Why the United States is no longer AAA

Alvise Lennkh
Associate Director, Public Finance
a.lennkh@scoperatings.com

Giacomo Barisone
Managing Director, Public Finance
g.barisone@scoperatings.com

Analyst Conference Call, 11 October 2017, Frankfurt

Why the United States is no longer AAA

Inherent credit strengths but important rating constraints

- **On 29 September 2017, Scope affirmed US sovereign rating at AA Stable Outlook**

Credit strengths

- Wealthy, diversified economy
- Institutional checks and balances
- Global reserve currency status
- Deep, liquid capital markets

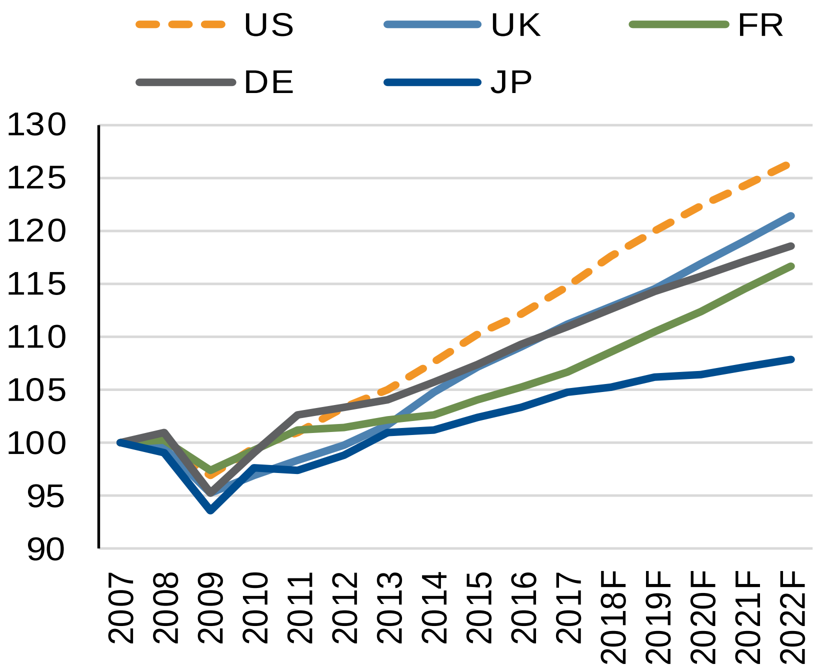
Credit weaknesses

- Weakening potential growth outlook
- Large government debt burden
- High contingent liabilities
- Policy inaction and uncertainty

Why the United States is no longer AAA

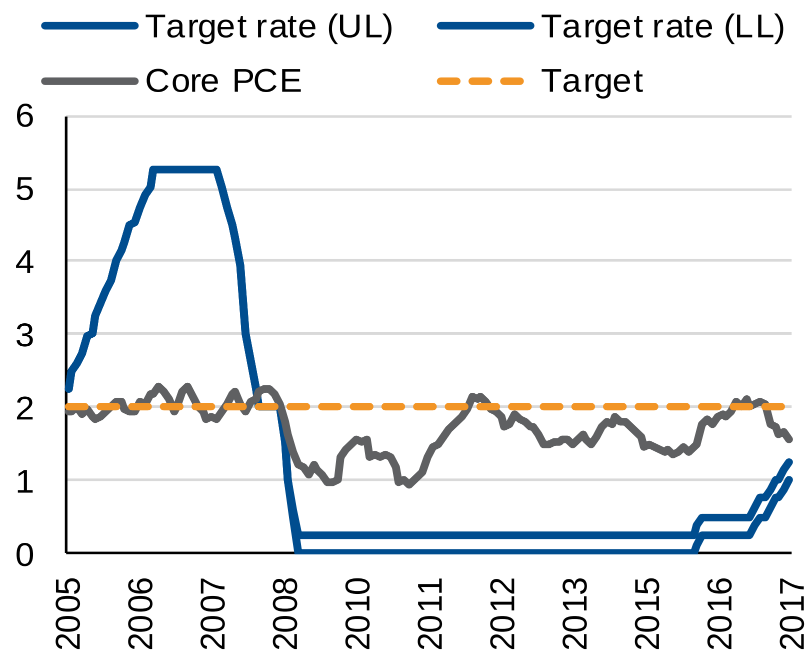
Quick recovery with full employment; comprehensive crisis response

