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Currencies And Credit Downgrades

Summary: Market participants are keenly focused on the current U.S. debt ceiling negotiations and, given the ongoing uncertainty, the U.S. dollar is under some pressure. Even if an agreement to reach the debt ceiling is reached, a risk of a U.S. credit rating downgrade remains. In this article we look at currency market reaction for some prior instances of countries losing their top AAA (or Aaa) credit rating. We believe that a credit downgrade would be negative for the U.S. dollar were it to occur, but that the impact should be moderate rather than extreme. Past experience hints at a dollar decline of perhaps 3% to 5% in the months following a credit rating downgrade.

Slipping From The Top Notch

In recent decades, there have been relatively few instances of countries that have slipped from the top AAA or Aaa rating. Accordingly, were such a downgrade to occur for the United States, it would represent a landmark financial market event. Faced with that risk, we examine the prior downgrade episodes to see if any lessons can be learned about a possible U.S. downgrade. These prior instances point to continued but moderate weakness in the greenback in the event that the U.S. credit rating is cut.

The relevant examples we consider are developed market currencies that have experienced a downgrade from the top rating in recent decades. Specifically, we also consider the *first* downgrade by a major rating agency (either Moody's or S&P) on the basis that such an event should have the greatest market impact, and that any subsequent downgrades from other agencies would represent 'catch-up'. On these criteria, countries that have slipped from the top notch include:

- *Australia*, which was cut by one notch from Aaa to Aa1 on 10 September 1986.
- *Sweden*, which was cut by one notch from Aaa to Aa1 on 17 January 1991.
- *Italy*, which was cut by one notch from Aaa to Aa1 on 1 July 1991.
- *Canada*, which was cut one notch from AAA to AA+ on 14 October 1992.
- *Japan*, which was cut one notch from Aaa to Aa1 on 17 November 1998.
- *Spain*, which was cut one notch from AAA to AA+ on 19 January 2009.

In analyzing the examples, we exclude the downgrade episodes for Italy and Spain. When Italy was downgraded in 1991, the Italian lira was part of European Exchange Rate Mechanism, which constrained the currency market reaction. When Spain was downgraded in 2009, it did not have an independent currency but was instead a member country of the euro. While we examine Australia and Sweden below, we believe these episodes have somewhat limited relevance given that they are the most dated and economic circumstances are somewhat dissimilar. Instead, we believe that the Japanese and Canadian downgrade episodes, which we will assess later, provide the best guidance for possible FX reaction should a U.S. downgrade occur.

Australia

While the Australian dollar fell by 0.9% on the date of the initial downgrade, the currency had rebounded sharply three and six months later.

Australian dollar move after:	*One day*	*Three months*	*Six months*
	-0.9%	*+7.4%*	*+12.6%*

In part, the Australian dollar's quick rebound was due to the fact that the downgrade reflected an episode of only modest fiscal slippage and a moderate economic slowdown. The underlying budget deficit peaked between 2% to 3.5% of GDP during the 1984 to 1986 years, while general government net debt peaked at 10.3% of GDP in mid-1986. In 1986, GDP growth reached a low point of 1% y/y in Q3 (but did not turn negative), before rebounding quite quickly to nearly 6% y/y by Q3 1987. That quick rebound in growth likely played a part in the Australian dollar's recovery, though few analysts expect a similarly quick recovery in U.S. economic activity at the current juncture.

Sweden

The Swedish krona actually gained by 1.5% against the greenback on the date of that country's initial downgrade. However, the krona subsequently fell sharply in the following three and six months.

Swedish krona move after:	*One day*	*Three months*	*Six months*
	+1.5%	*-4.6%*	*-11.4%*

We would note however that Sweden suffered a severe banking crisis in the early 1990s, an event that led to rapid economic and fiscal deterioration. According to the Organization for Economic Cooperation and Development (OECD), Sweden's budget position moved from balance in calendar 1991 to a deficit of 8.9% of GDP in 1992 and an 11.2% of GDP deficit in 1993. Meanwhile, the economy shrank by a cumulative 4½% for the three years 1991 to 1993. We are doubtful a U.S. downturn would be as sustained and, as a result, the greenback's reaction could also be more modest.

Canada

In the case of the Canadian dollar, the currency fell by 0.6% on the date of the initial credit rating downgrade, and remained lower over the subsequent three and six months.

Canadian dollar move after:	*One day*	*Three months*	*Six months*
	-0.6%	*-2.8%*	*-1.6%*

We see parallels between the Canadian experience and a possible U.S. downgrade. According to the OECD, Canada's budget deficit widened from an already high 5.8% of GDP in 1990 to 8.3% of GDP in 1991 and 9.1% of GDP in 1992. General government net debt rose steadily during the 1990s, reaching around 70% of GDP by the middle of the decade. With respect to economic growth, the Canadian economy did suffer a recession in the early 1990s. However, GDP growth was actually steady at just below 1% y/y through most of 1992, ahead of the initial downgrade. In 1993, the year following the initial rating downgrade, GDP growth quickened to around 3% y/y. The steady fiscal slippage along with the sub-par economic performance is perhaps appropriate to the current U.S. situation.

Japan

Japan's credit rating was initially downgraded by Moody's to Aa1 in late 1998, with the yen falling by 0.7% on that date. Although the yen was actually stronger three months later, it had returned to a weakening path six months after the credit rating announcement.

Japanese yen move after:	*One day*	*Three months*	*Six months*
	-0.7%	*+1.1%*	*-2.7%*

Arguably, this downgrade occurred against the backdrop of a relatively sharp fiscal and economic deterioration. Based on OECD figures, Japan's general government budget deficit worsened from 4% of GDP in 1997 to some 11.2% of GDP in 1998. Japan's net government debt jumped from 35% of GDP in 1997 to 46% of GDP in 1998, and has continued to climb since.

In terms of economic performance, the worst of the Japanese recession actually occurred before the downgrade. The decline in GDP troughed at 2.5% y/y in Q2 of 1998. By Q4 of that year the decline was 2% y/y, while for most of 1999 the decline in GDP was between 1%-2% y/y. While the economic downturn was relatively marked surrounding this episode, the limited foreign holdings of Japanese government bonds may have restrained the currency market impact. As a result, we view Japan's experience as providing somewhat useful guidance for the current U.S. situation

Lessons For The U.S. Dollar

The risk of a U.S. downgrade stems from a large budget deficit and elevated net government debt position. For 2010, the OECD estimates the U.S. general government deficit at 10.6% of GDP, while net government debt was estimated at 67% of GDP. That arguably represents a worse fiscal starting point than some of these prior episodes. However, U.S. economic activity has remained reasonably steady to date and it's possible that the downturn may be less severe than in some of the instances above. Overall, we find the Canadian and Japanese experiences useful precedents, with currency declines of around 3% seen in the months following the initial downgrade. If the U.S. does lose its AAA (or Aaa) credit rating, a further fall in the dollar of perhaps 3% to 5% is possible, given the somewhat troublesome fiscal starting point for the United States. Probable market volatility and at least modest economic slowdown may also have implications for the timing of any Fed tightening, and could delay a sustained U.S. dollar recovery against the major currencies.