

REVIEW OF COMMONWEALTH GOVERNMENT SECURITIES MARKET

*ACCI SUBMISSION
TO THE
TREASURY*

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Background

The Australian Chamber of Commerce and Industry (ACCI) is the peak council of Australian business associations. ACCI's members are employer organisations in all States and Territories and all major sectors of Australian industry.

Through our membership, ACCI represents over 350,000 businesses nation-wide, including the top 100 companies, over 55,000 enterprises employing between 20-100 people, and over 280,000 enterprises employing less than 20 people. This makes ACCI the largest and most representative business organisation in Australia.

Membership of ACCI comprises State and Territory Chambers of Commerce and national employer and industry associations. Each ACCI member is a representative body for small employers or sole traders, as well as medium and large businesses.

Review of Commonwealth Government Securities Market Introduction

The re-payment of Commonwealth Government debt in recent years has presented the business community and the Government with an opportunity to debate the future of the Commonwealth Government Securities (CGS) market. ACCI considers this to be an important issue and welcomes the opportunity to add its voice.

The Federal Government's success in paying down Australia's debt obligations has been one of its fundamental policies and has been a major contributor to the high economic growth experienced in recent times. We completely agree with Treasury's observations:

“Reduced net debt has benefited Australia, contributing to lower interest rates and reducing pressure on the current account deficit.”¹

The business community fully supports the efforts taken by the Government in terms of its commitment to maintaining a budget surplus and its policy of continuing down the path of retiring debt.

Given the merits of such a policy it is important that any negative consequences for the business sector arising from the reduction of

¹ Discussion Paper, “*Review of the Commonwealth Government Securities Market*”, Introduction Chapter 1, p 12.

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Government debt be looked at in detail to establish whether or not the potential costs outweigh the established benefits.

Potential problems of eliminating CGS in financial markets must, however, not under any circumstance cause the Government to review its present policy of reducing debt and maintaining a surplus. Importantly, proceeds from asset sales should be overwhelmingly used to retire debt.

It is the view of ACCI that the risks of building a portfolio of the size required to maintain the CGS market are far too large relative to the benefits that might accrue. ACCI does not believe the government should be allowed to maintain such a portfolio that would be managed or overseen by the public service. If the CGS market should disappear as a result of the maintenance of a surplus and is hastened by the privatisation of public assets, there should be no artificial means taken to maintain the CGS market.

Many proponents of reducing government debt believe that over time the market will develop its own substitutes for the services that the CGS market currently provides and they point to this trend occurring in other markets. The amount of time taken to produce a substitute instrument to an important extent depends on how well the private debt market has adjusted to the already dwindling stock of Government bonds.

The current debate on sovereign debt is also occurring in other jurisdictions around the world as their respective governments maintain or forecast surpluses. While these debates are taking place, it may be correct to conclude that not one other country has the degree of urgency that Australia is currently facing, which is in part due to the Government continually producing surpluses resulting in a low amount of debt to GDP ratio relative to other countries and the possible further sale of government assets, namely Telstra.

Given that many countries face the elimination of their bonds markets, recent literature has focussed on the ability of markets to adapt to a future without government securities; changes that are currently taking place due to the falling supply of many government securities; and the effects of losing the government securities market altogether.

This research has led commentators to make various assumptions about the validity of substitutes and the possible implications if those substitutes are not as effective as government securities. Other commentators are looking at what is occurring in the markets as the transformation to a market devoid of government securities eventuates.

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Some of the functions performed by the CGS market and stated in the Treasury discussion paper include pricing and referencing other financial products, managing financial risk, providing a long-term investment vehicle, implementing monetary policy and providing a safe haven in times of financial instability. While there is little doubt that the CGS market performs or is used for these functions, the benefits that accrue out of government securities are not exclusive to them.

One of the options to maintain a CGS market would be for the government to sell an amount of bonds and buy a large portfolio with the proceeds to invest in the Australian and international market. In this example the funds objective would be to serve the currently unfunded superannuation liability. This option is not supported by the ACCI, as it believes the Government should not be holding large portfolios for investment purposes.

Various States Governments have in recent times taken this approach and one of the problems with the Federal Government taking the same approach is the large amount of funds that it would need to invest in Australian capital market. This could, with such a large player entering the market, influence the market through changes to relative prices. ACCI does not believe that the raising of debt should be used to maintain a government portfolio and that instead removing debt should be the overriding objective of the Government.

