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Commonwealth Debt Management Review
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SFE Submission to Bond Market Review

SFE welcomes the Commonwealth Government Securities (CGS) market review. It is an opportunity to help the Government properly value the contribution made to the broader economy by having a viable Commonwealth Government Securities market and complementary futures and options market.

A copy of our submission is attached.

Yours sincerely



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**SFE SUBMISSION TO THE REVIEW OF THE
COMMONWEALTH GOVERNMENT SECURITIES MARKET**

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1. EXECUTIVE SUMMARY

The SFE welcomes the Commonwealth Government Securities (CGS) market review. It is an opportunity to help the Government properly value the contribution made to the broader economy by having a viable Commonwealth Government Securities market and complementary futures and options market. The Government's simple choice comes down to choosing between achieving a combination of the lowest possible cost of capital for the nation and the most efficient and transparent financial system, on the one hand, or on the other, eliminating at a Federal level what is already a low level of public debt by international standards.

The CGS market provides a vital benchmark for rates of return on a wide variety of assets in the Australian economy – from industrial and agricultural assets to sophisticated financial assets and structures. One of the roles of the SFE is to permit the transfer of risk profiles associated with holdings of CGS and, in so doing, enhance pricing efficiency and add significantly to market liquidity.

The fact that every A\$1.00 of outstanding debt on issue by the Government is traded at least 9 times each year in the physical market but at least 40 times in the futures market provides a partial insight into the extent to which these securities and the related markets in which they are traded sustain financial market efficiency. The transparency and homogeneity of the physical and futures markets for CGS drives the most efficient private sector process of capital formation and allocation. What these numbers don't immediately reveal is the extent to which the existence of an adequate CGS market assists the efficiency and orderliness with which interest rate risk is transferred in the financial system and how this translates into benefits for the entire Australian community. That is the subject of this submission.

The benchmark pricing function provided by the physical CGS market cannot be performed without futures markets being able to perform a reliable price discovery function that feeds back into the physical market. This complementary relationship enables futures markets to contribute to lower borrowing costs and investment risks for both the corporate and household sectors.

More importantly, it enables these benefits that accrue to the entire Australian community to be much greater than would be achieved if interest rate price discovery were to migrate to the major banks that dominate the interest rate swap market. As there is no likelihood of interest rate swap futures contracts being able to totally replace the existing bond futures contracts, migration of interest rate price discovery to less transparent bank balance sheets would be inevitable. That is why we say the choice is between achieving the combination of the lowest possible cost of capital for the nation and the most efficient and transparent financial system, and eliminating at a Federal level what is already a low level of public debt by international standards.

Put another way, does the Government preserve and support the interests of retail shareholders, superannuants and the small business sector (who have supported its privatisation program) by ensuring the lowest possible cost of capital for the entire community through an efficient and transparent process? Or does it hand over to the major trading banks greater profitability and market power through medium to long term interest rate price setting becoming the domain of the inter-bank swap market?

The unrivalled efficiency with which futures markets facilitate transfer of interest rate risk is an important national asset, recognised as such by the Government barely 6 months ago in legislation declaring the futures markets conducted by SFE to be markets of "national interest". So important

were these markets thought to be that the Government reserved the right to impose limits on shareholdings in SFE group companies. The efficiency with which SFE facilitates the transfer of interest rate risk would be severely reduced were the Government to undervalue the importance of maintaining viable CGS bond and bond futures markets.

In the same landmark financial service reforms to the Corporations Act in March 2002, the Government consciously amended the objectives underpinning regulation of futures markets to add ‘transparency’ to the traditional focus on maintaining efficient, fair and orderly markets. It can be assumed from this that these are at least some of the desired attributes the Government would wish to encourage in the financial markets. Eliminating or further winding back the CGS market would be the antithesis of a commitment to transparency in the transfer of interest rate risk. In fact, the elimination or further winding back of the CGS market would significantly reduce the current levels of transparency, efficiency and fairness in interest rate setting.

A failure to maintain these markets would hurt Australian borrowers and investors. Contrary to some misinformed media coverage to date, this is not primarily an issue about what happens to financial market participants that actually trade CGS bonds or futures, albeit the sophisticated infrastructure they represent underpins the transparency and efficiency earlier referred to.

Allowing these markets to disappear would jeopardise the ability to deliver a number of sensible existing policy approaches. These include:

- supporting competition amongst financial service providers and acknowledging the efficiency of exchange-traded markets to achieve otherwise unattainable reductions in borrowing costs for consumers of financial services.
- assisting the corporate and household sector – that will continue to need to borrow even if the Government’s need temporarily abates – to have the capacity to do so from the capital flows encouraged by Australia being seen as a sophisticated and significant financial centre; and
- ensuring that investing in their superannuation is a sensible proposition for ordinary Australians, with the opportunity to invest in (default) risk-free Australian dollar denominated securities as a component of that choice.

The Discussion Paper issued by the Government appears to acknowledge that a viable CGS and bond futures market produces ‘public goods’. It does not adequately acknowledge that dismantling of the CGS market effectively equates to a decision to:

- lower pricing efficiency in financial markets.
- lower capital efficiency by reducing the role of transparent exchange traded interest rate risk transfer in the Australian marketplace.
- preside over and sanction a shrinkage in activity levels in securities and derivatives markets to the benefit of the banking system and bank balance sheets. Somewhat perversely, major trading bank liabilities would assume quasi sovereign status in an already concentrated and publicly ‘poorly perceived’ banking sector.
- remove or make even scarcer the ultimate domestic ‘safe haven’ security during periods of extreme volatility in financial markets, producing an economy with a higher risk profile that is more vulnerable to financial panic.

- deny superannuants an A\$ denominated (default) risk free investment for their retirement planning at a time of an ageing population and in a mandatory superannuation environment.
- deny the beleaguered insurance and annuity industries a domestic risk free asset of long dated maturity to match the long dated nature of their natural liability profiles.
- diminish Australia's relevance as a financial centre to international investors and global intermediaries.
- impose a structural weakness in the value of the A\$ by virtue of the likelihood of lower capital inflow from offshore accompanied by higher domestic outflows, with 'knock-on' consequences for nominal interest rates in Australia to be higher than otherwise would be the case in order to attract capital.
- accelerate the likelihood of losing an independent currency and independent monetary policy by forcing domestic investors and superannuants to be able to source risk free securities only from foreign government bond markets.

It should be remembered that it was not until Australia had active, liquid and deregulated CGS and CGS futures markets in the mid 1980's that the capital markets were able to develop and deliver the efficient techniques which are taken for granted today eg., interest rate swaps, securitisation, corporate bonds. This was not just an Australian phenomenon. No country without an active government bond market has developed sophisticated efficient capital markets. It would be an unfortunate development if any lowering of commitment to the CGS market were to take us back to a less efficient marketplace.

The Discussion Paper does not justify radical experimentation with the efficiency and effectiveness of the Australian financial system. Many of its propositions are based on supposition and belief rather than on objective research or international precedent.

The issues raised by the Paper are profound for the efficiency, stability and competitiveness of the Australian financial system. They are as profound for the whole economy and the investing public as they are for issuers for all types of fixed income securities and, in the fullness of time, for issuers of any type of financial security, including equities.

Those who argue in support of CGS elimination have an obligation to explain how unintended consequences and other adverse policy outcomes are to be avoided. Of course, these adverse outcomes can and should be avoided altogether by the renewal of the Government's commitment to the CGS market.

2. INTRODUCTION

SFE Corporation Limited (SFE) and its subsidiary companies, Sydney Futures Exchange, New Zealand Futures and Options Exchange, SFE Clearing Corporation and Austraclear, provide exchange-traded and over-the-counter (OTC) financial services throughout Australia, the Asia Pacific region and in other major financial cities in the world. SFE offers trading and risk management products and clearing/settlement/depository and registry services to government, banking and funds management users of the exchange traded and OTC markets of Australia and New Zealand. Users of SFE products and services include the major trading and investment banks, large corporations, State based borrowing authorities, fund managers, brokers, exporters, primary producers, electricity generators and proprietary and retail traders.

SFE's exchange traded derivatives franchise covers 5 major markets – equities, interest rates, currencies, commodities and electricity, but its pre-eminent franchise is in the interest rate and fixed income market space. During 2001, on average more than 141,000 futures and options contracts were traded each day on the Sydney Futures Exchange, representing in excess of A\$48.0 billion nominal value of futures and options contracts over underlying securities and commodities. The annual nominal value of this trading activity exceeds A\$11.5 trillion – significantly larger than Australia's gross national product and the turnover of the Australian equity market and second only in turnover to the Australian foreign exchange market¹. Even more relevant to the CGS market is the fact that for every A\$1 of Commonwealth stock on issue, the velocity of trading activity in the primary (cash) market for CGS in an average year is a multiple of 9x and a multiple of 40x in the futures market, which is the basis for the most efficient form of interest rate price discovery in the Australian environment.

When regard is had to the significant role exchange traded markets play in capital formation and risk transfer in the Australian capital market, and the disproportionate volume of risk transference to volume of underlying capital flows and financing activities, it is not surprising that the futures market is second only in turnover to the foreign exchange market in overall significance. The diagram below provides an overview of the exchange traded segment of Australia's capital market in terms of the overall value chain, network infrastructure and major participants.

Australian Financial Markets (Exchange Traded) Overview

	Order Entry and Routing Client Account Management	Listing and Quotation	Trade Execution	Clearing and Settlement	Registry Services
Debt	Principal Dealers/Market Makers for Government securities			SFE (Austraclear)	SFE (Austraclear) ASX
	Principal Dealers/Market Makers for all other money market securities			SFE (Austraclear)	SFE (Austraclear) Computershare Perpetual Trustees
Equities	Brokers	ASX - SEATS		ASX - CHESS ASX - PALLION	APRL Computershare
Options	Brokers	ASX - CLICK SFE - SYCOM		SFE - SECUR	
Futures	Brokers	SFE - SYCOM			

¹ Source: AFMA 2002 Australian Financial Markets Report (June 2001 to June 2002) and Australian Bureau of Statistics.

The Reserve Bank of Australia's 2002 Annual Report explicitly recognised the role SFE's exchange trading activities play in the operations of financial markets in its description of events pursuant to the September 11, 2001 terrorist attacks in the US:

“Liquidity in domestic securities markets (ie the ability to trade at very fine margins) deteriorated sharply in the immediate aftermath of September 11. Interbank price-making for Treasury and semi-government bonds contracted and Trading in the corporate bond market virtually ceased. Activity in the repo market also fell sharply..... In contrast to the lower activity in physical bond and repo markets, turnover in interest rate futures and options traded on the Sydney Futures Exchange held up in the days following September 11. The futures market played an important role in facilitating risk management and price discovery through this period.”

It is important to understand that the stabilising role played by the futures market, despite lower activity in the physical bond and repo markets, depended upon the existence of a physical market and investor expectations that the physical market would recover to normal levels in the future. The SFE's ability to fulfil the stabilising role outlined by the RBA in the future is a direct function of two factors; firstly, the continued existence of liquid futures contracts over 3 and 10 year government bonds and, secondly, the efficiency and financial health of the SFE itself as the market provider.

SFE's significance to the Australian financial system extends beyond its exchange trading activities. Since its demutualisation in September 2000, SFE has increased the significance of its clearing and settlement franchise within the payments system in Australia primarily in three ways:

- December 2000: SFE acquired Austraclear, the major A\$ depository for money market and fixed income securities previously owned predominantly by the 4 major trading banks. This initiative was undertaken in order to converge fixed income cash market clearing arrangements with fixed income derivative clearing and settlement, to the benefit of market users, who were strongly supportive of this initiative.
- September 2001: Via a wholly owned subsidiary (SFE Clearing Corporation), SFE launched a central counterparty clearing initiative for OTC bonds and repos through which it novates cash market trading activities of these OTC instruments in a fashion similar to the novation process that underpins the market for exchange traded derivatives operated by the Sydney Futures Exchange. This initiative was undertaken to offset partially the cash market impact of declining government bonds on issue and the related declining CGS turnover trend by freeing up capital that previously had been allocated to bilateral OTC bond trades by the major bond market makers.
- February 2002: Clearing and settlement arrangements for CGS migrated from the RBA's RITS system to the SFE's Austraclear system. This initiative was supported unanimously by the 4 major trading banks and all the major investment banks operating in Australia due to the centralisation of the complete suite of fixed income products clearing and settlement arrangements into one depository system and one institutional entity.

These clearing and settlement initiatives have reduced the number of independent clearing systems in Australia from five to three in a short period of time, in harmony with stated RBA objectives (1999) and with the concurrence of the ACCC, to the benefit of market users. An independent (SIRCA) review of clearing and settlement arrangements in Australia, published in 2000, concluded

prior to these rationalisation initiatives that Australia already had one of the most efficient and cost competitive clearing and settlement systems in the world; it has since become even more so, with SFE effecting across the board fee reductions for users of the Austraclear system in May of 2002.

