ASX Submission On The Commonwealth Government Securities Market

November 2002

Contents

Executive Summary

The Commonwealth Government is right to query the automatic continuation of Commonwealth Government Securities (CGS) and we are pleased to respond to the invitation to comment on the implications for the CGS market. The CGS market has historically played a significant role in the operation of the financial system and the projected winding down of the CGS market will impact on the broader structure of financial and capital markets. It is therefore appropriate to consider the implications of the continuation or otherwise of Commonwealth Government bonds, possible alternatives, and whether specific policy action is needed.

ASX is making a submission because of its interest in the overall health of the national financial services industry and in recognition of the interdependence of financial markets. ASX does not, at present, provide a market for Commonwealth Government bonds.

The Australian financial system is sophisticated, dynamic and robust and represents one of the strengths of the Australian economy.

The financial sector directly employs around 350,000 people and accounts for around 7% of the total value of production. The efficient operation of Australia's financial markets generates significant benefits for the broader economy. These benefits include efficiency in the allocation of capital, a lower cost of capital and greater flexibility in the management of financial risk. The efficient operation of Australia's capital markets brings benefits to all businesses and households.

Australian financial market activity has grown strongly in recent years and it is important that these gains be retained and, if possible, further enhanced. In financial markets, improved liquidity enhances market efficiency and, in a virtuous cycle, leads to further growth in liquidity. The reverse also applies - declines in market liquidity can set in motion a negative cycle of reduced participation and market liquidity.

In the case of the CGS market, the stock of outstanding Commonwealth Government fixed coupon bonds has already declined to around $50bn with at least 30% of that held by offshore investors. Even at its current level the market is close to a minimum critical mass. If the stock of outstanding Commonwealth Government bonds were allowed to continue to decline it is likely that CGS market activity would be significantly impaired, prompting some market participants to withdraw from the market. There is a risk that the loss of liquidity in the CGS market would have an impact on activity in other financial markets.

European and US markets have seen movement towards alternative financial benchmarks, for example, based on swap contracts. This development is, importantly, still in its infancy in Australia. SFE has only recently launched a swap futures contract. While there may be other economic benefits from the decline in Commonwealth Government debt, it is important that there be sufficient time to permit a smooth transition in financial markets.

The future of the CGS market should be considered by the Commonwealth Government in the context of several broader public and fiscal policy issues. In particular:

- The Commonwealth Government's success in having reduced the level of Commonwealth Government debt to very low levels now provides the opportunity to reconsider questions as to the role of the Commonwealth Government going forward. At the same time, there will be strong flows into superannuation. Opportunities may present themselves for the Commonwealth Government, in partnership with the private sector, to undertake investment in areas such as education, transportation, power and water infrastructure that will further the economic well being of Australia. Increased infrastructure investment could have implications for the future financing needs of the Commonwealth Government and, therefore, the future of the CGS market.

- Changing economic conditions and longer run structural pressures impose a high degree of uncertainty on economic policy and on the budget balance that needs to be taken into account. A slowing of Australian economic growth, possibly caused by adverse international developments, could push the budget back into deficit. As well, the Intergenerational Report identified a significant challenge for future generations arising from the retirement and health care needs of an aging population.

- It is noted that there is still a considerable unfunded liability attached to the Commonwealth Government's superannuation obligations.

The Commonwealth Government's decision on the CGS market will have consequences for activity in other financial markets because of the integrated nature of financial markets:

- To develop successfully, financial markets require a critical mass of products, physical infrastructure, services, and skills to be in place. If the CGS market continues to decline, some CGS-related market infrastructure will also be wound down or even drift overseas. The loss of infrastructure may check the development of other financial product markets.

- The CGS market has provided an accessible and visibly priced investment option for many foreign investors, particularly fund managers. It is also a component of several international fixed interest indices that guide fund manager investments. If the CGS market winds down it will reduce the visibility of Australia as an investment destination with some flow-on impacts on activity in other financial and equity markets. However, Australia will still retain many other strong attractions for foreign investors.

- The volume of Commonwealth Government debt on issue is so low at present that it does not pose a threat of crowding out private issuers.

The CGS market has fulfilled several functions that assist in the efficient and stable functioning of the financial system. In particular, the structure of the CGS and related derivatives markets has facilitated efficient price discovery. Commonwealth Government bond yields have served as an efficient minimal credit risk price benchmark or reference point for the pricing of other financial instruments. Financial market participants, including domestic and international investors, and the broader economy have benefited from a related reduction in search and uncertainty costs. A winding down of the CGS market may lead to an uncertainty premium being priced into other instruments, at least until an alternative benchmark develops, adding to the cost of capital.

The CGS market has also provided a safe-haven investment, although the CGS market itself is not completely immune to periods of heightened uncertainty. Absent the Commonwealth Government bond market:

- There would be greater reliance placed on the banking sector, a move which may create a less diversified and robust financial system.
- During a domestic financial crisis, there may be an increase in the flow of funds offshore at a time when domestic financial and currency markets are already under stress.

Commonwealth Government bonds also represent an essentially credit risk free asset class that has been of value to superannuation funds and other investors. The assets of superannuation funds will grow very strongly in coming years, in large part due to sensible Government policy mandating greater self-provision for retirement. Superannuation fund holdings of Commonwealth Government bonds are small, but they still play an important role in enabling superannuation funds to diversify the credit risk of their portfolios. If the CGS market declined further, then large superannuation funds may accelerate their shift into overseas government bonds. The desire for smaller superannuation funds and individual retirees to have access to long term minimal credit risk assets should also be recognised.

If the CGS market were to decline further there is an expectation that other markets will develop to fill the functions currently fulfilled by the CGS market. In many instances overseas, private financial instruments are already replacing government bonds as a benchmark for pricing. For example, the Eurodollar (USD Libor and related swaps) curve is increasingly used as a benchmark for USD rates. Already in Australia bank bills provide a benchmark for pricing shorter term rates. However, there are still some uncertainties as to the time it will take for domestic substitute markets to evolve to fully fulfil the functions of the CGS market and whether they could fulfil these functions as efficiently.

Australia's financial system is adaptable and will continue to make an important contribution to Australia's economic well being over time, even if the CGS market were to contract further. However, there would be transition costs and these costs may be significant. Overall, ASX believes that the Commonwealth Government should maintain a viable CGS market until such time that it is clearer that substitute products and markets have developed sufficiently to perform the important functions that have been fulfilled by Commonwealth Government bonds.

If the Commonwealth Government chooses to retain the CGS market, and there is no change in the stance of fiscal policy, then ASX believes that it would be prudent to use the surplus funds raised by the issue of Commonwealth Government bonds to fund the Commonwealth Government's unfunded superannuation liabilities. This funding could be either through a hypothecated asset portfolio or through the transfer of funds into a superannuation fund. If the Commonwealth Government favoured the option of the hypothecated asset fund, it would be best if the management of the fund was conducted at arms length from the policy-making arms of the Commonwealth Government or farmed out to private managers.

The Financial System

Summary

The Australian financial system is sophisticated, dynamic and robust and represents one of the strengths of the Australian economy.

The financial sector directly employs around 350,000 people and accounts for around 7% of the total value of production. The efficient operation of Australia's financial markets generates significant benefits for the broader economy. These benefits include efficiency in the allocation of capital, a lower cost of capital and greater flexibility in the management of financial risk. The efficient operation of Australia's capital markets brings benefits to all businesses and households.

