Sovereign Credit Rating Report of the United States of America

Dagong Global Credit Rating Group

January 16, 2018

DAGONG

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Sovereign Credit Ratings

Local-currency/Outlook	BBB+/Negative
Foreign-currency/Outlook	BBB+/Negative
Date	January 16, 2018

Rating Action

Dagong has decided to downgrade both the local and foreign currency sovereign credit ratings of the United States of America (hereinafter referred to as “the United States” or “the US”) from A- to BBB+, and each with a negative outlook. The perennial negative impact of the superstructure on the economic base has continued to deteriorate the debt repayment sources of the federal government, and this trend will be further exacerbated by the government’s massive tax cuts. The increasing reliance on the debt-driven mode of economic development will continue to erode the solvency of the federal government.

- The perennial negative impact of the political ecology and credit ecology on the economic base will lead to a continued deterioration of the federal government’s debt repayment sources, and this status will keep lasting for a long time.

- The large-scale tax cuts directly reduce the federal government’s debt repayment sources and further weaken the base of the government’s solvency.

- Using the rising debt to make up for the fiscal gap brought by the tax cuts will inevitably increase the credit risk of the federal government.
- The US debt-driven mode of economic development will lead to continuous weakening of the federal government solvency.

Outlook

The debt-driven mode of economic development as determined by the US political system, national strategy and economic base will not change. Since the negative impact of tax cuts on the sources of repayment of the federal government will become even more significant and the government's fiscal position will continue to deteriorate, the debt burden will keep piling up in a higher level. Furthermore, constrained by interest rates and debt cap, borrowing new debt will be unsustainable, so the government solvency will continue to deteriorate. Therefore, Dagong has decided to maintain a negative outlook of both local and foreign currency sovereign credit ratings of the United States in the future.

Key indicators

Key Rating Indicators (%)						
	2014	2015	2016	2017e	2018f	2019f
GDP（bn US$）	17427.6	18120.7	18624.5	19362.1	20200.0	21024.4
GDP Growth Rate (real)	2.6	2.9	1.5	2.2	2.3	2.1
GDP per capita (US$)	54668.1	56436.7	57607.6	59495.3	61687.4	63809.6
Inflation Rate	1.6	0.1	1.3	2.1	2.0	2.2
Unemployment Rate	6.2	5.3	4.9	4.4	4.1	4.2
Credit to Private Sector/GDP	194.6	189.1	192.7	193.0	192.4	192.6
Credit to Private Sector Growth Rate	5.5	1.0	4.7	4.1	4.0	4.2
Federal government Primary Fiscal Balance /GDP	-2.0	-1.6	-1.6	-1.9	-2.3	-2.5
Federal government Fiscal Balance /GDP	-4.0	-3.5	-3.2	-3.5	-3.9	-4.1
Federal government Interest Payment /fiscal revenue	11.6	10.5	8.7	9.4	9.9	10.4
Federal government gross debt /fiscal revenue	605.9	586.6	598.9	620.8	681.9	715.9
Federal government Foreign Debt /GDP	35.7	34.8	33.4	33.7	33.7	33.7
Current Account Surplus/GDP	-2.1	-2.4	-2.4	-2.4	-2.6	-2.7
Gross External Debt/GDP	99.0	97.7	96.8	99.7	101.5	103.2
Short-term External Debt/GDP	31.3	28.8	27.9	28.5	28.9	29.2
International Reserves/GDP	2.5	2.1	2.2	2.2	2.4	2.5
Gross External Financing Needs/GDP	39.7	40.6	40.0	40.0	40.3	40.7
Net International Investment Position /GDP	-40.1	-41.4	-44.7	-44.5	-45.7	-46.9
Official Exchange Rate (SRD per US$, yearly average)	1.0	1.0	1.0	1.0	1.0	1.0

Sources: Federal Reserve, BEA, CBO, IMF, World Bank, Dagong.

e: estimate f: forecast

Main Reasons of downgrading the sovereign credit rating of the Unites States:

The federal government solvency has become abnormal, as caused by the perennial negative impact on the economy by the political ecology formed by the defected political system and the distorted credit ecology that deviates from the law of the of the residual value distribution. The tax cuts act formally implemented in 2018 will directly reduce the federal government's fiscal revenue, and the resort to increasing the debt income to make up for the fiscal gap brought by tax cuts will surely aggravate the imbalance between sources of repayment and liabilities, therefore continue to weaken the government's solvency.

