Policy Backgrounder: Fitch Downgrades US Rating Amid Fiscal and Governance Concerns

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Insights for What's Ahead:

Fitch Ratings downgraded the credit rating of US debt obligations this week after warning of a potential downgrade during the debt ceiling negotiations that were resolved in June.

- Fitch cited a worsening US fiscal outlook over the next three years in addition to deteriorating standards of governance over the past two decades that impair the ability of the US to take action on fiscal and debt matters.
- Fitch forecasts the US publicly held debt to GDP ratio to rise to 118 percent by 2025, from 98.2 percent today and from 79.4 percent pre-pandemic. That compares to 39.3 percent for the median AAA-rated peer country. Over the first 9 months of the current fiscal year, the federal deficit hit $1.39 trillion—more than 170 percent higher than the same period in FY 2022.
- Fitch noted that the US, unlike most peers, does not have a medium-term fiscal framework and cited addressing tax revenues, Social Security, and healthcare spending—items that have largely remained off the table as Congress negotiated the debt ceiling and FY 2024 appropriations bills. Disagreement between the Senate and House continues to raise the likelihood of at least a partial government shutdown as the October 1 fiscal year deadline approaches.

Elements of the Downgrade

On Tuesday, Fitch Ratings downgraded US government debt from AAA to AA+, the second lowering of the country's credit rating in US history and the first since S&P Global Ratings' decision in 2011. US debt continues to hold Moody's highest AAA rating, while S&P has never reversed its 2011 change. Fitch justified the move citing projections of a worsening US fiscal outlook over the next three years from a combination of tax cuts, spending initiatives, economic shocks, and continued political gridlock. In response, Treasury Secretary Janet Yellen said in a statement that "[t]he change by Fitch Ratings announced today is arbitrary and based on outdated data. Fitch's quantitative ratings model declined markedly between 2018 and 2020—and yet Fitch is announcing its change now," which did not in her view reflect the progress made on a number of indicators over the recovery. Fitch still expects a mild US recession in the fourth quarter of 2023 and the first quarter of 2024, leading the timing of the move to puzzle analysts who see the US economy as recovering faster than other nations and having at least the possibility of avoiding a recession.

However, the US fiscal outlook has continued to deteriorate since 2011 when US publicly held debt stood at 65.5 percent of GDP. The Congressional Budget Office projects the ratio to rise to 98.2 percent his year, up from 79.4 percent prior to the pandemic. Fitch cited the country's rapidly growing "general government" debt burden, which it forecasts to reach 118 percent of GDP by 2025 from 112.9 percent this year. That level is three times higher than the median AAA-rated country's ratio of 39.3 percent. That figure, though, stands in contrast to the Congressional Budget Office's May 2023 forecast of a 102.2 percent debt-to-GDP ratio in 2025 using the narrower category of debt held by the public; Fitch is relying on the broader measure.

Partially driving this week's downgrade was the Treasury raising its borrowing forecast for the current quarter to $1 trillion, substantially lifting its May projection of $733 billion. According to Fitch, weaker than expected tax receipts and higher interest payments on government debt have led the US fiscal picture to underperform in comparison to earlier forecasts. Over the first 9 months of the current fiscal year, the federal deficit hit $1.39 trillion—more than 170 percent higher than the same period in FY 2022. Because of the impact of higher interest rates, the interest-to-revenue ratio is expected to reach 10 percent in the US by 2025, compared to medians of 2.8 percent and 1 percent for AA-rated and AAA-rated peers, respectively. Also contributing is the fact that the fiscal surpluses held by state and local government in 2021-2022 have largely reversed, expected to total a deficit of 0.6 percent of GDP in 2023 and growth to 1.2 percent in 2024-2025, according to Fitch.

Another key component of the downgrade is concern over US governance, including but not limited to governance on debt and fiscal matters, which was cited in Fitch's Rating Watch Negative amid the extended debt ceiling standoff that was resolved in the first week of June. The repeated clashes over the borrowing limit and inaction on substantial fiscal reforms have eroded confidence in the country's fiscal management. At the time, Fitch cited weak governance as a key US weakness versus AAA-rated peers, writing that"[t]he contested 2020 presidential election, brinkmanship over the debt limit to advance political agendas, and failure to reach consensus on the country's fiscal challenges are recent signs of the deterioration in governance." In that review, Fitch listed watch items that could trigger a downgrade, including the failure to pay debt securities or other obligations, a decline in coherence and credibility of US policymaking that undermines the government's finances, and signals of further weakening of governance and inability to reach political compromises. Governance remains a concern, with Richard Francis, Fitch's co-head of Americas sovereign ratings, telling the *New York Times* NYTimes this week that partisanship was inhibiting policy decision making; "[t]here is no willingness on any side to really tackle the underlying challenges."