In conjunction with the 3 and 10 year bond futures franchise that emanates from the activities of the Sydney Futures Exchange, SFE's future as a service provider, central counterparty clearer, front line regulator, and facilitator of interest rate price discovery and risk transfer to the Australian financial system is integrally linked to the national significance of maintaining a liquid CGS market in Australia. However, the issue of maintaining the CGS market extends well beyond the fortunes of SFE, given that the financial infrastructure SFE represents is likely to figure prominently in any evolution of interest rate price discovery in Australia.

The Commonwealth Government recently renewed its funding commitment to AXISS to promote Australia as a global financial centre, implying a sovereign interest in the health of domestic capital markets. As recently as July 2002 the Australian Office of Financial Management (AOFM) website reiterated that

“The reduction in net debt will continue to be managed in line with the objective of maintaining the viability of the Commonwealth Government Securities (CGS) market.”

The Commonwealth also defined the SFE (and ASX) as a market of sufficient national interest in this year's Financial Services Reform legislation to warrant ownership restrictions being imposed on its shareholding structure. That same legislation heralded the introduction of a 'transparency' test, to sit alongside the former 'fairness and orderliness' benchmarks for regulatory oversight of financial markets. The Federal Treasurer, in a foreword to the 2002 Australian Financial Markets Report, reinforced that emphasis in stating that

‘Key to confidence in any market is its transparency’

SFE welcomes the opportunity to present its views on the evolution of the Commonwealth Government bond market in Australia, especially given its concerns about the progressive decline in the amount of CGS on issue, the conflict between this trend and the Government's explicit objectives to promote Australia's capital markets and the potential for lower levels of transparency for interest rate price discovery associated with several of the propositions outlined in the Discussion Paper released by the Treasury on 30 October 2002.

The Government's review of the future of its own bond market is the most significant review process since the Campbell and Wallis Inquiries into Australia's financial system. The Discussion Paper contains numerous charts and graphs relevant to the issues surrounding the review process and SFE has chosen in this submission not to simply replicate data which the Government has already provided in that paper.

SFE is in a unique position to provide insight into the review process and to answer questions posed in the Discussion Paper based on its own competencies. This submission will thus complement those from other financial intermediaries/institutions who, no doubt, will focus their submissions on their areas of specialisation. Nevertheless SFE has provided its own thinking on some of the wider policy issues raised in the Discussion Paper. SFE is prepared to answer any questions the review team may have concerning this submission or any other issues raised during the consultation process.

3. FUNCTIONS OF THE MARKET FOR COMMONWEALTH GOVERNMENT SECURITIES (CGS)

“Government bonds are the backbone of most fixed-income securities markets in both developed and developing countries. They provide a benchmark yield curve and help establish the overall credit curve. Government bonds typically are backed by the ‘faith and credit’ of the government.”

- International Monetary Fund/World Bank, July 2001. Developing Government Bond Markets. A Handbook

The existence of an active CGS market confers important public benefits on the Australian economy, and on a sophisticated but small Australian capital market. These benefits support the plausibility of the hypothesis that Australia ‘punches beyond its weight’ in terms of capital market sophistication. However, this hypothesis, if taken outside of the realm in which a viable CGS market exists, has the capacity to distort policymakers’ (and policy influencers’) views of the substitutability of the CGS market, a point developed more fully in section 5 of this submission. Thus, it is important to understand the key functions of the CGS market beyond its original mandate of financing capital infrastructure and fiscal imbalances. These functions include:

- **Benchmarking:** supporting the corporate finance activities of private financial market participants in areas such as equity valuation, capital budgeting and capital raising via the provision of a ‘risk-free’ benchmark for the pricing of nearly all other financial market instruments including semi-government bonds, corporate bonds, swaps, foreign exchange and FX forwards (interest rate parity), options, futures and equities.
- **Default risk free yield curve:** providing a means to assess market expectations of future interest rates which:
 - facilitates active trading in CGS due to the offering of a wider range of maturities than any other class of borrower;
 - creates issue fungibility; and
 - enables market participants to take long and short positions that reflect their views of future interest rate movements
- **Fixed income infrastructure:** enhancing the development or prospects for development of other fixed income markets in Australia such as those for corporate bonds or mortgages.
- **Support for a derivatives market:** underpinning the existence of a sophisticated and efficient interest rate derivatives marketplace in Australia comprising an exchange traded futures market conducted by SFE and a coexisting but less transparent and efficient OTC swap market dominated by the major trading banks.
- **‘Safe Haven’:** being a source of ‘safe haven’ investment during periods of heightened or extreme volatility and turbulence in financial markets in response to exogenous shocks or structurally profound asset reallocations; the period since September 11, 2001 has been both a recent illustration of this as well as perhaps setting (tragically, and hopefully uniquely) a new benchmark for such turbulence.

- **Australian sovereignty:** providing a unique (A\$ denominated) risk-free investment vehicle for superannuation funds and institutional investors at a time when growth in such funds is already outstripping A\$ asset availability in equities, property and infrastructure funds, and other fixed income assets, causing domestic investors to assume higher currency translation exposures (on international assets) or higher risk exposures (on alternative domestic assets) than they might otherwise desire.
- **Investor confidence:** providing offshore investors with a reason to continue to view Australia as a relevant centre for investment. This point should not be confused with the quite separate issue of Australia's relative attractiveness as a physical and infrastructure domicile for regional headquarters of foreign financial services firms.

These functions decrease investor risk and lower the cost of capital in Australian capital markets, in a manner that alternative markets, mechanisms, or assets are unlikely to do as efficiently, for reasons spelt out later in this submission. Whilst it is perhaps tempting for academic economists and policymakers to argue that substitute markets, mechanisms or assets either are or have the potential to become available in the absence of a CGS market, there is both a fundamental question of economics and political will at stake in this review process. The economic question is whether the questionable benefits of further CGS redemption, or even elimination, outweigh the value lost through the removal of the wider 'public good' functions fulfilled by the existence of a CGS market. The political question is whether the Australian government is willing to engage in a process that runs contrary to its efforts to, firstly, promote Australia as a financial centre, and, secondly, support the independence of an Australian currency.

Australia could already be regarded as 'undergeared' in sovereign debt terms by international standards, with no evidence of non CGS debt issuance being "crowded out" by the existence of the CGS market. Furthermore, there is no precedent for a developed economy consciously to dismantle its own government bond market; thus there is very little financial literature to provide guidance as to how important the wider consequences for the country's financial markets might be. It therefore would seem very high risk for policy on this issue to be influenced by desire to be a world 'first', if Australia's capital markets lack the depth or degree of competitiveness by virtue of scale (not to be confused with sophistication) of other leading capital markets overseas.

Similarly, it would seem premature for policy to wish to avoid asset portfolio solutions adopted by other countries faced with similar trends such as Canada, Singapore, Norway and Eire, on the grounds that such solutions might "increase the Commonwealth's financial risk exposure" when policy support for eliminating the CGS market has the potential to produce the same economic financial risk exposure for underlying investors and a growing stock of superannuants. The proposition that it is fine for citizens to invest in equities via compulsory superannuation but not for the Commonwealth lacks robustness. The asset portfolio risks referred to in the Discussion Paper could also be minimised in other ways referred to later in this submission.

Equally, it would seem unwise for policy on this issue to be predicated on a simple faith in the ability of markets and intermediaries to simply 'adapt' in the absence of proven (let alone superior) alternatives. At a minimum, it would be incumbent on policy to prescribe adequate transitional arrangements, which allow markets both time to adjust and adequate safety nets in the event unproven hypotheses (quoted below) were to produce adverse outcomes for the efficiency or transparency of financial markets in Australia. Better still, policy would seek to preserve CGS benefits at the same time as stimulating the natural evolution of markets, a point more fully developed in Section 5 of this submission.

The Discussion Paper is characterised by assertions such as

“removing a government debt market from an already sophisticated financial market is less likely to have adverse consequences” *Page 5*

“market infrastructure is unlikely to deteriorate significantly in the absence of outstanding CGS” *Page 67 and Page 78*

“withdrawal of the CGS market may encourage further innovation and development” *Page 68*

“given the growth in private markets in recent years, the absence of the CGS market may not affect Australian financial market liquidity or innovation” *Page 68*

each of which, individually and collectively, appear to be unsubstantiated hopes or beliefs, presumably based on perceptions of the relative sophistication of the Australian capital market. Sophistication in the Australian context, however, is based on a mix of intellectual property and the transparency, efficiency and fungibility of the CGS market and its adjacent derivatives infrastructure. It should not be confused with, and is not a substitute for, a lack of depth and scale to many of its asset markets and the issue of relative pricing efficiency attributable to the interplay of the CGS and adjacent futures market.

Fiscal responsibility clearly is in the national interest and the government is to be duly credited for its record on economic management. The maintenance and ongoing pursuit of the most efficient form of financial system in Australia, for the benefit of the corporate and household sectors, is also in the national interest. Similarly, the Government’s efforts to position Australia as a global financial centre, presumably to attract capital flows and retain the quality of financial infrastructure that usually accompanies a modern, developed financial system and economy reflect important policy goals and is also in the national interest. Growth in the CGS market commensurate with the underlying growth of the economy would be a strong lever in the pursuit of all three national interest objectives, which need not be in conflict with each other from an economic or a political point of view.

Further conscious dismantling of the CGS market would be at serious odds with these wider national interests and could be construed as almost a conscious decision to:

- lower pricing efficiency in financial markets.
- lower capital efficiency by reducing the role of transparent exchange traded interest rate risk transfer in the Australian marketplace.
- preside over and sanction a shrinkage in activity levels in securities and derivatives markets to the benefit of the banking system and bank balance sheets. Somewhat perversely, major trading bank liabilities would assume quasi sovereign status in an already concentrated and publicly ‘poorly perceived’ banking sector.
- remove or make even scarcer the ultimate domestic ‘safe haven’ security during periods of extreme volatility in financial markets, producing an economy with a higher risk profile that is more vulnerable to exogenous shocks or financial panic.

- deny superannuants an A\$ denominated risk free investment for their retirement planning at a time of an ageing population and in a mandatory superannuation environment.
- deny a beleaguered insurance industry a domestic risk free asset of long dated maturity to match the long dated nature of its natural liability profile.
- diminish Australia's relevance as a financial centre to international investors and global intermediaries.
- impose a structural weakness in the value of the A\$ by virtue of the likelihood of lower capital inflow from offshore accompanied by higher domestic outflows, with 'knock-on' consequences for nominal interest rates in Australia to be higher than otherwise would be the case in order to attract capital.
- accelerate the likelihood of losing an independent currency and independent monetary policy by forcing domestic investors and superannuants to only be able to source risk free securities from foreign government bond markets and incur exchange rate exposure.

A recent report by IMF economists concerning the shrinking supply of US treasury bonds concluded that:

“The public benefits of effective government securities markets for pricing, quoting and hedging private financial risks can be significant. Moreover, in providing some of the important characteristics of base money, and in serving as a safe haven during periods of turbulence, well developed markets for government securities, in adequate supplies in a range of maturities, may provide significant public benefits that would be difficult; if not impossible to replicate, even in the comparatively well developed (US) dollar fixed income market.”²

If this view is accurate in its application to the deepest and most sophisticated capital market in the world, it would be even more applicable to the Australian capital market. The fact that the Australian market is characterised by strong regulatory oversight, an independent and well regarded central bank, adequately capitalised (as well as well run) banks and sophisticated stock and derivative exchanges does not mean that it doesn't also face some major challenges:

- **Lack of depth and liquidity:** many of its asset markets lack the depth and liquidity of the equivalents in the major countries/financial centres of the world.
- **Competition from trade partners:** Australia competes for capital and financial infrastructure with other Asian centres seeking to develop their government bond markets with the full support of their governments.
- **Globalisation:** Australia's major end users of financial services (major corporations) understandably are shifting their demands for financial services to match their increasingly international asset profiles and lowest cost funding and risk management alternatives to markets with the deepest 'pools' of liquidity.

² Schinasi, G., Kramer, C. and R. Todd Smith (2001) "Financial Implications of the Shrinking Supply of US Treasury Securities", IMF Working Paper, WP/01/61

- **External shocks:** turbulence in financial markets is not a function of the coincidence of low inflation and fiscal responsibility enjoyed by most developed economies in recent years, but of exogenous shocks and what Alan Greenspan characteristically describes as ‘exuberance’ and ‘excesses’ in the behaviours of individuals, corporations and financial firms. Such shocks and behaviours do not seem to be abating in the current global climate.

The government’s responsibilities to the nation are not limited to appropriate regulation and oversight of the financial system. The government’s participation as a borrower ensures the provision of ‘public goods’ of a much broader nature. Such positive externalities have swayed policy authorities in other countries to deem the social benefits of CGS markets to be more than sufficient to offset the cost of issuing debt and offsetting this by a number of asset portfolio solutions.

