United States of America Rating Report

AA
STABLE OUTLOOK

Credit strengths

- Wealthy, diversified economy
- Global reserve currency status
- Institutional checks and balances
- Deep, liquid capital markets

Credit weaknesses

- Weakening potential growth outlook
- High and rising public debt burden
- Elevated contingent liabilities
- Polarisation and policy uncertainty

Rating rationale and Outlook:

Scope's affirmation of the United States' AA rating reflects the country's wealthy, competitive and diversified economy, its transparent and accountable institutional framework, as well as the US dollar's unparalleled global reserve currency status, which enables the country to run fiscal and current account deficits with limited debt sustainability concerns. The rating is constrained by a relatively weak potential growth outlook, combined with the high and rising level of government debt given the administration's strongly procyclical policies, and the sovereign's significant contingent liabilities from pension and healthcare-related obligations. Given the divisions between the political parties, and the lack of bipartisan collaboration, solutions to these underlying structural challenges are unlikely to be implemented in the foreseeable future.

Figure 1: Sovereign scorecard results

Scope's sovereign risk categories	USA	Peer comparison Average
Domestic economic risk		
Public finance risk		
External economic risk		
Financial risk		
Political and institutional risk		
Qualitative adjustment (notches)	3	
Final rating	AA	

AAA AA A BBB BB B CCC CC C

NB. The comparison is based on Scope's Core Variable Scorecard (CVS), which is determined by relative rankings of key sovereign credit fundamentals. The CVS rating can be adjusted by up to three notches depending on the size of relative credit strengths or weaknesses.

Positive rating-change drivers

- Improved potential growth outlook
- Debt trajectory on downward path
- Reduction in contingent liabilities

Negative rating-change drivers

- Reduced global role of the US dollar
- Deterioration in public finances
- Weakening fiscal framework

Ratings and outlook

Foreign currency

Long-term issuer rating	AA/Stable
Senior unsecured debt	AA/Stable
Short-term issuer rating	S-1+/Stable

Local currency

Long-term issuer rating	AA/Stable
Senior unsecured debt	AA/Stable
Short-term issuer rating	S-1+/Stable

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Bloomberg: SCOP

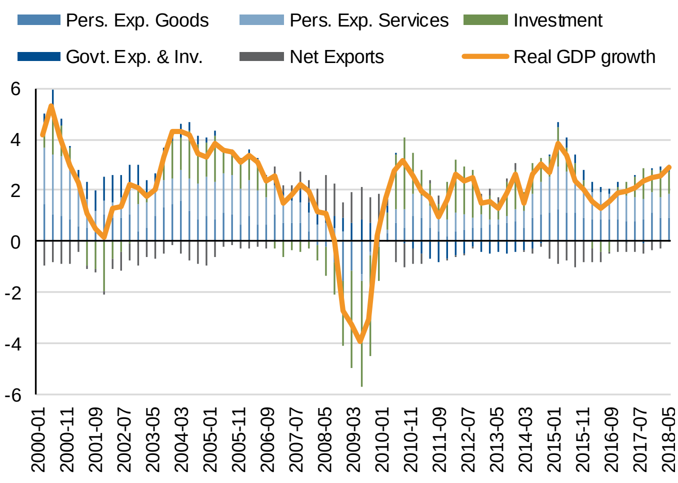
Domestic economic risk

Growth potential of the economy

US economy is above full employment

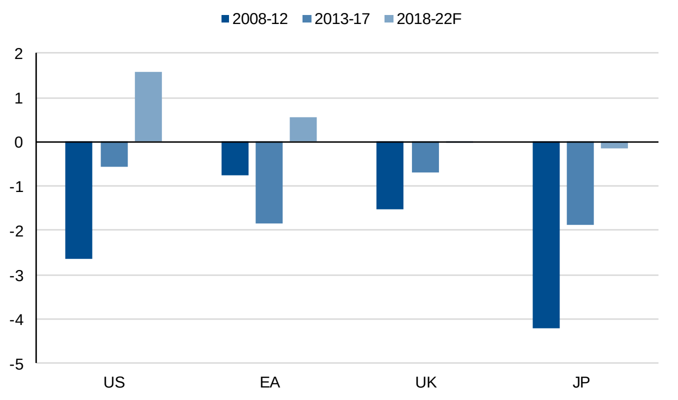
The economic recovery in the United States has proven resilient, with the economy growing for 35 consecutive quarters, averaging a real GDP growth rate of about 2.2% since 2010. The economy is beyond full employment, with an unemployment rate below 4% since June 2018, and core inflation near, and in fact slightly above, the Federal Reserve's price stability mandate of 2% since April 2018. The US economy recovered faster from the Great Financial Crisis (GFC) than its peers and, in terms of real GDP, is now a solid 18% above its pre-crisis level. This reflects the country's flexible and competitive economy, which has led to one of the highest GDP per capita levels in the world, of around USD 60,000 (the seventh highest level, based on IMF figures).

Figure 2: Real GDP growth (YoY, %)



Source: Bureau of Economic Analysis

Figure 3: Output gap (% of potential GDP)



Source: IMF, calculations Scope Ratings GmbH

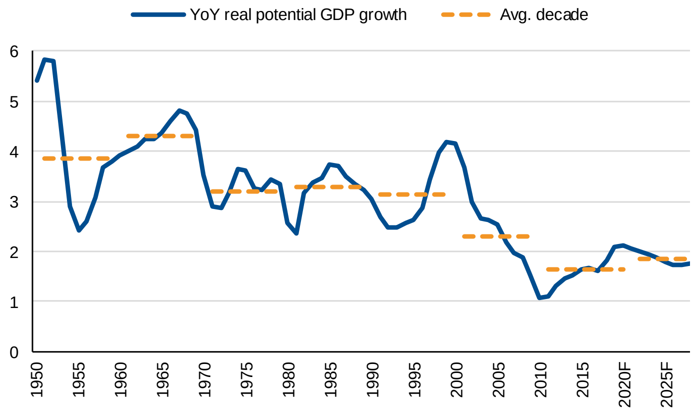
Going forward, over the medium-term, Scope expects real GDP growth to hover around 2%, driven by the government's fiscal stimulus, solid private consumption helped by a strong labour market and rising household wealth, as well as a recovery of private investment on the back of strong purchasing manager indices and industrial orders as well as supportive financial conditions and a still favourable external environment. While 2018 is likely to record a comparatively high growth rate of around 3% – Q2 2018 figures indicate an annualised growth rate of around 4%[1] – several factors constrain the medium-term growth outlook.

Considerable medium-term growth challenges

These include the difficulty in adapting to structural shifts arising from technological changes reshaping the labour market, low productivity growth, rising skills premia and an ageing population, and declining labour force growth, which has been the main contribution to real GDP growth over the past few years according to the OECD. In fact, potential GDP growth has slowed significantly because of falling total-factor and labour productivity and is now estimated at around 1.6% for 2011-20 – an all-time low since the 1950s, according to data from the Congressional Budget Office (CBO). The CBO's outlook for 2020-28 averages potential growth at around 1.9%, similar to the IMF's 1.75%, which expects the short-term boost to investment following tax reforms this year to fade after 2019.

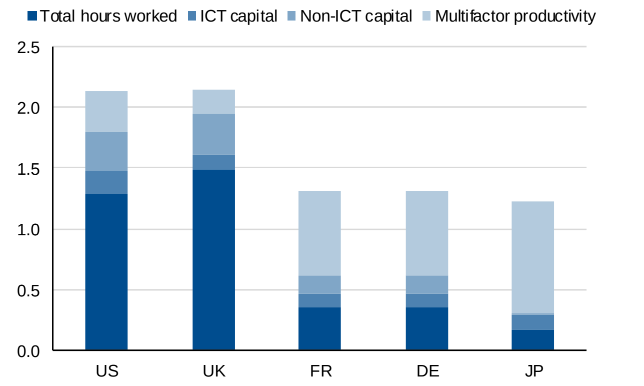
[1] According to the CBO, second-quarter growth figures were boosted in particular by a rebound in the growth of consumer spending from a weak first quarter and a surge in agricultural exports. CBO 2018. An Update to the Economic Outlook 2018 to 2018.

Figure 4: Real potential GDP growth (YoY, %)



Source: CBO

Figure 5: Contribution to real GDP growth (avg. 2012-16, %)



Source: OECD

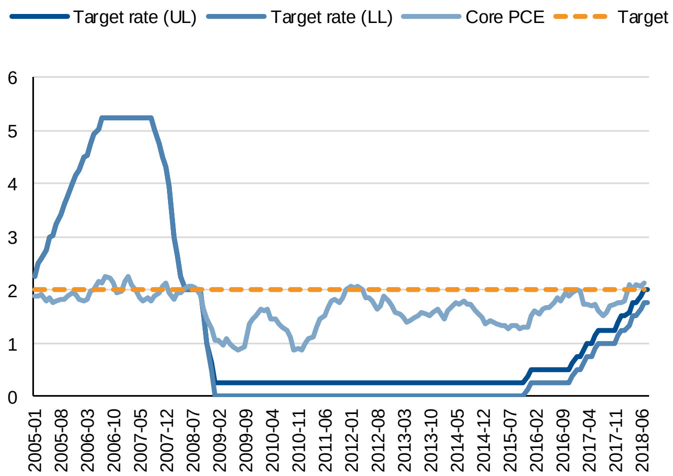
Economic policy framework

Effective monetary policy framework

The United States benefits from an overall very effective policy implementation of the Federal Reserve. Following decisive policy action over the past few years, resulting in historically low interest rates and a marked increase in the Fed's balance sheet to USD 4.5trn (or 25% of GDP) in January 2015, the Fed is achieving its dual mandate of price stability and maximum employment. Core personal consumption expenditure (PCE) inflation is broadly in line with, albeit just above, the medium-term target of 2%.

