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Commonwealth Debt Management Review
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PARKES ACT 2600

ICAP submission on the Review of the CGS Market

ICAP welcomes being given the opportunity to comment on what clearly is a very important issue not only for the health of the domestic financial market but also for the functioning of the overall economy. The bond market has provided ballast for the entire system as the Australian economy has matured and met numerous challenges.

As reviewed in the Discussion Paper, the amount of government bonds on issues has been reduced in recent years. Financial markets are quite capable of taking such incremental change in their stride. It is quite another matter to determine how effectively and efficiently the system would operate without any CGS, or in fact at what level of outstanding paper does it cease to fulfil its key roles. The Review, accordingly, provides a very valuable opportunity to thoroughly analyse all the possible implications and avoid the possibility of a decision being taken by default.

ICAP is the world's largest interdealer broker in derivatives, bonds and money markets. ICAP's Asia-Pacific arm is headquartered in Sydney.

In preparing this Submission, we have drawn on the knowledge of a group of highly skilled and experienced individuals. Many of our staff have been at the forefront of the innovation that has taken place in financial markets over the past two decades. The Submission places those views in a broader context. Financial markets will adapt to any changes that may be forthcoming in the issuance of CGS. The critical issue is at what cost to the overall economy and community.

Please do not hesitate to contact us if we can be of further assistance.

Yours sincerely



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ICAP's Submission to the Review of the Commonwealth Government Securities Market

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1. OVERVIEW

ICAP welcomes the opportunity to comment on the Federal Government's Discussion Paper on the Review of the Commonwealth Securities Market. This is an extremely important matter for the effective provision of financial services throughout the economy and community. ICAP encourages a broad debate that extends well beyond those in the financial sector who are narrowly involved in delivering such services in order to produce fully informed decisions on the future of the CGS market.

Financial markets have proved to be adaptable and would cope in a world without government bonds. The vital issues relate to, firstly, the extent to which financial markets would perform their functions less efficiently and less effectively, and secondly the extent of any difficulties that may be involved in keeping CGS on issue.

The core functions currently performed by CGS that would be most called into question include the pricing of long-dated securities, the provision of cost-effective risk management of, especially, long-dated investments throughout the economy and the ability of the domestic financial sector and, in turn, the economy to operate as smoothly as possible in times of financial crisis. No alternative to government bonds performs these tasks nearly as well as revealed by the lack of inroads made by other financial instruments in these areas.

Sections 2 and 3 provide responses to the specific questions raised in the Discussion Paper. Section 4 places the issues into the broader context of how an efficient and effective financial system provides benefits throughout the economy and community.

Alternatives to Commonwealth bonds

The Discussion Paper at various points inquires about possible alternatives. Semi-government bonds provide an option given the similarity in credit ratings. However, while they are a useful complement to CGS – and would become even more useful if steps were taken to allow the two markets to be better integrated – semis alone would prove to be a poor substitute. The failure of a futures contract for semis to be established in the 1990s demonstrated the advantages of CGS while the amount of semis on issues would make it difficult to establish a deep and transparent market.

The quite rapid expansion of corporate and asset-backed paper that has been recorded over the past few years is likely to continue and these markets will become progressively deeper (although, to date, their expansion in the domestic market has been aided by a robust CGS market). However, it is very difficult to envisage, say, corporate bonds assuming the role currently played by government paper in the core and most active parts of the system (notably repos, swaps and interest rate futures). The limited size of many issues especially beyond 5 years and their lack of uniformity would make for costly derivative instruments.

Instead, the most likely alternatives to develop in the absence of CGS would be based on obligations of the major commercial banks. Initially, it is likely that foreign sovereign paper would assume a significant role – the markets are well known and already active – with currency exposure being managed at a cost and largely through the banks or their involvement in OTC markets.

Over time, the swaps market based on the obligations of the major banks could evolve into a significant role. This will take some time – at present, interest rate swaps are priced as spreads over bonds and the demise of the bond market could well initially hurt the swaps market. But by using paper or obligations of the major banks, financial markets may be able to develop the necessary derivative products where monitoring costs are manageable and risks would be mitigated by implicit government guarantees (whether such guarantees be real or not). Market forces are thus likely to head in this direction.

A less effective system

Government bonds have proved to be the instrument of choice for many purposes and any alternative will add to costs and not perform the task at hand as well. However, quantifying the costs involved is intrinsically difficult. For example, the loss of transparency that would result is very real, and will alter behaviour, but it is far from clear as to how to measure the impact.

In our opinion, the most significant costs relate to the following three roles played by CGS (other issues are taken up in the following sections):

(1) Pricing, especially for long-dated securities.

The breadth and uniformity of the CGS market make it ideal for establishing benchmarks for prices throughout the market. It is a very competitive market, trading on narrow spreads with a wide group of participants and low transactions costs.

Any alternative to CGS would not provide as transparent pricing. At a minimum, the alternatives would suffer from credit risk that could vary over the cycle or according to the fortunes of the underlying institution. Price discovery would be more costly.

