Is a Downgrade Still Justified for the United States?

Carmen M. Reinhart says that despite an averted default and pledges to cut spending, the United States' problems are so large that its AAA credit rating remains in doubt.

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Steve Weisman: The last minute rescue from default in the United States is going to have long-range repercussions. Here to talk about some of them is Carmen Reinhart, senior fellow at the Peterson Institute for International Economics. This is Steve Weisman. Carmen, you and Vincent Reinhart have written in the Financial Times that the United States may still be, and probably should be, downgraded on its credit rating after this episode. Why?

Carmen Reinhart: First and foremost, let me say I am delighted that there was something to avoid a default. I think the term default had been bandied about without really thinking very hard of what the short run pain and the long-term credibility consequences a default has.

Steve Weisman: You took that very seriously.

Carmen Reinhart: I took that very seriously. If you look at history, countries don't default on whims. They don't default because their politicians can't come to an agreement. They usually default because of inability to service their debt.

So the issue of defaulting, not because you can't pay, but because you won't, is not something that is your norm, historically. As I said, you know, historically the pattern is one in which governments go to great lengths to try to avoid default in terms of meeting debt payments.

So let me reiterate that I am delighted that we have had the sense to avoid what I think would be an unambiguously negative short run, medium run, long run consequence of default.

Steve Weisman: With a messy political compromise.

Carmen Reinhart: Indeed. Indeed. And I'm sure more of that will follow. But directly on your question, why is it that, compromise notwithstanding, we are still vulnerable to a downgrade? That has three parts, my answer to that. And one really has to go back also to the S&P [Standard & Poor's] document, when they changed the outlook on the US to negative outlook, they pointed in three directions. Number one is the absence of a political process to correct the medium term debt problems and correct the deficit profile and the steadily rising debts.

Number two, they mention very clearly that they had concerns about contingent liabilities. That is not the kind of debt that we've been arguing. We've been arguing about the debt that's subject to a [federal] ceiling. This is the federal debt.

But looming large in their radar screen and certainly in my radar screen is the issue of contingent liabilities. And let me be explicit about what kinds of contingent liabilities.

We remained, and the recent data makes this very plain, with a housing sector that has not yet healed. And among the many alarming things associated with the bust of the housing market is the fact that we still have unfinished business. We have debts that are still not reflecting the reality of what housing prices are.

Steve Weisman: You talking about debts owed by Americans on their mortgages.

Carmen Reinhart: Absolutely.

Steve Weisman: Consumer debts, not about the government debts.

Carmen Reinhart: Absolutely. I am talking...

Steve Weisman: But the overall solvency of the country or the government is affected by that, at least according to S&P?

Carmen Reinhart: Absolutely. And the way it works or historically has worked, Steve, is that -- and we see this nowhere more clearly than in Ireland -- what starts out often as private debt, after a crisis becomes public debt.

Steve Weisman: Right.

Carmen Reinhart: And the corporate non-financial sector in the US is what I would call in the pink. I mean, they have very strong balance sheets. But the financial industry still has a big debt overhang.

More than a quarter of US households have negative equity. And that is still unresolved business, unfinished business. At some point, those debts are also going to be written off. There's a contingent liability of potentially having to take over this mortgage debt that is still out there.

Steve Weisman: Right.

Carmen Reinhart: The other form of contingent liabilities, of course, has to do with other layers of government. Over the near term, some issues pertaining to state or local debts and finances are still very iffy. And then of course, the longer term pension issue.

So now let me turn to the third factor, which is the factor that hasn't come up with a bang but has been building up gradually. Over the course of the years, we have become increasingly dependent on foreigners purchasing US debt. More and more of the stock of US Treasuries is in the hand of non-residents -- notably, foreign central banks.

And so the source of concern is that if you look at a lot of the historic episodes, domestic sources of funding tend to be more stable than foreign sources of funding. And certainly, the government -- when push comes to shove -- has more control over domestic residents than over non-residents.

At some point, foreign central banks may start moving further and further away from their fix on US Treasury securities. To some extent, we have seen already that process begin. So that process is under way.

But, the dependence on foreign holders -- the fact that there are hidden debts, contingent liabilities, and the fact that our agreement is still quite tenuous – are all areas that are still out there, which could, and probably will, be a factor in influencing a US downgrade.

Steve Weisman: Let's talk about the credit rating agencies themselves. You and others have pointed out that they were kind of asleep in previous crises affecting Europe and also the Unites States. Does that make them more likely to be tough in looking at the balance sheet information this time around?

Carmen Reinhart: I would be inclined to say yes. If you look back to the Mexican peso crisis of the mid-1990's, Mexico was upgraded a couple of months before the crisis. Rating agencies did not catch the Asian crisis, as you rightly point out. They were looking the other way in Iceland and Europe and the whole vulnerability of the housing debt.

I think that they have been a lot more active and zealous in looking at this broader profile of debt, the contingent liabilities, the composition of debt, and such. And thus, because they want to salvage some of their reputation [they are taking] maybe a stricter tone.

Steve Weisman: I have to say that my favorite part of your piece in the Financial Times was when you said this was like the opening act of "The Ring of the Nibelungs." The pedant in me would point out that in that opening act [of the four operas[, the gold is stolen, which is a debt that's not redeemed until fifteen or sixteen hours later. By that I take it that you mean we are going to be seeing this drama over and over again in coming years.

Carmen Reinhart: That is very much my concern. Look, the Fiscal Commission [National Commission on Fiscal Responsibility and Reform, established in 2010] was set up as a bipartisan effort to look into deficits and to deal with the surging debts. And the Fiscal Commission [led by Erskine Bowles and former Senator Alan Simpson] took this very seriously, and it ended with a recommendation and that proposal just went nowhere.

And so all we have done thus far is say, "OK, we're going to put a mechanism in place for a future group to look at ways in which we can reduce the deficit and the debts." But that doesn't say anything, or has guarantee of how successful such an effort would be.

Steve Weisman: Thank you, Carmen.

Carmen Reinhart: Thank you.