Review of the Commonwealth Government Securities Market
A Plea for its overdue Revival
by
A R Hall

1. The Government's discussion paper *Review of the Commonwealth Government Securities Market* is focused on this market simply in the role it provides as a form of safe security which is the base of, and the maturity structure for, the whole national set of interest rates. It recognizes that, as such, it is an efficient market. The *Review's* blinkers do not allow it to acknowledge that a government bond market can, and did in the past, serve other government purposes of national economic policy. Its use as a benchmark for interest rates was a by-product of those purposes not its *raison d'etre.* There are good reasons to believe that the purposes for which the government bond market was originally developed are not extinct. They are merely in abeyance at the whim of current fashions in economic dogma which, unfortunately, appear embedded in the Treasury and hold unthinking sway over the present Government. This note is a brief reminder that if the present Commonwealth Government Securities (CGS) market is destroyed the long term requirements of efficient government economic policy are such that it will have to be re-invented. The costs of its death and re-incarnation in terms of human capital, and of the temporary re-arrangements of the inter-related, well functioning, private financial institutions, are unlikely to be negligible.

Why is the market deemed doomed?

2. If there is a continuing role for the CGS market then what needs examination is not the question can suitable private financial substitutes be found but what are the reasons for the belief, inside and outside the Treasury, that a continuing efficient CGS market is doomed?

3. One reason is the apparent Government view that debt repayment is an extremely worthy use for dissipating the sales proceeds of capital assets. This is an expression of a political philosophy, not of economic necessity. It remains to be seen whether there are sufficient remaining marketable Commonwealth assets completely to wipe out the CGS market. Another is the view that the implementation of the government's Medium Term Fiscal Policy (MTFS) means that there will be no trend increase in the stock of CGS. MFTS is the doctrine that budgets should be balanced over the course of an economic cycle. By itself, as interpreted by the Government, this policy means no long term increase in the size of the CGS market. This prospective stable size, in the context of a growing economy and growing financial markets, is expected to undermine the efficiency of the CGS market as a financial benchmark.

4. This view is strengthened by an ambiguity in Government thinking in its *Charter of Budget Honesty Act 1998* which requires "maintaining fiscal surpluses over the forward estimates period while economic prospects remain sound". This seems

reasonable enough but what Treasurer is going to anticipate a forthcoming recession when there are no obvious clouds in the sky? The practice of forward estimate surpluses, not always realized in practice without fudging, biases the whole system towards an expectation that continuing surpluses are always reasonable outcomes in which case the CGS market would grow smaller and its efficiency decline still further.

5. The *Review* focuses on the wider financial implications of this prospect. It acknowledges the efficiency of the existing market and the private financial market concerns about any further declines in the CGS market. It considers the possibility of developing substitute private financial market instruments such as interest rate swaps and Treasury bond futures. Its discussion of them gives the impression that they are realistic alternatives though there must remain doubts that they will operate as effectively in the absence of an efficient CGS market as they do in its presence. It also explores the possibility of an increase in CGS simply to maintain its efficiency with the unwanted-by-the-Government proceeds re-routed to the purchase of private sector financial assets at home or abroad. The most realistic of these is the diversion of the sales proceeds into funding the Commonwealth's unfunded superannuation liabilities. Whether that would be a wise use of private sector saving is not seriously explored.. One gets the impression that it is believed that private financial market stakeholders are unduly worried about their ability to cope with whatever does happen and that the demise of the CGS market is unlikely to be a matter of great concern.

6. It is the theme of this paper that the weakening of the CGS market has been a serious mistake and that it can be restored to much needed growth in a fiscally responsible way. Detailed comment on a series of financial red herrings is therefore unwarranted. It is, nevertheless, relevant to an appreciation of the positive role of the CGS role to recognize some of the shortcomings of the *Review*'s doomed bond market arguments.

