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U.S. rating downgraded for first time

TREASURY OBJECTIONS REBUFFED

S&P cites 'political brinkmanship,' debt concerns

BY ZACHARY A. GOLDFARB

Standard & Poor's announced Friday night that it has downgraded the U.S. credit rating for the first time, dealing a symbolic blow to the world's economic superpower in what was a sharply worded critique of the American political system.

Lowering the nation's rating to one notch below AAA, the credit rating company said "political brinkmanship" in the debate over the debt had made the U.S. government's ability to manage its finances "less stable, less effective and less predictable." It said the bipartisan agreement reached this week to find at least $2.1 trillion in budget savings "fell short" of what was necessary to tame the nation's debt over time and predicted that leaders would not be likely to achieve more savings in the future.

"It's always possible the rating will come back, but we don't think it's coming back anytime soon," said David Beers, head of S&P's government debt rating unit.

The decision came after a day of furious back-and-forth debate between the Obama administration and S&P. Treasury Department officials fought back hard, arguing that the firm's political analysis was flawed and that it had made a numerical error in a draft of its downgrade report that overstated the deficit over 10 years by $2 trillion. Officials had reviewed the draft earlier in the day.

"A judgment flawed by a $2 trillion error speaks for itself," a Treasury spokesman said Friday night.

The downgrade to AA+ will push the global financial markets into uncharted territory after a volatile week fueled by concerns over a worsening debt crisis in Europe and a faltering economy in the United States.

DOWNGRADE CONTINUED ON A9

CHRIS RATCLIFFE/BLOOMBERG

Traders work on the floor of the London Metal Exchange on Friday as Europe's debt crisis continues to pressure world economies. Wall Street had a seesaw day, as investors reacted to the jobs picture.

DOWNGRADE FROM A1

The AAA rating has made the U.S. Treasury bond one of the world's safest investments — and has helped the nation borrow at extraordinarily cheap rates to finance its government operations, including two wars and an expensive social safety net for retirees.

Treasury bonds have also been a stalwart of stability amid the economic upheaval of the past few years. The nation has had a AAA rating for 70 years.

Analysts say that, over time, the downgrade could push up borrowing costs for the U.S. government, costing taxpayers tens of billions of dollars a year. It could also drive up interest rates for consumers and companies seeking mortgages, credit cards and business loans.

A downgrade could also have a cascading series of effects on states and localities, including nearly all of those in the Washington metro area. These governments could lose their AAA credit ratings as well, potentially raising the cost of borrowing for schools, roads and parks.

But the exact effects of the downgrade won't be known until at least Sunday night, when Asian markets open, and perhaps not fully grasped for months. Analysts say the initial effect on the markets could be modest because they have been anticipating an S&P downgrade for weeks.

Federal officials are also examining the impact of a downgrade in large but esoteric financial markets where U.S. government bonds serve an extremely important function. They were generally confident that markets would hold up but were closely monitoring the situation. Regulators said that the downgrade would not affect how banking rules treat Treasury bonds — as risk-free assets.

The ratings action immediately fueled partisan wrangling Friday night. Allies to President Obama said it underscored his call for a "grand bargain" that would trim $4 trillion from the federal budget involving a mix of tax revenue and spending cuts.

Republicans criticized Obama's handling of the economy.

"Standard & Poor's rating downgrade is a deeply troubling indicator of our country's decline under President Obama," Republican presidential candidate Mitt Romney said.

S&P has angered government officials with aggressive warnings during the past few months of a potential downgrade. S&P corrected its draft report Friday after Treasury raised concerns about the math.

Over the past few months, the multiple warnings from S&P have not worried government bond markets. What's more, the two other major credit rating companies, Moody's Investors Service and Fitch Ratings, have said they would preserve the nation's AAA rating for now.

S&P's downgrade was as much a political critique as a financial conclusion. It is based on a view that U.S. political leaders would be unable to come up with at least $4 trillion in savings, which is needed to bring the nation's debt to a manageable level over the next decade.

The debt deal swung earlier this week proposed spending cuts in two phases. Democrats and Republicans agreed to the first round, worth nearly $1 trillion. But a congressional committee must decide on the remaining $1.2 trillion to $1.5 trillion — and S&P questioned whether that would ever happen.

S&P added that it expects that the upper income Bush-era tax cuts will continue, despite vows from Obama to end the breaks next year.

"The majority of Republicans in Congress continue to resist any measure that would raise revenues," the firm said.

S&P's downgrade served as an indictment of the gridlock that sent the nation to the edge of defaulting on its debt obligations. It is also striking in part because it reflects the tremendous power of a small group of financial analysts employed by a New York company — part of McGraw-Hill. Credit-rating companies' reputations were sullied during the financial crisis.

