STANDARD
&POOR'S

Global Credit Portal®
RatingsDirect®

August 5, 2011

Research Update:

United States of America Long-Term Rating Lowered To 'AA+' On Political Risks And Rising Debt Burden; Outlook Negative

Primary Credit Analyst:
Nikola G Swann, CFA, FRM, Toronto (1) 416-507-2582;nikola_swann@standardandpoors.com

Secondary Contacts:
John Chambers, CFA, New York (1) 212-438-7344;john_chambers@standardandpoors.com
David T Beers, London (44) 20-7176-7101;david_beers@standardandpoors.com

Table Of Contents

Research Update:

United States of America Long-Term Rating Lowered To 'AA+' On Political Risks And Rising Debt Burden; Outlook Negative

Overview

- We have lowered our long-term sovereign credit rating on the United States of America to 'AA+' from 'AAA' and affirmed the 'A-1+' short-term rating.
- We have also removed both the short- and long-term ratings from CreditWatch negative.
- The downgrade reflects our opinion that the fiscal consolidation plan that Congress and the Administration recently agreed to falls short of what, in our view, would be necessary to stabilize the government's medium-term debt dynamics.
- More broadly, the downgrade reflects our view that the effectiveness, stability, and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenges to a degree more than we envisioned when we assigned a negative outlook to the rating on April 18, 2011.
- Since then, we have changed our view of the difficulties in bridging the gulf between the political parties over fiscal policy, which makes us pessimistic about the capacity of Congress and the Administration to be able to leverage their agreement this week into a broader fiscal consolidation plan that stabilizes the government's debt dynamics any time soon.
- The outlook on the long-term rating is negative. We could lower the long-term rating to 'AA' within the next two years if we see that less reduction in spending than agreed to, higher interest rates, or new fiscal pressures during the period result in a higher general government debt trajectory than we currently assume in our base case.

Rating Action

On Aug. 5, 2011, Standard & Poor's Ratings Services lowered its long-term sovereign credit rating on the United States of America to 'AA+' from 'AAA'. The outlook on the long-term rating is negative. At the same time, Standard & Poor's affirmed its 'A-1+' short-term rating on the U.S. In addition, Standard & Poor's removed both ratings from CreditWatch, where they were placed on July 14, 2011, with negative implications.

The transfer and convertibility (T&C) assessment of the U.S.--our assessment of the likelihood of official interference in the ability of U.S.-based public- and private-sector issuers to secure foreign exchange for debt service--remains 'AAA'.

Rationale

We lowered our long-term rating on the U.S. because we believe that the prolonged controversy over raising the statutory debt ceiling and the related fiscal policy debate indicate that further near-term progress containing the growth in public spending, especially on entitlements, or on reaching an agreement on raising revenues is less likely than we previously assumed and will remain a contentious and fitful process. We also believe that the fiscal consolidation plan that Congress and the Administration agreed to this week falls short of the amount that we believe is necessary to stabilize the general government debt burden by the middle of the decade.

Our lowering of the rating was prompted by our view on the rising public debt burden and our perception of greater policymaking uncertainty, consistent with our criteria (see "Sovereign Government Rating Methodology and Assumptions ," June 30, 2011, especially Paragraphs 36-41). Nevertheless, we view the U.S. federal government's other economic, external, and monetary credit attributes, which form the basis for the sovereign rating, as broadly unchanged.

We have taken the ratings off CreditWatch because the Aug. 2 passage of the Budget Control Act Amendment of 2011 has removed any perceived immediate threat of payment default posed by delays to raising the government's debt ceiling. In addition, we believe that the act provides sufficient clarity to allow us to evaluate the likely course of U.S. fiscal policy for the next few years.

The political brinksmanship of recent months highlights what we see as America's governance and policymaking becoming less stable, less effective, and less predictable than what we previously believed. The statutory debt ceiling and the threat of default have become political bargaining chips in the debate over fiscal policy. Despite this year's wide-ranging debate, in our view, the differences between political parties have proven to be extraordinarily difficult to bridge, and, as we see it, the resulting agreement fell well short of the comprehensive fiscal consolidation program that some proponents had envisaged until quite recently. Republicans and Democrats have only been able to agree to relatively modest savings on discretionary spending while delegating to the Select Committee decisions on more comprehensive measures. It appears that for now, new revenues have dropped down on the menu of policy options. In addition, the plan envisions only minor policy changes on Medicare and little change in other entitlements, the containment of which we and most other independent observers regard as key to long-term fiscal sustainability.