Real GDP growth
2007=100



Source: Bureau of Economic Analysis

Federal funds, target and core inflation
%



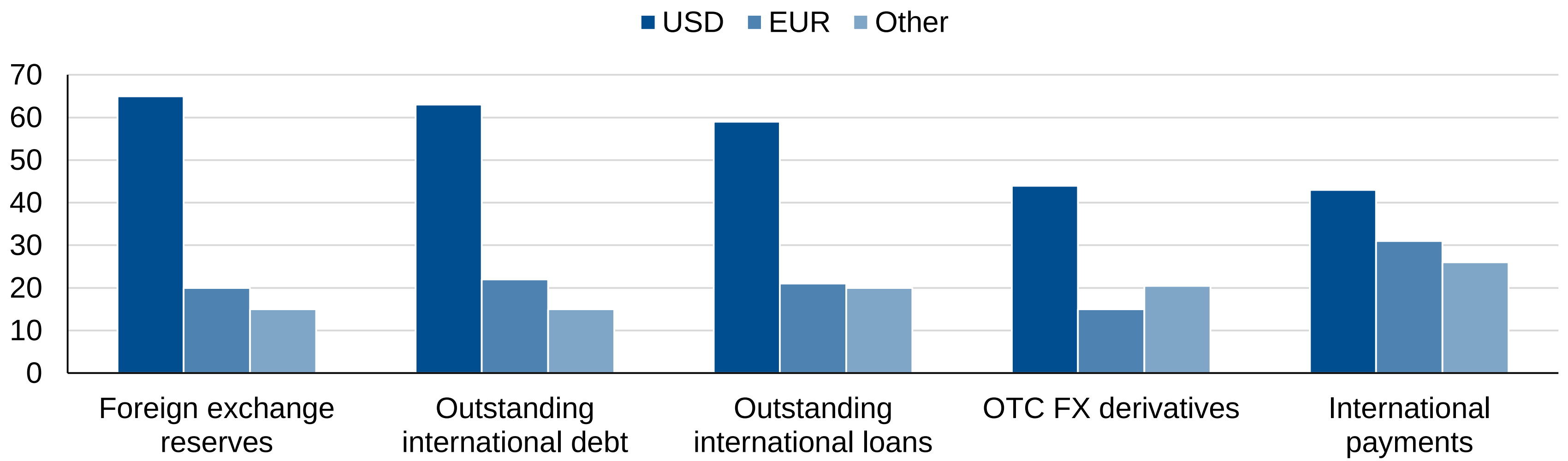
Source: IMF, Calculations Scope Ratings AG

Why the United States is no longer AAA

Unparalleled global reserve currency status

Currency composition

% of total



Source: BIS, ECB, IMF

➢ Qualitative Scorecard

- Excellent - Market access and funding sources
- Excellent - External debt sustainability
- Excellent - Resilience to short-term shocks

SCOPE

Why the United States is no longer AAA

Inherent credit strengths but important rating constraints

Credit strengths

- ✓ Wealthy, diversified economy
- ✓ Institutional checks and balances
- ✓ Global reserve currency status
- ✓ Deep, liquid capital markets