Australian financial market activity has grown strongly in recent years and it is important that these gains be retained and, if possible, further enhanced. In financial markets, improved liquidity enhances market efficiency and, in a virtuous cycle, leads to further growth in liquidity. The reverse also applies - declines in market liquidity can set in motion a negative cycle of reduced participation and market liquidity.

In the case of the CGS market, the stock of outstanding Commonwealth Government fixed coupon bonds has already declined to around $50bn with at least 30% of that held by offshore investors. Even at its current level the market is close to a minimum critical mass. If the stock of outstanding Commonwealth Government bonds were allowed to continue to decline it is likely that CGS market activity would be significantly impaired, prompting some market participants to withdraw from the market. There is a risk that the loss of liquidity in the CGS market would have an impact on activity in other financial markets.

Financial System

Australia's financial system is an important and vibrant part of the Australian economy. The financial sector directly employs around 350,000 people and directly accounts for around 7% of the total value of production.

A range of indicators give testimony to the strength and dynamic nature of the Australian financial system and markets:

- The total assets of financial institutions stood at $2.1tn as at June 2002, roughly three times as large as annual GDP. The total assets of financial institutions has grown at an average rate of over 10%pa over the past five years.[1]
- The assets of managed funds totalled $645bn as at June 2002, having grown from $395bn as at June 1997.[2]

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[1] Reserve Bank of Australia, Bulletin, November 2002, Table B1

[2] Reserve Bank of Australia, Bulletin, November 2002, Table B15

- The volume of domestic debt securities on issue in Australia is the third largest in the Asian region (not including Japan).[3]
- Medium and long term debt securities on issue in Australia amounted to over $230bn as at June 2002. Within this total, the volume of asset-backed securities on issue amounted to over $42bn as at June 2002 up from less than $14bn as at June 1997.[4]

The Australian Stock Exchange is large and liquid, giving issuers access to capital at an efficient market determined rate[5]:

- There were over 1,400 entities listed on ASX as at June 2002.
- The market capitalisation of domestic listed entities was equal to around $700bn as at June 2002 and the market capitalisation of all listed entities amounted to over $1tn.
- The turnover of equities in 2001/02 totalled around $519bn.
- At the end of June 2002 Australia was ranked 9th on the Morgan Stanley Capital International (MSCI) Global Index.
- ASX equity derivative market activity has also continued to rise strongly, with around 14.8mn option contracts traded in 2001/02.

There is also a high level of foreign participation in Australia's financial markets. As at June 2002 foreign investors held over 35% of Commonwealth Government bonds and over 35% of listed equities.

The financial system plays a significant role in facilitating activity in the broader Australian economy. Key functions performed by the financial system include:

- The channelling of funds from savers to borrowers, thereby facilitating investment.
- Assisting business and individuals in managing financial risks.
- Enabling investors to achieve their desired balance between risk and return.
- Facilitating transactions in goods and services.

Financial system efficiency is enhanced by high levels of liquidity and transparency in financial markets. High levels of liquidity and transparency are factors that help to

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[3] Bank For International Settlements, BIS Quarterly Review, September 2002 Table 16A

[4] Reserve Bank of Australia, Bulletin, November 2002, Table D4

[5] Further information is available from the ASX website (www.asx.com.au) or the ASX Annual Report

ensure that financial market instruments are efficiently priced, in the process providing a benchmark price for other financial transactions. In this way, liquid and transparent financial markets provide a significant benefit to the broader economy.

In Australia, the CGS market has played an important role as a pricing benchmark within the financial marketplace, particularly for medium and longer term rates. As a result, the operation of the CGS market has provided benefits through out the broader Australian economy through a lower cost of capital and greater certainty in pricing.

In recent years, the stock of outstanding Commonwealth Government bonds has declined significantly. Current projections for the headline budget surplus imply that the Commonwealth Government's net debt could be eliminated by 2005/06. If the stock of outstanding Commonwealth Government bonds was allowed to continue to decline it is likely that CGS market activity would be significantly impaired, prompting some market participants to effectively withdraw from the market. The loss of liquidity in the CGS market would be detrimental to pricing efficiency in the CGS market and related derivatives markets and would have an impact on activity in other financial markets.

Australia's financial markets are strong and vibrant. If the stock of CGS was allowed to continue to decline, Australia's financial markets would adjust and would continue to make a positive contribution to the broader Australian economy. But there would be transition costs which may be significant. Some CGS related infrastructure would be wound down or drift overseas, checking the development of other financial product markets. The loss of Commonwealth Government bonds as a minimal credit risk price benchmark would create an element of uncertainty in financial market pricing, adding to the cost of capital, until a suitable alternative developed.

Public Policy Considerations

Summary

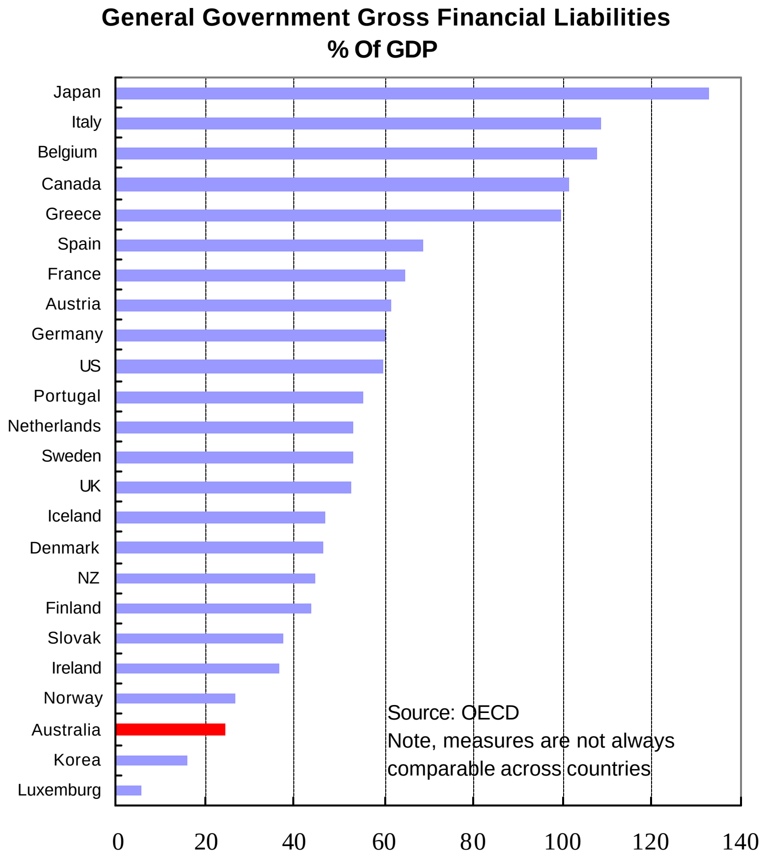
The future of the CGS market should be considered by the Commonwealth Government in the context of several broader public and fiscal policy issues. In particular:

- The Commonwealth Government's success in having reduced the level of Commonwealth Government debt to very low levels now provides the opportunity to reconsider questions as to the role of the Commonwealth Government going forward. At the same time, there will be strong flows into superannuation funds. Opportunities may present themselves for the Commonwealth Government, in partnership with the private sector, to undertake investment in areas such as education, transportation, power and water infrastructure that will further the economic well being of Australia. Increased infrastructure investment could have implications for the future financing needs of the Commonwealth Government and, therefore, the future of the CGS market.
- Changing economic conditions and longer run structural pressures impose a high degree of uncertainty on economic policy and on the budget balance that needs to be taken into account. A slowing of Australian economic growth, possibly caused by adverse international developments, could push the budget back into deficit. As well, the Intergenerational Report identified a significant challenge for future generations arising from the retirement and health care needs of an aging population.
- It is noted that there is still a considerable unfunded liability attached to the Commonwealth Government's superannuation obligations.

