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**Credit FAQ:**

# Why It Is Unlikely That The Ratings On The U.S. Government Will Be Lowered In The Near Term

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## **Credit FAQ:**

# Why It Is Unlikely That The Ratings On The U.S. Government Will Be Lowered In The Near Term

The public finances of many highly rated sovereigns have suffered recently. In Standard & Poor's Ratings Services' view, this deterioration could be difficult to reverse in the medium term. Some market participants have asked whether the magnitude of the fiscal deficits and debt burden the United States of America (AAA/Stable/A-1+) government faces could affect our assessment of its creditworthiness. We maintain our view that our ratings on the U.S. government are not likely to be lowered in the near term.

## Frequently Asked Questions

### What Is Standard & Poor's Current Opinion On The U.S. Government's Creditworthiness?

The long- and short-term ratings on the U.S. government are the highest Standard & Poor's assigns, and the outlook is stable (see "United States of America 'AAA/A-1+' Ratings Affirmed; Outlook Stable," published Jan. 13, 2009, and "United States of America," published Feb. 28, 2008, both on RatingsDirect). Currently, 17 of the 124 sovereigns we rate have 'AAA' long-term ratings and stable outlooks. These include close G7 peers, such as Canada, France, and Germany (see "Sovereign Ratings And Country T&C Assessments," published June 9, 2009, on RatingsDirect).

### Is Standard & Poor's Reconsidering This Opinion?

Like all our other ratings, we continually surveil our sovereign rating on the U.S. We evaluate new information pertaining to the U.S.'s creditworthiness as it becomes available. That said, despite significant weakening in the near-term economic outlook, projected fiscal deficits, and the high fiscal costs of government support of the U.S. financial sector, we still believe that the U.S. government's credit strengths continue to outweigh its weaknesses.

### Why Does Standard & Poor's Continue To View The U.S. As A 'AAA' Credit?

We believe the U.S.'s key credit strengths include:

- A high-income, highly diversified economy, with unusually flexible labor and product markets.
- The unique advantages associated with the U.S. dollar's preeminent role as the world's most used currency (see "Despite Pressures, The U.S. Dollar Remains The Key International Currency," Oct. 15, 2007, RatingsDirect).
- The country's openness to trade and capital flows and experience in adapting to associated fluctuations.
- The country's stable political system with strong, long-established institutions, its ability to respond to changing economic and financial circumstances, and its transparency in policymaking.

We explained the importance of these factors to our analysis in "Sovereign Credit Ratings: A Primer," May 29, 2008, RatingsDirect. Since we published our last FAQ on the U.S. (see "What Could Change Our 'AAA' Credit Rating On The U.S. Government?" published Sept. 2, 2008, on RatingsDirect), the strength of the U.S. government's fiscal position relative to those of several other 'AAA' sovereigns has diminished, in our view. All else being equal, if the net general government debt burden exceeded that of other 'AAA' rated governments for a sustained period, with little prospect of policy actions that would restore the debt burden on a credible downward trajectory, or if the dollar began to lose its key currency status, then the rating could come under pressure. Nevertheless, we continue to believe it likely that the government will take steps to counter the large fiscal deficits that—under current policy settings—would otherwise persist over the medium term, and thus help maintain the central status of the U.S. dollar.

## How Does The U.S. Compare With Other Highly Rated Sovereigns?

Many sovereigns' fiscal profiles have deteriorated recently because of the global recession and the need to recapitalize parts of their financial systems (see "Public Finances In Highly Rated European Sovereigns: The Deterioration Sets In," May 28, 2009, and "Sovereign Ratings Sag Under The Global Economic Strain," Jan. 27, 2009). Although the rise in the U.S. government's debt stocks as a percentage of GDP will be among the most rapid of this set, the U.S. benefitted from entering this downturn from a position of relative fiscal strength. In addition, we believe that the U.S. Treasury and the Federal Reserve have been more proactive in redressing problems in the U.S. financial system than several European peers, which we expect should help the U.S. economy recover more quickly.

**Table 1**

<b>U.S. Government Indebtedness Under Various Financial-Sector Recapitalization Scenarios</b>						
	<b>2008</b>	<b>2009*</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>
<b>Baseline scenario, assuming 14% GDP recapitalization</b>						
Net general government debt (% of GDP)	47	74	83	88	89	90
<b>Optimistic scenario, assuming 10% GDP recapitalization</b>						
Net general government debt (% of GDP)	47	70	80	84	86	87
<b>Pessimistic scenario, assuming 20% GDP recapitalization</b>						
Net general government debt (% of GDP)	47	80	90	94	95	96
<b>Fundamental assumptions for all the scenarios</b>						
General government balance excluding recapitalization (% of GDP)		(12.0)	(11.5)	(7.9)	(6.2)	(5.9)
Real GDP (% change)		(3.1)	1.3	3.3	3.9	3.1
GDP deflator (% change)		1.6	1.1	1.2	1.3	1.6
<b>Memorandum item:</b>						
Our forecast (nominal) GDP level (Bil. \$)	14,265	14,048	14,395	15,046	15,832	16,585

\*After 2008, 15% asset reduction and allocating all assumed recapitalization costs to 2009.