Notwithstanding Australia’s current fiscal position (ignoring unfunded superannuation at the Commonwealth level), numerous studies point to fiscal deterioration in most industrial countries beyond 2010, begging the question as to why policymakers would seek to dismantle the financial infrastructure which delivers the public benefits herein referred to, has taken decades to build, and will be needed at a future date to address either projected (cyclical) deficits or unforeseen budgetary shocks which would seem likely to become more prevalent.

It is one thing to turn ‘on and off’ a government’s need for capital, it is another entirely to turn ‘on and off’ the efficient financial infrastructure which currently exists in Australia that supports and is dependent on the existence of the CGS market. Somewhat perversely, Australia’s standing as a financial centre would be materially enhanced by strengthening the CGS market and adopting any of the asset portfolio alternatives suggested in this submission.

Having said this, SFE does not agree with the Discussion Paper’s arguments that CGS would need to grow at between 6-12% per annum to continue to fulfil its wider role. Both the lower (pricing/benchmarking) and higher (safe haven) estimates of the required growth rates quoted in the Paper are likely to be overstated relative to functional requirements of either purpose. SFE would suggest that growing CGS on issue at or close to the nominal GDP growth rate would maintain the liquidity of the physical market and underpin the price discovery efficiency of the complementary futures market. Correspondingly, SFE believes the estimated size of a Commonwealth financial asset portfolio by the end of the present decade to be materially overstated in the Discussion Paper.

4. INTERDEPENDENCE BETWEEN THE CGS MARKET AND THE FUTURES MARKET

A futures market cannot exist without an underlying physical (or synthetic) market. The ability of the futures market in Australia to fulfil its current role in interest rate price discovery and risk transfer is a direct function of:

- its ability to facilitate liquidity in futures contracts over underlying securities such as the 3 year and 10 year (CGS) bonds; and
- the financial health and efficiency of the market operator (SFE).

In relation to the first function, since the failure rate on listing new futures contracts is (globally) very high it is unlikely that supplementary contracts such as interest rate swap futures contracts could or would (let alone should) simply replace the existing bond futures contracts via a migration of the scale of existing derivative liquidity from one type of contract to another. SFE's listing of such new contracts is not designed to substitute for existing CGS futures liquidity but to complement it.

There is no precedent of a futures market in the world where such a substitution has ever occurred and it is by no means certain (indeed it is quite unlikely) that OTC swap market liquidity simply would migrate to the more efficient and risk diversified futures market. SFE's contemplation of listing interest rate swap futures, bond index futures or exchange traded credit derivatives is recognition of differing 'clientele' effects or hedging demands within its markets, not as potential outright substitutes for existing CGS bond derivative liquidity. This point is more fully developed in Section 5. Further CGS redemptions or complete elimination will inevitably migrate the primary interest rate price discovery process from the futures market to the (predominantly) trading banking system which would seem an odd policy preference or outcome in a world that has become characterised by bank disintermediation and risk securitisation. It would also seem contrary to a policy desire to minimise the vulnerability of the financial system, and wider economy, to any crisis of confidence in an individual bank.

The exchange traded business model represented by the SFE is characterised by high transactional efficiency and the capital efficiency benefits of central counterparty clearing (novation), reduced need for bilateral collateralisation agreements, and margin offsets between correlated instruments. In relation to the financial health of the market operator SFE, the operation of an exchange and vertically integrated clearing system such as that conducted by SFE essentially can be characterised as an efficient processing utility of sufficient financial standing (capital adequacy) to honour its oversight of a 'mutualisation of risk' principle embedded in futures clearing activities. SFE's financial health is a function of:

- variable revenues tied to trading volumes on the Sydney Futures Exchange.
- fixed income depository volumes through the Austraclear system, and
- an expense structure characterised by an almost totally fixed cost base (a function of non scaleable investments in electronic trading/clearing platforms and telecommunication distribution systems).

Beliefs or assertions³ that as a result of further CGS redemptions:

“The physical bond market would cease to be the locus of price discovery and be replaced by the futures market; this transition is essentially already complete in Australia.”

(whilst flattering and accurate) confuse a simple truth that while deep, liquid futures markets in securities or physical commodities assume the significant role in a price discovery process (back into underlying cash markets), it is impossible to sustain a futures market independently from the state of health or existence of its underlying cash market. There is no global precedent in which a futures contract is traded on an organised exchange without a robust underlying cash market. To the extent the underlying physical asset disappears (or is so reduced in supply as to threaten derivative market fairness and orderliness), so too do the financial instruments such as futures and options (i.e., the derivatives) that are “derived” from that asset.

Further CGS redemptions carry the potential to impact adversely the liquidity of the 3 year and 10 year bond futures contracts traded on the Sydney Futures Exchange. Such redemptions also carry increasing potential to trigger ‘squeezes’ in contract settlement processes and/or market manipulation. Either or both of these event risks have the potential to threaten the reputation and financial health of SFE which may not be a matter of policy concern in itself, but either or both are likely to have adverse consequences for the reputation and effectiveness of Australia’s financial system.

Market experience to date

There are a number of reasons why cash market outstandings are related to futures and options trading volumes. The greater the number of bonds outstanding, the greater the demand:

- for hedging from investors who hold those bonds, as well as from market makers and arbitrageurs who temporarily hold those bonds, and
- from investors (fund managers) seeking to manage their exposures through futures for transactional efficiency and relative liquidity reasons.

10 year bond futures contract volumes generally have stagnated as the stock of physical bonds of equivalent maturity has reduced. Conversely, 3 year bond futures volumes have risen as the stock of physical bonds has reduced. Differential volatility between 10 year and 3 year bond futures is unlikely to be the reason for this phenomenon since the yield volatility for both contracts has been highly correlated. There are many possible explanations, including:

- the correlation of 3 year bond futures volumes with the total stock of long term securities on issue (declining CGS offset by non CGS debt issuance), implying that bond futures are being used as a hedge or exposure overlay for shorter dated non CGS debt securities.
- the use of the 3 year bond future as a proxy for non-CGS hedging is precisely because it is a CGS based futures contract (ie., there is unlikely to be an acceptable corporate bond or bond index future in the near term due to the unavailability (or lack of likelihood) of real time pricing emanating from the cash market).

3 Edey, M and Ellis, L. ‘Implications of declining government debt for financial markets and monetary operations in Australia’, RBA BIS Papers No. 12

- participants wanting to hedge for longer holding periods are more susceptible to the credit spread risk between CGS and non CGS securities. The shorter the holding period, the more likely the interest rate risk will be hedged with lower transaction cost CGS or CGS futures contracts.
- the migration from floor based trading to electronic trading at the end of 1999 tightened spreads and improved liquidity, giving rise to a multiplier effect (liquidity breeds liquidity) biased towards the 3 year contract.
- SFE's 24 hour trading capability provides trading opportunities from intra-day volatility in US indicators, supplemented by its offering of direct access to SYCOM via its Chicago hub for new US customers who are initially attracted to the most liquid contract (the 3 year bond, in the case of SFE) offered by any non US exchange seeking direct access to US customers.
- the change in the coupon rates from 12 percent to 6 percent in 2001 to better align the yields on comparable futures contracts with the underlying cash market, supplemented by the introduction of intra-day options in 2002 on both futures contracts, have served to boost trading volumes, particularly in the most liquid 3 year bond contract.
- Australia is one of very few western countries offering international investors (and the derivative trading community) bond derivative liquidity on a scale comparable to much larger capital markets. As can be seen from the table overleaf, government bond futures contracts are the 'norm' for the international trading and investment community to manage underlying exposure or trade medium to long term interest rate obligations. This is not an accident of history; rather, recognition of the credit homogeneity of a risk free security lending itself to being the perfect security on which to base a futures contract and bestowing lower transactions costs than alternative instruments,⁴ a point more fully developed later in this submission when potential substitutes are reviewed.

The table overleaf highlights that SFE's 3 year bond futures contract volume for the first 8 months of 2002 was higher than that of the long gilt contract traded on LIFFE or the long JGB contract traded on the Tokyo Stock Exchange, and represented the largest pool of government bond derivative liquidity outside of the US and German bond markets.

BOND FUTURES AND OPTIONS VOLUMES (2002)

Contract	Exchange	Year to Date Contract Volume
Euro-BUND	Eurex	108,220,044
Euro-BOBL	Eurex	63,379,894
Euro-SCHATZ	Eurex	61,463,229
10 year Treasury Notes	Chicago Board of Trade	48,768,369
30 year US Treasury Bonds	Chicago Board of Trade	32,362,915
5 year Treasury Notes	Chicago Board of Trade	26,805,311
Euro-BUND Option	Eurex	10,167,396
3 year Commonwealth Treasury Bond	Sydney Futures Exchange	9,973,422
KTB	Korean Futures Exchange	7,942,373
30 year US Treasury Bonds Option	Chicago Board of Trade	7,775,509
5 year Treasury Notes Option	Chicago Board of Trade	4,866,234
Long Gilt	Euronext-Liffe	4,496,933
10 year Japanese Government Bond	Tokyo Stock Exchange	3,798,909
Euro-SCHATZ Option	Eurex	3,424,337
10 year Commonwealth Treasury Bond	Sydney Futures Exchange	3,046,383
Euro-BOBL Option	Eurex	2,238,308
2 year Treasury Notes	Chicago Board of Trade	1,744,434
10 year Euro Swapnote	Euronext-Liffe	981,586
3 year Treasury Commonwealth Bond	Sydney Futures Exchange	650,571
Overnight Option	Tokyo Stock Exchange	625,312
10 year JGB Option	Euronext-Liffe	570,190
2 year Euro Swapnote	Broker Tec Exchange	512,303

Source: *Futures and Options Week (Jan – August 2002)*

Attempts by exchanges to list futures contracts on agency securities such as Fannie Mae's in the US or semi-government securities in Australia have failed dismally, for reasons more fully dealt with later in this submission. The inability to trade futures for agency securities and semi-government debt is testimony to Wojnilower's⁵ belief that:

“Without Treasuries, it is questionable whether derivatives activity in general can be maintained to the present extent.”

Significantly, swap futures contracts listed on LIFFE and the Chicago Board of Trade are yet to attract strong market support. When one considers that a swap contract is itself a derivative, and that a swap futures contract is a derivative on a derivative, it is easier to understand that, whilst having a place in the futures product landscape, swap futures contracts are unlikely to substitute for government bond futures, for reasons more fully developed in Section 5 of this submission.

Market risks

A minimum amount of outstanding CGS is required to maintain a transparent and orderly settlement price expiry process for SFE's 3 year and 10 year bond futures contracts pursuant to its market operator obligations. In a paper sent to the Commonwealth Treasury in July 1998 under its then CEO's (Mr Hosking) signature, SFE stated that a minimum of A\$30.0 billion CGS for

⁵ 'Life Without Treasury Securities', A.M. Wojnilower, Business Economics, October 2000

inclusion in the 3 year and 10 year bond baskets would be necessary to maintain fair and orderly futures markets in these securities, plus an additional buffer of A\$20.0 billion. At the time of that advice, CGS outstanding totalled A\$73.2 billion and the outstanding amounts for stocks included in the baskets totalled A\$14.6 billion (3 year) and A\$19.1 billion (10 year), for a total of A\$33.7 billion. The ratio for CGS outstanding relative to those included in the baskets was 2.17:1.

More importantly, the buffer amount of CGS available for end holders to switch into if basket stocks became 'tight' in the secondary market, was then A\$39.5 billion. A buffer is necessary in order to ensure that stocks do not get extraordinarily expensive, or unavailable to borrow in the repo market, as occurred in other securities in September 1998 and June 1999 in the Euro-BUND futures contract traded on Eurex, and in March 2001, when a similar squeeze affected the 5 year Euro-BOBL contract. The buffer encourages and allows end holders to switch into similar duration stocks that are 'cheaper' on the yield curve, maintaining orderly markets and transparent price information.

As of October 2002, there were approximately A\$53.2 billion of CGS outstanding (excluding October 2002 maturities) of which A\$33.6 billion are included in the SFE baskets (3 year A\$17.3 billion and 10 year A\$16.3 billion). The ratio for CGS outstanding relative to those included in the (settlement price expiry) baskets has fallen to 1.55:1 and the buffer for switching has more than halved to A\$19.6 billion, fractionally under the minimum buffer advised in 1998. With an estimated 38 percent of all CGS currently held in offshore hands and an additional unknown quantity held by 'passive' fund managers, the risk of manipulation of individual stocks in the basket has increased as the Commonwealth has continued to redeem outstanding bonds. Further elimination of the buffer would heighten the risk of manipulation at close out and cast a serious question over participants' ability to confidently hold 'open positions' as expiry quarters approach. For CGS futures contracts to remain viable, no further redemptions should occur and an increase in the buffer will be required over time if FSR legislated 'fair, orderly and transparent' market tests are to be maintained. This is especially important as growth of funds under management resulting from GDP growth and recent increases in the Superannuation Guarantee Levy strengthen the demand for medium to long term risk free assets.

