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Would a Credit Downgrade Matter?

A prediction, widely shared in Washington and on Wall Street: One month from now, Congress will have lifted the federal debt ceiling, the U.S. government will be paying its bills, the president will have signed a convoluted deficit-reduction law that defers decisions on benefits and taxes—and the U.S. will have lost its AAA credit rating.

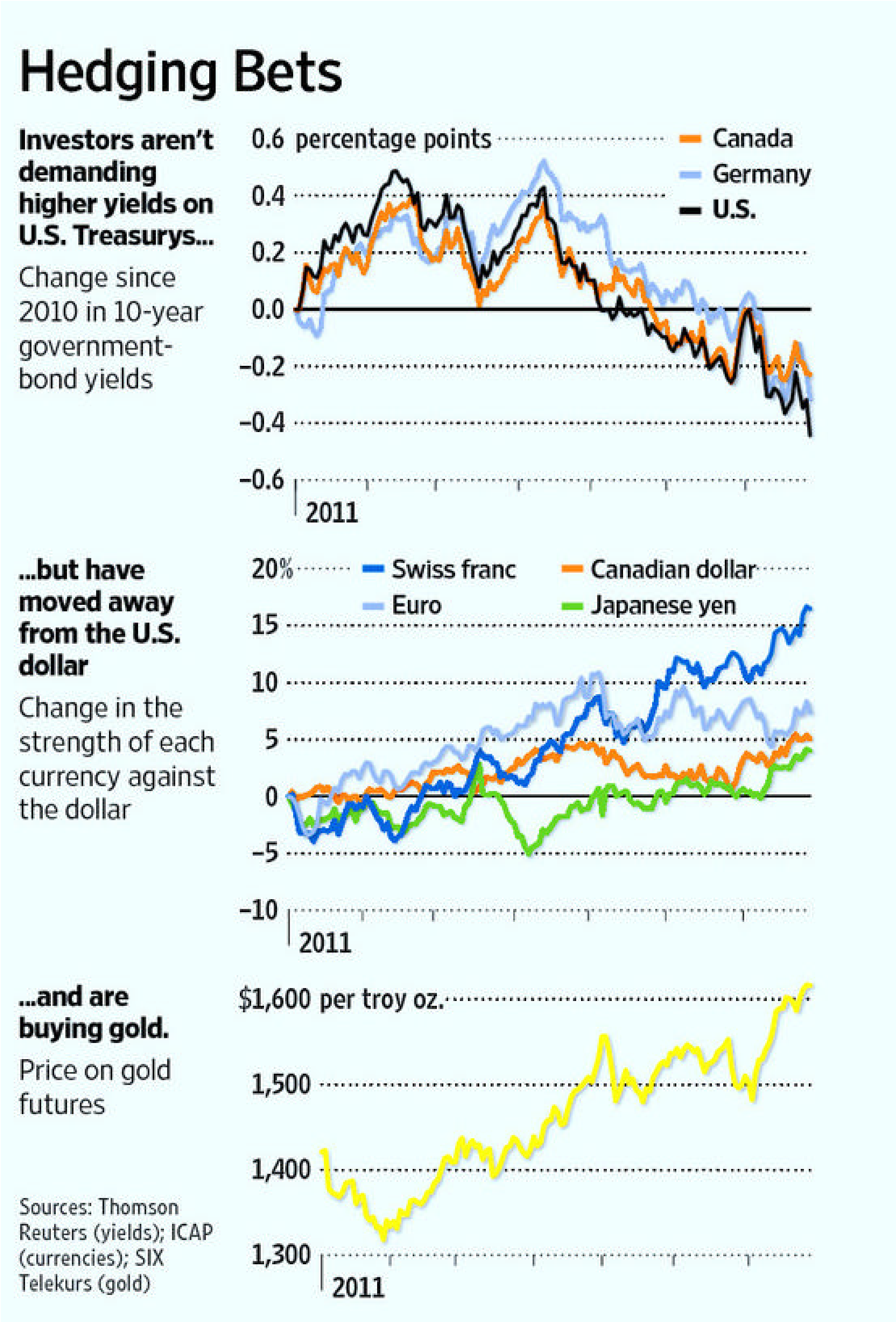
A downgrade of the U.S. to AA by Standard & Poor's—putting the U.S. in the company of Slovenia, among others—is not good. Full stop.

