

Economics 325
Intermediate Macroeconomic Analysis
Supplement 2
Professor Sanjay Chugh
Fall 2011

In the following *Wall Street Journal* article, published on August 6, 2011, market reaction of the downgrade by S&P (one of the three financial ratings firms) appears. The other two financial ratings firms (Fitch and Moody's) had reaffirmed their triple-A rating following the U.S. deficit scandal.

S&P Strips U.S. of Top Credit Rating

*Unprecedented Downgrade Comes After Last-Minute Standoff;
Treasury Says Decision Is 'Flawed by a \$2 Trillion Error'*

By DAMIAN PALETTA And MATT PHILLIPS

A cornerstone of the global financial system was shaken Friday when officials at ratings firm Standard & Poor's said U.S. Treasury debt no longer deserved to be considered among the safest investments in the world.



S&P removed for the first time the triple-A rating the U.S. has held for 70 years, saying the budget deal recently brokered in Washington didn't do enough to address the gloomy outlook for America's finances. It downgraded long-term U.S. debt to AA+, a score that ranks below more than a dozen countries, including Liechtenstein, and on par with Belgium and New Zealand. S&P also put the new grade on "negative outlook," meaning the U.S. has little chance of regaining the top rating in the near term.

The unprecedented move came after several hours of high-stakes drama. It began in the morning, when word leaked that a downgrade was imminent and stocks tumbled. Around 1:30 p.m., S&P officials notified the Treasury Department that they planned to downgrade U.S. debt and presented the government with their findings. Treasury officials noticed a \$2 trillion error in S&P's math that delayed an announcement for several hours. S&P officials decided to move ahead, and

after 8 p.m. they made their downgrade official.

S&P said the downgrade "reflects our opinion that the fiscal consolidation plan that Congress and the administration recently agreed to falls short of what, in our view, would be necessary to stabilize the government's medium-term debt dynamics." It also blamed the weakened "effectiveness, stability, and predictability" of U.S. policy making and political institutions at a time when challenges are mounting.

"A judgment flawed by a \$2 trillion error speaks for itself," a Treasury representative said.

The ratings firm responded early Saturday Eastern time, saying its decision was not affected by a change of assumptions regarding the pace of discretionary spending growth.

"In taking a longer term horizon of 10 years, the U.S. net general government debt level with the current assumptions would be \$20.1 trillion (85% of 2021 GDP). With the original assumptions, the debt level was projected to be \$22.1 trillion (93% of 2021 GDP)," S&P said.

Also Saturday, government [officials in Asia](#) issued cautious statements about the news.

The downgrade will force traders and investors to reconsider what has been an elemental assumption of modern finance. Since July 14, when Standard & Poor's warned it could downgrade the credit rating, analysts have struggled to determine how such a move could affect the financial landscape, given how Treasuries permeate Wall Street and the economy.

It's possible the blow in the short run might be more psychological than practical. Rival ratings firms Moody's Investors Service and Fitch Ratings have maintained their top-notch ratings for U.S. debt in recent days. And so far, U.S. Treasury bonds have remained a haven for investors worried about the health of the U.S. economy and the state of Europe's debt crisis. The pre-announcement spat could further undermine the impact of the downgrade.

But the move by S&P still could serve as a psychological haymaker for an American economic recovery that can't find much traction, and could do more damage to investors' increasing lack of faith in a political system that is struggling to reach consensus even on everyday policy matters. It could lead to the prompt debt downgrades of numerous companies and states, driving up their costs of borrowing. Policy makers are also anxious about any hidden icebergs the move could suddenly reveal.

A key concern will be whether the appetite for U.S. debt might change among foreign investors, in particular China, the world's largest foreign holder of U.S.

Treasuries. In 1945, foreigners owned just 1% of U.S. Treasuries; today they own a record high 46%, according to research done by Bank of America Merrill Lynch.

Late Friday, federal regulators said the downgrade wouldn't affect risk-based capital requirements for U.S. banks—the cushion banks must hold to protect against losses. The Federal Reserve, Federal Deposit Insurance Corp. and other federal banking regulators said in a statement the lowering "will not change" the risk weights for Treasury securities and other securities issued or guaranteed by the U.S. government or government agencies.

Because S&P left the U.S. short-term credit rating unchanged, the downgrade is unlikely to have a big impact on money market funds that own U.S. Treasury bills.