In the same vein, an appropriate amount of outstanding CGS is required to maintain the relevance of flows and price changes in the physical market to those occurring in the futures market. Any further significant reduction in the amount of stock on issue would result in high price volatility in the physical market, which subsequently would be translated into volatility in the futures market, causing the price of individual stock lines to be prone to significant movement in times of short supply. While price volatility is not necessarily a negative feature of markets, it is disruptive when caused by low supply and illiquidity. Excessive price volatility in the futures market because of short supply would reduce the effectiveness of the futures market as a risk management transfer mechanism and the yield curve benchmark.

Whilst it is not reasonable to expect CGS issuance to outpace the economy's natural rate of growth or to give rise to 'crowding out' of non CGS debt issuance, it is reasonable to expect that, if policymakers can be convinced of the undesirable consequences of further CGS redemption, then the stock of CGS on issue can be at least maintained at current levels in order to:

- allow the efficient functioning of the futures market.
- avoid market manipulation, and

- maintain relevance for the World Government Bond Index which (circuitously) creates some of the demand for A\$ bond derivative liquidity for which the Australian financial system is a beneficiary.
- maintain the ultimate safe haven asset and avoid the consequences of dependence on the banking system and bank balance sheets to fulfil this function.

To date, a combination of RBA broadening of the menu of securities it will accept for its repo activities (to include semi and supranational A\$ bonds) and the September 2001 launch by SFE of its central counterparty clearing initiative for bonds and repos have served more recently to arrest the trend towards declining liquidity in the CGS market. One could consider this an example of a market adapting or evolving to change. An alternative explanation is that it is a necessary defensive move required as a result of policy propensity for CGS redemptions without due regard to market health. Had neither of these changes occurred, RBA's stabilisation role within the financial system and SFE's oversight of fair and orderly trading markets could have been compromised.

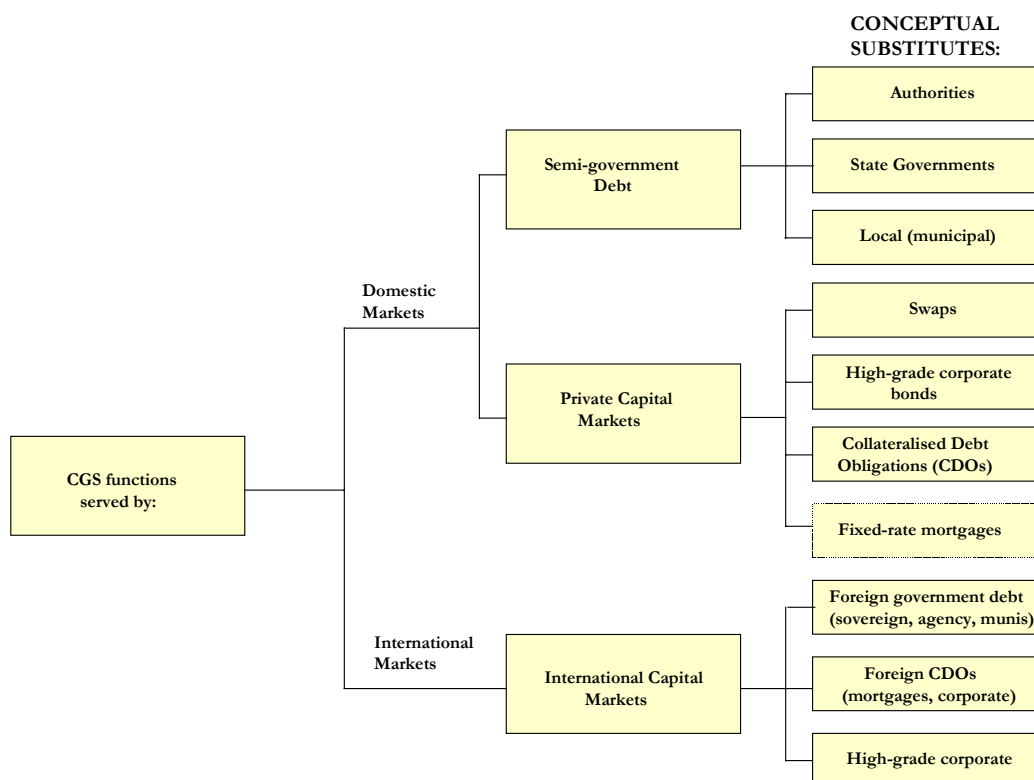
The total amount of securities available to the RBA to manage liquidity in the financial system has been relatively flat over the past 3 to 4 years, with a decreasing portion comprising the most liquid CGS. Whilst 3 year bond derivative volumes have grown and offset the decline in the physical stock of shorter dated CGS on issue, this trend is unlikely to continue with further physical bond redemptions, let alone complete elimination of the CGS market. Indeed, the signalling of this very review process has already triggered a serious thwarting of the SFE's international distribution strategy as independent software vendors have questioned the sense in continuing to build interfaces to an Australian based exchange promoting CGS bond futures liquidity internationally at the same time as the Australian government is reviewing the desirability of maintaining a CGS market.

5. IMPERFECT SUBSTITUTES

Combined with Australia’s regulatory framework that oversees financial markets and the country’s ‘first world’ financial skill sets and competencies, the CGS market is among Australia’s most valuable assets. To the extent to which the CGS market fulfils ‘public good’ functions described in an earlier section of this submission, it adds to the efficiency and effectiveness of the financial market to allocate capital.

The Chairman of the Federal Reserve in the US acknowledged that the elimination of US Treasury debt “does remove something of economic value”.⁶ The US Federal Reserve, in a 2001 paper by Antulio Bomfim entitled ‘Optimal portfolio allocation in a world without Treasury securities’, estimated the cost of fund managers not having access to a risk free asset to be 0.5 percent of US private sector wealth. In Australia, elimination of Commonwealth debt has far broader and more significant implications, given its lack of comparability to the depth of US capital markets and range of securities. Equivalent illiquidity premiums being reflected in fixed and floating rate debt spreads across the entire household and corporate debt sectors would represent a serious uplift in the nation’s cost of capital, with the potential to dwarf the interest servicing costs of existing CGS debt. The Discussion Paper makes no attempt to quantify these impacts.

Demand for the functions provided by the CGS market would remain, even in the absence of the supply of such debt. If the CGS market were not available to meet this demand, one could conceptually expect that the markets for other financial instruments such as securities and debt obligations would be required to provide surrogacy for these functions. These potential substitutes conceivably could take any of the following forms:



⁶ ‘The Paydown of Federal Debt’, remarks by Chairman of the US Federal Reserve, Alan Greenspan, before the Bond Market Association, April 27, 2001

The ability of any of these conceptual substitutes to provide the functions of the CGS market is highly questionable. In Australia, deep and liquid markets currently do not exist for most of these potential substitutes. Furthermore, given the maximum potential size of these markets in Australia, domestic markets are unlikely to be able to fulfil the entire shift in demand that otherwise would be met by the CGS market. The result of CGS elimination is likely to be a shift away from Australian financial markets by both issuers and investors towards international capital markets and the use of currency swaps to mitigate exchange rate risk.

Semi-government debt

Interest rates for semi-government bonds reflect the differential credit standing of the individual state borrowing entities. Not only do these debt instruments reflect the higher risk of Australian states (ranging from AA- to AAA credit ratings), they also have followed a similar diminution path as CGS. Semi-government bonds on issue totalled A\$50.0 billion in June 2000.⁷

Currently there are 36 different lines of semi-government bonds, with an average size of A\$1.3 billion, much less than that of the 12 lines of CGS with an average benchmark issue of A\$4.7 billion. For semi-government bonds to supersede the CGS market there would need to be greater co-ordination between the state borrowing authorities (or the creation of a single authority). For semi-government bonds to become the supporting market for futures contracts there would need to be consistency in coupon and maturity dates of the different bonds on issue to ensure the homogeneity of the market. A semi-government based futures contract listed by SFE in the 1990's failed to gain liquidity because of a lack of standardisation, which is a prerequisite for a successful futures contract and the very reason why government bond contracts dominate the global futures industry landscape.

Private capital markets

While bank-accepted commercial bills provide the underlying physical instrument at the short end (90 days) of the market, this reflects the fact that a significant proportion of bank lending is done on this basis, both as a liquidity instrument for banks and in response to demand from customers (who can negotiate the best price for their paper in an active physical market). There were also historical reasons for the growth of this market, to do with lending controls and differential reserve costs.

There is no such bank-guaranteed commercial instrument in the medium/longer end of the market, nor is one likely to develop, because of the risks to the guaranteeing bank associated with an unconditional medium/longer term credit commitment. All bank credit commitments are subject to financial covenants and banks need to preserve their ability to respond to breaches of these covenants. This is not an issue in the 90 day market.

Corporate debt issuance has benefited from the generally lower level of interest rates but the market for corporate bonds is not actively traded and, as the RBA acknowledged in its 1999 Annual Report,

“There is a degree of complementarity between the two market segments – i.e., at some stage further reductions in the supply of government bonds will not necessarily lead to even greater issuance by the private sector, as the existence of a government (risk free) yield curve is an important part of the infrastructure underpinning non-government issues.”

7

It would be unwise for policymakers to seek comfort from the fact that the decline in CGS on issue appears to have been offset by non-CGS debt issuance because liquidity is not remotely comparable between the two markets. As importantly, the CGS market has the attendant exchange traded derivatives infrastructure attached to it in a manner that the non-CGS fixed income market is unlikely to develop equivalent liquidity in the near future, for reasons explained below. Although the corporate bond market has undergone a transformation over the last few years, with debt outstanding increased from just over A\$10.0 billion in June 1996 to around A\$80.0 billion currently, only a portion of this is high-grade corporate debt. Corporate debt also suffers from volatility that is highly correlated to the economy, preventing it from serving as a safe haven during economic downturns or during periods of turbulence in financial markets.

Some commentators point to the fact that corporate bonds on issue have benchmark potential. However, while the CGS market comprises 12 lines of bonds, with an average on issue of over A\$4.0 billion per line, the corporate bond market has over 275 lines of bonds on issue, with an average size of just on A\$300.0 million. Most of the commentary on Page 32 of the Discussion Paper explains the very reasons why the corporate bond market lacks liquidity and why interest rates are more likely to rise than fall in a non CGS world. Every corporate issuer is subject to idiosyncratic changes in its individual credit rating and that of its industry or sector. Anticipating or even keeping up with such changes requires a significant research effort by investment banks that are unlikely to see it as a viable economic activity in a small market such as Australia.

Commonwealth data shows that while CGS have a liquidity ratio (ie., ratio of turnover to stock outstanding), of just under 9 which has declined over time with bond redemptions since 1996/7 and been outpaced by an even sharper decline in turnover by fund managers, the corporate bond market liquidity ratio is a much lower 2, while asset backed bonds have a liquidity ratio of only 1.5, clearly evidencing the 'buy and hold' attributes of the latter two markets.

Whilst the SFE has given active consideration to listing futures contracts on corporate bond indices (and credit derivatives), the fact that such a contract has not been listed on a major US or European derivatives exchange, where underlying cash markets are more liquid than in Australia, is prima facie evidence that it is unlikely to gain near term broad market acceptance and liquidity, unlike the existing CGS futures contracts. Policy action designed to test such acceptance by conscious removal of existing derivative liquidity would be unwise and somewhat irreconcilable with having defined SFE as operating a market of national interest in FSR legislation enacted only months ago.

It is also worth noting that for the RBA to use the corporate bond market for its repo activities would introduce an element of credit risk to the stability of Australia's financial system which could be tested during periods of financial stress (this is exactly what happened in the Korean bond market during the Asian crisis in the late 1990's).

Collateralised debt obligations, specifically mentioned by US Federal Reserve Chairman Greenspan as a potential substitute in the US market, are currently not a robust offering in the US let alone Australia. Size and diversity limitations with respect to the Australian market for corporate debt severely inhibits the ability of this potential market to replace the functions of the CGS market.

Long-term mortgages play a significant role for long-term interest rate benchmarking in Korea as well as the United States. The transfer of this role to Australia, however, also suffers from inapplicability. Mortgages in Australia are predominantly variable rate, with fixed rate offerings rarely exceeding 5 years. Furthermore, Australian mortgages are not backed by either the Commonwealth or State governments such as is the practice in the United States via the Federal

National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).⁸ As a result, the securitised (collateralised) mortgage sector finances about 10 percent of housing loans in Australia and exhibits growth but lacks relevant 'benchmark' attributes. Reliance on long-term mortgage rates to set an adequate benchmarking mechanism would require a structural change in the Australian mortgage market and a policy change by the government.

