



**Submission to the**

**Review of the Commonwealth  
Government Securities Market**

*by*

**The Commonwealth Bank of Australia**

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# Review of the Commonwealth Government Securities Market

## EXECUTIVE SUMMARY

### *Introduction.*

The Commonwealth Government Securities (CGS) market has fallen from a peak of \$115bn outstanding in 1996 to the current level of about \$55bn, largely as a result of fiscal consolidation and a series of asset sales. As a consequence of this significant reduction, some have questioned the ongoing role of the CGS market in the Australian financial system.

We believe that the CGS market is a fundamental pillar of Australian debt and investment capital markets. The ongoing viability, efficiency and cost competitiveness of those markets is, in our view, contingent upon the CGS market being sustained in some form.

An understanding of the various interdependencies within financial markets is a crucial part of any assessment of the ongoing value in preserving a CGS market.

The Commonwealth Bank of Australia favours the retention of the CGS market and would welcome the opportunity to discuss our views in greater detail.

### *Key considerations.*

This Submission specifically responds to the issues and questions raised within the *Discussion Paper*. It examines and identifies issues that we believe should be taken into account as part of the Commonwealth's deliberations on this fundamental issue.

### *Pricing other financial products.*

It is generally accepted that efficient debt markets need effective benchmarks.

For an instrument to be accepted as a benchmark in Australian debt and investment markets, it must ideally be: risk free, liquid, relevant to all users, domestically oriented, AUD denominated, transparently priced across a full term structure and a homogeneous investable instrument.

In our view only the CGS market satisfies these key criteria.

### *Referencing other financial products.*

Furthermore, Australian capital markets would not operate as effectively or as efficiently with an alternative benchmark. To suggest otherwise seriously undervalues the effectiveness of the mechanism by which markets interact with each other. This interaction and interdependency has generated the base liquidity and pricing benefits enjoyed by the broader investor and borrowing community over the past twenty years.

### *Managing financial risk.*

The risk-free and highly-liquid nature of the CGS market and associated derivative markets has provided the full spectrum of market participants with an important vehicle for managing financial risk.

If the CGS market were to be abolished or significantly wound down, we do not believe that a replacement market would provide the same degree of cost-effective, broad-based market acceptance.

### *Providing a long-term investment vehicle.*

Although investment portfolio allocations to CGS specifically (and fixed interest generally) is currently low by historical standards, this in part reflects a prolonged period of excess returns in other asset classes. In our view recent market corrections (particularly in offshore markets) should ensure a return to allocations more consistent with historic norms.

This return to CGS should be particularly apparent amongst the more conservative investors such as retirees who typically invest in funds that have much higher allocations to CGS than the overall average.

CGS usually represent the largest single credit exposure within a fixed interest or balanced investment portfolio. There is still significant excess



capacity for CGS within the investment market. This capacity is, in part, a consequence of the clear supply gap in the domestic debt market.

Furthermore the removal of the CGS market would create a fiduciary dilemma for most fund managers governed by mandates that oblige them to invest a portion of their funds under management in so called risk-free assets (ie CGS) and restrict them from dealing in alternative products.

It is also arguable that the elimination of the CGS market may further escalate the flow of funds offshore.

*Providing a safe haven in times of financial market volatility.*

The CGS market is widely accepted as a safe haven during periods of financial-market instability. The CGS market replicates the role that Government bond markets play in other developed financial markets. Only the CGS market has the required characteristics to act as a safe-haven.

*Implementing monetary policy.*

We believe that there would be only a limited impact of the Reserve Bank of Australia's (RBA) ability to implement monetary policy from removing the CGS market. There is a sufficiency of private sector paper currently available for the RBA's liquidity and policy activities.

The RBA does differentiate between government and non-government risk in conducting open market operations. In this context we note that bank bills are currently only used for *intra-day* repurchase agreements.

*Attracting foreign capital flows.*

Global investors are an important component of the CGS market. Offshore holdings increased from about 10% in the mid 1980s to a peak of 40% in 1998. There has been a small net decline since then towards 35%.

If the CGS market were eliminated it is likely that some funds would be transferred to other Australian dollar (AUD) denominated assets. But the additional element of (credit) risk may inhibit offshore investor interest.

For investors linked to global government bond indices, the decision is straightforward. Eliminating the CGS market would result in Australia having a zero-weighting in global bond indices. These fund managers would permanently shift funds out of Australia.

*Promoting Australia as a global financial centre.*

In our view the existence of a government bond market provides Australia with a major regional competitive advantage. Apart from Japan, no other Australasian market is included in the various global bond indices. We also note that Australia, along with Singapore, is the highest-rated sovereign credit within the Asian region. Global fund managers, as a consequence, have a benchmark driven need to participate in Australian financial markets, thereby adding to liquidity.

The existence of the CGS market offers diversification benefits to domestic and international investors. The low correlation of returns on AUD debt with Euro-denominated debt in particular has lifted the attractiveness of Australian markets for global fund managers looking to offset the loss of currency diversification resulting from monetary union in Europe.

We also note that AXISS Australia, the government body charged with promoting Australia as a global financial centre, has stated that a liquid Commonwealth Government yield curve is a "core element" of Australia's financial market infrastructure.

*Client feedback.*

Domestic and international client feedback overwhelmingly supports the retention of the CGS market. The pay down of the CGS market is not seen as supportive of foreign investment in Australia. Nor is it perceived as consistent with the development of Australia as a regional financial centre.

*Disclosure*

The Commonwealth Bank of Australia is a shareholder in the Sydney Futures Exchange



## Other Considerations

### Impact on cost of funds for private sector.

An assumption running through the *Discussion Paper* is that eliminating public debt will reduce private sector capital costs. We believe that costs may in fact rise. Borrowers, investors and financial intermediaries use CGS, interest-rate swaps and other instruments to manage interest-rate risk. Without an effective underlying risk-management medium, we would expect the cost of executing transactions associated with managing these risks to increase. The increase would largely reflect increased bid/offer spreads as a consequence of a less transparent price-discovery process.

### Option 1

The elimination of the CGS market will result in the removal of the liquid, benchmark, risk-free rate from Australian financial markets. We believe that this will result in an increase in the risk profile of investors' asset portfolios, and a rise in the cost of capital. One of the implications will be a further outflow of funds from fixed-income portfolios to overseas assets.

Our preferred option is the retention of a liquid CGS market. If the Government did decide to follow a second-best option and eliminate the CGS market, we believe the best method would be to retire CGS debt when it matures. This approach would allow financial markets time to develop an alternative to the CGS market. We also believe that repurchasing debt on-market would be an expensive exercise, as highlighted by the experience with previous reverse tenders.

There will be a re-entry premium to be paid if the Commonwealth exits the debt market, and then wishes to return at a future date. We note that the *Discussion Paper* suggests that the costs could be up to 30bpts annually. In our view the direct cost to the Government of shutting and re-opening the CGS market is a second-order issue. More important are the externalities involved with removing the liquid, benchmark, risk-free rate from the domestic financial market infrastructure.

### Option 2

The option of combining the Commonwealth and State government bond markets has two advantages. It would increase the liquidity of the bond market, and it would most likely reduce the cost of capital for the States.

The combined amount on issue is currently of sufficient critical mass to warrant consideration as a surrogate benchmark. State government budget positions and current fiscal policies, however, suggest that this sector is unlikely to require substantial new debt issuance in the foreseeable future. The maintenance of a minimum critical mass on issue would, therefore, be crucial to the acceptance of Semi-government bonds as a substitute benchmark market

We note that the Commonwealth and State governments decided not to proceed down this path in 2001.

### Option 3

The *Discussion Paper* assumes that the only alternative use for Budget surpluses is to offset unfunded superannuation liabilities. Other options are worthy of consideration.

Furthermore Governments have a role to play because of weaknesses in the market system. Keynes perhaps best summed it up as "the important thing for government is not to do the things which individuals are doing already.....but to do those things which at present are not done at all".

In this context we believe that the economic costs of eliminating the remaining debt are likely to offset the potential benefits. And that debt elimination arguably sits at odds with the broader theoretical role of government.



## PRICING OTHER FINANCIAL PRODUCTS

**Question 1:** *Are CGS used extensively as the primary benchmark for pricing the debt securities of other issuers?*

**Response:**

CGS and associated derivative products are used extensively as the principal benchmarks for the pricing of fixed-rate debt securities. CGS is the key benchmark in both the primary and secondary markets. It is the key benchmark across a broad spectrum of issuers and transaction types.

Primary and secondary-market pricing referenced to other financial markets products such as interest-rate swaps are also used. The use of alternative products is considered largely ancillary to, and dependent upon, the use of CGS and associated derivative markets.

Table 1: Benchmark Profiles

Product Pricing	Primary Markets		Secondary Markets	
	CGS*	Swap**	CGS*	Swap**
Semi Government	✓		✓	
Corporate	✓	✓	✓	✓
RMBS Fixed	✓	✓	✓	
CMBS Fixed	✓	✓	✓	✓
Credit Wrapped Fixed	✓	✓	✓	✓
Debt/Equity Hybrids		✓		✓

\* Reference to CGS & associated derivative markets \*\* Reference to Bank Bill Swap Reference Rate as distinct from fixed rate

**Question 2: (part 1)** *Is the interest rate swap curve used widely for pricing debt securities?*

**Response:**

The swap curve is not as widely used as the CGS curve for pricing fixed-rate debt securities.

The swap curve is used principally to provide another dimension to comparative-value assessments, and not as a preferred benchmark for price-setting purposes.

**Question 2: (part 2)** *If not, are there obstacles to using the swap curve in the future?*

**Response:**

For an instrument to be accepted as a domestic benchmark it must be:

- risk free;
- universally accepted by prospective users;
- liquid and freely tradeable;
- domestically oriented and AUD denominated;
- transparent in its pricing;
- comprehensive in term structure coverage;
- supported by an underlying homogeneous instrument;
- investable.

On the above criteria, the swap curve has several significant structural impediments that may permanently limit its acceptance as a surrogate or replacement benchmark. In particular:

- Swaps contain inherent credit risk and therefore, unlike CGS, cannot rightly be considered "risk free".



*There are structural impediments to the swap curve acting as a replacement benchmark.*

- Swaps are not universally used by all market participants.
- Swaps are less liquid than CGS (and associated derivative markets) even though swaps turnover is notionally higher than that for physical CGS.
- Swaps are not a homogeneous product, with each swap transaction being the unique product of a bilateral agreement between counterparties.
- Swaps lack the observable price transparency of CGS and associated derivatives.
- Swaps are an effective measure of relative value rather than a market benchmark.
- Swaps cannot be invested in (ie they are not a physical instrument).

*Swaps contain credit risk and cannot be considered "risk free".*

Unlike the CGS market with its homogeneous credit risk, swap counterparties vary in credit quality. As such, any swap rate includes a credit-risk and documentation component that the CGS market does not.

*Swaps are not universally used.*

Fund manager mandate constraints inhibit the broad-based use of swaps in portfolio management. Furthermore the inability to invest in a physical swap instrument will continue to further limit the acceptance of the swap market amongst the broader fund industry.

*Swaps are less liquid than CGS.*

Swap turnover is greater than CGS physical turnover. But the unique bilateral over-the-counter nature of each swap transaction ensures that the swap market is perceived as inherently less liquid than the homogeneous physical CGS and its associated exchange-traded derivative markets. According to Australian Financial Markets Association (AFMA) data the combined turnover of the CGS physical market and associated futures contracts is more than ten times that of the interest-rate swaps market. As an example of the relatively greater liquidity, the bid/offer spread for CGS is typically around 2bpts while that for swaps is often around 6bpts.

*Swaps lack the same degree of observable price transparency as CGS.*

The CGS market has a large number of active participants who freely price Commonwealth of Australia risk to each other on reciprocal demand. This promotes a highly-liquid, price-transparent market capable of being used as an effective market benchmark, including providing underlying support for the exchange-traded futures market.

The swap curve, in contrast, is not an homogenous product and reflects a series of prospective over-the-counter bilateral obligations between consenting counterparties. Participation is contingent upon each player having counterparty credit limits available on mutually-acceptable terms. Swap trade sizes tend to be significantly larger than for CGS.