Credit weaknesses

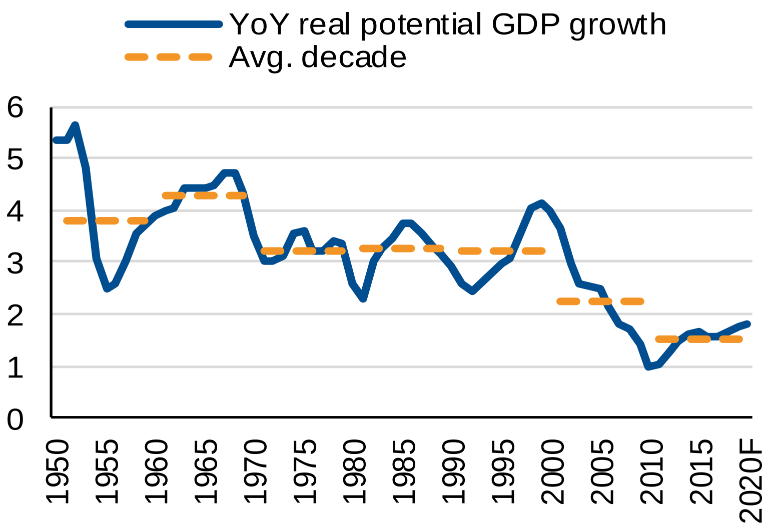
- ➢ Weakening potential growth outlook
- – Large government debt burden
- – High contingent liabilities
- – Policy inaction and uncertainty

Why the United States is no longer AAA

Weakening potential growth outlook due to lower productivity…

Real potential GDP growth

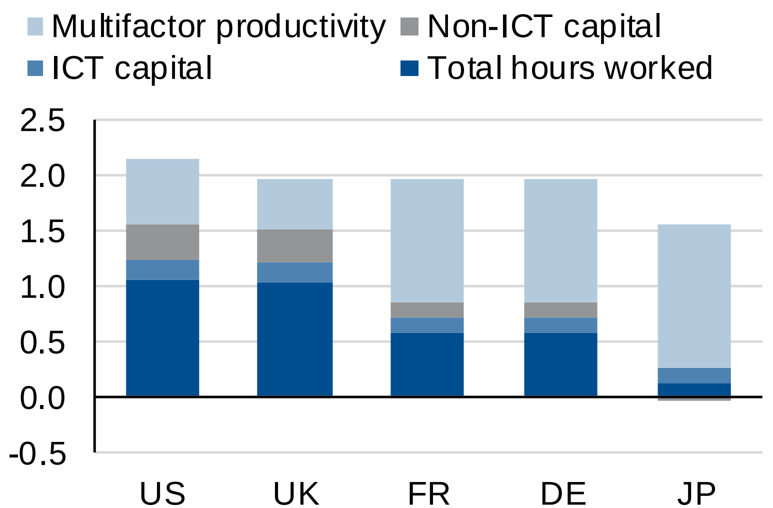
Y-o-Y % change



Source: CBO

Contribution real GDP growth

Avg. 2010-15, %



Source: OECD

Causes

- Dwindling impact of IT revolution?
- Slower ‘Schumpeterian’ forces?
- Slowdown in global trade?

