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U.S. Credit Rating Downgraded: Now They've Done It

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Late on Friday, August 5, Standard & Poor's (S&P) downgraded the United States credit rating from AAA, and really best in class, to AA+. In one fell swoop, S&P sent two separate and powerful messages. First, as The Heritage Foundation and many others warned, the spending reductions in the deal negotiated by President Obama to raise the debt ceiling were entirely and woefully inadequate. Second, the global economy, the national economy, and state finances have all in their own ways been delivered a mighty and frightening body blow.

A Lost Standard of Excellence. For decades past memory, United States government debt was deemed the gold standard of credit quality. Textbooks referred to U.S. Treasuries as the "riskless asset" against which all others were compared. Those days have passed, at least for now, because the U.S. government has rapidly piled debt upon debt and, on its current trajectory, evidences no inclination to stop. Under the circumstances, without a fundamental policy course correction, a repeatedly threatened credit rating downgrade became inevitable, with only the timing at issue.

President Obama and his allies in and out of Congress do not deserve all the blame for the downgrade. Unaffordable entitlement programs were built up Congress after Congress, President after President, and their imposing fiscal dangers for the future were ignored thereafter. To his credit, President George W. Bush tried to reform the lesser problem of Social Security, spending virtually all the political capital acquired in his strong re-election in doing so, yet even many of his allies in Congress wanted no part of it. And so the basic facts regarding the tens of trillions in unfunded obligations in Social Security, Medicare, and Medicaid remain and are not in dispute.

While not solely to blame, President Obama and his allies are most certainly preeminently to blame. Facing a rapidly growing budget deficit in 2009, President Obama pushed through a massive fiscal stimulus program followed by a succession of lesser efforts. As the anemic state of the economy attests quite clearly, those programs failed miserably—except in raising federal spending and national debt.

Then the President pushed through his disastrous and highly unpopular health care reform. On paper, these reforms give the appearance of improving the fiscal picture modestly. But as the Medicare trustees' report has reminded us every year after Obamacare's passage, this happy picture is an illusion. Aside from the damage it has done and will do to health care costs and services, from a fiscal perspective Obamacare ultimately is just yet another unaffordable entitlement piled on top of those already on the books.

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A Lost Opportunity. In the recent debt ceiling fight, the President's initial view was that Congress should pass a "clean" debt ceiling, allow yet more borrowing, and attend to whatever deficit reduction might be possible later. The reaction by S&P demonstrates undeniably how wrong the President was. And the nation knew it. Rarely have the American people been more engaged in and more concerned about a matter of federal fiscal policy. Yet after ignoring his own high-profile if fatally flawed fiscal commission, and after offering a budget in January that was utterly silent on these critical issues, the President told the Congress: Don't worry, be happy.

In the course of negotiations on the debt ceiling, congressional Republicans tried tirelessly to get the President and Senate Democrats to get serious about cutting spending. All Obama and Senate Majority Leader Harry Reid (D–NV) could do was carp about symbolic tax hikes on the rich, oil companies, and their latest silly affection—corporate jets. To be clear, despite the perilous state of the nation's finances, the President's sole objective was ideological and symbolic: Even if Republicans had caved on tax hikes, which they wisely refused to do, the revenue gains would have been inconsequential compared to the spending cuts that are necessary. The President played politics while the nation's credit rating was set to burn, and now it has.

Whether the congressional Republican leadership should have forced deeper spending cuts before agreeing to raise the debt ceiling is now a settled question. S&P settled it. Whether they could have forced deeper spending cuts in the face of a politics-playing President and Senate dominated by spenders will never be known. But the nation will soon see the consequences.

Failure Has Consequences. Taken in isolation, a credit rating downgrade will eventually mean higher interest rates on U.S. government debt. This may be hard to imagine given the recent drop in Treasury bond rates in response to events overseas. But higher future rates are certain, and that means that even more federal tax dollars must be dedicated to paying the interest on past government excesses. Higher interest rates and interest cost means greater deficit pressures, which can mean more debt, which can lead to higher interest rates. This is why it is termed a debt spiral.

