, beyond which the country enters the Aa-space.
When a debt trajectory enters the reversibility band, it means that the adjustment capacity of the country is being tested. It is important to note that the width of the band is country-

specific[2]. Of course, one has to be clear that surpassing this ratio does not automatically lead to a rating downgrade. Many other factors matter for a country's sovereign rating (e.g. institutional strength, fiscal and monetary flexibility, economic vitality, fiscal consolidation record, etc).

We can deduce from the figure that the US is still a long way off from a rating downgrade, by Moody's, given that its debt affordability, although the lowest amongst Aaa-rated countries (see figure 5), has not yet entered the debt reversibility band.

Figure 5: Debt affordability compared



Source: OECD, Bloomberg, Rabobank

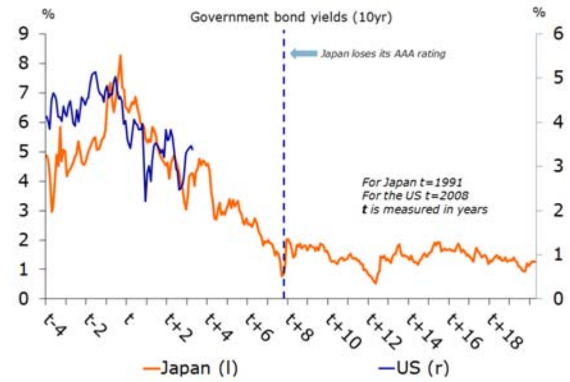
An important reason for this is the role of dollar as the world's most used currency. This has given the US extra fiscal space since foreign investors can hardly find a deeper and more liquid market to invest in (especially during times of financial distress). Another reason is the extremely loose monetary policy by the Federal Reserve, which has put downward pressure on long-term interest rates (i.e. improved debt affordability while public debt was rising).

What's more, Moody's assessment of recent events on Capitol Hill has been more positive than S&P's. At the same time, given the amount of criticism on rating agencies since the outbreak of the credit crisis, and S&P's first move, Moody's may feel pressured to put the US on negative outlook somewhat earlier than it would otherwise have done.

Does a downgrade matter for rates?

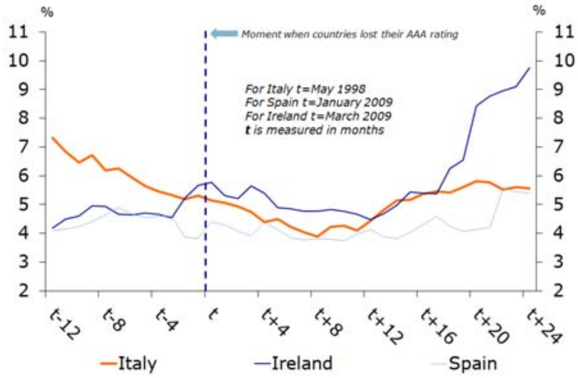
Even if the downgrade is only a medium-term risk, we still need to understand the implications of such a move on US interest rates. To do so, we could take a closer look at how other countries fared once they kissed their AAA-rating goodbye. We first plot the US government bond yield versus Japan's (see figure 6). Based on Japan's experience (which was also going through a painful private sector deleveraging following the burst of its asset bubbles), we may conclude that nominal yields do not necessarily rise once the sovereign is downgraded. In fact, Japanese yields have only fallen further after it lost its AAA-rating in 1998. It should be mentioned, however, that Japan faced a stagnant economy and deflation during this episode.

Figure 6: The impact of a rating downgrade (1)



Source: Reuters EcoWin, Bloomberg, Rabobank

Figure 7: The impact of a rating downgrade (2)



Source: Reuters EcoWin, Bloomberg, Rabobank

[2] According to Moody's, the Aa-space is reached when the US debt affordability ratio exceeds 14%.

Let's turn to Europe (see figure 7) to expand our sample. Italian yields continued to drop in the months after it lost its AAA rating in 1998. However, it should be noted that its spread with Germany widened modestly. More recently, Ireland and Spain's long-term interest rates hardly reacted to their downgrade until many months later (possibly due to other reasons such as further clarity about the troubles in their respective banking sectors).

So why don't yields spike after a sovereign loses its AAA rating? We can think of three important reasons. First, changes in ratings can be considered as a lagging indicator. Markets tend to move faster than rating agencies in pointing to unsustainable fiscal policies. A deterioration in the fiscal outlook may already be reflected in government bond yields long before the downgrade takes place. Second, the rating downgrade can be 'priced-in' by bond vigilantes way before the rating agencies take action because the decision to place a sovereign on negative outlook is already a clear communication on the part of rating agencies, though not a commitment, that a downgrade is possible. Third, a massive increase in private sector savings in a weak economic environment, over and above the government deficit, can be enough to absorb the outstanding as well as the newly issued public debt. This will keep interest rates in check even if the government is continuously running a deficit; this has been the case for many years in Italy and in Japan.

Concluding remarks

Our analysis shows that a AA+ rating for the US sovereign debt does not lead to economic catastrophe as interest rates may hardly react to a one-notch downgrade. But the more important question is whether this should give the authorities a sense of comfort that nothing is wrong with their public finances.
The short is answer is: no.

The current fiscal stance of the US is clearly unsustainable. The special role of the dollar will not indefinitely make the country immune from a debt crisis. If foreign investors truly fear that the US public debt is on an unsustainable trajectory, then they would have no option but to invest in other assets. This will naturally lead to a self-fulfilling vicious spiral, whereby higher interest rates amid market nervousness lead to rising debts, which will further undermine investor confidence and (perceived) government willingness and ability to service its debt. In such scenario, one cannot expect that the US rating will remain even AA+ for an extended period. Further downgrades will complicate matters for the US fiscal policymakers.

In our view, the negative outlook by S&P should further concentrate US fiscal policymakers' minds. The government cannot afford to test market nerves by allowing debt ratios to rise without having a **credible medium-term strategy** to restore order to the public finances. This is all the more necessary against the backdrop of an ageing population, which will put an enormous amount of pressure on public finances in the coming decades.

To conclude, the policy of kicking the can down the road is no longer a viable solution to America's long-term fiscal challenges. Time for tough choices has arrived!

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Shahin Kamalodin (+31 30 2131106)
S.A.Kamalodin@rn.rabobank.nl
Economic Research Department

Philip Marey (+31 30 2169721)
Philip.Marey@rabobank.com
Financial Markets Research

www.rabobank.com/kennisbank
www.rabotransact.com