

No Silver Lining Behind This Cloud

Michael E. Lewitt

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The USA is no longer AAA. For the first time since 1917, the credit of the United States is not considered 100% bulletproof. On Friday, Standard & Poor's downgraded the credit of the United States to AA+ from AAA. While this downgrade was widely expected after US leaders failed to adopt a debt-ceiling package that met S&P's requirements, it is still a momentous event. Pundits and economists who argue otherwise do not understand the psychology of economies and markets.

This decision comes at a time when market confidence is extremely fragile. The credit rating agencies have a bad habit of delivering bad news at the worst possible time, but in this case their action was justified. S&P served notice well in advance of what was required to maintain an AAA rating. But rather than pass a serious debt reduction plan, US leaders virtually thumbed their noses at the rating agency by passing a debt-ceiling bill that did not include any tax increases (even on those who can easily afford them) and in which 70% of the spending cuts (which in themselves are so small that they won't even make a dent in America's debt burden) don't even begin until 2017. America's leaders turned out to be their own worst enemies.

The US has \$20 trillion of debt today including the obligations of Fannie Mae and Freddie Mac, the two insolvent housing agencies that are held in conservancy by the U.S. government. That is equivalent to 140% of GDP. By 2020 this figure will be much closer to \$30 trillion than \$20 trillion and likely be equivalent to 160% of GDP. The US economy cannot grow fast enough to sustain this dent even if its political classes could begin to act like adults because the weight of so much debt crushes economic growth.

The weakened condition of the US economy is the result of a long list of flawed policy decisions that reach back far earlier than the Bush II and Obama administrations. But the deterioration of America's finances accelerated with frightening velocity in the early part of the 2000s. When fiscal, monetary and tax policy reward speculation and set obstacles in the way of productive economic activity, the inevitable result is economic degradation.

It is impossible to know how severely the financial markets will react to S&P's decision, but it is difficult to find a silver lining behind this cloud. Some people will argue that this is a wake-up call to U.S. leaders, but that underestimates the profound policy differences that divide the Democratic and Republican parties. This gap was one of the primary reasons by S&P took the action it did, and there are few indications that comity will return to the U.S. government any time soon. Global interest rates will be pushed higher by this decision although the impact may not be felt immediately because economic weakness in the US and Europe are pushing them lower. But when the inflationary effects of incessant money printing by the US Fed and ECB are finally felt, a lower U.S. debt rating certainly won't help matters. For now, however, economic weakness should keep interest rates and government bond markets under control. But risk assets such as high yield corporate bonds and mortgage bonds may not fare so well because their performance is related not only to interest rates but to the economy's health.

The primary worry of bond markets right now is economic weakness, of which there is an abundance on both sides of the Atlantic.

The equity markets are another matter. They have already entered a correction phase due to concerns about weak economic growth and lack of confidence in global economic stewardship. S&P's decision is a blow to global confidence at a point when it is already extremely vulnerable. Stock markets could fall much further unless concrete steps to improve confidence are taken immediately. If the recent performance of the world's leaders is any indication, that is unlikely to happen. So the sell-off in stocks will likely continue on Monday morning.

And ultimately that is the rub. The world has seen anything other than prudent policy in recent years. Investors and citizens alike have caught on to the fact that governments are unwilling to make the painful choices necessary to deal with the problems their economies are facing. They are losing their willingness to believe the false promises of their leaders. Of course, citizens must be prepared to support their leaders if they decide to pursue a better course. For the moment, however, the unwise actions of their leaders do not deserve support. The circus surrounding the US debt-ceiling deal demonstrated that the US is unable to govern itself. Europe's debt crisis shows with each succeeding bailout by European economic authorities that the deep structural problems that lie at the heart of the Continent's troubled economies won't be addressed - labor, tax and industrial policies that retard growth and reward speculation. The latest announcement that the European Central Bank is going to start purchasing Italian debt is one more example of this. It may calm markets for a brief moment, but it will further weaken the ECB's balance sheet and exacerbate future crises. And markets are catching on to the fecklessness of such policies.

World leaders face a choice of truly historic proportions. They can follow one of two paths. The first path would require them to finally admit their prior policy errors and embark upon comprehensive reform of all of the fiscal policies that affect the economy - energy, education, tax, business regulation, technology and science policy and industrial policy - in order to give their economies a chance to grow through productive investments. (By the way, these investments and policies would also have the side benefit of improving the quality of human life.) This path would also require central bank discipline on the long-lost Paul Volcker model. Or they can stay on their current path and continue to monetize their debts in the hope that future generations will be able to repay them with deflated currencies and the markets won't abandon them. The choice is clear. The question is whether leaders will have the courage to make the right one, and their citizens the fortitude to stand behind them.

Michael Lewitt is the author of the investment newsletter The Credit Strategist (www.thecreditstrategist.com) and the author of **La muerte del capital**.