The perennial negative impact of US political and credit ecology on its economy may lead to a lasting process of deterioration in the debt repayment source of the federal government.

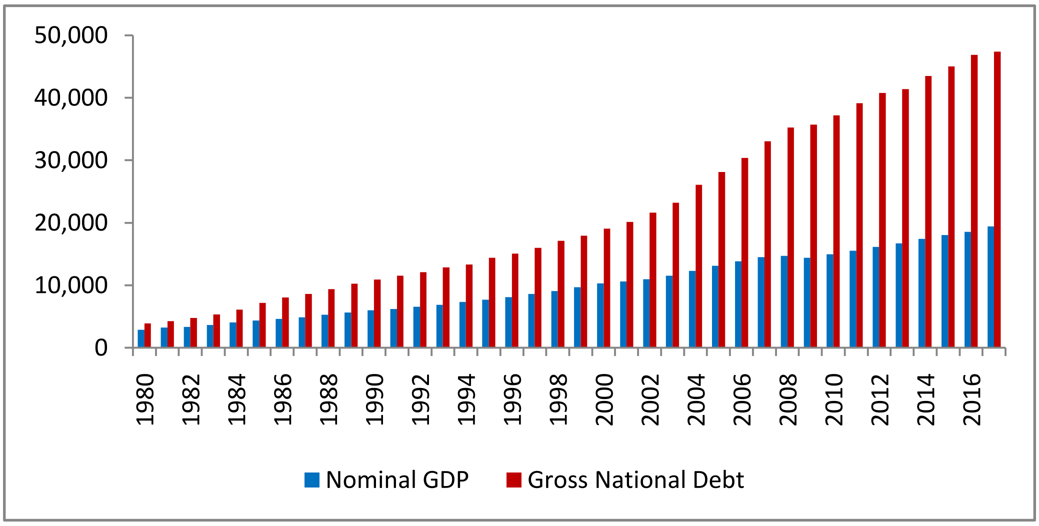
1. Deficiencies in the current US political ecology make it difficult for the efficient administration of the federal government. As the US national economy derails from the right track, it in turn threatens the federal government's debt repayment capability.

The working essence of the US political system is characteristic of the endless factional rivalries for supreme state power. When the political conflict, as featured by the opposition for the sake of opposition rules the operation of the state machinery, many policy proposals, amid the endless quarrels and disputes, are either blocked or passed in a watered-down version, showing a continuous decline in government efficiency, trustworthiness, and competence. When pledges of favor to certain interest groups replace the national programs based on broad research and insight, the government harms its own leadership. When factions in power can backtrack almost at will from their predecessors' domestic and foreign commitments, the nation is inevitably harmed for a lack of consistent goals and images. When divisive politics resulted in polarization in thinking, social networks and actions, they leave a deep and lasting influence on the environment needed by healthy socio-economic development. When factional interests are prioritized, they inevitably bring forth errors in the policy level. At the same time, when government is locked in the battles against various opposition forces, one can hardly expect it focus on its public duties.

Development attests a government's competence. Since the country became a net debtor in 1985, the US has never shown a true capacity to pay back all its national expenditures. It has always been making less and spending more. Such a contradiction between production and consumption, as a main feature of US capitalism, has led it to adopt the model where growth is constantly driven by credit expansion and currency issuance. In this model, when the capability of consumption is enlarged, a future possibility of wealth creation is taken as a source of debt repayment, and when consumption is to be further enlarged, a possibility of wealth creation projected into an even more distant future is taken as a source of debt repayment. Such a growth model runs counter to the basic, constant law governing production and consumption, and has resulted in the US economy's heavy debt financing. From 1985 to 2015, when the US GDP increased 315 times, its total debt increased by 529 times by contrast (Figure1), betraying the fact that the economy has become an enormous debt load with little internal debt repayment capability; its main operational mechanism being to export its debt to other countries by taking advantage of its status as the world's financial center and of US dollar as an international reserve currency. The financial crisis in 2008 was an explosion of such a general imbalance between the source of national debt repayment and amount of national debt in the US. However, the US government still does not seem to realize that the root cause of the crisis is the contradiction between its global hegemonic strategy and its counter-productive economic model. Instead, it has been continuing to seek credit through direct currency issuance. Such unbridled credit expansion, not backed up by reliable source of debt repayment, may push the US towards the brink of yet another crisis.

