Australian Government Debt in Interesting Times

Presentation to the Australian Business Economists, Sydney, 20 May 2010 by Neil Hyden, Chief Executive Officer, Australian Office of Financial Management

I thank the ABE for hosting this function. The ABE also nominated the title for my presentation today; I have been wondering what exactly you meant by it. In China, "may you live in interesting times" is reputed to be a traditional curse; after what we have seen in global financial markets over the last two years, I can understand why they may see it that way.

Australia has been relatively well placed to deal with the shocks that have affected global markets. Our banking system is strong, with little exposure to risky investments. Both monetary and fiscal policy were able to react quickly and decisively in response to the external shocks. Our level of sovereign debt remains very low compared with other OECD countries. And the strong momentum of growth in our major trading partners in Asia has continued largely uninterrupted.

I don't propose to talk today about the Australian economy. Last week's Budget and the accompanying Budget documents provide a comprehensive account of the Government's assessment of the current economic outlook – and most of you will have attended the talk which the Secretary to the Treasury gave to the ABE on Tuesday.

I will concentrate on three topics: the AOFM's issuance program for the year ahead; the longer term prospects for the Australian sovereign debt market; and an update on the AOFM's activities in investing in residential mortgage backed securities and in establishing a public register of the country of ownership of Commonwealth securities.

Planned Issuance in 2010-11

Our issuance program for 2010-11 comprises around $56 billion of Treasury Bonds and $4 billion of Treasury Indexed Bonds. In total, this is similar to the issuance in the current financial year, where (with just six weeks to go) we expect to have issued around $53 billion of Treasury Bonds and $6.1 billion of indexed bonds.

Table 1: Planned Issuance ($ billion)

	2009-10	2010-11
Gross issuance of bonds		
Treasury Bonds	53.0	56.0
Treasury Indexed Bonds	6.1	4.0
	59.1	60.0

This small increase contrasts with the large reduction in the Budget deficit that is forecast to occur between the two years. The table below shows how this difference arises.

Table 2: Planned Issuance and Net Funding ($ billion)

	2009-10	2010-11
Gross issuance of bonds		
Treasury Bonds	53.0	56.0
Treasury Indexed Bonds	6.1	4.0
	59.1	60.0
plus		
Net increase in Treasury Notes	-5.9	14.2
	53.2	74.2
less		
Maturities and repurchases of Bonds and Indexed Bonds	6.7	19.5
Net increase in short-term financial assets	-14.0	2.5
Net increase in RMBS	2.6	4.5
Other financing	-1.3	-0.3
	-6.0	26.2
Financing of headline cash balance	59.2	48.0

The difference is more than accounted for by bond maturities and repurchases, which will be much higher next year than this. Two Treasury Bond lines mature next year, together with an indexed bond line, compared to only one this year. Also, maturing bond lines are growing in size as we issue more bonds.

As the table indicates, this is not quite the whole story, as other changes are also occurring. In 2009-10 we have run down our holdings of short term financial assets, thereby meeting part of the Budget funding requirement and reducing Treasury Notes on issue. Next year, we will not be able to do this, and we will need to increase Treasury Notes to cover our within year cash management needs. However these changes are largely offsetting across the two years.

In summary, a smaller Budget deficit next year will be offset by increased maturities. As a result, the net increase in bonds on issue will be smaller next year than this, but gross issuance will be similar across the two years.

Treasury Bonds

The proposed issuance of Treasury Bonds next year is higher than this year ($56 billion compared to $53 billion) but we expect it to continue to absorbed relatively smoothly by the market.