Public Policy Considerations

The Commonwealth Government's fiscal strategy has contributed to the strong performance of the Australian economy over recent years. A key part of this fiscal strategy has been the reduction in the level of Commonwealth Government debt to very low levels. This strategy has brought significant benefits to Australia. It has eased pressure on interest rates, thereby helping to deliver a more favourable operating environment for households and business. As well, by maintaining relatively low levels of debt, the Government has gained greater flexibility in the implementation of fiscal policy.

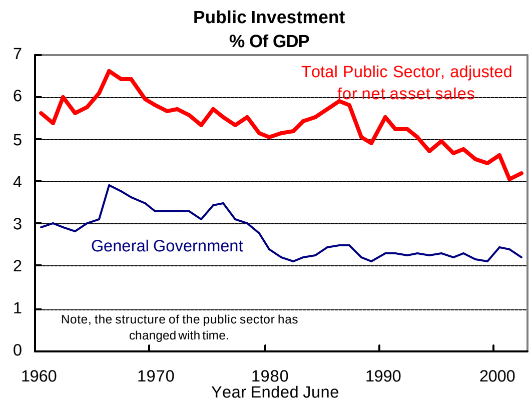
It is important that these gains be maintained if economic growth is to remain robust in the future. However, it is also true that most of the benefits from the reduction in the level of outstanding Commonwealth Government debt have already been realised. The economic benefits from a further reduction in Commonwealth Government debt are likely to be smaller and need to be balanced against what transitional negative effects on financial market activity and pricing might be associated with a further contraction of the CGS market at this point in time.

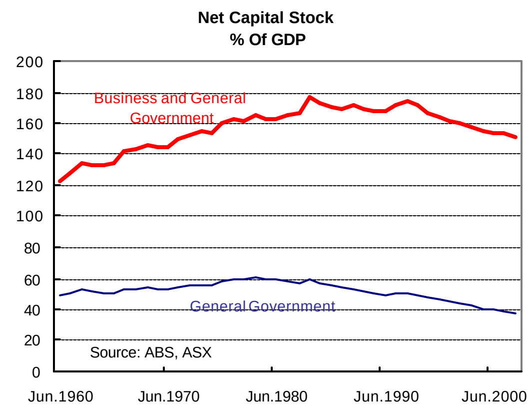


The Commonwealth Government's success in having reduced the level of Commonwealth Government debt now provides the opportunity to reconsider the role of Government in facilitating economic growth through the provision of social and economic infrastructure. At the same time there will be continuing strong private flows into superannuation funds which will be looking for domestic investments. Opportunities may present for the Commonwealth Government, in partnership with the private sector, to undertake investment in areas such as education, transportation, power and water infrastructure that will further the economic well being of Australia.

It is important that Australia has a level of social and economic infrastructure that is appropriate to Australia's longer term economic needs and our community's aspirations. Adequate infrastructure is vital in ensuring that Australia is able to maximise its growth and productivity performance. The debate over the determinants of long term economic growth continues, but it is clear is that small differences in rates of productivity growth make an enormous difference to future economic prosperity.

The relationship between public infrastructure spending and economic growth has been the subject of debate. [6] However, several studies show that there is a positive relationship between public infrastructure spending and the performance of the broad economy. Public investment was one factor that underpinned Australia's post-WWII economic growth. While the nature of public sector investment is changing with time, the public sector still has a role to play in the future in conjunction with the private sector.





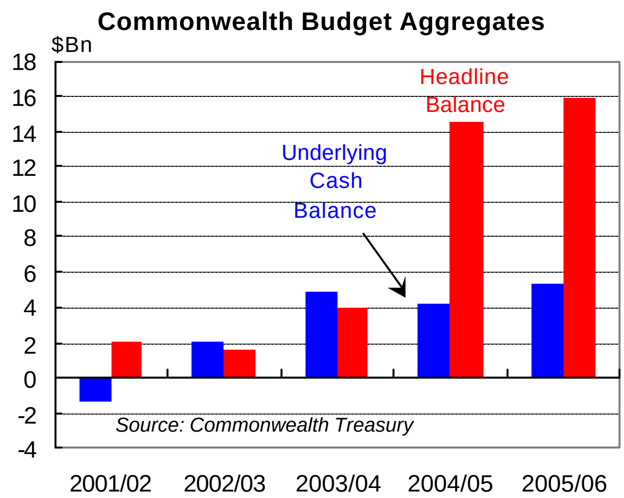
Increased infrastructure investment could have implications for the future financing needs of the Commonwealth Government and, therefore, the future of the CGS market.

Fiscal Policy

The Commonwealth Government also needs to take account of several other fiscal policy issues when considering the future of the CGS market. In particular, future budget outcomes remain subject to a high degree of uncertainty. As well, there may be times when economic circumstances make a stimulatory fiscal policy appropriate.

The Commonwealth Treasury has projected that the Commonwealth Government will run headline cash budget surpluses through to at least 2005/06. These headline budget surpluses reflect underlying cash surpluses coupled with the proceeds of significant asset sales over the latter part of the period. It is the accumulation of funds implied by the headline budget surpluses that will potentially enable the Commonwealth Government to eliminate net debt by 2005/06. Of the Commonwealth Government bonds currently on issue, the last will mature in 2015.

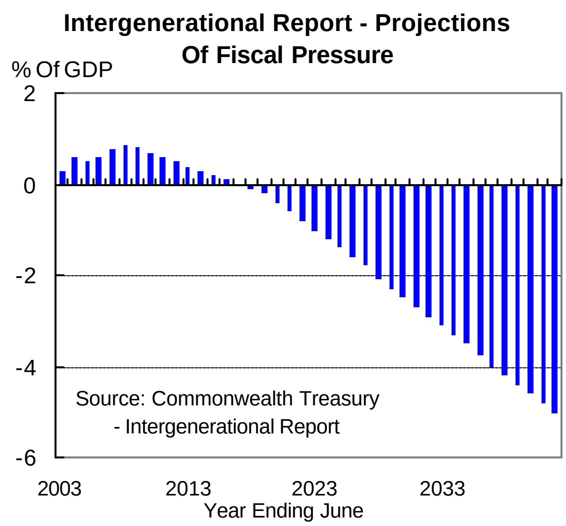
[6] For example see: Otto G and Voss G M, 'Public Capital Expenditure And Private Sector Productivity', Economic Record 70, 1994 pp121 – 132. Issue briefly discussed in Dowrick S, 'The Determinants Of Long-Run Growth', in Reserve Bank Of Australia, Productivity And Growth Conference, 1995



The Commonwealth Government has made great progress in improving Australia's budget position. However, the budget balance is very sensitive to economic conditions. The underlying budget surpluses for the period to 2005/06 are projected to remain under 1% of GDP. An adverse economic shock or a deliberate fiscal policy stimulus strategy could push the headline budget balance back into deficit.

Historical experience also suggests that there is the potential for a deterioration in Australia's fiscal position, particularly if an adverse shock caused Australian economic conditions to weaken. From 1981/82 through to 2001/02 the Commonwealth budget was in deficit in 12 years. At times, changed economic circumstances impacted significantly on the budget bottom line. The Commonwealth budget recorded a surplus equal to 1.8% of GDP in 1988/89. The recession of the early-1990s meant that the budget was in significant deficit by 1991/92. The budget deficit equalled 4.0% of GDP in 1992/93. Looking forward, there is a risk that adverse international economic conditions could dampen Australian economic growth.