In Europe, political leaders have taken aim at credit rating companies when they cut the ratings of governments struggling with heavy debt burdens.

S&P said the nation could suffer additional downgrades later on if the nation's debt burden grows worse. "A new political consensus might [or might not] emerge after the 2012 election, but we believe that by then the government debt burden will likely be higher," the firm said.

The company said the United States's financial position was diverging from that of other AAA countries, including Canada, France, Germany and Britain.

Countries with a AA+ rating include New Zealand and Belgium. Among those countries with a AA rating, one notch lower, are Bermuda, Spain and Qatar.

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SUNDAY, AUGUST 7, 2011

Political parties trade blame for U.S. rating downgrade

Partisan battles, in addition to major debt burden, led to S&P's decision

BY ZACHARY A. GOLDFARB

Standard & Poor's historic downgrade of the U.S. credit rating caused Washington to erupt on Saturday in the exact partisan clashes that S&P had said led to its decision in the first place.

Both major political parties accused each other of causing the downgrade and used the credit rating agency's report to make their cases. Democrats criticized Republicans for refusing to consider increasing tax revenue to help tame the nation's debt. Republicans blamed Democrats for not taking serious action to reform entitlements and faulted President Obama for allowing the downgrade to happen on his watch.

It was hardly a banner day for the nation's capital, where Congress and the president, already suffering low poll numbers for their inability to work together, endured reprimands and lectures from nations worldwide.

China, a major holder of U.S. debt, berated the United States in an editorial in a state-run newspaper for "its addiction to debts." In Germany, a news magazine called the downgrade "a public humiliation."

S&P said Friday night that it had downgraded the U.S. credit rating one notch — from AAA to AA+ — because "political brinkmanship" had made the government's ability to manage its finances "less stable, less effective and less predictable."

The agency's decision was a reflection of the nation's massive debt burden and its inability to function politically. Although the fallout largely triggered political recriminations, analysts worried that the consequences of the downgrade, while not fully known, could lead to higher borrowing costs for the government and consumers over time.

S&P officials said it is unlikely that the country will regain its top-notch credit rating anytime soon. And if one of the two other ratings agencies — Moody's Investor Service and Fitch Ratings — followed suit, analysts say, financial markets could erupt in widespread turmoil as investors lose faith in the nation's ability to meet its financial obligations.

For now, those two agencies say they plan to preserve the AAA rating, although they warned that they could change their view if there is a significant deterioration in the economy or if leaders are unable to find more budget savings.

Still, given S&P's move, government officials and investors worldwide were bracing for signs of distress that may occur when financial markets open Monday.

The S&P downgrade was announced after a frantic day of contacts between the Treasury Department and the company. S&P had warned for months that it might downgrade the United States if leaders did not come up with a plan to cut the deficit by $4 trillion over 10 years.

S&P noted that the budget deal reached last week — which calls for $2.1 trillion in savings and was considered a crisis-averting breakthrough in Washington — "fell short."

On Friday, before Obama left for a weekend at Camp David, Treasury Secretary Timothy F. Geithner and National Economic Council Director Gene B. Sperling briefed Obama on the potential downgrade.

On Saturday, the administration quickly moved to cast doubt on S&P's conclusions, saying it had neglected to recognize that leaders in Washington had made progress despite the political wrangling. Officials also said that S&P's methodology was "flawed" and that the company had to correct large math errors in an early draft of its report.

But officials also said the downgrade supported Obama's call for a "grand bargain" to cut the nation's debt through a combination of tax increases and an overhaul of entitlement programs such as Social Security and Medicare.

"The bipartisan compromise on deficit reduction was an important step in the right direction. Yet the path to getting there took too long and was at times too divisive," White House press secretary Jay Carney said. "We must do better to make clear our nation's will, capacity and commitment to work together to tackle our major fiscal and economic challenges."

Another administration official said: "The S&P decision was shockingly flawed" but added that "the truth is that it takes two parties to solve a problem, especially one as serious as bringing down our deficit."

Others in Washington used the downgrade as a political weapon, which bodes ill for a congressional "supercommittee" that is supposed to agree on at least $1.2 trillion in budget savings by Thanksgiving to supplement the nearly $1 trillion in cuts lawmakers already agreed to. In its report, S&P expressed doubt that the panel would succeed

Said House Speaker John A. Boehner (R-Ohio): "Democrats who run Washington remain unwilling to make the tough choices required to put America on solid ground." He quoted the S&P report as saying that reforming entitlement programs is necessary, but he did not mention its discussion of the potential need for new tax revenue.

