Credit Rating Downgrade of the US – Possible Implications for the Caribbean Region

On August 1st, 2023, Fitch Ratings downgraded the United States' AAA credit rating to AA+. What are the expected impacts of this rating action on our Caribbean credit ratings? Before we discuss the anticipated ripples from Fitch's decision, let us first examine how a US sovereign debt credit downgrade could filter through their market to potentially affect ours. The first, and most immediate impact of a credit rating downgrade is usually a rise in the entity's borrowing costs to compensate investors for the heightened risk. An increase in rates offered on US government securities would be expected to pull up rates offered in the US financial system more generally; and, as Caribbean Authorities would not want capital flowing out of our domestic systems to chase higher yields in the US, regional interest rates may rise as well. Some portfolio rebalancing could also occur if the US sovereign downgrade is large enough. Financial system regulators and sector players have limits to what they allow for credit risk exposures. Additionally, the US government may switch some of its borrowings to less expensive shorter-term debt. If Caribbean sovereigns face higher borrowing costs as a result of interest rate increases, they may do the same. The implication in both the US and regional cases is lower debt sustainability as rollover risks increase.

Fiscal and Monetary Impacts

Given the preceding pressures, there are likely to be fiscal and monetary responses, and these can bring about broader macroeconomic impacts. The higher interest expense faced by the US and regional governments can result in fiscal rationalization in the form of lower capital expenditure or increased taxation. Both these actions will have a tendency to lower gross domestic product (GDP or output). Lower GDP often correlates with lower employment; and generally, the lower output and employment should lead to lower prices (or at least, dampened inflation). In summary, the lower credit rating could facilitate recessionary conditions in the US and subsequently, in our regional economies. And this is not even factoring shrinkage in US demand for regional output like tourism and energy-related products.

How monetary policy responds would very much be dependent on the initial conditions. In present circumstances, the US downgrade occurred in a high interest rate and inflationary environment, and this gives the Fed room for easing contractionary policies so as to not compound the downgrade fallout. Similarly, regional central banks would take the opportunity to take the foot off the economies' brakes. However, regional currencies tied to the US dollar would likely experience some depreciation against other currencies, which while theoretically helping exports, this would more likely hurt imports in the short term, and again, create inflationary pressures and reduce foreign exchange availability.

Downgrade not a surprise

It is clear to see that overall, a US sovereign credit rating downgrade would not be good for our Caribbean economies and borrowers. But is this the scenario we face given the August 1st Fitch downgrade? Let us summarize the hypothetical impact areas discussed and examine each in turn. These are: interest rates, Treasuries' liquidity, fiscal/debt sustainability, output, inflation, and foreign currency value/availability. Interest rates in the US were at highs not seen in 16 years prior to the downgrade. Rates had already factored in monetary policy and US economic conditions, including the underlying creditworthiness of the US government; in short, the downgrade was not a surprise and should not lead to any significant increase to interest rates. Portfolio managers were put on warning that US Treasuries could completely lose their AAA rating when S&P downgraded in 2011. Allowances in regulations and policies were already created to facilitate holdings of either AAA securities or US Treasuries. Nonetheless, the US government is still rated Aaa by Moody's. Overall, there is not much concern about diminishment of US Treasuries' demand or liquidity. As much as interest rates and liquidity are not affected by the downgrade, fiscal and debt sustainability issues are not directly caused; though, that does not mean that there are not legitimate concerns about both. US GDP is increasing, and recession fears are abating. Furthermore, the raising of the debt ceiling means that stimulus could be used to strengthen the economy's gains. The downgrade is not anticipated to impact growth. The predicted soft landing for the Fed's monetary policy would be unaffected by the downgrade as inflation already appears to be declining following previous rate hikes. Additionally, increases to businesses' inventories as a result of ongoing growth would ease cyclical inflationary pressures. And finally, foreign currency values are determined by the forces of demand and supply, therefore, increasing US output and exports would strengthen the US dollar. But what does this all translate to for our regional economies?

As much as the US interest rate and fiscal impacts are avoided, alongside recessionary effects, regional economies can expect similar causal inertia. Inflation is largely imported, so, a subsiding US price environment would mean the same here. However, with regard to foreign exchange availability and currencies' valuation pressures, it will, as usual, come down to our export competitiveness and our ability to attract FDIs. We should not be distracted but remain laser-focused on creating attractive private sectors and pursuing export diversification, regardless of any US downgrade.

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