Impact

- Lower growth contribution from multi-factor productivity

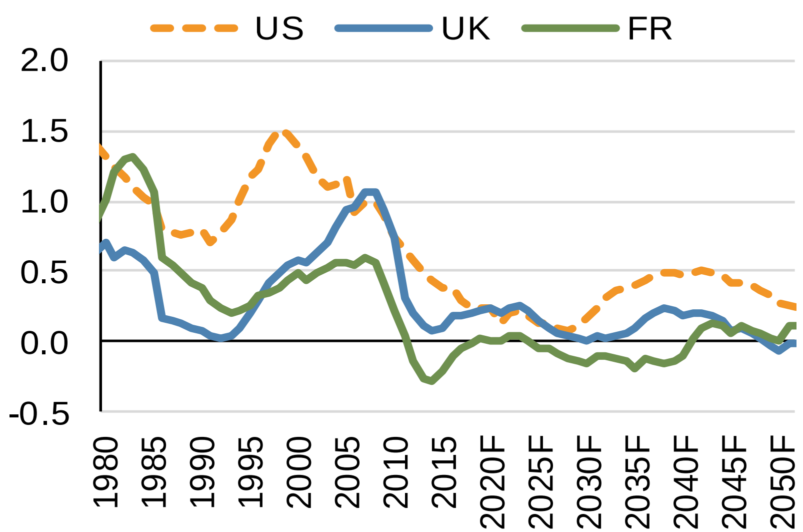
SCOPE

Why the United States is no longer AAA

…and a lower growth contribution from labour going forward

Working-age population

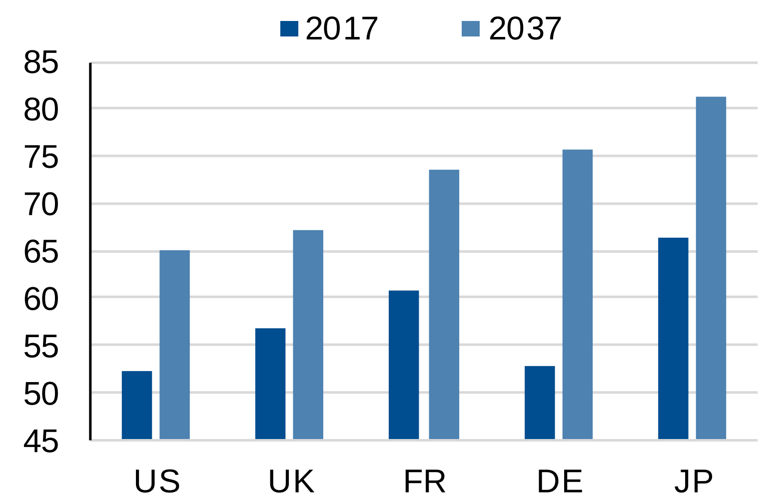
Y-o-Y % change



Source: UN

Dependency ratio

Per 100



Source: Census Bureau

➢ Causes

- Demographics
- Institutional factors
- Declining opportunities for low-skilled workers

➢ Impact

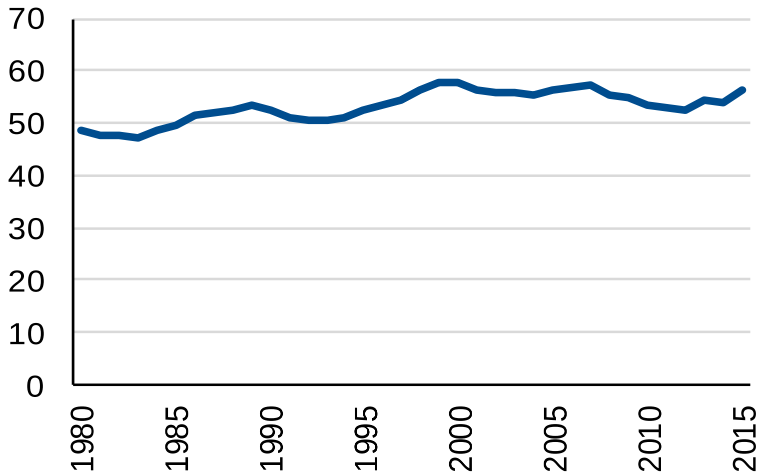
- Lower growth contribution from labour

Why the United States is no longer AAA

Income stagnation and inequality also dampen growth outlook

Income stagnation…

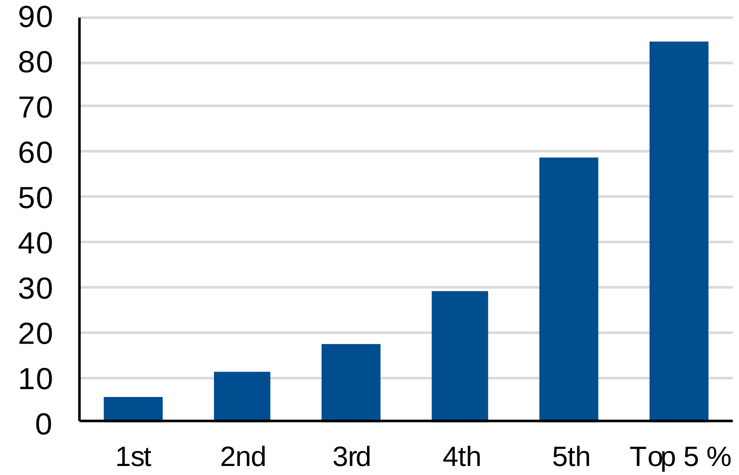
Real median household income, USD (1,000s)