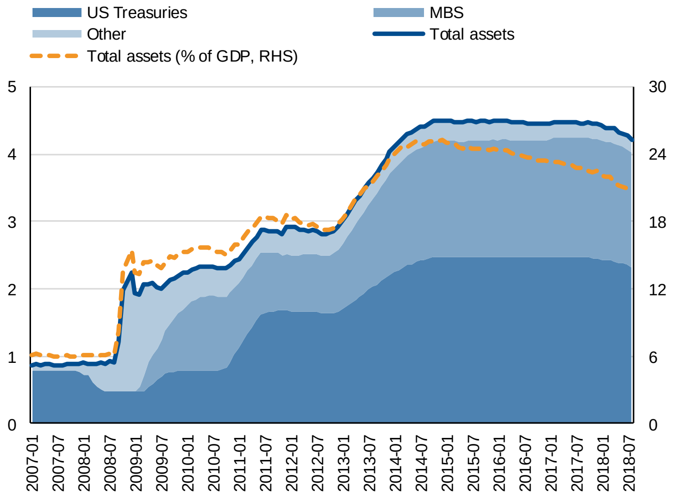
The Federal Open Market Committee (FOMC) raised the target range for the federal funds rate for the first time in December 2015 and several times since then, including in March and June 2018, bringing it to 1.75%-2.00%. Given the expansionary and strongly procyclical fiscal policy at this stage of the cycle, Scope expects monetary tightening to continue in 2018-19, with the federal funds rate rising to 2.75%-3.00% by 2019.

Figure 6: Federal funds, target and core inflation rate (%)



Source: Federal Reserve, BEA

Figure 7: Federal Reserve balance sheet (USD trn)



Source: Federal Reserve

Federal Reserve gradually reducing its balance sheet

In addition, the FOMC has continued to implement the balance sheet normalisation programme since October 2017, in a gradual and predictable manner, decreasing the reinvestment of principal and payments it receives from these securities. Specifically, principal payments received are reinvested only until they exceed gradually rising caps, in order to limit the volume of securities absorbed by private investors[2]. Since October 2017, holdings of Treasuries dropped from USD 2.5trn to USD 2.3tr in August 2018 and similarly, holdings of mortgage-backed securities dropped from USD 1.8trn to USD 1.7trn over the same period, decreasing the Fed balance sheet in total by about USD 242bn.

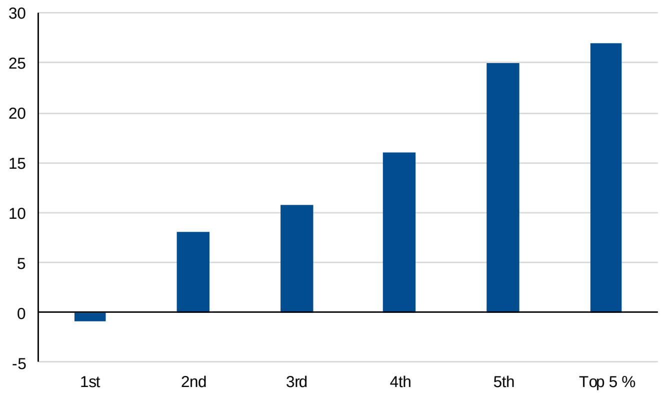
Macro-economic stability and sustainability

Income inequality risks reducing consumption and future productivity

Low productivity has been associated with a stagnation in household incomes for a large share of the population. Median household income in inflation-adjusted terms has improved over the past few years, standing at USD 59,039 in 2016, just above the level recorded in 1999 (USD 58,665). Moreover, there has been a widely documented acceleration in income inequality over the past few decades.

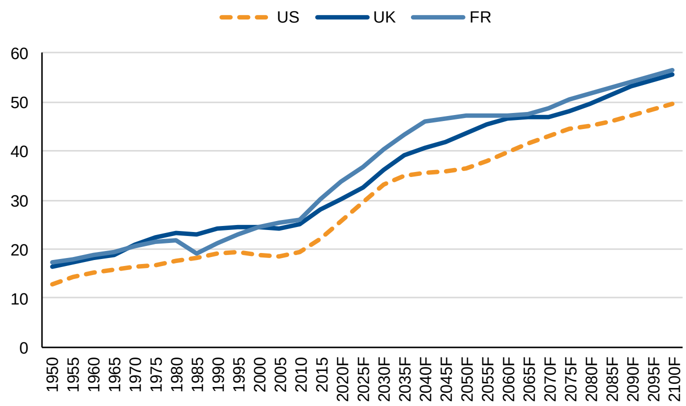
Based on Census Bureau data, while the real mean household income of the lowest quintile actually fell by about 1% compared to its 1995 level, over the same time period the second, third, fourth and fifth quintiles increased their real incomes by about 8%, 11%, 16% and 25% respectively. These developments affect US growth prospects as, according to the IMF, income inequality curbs consumption (which has been the main growth driver), weighing on the labour supply and reducing the ability of households to adapt to shocks.

Figure 8: Real mean household income (quintiles, % change 2016 vs 1995)



Source: Census Bureau, calculations Scope Ratings GmbH

Figure 9: Dependency ratio (per 100)



Source: UN, calculations Scope Ratings GmbH

Looking at the US labour market which has made significant gains, with the unemployment rate falling to 3.9% in August 2018 from 10% in 2009, and non-farm employment increasing by about 19.5m people since 2010, Scope notes that labour force participation peaked in 2000 at 65% and has since fallen to around 60%. According to the IMF, this comparatively low labour force participation rate is due to demographics, institutional factors such as limited subsidies for childcare and lack of paid family leave, as well as declining work opportunities for the low-skilled[3].

Finally, based on UN data, demographic changes alone will further slow labour force growth from an annual average of about 1% over the last 25 years to about 0.2% in the coming decade. Consequently, the dependency ratio, i.e. the share of the old and young (dependents) to the working-age population will increase from about 22% in 2017 to

[2] For payments of principal that the Federal Reserve receives from maturing Treasury securities, the Committee anticipates that the cap will be an initial USD 6bn per month initially, increasing in steps of USD 6bn at three-month intervals over 12 months until it reaches USD 30bn per month. For payments of principal that the Federal Reserve receives from its holdings of agency debt and mortgage-backed securities, the Committee anticipates that the cap will be USD 4bn per month initially, increasing in steps of USD 4bn at three-month intervals over 12 months until it reaches USD 20bn per month. https://www.federalreserve.gov/monetarypolicy/files/FOMC_PolicyNormalization.20170613.pdf.

[3] IMF, 2017 Article IV Consultation United States, IMF Country Report No. 17/239.

around 50% by 2100. The United States will therefore, despite positive net migration, not be immune to the consequences of an ageing population, in line with its peers.

Public finance risk

Fiscal policy framework

Statutory debt limit suspended through to March 2019

In Scope's view the US debt ceiling rule[4] has led to a rating-relevant inconsistency. At present, lawmakers first approve spending but then debate whether to allow the US Treasury to borrow the funds needed to honour its obligations. In fact, over the past few years, this situation has led to several instances in which the US Treasury was weeks or even days away from defaulting on its obligations[5]. Following the temporary suspension of the statutory debt limit (on 8 September 2017) and an increase (on 9 December 2017) to reflect cumulative borrowing through the period of suspension, in February 2018, the statutory debt limit was again suspended through to 1 March 2019.

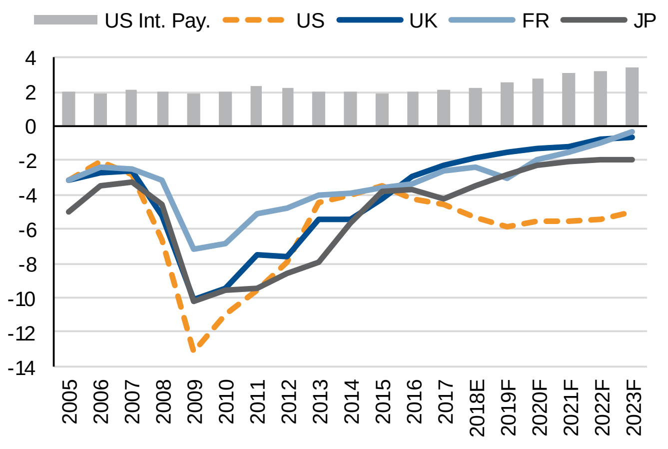
Misuse of debt ceiling meaningful risk to ability of the government to service its debt

While it is Scope's baseline that another short-term solution will likely be found in 2019, structural fixes to this fundamental issue will likely remain elusive. In Scope's view, the limitations of the US fiscal framework within a highly polarised environment, coupled with the misuse of the US debt ceiling for partisan purposes, is a unique risk among Scope's highly rated sovereigns. In Scope's opinion, it represents a meaningful operational risk to the ability of the US government to service its debt.