However, Fitch also highlighted some positive aspects of the US' overall outlook, noting that "[s]everal structural strengths underpin the United States' ratings. These include its large, advanced, well-diversified and high-income economy, supported by a dynamic business environment." Fitch also cited "the resilience of the economy and the labor market" in discussing its expectation that the Federal Reserve will continue to raise interest rates.

Analysis

The downgrade sent jitters through markets, with equities falling in their worst day since February and the yield on 10-year Treasuries rising to its highest level since November. While few investors see Treasuries losing their status as the world's safe haven—and indeed Fitch noted that "[c]ritically, the U.S. dollar is the world's preeminent reserve currency, which gives the government extraordinary financing flexibility"—the downgrade highlights the concerns over the worsening US fiscal outlook and the US' inability to address the most significant budget items.

The Washington *Post* reported that the Administration had sought to dissuade Fitch from issuing the downgrade, in particular questioning why Fitch is applying a new methodology only in 2023 to reflect negative changes that occurred from 2018 to 2020, particularly with regard to Fitch's evaluation of governance.

The downgrade sparked new partisan bickering as the House and Senate appear far apart on topline spending numbers as they approach the October 1 new fiscal year. House Budget Committee Chairman Jodey Arrington (R-TX) said in a statement that "[t]his is a wakeup call to get our fiscal house in order before it's too late." He cited that both the last two Democrat presidents have had the US rating downgraded after fighting against Republican Congressional attempts to restrain deficits. Senate Majority Leader Chuck Schumer (D-NY) commented that the downgrade "shows that House Republicans' reckless brinksmanship and flirtation with default has negative consequences for the country." In Yellen's comments, she reiterated progress in reducing the deficit by $1 trillion under the Fiscal Responsibility Act and highlighted that President Biden's budget proposal would reduce the deficit by $2.6 trillion over the decade.

Yet policymakers have not seriously grappled with addressing underlying budget issues. Fitch cited increasing healthcare costs and Social Security spending as key factors needing to be addressed as the US population rapidly ages. These issues largely remained off the table during spring's debt ceiling negotiations and in current deliberations of FY 2024 appropriations.

Additionally, Fitch assumes that the 2017 tax cuts set to expire in 2025 will encounter political pressure to be made permanent, as both parties have broadly committed to not raise taxes. More broadly, Fitch cited "cyclically weaker federal revenues" as the lead factor driving rising general government deficits and revenue challenges as a factor in the downgrade and highlighted both "[i]mplementation of a fiscal adjustment to address rising mandatory spending or to fund such spending with additional revenues" as factors that could lead to an upgrade or positive rating action.

Conclusion

Critics of the timing of Fitch's downgrade point to recent strong economic data and growing expectations the US may avoid a recession, particularly when compared to the 2011 S&P downgrade during which a more prolonged debt ceiling crisis coincided with an economy still recovering from the financial crisis and Great Recession when unemployment stood at 9 percent. US Treasury securities remain "the world's preeminent safe and liquid asset" and "the American economy is fundamentally strong" according to Secretary Yellen.

However, following June's debt ceiling agreement that avoided the catastrophic damage of a default, the prospects for at least a partial government shutdown continue to rise around the October 1 FY 2024 deadline or in December in the event Congress enacts a continuing resolution. The House and Senate failed to pass any of the 12 appropriations bills for the new fiscal year before departing for August recess. The chambers still remain far apart after Speaker Kevin McCarthy backed off topline spending numbers agreed to in June, allowing House Republicans to draft bills with different spending totals than the Senate.

Despite the Fitch downgrade adding fuel to the contentious negotiations, no path currently being debated is likely to meaningfully address the concerns highlighted by the Fitch report. The two pathways listed for the US to recover its AAA rating—(1) fiscal adjustments to address rising mandatory spending or funding spending through higher revenues, and (2) a sustained reversal of the trend deterioration of governance—are not likely to be included in the appropriations discussions for next year. For that, a bipartisan agreement needs to grow to reform taxes or spending on major programs such as Medicare or Social Security, as well as a longer-term resolution on reforming the recurring debt limit.

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