Now in the US, debts that can never be repaid make up economic foundation, its superstructure cannot have any choice but continue to rely on such a foundation and make hardly any change, as if to serve as a "track walker" on a wrong track, one that departs from logic. The Trump administration's performance only confirms this basic judgment about the United States.

Figure 1 Gross National Debt and Nominal GDP(bn USD)



Source: BIS, IMF, Dagong

2. Lopsided credit ecology that violates the law of residual value distribution leads to abnormal solvency of the US government.

The US credit ecology has been twisted by capital's desire for profits. The credit ecology supplies credit to the social reproduction system. It does not create value, and its profit mainly comes from the distribution of the residual value created by the real economy. The law of residual value distribution should be that the interest expense of the real economy is equal to the profit of credit supply sectors. The US statistics show that in 2007, interest of credit supply sectors harvested from credit supply was $551.97 billion, and its interest from internal transactions within credit supply sector was $263.42 billion (The residual value distributed through equity trading from the overseas real economic sector has been subtracted). The former interest accounts for 67.7% of credit supply sector's aggregated interest in that year, while the ratio was 57.2% in 2016. These data reveal that the US credit supply sector has completely deviated from the law of residual value distribution, and has become a debt economy sector that creates price differences of capital and profits through continuous expansion of the chain of credit transactions by designing capital products and trading structures. This virtual value-added model of capital self-circulation outside social reproduction system is the engine of the US debt bubble.

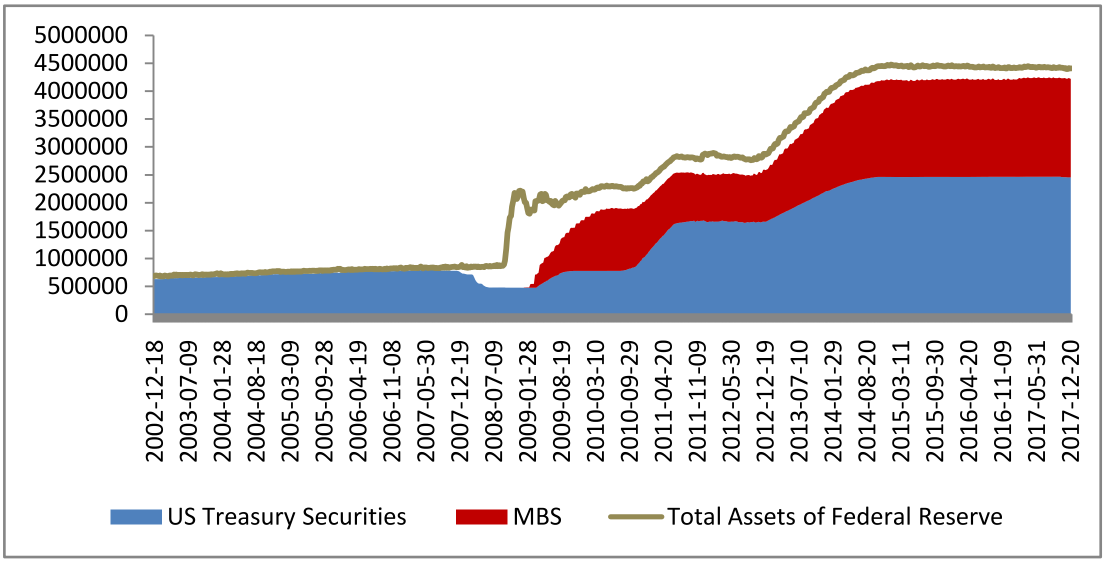
Lopsided credit ecology leads to the abnormal solvency of the federal government. Research shows that fiscal revenue is the government's fundamental source of debt repayment. In 2006, the federal government had fiscal revenue of $4.37 trillion and gross debt of $8.89 trillion, so the fiscal revenue-debt ratio was1:2.05. In

2016, the fiscal revenue was $5.73 trillion and its debt reached $19.98 trillion, so the fiscal-to-debt ratio was1:3.47. From 2006 to 2016, fiscal revenue grew by $1.36 trillion with a growth rate of 31.1%. The growth in debt was $11.09 trillion, an increase of 124.7%. During the 10 years, despite the fact that increase of US fiscal revenue was significantly lower than that of debt, the federal government continued to break debt ceiling for 11 consecutive times with a net increase in liabilities of $14.78 trillion. The federal government has long failed to develop its actual debt repayment ability. Instead, it has been rolling over its debts.