We believe the U.S. shares some credit characteristics with the U.K., the outlook on which we recently revised to negative (see "United Kingdom Outlook Revised To Negative On Deteriorating Public Finances; 'AAA/A-1+' Ratings Affirmed," May 21, 2009, on RatingsDirect). We project that the cost of recapitalizing the financial system will be higher in the U.S. than the U.K. (10%-20% of GDP for the U.S. versus 7%-10% of GDP for the U.K.) and that both countries will endure a period of subpar growth as the private sector deleverages. Still, we believe that the

fiscal outturn in the U.S. will be somewhat better than that in the U.K. because of what we view as the greater diversity and, consequently, resiliency of its economy. We expect that the U.S.'s net general government debt will rise to about 90% of GDP by 2013; we expect that of the U.K. to rise to nearly 100%. Possible trajectories of future U.S. indebtedness are traced in Table 1.

More importantly, however, in Standard & Poor's opinion, the key international role of the U.S. dollar gives the U.S. government substantially greater fiscal flexibility than the U.K. government, owing to the more modest global role of the U.K. pound sterling. We believe this flexibility would even enable the U.S. general government to carry debt in excess of annual GDP without a widening of credit risk premiums in its borrowing costs, as long as the market viewed its plan for fiscal consolidation as credible.

## How Serious Are The Medium-Term Fiscal Pressures The U.S. Government Faces?

We believe that fiscal pressures in the U.S. are, in relation to GDP, the highest since World War II and, absent steps by the government to counter them, would likely persist over the longer term. Consistent with our sovereign ratings criteria, we focus on the general government fiscal balance and the trend in net general government debt, two measures that consolidate the operations of local, state, and federal governments. However, most of the fiscal deterioration we expect in both the near term and the longer term is in the budget of the federal U.S. government. In the U.S. government's own words, increasing health costs and the aging of the population will place the budget on an unsustainable course without changes in policy to address these challenges (see "The Long-Run Budget Outlook," in Budget of the U.S. Government, Fiscal Year 2010: Analytical Perspectives). Recent projections by the Office of Management and Budget show deficits remaining at high levels, in comparison to the past 15 years, for the next 10 years (see Table 2).

**Table 2**

Obama Administration's 10-Year Budgetary Forecast												
	2008 (actual)	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Unified (federal) budget deficit (Bil. \$)	459	1,752	1,171	912	581	533	570	583	637	636	634	712
% of GDP	3.2	12.3	8.0	5.9	3.5	3.0	3.1	3.0	3.2	3.0	2.9	3.1
Total (federal) requirement to borrow from the public (Bil. \$)	768	2,562	1,144	927	549	520	565	589	638	634	625	813
% of GDP	5.4	18.0	7.8	6.0	3.3	3.0	3.1	3.1	3.2	3.0	2.9	3.6
Federal debt held by the public (Bil. \$)	5,803	8,364	9,509	10,436	10,985	11,505	12,070	12,659	13,297	13,932	14,557	15,370
% of GDP	40.8	58.7	64.6	67.3	66.7	65.8	65.6	65.9	66.3	66.5	66.5	67.2
<b>Memorandum item:</b>												
Administration's forecast (nominal) GDP level (Bil. \$)	14,222	14,240	14,729	15,500	16,470	17,498	18,386	19,205	20,060	20,952	21,884	22,858

All years are federal fiscal years ended Sept. 30. Source: Office of Management and Budget, Executive Office of the President of the United States, "A New Era of Responsibility: Renewing America's Promise," Feb. 26, 2009.

We expect the U.S. government to rein in its fiscal accounts by implementing fiscal spending rules (pay-as-you-go), by achieving some real expenditure cuts in military and health spending, and by raising revenues. Apart from sales of allowances under carbon tax and trade permits and the reform of taxation on unrepatriated international earnings, the new U.S. administration has not announced any significant revenue-raising measures. Although there

will likely be challenges to achieving a sufficient level of political support, particularly in the midst of recession, we believe that bond investor sentiment will compel the Obama administration to take steps, including raising revenues, to enable the government debt to fall as percentage of GDP over time. All revenue measures would probably be unpalatable to the U.S. public; letting sunset provisions take effect on previous tax cuts or raising contributions on Medicare might be the least distasteful of the government's options. Absent a robust policy response, Standard & Poor's projects that U.S. net general government (all levels) debt will approach 90% of GDP by 2013.

