# <u>The debate over the Australian Governments declared intention to retire its outstanding debt.</u>

The Australian Government, particularly Mr. Costello, has recently stated their intention to retire government debt. Interested parties have been invited to give their thoughts on the ramifications of doing this and any arguments they might have for sustaining the CGS market. The current fiscal situation brought about by prudent management and a potential one off windfall from the proposed sale of Telstra has threatened the sustainability and questioned the need for a government debt market. Obviously most market participants would argue for maintaining the CGS market and it is easy to jump to the conclusion that they are mainly driven by self-interest. Despite being a market participant I believe I have been as impartial as possible.

**Allied Irish Bank’s interest in the Australian Market**

AIB is continuing to diversify its treasury interest to include different markets in order to supplement its traditional core areas. This is mainly a consequence of the demise of the IEP and the creation of the single European currency. At present we have a keen interest in FX, FX swaps, IRS, money market, futures, FRA’s, mortgage backed securities and of course bonds. We view our investment in Australian markets as being significant and are very concerned over the proposed developments and any potential consequences that this may bring about.

**Current situation**

The success of the Government’s fiscal strategy over recent years has reduced Commonwealth outstanding debt as a proportion of GDP, from about 20 per cent in 1995-96 to 5 per cent in 2001-02. In dollar terms, this represents the repayment of around 60 billion dollars of debt since 1995-96 and leaves about 62 billion dollars outstanding. The size of the CGS market is now getting close to what is regarded as a minimum sustainable size. The question is whether the CGS market plays a critical, and presently, irreplaceable role in the economy. If the requirement for issuance continues to diminish then does the Government sustain it or try to pay off the outstanding debt? Presently the government is able to look at paying the outstanding debt off with a sale of its remaining Telstra holding. Without this windfall (Telstra) would the question of debt retirement arise? Can the CGS market be replaced by any other assets, such as the private sector, without causing damage to the financial sector and to the economy as a whole? If it can’t now, then when? If it were to be kept at a sustainable level, what would they do with the money? Where would they invest it?

**Benefits of the CGS market**

What are the main benefits of having a liquid and efficient government debt market? Government bond issuance has a broad range of maturities, and for users of the Australian Government debt market the assets have minimal credit risk which can be matched to longer dated liabilities. In other words CGS is an important low-risk long-term investment vehicle. They are attractive to investors with long term risk exposure. Historically, government securities have been the principal source of long-dated financial assets. Life insurance companies and Superannuation Funds hold around a third of existing CGS’s. It has been argued though that in the overall picture of long-term investment they are a relatively small percentage. This is probably more of a consequence of the lack of supply than their perceived desirability and importance. CGS' provide the base investment for most long term investors and the size of this is misleading and misrepresents there overall importance. In addition the bond futures expand the effective size and liquidity of the CGS market.

The bonds have good levels of liquidity and the mature infrastructure and nature of the asset lend confidence to the financial market. The CGS yield curve is the main reference benchmark for comparing yields on different debt securities. Several other financial market activities and products have developed from the CGS market. It improves the markets capacity to undertake arbitrage. It allows different market participants to compare yields of different asset classes against a common and reliable benchmark and assess whether the risk characteristics warrant the difference in yield.

Businesses (including financial market participants) currently use the CGS market and its associated derivative markets (particularly three-year and ten-year bond futures) to manage their interest rate risk. They use them because of their liquidity and of their low risk.

The ability to effectively manage interest rate risk also affects the domestic cost of capital. For example, investors may be prepared to accept a lower yield on a corporate bond if a suitable hedge for their interest rate risk is available. If the cost of capital is reduced, due to the efficient capability to manage interest rate risk, then the corporate sector and the economy as a whole will benefit. Correspondingly with no efficient and relatively safe avenues to hedge interest rate risk available, corporate cost of borrowing will rise and output will suffer.

CGS' are the ultimate safe haven assets, offering investors a risk free rate of return within a country. Without this option in times of trouble, investors would be forced to look abroad for similar low risk securities. I believe there is no existing security to replace this. If investors hold cash or corporate bonds, or cash and swaps, then they are taking on the credit risk of the financial institution involved. Under normal circumstances this would depend partly on their view of the central bank and of the institution itself. However, in times where a safe haven is suddenly required this could possibly be a very unattractive alternative. Also if there were a shock, the system would be much more resilient due to the support and confidence that government securities lend to other assets. It is in effect a parachute, which if it didn't exist, might make investors reluctant from the outset.

Australia has a current account deficit and foreign capital is needed to finance the deficit.
Both private and public debt markets are recipients of foreign capital. The question is whether the removal of the CGS would undermine foreign investor's confidence and deter them from investing in Australia. If there were no other realistic and equivalent asset then the answer would be an emphatic yes. At the moment there isn't. Many large investors allocate their funds based on global bond indices, and linked to the government bond issuance size. No Bonds, no indices. Persuading large global funds to invest in Australia based on a new untried benchmark would be difficult, and why should they risk it when there are many alternatives globally. The Australian government has to decide if it can do without these investors to finance the deficit.

Australia, to my knowledge, still wants to be a major financial center. Every country trying to develop a financial market has acknowledged the need for a government debt market and set about developing one. It is argued though that it would be different for a sophisticated financial market and that they would be able to do without a government debt issuance, but is the Australian Financial market that sophisticated and large to persuade foreign investors to remain without a bond market?

**Alternatives**

In the absence of government bonds, businesses could use some of the following possible alternatives to manage their interest rate risk.