7. The forecasting bias mentioned in paragraph 4 above strengthens expectations, not necessarily outcomes. There are inevitable differences between intentions and realizations. The MTFS is proclaimed in terms of economic 'cycles'. This suggests both regularity of phases and equality of amplitude of fluctuations. Neither of these characteristics is evidenced by actual economic fluctuations. The recession of the early 1990s was more demanding of deficits than the subsequent prosperity has been of purely fiscal surpluses. Considered only in fiscal terms the last decade remains a net fiscal deficit. The theory of medium term fiscal balance has not been realized in practice. Despite the substantial proceeds of assets sales the outstanding fiscal debt in 2001-02 is still greater than at the last prosperity peak. In terms of actual fiscal management there has been a continuing need for an *increased* stock of CGS. The possible rejoinder that the Government's version of fiscal strategy was not in place throughout this period is true but this does not necessarily mean that outcomes would have been very different. Moreover, one cannot rely on all governments enjoying more than a decade of continuing office.

In general, despite the forecasting bias, one should probably expect MTFS short term deficits to be pursued more vigorously than its short term surpluses. This would result in a long term rising trend in the stock of CGS. In practice it is not demonstrated that a MTFS will result in a stable stock of CGS.

8. An argument that appears at a number of points is that interest rates will decline if the stock of CGS is reduced. This is based on a situation, taken in isolation, in which a reduction in the supply of CGS raises their price and consequentially reduces interest rates. This in turn is anticipated to spread to near substitutes and hence to the economy as a whole. This argument is based on quite illegitimate *ceteris paribus* assumptions. Apart from Reserve Bank changes in interest rates at the short end of the market, which will only be sustained if the changes are roughly in line with general market conditions for the supply of, and demand for funds, it is the whole range of circumstances affecting the latter, not just the yield on CGS, which determines the level of interest rates. To ascribe aggregate interest rate changes, and growth of national output benefits, to a reduction in the stock of CGS is quite misleading and amounts to special pleading.

9. A more irritating lapse in economic argument, one can hardly call it analysis, occurs in the discussion of the relationship between the CGS market and foreign capital. It runs: "Since the Government is not investing more than it is saving (and therefore not borrowing by issuing CGS), it does not require additional foreign capital inflow. Instead, private sector savings and investment decisions will determine whether additional foreign capital inflow is required". (p. 64) This simple manipulation of aggregate economic accounting identities has no economic behavioural meaning. The determinants of the economic structure, which is described in the national accounts, are the rate of growth of aggregate expenditure and the relative costs of Australian production to those abroad. These relationships are influenced by changes in the terms of trade and in the relative attractiveness of overseas investment in Australia. The necessary adjustments occur through changes in profit expectations, in real wages, and interest rate differentials. The aggregate national accounting outcomes merely measure the consequences of these processes. They, in themselves, cannot be manipulated to produce some desired rate of change and structural pattern of economic events.

10. A much more realistic approach to the government's role in capital inflow is along the following lines. So long as the Australian community is not prepared to increase domestic saving to the extent necessary to avoid reliance on overseas saving (= overseas capital) then Australia must tap that saving. The exact mode of doing so is a secondary consideration. In a growing economy any given degree of reliance on overseas saving requires a continuing increase in overseas funds. Both the amount and stability of overseas supply are not guaranteed. The security of supply is probably enhanced if the portfolio of overseas holdings ranges across the safety/risk spectrum. This is important in a world in which short-term capital flows may be large and capable of damaging even well-run economies. The cheapest way to obtain part of the necessary supply of overseas funds, and at the

same time avoid foreign exchange risk, is overseas purchases of CGS issued in Australia. To deny ourselves this form of saving because of manipulation of national accounts identities verges on the absurd.

Towards a rational medium term fiscal strategy and revival of the CGS market

11. It is now time to examine the reasons, completely neglected in the *Review*, why an expanding CGS market makes a positive contribution to the growth and efficient management of the national economy. The growth of this market is necessary for, but quite distinct from, its present vital role as an efficient financial benchmark for both real investment and private financial market purposes. The setting for this discussion can be provided by a thumb-nail sketch of the economic history of the CGS market.