The Sydney Futures Exchange (SFE) has recently launched three-and-ten-year interest rate swap futures contracts. Australian markets have, historically, not always embraced new futures contracts. The last successful futures contract taken up by the market was the three-year bond contract over fifteen years ago. Similar futures contracts in the US for USD interest-rate swaps and Agency securities remain significantly less liquid than futures contracts based on Treasuries. The Commonwealth Bank of Australia is shareholder in the SFE.

*Swaps are an effective measure of relative value.*

The swap curve does not play a lead role in the final price-setting process for primary fixed-rate debt securities. But it is used extensively as an alternative measure of relative value between different types (ie fixed and floating rate) of debt securities, particularly in the secondary market.

*Swaps are not investable.*

A fundamental obstacle to the swap market being used for pricing debt securities is that, unlike physical debt securities, swaps are not investable. Nor can they be used as collateral. Dealing in swaps involves incremental transaction costs and is thus a less efficient risk management tool than CGS.

This lack of investability has significant implications for the funds-management industry. They would be effectively precluded from transacting in a product that they are potentially benchmarked against.



When an investor buys a bond they acquire a freely tradeable asset with a series of known, fixed cash flows at known future dates in exchange for a known up-front payment. The supply of bonds is also finite at the time of purchase.

Swaps are not a physical instrument. Under an interest-rate swap contract counterparties agree to exchange a series of cash flows at known future dates. There is no up-front exchange of principal or consideration. There are also no supply constraints to swaps (other than availability of counterparty credit limits). Instrument transfer is effected by negotiation of terms and conditions unique to the individual swap.

#### Implications for fund managers

A significant implication of all of these factors for funds management is that portfolios would become administratively complex in what should be the simplest and most straightforward type of portfolio. A swap contract can't be sold, as a physical bond is sold. The investment impact can only be closed out by entering into an offsetting contract or executing a swap termination. Thus, the processing of inflows and outflows over time, and implementation of active investment management decisions, will result in a plethora of transactions that would need to be monitored, revalued and administered. Many fund managers would be reluctant to use swaps extensively for these reasons.

#### Question 3: (part 1)

#### What other options are available for pricing debt securities?

##### Alternative options to CGS for pricing debt securities.

Efficiently pricing fixed rate debt securities without a CGS curve requires the wide acceptance of another reference benchmark curve to reflect term interest rates. Alternatives to the CGS market and the domestic swap curve include:

- Semi-government bond curve (Semi's);
- Supranationals (Supra);
- Australian major bank curve (Bank);
- US Treasury curve (UST).

#### Question 3: (part 2)

#### How effective are they?

The likely effectiveness of a prospective benchmark needs to be evaluated in the context of the benchmark characteristics previously defined

Table 2: Benchmark Characteristics

Characteristics	CGS	Swap	Semi	Supra	Bank	UST
Risk Free	✓			?		(1)
Liquid	✓	✓	✓	?	?	✓
Relevant to all Users	✓					
Domestically oriented	✓	✓	✓		✓	
Transparent Pricing	✓		✓			✓
Full Term Structure	✓	✓	✓			✓
Homogenous Instrument	✓					✓
Investable	✓		✓	✓	✓	✓

(1) Risk free to US benchmarked participants only

#### Semi-government bonds.

The Semi-government bond market offers a virtually risk-free domestic Australian dollar yield curve. It is certainly closest in representation and credit quality to the CGS yield curve although we note that the credit ratings are discrete and unique to each issuing entity.

We also note that Semi-Government bonds enjoy the same Real Time Gross



Settlement (RTGS) status as CGS.

Pricing of Semi-government bonds is transparent and readily accessible through the agency of each issuing authority's dealer panel. As a consequence, the Semi-government market is perceived as liquid. Most State Government issuing authorities support dealer panel members price-making obligations through access to stock lending facilities. We note that this facility is not currently available from Commonwealth Treasury for CGS.

Semi-government authorities issue across a broad term structure, including some issues with maturities significantly longer than current CGS issuance (eg Queensland Treasury Corporation have issues maturing in 2019 and 2021 currently outstanding).

Each issuing State Government authority is rated, managed, borrows and invests as a separate legal entity under the direction of their respective State Treasuries. As a consequence, the Semi-government bond market is not as homogeneous as the CGS market.

The domestic and international investor base for Semi-government bonds is deep. We also note that some State borrowing authorities have active offshore issuance programs structured to specifically accommodate offshore investor interest in this market.

The combined amount on issue in this sector is currently of sufficient critical mass to warrant consideration as a surrogate benchmark. State Government budget positions and current fiscal policies, however, suggest that this sector is unlikely to require substantial new debt issuance in the foreseeable future. The maintenance of a minimum critical mass on issue would, therefore, be crucial to Semi's acceptance as a substitute benchmark market.

The Semi-government market is closest in characteristic to the CGS market. Although there are some governance issues that need to be addressed, it has potential to fulfil some of the benchmark functions of the CGS market. The lack of homogeneity, however, would be a significant structural impediment to this market assuming benchmark status.

#### *Supranationals.*

Supranational issuance into the Australian domestic market is a relatively recent phenomenon. Despite their generally very high credit quality (AAA) we believe it is difficult to rationalise using Supranational bonds to replace CGS as a domestic risk free benchmark.

Broadly speaking, the risk-free status of CGS in the Australian market is derived from the credit rating of the Commonwealth of Australia (AAA) as a sovereign local currency borrower with a capacity to levy taxes. Supranational borrowers, in contrast, are very well capitalised foreign corporate entities with sovereign shareholders that access the Australian market on a largely opportunistic basis. Furthermore each Supranational is a separate legal entity with a unique and distinct internationally oriented Mission Statement.

Selected supranational issues do enjoy the same RTGS status as CGS.

Pricing in Supranational issues is less transparent than for CGS and Semis. Most issues trade more like corporate bonds. As such pricing between intermediaries is generally on an "if suits" basis. Given the largely opportunistic nature of most Supranational issuance, most borrowers have incomplete term structures in the domestic market. The amount on issue in this sector also lacks sufficient critical mass to warrant consideration as a surrogate benchmark.

We do not believe the Supranational bond market can be viewed as being as homogeneous as the CGS market and as such is unlikely to be accepted by users as an effective surrogate benchmark.

*Major Australian Banks.*

As the highest-rated non-government group of corporate entities in the domestic market, Australian banks collectively enjoy a prominent position within the Australian financial system. They dominate the domestic swap market. This dominance means that there is already a high degree of exposure to the credit of Australian banks across the financial system.

Pricing in Australian bank issues is significantly less transparent and less liquid than for CGS. Pricing between intermediaries is on an "if suits" basis. The amount on issue in this sector also lacks sufficient critical mass to warrant consideration as a surrogate benchmark.

In addition, almost all debt-security issuance by major Australian banks has been for terms of five years and under. There are currently no longer-dated issues in the market for any borrower from this sector.

We do not believe that a greater level of term issuance by major Australian banks will be viewed as being as a replacement benchmark.

*US Treasury curve.*

The US Treasury curve represents a globally-accepted, liquid, risk-free benchmark priced in US dollars.

Although the US and other global factors heavily influence the Australian market, the US Treasury curve has limited domestic applicability. The US Treasury curve reflects US economic/political fundamentals, not Australian. Its adoption as a benchmark would marginalise the domestic markets.

Furthermore, the use of any foreign benchmark directly introduces currency exposure to the risk-management process and, as a consequence, would clearly increase the cost of transacting for all users.

We do not consider the US Treasury market to be a viable alternative domestic benchmark.

*Liquidity of the CGS market.*

A key factor behind the importance of a government bond market to the domestic market is the greater liquidity of CGS. Recent activity statistics offer an insight into changes in investor behaviour.

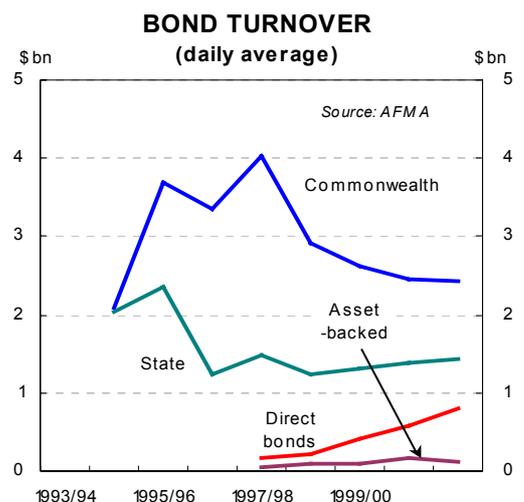
*An increase in velocity of turnover has sustained CGS market liquidity.*

Although the average daily turnover of CGS has fallen significantly, the velocity (defined as turnover divided by stock of underlying debt) of this market has proved remarkably resilient.

This resilience has sustained the markets' underlying liquidity and viability during a period when the amount on issue has fallen.

This trend was supported by a matching surge in CGS Repurchase Agreement (repo) activity.

*Fig. 1:*





*Institutional investors playing a bigger role in CGS market.*

According to data from the Australian Prudential Regulation Authority (APRA), domestic banks held less than \$6bn of CGS at the end of March 2002, suggesting that domestic and international institutional investors are again significant participants in this key benchmark product.

This trend was supported in part by the broadening of the base of eligible RTGS securities. In contrast, although turnover in corporate and non-government paper has continued to grow, trading velocity has dropped off markedly.

This drop-off is synonymous with institutional investors developing a buy-and-hold mentality in relation to their non-CGS holdings.

Significantly, this trend is also clearly apparent in the non-resident category, which includes Supranationals.

*Table 3: Bond Market Turnover Ratios*

<b>Sector</b>	<b>98/99</b>	<b>99/00</b>	<b>00/01</b>
Financials	3.9	2.2	3.9
Corporate	9.0	4.4	3.8
Non Residential	1.9	1.3	0.9
Asset Backed	0.9	1.4	0.7
Total Private	2.7	2.3	2.1
CGS	7.9	8.1	8.9

*Source: AFMA*

**REFERENCING OTHER FINANCIAL PRODUCTS**

**Question 1: (part 1)**

***Is the yield on CGS commonly used as a reference benchmark for comparing the yields on other debt securities?***

**Response:**

The CGS curve is actively used to reference bonds and other financial instruments. It is the base upon which all related ancillary market pricing and liquidity is built. As a consequence, the CGS market (and associated derivative market) is rightly perceived as the “primary benchmark”.

Market participants take the level relative to swap into consideration in the pricing and decision making process. But the “risk-free” CGS rate is unambiguously the primary reference benchmark both directly (through the physical CGS market) or indirectly (via the CGS futures market).

In addition, many market transactions are executed on an Exchange for Physical (EFP) basis. Under this arrangement, a physical security is bought or sold in exchange for an agreed volume of CGS futures contracts at a defined price. This type of transaction is particularly prevalent in the professional market as a means of managing or shifting risk amongst market participants. It is a core component of market liquidity.

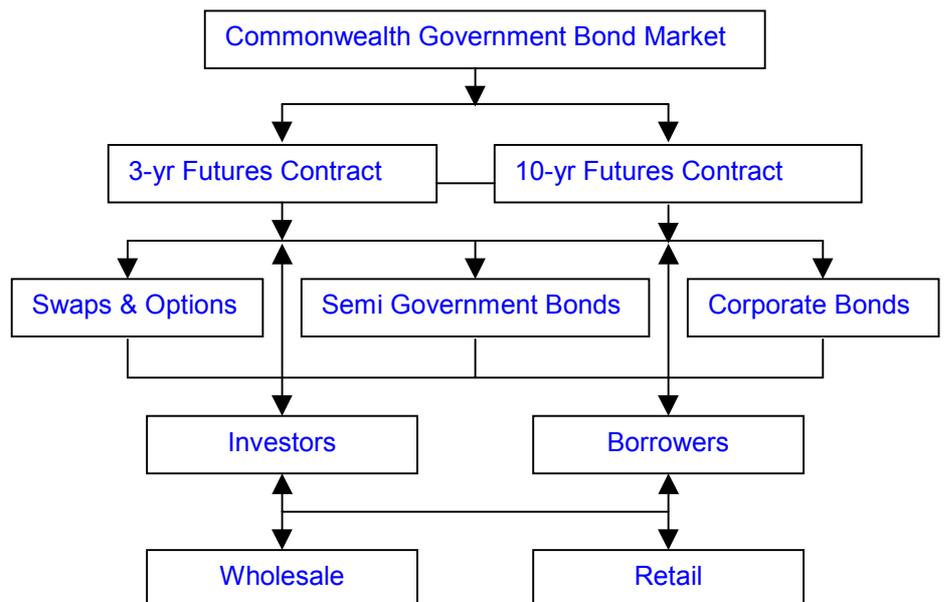
All Semi-government, corporate debt and derivative instruments are referenced to the CGS and associated derivative curve.