The Intergenerational Report also indicated that there will be significant pressure on the budget balance in the longer run caused by increased expenditure on health and aged care as the population ages. Given this pressure, the Budget could return to a structural deficit position over time, most likely requiring funding through net Commonwealth Government bond issues.



It is also noted that the Commonwealth Government has significant unfunded superannuation liabilities for its employees. As at June 2002, these unfunded superannuation liabilities totalled over $80bn.[7]

Changing external conditions and longer run structural pressures impose a high degree of uncertainty on economic policy and on the budget balance. The future of the CGS market should be considered in this context.

[7] Australian Bureau Of Statistics, Financial Accounts, Cat 5232.0, June Quarter 2002

Financial System Considerations

Summary

The Commonwealth Government's decision on the CGS market will have consequences for activity in other financial markets because of the integrated nature of financial markets:

- To develop successfully, financial markets require a critical mass of products, physical infrastructure, services, and skills to be in place. If the CGS market continues to decline, some CGS-related market infrastructure will also be wound down or even drift overseas. The loss of infrastructure may check the development of other financial product markets.
- The CGS market has provided an accessible and visibly priced investment option for many foreign investors, particularly fund managers. It is also a component of several international fixed interest indices that guide fund manager investments. If the CGS market winds down it will reduce the visibility of Australia as an investment destination with some flow-on impacts on activity in other financial and equity markets. However, Australia will still retain many other strong attractions for foreign investors.
- The volume of Commonwealth Government debt on issue is so low at present that it does not pose a threat of crowding out private issuers.

Critical Mass In Financial Markets

To develop successfully, financial markets require a range of factors to be present. Once this "critical mass" of products, services, skills, and participants is in place, the financial market will attract further participation and market liquidity will continue to expand. Elements of the "critical mass" of infrastructure and participants that contribute to the growth of active financial markets include:

- Issuers of the underlying financial instrument and investors willing to hold or trade in the financial instrument.
- Intermediaries that act as "market makers". In other words, intermediaries that will maintain an active trading presence in the market, thereby facilitating price discovery.
- Arbitrage traders, whose activities can add to market liquidity and also help ensure efficient pricing across markets.
- The physical infrastructure such as trading screens and communication facilities. In addition, sophisticated software, including accounting systems, is used to manage financial portfolios, with a related requirement for skilled technical support staff.
- Skilled staff, spanning from traders at the market coal-face through to the back-office staff that carry out verification and settlement procedures.

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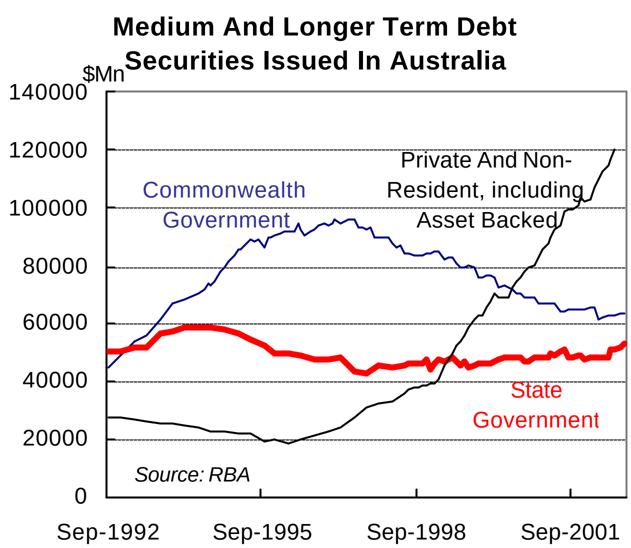
- Research capacity, so that investors and issuers can act in an informed capacity and with greater confidence.
- Related derivative products and markets that enable the management of risk associated with asset and liability positions in the underlying financial instrument.

As well, for financial markets to function effectively it is essential that a critical mass in liquidity be achieved, as high levels of market liquidity attract additional participants to the market contributing to further growth in market activity. However, if market liquidity is reduced for any reason, there is a risk that market participants will leave the market, implying a further contraction in market activity.

Australian financial market activity is supported by a strong "critical mass" of products, skills, infrastructure and market liquidity that are mutually supportive. The volume of medium and long-term securities issued in Australia by the private sector and non-residents has increased very strongly in recent years, while the volume of Commonwealth Government bonds on issue has declined. However, the strong growth in medium and long-term securities issued by the private sector has been facilitated by the "critical mass" of sophisticated infrastructure and market liquidity built up around the Commonwealth Government bond market. For example, the derivative products used to hedge Commonwealth bond portfolios are highly liquid and are also used to hedge holdings of other debt instruments. Intermediaries that have developed a core business in trading Commonwealth Government bonds may have extended those operations to other financial instruments including corporate bonds.



There is an argument that a further winding down of the CGS market will provide more room for the growth of medium and long term private debt markets. However, the volume of Commonwealth Government debt on issue has shrunk to a point that it is not crowding out private sector activity. Commonwealth Government fixed coupon bonds on issue as at June 2002 amounted to around $50bn, while the total stock of CGS (AUD denominated) on issue amounted to around $67bn.[8] The total stock of CGS on issue was equal to less than 10% of GDP. To put this in context, the value of outstanding fixed for floating interest rate swaps as at May 2002 totalled $1.7tn.[9] Australia has the third lowest level of gross general government liabilities as a percent of GDP in the OECD area.

Overall, if the CGS market is allowed to contract then some of the CGS related market infrastructure will also be wound down or even drift overseas. The loss of this market infrastructure will check growth in some other financial product markets in which it was also used. There is a risk that the loss of liquidity in the CGS market and related derivative markets could also impact on activity in other financial markets. As a consequence, market pricing in domestic private debt markets may be less fine then would otherwise be the case, implying a higher cost of capital, and some further financial market activity may drift overseas.

The Commonwealth Bond Market And Overseas Investors

Australia holds a range of attractions for foreign investors, including a strong economic growth performance, skilled workforce and well developed legal and regulatory structures. The CGS market has been one part of the complex economic and financial structure that attracts foreign investor interest into Australia.

Commonwealth Government securities account for only a small portion of total foreign investment in Australia. As at March 2002, Australia's gross foreign liabilities totalled over $840bn. Foreign holdings of Commonwealth Government Securities totalled $23bn. [10] However, the CGS market may still represent an important part of the financial and economic landscape for many foreign investors, particularly foreign fund managers.

There are several features of the CGS market that make it attractive as a destination for foreign investors:

- Commonwealth Government bonds are effectively credit risk free. This is an important point, particularly for foreign investors who may have only a limited exposure to Australia or a small portion of their overall portfolio in Australian assets:
    - The low credit risk of the Commonwealth Government bond lowers the transaction cost of investment. Investment in corporate bonds or a swap transaction may require the foreign investor to undertake prior credit research, implying a higher cost to undertake the transaction.

[8] Australian Office Of Financial Management, Annual Report 2001/02 p61

[9] Australian Financial Markets Association, 2002 Australian Financial Markets Report

[10] Reserve Bank Of Australia, Bulletin, November 2002, Table E3 and Australian Bureau of Statistics, Balance of Payments And International Investment, Cat 5302.0

  - Foreign investors may also have credit limits on their exposure to individual Australian corporate issuers that limits their capacity to freely deal in the corporate debt market.

- CGS market liquidity has declined in recent years but remains high. The high liquidity of the CGS market, and associated derivative markets, is likely to be valued by foreign investors.