But how much will it really matter?

Is S&P's opinion akin to sports columnists writing about the World Series? (Entertaining, but what really matters is what's happening on the field.) Will a downgrade finally trigger the much-predicted plunge in markets and spike in bond-market interest rates? (If so, that would be economically devastating.) Or will the loss of AAA status be a near-term non-event, but become a date highlighted in history-textbook timelines tracking America's slow decline? (In other words, a downgrade reflects the disturbing underlying economic and political woes rather than worsening them.)

The markets, we have been warned for weeks, are about to crash at any moment. ("Investors refuse to panic," read one headline.) A default surely would provoke a market drop. But if that is averted, will markets plunge because S&P points out the obvious: U.S. politicians can't agree on a fix for the nation's long-term finances?

Let's break it down.



Very little happens automatically if the U.S. Treasury long-term debt is stamped AA by S&P. A few institutions with strict rules about holding only AAA paper would have to sell, or change their charters. And no one knows precisely what will happen in the big "repo market," where institutions make short-term loans collateralized by U.S. Treasury debt. But money market mutual funds—which hold $684 billion in U.S.

government debt—wouldn't have to dump Treasurys or stop buying them, their trade association says. Life-insurance companies could still hold U.S. Treasurys, their trade association says. U.S. banks, under current rules, wouldn't have to retain bigger capital cushions against U.S. Treasury holdings. The Federal Reserve would still accept U.S. Treasurys as collateral after a downgrade. China, as long as it keeps buying dollars with yuan to keep the yuan from rising, still will have dollars to put in securities denominated in U.S. dollars.

Don't relax yet. If the U.S. government loses S&P's good-financial-housekeeping seal of approval, one would expect investors to demand higher yields in compensation. If they do, that's expensive. A sustained one-half percentage-point increase in interest rates would add $435 billion to the federal deficit over 10 years and $65 to monthly payments on a $200,000 mortgage. Simple comparisons of average yields paid by AAA-rated and AA-rated countries are unconvincing; there are too many other factors. Australia (AAA) is paying 4.9% on its 10-year government debt. Debt-laden Japan (AA) is paying 1.1%, and its downgrade had little perceptible impact on its borrowing costs.

The pros disagree on the effect of a downgrade. Michael Feroli, a top economist at JPMorgan Chase, says, "Whether I look domestic or foreign, I don't see huge implications" of a downgrade. But on the same day the global head of fixed income strategy at the same bank, Terry Belton, predicted that a downgrade would add 0.05 to 0.10 percentage points to Treasury yields immediately and 0.6 to 0.7 over time, which would be huge.

There's no way to know for sure. Despite all that has—and hasn't—transpired, despite the expectation that S&P will lower the U.S. to AA, Treasury yields have risen only slightly and the gap between U.S. and, say, German or Canadian rates hasn't widened. One reason: People, government and institutions buy U.S. Treasurys not only because they're regarded as the safest asset around, but because the Treasury market is the biggest, most liquid in the world. People know they can sell Treasurys instantly, and be nearly certain of the price they'll get. There aren't, yet, any good alternatives to the U.S. Treasury.

Still, it's hard to grasp a world in which the one security regarded as "risk-free" is rated lower than the government debt of Austria, Denmark, Finland, the Netherlands and Hong Kong (all AAA.) The ripples from a downgrade are unpredictable. "It's far from clear how American and the global financial system would function over time with an AA at the core," said Mohamed El-Erian of bond-giant Pimco. "Will the system simply re-normalize, and therefore the implications will be ... limited? Or will the loss of the absolute 'risk-free' asset (i.e., no credit risk, just interest-rate risk) cause a series of structural breaks?"

A downgrade could have more political than financial impact: Pushing Congress to actually do something about the deficit, instead of passing bills that don't become law. Or it could push the ratings firms further to the sidelines. Economist Carmen Reinhart of the Peterson Institute for International Economics in Washington predicts a downgrade will accelerate efforts by governments on both sides of the Atlantic to de-emphasize rating-firm opinions, a particularly convenient move at a time when governments are borrowing so heavily.

Ultimately, the issue is the unsustainable fiscal trajectory of the U.S. government and the inability of the political system to change course.The credit rating isn't the problem.The problem is the problem.

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