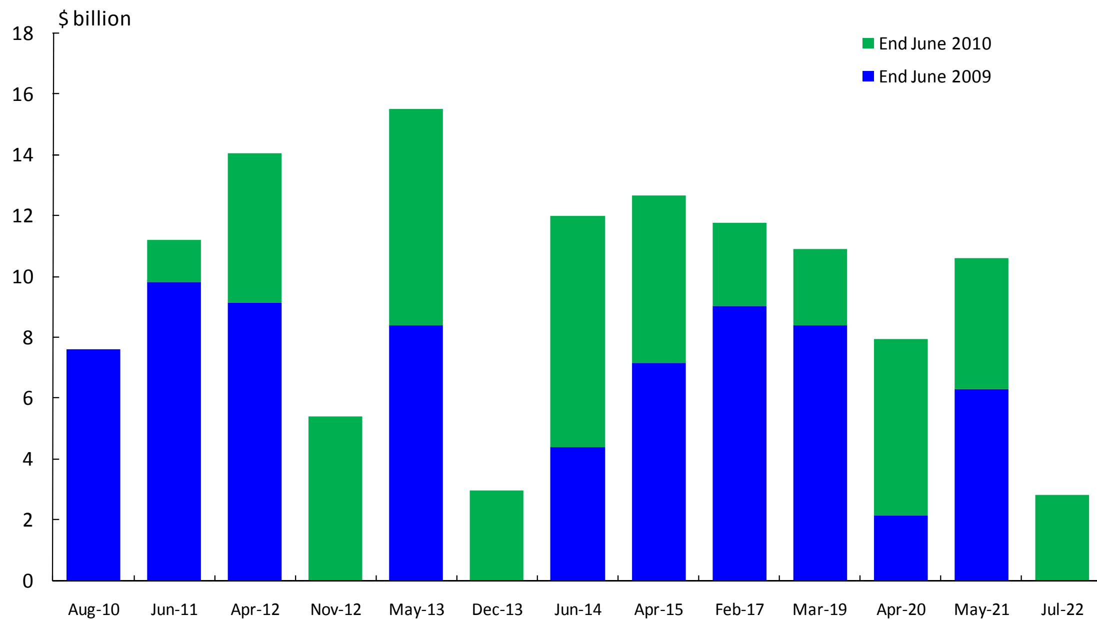
In 2009-10 issuance has been spread over the existing bond lines and three new lines, as shown in chart 1.

This strategy has been driven by two key objectives:

- First, to build up the liquidity of the bond lines to make them attractive to large global investors. Two years ago, our largest bond line was less than $6 billion; by the end of June we expect to have eight lines with each around $10 billion or more.
- Second, to manage refinancing risk and the cash management task when individual bond lines mature. To this end, we are limiting the further growth of the largest lines. This year

we started two new lines (maturing in November 2012 and December 2013) to relieve the pressure on the lines with maturities adjacent to them.

Chart 1 – Treasury Bonds on Issue 2009-10



We will continue these strategies in 2010-11. Issuance will continue to be spread over existing bond lines nad some new lines. We intend to launch two new lines maturing in November 2014 and June 2016, which will allow us to fill and cap the adjacent lines.

We also intend to launch two new Treasury Bond lines maturing in February 2023 and March 2025. This will extend the curve to 15 years.

Some other sovereigns issue bonds with much longer maturities, and we have considered whether we should do so.