ACCI recommends that the government buy back its outstanding Government bonds withdrawing from the market at the time of their maturity in order to avoid paying higher premiums and also to give the market time to adjust to the removal of CGS.

Reducing Government Debt

The steady reduction in government debt in Australia has produced one of the lowest debt to GDP ratios amongst all developed economies. This policy has seen the Australia economy enjoy low inflation and high growth over a relatively long period of time. To undermine this position would not be beneficial to any sector of the Australian economy or the community at large.

The Government by wishing to eliminate the CGS market is following its strategy of relieving the public of its debt burden and interest payments. The removal of the CGS market also has broader macroeconomic implications such as reducing the average interest rate, with lower interest rates reflecting increased investment, growth and real incomes. This is assuming that the cost of capital does not rise for Australian firms due to their inability to manage interest rate risk. ACCI believes that suitable substitutes will, in time, allow business to effectively manage such risks.

Exchange rate implications from lower Australian interest rates will increase domestic exporters' competitiveness and maintain high national rates of growth. Any price implications from a low exchange rate is likely to be small given the timeframe for removing CGS from the market. In particular these effects are difficult to measure and should not act as a barrier to the already successful policy of debt reduction.

Benefits of the CGS Market

Some of the roles that are identified in the discussion paper as central to the CGS market include:

- pricing other financial products
- managing financial risk
- providing a long-term investment vehicle
- implementing monetary policy and
- acting as a safe haven during period of financial instability.

The risk-free properties of government bonds are derived from the ability of the government to increase revenue through taxation. Estimates using the yield curve and interest rate futures are generally based on medium and long-term government bonds. The safe haven property is also derived from the default-free nature of the government even during periods of instability.

Proponents of the CGS market state that these benefits differ from those that the private sector can provide and that such roles cannot

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be replicated in the private sector financial markets. They go on to conclude that since they cannot be replicated in private markets, any reduction in the quantity or removal of government bonds from the market will result in lower economic output.

Australia like many countries is continuing to pay down its debt, with debt having fallen by approximately sixty billion dollars in the past six years. As such, government must find alternatives to being reliant on raising funds through issuing securities. In various countries substitutes are being used by the financial markets to fulfil the role that diminishing government bonds once had.

Although private debt securities differ from CGS in respect to their risk status they are able to function in a similar role. This being the case the need to rely on government bonds for any of these functions is diminished. Markets are dynamic and therefore it is difficult to predict the success of various new instruments, although given the growth currently experienced in corporate debt issuance and increased trading activity of swaps it appears that the market is already finding alternatives to the lower amount of government debt.

Indeed, the issuance of Government bonds has become less frequent and the amount of liquidity and turnover in the market has fallen in recent years, the efficiency with which the bond market currently works and the benefits it produces are slowly being reduced.

Reducing the amount of Commonwealth securities (treasuries) on issue may also have the effect of causing particular treasury securities to perform disparately from other securities and other types of securities to perform disparately from other sectors. This has already occurred in respect to thirty-years bonds in the US where Treasury bonds and other thirty-year securities have diverged making them a less effective tool for hedging.² While establishing and removing positions may still be relatively low it may not balance out with the less reliable yield curve.

This situation means the government would literally have to prop up its bond market and intervene in the marketplace by increasing gross debt in line with the growth of financial markets or some other measure. If the government wishes to maintain net debt equal to zero then by definition it means the size of any government's assets portfolio would need to increase.

² Michael J Fleming, "Financial Market Implications of the Federal Debt Paydown", Introduction p 14

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Pricing and Referencing Other Financial Products

The CGS yield curve is used to price other debt securities because of its risk-free nature at all maturities. This process allows for the yield of government bonds to be taken as a base rate of interest. By adding market risk to the debt security, the market establishes a price.

Benchmarking functions of the CGS market while important should not guarantee the continuation of the market. That is to say, just because the CGS yield curve does at present have a full range of maturities with which to reference other financial products of similar maturity does not mean that the Government should maintain the CGS market.

Two alternatives in the government discussion paper are mentioned. The first alternative of using other securities as a reference involves looking at relative risks rather than starting from a base and adding a premium. The second alternative uses the interest rate swap market. What makes this an alternative is the fact that the interest rate swap market has a wide range of maturities and incorporates a degree of credit risk.