Expansionary fiscal policy…

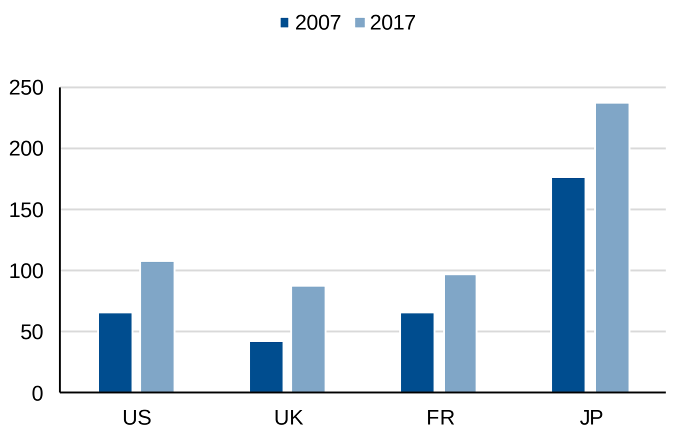
In response to the GFC, the budget deficit hit a record high of 13.2% in 2009, falling gradually to 3.5% in 2015 before rising to 4.6% in 2017, despite record-low interest expenses of around 2% of GDP, according to IMF data. The accumulation of fiscal deficits has also led to a sharp increase in general government gross debt from 65% of GDP in 2007 to around 108% in 2017, currently the second-highest in its highly rated peer group after Japan.

Figure 10: Fiscal balance and US interest expenses (% of GDP)



Source: IMF

Figure 11: General government gross debt (% of GDP)



Source: IMF, calculations Scope Ratings GmbH

[4] The Public Debt Act of 1941 set an overall limit of USD 65bn on Treasury debt obligations that could be outstanding at any one time. Since 1960, Congress has acted 78 times to permanently raise, temporarily extend, or revise the definition of the debt limit. Increasing or suspending the debt limit was done to permit the United States to honour pre-existing financial commitments. https://www.treasury.gov/initiatives/Pages/debtlimit.aspx

[5] Scope recalls that in 1979, the US Treasury was unable to repay investors around USD 120m in Treasury bills on April 26, May 3 and May 10, owing to a failure of Congress to act in a timely fashion to lift the debt ceiling rule. Zivney, T., Marcus, R. 'The Day the United States Defaulted on Treasury Bills', The Financial Review, Volume 24, Issue 3 August 1989 Pages 475–489. In addition, Scope notes that in total, there have been 12 government shutdowns since 1981, ranging from one to 21 days.

…is strongly pro-cyclical

Looking ahead, despite the strong cyclical position of the US economy, the government has cut taxes[6] and raised both defence and non-defence discretionary spending[7]. According to the IMF, the tax changes are expected to have modestly positive supply-side effects, largely by incentivising an increase in the capital stock and, in doing so, raising the level of potential GDP. However, the fiscal cost is substantial: the IMF estimates that the combined effect of the administration's tax and spending policies will cause the federal government deficit to exceed 5% this year and stay above that level over the coming years.

Similarly, according to the Congressional Budget Office, the federal deficit is expected to increase from 3.9% in 2018 (significantly lower than the IMF figure) to 4.9% for 2019-28 (in line with the IMF). As revenues are projected to be roughly flat over the next few years, averaging 17.5% of GDP, this increase is mainly driven by a significant rise in expenditures, averaging 22.4% over the next decade. Specifically, spending for Social Security and the major health care programmes (Medicare), will increase from 12.6% to 13.9% of GDP as a result of the ageing population. In addition, net interest expenditures are also set to increase by about 1 pp to 2.7% of GDP. However, these increases are somewhat offset by an annual decrease in discretionary spending of about 0.6% of GDP for 2019-28. As a result, according to the CBO, debt held by the public will increase from 78% to 96% of GDP by 2028. Overall, therefore, Scope assesses the US fiscal policy as strongly procyclical, and thus inadequate, raising debt sustainability concerns.

Debt sustainability

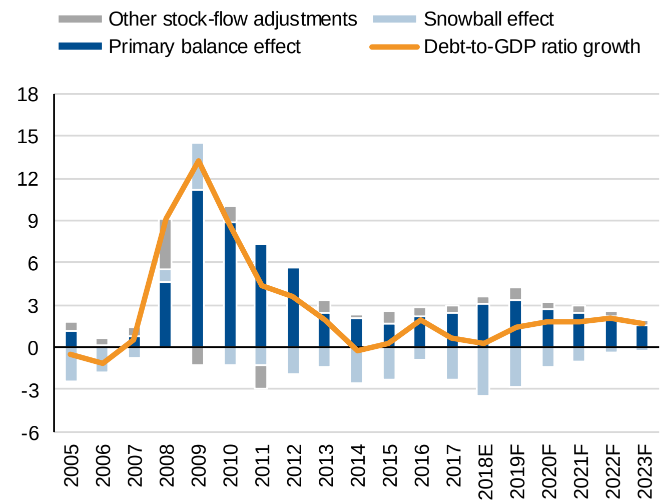
Debt sustainability concerns

The results of Scope's debt sustainability analysis raise concerns regarding the debt trajectory. The IMF's baseline scenario expects the debt-to-GDP ratio to increase modestly from about 108% in 2017 to around 117% by 2023. While this is a manageable increase, the IMF's baseline favourably assumes that the interest-rate growth differential becomes a debt-creating flow only after 2023. In Scope's view, the lower potential growth outlook combined with the expected increase in interest rates in line with the ongoing normalisation of the Fed's monetary policy, and an almost 47-year track record of fiscal deficits (with four years of exception), raises debt sustainability concerns.

Thus, in Scope's stressed scenario, which in 2018-23 assumes a 1.0 pp reduction in real GDP growth and a 0.5 pp increase in interest rates and the primary deficit compared to the IMF's baseline scenario, the debt-to-GDP level rises to around 126% by 2023. Conversely, under a more optimistic scenario, assuming a real GDP growth rate of around 3.0% (in line with administration forecasts), reducing the primary deficit by 1 pp and keeping interest rates in line with the IMF baseline, the debt level remains essentially unchanged at around 102% of GDP. Notably, even under this optimistic scenario, the debt-to-GDP ratio of the United States will not fall below 100% by 2023 and will therefore remain significantly above its AA rated peers France (89%), the UK (83%), and Belgium (89%).

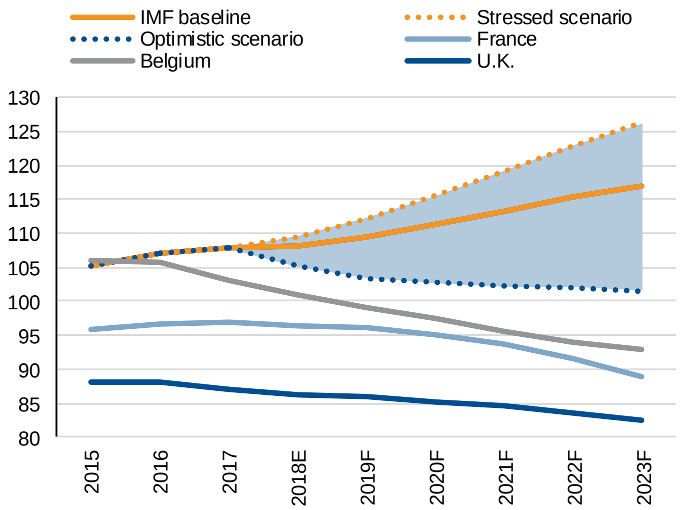
[6] See US Fiscal Outlook: Politically polarising tax cut boosts short-term growth, raises deficits.
[7] The Tax Cuts and Jobs Act permanently lowered the top corporate income tax rate to 21% and changed the way that business' foreign income is taxed. The act also lowered individual income tax rates and broadened the base of income subject to tax through to 2025. In addition, it included various provisions that affect how businesses and individuals calculate their taxable income. The two other pieces of legislation affected spending. The Bipartisan Budget Act of 2018 (P.L. 115-123) increased the caps on discretionary funding for 2018 and 2019 and provided substantial funding for emergency assistance. The Consolidated Appropriations Act, 2018 (P.L. 115-141), provided appropriations for all discretionary accounts for 2018. CBO August 2018.

Figure 12: Contribution to gov't debt changes (% of GDP)



Source: IMF, calculations Scope Ratings GmbH

Figure 13: General government debt (% of GDP)



Source: IMF, calculations Scope Ratings GmbH

Scenario	Time period	Real GDP growth (%)	Primary bal. (% of GDP)	Real eff. int. rate (%)	Debt end period (% of GDP)
History	2013-17	2.2	-2.2	0.4	107.8
IMF baseline	2018-23	2.0	-2.6	0.6	116.9
Optimistic scenario		3.0	-1.6	0.6	101.6
Stressed scenario		1.0	-3.1	1.0	126.3

Source: IMF, calculations Scope Ratings GmbH

Significant commitments and contingent liabilities

As part of its debt sustainability analysis for the United States, Scope notes the significant burden arising from direct liabilities, obligations and contingent liabilities of the federal government. In addition to debt held by the public and intra-governmental debt[8], these include: i) federal employee and veteran benefits payable (USD 7.7trn, or 40% of GDP); ii) accrued trust fund deficits related to Social Security and Medicare (USD 48.9trn, or 251% of GDP); iii) state and local government debts and unfunded pension obligations[9] (USD 6.7trn, or 34% of GDP); and iv) liabilities of the housing-related government-sponsored enterprises[10] (GSEs; USD 9.0trn, or 46% of GDP)[11].

In Scope's assessment, the first category is a direct liability, while Social Security and Medicare (category two) refer to obligations which the federal government can alter unilaterally. Categories three and four are contingent liabilities which, although not explicitly related to the federal government, could, under specific circumstances, require federal intervention. Adding the first two categories to the officially reported federal

8 The Financial Report 2017 states that intra-governmental debt is effectively money that the government owes to itself and should therefore not be included when accounting for government-wide obligations. However, Scope notes that the USD 5.6trn in Treasury securities held by the trust funds are counted as assets in the present value calculations of their respective obligations. If these US Treasuries are not counted as federal government liabilities, the logical conclusion is that trust fund holdings of US Treasuries are not to be counted as assets either. Since this is not the case, Scope includes intra-governmental debt as a direct liability of the federal government.