Swap markets

The strongest theoretical contender for CGS pricing/benchmarking substitution is the OTC swap market in Australia for domestic (fixed/floating) interest rate obligations and A\$ based cross currency swaps. This is principally for two reasons, firstly, because it exhibits liquidity (albeit more tenuous for longer dated maturities and not on the scale of the CGS futures market), and secondly, because it is not dependent on an underlying asset. Aside from the fact that the swap market has few of the positive externality attributes of the CGS market, interpretation of its liquidity should take into account a lack of comparable homogeneity to the CGS market. The OTC swap market itself suffers from the following shortcomings relative to the existing CGS/futures model:

- **Prepayment risk:** non CGS fixed rate debt typically includes either a prepayment option or a call provision. In contrast, swap agreements do not contain a prepayment option, instead requiring active managers to incur additional unwinding, grossing up or cancellation costs in order to manage underlying exposures.
- **Default risk:** average risk premiums for medium to longer dated swaps are higher than those on long term CGS, making the overall swap curve steeper than the bond curve. This would represent an explicit cost to users of capital markets, given the prima facie lack of evidence that the existence of the CGS market is not giving rise to any 'crowding out' effects on non CGS debt issuance.
- **Liquidity risk:** withdrawal of key market makers can seriously damage the availability of a swap curve. The fragility of a swap curve is illustrated by the European financial crisis of 1992 and the dramatic flight of financial investors after the Russian crisis in 1998. In 1992, the ECU sector was also plagued by a general lack of liquidity and the Eurobond market suffered from major structural problems. Liquidity problems were exacerbated by the minimal amount of hedging opportunities (i.e., no swap curve available) and with the withdrawal of key market makers. The only factor that caused the market to rebound was, "commitment of governments to the markets..."⁹

The BIS¹⁰ has recently acknowledged that:

“Concerns remain about the resiliency of the swaps market. Market participants report that liquidity can be quick to evaporate from swaps markets during periods of volatility.”

⁸ Historical exceptions include government guarantees such as NSW Housing Loans Insurance Corp (HLIC) or General Mortgage Acceptance Corp (GMAC).

⁹ www.geocities.com/e_philip_davis/mlr983.pd

¹⁰ BIS Papers, No. 5, 2001 Page 32

Swaps are by their very nature more complex hedging mechanisms that are imperfectly correlated with risk free rates and subject to the categories of risk itemised above. In effect the swap market cannot replicate sovereign risk in Australian currency. Its substitution for a risk free curve would represent a much less efficient hedging tool and would constitute a conscious policy decision to migrate interest rate price discovery from an efficient, transparent and agnostic futures market to bank balance sheets, with the attendant susceptibility to changes in the credit quality of banks.

- **Asymmetrical access:** Unlike CGS, which are issued to the market at a single price and then traded in a secondary market, swaps are negotiated between parties in accordance with terms that reflect the credit worthiness and risk characteristics of each party to the transaction. This is because unlike a government bond, an OTC swap is not a security or an investment but a bilateral financial arrangement. Each party to an OTC swap transaction has to take a counterparty credit risk. An OTC swap transaction between A and B is not the same transaction as one between X and Y even if all the payment terms are the same. In fact, an OTC swap between A and B is not the same as one between A and X for the same reason. This is totally the opposite to the CGS market where there is a one way credit risk flow from the issuer, the Commonwealth (which is considered to be effectively zero or risk free) to the investor.

This lack of credit homogeneity means that the OTC swap market can never be as liquid as the CGS and adjacent futures market. Market participants cannot stand in the market quoting prices for swaps because they do not know who will be on the other side of the transaction. Prior to an OTC transaction being transacted each party must have a pre approved credit limit in place for the other party.

This means that the OTC swap market is, in fact, not available to many market participants and certainly nowhere near as accessible as the CGS market. This is the very reason why swap futures contracts listed on overseas exchanges are not anything like as actively traded as government bond futures contracts because a swap futures contract attempts to homogenise underlying credit differences which, by definition, do not exist for a government bond.

A possible method to homogenise the credit differences in the OTC market would be interpose or novate one side of every OTC swap to a central counterparty such as SFE Clearing Corporation. This would streamline one side of the credit risk process. However, even though such a third party may have a high credit standing it could never be as creditworthy as the Commonwealth of Australia. Because of the very nature of a swap, the trusted third party would have to manage the credit risk of the other side of the swap which would necessitate applying capital or calling for collateral which would incur additional cost and could never be as efficient as the CGS market.

This intrinsically inferior liquidity and lack of transparency will mean the OTC swap market will never be as efficient a risk transfer or hedging market as the CGS market. Lower liquidity implies a higher degree of risk in holding a position and therefore a market participant must charge a risk premium to compensate for this, meaning transaction costs to enter into a transaction and then close it out in the OTC swap market are significantly higher than in the CGS market.

This lack of liquidity also limits the volume which can be transacted at any one price. Because a government bond is a security it can be delivered in very small parcels, ie down to \$1000.00 lots. OTC swaps, because of their complexity and administrative intensity, could not be cost

efficiently delivered at anything like this trade volume. In fact the minimum parcel size without incurring a significant price premium would be greater than \$1 million. Similarly, there is also a price penalty for large volume transactions in the swap market. In the CGS market large parcels of securities, in excess of \$100 million, can be bought and sold without affecting the market price. This is not the case in the OTC swap market.

Another reason for the high cost of OTC transactions is residual credit risk involved in the transaction even after the interest rate risk may have been removed. In the CGS market if B buys a bond from A and then sells it to C, B has nothing more to do with the transaction. In the OTC swap market if B enters into a swap with A and subsequently offsets that swap with C, B will continue to have to make periodic (usually quarterly or semi annually) payments for the remaining life of the swap incurring both administrative expense and assuming the credit risk of either A and/or C defaulting.

- **More complex price discovery:** Price discovery in the OTC swap market is a two step process. First, establishing the price for “base interest rate risk” and second, adding a margin for appropriate credit risk and administrative cost. Currently the price for the “base interest rate risk” is determined from the CGS and CGS futures markets with a bond/swap margin then being added. Those market participants quoting prices in the OTC swap market are thus leveraging off and adding to the liquidity and efficiency of the CGS market, both cash and futures, which are used by all other market participants. To retain the efficiency of price discovery in the OTC swap market in the absence of a CGS market all the current participants, investors, speculators and hedgers, would have to move to the same market and trade it just as actively and efficiently. Unfortunately, there is no such market. If such a market existed, in order for other securities to be priced, market participants would need to decompose the return on swaps into a risk free return and risk premium and then ‘discover’ the risk premium for the security they would be seeking to price.

Conceptually such a market need could be met by an interest rate swap futures contract, however, whilst such contracts are about to be listed by SFE they are not expected to assume the benchmark status of the CGS futures market. It should be noted that the swap futures contract is quite a different animal to an OTC swap contract. A swap futures contract is in fact a contract to enter into a swap at a point in the future, except that instead of entering into that contract the futures contract will expire and there will be a cash settlement, identical to the manner in which the bond futures contract works. Whilst there is no direct transfer mechanism from a bond futures contract into a government bond it is, in practice, an easy, cost effective and low risk transaction to execute. However, as stated above not all participants have easy, convenient or in some cases any access to the OTC swap market making the adjacent swap futures contract a less attractive proposition.

Worsening each of these serious shortcomings, it should be noted that the swap market does not in anyway offer firm prices which can be acted upon. The OTC swap market, by its nature, cannot be contrasted as a benchmark for liquidity or efficiency, with any comparability to the CGS/futures market.

SFE provides an important service to users of Australian and New Zealand financial (particularly interest rate) derivative instruments. In providing transparent price discovery through its central trading system (SYCOM), and by connecting the widest possible number of users to that system through global electronic access, transaction costs are kept as low as possible for users. This is

because any user has the opportunity to trade at the best price – regardless of the size of the transaction, the identity of the user or location around the globe. In disseminating market information through the exchange’s own trading system and via the global networks of data vendors, all users have simultaneous access to all information relating to bids, offers and trades as they occur in real time.

In addition, SFE provides central counterparty clearing whereby its clearing corporation is interposed between every buyer and seller – ensuring the highest quality risk management and removing counterparty risk. Importantly, this frees up credit lines between counterparties and improves overall market liquidity.

OTC markets (e.g. bonds or swaps) are characterised by flexibility to handle less commoditised products. Whereas SFE facilitates the trading of highly commoditised products, OTC primary and derivative markets allow users to trade non-standard products. The two types of derivative market efficiently co-exist, but with a degree of interdependency. Just as the SFE’s bank bill futures contract is used as a hedging mechanism for the short dated OTC swap market, the bond futures contracts traded on SFE share some degree (albeit lower) of interdependence with the longer dated OTC swap market. Without deeply liquid bond futures contracts, the liquidity and efficiency of the swap market itself would be seriously impacted, whereas in the absence of a swap market it is unlikely that bond futures contract volumes would be materially impacted.

However, as touched on earlier, the transparency of price discovery in OTC markets is significantly inferior to exchange traded markets as they are typically operated via the telephone rather than through a central trading system. Price dissemination does occur through the global networks of data vendors, but not in real-time and often many hours after a transaction takes place. Users are not connected electronically, but must phone each other in order to establish the best price at which they can trade – which is dependent on the size of the transaction and the identity of the user. This is because OTC markets often operate on a hierarchy basis, where inter-bank dealers can access better prices than end users. OTC markets also have less ‘real time’ and ex post regulatory oversight than exchange traded markets (with knock-on systemic risk implications of seeing interest rate price discovery migrate to a less regulated non exchange traded (banking) model).

Transactions are bilaterally executed in the OTC market and the counterparties have credit exposure to each other. The effect of these bilateral arrangements is to tie up credit lines between counterparties thereby reducing overall market liquidity – an effect which can be crippling to a market. SFE is already providing a central clearing facility to the OTC government bond market in an attempt to improve liquidity and offset the impact of the CGS redemptions of recent years. The Australian OTC electricity market is similarly constrained.

If the swap curve were to become a replacement to the benchmark CGS yield curve, with liquidity migrating from the exchange traded market for CGS futures contracts to the OTC swap market, the effects are obvious. Access would be inferior (in fact many of the smaller liquidity providers would not be able to gain access to the inter-bank OTC market and would therefore exit the market), price transparency would be reduced, bid/offer spreads would widen for end users, and liquidity would not be helped through the tying up of credit lines. These all translate into higher transaction costs for users.

In Australia, the interest rate swap market is an OTC market dominated by the 4 major trading banks and characterised by many different types of swap said to constitute the ‘market’. Whilst efficient, it is less transparent and efficient than the CGS and attendant futures market, which is

more diversified and centrally cleared. Similarly, whilst Australian investors might accept a financial market system based on bank credit risk, international fund managers are in many cases either precluded under their own mandate arrangements from investing in anything other than government bonds, or look for longer dated exposures than the shorter dated liquidity of the swap market offers.

Significantly, 3 of Australia's 4 major trading banks are noticeably absent from participation (as settlement price providers) in 3 and 10 year interest rate swap futures contracts shortly to be listed at SFE, for the logical reason that it is not in the narrow interests of bank shareholders to see swap price discovery migrate from the OTC derivatives market to the exchange traded derivatives market. This is understandable from the shareholder perspective of a financial firm. From the point of view of the financial system as a whole and the public interest, however, it has the potential to produce a second best outcome if the demise of the CGS market and related futures contracts is the price paid for the pursuit of such private interests indirectly supported by the stance of public policy.

The recent BIS study group¹¹ concluded that further improvements in the liquidity of swaps were likely to depend on the migration of swaps trading onto organised exchanges due to the fact that 'trading in the over the counter market is dominated by a few highly rated dealers'. This is exactly the situation in the Australian capital market at the present time. BIS went on to say that:

“Owing to this concentration, the swap market labours under higher transaction costs and remains less liquid than it might be if swaps were traded on an organised exchange.”

It is somewhat ironic that policymakers in Australia could even be contemplating triggering the demise of the CGS market (with its 'knock-on' consequence for the futures market) if the inferior potential substitute price discovery mechanism (the swap market) would be more efficiently and transparently conducted on the most logical organised exchange (SFE), and that exchange is already trialing the first of several 'step out' contracts.

Even the Commonwealth's own Discussion Paper (Page 47) concedes that the interest rate swap market is unlikely to assume the primary role for managing interest rate risk in Australia 'due to limits on improving market liquidity'. Whilst SFE has every intention of extending its central counterparty clearing (novation of bonds and repos) facility to include interest rate swaps, (irrespective of the success of its swap futures contracts), the fact remains that swaps form only a part of the demand function for existing CGS futures liquidity and only a part of the overall demand for interest rate risk management services.

SFE currently estimates, based on a breakdown of participant type and other data sources, that approximately 20 percent of contract volumes in the 3 year bond futures contract and 10 percent in the 10 year bond futures contract are dedicated to swap hedging. Other underlying demand drivers include longer term asset hedging, overlay exposure management, portfolio curve smoothing, non expiry speculation (including day trading) and the use of the contracts as a capital efficient proxy for physical bonds, among other reasons.

Unless these estimates are wildly inaccurate, which SFE does not believe to be the case, it would seem more likely that the demise of CGS futures contracts would be more deleterious than beneficial for the efficiency of the medium term swap market (and for the entire process of interest

¹¹ BIS Papers, No. 5, 2001 Page 32

rate price discovery). Interest rate swap futures contracts have a place in the product landscape but cannot be expected to provide equivalent futures market liquidity and efficiency to that currently provided by the SFE's 3 year and 10 year bond futures contracts.

