LBBW Bereit für Neues

To the point!

Cross-Asset- and Strategy-Research

Fitch downgrades the U.S. – so what?

LBBW_Research

Moritz Kraemer -- Chief Economist

LBBWResearch@LBBW.de

August 18, 2023

The downgrade is not a harbinger of things to come for Germany

The U.S. downgrade: a storm in a teacup

In early August, the international credit rating agency Fitch – the smallest of the "Big 3" – gave the United States federal government the thumbs down. Instead of the top rating of 'AAA', the U.S. are now only awarded an 'AA+'. It's kind of like when a student brings home "only" an A instead of an A+. No big deal. Historically, there have been virtually no sovereign defaults for either rating category. (Let's keep a veil of silence over the lamentable performance of some 'AAA'-rated subprime bonds during the financial crisis).

Following the Fitch move, the reaction of the financial markets was correspondingly restrained. The excitement was all the less because the U.S. had already lost its immaculate rating record in 2011 when S&P Global, the world's largest rating agency, had lowered it by a notch. (In the interest of full disclosure: At the time, I was part of the S&P rating team that made this move. It wasn't a walk in the park back then!).

The Fitch decision has no relevance for Germany

As expected, it did not take long for some German politicians to speak out, saying that the U.S. downgrade was proof of the importance of the German so-called "debt brake", which severely limits the government's ability to borrow. Without the debt brake, so the fiscal doomsters go, Germany would also be threatened to be relegated in the ratings league table. Interest rates on the national debt would rise as a direct consequence. It might then no longer be possible to finance important investments.

At first glance, this sounds plausible. But fortunately, this thesis is entirely incorrect. Both previous U.S. downgrades were based on the dysfunctional political processes, most recently on display in May during the unseemly wrangling over the U.S. debt ceiling. Fortunately, an absurd legal budget framework, exacerbated by extreme political polarization, is not (yet) a problem in Germany. Thus, the U.S. case is fundamentally different.

Downgrade had no effect on the interest burden

Moreover, neither of the two U.S. downgrades to date had any noticeably impact on the refinancing costs of the U.S. federal government.

More generally speaking: There is no empirical evidence that a sovereign downgrade in the AAA/AA categories entails significant interest rate effects. This is not surprising, because the historically observed default rates are, as mentioned above, close to zero for both categories. Investors generally understand this. Some politicians do not.

Rating Agencies: Growth is Germany's Achilles' heel

Germany's credit rating: Growth more important than the debt brake

More specifically, it is not correct that the rating agencies consider the debt brake as a key anchor for Germany's top-notch rating. They simply don't. If there is a threat to Germany's AAA, it would most likely come from weak growth. This in turn would be a result of declining demographics, burgeoning bureaucracy, and insufficient investment in education, infrastructure, and digitization. All three major agencies make this crystal clear in their credit reports. Germany's public investment backlog is partly due to the rigid debt brake enshrined in the constitution.

It follows that dogmatic insistence on the debt brake at a time of massive investment needs may make a German downgrade <u>more</u> likely, not less. If Germany won't make progress with productivity-enhancing investments, the already weak growth potential (see To-the-Point! last week) could fade even further.

For the fans of the debt brake it seems that if the only tool available is a hammer, then every problem somehow looks like a nail.