It is not possible to provide definitive estimates of the magnitude of such efficiency losses. Higher costs will result from the loss of liquidity and the cost of valuing, packaging, monitoring and managing alternative instruments. Even under the most optimistic of assumptions, it is difficult to see the interaction of these factors not leading to an increase of at least 20bps in the cost of capital for funds raised in the domestic market – an amount that would be very significant economy-wide.

Moreover, the cost would be noticeably higher if the loss of CGS seriously hurt overall liquidity in the markets as is quite possible given that CGS underpins all the key derivative markets. For example, while the case is not identical, it is instructive to note that yields on NZ bonds – and in turn their whole structure of interest rates – have tended to be high relative to many other developed countries (after adjusting for differences in macroeconomic performance). The single most important factor appears to be a lack of liquidity.

(2) The management of risk, including for long-dated investments.

One of the consequences of less transparent pricing, with a higher cost of capital, is that it makes effective risk management more difficult. Government by its very

nature is able to pool and cope with the fall out from events that will periodically hit the economy (eg economic cycles, financial crisis). As a result, government bonds provide a clear and relatively stable anchor for the management of risk particularly beyond the 3-year part of the curve where government bonds and their derivatives are clearer the deepest and most active markets.

Of course, financial intermediaries already provide plenty of products with maturities extending well beyond that of the underlying collateral (eg witness the gold lending market). But the more that such duration mismatches are to be passed on to someone who is not in a natural position to bear that risk, the greater the costs that will be charged.

These costs are intrinsically difficult to quantify. Indeed, the real cost of not being able to efficiently manage such long-dated risk may only be evident at times of crisis. (For example, maturity mismatches were a major element of the S&L crisis in the United States in the late 1980s.)

In a similar vein, the management of long-term investment portfolios, including those established for retirement incomes, would be significantly affected. A recent study by a Federal Reserve economist, Antulio Bomfin, makes an attempt to quantify the cost to that optimal portfolio of removing treasuries from the basket of possible investments. The removal of any asset from the portfolio will definitely not leave the optimising investor better off – ie otherwise, the investor could have chosen to hold none of the asset in question in her original portfolio. The question, instead, is how large the costs could be? Moreover, is the removal of an asset a greater issue when that asset is free of credit risk?

There are numerous simplifying assumptions in Bomfin's analysis and the results cannot be regarded as precise. However, the dimensions involved should give cause for reflection. Taking a conservative view of Bomfin's estimates and applying the results to Australia shows that the benefits that having an asset virtually free of default risk in the form of CGS run well into the **billions of dollars** (in excess of \$3 billion in applied narrowly to current superannuation funds and well above \$10 billion in applied to all of private sector wealth).

We understand that similar calculations for Australia prepared for the *CGS Market Industry Working Group* have found a larger impact than Bomfin with the overall cost to welfare estimated to be \$16 billion. Sizeable benefits would also appear to accrue to other risk management activities throughout the economy such as insurance.

There can be debate around the exact impact on overall economic welfare of removing CGS from investment portfolios. However, the dimensions of all the estimates highlight that the impact would be substantial, and rival or exceed the estimated benefits from the economic reforms Governments have worked so hard to deliver over the past 20 years.

(3) *The protection of the domestic economy from periods of financial crisis.*

The above argues that there could be quite substantial costs involved in the *regular* conduct of the economy if the Government were to redeem all its debt. Of even

greater concern is the economy's ability to cope with stress. World best practice involves:

- a robust, transparent system of regulations and governance practices; and
- sufficient diversity in the domestic financial markets based on *both* strong banks and deep securities markets that are largely independent of the major banks.

In the light of the Asian financial crisis, Alan Greenspan commented favourably on Australia's ability to weather the storm:

"The addition of capital market alternatives [to banks] is possible only if scarce real resources are devoted to building a financial infrastructure – a laborious process whose payoff is often experienced only decades later."

Australia embarked on just such an investment over the past couple of decades. The payoff has been, in Greenspan's words:

"Despite its close trade and financial ties to Asia, the Australian economy exhibited few signs of contagion from contiguous economies, arguably because Australia already had well-developed capital markets as well as a sturdy banking system. But going further, it is plausible that the dividends of financial diversity extend to more normal times as well. The existence of alternatives may well insulate all aspects of a financial system from breakdown."

A more costly system

It should be stressed that not only would a world without CGS make risk management throughout the economy and community more difficult, it would also be more costly. There appears to be a hope in some quarters that with fewer resources being devoted to operating the bond market, that there would be savings for the financial system overall and thus the economy.

This hope is false. The liquidation of the bond market does not mean that the *demand* for financial services would disappear. To the contrary, those services are integral to the efficient functioning of many activities throughout the economy and would persist. Instead, however, they would have to be met without the benefit of CGS.

