

## The Downgrading of the United States of America: Does it Certify the Fiscal Decline of America?



**Craig Johnson**  
Associate Professor  
School of Public and Environmental Affairs  
crljohns@indiana.edu

*The views expressed are solely those of the author and do not imply endorsement by Indiana University or the School of Public and Environmental Affairs.*

*Peer Reviewers:*  
*Dwight V. Denison, Ph.D., Professor of Public and Nonprofit Finance and Director of Graduate Studies, MPA and MPP Programs, Martin School of Public Policy and Administration, University of Kentucky and W. Bartley Hildreth, Ph.D., Professor of Public Management and Policy, Andrew Young School of Policy Studies, Georgia State University*

Credit –

*faith, trust; power based on confidence; confidence in reputation of solvency; to put trust in; do credit to.<sup>1</sup>*

### Summary

As the world's leading fiscal power, the United States has long enjoyed an impeccable triple-A credit rating. This summer, for the first time in history, Standard & Poor's downgraded the United States' credit rating to AA+. While Moody's Investors Service and Fitch Ratings did not change their overall U.S. credit ratings, S&P determined that the U.S. political system is dysfunctional and cannot solve the federal government's fiscal problems, and that the federal debt is growing at a rate and by an amount that is unsustainable. In this issue of *Insight*, I explain credit ratings and the actions of "The Big Three" rating agencies, the nation's forecasted debt burden based on the 2011 Budget Control Act, and the roles Congress, the administration, and S&P are playing in determining the future of U.S. fiscal policy.

### The Day U.S. Credit Took a Hit

Friday, Aug. 5, 2011, was a sad day in American fiscal history. It was the day the credit rating firm Standard & Poor's (S&P) downgraded the credit rating of the United States from AAA to AA+. The historic decision is an emphatic statement by S&P that, in its expert opinion, the United States is no longer among, much less *the*, preeminent sovereign fiscal power in the world.

While the downgrade is a tragedy, it was both foreseen and avoidable. It was foreseen because S&P gave the U.S. government plenty of private and public notice of what policy actions and fiscal outcomes were required to avoid a rating downgrade. The downgrade was avoidable because such necessary actions could, and *should*, have been taken in full by the political actors.

### What is a Credit Rating?

A rating provides third-party certification of the quality of the issuer's debt to potential investors and other stakeholders. The rating enables investors to distinguish and compare the quality of alternative debt instruments. Long-term debt rating categories are discrete alpha symbols (e.g., AAA, AA, etc.). As shown in Table 1, the rating structure represents a qualitative, ordinal scale of highest (AAA/Aaa) to lowest (D) credit quality. Rating symbols provide investors with an objective measure of a debt issues relative credit quality – the higher the rating, the better the credit quality. The higher/lower the rating, the less/more credit risk.

---

<sup>1</sup> Hoad 1993.

Table 1. Rating Scale of the Major Credit Rating Agencies.

	Moody's	Standard & Poor's	Fitch
Investment Grade ↓	Aaa	AAA	AAA
	Aa1	AA+	AA+
	Aa2	AA	AA
	Aa3	AA-	AA-
	A1	A+	A+
	A2	A	A
	A3	A-	A-
	Baa1	BBB+	BBB+
	Baa2	BBB	BBB
	Baa3	BBB-	BBB-
Non-Investment Grade ↑	Ba1	BB+	BB+
	Ba2	BB	BB
	Ba3	BB-	BB-
	B1	B+	B+
	B2	B	B
	B3	B-	B-
	Caa1	CCC+	CCC+
	Caa2	CCC	CCC
	Caa3	CCC-	CCC-
	Ca	CC	CC
	C	C	C
	Weakest	D	D

Credit ratings are important because they affect borrowing cost. In general, ratings and borrowing cost are inversely related: the higher/lower the rating, the lower/higher the issuer's borrowing cost. It is in this sense that rating agencies are viewed as gatekeepers because they influence which capital cost gate a borrower can go through, (i.e., the triple-A low-cost gate, or the higher-cost double-A or single-A gates) and, indeed, whether any gate providing access to the capital markets will be opened at all.