*Australian capital markets would not operate as effectively or as efficiently with an alternative benchmark.*

Australian capital markets would not, in our view, operate as effectively or as efficiently with an alternative benchmark. To suggest otherwise seriously undervalues the mechanism by which domestic interest-rate markets interact with each other. This interaction provides the base liquidity and pricing benefits that the broader investor and borrowing community has enjoyed over the last twenty years.

The interdependent relationship of the various market sectors, and the crucial role the CGS market plays, is clearly illustrated in *Diagram 1*.

**Diagram 1: Financial Market Interdependencies**





*Benchmarking fixed interest investment portfolios*

The fixed interest investment process at most major fund managers is based upon valuations that build from the CGS yield curve as the default risk-free investment universe. The relative attractiveness of other assets is determined by evaluating their yield premium over similar duration CGS.

**Question 1: (part 2)**

***Are there any major obstacles that hampers the swap curve or some other benchmark being used as a reference benchmark?***

We have addressed this question more fully in our response to Pricing Other Financial Products, Question 2 parts 1 & 2.

**Response:**

*The swap curve has significant structural impediments limiting its capacity to become a replacement benchmark.*

In summary, we believe the swap curve has several significant structural impediments that may permanently limit its capacity to be accepted as a surrogate or replacement benchmark. In particular:

- Swaps contain inherent credit risk and, therefore, cannot rightly be considered “risk free” like CGS.
- Swaps are not universally used by market participants.
- Swaps are arguably less liquid than CGS even though in isolation market turnover in swaps is notionally higher than CGS.
- Swaps are not a homogeneous product with each swap transaction being a unique bilateral agreement between counterparties.
- Swaps lack the same degree of observable price transparency as CGS.
- Swaps are an effective measure of relative value rather than a market benchmark.
- Swaps cannot be invested in (ie they are not a physical instrument).

*The swap curve is itself benchmarked to the CGS market.*

In addition, we also note that the existing swap curve is itself benchmarked to the CGS market. And that interest-rate swap transactions (including terminations) are frequently transacted on an EFP basis.

Furthermore, the liquidity available through the CGS futures market heavily influences the stability of the swaps market. If the CGS futures contract was unavailable for hedging, the stability and liquidity of the swaps market may be affected considerably, with potentially adverse consequences for pricing.



## MANAGING FINANCIAL RISK

The CGS market has two important characteristics: status as a risk-free benchmark, and a high degree of liquidity. These characteristics mean that the CGS and associated derivative markets play a key role in managing financial risk.

A liquid *futures* market has developed around the CGS market and currently plays an integral role in managing financial risk. In fact, Australia has what is arguably the most liquid sovereign debt market in the world (see *Table 4*).

*Table 4: Liquidity Ratios*

Market	Physical Market	Futures Market	Total
US	14	5	19
Japan	4	5	9
Italy	5	1	6
UK	4	4	7
Canada	15	1	16
Sweden	18	6	24
Korea	1	0	1
Australia	8	20	28
Singapore	4	0	4

Source: AXISS Australia

If the CGS market is abolished or significantly scaled back, the key issue is “what might act as a satisfactory substitute?”

### Question 1: (part 1)

#### *Is there scope for the Treasury bond futures market to be replaced by a futures market based on an alternative instrument?*

#### **Response:**

*Alternative instruments would need to develop the risk-free status and liquidity enjoyed by CGS.*

The key features of the Treasury bond futures contract supporting its broad-based acceptance by risk managers and traders are:

- underlying support by a risk-free asset;
- liquidity; and
- price transparency through an exchange-traded medium.

These features provide a high level of confidence to the participants in the contract. Alternative instruments would need to develop these characteristics.

A quick development of an alternative futures market is unlikely. The development of a liquid universally accepted bond futures market was an extended process. A deep physical market for CGS assisted this development. The depth of the CGS market has attracted a large number of traders thereby helping to further boost liquidity for the futures contract.

### Question 1: (part 2)

#### *What could hamper an alternative futures market from developing?*

#### **Response:**

A potential alternative to the CGS futures contract is one based on interest-rate swaps. A swap contract would require the same level of support from market participants. There needs to be confidence around the transparency of the settlement process and understanding of the dynamics affecting the pricing of the contract.



*It would take a considerable period of time for any CGS replacement to gain acceptance.*

Gaining confidence in a swap (or another replacement) contract will take time. A further unknown is whether foreign market participants would use a contract based off a derivative or synthetic curve. These concerns mean that any swap contract would suffer for an extended period from a lack of liquidity and may never evolve into a satisfactory alternative to the CGS market.

Australian markets have, historically, not always embraced new futures contracts. The last successful futures contract taken up by the market was the Three-Year Bond Contract over fifteen years ago. Similarly-styled futures contracts in the US for USD interest-rate swaps and Agency securities remain significantly less liquid than futures contracts based on Treasuries.

**Question 2:**

***Is the interest rate swap market sufficiently liquid at maturities longer than five years to facilitate interest rate risk management?***

**Response:**

AFMA have observed that less than 20% of swaps outstanding have a maturity of greater than five years. Participation at the long end of the swap curve is generally deal driven and therefore flow is often sporadic. As a consequence, bid/offer spreads at the long end of the swap curve tend to be noticeably wider than for shorter maturities.

Furthermore, without an effective long-dated risk-free reference rate, the development of the long-dated domestic capital market will be significantly impaired.

**Question 3:**

***Would the viability of the interest rate swap market be affected significantly by winding down the CGS market?***

**Response:**

*The interest-rate swap market would be significantly less efficient without CGS*

The interest-rate swap market would still be viable without the CGS market. But it would be significantly less efficient. Without a CGS market, the three-year and ten-year bond futures contracts could not exist in their current form. The CGS futures contracts are the primary market used to hedge swap market risk. Without a viable alternative, the liquidity of the interest-rate swap market would decline. This decline would lead to wider bid/offer spreads, increasing transaction costs.

**Question 4:**

***If alternate risk management tools were not available, what would be the likely impact of this on the cost of capital for corporate bond issuers?***

**Response:**

*The loss of an efficient benchmark will have an adverse impact on the cost of managing financial risk.*

The removal of highly effective interest-rate benchmark will have an adverse impact on the cost of managing financial risk. And this cost will ultimately be borne by the broader community.

In this context we believe it is reasonable to conclude that the average cost of finance will increase across the wholesale and retail sector. A direct impact is difficult to quantify. But we note that a 10bpt increase in the cost of funds across the stock of private sector (household and corporate) debt equates to a least \$1.6bn a year incremental cost to these sectors (based on a stock of debt of \$1,651bn).

Financial institutions use swaps for managing the interest-rate risk in their balance sheets. Anything that inhibits that ability to hedge, and/or increases the price of hedging, will ultimately be reflected in the price of debt. An increase in hedging costs and an associated reduction in liquidity will inhibit to some extent the flow of cost-effective innovations that are a feature of Australian financial markets. The increase in the price of hedging, and a decline in liquidity in the domestic financial market, would also lead to more issuers raising capital in offshore capital markets.



## PROVIDING A LONG-TERM INVESTMENT VEHICLE

*Access to a “risk-free” asset is essential.*

Access to an investable “risk-free” asset is critical for not only the fixed income market but for investors more generally.

This risk-free role is an essential component of any benchmark for pricing other financial products, it provides an objective assessment of where markets believe interest rates are heading, and it provides a safe haven during turbulent times.

*There is a potential welfare loss associated with scaling back the bond market.*

There is no doubt that having a generic, Australian, risk-free investment medium assists the development of an efficient capital market.

It is difficult to quantify the “value” of the bond market to the economy. But some work by the US Federal Reserve concludes that “the pool of available investment opportunities may be significantly affected by the retirement of government debt, and there is a potential welfare loss associated with such an effect”. The US work produces a range of estimates of that welfare loss. Depending on the degree of investor risk aversion, the rise in wealth required to compensate for the removal of (US) Treasuries from the investment opportunity set lies in a 0.1-0.9% of wealth range (see A. Bomfim (2001)).

### **Question 1:**

***What is the significance of CGS as a long-term investment vehicle, particularly for institutional investors such as superannuation funds and life offices?***

### **Response:**

Government bonds are a vital component in the menu of available investment opportunities for all investors. They are vital not only to superannuation funds and life offices, but also other managed investment vehicles and general insurers.

*The Commonwealth Government is the largest single issuing entity in which people invest.*

Investment institutions offer to the market a range of products, covering the full spectrum of risk-return characteristics to meet a variety of investor needs. An allocation to the default-risk-free CGS market is an important ingredient for the majority of those products. The Commonwealth government is typically the largest single issuing entity in which people invest (either directly or indirectly). In conjunction with various combinations of other assets, the allocation to CGS (and similar assets priced off CGS) creates an appropriate overall portfolio risk-return outcome for different investors.

*Allocations to CGS understate their importance to the market.*

It is worth examining the available data on fund allocations to CGS more closely before drawing firm conclusions about what they are telling us. CGS accounts for “less than 5%” of the total investments of superannuation funds and life offices. But it is incorrect to infer from this, as the *Discussion Paper* does, that “CGS may not be a crucial instrument in the investment strategy of the superannuation sector at the moment”.

*CGS represents the largest single exposure by the managed-funds industry.*

ABS data (ABS (2002)) shows that at a level of 3% of total assets, the Commonwealth Government is the largest and most significant individual exposure in the superannuation and managed-funds sector. Some individual Australian equity investments might come close to this level of exposure. But we believe that even the largest individual share take-up falls short of the amount invested in Government bonds. This outcome reflects the low-risk, high-liquidity characteristics of CGS and reveals that they are a highly significant investment.

*CGS are very important for risk-averse investors.*

CGS are more significant for those investors at the conservative end of the risk spectrum than they are for the overall average position. The superannuation system (and managed funds more generally) service investors at different stages of life with different risk profiles.



*The aging population will see the proportion of “conservative” investors rise.*

Younger and more risk-tolerant investors tend to have greater allocations to equities, often investing only in equities as their time horizon extends for decades. More conservative investors, such as many retirees, invest in funds that have much higher allocations to CGS than the overall average. The aging population will see the proportion of conservative investors rise. Conservative funds tend to have an allocation of 70% to income assets, the most significant being CGS.

It is also worth noting in this connection that the total allocation of funds to fixed interest overall is quite low at the moment. The share of “long-term securities” in total superannuation assets has fallen from around 20% in the late 1980s/early 1990s to around 8% at present. This fall in part reflects the entrance into the managed-funds system of a larger number of younger and more risk-tolerant investors. Their portfolio allocations are intentionally focussed on growth assets rather than income assets.