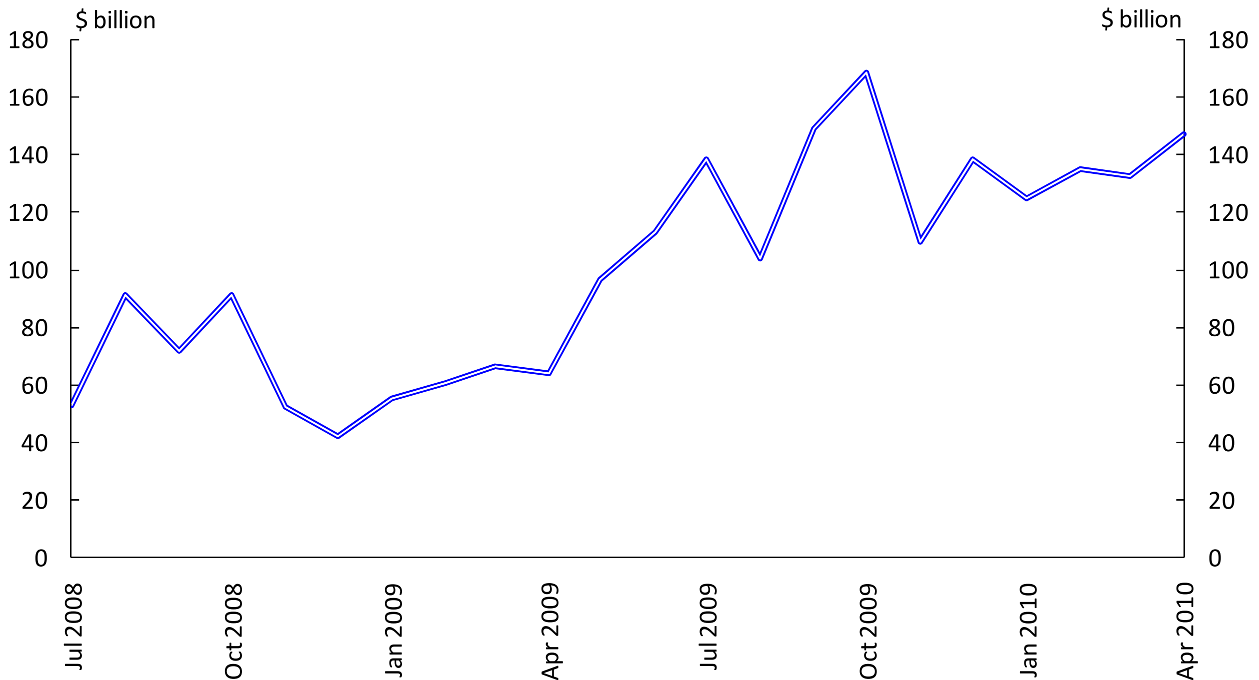
Last year's Budget papers indicated that the AOFM would explore the use of other financing instruments in consultation with market participants. We consulted widely at that time on the potential for longer maturity bonds. The views expressed were mixed and we decided against extending the curve for Treasury Bonds at that stage.

However there are indications that the issue last year of a Treasury Indexed Bond maturing in 2025 has increased market interest in a nominal bond with a similar maturity, both domestically and overseas. The proposed issuance of new lines maturing in 2023 and 2025 will extend our range of issuance options, offset the normal aging of the portfolio, and help manage refinancing risk.

Next year we will continue to issue Treasury Bonds by tender, with two tenders per week in most weeks, and deciding each week on the size and choice of bond lines to be offered the following week. This provides us with flexibility to respond to market conditions and investor demand, while maintaining a desirable overall maturity profile.

Over the past year the growth and quality of the market has attracted new market-makers and investors. These new participants, in turn, have further enhanced the liquidity, efficiency and competitiveness of the market. Treasury Bond market turnover also increased (Chart 2). We expect these conditions to continue next year.

