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Obama's Deficits Put U.S. Credit Rating at Risk

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The credit rating company Standard & Poor's (S&P) recently lowered the United Kingdom's debt rating from "stable" to "negative" as its debt-to-GDP ratio approaches 100. On May 21, Bill Gross, the co-chief investment officer of PIMCO, a leading bond trading house, said the U.S. may lose its credit rating as the federal government issues trillions in additional debt.

The consequences of such a development would be significantly higher interest rates facing the U.S. Treasury and possibly throughout the economy. The dangers are real, and an imminent fundamental policy course correction appears inevitable.

Ever-Growing Deficits. The Obama Administration may succeed in doubling the national debt over the next five years, driving the debt-to-GDP ratio from 41 percent to 71 percent as the Congressional Budget Office forecasts.[1] Yet no one seriously questions the ability and intention of the U.S. to service this debt (though if Washington threatened to continue this policy indefinitely, serious doubts would at some point arise). So this repayment risk is not relevant to U.S. government debt for the near or medium term. The U.S. is not Russia or Zimbabwe.

Similarly, there is no reasonable doubt that the U.K. will make all payments on its debt. Why then the threatened downgrade of its debt rating by S&P?

Government Debt Credit Ratings Are Different. Government credit ratings usually reflect different factors than does the credit rating of a private company. A private company's credit rating depends on the market's assessment of whether the company will repay the money borrowed according to the terms of the contract. The market demands higher interest rates for debt issued by less creditworthy companies reflecting the lesser certainty of repayment.

Government credit ratings take into account two factors not present for private debt. First, while the U.S. government will make all payments as they come due, markets do not know what the U.S. will pay with. Unlike private companies, governments can devalue the currency in which their debt is denominated. As markets know well, governments throughout history have escaped the discipline and consequences of massive debt issuance by devaluing their currencies through high inflation.

The U.S. is rapidly building a mountain of public debt, and the Federal Reserve has issued another mountain of dollars in its fight to sustain credit markets in recent months. As the economy recovers (despite the many threats posed by Obama Administration policies on new spending, higher taxes, and new regulatory regimes in health care and the environment), the Federal Reserve will face a difficult task of removing this excess monetary stimulus before much higher inflation and inflationary expectations take hold. The possibility of much higher inflation, which would reduce the real value of the payments received by the holders of U.S.

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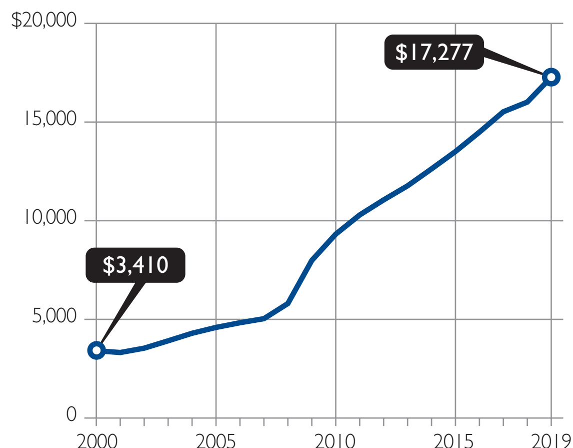
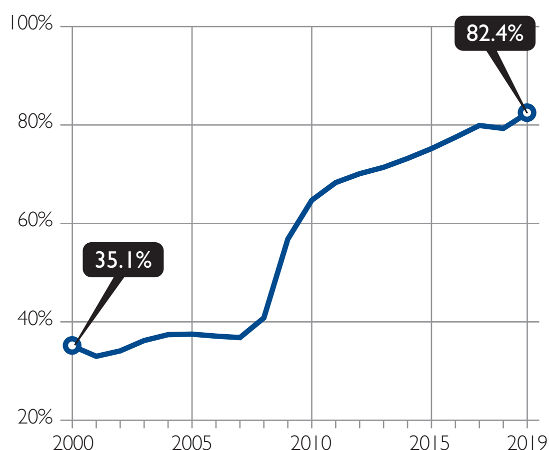
U.S. Debt Projected to Skyrocket

Publicly Held U.S. Government Debt, in Billions



U.S. Government Debt, as a Percentage of GDP



Source: Congressional Budget Office, "A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook," March 2009, at *http://www.cbo.gov/ doc.cfm?index=10014* (June 1, 2009).

debt, is a very real threat to the economy generally but especially to debt holders and, therefore, to the U.S. credit rating.