Modifiers are used after the alpha characters to indicate rating sub-categories or notches. S&P and Fitch use plus (+) and minus (-) signs as modifiers, so a AA+ rating is of higher credit quality than a AA rating, which is higher than a AA- rating. Moody's modifiers are numeric suffixes – 1, 2, or 3 – to indicate relative standing from higher (1) to lower (3) standing within a category (Aa1, Aa2, Aa3). Ratings that end in 2 represent the general category.

### The Path of the United States' Fall – From Outlook Negative to CreditWatch Negative to Downgrade

Since the early 1990s, rating firms often take rating outlook and credit watch actions on outstanding debt prior to making a rating change. Rating outlooks are a medium-term refinement to the current rating. A CreditWatch (or Watchlist in Moody's terminology) action is indicative of a short-term trend, which is usually associated with a significant event such as a budget impasse or passage of a tax limitation measure. CreditWatch status indicates that a rating change may be imminent.<sup>2</sup>

On April 18, 2011, S&P affirmed the AAA rating on U.S. debt, but revised the Outlook from stable to negative. The negative

<sup>2</sup> Johnson and Kioko 2011; Hamilton and Cantor 2004; Varza et al. 2005.

outlook was a warning to officials that if material improvements to the federal government's fiscal condition were not made, a rating downgrade was likely. The commentary explaining the April S&P negative outlook action forewarned government officials by presenting a clear statement of the problem:

“Because the U.S. has, relative to its peers, ... very large budget deficits and rising government indebtedness and the path to addressing these is (sic) not clear to us, we have revised our outlook on the long-term rating to negative from stable.”

“We believe there is material risk that U.S. policymakers might not reach an agreement on how to address medium- and long-term budgetary challenges by 2013; if an agreement is not reached and meaningful implementation does not begin by then, this would in our view render the U.S. fiscal profile meaningfully weaker than that of peer AAA sovereigns.”<sup>3</sup>

The negative outlook commentary did not stop at providing a statement of the problem; it also provided officials with a solution:

“Some compromise that achieves agreement on a comprehensive budgetary consolidation program – containing deficit reduction measures in amounts near those recently proposed, and combined with meaningful steps toward implementation by 2013 – is our baseline assumption and could lead us to revise the outlook back to stable. Alternatively, the lack of such an agreement or a significant further fiscal deterioration for any reason could lead us to lower the rating”.<sup>4</sup>

After watching with the rest of the world the political wrangling between Congress and the administration over the summer, S&P officials intensified their warning of a rating downgrade on July 14, 2011, when they placed U.S. debt on CreditWatch-Negative. Being placed on CreditWatch with negative implications signals to the market that a downgrade of the issuer's debt is imminent and should be fully expected.

The placement of the U.S. government on CreditWatch with negative implications was based on the “dynamics of the political debate on the debt ceiling.” According to S&P, “despite months of negotiations, the two sides remain at odds on fundamental fiscal policy issues. Consequently, we believe there is an increasing risk of a substantial policy stalemate enduring beyond any near-term agreement to raise the debt ceiling.”<sup>5</sup>

Seemingly frustrated that their communications were not being heeded by the administration and Congress, S&P crossed the line of an impartial, external evaluator of credit quality and insinuated itself into the federal government's internal fiscal policy decision-making process by explicitly informing the government how much it had to cut the deficit to avoid a downgrade:

“We expect the debt trajectory to continue increasing in the medium term if a medium-term fiscal consolidation plan of \$4 trillion is not agreed upon. If Congress and the administration reach an agreement of about \$4 trillion, and if we conclude that such an agreement would be enacted and maintained throughout

<sup>3</sup> S&P, April 18, 2011, pg. 2.