The solvency of the federal government comes from its currency issuance right. The distorted credit ecology that violates the law of value has been providing living space for the federal government to use its ever-blooming debt bubble to stay solvent. Since 2008, the government's virtual solvency has come to the brink of collapse. In order to prevent the destruction to the US credit ecology and federal government repayment ability, the federal government openly started the mechanism of printing dollars to repay debts in the name of quantitative easing (Figure 2). In fact, the market has never judged the federal government solvency by using the coverage of revenue to debt. The only reason to support the purchase of federal government bonds is its right to issue dollar as the international reserve currency. The distorted credit ecology, marked by the virtual solvency, has made the federal government's abnormal solvency become its derivative product.

The general environment of the US political ecology and credit ecology fundamentally determines the general trend of declining solvency ability of the federal government.

Figure 2 Total Assets of Federal Reserve（mil. USD）



Source: Federal Reserve, Dagong

Large-scale tax cuts directly reduce the federal government's sources of debt repayment, which further weakens the government's debt repayment capability.

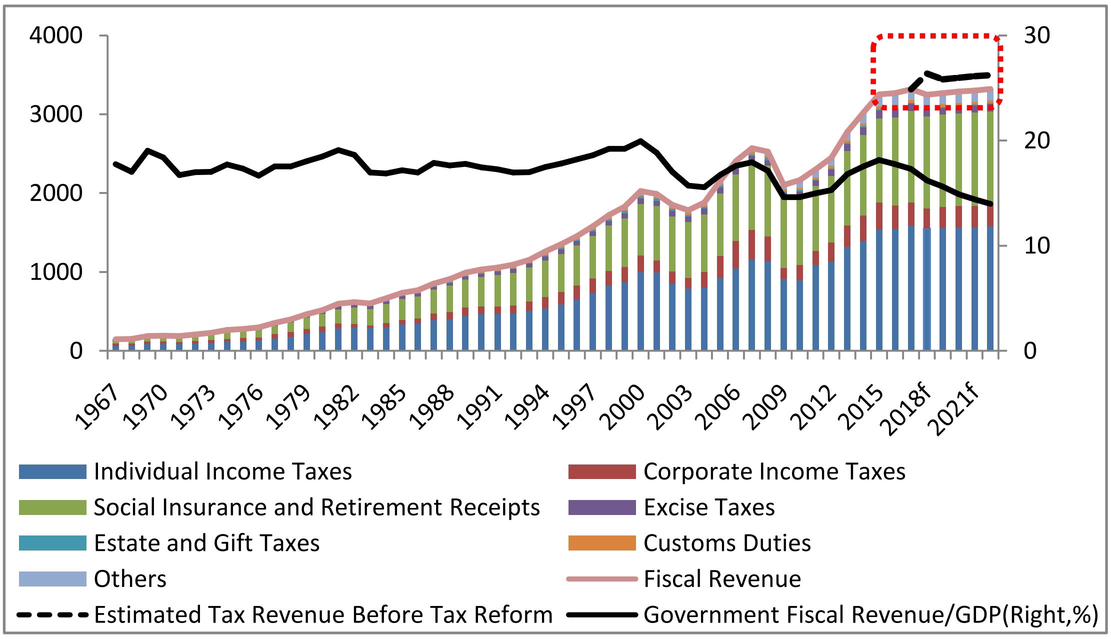
1. Trump's tax cuts will directly reduce the federal government's revenue and adversely affect the government's fundamental source of debt repayment.