Source: Census Bureau

…and rising income inequality

1980 to 2015, % change per quintile



Source: Census Bureau
NB: Real mean household income

➢ Causes

- Automation of tasks
- Exposure to trade
- Decline in union representation

➢ Impact

- Curbs consumption
- Weighs on labour supply
- Creates disparities in education system

SCOPE

Why the United States is no longer AAA

Inherent credit strengths but important rating constraints

Credit strengths

- ✓ Wealthy, diversified economy
- ✓ Institutional checks and balances
- ✓ Global reserve currency status
- ✓ Deep, liquid capital markets

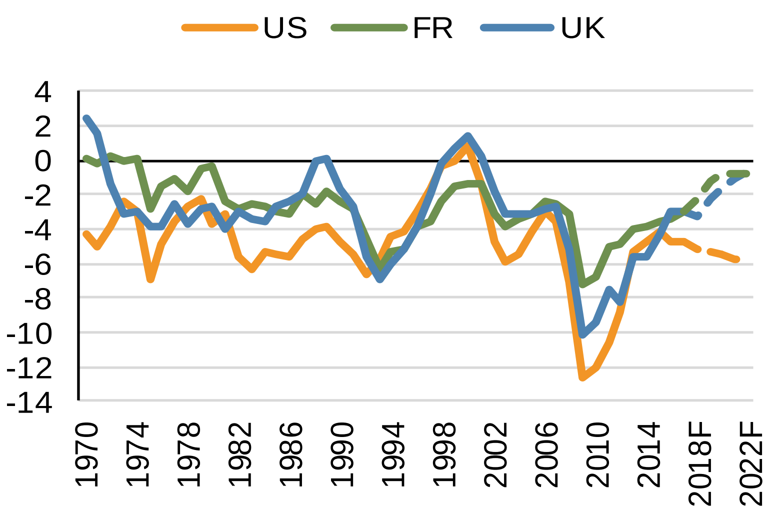
Credit weaknesses

- ✓ Weakening potential growth outlook
- ➢ Large government debt burden
- – High contingent liabilities
- – Policy inaction and uncertainty

Why the United States is no longer AAA

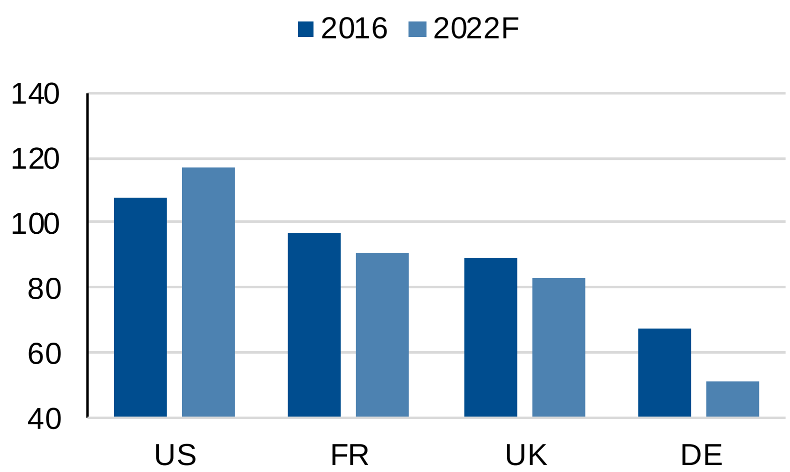
Continuous fiscal deficits and rising debt level