The downgrade and fall in the stock market "provide further evidence that President Obama's agenda has been a disaster for our economy," added Sen. Ronald H. Johnson (R-Wis.).

Democrats were just as critical of Republicans.

Timothy M. Kaine of Virginia, a former chairman of the Democratic National Committee who is running for the Senate, said that "the continuing resistance of congressional Republicans to entertain the need for new revenue as part of a reasonable solution is a critical part of the downgrade decision." He did not mention S&P's statement about entitlements.

Added Sen. Christopher A. Coons (D-Del.): "By refusing to negotiate in good faith, Republicans turned the debt-ceiling debate into a hostage crisis and last night we saw its first casualty."

Republican presidential candidates went for the jugular, issuing statements that tried to pin S&P's action on Obama. Former Minnesota governor Tim Pawlenty called the president "inept," while Rep. Michele Bachmann (Minn.) said he is "destroying the foundations of the U.S. economy one beam at a time."

Obama aides said they hope the political fallout will be minimal for the president as he seeks reelection, so long as the downgrade has a limited effect on the economy. The aides noted that voters will decide next fall based on their personal financial situations, rather than a broad event that deals with a national rating.

"The Republican candidates would have put our economy at great risk by allowing the nation to default on its obligations," said Ben LaBolt, a spokesman for the Obama campaign.

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Staff writers Rosalind Helderman, Felicia Sonmez and Ylan Q. Mui contributed to this report.

Debate preceded the downgrade

A furious set of exchanges between Treasury and S&P

BY ZACHARY A. GOLDFARB

The Obama administration had just finished a fight with House and Senate Republicans when it entered a battle with a small group of credit-rating analysts based in New York, London and Toronto.

Standard & Poor's had warned for months that it might downgrade the U.S. credit rating if leaders couldn't find a way to reduce the growing national debt by $4 trillion over 10 years.

When the deal reached Tuesday fell short of those expectations, the Treasury Department and S&P engaged in a furious set of exchanges that ultimately led to a downgrade Friday night. Since then, the Obama administration and S&P have been engaged in a war of words over the circumstances of the downgrade.

Gene B. Sperling, director of the National Economic Council, said Saturday that S&P's conduct was "breathtaking," adding that "it smacked of an institution starting with a conclusion and shaping any arguments to fit it."

David Beers, the head of S&P's sovereign rating unit, had a different view. "This agreement will not produce a stabilization of the government's debt burden on its own, and we don't have a lot of confidence that another agreement is going to follow this one," he said.

Friday's hectic events began at 1:15 p.m. when an S&P analyst called Treasury to say a downgrade would come after the stock market closed, said people familiar with the matter, who spoke on the condition of anonymity to discuss it freely. The analyst sent a draft copy of the downgrade report.

The initial report said the debt in 2021 would reach a worrisome $22.1 trillion, equal to 93 percent of the size of the economy.

Treasury officials reviewed the report and after about 30 minutes found what John Bellows, the acting assistant secretary for economic policy, on Saturday called a "a basic math error of significant consequence."

Treasury argued that S&P calculated spending over the next 10 years in a way that overstated the debt by $2 trillion. Treasury said S&P used the wrong budget metrics to project spending levels.

About 3:15 p.m., Treasury officials called S&P to tell analysts that they had overstated the debt. They heard "stunned silence," according to some sources familiar with the call. Other sources disputed the characterization.

Two hours later, S&P called Treasury to acknowledge that Treasury's analysis was correct but told officials that the downgrade would still occur. According to the new calculations, the debt is projected to reach $20.1 trillion, or 85 percent of the size of the economy.

Treasury asked S&P to take more time and wait until Monday to make a final decision.

The officials also argued that S&P analysts did not recognize that Washington was taking steps to tame the national debt despite the political theater of recent months.

But S&P analysts took the opposite view — that all the partisan wrangling made it far less likely that leaders would be able to do what's necessary to achieve budget savings and that the altered calculation did not change that picture.

Beers reconvened a committee of analysts who vote on ratings decisions to decide whether to proceed with the downgrade. They voted to do so.

At 7:15, S&P called to say it would downgrade and soon provided a copy of the report to Treasury.

The revised downgrade report more greatly emphasized political analysis compared with the original report, according to a version of the first report reviewed by The Washington Post.

It announced the unprecedented decision at 8:30 p.m.

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The Washington Post

MONDAY, AUGUST 8, 2011

U.S., European officials work to calm anxiety

EMERGENCY FINANCIAL ACTIONS PLEDGED

Downgrade, debt crisis could feed on each other

BY ZACHARY A. GOLDFARB AND ANTHONY FAIOLA

Top economic officials from around the world scrambled Sunday to contain the fallout from an unprecedented downgrade of the U.S. credit rating and a serious worsening of Europe's economy.