9 As of fiscal year 2015 (latest available figure), states and local governments reported unfunded pension liabilities of USD 1.4trn, based on the optimistic assumption of public pension plans yielding a nominal return of 7.6% on their whole portfolios. Using a more conservative discount rate of 5%, which is still above the return on 10-year US Treasuries, implies an unfunded liability of about USD 3.6trn.

10 These agencies were originally created by an Act of Congress and are today entirely owned by the federal government. These liabilities do not have the same status as direct liabilities or even Treasury obligations given the offsetting assets, specifically, the underlying mortgages. However, they do expose the federal government to shifts in the housing sector as well as the creditworthiness of US households, as demonstrated during the Great Financial Crisis.

11 Scope has excluded guarantees from the Federal Deposit Insurance Corporation (FDIC) from this assessment, given the fact that even the recent global financial crisis was not enough to cause these guarantees to be called and result in a direct cash outflow from the US Treasury. However, the FDIC is a government corporation that was created as part of the Banking Act of 1933 to insure depositors against losses should their banks become insolvent, and on 3 October 2008 the Congress raised the limit on deposit insurance from USD 100,000 to USD 250,000.

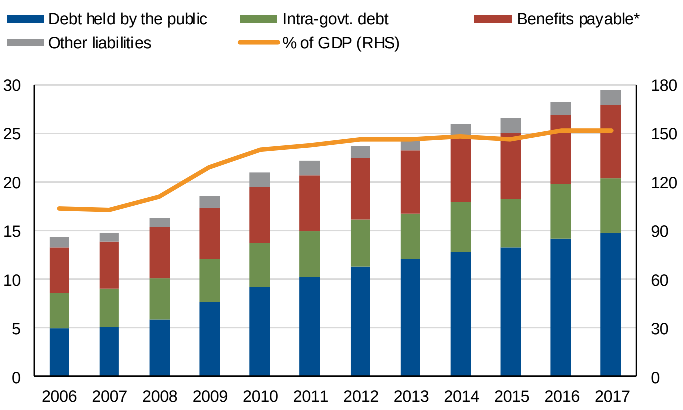
government debt, which includes debt held by the public as well as intra-governmental debt, results in a debt-to-GDP ratio of approximately 400%; while adding contingent liabilities raises the potential burden to around 480% of GDP.

Table 1: US federal government commitments, 2017

Liability - Category	Description	USD (trillion)	% of GDP
Direct Liabilities	Debt held by the public	14.7	75.4
	Intra-governmental debt	5.6	28.7
	Debt s.t. the debt limit	**20.3**	**104.2**
	Federal employee & veteran benefits payable	7.7	39.5
	Other liabilities	1.5	7.7
		29.5	**151.4**
Obligations (75-year horizon)	Social Security (OASDI) - NPV	15.4	79.0
	Medicare Part A (HI) - NPV	3.5	18.0
	Medicare Part B (SMI) - PV future govt. transfers	22.4	115.0
	Medicare Part D (SMI) - PV future govt. transfers	7.6	39.0
		48.9	**251.0**
Total Direct Liabilities & Obligations		**78.4**	**402.4**
Contingent Liabilities	State & local govt. debt	3.1	15.9
	State & local govt. unfunded pension liabilities	3.6	18.5
	Housing GSEs' liabilities & mortgage pools	9.0	46.2
		15.7	**80.6**
Grand Total		**94.1**	**482.9**

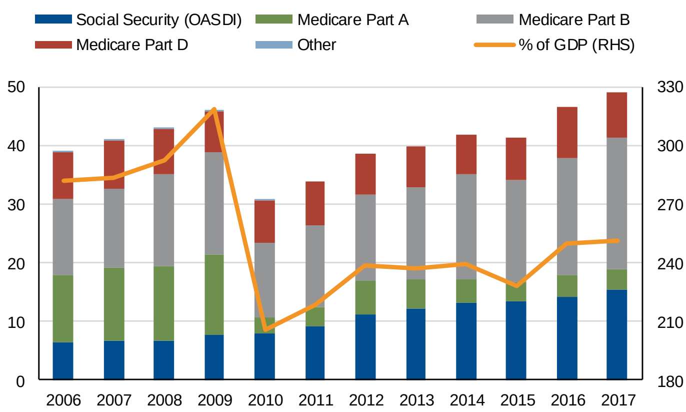
Source: Financial Report US government 2017, Federal Reserve. St. Louis Fed. Center for State & Local Government Excellence. PV=Present Value; NPV=Net Present Value; GSEs=Government-sponsored enterprises.

Figure 14: Direct liabilities (USD trn, % of GDP)



*Federal employees & veteran benefits payable
Source: Financial Reports US government, calculations Scope Ratings GmbH

Figure 15: Social Security and Medicare obligations (USD trn, % of GDP)

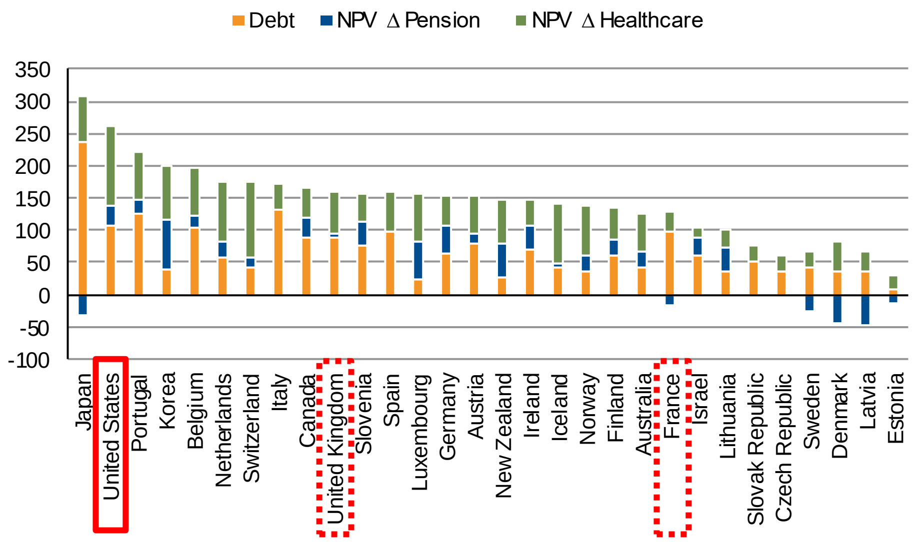


Source: Financial Reports US government, calculations Scope Ratings GmbH

These figures are in line with those from related studies. For example, the latest IMF Fiscal Monitor shows that among 30 advanced economies, the United States ranks second in terms of total government liabilities, including the net present value of future pension and healthcare obligations, with a ratio of around 260% of GDP, just below that of Japan (277%), but significantly above that of the UK (160%) and France (110%)[12]. For the United States, the main driver of these extraordinary figures are healthcare-related costs, which point to the urgent need to implement reforms to the numerous benefit programmes.

[12] IMF Fiscal Monitor, April 2018.

Figure 16: General gov't obligations, including NPV of future pension and healthcare obligations (% of GDP)



Source: IMF Fiscal Monitor, April 2018

Market access and funding sources

Unparalleled market access

Purchases of US government bonds benefit from the safe-haven status of the US. Concerns about the sustainability of US debt are partially offset by the US government's low financing costs and unparalleled market access and capital market depth, based on the US dollar's reserve currency status. Specifically, as of Q2 2018, the share of short-term debt (Treasury bills) was around 14% of the total marketable debt stock, with the average maturity of marketable debt ranging between five and six years. The bid-to-cover ratio of the 10-year (30-year) Treasury note has averaged 2.8 (2.5) since 2009 and currently stands around 2.6 (2.4) while the average interest rate on interest-bearing debt stands at around 2.4%.

While the share of marketable securities held by major foreign holders has hovered around 50% since 2005, falling slightly in the past year to around 40%[13], refinancing risks are limited due to the US dollar's global reserve currency status. Underscoring the ability to finance almost exclusively using the US dollar, only once, during the 1980s, did the US finance itself in foreign currency, when it borrowed in Japanese yen[14].

External economic risk

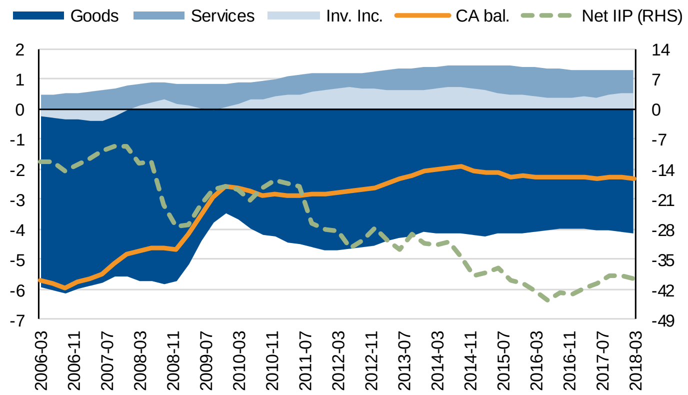
Current account vulnerability

Sustained current account deficits and negative international investment position

The US generates a persistent current account deficit that represents a risk to the US external position. While the current account deficit has stabilised at around -2% of GDP, going forward, Scope expects a slight increase in the deficit as a result of higher economic growth and solid disposable income growth in the short term, boosted by expansionary fiscal policies. However, Scope notes positively that the composition of the current account balance has changed markedly, particularly due to a significantly improved energy trade balance. Specifically, the US trade balance for petroleum-related goods has improved from a deficit of around 4% of GDP in 2005 to a deficit of just below 1% in Q2 2018. This reflects the US own production and petroleum exports coupled with a reduction in imports.

