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**Research Update:**

# United States of America 'AAA/A-1+' Rating Affirmed; Outlook Revised To Negative

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## Overview

- We have affirmed our 'AAA/A-1+' sovereign credit rating on the United States of America.
- The economy of the U.S. is flexible and highly diversified, the country's effective monetary policies have supported output growth while containing inflationary pressures, and a consistent global preference for the U.S. dollar over all other currencies gives the country unique external liquidity.
- Because the U.S. has, relative to its 'AAA' peers, what we consider to be very large budget deficits and rising government indebtedness and the path to addressing these is not clear to us, we have revised our outlook on the long-term rating to negative from stable.
- We believe there is a material risk that U.S. policymakers might not reach an agreement on how to address medium- and long-term budgetary challenges by 2013; if an agreement is not reached and meaningful implementation does not begin by then, this would in our view render the U.S. fiscal profile meaningfully weaker than that of peer 'AAA' sovereigns.

## Rating Action

On April 18, 2011, Standard & Poor's Ratings Services affirmed its 'AAA' long-term and 'A-1+' short-term sovereign credit ratings on the United States of America and revised its outlook on the long-term rating to negative from stable.

## Rationale

Our ratings on the U.S. rest on its high-income, highly diversified, and flexible economy, backed by a strong track record of prudent and credible monetary policy. The ratings also reflect our view of the unique advantages stemming from the dollar's preeminent place among world currencies. Although we believe these strengths currently outweigh what we consider to be the U.S.'s meaningful economic and fiscal risks and large external debtor position, we now believe that they might not fully offset the credit risks over the next two years at the 'AAA' level.

The U.S. is among the most flexible high-income nations, with both adaptable labor markets and a long track record of openness to capital flows. In addition, its public sector uses a smaller share of national income than those of most 'AAA' rated countries--including its closest peers, the U.K., France, Germany, and Canada (all AAA/Stable/A-1+)--which implies greater revenue flexibility.

Furthermore, the U.S. dollar is the world's most used currency, which provides the U.S. with unique external flexibility; the vast majority of U.S. trade flows and external liabilities are denominated in its own dollars. Recent depreciation of the currency has not materially affected this position, and we do not expect this to change in the medium term (see "Après Le Déluge, The U.S. Dollar Remains The Key International Currency," March 10, 2010, RatingsDirect).

Despite these exceptional strengths, we note the U.S.'s fiscal profile has deteriorated steadily during the past decade and, in our view, has worsened further as a result of the recent financial crisis and ensuing recession. Moreover, more than two years after the beginning of the recent crisis, U.S. policymakers have still not agreed on a strategy to reverse recent fiscal deterioration or address longer-term fiscal pressures.

In 2003-2008, the U.S.'s general (total) government deficit fluctuated between 2% and 5% of GDP. Already noticeably larger than that of most 'AAA' rated sovereigns, it ballooned to more than 11% in 2009 and has yet to recover.

On April 13, President Barack Obama laid out his Administration's medium-term fiscal consolidation plan, aimed at reducing the cumulative unified federal deficit by US$4 trillion in 12 years or less. A key component of the Administration's strategy is to work with Congressional leaders over the next two months to develop a commonly agreed upon program to reach this target. The President's proposals envision reducing the deficit via both spending cuts and revenue increases, and the adoption of a "debt failsafe" legislative mechanism that would trigger an across-the-board spending reduction if, by 2014, budget projections show that federal debt to GDP has not yet stabilized and is not expected to decline in the second half of the current decade.

The Obama Administration's proposed spending cuts include reducing non-security discretionary spending to levels similar to those proposed by the Fiscal Commission in December 2010, holding growth in base security (excluding war expenditure) spending below inflation, and further cost-control measures related to health care programs. Revenue would be increased via both tax reform and allowing the 2001 and 2003 income and estate tax cuts to expire in 2012 as currently scheduled--though only for high-income households. We note that the President advocated the latter proposal last year before agreeing with Republicans to extend the cuts beyond their previously scheduled 2011 expiration. The compromise agreed upon in December likely provides short-term support for the economic recovery, but we believe it also weakens the U.S.'s fiscal outlook and, in our view, reduces the likelihood that Congress will allow these tax cuts to expire in the near future. We also note that previously enacted legislative mechanisms meant to enforce budgetary discipline on future Congresses have not always succeeded.