It is inconceivable (having due regard to the relative efficiencies of the CGS/futures market attributable to issue fungibility, credit homogeneity, access transparency, global distribution and liquidity) that alternative instrument futures contracts could totally replace the current 3 year and 10 year CGS bond futures contracts.

By virtue of the fact that the return on CGS exhibits no risk premium, physical CGS or complementary futures contracts are particularly versatile in terms of their efficiency for hedging any other type of debt security. An interest rate swap future is less efficient because embedded in its rate of return is a time varying risk premium.

While Page 47 of the Discussion Paper reports impressive correlations (all exceeding 0.95) between changes in yields on interest rate swaps, CGS and corporate debt, leading the Paper to conclude

“interest rate swaps may be an effective hedging tool for managing interest rate risk on other securities”

the correlations reported are averages. They do not reveal the stability of relationships (correlations) through time and consequently the efficiency of swaps as a hedging tool through time. Recasting the data for 12 month rolling correlations gives rise to higher correlations for 3 year CGS than interest rate swaps of equivalent maturity. Similarly, the variability (standard deviation) of correlations based on swaps are all higher than analogous correlations based on CGS, suggesting that the correlations are less stable through time. In fact the standard deviations of correlations based on swaps are between 36 percent and 100 percent higher than those based on CGS, implying that interest rate swaps are substantially less effective as a hedging instrument through time.

It may well be that, over time, the gravitational ‘pull’ of credit homogeneity and tight bid/offer liquidity of CGS futures could be slightly reduced by the lower ‘basis risk’ appeal of alternative interest rate based futures contracts (which SFE has every intention to list). To the extent to which this happens, however, it is likely to grow the overall efficiency of the market for interest rate risk transfer by virtue of co-existence, as opposed to the Discussion Paper's policy proposition that is likely to result in lowering that efficiency upfront by gradually or more dramatically eliminating the CGS market. The appendix to this submission compares the attributes of the CGS market, the bond futures market and the OTC interest rate swap market against liquidity, transparency, efficiency and regulatory oversight criteria and demonstrates the vast superiority of the existing market model.

International capital markets

It is important to note that even Alan Greenspan did not suggest that international capital markets could substitute for the US Treasury market. This omission was for good reason. The fact is that international capital markets do not meet these functions unless accompanied by a financial instrument that mitigates exchange rate risk. Thus, a risk-free return that reflects Australian sovereign risk cannot be provided by an international investment without an accompanying currency swap, thereby increasing the cost to make such an investment and decreasing the effective yield. Diminution of the CGS market will therefore increase the demand for currency swaps as investors turn towards international substitutes and are required to hedge exchange rate risk to the extent those investors have obligations in Australian currency.

The extent to which the current functioning of the cross currency swap market would be a prerequisite (and unnecessary cost) to the international capital markets providing a 'de facto' ability to provide a robust, alternative yield curve is a somewhat tautological point, not worthy of further analysis unless the objectives of policymakers are also to establish 'de facto' currency status for the Australian dollar alongside any chosen foreign sovereign yield curve. Since the most likely candidate offshore capital market to fulfilling this role is the United States, it should be noted that both the Australia/US cash rate spread and 10 year bond spread have traded in a very wide range in the past decade, consistent with different economic fundamentals. It should also be noted that this would heighten the likelihood of Australian companies by-passing the local corporate bond market and financing in US\$ and US or Euro capital markets rather than in Australia.

In the same vein it has been suggested in some quarters that supranational issues of A\$ debt could form an alternative benchmark market for Australia. The Australian financial market over the last few years has experienced increased activity by non-resident issuers both through domestic issuance ("kangaroo bonds") and through global structures. There have been 19 issues by non-residents amounting to A\$7.0 billion in 1999 and 2000. To date issuance has come primarily from highly-rated financial institutions from Europe and the US and also supranationals such as the IBRD and ADB. While still only accounting for 20 percent of the non-government market, the involvement of this class of issuer is important as they are able to bring large issues to market and build yield curves. However, the credit of such non-residents is variable and their commitment to Australian capital markets is inconsistent. The same criticisms against corporate debt as a substitute apply to this category, including lack of liquidity, fungibility and inability to serve as a benchmark for futures contracts.

In short it would appear that substitute yield curve benchmarks are either inferior, or prone to risk shortcomings that are undesirable from the point of view of maintaining the existing highly efficient financial infrastructure predicated on a CGS yield curve supported by a centrally cleared futures market. As the BIS recently acknowledged:

“All things considered, there do still appear to be advantages to using the government yield curve as the proxy for risk free rates The market saves on resources if price discovery about macroeconomic fundamentals is concentrated in only one homogeneous instrument.”

Potential substitutes that could fulfil the functions of the CGS market are either inferior, non-existent, or prone to risk shortcomings that are undesirable from the point of view of maintaining the existing highly efficient financial infrastructure. Continued diminution and potential elimination of the CGS market will not change the demand for the functions currently fulfilled by the supply of Commonwealth debt. Thwarted demand will simply shift towards imperfect substitutes with wider 'contagion' effects on A\$ denominated fixed income activity levels as the Commonwealth signals its disinterest in its own CGS market and preference for a trading bank dominated financial system. Investors who otherwise would prefer to invest in the CGS market or use it as the preferred mechanism for transferring interest rate risk will be faced with increased costs and lower returns for second-best alternatives.

6. AUSTRALIA AS A CAPITAL MARKET

“Given the potential for adverse impacts on Australia, it is in our interests to participate in constructive dialogue on medium to long term fiscal issues in the regional and multilateral forums to which we belong.”

- Commonwealth Department of Treasury, 2001.¹²

Australia’s financial markets are highly dependent on international investment. For example, international interest was a critical factor in the growth in trading fixed-interest futures during the late 1990s, driven by two factors: (i) increased confidence that Australia’s much improved inflation record in the 1990s would be sustained, with international investors positioning themselves to profit from likely falls in interest rates; and (ii) decreased liquidity in numerous Asian markets during 1997 and 1998, causing investors to view Australia as a proxy for investments elsewhere.¹³

Increasing international integration of both the Australian sharemarket and the market for A\$ derivatives listed on the SFE has occurred in recent years. As of 2002, 76 overseas-based companies are listed on the ASX. Foreign investors account for about 30 percent of trading on the ASX,¹⁴ roughly comparable to SFE’s estimate of its own offshore trading community. These estimates represent significant increases from a decade earlier when SFE was a floor based exchange and there were only 36 foreign companies with capitalisation of A\$53.0 billion, and continued increases from 1999 when there were 60 overseas-based companies listed on the ASX with capitalisation of A\$340.0 billion.¹⁵ Globally, the ASX is middle-ranking in most measures of stock market size (i.e., turnover and market capitalisation). More importantly, through no fault of its own, it lacks the scale to absorb the growth in superannuation funds Australia is generating at the very time that government policy is advocating CGS redemptions.

Australia’s trading partners have made concerted efforts to support their own financial markets in order to compete for international capital. Of particular relevance to Australia are the initiatives being undertaken in Hong Kong, Korea, and Singapore. These countries are in a position similar to Australia, experiencing budget surpluses and accumulating large reserves. Despite the lack of a need to issue long-term debt, the governments of these countries have embarked on programs to support their government securities markets, including the establishment of investment corporations, provident funds, one-time distributions to adult citizens, and support of the infrastructure for government debt markets. Many of these governments also engage in a high level of public infrastructure investment, although whether such investment is meant to support the bond markets or simply reflect a generous fiscal policy is unclear. The Discussion Paper’s dismissal of such precedent on the grounds that it is only relevant for countries trying to establish financial markets is contrary to any concept of regional capital allocation (outside of the major capital centres of the world) which all financial market practitioners live with on an everyday basis.

¹² Commonwealth Department of Treasury, “A survey of international fiscal policy issues – current drivers and future challenges,” *Economic Winter Roundup*, 2001.

¹³ Reserve Bank of Australia Bulletin, “Australian Financial Markets,” March 1999, p. 6.

¹⁴ 2002 ASX Fact Book, p. 4.

¹⁵ Reserve Bank of Australia Bulletin, “Australian Financial Markets,” March 1999, p. 6.

As part of their post-crisis policy agenda, other governments in the Asia-Pacific region are starting to focus on the development of effective government bond markets. In many cases, these governments have decided to continue to foster their long-term debt markets and issue government securities for the following reasons:¹⁶

“A well-functioning government bond market – more pertinently a Treasury securities market – can play a critical role in developing domestic bond markets. It can increase investor confidence in overall bond and financial markets. It can also provide a risk-free benchmark yield curve, which is crucial for revaluing portfolios and pricing corporate bond issues.”

Somewhat ironically, given the tone and direction implied in the Discussion Paper, the Australian Government also has adopted a policy position to support Australia’s financial markets and position Australia as a global financial services centre in the Asia Pacific region. In 1999, the government established what became known as Axiss Australia to capture the opportunities created by globalisation and advances in technology that are leading financial services firms to reassess the location of their global operations. However, in the absence of Commonwealth support for the CGS and attendant derivatives market, it is uncertain whether the government’s aspirations for financial centre status will be able to compete for international investors against trade partners that have established programs both to support their financial infrastructure and to foster their government bond markets. The sentiments expressed on Pages 67-68 of the Discussion Paper are little more than beliefs, unsupported by any transition timescales and unsupported by objective research.

As Australia’s trading partners engage in significant efforts to support their bond markets, the Commonwealth should consider the consequences of its failure to support the infrastructure of its own bond markets, namely:

- a weakened infrastructure for capital investment in Australia.
- a non risk free yield curve for Australian investments.
- decreased returns on investment resulting from shifted demand from the CGS market towards substitutes, offset by increased returns as Australian debt issuers struggle to attract international capital.
- lower foreign interest in the ongoing existence of Australian capital markets, as opposed to Australia’s natural appeal as a country for regional headquarters.
- the increased need for investment opportunities by Australian superannuation funds which will drive domestic investors towards international capital markets.
- weakening of the Australian dollar due to:
 - increased demand for conversion of Australian dollars into foreign currency to invest in international securities.
 - decreased demand for conversion of foreign currency into Australian dollars.

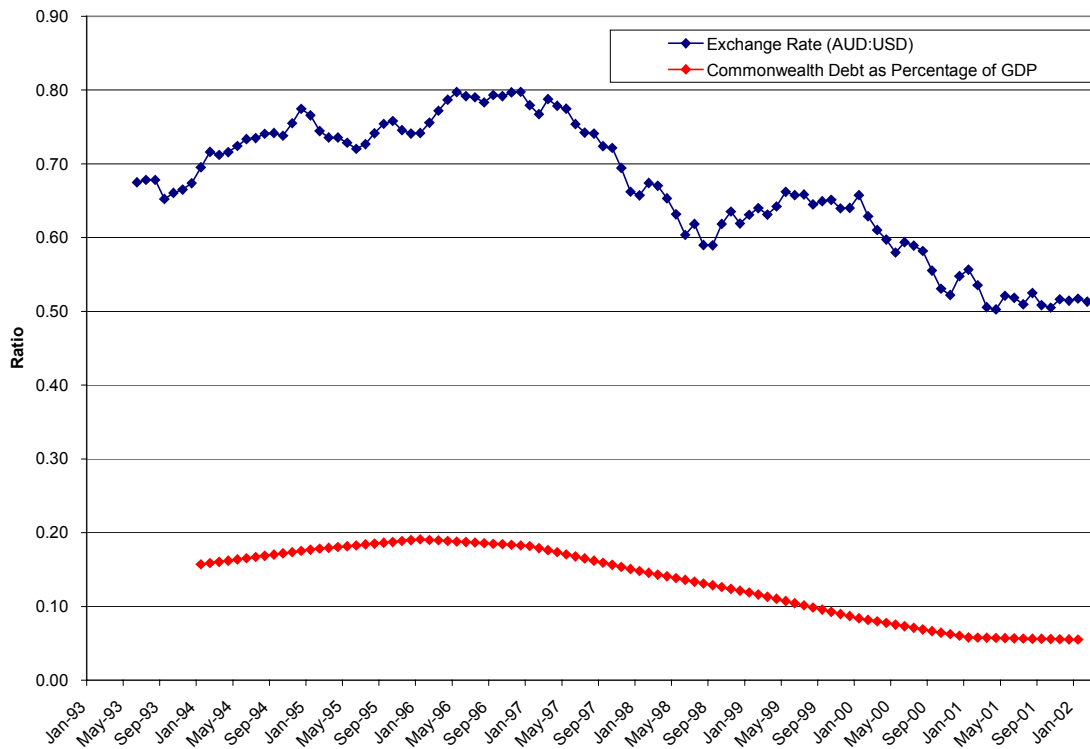
¹⁶ Asian Development Bank, “Government Bond Market Development in Asia,” Yun-Hwan Kim (editor), 2001.