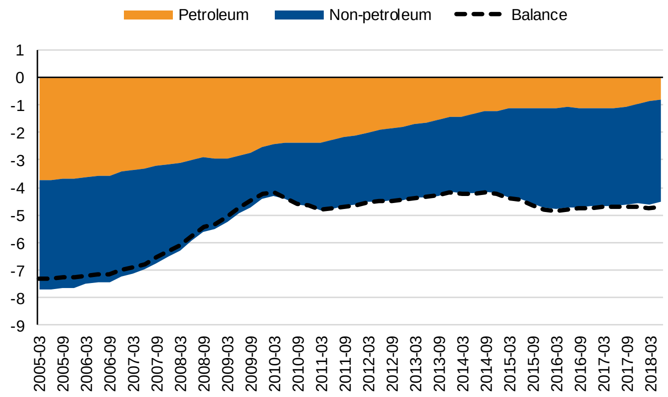
[13] http://ticdata.treasury.gov/Publish/mfhhis01.txt
[14] http://voxeu.org/article/external-debt-us-no-cause-concern-yet

Figure 17: Current account balance (% of GDP)



Source: Bureau of Economic Analysis

Figure 18: Real trade balance (% of GDP)



Source: Census Bureau, calculations Scope Ratings GmbH

As a result of successive current account deficits, the net international investment position (NIIP) deteriorated from -12% of GDP in 2006 to -39% in Q1 2018. A negative NIIP usually implies a negative balance of primary income. However, the international assets held by the United States have strong components of direct investment (32% of total assets) and portfolio equity investment (32%) while external liabilities are overwhelmingly in debt securities (33% of total external liabilities) and loans and deposits (15% of total liabilities) as of Q1 2018.

The large share of relatively high-yielding investments in US international assets on the one hand and the large share of (still) low-yielding liabilities on the other results in the US receiving more in dividends and profits on investments abroad than it has to pay on its lower-yielding external liabilities. For this reason, the net investment income of the United States has been positive over past years.

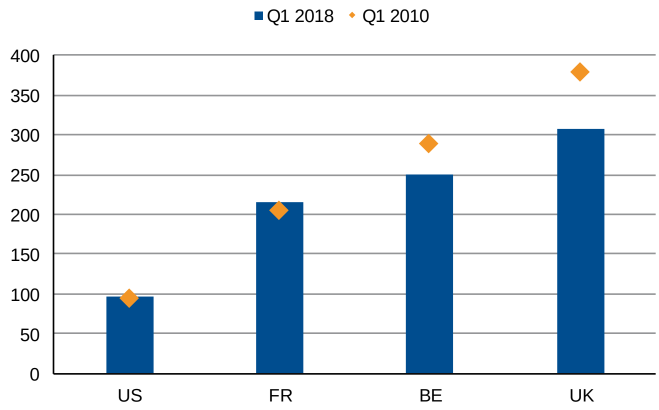
US assets in foreign currency but liabilities in domestic currency

Further, most US foreign assets are in foreign currency, while liabilities are in US dollars. Hence, any appreciation of the US dollar reduces the value of US foreign assets and increases the valuation of its liabilities, negatively impacting the NIIP. Conversely, a depreciation of the US dollar would improve the US NIIP. The recent appreciation of the dollar, up 5% since the beginning of this year on a real trade-weighted basis, should thus contribute negatively to valuation effects on the NIIP going forward.

External debt sustainability

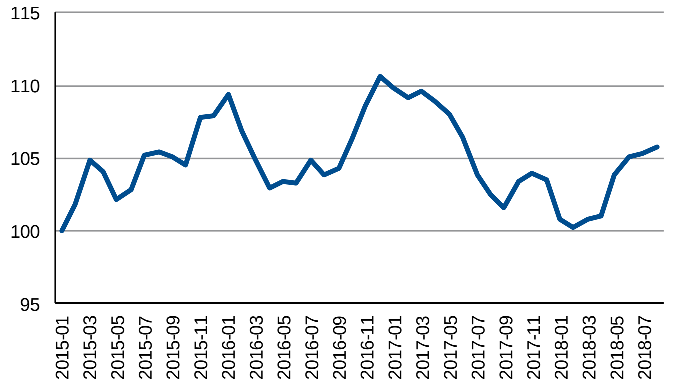
As US foreign liabilities largely consist of debt securities, Scope believes that rating-relevant financial stability risks may emerge due to an unexpected decline in foreign demand for US debt securities. Such a scenario, although not Scope's baseline, could emerge from a failure to re-establish long-run fiscal sustainability. Within this context, both fiscal and external debt sustainability are crucially intertwined and ultimately depend on the global reserve currency status of the US dollar. However, the external debt position of the US compares favourably with that of peers, with the total amount outstanding, at around 90% of GDP, significantly below those of France (215%), Belgium (250%) and the UK (308%). In addition, the US external debt position has been very stable over the past eight years.

Figure 19: External debt (% of GDP)



Source: National sources, calculations Scope Ratings GmbH

Figure 20: US dollar real trade-weighted exchange rate (Jan 2015=100)



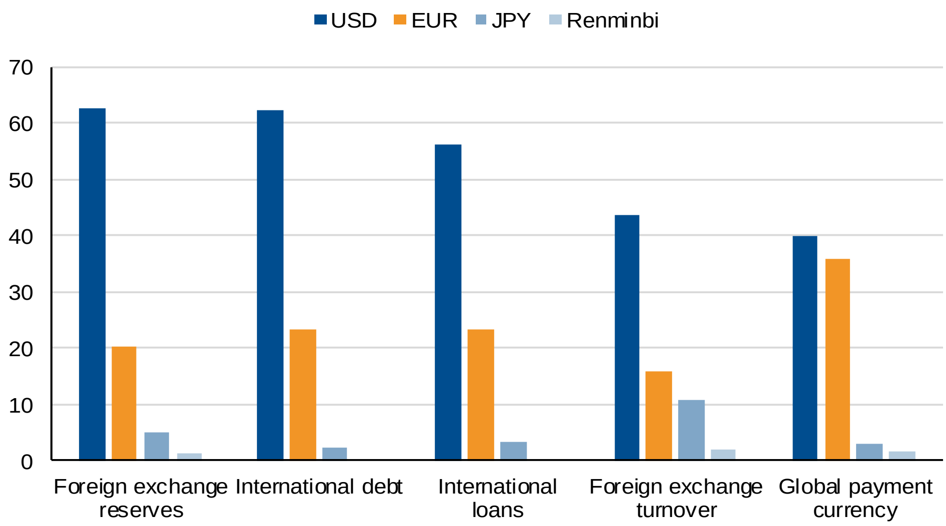
Source: FRB, calculations Scope Ratings GmbH

Vulnerability to short-term external shocks

Unparalleled role of the US dollar as reserve currency

Scope does not believe that the US dollar's reserve currency status will be questioned by investors over the coming years. This status is also because credible alternatives to the US dollar have yet to emerge. In fact, according to the IMF's COFER database, 62.5% of the world's allocated total foreign exchange reserves are allocated in US dollars, followed by the euro (20.4%), yen (4.8%) and pound sterling (4.7%) while currently only 1.4% of allocated reserves are denominated in Chinese renminbi. Similarly, the share of the US dollar remains the highest among several indicators, including outstanding international debt securities (62.2%, followed by the euro with 23.4%), outstanding international loans (56.3%, followed by the euro with 23.2%), over-the-counter foreign-currency derivative contracts (44%, followed by the euro with 16%) and international payments (40%, followed by the euro with 36%)[15].

Figure 21: International finance, use of global currencies, % of total



Source: ECB

[15] https://www.ecb.europa.eu/pub/ire/html/ecb.ire201806.en.html#toc17

Weakening indispensability of US leadership but no credible alternative in sight

In addition, the US dollar has maintained its position as the dominant exchange rate anchor, with seven countries having adopted it as legal tender and another 32 using it as the official monetary anchor. However, the share of countries using the dollar as an exchange rate anchor has been steadily decreasing from 33% in 2008 to 20% in 2017[16]. In Scope's view, given the overwhelming dominance of the US dollar, any shift towards another global reserve currency – or a weighted basket of currencies such as the IMF's special drawing rights – is likely to take place either abruptly, via a major geopolitical shock akin to the one that led to the British pound being substituted by the dollar, or very gradually, owing to either US domestic and foreign policies or market-driven structural changes.