As noted above, either some of those functions would be carried out in global markets, thereby adding to the import of services, and/or they would rely on more expensive domestic instruments (which at a minimum involve additional monitoring and packaging costs). In either case, there would be additional costs to the overall economy.

There would also be sizeable *adjustment costs* associated with any major policy change. Such costs are hard to ascertain ahead of time for there is often little to guide policy-makers in terms of precedence or relevant economic theory.

The introduction of the GST is a case in point. Tax experts were reasonably well placed to debate the merits of the new tax system fully implemented, but the extent of

the transitional costs was mere guesswork. As it turned out, the adjustment costs associated especially with compliance were grossly underestimated. In such circumstances, it is imperative to have confidence that the long-term benefits of any policy change are sizeable.

Potential adjustment costs associated with the demise of CGS relate to both costs to the costs of transforming the financial markets initially and the possible need to re-establish a Government debt market in the future. Costs will be born narrowly within the financial sector but also much more broadly. Y2K kept a lot of computer specialists gainfully employed. The end of CGS and the replacement with other instruments would see a level of (generally unproductive) activity that would be larger still.

If CGS were abolished, it is quite conceivable that a future Government would face circumstances where it would like to re-establish the market. Ideally, Governments will manage such contingencies ahead of time given the undesirability of trying to re-establish a CGS market at the height of a crisis. An element of such management would be for Governments to accumulate a sizeable pool of assets in the good times in order to handle the risks associated with tough times.

Governments as owners of assets

The Discussion Paper highlights concerns that, if the Government had to hold a portfolio of assets to match the continued issuance of CGS, it would be “increasing the Commonwealth’s financial risk exposure”.

Governments must take pains to manage their financial affairs prudently. But much more important is the overriding objective of ensuring that the overall financial system is as robust as possible including through facilitating effective risk management throughout the community.

Moreover, there are plenty of precedents to draw upon when designing the mechanics involved in managing portfolios of assets within the public sector. The difficulties are far from insurmountable:

- an arms length operation subject to clear benchmarks and run by an independent board provides the basis for suitable governance procedures to be established; while
- returns from a diversified portfolio will, on average, comfortably exceed the yields on bonds and thus provide healthy net contributions to the budget.

Further suggestions on how the mechanics may work are provided in the attachment. It seems to us that the real concerns relate to perceptions arising from years of effort to reduce government debt. Such concerns are legitimate in situations where net debt levels are high, but that is not the case in Australia today. Simplistic perceptions about all debt being bad should not be allowed to override good policy.

2. Responses to Key Questions*

1. Pricing other financial products

2. Referencing other financial products

ICAP's Assessment

Both are **important** concerns

Apart from the front end of the curve, all pricing in the domestic market is based either directly or indirectly on Commonwealth Government securities. The CGS market is the only market with sufficient liquidity, transparency and uniformity across the curve to play this role.

Interest rate swaps are traded as a spread over bonds. Similarly, the swaps futures contract that the SFE has recently launched uses the CGS market as a reference point.

It may be feasible for the swaps market to develop so that it is independent of CGS. This would take some years to evolve. The swaps market would then be primarily dependent on the large banks (ie for the whole contract and not just spreads). Sufficient liquidity in the system would only result when there was a parallel market in swap futures.

Swaps involve credit risk and, for pricing purposes, longer-dated paper in particular would be susceptible to fluctuations in risk for reasons that will not always be transparent. At present, with just four players accounting for some 60 per cent of the turnover, there are occasional episodes where movements are unclear – and this despite the considerable volumes that have been traded in recent times.

As an alternative to swaps, it may be feasible for pricing to be based on foreign sovereign paper. Again, the end result would be subject to fluctuating risk (ie currency risk and/or credit risk of the counterparties involved in providing hedging facilities).

It is most improbable that corporate paper or asset-backed securities, or derivatives thereof, would ever assume a significant (independent) role in pricing and establishing reference benchmarks. Corporate issues tend to be too small and idiosyncratic making it a costly exercise to construct and maintain the liquid derivative instruments that would be necessary for transparent pricing. This is illustrated by the limited turnover in corporate bonds today despite the fact that the outstanding amount of corporate paper rivals government bonds (including semis).

Finally, it is worth emphasising that the difficulties that arise inevitable are concentrated at the longer-end of the curve, particularly 5 years and beyond. Bank bills and related derivatives have become the lynchpin of the short-end of Australia's capital markets. High credit ratings for the major banks, supported by close prudential supervision and an element of implicit government guarantees, have

* The full questions are set out in Appendix 1 of the Commonwealth's Discussion Paper.

allowed very liquid markets to evolve. The markets for bank bills and related securities have assumed this dominant position despite the availability of short-dated Government paper (although the amount of such paper has declined in recent times).

In contrast, CGS continues to be the clear asset of choice for longer maturities. A principle reason why private instruments have not out-competed longer-dated CGS is credit risk. While counterparties may be prepared to manage short exposures associated with major banks, to do so for beyond a few years is a big ask.

