The U.S. Government's Bad Credit Means Higher Costs for Us All

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Treasury Secretary Janet Yellen got huffy earlier this month after Fitch Ratings lowered the credit rating of the United States. Insisting that the downgrade is "arbitrary and based on outdated data," she assured the world that "Treasury securities remain the world's preeminent safe and liquid asset, and that the American economy is fundamentally strong."

Of course, it's Yellen's thankless job to blow sunshine up the asses of the world's financial markets even as the U.S. government ignores constant warnings that its fiscal policies are reckless. But blow though she will, nobody seems to find her especially convincing.

Poor Federal Credit Means Higher Mortgage Rates

"US mortgage rates jumped above 7% in a week that government bond yields spiked following a surprise decision by Fitch Ratings to lower the nation's credit rating," Bloomberg's Augusta Saraiva reports. "Mortgage rates are benchmarked to 10-year Treasury yields, and those hit the highest level of the year last week after Fitch stripped US government debt of its prized AAA rating."

That makes sense. Fitch lowered the credit rating (as it warned it might) because the U.S. government is perceived as an increasingly risky borrower, and riskier borrowers have to pay more to lenders.

"The rating downgrade of the United States reflects the expected fiscal deterioration over the next three years, a high and growing general government debt burden, and the erosion of governance relative to 'AA' and 'AAA' rated peers over the last two decades that has manifested in repeated debt limit standoffs and last-minute resolutions," Fitch noted. Among other concerns, it pointed to the current debt-to-GDP ratio of 112.9 percent and growing budget deficits.

This is the second time the U.S. has been dinged; Standard & Poor's downgraded U.S. credit in 2011.

"When you lower the rating of a government, they're always very upset," John Chambers, who headed S&P's sovereign rating committee in 2011, told Reuters earlier this year. "We think we've been vindicated with the passage of time."

Credit rating agencies aren't the only observers concerned about U.S. finances. Earlier this year, the Congressional Budget Office's long-term budget outlook foresaw the budget deficit rising from 5.8 percent of GDP this year to 10 percent in 2053 while federal debt increases to 181 percent of GDP over that time (it has since boosted its estimate for this year's deficit). But the CBO's official forecasts are based on mandatory and rather rosy assumptions, so it publishes alternative scenarios; some of those see debt rising above 250 percent of GDP.

"The reduction of the US credit rating is overdue in light of the long and enthusiastic abandonment of fiscal soundness in Washington DC, recently abetted by monetary policy authorities," writes economist Peter C. Earle of the American Institute for Economic Research. His take is that the credit downgrade is well-deserved given that "the median debt-to-GDP ratio of AAA rated sovereign debt issuers is currently 39.3 percent; for AA rated issuers, 44.7 percent. The current US debt-to-GDP ratio is 112.9 percent."

The hike in bond yields and subsequent rise in mortgage rates caught some people off-guard since there was no comparable reaction after the Standard & Poor's downgrade. But that took place in different economic times when the U.S. government had more room to maneuver.

Changing Times and Eroding Credibility

"Private investment was subdued, unemployment at 9%, underlying inflation below the Federal Reserve's 2% target and interest rates stuck at around zero," Grep Ip comments about the last downgrade at *The Wall Street Journal*. "Today's circumstances are just the opposite. Private investment is healthy, unemployment near a 53-year low at 3.5%, and interest rates above 5% as the Fed combats inflation roughly double its 2% target."

Ip warns that the "global saving glut—the wall of money in search of safe assets that kept yields down a decade ago—is no more" and that investors may fear the government will use "inflation to reduce the real value of its debts, which raises interest rates today."

Economist John Cochrane, a Senior Fellow of Stanford's Hoover Institution and an adjunct scholar with the Cato Institute, agrees that "Fitch is right to downgrade the US." He also warns that inflation has eroded the U.S. government's credibility as a borrower.

"Inflation is the economic equivalent of a partial default. The debt was sold under a 2% inflation target, and people expected that or less inflation. The government borrowed and printed $5 Trillion with no plan to pay it back, devaluing the outstanding debt as a result," he cautions. "Yes, this is not a formal default. And a formal default would have far reaching financial consequences that inflation does not have. Still, for a bondholder it's the same thing."

Having been burned by the U.S. government's policies, investors perceive it as an increasingly risky borrower, just as Fitch (and S&P in 2011) say. As a result, they demand a greater price to loan the feds money—hence higher bond yields. And since 10-year Treasury yields serve as benchmarks for other borrowing rates, such as mortgages, that means higher cost for average Americans who have little say in D.C.'s financial shenanigans but have to suffer the consequences.

"Steady Deterioration in Standards of Governance" With High Costs for Everybody

That doesn't mean that Treasury yields and mortgage rates are destined to rise in an unbroken line—other factors are in play. But as Fitch points out, "there has been a steady deterioration in standards of governance over the last 20 years, including on fiscal and debt matters," and "there has been only limited progress in tackling medium-term challenges related to rising social security and Medicare costs due to an aging population." The U.S. government has put itself on a path of unsupportable expenditures funded by growing debt accumulated at rising expense.

"Such high and rising debt would slow economic growth, push up interest payments to foreign holders of U.S. debt, and pose significant risks to the fiscal and economic outlook," according to the CBO.

That means unpleasant consequences not just for government officials, but for those of us who live in the economy they hobble. The government will have to pay more to borrow, and so will we. We'll do so in a country less prosperous than it should have been.

Janet Yellen may resent Fitch's credit-rating downgrade, but the public has even more reason to resent the continuing fiscal irresponsibility of the federal government and the costs it inflicts on the wider world. Without radical reforms to the way government officials handle our money, Fitch's action will be just one more unheeded warning along the way to an unpromising future.