  - The high liquidity of the CGS market gives foreign investors the ability to quickly adjust their portfolios.

  - Foreign institutions are also likely to value the trading opportunities afforded by the liquidity of the CGS market and related derivatives markets. The situation is one of high liquidity acting to attract further liquidity.

- Foreign institutions have a degree of familiarity with government bonds. The nature of government bonds are well understood, pricing is reasonably visible, and foreign investors can broadly compare government bond yields between countries.

In addition, the existence of the CGS market is likely to have a positive influence on foreign investment in other Australian financial and equity markets for several reasons:

- Commonwealth Government securities, and the related infrastructure, can play a role in assisting foreign investors, particularly foreign fund managers, to balance the credit risk and liquidity characteristics of their Australian portfolios. In this case, the winding down of the CGS market may lead foreign investors to wind back their aggregate Australian investments, to the detriment of inflows into other financial and equity markets.

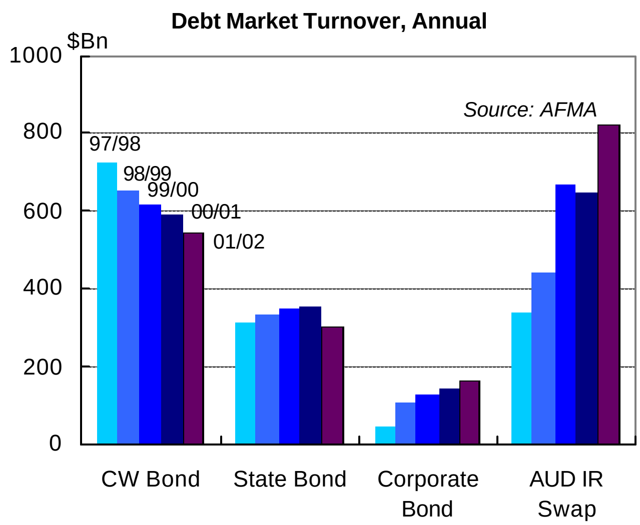
- Commonwealth Government bonds are one of a suite of financial instruments that foreign institutions invest in. If the CGS market and related derivatives markets were wound down, this would directly close one avenue of investment and trading activity. As a consequence, foreign institutions may wind back their overall research effort into Australia, impairing foreign capital inflows into other financial and equity markets.

The closure of the CGS market may also lower foreign investor interest in Australia in a relatively mechanical way, because of the role of international benchmark indices in investment decisions. If the Commonwealth Government does retire outstanding Commonwealth Government bonds it would lower Australia's weighting in international fixed interest indices. Foreign investors that allocate investments according to the benchmark fixed interest indices are likely to reduce their investment in Australia. As such, the re-weighting might imply some reduction in capital inflows into Australia and downward pressure on the AUD. However, an increase in Australia's weight in free float equity indices (for example, resulting from the full privatisation of Telstra) could provide some offset.

In conclusion, it must be said that Australia does possess many favourable attributes that will attract the interest of foreign investors even if the CGS market were to continue to contract. However, further contraction of the CGS market would have an impact. Foreign investor interest, particularly from fund managers, would be less than if the CGS market were maintained.

Turnover In Financial Markets

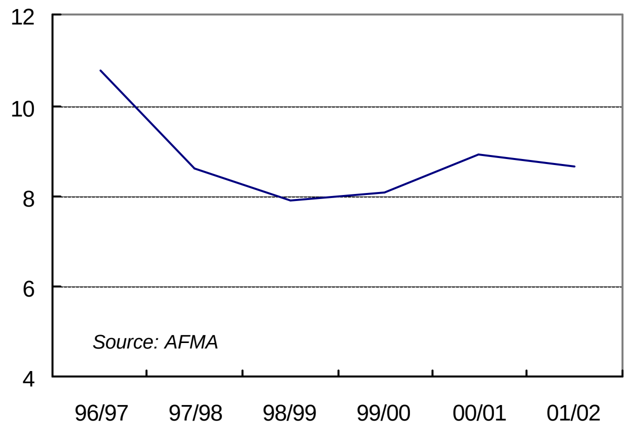
Turnover in the CGS market has been on a declining trend in recent years, influenced by the decline in the volume of Commonwealth Government bonds on issue. A portion of outstanding Commonwealth Government bonds are also effectively “bedded down” and infrequently traded. Nonetheless, current indications are that the efficiency of the CGS market and related derivatives markets has held up well. Trade in corporate bonds has risen but remains relatively small. Turnover in interest rate fixed-for-floating swaps has risen strongly and is larger than turnover in the CGS market, but is not high relative to the volume of swap agreements in place.



Note, Corporate bonds include asset backed securities

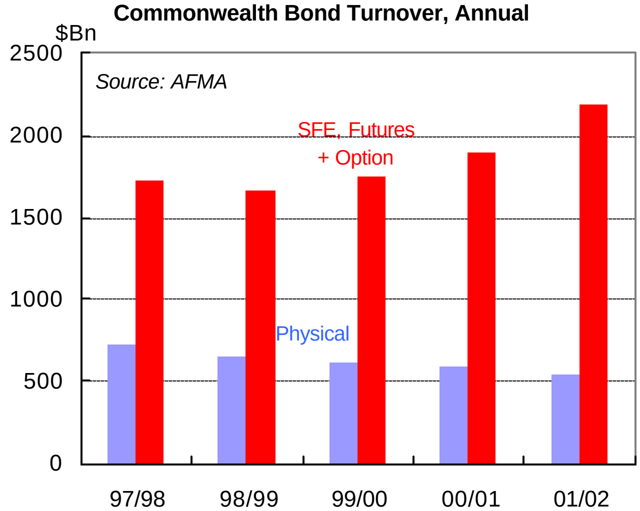
The liquidity ratio (defined as turnover divided by bonds outstanding) in the CGS market has steadied after declining in earlier years. The decline in turnover has been balanced by the decline in bonds outstanding. Nonetheless, the liquidity ratio for the CGS market remains high by the standards of other debt markets. The relatively frequent turnover of Commonwealth Government bonds contributes to the maintenance of efficient market pricing.

Commonwealth Bond Liquidity Ratio



In addition to the turnover in the physical bonds market, there is also a high level of activity in CGS derivative markets. Turnover in Commonwealth Government bond futures contracts has risen in recent years, in part compensating for loss of turnover in the physical Commonwealth Government bond market. The increase in turnover has been largely accounted for by increased turnover of the 3 year bond futures contract. Investors have traded bond derivatives contracts in lieu of physical bonds, influenced by the increasingly limited supply of physical Commonwealth Government bonds. The bond futures and options contracts are also used to hedge other financial transactions.

Commonwealth Bond Turnover, Annual



The high turnover in CGS markets and related derivatives markets has helped ensure the efficient pricing of Commonwealth Government bonds. Commonwealth Government bond derivative products also represent liquid tools which are used to manage other financial risks. If the CGS market and related derivatives markets were wound down, financial market participants would develop alternative pricing and hedging strategies.

However, there would be transition costs, including a loss of pricing efficiency for a period that would add to the cost of capital.

Functions Of The CGS market

Summary

The CGS market has fulfilled several functions that assist in the efficient and stable functioning of the financial system. In particular, the structure of the CGS and related derivatives markets has facilitated efficient price discovery. Commonwealth Government bond yields have served as an efficient minimal credit risk price benchmark or reference point for the pricing of other financial instruments. Financial market participants, including domestic and international investors, and the broader economy have benefited from a related reduction in search and uncertainty costs. A winding down of the CGS market may lead to an uncertainty premium being priced into other instruments, at least until an alternative benchmark develops, adding to the cost of capital.