*CGS is still the critical asset for duration management and for the processing of fund inflows and outflows.*

*CGS also plays an important role in managing a fixed-interest portfolio.*

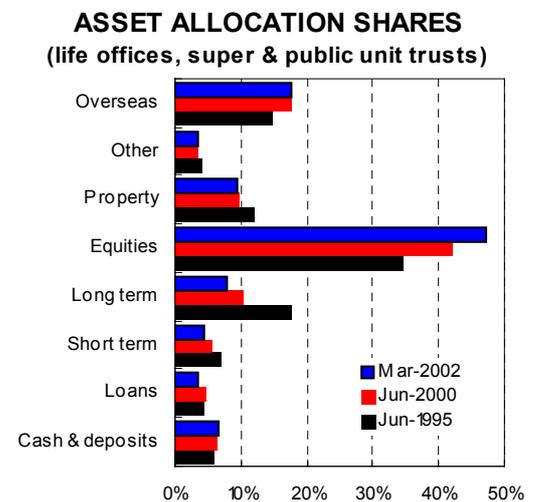
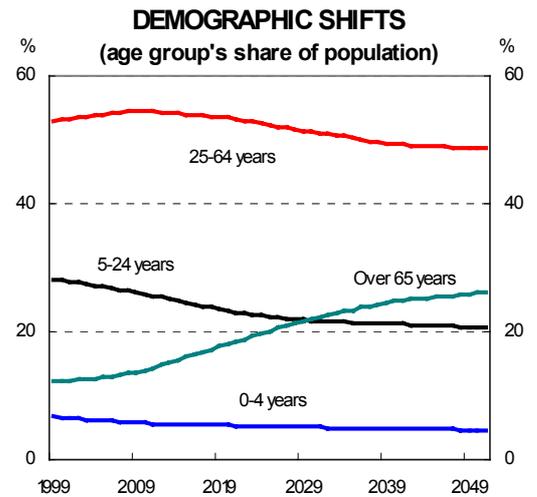
Within the broad “long-term securities” category, CGS remains the dominant allocation. The allocation has fallen from a peak of 60% in the mid-1990’s to 40% presently. But it remains double the proportion of long-term securities in CGS held in 1990. Corporate bond exposure has definitely increased in recent times, but largely at the expense of Semi-government holdings rather than CGS. In 1993 the proportion of long-term securities in CGS and semis was similar (at just over 40% each); but now, while the CGS proportion is still just over 40%, Semis have slipped below 20% and corporates have increased to match the CGS level.

The point needs to be made again in this context, however, that the CGS allocation is exposure to the one issuer, the one source of risk – whereas corporate exposure is diversified and much less liquid than CGS holdings.

Also, simply looking at CGS holdings in aggregate does not recognise the role that changing the maturity of specific securities has for the management of fixed-interest portfolios. Corporate holdings tend to be maintained for longer periods of time (as evidenced by the turnover and velocity statistics noted elsewhere in this submission).

CGS is still the critical asset for duration management and for the processing of fund inflows and outflows. This is because the CGS sector offers the liquidity and pricing transparency required for use in the active management of fixed interest portfolios.

*Figs 2-3:*





**Question 2:** *Is there currently an unmet demand for CGS within the superannuation sector?*

**Response:**

Yes. The allocation to CGS is currently quite low by historical standards and would undoubtedly be higher if there were more CGS on issue.

*There is an unmet demand for CGS.*

Some funds invest in line with bond indices that reflect the amount of securities on issue and thus have reduced their exposure to CGS in recent years. There is concern within the industry, however, that this trend is distorting the risk-return profile of investment portfolios and many funds would prefer to have larger allocations to CGS than are currently consistent with the index. There is absolutely no doubt that if CGS weightings in the major domestic bond indices increased, then the allocation in institutional funds would be higher than is currently the case.

*More importantly, the demand for CGS is expected to increase in the future.*

More importantly, the demand for CGS is expected to increase in the future. The long-running adjustment phase in overall super-fund allocations between sectors does seem to have run its course. The overall proportion of assets invested in equities rose sharply from 30% to around 45% during the mid-to-late 1990s, but appears to have stabilised since then. Similarly, the proportion held in overseas assets rose from 10% in 1992 to 20% in 1999, and has held at the higher figure in recent years. The allocation to longer-term fixed interest, which as previously noted has fallen over the past decade, appears to have bottomed out at around 8%.

With greater stability in the allocation to different assets, it follows that growth in super and other managed investments will increase the demand for bonds (including CGS) in the coming years.

**Question 3:** *What is the potential to develop alternative long-term investment instruments?*

**Response:**

*The liquid, risk-free characteristics of the CGS market will be difficult to replicate.*

The risk free and liquid character of CGS is a key determinant in structuring a risk-adjusted investment portfolio. Although alternative long-term investment instruments will no doubt be developed, no issuer can provide the liquidity and risk-free characteristics that the national government provides in an advanced and mature economy like Australia. Whatever the substitute, the overall investment profile of superannuation funds and life company investments would be made more risky by the absence of appropriate exposures to CGS.

The simplest and most attractive alternative from an institutional investor perspective would be for other issuers already active in the AUD debt market to take over the role of providing a liquid, low-risk yield curve. Other suggested alternatives involve some degree of intermediation, whether via swaps, or currency hedging. Credit risk increases as soon as another party gets involved. One suggestion involves providing some form of collateral to cover for the possibility of counterparty losses. In any event most alternatives lack the simplicity and liquidity of the CGS market.

In this context we note that fixed interest unit trusts are required by the Corporations Act, 2001 to be liquid offerings. CGS, although not the only liquid instrument, still play a crucial role in meeting that obligation



## IMPLEMENTING MONETARY POLICY

**Question:** *The Government would appreciate views from stakeholders on the declining importance of CGS in the operation of monetary policy.*

**Response:** Monetary policy is one of the key instruments of economic management. Whether the winding down of the CGS market will have an impact on the ability to run economic policy in general and monetary policy in particular should be a key focus of the *Discussion Paper*.

In a narrow technical sense we believe that there would be only a limited impact on the Reserve Bank of Australia's (RBA) ability to implement monetary policy. The increase in the range of issuers that the RBA will accept for Repo's has reduced the importance of CGS. In our view, provided the RBA is willing to use them, there is a sufficiency of private-sector paper.

The RBA differentiates between government and non-government risk in conducting open market operations. In this context we note that bank bills are only used for *intra-day* repurchase agreements.

### Other Issues:

*Changes in the perceived risk of investing in a particular security.* One issue that should be considered is whether RBA trading in a particular private-sector security changes the perceived risk from investing in that security. Some unintended benefits may flow to the issuer/holder of those securities (and unintended costs to others) as a result.

*Reduced effectiveness of fiscal policy.* The global environment is characterised by very low inflation. At the extreme, there is a risk that any cyclical reduction in inflation during an economic downturn tips over into deflation. Monetary policy loses its effectiveness in this scenario – witness Japan. The other arms of economic policy, including fiscal policy, need to be able to respond quickly and decisively. It is arguable that the lack of a government bond market may constrain the ability of fiscal policy to respond.

*Impact on cost of funds to private sector: - a de facto permanent tightening of monetary policy?* An assumption running through the *Discussion Paper* is that eliminating public debt will reduce capital costs. We believe that costs may in fact rise. The cost of executing an interest-rate swap transaction is a function of risk. Without an effective hedging tool for the swaps market, bid/ask swap spreads will be wider. Financial institutions use interest-rate swaps for managing the interest-rate risk in their balance sheets. The inability to hedge and/or an increase in the price of hedging will reflect in higher costs for borrowers. This increase in costs is, in some ways, equivalent to a de-facto tightening in monetary policy.

A side issue is that any increase in hedging costs could well mean that lenders/intermediaries become less innovative, inhibiting the development of financial solutions available to clients.

To the extent that longer-term rates rise relative to short-term rates, there may be a shift in favour of financing at the short end. The higher cost of hedging could well lead to a higher proportion of issuance of floating-rate bonds. These developments would leave investors more vulnerable to changes in interest rates. The need for more active management of financing positions will involve some costs for businesses and may discourage some capex plans.

**PROVIDING A SAFE HAVEN IN TIMES OF FINANCIAL VOLATILITY**

**Question 1:** *What is the importance of the CGS market in providing a safe haven during periods of financial instability?*

**Response:** One of the key features of financial-market operations is the retreat to “safe havens” during periods of financial-market instability.

*A safe-haven asset needs to be a low-risk, highly liquid asset.*

A safe haven will have a number of key features. First, it will be low risk, and preferably credit-risk free. At times of heightened risk aversion, investors want to be in no doubt about the borrowers’ ability to repay funds. Second, it must be liquid. During periods of heightened risk aversion, investors will want to be easily able to transfer funds in and out of the safe-haven asset.

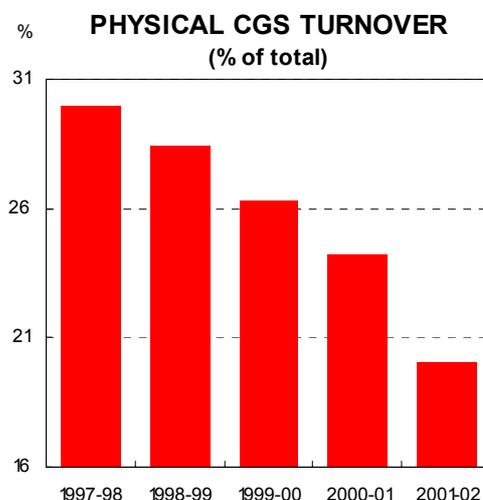
*The CGS market is widely accepted as a safe haven.*

The CGS market is widely accepted as a safe haven during periods of financial-market instability. The Australian CGS market is replicating the role that government bond markets play in other developed financial markets. The Government’s ability to tax its citizens underpins the CGS market standing as a risk-free rate.

The other key feature of the CGS market that lies behind its safe-haven role is its high degree of liquidity. Although the CGS market has shrunk dramatically over the past six years, the Commonwealth remains by some distance the biggest issuer in the Australian market.

Looking at the value of physical bonds outstanding underestimates the ability of CGS to act as a risk mitigant. The derivatives market, based on CGS, also plays a very important role. Taking into account the physical market, futures and options, total trading in CGS has risen modestly over the past five years. Although trading in physical bonds has declined in recent years in line with the reduction of debt on issue, this has been more than offset by the rise in trading in bond futures.

*Fig. 4:*



**Question 2: (part 1)** *What evidence is there of the role of CGS as a safe haven?*

**Response:** A key indicator of the importance of CGS as a safe haven is the movement in credit spreads. When the spread between credit products and CGS rises, it means that the market is demanding a higher return for higher risk products.

The chart on the following page shows the 5-year CGS yields compared with the 5-year A-rated corporate bond as calculated by *CBASpectrum\**; a proxy for the average credit in the Australian corporate bond market.

*\*CBASpectrum* is a proprietary credit model developed by the Commonwealth Bank of Australia.



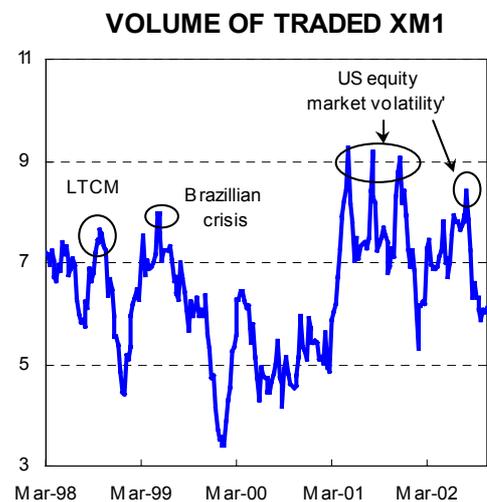
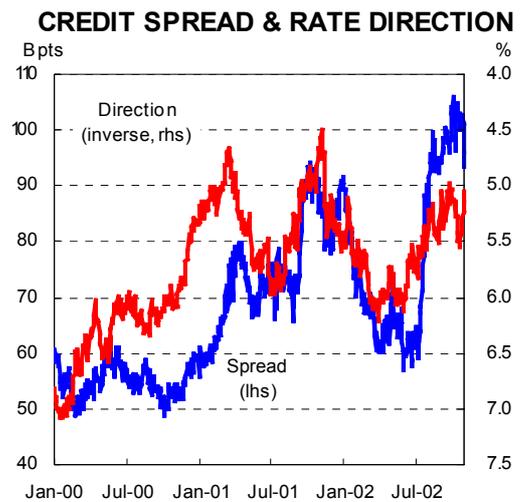
A compelling argument on the need for safe havens was provided during the Asian financial crisis.

As the chart indicates, the spread widens during periods when the direction of CGS yields falls, and vice versa (note that on Fig. 5 yields are shown inverted). Investors are indicating their preference for a liquid, risk-free rate during periods of investor risk aversion.

Another indication of the investor preference for CGS in times of financial-market stress is to examine trading volume of bond futures contracts (see Fig. 6). There is a notable rise in the volume of trading in bond futures during periods of financial-market stress.

Another compelling argument on the need for safe havens was provided during the Asian financial crisis of the late 1990s. The lack of a liquid bond market saw major capital outflows from some Asian economies during the Asian crisis. These outflows put exchange rates under significant downward pressure and imposed significant adjustment costs on domestic economies.