The tax cuts policy directly undermines the base of the government's sources of repayment. Personal income tax and corporate income tax are the first and third largest source of federal income respectively in the United States. These two sources account for 56.9% of the fiscal revenue of U.S. The tax reform act[1] which focuses on lowering the tax rate of personal tax, large corporate income tax and enterprise overseas profits

[1] The tax reform act provides that personal income tax rate is classified into seven levels: 10%, 12%, 22%, 24%, 32%, 35% and 37%. The tax reform act will cut large corporate income tax from 35% to 21%. The tax reform act will cut enterprise overseas profits return income tax from 35% to about 8-15.5%.

return income tax can lead to a continuous sharp reduction in the federal government's fiscal revenue. The personal income tax is estimated to be reduced by $114.12 billion while the corporate income, by $147.05 billion to FY2022. The ratio of federal government's revenue to the GDP can be reduced by 3.3% to the degree of 14.0% compared to FY2017 (Figure 3).

Figure 3 Fiscal Revenue Structure of Federal Government (bn USD)

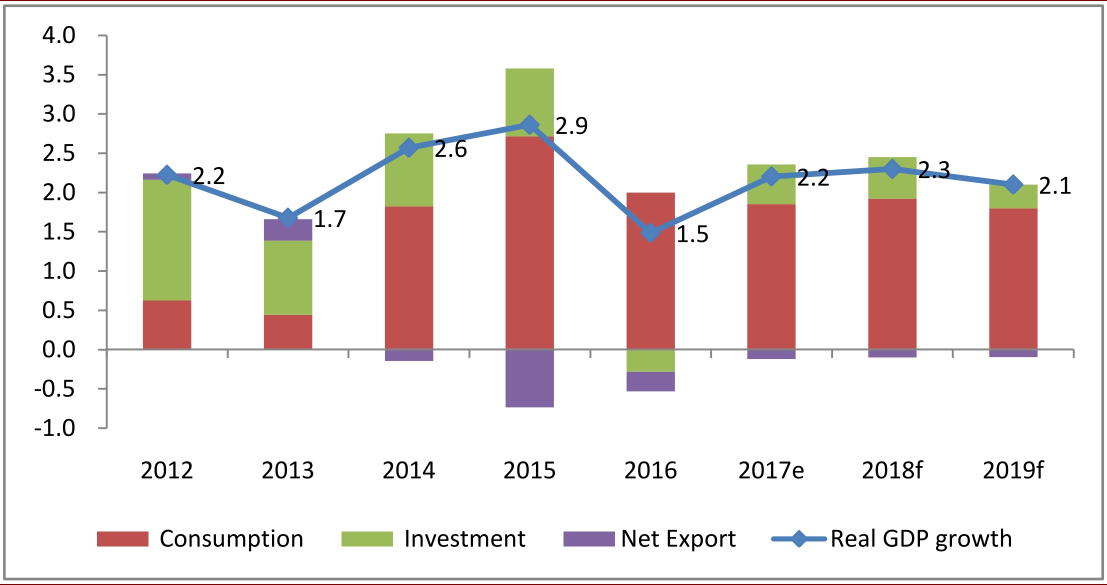


Source: CBO, Dagong
e: estimate f: forecast

2. Fiscal stimulus cannot root the cause of US debt economy. The source of government debt repayment becomes water without a source, which in turn further weakens the fundamental of debt repayment ability.

The tax cuts policy did not attack the root cause of the unsustainable debt-driven economy of the US, so economy that lacks momentum for growth makes the debt repayment ability like the water without a source. The US debt economy is not sustainable because it is deviated from the law of value. Furthermore, the tax cuts act does not touch the fundamental conflicts in the US debt economy, and cannot boost the economy substantially. According to Dagong's projection, the real US economic growth rate will be 2.3% in 2018. The economic growth rate will come down to 2.1% in 2019, while the mid-term and long-term prediction will drop to 1.7%. It is because that the interest rate rise leads to higher interest rate and gradually offset the tax cut short-term effect (Figure 4). The diminishing economy will inevitably keep government revenue under pressure.

