ASK AN ECONOMIST

Rajdeep Sengupta has been an economist in the Research division of the Federal Reserve Bank of St. Louis since 2006. His main expertise is financial intermediation and corporate finance. Recently, Sengupta also has studied the behavior of subprime mortgages prior to the financial crisis. He is from India and has been in the U.S. since 2001. He is an avid fan of cricket and soccer. For more on his work, see http://research.stlouisfed.org/econ/sengupta/

Sengupta in Vancouver, Canada.

Q. What impact will the downgrade of U.S. debt have on the country's ability to sell debt in the future?

On Aug. 5, Standard & Poor's downgraded the United States' credit rating for the first time in the history of credit ratings. This was a major development because, throughout recorded financial history, U.S. Treasury debt has been considered the safest debt instrument available. The reason for the downgrade was given as "the prolonged controversy over raising the statutory debt ceiling and the related fiscal policy debate." Taken at face value, this implies increased uncertainty of timely payment of interest and principal on U.S. Treasury obligations.

Typically, the downgrade of sovereign credit ratings is accompanied by a flight of capital away from the country and, in some cases, a sharp depreciation of the sovereign currency. Surprisingly, however, what occurred following the U.S. downgrade was the exact opposite: a sharp decline in both equity and commodity markets and a flight toward U.S. Treasury securities—the subject of the downgrade. Consequently, the yields on the benchmark 10-year Treasury notes fell to their lowest levels since January 2009.

This anomalous behavior can have several explanations. First, despite the downgrade, the financial markets continue to believe in the creditworthiness of the U.S. Treasury. Second, the downgrade occurred during a period of increased uncertainty about the European debt crisis; consequently, U.S. Treasury securities were still a safe haven relative to the sovereign credit risk of other major economies. Third, immediate market reactions to sovereign credit rating downgrades have often been determined by factors other than the downgrade; following the S&P downgrade of Russia's foreign-currency sovereign credit ratings in December 2008, equity markets in Moscow actually posted gains, buoyed by soaring commodity prices.

In the future, the borrowing costs of the U.S. will almost certainly depend on its ability to resolve some of its long-term fiscal challenges. If uncertainty over U.S. debt repayment continues, global investors will seek a safer alternative to U.S. Treasuries—an alternative that has yet to emerge.

Submit your question in a letter to the editor. (See instructions at right.) One question will be answered by the appropriate economist in each issue.

LETTERS TO THE EDITOR

This is in response to an article headlined "The Mismatch Between Job Openings and Job Seekers," which appeared in the July issue.

Dear Editor:

Your excellent July issue of *The Regional Economist* concludes that mismatch (structural unemployment) only accounts for a small part of the problem. I would urge you to check (whether) the influence of massive and growing inequality of income, wealth and opportunity might be a major cause. The latest *New Yorker*, in discussing a spectacularly successful hedge fund, suggests that the rapid growth of corporate salaries may have been accelerated by the competition with hedge fund salaries. If we had the data, I think we could find that prior to each major recession was a rapid increase in income inequality. The few very large incomes drain a lot of purchasing power and leave corporations with piled-up cash and no good markets for new investments.

With this "demand side" analysis, much of the current panic response to growing federal debt is cutting jobs, particularly at the state level. Tax cuts for the affluent never trickled down, but more income at the bottom would surely rapidly move up.

Jim Morgan, professor of economics, emeritus, University of Michigan, Ann Arbor

This is in response to "Commodity Price Gains: Speculation vs. Fundamentals," which appeared in the July issue.

Dear Editor:

I found your piece "Speculation vs. Fundamentals" very interesting. One thing that I did find missing was any mention of how futures contract margins are adjusted in response to higher/lower prices and how this, along with interest rates, impacts the cost of holding futures. I've attached the link to the CME web site which contains the historical margin rates for your reference: www.cmegroup.com/clearing/risk-management/historical-margins.html

I also suspect that the terms and willingness at which banks extend credit to businesses, like that of the athletic apparel wholesaler cited in your piece, may have an impact on commodity prices.

I've always wanted to take the time to try and understand better many of the points raised in your piece; so, I appreciate your work.

Mark Pfeiff, portfolio director, Kaiser-Francis Oil Co., Tulsa, Okla.

This is in response to another article in the July issue, "The Foreclosure Crisis in 2008: Predatory Lending or Household Overreaching?" Because this letter was unusually long, only a portion appears here; the rest can be read online at www.stlouisfed.org/publications/re/letters/index.cfm

Dear Editor:

The authors conclude that the spike in mortgage defaults is not explained by lenders behaving as the equivalent of drug dealers in the schoolyard, leaving "overreaching" as the default explanation. The authors observed that prevention "requires the ability to 1) recognize an asset bubble, 2) classify the bubble as a systemic risk to the economy and 3) curb the formation of the bubble." My suggestion is to use the Federal Reserve's Z.1 balance sheet reports as an assets "overreach" detection and diagnostics data source. Although the Federal Reserve's Z.1 release notes barely acknowledge the existence, let alone the dynamism, of assets and asset values, Z.1 reporting fortunately includes balance sheets, which I suggest be made more inclusive and available in normalized "real" dollar variants to help with time series analysis of asset trends.

Fulton Wilcox, senior partner, Colts Neck Solutions Inc., Colts Neck, N.J.

To write a letter to the editor online, go to
www.stlouisfed.org/re/letter
To send a letter through the mail, address it to
Subhayu Bandyopadhyay, editor, *The Regional Economist,*
Federal Reserve Bank of St. Louis, Box 442, St. Louis, Mo. 63166.