Fiscal balances
% of GDP



Source: IMF, EC, UK ONS

General government debt
% of GDP



Source: IMF

➢ Uncertainty related to fiscal legislation

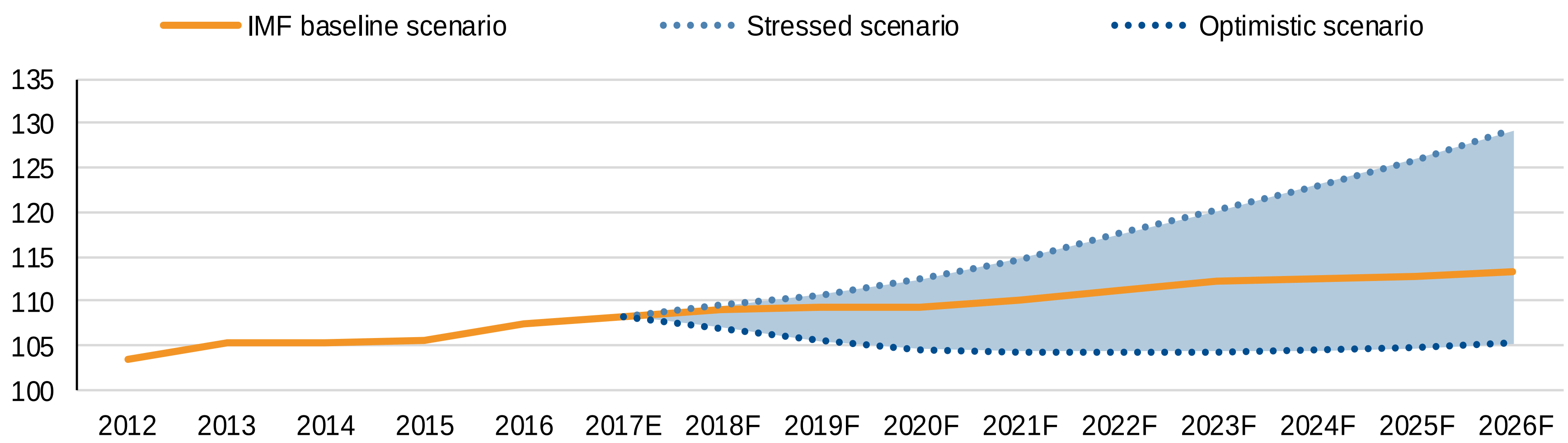
- Proposals include significant discretionary spending and tax cuts
- Scope's baseline: deficit enhancing budget by the end of the year

Why the United States is no longer AAA

Debt sustainability concerns

Debt sustainability analysis

% of GDP



Source: IMF, Scope Ratings AG

2017-2026 average	Real GDP growth (%)	Primary balance (% of GDP)	Real eff. interest rate (%)	Debt end period (% of GDP)
Historic values (2012-2016)	2.1	-2.8	0.4	107.4
IMF baseline	1.8	-1.4	1.1	113.4
Optimistic scenario	2.7	-1.4	1.1	104.7
Stressed scenario	1.4	-1.8	1.6	129.2

Why the United States is no longer AAA

Inherent credit strengths but important rating constraints

Credit strengths

- ✓ Wealthy, diversified economy
- ✓ Institutional checks and balances
- ✓ Global reserve currency status
- ✓ Deep, liquid capital markets

