

**Submission By Deutsche Bank AG (Aus/NZ) to
the Review of the Commonwealth Government
Securities Market**

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Section 1

Summary

Section 1.1: A step into the unknown

The Australian Government is proposing an experiment with no international precedent. Against the general practice around the globe of budget surplus governments accumulating a fund of financial assets and maintaining a government debt market, the Australian Government is proposing that if the current projections of budget surpluses eventuate it will use these funds, plus the receipts from the further sell-down of Telstra, to fully pay back debt.

While supporting the Government's medium-term fiscal strategy of maintaining budget balance, on average, over the cycle, we strongly dispute the conclusion that this leads inextricably to debt elimination.

The fiscal strategy actually equates to a stable level of nominal debt outstanding over time, meaning that the real question to be addressed is one of balance sheet management, i.e. should the average level of nominal net debt be zero, positive or negative and how should assets be managed to achieve this, and at what point does the accumulation of cash surpluses become "excessive", triggering a need to return these to the public via tax cuts or increased spending.

This has recently been acknowledged by the Prime Minister when he noted on Channel Nine's *Sunday* program that: "When you have a low level of Government debt and you have a surplus, there comes a time when people might want some of the surplus returned by way of general or specific tax cuts". The PM noted that his Government would seek tax cuts rather than increased spending because "we are still a Government that believes where you have a capacity to do so you should reduce taxes."

The likely receipt of proceeds from the further sell-down of Telstra obviously advances the point at which these balance sheet decisions need to be made, but the further elimination of debt is only a temporary measure if the Government does not change its policy from one of running ongoing cash surpluses. If cash surpluses are accumulated indefinitely a government will at some point accumulate assets, even if it is just cash at the central bank.

Section 1.2: CGS play a central role in Australian financial markets

In our view the proposal to eliminate CGS could have a serious impact on the size, liquidity and evolution of Australian debt and derivative markets. This policy seems to us to be in direct contradiction to the policy of promoting Australia as a regional financial centre.

The Government's discussion paper takes it almost as given that the size and liquidity of the swap and corporate debt markets will continue to display the sort of growth rates achieved over recent years as the stock of Government debt has fallen. In a recent speech the RBA Assistant Governor Financial Markets makes the same assertion.

While this may be the case, we think there is a very real risk that it will not be so. The domestic debt markets are inexorably interconnected and it may well be that a liquid CGS market is not only a building block for other markets but a critical foundation.

If this is the case then the cost of transacting in the Australian market may rise if CGS disappear – perhaps significantly when both wider spreads and lower liquidity are considered. This will represent a real economic cost and have an impact on the growth of domestic debt markets and the cost of funding by Australian corporates domestically versus overseas.

Given there is \$1.2 trillion in debt owed by the various sectors of the Australian economy an increase in borrowing costs of as little as 0.1% would boost gross interest costs by around \$1.2 billion a year and net interest costs for the total economy by around a third of this amount. A key issue is this impact is likely to be felt disproportionately by small / medium sized business and households, with large firms likely to seek cheaper offshore funding.

As well, any negative impact on the size and growth rate of the domestic debt market will likely have a negative impact on the financial market infrastructure present in Australia. If more "Australian" deals are done offshore because of the cost advantage, problems with liquidity, etc., then it seems likely that at least some of the infrastructure required for the deals will be relocated.

The "safe haven" role of CGS should not be understated. It is notable that during the various financial market crises of the past few years, the liquidity and efficiency of the corporate debt and swap markets significantly reduced while the CGS and associated futures markets continued to trade strongly.

This suggests to us that the elimination of CGS carries significant risk of considerable unintended negative consequences. In our view this means the Government should be very cautious about deciding to eliminate the CGS market without ensuring a smooth transition to a new "model". The fact that a number of countries that have this option (e.g. Singapore, Norway, etc.) have chosen not to, and are accumulating assets while continuing to issue bonds, suggests that if there is a "status quo" in this situation it is to accumulate financial assets, not eliminate debt.

Section 1.3: A sustainable alternative to debt elimination

In our view the most important role played by CGS, and the issue around which the greatest risks and uncertainty exists if the Government announces an intention to eliminate debt, is the key role that CGS play in price discovery, referencing and hedging in the Australian debt market. This role is crucial and becomes acutely evident during periods of financial market turmoil when the private sector's willingness to take on risk is sharply curtailed.