Figs 5-6:



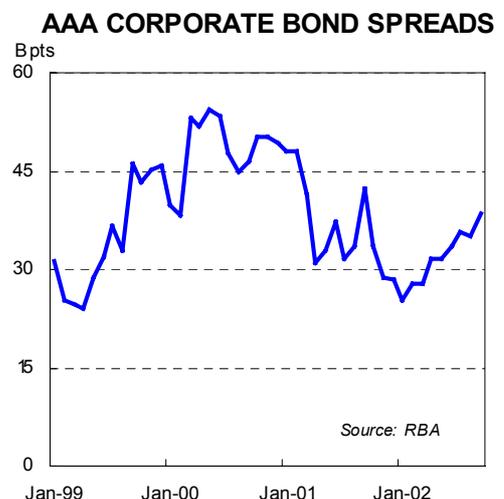
**Question 3:**

**What other possible alternative safe havens exist and how appropriate are they?**

**Response**

The CGS market ideally fits the requirements needed for a safe haven. It is both liquid and is the benchmark risk-free asset. There is other AAA-rated debt available in the domestic market. But this debt contains an element of credit or other risk unique to the instrument and/or issuer (eg prepayment risk on Residential Mortgage Backed Securities). Assets rated AAA generally outperform lower-rated assets during periods of financial-market instability. Investors still prefer CGS to other AAA-rated assets during periods of heightened risk aversion. For example, AAA-rated corporate-bond spreads widened in the

Fig. 7:



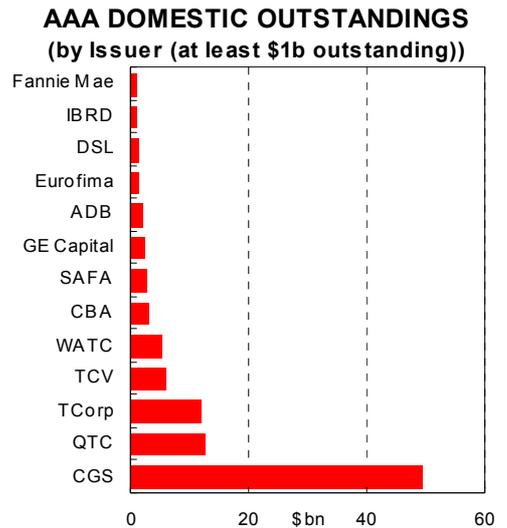
second half of last year around September 11 (see Fig. 7).

Just as important as credit risk is the greater liquidity available in the CGS market. Despite the big reduction that has taken place in CGS on issue in recent years, the Commonwealth Government remains by some distance the biggest issuer in the domestic market (see Fig. 8). Note that the chart only takes into account physical bonds on issue. The liquidity advantage of the CGS market is substantially greater once derivative turnover is taken into account.

Of course, in the absence of a CGS market investors could always take the option to convert their assets into cash.

*Fig. 8:*

The substitution of cash for CGS would involve a reduction in returns for investors and the assumption of bank-credit risk. So eliminating the CGS market reduces returns available on assets, and by removing the risk-free asset, increases the risk in investing in Australian assets. This alteration in the risk/return trade-off would make the Australian bond market relatively less attractive than offshore bond markets. Accordingly we would expect to see an asset re-allocation towards overseas debt markets.



**ATTRACTING FOREIGN CAPITAL INFLOW**

The small size of our market is certainly a factor influencing international fund managers to either reduce the quantum of their Australian dollar holdings or seek alternative international investment markets.

**Question 1:** *Would the absence of a CGS market affect Australia’s attractiveness to foreign investors*

**Response:**

Global investors are an important component of the CGS market. The offshore share increased from about 10% in the mid 1980s to a peak of 40% in 1998. There has been a small net decline since then towards 35%.

*Fig. 9:*



*Those who invest on the basis of Australia’s fundamentals are likely to stay.*

The increase in the proportion of foreign ownership of the CGS market, however, distorts the picture of overseas participation in the Australian financial market. Although the proportion of overseas ownership is higher, there has been a big decline in CGS on issue. The absolute amount of CGS owned by foreign

investors has declined. Although a portion of these funds has been directed towards other Australian investments such as corporate bonds, overseas interest in the Australian financial market has already declined.

*Those who follow global bond indices will leave.*

For the group of investors that follow global government bond indices the decision is straightforward. Eliminating the CGS market would result in Australia having a zero weighting in global indices. These fund managers would shift funds out of Australia.

*Any reduction in perceived liquidity would be a significant negative.*

A key attraction of the CGS market is its liquidity. Many global investors have a large pool of funds under management. They need liquid markets in which to invest. A significantly diminished CGS will reduce the attractiveness of Australian capital markets to offshore investors.

As noted elsewhere in this submission, the CGS market remains by far the biggest domestic debt market, despite the contraction over the past few years. It is certainly one of the most liquid in the world relative to its size (see Table 4).

A related attraction of the CGS market for overseas investors is that it provides a safe haven. The importance of having a safe-haven asset in a country’s portfolio was reinforced by the events surrounding the Long Term Capital Management (LTCM) crisis in 1998. By offering a liquid risk-free asset, the risk profile of investing within Australia is reduced. The lack of a safe-haven asset might accentuate fund outflows during difficult times.

**Other Issues:**

A factor working against the substitution of private debt for government debt is that investors demand a risk premium for “names” they are unfamiliar with. While the Australian Government is clearly well known, company-specific names are a different proposition. Investors will be reluctant to transfer funds from Government paper to company paper without appropriate compensation.



Australian dollar debt spreads rose relative to the US in 2002. The rise was more a reflection of Australian economic outperformance rather than any rise in risk premium. But a lift in the premium as the bond market winds down would be a factor that could see credit spreads widen further.

**Question 2:**

***How important are global bond indices for foreign investment in Australia?***

**Response:**

A significant proportion of global fund managers use global bond indices. The lower the weighting the Australian bond market has within global indices, the lower the participation of these investors within Australian markets.

**Other Issues:**

The government's financing requirements are not contributing to Australia's current account deficit. But the financing of the gap between national savings and national investment that the current account deficit represents requires accessible and acceptable investment options in which foreign investors can place funds. There is still a role for CGS as one of those investment options. The cost of servicing our net foreign liabilities will be higher if we have to do so entirely through higher-risk assets.

Any reduction in foreign capital inflows weakens one side of the AUD market and may accentuate volatility and the size of falls when the currency is under downward pressure. Big moves in the currency, and high levels of volatility, can damage economic prospects.



## PROMOTING AUSTRALIA AS A GLOBAL FINANCIAL CENTRE

Australia's position as a financial centre will be influenced by:

- legislated growth in superannuation funds and the investment activity surrounding those funds;
- private and public equity and debt financing required over time;
- Australia's relative attractiveness as an investment to global investors; and
- the existence of financial assets and instruments which can be traded by investors on a short and long-term basis.

The absence of a liquid CGS market is likely to adversely impact Australia's attractiveness as a global financial centre.

### Question 1: (part 1)

### Does the CGS market play a significant role in promoting Australia as a global financial centre?

#### Response:

There is no doubt that the CGS market plays a key role in Australia's status as a regional financial centre being higher than should otherwise be expected based on the relative size of its economy and markets.

*The CGS market is an important component of AUD activity.*

In addition to fixed-income investors, currency investors and other market participants are attracted to the AUD market by the ability to arbitrage and hedge their positions using amongst other things risk free CGS assets. The currency market and bond markets enjoy a symbiotic relationship – many global currency managers invest their currency positions in risk-free CGS, and global fixed-income investors must buy or sell AUD to execute their CGS trades.

It is difficult to believe that these activities will not be significantly curtailed by the absence of a risk-free CGS curve. It should be noted that numerous international financial intermediaries have scaled back their Australian operations as a direct result of the reduction in the size of the CGS market.

Australia attracts certain levels of foreign capital as a result of its inclusion in international indices. The demise of the CGS market would likely result in Australia being removed from the indices. This will reduce global focus on Australia as an investment medium as well as the level of resourcing which international financial institutions devote to Australia.

*The CGS market is a "core" component of Australia's financial-market infrastructure.*

Australian debt markets have quite a high level of foreign participation. This participation is particularly evident in the government bond market. AXISS Australia, the government body charged with promoting Australia as a global financial centre, makes much of this participation (Axiss (2000)). It argues that a liquid Commonwealth Government yield curve is a "core element" of Australia's financial market infrastructure. It;

- means that we are included in global bond indices, so global fund managers are in a sense forced to participate in Australian markets;
- gives Australia a major competitive advantage – apart from Japan, no other Asia Pacific market is included in the indices;
- delivers synergies from being seen as part of the \$-bloc; and
- offers diversification benefits – the low correlation of returns on AUD debt with Euro-denominated debt in particular has enhanced the appeal of Australian markets to global fund managers looking to offset the loss of currency diversification in Europe.

*The composition of the Australian market is well balanced.*

Furthermore, Australia is one of the better-balanced markets globally. There is no indication that the demands the public or financial sectors are inhibiting or crowding out the borrowing demands of the corporate sector.



Table 5: Domestic Debt on Issue in Selected Countries (end 2001)

Sector	Total		Public		Financial		Corporate	
	(USDbn)	(USDbn)	% total	(USDbn)	% total	(USDbn)	% total	
USA	15,377	8,557	56	4,367	28	2,453	16	
Japan	5,847	4,440	76	714	12	693	12	
Europe	5,319	3,211	60	1,751	33	357	7	
UK	921	411	45	289	31	221	24	
Canada	564	396	70	97	17	71	13	
China	332	227	68	97	29	8	2	
Brazil	311	262	84	47	15	2	1	
Sth Korea	293	77	26	98	33	118	40	
Denmark	247	73	30	161	65	13	5	
Australia	171	63	37	62	36	46	27	
Sweden	159	81	51	57	36	21	13	
Total	29,541	17,798	60	60	26	4,003	14	

Source: BIS & AXISS Australia

### Question 1: (part 2)

**Would the absence of a CGS market affect transaction costs and Australia's attractions as a centre for global financial services?**

#### Response:

Any loss in liquidity will affect both bid/offer spreads and the outright margin to global benchmarks. This margin represents a premium for the loss of liquidity. The premium would result in the loss of a competitive advantage because Australian bid/offer spreads are currently quite narrow by regional standards.

Issuing costs in Australia are also relatively low. To the extent that the absence of a government bond market boosts costs, the relative attractiveness of Australia from a global perspective would decline.

*A liquid CGS market underpins low transaction costs.*

The low transaction costs resulting from the liquid nature of the CGS market attracts foreign investors and more importantly intermediaries to the Australian capital markets. Any loss in liquidity will affect both the bid/offer spreads paid and the outright margin to global benchmarks.

Financial intermediaries play a critical role in transferring and absorbing financial risk. Intermediaries will be active in liquid, sophisticated, low-cost markets and it is likely that Australia's status as a global financial centre would be significantly diminished if intermediaries are inhibited in dealing in Australian debt instruments.

*Market infrastructure will deteriorate.*

The *Discussion Paper* contends with little supporting argument that "market infrastructure is unlikely to deteriorate significantly in the absence of outstanding CGS". It should be noted, however, that market infrastructure is almost exclusively provided by the private sector. The private sector is unlikely to provide this infrastructure unless there is sufficient transactional activity to generate providers with an adequate return on their capital invested. Replacement or upgrading would depend entirely on transaction volume expectations. At worst, significant parts of the market infrastructure may be closed or out-sourced offshore.

**APPROPRIATE SIZE OF THE COMMONWEALTH GOVERNMENT SECURITIES MARKET**

There are a number of factors that need to be taken into account when determining the appropriate size of the government bond market. These include what level of issuance is needed to ensure that the CGS market can continue to act as a safe haven, to underpin a risk-free benchmark, attract capital inflow and remain a long-term investment vehicle.

**Question:**

***The Government would appreciate views from stakeholders on the appropriate size of the CGS market in the event that the market is to be maintained.***

*Offshore allocations driven by portfolio diversification.*

The shift of funds by domestic managers offshore in recent years has been partly triggered by a desire to improve portfolio diversification. For offshore investors managing to a benchmark, the reduction in the size of the Government debt has reduced the weighting of the Australian bond market in global indices, and therefore the amount of funds invested in Australia to match the index.

