

The US Downgrade – The End of the Road for Keynesian Economics?

On Friday August 5th Standard and Poor's downgraded the **long-term** rating of US sovereign debt from AAA to AA+ for two main reasons:

- First, the US government failed to provide assurance that in the long term its debt would stabilize as a fraction of national income. The agreement between the Democrats and Republicans falls short of what, in S&P's view, "would be necessary to stabilize the government's medium-term debt dynamics." In other words, even the \$2.4 trillion (or likely \$2.1trillion) cut in expenditures proposed by the Congress over the 10 years to 2021 is simply not enough to reduce the rising trajectory of the debt-to-GDP ratio.
- Second, the deplorably dysfunctional political process demonstrated over recent weeks in the run-up to the eventual agreement to raise the debt ceiling suggests an inability to settle these matters in the future. As S&P put it, "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." The political brinksmanship of the past few months made "America's governance and policymaking...less stable, less effective, and less predictable."

To gain proper perspective on this momentous event we need to step back for a moment and consider some history. Looking across the world over the past 65 years since the start of the Bretton Woods system of pegged currencies in the aftermath of World War 2, there have been hundreds of recessions and dozens of more serious crises for individual economies, currencies and sovereign states. These more serious crises have involved both developed and emerging economies. In almost every case the underlying causes included the excessive growth of private sector credit or public (government) sector debt in the period prior to the crisis. These episodes were often -- but not always -- accompanied by excessively rapid growth of the quantity of money and hence inflation.

Time and again the preferred solution by politicians and central bankers was either to spend their way out of these recessions, or to devalue the currency to regain competitiveness and enable growth to revive. In many cases this meant transferring the pain from the private sector -- banks or firms or households that had over-borrowed and overspent -- to the government through some kind of bail-out mechanism. The result has been persistently rising ratios of public and private sector debt to GDP in one economy after another. In the US case, the combined debt-to-GDP ratio for the private and public sectors together increased modestly from around 140% in the late 1950s to 160% by 1980, but then soared over the next three decades to 379% in 2009. Numerous countries in Europe have seen similar increases.

Since the credit crisis of 2008-09 the US private sector has been trying to de-leverage, but this has been offset by the federal government leveraging up to finance spending on fiscal stimulus. Since the depths of the recession in early 2009 US household debt has declined from 98% of GDP to 88% (based on Flow of Funds data), while financial sector debt has decreased from 121% to 94%. Corporate sector debt is roughly unchanged at 49% of GDP.

But at the same time enormous amounts of government debt have been piled on top of the existing private sector debt, raising total government debt to 80% of GDP. The result is that non-financial sector debt has not declined, but has remained roughly static at 242%.

In their efforts to solve the 2008-09 crisis politicians and policy-makers of US and European governments are grasping at the same old solutions again: borrow and spend more money in the hope that private sector growth will pick up, GDP will revive, and government tax revenues will recover. In the past, if necessary, central banks stood ready to create the money to finance the spending. This Keynesian solution always seemed to work. Surely it will work again.

The problem is that there is a flaw in the Keynesian solution. It ignores the underlying deterioration in private and public sector balance sheets. The recovery formula only worked as long as private and government debt levels were relatively low in relation to annual incomes, or the debt could be devalued or forgiven. Now that both the private sector and governments are overburdened with debt and neither the US nor the Eurozone can overtly devalue, the mechanism is seizing up.

On one side households and firms are reluctant to spend and banks are unwilling to lend until they have repaired their balance sheets, while on the other side incontinent governments are looking less and less creditworthy -- even to those who have funds to lend or invest. So the economic recovery is stalling, and investors are demanding bigger risk premia (higher yields) for lending to financially weak governments.

In effect, the US and European governments have maxed out their credit cards. The Keynesian formula has reached the end of the road. It is time to turn to a different, more durable solution.

S&P is in effect advising individual and institutional investors not lend to the US federal government on the same terms as before. Excessive government spending -- on welfare, on health, on transport, on the armed forces, on policing and justice, on regulation and a myriad of other seemingly worthwhile causes -- is creating huge annual deficits of 10% of GDP. The deficits are adding to government debt, and the debt has now climbed to dangerous levels. This cannot continue. Get control of your long term spending plans, S&P is saying to the US government, put your finances in good shape and then we will consider advising investors to lend to you on better terms. But until then, it may cost the US government more to borrow long term money from domestic and foreign investors.

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QUESTIONS (from Hong Kong)

To what extent had the downgrade already been priced in by the market?

The downgrade is probably a secondary matter compared to investors' current need for safety and liquidity, and the growing perception that the US and other major economies face the prospect of not just sub-par growth, but a growing risk of a second recession. Moreover, as inflation falls over the months ahead bonds and especially US Treasuries should benefit relative to equities. Investors will no doubt be re-assessing their exposure to US Treasury debt, and to the US dollar, but in a time of high risk aversion there are few other safe havens to turn to.

The downgrade should be viewed as just one more step along the long road to a less dominant US economy and a less dominant dollar. But equally we should not exaggerate its impact. After all, there are plenty of pressures working in the other direction. For example, the US dollar remains overwhelmingly the currency of choice for denominating international trade and capital transactions. In periods of risk aversion like the present many investors will sell historically more volatile assets — equities and commodities -- and turn to those assets they have always deemed safe – including US Treasury debt and the US dollar.

What will the likely impact be on financial markets in the short term?

On Monday S&P will release assessments concerning affected ratings in government-related entities such as Fannie Mae and Freddie Mac, financial institutions, insurance, public finance, structured finance sectors, and money market funds. The knock-on effects in these areas could be more significant than on Treasury bonds themselves, especially in the repo markets where the value of collateral may be less certain. Risk asset markets such as equities and commodities will almost certainly be weaker than they otherwise would have been as they price in lower GDP growth ahead.

Over the next few months bond market vigilantes will force governments in the US and in the Eurozone to cut spending, potentially slowing overall GDP growth and causing corporate sales and earnings to slow. The beneficial effects of lower GDP growth and lower inflation on the US Treasury bond and bill markets will probably overwhelm the adverse effects of the US downgrade.

Do you expect other ratings agencies to follow suit, and how would that make a difference?

Yes, over time I think it is highly likely that both Moody's and Fitch will follow S&P in adjusting their long term ratings. In order to regain AAA status, the US government will need to adopt programs that are deeply contrary to the views of the President and many in the Democratic party. So progress in cutting the budget deficit and hence government debt in relation to GDP is likely to be very slow, and resisted at every step of the way. The basic problem is what Milton Friedman called the "ratchet" – that once a government spending program is started it is immensely difficult to unwind and reverse it because all the beneficiaries and their allies become supporters of more government spending. This is why the Keynesian formula of increasing government expenditure as a means of bailing out the economy is so deeply pernicious.

Can you sum up how significant a development this is?

I think the downgrade is immensely significant, though more as a symbolic statement marking a stage in the gradual relative decline of the US than as a specific driver of market events or economic change. The US has been gradually losing its hegemony in the global economy for the past three or four decades. The credit crisis of 2008-09 has hastened its fall, undermining the strength of the US currency and now eroding the growth rate of the economy itself. But neither of these events was triggered by the downgrade itself.