Our position is, therefore, that irrespective of the level of net debt that the Government decides is appropriate it should commit to a level of gross debt outstanding that allows for the continued operation of a liquid and efficient market in 3 and 10 year bond futures, the key source of liquidity in the Australian debt market.

In our view there is no "magic rule" that determines this level and the ongoing evolution of the market may result in a surprisingly low level of bond issuance proving to be feasible. The key is a commitment by the Government to supporting a CGS market large enough to provide for the efficient pricing of the 3 and 10 year futures contracts.

Accumulation of cash surpluses beyond the point where the CGS yield curve provides this infrastructure, if it ever eventuates, would require the accumulation of financial assets to allow the indefinite maintenance of a CGS market as the cornerstone of price discovery and referencing in the Australian debt market.

Section 1.4: The Government as a balance sheet manager

Despite there being a range of significant issues created by the Government deciding to manage a pool of financial assets for the sole purpose of maintaining a liquid and efficient bond market, we do not see any of these as being insurmountable or particularly costly as suggested in the discussion paper.

In fact, as noted above, this option, rather than the total elimination of Government debt outstanding, is the international "status quo" and is unlikely to be as risky as the Government's proposed model of eliminating debt entirely.

Section 2

Possible Consequences of Eliminating CGS

Section 2.1: Overview

In our view the proposal to eliminate CGS could have a serious impact on the size and liquidity of Australian debt and derivative markets. Australian debt markets are currently inexorably interconnected and it may well be that a liquid CGS market is not only a building block for other markets but a critical foundation.

The elimination of CGS could therefore have a range of negative effects including:

- An increase in the cost of transacting in Australian debt in general – perhaps significantly so when both wider spreads and lower liquidity are considered;
- The risk of a negative impact on the financial market infrastructure present in Australia if the increase in transaction costs force more deals offshore; and
- Doubt about the ability of Australian capital markets to function efficiently (or to any reasonable degree) during periods of elevated financial market uncertainty and crisis without the “safe haven” CGS market

All of which suggests to us that the elimination of CGS carries the significant risk of considerable unintended negative consequences. We also note that many of the problems created by falling liquidity and efficiency may occur soon after a decision to eliminate CGS is announced, even if it takes many years for Government debt to actually disappear (or not, as in the US case where the rhetoric about the elimination of the Treasury market reached its zenith just as the budget was beginning to suffer a sharp cyclical reversal).

This means that decision makers should not believe they can make a decision to eliminate the market but delay any negative consequences for a considerable period because the practical implementation of the decision will take many years.

Section 2.2: Imperfect substitutes for CGS will raise transaction costs

There is little doubt that Australian financial market participants will find substitutes for the roles currently played by CGS should they disappear. After all, there will be little option but to find other instruments to use.

It is our contention, however, that since these substitutes are imperfect they will necessarily raise transaction costs and reduce the efficiency of the market. The clearest evidence for this contention is if alternatives were viable and cost competitive they would already be in use.

In our view, no substitute will offer the attributes of being highly liquid, essentially free of credit risk and having a reasonably close relationship with other domestic debt instruments currently provided by CGS.

Section 2.2.1: Semi-government securities ('Semis') market

The limited liquidity of Semis and the absence of a futures contract mean that the cost of transactions using Semis for hedging purposes will be greater than for CGS. Over time the liquidity of Semis would likely improve and a Semi-futures contract may develop, although the SFE tried to introduce such a contract in the 1990s and it failed for lack of homogeneity among issuers and liquidity. This suggests that, among other things, changes in the way Semi-issuers operate and market perceptions will be required.

A significant issue in this regard is the impact on the market should the credit quality of Semi issuers diverge for any reason. Such an event could seriously undermine the basis for any futures contract. This underscores a further point. In thinking about the structure of the market in the absence of CGS any proposals will need to be robust in the face of changing circumstances.

Section 2.2.2: The interest rates swaps (IRS or 'Swaps') market

The interest rates swaps (IRS) market is the most liquid part of the Australian debt market. At a surface level this makes it potentially very attractive as an alternative to CGS. Unfortunately this assessment bears little scrutiny.

The IRS market developed in the late 1980s to allow off-balance sheet management of term interest rate risks. Transaction spreads were initially very wide, of the order of 100 basis points, but began to narrow once the CGS market was recognised as an efficient hedge for swap rate risk.

Early in the 1990s the increase in volume of bond futures trading on the SFE and the acceptance by the SFE of EFP trades (where IRS trades can be offset by futures trades of the opposite effect) resulted in a sharp narrowing of transaction spreads and a dramatic increase in IRS transaction volumes.

