Analytics

Published by the Caesar Rodney Institute

RELEASE: CRI - Center for Economic Policy and Analysis

RE: S&P: the emperor has no clothes!

DATE: August 16, 2011

Friday August 5, 2011 will likely be remembered as "the NEW Black Friday" or "THE" Black Friday. On that day, after markets closed, Standard and Poor's (S&P) fulfilled its previous warning and downgraded the sovereign credit rating of the USA to AA+ from the fifty-years-old AAA.

On Monday the 8th, the stock market took a tremendous dive in excess of 6% and all the pundits and talking heads blamed it on S&P's downgrade. Clearly, the downgrade came in handy to justify the selloff of Monday, but doesn't explain the drop in stock market indexes since late July.

An important point to keep in mind is that what is in doubt by S&P is the capacity of the U.S. to face its debt obligations given the high probabilities of increases in the stock of debt (the only way to fund the fiscal deficit, implemented so far.) That is what the sovereign credit rating means: evaluation of the government (sovereign authority) to pay interest and amortization of the bonds.

The selloff in the equity market created a flight-to-safety, which, paradoxically, helped US treasuries as bond traders consider them as the "safest" investment. Clearly, the reason for the equity selloff is not the downgrade per-se but the possibility that the downgrade could scare capital from investment and decelerate the economy even further. The risk assessment that traders attached to the "double-dip" has increased.

S&P's Reasons for the Downgrade

Before releasing the report, S&P informed the US Treasury of its intentions. The Treasury questioned some numbers and calculations made by S&P, and accused the agency of basing its decision in a "$2 trillion mistake."[1]

In an initial report (shown to the Treasury) the rating agency seems to have overstated the increase in government debt (due to accumulative fiscal deficits) or to failed in the assessment of the savings set out by the Budget Control Act of 2011 (BCA) passed by Congress and signed by President Obama on August 2.

The BCA will save $917 billion during the 10-year period. To reach the advertized $2.4 trillion, a bipartisan congressional committee of 12 members (half from each party) will be chosen by the leadership of each block in Congress and they have to agree on further savings for $1.2 trillion, of

[1] http://www.treasury.gov/connect/blog/Pages/Just-the-Facts-SPs-2-Trillion-Mistake.aspx

course, over the 10-year period. If the commission fails to deliver automatic cuts between defense and non-defense spending will be introduced.

The initial projections used by S&P are part of an alternative scenario calculated and projected by the non-partisan Congressional Budget Office (CBO). The difference was that the CBO estimated the annual increase in discretionary spending by the government at 5% per annum, but the BCA forced the CBO to drop the increase in discretionary spending to 2.5% per annum. This amounts to $2 trillion reduction in spending after 10 years.

Consequently, S&P revised the report before releasing it and changed the assumption from 5% to 2.5% in discretionary spending annual growth as requested by the Treasury.

However, and in big blow to the US government and political system in general, S&P concluded that the "The primary focus remained on the current level of debt, the trajectory of debt as a share of the economy, and the lack of apparent willingness of elected officials as a group to deal with the U.S. medium term fiscal outlook."[2].

In other words, the main reason supporting the downgrade is the lack of confidence in the savings delivery capacity of elected officials.

Projections on Projections

Some words have different meanings to different people beyond synonyms. For example, when Joe and Mary face some economic hardship, for instance a temporary suspension, layoff, etc. their immediate action (other than searching for another job) is to reduce spending in order to extend savings as long as possible and adjust to expected lower income.

Congress and the executive have a different approach: if they said "we will be saving $2.4 trillion during the next 10 years," what they mean is not actual reductions in spending but reductions in "projected spending." In other words, the cuts introduced by the BCA will not be calculated from the actual spending in 2010 but from the CBO's projections.

I have high professional respect for economists working at the CBO. However, their forecasting or projection record is not brilliant. In fact it is bad. For instance, in 1999, the CBO was projecting that the federal government would run fiscal "surpluses." Doesn't look encouraging, right?

What's Next?

For the next several weeks we are going to face market volatility, and further drops in the stock market cannot be ruled out. It will depend upon the congressional committee to calm the waters and sail us to a safe port. But considering that since the rejection of the budget proposed by President Obama during the first quarter of the year, Congressional leaders and the President only reached an agreement with few minutes to spare before falling into technical default, we should keep our hopes low.

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[2] S&P Clarifies Assumption Used On Discretionary Spending Growth. http://www.standardandpoors.com/home/en/us

The whole situation has reached such a nonsensical level that even Chinese and Russian economic and political authorities are pressuring the U.S. to put the house in order. Is like Hugh Heffner talking about family values.

Nevertheless the reality remains that the stewards of our national government are proliferate spenders that, in the opinion of financial markets, cannot recover from their addiction.

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