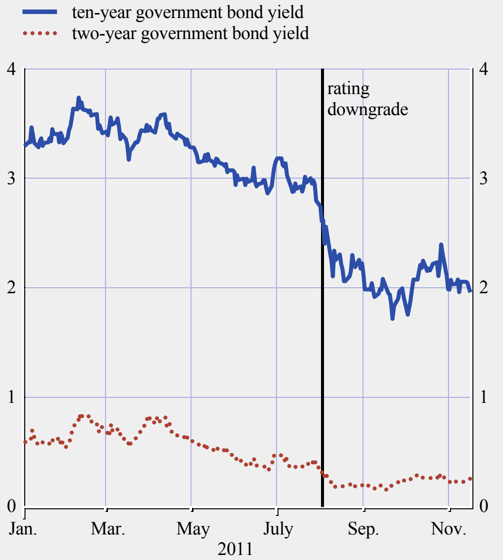
Box 2

WHAT ARE THE CONSEQUENCES OF THE DOWNGRADE OF THE UNITED STATES' SOVEREIGN DEBT?

On Friday 5 August, the United States' long-term sovereign debt was downgraded from AAA to AA+ (with a negative outlook) by Standard & Poor's (S&P), one of the three global rating agencies, without a clear reaction of the bond market following this announcement: the Treasury yields did not increase (see Chart A) and market liquidity did not dry up (see Chart B). To some extent the decision by S&P was expected, as the conditions under which a downgrade would take place had been communicated on several occasions by S&P.

Chart A Yields on two and ten-year US government bonds

(Jan. 2011 – Nov. 2011; percentages)

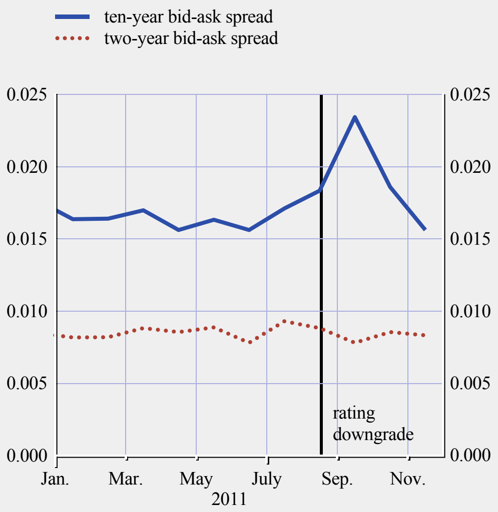


Source: Bloomberg.

The impact of the downgrade is difficult to assess since many factors may have accounted for this inertia. First, it can take some time, if ever, for investors in US Treasuries to adjust their portfolios: institutional long-term investors need to find alternatives to use as a "safe-haven" asset. Second, the positive tone of the US bond market cannot be disentangled from the negative dynamics in August on

Chart B Bid-ask spreads for two and ten-year US government bonds

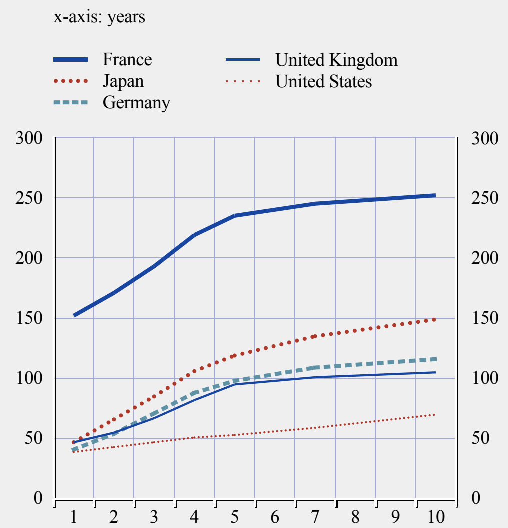
(Jan. 2011 – Nov. 2011; monthly average of bid-ask spreads, basis points)



Source: Bloomberg.

Chart C Sovereign CDS curves for selected developed countries

(17 Nov. 2011; basis points)



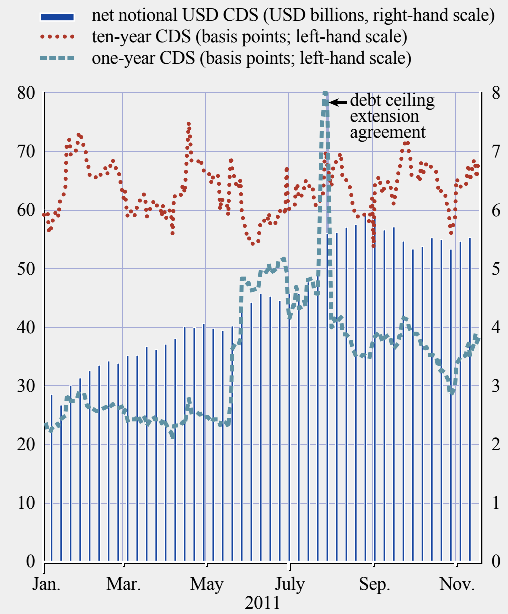
Source: Bloomberg.

global stock markets and from the downward revision of the US economic growth forecast by most market economists. Third, the decline in long-term US yields partly reflects the sharp downward movement in the expected path of US short-term interest rates following the commitment by the Federal Reserve on 9 August to keep short-term interest rates at low levels until mid-2013.

While the US Treasury market was able to withstand the rating downgrade, developments in the sovereign credit default swap (CDS) market showed signs of market concerns. A comparison between the sovereign CDSs of major developed economies shows that the United States fares well relative to other countries (see Chart C). However, the surge of the one-year CDS before the last-minute political agreement on 31 July 2011 on the debt ceiling extension appears to suggest market concerns (see Chart D). While the increase in the premia of the short-dated US sovereign CDS was only short-lived, the premia of the

Chart D One-year and ten-year sovereign CDSs on the United States and net CDS notional

(Jan. 2011 – Nov. 2011; CDS premia in basis points and net CDS notional in USD billions)



Sources: Bloomberg and Depository Trust & Clearing Corporation.

longer-dated CDS remained more stable.[1] The significant increase in the net notional amount outstanding of CDSs on the US sovereign may also reflect those concerns (see Chart D), even if this amount remains very small relative to the size of the US Treasury market.

More generally, the downgrade of US sovereign debt by S&P, which occurred as several euro area government bond markets were facing intense pressure, may have led market participants to further reconsider the notion of "risk-free" asset. Looking ahead, this may have far-reaching consequences on portfolio allocation strategies, which have long been based on the assumption that large advanced economies' sovereign debts bear little credit risk.

1 There are also other factors that could have potentially contributed to the rise in sovereign CDS premia. For instance, the deceleration of global economic growth has, to a certain degree, contributed to increases in all sovereign CDS premia, with differences across countries and maturities. The US sovereign CDSs may also have been affected by the developments in euro area sovereign risks given the interconnectedness of the two major economic areas. Finally, part of the increases in the sovereign CDSs may have also been related to a repricing of risks rather than to the perceptions that risks have generally increased.