Key members in the U.S. House of Representatives have also advocated fiscal tightening of a similar magnitude, US$4.4 trillion, during the coming 10 years, but via different methods. House Budget Committee Chairman Paul Ryan's plan seeks to balance the federal budget by 2040, in part by cutting non-defense spending. The plan also includes significantly reducing the scope of Medicare and Medicaid, while bringing top individual and corporate tax rates lower than those under the 2001 and 2003 tax cuts.

We view President Obama's and Congressman Ryan's proposals as the starting point of a process aimed at broader engagement, which could result in substantial and lasting U.S. government fiscal consolidation. That said, we see the path to agreement as challenging because the gap between the parties remains wide. We believe there is a significant risk that Congressional negotiations could result in no agreement on a medium-term fiscal strategy until after the fall 2012 Congressional and Presidential elections. If so, the first budget proposal that could include related measures would be Budget 2014 (for the fiscal year beginning Oct. 1, 2013), and we believe a delay beyond that time is possible.

Standard & Poor's takes no position on the mix of spending and revenue measures the Congress and the Administration might conclude are appropriate. But for any plan to be credible, we believe that it would need to secure support from a cross-section of leaders in both political parties.

If U.S. policymakers do agree on a fiscal consolidation strategy, we believe the experience of other countries highlights that implementation could take time. It could also generate significant political controversy, not just within Congress or between Congress and the Administration, but throughout the country. We therefore think that, assuming an agreement between Congress and the President, there is a reasonable chance that it would still take a number of years before the government reaches a fiscal position that stabilizes its debt burden. In addition, even if such measures are eventually put in place, the initiating policymakers or subsequently elected ones could decide to at least partially reverse fiscal consolidation.

In our baseline macroeconomic scenario of near 3% annual real growth, we expect the general government deficit to decline gradually but remain slightly higher than 6% of GDP in 2013. As a result, net general government debt would reach 84% of GDP by 2013. In our macroeconomic forecast's optimistic scenario (assuming near 4% annual real growth), the fiscal deficit would fall to 4.6% of GDP by 2013, but the U.S.'s net general government debt would still rise to almost 80% of GDP by 2013. In our pessimistic scenario (a mild, one-year double-dip recession in 2012), the deficit would be 9.1%, while net debt would surpass 90% by 2013. Even in our optimistic scenario, we believe the U.S.'s fiscal profile would be less robust than those of other 'AAA' rated sovereigns by 2013. (For all of the assumptions underpinning our three forecast scenarios, see "U.S. Risks To The Forecast: Oil We Have to Fear Is…," March 15, 2011, RatingsDirect.

Additional fiscal risks we see for the U.S. include the potential for further extraordinary official assistance to large players in the U.S. financial or other sectors, along with outlays related to various federal credit programs. We estimate that it could cost the U.S. government as much as 3.5% of GDP to appropriately capitalize and relaunch Fannie Mae and Freddie Mac, two financial institutions now under federal control, in addition to the 1% of GDP already invested (see "U.S. Government Cost To Resolve And Relaunch Fannie Mae And Freddie Mac Could Approach $700 Billion," Nov. 4, 2010, RatingsDirect). The potential for losses on federal direct and guaranteed loans (such as student loans) is another material fiscal risk, in our view. Most importantly, we believe the risks from the U.S. financial sector are higher than we considered them to be before 2008, as our downward revisions of our Banking Industry Country Risk Assessment (BICRA) on the U.S. to Group 3 from Group 2 in December 2009 and to Group 2 from Group 1 in December 2008 reflect (see "Banking Industry Country Risk Assessments," March 8, 2011, and " Banking Industry Country Risk Assessment: United States of America," Feb. 1, 2010, both on RatingsDirect). In line with these views, we now estimate the maximum aggregate, up-front fiscal cost to the U.S. government of resolving potential financial sector asset impairment in a stress scenario at 34% of GDP compared with our estimate of 26% in 2007.