The CGS market has also provided a safe-haven investment, although the CGS market itself is not completely immune to periods of heightened uncertainty. Absent the Commonwealth Government bond market:

- There would be greater reliance placed on the banking sector, a move which may create a less diversified and robust financial system.
- During a domestic financial crisis, there may be an increase in the flow of funds offshore at a time when domestic financial and currency markets are already under stress.

Commonwealth Government bonds also represent an essentially credit risk free asset class that has been of value to superannuation funds and other investors. The assets of superannuation funds will grow very strongly in coming years, in large part due to sensible Government policy mandating greater self-provision for retirement. Superannuation fund holdings of Commonwealth Government bonds are small, but they still play an important role in enabling superannuation funds to diversify the credit risk of their portfolios. If the CGS market declined further, then large superannuation funds may accelerate their shift into overseas government bonds. The desire for smaller superannuation funds and individual retirees to have access to long term minimal credit risk assets should also be recognised.

Commonwealth Bonds, Price Discovery And Price Benchmarks

The CGS market has filled an important role in financial markets, facilitating the process of price discovery and providing a minimal credit risk benchmark against which other rates and many derivative products are priced or referenced.

The Bank For International Settlements (BIS) has argued that the benchmark status of government debt in countries derives from characteristics of government securities that make them “unique in financial markets”.[11] These characteristics are:

- Governments are regarded as the most credit-worthy of borrowers, so that the government yield curve is a proxy for the nominal risk-free rate. The IMF has said that “benchmark interest rates are most useful when they allow investors to clearly distinguish fluctuations in premia for credit risk from fluctuations in the general level of interest rates.”[12]

- There is typically a large amount of government debt on issue (no longer the case in Australia) and the fungibility of issues facilitates trading. Government bonds tend to be more liquid than private debt.

- Governments are able to offer a wide range of debt maturities. This is partly because Governments typically have large and long standing borrowing needs (also no longer true in Australia). As well there is little question as to the continued existence of the Government over the longer run.

- Typically, well developed government debt related derivatives and repo markets assist market participants in taking positions.

In Australia, the high level of investor interest in the CGS market and related derivatives markets, the related liquidity of the CGS market, and the minimal credit risk characteristic of Commonwealth Government bonds, have combined to ensure that the price discovery process has been highly efficient in the CGS market.

Efficient price discovery in the CGS market contributes to pricing efficiency in other financial markets. The pricing of Commonwealth Government bonds provides, at a minimum, a reference point for pricing in other financial markets. Efficient price discovery processes lowers the cost of capital, as investors face lower search and uncertainty costs. It also enables investors and borrowers to transact with greater confidence – a factor that may be particularly significant in maintaining foreign investor interest in Australian financial markets.

A winding down of the CGS market, and a related decline in the availability of a minimal credit risk benchmark, will impact on pricing in other financial and equity markets. The pricing of corporate bonds and swaps, sometimes cited as potential substitutes for Commonwealth Government bonds, are often calculated with reference to the Commonwealth Government yield curve. An uncertainty premium may be priced into other financial instruments, at least until an alternative benchmark develops, adding to the cost of capital. Market participants will adapt over time, developing alternative

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[11] Bank For International Settlements, ‘The Changing Shape Of Fixed Interest Markets’, BIS Working Papers, No. 104, 2001 p33

[12] International Monetary Fund, Schinasi G J, Kramer C F, Smith R T, Financial implications of the shrinking supply of U.S. Treasury Securities, March 2001 p13

pricing strategies and benchmarks for comparison, but there will be transition costs which may be significant.

The Commonwealth Bond Market And Financial System Stability

Commonwealth Government bonds have been one part of the complex of regulatory and market structures that helps safe-guard the stability of the financial sector during periods of heightened instability or uncertainty.

Financial institution's and fund manager's holdings of Commonwealth Government bonds represent a low risk and liquid asset. Institutions can sell these assets, even during periods of heightened uncertainty, in order to meet margin calls, compensate for restrictions on lines of credit or meet retail investor demand for fund withdrawals.

The low risk and high liquidity characteristics of Commonwealth Government bonds also make them attractive as a safe haven for investment funds in times of economic uncertainty. During the international financial crisis in September 1998 there was a strong flow of domestic funds into Commonwealth Government bonds. Fund managers moved into Commonwealth Government bonds, partly in order to limit the risk characteristics of their overall portfolios. In other words, the presence of a liquid CGS market assisted fund managers in rapidly adjusting their portfolios to maintain an appropriate risk balance during a time of heightened uncertainty.

If the CGS market is no longer able to perform this role there will be increased reliance on the banking system to function as a safe haven in times of heightened uncertainty. Australia's banking system is well managed and meets high prudential standards. Domestic investors rightly have a high level of confidence in the stability of the Australian banking system. Nonetheless, a further increase in the reliance on the banking sector may contribute to a slightly less diversified and robust financial system.

If a domestic financial crisis were to emerge then, in the absence of the safe haven of the CGS market, there may be an increase in financial outflows overseas, creating additional pressures in currency and domestic financial markets.

The CGS market and associated derivative markets may also play a stronger role in preserving price discovery during periods of heightened economic uncertainty, particularly in the middle and longer parts of the yield curve. Market participants report that activity in the Australian corporate bond market has often contracted sharply in times of heightened uncertainty.

Of course, the CGS market is only one part of the regulatory and market structures that work to ensure financial sector stability. Others include the system of financial regulation and the RBA's capacity to adjust banking system liquidity.

A review of market developments during recent periods of heightened uncertainty shows that the CGS market is also affected. Nonetheless, it still performs a valuable role as a safe-haven for capital and, along with related derivative markets, as a pricing benchmark.

The events of 11 September 2001 had a significant disruptive effect on financial markets around the world, testing the structures designed to ensure financial sector stability. The RBA[13] reported that in Australia there was virtually no trading in the corporate bond market in the first two days after 11 September. According to the RBA, trading of domestic AAA-rated bonds and bonds issued by banks returned to more normal levels by 20 September, but overall market volumes were much lower than normal. The RBA also notes that in the CGS market, interbank price-making for Commonwealth Government bonds was very limited for a few days after 11 September. But trading in exchange traded interest rate derivatives remained strong. The RBA injected significant additional liquidity into the banking system in the aftermath of 11 September in order to help ensure financial sector stability.

The Russian debt restructuring in August 1998 and Long-Term Capital Management crisis in the US in September 1998 also placed significant pressure on the US and international financial systems. The BIS reviewed international financial markets over this period, noting that :

"During this brief spell, financial markets around the globe experienced extraordinary strains, raising apprehensions among market participants and policymakers of an imminent implosion of the financial system. As investors appeared to shy away from practically all types of risk, liquidity dried up in financial markets in both industrial and emerging economies, and many borrowers were unable to raise financing even at punitive rates."[14]

Regarding the same period the IMF wrote that:

"Market liquidity dried up temporarily even in the deepest and most liquid markets as risks were repriced and positions deleveraged. Anecdotal evidence suggests that this occurred in U.S treasury securities markets (in both August and September), the U.S repo market (in October) and the yen/dollar market (during October 7-9)."[15]

The BIS also noted that exchange traded derivatives market activity rose strongly over the third quarter of 1998, with investors having a "preference for the safety of exchange-traded transactions, whereas concerns about counterparty risk hampered business in swaps and credit-related products."[16]

In Australia, Commonwealth Government bond yields fell sharply over September 1998. This fall reflected the trend in international bond yields, shifting expectations of the economic and policy outlook, as well as safe haven flows.

