Chris Terry
126 Mount Street
Coogee 2034
Australia
Phone / Fax (02) 9315.7159

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Commonwealth Debt Management Review
c/- Department of the Treasury
Langton Crescent
Parkes ACT 2600

Submission to the Debt Management Review

I welcome this review of the Treasury bond market. It presently plays a major role in Australia's financial system and thus both the financial sector and the financial authorities, at the very least, should clearly understand its functionalities.

While this is a private submission, I wish to note that in my capacity as Head of the School of Finance & Economics at UTS, I arranged a workshop on the bond market and the Discussion Paper that was held on Friday 22 November at the University of Technology, Sydney, at which Rosalie Degabriele and I present short papers. This submission has regard to the discussion at that workshop.

Given the short notice it is possible for me to respond to the many good questions posed in the Discussion Paper. Some of these key questions, such as the follow-up question on page 40, "what other options are available for pricing debt securities? *How effective are they?*" require a major research effort to answer.

Rather than attempt to present answers to the many key questions, this submission merely poses its own questions. I presume the intention in the Discussion Paper of posing key questions about the financial system without a Treasury bond market is to seek the assistance of stakeholders in answering them. But it arouses the concern that the Government is adopting a faulty decision-making process in which it seeks to be convinced of the need for the market. The flaw with such a process is that a decision to close the market should be made only with a clear picture of how the Treasury and Australia's financial system will operate effectively without the Treasury bond market.

The two broad questions posed in this submission are, first, can the Government be confident that it can fund its expenditures in the future without access to the bond market and second, can the financial system effectively perform its functions without the Treasury bond market?

1 Bonds as a source of funds

The role of the market for the Government, as an organisation, is to provide an efficient source of long-term capital. The most basic questions that needs to be answered are why would the Treasury close down a source of funding (ie limit its access to funds) and why would it close down this source (ie its only source of long-term capital)?

The Government, being by far the largest entity in the economy, has the greatest need for finance and even though it has the greatest access to funds (through the tax system) of any organisation. It would seem prudent that in an uncertain world, it should retain access to this source of finance.

The balance budget objective will not always be achieved, even when the recent experience is encouraging. Economies are subject to unexpected shocks that can undermine the achievement of budget outcome objectives. The ‘war on terror’ is simply one example of events that could have a major impact on government expenditure and hence budget outcomes.

The related issue is the role of long-term capital as a source of funds. The Government spends substantial amounts on social capital (even with privatisation) and long-term capital is the most appropriate source of funding for such expenditure. Long-term assets generate long-term benefits and thus debt funding is broadly consistent with the user pays principle.

While the recent experience prompts the question of the continuing need for bond issues to finance government expenditure it does not demonstrate that the Government should terminate its use of long-term capital as a source of funds.

2 Bonds as financial assets and their secondary market

While a private borrower would not be expected to consider the role of its debt for investors and other participants in the financial system, the Government’s responsibilities require it to consider these parties.

I am referring to the role of Treasury bonds to investors, especially investors in pension funds and retirees, and within the financial system (in revealing the cost of long-term funds in the Australian economy and as a basis for pricing related derivatives, as described in the Discussion Paper).

Financial innovation has been a distinctive achievement of most financial systems and thus I expect that new financial products and markets will continue to emerge to better meet financial needs. The development of the Treasury bond market itself is an important example of financial innovation.

Knowledge of the stage of development of financial products that complement the Treasury bond market (that the questions on page 49 may elicit) helps to provide an understanding of the depth and breadth of Australia’s financial system. Such knowledge though does not of itself answer the question, whether such developments have replaced the need for Treasury bonds (and its secondary market). The Discussion Paper refers to possible substitutes, such as high-grade corporate bonds, plain-vanilla swaps and to credit derivatives, but clearly these instruments and their markets have not reached a stage where they are credible substitutes for Treasury bonds and their secondary market.

Moreover, the operations of the markets for these products may require the secondary market for Treasury bonds. For instance, the swap yield curve (illustrated in Box 1) may be used for price discovery purposes because it can be compared with the Treasury yield curve and the data in Chart 17 provides a picture of the price of risk against the Treasury yield curve. The existence of these other yield curves does not mean that reliance for price discovery purposes is shifting to them in preference to the Treasury bond yield curve. Eliminating the Treasury bond yield curve will most likely diminish the financial system's price discovery capability.

The Discussion Paper invites the financial community to demonstrate, in effect, that it needs the Treasury bond market. While this strategy (to invite the financial sector to answer key questions) may help provide answers these questions, the Treasury ultimately needs to demonstrate the effects of closing its bond market and in particular how efficiently the financial system will operate without the Treasury bond market. Discussion of the developmental role of a Treasury bond market does not reveal its role in a developed financial system. The Discussion Paper does not refer to any developed financial system that does not have a Treasury bond market. Hence it does not present any experience to inform its consideration of the central proposal.

Conclusions

The Treasury bond has been an important source of funds for the Government and while closing down the market may be of symbolic importance politically, the decision to do so should be based on clear evidence that this source of funding is unnecessary for a considerable future period.

The Treasury bond market is an important part of the financial system, for investors, financial institutions and for other borrowers. Whether it is of crucial importance is not clear. This may be established in two ways. The Treasury (via the Discussion Paper) seeks to be convinced that it is not possible for it to be replaced through financial innovation. An alternative approach is to attempt to demonstrate that the financial system's stability and functionality will not be diminished by the removal of the Treasury bond market.

Yours sincerely

Chris Terry
Associate Professor and Head
School of Finance & Economics
University of Technology, Sydney