Financial stress in even the seemingly most robust of systems can hit the major institutions as seen in virtually all developed financial markets – including Australia – over the past 15 years. Such a possibility would need to be monitored, managed and priced. Governments have an intrinsic ability to better pool such risk, and government bonds thereby have the dual advantages of being more cost effective to manage (eg less monitoring costs) and having lower and more stable risk characteristics.

(As a consequence, for many purposes, companies or individuals may find it attractive to turn to foreign sovereign paper rather than domestic paper despite the costs involved in managing currency risk.)

3. Managing financial risk

ICAP's Assessment

An important concern

An alternative futures market would evolve, albeit one where the underlying securities have higher credit risk and where additional monitoring and packaging costs would have to be priced.

The fact that there would be a clear loss of efficiency is illustrated by the attempt in the 1990s to establish a futures market for semis. This failed primarily because it could not compete with CGS. Note that there was, and is, greater uniformity and liquidity in semis than there would be in, say, corporate paper.

It may be that a semis futures contract would be the first to get established in the absence of CGS. But given the size of the underlying issues and the inevitable differences across jurisdictions, the end result would be a poor substitute for the current bond futures.

A more liquid and long-term solution may develop from swaps. For this to occur, however, would take time and the end result would be less than ideal. The recent launching of a swaps futures contract by the SFE highlights some of the difficulties involved. That contract should be seen as being very much a complement, **not** as an alternative, to bond futures – it is in fact dependent on bonds. It is early days yet, but the reactions to date have been rather skeptical.

The longer part of the swaps market would be hit quite hard by the winding down of the CGS market. At present, about two-thirds of interest rate swaps have a maturity

of less than 3 years. The hope appears to be that swaps would evolve to form the basis of a liquid market in, say, 3 to 10 year maturities. But the starting point would be one where, because swaps are priced as spreads over CGS, the liquidation of the CGS market would initially lead to an even greater concentration of the swaps market in short-dated paper.

Moreover, while, given sufficient time, swaps may take over some of the key roles currently played by CGS, it is extremely risky to assume that would be the case. There would be very significant transitional costs along the way and market forces could well drive the system elsewhere. A much less liquid and much less robust system could evolve based on a return to more traditional roles for the major banks augmented by some financial products being imported from a global market. That is, the result would be a less efficient system with greater costs and risks for the entire economy.

It is not possible to provide definitive estimates of the magnitude of such efficiency losses. Higher costs will result from the loss of liquidity and the cost of valuing, packaging, monitoring and managing alternative instruments. Even under the most optimistic of assumptions, it is difficult to see the interaction of these factors not leading to an increase of at least 20bps in the cost of capital for funds raised in the domestic market – an amount that would be very significant economy-wide.

Moreover, the cost would be noticeably higher if the loss of CGS seriously hurt overall liquidity in the markets as is quite possible given that CGS underpins all the key derivative markets. For example, while the case is not identical, it is instructive to note that yields on NZ bonds – and in turn their whole structure of interest rates – have tended to be high relative to many other developed countries (after adjusting for differences in macroeconomic performance). The single most important factor appears to be a lack of liquidity.

Finally, we note that the cost is likely to be greater at times of heightened uncertainty. In turn, this will heighten, to an extent, the risks of financial stress affecting the entire system and economy.

4. Providing a long-term investment vehicle

ICAP's Assessment

An important concern

Commonwealth Government securities play a significant role as an anchor for longer-term risk management throughout the economy and the broader community. Government is in a unique position to bear various risks that the private sector will never be able to duplicate as well or as cost effectively – see pp 29-30 in Section 4.

Of course, it is theoretically feasible for the private sector to develop products that do have very low default risk. This is already achieved in many diversified investment vehicles while more credit-enhanced derivatives are likely to evolve. Yet, these cannot be expected to be perfect substitutes and, in fact, the welfare losses involved may run well into the billions of dollars – see pp 35-36 in Section 4. It is also worth

noting that the structure of the corporate sector in the Australian economy makes it more difficult to develop a comprehensive derivative from corporate bonds that spreads the risks effectively across all sectors of the economy.

The Discussion Paper asks whether there is untapped demand for CGS. This does, in fact, appear to be the case although this inevitably is extremely difficult to prove. The 5 per cent of superannuation portfolios made up by CGS reflects relative supplies rather than demand with, presumably, relative interest rates adjusting to clear the respective markets.

Note that this 5 per cent figure understates the role of CGS in such portfolios. The more relevant figure is probably something closer to the share of domestic fixed interest in such portfolios ie CGS is far more liquid than other fixed interest products and is accordingly used to manage changes to the portfolios over time with the other instruments used more to enhance yields. This raises some issues regarding risk for corporate paper but not really semis.

Finally note that, as well as semis, some of the asset-backed paper have either implicit or explicit Government guarantees although, unlike in the United States, these are too sparse to be a viable alternative to CGS.

5. Implementing monetary policy

ICAP's Assessment

A secondary concern

The Reserve Bank should be able to conduct monetary policy with few hiccups. Presumably, it will operate increasingly through the bank bill and related markets.