## **Could The Financial Situation Of California Or Other Regional And Local U.S. Governments Materially Affect The U.S. Government's Finances?**

In our view, it is unlikely. Although public debates over California's budgetary situation have drawn much attention (see "California's Budget, Cash Likely To Remain Strained Following Failed Vote," May 20, 2009, and "California; General Obligation; Note," April 14, 2009), we believe the amounts involved are too small to make a meaningful difference to U.S. federal finances. Recent projections by the Legislative Analysts Office are for California to experience a \$24 billion budget deficit in fiscal-year 2010. This amount is only 2% of the Obama administration's own projection of the total federal requirement to borrow in the same year. Similarly, California's \$52 billion of general obligation debt as of April 2009 amounts to less than 1% of federal debt held by the public. In aggregate, debt issued by all state and local governments was just over a quarter of U.S. general government debt at year-end 2008. With the federal government borrowing exceptionally large amounts in 2009 and 2010, we expect that the relative share of state and local government debt in the total general government debt will diminish further.

## **What Are The Main Contingent Fiscal Risks To The U.S.?**

In our view, the main contingent risk to the U.S. government emanates from its financial system (see "U.S. BICRA Revised To Group 2 From Group 1 On Increased Credit Deterioration," Dec. 17, 2008, RatingsDirect). Some of these risks have already crystallized, which accounts for much of the jump in net debt in 2009 (see Table 1). Other risks stem from public enterprises, particularly Fannie Mae and Freddie Mac (see "For The U.S. 'AAA' Rating, Government Sponsored Enterprises Pose Greater Fiscal Risks Than Brokers," April 14, 2008). The Federal Reserve also incurs credit risk on its direct and secured lending. We expect any losses in a given year on these programs to be well less than its average earnings of US\$27 billion during the past five years.

## **Is The U.S. Dollar's Role As The Key International Currency At Risk?**

No, not for the foreseeable future, in our opinion, for four main reasons:

- The dollar has a long track record as a reliable store of value.
- The dollar is the most widely accepted medium of exchange for international payments, especially in quickly growing Asia.
- Large, deep, liquid, and 24-hour financial markets exist for currency trading, which is principally conducted against the dollar, and for trading in securities denominated in U.S. dollars.
- The dollar's long dominance has allowed it to become an integral part of the international financial trading architecture, and no other currency can readily replicate the advantages that come from these network effects.

(For more detail, see "Will The U.S. Dollar Be Clipped?" published April 21, 2009, and "Despite Pressures, The

U.S. Dollar Remains The Key International Currency," cited above.)

## How Does Your Current Macroeconomic Outlook Factor Into Your Analysis?

We do not rate to this year's or next year's forecast for real GDP growth or other typical macroeconomic variables. Rather, we examine historical economic trends and forecasts based on scrutiny of how fundamentals affecting investment and competitiveness have evolved—and how we expect them to evolve.

We currently expect U.S. real GDP growth to recover from the 3.1% contraction projected for 2009—to 1.3% growth in 2010 and 3.3% in 2011. For our complete U.S. macroeconomic forecast, see "U.S. Economic Forecast: The Teddy Bears' Panic," June, 10, 2009.

## What Could Be Leading Indicators Of An Impending Rating Action On The U.S.?

For us, such indicators would likely fall into one of the following three categories:

**Those implying degradation of the U.S. fiscal profile to a point where it would differ markedly from that of other 'AAA' sovereigns**

Leading indicators could include:

- A forward fiscal forecast of persistent deficits that result in a lasting and material rise in debt in terms of GDP.
- Discontinuous and significant upward jumps in the U.S. general government debt burden, perhaps resulting from the cost of a second round of assisting distressed U.S. financial institutions or government-sponsored enterprises.

**Those implying that the U.S. dollar was losing key-currency status**

Leading indicators could include:

- U.S. inflation significantly higher than in the eurozone, the U.K., or Japan.
- A U.S. financial system that foreigners perceive to be materially less creditworthy than those of other industrialized countries.

Developments such as these would likely reduce the appeal of the dollar as a store of value and a medium of exchange. Were they to persist, we would expect such differentials to, sooner or later, result in:

- Accelerated dollar depreciation.
- Significant declines in the dollar's share of export and import invoicing globally.
- Significant declines in official dollar holdings.
- Significant U.S. Treasury borrowing in foreign currency.

**Those implying a series of significant policy mistakes**

Leading indicators could include:

- Significant and persistent interference with the free flow of goods, services, and capital across border, particularly if such actions provoked similar responses from trading partners.
- Significant and persistent forbearance regarding necessary financial sector restructuring.

We do not expect to lower our 'AAA' rating on the U.S., as our stable outlook signals. As always, our opinion will

evolve as new data and events warrant.

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