A by-product of the reduction in Government bonds on issue is, therefore, reduced support for the AUD.

*The reduction in CGS has (perverse) reduced support for the AUD.*

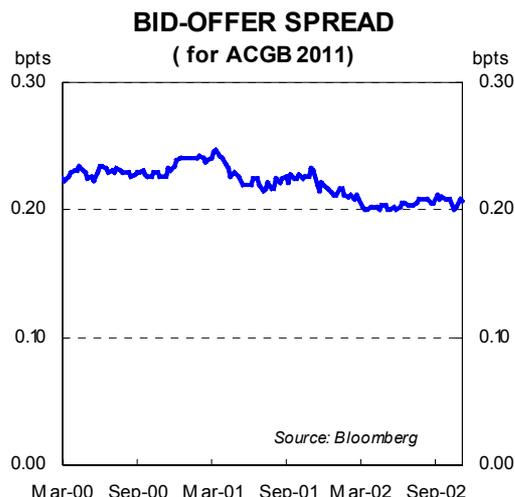
A case exists that some increase in government bonds on issue would be a plus for the AUD. By global standards, the amount of Australian Government debt on issue is low. Accordingly, it is unlikely that investors would attach a risk premium to Australian Government bonds for a rise in net issuance. Indeed the indications are that investors could comfortably absorb a significant rise in debt on issue.

The key question, then, is what level of debt is needed to maintain the other key characteristics of the CGS market, such as its use as a risk-free benchmark and as a safe-haven investment? In short, what level of issuance is needed to maintain an efficient CGS market?

*Current levels of debt are enough to support an efficient market.*

The current level of debt has been enough to maintain an efficient market. One indication is the bid/offer spread for physical bonds. One would expect that low liquidity would result in a widening in the bid/offer spread as market makers become more reluctant to take on risk. An examination of the 2011 ACGB, up to recently the benchmark 10-year bond, indicates that the bid/offer has if anything narrowed over the past couple of years.

*Fig.10:*



Another indication that the market remains efficient can be derived from the volatility of weekly yield changes. Intuitively volatility should be higher in illiquid and inefficient markets.

*No notable structural rise in bond volatility*

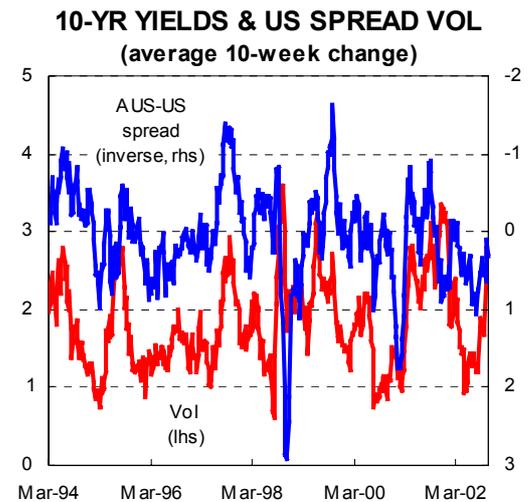
A perspective on this can be obtained by examining weekly changes in the generic ten-year bond yield as calculated by Bloomberg (see Fig. 11) Utilising the ten-week moving average of the weekly change will provide a sense of broad trends.

In mid November, bond volatility was relatively high. It was within the range



recorded over the past decade but it was at the higher end of that range. Australian long-end yields are driven by a combination of global and domestic factors. The global impact can be partially neutralised by a comparison of the spread of volatility of Australian and US yields. If the volatility of the Australian market had risen relative to the US market, that may reflect the development of a domestic liquidity premium. There was no notable increase in volatility of the Australian market relative to the US market over this period.

Fig. 11:



As long as market participants remain comfortable with the efficiency of the CGS market, the futures market will remain liquid. This has, in turn, mitigated some of the reduced turnover in the physical CGS market.

*The CGS market could still be efficient with eight benchmark lines.*

What is the minimum amount of debt needed to maintain an efficient market? The key characteristic is that there will need to be enough liquid benchmark lines to define a yield curve. Clearly, the more benchmark lines available the greater the credibility of the yield curve. At present the three- and ten-year futures are each underpinned by three bonds. With another two bonds in the mid-part of the curve, the CGS market could remain efficient with a total of eight benchmark stocks.

At an absolute minimum, it is possible that two bonds for each of the three- and ten-year futures could suffice. One bond, however would be too few as it would increase the chances that the pricing of three- and ten-year future contracts could be driven by market factors related to a particular bond, as opposed to fundamental reassessment of movements in three- and ten-year yields. Accordingly, with three maturities in the middle part of the curve, it is possible that market could make do with as few as seven benchmark stocks.

*The AOFM would need to be an active participant in the market.*

If there were to be a move to reduce the number of benchmark stocks, the Australian Office of Financial Management (AOFM) would need to be even more active in repurchasing short-dated securities and issuing longer-dated securities to maintain a liquid CGS curve.

*Minimum of \$5bn outstanding needed for each benchmark line.*

The other key concern is the minimum amount of issuance needed to maintain liquidity for each stock. The current level of \$5bn for each benchmark line appears appropriate in meeting the needs of most participants, and therefore maintaining an efficient market. As issuance is reduced from current levels, however, there will be a growing risk that the CGS market will become progressively less efficient. For example, as issuance declines it will become increasingly difficult to access physical bonds to undertake repurchase agreements.

*Minimum issuance needed for efficient market is \$35-45bn.*

We believe that an efficient market could be maintained with 7-9 benchmark lines, each containing around \$5bn of issuance. Accordingly, we believe the CGS market could continue to play an important role if a minimum of \$35-45bn remains on issue.

**OPTIONS AVAILABLE TO THE COMMONWEALTH**

**Option 1: Wind down the Commonwealth Government Securities market**

**Question 1: What are the potential implications of winding down the CGS market?**

**Response:**

*Most of the implications of winding down CGS market are negative.*

The following outcomes are highly probable if the CGS market is wound down:

- a rise in risk profile of all Australian deposit taking institutions who will not have the ability to invest a portion of their liquidity/capital in risk-free CGS assets;
- a rise in the cost of capital in Australia given the removal of a risk-free benchmark and additional lack of liquidity premium which investors will demand;
- an outflow of the fixed-income portion of superannuation, life insurance and other invested funds into offshore “risk-free” and liquid assets;
- a consequent increase in the risk profile of these funds as a result of the need to accept foreign exchange risk and/or counterparty risk with financial institutions with whom investors would transact currency hedge transactions.

Other potential implications include:

- superannuation, life insurance, and other invested funds are expatriated to offshore management as portfolio-management discipline, economies of scale and cost dictate that the majority of funds be managed by the same managers as those managing the fixed-income and risk-free portion of the portfolios;
- run-down in domestic financial-market infrastructure such as futures and bond markets, out flow of funds from the corporate-bond market, stock market, and commercial-property market if the majority of funds are invested from offshore.

**Question 2: What is the likely impact on the cost of capital?**

**Response:**

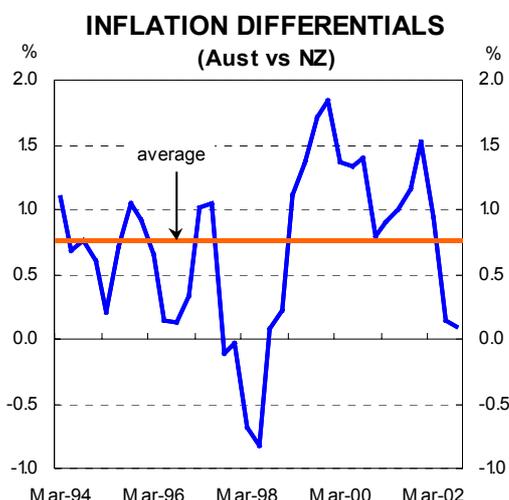
*The New Zealand market is seen as relatively illiquid.*

The implicit assumption of the Treasury Paper is that although there is a change in supply of AUD assets, there is no (or only minimal) change in demand. The New Zealand case provides an alternative illustration.

There are a number of similarities between Australia and New Zealand. Both Governments have run Budget surpluses, resulting in lower debt (both in absolute terms and as a proportion of GDP). Both Australia and New Zealand also run current account deficits, and have currencies that historically have close ties to commodity-price movements.

Such has been the decline in government debt that the New Zealand market is now seen as relatively illiquid. Anecdotally, if offshore funds want to take a position in the New Zealand market it is often done via taking positions from a tender.

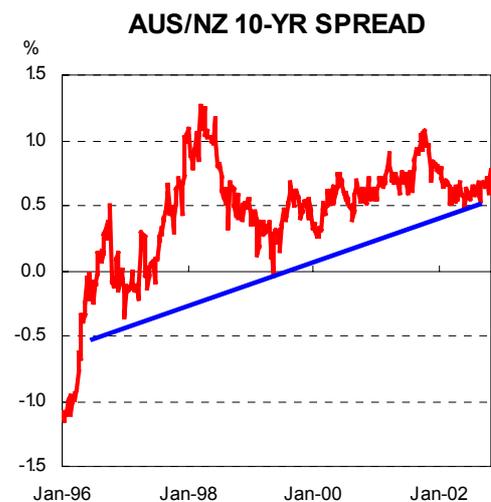
*Fig. 12:*





We examined how the market has assessed the reduction in liquidity in New Zealand markets by examining the AUS/NZ 10-year spread. New Zealand core inflation has been around 0.75ppts lower, on average, than Australian inflation since 1994. Despite New Zealand inflation being lower, the AUS/NZ spread has been trending higher. The rise in the spread up to around 1998 reflected the drop in Australian financial market expectations of inflation. Australian economic out-performance means that the

Fig. 13:



widening in the spread cannot be explained by growth differentials. The only logical explanation is that the level of the spread reflects a liquidity premium for New Zealand bonds. Eyeballing the AUS/NZ 10-year spread (see Fig. 13) the rise in the premium looks to be worth 25-50bpts.

### Question 3: (part 1)

**What is the most appropriate approach and timeframe to implement a decision to wind down the market, if this decision is made?**

#### Response:

The preferable method for winding down the CGS is for the government to retire outstanding CGS as they mature. This approach will give investors time to adjust their investment strategies and identify alternative offshore or (if available) domestic investment alternatives.

*Buying back CGS will distort fixed-income markets.*

Buying back outstanding CGS in a relatively short time frame will distort fixed-income markets. This distortion will have a fiscal cost to the government as they will have to pay a premium to prise loose CGS holdings from investors not wishing to sell them.

It should be noted that the government cannot be assured that investors will sell CGS (no matter what price is bid) as some CGS are held to match long-term liabilities – and suitable replacement assets may prove difficult to find.

### Question 3: (part 2)

**What are the likely re-entry costs (in the form of additional borrowing costs) if the Commonwealth withdraws from the market?**

#### Response:

It is difficult to quantify the additional borrowing costs incurred should the Commonwealth close down the CGS market but then at some future time decide to access the bond market. Factors determining the cost include:

- the length of time between the closure of the market and its re-establishment;
- the cost of re-establishing appropriate bureaucratic supervision and operational infrastructure to manage the program;
- whether or not associated market infrastructure such as the futures markets, settlement systems, and market intermediaries still exist; and
- the size and ongoing nature of the new borrowing requirement.

Setting aside these aspects, any new program will attract a liquidity premium until the outstandings and ongoing issuing intentions of the government are viewed by the market as providing optimum liquidity. We do not have strong views as to what the cost of shutting and re-opening the CGS market would be. We note that the *Discussion Paper* suggests that



the costs could be up to 30bpts per annum.

In our view, the direct cost of shutting and re-opening the CGS market is a secondary issue. The main issue, though, revolves around the externalities involved with eliminating the liquid, benchmark, risk-free rate from the domestic financial markets. We believe that the elimination of the CGS market will result in a riskier, less liquid domestic financial market, one result of which will be a rise in the cost of capital.

**Option 2:****Consolidate Commonwealth and State government debt**

One suggestion to help boost liquidity in the CGS market is to merge the Commonwealth and Semi-government bond markets. A benefit of this Option is that it would potentially reduce the cost of capital for State governments.