Growth in the corporate bond market in recent years has made for a deeper and more liquid private debt market although these characteristics still differ from that of the government bond market. The difference in depth and liquidity over time if current trends continue will evaporate making corporate bonds a more viable alternative. The growth in corporate bonds has mostly occurred in investment grade bonds which make a more suitable alternative to government bonds than do lower grade debt issues.

It can be seen that using other corporate debt issuance as a benchmark may be a fundamentally better strategy. Assuming that idiosyncratic risk is small, the risk of different corporate securities may be more correlated with other private sector debt than those that the central government issue.³

Liquidity in the market reduces the bid-ask spread when trading securities. Liquidity is important to the market because it allows investors to see information in the price that may otherwise be lost in less liquid instruments. In terms of the corporate bond market the amount of turnover in recent years has replicated the growth in debt outstanding. However while both the amount of debt outstanding and turnover has improved market liquidity, it has not reached that

³ Paul Mylonnas et al, "New issues in public debt management: Government surpluses in several OECD countries, the common currency in Europe and rapidly rising debt in Japan", Policy options in an environment of declining net debt, p 8.

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of the government bond sector and therefore will need time to develop into a fully functioning alternative.

Liquidity in the corporate market is also complicated by the fact that corporations issue many different benchmark lines, which tends to both reduce market liquidity and make for a less efficient pricing instrument.

At present corporate bond market maturities extend to only relatively short terms on the yield curve. This makes the corporate bond market unsatisfactory for pricing issues in the longer term.

The corporate bond repurchase (repo) market is also smaller than the Commonwealth bond market but similar to the amount of debt on issue, it has grown while the Commonwealth bond repo market has shrunk. If the secondary market for corporate bonds continues to grow then price discovery will become more reliable and less costly.

Interest rate swaps have also experienced an increase in turnover during recent years and now rival that of the CGS market. This means that the present problems with liquidity experienced in the corporate bond market does not apply here. Also the duration of maturities that make up the interest rate swap curve are comparable to those of the CGS market. Again this is a problem that has not been overcome by the corporate bond market at present.

The ability to enter into and create swaps along with the interchangeable nature of the underlying cash flows prevents swaps with similar or identical cash flows from trading at widely different prices. These features produces a smooth swap curve.⁴

If a dealer wishes to unwind the transaction the dealer must either return to the counterparty or find a third party willing to undertake the contract on terms acceptable to the original counterparty. While swaps are agreements between two parties to interchange a stream of income which is highly specific, the ability to trade these agreements are at present insufficient. To overcome this problem would require infrastructure improvement. This could be provided through the development of a central clearinghouse with such an investment in infrastructure helping to overcome the heterogeneous nature of swaps and improve the commoditisation or differentiation of the swap market.

⁴ Michael J Fleming, "*Financial Market Implications of the Federal Debt Paydown*", Introduction p 20

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The development of this type of infrastructure may also help to reduce counterparty risk through the active monitoring of both parties in the transaction. If one should not meet its obligation, another party could be found to replace the defaulting party.

To be an effective reference benchmark requires that yields change with those of other securities. Swaps contain credit risk and as such interest rate swaps can provide a better tool for hedging and benchmarking than that of treasuries⁵ while the counterparty risk is minimal. The fact that interest rate swaps contain a credit risk makes them a more effective instrument for hedging, as is the case for benchmarking other financial assets using corporate bonds.

One of the problems with government bonds is the need for the government to issue more debt in order to maintain supply and liquidity. Swaps rates are unaffected by supply side considerations and due to the inclusion of minimal credit risk will tend to move with other fixed-income securities.

Other countries with developed capital markets facing the same problem of falling government debt have had to make changes in their pricing behaviour. One measure used in other market is to quote yields using numerous reference points on all maturities of fixed-income instruments. This could include basing market prices on those of existing debt securities that are similar in respect to their credit risk characteristics, the structure of the security such as the coupon rate and maturity, the industry of the issuer and the liquidity of the issues.

“A variety of non-treasury benchmarks – including swaps, agency securities, and some large corporate issues – could be and are used for referencing purposes. Thus, the science and art of pricing and quotation of fixed-income instruments in US dollars are unlikely to be significantly affected by the shrinking supply of treasury securities.”⁶

One must be careful not to translate the US experience to Australia in an overly detailed manner. Australia does, however, have a well-developed financial market and there is no reason to believe that, given time, our financial sector could not pursue the same methodology.

⁵ Michael J Fleming, “Financial Market Implications of the Federal Debt Paydown”, Introduction p 2.