One consequence of this is that it further intensifies the reliance of the overall system on the major banks increasing, to an extent, concerns over their status as being 'too big to fail'.

6. Providing a safe haven in times of financial volatility

ICAP's Assessment

An important concern

Financial crises are generally low probability events with potentially severe consequences. No single source is likely to cause such a crisis. Indeed, even after experiencing such a period of financial instability, there tends to be debate over the various contributing factors.

However, given the scale of the potential consequences, it is crucial for Governments to establish best possible infrastructure to minimise the risk of occurrence and to manage events if a period of instability does arise. World best practice involves:

- a robust banking system supported by sound prudential regulations; operating alongside
- robust capital markets that are largely *independent of the banking system*.

The simple message is that diversification pays. This has been the clear lesson taken from the Asian financial crisis – see pp 37-40 of Section 4. Australia emerged from that experienced unscathed because of the then robust state of the banking system plus its healthy capital markets (which included the floating exchange rate).

In a world without CGS, it would be most unlikely for the key parts of Australia's capital markets (eg swaps, repos and interest rate futures) to be as deep or transparent as is currently the case. And the major banks and bank paper would inevitably underpin the system that evolved. So, if a major commercial bank were to be seriously affected by the next financial crisis, the whole system would be compromised. The history of Australian banking does not provide much comfort, while it might be recalled that the Japanese banks were regarded as very robust a decade ago.

Cash has been mentioned as an alternative to bonds at times of crisis, but with the capital markets underpinned by bank paper, it would not be effective. To manage a crisis effectively, it is desirable to have as much stability throughout the system as possible and not simply have a short-term instrument available for panic purchases.

7. Attracting foreign capital inflow

ICAP's Assessment

A secondary concern

The bulk of capital inflows and outflows would be at most marginally affected by the liquidation of the bond market. For example, the large swings seen in recent years have involved changes in net equity and FDI flows offset by increased purchases of bank paper.

On the other hand, certain activities could disappear from the domestic landscape. Just as most superannuation invested in global equities is now managed offshore, so too would most fixed income. It is also quite conceivable that most of the major corporate bond issues would be conducted offshore in foreign currencies.

8. Promoting Australia as a global financial centre

ICAP's Assessment

A secondary concern

Efforts to develop Australia as a global, or regional, financial center would be harmed. For example, active domestic markets are generally needed to make it viable for an institution to participate in broader global financial services. (eg an institution wishing to trade in US treasuries in our time zone would find it easiest to associate

such activities with an operation already active in a domestic market. This idea applies broadly to other activities.)

9. Appropriate size of the Commonwealth Government Securities market

ICAP's Assessment

The CGS market can survive at its current level and, presumably, at a somewhat smaller size. But it will reach a point where a loss of liquidity will be reflected in less transparency and more awkward risk management. For example, as the share of CGS in global indexes wanes, managers can match benchmarks without adjusting holdings of Australian bonds.

Moreover, a deeper, more liquid CGS market would help to ensure that the whole capital markets are as transparent and efficient as possible. Benefits would thereby filter through the whole economy.

A comparison can be made with New Zealand's bond market. Its lack of liquidity means that bond yields are typically much higher than warranted by New Zealand's economic fundamentals with effects throughout the whole structure of interest rates.

We judge that a prudent level for the CGS market today would be in the range of \$60 billion to \$80 billion (for bonds plus indexed bonds). The market should be increased over time to broadly keep pace with nominal GDP.

3. Options available to the Commonwealth

Option 1: Wind down the Commonwealth Government Securities market

The Government would appreciate views from stakeholders on:

- (a) potential implications of winding down the CGS market;
- (b) the likely impact on the cost of capital;
- (c) the most appropriate approach and timeframe to implement a decision to wind down the market, if this decision is made; and
- (d) the likely re-entry costs (in the form of additional borrowing costs) if the Commonwealth withdraws from the market.

ICAP's Assessment

(a) The broader economy and community would still need and demand the complete range of financial services currently provided. Without CGS, they would not be provided as effectively or as economically. Conceivable domestic alternatives would take some years to evolve and even then would not perform the tasks as well. It may be that some activities shift offshore resulting in additional imports of services.

Moreover, the financial system and, in turn, economy would be that much more exposed when the next financial crisis hits. The benefits from the diversification that results from a capital market based on government securities to stand alongside a robust banking system should not be underestimated.

A fuller discussion of these issues is presented in the accompanying research paper.

- (b). See response to Question 3 in Section 2.
- (c) Over the past few decades, there has been a perennial debate in policy circles about the relative virtues of introducing change gradually or not. It is sometimes argued that a sharper shock can induce more rapid adjustment by the various parties affected by change and limit the chances of, for example, an industry languishing in a half-way stage.

The possible closing of the bond market is one area where such arguments do *not* apply. The sector is already efficient and flexible. The real difficulty is experimenting with something for which there is no precedent internationally and where there is a real danger of serious disruption at a cost to the broader economy. In these circumstances, the longer the lead time the better.