**Question 1: (part 1)*****Is there merit in reconsidering the idea of consolidating Commonwealth, State and Territory government debt into one market; and*****Response:**

Some discussion regarding the merger of the State and Commonwealth Government bond markets took place in 2001. At face value, such a plan appeared to have some merit. For the States, it would most likely reduce their borrowing costs. The extent of the reduction would vary depending on a range of factors such as the credit rating of each State. In the *Discussion Paper*, Treasury estimates that the reduction in State borrowing costs could be worth up to \$150mn if borrowing costs fall to the current Commonwealth Government level.

The Commonwealth's superior taxing powers mean that rating agencies would view there being a lower risk of Commonwealth Government default than any particular State default. State governments would therefore probably benefit if they were able to borrow using the Commonwealth's name.

*Merging Commonwealth and State bond markets would boost liquidity.*

Merging the Commonwealth and State bond markets would boost the size, and therefore liquidity, of the overall market. Among other benefits, a more liquid bond market could help attract foreign capital inflow. For example, boosting the size of the sovereign bond market will lead to a higher weighting in global-bond indices. Fund managers that follow these indices, particularly passive index managers, will need to increase their weighting to the Australian market, with flow-on effects to the currency.

*Commonwealth and State governments decided not to proceed down this path in 2001*

The concept of the Commonwealth borrowing on behalf of the States is not new. Indeed it was standard practice up to the late 1980s. The Commonwealth, as the borrowing authority, raised the funds and then passed them on to the States.

However we note that the Commonwealth and State governments decided not to proceed down this path in August 2001 as noted in Appendix 5 of the Discussion Paper

**Question 1: (part 2)*****Does this option assist with the transition to reducing the supply of Government debt?*****Response:**

The key issue is that there is currently no effective alternative within domestic financial markets to CGS in providing a liquid, risk-free benchmark. It is possible that other benchmarks will develop over time. So, the longer that the CGS market can be maintained, the greater the chance that alternative benchmarks will emerge.

Nonetheless, consolidating the Commonwealth and State government bond markets is not our preferred option. It may increase the liquidity of government bond markets and reduce the cost of borrowing of State governments. But we believe that it would be complex to administer.

**Option 3:**

**Maintain the Commonwealth Government Securities market and fund the Commonwealth’s unfunded superannuation liabilities**

This option considers only one use for surplus funds. Funding the Commonwealth’s unfunded superannuation liabilities is one potential use of excess funds worth examining. But we believe that there are other options warranting consideration. A review of these alternatives centres on defining the role of government and the contribution of debt in fulfilling that role.

Governments have a role to play because of weaknesses in the market system. Keynes perhaps best summed it up as “the important thing for government is not to do the things which individuals are doing already.....but to do those things which at present are not done at all”.

*Costs of eliminating the remaining debt are likely to offset the benefits.*

In this context we believe that the economic costs of eliminating the remaining debt are likely to offset the benefits. And that debt elimination arguably sits at odds with the broader role of government.

The potential costs of eliminating the CGS market include:

- The loss of an important economic safety-valve;
- The loss of an important economic policy instrument;

We should also consider the “nation building” role governments are expected to fill.

**The loss of an important economic safety-valve**

*Role of the CGS market.*

The CGS market as we know it had its beginnings in the swing into sustained Budget deficits in the 1970s. This swing was evident in most countries. Budget deficits were the norm for much of the twenty years that followed. To state the obvious, the CGS market exists to cover any shortfall between government revenue and government spending.

*Accommodating cyclical funding needs.*

This shortfall can occur courtesy of (transitory) cyclical influences and (longer-lasting) structural changes. The absence of a bond market would make it difficult if not impossible to accommodate these structural and cyclical influences. At the very least, there would be significant costs associated with resuscitating the bond market if and when required.

*The business cycle is not dead.*

The business cycle is not dead. There will be periods of below-trend growth. And there is a range of issues looming on the horizon that could have some far-reaching implications for structural budget positions.

*Forecasting Budget aggregates is difficult – errors are common.*

Forecasting the Budget aggregates is difficult. The deficit/surplus is no more than the difference between two big numbers – spending and revenue. Small divergences in either have a magnified impact on the overall balance. A 0.1ppt undershoot in revenues and a 0.1ppt overrun in expenditures would, for example, produce a deterioration in the Budget bottom line of \$330mn.

A comparison of actual Budget outcomes with those expected at Budget time (see

*Fig 15:*

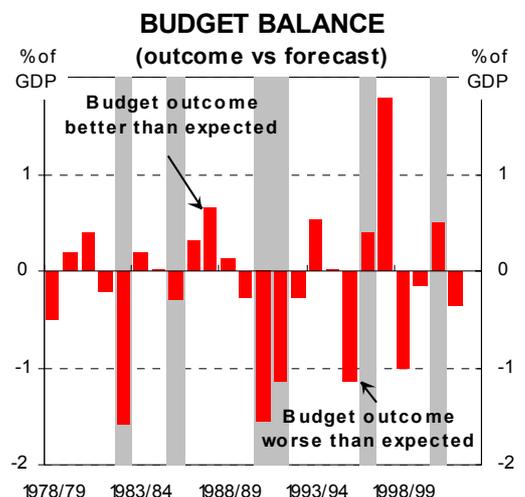


Fig. 15) illustrates the point:

- The average absolute error in Budget forecasts over the past twenty-four years is equivalent to 0.6% of GDP. Or \$4.3bn in 2001/02 prices.
- Budget projections have been undershot on twelve occasions and been bettered on twelve occasions.

There is less symmetry in the degree of error. The errors are larger when Budget outcomes come in worse than expected (averaging 0.8% of GDP) than when outcomes are better than expected (averaging 0.4% of GDP).

The larger Budget shortfalls tend to coincide with recessions or growth pauses (the grey-shaded areas on Fig.15). This tendency highlights again the significance of the business cycle for driving Budget divergences.

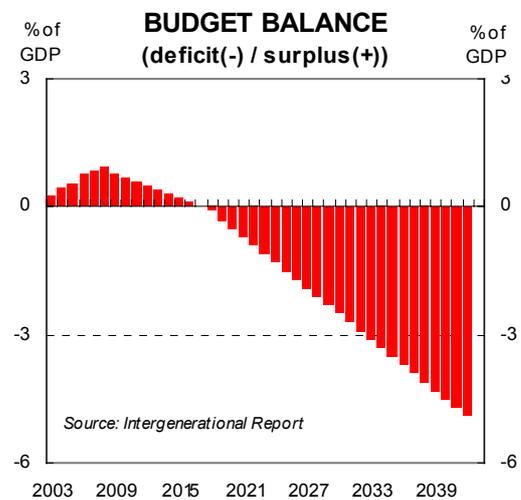
Budgetary positions in the future will also be under pressure from a range of issues that are more structural in nature. The common theme of these issues is that they will be expensive to deal with.

*The common theme of structural issues is that they will be expensive to deal with.*

Structural threats to Budget bottom lines include:

- the aging of the population;
- an associated slowing in potential economic growth rates;
- the upward trend in health-care costs;
- the stockpile on unfunded government superannuation liabilities;
- a range of environmental issues.

Fig 16:



An aging population, slower growth, and rising health costs are, on the government's own figuring (Budget paper No. 5 (2002)), set to produce Budget deficits near 5% of GDP (\$87 billion in current prices) over the next forty years (see Fig. 16). The unfunded superannuation liability and other employee entitlements of the overall public sector stood at \$148bn as at June 2001. Estimates of the cost of fixing a range of environmental problems vary widely. But they are all expensive.

*The current run of Budget surpluses should be seen as a transitory phenomenon in the broad historical sweep.*

The implication is that the current run of Budget surpluses should be seen as a transitory phenomenon in the broad historical sweep. They are unlikely to persist. Budget deficits will need to be financed again at some stage.

The Intergenerational Report raises some interesting issues. After debt has been repaid, what happens to any subsequent surpluses? Paying off debt avoids the asset-accumulation question for a while. But that is all it would be – a delay.

**The loss of an important economic policy instrument**

Budgets are more than just the annual national accounting of public finances. They are also an important part of the economic policy infrastructure.

From the narrow fiscal policy perspective, Budget deficits should not be the undesirable that they seem to be in the broader debate. Indeed the framing of the government's fiscal strategy in terms of achieving balance over the course of the business cycle explicitly allows for deficits when appropriate.

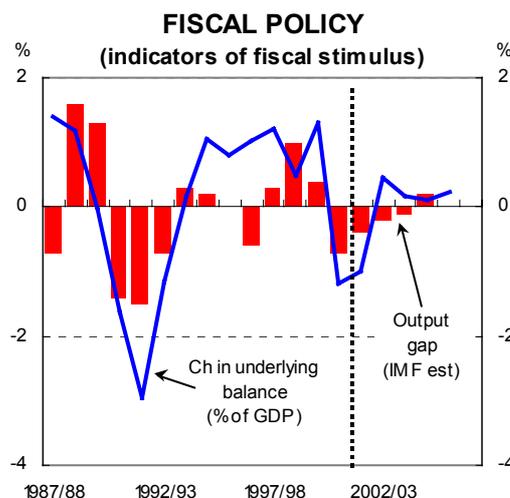


*Closing down the government bond market would limit the ability of fiscal policy to contribute to the overall thrust of policy.*

Getting the Budget back into shape and paying off some of the public debt has allowed fiscal policy to play more of a role in recent years.

The *change* in the underlying Budget balance is a fair approximation for the degree of fiscal stimulus. Using IMF estimates of the output gap as a proxy for the requirements of the underlying economy, fiscal policy has been able to move in a countercyclical fashion (see Fig. 17). The fiscal stimulus injected into the economy during 2000/01, for example, was an important factor helping to moderate the downturn in activity at that time.

Fig. 17:

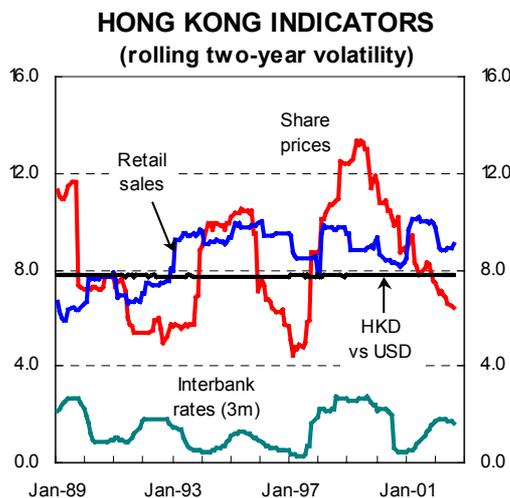


At the extreme, a permanent closure of the government bond market would limit the ability of fiscal policy to contribute to the overall thrust of policy. At the very least it would be a lop-sided contribution. Policy could deliver an outright contractionary influence when required by running larger surpluses. But it could only *move* in an expansionary direction. The degree of stimulus would be contained by the difficulties in running a deficit. Surpluses could be cut but outright deficits would be difficult to produce.

*If Budget deficits were prevented, then the required adjustments would be forced elsewhere in the economy.*

There are other difficulties associated with fighting with one hand tied behind your back:

Fig. 18:



- If the Budget was barred from slipping into deficit, then the required adjustments would be forced elsewhere in the economy. And these adjustments would no doubt involve some cost. Hong Kong is a good example. The fixed link between the HKD and the USD closed off one of the economic safety valves. The exchange rate has not always been appropriate for the needs of the Hong Kong economy. The adjustments when required were forced instead through the real economy (via recession) and other parts of the financial system (via falling share prices). The spikes in volatilities in a range of Hong Kong financial and real economy variables illustrate this point (see Fig. 18).

*A lop-sided fiscal policy may mean that other arms of economic policy have to take up the slack.*

- A lop-sided fiscal policy may mean that other arms of economic policy have to take up the slack. Hong Kong is again a good example. The USD link means that interest-rate settings have to essentially mimic those in the US. The interest rates that are required by US economic conditions are not necessarily appropriate for the Hong Kong economy. The price again is a sub-optimal economic performance.



- The global environment is characterised by very low inflation. At the extreme, there is a risk that any cyclical reduction in inflation during an economic downturn tips over into deflation. Monetary policy loses its effectiveness in this scenario – witness Japan. The other arms of economic policy, including fiscal policy, need to be able to respond quickly and decisively.

