What lies behind Fitch's consideration of a downgrade of US sovereign credit

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The ability of the United States to govern itself is once again in the spotlight. On May 24, 2023, during the most recent stand-off between the White House and House Republicans over raising the US government's debt ceiling, the credit rating agency Fitch placed the US sovereign credit on negative watch. . In considering a downgrade, Fitch is essentially asking the question posed by the flight attendant in the 1980 movie, Airplane, "By the way, is there anyone on board who knows how to fly a plane?"

Fitch's announcement came 12 years after Standard and Poor's (S&P) took the unprecedented action of lowering the US credit rating from AAA to AA+, going from the highest possible credit rating to reflect "susceptibility to long-term risks appears somewhat greater." As S&P explained at the time, "The downgrade reflects S&P's judgment that the capacity of Congress and the Administration to deal with the debt has become less stable, effective, and predictable."[1]

The policy environment has grown more challenging in the 12 years since the S&P downgrade. A major war rages in Europe, the Federal Reserve continues its efforts to control inflation without thwarting an economic recovery, and a razor-thin House Republican majority leaves the current Speaker trying to balance the demands of his most conservative members with the increasingly vocal moderate Republicans demanding his attention.

The inability of collective Washington to control federal deficits is a key concern of Fitch. Since 2011, the national debt has increased from about $15 trillion in 2011 to more than $31 trillion today with federal debt as a percentage of GDP growing from 65% in 2011 to 95% in 2023, according to the Congressional Budget Office. The trust funds supporting Social Security and Medicare are getting closer to insolvency absent any action to get those programs on firmer financial ground.

In explaining its May action, Fitch stated[2]:

- "Governance is a weakness relative to 'AAA' rated peers, and the future direction of the rating is sensitive to the direction it takes."

[1] Following S&P's action, Fitch and Moody's both changed the US outlook from stable to negative but later restored the rating to stable.

[2] https://www.fitchratings.com/research/sovereigns/fitch-places-united-states-aaa-on-rating-watch-negative-24-05-2023#:~:text=Sovereign%20Rating%20Model%20(SRM)%20and,(LT%20FC)%20IDR%20scale

- “The contested 2020 presidential election, brinkmanship over the debt limit to advance political agendas, and failure to reach consensus on the country's fiscal challenges are recent signs of the deterioration in governance.”
- “Political partisanship has brought about repeated debt-limit brinkmanship and led to near-default episodes that could erode confidence in the government's repayment capacity.”

I. The impact of the 2011 S&P downgrade was assessed by the Congressional Research Service[3].

- “U.S. government bonds have long been considered the “risk-free” baseline against which other investments are measured; they are a global “safe haven” during financial crises; they serve as collateral in a wide range of financial transactions; they are held by many financial institutions around the world, including central banks. Even if holders of Treasury debt wished to switch to other debt instruments, no immediate substitute is available in many cases.”
- “Reserve currency status gives the United States access to cheaper financing and the ability to borrow in its own currency; loss of that status could raise the cost of borrowing from abroad. But the long-run position of the United States in the global economy depends more on fiscal and economic developments than rating agency decisions.”
- “The downgrade may be a step in a gradual process that erodes the United States' central position in the global financial system and the dollar's role as reserve currency. These developments could make the process of dealing with the U.S. budget and trade deficits more difficult.”

II. Before the June 2 debt ceiling agreement was reached, a number of market experts assessed the possible impact of a downgrade

Moody's Analytics (May 2023)[4]:

- “Standard & Poor's downgraded the nation's debt in the 2011 debt limit battle for much less, citing the political dysfunction at the time. Since then, that dysfunction has only intensified.”
- “A downgrade of Treasury debt would set off a cascade of credit implications and downgrades on the debt of many other financial institutions, nonfinancial corporations, municipalities, infrastructure providers, structured finance transactions, and other debt issuers. Those institutions that are clearly backstopped by the U.S. government, institutions such as Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, would suffer the biggest changes to their ratings. The effects on other

[3] https://sgp.fas.org/crs/misc/R41955.pdf

[4] https://www.moodysanalytics.com/-/media/article/2023/debt-limit-scenario-update.pdf

institutions' ratings would vary depending on their relationship with the U.S. government and offsetting financial strengths."

Wall Street Journal (May 17, 2023):

- The WSJ reported that at a meeting of the G-7, the Indonesian Finance Minister Sri Mulyani Indrawati said the uncertainty every few years around whether Congress will raise the debt limit is starting to undermine faith in the U.S. around the world. "The world is starting to question whether this is only just a game of repetition that can be solved, or the world's to start to learn to wean ourselves from that kind of situation at the end of the day. That's not good for the United States."

III. Post debt ceiling deal, Fitch reviews the negative watch.[5]

- "Fitch intends to resolve the Negative Watch on the U.S.'s 'AAA' rating in 3Q23. The coherence and credibility of policymaking, as well as the expected medium-term fiscal and debt trajectories will be key factors in our assessment."
- "Fitch believes that repeated political standoffs around the debt-limit and last-minute suspensions before the x-date (when the Treasury's cash position and extraordinary measures are exhausted) lowers confidence in governance on fiscal and debt matters."
- "There has been a steady deterioration in governance over the last 15 years, with increased political polarization and partisanship as witnessed by the contested 2020 election, repeated brinkmanship over the debt limit and failure to tackle fiscal challenges from growing mandatory spending has led to rising fiscal deficits and debt burden."
- "Fitch believes the U.S. rating is supported by exceptional strengths, including the size of the economy, high GDP per capita and dynamic business environment. The U.S. dollar is the world's preeminent reserve currency, which gives the government unparalleled financing flexibility. Some of these strengths could be eroded over time by governance shortcomings."

[5] https://www.fitchratings.com/research/sovereigns/despite-debt-limit-agreement-us-aaa-rating-remains-on-negative-watch-02-06-2023