In summary, recent Australian and international experience suggests that government bond markets are not completely immune to periods of heightened uncertainty. Indeed,

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[13] Reserve Bank Of Australia, Statement On Monetary Policy, November 2001

[14] Bank For International Settlements, 69th Annual Report, p82

[15] International Monetary Fund, World economic Outlook And International Capital Markets, December 1998, p51

[16] Bank For International Settlements, BIS Quarterly Review, November 1998 p1

at times, the resultant inflow of capital to the safe haven of Commonwealth Government bonds has pushed yields to artificially low levels. But the CGS market, like government bond markets in other countries, does perform a valuable function in times of heightened uncertainty, providing a safe haven investment. It also appears that the CGS market is less vulnerable to a loss of liquidity than the corporate bond market during periods of heightened uncertainty.

As such, the absence of the CGS market could result in increased pressures in other markets during periods of heightened uncertainty. In particular, capital flows overseas may increase. However, it is also important to note that there remain many other safe-guards to the stability of the financial system. Australia's prudential environment is well developed. The RBA's capacity to add liquidity to the banking system during periods of heightened uncertainty also represents an important anchor for financial markets during periods of heightened uncertainty.

Commonwealth Bonds As An Asset Class

Commonwealth Government bonds provide a long-term minimal credit risk investment option, which have been of value to superannuation funds and life insurance offices. Australian Bureau Of Statistics[17] data shows that as at June 2002, pension fund holdings of Commonwealth Government securities totalled around $11.5bn, slightly down from holdings of $13.8bn as at June 1999. Their holdings of Commonwealth Government bonds account for only around 2.5% of the financial assets of pension funds. Nonetheless, the Commonwealth Government securities still play an important role in the portfolio of superannuation funds.

Superannuation funds and life offices have a requirement for a minimal credit risk asset to provide credit diversification from other assets in their portfolio. Long term assets such as Commonwealth Government bonds have the added benefit of allowing superannuation funds some matching of the maturity profile of their assets with their liabilities.

The superannuation sector is projected to grow strongly in coming years, reflecting sensible government policy aimed at encouraging self-provision for retirement. For superannuation funds to perform their function of providing for peoples retirement in an efficient and risk controlled manner, they need to be able to invest in a range of asset types including, ideally, minimal credit risk assets and long-term assets. Superannuation funds may be reluctant to significantly increase their investment in corporate bonds as they do not provide the credit risk diversification that Commonwealth Government bonds do. As well, superannuation funds may already have exposure to the corporates issuing debt through their equity and property portfolios.

If the CGS market is closed, then superannuation funds will seek alternative minimal credit risk investments. Large superannuation funds are likely to further increase their weighting in overseas government bonds, probably hedged back into Australian dollars

[17] Australian Bureau Of Statistics, Financial Accounts, Cat 5232.0, June Quarter 2002

(note that the hedging process introduces an element of counter-party risk). The end result is a further flow of capital out of Australian financial markets, possibly also entailing some relocation of financial market infrastructure offshore.

Small superannuation funds, including do-it-yourself funds, may particularly benefit from a domestic longer term minimal credit risk asset, such as Commonwealth Government bonds, to diversify the risk characteristics of their portfolios. These funds may be less able to directly access overseas bonds or manage the associated exchange rate risk. Retaining the CGS market may be one step in assisting the smaller superannuation funds to better manage their portfolios in a prudent and cost effective manner.

Substitutes For Commonwealth Government Bonds?

Summary

If the CGS market were to decline further there is an expectation that other markets will develop to fill the functions currently fulfilled by the CGS market. In many instances overseas, private financial instruments are already replacing government bonds as a benchmark for pricing. For example, the Eurodollar (USD Libor and related swaps) curve is increasingly used as a benchmark for USD rates. Already in Australia bank bills provide a benchmark for pricing shorter term rates. However, there are still some uncertainties as to the time it will take for domestic substitute markets to evolve to fully fulfil the functions of the CGS market and whether they could fulfil these functions as efficiently.

Review Of Possible Substitutes

If the Government bond market were to be wound down, there is an expectation that substitute products will emerge to fulfil similar functions. Financial markets are highly innovative. In some instances in Australia and overseas, private financial instruments are already replacing government securities as a benchmark for pricing, particularly at the short end of the yield curve. In Australia, the bank bill curve provides a benchmark for pricing shorter term rates. Overseas, swap curves based on Libor and Euribor are often used as a benchmark for USD and EUR interest rate pricing.

The Bank for International Settlements has noted the trend for non-government debt to emerge as a benchmark for some pricing purposes on major international markets:

"While government securities remain among the most liquid assets available to investors, as non-government instruments gain liquidity they are increasingly being used to price and hedge other securities and perform other functions for which government securities tended to be used in the past. This process appears to be furthest advanced in the euro market, where the interest rate swaps curve is emerging as the benchmark yield curve."[18]

Nonetheless, it is uncertain how quickly and effectively substitute markets will develop in Australia to perform the functions performed by the CGS market, implying potentially high transition costs. Currently, the structure of the corporate bond and swap markets limit their ability to completely substitute for the CGS market as a minimal credit risk price benchmark or a safe-haven asset.

The **corporate bond** market has grown strongly but is not yet in a position to perform the functions of the CGS market in facilitating the formation of benchmark prices and acting as a safe-haven investment. The corporate bond market suffers from several limitations relative to Commonwealth Government bonds in performing these roles:

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[18] Bank For International Settlements, 'The changing shape of fixed interest markets', BIS Working Papers, No. 104, 2001 p1

- Corporate bonds carry the credit risk of the issuer, although credit enhancement is possible.

- The issuance of corporate bonds can be intermittent and susceptible to economic and financial market conditions.

- Liquidity in the corporate bond market is lower than in the CGS market. Turnover in fixed non-government debt securities has risen strongly in recent years but still totalled only $165bn (fixed rate, including asset backed securities) in 2001/02.[19] Trading activity in the corporate bond market is sensitive to prevailing economic and financial market conditions.

- The spread in yield of individual corporate bonds over Commonwealth Government bonds can also be affected by industry or company specific factors. As such, the corporate bond market is not yet in positioned to effectively act as a pricing benchmark.

- Trading in the corporate bond market can be constrained by credit limit considerations. These limits can also be affected by prevailing economic and financial market conditions, making activity in the corporate bond market vulnerable to adverse economic or financial developments.

- Corporate bonds are less fungible than Commonwealth Government bonds, a factor that constrains market liquidity and also impairs the capacity of the corporate bond market to facilitate the discovery of a benchmark price structure.

- The derivatives markets for the corporate bond market are limited in size.