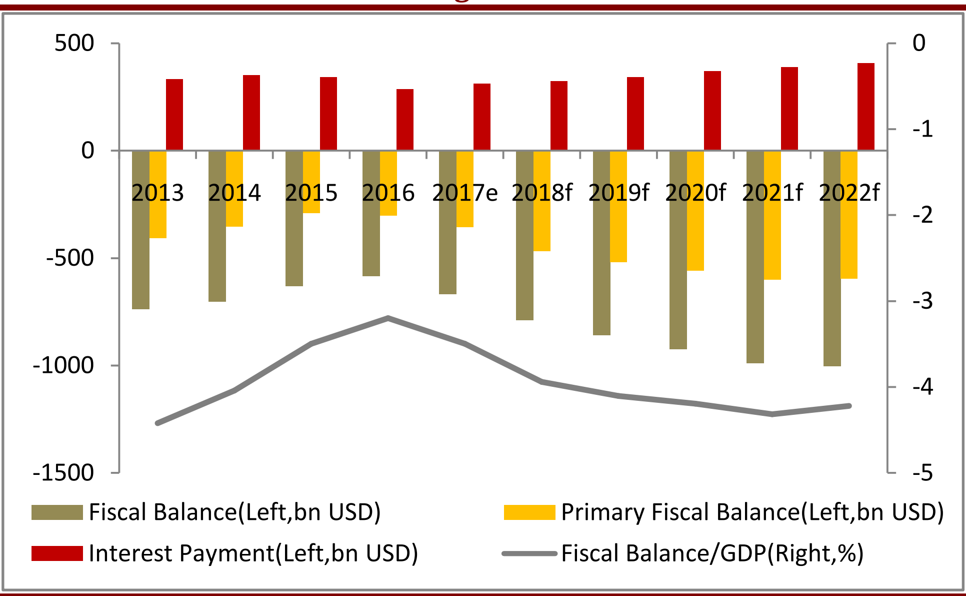
Figure 4 Real GDP Growth (%)



Source: BEA, Dagong
e: estimate f: forecast

The base of debt repayment sources is further weakened by the increasing government fiscal deficit led by the sharply decreasing fiscal revenue and difficulties in reducing fiscal expenditure. The rising demand for national defense, infrastructure and rigid spending has made it hard for the federal government to reduce its expenditure effectively. According to the budget in FY2018, the Trump administration will ease the pressure of social transfer payments by adopting regular federal government spending restrictions on low-income groups and setting a federal government cap on payments for public medical services. However, the non-national defense reduction of $54 billion will be used to increase defense spending, which will greatly reduce the effect of the reduction in expenditure. Meanwhile, Trump's plan of constructing infrastructure by both government and private firms can increase the pressure of financial allocation. The rigid spending including pension and health care expenditures occupy about 47.8%. The ageing population will further exacerbate the burden of social transfers. As a result, the mid-term target of federal government to reduce the fiscal expenditure cannot be realized. It is projected that the primary fiscal deficit rate of the federal government will be 2.3% and 2.5%, and the fiscal deficit will rise to 3.9% and 4.1% in FY2018 and FY2019 (Figure 5). Besides, the rising cost of financing brought by the Fed's rate hike and balance sheet unwind will increase the interest payment of the government, so the government's interest payments will be as high as 9.9% and 10.4% of the fiscal revenue respectively.

Figure 5 Fiscal Balance of the Federal government



Source: CBO, Federal Reserve, IMF, Dagong

e: estimate f: forecast

Using the rising debt revenues to make up for the fiscal gap brought by tax cuts will incur increased credibility risks facing federal government.