Beyond the short- and medium-term fiscal challenges, we view the U.S.'s unfunded entitlement programs (such as Social Security, Medicare, and Medicaid) to be the main source of long-term fiscal pressure. These entitlements already account for almost half of federal spending (an estimated 42% in fiscal-year 2011), and we project that percentage to continue increasing as long as these entitlement programs remain as they currently exist (see "Global Aging 2010: In The U.S., Going Gray Will Cost A Lot More Green," Oct. 25, 2010, RatingsDirect). In addition, the U.S.'s net external debt level (as we narrowly define it), approaching 300% of current account receipts in 2011, demonstrates a high reliance on foreign financing. The U.S.'s external indebtedness by this measure is one of the highest of all the sovereigns we rate.

While thus far U.S. policymakers have been unable to agree on a fiscal consolidation strategy, the U.S.'s closest 'AAA' rated peers have already begun implementing theirs. The U.K., for example, suffered a recession almost twice as severe as that in the U.S. (U.K. GDP declined 4.9% in real terms in 2009, while the U.S.'s dropped 2.6%). In addition, the U.K.'s net general government indebtedness has risen in tandem with that of the U.S. since 2007. In June 2010, the U.K. began to implement a fiscal consolidation plan that we believe credibly sets the country's general government deficit on a medium-term downward path, retreating below 5% of GDP by 2013.

We also expect that by 2013, France's austerity program, which it is already implementing, will reduce that country's deficit, which never rose to the levels of the U.S. or U.K. during the recent recession, to slightly below the U.K. deficit. Germany, which suffered a recession of similar magnitude to that in the U.K. (but has enjoyed a much stronger recovery), enacted a constitutional limit on fiscal deficits in 2009 and we believe its general government deficit was already at 3% of GDP last year and will likely decrease further. Meanwhile, Canada, the only sovereign of the peer group to suffer no major financial institution failures requiring direct government assistance during the crisis, enjoys by far the lowest net general government debt of the five peers (we estimate it at 34% of GDP this year), largely because of an unbroken string of balanced-or-better general government budgetary outturns from 1997 through 2008. Canada's general government deficit never exceeded 4% of GDP during the recent recession, and we believe it will likely return to less than 0.5% of GDP by 2013.

## Outlook

The negative outlook on our rating on the U.S. sovereign signals that we believe there is at least a one-in-three likelihood that we could lower our long-term rating on the U.S. within two years. The outlook reflects our view of the increased risk that the political negotiations over when and how to



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address both the medium- and long-term fiscal challenges will persist until at least after national elections in 2012.

Some compromise that achieves agreement on a comprehensive budgetary consolidation program--containing deficit reduction measures in amounts near those recently proposed, and combined with meaningful steps toward implementation by 2013--is our baseline assumption and could lead us to revise the outlook back to stable. Alternatively, the lack of such an agreement or a significant further fiscal deterioration for any reason could lead us to lower the rating.

Standard & Poor's will hold a global teleconference call and Web cast today--April 18, 2011--at 11:30 a.m. New York time (4:30 p.m. London time). For dial-in and streaming audio details, please go to www.standardandpoors.com/cmlive.

## Related Criteria And Research

- Sovereign Credit Ratings: A Primer, May 29, 2008.

## Ratings List

Ratings Affirmed; Outlook Action

| | To | From |
|---|---|---|
| United States of America (Unsolicited Ratings) | | |
| Sovereign Credit Rating | AAA/Negative/A-1+ | AAA/Stable/A-1+ |

Ratings Affirmed

| | |
|---|---|
| United States of America (Unsolicited Ratings) | |
| Senior Unsecured | AAA |
| United States of America (Unsolicited Ratings) | |
| Transfer & Convertibility Assessment | AAA |

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