Treasury Secretary Timothy F. Geithner and Federal Reserve Chairman Ben S. Bernanke joined counterparts from six of the world's largest economies in an emergency conference call Sunday evening to discuss how world markets would respond to the Standard & Poor's downgrade and the escalating European debt crisis. Afterward the officials released a statement pledging to support financial stability.

At the same time, the European Central Bank, after a hastily arranged meeting, signaled that it would invest in European bond markets in a bid to prop up hard-hit Italy and Spain, Europe's fourth- and fifth-largest economies, which are in the midst of a worsening financial crisis.

U.S. and European officials are trying to calm anxiety about the global economy as the U.S. downgrade and European debt problems threaten to feed on each other, weighing on markets and a limp economy on both sides of the Atlantic.

The emergency actions evoked memories of the response to the financial crisis in 2008 and portended intense volatility in global financial markets this week. The

ECONOMY CONTINUED ON A4

MARKET TURMOIL

ECONOMY FROM A1

dollar fell over the weekend while gold soared. Stock markets in the Middle East plunged, and U.S. stock futures appeared negative. Asian markets dropped at the opening.

After the emergency conference call involving Geithner and Bernanke, the top seven economies expressed support for actions taken by both the United States and Europe and committed "to taking coordinated action where needed, to ensuring liquidity, and to supporting financial market functioning, financial stability and economic growth." They said they would particularly take action to curb volatility in currency trading.

Amid this uncertainty, the Obama administration announced Sunday that Geithner, the president's longest-serving economic adviser, would remain in his post through fall 2012. Geithner had told President Obama that he was ready to step down after leaders reached an agreement to raise the debt ceiling last week, but the president asked him to stay.

Geithner told Obama on Friday morning that he would agree to remain in the administration — only to inform the president later in the afternoon that the country would face a downgrade.

S&P cited the U.S. debt burden and political paralysis in its decision to remove the nation's sterling AAA rating. The Obama administration blasted the decision, saying it was based on faulty logic and math, while acknowledging that Washington must do more to tame its debt.

"I think S&P showed really terrible judgment," Geithner said Sunday on NBC's "Nightly News." "Our country is much stronger than Washington."

The political parties continued to point fingers at each other Sunday for the downgrade. On NBC's "Meet the Press," Sen. John F. Kerry (D-Mass.) called S&P's action the "tea party downgrade," referring to conservative Republicans who refused to vote for an increase in the federal debt limit.

RICK RYCROFT/ASSOCIATED PRESS

Rudalf Oultz watches display boards at the Australia Stock Exchange in Sydney. Australian markets opened lower Monday.

On CBS's "Face the Nation," Sen. Lindsey O. Graham (R-S.C.) blamed Obama, saying that "if he was in the Southeastern Conference, he'd be fired as a coach."

Most analysts say the markets have been prepared for a downgrade by S&P, which had been issuing threats about a downgrade for months. And although the direct impact might be limited, the downgrade adds to broader concern about the state of the U.S. and European economies.

On Monday, S&P will issue more detailed guidance about the impact of the downgrade on the many entities whose own ratings rely on the U.S. government's AAA rating. These include money market funds, government-owned corporations such as Fannie Mae and Freddie Mac, banks, insurance firms, and states and localities, including those in the Washington area.

The ratings on numerous municipalities are likely to be downgraded after the S&P action, according to a report issued Saturday by J.P. Morgan Chase.

Meanwhile, on Tuesday, the Fed is set to meet amid increasing evidence that the U.S. economic recovery is faltering.

The central bank is expected to downgrade its assessment of the U.S. economy and is considering taking new, modest steps to bolster economic growth, such as pledging to continue its ongoing efforts to support the economy for a longer period. Fed officials are unlikely to take a significant step toward stimulating the economy at this meeting.

By intervening in bond markets, the European Central Bank could at least temporarily take some of the pressure off Italy and Spain. Investors have been dumping Spanish and Italian bonds, driving their borrowing costs to record levels in recent days.

The events have sparked fears that the world's seventh- and 12th-largest economies could be engulfed by the same kind of crisis that forced far smaller Greece, Ireland and Portugal to request emergency bailouts.

The ECB, as is customary, did not explicitly say it would buy Italian and Spanish bonds. But it strongly suggested that it would. The bank's governing council agreed after an eleventh-hour emergency teleconference to take more drastic steps "to ensure [bond] price stability in the euro area."