**Governments have a “nation-building” role**

*Budgets also have a “nation-building” role.*

Budgets also have a “nation-building” role. Nevertheless, one of the factors contributing to budget deficits over the last century is an excess of public investment over public savings.

Allowing public investment to run ahead of public savings contributed to a build-up in public debt for much of the past century. But it also arguably allowed the economy to grow more rapidly than would otherwise have been the case. And living standards would arguably have also risen more quickly.

*Studies suggest that public investment complements private investment and helps promote growth.*

There is no universal agreement amongst economists. But a number of studies suggest that public investment complements private investment and helps promote growth. One study, for example, found that for the US a 1% rise in the stock of public capital raised private-sector capital productivity by 0.4%. This outcome implies very high returns on public sector investment (Aschauer (1989)).

Similar estimates have been derived for Australia (Otto & Voss (1994)). The main Australian study concluded that a 1% rise in the general government capital stock increases private productivity by about 0.4%.

The general government net capital stock as at mid 2002 stood at \$267bn. A 1% rise in that stock financed via debt would boost CGS by \$2.7bn. The public debt interest cost would be in the vicinity of \$0.17bn pa. Some back-of-the-envelope calculations suggest that the resulting boost to private sector productivity would be worth \$1.3bn pa. The returns would seem to outweigh the costs by a significant amount.

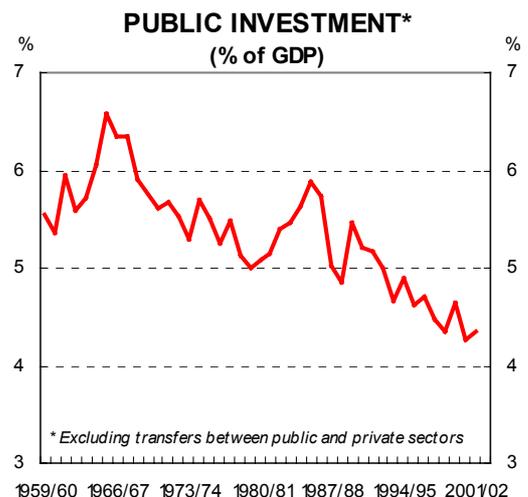
*The main Australian study concluded that a 1% rise in the general government capital stock increases private productivity by about 0.4%.*

There seems to be broader agreement that public investment in communications, transport and education has the largest knock-on effect to the rest of the economy (Andersen & Gruen (2000)).

One other implication is that the benefits of microeconomic reform in the public sector may generate an additional dividend in the broader economy.

The main message, however, is that cutting public investment spending (see Fig. 19) solely to reduce Budget deficits can be sub optimal for longer-run growth outcomes.

*Fig 19:*



Growth theory throws some interesting light on this issue from an Australian perspective. The Solow growth model, for example, defines a “golden rule” for capital accumulation that allows consumption to be maximised.

The golden rule level of capital is reached when the marginal product of capital less the depreciation rate matches the GDP growth rate. A variation of this rule allows the determination of an optimal capital: output



The "golden rule".

ratio (Browne & Hellerstein (1997)). The optimal outcome for Australia would appear to be a ratio around 4.3 (see Fig. 20. Under this model the actual ratio at present is 2.8. The implication is that the capital stock is short of optimal levels. Similar results are evident from US calculations.

These calculations throw the downward trend in public capex evident in many countries into sharp relief. It is an open issue whether this trend has been pushed too far in the name of balancing the government's books.

Many of the benefits of public investment accrue over longer time periods and should be funded accordingly.

A related issue follows as to how public investment spending should be financed. A reasonable case can be made on intergenerational equity grounds that the community should meet the costs of government spending over the period that the benefits accrue.

So public consumption (current spending) should theoretically be financed out of taxation. But many of the benefits (direct and indirect) of public investment accrue over longer time periods. Nobody expects private investment to be financed out of current incomes. And there doesn't seem to be any reason why public capital spending should be either.

If public investment is to be financed via borrowing, then the government bond market is almost certainly the cheapest and easiest way to do it.

"Crowding out/crowding in" is really an argument about extremes.

Another related issue follows from concerns that rising government debt puts upward pressure on real interest rates and so "crowds out" private investment.

So reductions in government debt could stimulate an increase in private investment. And there is certainly some evidence in recent trends to support this contention. The reduction in US net public sector borrowing during the 1990s, for example, was associated with a decline in long-term interest rates and a shift towards sizeable net borrowing by the private sector (see Fig. 21). This borrowing fuelled a significant rise in US business investment spending.

Fig 20:

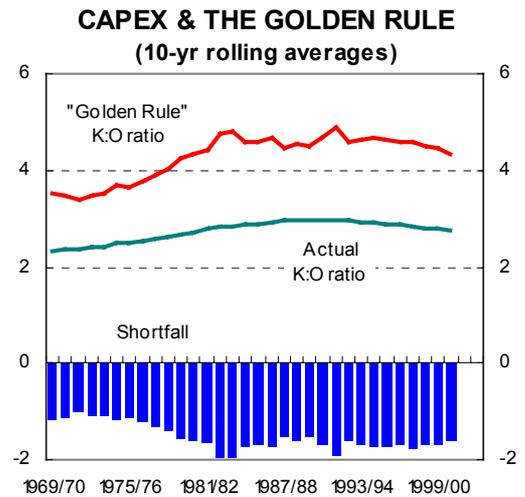
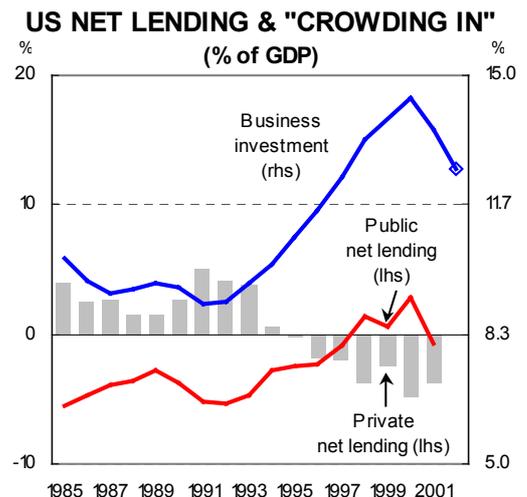


Fig. 21:



But "crowding out/crowding in" is really an argument about extremes. Very high levels of public debt no doubt lead to sub-optimal levels of private investment. By extension, very low levels of public debt may lead to over-investment by the private sector that is just as damaging.

The rise in US business investment during the 1990s, for example, contained many of the elements of a speculative bubble (see Fig. 21). The deflation of that bubble has imposed significant costs on the US economy.

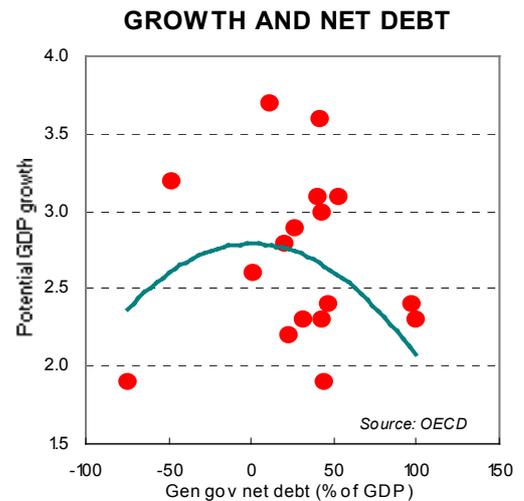


Very low levels of public debt may lead to over-investment by the private sector and a consequent painful correction.

A simple scatter diagram of potential growth rates versus general government net debt (see Fig. 22) also provides some tentative evidence that there is an optimal level of debt that maximises growth.

Shrinking bond supplies beyond a certain minimum point would see bond yields increasingly diverge from the underlying fundamentals. To the extent that bond yields influence hurdle rates of return, the whole capex decision-making process could be distorted.

Fig. 22:

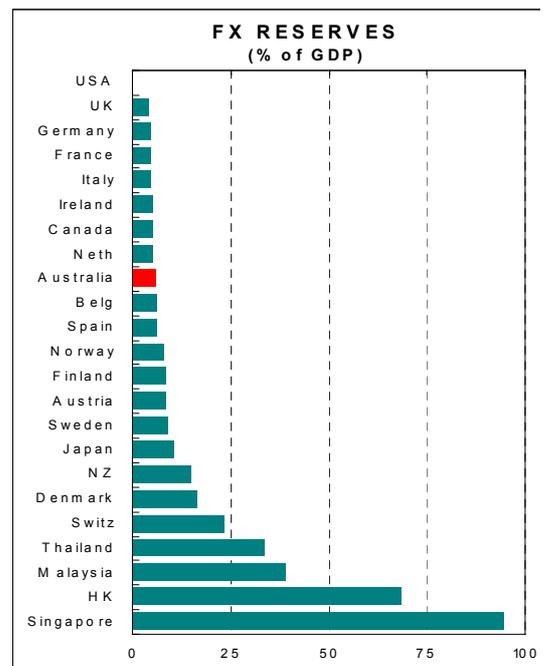


The Government already runs a significant asset portfolio: the RBA-managed foreign reserve portfolio.

Even if the Government decides not to make any changes to current fiscal arrangements, we believe that many of the concerns raised in the

Discussion Paper are overstated. The government already holds a significant asset portfolio and has taken on aspects of the fund-manager role. The RBA, for example, manages foreign exchange reserves (largely invested in foreign government securities) worth USD20bn. And it has managed them quite successfully. Those RBA holdings, as a share of GDP, are relatively small on a global scale.

Fig. 23:



Concerns about insulating investment decisions from direct government control are in our view also overstated. If the Government set up a statutory fund with a transparent reporting process, this would preserve autonomy and independence. A number of statutory authorities, such as APRA and the RBA, operate successfully at arms length from the government.

Other regions are able to run an asset portfolio without governance issues.

As set out in the Discussion Paper, other regions are able to overcome governance issues associated with running an asset fund. Queensland, for example, has run a net asset position for some time. Countries such as Norway, Hong Kong, Singapore and Ireland also run asset funds with minimal governance concerns.

Questions as to the composition of the asset portfolio come down to the investment aim of the investor. What risk/return characteristics an investor would look to from an asset portfolio depends upon the risk appetite of the investor. The Social Security and Trust funds run by the US Treasury, for example, are only mandated to purchase debt securities with US Government guarantees.

Most of the benefit to be gained from reducing Government debt has already been made. The differential in the AUS/US spread now largely reflects cyclical differences in the relative performance of the US and



Australian economies, although there is a premium for the greater liquidity of the US bond market. Rating agencies have also indicated that a reduction in debt will not lead to any improvement in Australia's credit rating. S&P, for example, noted that the current level of government debt is not an issue for the level of credit rating.



## Glossary of terms

<b>ABS</b>	Australian Bureau of Statistics
<b>AFMA</b>	Australian Financial Markets Association
<b>AOFM</b>	Australian Office of Financial Management
<b>APRA</b>	Australian Prudential Regulation Authority
<b>AUD</b>	Australian dollar
<b>Axiss</b>	Axiss Australia
<b>bpts</b>	basis points
<b>CBA</b>	Commonwealth Bank of Australia
<b>CBASpectrum</b>	A proprietary credit model developed by the Commonwealth Bank of Australia
<b>CGS</b>	Commonwealth government securities
<b>Discussion Paper</b>	Commonwealth Treasury Discussion Paper on the <i>Review of the Commonwealth Government Securities Market</i>
<b>EFP</b>	Exchange for physical
<b>EUR</b>	Euro
<b>FUM</b>	funds under management
<b>HKD</b>	Hong Kong dollar
<b>IMF</b>	International Monetary Fund
<b>LTCM</b>	Long Term Capital Management
<b>QTC</b>	Queensland Treasury Corporation
<b>RBA</b>	Reserve Bank of Australia
<b>Repo's</b>	Repurchase Agreements
<b>RTGS</b>	Real Time Gross Settlement System
<b>S&amp;P</b>	Standard and Poors
<b>Semi's</b>	Semi-government bonds
<b>SFE</b>	Sydney Futures Exchange
<b>Supra's</b>	Supranational bonds
<b>Treasuries</b>	US government Treasury bonds
<b>USD</b>	US dollar



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