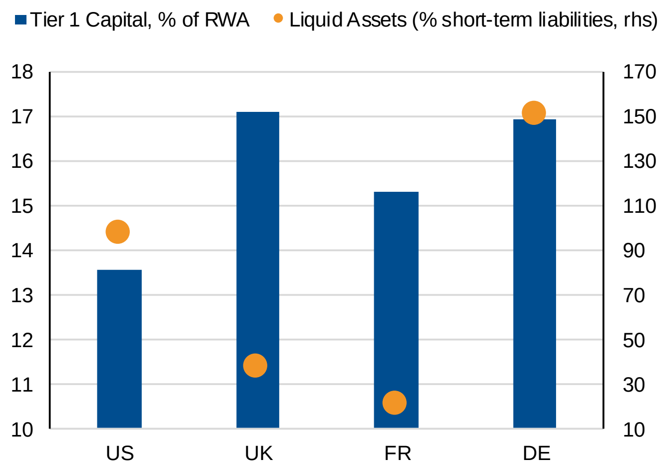
Financial stability risk

Banking sector performance

Adequate capital and liquidity position of banking system

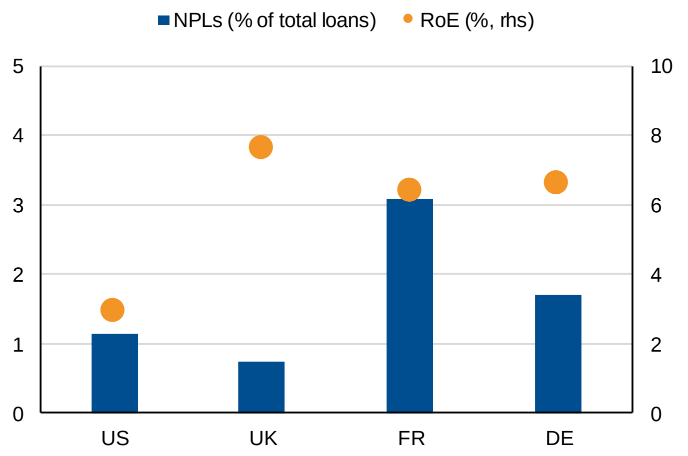
In line with peers, US banks have increased their regulatory Tier 1 capital to risk-weighted assets ratio from about 11% in 2009 to around 13.5% at the end of 2017, reflecting an increase of about USD 420bn, according to IMF data. UK and German banks stand out with CET ratios of around 17%. Scope sees the liquidity of the US banking sector to be adequate, with coverage of short-term liabilities of around 98%, below that in Germany (151%) but significantly above those in the UK (38%) and France (21%). With a falling non-performing loan ratio, currently around 1.1%, asset quality is in line with that of peers and in Scope's view, does not constitute an area of concern. However, profitability, measured as return on equity, remains somewhat low compared to peers at around 3%, despite having improved slightly over the past few years.

Figure 22: Capitalisation and liquidity (2017)



Source: IMF

Figure 23: Asset quality and profitability (2017)



Source: IMF, Calculations Scope Ratings GmbH

Banking sector oversight and governance

Comprehensive regulatory reforms following the Great Financial Crisis

From a regulatory perspective, substantial progress has been made since the GFC in several areas, including enhanced capital and liquidity requirements, better underwriting standards in the housing sector, greater transparency to mitigate counterparty risks, and limits on proprietary trading. The current law covering financial oversight, the Dodd-Frank Act, requires heightened supervisory intensity, with increased emphasis on bank capital planning, stress testing, and corporate governance, including the Fed's Comprehensive Capital Analysis and Review.

[16] IMF Annual Report on Exchange Arrangements and Exchange Restrictions. 2016 and 2017.

Recent reform proposals could risk eroding the effectiveness of the regulatory regime

More recently, the Trump administration aims to simplify financial regulations and appropriately tailor them to the size and systemic risk profile of institutions. Consequently, legislative steps taken include i) raising the total asset threshold to USD 250bn for bank holding companies to be classified as systemic, lessening the compliance costs for medium-sized banks; ii) changes to the calculation of the Supplementary Leverage Ratio, including highly liquid municipal bonds in the definition of High Quality Liquid Assets and exempting banks with total assets under USD 10bn from the Volcker rule; iii) proposals to modify the enhanced supplementary leverage ratio for globally systemic important banks such that the risk-based capital requirement, instead of the leverage ratio, becomes binding for most GSIBs. While some reforms reduce regulatory overlaps and unnecessary compliance costs, Scope notes the heightened risk of potentially important interactions between the various regulatory changes that, according to the IMF, largely move in a procyclical direction, raising medium-term financial stability risks[17].

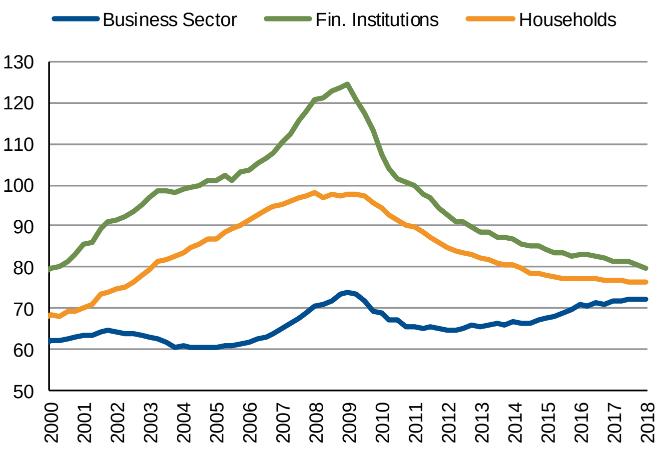
Financial imbalances and financial fragility

Private debt levels do not pose a concern but a rise in student loans could have negative long-term consequences

Following the GFC, financial institutions reduced their outstanding debt relative to GDP significantly, from 125% in Q1 2009 to around 80% in Q1 2018. Households also cut debt levels from about 98% of GDP to 76% over the same period. While corporate debt has increased since 2012, the moderate debt ratio of around 72% of GDP remained largely unchanged. Scope notes, however, that the composition of household debt has changed meaningfully since Q3 2008. Mortgage debt fell by about USD 1.5trn during the crisis before regaining USD 1.2trn since Q2 2013. This overall net decline has been more than offset by significantly higher auto loans (up USD 430bn) and student debt (up USD 800bn). Student debt has consistently increased over the past 15 years to around USD 1.4trn in Q2 2018, with possible long-term consequences for the mortgage market, consumption and potential growth[18].

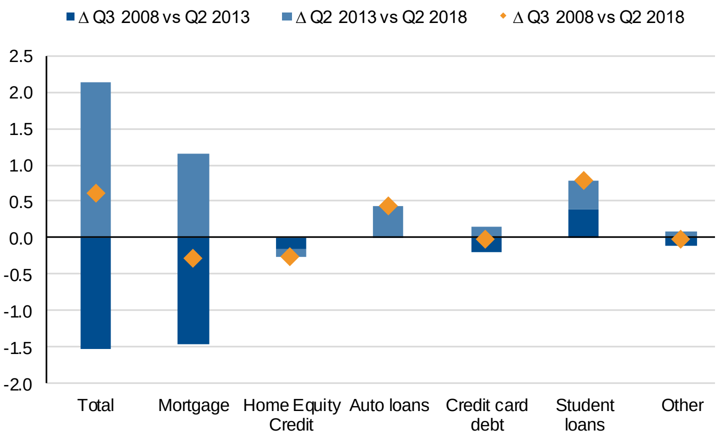
Despite these emerging risks, total debt servicing of households remains below financial-crisis levels, at around 10% of disposable personal income (13% in 2009). In addition, new household borrowing has been driven primarily by households with relatively strong credit scores, with the share of new mortgages with a credit score below 620 constituting 3.7% of the mortgage origination as of Q2 2018, compared to the peak of 15.2% in Q1 2007.

Figure 24: Outstanding private sector debt (% of GDP)



Source: FRB

Figure 25: Household debt changes (USD trn)



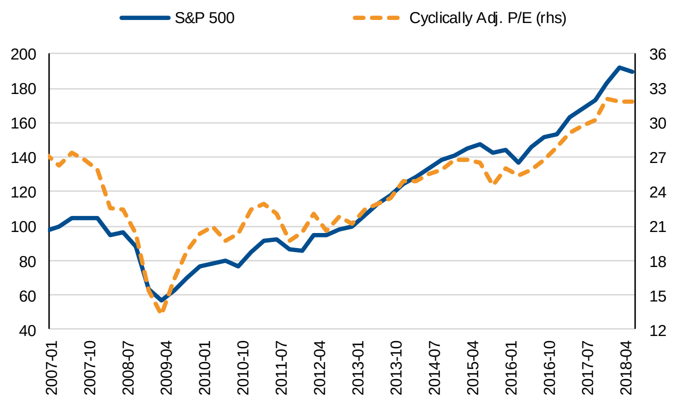
Source: FRBNY, calculations Scope Ratings GmbH

[17] IMF, 2018 Article IV Consultation United States, IMF Country Report No. 18/207.
[18] https://www.nar.realtor/sites/default/files/reports/2017/2017-student-loan-debt-and-housing-09-18-2017.pdf

Elevated equity and recovering housing markets

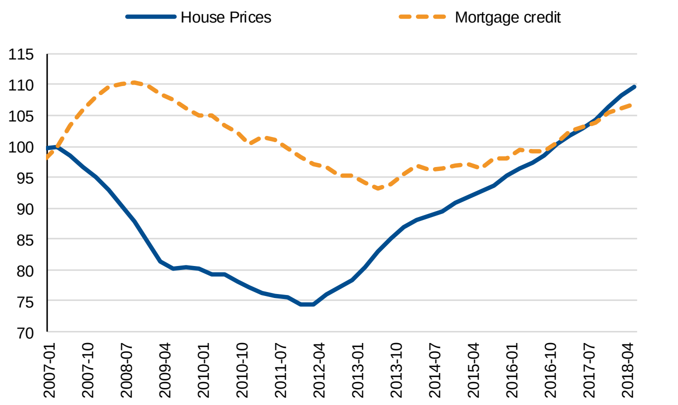
Finally, Scope believes elevated US asset prices constitute a growing source of financial risk. Equity market valuations are at all-time highs and price-earnings ratios are well above long-term averages. Similarly, nominal house price indices are again above pre-crisis peaks and mortgage growth has picked up during the last few quarters. However, Scope notes that the house-price-to-rents ratio, while rising to 1.34 in Q2 2018, remains well below the previous peak of 1.65 in Q2 2006[19]. Still, as interest rates rise, household debt servicing will increase, albeit gradually as most debt is fixed-rate.