Raj Badiani, economist with IHS Global Insight in London, said the ECB's action represents "a vote of confidence in the respective governments and an attempt to provide a sharp jolt to the negative sentiment engulfing Spain and Italy."

German Chancellor Angela Merkel and French President Nicolas Sarkozy issued a separate statement Sunday saying that they support efforts announced last week by Spain and Italy to shore up their finances and that they support an expanded European rescue fund.

But analysts say the actions may be only a short-term solution. If Italy or Spain fail to quell market panic, analysts say, Europeans might be forced to move toward the advent of a new euro-bond, putting the economic weight of Germany and France behind their profligate neighbors. Germany and other strong European economies are opposed to such a deal or other measures that would make them carry the burden of their struggling neighbors any longer.

Concern over Italy, in particular, is growing in large part because Europe's economies are slowing at the same time that the countries need strong economic growth to tame their debt loads.

Although a snapshot of the Italian economy released by authorities Friday indicated that the country's economic growth is better than that of some other nations in the region, investors are fixating on its $2.2 trillion debt and the question of who would aid Italy if it cannot pay its bills.

Last week, the ECB began to scoop up the debt of Portugal and Ireland for the first time since March. But even that measure was opposed by Germany and other fiscally conservative nations, and analysts expect greater concern about the vast sums that would be spent to bolster Italy and Spain.

In a worst-case scenario, Italy would need a bailout of about $1.4 trillion — or more than double the size of an established European rescue fund.

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Geithner to remain Treasury secretary

BY ZACHARY A. GOLDFARB

Treasury Secretary Timothy F. Geithner has told President Obama he plans to remain in his job through the fall of 2012, keeping in place Obama's longest-serving economic adviser after the first-ever U.S. credit downgrade and renewed fears of a second recession.

Geithner, who has been battling financial crises since 2007 as a top Federal Reserve official and then Treasury secretary, considered leaving the administration after Congress raised the federal debt ceiling and reached an agreement with Obama to tame the national debt.

But several developments have made his departure more difficult. The debt ceiling was raised with only hours to spare. The deal to tame the debt fell short of what Geithner and Obama wanted. The economy has suddenly taken a turn for the worse. And on Friday, Standard & Poor's downgraded the U.S. credit rating for the first time. And the White House, worried that it would be hard to find a suitable replacement, pressured him to stay.

Geithner told the president Friday morning that he would remain in his post. Hours later, he had to go to the White House to meet with Obama again and tell him the nation would likely lose its AAA credit rating.

On Sunday afternoon, Geithner joined an emergency conference call involving the seven major economic powers to discuss the impact of the downgrade.

"Secretary Geithner has let the president know that he plans to stay on in his position at Treasury," Treasury spokeswoman Jenni LeCompte said in a statement. "He looks forward to the important work ahead on the challenges facing our great country."

White House press secretary Jay Carney said, "The president asked Secretary Geithner to stay on at Treasury and welcomes his decision."

Exhausted from the multiple crises of recent years, Geithner and his family had decided to move back to New York, where they lived when he was head of the Federal Reserve Bank of New York. His son will finish his senior year of high school there.

Geithner planned to commute from New York to Washington during the week. He did so during the beginning of the term and didn't like it, so he considered stepping down to tend to his family needs and get a break from government service.

His departure would have marked the loss of Obama's longest-serving economic adviser at a time when the recovery has slowed and the unemployment rate remains stubbornly high.

Geithner is the last remaining member of the president's original economic team. Austan Goolsbee, chairman of Council of Economic Advisers, left Friday. Other key members of the team include National Economic Council director Gene Sperling, a former Treasury counselor who is reprising a role he held in the Clinton administration, and Jacob Lew, the budget director who is likewise reprising a Clinton-era role.

During his tenure, Geithner has continually won over Obama in contentious policy debates. He shaped the president's response to the financial crisis, successfully arguing that the government should not seize struggling banks.

More recently, he urged Obama to propose cutting the annual deficit by $4 trillion over 10 years, despite other top advisers advocating that the president focus squarely on the nation's high unemployment.

Geithner turns 50 later this month. He was one of the architects of the Wall Street bailout in the fall of 2008 and faced sharp criticism in his first year as Treasury secretary, including calls for his resignation. He has been accused of protecting the bonuses of Wall Street traders while paying insufficient attention to the nation's foreclosure epidemic.

In the past, analysts have discussed Roger Altman, an investment banker and deputy Treasury secretary in the Clinton administration, and Erskine Bowles, a former Clinton chief of staff who co-chaired Obama's deficit reduction commission, as possible candidates for the top Treasury post. But administration officials have feared what a confirmation battle would look like in a time of intense partisanship.

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