Credit weaknesses

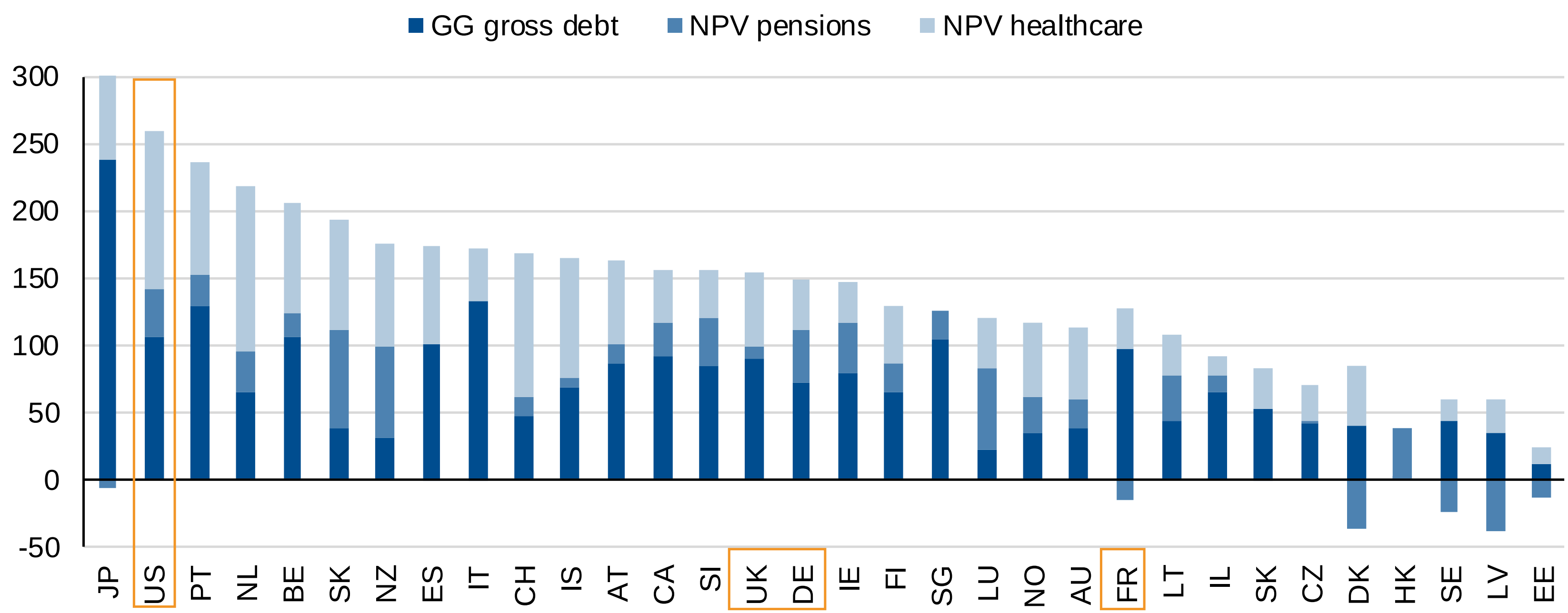
- ✓ Weakening potential growth outlook
- ✓ Large government debt burden
- ➢ High contingent liabilities
- – Policy inaction and uncertainty

Why the United States is no longer AAA

High contingent liabilities

General gov't obligations, including NPV of future pension and healthcare obligations

% of GDP



Source: IMF Fiscal Monitor 2017

➢ Similar studies

- Cato Institute (2014): 360% of GDP (incl. FDIC and GSEs, excl. states, higher PV for pensions/health)
- Federal Reserve (2016): 316% of GDP (incl. state debt, pensions and health-care, excl. FDIC and GSEs)

Why the United States is no longer AAA

Inherent credit strengths but important rating constraints

Credit strengths

- ✓ Wealthy, diversified economy
- ✓ Institutional checks and balances
- ✓ Global reserve currency status
- ✓ Deep, liquid capital markets

Credit weaknesses

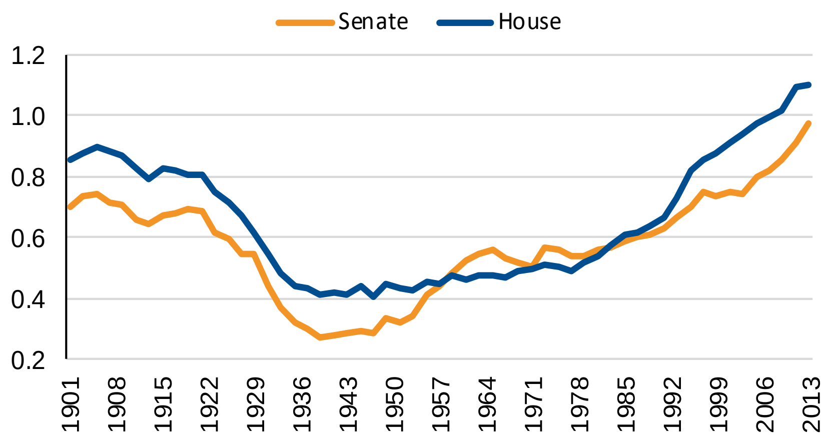
- ✓ Weakening potential growth outlook
- ✓ Large government debt burden
- ✓ High contingent liabilities
- ➢ Policy inaction and uncertainty

