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Market Bulletin

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What's happening now

By law the US Government is currently allowed to borrow up to US\$14.3 trillion and in May 2011 this limit (the debt ceiling) was reached. To raise the limit further a law must be passed by the House of Representatives and Senate, and signed by President Obama.

The debt ceiling must be raised by Tuesday 2 August 2011 or the US Treasury will not be able to borrow more money to help pay the Government's bills. With an annual budget deficit of over \$US1 trillion it is vital that the debt ceiling is increased. At present the Republican and Democratic parties, including President Obama, are debating how to both increase the debt ceiling and reduce the budget deficit in the years ahead.

Credit rating agencies are also running out of patience and a credit rating downgrade to the US Government's AAA rating now looks like a very real prospect. If this happens, there is the real possibility that the Government will have to pay a higher interest rate on its debt, worsening the budget deficit.

What could happen?

The situation remains very fluid and will develop rapidly. An 11th hour deal to increase the debt ceiling is still the most likely and preferred option. But a less satisfactory outcome is also possible as the political posturing continues.

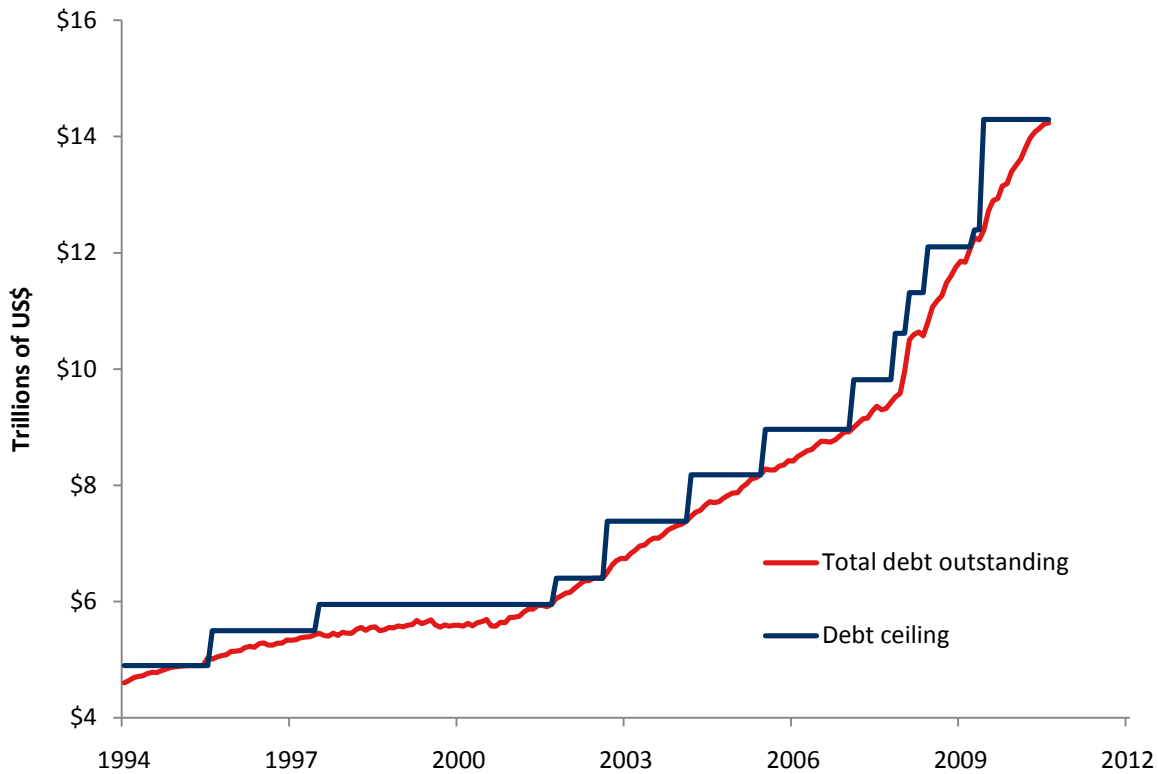
If the debt ceiling is not raised, the US Treasury will then have to make some hard decisions on spending priorities. For every \$US10 the US Treasury spends, around \$US6 is from taxes and other revenue, while the remaining \$US4 is borrowed. To avoid defaulting on its debt the Treasury may not be able to make payments, such as salaries for Federal employees. Justice, energy, transport and housing programs may also be affected. If the Treasury chooses to default on its debt, the implications for the US economy and global financial system would be significant.

What we think

As the chart on the next page shows, the US debt ceiling has been raised many times before over the past 20 years. Some brinkmanship on the political front should always be expected in such a situation, and this time is no different. However, the risks of a more damaging outcome do seem to be increasing.

We also think it likely that the US Government will have its AAA credit rating downgraded due to the lack of a credible long term plan to reduce the budget deficit. The pace of increase in the US debt level is accelerating and the Government must make some very difficult decisions to address the worsening long term fiscal situation sooner rather than later.

US total debt outstanding vs debt ceiling



Source: Bloomberg and US Treasury

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