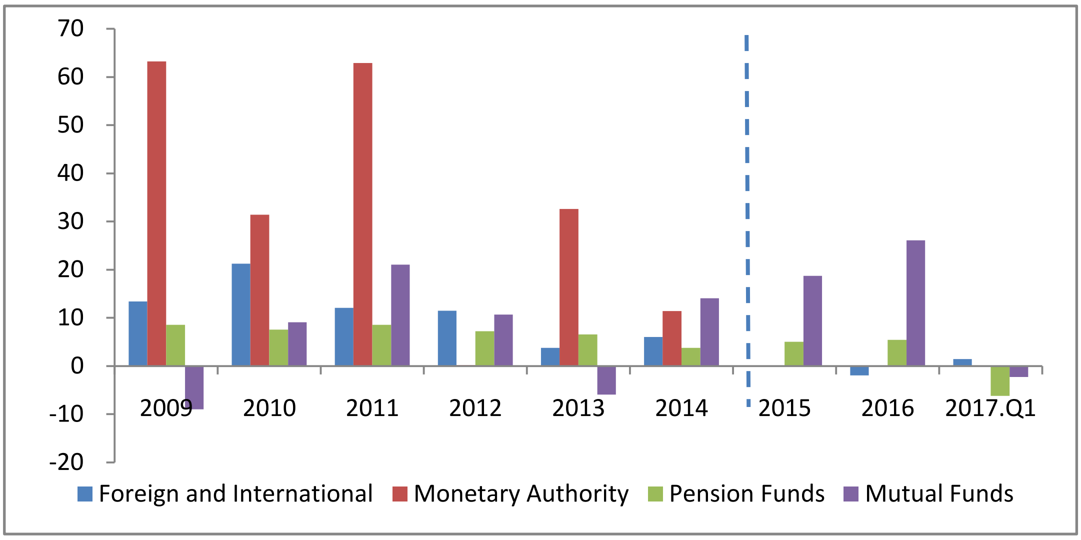
1. The government is trapped into the debt rollover.

As the government fails to build its wealth creation ability to make up the financial gap, the government has to rely heavily on debt monetization to maintain the balance between repayment sources and debt in the future. The financial gap resulting from the massive tax cuts and the pressure to repay maturing debts raise the financing needs of US government. It is projected that in FY2018 and FY2019, government financing needs will account for as much as 121.8% and 109.3% of financial revenues. Meanwhile, the monetary policy is gradually tightened, which will further push up government financing costs and increase the difficulties in rolling government debt. As a result, government debt is close to the red line and face the possibility of raising the debt ceiling while it is unsustainable to take on new debt to repay the old debt.

2. The government will continue printing money to cover the severe imbalance between repayment sources and existing debt.

Money issuance is the last resort for debtors. Using money issuance to keep seemingly solvent is to cover the mismatch between repayment sources and debts. The Federal Reserve's balance sheet reduction and the increasing financing needs will push up the future treasury supply. However, foreign investors tend to reduce their holdings of the US treasures while the domestic mutual funds face limited space of increased holding (Figure 6). All will lead to less demand for national debt. The future imbalance between government treasury supply and demand might cause the Federal Reserve to return to the quantitative easing again, to increase the purchase of the treasuries so as to cover government debt.

Figure 6 Changes of the Federal Government Debt Holder Structure（%）



Source: SIFMA , Dagong

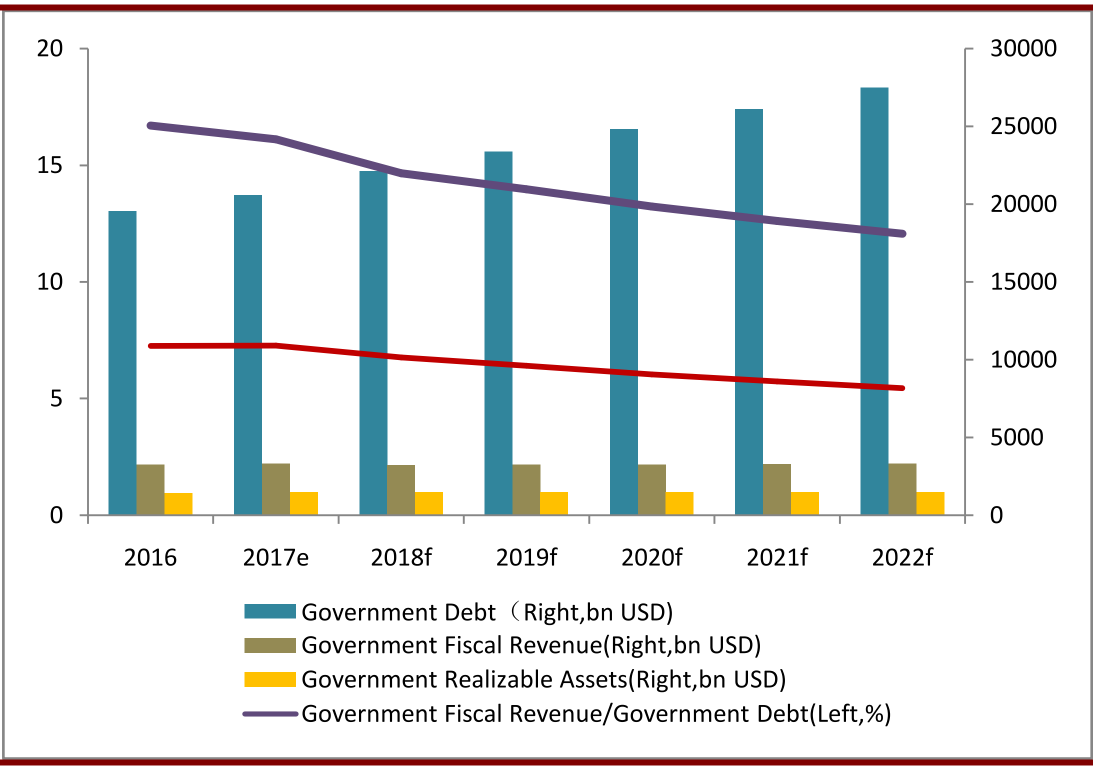
The debt-driven model of economic development will continue to deteriorate the federal government solvency.