Another factor unique to governments is that they can issue so much debt that, long before questions of default arise, potential buyers may begin to resist further purchases. The global demand for U.S. debt is not infinite. At some point, domestic and foreign debt buyers reach a point of saturation. China has already suggested it is nearing that point.[2] As the point of saturation nears, buyers must be induced by ever-higher rates of interest.

It appears something of these factors is at work already, as Treasury rates have soared recently in the face of government borrowing. As markets demand higher rates, the higher rates themselves become a statement of the market's acceptance of government debt analogous to a lower credit rating.

There are thus three unique factors that can influence the market's acceptance of an issuer's debt:

1. expectations of repayment,
2. value of currency, and
3. extent of saturation.

Of these three, only the latter two apply to the U.S.—for now. These factors can be shown graphically for the U.S. and Russia. Russia is chosen in this case because its recent history raises serious questions about whether debt payments will be made in full and on time, questions about Russian inflation persist, and the market's appetite for Russian debt is limited. In the graph, the greater the area described by the three points, the greater the perceived credit risk and the higher the interest rate for an additional amount of debt.

The values chosen in the spider chart are entirely illustrative, but they likely represent a reasonable approximation of current conditions. As the U.S. and other nations consider their various policies, two additional features of these three risks bear mentioning.

First, the market's perception of these risk factors can change quickly. For example, a greater belligerency on Russia's part could quickly elevate the mar-

1. See Congressional Budget Office, "A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook," March 2009, at *http://www.cbo.gov/doc.cfm?index=10014* (June 1, 2009).
2. Anthony Faiola, "Premier Worried over China's U.S. Debt Holdings," *The Washington Post*, March 14, 2009, at *http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2009/03/13/MNTH16EUOE.DTL* (June 1, 2009).

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As the Triangle Grows, Interest Rates Rise

Increases in lending risks result in higher interest rates. When considering three main categories of risk—repayment, devaluation, and saturation—the U.S. federal government has increased its risk profile due to large amounts of borrowing, which is now comparable to Russia's. Figures are illustrative.

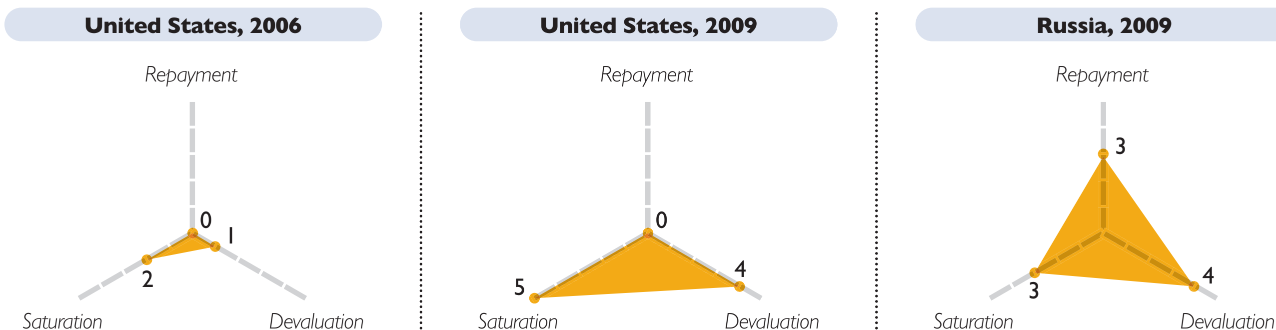

Chart 2 • WM 2465 heritage.org

ket's perception of repayment risk, while a growing recognition that the U.S. government is more inclined to exacerbate than correct the perilous conditions of America's entitlement programs could quickly change the market's saturation point for federal debt.

Second, while these three risks can be identified individually, they can also be highly interactive and reinforcing. For example, any suggestion on the part of the Obama Administration or the Federal Reserve of a tolerance for higher inflation would quickly elevate the market's perception of devaluation risk, but this in turn would quickly raise the risk of saturation.

Defending the U.S. Credit Rating. The U.S. credit rating is at risk. The Obama Administration can and should protect it by taking the following actions:

- Encourage and express firm and unwavering support for the Federal Reserve in its efforts to contain inflation and inflation expectations. These actions will diminish the market's perception of devaluation risk.
- Dramatically shrink the budget deficit in the near term in such a way as to preserve and strengthen the vitality of the nation's economy. Specifically, the Administration must abandon its goals of greatly expanded government spending and taxation.
- Finally, the Administration must match actions to words to rein in entitlement spending and eliminate the threat of future, massive budget deficits.

These latter two actions addressing the deficit in the near term and the long term will go far in mitigating the risk to the U.S. government credit rating from runaway debt.

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