TREASURY EXECUTIVE MINUTE

Minute No.

5 August 2011

Deputy Prime Minister and Treasurer

cc: Secretary to the Treasury
Executive Director, Macroeconomic Group

UNITED STATES: DEBT CEILING COMPROMISE AND ECONOMIC MALAISE

Timing: At your convenience.

Issue:

- That you note the following briefing.

Noted Signature: .... …../…../2011

KEY POINTS

Section 22

Section 22

Section 22

Impact of a ratings downgrade highly uncertain

- Standard & Poor's (S&P) may still downgrade the US AAA rating on the basis that long-term fiscal sustainability may not be achieved, while both Moody's has its US rating on negative watch, pending further progress in fiscal consolidation.
- A downgrade may prompt some initial market turbulence and would be a further damper on US consumer and business confidence. It may also have flow on impacts for other AAA assets (including other countries' sovereign bonds) given that US Treasuryies would likely maintain their role at the centre of the global financial system.
- Specific impacts in financial markets are hard to predict, given the unprecedented nature of any downgrade on the US sovereign. However, the fact that S&P have clearly telegraphed their intention should give markets time to adjust, limiting short term fallout from a 'surprise' downgrade.
- With US Government debt accounting for 60 per cent of AAA government debt, and having unrivalled liquidity, most large scale asset managers, including other sovereigns, simply lack feasible alternatives.
- If necessary, asset managers are likely to adjust internal mandates to allow continued holding of US Treasuries, while diversifying at the margin. Problems are most likely where AAA status is 'hard-wired' into regulatory requirements, removing the discretion of fund managers.
- According to APRA, a downgrade in US debt would only have a minor direct impact on Australian banks, as domestic banks currently hold capital in excess of requirements.
  - Additionally, a single-notch downgrade of US debt (for example, to AA) would, on its own, be unlikely to result in enough of a loss of confidence in credit markets to negatively impact access for Australian banks.

- However, ongoing concern over the capacity of the US to implement a credible plan to curtail its government debt could lead to further downgrades.
- The failure of the bipartisan committee to reach agreement on at least a US$1.2 trillion package of deficit reduction measures would have a further adverse impact on confidence and reduce further the prospect of agreement on the even larger package of deficit reduction measures required to put US debt on a sustainable path.

Section 22

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ADDITIONAL INFORMATION

Section 22 - Pgs 5-6

Section 22

Implications of a ratings downgrade

- S&P has not made any comments on the Budget Control Act of 2011, but on 18 April 2011, it stated that its decision regarding a US downgrade would focus on ‘whether agreement can be reached on a program that would reduce projected budget deficits by the target of US$4 trillion over the coming decade, and ... if so, the nature and likely effectiveness of the legislative decisions and assumptions underlying the program.’
- Moody’s confirmed its US Aaa rating on 2 August, but assigned it a negative outlook, indicating that there would be a risk of downgrade if there is a weakening in fiscal discipline, a lack of further fiscal consolidation measures by 2013, or if the economic outlook deteriorates significantly.
  - Moody’s noted that ‘Attempts at fiscal rules in the past have not always stood the test of time ... should the new mechanism put in place by the Budget Control Act prove ineffective, this could affect the rating negatively’.
- Fitch is reported to have said in a statement that the US credit rating is under review as the nation’s debt burden is increasing at a pace that isn’t consistent with its AAA sovereign credit rating, and that the US faces ‘tough choices on tax and spending against a weak economic backdrop if the budget deficit and government debt is to be cut’.
  - Fitch is reportedly expected to complete its ratings review by the end of August 2011.

- Some possible specific impacts of a downgrade include: a rise in the cost of credit; flow on downgrades to other state and municipal issuers; and dislocations in particular financial markets, as small changes in US Treasury holdings translate into large changes in demand for less liquid assets.

- In the longer term, a ratings downgrade would only add momentum to moves to diversify out of US dollar assets and to establish other reserve currencies. However, this will remain a gradual and fundamentally market-driven process.

- Money market funds have been the focus of some media concern. There is likely to be enough flexibility in money market funds to manage a one-notch downgrade in US ratings.

  - A downgrade should not trigger forced selling of Treasuries from money funds, since money market fund rules define any US government securities automatically as 'first-tier'. Money market funds which have specific mandates that imposed constraints due to a downgrade could likely be adjusted.

- Foreign holders of US Treasuries with large existing holdings, most notably China and Japan, are also unlikely to make any wholesale changes to their holdings, given the lack of alternative AAA assets and their interest in not undermining the value of their stock of US-dollar denominated debt.

Section 22

Section 22