EXECUTIVE SUMMARY

Introduction

In the 1996-97 Budget, the Government introduced its medium-term fiscal strategy to maintain budget balance, on average, over the cycle. The fiscal strategy and asset sales have reduced the ratio of Commonwealth general government net debt to gross domestic product (GDP) from a peak of 19.1 per cent in 1995-96 to 5 per cent in 2001-02. In dollar terms, this represents the repayment of around $60 billion of debt since 1995-96.

The strategy has contributed to Australia's sound macroeconomic framework and continuing strong economic performance. These have been particularly important in securing investor confidence during a period of considerable international uncertainty. The Government is committed to maintaining this strategy.

The reduction in gross debt accompanying the decline in net debt has raised concerns by some market participants about the future viability of the Commonwealth Government Securities (CGS) market. They argue the CGS market plays a critical role in the economy that the private sector cannot easily replicate.

The Government acknowledged these concerns in the 2002-03 Budget and announced its intention to consult on the issue with key stakeholders. This discussion paper forms a key element of the consultation process. It highlights the main considerations in the Government's deliberations, provides a clear framework setting out the issues, and guides stakeholders on key questions the Government needs to resolve.

The framework setting out the issues is particularly important given the lack of international evidence. The other OECD economies that have well-developed financial markets operate with a significant government debt market. These economies have a much higher stock of government debt than Australia.

Issues

Some market participants argue for maintaining the CGS market. Given the fiscal strategy, this would require the Government to accumulate a substantial portfolio of financial assets. The Government therefore must assess whether it is necessary to maintain the CGS market and whether doing so will give benefits that are likely to outweigh the risks associated with accumulating substantial assets.

This discussion paper first outlines the arguments that are advanced to support maintaining the CGS market and attempts to specify the key assumptions underlying the arguments to allow them to be tested. Second, the paper considers the options available to the Government.

The role of the Commonwealth Government Securities market

Minimal credit risk, issuance at a broad range of maturities, high levels of liquidity, and well-developed infrastructure characterise government debt securities and their associated markets. These characteristics have seen several other financial market activities develop from the CGS market.

The following sections outline the financial market activities the CGS market currently supports and potential alternatives that already exist or could arise in the absence of outstanding CGS. These are ordered from the specific financial market roles of CGS to the broader macroeconomic roles. The roles are: assisting the pricing and referencing of financial products; facilitating management of financial risk; providing a long-term investment vehicle; assisting the implementation of monetary policy; providing a safe haven in times of financial instability; attracting foreign capital inflow; and promoting Australia as a global financial centre.

Pricing other financial products

Some financial market participants suggest the CGS yield curve is important for pricing other debt securities because the yield on CGS at a particular maturity is the best available estimate of the rate of interest on a risk-free asset of that maturity. Market participants can use this yield as a starting point, then add a margin for the risk associated with the debt security they are pricing.

At least two alternatives are available for pricing financial products. First, market participants could price securities against other securities in the market that have similar characteristics. For example, a corporate issuing a new bond may attempt to set its price at a similar level to that available on bonds a corporate with a similar risk profile has issued. This is feasible if the other bond is of the same maturity or the corporate bond market is sufficiently liquid to form a yield curve for given credit risk.

Second, market participants could price securities with respect to the interest rate swap curve. Interest rate swaps are available across a wide range of maturities and incorporate some credit risk. Evidence indicates that some market participants already use the interest rate swap curve to price securities rather than the CGS yield curve.

Referencing other financial products

Some market participants may use the CGS yield curve as a reference benchmark for comparing yields on different debt securities, improving their capacity to undertake arbitrage. For example, if a debt security is trading at 50 basis points above CGS and another debt security is trading at 75 basis points above CGS, then a market participant could compare these yields and assess whether the risk characteristics warranted the difference in yield.

As an alternative, market participants could compare directly the yields on non-CGS securities, or compare with another reference such as the swap curve, to determine whether arbitrage opportunities exist.

Managing financial risk

Businesses (including financial market participants) currently use the CGS market and its associated derivative markets (particularly three-year and ten-year bond futures) to manage their interest rate risk. Businesses use these markets as movements in CGS yields are highly correlated with yields on other securities and the liquidity of the market enables businesses to take positions without significantly affecting market yields.

The ability to effectively manage interest rate risk also may affect the domestic cost of capital. For example, investors may be prepared to accept a lower yield on a corporate bond if they can manage their interest rate risk. If the capacity to manage these risks results in lower interest rates, then investment, consumption and economic output will be higher.

In the absence of outstanding CGS, businesses could use one of three possible alternatives to manage their interest rate risk. First, businesses already use the interest rate swap market for managing some interest rate risks. For example, a business that has borrowed funds at a floating rate could enter into a swap agreement whereby it receives a floating rate, and pays a fixed rate, effectively giving it a fixed rate obligation.

