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Credit-Land Report: Downgrade to U.S. debt could lead to higher Variable APRs on credit cards.
Comments on the General Impact of Standard and Poor's Cutting the Outlook for U.S. Debt to Negative

NEW YORK - The recent announcement that Standard and Poor's was cutting the outlook for the federal government to repay the debt it has accumulated raises the importance of the total sum of U.S debt and the government's ability to pay back the lenders as well as to impact the pace of economic activity.

Even as the debt has risen dramatically in the last decade, it has not affected interest rates on the bills, bonds and notes issued by the U.S. Treasury Department to finance the borrowing.

First let's give a brief overview and analysis of the problem. Just a decade ago, in 2000, the U.S. was running a surplus approaching $200 billion, which marked the fourth consecutive year in which the federal government took in more revenue than it spent. The positive position for the nation was due to a combination of a strong economy during the 1990s and the increase in taxes earlier in the decade. The government is on track to spend $1.5 trillion more than it takes in this year. Just four years ago, the deficit was $246 billion. Since that time expenses rose by $990 billion while revenue has actually slid by $138 billion. That is certainly not the way to deal with a budget deficit.

To a large extent, and particularly since the fears of a financial meltdown in 2008 and the steepest recession since the 1930s, the Federal Reserve has largely been accommodating with sharp gains in the money supply, pushing rates, particularly short-term rates low, in some cases to near zero, and keeping them there for an extended period.

Even earlier in the decade, rates may have been seen as artificially low, well beyond the end of the 2001 recession. These low rates, particularly short-term rates, allowed the federal government to raise its debt levels, and effectively it's spending level without truthfully incurring the full price. The Federal Reserve pushed the rates to near zero to help spur the economy, and when the economy slid further into the steep recession, it undertook additional stimulative actions including the large scale purchase of Treasury securities, mortgage securities and other debt products.

These actions in a way served to offset the crowding-out effect that would be expected to raise the borrowing costs for all with a sharp rise in borrowing by the federal government. But it has left the nation with a debt level that exceeds $14 trillion. The S&P seems to be implying that the projected growth for the economy, however strong it may be, will not be sufficient to cut the deficit to a reasonable level. Then add the likelihood that the current quantitative easing by the Federal Reserve will end during the current quarter, and there seems to be no easy way out.

So why the country can't bounce back and see strong enough growth to at least make some headway on the debt? Of course Medicare, Social Security and related topics have been discussed by many with differing viewpoints with nothing clear being resolved.

Consider the overall state of the nation's labor force as one factor. At the start of the recession, in excess of 146 million Americans were employed. That number as of March this year was close to 140 million, implying that 6 million fewer people had jobs than did three years earlier. The low point for employment was in December 2009 when employment dipped to 138 million and thus we have seen a gain of 2 million jobs in 15 months, a little more than a 133,000 per month. At this pace it will take many years just to reach the pre-recession peak, and that doesn't even consider the new people, estimated at 150,000, who are ready to enter the labor force each month.

Without income, these people do not pay taxes (though unemployment benefits are taxed), and the government must bear the burden of additional unemployment insurance and greater need for food stamps and other assistance.

As said above, the federal government has been able to borrow at very low costs because of the accommodative stance by the Federal Reserve. It has also benefited from sluggish aggregate demand for goods and service just prior to and since the recession. Foreign investors and governments have also aided the federal government since it is in their interest that such a major borrower has the ability to repay them.

So what happens when what was one thought of as the most secure, risk-free investment starts to bear some risk of repayment, however small?

Investors will demand to be compensated for the risk. This compensation generally implies a higher level of return to encourage people to invest in these securities. Consider the level of risk an investment carries on a scale of 0 to 100. If previously the Treasuries had no risk, namely a 0 on the scale, and were to move to a risk value of 1, namely extremely little risk, there would still be some risk and investors would need to be compensated.

The federal government issues would then be competing in the market with other risky investments. This would likely imply a general increase in rates, particularly those closely associated with low-risk instruments.

With that said the federal government issues would now be competing in the market with other risky investments. This would likely imply a general increase in rates particularly those closely associated with the low risk instruments. There is a range of riskiness attached to specific assets.
At one end of the spectrum are risk free assets, namely U.S. Treasury issues, where there is no risk; an investor is 100% sure that he/she will receive the principle plus the promised interest. The next level for risk is state and local government bonds where there is a very high probability of receiving the principal plus the promised interest, but not a 100% guarantee, since there have been some defaults, not that many but still some nonetheless. The next level of risk may be high quality corporate bonds, then moderate corporate bonds, lower quality, then high risk corporate bonds, namely, junk bonds. Further along that may be credit cards, which carry a much higher level of risk. As one move further along the scale for a higher degree of risk, the interest rates are less impacted by the rates for the risk-free investments, namely U.S. Treasuries.

This is because the investments have a risk element already included in their interest rate as determined by the specific type of product, and the risk levels similar to those for credit cards.

With credit cards, some credit card offers come only with variable annual interest rates (APR), which protects banks in a situation of a rising risk factor. In this case, if the APR is variable, namely it moves up or down depending on another interest rate, say a specific Treasury rate, then the APR will be impacted to the degree the other rate is impacted. The immediate impact for the variable APR is that it would go up because the underlying rate increase subjected to increased level of risk. Whenever a credit card APR is tied to a Treasury rate, for example, then it is important for both the borrower and the lender to closely watch that rate. If it increases, the borrower may wish to pay off the loan because their APR and thus the payments will go up soon. However, if the Treasury rate decreases the borrower will benefit by paying back the loan with lower payments.

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If you would like more information on this topic or to schedule an interview Arnold Taubman, Credit-Land.com senior economist, please contact **Michael Germanovsky** or email **michael.german@creditland.com**