Currently more than 90% of inter-bank IRS trades are executed on an EFP basis. That is, rather than trading on an outright basis swaps are quoted as a margin to bond futures. By their very nature spread positions are less volatile than outright positions and in our view this explains much of the growth in IRS volumes. That is, IRS volumes are intrinsically linked to the liquidity and efficiency of the CGS and associated futures markets.

The existence of the efficient and liquid hedge market provided by bond futures allows relatively large risks to be 'warehoused' for substantial periods, keeping transaction spreads much narrower than would otherwise be the case and enabling the 'liquidity' in the Swaps market.

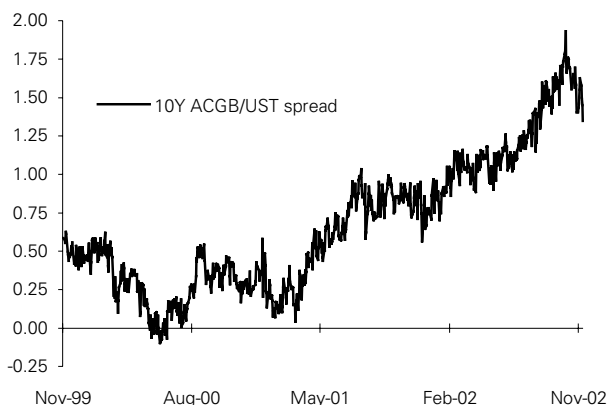
If CGS disappear then so to will the current bond futures. This means that traders will most likely quote swaps outright as they are forced to price both outright interest rate and credit risk simultaneously. As a result bid/ask spreads will widen to compensate for the additional risk involved in the outright market.

What if a swap futures contract evolves? We have doubts that such a contract will function anywhere as efficiently as the current bond futures given the lack of commoditisation in the swap market and the credit aspect of the market (transactions being conditional on name acceptance). As the SFE submission points out, efforts to create swap futures contracts in other, more liquid, markets have not been particularly successful. At best it seems likely that the evolution of a liquid and efficient swap futures market will take at least some considerable time and cannot be "assumed".

What about hedging swap flows with other instruments such as US Treasuries? In all cases we believe the hedge will be less efficient than CGS. Obviously a greater number of factors influence the AUD swap to US Treasury spread than the AUD swap to CGS spread and this increase in risk will be reflected in price and spread.

This was starkly evident during the 1998 Russian and LTCM debt crises. CGS to swap spreads moved by much less than the AUD swap to US Treasury spread, meaning that US Treasuries would have been a very poor hedge for a swap position.

The 10Y CGS/UST spread has been volatile



Source: DB Global Markets Research

The volatility of the 10Y CGS/UST spread over the past few years provides another illustration of how poor USTs can be in providing a hedge for AUD debt transactions. In the past three years the 10Y CGS/UST spread has moved within a range of more than 200bp. Over this period 10Y CGS/swap spreads have been considerably less volatile.

What about hedging via corporate debt? While there is a very high correlation between swap rates and corporate yields, the limited liquidity in the corporate debt market makes them a poor choice as a vehicle to hedge transactional flows, see Section 2.2.3 below.

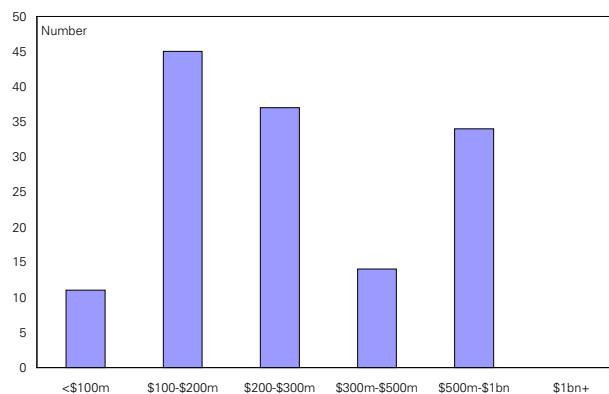
Section 2.2.3: Corporate debt market

We think it unlikely that corporate debt could perform many of the functions of CGS given issues such as credit quality, limited liquidity, the absence of corporate yield curves and the concentration of issues in the short end of the maturity structure. Indeed, if CGS disappear then we think the liquidity in the corporate market could well deteriorate further, making them even less suitable as substitutes for CGS.

