GLOBAL ECONOMIC CRISIS

The Global Economic Crisis

U.S. Treasury Bonds Downgraded!

The worsening recession that began at the end of 2007 led Congress to pass a huge economic stimulus package in early 2009. The combination of the stimulus package and the government's bailouts of financial institutions caused the U.S. government to increase its borrowing substantially. The current (March 2012) level of public debt is $10.4 trillion, about 68% of gross domestic product (GDP). The Congressional Budget Office long-term projections show this percentage growing to 70% to 90%, depending on the assumptions. Any way you look at it, this is a lot of money, even by Washington standards!

With so much debt outstanding and enormous annual deficits continuing, in mid-2011 Congress was faced with the need to increase the amount of debt the federal government is allowed to issue. Although Congress had increased the debt ceiling 74 times previously, and 10 times since 2001, partisan and heated debate seriously delayed approval of the measure and brought the federal government to the brink of default on its obligations by August. At the last minute, Congress approved a debt ceiling increase, narrowly avoiding a partial government shutdown. However, the deficit reduction package that accompanied the legislation was small, doing little to address the structural revenue and spending imbalance the federal government faces going forward.

On August 5, 2011, the combination of a dysfunctional political process apparently incapable of reliably performing basic financial housekeeping chores, and the lack of a clear plan to address future deficits, raised enough questions about the U.S. government's financial stability to induce Standard & Poor's (S&P), the credit rating agency, to downgrade U.S. public debt from AAA to AA+, effectively removing it from its list of risk-free investments. Financial markets quickly responded to this dark assessment with the Dow Jones Industrial Average plunging some 13% over the next week. Moody's and Fitch, the other two major rating agencies, however, kept their ratings of U.S. public debt at their highest levels. With 2 out of 3 agencies rating U.S. debt at the highest level, is the yield on U.S. debt still a proxy for the riskless rate? Only time will tell.

apart in early 2009. In other words, BAA investors didn't require much extra return over that of an AAA bond to induce them to take on that extra risk most years, but in 2009 they required a very large risk premium.

Not only do spreads vary with the rating of the security, they also usually increase as maturity increases. This should make sense. If a bond matures soon, investors are able to forecast the company's performance fairly well. But if a bond has a long time until it matures, investors have a difficult time forecasting the likelihood that the company will fall into financial distress. This extra uncertainty creates additional risk, so investors demand a higher required return.

SELF-TEST

Differentiate between mortgage bonds and debentures.

Name the major rating agencies, and list some factors that affect bond ratings.

What is a bond spread?

How do bond ratings affect the default risk premium?

A 10-year T-bond has a yield of 6%. A 10-year corporate bond with a rating of AA has a yield of 7.5%. If the corporate bond has excellent liquidity, what is an estimate of the corporate bond's default risk premium? (1.5%)