<sup>4</sup> S&P, April 18, 2011, pg. 6.

<sup>5</sup> S&P, July 14, 2011, pg. 2.

the decade, we could, other things unchanged, affirm the AAA long-term rating ... on the U.S.”<sup>6</sup>

Leave aside for the moment the direct intrusion by S&P into the internal machinery of U.S. fiscal policy making, they were very clear on what the U.S. needed to do to keep its S&P triple-A rating. S&P’s ongoing credit surveillance role could be seen as providing the actors in this tragic political drama – Congress and the administration – the political cover to compromise on credible and substantial budget deficit reduction.

On Aug. 5, 2011, S&P downgraded the U.S. long-term credit rating to AA+ from AAA with a negative outlook.<sup>7</sup> S&P justified the downgrade on two factors:

1. Political risk – The federal political system is dysfunctional and cannot solve the federal government’s fiscal problems.
2. Federal debt burden – The federal debt is growing at a rate and by an amount that is unsustainable.

## Political Risk

The notion that a nation may be unable or unwilling to pay its debt in full and on time because it has a weak political system – the notion of “political risk” – is something we have traditionally ascribed to nations with marginal economies ruled by dictators and subject to coups; not the United States of America. In America political risk was thought to be effectively zero, as evidenced by the U.S. currency serving as the world’s reserve currency and Treasury bills being the de facto default-free security in financial transactions around the world.

Since studying the interaction between political officials in New York and the credit rating agencies in the mid-1980s, it has been my view that S&P places more weight on the “political” dimension of credit quality than Moody’s Investors Service or Fitch. Very messy and very public political brawls between elected officials have been punished by S&P, especially if they produce less than a long-term solution to a structural fiscal crisis. Political ineptitude on public display in response to real and fundamental fiscal problems is not taken lightly by S&P.

Moody’s Investors Service and Fitch Ratings had a different assessment. On Aug. 2, Moody’s confirmed the U.S.’s Aaa rating, but assigned a negative outlook. Compared to S&P, Moody’s was less influenced by the summer’s media circus over debt ceiling negotiations and more impressed with the passage of the Budget Control Act of 2011.<sup>8</sup>

Fitch was even more conciliatory. On Aug. 18, Fitch affirmed the U.S.’s AAA rating with a stable outlook by simply proclaiming that the “U.S. can tolerate more debt than other AAA sovereigns.”<sup>9</sup> Fitch interpreted the summer’s negotiations and outcome, the Budget Control Act, as mere expressions of the United States’ dynamic democratic process and strong political will. It commented that the “U.S. dollar’s position as the global reserve currency means

it can tolerate higher debt to GDP levels than other AAA rated sovereigns,” and the “U.S. is anything but just another sovereign.”<sup>10</sup>

The result of “Big Three” rating agency actions is that the United States now has a split rating: AA+/Aaa/AAA. Split ratings are common. Interest rates on federal debt issued in the future should reflect the split rating differential with the interest rate based primarily on the two higher identical ratings. As long as the United States maintains at least two triple-A ratings, the difference in new issue Treasury interest rates will likely be statistically non-significant. If all three rating agencies were to lower the United States’ rating to double-A, however, the interest rate increase will likely be significant – empirical research suggests as high as 22 bps (basis points).<sup>11</sup>

S&P’s downgrade was accompanied by a negative outlook, indicating that another downgrade may occur within the next two years. An S&P rating downgrade would take U.S. debt down to AA or AA-. Since most split ratings are within one or two notches, it is unlikely that Moody’s and Fitch’s U.S. ratings would remain triple-A if S&P lowered their rating any further.