Chart 2 – Treasury Bond market turnover



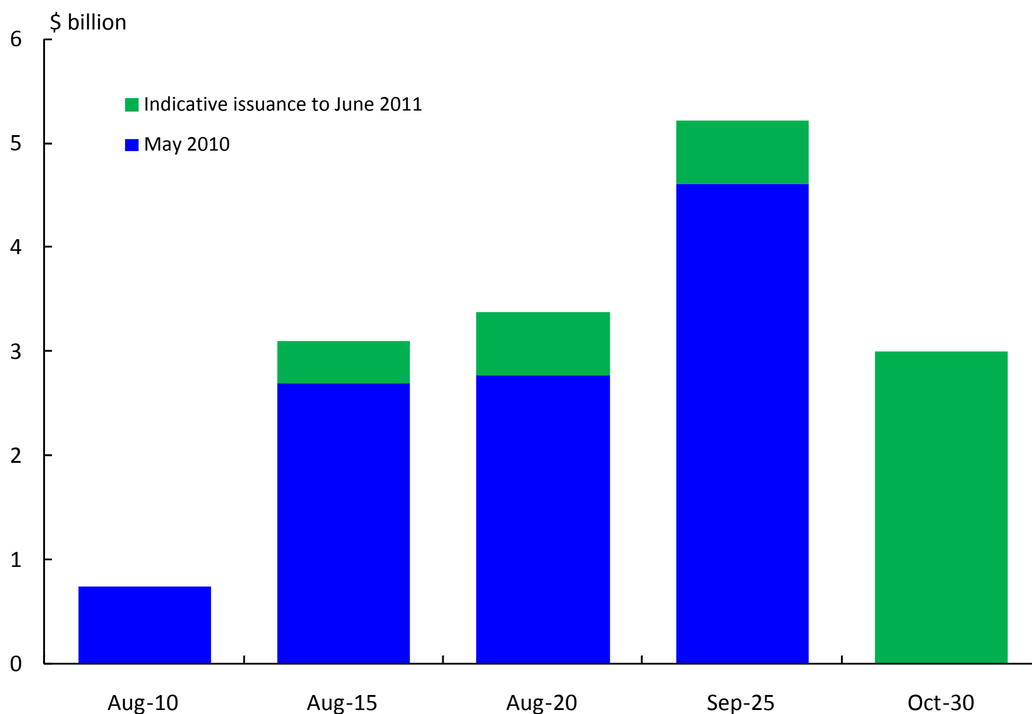
Treasury Indexed Bonds

We recommenced issuing Treasury Indexed Bonds (TIBs) in September 2009 with the syndicated issue of $4 billion of a new line maturing in September 2025. This revitalised the market. Since then we have continued to issue through monthly tenders into the existing lines and the new line. Overall gross issuance of TIBs for the year is expected to be around $6.1 billion, with net issuance around $5.4 billion (face value).

We plan to continue this approach in 2010-11, with a gross program of around $4 billion, including a new line maturing in 2030. The initial issue of the new line is likely to be by a syndicated issue.

The new line will extend the yield curve for TIBs out a further five years, widening our future issuance options and building up the indexed market in Australia. In addition, other potential issuers of indexed bonds may be encouraged to also issue into this part of the curve.

Chart 3 – Treasury Indexed Bond Indicative Issuance 2009-10 and 2010-11



We will also hold monthly tenders for indexed bonds except in December and the month when we launch the new issue. We think that the holding of regular monthly tenders is important for the liquidity and smooth functioning of the market for TIBs. It means that there is a steady stream of new issuance. Market-makers can be confident that, if they are short on a particular bond line, there will likely be more coming into the market within a month or two. In this regard, the AOFM aims to be responsive to market conditions in its selection of the bond line to issue each month.

The monthly TIB tenders we have held this financial year have been for $300 million each. Given the planned smaller size of the overall TIBs program, the average size of the monthly tenders will be smaller next year. The size of the monthly tenders is will have to be balanced with the size of the initial issue of the proposed new 2030 line, which will not be finalised until the time of the issue. On the one hand, we want the new line to be reasonably liquid when it is launched; on the other, we want to maintain the liquidity of the overall market through the monthly tenders.

Infrastructure Bonds

In April 2009 the Government announced that its investment in the national broadband network would be partly funded by the issuance of Aussie Infrastructure Bonds to both household and institutional investors.

The 2010-11 Budget papers indicate that next financial year Aussie Infrastructure Bonds will finance $300 million of the Government's investment in NBN Co.

The component of this funding to be provided by institutional and other wholesale investors will be through the issue of CGS as part of the Government's overall debt issuance. These bonds will

not be identified separately from other CGS at the time of issue, but will be reported in the annual budget statements.