- (d) Presumably “re-entry”, at least initially, would be through paper issued in global markets. We understand that, for example, superannuation funds would demand at least 30bps more than is currently the case given, solely, the lack of liquidity. This would appear to be the minimum additional cost especially since the

circumstances that might be prevailing at the time of re-entry are unlikely to be propitious.

The so called transitional costs that would be incurred in closing and re-opening the markets could well be much larger. Changed behaviour and systems would be needed throughout the financial markets and in much of corporate Australia. These adjustment costs are inherently difficult to estimate and there is the inevitable temptation to simply mention them in a footnote to a broader policy. However, we are very mindful of the experience with Y2K and GST where the adjustment costs were large and, in the case of the GST, seriously underestimated in advance.

Option 2: Consolidate Commonwealth and State government debt markets

The Government would appreciate views from stakeholders on:

- (a) whether there is merit in reconsidering the idea of consolidating Commonwealth, State and Territory government debt into one market; and
- (b) whether this option would assist with the transition to reducing the supply of Government debt.

ICAP's Assessment

- (a) There is merit in consolidating the two markets, whether it is done formally or informally by agreement to have the issues concentrated at given dates. As noted above, the optimal size for the government bond market does appear to be greater than its current size and the biggest difference between CGS and semis relates to liquidity rather than credit risk.

We realise that there are concerns about the loss of accountability for individual States if a formal consolidation of the markets were to be considered. However, a model worthy of further consideration is one whereby the Commonwealth were to issue paper on behalf of individual States (at, say, 5-10bps over CGS) with triggers for a higher margin if the ratio of State debt to GSP exceeds pre-defined markers.

- (b) the consolidation of the two markets would assist transition problems, but semis alone would not be a real long-term alternative to CGS.

Option 3: Maintain the Commonwealth Government Securities market and fund the Commonwealth's unfunded superannuation liabilities

The Government would appreciate views from stakeholders on:

- (a) governance arrangements for a hypothecated asset fund that stakeholders suggest would insulate investment decisions from direct Government control;
- (b) whether funding the unfunded superannuation liability through a superannuation fund is a good way of dealing with the governance issues associated with substantial Government asset holdings;

- (c) the appropriate limits on holdings of any single instrument if the Government were to invest in debt securities;
- (d) the appropriate limits for equity holdings in any one company if the Government were to invest in equities;
- (e) the likelihood of Government investment distorting asset prices;
- (f) the impact of restricting Government investment to foreign securities; and
- (g) the increased uncertainty for fiscal policy arising from variations in investment returns.

ICAP's Assessment

- (a) The governance issues have been addressed in similar circumstances both in Australia and overseas. While not identical, the CSS and PSS superannuation funds have managed governance issues seemingly comfortably without embarrassment for the Government of the day. See discussion in accompanying research paper.
- (b) Clearly accounting for, and budgeting for, unfunded liabilities has merit on its own account. It is not necessary, however, to have any fund that may match the issuance of CGS to be narrowly related to such unfunded liabilities. Indeed, the optimal size of such a fund should be determined by considerations relating to the role of CGS in anchoring financial markets rather than what is conceptually a separate issue.
- (c) The aim would be to have a diversified portfolio that (i) has a neutral impact on the markets and (ii) is not unduly exposed to isolated risks. The starting point for establishing such benchmarks and related limits could be those that currently apply to “balanced” super funds.
- (d) Again, the starting point could be limits that apply to super funds. The more important consideration is that the management of any such investment be carried out on a strictly arms length basis under the auspices of a professional board.
- (e) A sufficiently diversified fund should not distort asset prices.
- (f) The fund should include both domestic and foreign securities. We note that the Norwegian Petroleum Fund as originally conceived was invested solely in foreign sovereign paper. This reflected the rationale for the Fund, namely that it was intended to smooth the impact of what was expected to be a temporary boost to Norway’s external accounts. Similarly, the Government could set benchmarks for the proportion of funds invested overseas based on broader objectives related to national saving policy.
- (g) It would be important not to have the conduct of fiscal policy affected by fluctuations of distributions from such a fund. This could be achieved by having distributions determined by a moving average of, say, the past 5 years returns.

4. THE BOND MARKET: A National Institution Worth Saving

*The following article is an extract from
ICAP's Economics and Strategy, November 2002*

Preamble

The following series of articles analyse the major considerations that should be taken into account in the debate over whether the Commonwealth should redeem all its bonds on issue.

The articles were prepared in anticipation of the Treasury's Discussion Paper with the idea that we could use the material to respond directly to the issues raised by Treasury. In the event, we decided against going down this path.

*Treasury's
Discussion Paper
invites a debate over
minutiae ...*

The focus and tone of the Discussion Paper invites a debate over minutiae, and one to be conducted by people perceived to be protecting vested interests. These atmospherics are simply the wrong environment in which to develop and decide on what should be a major piece of public policy.