The last point concerning the relationship between the strength of the Australian dollar and the Commonwealth’s commitment to Australia’s financial infrastructure deserves further explanation, especially as this is completely ignored in the Discussion Paper. Australia has a floating exchange rate regime in which the currency is allowed to move over a wide range in reflection of external shocks. However, the RBA has intervened in the past to moderate movements that seem excessive relative to changes in economic or financial conditions. Although the circumstances in which intervention occurs are infrequent, RBA intervened on numerous occasions in 1998. These occasions provide insight into potential implications for a weakened Australian currency.

The state of the Australian dollar by the summer of 1998 already had been weakened by a fall in the exchange rate against the US dollar by more than 15 percent in total over the course of a year. In June of that year, speculative selling of the Australian dollar on a large scale commenced. In mid-August, the Australian dollar again came under heavy speculative selling following the Russian crisis and the resulting turmoil in the markets. By this point, the exchange rate had fallen by about 25 percent against the US dollar, to a record low level. In response to these events, the RBA purchased Australian dollars on the spot market and purchased call options on the Australian dollar. Further weakening of the Australian dollar may increase the need for government intervention to bolster demand for a currency that has diminishing relevance.

Commentators recently have been linking the decline of the Australian dollar to the ongoing diminution of the CGS market. The chart below illustrates the correlation between redemption of Commonwealth debt and the exchange rate of the Australian dollar to the US dollar.

Comparison of Exchange Rate to Public Debt: 1994-2002



Source: Exchange Rate: OANDA.com

Government decisions concerning the CGS market should consider potential effects on the Australian dollar. Once Australia's share of global government bond markets fell below 0.5 percent of global indices, many global fund managers began to eliminate their Australian dollar exposure, because it was difficult to index and track. The resulting implications include decreased international interest in Australian government bonds, increased impediments to domestic capital raising, and even the relatively recent devaluation of the Australian dollar.¹⁷ Some commentary claims that ongoing repayment of debt and further downward pressure on the Australian dollar may "ultimately translate into a case for abandoning a currency that some believe is now little more than a shock absorber for the terms of trade."¹⁸

Given the proactive maintenance of government bond markets by Australia's Asian trading partners, domestic capital markets increasingly will be unable to compete for international investment if the government fails to support the underlying structure of its public debt markets in Australia. Hong Kong and other Asian centres are already positioning for bond trading centre status, in the wake of the Discussion Paper's release.

Continued defeasance of CGS is likely to result in further devaluation of the Australian currency. The perceived increase in foreign exchange risk will eliminate potential private market substitutes for key functions provided by sovereign debt, further eroding Australia's capital markets. This financial downward spiral will drive financing options overseas, straight into the arms of Australia's trading partners who have had the foresight to support their government bond markets in order to maintain a robust infrastructure for international capital investment in their economy.

The Commonwealth requires international investment to support its economy and financial markets. The Government's failure to engage in equivalent measures to support its debt markets in the belief (or hope) that the vacuum will simply somehow be filled (based on little more than hoped for 'innovation' cited in the Discussion Paper) may result in an inability of Australia to compete for international capital simply because of financial irrelevance, not because of any lack of a 'good story'. Any passive policy to attract foreign funds management operations to Australia as a regional headquarters ought not to be confused with being a substitute for growing the scale of the Australian capital markets, with an appropriate degree of Government commitment to its own financial infrastructure.

Demise of the CGS market corresponds to removal of sovereign support of an ongoing structure for capital investment, sending a message to international investors that the value of their potential investments in Australia is lessened because the Government is unwilling to support the infrastructure for future capital investment. It is one thing for the Government to privatise public sector enterprises; it is another for Government to abdicate its involvement in ensuring it has the most transparent and efficient form of financial system. The Commonwealth's contemplation of a policy to eliminate or erode the CGS market should consider the potential message that elimination of the CGS market sends to the international investment community, especially in light of the inconsistency with other policy that has aimed to position Australia as a global financial services centre in the Asian time zone.

¹⁷ Kimberly Gaskin, "Charting the undercurrents," INSTO: The Australian Financial Markets Newsletter, April 2002.

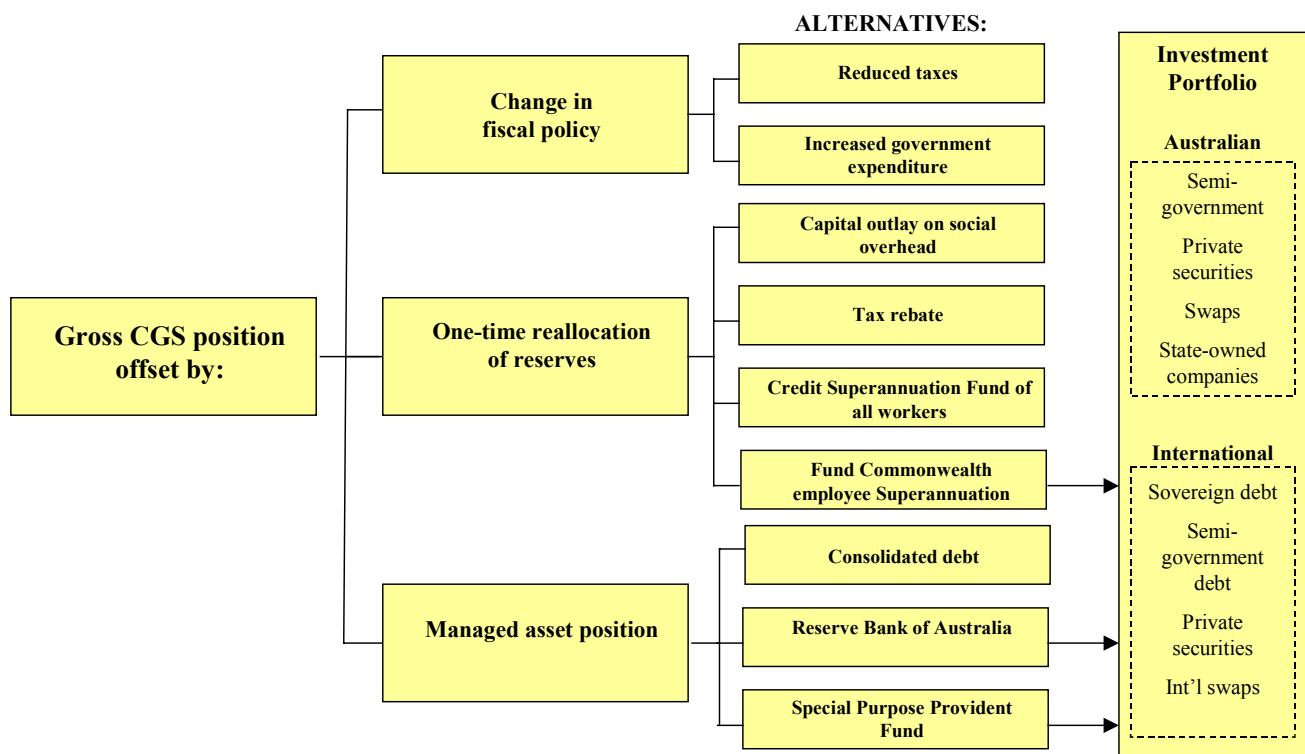
¹⁸ Ibid., p. 59.

7. ALTERNATIVES TO CGS ELIMINATION

“The reduction in Commonwealth net debt has raised questions by some market participants about the future viability of the CGS market. The Government acknowledges these concerns and is carefully considering them, taking the views of key stakeholders into account.”

- The Australian Office of Financial Management, 2002.¹⁹

The Commonwealth does not have to eliminate debt or even allow for its continued diminution. Even in the absence of a need for debt, the government can maintain the CGS market at levels that support the Australian financial markets and a domestic currency. Thus, the Telstra sale does not have to be used to pay down debt and eliminate the CGS market. There are a variety of alternative approaches that the Commonwealth government may use to maintain a viable CGS market and the benefits associated with it. In all probability no one approach or solution is right, with the answer (as often the case), consisting of the right mixture of different solutions. These alternative approaches conceivably can take any of the following forms:



Change in fiscal policy

The Commonwealth can maintain a need for debt by changing fiscal policy, either reducing taxes and/or increasing government expenditure. It is clearly not advocated that the Government consciously run budget deficits so as to create the need for new CGS issuance, albeit it would seem illogical to ignore fiscal policy as a stimulus in a declining growth world at present. The merits of fiscal policy changes will not be discussed here, as it is assumed that the government wishes to maintain current fiscal policy in balance, on average, over the course of the economic cycle.

¹⁹

One time reallocation of reserves

The government could use the proceeds of the Telstra sale to fund a one-time rebate of taxes and/or an increase in public expenditure on social overhead capital (schools, hospitals, environmental amenities, etc). Such an alternative would be neutral to the underlying fiscal settings of the budget, although it would be stimulatory to the Australian economy. The Discussion Paper ignores this alternative even though such an approach has been adopted by other countries that have received one-time infusions through the privatisation process.

If the surplus is distributed as a tax rebate, the recipients may save a part of the increase in disposable income, leading to a partial increase in private saving to offset the reduction in public saving. However, national saving most likely would fall and the current account deficit would rise as a result.

If the government invested the proceeds in social overhead capital (akin to repaying unaccounted for environmental indebtedness), on the other hand, such an investment could be enjoyed by a broad cross-section of society (unlike the tax rebate, which would accrue to taxpayers only). In addition, since the investment could be in capital items in which the private sector would not normally invest, there would be no sense in which the Government was engaging in “reverse privatisation.” Furthermore, an increase in public capital expenditure (e.g., on transport infrastructure, controlling salinity, waterway degradation and wastage etc) – which has been declining steadily as a proportion of total public expenditure in recent decades – may even stimulate higher levels of private capital investment.

Public capital outlays could bolster public capital to the benefit of the entire Commonwealth. If implemented through a one-time expenditure, there would be no acquisition by the public sector of claims on the private sector nor would there be any need to re-purchase outstanding CGS. Since both public investment and public saving would remain unchanged, there would be no impact on private saving and no impact on the current account deficit (unless private investment were ‘crowded in’, in which case the current account deficit might rise).

Another form the one time reallocation could take is to use the proceeds from the Telstra sale to credit the superannuation funds of all workers. The distribution could be effected by granting a one-time credit against taxes levied on the earnings of superannuation funds. This idea has the benefit of forcing preservation of the windfall until retirement, effectively forcing the proceeds to be saved, at least by those yet to retire. Politically, the Government could not avoid crediting the accounts of retirees as well, and they would spend it faster than current workers. Nevertheless, like a general tax break, this alternative distributes the proceeds more narrowly than a one-time increase in public capital expenditure – in this case, to the benefit of current and future superannuants.

If credited to superannuation funds via a rebate of tax on super fund contributions or earnings, the proceeds of the Telstra sale would return to the stock and bond markets via the investments of individual superannuation funds. This would very likely increase the demand for CGS. So while the supply of CGS would be preserved, CGS would nevertheless rise in price due to stimulated demand. The increase in price could switch some demand for CGS to substitutes such as semi-government securities and Commonwealth guaranteed debt. The shortage of CGS would effectively become more obvious, even though the supply of CGS was unchanged.

Another variation could be to transfer part of the current Telstra holding to a superannuation trustee, thereby reducing the scale of the market challenge and reducing the government’s transaction costs on sale and funds manager’s costs of procurement.

A final alternative for reallocating reserves would be to credit the Commonwealth employees' superannuation fund. This would finance the currently unfunded liabilities of that fund. The set of government workers is even smaller than the set of taxpayers so the distribution is more selective and the impact of this alternative is even narrower than the two alternatives considered so far.

Of course, the future dividend stream from the Government's investment in Telstra would have been one source for paying the future liabilities of the Commonwealth's employees. Effectively, this proposal simply tags the dividend stream for this specific purpose and results in the Government diversifying its asset portfolio to include more than equity in a telecommunications provider. The trustees of the Commonwealth Super Fund would choose from a wider selection of assets.

Managed asset position

A final set of alternatives is to invest the proceeds on behalf of future taxpayers, in anticipation of the day when public expenditure on age-related goods and services rises with the ageing population. This makes sense in view of the Government's own projections of looming deficit in the budget as public health and age-related expenditures rise over the next 30 years. Under this approach, the conversion of assets from Telstra equity to an investment fund allows for diversification, better risk management, and a remedy to the inefficiency of public sector control of business enterprises. There are at least two ways to establish such an investment fund: (i) use the existing portfolio of the Reserve Bank of Australia; and (ii) establish de novo a dedicated provident fund at arm's length from the Government. Under either of these approaches, funds could be invested in a variety of portfolio options. Alternatively, the Commonwealth could use the funds to consolidate state and local debt, thereby limiting the investment options available to the managed asset portfolio.

The first option is simply for the Government to allow its cash surplus to remain in its account at the RBA. The Discussion Paper asserts that the RBA would be an inappropriate long term manager but fails to support this view with any logic or discussion.