The corporate bond market is notable for its large number of small issues. This lack of liquidity makes the market unsuitable for various roles performed by CGS such as hedging or providing a pricing reference. Data from the RBA highlights the low turnover in corporate bonds, in contrast with the much larger turnover in CGS. This illiquidity tends to be accentuated during times of financial market stress.

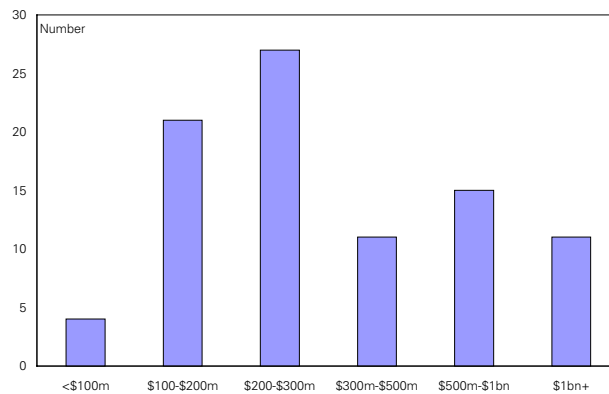
The following two charts highlight the lack of liquidity in the corporate debt market, both current and near term prospective. The first chart shows that currently there is no outstanding line of corporate debt in excess of A\$1 billion, while the second chart shows that there are only eleven issuers that have cumulative issuance, over *all* lines, of more than A\$1 billion.

Number of Corporate Issues by Issue Size



Source: DB Global Markets Research

Number of Corporate Issuers by Total Issued



Source: DB Global Markets Research

Arguably a highly rated issuer such as the World Bank may decide to build up a benchmark presence in the Australian market. While this is a possibility, such issuers have no reason to support the market except on the purely opportunistic basis of cost. Thus, there will have to be a clear cost advantage to issuing in Australia and it is not obvious that this will be the case. At the very least it will take time for an alternate issuer to build up a large enough presence in the Australian market to be able to perform any of the functions of CGS.

In the meantime, the absence of CGS or the expectation of their rapid disappearance may leave investment fund managers with little choice but to push a larger share of their funds offshore. In other words, it should not be taken as a given that there will be significant, or even excess, demand for “Australian” issues of corporate debt in the absence of CGS. Both supply and demand for corporate paper will likely remain highly opportunistic and price sensitive.

Section 2.3: Other Issues

Section 2.3.1: The “safe haven” role of the CGS market

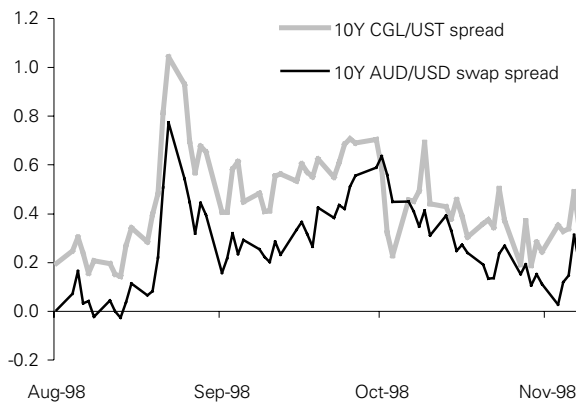
If CGS disappear, domestic investors and traders will have little option but to use an alternative such as US Treasuries as a “safe haven” in times of stress. At least some of these flows are likely to be unhedged and would, at the margin, add to any downward pressure on the AUD at such times. We do not see this as a particularly significant issue, however.

Potentially of greater significance for the currency are international investors who have typically used CGS as a regional safe haven during these periods. These investors will place these funds elsewhere. This suggests to us that the absence of safe haven CGS and the resulting additional AUD demand created during periods of financial market turmoil may expose the currency to even greater volatility and downside risk than previously.

While unable to quantify this impact there has been a clear trend to Australia being viewed as a financial safe haven in the region and the existence of CGS plays a significant role in this.

Looking specifically at the Russian and LTCM crises of 1998 we can see the impact on pricing. While the initial impact of the Russian debt default on the CGS and AUD swap markets was similar in so far as their margin over equivalent US assets was concerned (see chart below), in the ensuing few months, CGS significantly outperformed swaps.

Bond and swap spreads during the Russian and LTCM crises



Source: DB Global Markets Research

This was evident in the widening in swap spreads that occurred, with the gap between the 10Y CGS yield and the 10Y swap yield moving to a high of almost 100bp on 8 October. The 10Y CGS yield fell 100bp between 27 August and 8 October, while the 10Y swap rate fell 70bp over the same period.