## The Federal Deficit and Debt Burden

On Aug. 2, 2011, President Obama signed into law the Budget Control Act of 2011 (BCA).<sup>12</sup> The BCA increases the federal debt limit and enacts budgetary changes estimated to cut the total federal deficit by \$2.2 trillion over the next ten years, a reduction of 32 percent.<sup>13</sup>

By directly reducing the federal deficit, the BCA will reduce the amount of federal debt necessary to finance the deficit. The trajectory of the federal debt burden has now changed. Figure 1 shows federal debt projections before and after the passage of the BCA. Before and after figures show that the dollar amount of debt is expected to be lower every year in the future. It has a lower slope indicating that, while still growing, is growing at a slower pace.

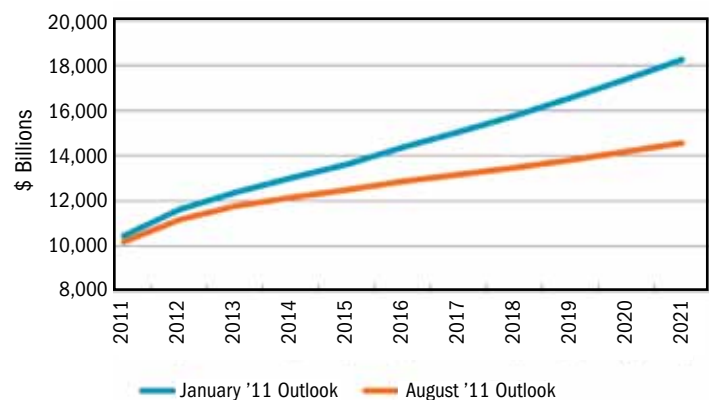


Figure 1. Federal Debt Held by the Public (\$ Billions). Data Source: CBO, January 2011 and August 2011.

<sup>6</sup> S&P, July 14, 2011, pg. 4.

<sup>7</sup> S&P, August 5, 2011.

<sup>8</sup> Moody’s, August 8, 2011.

<sup>9</sup> Fitch Ratings, August 18, 2011.

<sup>10</sup> Fitch Ratings, August 18, 2011.

<sup>11</sup> These results are based on Johnson & Kriz (2002), which covers state government bonds but is the only empirical split-rating interest cost study that uses Fitch data along with Moody’s and S&P.

<sup>12</sup> Public Law 112-25.

<sup>13</sup> CBO, August 2011.

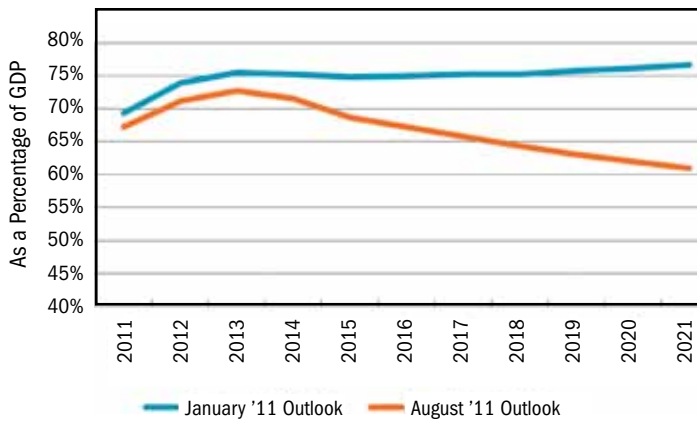


Figure 2. Federal Debt Held by the Public (as a Percentage of GDP). Data Source: CBO, January 2011 and August 2011.

Projected federal debt as a percentage of GDP in 2021, shown in Figure 2, goes from 76.7 percent of GDP to 61.0 percent of GDP – still a high portion of GDP, but 16.7 percent lower. What was an increasing burden on the economic life of the nation is now a decreasing burden. By any reasonable measure, the trajectory of federal debt has materially improved.

The most important measure of debt burden is debt service. Debt service is principal and interest. Using outstanding debt as the only measure of debt burden misses the largest cash outflow: interest payable. CBO estimates federal debt service will be reduced by \$331 billion from 2011–2021, \$134 billion from lower forecasted interest rates, and \$197 billion directly from financing lower deficits from the BCA. Therefore, federal taxpayers can expect to save \$331 billion that otherwise would have been spent servicing higher deficits at higher interest rates.