Some investors believe Treasuries will remain a safe place in a volatile world, even without a solid triple-A credit-rating. Others believe the U.S. will be forced to pay higher interest rates, say about 0.5 percentage point higher, simply because they are seen as being slightly riskier than before. While only a slight gain, such a jump would increase the cost of a wide array of debt, from a home mortgage to the trillions of dollars in debt carried by the U.S. government itself.

Lessons from other countries, such as Canada and Australia, suggest it can take years for a country to win back its AAA rating. At the same time, the economic impact of past downgrades has tended to be larger when multiple firms move to rate a country's debt as riskier, as opposed to a single firm acting unilaterally.

The downgrade from S&P has been brewing for months. S&P's sovereign debt team, led by company veteran David T. Beers, had grown increasingly skeptical that Washington policy makers would make significant progress in reducing the deficit, given the tortured talks over raising the debt ceiling. In recent warnings, the company said Washington should strive to reduce the deficit by \$4 trillion over 10 years, suggesting anything less would be insufficient.

Negotiations to reach that threshold collapsed, and political leaders instead agreed to a last-second deal to cut the deficit by between \$2.1 trillion and \$2.4 trillion, making a downgrade almost unavoidable. When the \$4 trillion deal fell apart, some Obama administration officials immediately warned that a downgrade from S&P was a real possibility. S&P officials acknowledged the error Treasury pointed out but didn't believe it was so significant. It was a technical error, though it could have serious implications. It concerned the future ratio of U.S. debt to the size of the economy, with S&P officials projecting a larger share than many experts.

S&P officials conferred with a team from the Treasury Department earlier in the week to talk about the debt plan, and government officials tried to explain its scope. S&P officials ended their briefing with an air of mystery about what they might do, and Treasury officials were braced for an announcement later in the

week, people familiar with the matter said.

The firm's conclusion "was pretty much motivated by all of the debate about the raising of the debt ceiling," John Chambers, chairman of S&P's sovereign ratings committee, said in an interview. "It involved a level of brinksmanship greater than what we had expected earlier in the year."

The full faith and credit of the U.S. was established by Alexander Hamilton's 1790 push to have the fledgling federal government assume and pay back debts that states incurred during the Revolutionary War. It has gone largely unquestioned since, with just the occasional hiccup, including a 1979 debt-ceiling argument that delayed a few payments.

Recent demographic and economic changes, in particular the aging population and ballooning health-care costs, have made the long-term U.S. picture an ugly one, a problem exacerbated by a deep recession, which cut tax receipts and prompted a flood of fresh debt-financed spending.

Forging an agreement to tackle these problems has been elusive, with bitter partisan disagreements about tax policy and entitlement programs such as Medicare taking center stage.

The world's desire to invest in U.S. debt has a direct effect on businesses and consumers around the world. Many different types of debt, from the interest rate on a mortgage to the cost of a student loan, are pegged to the price the U.S. government pays to borrow money.

So far, economic turmoil in Europe and other parts of the world has continued to drive investors towards Treasuries, sparing the U.S. from a price usually paid by countries that can't get a handle on their debt problems. The phenomenon has kept interest rates paid on government debt very low, making it relatively inexpensive for the Treasury to finance its large deficits.

As a result of the downgrade, a few money-market funds might have to liquidate some of their Treasury holdings if they have tight rules about owning AAA-rated assets, but most aren't expected to be affected. Banks and insurers are unlikely have to hold significantly more capital against their Treasury holdings, though they could see their own bond ratings suffer.

J.P. Morgan Chase & Co. analysts estimate some \$4 trillion worth of Treasuries are pledged as collateral by borrowers such as banks and derivatives traders. If that collateral isn't considered as high quality by lenders, the borrowers could be required to cough up more cash or securities to put the minds of lenders at ease.

That could force investors to sell off other assets to come up with the money. In a worst case scenario, credit markets could seize up, as they did during the Lehman Crisis.

Money market funds held by millions of Americans hold some \$1.3 trillion in securities directly or indirectly exposed to Treasury and government agency securities, as well as short-term loans to financial institutions, known as repos, which are backed by Treasuries. Experts say that the downgrade won't force money market funds to sell. But there are still risks.

If Treasuries tumble in value, funds will be forced to mark down their holdings, raising the potential for some to "break the buck" as the Reserve Primary fund did during the worst of the financial crisis.

Write to Damian Paletta at damian.paletta@wsj.com and Matt Phillips at matt.phillips@wsj.com

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