Investors seeking to transact during this period had to either use the liquidity available in Government bond markets or face the higher cost of using other instruments such as swaps. This choice will not be available if CGS disappear, leaving investors the choice of using relatively illiquid instruments or seeking “safe haven” options in other currencies such as US Treasuries.

Section 2.3.2: Small changes in costs can change the location of transactions

Financial market transactions are invariably very price sensitive. As discussed above, the use of imperfect substitutes for CGS will almost certainly raise transactions costs. The following table provides a stylised example of how these costs cascade for even a simple transaction.

Steps for an Investor to achieve a "risk-free" AUD return							
With CGS Market				Synthetic using US Treasuries & Swaps			
Steps	Action	Yield	Spread	Steps	Action	Yield	Spread
1	Buy CGS	CGS%	1.0 bp	1	Buy USD Treasury	USD%	0.5 bp
				2	USD IR swap	3M Libor -50 bp	0.5 bp
				3	X-Currency swap	3M BBSW -50 bp	1.5 bp
				4	AUD IR swap	Swap -50 bp	1.0 bp
Gives				Gives			
	AUD risk free asset	CGS%	1.0 bp		"Synthetic" AUD risk free asset	CGS% -25 bp	3.5 bp

Source: DB Global Markets Research

In the simple example above an Australian investor uses various swaps markets to produce a "synthetic" AUD risk-free return from a USD Treasury. Not only does the increased number of steps in the transaction increase the spread costs but the resulting synthetic risk-free asset will yield approximately 25 bp below the equivalent CGS due to the fact that Treasuries trade further below swap than do CGS (a reflection of the deeper liquidity, etc. of the Treasury market).

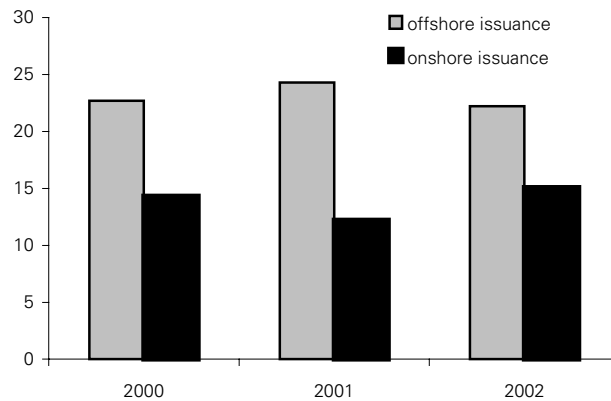
The table assumes, however, that the AUD swap risk can be cleared via bonds futures. In the absence of CGS and bond futures the spread cost of Step 4 would likely increase to around 3.0 bp, lifting the spread cost of the entire transaction to 5.0 bp. This estimate of 5.0 bp may well prove conservative, particularly in times of heightened market volatility when all spreads tend to widen.

A-priori it is impossible to quantify the impact of this cost increase on transaction volumes but the difficulty in clearing volume and the lack of demand for long dated corporate issues already pushes considerable activity offshore. That is, price sensitivity is such that in the past three years domestic issuers have raised more money offshore than onshore and a further increase in costs would likely see this imbalance extend significantly further. The debt would continue to be issued, but just not in Australia in the first instance.

The chart below shows our estimate of the amount of debt raised by domestic issuers, both onshore and offshore, over the past three years, excluding MBS. The offshore issuance figures also exclude private placements by Australian issuers, such as those into the Asian

markets. These exclusions mean that the amount of offshore issuance by domestic issuers is understated by these data. Comparable RBA figures also show that more debt is issued offshore than onshore by Australian issuers.

Debt issuance by domestic issuers (excluding MBS) A\$ billion



Source: DB Global Markets Research

The key point of this is that domestic borrowers are already quite willing to fund offshore. Indeed, for many the domestic market is already too small to support the nature of the transactions they wish to undertake. Cost will also be a consideration in this decision. In our view an end to the CGS market will most likely increase the cost of dealing in Australia. We believe this will see more and more deals completed in offshore markets. As well as having an impact on the liquidity of the Australian market, we believe this will have an impact on the amount and nature of financial market infrastructure in Australia.

In our view this runs counter to the objective of promoting Australia as a regional (let alone “global”) financial centre, more likely consigning it to the role of a branch office economy characterised by the retail distribution of financial products and services produced elsewhere.

Section 3

Medium-term fiscal strategy does not imply debt elimination

Section 3.1: Does fiscal prudence mean no debt?