*... but there are far
bigger issues at
stake.*

For one, the perceived vested interests are pretty ephemeral – as we argue below, employment opportunities in the finance sector would probably be greater, not fewer, in a world where other instruments replaced Government bonds. But more importantly, there are far bigger issues at stake relating to the overall strength of the economy and well being of the broader community. The debate, and the subsequent decisions on policy, needs to be based on these broader considerations.

The following articles are a contribution to such an endeavour. We would welcome the reactions of interested readers.

THE BOND MARKET: Part 1. Introduction

The future of the Commonwealth bond market should not be decided by self-interest.

Mention the idea that the Government may redeem all Commonwealth bonds to players in financial markets and the reaction will often be one of incredulity. Why undermine a system that works so well? Of course other instruments have become more prominent within financial markets in recent years, but government bonds remain at the core. They play critical roles in the management of risk throughout the economy. And aren't we told that a sophisticated and robust financial system has been critical to the economy's ability to cope at times of stress, including during the Asian financial crisis or when LTCM and Russian debt were centre stage?

But mention the notion of an end of government debt in Canberra or sections of the media and the reaction is quite different. Debt is bad; bonds are bad; let's get rid of them. This is the Treasurer's current position, as reflected in some comments he made on his latest visit to New York:

"The argument is that even though you don't need the money, you should have these securities on issue for financial market reasons. I've not been convinced by the argument." He went on to say, "the onus would be on those financial market participants to convince us."

Given this wide divergence in views, we embarked on a project to extensively investigate all aspects of the issue, including those narrowly relating to the functioning of the financial system and the broader implications for the economy. It was important that all facets be thoroughly considered and debated. All too often, it seems, important policy issues are debated in the most simplistic of terms increasing the chances of poor decisions.

The debate over the possible sale of the remainder of Telstra is a point in case. The vital issues of what ownership structure and what regulatory regime best delivers telecommunications for an economy and a community are deemed too difficult to argue in public. So we are left with one-liners about what a good idea it would be to eliminate debt; or for what will any proceeds from the sale be used.

In such an environment, the debate over the future of the bond market would seem to have only one fate. Abolish it.

It demands a considered debate ...

But the bond market has been a critically important institution that has underpinned the development of Australia's financial system that, in turn, is at the heart of what is a highly developed economy. It demands a much more considered debate.

When we embarked on the exercise, our starting position was roughly neutral. Yes, bonds did seem to have a special place in financial markets and there may

be some adjustment costs if they were redeemed. But, of all parts of the economy, financial markets have proved to be most flexible, rapidly developing new products and new ways of conducting business. They'd cope.

On full investigation, we are no longer indifferent. Of course, financial markets would cope – in fact, parts would prosper and the financial sector might even end up contributing a greater proportion of national production.

... because it impinges on the effectiveness of the financial system and the strength of the broader economy and the potential costs of getting it wrong run into billions of dollars.

But the fate of the employment opportunities in the financial sector should not be the driver of policy. Rather, the critical issue is how effectively the financial sector without Government bonds could serve its role in supporting a developed economy. And, if there are benefits from maintaining the bond market, are there difficulties associated with the Government owning a matching portfolio of assets?

It has been the examination of these central issues that has led us to change our minds:

- the efficiency losses from the abolition of Government bonds appear to be large and are likely to run well into the billions of dollars;
- most importantly, the risks that the financial system – and in turn the broader economy – may not be able to cope relatively smoothly at times of stress would be unnecessarily heightened; while
- the costs and problems associated with maintaining a bond market appear to relate more to perception than to reality.

These considerations lead to the observation that this is a policy matter of consequence. Given the subject matter, however, it runs the risk of being regarded as an esoteric affair of interest to few. It deserves better than a few column inches buried in the middle of our newspapers.

Even many in the markets with a direct interest are happy for it to be sorted out elsewhere. The questions that many in the market would like answered are simply: will the stock of CGS disappear? Will there be a government bond market? Never mind the pros and cons, just tell me what they're going to do. Then, whatever the rules of the game, I'll get out and make some money. Quite a reasonable attitude!

But this doesn't lessen the need to get this policy right. The costs involved could be larger than, say, the most optimistic of the estimates of any benefits that accrue from the GST. Or much larger than the most optimistic estimates of gains from a free trade agreement with the United States. Simply stated, the bond market represents a national institution that has taken many years to develop. We had better be certain of the outcome before we go down the path

of abolishing it.

The following articles summarise some of our major findings. Part 2 sets the scene by reviewing some of the basic trends in fixed income markets. This is followed by a rather lengthy discussion of the role played by government bonds and life without them. Financial markets have proved to be very adaptable and solutions would again be found. But at what cost?

Part 4 then considers some of the issues involved in maintaining a bond market especially, as the Government plans, if the remainder of Telstra is sold and the Government's net debt position falls close to zero.

THE BOND MARKET: Part 2. Trends in Fixed Interest Markets

A government bond market is an important institution.