The **fixed-for-floating interest rate swap market** is often cited as a possible substitute for the CGS market as a source of price benchmarks. The swap market is large and actively used by the bank and business sectors. Activity is greatest for terms out to 5 years but does extend out to longer terms. Swaps also have the benefit that, being a financial transaction, they do not depend upon the issue of a particular security. Therefore the swap market faces less restriction in terms of its potential size. However, in several respects the swap market also suffers from limitations relative to the CGS market that affects its ability to act as a price benchmark and as a structure for safe-haven investment:

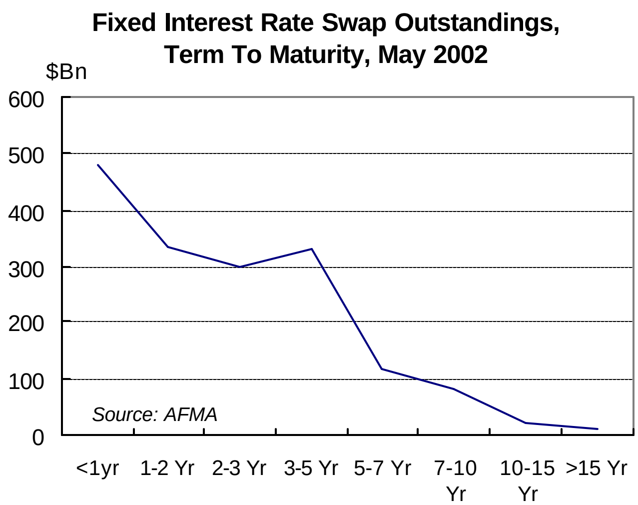
- Swap transactions are not credit risk free because of counterparty risk. The credit limits on potential counter parties are also a factor limiting swap market trading activity.

- The nature of swap transactions, at their most simple being an agreement between two parties to exchange interest obligations, can limit market liquidity. As well, swaps are not as fungible as Commonwealth Government bonds, often being tailored to particular transactions. These characteristics are an impediment

[19] Australian Financial Markets Association, 2002 Australian Financial Markets Report

to the efficient establishment of clear price benchmarks.

- The derivatives markets for swaps are less developed and visible than those for the CGS market.



Another possible substitute for the CGS market is the rapidly growing **asset backed securities market.** Asset backed securities are often of a high credit quality. But the maturity profile of asset backed securities generally is more limited than for Commonwealth Government bonds.

It has also been suggested that **overseas financial benchmarks**, such as US Treasury bonds yields or Euromarket rates, could serve as price benchmarks for Australian rates. The related currency risk might be hedged. Arguably the US Treasury curve is already a powerful influence on the Australian Commonwealth Government bond curve. The Eurodollar (USD) and related swap market is well developed and deep. It is used for funding purposes by many international financial intermediaries and corporates (including Australian businesses).

However, unhedged overseas interest rates are unlikely to always be appropriate to Australian conditions. The margin between Australian and US interest rates is highly variable.

If an overseas interest rate came to be used as a pricing benchmark in Australia it might also cause some drift of financial market activity overseas. Australian institutions would probably shift at least some of their funding and hedging activity overseas to the locations where these prices were determined. Large Australian borrowers may also make greater use of overseas funding options in these circumstances.

If the CGS market were wound down it would also impact on Commonwealth bond derivative products that are currently used to hedge financial risks. It may be argued that the absence of Commonwealth Government bonds may leave a gap that will allow or even encourage the development of other derivatives markets and new products. The

Sydney Futures Exchange has introduced swap futures contracts. However, this process may take time and the new products may not be perfect substitutes for the current Commonwealth Government bond derivatives markets. There is also some risk that the vacuum left by the closure of the CGS market and related infrastructure would not be conducive for the development of other liquid derivative markets.

In summary, if the CGS market is wound down, there is an expectation that substitute markets will evolve to fulfil its functions. The Australian financial system is highly sophisticated and adaptable. In major overseas markets, private sector benchmarks are gaining increased recognition. Nonetheless, important questions remain about the time it will take for substitute markets to evolve sufficiently to perform these functions in Australia and whether the substitute markets will be as efficient. The corporate bond and swap markets are not yet in a position to take over the reins from the CGS market. In this context, if the Government were to retain a given volume of Commonwealth Government bonds on issue in order to fund its unfunded superannuation liabilities, it would have the significant benefit of giving domestic financial markets additional time to develop alternative pricing benchmarks, thereby minimising transition costs.

The Investment Problem

Summary

If the Government chooses to retain a Commonwealth Government bond market of $50-$100mn, and the stance of fiscal policy is unchanged, it would raise the question of what to do with the surplus funds raised by the issue of Commonwealth Government bonds. In this situation, ASX would support the option identified in the Review of using the surplus funds raised by the issue of Commonwealth Government bonds to fund the Government's currently unfunded superannuation liabilities, either through a hypothecated asset portfolio or through transferring funds into a superannuation. If the Government favoured the option of the hypothecated asset fund, it would be best if the management of the fund was conducted at arms length from the policy-making arms of the Commonwealth Government or farmed out to private managers.

Asset Portfolio Issues

Currently, the Commonwealth Government's primary fiscal objective is to maintain budget balance, on average, over the course of the economic cycle. The Commonwealth Government's supplementary objective is to maintain budget surpluses over the forward estimates period while economic growth prospects remain sound. If the Commonwealth Government does run headline budget surpluses in coming years and also retains a viable CGS market by maintaining a given gross level of bonds on issue, the Commonwealth Government would face the problem of what to do with surplus funds raised by the issue of Commonwealth Government bonds.

The OECD considered this general issue saying:

"…if private debt cannot fulfil all the desirable functions of public debt, governments may consider maintaining a minimum level of gross debt despite the reduction in net debt. This could be done by investing government surpluses in private financial assets (domestic or foreign). The level of gross debt would have to be sufficient to maintain liquidity in the government bond market, permit issuing in selected (benchmark) segments and support the existence of the large derivative markets based on government bond markets."[20]

Investing funds raised by the issue of Commonwealth Government bonds would leave the Government facing some investment risk – the return on the Government's asset portfolio may be less than the cost of servicing Commonwealth Government bonds on issue. The desire to remove this investment risk represents an argument against retention of the CGS market longer than required for budget funding purposes.

The Review discussed the option of using surplus funds raised by the issue of Commonwealth Government bonds to fund the Government's currently unfunded

[20] OECD, OECD Economic Outlook No 66, Public Debt Management At The Cross-Roads", December 1999 p167

superannuation liabilities. This could be done in two ways. The Government could use the surplus funds raised by the issue of Commonwealth Government bonds to build a hypothecated asset fund. The proceeds of the hypothecated fund could then be used to meet the Government's superannuation obligations. Alternatively, the Commonwealth Government could directly place the surplus funds in a superannuation fund for Commonwealth employees. The Commonwealth Government may still bear some residual investment risk.

If the Commonwealth Government did build a large hypothecated asset fund there would be questions as to where and how the funds would be invested, potentially raising governance issues. Some of the issues are:

- The Commonwealth Government could directly invest the funds raised by the issue of Commonwealth Government debt in domestic private securities, including debt or equities. However, given the potential size of the funds to be invested, the Australian government could emerge as a significant investor in private enterprises, raising some governance issues.
- Investing the funds in overseas Government bonds is another option, but may leave the Commonwealth Government carrying some residual spread or currency risk.
- The Commonwealth Government's hypothecated asset portfolio could be farmed out to private fund managers. This option may be best in ensuring the smooth functioning of investment markets.

The governance issues associated with a hypothecated asset fund are real but not insurmountable. There are several examples of countries, including Norway and Singapore, where Governments have accumulated large asset portfolios. The management of the asset portfolio can be structured in a way as to be separated from the policy-making arms of Commonwealth Government. The potential governance issues are lessened if the Commonwealth Government places the surplus funds directly in a superannuation fund.

ASX believes that if the Commonwealth Government chose to maintain the CGS market, and the stance of fiscal policy was unchanged, then the surplus funds raised by the issue of Commonwealth Government bonds should be used to fund the Commonwealth Government's unfunded superannuation liabilities. The surplus funds could be transferred to a superannuation fund or used to fund a hypothecated asset portfolio. In the case of a hypothecated asset portfolio, management of the assets should be farmed out to private fund managers in order to minimise potential governance concerns and ensure the smooth functioning of investment markets.

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