The Government's medium-term fiscal strategy of maintaining budget balance, on average, over the cycle is an important anchor for fiscal policy and combines with the RBA's medium-term target of limiting inflation to an average of 2-3% over the cycle to provide a sound underpinning for Australian macroeconomic policy. On no account, however, does this strategy lead inextricably to the elimination of Commonwealth debt.

Based on the Government's own forward budget projections, updated in the recent MYEFO, the only reason it will be in a position to eliminate debt in the foreseeable future is the sale of its final 50.1% holding in Telstra (i.e. T3).

This is nothing new, while bonds outstanding outside the Commonwealth's own holdings (hereafter bonds outstanding) have fallen \$34 billion (from over \$92 billion to \$58 billion) between June 1996 and June 2002, cumulative net advances actually totaled \$48 billion. That is, proceeds of business asset sales and like transactions more than fully accounted for the reduction in bonds outstanding over the period, even though the Commonwealth adhered to its medium-term fiscal policy and ran underlying cash surpluses in all but two of the years in question.

The latter is reflected in the reduction of the Commonwealth's *net* debt outstanding of A\$60 billion over the period in question. Viewed another way, the Government has already been an active manager of its debt portfolio and below we recommend that it extends this to become an active manager of its entire balance sheet.

Given the timing and pricing uncertainties associated with undertaking any major equity listing, reflected in the Government's decision to postpone T3, we believe the Government should be extremely cautious about risking the range of negative consequences of the type detailed in the previous section.

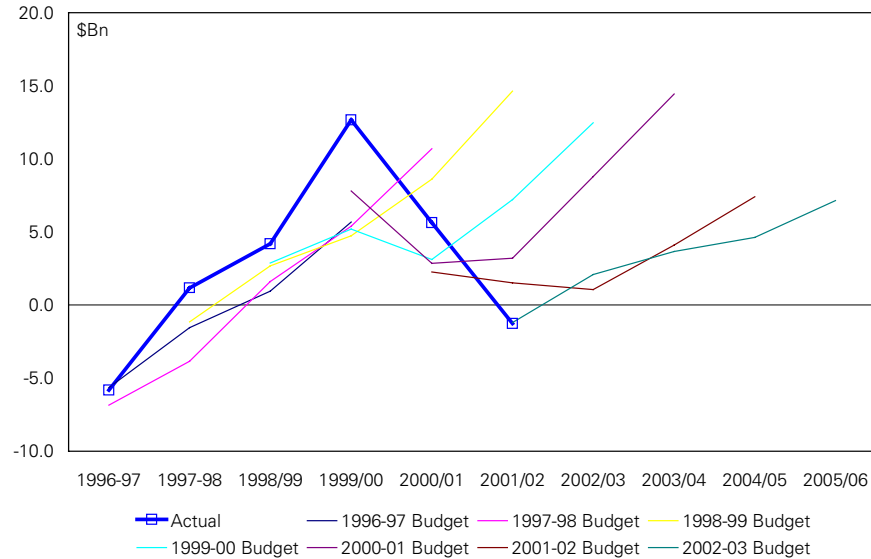
While we acknowledge that the eventual sale of Telstra will create issues regarding balance sheet management for the Government we dispute that adherence to the medium-term fiscal strategy per-se implies debt elimination.

In fact, based on the projections provided by the Government in the latest MYEFO, bonds outstanding would still be above \$40 billion at the end of the current projection period (2005-06) if it were not for the anticipated proceeds from T3.

Even this rate of "underlying" debt pay down is unlikely since in the past two years, after a period of over achievement, the medium-term budget projections have tended to over

predict the eventual budget outcomes. This “optimistic” bias in the forward estimates has occurred despite the period shown being one of relatively consistent economic growth for Australia.

Evolution of Underlying Cash Balances



Source: DB Global Markets Research

Following a significant domestic economic downturn, i.e. a recession, the underlying cash balance is likely to return to a deficit of between 2 and 4% of GDP for at least two or three years based on the historical response of the budget to significant slowdowns. Such a deficit would generate cumulative demand for deficit financing in the order of at least \$50 billion. An *extended* downturn may even produce a significantly greater demand for debt, despite being compatible with the medium-term fiscal strategy provided the Government does not embark on excessive structural easing during the period of economic weakness.

Even if the proceeds of T3 occur as predicted in the forward MYEFO projections, bonds outstanding are not expected to fall below \$40 billion until the very end of the current projection period, i.e. 2005-06.