Why the United States is no longer AAA

Political polarisation at the expense of moderates

Distance between parties

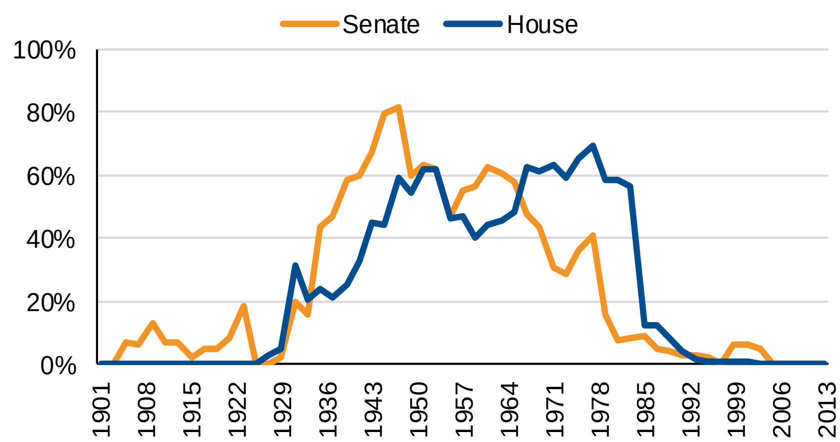
Variance in DW-NOMINATE scores*



Source: https://legacy.voteview.com/Political_Polarization_2014.htm
NB: Distance between parties refers to ideological distance between moderates of each party
*Higher value indicates greater ideological distance between parties.

Overlapping members

% of total Congress members



Source: https://legacy.voteview.com/Political_Polarization_2014.htm
NB: Overlapping members refers to members of both parties that have overcome traditional party discipline by voting with the other party.

- **Among the electorate**
  - Americans with a 'very unfavourable' view of the opposing party: 2016 (>50%); 1990s (20%)
- **In Congress**
  - At the expense of moderates who bridge the parties to broker crucial compromises

SCOPE

Why the United States is no longer AAA

Policy inaction, swings and uncertainty

➢ Policy inaction

- Missed deadlines (appropriations process)
- Widespread use of the filibuster threat
- Delays in appointments

➢ Policy uncertainty

- Repeal and replace Affordable Care Act
- Budget reform / tax legislation
- Appointments to Federal Reserve Board

➢ Inability to address

- High debt level
- Significant pension and health-care liabilities

➢ Policy swings

- Inward-looking trade negotiations
  - Withdrawal from Trans-Pacific Partnership
  - Renegotiating NAFTA
- Withdrawal from Paris Climate Change Agreement

SCOPE

Why the United States is no longer AAA

Inherent credit strengths but important rating constraints

Credit strengths

- ✓ Wealthy, diversified economy
- ✓ Institutional checks and balances
- ✓ Global reserve currency status
- ✓ Deep, liquid capital markets

Credit weaknesses

- ✓ Weakening potential growth outlook
- ✓ Large government debt burden
- ✓ High contingent liabilities
- ✓ Policy inaction and uncertainty

Positive rating-change drivers

- Improved potential growth outlook
- Debt trajectory on downward path
- Reduction in contingent liabilities

Negative rating-change drivers

- Reduced global role of the US dollar
- Deterioration in public finances
- Weakening fiscal framework

Contact

BERLIN

Lennéstraße 5
10785 Berlin
Germany

+49 30 27891-0
info@scoperatings.com
www.scoperatings.com

FRANKFURT – GERMANY
Eurotheum
Neue Mainzer Straße 66-68
60311 Frankfurt am Main

LONDON – UK
2 Angel Square
EC1V 1NY London

MADRID – SPAIN
Paseo de la Castellana 95
Edificio Torre Europa
28046 Madrid

MILAN – ITALY
Via Paleocapa 7
20121 Milan

OSLO – NORWAY
Haakon VII's gate 6
0161 Oslo

PARIS – FRANCE
33 rue La Fayette
75009 Paris

Disclaimer