Second, the private sector could develop an interest rate swap futures market. This could include standardised contracts that are traded on a futures exchange. Businesses could use these contracts to manage risk, provided the underlying price (the swap rate) is highly correlated with interest rates on other securities, and the underlying price cannot be manipulated. Evidence indicates that the swap rate is highly correlated with corporate bond yields and is highly liquid, suggesting market manipulation is unlikely. Consequently, an interest rate swap futures market may be a viable alternative.

Third, continued development of the corporate bond market may lead to development of a corporate bond futures market. However, the corporate bond market currently is not liquid enough to support a futures market.

The absence of CGS outstanding may encourage the development of the last two options as businesses still will need to manage their risks, providing a ready market for new products. That said, the risk is that these products may not be effective, or they may take substantial time to develop.

Providing a long-term investment vehicle

CGS may be important in providing investors with a low-risk long-term investment vehicle. CGS are particularly attractive for investors, such as life insurance companies and superannuation funds, with long-dated liabilities. Historically, government securities have been the principal source of long-dated financial assets. Life insurance companies and superannuation funds hold around 30 per cent of CGS on issue.

The holding by superannuation funds and life insurance companies of CGS needs to be considered in the context of the overall asset holdings of the industry. CGS currently comprise less than 5 per cent of total assets, suggesting that CGS may not be central to the sector's investment strategy. However, the industry may wish to hold a higher proportion of CGS if the supply were increased.

CGS provide investors with a different class of assets that may assist in diversifying their portfolios. However, the extent of this benefit is unclear, given the range of other mechanisms through which investors can diversify risk. In addition, the current level of CGS outstanding may be insufficient to significantly assist portfolio diversification.

Implementing monetary policy

In the past, the CGS market has played a central role in the Reserve Bank of Australia (RBA) implementing monetary policy. In undertaking open market operations, the RBA has bought and sold CGS to inject and remove cash from the economy. However, the RBA more recently has moved to accept a broader range of instruments in its open market operations. The RBA would be able to respond to further reduced CGS supply, maintaining its capacity to effectively implement monetary policy.

Providing a safe haven in times of financial instability

Government securities may play an important role as a safe haven in times of financial instability, when investors seek safe assets to avoid the potential of capital losses. The existence of CGS may allow investors to move funds into a safe asset without the need to go offshore.

To assess the merit of this argument, the Government needs to consider other possible assets that investors could move funds into during episodes of financial instability. Investors also could increase holdings of money. In practice, this may consist of increasing banking system deposits. The viability of this strategy would depend on investors' confidence in the soundness of individual banks and, more generally, in the banking system. An important element of this would be the market's view of the prudential regulation regime.

The range of shocks for which the CGS market could provide an important safe haven is unclear. For small shocks, investors may not need the CGS market as they may be prepared to increase bank deposits or hold other assets. For very large shocks, where the viability of the banking system was threatened, the existence of a CGS market may have little effect on the ultimate impact on the economy. That said, during periods of financial instability any factor that reduces volatility may be valuable.

Attracting foreign capital inflow

Some market participants argue the CGS market assists in attracting capital inflow. This is important as Australia has a current account deficit requiring a continual supply of foreign capital to finance the deficit. Two main reasons are cited.

First, government debt markets help develop private sector debt markets. Both private and public sector debt markets provide a potential destination for foreign capital. This is likely to be most relevant for countries trying to establish financial markets. However, removing a government debt market from an already sophisticated financial market is less likely to have adverse consequences.

Second, some investors allocate their funds by following global bond indices. Investors who follow such indices provide a source of finance that is linked to government bond market size. If the CGS market drops below a critical level, then an alternate supply of funds may be needed to finance the deficit.

In assessing the validity of this argument, it is important to note that decline in the CGS outstanding is a direct result of the Government's improved fiscal position. Previously, the capital inflow was required to fund the Government's budget deficit. This is no longer necessary, as the Government makes no direct contribution to the current account deficit. Further, the level and composition of capital inflows are not themselves policy goals. A more desirable policy goal is to keep the cost of capital in Australia as low as possible. If additional CGS issuance attracts greater capital inflow due to higher interest rates, then this is not likely to be desirable. The Government will need to assess whether the CGS market lowers the cost of capital.

Promoting Australia as a global financial centre

Well-developed debt markets may play a role in attracting foreign investment into a country and promoting efficient markets. Government debt markets may facilitate the development of private debt markets. This is particularly relevant for countries in the development stage. On the other hand, as noted above, it is unlikely that the removal of a government debt market from an already sophisticated market will affect adversely future market development.

