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NRO's eye on debt and deficits . . . by Kevin D. Williamson.

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The Democrat Downgrade: Reality and Repercussions

By Kevin D. Williamson

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Question: How many U.S. banks and insurance companies do you think will remain rated AAA if the U.S. government gets downgraded?

That is *not* a rhetorical question.

The direct consequences of a downgrade of Uncle Sam's credit on U.S. public finances would be pretty bad. But, as with natural disasters, the aftershocks of this man-made catastrophe might prove more devastating than the main event. In this case, imagine a tsunami of rolling corporate downgrades following the earthquake of a Treasury downgrade, a run on the banks, a discredited FDIC, frozen money-market funds, and a plunging dollar.

It's not Beijing that's going to take it in the shorts — it's our still-fragile financial system.

Standard & Poor current gives AAA ratings to six major insurance companies: New York Life, Northwestern Mutual, etc. Those companies already are on the watch-list for a downgrade, *simply because of their extensive holdings of U.S. Treasury securities* — regardless of the fact that Treasuries themselves have not yet been downgraded.

Many banks could find themselves downgraded as well, just because of all the U.S. government debt on their balance sheets. One of our old friends from the bailout days, the AAA-rated Temporary Liquidity Guarantee Program, could get downgraded as well, along with Fannie Mae, Freddie Mac, the Federal Home Loan Banks, and, critically, the FDIC. And Fannie and Freddie still prop up a bunch of mortgage-backed securities. What happens to them? Here's what Fitch says: "Ratings on bonds with direct credit enhancement provided by Fannie Mae, Freddie Mac, or other GSEs would generally reflect the ratings of the credit enhancement provider." In English: If the government isn't AAA, nothing that the government backs is AAA, either.

Fitch also warns that money-market funds could face "liquidity pressure," something to keep in mind if there's a run on downgraded banks backed by a downgraded FDIC.

So, who's who in this world of hurt?

The ten major holders of U.S. Treasury debt are, in order: 1. the Fed, which has more than doubled its holdings of U.S. sovereign debt in the past few years; 2. individual investors, mostly in the United States; 3. the Chinese; 4. the Japanese; 5. pension funds; 6. mutual funds; 7. state and local governments; 8. the Brits; 9. the banks; and 10. insurance companies. (More here.) The national governments have worries of their own already — some of them are in pretty dire straits (the Japanese national debt is 200 percent of GDP) and some of their situations are basically unknowable (China). God alone knows what the Fed will do.

Even if the banks and insurances companies don't get downgraded, a Treasury downgrade is still going to be enormously disruptive to their businesses. Typically, regulated financial institutions are required to hold "investment grade" assets, which does not limit them to AAA bonds. AA is still "investment grade." So they don't *have* to dump all their Treasuries. (Which is not to say they *won't*.) But capital-requirement rules — which govern the amount of money a financial institution has to hold in reserve — naturally take into account whether bonds are AAA, AA, or something else. That's because $1 worth of Exxon debt is not really worth the same thing as $1 worth of debt from Barney's Subprime Bait-'n'-Tackle, and $1 million in Swiss bonds is not the same thing as $1 million in Haitian bonds. A downgrade of U.S. Treasuries would mean that basically every bank and insurance company of any stature would *immediately* have to raise a great deal of capital to offset the downgrade of the more than $1 trillion worth of U.S. Treasury debt they are holding. They'll have to try to raise that capital in a market suffering a jacklighted panic over that sovereign downgrade, scrambling for investment in an environment in which the U.S. government is no longer considered a gold-plated, top-shelf safe haven. In terms of a "credit event," that's probably going to make 2008 look like a day relaxing upon the sandy beaches of Calais with tropical-themed umbrella-garnished drinks.

State and local governments are holding another $1 trillion or so in Treasuries, meaning that the credit profile of our already struggling states and cities would have about as much credibility as Dominique Strauss-Kahn's wedding vows. A lot of that pension-fund exposure to Treasury debt is for state and local government retirees, too, so Austin and Sacramento and Boise and Augusta will be right between the hammer and the anvil, getting pounded. And so will Springfield — the Typhoid Mary of fiscal contagion at the state level. As I've written before, I suspect that Illinois will be the first state to go into something like a full-blown insolvency, largely due to its unfunded pension liabilities. Just Monday, Ben Bernanke confessed himself worried about the situation in Illinois and California. And if I may be forgiven for repeating myself: Most states have either statutory or constitutional obligations to pay those pensions, so they cannot just reduce them or walk away. There's really no such thing as a state-bankruptcy law, so nobody knows how a default would unfold. How's that for uncertainty in the markets?

Back to those banks and insurance guys: Contrary to what our dear leaders in Washington have claimed, the world's financial system has not been reformed. In fact, a great deal of the bailouts and the legislation that followed them was designed specifically to prevent the kind of fundamental reforms that are needed. A

global financial system brought to its knees by a raft of bad mortgages is going to be knocked ass-over-teakettle by a downgrade of U.S. Treasury debt.

I was in Washington Monday, debating Cato's erudite Dan Mitchell about the no-new-taxes pledge. Mr. Mitchell and I agree on the fundamentals and differ on the politics. What I found mildly despair-inducing, however, was the question-and-answer session, during which the predominant concern expressed by the audience was how to ensure that our guys "win" the debt-ceiling debate. While I understand that you have to win elections to get things done, we simply must head off a downgrade, even if at great political cost. Nobody is going to "win" a downgrade.

The thing that has not been sufficiently understood, I think, is this: The United States is not on a downgrade watch because the markets fear we won't raise the debt ceiling in time to avoid a default; the United States is on a downgrade watch because the markets believe the debt-ceiling debate presents the last real opportunity for the government to enact a meaningful fiscal-reform program before it is well and truly too late to avoid a national crisis. The credit agencies, wisely or not, aren't worried about the short-term political fight leading to an immediate default, but about the near- to medium-term fiscal situation, which is plainly unsustainable.

I sincerely hope that in five or ten years, I will have to sheepishly admit that I was among the alarmists back in 2011. But right now, I believe that the question isn't how to "win" the debt-ceiling fight, but how to *survive* the underlying economic disorder it represents.

— *Kevin D. Williamson is a deputy managing editor of* National Review *and author of* The Politically Incorrect Guide to Socialism,*published by Regnery. You can buy an autographed copy through* National Review Online *here*.

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