Figure 26: Equity market (Q1 2007 =100)



Source: IMF, Robert Shiller

Figure 27: Housing prices & mortgage credit (Q1 2007=100)



Source: FRBNY, calculations Scope Ratings GmbH

Institutional and political risk

Perceived willingness to pay

Strong institutional checks and balances

The US benefits from a strong institutional framework with multiple checks and balances between the executive branch, headed by the President, the Congress (Senate and House of Representatives) and the judiciary (the Supreme Court and lower federal courts) at both the federal and state level. This institutional arrangement has allowed the US to effectively address domestic issues and defend its foreign interests in a timely manner, irrespective of which political party is in the Oval Office or commands a majority in either the Senate or the House. From a credit perspective, Scope sees no reason why the United States would be more or less willing to honour its debt compared to peers.

Recent events and policy decisions

Heightened policy uncertainty

The Trump administration assumed office in January 2017. Despite enjoying a Republican majority in both the House and Senate, President Trump has faced difficulties in implementing his America First policy agenda. As noted previously, the procyclicality of the budget and tax policies will adversely affect the fiscal deficit and debt sustainability. In addition, recent protectionist trade policy proposals are starting to trigger retaliatory responses and are thus already undermining the open, fair and rules-based multilateral trading system.

This administration's fiscal and trade policies have thus the potential to add to global imbalances and increase the range and size of future risks and uncertainties faced by the United States as well as the world economy, in particular, emerging market economies with high levels of US dollar debt and/or significant rollover needs.

Bipartisan collaboration needed to address structural challenges

In addition, Scope believes today's political polarisation adversely affects the institutional

[19] https://fredblog.stlouisfed.org/2018/09/is-the-housing-price-rent-ratio-a-leading-indicator/

framework of the United States. This is despite the system of checks and balances enshrined in the US constitution. Nonetheless, in Scope's assessment, the country's long-term structural challenges, including: i) low productivity levels and labour force participation; ii) a high and rising debt level; and iii) elevated contingent liabilities due to Social Security and healthcare programmes, can only be met via bipartisan cooperation. Scope believes the polarisation of US politics results in costly policy inaction and uncertainty, especially in relation to tackling elevated US government debt and needed structural reforms.

Geopolitical risk

Geopolitical risks likely to drain government resources

From a geopolitical point of view, the US is exposed to several ongoing conflicts that could continue to drain the federal government's resources, including the North Korea crisis, wars against the Taliban in Afghanistan and the Islamic State in Iraq, the civil war in Syria as well as territorial disputes in the South and East China Seas between China and its neighbours, including Japan[20].

Methodology

The methodology applicable for this rating and/or rating outlook 'Public Finance Sovereign Ratings' is available on www.scoperatings.com.

Historical default rates of Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/governance-and-policies/regulatory/esma-registration. Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

A comprehensive clarification of Scope's definition of default, definitions of rating notations can be found in Scope's public credit rating methodologies at www.scoperatings.com.

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months. A rating change is, however, not automatically ensured.

Rating History

Date	Rating Action	Outlook
21 September 2018	Affirmation AA	Stable
29 September 2017	Affirmation AA	Stable
05 May 2017	Under Review	Developing

Source: Scope Ratings GmbH

[20] https://www.cfr.org/interactives/global-conflict-tracker#!/global-conflict-tracker

I Appendix: Factoring of Environment, Social and Governance (ESG)

Scope considers ESG sustainability issues during the rating process as reflected in the sovereign methodology. Governance-related factors are explicitly captured in Scope's assessment of 'Institutional and Political Risk', in which the United States of America scores high in the World Bank's Worldwide Governance Indicators, in line with other highly-rated sovereigns. Qualitative governance-related assessments in Scope's 'recent events and policy decisions' and 'geo-political risk' categories of its QS are assessed as 'weak' compared with the US' sovereign peers.

Socially-related factors are captured in Scope's CVS in the US' very high GDP per capita (USD 59,609 in 2017), low level of unemployment but weak old-age dependency ratio. Qualitative assessments of social factors are reflected in Scope's 'macro-economic stability and sustainability', which Scope assesses the US at 'neutral', balancing a very diversified economy with heighted inequality levels. Finally, environmental factors are considered during the rating process but did not have an impact on this rating action.

II Appendix: CVS and QS results

Sovereign rating scorecards

Scope's Core Variable Scorecard (CVS), which is based on relative rankings of key sovereign credit fundamentals, signals an indicative 'A' ('a') rating range for the United States of America. This indicative rating range can be adjusted by up to three notches on the Qualitative Scorecard (QS) depending on the size of relative credit strengths or weaknesses versus peers based on the analysts' qualitative findings.

The following relative credit strengths have been identified for the United States of America: i) economic policy framework; ii) market access and funding sources; iii) current account vulnerability; iv) external debt sustainability; and v) resilience to short-term external shocks. Relative credit weaknesses include: i) fiscal policy framework; ii) debt sustainability; iii) recent events and policy decisions; iv) geopolitical risk; and v) financial imbalances and financial fragility. In addition, a positive two-notch adjustment is made for the unparalleled status of the US dollar as the world's global reserve currency.

The combined relative credit strengths and weaknesses generate a three-notch adjustment and signal a sovereign rating of AA for the United States of America. A rating committee has discussed and confirmed these results.

Rating overview	
CVS category rating range	a
QS adjustment	AA
Final rating	AA

Rating committee

The main points discussed by the rating committee were: i) economic growth potential and outlook; ii) public finance performance, tax and spending policies; iii) debt sustainability analysis, including contingent liabilities; iv) current account balance developments; v) external debt sustainability; vi) the role of the US dollar; vii) financial imbalances with respect to equity and housing markets; viii) political situation and upcoming mid-term elections of Congress and ix) consideration of peers.

QS results

CVS: Rating indicator	Category weight	QS (Maximum adjustment = 3 notches)	+2 notch	+1 notch	0 notch	-1 notch	-2 notch
Domestic economic risk	35%	Growth potential of the economy	Excellent outlook, strong growth potential	Strong outlook, good growth potential	**Neutral**	Weak outlook, growth potential under trend	Very weak outlook, growth potential wel under trend or negative
Real GDP growth Real GDP volatility GDP per capita Nominal GDP Inflation rate		Economic policy framework	Excellent	**Good**	Neutral	Poor	Inadequate
Unemployment rate Old-age dependency ratio		Macro-economic stability and sustainability	Excellent	Good	**Neutral**	Poor	Inadequate
Public finance risk Primary balance	30%	Fiscal policy framework	Exceptionally strong performance	Strong performance	Neutral	Weak performance	**Problematic performance**
Interest payments		Debt sustainability	Exceptionally strong sustainability	Strong sustainability	Neutral	**Weak sustainability**	Not sustainable
Gross debt Gross financing needs		Market access and funding sources	**Excellent access**	Very good access	Neutral	Poor access	Very weak access
External economic risk External debt	15%	Current account vulnerability	Excellent	**Good**	Neutral	Poor	Inadequate
Currency turnover/reserves		External debt sustainability	**Excellent**	Good	Neutral	Poor	Inadequate
Net international investment position (NIIP) Current account balance		Vulnerability to short-term external shocks	**Excellent resilience**	Good resilience	Neutral	Vulnerable to shock	Strongly vulnerable to shocks
Institutional and political risk	10%	Perceived willingness to pay	Excellent	Good	**Neutral**	Poor	Inadequate
Worldwide Governance Indicators		Recent events and policy decisions	Excellent	Good	Neutral	**Poor**	Inadequate
		Geopolitical risk	Excellent	Good	Neutral	**Poor**	Inadequate
Financial risk Non-performing loans (NPLs)	10%	Banking sector performance	Excellent	Good	**Neutral**	Poor	Inadequate
Tier 1 ratio Credit to GDP gap (bubble)		Banking sector oversight and governance	Excellent	Good	**Neutral**	Poor	Inadequate
Credit to GDP gap (imbalance)		Financial imbalances and financial fragility	Excellent	Good	Neutral	**Poor**	Inadequate
Indicative rating range	**a**						
QS adjustment	**A+**						
Analyst adjustment	**2**						
Final rating	**AA**						

* Implied QS notch adjustment = (QS notch adjustment for domestic economic risk)*0.35 + (QS notch adjustment for public finance risk)*0.30 + (QS notch adjustment for external economic risk)*0.15 + (QS notch adjustment for institutional and political risk)*0.10 + (QS notch adjustment for financial stability risk)*0.10

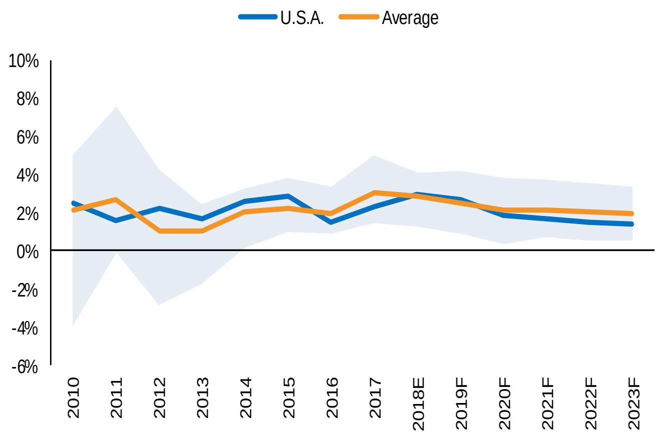
Source: Scope Ratings GmbH

Foreign- versus local-currency ratings

The United States of America had foreign-currency-denominated debt for a brief period during the 1980s only. Scope sees no evidence that the United States of America would differentiate among any of its contractual debt obligations based on currency denomination should foreign-currency-denominated debt be issued again. This is further corroborated by the recent history of sovereign defaults, which does not provide a strong justification for a rating bias in favour of either local- or foreign-currency debt.