Given the uncertainty associated with these receipts, as indicated by the Government’s own decision to postpone their impact in the budget projections, and the sensitivity of the budget bottom line to a significant economic downturn, we find it remarkable that the Government is contemplating risking the range of unintended consequences suggested above rather than opting for a more conservative strategy.

Only if the Government’s remaining 50.1% of Telstra is sold will it be able to make further significant inroads into the stock of debt outstanding in the foreseeable future. An ability to

otherwise do so, i.e. a significant accumulation of underlying cash surpluses, implies a departure from the medium-term fiscal objective and therefore a change of policy, as the PM recently highlighted. Put another way, the entire debate decomposes to one of balance sheet management, since a rigorous application of the medium-term fiscal strategy requires the Government to return excessive anticipated cumulative budget surpluses to the public via either tax cuts or expenditure increases.

In short, a balanced budget over the medium-term does not imply an elimination of debt, it implies maintenance of the current nominal stock of debt outstanding on average overtime. It is the prospect of proceeds from the final sell-down of Telstra that allows choice of whether this average level of debt is zero so the debate is one of balance sheet, not merely cash flow and debt, management.

Section 3.2: Impact of a future significant asset sale

Despite this, we acknowledge the Government's intention to sell-down its remaining 50.1% stake in Telstra following Parliamentary approval and the emergence of more favourable equity market conditions. As noted above, this raises the possibility (but in no way certainty) of further significant net debt reduction over the next few years.

This creates an issue of balance sheet management for the Government but the discussion paper fails to acknowledge this, seeming to hide behind the erroneous assumption that debt elimination is the logical conclusion of the medium-term fiscal strategy. In our view this has created the mistaken impression that debt elimination is the "status-quo", when it is in fact an active policy decision by the Government with significant risks and potential costs, as well as potential benefits.

In the section below we suggest a model that provides an appropriate balance between the costs and benefits of this policy decision. In our view this approach maximises the likelihood that other financial instruments will further evolve to better accommodate some of the current roles of CGS, e.g. as a long-term investment vehicle, without risking a potentially costly discontinuous break in Australian markets triggered by the announcement of an intention to eliminate the CGS market.

Section 3.3: A sustainable alternative

In our view the most important role played by CGS, and the issue around which the greatest risks and uncertainty exists if the Government announces an intention to eliminate its debt, is the market's central position in price discovery, referencing and hedging in the Australian debt market.

Other submissions have provided ample evidence that the key liquidity and efficiency provided by the CGS market is due in large part to the synergy provided by its relationship with the 3 and 10 year futures contracts. We strongly recommend, therefore, that maintenance of this liquidity and efficiency becomes the focus of the Government's balance sheet management strategy.

The multi-year and uncertain nature of any future debt pay-down, and the current level of outstandings (total CGS of \$70bn with just under \$50bn in hot stocks), suggest that the Government should further move to consolidate issuance in an alternate maturity year yield curve.

Maturities of around \$5.5 billion in 2003-04, \$5.7 billion in 2004-05 and \$10 billion in 2005-06, combined with ongoing use of cash balances at the RBA, would allow much of the restructuring required to be achieved without encountering the potential costs associated in a significant buy-back program. An ongoing program of reverse tenders could be used to achieve any remaining yield curve restructuring/management that is required.

We do not agree that CGS on issue will need to rise in proportion to nominal GDP growth because the crucial feature of the proposed model is the liquid and efficient pricing of each of the stocks on the alternate year yield curve required to back the 3 and 10 year futures contract.

Erosion of this liquidity and efficiency would be grounds for reassessing whether the amount of CGS on issue is adequate, not an arbitrary nominal growth rule. In particular, the latter ignores the high (and increasing) velocity of circulation that is attendant with liquid and efficient markets.

This suggests the Government needs to commit to an ongoing process of consultation with industry groups and participants to ensure that the level of CGS outstanding is continuing to provide an appropriately liquid back-drop to the operation of the 3 and 10 year futures contracts, rather than committing to a specific level of debt per-se.

The current performance of the market suggests that around \$50 billion in hot stocks is adequate, although we suspect that anything below six or seven lines of around \$5 billion each, i.e. around \$30 / \$35 billion of hot stocks on issue, would prove unworkable. In practice, deteriorating liquidity and efficiency in the CGS and futures markets will provide the evidence of when the level has become 'too' low.

As noted above, however, there is no "magic rule" that determines this level and the ongoing evolution of the market may result in a surprisingly low level of issuance proving to

be feasible. The key is a commitment by the Government to supporting a CGS market large enough to provide for the efficient pricing of the 3 and 10 year futures contracts.

