



Standard & Poor's Downgrade No Surprise

Carmen M. Reinhart says it was only a matter of time before rating agencies caught up to mounting and hidden debts at the federal, state, and local levels.

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Steve Weisman: The markets are reacting to Standard & Poor's move on U.S. debt this week. This is Steve Weisman at the Peterson Institute for International Economics with Carmen Reinhart, Senior Fellow here. Carmen, what did Standard & Poor's do?

Carmen Reinhart: It changed the outlook. It is not a change in the rating per se but in the outlook. It was changed to negative. And the main reasons, of course, cited behind their decision is the current and projected level of debts and deficits as well as some other vulnerabilities that they see as regards potential additional sources of uncertainty, such as external financing and such.

Steve Weisman: Do they look at political developments or do they just look at the debt picture.

Carmen Reinhart: No, no, no. They certainly look at political developments. I think they also make an assessment of how much can be achieved in terms of real tangible deficit reduction.

Steve Weisman: A number of economists say that while there needs to be action on the debt it shouldn't happen too quickly because of the precariousness of the recovery. Does Standard & Poor's look at that sort of thing too?

Carmen Reinhart: That argument is getting a little old. The crisis began in the summer of 2007. Since then we certainly had every reason to have a big fiscal stimulus to support the economy in crisis time, but we have signs of recovery. And if anyone can tell me when there is such a thing as a good time for making difficult decisions about spending and taxes, I don't think there really is an ideal time.

Steve Weisman: Politically.

Carmen Reinhart: Politically, yes.

Steve Weisman: Now you have studied debt and deficit and financial crises, and have applied certain criteria to the current U.S. situation that sends off warning signs. Are your criteria similar to what S&P is looking at? Do you happen to know what thresholds they might be considering? Are they more imminent in their view or your view?

Carmen Reinhart: I think they have, quite understandably, a fairly eclectic approach. And it is for me not surprising to see that they've taken this step. Standard & Poor's among other ratings agencies have been singled out, including by people like myself, of acting after the fact rather than before the fact sort of validating what markets had already done before hand. And that is something that they're certainly weighing in on their decisions. If you look at, for example, Japan, which is a country that does have a higher debt level than the U.S. relative to GDP, but on the other hand it finances all its debt domestically -- it doesn't depend on foreign financing -- Japan lends to the rest of the world and they've been downgraded several times. So the situation in the U.S. can be summarized as one in which the change in outlook is a progression that goes

hand in hand with what has been a very sharp deterioration in the fiscal fundamentals.

Steve Weisman: Review for me what the numbers are that you see over the next five or ten years that are alarming.

Carmen Reinhart: I really, Steve, don't do forecasts. But I can tell you what they are right now. If you look at gross public debt of the federal government; it's 94 percent. It's not yet hit the post-war high. But it's moving very closely in that direction: the 1946-1947 highs. If you look however at a broader measure of government -- for example the Federal Reserve flow of funds -- even using net federal debt, then you add state and local, then you add government sponsored enterprises like the giants Fanny Mae and Freddy Mac. And you work yourself to a debt to GDP of 124 percent which is an all time high since the numbers have been kept, going back to 1960.

So you also look at the projections of CBO [Congressional Budget Office], for instance. And you don't find a lot of solace in those projections. And you look at all the wealthy economies, the advanced economies, and the U.S. deficit at present is at the extreme end of that spectrum. So again we shouldn't be surprised by the concerns that Standard & Poor's has put forth in their negative outlook.

Steve Weisman: Do you think that markets are impressed at all with the consolidation that is going on in state and local levels? What is the market reaction to the talk of trying to reach a bipartisan agreement on the long-term situation?

Carmen Reinhart: The fact is the markets haven't reacted wildly to the Standard & Poor's news. And in large part we've already heard the likes of PIMCO, a leader in purchases of treasury securities, saying we're walking away. We don't like these fundamentals.

In terms of your other two questions on state and local. If there is progress on consolidations, state and local, there is also a lot of hidden debt. Ken Rogoff and I in our work together have highlighted that hidden debt problems are precisely the sort of thing that will jump out and bite you.

Steve Weisman: Things like unfunded pension liabilities.

Carmen Reinhart: Absolutely. And those are a longer-term problem. But there are more even immediate hidden debts at the state and local level. There are below the line arrears, namely unpaid bills that are not calculated in the debt totals. They are not securitized debt so they're not on the balance sheet as we understand them. And similarly at the federal level, and this is cited in the S&P report, there are concerns that there are still contingent liabilities for the government in the financial industry in which we haven't seen write downs yet of many bad loans that we know are going to have to be written off or written down at some point.

Steve Weisman: Final question. What about the talk of not raising the debt limit therefore possibly defaulting on U.S. debt?

Carmen Reinhart: I hope that remains just at the level of talk. I think the expectation is that the debt limit will be raised and the U.S. would not go into default mode. I think that one cannot take default lightly in any way, shape, or form.

Steve Weisman: Thanks, Carmen.

Carmen Reinhart: Thank you.