Firstly the IRS market. Businesses already use the interest rate swap market for managing some interest rate risks. In addition you could develop an interest rate swap futures market, something that is already being launched. This will include standardized contracts that are traded on a futures exchange. Businesses could use these contracts to manage risk. Consequently, a combination of interest rate swap and swap futures market may be a viable alternative. Secondly, you could use the semi's or supra's as an alternative bond yield curve, replacing in a very similar structure the present CGS.

Thirdly, the continued development of the corporate bond market and the development of a corporate bond futures market could replace the CGS market. The nature of corporate bonds may make this difficult.

**Arguments for/against the alternatives to the CGS: -**

The swap market does not appear to be big enough yet to be the IR benchmark. That said, the size of the IRS market is of some concern with regard to using IRS as the primary IR Benchmark. I believe at present that the present total outstanding of IRS' is less than 1% of GDP, whereas the outstanding CGS' are approximately 5% of GDP. The swap market does not have the liquidity of the CGS market and doesn't yet have the longevity that adds to confidence in a market benchmark. In other words it does not have enough of the characteristics of the CGS market that would provide it with the confidence and stability required by investors abroad and at home. It does not have the 'safe haven' qualities of the CGS market. It is too closely tied in with the credit of the financial institutions involved. In addition, anyone hedging cash positions would have the double credit risk of cash and swaps with financial institutions involved. Finally the swap futures contracts are not established and will not have the liquidity needed for some time to come.

The semi and supra market probably have then most similar characteristics to the CGS market. However they do not have the same safe haven desirability and are not big enough to provide the liquidity needed to replace the CGS market on their own. One possibility is a mix of state and CGS markets. If the Government were to guarantee state bonds, adding some conditions to make sure that the states continue to show fiscal prudence, then the two combined would be of sufficient size to provide the market with the liquidity required. You could even potentially continue to reduce straight government issuance and still sustain a liquid enough benchmark.

The corporate bond market also lacks most of the qualities of the CGS market. True it has grown in size so that now it is larger in total size than the CGS. This does not take into account the futures market though. However, I believe that this growth has only been possible because of the very existence and qualities that the CGS market offers the financial markets. It also seems clear that the actual cost of capital would be substantially higher to the private sector without the hedging characteristics of the bond and bond futures market. The corporate bond market currently is not liquid enough to support a futures market and none exists. Also the very nature of the diversity of corporate bonds makes it very hard to establish a benchmark yield curve as well as a standardized futures contract. The average maturity of corporate bonds is less than five years, one of the attractions of the CGS is the longer maturities available.

At present the private sector has been fairly stable in comparison to global equivalents. This has been due to the special conditions that have contributed to the economy over the last few years and have sheltered the Australian corporate sector from many of the troubles suffered by other developed economies. This cannot be guaranteed to be the case in the future. If the private sector were to become the benchmark and a shock were to happen, what then? With no safe haven from CGS and acting as the IR benchmark the consequences to a country could be magnified dramatically.

## **Conclusion**

The Australian Government has to weigh the options available and make its decision. Do they sell off the remaining holding in Telstra and use it to pay off the outstanding debt? This very question leads to another rather important one, that is whether or not they can actually sell Telstra at a reasonable and politically acceptable price? The positive ‘political currency’ they may receive could possibly have an equally negative side.
If they did manage this feat successfully, then what to do with the money and the present government debt? Retiring debt may be fine now but what happens in the future? Economies have a tendency to change and go in cycles. Can they really guarantee themselves and the country that they will never need to issue again? An established and developed CGS market has taken years to achieve and may possibly take many more to re-establish if the need arose again. Most countries would be envious of the market that Australia has so painstakingly developed and would be somewhat surprised to see them give it away.
The retirement of the CGS market may encourage the development of other options as businesses will still need to manage their risks, providing a ready market for new products. That said, the risk is that these products may not be effective, or they may take substantial time to develop. Wouldn’t it be better to wait for these markets to develop enough before retiring the government debt market? If there are worries about the investment of surplus funds that may occur due to current or future fiscal conditions, then it must be possible to prudently reinvest them in such a way as to be politically and economically acceptable. Alternatives to supplement the size of CGS market and allow it continue to perform it’s vital functions could be found. Such as guaranteeing state bonds, at the same time placing conditions on the fiscal behaviour of the states to avoid fiscal impropriety in the future. This would be add to the liquidity of the benchmark and possibly bring down the cost of state borrowing as well. Likewise any funds from the sale of assets could be equally prudently reinvested, and maybe tied down legally to avoid improper use of these funds by other governments in the future. Economies aren’t always guaranteed to be as healthy as Australia has managed these past few years.
The intention of ridding a country of debt is indeed noble, but this can be done without actually retiring the CGS market. The possible costs of continuing the CGS market have to be weighed against the tried and tested benefits which a mature and liquid government bond market add to a financial market and to an economy as a whole. Also they have to consider the possibly disastrous consequences that may occur if a financial market loses the confidence of investors, both domestic and international. If the Australian government really wants to continue to develop as an international financial market, why take such a risk?

The reality of an efficient financial market existing without government securities is completely untried and unproven. There is a real risk here for any government intending to be the first do so and the Australian Government has to really ask itself if it wants to be the guinea pig in such an enterprise.
Market and investor confidence is a fragile quality, easily destroyed and very hard to rebuild.

Peter Carpenter, Allied Irish Bank, London