Accumulation of cash surpluses beyond the point where the CGS yield curve provides this infrastructure, if it eventuates, would require the accumulation of financial assets to allow the indefinite maintenance of a CGS market as the cornerstone of price discovery and referencing in the Australian debt market.

Section 3.4: The Government as a balance sheet manager

Our understanding is there are four key concerns about the Government adopting this course. In no particular order of importance these concerns are:

- The creation of an easily accessed pool of funds for “inappropriate” Government spending;
- The risk of experiencing financial loss on the portfolio;
- The diversion of scarce public sector resources to the management of the fund; and
- The potential impact on local markets of the fund’s investment decisions.

None of these concerns are trivial but they are all surmountable in our view. Suggested possible solutions, taken in turn, could be:

- To alleviate concerns that the pool of financial assets would be “raided” for “inappropriate” activities we suggest that the asset fund is set up with a designated purpose and legislation that requires any capital draw-down from the fund to be directed to that purpose. If returns from the fund exceed the associated interest bill on the matching CGS then the difference would be available to Commonwealth general Government budget (just as the net of Telstra dividends and the PDI from the CGS outstanding equivalent to the value of the Government’s Telstra holding is currently available to the budget). On the other hand, if fund revenues fall short of the CGS interest bill, the difference would have to be met from the budget.
- Risk of financial loss can be minimised or largely eliminated by choice of asset (restricted to cash or short duration fixed interest) or by investing in a diversified portfolio and purchasing an income/capital guarantee overlay, e.g. paying away any upside above a certain level in return for a guaranteed minimum return. Such “insurance policies” are increasingly been used by insurance companies that provide guaranteed income products and corporates that run defined benefit pension funds;

- While any change in policy requires additional public sector resources, international experience suggests that central banks are well positioned to take on the role of asset manager for the government in the first instance. Central banks already undertake the role of an asset manager for Government through their holdings of foreign reserve assets and also act as an asset manager by default for budget surplus governments who accumulate cash holdings. (In fact we note that the experience in Australia has been that the RBA has acted as a balance sheet manager for the Government, running down Treasury note issuance and using the accumulating cash balances as a source of liquidity instead); and
- A government portfolio of the size implied by the discussion above is unlikely to provide significant risks of market imperfections in any particular asset provided foreign assets (hedged back into AUD) are held as part of a well diversified portfolio. This assertion rests on the assumption that the Government achieves its medium-term fiscal strategy of a balanced budget over time, rather than accumulating excessive underlying cash surpluses.

Section 4

Conclusions

Our concern over the prospect of the disappearance of the CGS market is not directly with trading in the CGS market itself. Rather, we see CGS as providing an important building block for a large range of financial market transactions.

While we accept that substitutes will evolve in the event that CGS disappear we believe that the efficiency of the Australian debt market could be seriously affected and these substitutes may well be overseas. This will have an impact on the cost of transactions and, as a consequence, on the type of transactions that occur and their location. Australia risks becoming a branch office economy for the distribution of financial products and services developed elsewhere.

As well, there could be implications for a range of Australian financial market products when disruptions to markets occur and/or “safe haven” assets are sought. The Australian financial market has proved to be very robust in the face of a number of external shocks over the past few years: the Asian debt crisis, the Russian debt crisis, the LTCM problems and the collapse of equity prices to name just a few, and the role that the CGS and attendant futures market has played in this should not be understated.

We believe it is vital that any proposal be robust in the face of such external shocks. We also have to be aware to the possibility of domestic shocks that might significantly alter the fiscal outlook for the State governments or Commonwealth, for instance, or the health of the domestic banks. Again, the proposed structure needs to be robust in the presence of a large range of possible outcomes.

Our concern is that by eliminating CGS the ability of Australian financial markets to respond to these many and various risks in a relatively low cost and efficient manner will be compromised in a serious manner.

While not without its own risks, a deliberate and clearly enunciated policy of asset accumulation to maintain sufficient CGS on issue to support the efficient pricing of the 3 and 10 year futures contracts appears to us to be the lowest risk option available to the Government in this situation.

We therefore strongly recommend that the Government makes a decision to commit to maintaining a viable CGS market as a result of the current review process. Given that uncertainty is highly debilitating for financial markets it is important in our view that the Government reaches this decision in accordance with the announced timetable. A delay would risk many of the negative consequences of falling debt market liquidity without any material benefit to the Government or economy in general.