## Conclusion

While the media circus that was the debt ceiling negotiations of the summer of 2011 was unseemly, reputable financial experts are expected to have the vision to see beyond the immediate frenzy into the longer-term substance of fiscal affairs. I believe S&P got caught up in the emotional frenzy and lost their perspective. By trying to influence fiscal policy events, they lost their way and became part of the process rather than simply being an unbiased, third-party evaluator of credit quality for investors.

I believe Moody's got it right. The actions taken by Congress and the administration, which resulted in the BCA, should produce meaningful reductions in the federal deficit, debt burden, and debt service costs. These steps begin to put the nation's fiscal house back on the right path and justify maintaining the United States as a triple-A nation. I also agree with Moody's that the credit outlook should be negative (from the level of a triple-A, not double-A+, credit), not stable. Congress and the administration must demonstrate over the next few years that they can maintain fiscal discipline and steer the nation through the struggling economy or a rating downgrade from Moody's and Fitch – truly certifying the fiscal decline of America – may be fateful.

## Acknowledgements

I would like to thank Aliyah Johnson and Ann Richardson for excellent research assistance on this project.

## References

- Congressional Budget Office (CBO). *The Budget and Economic Outlook: Fiscal Years 2011 to 2021*. January 2011.
- \_\_\_\_\_. *The Budget and Economic Outlook: An Update. The Congress of the United States*. August 2011.
- FitchRatings. *US Can Tolerate More Debt than Other 'AAA' Sovereigns*. August 18, 2011.
- Hamilton, D. and R. Cantor. *Rating Transition and Defaults Conditional on Watchlist, Outlook and Rating History*. Moody's Investors Service. Special Comment. February 2004.
- Hoad, T.F. *The Concise Oxford Dictionary of English Etymology*. Oxford University Press. Oxford, New York. 1993.
- Johnson, Craig L. and Kenneth A. Kriz. "Impact of Three Credit Ratings on Interest Cost of State GO Bonds." *Municipal Finance Journal*. 23/1; pg. 1. Spring 2002.
- Kioko, Sharon N. and Craig L. Johnson. *The Impact of Credit Rating Agency Outlooks on Debt Borrowing Costs*. Unpublished Manuscript. 2011.
- Moody's Investors Service (Moody's). *The Key Drivers Behind Moody's Confirmation of the US Aaa Rating*. (Extracted from "Moody's Weekly Credit Outlook, dates August 8, 2011.") August 8, 2011.
- Standard & Poor's (S&P). *Ratings Direct on the Global Portal. Research Update: United States of America 'AAA/A-1+' Ratings Affirmed; Outlook Revised to Negative*. April 18, 2011.
- \_\_\_\_\_. *Ratings Direct on the Global Portal. Research Update: United States of America 'AAA/A-1+' Ratings Placed On CreditWatch Negative On Rising Risk of Policy Stalemate*. July 14, 2011.
- \_\_\_\_\_. *Ratings Direct on the Global Credit Portal. Research Update. United States of America Long-Term Rating Lowered to 'AA+' On Political Risks and Rising Debt Burden; Outlook Negative*. August 5, 2011.
- \_\_\_\_\_. *Standard & Poor's Clarifies Assumption Used On Discretionary Spending Growth*. August 6, 2011.
- Vazza, Diane, et al. "CreditWatch and Ratings Outlooks: Valuable Predictors of Ratings Behavior." *Global Fixed Income Research*. Standard & Poor's. May 2005.

Each issue of *SPEA Insight* highlights a major public policy challenge in the USA or the world, along with analysis by SPEA faculty and other experts that will help policy makers address these challenges.

[www.spea.indiana.edu](http://www.spea.indiana.edu)