12. The origins of the present CGS market may be traced back to the 1890s when the colonial governments of the day found the London capital market more or less closed to them as a source of funds for public sector capital formation. Even then prevailing conventions wisely required governments to match *current* spending to current revenue. As the need for public capital formation remained the colonial governments, soon to be states, began to issue government securities on the domestic market to provide the necessary investment funds. (What would the present Australian Treasury have advised? Sell their railway systems?) By the eve of World War I the local market had come to provide about 30% of total outstanding government debt. It was, however, for wartime financial purposes during World War I that a major increase in CGS occurred and in doing so began to provide the basis for a national financial benchmark market. It was the much greater financial needs of World War II that gave rise to the scale of market upon which financial markets have built the now existing, complex superstucture.

13. The Government makes much of its contribution to the process of micro-economic reform, not always acknowledging that it is building on the work of its predecessor. One dimension of an efficient micro economy is that it has access to an efficient capital market in which the level and structure of long term interest rates and associated patterns of risk premia are clearly established. Australia has such a market which has been built up on the foundations of the Commonwealth Government capital market. If the Government ceases to use that market for its own capital purposes it runs the risk of signaling invalid messages for the determination of the national market long term rate of interest . This is quite aside from the consequences of destroying the efficiency of the benchmark characteristic of the AGS market. On both accounts it is possible that the Government may be weakening the efficiency of the whole micro-economic system.

14. The reasons why the *Review* examines the CGS market, simply as a financial market without a wider positive public finance role, arise out of present Government policy and the accounting conventions it is using to implement it. The *Review*'s discussion is constrained by two circumstances. The first is: "The Government will not consider options that build budget deficits to maintain the Commonwealth Government Securities (CGS) market." (p. 75) The second is the measurement of the fiscal balance and hence budget 'deficits' by an accounting convention which includes capital outlays (euphemistically described as 'non-financial' assets) as part of total current government expenditure.(p. 76) This is neither being transparent in the use of words nor economically justifiable.

15. It is true that in the general government economic sector the line between current and capital expenditures is somewhat arbitrary. The whole of educational spending could be described as investment in human capital the yield on which, to the government, comes in higher than otherwise taxation revenue in the future. Much of environmental outlays could be reported as investment in endeavouring to maintain the existing capital stock of biodiversity. Whether or not distinctions of this type have practical budgetary significance the Government allocated $4.16b. in 2001-02 on capital outlays by portfolio.

16. It is within the discretion of governments to fund their capital outlays from current revenues. It is also within their economically legitimate discretion to do so through the issue of CGS. The relevant issue here is not whether to use one method to the exclusion of the other but which one or which combination of them both should be preferred in any given set of circumstances. To use only one method, which is having the effect of destroying the traditional vehicle for government capital funding, demands a much more satisfying explanation than can be found in the *Review*.

17. "The other OECD economies that have well-developed financial markets operate with a significant government debt market. These economies have a much higher stock of government debt than Australia." (*Review* p. 1)

18. The reasons why governments (other than the current Australian one) develop and maintain markets in their long-term debt obligations are well known. Some of the reasons need itemizing here only because the Treasury's *Review* has given scant attention to the economic functions of the CGS market. They are:

    (i) They provide a means of tapping private sector savings to enable a level and rate of capital formation, and other long-term needs, that may not be realizable through taxation.
    (ii) They provide a more equitable means of sharing the costs of such spending across generations than is possible through taxation.
    (iii) The size of the market, and the safety of its securities, enable it to become the benchmark for the level, maturity structure, and standard for the assessment of risks for private financial markets and the micro-economy.

(iv) Its domestic issues may appeal to overseas investors and provide the cheapest source of overseas funds while remaining free of foreign exchange risk.
(v) The public issue of government debt gives some assurance that government capital requirements are properly incorporated into the determination of the overall cost of capital.
(vi) Their domestic issue can be associated with national savings campaigns designed to help raise the national propensity to save.