The debt-driven economic model will exacerbate the imbalance between debt repayment sources and liabilities of the federal government. The US economy is a credit economy based on a highly socialized credit relationship where the nation’s consumption ability relies mainly on borrowing. Therefore, the balance of production and consumption required by the law of social reproduction can be reflected by two most important national economic ratios, namely the ratio between wealth creation and consumption, and the ratio between sources of debt repayment and liabilities. In 2016, the ratio between wealth creation and consumption was 1:2.5, and the ratio between sources of debt repayment and liabilities was 1:1.4. The two sets of data reveal that the wealth creation in the US is far from meeting its consumption, and the sources of debt repayment are far from supporting its debts. Under such a serious imbalance in the national economy, the crisis-ridden real economy has no room for growth in revenue contribution to the government.

The federal government debt under the debt-driven economic model will keep snowballing to an even higher level. Thus the solvency of the federal government, which constantly breaks the debt ceiling, will inevitably deteriorate continuously. The huge pressure of financial needs will continue to push up the federal government's debt, and the rising debt and declining fiscal revenue will further exacerbate the imbalance between sources of repayment and liabilities of the federal government. According to Dagong's projections on the federal government's debt and fiscal revenue, the coverage of total debt by the federal government's fiscal revenue will keep declining year by year from 2018 to 2022. By 2022, the government revenue will only cover 12.1% of the total government debt, a 4.0 percentage points' decline from that of 2017 (Figure 7). Furthermore, in 2017, the realizable assets (adjusted by the realizable coefficient) of the federal government, which are constituted mainly by loans and tax receivables, covered only 7.3% of the total government debt. The liquidity will be affected by the uncertainties of loan recovery and tax payment and thus will further deteriorate. Since the realizable assets of the federal government are too limited to cover the huge debts, the US government in fact has completely lost its debt repayment ability.

It is likely that the virtual solvency of the US federal government would become the detonator of the next financial crisis. The serious imbalance between the sources of debt repayment and liabilities makes the federal government the weakest link in the US debt chain. Taking the advantage of its right to print money, the US strives to maintain its solvency by purchasing treasuries with newly-printed dollars, which, in itself, is a debt crisis. The market's reversing recognition of the value of US Treasury bonds and US dollar will be a powerful force in destroying the fragile debt chain of the US federal government.

Figure 7 Federal Government Fiscal Revenue and Realizable Asset to Gross Government Debt



Source: CBO, Dagong

e: estimate f: forecast

Rating History

Date	Local Currency Ratings/Outlook	Foreign Currency Ratings/Outlook
May 15, 2017	A-/Stable	A-/ Stable
Jan 14, 2016	A-/ Stable	A-/ Stable
Dec 12, 2014	A-/ Stable	A-/ Stable
Oct 17, 2013	A-/Negative	A-/Negative
Dec 25, 2012	A/ Negative observation	A/ Negative observation
Aug 3, 2011	A/ Negative	A/ Negative
July 14, 2011	A+/ Negative observation	A+/ Negative observation
Nov 9, 2010	A+/Negative	A+/ Negative
July 11, 2010	AA/Negative	AA/ Negative

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