How will the credit rating downgrade of U.S. government debt affect the states and municipal governments' interest costs? Nobody knows for sure, but it cannot be good. As a practical matter, U.S. government debt is the foundation of the U.S. financial system, as a point of reference if for no other reason. Interest rates paid by state and local government can only go up as a result of the downgrade, unwelcome news indeed to states wrestling with their own massive deficits due in part to the failure of the economy and state revenues to recover.

In today's global economy, however, the U.S. credit rating downgrade may prove catastrophic. Prior to the credit rating downgrade, Europe was already teetering on the brink. Last week European stock exchanges plunged 10 percent, their worst weekly losses since November 2008. The long-building government debt crisis in Europe, which had been so unsuccessfully papered over just a few weeks ago by its leaders, is reaching the boiling point, threatening to wash over not just the worst offenders like Greece and Portugal but also some of the pillars of the European Union like Spain and Italy.

This is a European government debt problem on top of a European currency problem on top of a European economic growth problem. But the 2007–2009 financial crisis taught an important lesson about the intense interconnectedness of global financial markets—and that a great many of these connections are little known and poorly understood.

What happens in Europe will not stay in Europe. What weaknesses in global finance and financial supervision will this crisis reveal? No one knows, but what a terrible time for the dominant financial actor in the global financial system, the United States government, to suffer an entirely preventable credit rating downgrade. The dangers to the global economy, and specifically to the U.S. economy, have increased markedly as the U.S. credit rating has been marked down.

Perhaps the Last Opportunity That Must Not Be Lost. President Obama and Congress have the time and opportunity to change the course of fiscal policy. The United States can recover its AAA credit rating and begin to heal the damage, but it must not delay. The debt ceiling deal included the provision for the creation of a joint select committee of Congress to cut at least $1.2 trillion over the next 10 years. Clearly, that figure is much too low. The committee was to report by November 23. Clearly, that is too late. In the eyes of many, the committee was designed to fail. That must not happen.

President Obama must now do things he has been loath to do heretofore. First, he must lead. No more grand speeches, no more politicking, no more finger-pointing while criticizing those who oppose him. Above all, leading now means corralling his forces to reach across the aisle to Republicans and work together.

Second, he should give up the ideological fight for higher taxes on anyone. For one thing, even suggesting higher taxes when unemployment is so high and economic growth is so low suggests a man more committed to politics than jobs. As The Heritage Foundation suggested at the start of his term,[1] President Obama should suspend his desire for higher taxes at least until the economy has moved far toward full employment. The wisdom (or lack thereof) of higher taxes can be debated when Americans are back to work.

Finally, the President should forego his inclination to use entitlement reforms for political purposes. Scaring seniors about Social Security checks and related "Mediscare" tactics, which are basic elements of the Democratic Party playbook, must stop. The problem is too much entitlement spending now and even more so in the near future. Republicans know it. Democrats know it. Conservatives know it. Liberals know it. The nation now knows it.

A number of sound incremental reforms can garner strong bipartisan support and can substantially improve these programs' sustainability and the nation's finances. The President must lead his party to join hands with Republicans in the joint select committee to embrace these reforms and be ready to enact them, saving far more than $1.2 trillion and far sooner than November 23.

It Can Be Done. The objective for the nation, the President, and the joint select committee is clear: drive down spending—including and especially on entitlement programs—toward a balanced budget while protecting America and without raising taxes. Properly done, this would lead to economic growth, more jobs, less government, and a restoration of the nation's credit rating. It can be done. The Heritage Foundation has described in detail how to do it in "Saving the American Dream: The Heritage Plan to Fix the Debt, Cut Spending, and Restore Prosperity."[2]

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1. J. D. Foster and William W. Beach, "Economic Recovery: How Best to End the Recession," Heritage Foundation *WebMemo* No. 2191, January 7, 2009, at *http://www.heritage.org/Research/Reports/2009/01/Economic-Recovery-How-Best-to-End-the-Recession*.
2. "Saving the American Dream: The Heritage Plan to Fix the Debt, Cut Spending, and Restore Prosperity," The Heritage Foundation, at *http://www.savingthedream.org*.