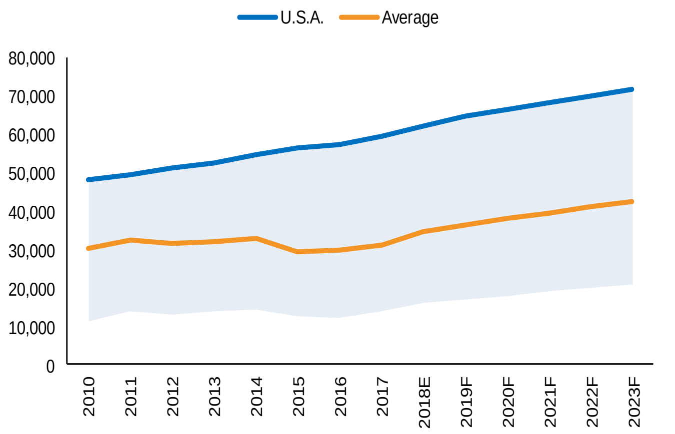
III Appendix: Peer comparison

Figure 28: Real GDP growth



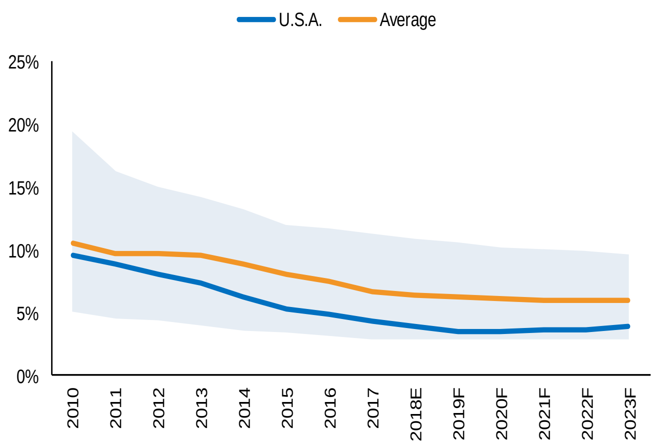
Source: IMF, calculations Scope Ratings GmbH

Figure 29: GDP per capita (USD per person)



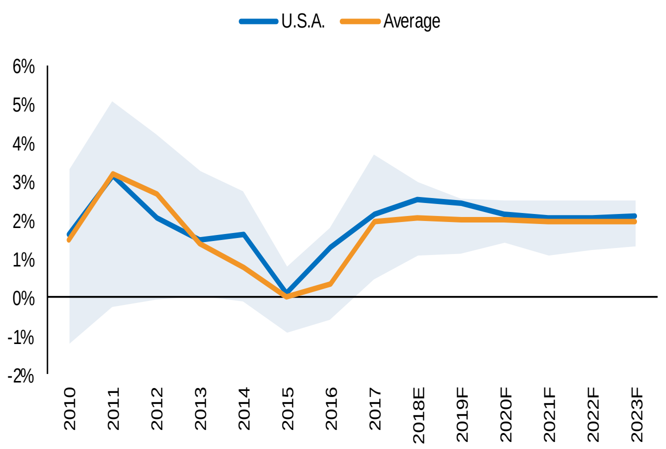
Source: IMF, calculations Scope Ratings GmbH

Figure 30: Unemployment rate, %



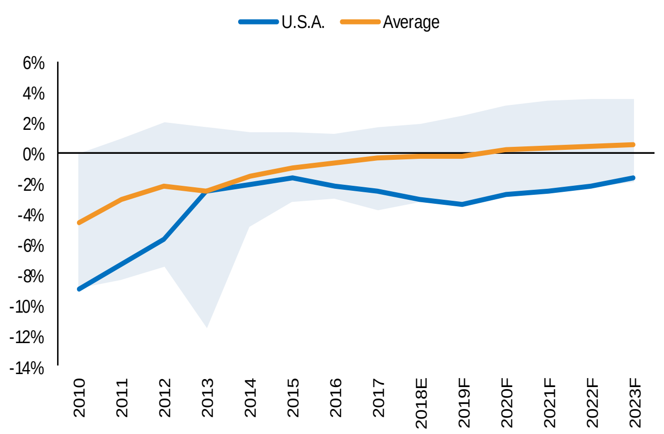
Source: IMF, calculations Scope Ratings GmbH

Figure 31: Headline inflation, %



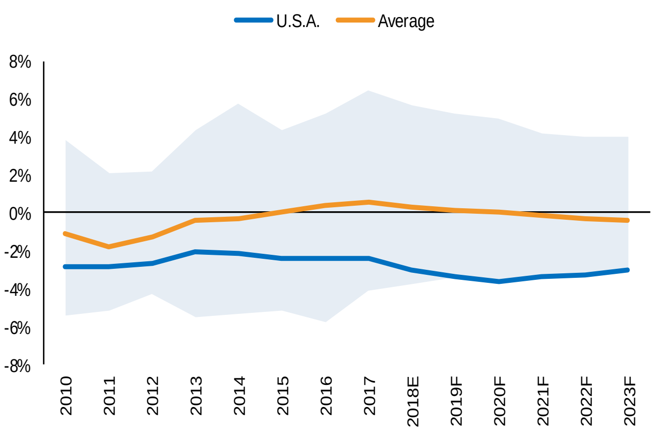
Source: IMF, calculations Scope Ratings GmbH

Figure 32: General government primary balance, % of GDP



Source: IMF, calculations Scope Ratings GmbH

Figure 33: Current account balance, % of GDP



Source: IMF, calculations Scope Ratings GmbH

IV Appendix: Statistical tables

	2013	2014	2015	2016	2017	2018E	2019F
Economic performance							
Nominal GDP (USD bn)	16,691.5	17,427.6	18,120.7	18,624.5	19,390.6	20,412.9	21,410.2
Population ('000s)	316,504.0	318,853.0	321,224.0	323,572.0	325,886.0	328,434.0	331,048.0
GDP per capita PPP (USD)	52,782.1	54,696.7	56,443.8	57,588.5	59,531.7	-	-
GDP per capita (USD)	52,737.1	54,657.1	56,411.4	57,559.0	59,501.1	62,152.1	64,674.1
Real GDP, % change	1.7	2.6	2.9	1.5	2.3	2.9	2.7
GDP growth volatility (10-year rolling SD)	1.9	1.8	1.7	1.7	1.7	1.7	0.5
CPI, % change	1.5	1.6	0.1	1.3	2.1	2.5	2.4
Unemployment rate (%)	7.4	6.2	5.3	4.9	4.4	3.9	3.5
Investment (% of GDP)	19.8	20.1	20.4	19.7	19.8	20.2	20.8
Gross national savings (% of GDP)	18.3	19.3	19.4	18.0	17.5	17.2	17.4
Public finances							
Net lending/borrowing (% of GDP)	-4.4	-4.0	-3.5	-4.2	-4.6	-5.3	-5.9
Primary net lending/borrowing (% of GDP)	-2.4	-2.0	-1.6	-2.2	-2.5	-3.0	-3.4
Revenue (% of GDP)	31.6	31.5	31.6	31.2	31.1	30.7	30.4
Expenditure (% of GDP)	36.0	35.5	35.2	35.4	35.7	36.0	36.3
Net interest payments (% of GDP)	2.0	2.0	1.9	2.0	2.1	2.3	2.5
Net interest payments (% of revenue)	6.3	6.4	5.9	6.3	6.7	7.4	8.2
Gross debt (% of GDP)	105.4	105.1	105.3	107.2	107.8	108.0	109.4
Net debt (% of GDP)	81.3	80.8	80.5	81.5	82.3	81.4	82.7
Gross debt (% of revenue)	333.4	333.8	332.8	343.2	346.7	351.6	360.0
External vulnerability							
Gross external debt (% of GDP)	98.4	98.5	96.4	98.0	97.6	-	-
Net external debt (% of GDP)	-	-	-	-	-	-	-
Current-account balance (% of GDP)	-2.1	-2.1	-2.4	-2.4	-2.4	-3.0	-3.4
Trade balance (% of GDP)	-4.2	-4.3	-4.2	-4.0	-4.1	-	-
Net direct investment (% of GDP)	0.6	0.8	-1.1	-1.0	0.1	-	-
Official forex reserves (EOP, USD mn)	47,599.0	41,944.0	39,242.0	39,023.0	42,775.0	-	-
REER, % change	0.6	2.6	13.3	4.1	-0.8	-	-
Nominal exchange rate (AVG, USD/EUR)	1.3	1.3	1.1	1.1	1.1	-	-
Financial stability							
Non-performing loans (% of total loans)	2.5	1.9	1.5	1.3	1.1	-	-
Tier 1 ratio (%)	12.8	13.1	13.1	13.2	13.5	-	-
Private debt (% of GDP)	123.9	122.6	121.6	122.9	123.7	-	-
Credit-to-GDP gap (%)	-14.8	-13.4	-11.6	-8.3	-6.3	-	-

Source: IMF, Bureau of Economic Analysis, Federal Reserve Bank, European Commission, World Bank, BIS, Scope Ratings GmbH

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