John Williams'
Shadow Government Statistics
*Analysis Behind and Beyond Government Economic Reporting*

**COMMENTARY NUMBER 381**
**Debt, Deficit and Sovereign Rating**

**July 25, 2011**

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**Dollar and Deficit Do Matter**

**Downgrade Almost as Damaging as Default**

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*This brief* Commentary *touches upon some of the issues being bandied about, as Washington remains mired in deficit-reduction and debt-ceiling negotiations. The next regular* Commentary *remains scheduled for Friday, July 29th. It will cover the "advance" estimate of second-quarter GDP and benchmark revisions, June new orders for durable goods and June new home sales. See the prior* Commentary No. 380 *for detail on the pending economic releases.*

*—Best to all, John Williams*

## SPECIAL COMMENT

**Downgrade Could Be Death Knell for U.S. Dollar.** If I were to script a scenario as to how the United States quickly could debase the U.S. dollar with maximum impact, impairing the dollar's reserve status and dwindling global credibility, and accelerating the movement towards a U.S. hyperinflation, it would be extremely difficult to come up with a more destructive course of action than what already is taking place in Washington, D.C. The chances of a U.S. debt default remain nil, but risk of a U.S. sovereign credit rating downgrade—though small—is increasing, as discussed below. In terms of the efforts by Congress and the President to reduce the government's long-term fiscal shortfalls, the numbers being discussed would not come close to bringing the system into balance. The broad inflation and economic outlooks discussed in the *Hyperinflation Special Report (2011)* continue to unfold and are unchanged.

Contrary to the policies of most administrations since the days of Franklin D. Roosevelt, the U.S. dollar and the federal deficit do matter. Following eight decades of deliberate fiscal abuse and dollar neglect, devaluations and debasements, the day-of-reckoning began to unfold in the 2007/2008 economic and systemic-liquidity crises, and it continues to play out and evolve, today.

A default on U.S. debt and/or a credit-rating downgrade should lead to—among other severe financial-system problems—heavy selling of the U.S. dollar and dollar-denominated paper assets, such as U.S. Treasuries. Given the recent behavior of the President and Congress, it is hard to imagine anyone eagerly looking to invest his or her cash in U.S. dollars, as opposed to exiting or to avoiding the U.S. currency.

While it remains beyond belief that the President and Congress deliberately would cause a default on U.S. debt (default here would be deliberate), the ongoing battle over raising the debt ceiling has gone beyond the pale, already focusing global attention on the long-term fiscal insolvency of the United States and raising the potential of a downgrade to the "AAA" credit rating of the United States and its debt.

Agencies rating sovereign debt usually give a "AAA" credit rating to debt denominated in the sovereign currency, in the context of that sovereign currency, simply because the sovereign state usually has the ability to print the money needed to pay its obligations. In the case of the United States, its sovereign currency—the U.S. Dollar—also is the global reserve currency, and the "AAA" rating of U.S. Treasury debt is the rating industry's benchmark for the near-riskless "AAA" category. A downgrade would not happen without significant discussion and advance warning from the rating agency to the U.S. Treasury.

How could a rating agency downgrade its benchmark? While extreme fiscal irresponsibility by the U.S. government has caused negative comment by most of the rating agencies, it is the existence of the debt ceiling and the controversy over raising same that creates the risk of an actual default now, as well as in the future, as this process gets repeated. With Treasuries moving out of the "riskless" category, on that basis, the concept of a U.S. rating downgrade has moved to the fore.

The administration claims the U.S. will default if the debt ceiling is not raised by August 2nd. There are those who suggest there is more time beyond that, if only the government selectively pays its bills, giving priority to interest and debt payments. With other government obligations not paid as due, though, that circumstance likely would trigger the rating downgrades and intensify dollar dumping and abandonment.

As to near-term market conditions, the President's Working Group on Financial Markets has a mandate to maintain orderly financial markets. It would get advance warnings on breakdowns in negotiations, a rating downgrade, or a default, and could move to mitigate early negative market reactions. In the event of a downgrade or default—or perceptions of same moving into the realm of the probable—any artificially-positive (or less-negative) market reaction would be limited and short-lived. What is afoot here is more dangerous than the actions around the Lehman failure, where regulatory people thought that circumstance would not trigger a run on the U.S. banking system. A U.S. default or a downgrade would savage the market value of the U.S. dollar and be extraordinarily disruptive to the financial system.

 