The Bank could invest the proceeds in a range of assets, including offshore assets, as it does currently. The advantage of this route is that the RBA is already constitutionally independent of the political process, thus avoiding the possibility of political interference with the investment of the assets. The Bank is also used to dealing with foreign currency assets of the Government and to managing foreign currency risk. The return on the Government's investment would come in the form of RBA profits, which would be credited to the Government's account annually and re-invested by the RBA until the Government draws down the account.

The RBA already undertakes transactions on its own account to enhance the liquidity of the bond market and believes that, as the supply of CGS on issue declines, stock shortages might become more frequent and the Bank's stock lending facility could become more important. In addition, the RBA already is considering consolidating positions to create a single central counterparty for certain debt securities and it would make sense for the RBA to consult with the SFE on this matter. It is important to note that the existence of higher cash deposits by the Government does not affect monetary policy; the RBA still must move its assets in and out of cash to effect monetary policy and can print cash to ensure liquidity. The money base will continue to be managed by the RBA through purchases and sales of its assets to the non-official public. The fact that it holds a variety of other assets on behalf of the Government (as its banker) would be of no consequence for monetary policy.

A second approach is to establish a special purpose provident fund. This would be established as a trust at arm's length from the government. The trustees would manage the funds in the interests of the beneficiaries, namely, future generations of taxpayers. The trust deed would need to specify the manner in which withdrawals could be made from the fund over time, giving somewhat greater protection against political abuse than the RBA model. Since the Bank is the Government's banker, it must honour the Government's lawful instruction to cash cheques against its account. There is no guarantee that a future government would not plunder the cash account for its own narrow purposes. However, the trust fund could not be so plundered without major political fallout, presumably involving resignations of trustees and High Court action. The intention of such a fund is the same as establishing the RBA as an asset manager; to facilitate the accumulation of assets for the use of future generations in meeting the costs of public health, aged pensioner benefits or civic infrastructure.

Although such a fund has the potential to be a substantial presence in domestic financial markets and its investment decisions could influence prices in those markets, its investments could take many forms including long term debt participation in private sector equity funded infrastructure projects. A trust deed could place restrictions on the classes of assets available for investment as well as limiting the fund's exposure to particular sectors and/or enterprises.

A third alternative is for the Commonwealth to invest its budget surplus by purchasing debt of the various State and Territory governments. This option has already been considered and rejected, nevertheless, it is one of the few alternatives put up in the Discussion Paper and is described here. Consolidation of semi-government debt could be done through either the Reserve Bank acquiring semi-government debt in its portfolio or by the provident fund acquiring such debt. Either way, Commonwealth budget surpluses effectively would be set off against budget deficits amongst the States and Territories. However, the latter would remain responsible for their debt, as they must deal with an intermediate authority - either the RBA or the provident fund.

One difficulty with this form of option is that it would merely transfer the problem from the market for CGS to the market for semi-government securities. The market for government paper still would be adversely affected, as the RBA or provident fund absorbed large quantities of semi-government paper and retained it in portfolio. The only way to avoid reducing the stock of both CGS and semi-government securities is for the Government to invest its surplus in some other form, for example, in social overhead capital as discussed above.

A variation on the consolidation approach that would allow the Commonwealth to repurchase CGS with its budget surplus and yet leave the overall stock of CGS higher than it is currently, would involve the Commonwealth resuming its former practice of borrowing on behalf of the States and Territories. If the Commonwealth assumed the debt of the States and Territories, the total stock of CGS on issue would rise to around A\$122.5 billion. Were the Commonwealth then to repay A\$25.0 billion to A\$30.0 billion over the next two years (funded by either its budget surplus or reserves), there still would be an outstanding stock of more than A\$92.0 billion on issue, which would be sufficient to maintain a liquid and efficient market. However, the market for semi-government securities would all but disappear.

Of course, the Commonwealth resuming its role as borrower on behalf of the States and Territories raises a host of issues associated with the ill-fated Loans Council. In particular, the disciplines which the Commonwealth would impose in return for extending its guarantee to the States and Territories may render this proposal unappealing to all parties, but there may be variations to this option that are worthy of review.

In summary

The fact that the Government has a policy preference to sell down its stake in Telstra need not imply that the only use for the proceeds so released is to repay Commonwealth debt. These are quite separate decisions. This section of the submission has identified three sets of alternatives, each with their own variations, to deal with the cash reserves currently being accumulated by the Commonwealth and that would proceed from any eventual Telstra sale. These alternatives do not involve buying back CGS and, arguably, assist the Government in meeting its commitments to future generations of Australians more productively than relieving them of debt, which is already a low percentage of GDP.

This Government is well aware of the need to invest for the future of all Australians. Liquidating its investment in Telstra need not imply that paying a cash dividend to holders of CGS is the most appropriate use of the money. At a time when Australians need to save more, repaying public debt rather than reinvesting the proceeds for the future is a poor choice. When one considers the damage already done to Australia's financial markets and reputation by the current diminution of the benchmark sovereign issue, the case to retain the current base level of Commonwealth debt is compelling. Equally, reticence about any managed asset solution based on policy unease about the temptation of any future government to 'plunder' such assets would seem to ignore the fact that such a future government could raise cash through debt issuance (off a zero debt base) regardless.

8. CONCLUSION

The Commonwealth government is in a position that few developed countries have faced. As a result, international precedent may provide some insight, but the government's policy decision for Australia concerning CGS must rely upon a thorough understanding of the potential implications of either maintaining the CGS market or allowing it to continue to diminish into potential obscurity. Either approach has significant policy implications, and the Government's own fiscal policy success for which it should be given credit requires that the Commonwealth has to make a complex decision.

The first approach is to allow the CGS market to continue its path of diminution towards gross CGS debt elimination. If this path is pursued, private markets and semi-government debt may strive to fill the functions currently offered by the CGS, namely:

- the provision of a risk-free benchmark.
- creating the infrastructure for the development of other fixed income markets such as those for corporate bonds or mortgages.
- underpinning the interest rate derivatives marketplace in Australia.
- serving as a "safe haven" during periods of volatility and uncertainty, and
- providing an Australian-dollar-denominated hedging vehicle for superannuation funds and institutional investors.

However, private capital markets and the swap market are unable to provide anything resembling good substitutes. Requiring these markets to fulfil the current functions of the CGS market is likely to result in higher costs of capital for Australian investors who must turn to corporate debt and collateralized instruments that currently do not exist in Australia at a sufficient level to replace CGS. In addition, the shift in demand towards these instruments will decrease the yield paid by riskier investments. Such results will be offset by the higher risk created in the absence of a CGS market and the need for debt issuers to promise higher returns to attract capital. Regardless, the securities market will shrink (particularly the most efficient exchange traded portion) and large financial banking-type intermediaries will gain if interest rate price discovery migrates to the interest rate swap market.

Limitations on Australia's debt markets also are likely to shift investors who are looking for risk-free hedges towards overseas investment opportunities, increasing the demand for international government bonds with currency swaps that hedge exchange rate risk. The combination portends a weakening of the domestic market for financial services as well as a weakening of the Australian dollar. This result is antithetical to a government policy that desires a viable Australian currency, provides support to the Australian financial sector through AXISS Australia and only six months ago passed legislation defining SFE as a market of such national interest as to warrant the imposition of shareholding limits on its own governance.

The second approach not only rejects the elimination of the CGS market, but requires ongoing support of it. In the absence of a change in fiscal policy that would eliminate budget surpluses and re-establish the government's need for net debt, the Commonwealth should adopt a program that

maintains demand for gross debt. Such a program may take many forms, including a one-time reallocation of reserves through a capital outlay in social overhead, tax rebate, superannuation fund credit, or funding of the Commonwealth employee superannuation obligation.

Alternatively, the government may follow the example set by other countries that have no net debt, and yet maintain markets for government securities through a managed asset position. The Commonwealth may maintain a managed asset position through a variety of portfolio vehicles, including consolidated debt, using the Reserve Bank of Australia, or establishing a special provident fund.

The executive summary to the Discussion Paper concludes with discussion of what are termed significant risks, both economic and political, associated with the Government maintaining the CGS market. In order to avoid such risks the summary seeks to shift the onus of proof onto market participants that the Government's experimentation with the efficiency and effectiveness of the Australian financial system will work on no other evidence than a belief that the private financial institutions and intermediaries in Australia will adapt, hopefully innovate or, at worst, cope. Worse still, no analysis is provided of the time frame or dislocation costs involved in transitioning to such a regime. The Discussion Paper is not a blueprint for such experimentation, given that it appears to be based on supposition and belief rather than objective research or international precedent. The Paper's release has created an atmosphere of the prospect of the imminent demise of the CGS market, which is unlikely to be the case on practical grounds.

If the government declines to establish a policy to maintain (or grow) the CGS market, it is likely to face a much less palatable series of policy outcomes akin to those described in the executive summary to this submission. The issues raised by the Discussion Paper are profound for the efficiency, stability and competitiveness of the Australian financial system. They are as profound for the whole economy and the investing public as they are for issuers for all types of fixed income securities, and in the fullness of time, for issuers of any type of financial security (including equities).

Those who argue in support of CGS elimination have an obligation to explain how unintended consequences and other adverse policy outcomes are to be avoided. Of course, these adverse outcomes can and should be avoided altogether by the renewal of the Government's commitment to the CGS market.

Comparison of the Attributes of CGS Bonds, SFE Bond Futures and OTC Interest Rate Swaps

Trading Attribute	Commonwealth Government Bonds	SFE Bond Futures	OTC Interest Rate Swaps
Liquidity Factors			
• Market Turnover	Very high (552 billion p.a.)	Extremely high (2173 billion p.a.)	Very high (821 billion p.a.)
• Accessibility	Open to all participants	Open to all participants	Restricted to counterparties with pre-approved credit limits
• Number of Participants	Many	Many	Few
• Professional Market Makers	Moderate	Many	Moderate
• Types of Participants	All market participants including investors(retail & wholesale), banks, investment banks, corporates, governments, insurance companies	All market participants	Restricted to mainly banks, investment banks, governments, corporates, some wholesale investors
• Cost- Bid Offer Spread	Very narrow (1-1½ basis points)	Extremely narrow (½-1 basis point)	Very narrow (pre credit costs; 1-½ basis points)
- Transaction Fees	Very low (\$40 per million)	Very low (\$30 per million)	High (½ basis point)
- Administration Cost	Very low (almost nil)	Very low (almost nil)	High – ongoing with rate sets
• Consistency of Availability	High but can deteriorate in times of market instability	Consistently very high, almost 24 hours per day	High but can deteriorate rapidly in times of market instability
• Consistency of Price	Most participants deal at same price	All participants deal at the same price	Price depends on credit quality
• Short Selling	Easily facilitated through stock borrowing and repo arrangements	No special arrangements required	No special arrangements required
• Active Yield Curve	Active pricing and trading of full yield curve currently out to 13 years	Active pricing and trading in 3 and 10 year terms	Rapid fall in pricing and trading in terms past 5 years with very little past 10 years
Transparency Factors			
• Level of price transparency	Very high via EFP's and brokers	Extremely high	Very high via brokers and EFP's
• Market Data	OTC brokers are the sources of real time firm quote data on screen	SFE provides real time price, market depth and volume data	No sources of real time firm quote data on screen; brokers supply prices for EFP's in standard maturities
• Valuation Processes	Many sources of daily independent valuation data including RBA	SFE provides end of day data with complete historical record	Daily independent valuation data supplied by AFMA

Efficiency Factors			
• Cost	Very low	Very low	Moderate
• Ease Of Operation	Simple	Very simple	Less simple
• Market infrastructure	Centralised confirmation, clearing, custodian and settlement facilities available through Austraclear and SFECH	Centralised exchange and clearing house providing full trading, confirmation, settlement, novation and accounting services	Austraclear provided confirmation function only
• Product Suitability	Fully suitable to all participants	Suitable to most participants with the exception of some retail.	Not suitable to many participants particularly retail, many pooled investment funds, lower credit rated corporates
• Market Domination	Market power spread widely between many sectors and many parties with no one group dominating.	Market power spread widely between many sectors and many parties including overseas participants with no one group dominating.	Market power concentrated in 4 major trading banks
Regulation Factors			
• Financial Services Provider Licenses	Required	Required	Required
• Market Operators License	Not Applicable	Required	Not Applicable
• Staff Training Requirements	Yes	Yes	Yes
• Product regulation	Yes	Yes	No as this is a bilateral agreement
• Customer Protection	Yes for retail, little for wholesale	Yes, high degree of customer protection provided in many ways	Effectively none as only available to wholesale
• Market Manipulation Rules	Yes – regulated by industry code	Yes – regulated by legislation and ASIC	Yes – regulated by industry code
• Front Running Rules	No	Yes	No
• Obligations and practices producing orderliness, transparency and efficiency	Partial – some aspects regulated by industry code	Yes, extremely high level; clear obligations imposed on market operator by legislation to ensure these outcomes; enforced by ASIC	Partial – some aspects regulated by industry code