CGS also may enhance overall liquidity and efficiency of financial markets. This raises the issue of whether a diminished CGS market would result in further development of private sector substitutes. If the depth of private sector markets continues to improve, then the aggregate depth and liquidity of Australian financial markets may not change significantly, implying that the absence of a CGS market would not diminish Australia's role as a financial centre.

Appropriate size of the Commonwealth Government Securities market

If the Government decides to maintain the CGS market, then it would need to assess the appropriate size of the market. Size is critical as it relates directly to liquidity, which is a key characteristic that distinguishes the CGS market from other financial markets. The CGS market's appropriate size would depend on the rationale for maintaining the market. Some market participants suggest that around $50 billion of benchmark Treasury bonds is the minimum required for a liquid and viable market, and that the market would need to grow in nominal terms to maintain its relative size.

If the market were maintained to facilitate management of financial risk and ensure adequate pricing and referencing benchmarks, then the CGS market may need to grow by around the growth rate of nominal GDP. This has been around 6 per cent per year in recent years.

If the market were maintained to act as a safe haven, provide a long-term investment vehicle and maintain Australia's position in global bond indices, then the CGS market may need to grow by around the growth rate of financial assets. This has been around 12 per cent per year in recent years.

Options available to the Commonwealth

The Government's fiscal strategy is to maintain budget balance, on average, over the course of the economic cycle. The Government will not consider options that weaken the fiscal strategy given its contribution to strong economic performance. In particular, the Government will not consider proposals to build budget deficits so as to create the need for new CGS issuance.

Some commentators suggest that the CGS market already is at or below the minimum level necessary to perform its key roles. If the market were close to its minimum viable level, the Government would need to increase issuance to maintain market viability. This would require the Government to accumulate substantial financial assets, given its fiscal strategy.

- For example, the market would need to be around $12 billion larger than its current level of around $50 billion in four years' time, assuming a required growth rate of 6 per cent per year. The current budget estimates indicate cumulative underlying cash surpluses over the next four years. As a result, maintaining the market could require the accumulation of an additional $20 billion to $30 billion of financial assets over the next four years.

The Government has two broad classes of options: wind down the CGS market or maintain the market and accumulate financial assets. The paper considers three specific options within these two broad classes.

Option 1: Wind down the Commonwealth Government Securities market

The first option is to wind down CGS outstanding. Several options exist for withdrawal from the market. The Government could choose to repurchase all outstanding debt over a short time. This is likely to bid up the price and generate large repurchase premiums. Alternatively, the Government could allow all outstanding debt to mature. With ongoing budget surpluses, this strategy would involve the Government building up substantial financial asset holdings over the rest of this decade.

The Government does not intend to undertake significant borrowing in the future. However, recognising the long timeframe involved, the Government would need to consider the possible cost of re-entering the market if, in the future, it faced a financing requirement. A range of shocks may affect the budget so significantly that the Government may need additional funds. The Government would need to assess these re-issuance risks and the likely costs of having to re-establish a CGS market.

Option 2: Consolidate Commonwealth and State government debt markets

The second option is to combine Commonwealth and State government debt markets. This option would enhance the liquidity of the CGS market, at the expense of State government markets. This would only be a temporary measure for maintaining the CGS market, if Australian governments continue the fiscal discipline displayed in recent years.

The Commonwealth and State governments rejected this option in August 2001.

Option 3: Maintain the Commonwealth Government Securities market and fund the Commonwealth's unfunded superannuation liabilities

The third option is to issue additional CGS and use the proceeds to fund the Government's unfunded superannuation liabilities. This could be achieved either through hypothecating a financial asset portfolio to the unfunded liability, or through transferring CGS issuance proceeds to a superannuation fund.

This option would increase the Commonwealth's financial risk exposure. There is a limit to the amount of domestic asset purchases that the Government could undertake without distorting markets and raising significant policy concerns due to the size of the market. This may lead the Government to consider investment in international assets, with consequent foreign exchange rate risks.

Investing in a superannuation fund may lock the asset portfolio away so that it cannot be used for other purposes, reducing the risk of investments being directed to achieve particular policy outcomes. Governance concerns also arise. First, scarce public sector senior management resources would be diverted from their core functions to oversee the activities of the fund. Second, it may dilute the Government's accountability as public scrutiny may be focussed away from core government functions.

Conclusion

The Government needs to make an important decision. The CGS market currently plays a number of important roles in the economy. However, it is likely that the private sector could undertake at least some of these roles and significant risks are associated with the option to allow the market to be maintained. Accumulating a substantial portfolio of assets exposes the Government to large financial risks, potentially distorts Australian markets, and raises very significant governance concerns. Given these issues, stakeholders advocating maintaining the CGS market will need to clearly demonstrate the benefits of the market and provide evidence that the private sector would be unable to adapt to an environment without CGS.

The Government welcomes views on the issues raised in this paper.