Our opinion is that elected officials remain wary of tackling the structural issues required to effectively address the rising U.S. public debt burden in a manner consistent with a 'AAA' rating and with 'AAA' rated sovereign peers (see Sovereign Government Rating Methodology and Assumptions," June 30, 2011, especially Paragraphs 36-41). In our view, the difficulty in framing a consensus on fiscal policy weakens the government's ability to manage public finances and diverts attention from the debate over how to achieve more balanced and dynamic economic growth in an era of fiscal stringency and private-sector deleveraging (ibid). A new political consensus might (or might not) emerge after the 2012 elections, but we believe that by then, the government debt burden will likely be higher, the needed medium-term fiscal adjustment potentially greater, and the inflection point on the U.S. population's demographics and other age-related spending drivers closer at hand (see "Global Aging 2011: In The U.S., Going Gray Will Likely Cost Even More Green, Now," June 21, 2011).

Standard & Poor's takes no position on the mix of spending and revenue measures that Congress and the Administration might conclude is appropriate for putting the U.S.'s finances on a sustainable footing.

The act calls for as much as $2.4 trillion of reductions in expenditure growth over the 10 years through 2021. These cuts will be implemented in two steps: the $917 billion agreed to initially, followed by an additional $1.5 trillion that the newly formed Congressional Joint Select Committee on Deficit Reduction is supposed to recommend by November 2011. The act contains no measures to raise taxes or otherwise enhance revenues, though the committee could recommend them.

The act further provides that if Congress does not enact the committee's recommendations, cuts of $1.2 trillion will be implemented over the same time period. The reductions would mainly affect outlays for civilian discretionary spending, defense, and Medicare. We understand that this fall-back mechanism is designed to encourage Congress to embrace a more balanced mix of expenditure savings, as the committee might recommend.

We note that in a letter to Congress on Aug. 1, 2011, the Congressional Budget Office (CBO) estimated total budgetary savings under the act to be at least $2.1 trillion over the next 10 years relative to its baseline assumptions. In updating our own fiscal projections, with certain modifications outlined below, we have relied on the CBO's latest "Alternate Fiscal Scenario" of June 2011, updated to include the CBO assumptions contained in its Aug. 1 letter to Congress. In general, the CBO's "Alternate Fiscal Scenario" assumes a continuation of recent Congressional action overriding existing law.

We view the act's measures as a step toward fiscal consolidation. However, this is within the framework of a legislative mechanism that leaves open the details of what is finally agreed to until the end of 2011, and Congress and the Administration could modify any agreement in the future. Even assuming that at least $2.1 trillion of the spending reductions the act envisages are implemented, we maintain our view that the U.S. net general government debt burden (all levels of government combined, excluding liquid financial assets) will likely continue to grow. Under our revised base case fiscal scenario--which we consider to be consistent with a 'AA+' long-term rating and a negative outlook--we now project that net general government debt would rise from an estimated 74% of GDP by the end of 2011 to 79% in 2015 and 85% by 2021. Even the projected 2015 ratio of sovereign indebtedness is high in relation to those of peer credits and, as noted, would continue to rise under the act's revised policy settings.

Compared with previous projections, our revised base case scenario now assumes that the 2001 and 2003 tax cuts, due to expire by the end of 2012, remain in place. We have changed our assumption on this because the majority of Republicans in Congress continue to resist any measure that would raise revenues, a position we believe Congress reinforced by passing the act. Key macroeconomic assumptions in the base case scenario include trend real GDP growth of 3% and consumer price inflation near 2% annually over the decade.

Our revised upside scenario--which, other things being equal, we view as consistent with the outlook on the 'AA+' long-term rating being revised to stable--retains these same macroeconomic assumptions. In addition, it incorporates $950 billion of new revenues on the assumption that the 2001 and 2003 tax cuts for high earners lapse from 2013 onwards, as the Administration is advocating. In this scenario, we project that the net general government debt would rise from an estimated 74% of GDP by the end of 2011 to 77% in 2015 and to 78% by 2021.

Our revised downside scenario--which, other things being equal, we view as being consistent with a possible further downgrade to a 'AA' long-term rating--features less-favorable macroeconomic assumptions, as outlined below and also assumes that the second round of spending cuts (at least $1.2 trillion) that the act calls for does not occur. This scenario also assumes somewhat higher nominal interest rates for U.S. Treasuries. We still believe that the role of the U.S. dollar as the key reserve currency confers a government funding advantage, one that could change only slowly over time, and that Fed policy might lean toward continued loose monetary policy at a time of fiscal tightening. Nonetheless, it is possible that interest rates could rise if investors re-price relative risks. As a result, our alternate scenario factors in a 50 basis point (bp)-75 bp rise in 10-year bond yields relative to the base and upside cases from 2013 onwards. In this scenario, we project the net public debt burden would rise from 74% of GDP in 2011 to 90% in 2015 and to 101% by 2021.

