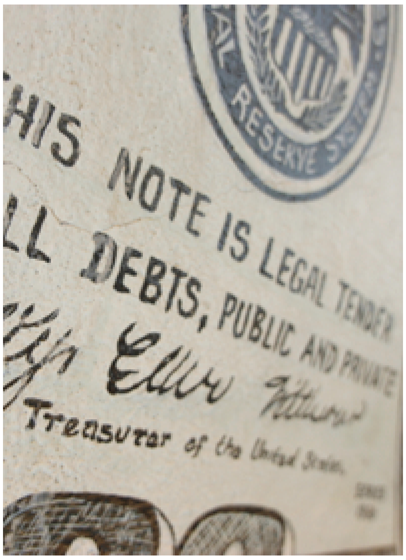
The Real Impact of a U.S. Debt Downgrade



> The debt ceiling is not the central preoccupation that we have. We put the United States on credit watch because we're growing less certain that this political debate can be resolved. This was not merely about the debt ceiling.
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> The problem with the U.S. is that there is no strategy. There is a debate about what the strategy would be. But there's nothing close to a consensus.
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> [And] we're wondering if a deal [does become] possible, would that make a difference in the underlying fiscal dynamics?

It's the long-term dynamics of reining in government spending that is the sticking point. Raising the debt ceiling (or not) is almost beside the point. It's the spending, and it always has been. Added the report from S&P, "If an agreement is reached to raise the debt ceiling but nothing meaningful is done in terms of deficit reduction, the US would like have its rating cut to the AA category." Furthermore:

> While banks and broker-dealers wouldn't likely suffer any immediate ratings downgrades, we would downgrade the debt of Fannie Mae, Freddie Mac, the 'AAA' rated Federal Home Loan Banks, and the 'AAA' rated Federal Farm Credit System Banks to correspond with the US sovereign rating.

The impact of such a downgrade would touch every entity that is holding U.S. sovereign debt, including municipal bond funds, state government debt, and foreign central banks as well. States would be impacted both directly and indirectly: Their costs of borrowing would increase, as well as the likelihood that federal funds flowing to the states would be curtailed. Cities, nonprofit hospitals, and universities would also "share the pain" according to S&P. In addition, the huge derivatives market, estimated at a mind-boggling $615 trillion, could also be impacted.

The S&P report follows the announcement by Moody's rating service on July 15 that it was putting the U.S. on a downgrade watch. In order for Moody's to continue the AAA rating that U.S. government debt has enjoyed since 1917, it wants a

> Deficit trajectory that leads to stabilization and then [a] decline in the ratios of federal government [spending] to GDP [as well as] debt to revenue beginning within the next few years.…
>
> We view any agreement that is reached this year as a first step … of what will ultimately need to be multiple deficit reduction measures over the next few years.

Writers at Reuters looked at the impact such downgrades might have, and noted that when Moody's revised its outlook to negative on Japan's AAA-rated sovereign debt in 1998, both the yen and government bond prices dropped sharply. They concluded that while similar weakening of the dollar could boost imports (by making foreign goods look cheap), it would also push up prices of imported goods, impacting the Consumer Price Index and exacerbating the already gathering increase in consumer prices. They also noted that higher interest rates could further slow any rebound in housing, and dampen automobile sales.

However, Tom Porcelli, chief economist at RBC Capital Markets, looked at the price performance of sovereign debt of four countries that lost their AAA rating and said the yields (which move inversely to bond prices) fell just six basis points — six one-hundredths of a percentage point — translating to a decline in bond prices scarcely worth mentioning.

JPMorgan surveyed 45 of its bond clients to see what their estimate in yields would be in the unlikely event that the U.S. government misses an interest payment, and learned that they might increase between one-third and one-half of a percent.

Thomas Lawler of Lawler Economic & Housing Consulting was blunt: "Who cares what they think? These are the same people who rated (subprime) bonds [as AAA]. I don't view [their opinions] as a big … deal."

Lawler's position on the rating agencies was confirmed by Rep. Ron Paul (R-Texas) who suggested in an interview on Bloomberg TV that he doesn't see much value in the rating opinions of any of the rating agencies. He said, "I think [US government debt] should have been marked down a long time ago." He added:

> We play along with this game with Social Security. We know it is insolvent. We know that if it were an insurance company, it would be in big trouble … ultimately, the fundamentals show [that] this country is bankrupt.

In the real world, then, if August 2 comes and goes without raising the debt ceiling, rather little would change. Interest rates might rise a little bit, but Social Security checks would go out, military personnel would get paid, some agencies might have to be curtailed slightly but only temporarily. The Treasury Department will find a way to continue spending, and that's the real impact of any downgrade: a recognition of the reality that government spending is out of control, and not likely to be reined in any time soon.