⁶ IMF “*International Capital Markets: Developments, Prospects and Key Issues*” The Changing Structure of the Major Government securities markets: Implications for Private Financial Markets and Key Policy Issues, Chapter IV p 95.

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In Europe a uniform euro-denominated yield curve does not exist so a private swap curve that is liquid at all maturities is the main instrument used as a benchmark for pricing and quoting yields.

Managing financial risk

Alternatives to the CGS market of managing interest rate risk are available that do not require the Government to continually finance its operation. These alternatives include interest rate swaps and at present, but to a lesser degree, corporate bonds. Presently, the corporate bond market may need to develop a more substantial derivatives market in terms of liquidity and reduce the affect of large transactions on prices.

Hedging interest rate risk is done through the derivatives market, which is underpinned by the CGS market. If these markets operate inefficiently and businesses are unable to manage their financial risk the cost of capital in Australia may rise.

For the CGS market to act as an effective interest rate hedging instrument the market must be liquid or else it ceases to be as effective or reliable. This puts the Government in a position where it must continue to push Government bonds onto the market and maintain a reasonable degree of liquidity in order to capture the benefits derived from a risk-free asset.

What is necessary for an efficient hedging tool is an instrument that is highly correlated with other debt instruments. During periods of normal fluctuations this is the case for the swap rate and in some countries, namely the US, corporate and agency bonds also have a high degree of correlation with other instruments.

Swaps, given their degree of credit risk and high degree of liquidity are the most appealing substitute to the CGS market in the hedging role. The fact that Government bonds are risk-free, representing a safe alternative to other instruments in times of flight to quality when demand for Government bonds increases with a constant supply, could see yields moving in opposite directions. As the swaps include a degree of credit risk the yield may more accurately reflect those other instruments.

With the addition of credit risk swaps may more accurately reflect the actual cost of borrowing for businesses. Since there is a low degree of credit risk this will generally reflect that of investment grade corporate bonds.

If the swaps market can in future become more liquid, in terms of using hedges, it will be a viable alternative to the CGS market. In

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terms of a pricing and referencing benchmark there will be no need for the government to increase gross debt and maintain a portfolio.

Option for paying off the bond market

Bond markets around the world are facing many of the very issues referred to in Treasury's paper. For the most part, substitutes for government bonds are being developed as the market is forced to adjust to the situation where Government bonds are no longer issued on a regular basis.

The resources, both time and money, required by the financial market to adjust to these substitutes and to a new environment will largely depend on how effective these substitutes currently are. ACCI believes that at present existing substitutes could not fulfil adequately the role of CGS but as is occurring in other jurisdictions, they could replace Australian government bonds in their role given adequate time.

With the corporate and swap market not yet sufficiently mature to undertake the role played by Government bonds, ACCI recommends that the Government continue to pay down its debt obligations over a period of time so as to avoid paying premiums as this approach will reduce the benefits of removing that debt and will allow time for the market to adjust.

This direction also allows for Government surpluses not to be tied up in buying inflated securities. This allows for the possibility of other initiatives being funded on a priority basis and while fiscal alternative policy is not being considered during this inquiry these surpluses do allow for a degree of flexibility.

Given that re-purchasing securities as they mature will take a significant amount of time the Government will be able to borrow from the market without incurring significant re-opening costs due to loss of infrastructure.

Government portfolio

ACCI is opposed to the Government maintaining equity and debt positions in Australian businesses. We strongly agree with the position of the Treasury paper where it states, 'a controlling (or even significant) interest in any individual stock may not be appropriate for public policy.'⁷

⁷ Discussion Paper, "Review of the Commonwealth Government Securities Market", Options available to the Commonwealth Chapter 5 p 90.

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Given the large amount of funds required to fund the Government's superannuation obligations in order to not distort the market, by changing relative prices, the Government would need to hold a stake in all companies, due to significant interest disclosure and effective control legislation limiting the size of the Government's holdings, and their debt obligations. This direction in Government policy is unacceptable to ACCI.

Conclusion

Australia's current growth rate stands out from that of other developed economies. To this end an important contribution to this success has been the steady decline in public debt. ACCI would like to see this policy continue into the future but does recognise some of the future obstacles facing the financial sector.

With these challenges in mind ACCI recommends Government securities be withdrawn from the market as they mature in order to reduce the transitional costs to the market of losing a risk-free asset and to reduce the premiums associated with immediate withdrawal.