Our revised scenarios also take into account the significant negative revisions to historical GDP data that the Bureau of Economic Analysis announced on July 29. From our perspective, the effect of these revisions underscores two related points when evaluating the likely debt trajectory of the U.S. government. First, the revisions show that the recent recession was deeper than previously assumed, so the GDP this year is lower than previously thought in both nominal and real terms. Consequently, the debt burden is slightly higher. Second, the revised data highlight the sub-par path of the current economic recovery when compared with rebounds following previous post-war recessions. We believe the sluggish pace of the current economic recovery could be consistent with the experiences of countries that have had financial crises in which the slow process of debt deleveraging in the private sector leads to a persistent drag on demand. As a result, our downside case scenario assumes relatively modest real trend GDP growth of 2.5% and inflation of near 1.5% annually going forward.

When comparing the U.S. to sovereigns with 'AAA' long-term ratings that we view as relevant peers--Canada, France, Germany, and the U.K.--we also observe, based on our base case scenarios for each, that the trajectory of the U.S.'s net public debt is diverging from the others. Including the U.S., we estimate that these five sovereigns will have net general government debt to GDP ratios this year ranging from 34% (Canada) to 80% (the U.K.), with the U.S. debt burden at 74%. By 2015, we project that their net public debt to GDP ratios will range between 30% (lowest, Canada) and 83% (highest, France), with the U.S. debt burden at 79%. However, in contrast with the U.S., we project that the net public debt burdens of these other sovereigns will begin to decline, either before or by 2015.

Standard & Poor's transfer T&C assessment of the U.S. remains 'AAA'. Our T&C assessment reflects our view of the likelihood of the sovereign restricting other public and private issuers' access to foreign exchange needed to meet debt service. Although in our view the credit standing of the U.S. government has deteriorated modestly, we see little indication that official interference of this kind is entering onto the policy agenda of either Congress or the Administration. Consequently, we continue to view this risk as being highly remote.

Outlook

The outlook on the long-term rating is negative. As our downside alternate fiscal scenario illustrates, a higher public debt trajectory than we currently assume could lead us to lower the long-term rating again. On the other hand, as our upside scenario highlights, if the recommendations of the Congressional Joint Select Committee on Deficit Reduction--independently or coupled with other initiatives, such as the lapsing of the 2001 and 2003 tax cuts for high earners--lead to fiscal consolidation measures beyond the minimum mandated, and we believe they are likely to slow the deterioration of the government's debt dynamics, the long-term rating could stabilize at 'AA+'.

On Monday, we will issue separate releases concerning affected ratings in the funds, government-related entities, financial institutions, insurance, public finance, and structured finance sectors.

Related Criteria And Research

- United States of America 'AAA/A-1+' Ratings Placed On CreditWatch Negative On Rising Risk Of Policy Stalemate, July 14, 2011
- U.S. Weekly Financial Notes: Soft Patch Or Quicksand?, Aug. 5, 2011
- Sovereign Government Rating Methodology And Assumptions, June 30, 2011
- 2011 Midyear Credit Outlook: Unresolved Economic And Regulatory Issues Loom Large, June 22, 2011
- Global Aging 2011: In The U.S., Going Gray Will Likely Cost Even More Green, Now, June 21, 2011
- United States of America 'AAA/A-1+' Rating Affirmed; Outlook Revised To Negative, April 18, 2011
- Fiscal Challenges Weighing On The 'AAA' Sovereign Credit Rating On The Government Of The United States, April 18, 2011
- A Closer Look At The Revision Of The Outlook On The U.S. Government Rating , April 18, 2011
- Banking Industry Country Risk Assessments, March 8, 2011
- Behind The Political Brinkmanship Of Raising The U.S. Debt Ceiling, Jan. 18, 2011
- U.S. Government Cost To Resolve And Relaunch Fannie Mae And Freddie Mac Could Approach $700 Billion, Nov. 4, 2010
- Global Aging 2010: In The U.S., Going Gray Will Cost A Lot More Green, Oct. 25, 2010,
- Après Le Déluge, The U.S. Dollar Remains The Key International Currency," March 10, 2010
- Banking Industry Country Risk Assessment: United States of America, Feb.

1, 2010

Ratings List

Rating Lowered

	To	From
United States of America (Unsolicited Ratings)		
Federal Reserve System (Unsolicited Ratings)		
Federal Reserve Bank of New York (Unsolicited Ratings)		
Sovereign Credit Rating	AA+/Negative/A-1+	AAA/Watch Neg/A-1+

This unsolicited rating(s) was initiated by Standard & Poor's. It may be based solely on publicly available information and may or may not involve the participation of the issuer. Standard & Poor's has used information from sources believed to be reliable based on standards established in our Credit Ratings Information and Data Policy but does not guarantee the accuracy, adequacy, or completeness of any information used.

Complete ratings information is available to subscribers of RatingsDirect on the Global Credit Portal at www.globalcreditportal.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column.