Is the real problem a shortage of national saving?

19. The ultimate source of aggregate domestic saving is the private sector. Government 'saving' is merely 'forced saving' through taxation of the private sector. Given the underlying assumption of competitive market theory that individuals know best what is good for them then the justification of forced saving through taxation must be that in respect to saving this is not true and that it is the Government that 'knows best'. This is not a proposition that one normally associates with the Liberal Party.

20. There are some, who have reservations about the complete rationality of individuals, who believe that, in respect to time, individuals tend to be myopic. In which case it is reasonable to believe that if individuals are left entirely to their own saving propensities the community rate of saving will be too low and hence that forced saving through taxation may be in the public interest. One suspects that this is the underlying rationale of the Government's mode of definition of current expenditure. It is feared that, if capital outlays are excluded (wholly or in part) from the definition of current expenditure, then the national saving rate would fall and even greater reliance would need to be placed on overseas savings.

21. How reasonable is this expectation? Consider the situation that the government of the day reverts to funding government capital outlays by the issue of CGS. It does so on the appropriate assumption for present purposes that the taxation revenue so released is returned to taxpayers. Some part of the income returned will be saved. Some part of the issue of CGS will be funded by overseas savings through the greater availability to overseas investors of a respected safe security. Whether the remaining part is consumed is still uncertain. The new issue of CGS, all other things being equal, will tend to raise interest rates though in practice this will depend on the size of the issue and the state of the capital market at the time when it is issued. If there is an increase in interest rates the ratio of private saving might increase. The extent to which this occurred would depend on the effectiveness of the associated campaign to encouraging community saving as part of the revival of the use of CGS. On balance some fall in the domestic saving ratio is likely.

22. At the same time it needs to be recognized that this is the initial impact effect of a re-arrangement of saving patterns. The medium term story might change. The

doubts about the future of the CGS are assumed to be dissipated. Private financial portfolio requirements for CGS might well be adjusted upwards. Part of the support for their re-use might take the form of a continuing vigorous advertising campaign to extol the virtues of saving in an attempt to wean the public off their media-supported credit card and property market binges. Saving ratios are not immutable and should be encouraged to increase. Support for a healthy CGS market is one means of doing this.

Is there a necessary rate of growth of CGS?

23. At this point it is appropriate to comment on one of the *Review*'s concerns – the necessary rate of growth of the CGS market in order to maintain its efficiency as a benchmark financial market. The *Review*'s discussion of this question appears to be designed to daunt supporters of retention of the CGS market. Thus it suggests that a plausible necessary rate of growth is the rate of growth of financial assets which in recent years has been about 12% per annum. (p. 72) One could pardon any government from hesitating to accept such a high target rate of growth for the CGS market. Fortunately it is a quite improbable one as an examination of the market's velocity of circulation over a decade or so would probably confirm. The record of history is that the basic stock of money has been a declining proportion of total financial assets for centuries. It would be surprising if the long-term trend of government bond markets didn't behave in a similar fashion. Just as market economies have been able to economize on the use of money so is it reasonable to expect that modern financial markets will be able to economize on the size of bond markets should that be necessary. There are plenty of signs that the Australian financial markets have been doing so in recent years. Rational use of CGS for the Commonwealth's long term investment purposes is unlikely to be any more than the rate of growth of current price GDP. If it should grow at, or below, this rate while the CGS market might fall below whatever might be its 'optimum' rate, and suffer some loss of efficiency in consequence, any potential problem on this account could no doubt be resolved by innovations in private financial markets. Moreover its non-financial-bench-mark functions would continue to exist. A well-working CGS market would still be well worth its economic weight in the former coin of the realm at less than perfect efficiency.

24. One illustration of how financial markets can adapt to a decline in CGS, let alone a slow rate of growth, is given in the *Review*'s account of the way in which the Reserve Bank has responded to the declining size of the market in recent years in its exercise of monetary policy (pp. 54-5). A growing CGS market would make it less needful for the Bank to spread its mantle over alternative securities while still taking advantage, when appropriate, of the greater liquidity of CGS securities.