The Government is considering possible arrangements for issuing retail Aussie Infrastructure Bonds.

Treasury Notes

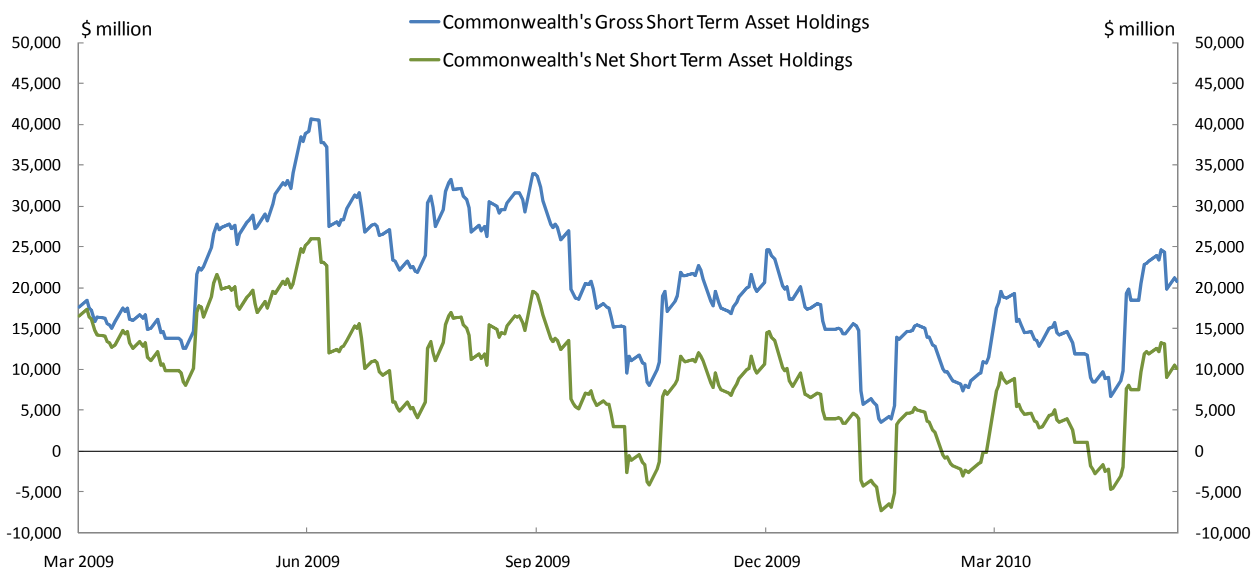
Treasury Notes are short term securities that we use to manage the Government's within year funding. There are substantial differences in the timing of cash inflows and outflows over the course of the year, and on some days the net flows exceed $10 billion.

For many years, we were able to perform the cash management task using transactions in short term assets (term deposits with the Reserve Bank and money market instruments with banks) that had accumulated from past Budget surpluses and asset sales. This was a relatively unusual situation that arose because a large volume of these assets had accumulated from Budget surpluses and asset sales. Since then, these short term assets have been drawn down as governments used them to establish the Future Fund, the Building Australia Fund and other nation building funds.

We therefore needed to return to the more standard methods of cash management using both short term assets and liabilities, and in 2009 we resumed the issuance of Treasury Notes.

Chart 4 shows the daily volume of short term assets and this volume less Treasury Notes. The gap between the two lines represents the volume of Treasury Notes on issue. This volume varies over the course of the year depending on the government's cash flows, but we have undertaken to keep a minimum of $10 billion on issue in order to maintain an on-going market. The volume on issuance is currently close to this minimum, at around $11 billion.

Chart 4 – Short Term Asset Balances



Next year we intend Treasury Notes to have a bigger effect in smoothing the week to week fluctuations. Having three bond lines mature during the year will add to that task, and the variability in the volume of Notes on issue is likely to be greater next year than this.