War and defence

25. It is to be hoped that the really substantial historical role of the CGS market as a major means of managing the use of real resources during wartime will not be

needed again. Unfortunately at the time of writing this possibility cannot be ruled out. In conformity with the Government's view of CGS its preliminary thinking about this possibility appears to be a 'war tax' rather than through an economically useful patriotic CGS issue which would have the incidental effect of helping revive an ailing bond market. Even if war is averted the current signs are that Australia will have to divert more of its national expenditures to defence purposes. Does the Government think it wise that present taxpayers should shoulder the whole of this burden much of which will be of a capital nature? Isn't this one of those occasions when future generations may legitimately be expected to share the costs?

26. In allowing defence spending to be an acceptable use for CGS it is not envisaged that this would be a permanent function. Usually defence spending is appropriately charged to revenue. It is when sudden substantial increases arise that recourse to the AGS market may be in order. Whether or not defence spending is allowable there can be no, in principle, objection to using AGS to fund Commonwealth spending on social investment in the form of the capital needs of health , education and the environment. That this is so is implicitly recognized by the Government in its use, for a limited period, of part of the sales proceeds of public assets to fund environmental spending. This wise transfer of capital resources built up by past saving to present capital needs is only for a limited period. The need for further environmental investment on such needs as the salinity problem and the restoration of the inland rivers will extend well beyond this period. As the full benefits of this spending will only be reaped well into the future the spreading of costs across generations via interest payments has the full support of public finance theory.

Conclusion

27. The central argument of this paper is that there are at present, and are likely to remain in the future, sound public finance reasons for the continuing use of CGS to fund necessary Commonwealth social and economic investment in preference to relying solely on taxation or on ad hoc sales of a diminishing stock of Commonwealth public assets. The latter is, at best, merely a temporary device for hiding the need to place proper reliance on the CGS market as a legitimate source of Commonwealth government capital funding. If asset sales must proceed they must be employed in such long term investment purposes as their medium term use for environmental rehabilitation or for funding the Commonwealth's unfunded superannuation liabilities.

28. Recognition of the independent need for a CGS market is a sufficient reason not to further weaken its financial market role on the narrow twin altars of asset sales, for which there is no better use than debt repayment, and medium term fiscal policy based on the failure to make a transparent distinction between current and capital spending. It is this combination, and only this combination, which is

responsible for any diminution of efficiency that has recently occurred in the CGS market, and its prospective demise that the *Review* is clearly anticipating.

29. It is ironic that, to date, the chief objectors to the Government's impending destruction of its own bond market should be private financial markets. It is easy to dismiss their concerns on the grounds of self interest. On the other hand they are the interests with the best understanding of how the market actually works and who make most everyday use of its financial bench mark functions.

30. The case for the restoration of the traditional non-benchmark roles of the CGS market is not based on narrow 'stakeholder' self interest as hints in the *Review* suggest. In pursuing its death the Government has apparently been receiving very poor economic advice.

31. A deficit under the Government's medium term fiscal strategy is defined as an excess of current expenditure over current spending. If these words meant what they appear to say, the strategy would be unexceptional. But this is not how the strategy defines expenditures. They include the Government's capital outlays and, **under this definition**, are starving the CGS market of its legitimate growth fodder. Expenditure from the proceeds of an issue of CGS does **not** entail a deficit. These expenditures are matched by current receipts and are financed from private saving and/or oversea saving. The time is long overdue when the Government recognizes this fact and begins to use the CGS market for supporting the Commonwealth's long term investment program. This is the independent and fully responsible way of restoring the CGS market's capacity to fulfill its king-pin role for the Australian financial system and for the real micro-economy; for providing a platform for maintaining public awareness of the need for saving as a means of countering the media's dedicated bias towards the alleged benefits of borrowing-in-order-to-consume; and for providing what is likely to be an indefinite need for a more-or-less stable supply of overseas capital.