The timing of cash flows is always difficult to predict and is subject to constant revision over the course of the year. Currently we expect to end 2010-11 with around $25 billion of Notes on issue.

Longer-term Prospects: Beyond 2010-11

The Budget papers project Government financial flows over the forward estimates period to 2013-14. They project a progressive reduction in the deficit and a return to surplus in the underlying cash balance in 2012-13. I am conscious that investors and other market participants are very interested in what this will mean for the future of the Treasury Bond and Treasury Indexed Bond markets.

The progressive reduction in the Budget deficit and return to surplus will bring a reduction in the net issuance of Treasury Bonds and Treasury Indexed Bonds. The gross issuance of bonds will also fall, but not as quickly due to the need to fund maturities of previously issued debt. This is shown in Table 3. Note that bond maturities are projected to exceed gross issuance in both 2012-13 and 2013-14.

Table 3: Projected Bond Issuance and Net Funding ($ billion)

	2009-10	**2010-11**	**2011-12**	**2012-13**	**2013-14**
Gross issuance of bonds	59.1	60.0	25.0	29.5	21.0
Net increase in Treasury Notes	-5.9	14.2			
	53.2	74.2	25.0	29.5	21.0
less					
Bond maturities	6.7	19.5	14.1	29.9	27.9
Net increase in RMBS	2.6	4.5	-2.7	-2.8	-2.7
Other	-15.3	2.2	-1.0	0.2	-0.1
Financing of headline cash balance	59.2	48.0	14.6	2.2	-4.1

This year's Budget Statement 7 includes a brief discussion of the future of the market for Australian Government bonds. It recognises that the existence of an active and efficient bond market alongside the banking system strengthens the robustness of the financial system and reduces its vulnerability to adverse shocks. And it restates the Government's commitment to ensuring the effective operation of Australia's financial markets and to maintaining an efficient and liquid CGS market to provide a sound foundation for Australia's financial system.

Global sovereign debt markets

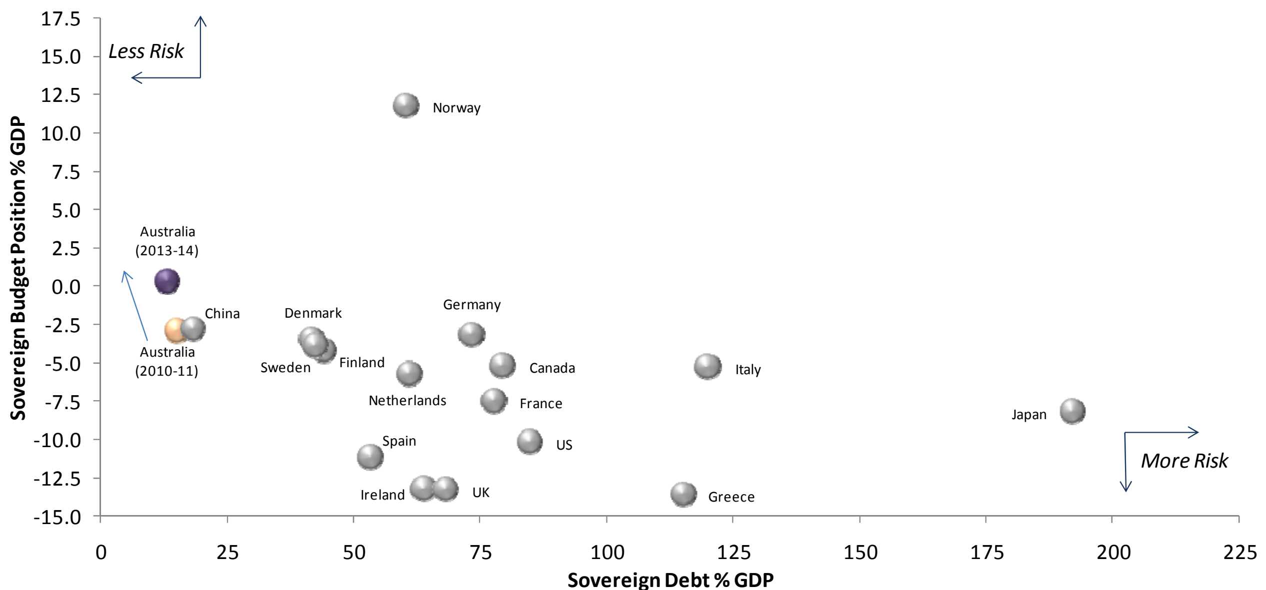
Another question confronting global sovereign debt markets at present is how they will digest the large volumes of debt that major overseas governments are issuing to fund their fiscal deficits and their support of financial systems.

I can assure you that we are monitoring developments closely. However, Australia appears to be relatively well place to weather any squalls that may develop. As I indicated in opening, our

banking system is strong, economic recovery is well under way, fiscal and monetary settings are returning to normal, and the strong momentum of growth in our major trading partners in Asia has continued largely uninterrupted.

Chart 5 illustrates two aspects of our exposure to disturbances in sovereign debt markets. Australia is firmly at the less risky end of the spectrum, and moving in a favourable direction.

Chart 5 – Sovereign Debt and Budget Position vs. GDP



Public Register of the Beneficial Ownership of Commonwealth State Government Securities

Legislation passed by Parliament last year requires the AOFM to publish each quarter a register of the beneficial ownership, by country, of all securities issued by the Commonwealth and any securities guaranteed by the Commonwealth that are issued by Australian States or Territories. I expect that the first register will be published soon on our website.

The legislation contains no provisions to compel the provision of information to the AOFM by the beneficial owners of securities or by persons holding securities on their behalf. This has limited the information in the register. In particular:

- There is no information on securities held by custodian and nominee companies.

- Some information has been made available to the AOFM on the condition that it will not be published in a form that would allow individual holdings of securities to be identified. To meet this condition, countries have been grouped together by region in most cases. Investors may be assured that individual holdings can not be identified from the register.

Residential Mortgage Backed Securities (RMBS)

Developments in global financial markets since 2007 led to dislocation in the Australian residential mortgage backed securities market. This in turn reduced competition in lending for housing from those lenders who depended significantly on RMBS for their funding. In October 2008 the Government directed the AOFM to invest $8 billion in high-quality Australian RMBS to support competition in lending for housing. This amount was increased by a further $8 billion in October 2009, when the objectives of the program were expanded to include lending to small business.

So far, the AOFM has invested around $8.7 billion in 26 RMBS transactions, sponsored by 14 different issuers. A further $3.15 billion has been committed to future issues under serial arrangements. Proposals are also being received under a reverse inquiry process.

Conditions in the RMBS market have improved significantly since the inception of the program. Investors (both domestic and offshore) are returning and investor sentiment has improved. The secondary market overhang has abated. The share of other investors in RMBS issues supported by AOFM has increased from around 20 per cent in late 2008 to around 80 per cent in the first months of 2010. However the market remains sensitive to shifting market attitudes towards credit risk and is not yet sufficiently robust to support sustained competition in mortgage lending.

The extent to which the AOFM participates in individual issues depends on the circumstances of each transaction. In some cases support from other investors has led to an increase in the size of an issue; in other cases, the size has been limited by the underlying mortgage pool and the full amount offered by the AOFM has not been taken up.

We continue to work with issuers, arrangers and other investors on strategies to improve access to RMBS markets, facilitate further investments by both domestic and offshore investors, and make RMBS a more competitive source of funding for housing for a diverse range of lenders. In particular, we are working with these parties to bring innovative RMBS structures to the market. We are aiming, in this way, to further encourage investor demand and to advance the role of RMBS in supporting competition in lending for housing and lending to small business, while maintaining their status as high quality safe investments.