The future of the bond market may seem to be an esoteric debate of interest to few. However, those who have been tasked with establishing solid structures on which to develop national economies have seen matters quite differently. For example, in 1791, Alexander Hamilton, the first Secretary to the US Treasury, stated:

“A national debt, if it is not excessive, will be to us a national blessing.”

More recently, the IMF and World Bank have helped a range of emerging and developing economies develop domestic bond markets:

“A key policy prescription to prevent or ameliorate financial crises in emerging markets has been the development of local bond markets, and this strategy has been embraced by a number of policymakers and international organisations. From a macroeconomic perspective, local bond markets could soften the impact of lost access to international capital markets or bank credit by providing an alternative source of funding ... From a microeconomic perspective, they could help create a wider menu of instruments to deal with inherent maturity mismatches in emerging markets.”

IMF, *Global Financial Stability Report*, 2002.

But, is it necessary, ...

In light of these comments, the critical issues become (1) whether a developed economy – with a sophisticated financial system – still benefits from a bond market, and (2) are there costs involved in maintaining a bond market?

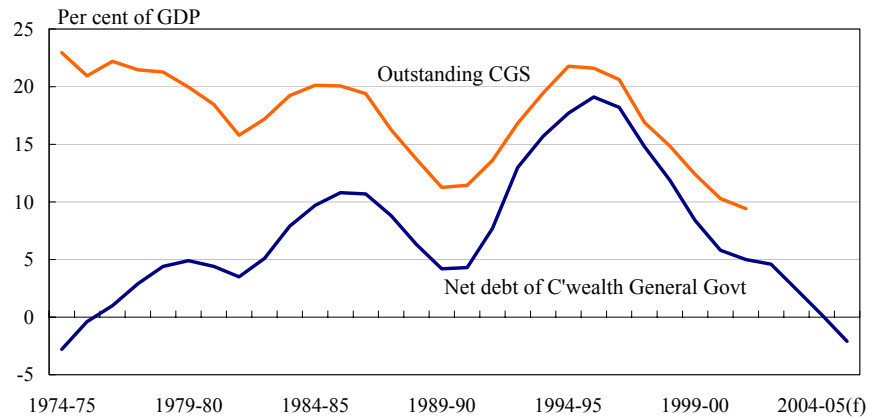
Behind these two seemingly straightforward questions are a myriad of considerations. Before turning to some of these, we begin by setting out some trends in the markets relevant for the discussion.

2.1 Trends in Net Debt

... especially when debt is low?

The reason why the future of the Government bond market is on the table at all is obviously the trend decline being delivered in the Commonwealth's net debt. By the end of June 2002, net debt had been reduced to \$A35.6 billion. And as the following chart shows, the full sale of Telstra would result in a positive balance within a few years.

Commonwealth Net Debt



Source: Budget Paper No. 1; Commonwealth Treasury

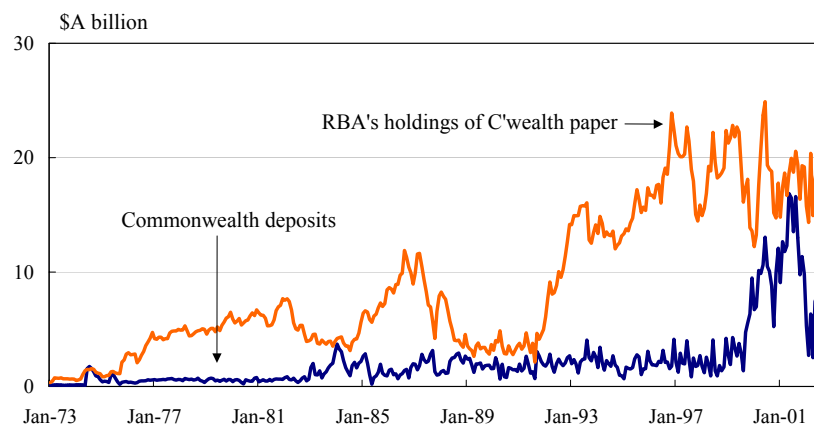
The Government will need to acquire assets to maintain a viable bond market.

The chart also shows that this would not be the first occasion on which there was no net debt for the 'General Government' part of the Commonwealth. However, the last time there was no net debt in the early 1970s the Commonwealth also held more assets. Thus, in the early 1970s, CGS had been issued to, *inter alia*, support a raft of government enterprises. The decision confronting government today is whether to acquire assets of a different form to balance a stock of CGS – see Part 4.

Over the past few years, the Commonwealth has redeemed debt to a level that is compromising liquidity in the market. The Government has recognised that this could, potentially, cause difficulties and has accordingly slowed the pace of redemption. Thus, while net debt fell to \$A35.6 billion by June, its \$A denominated debt amounted to \$A66.9 billion – see the emerging gap in the above chart.

One of the counterparts to this widening gap has been a significant rise in the Commonwealth's deposits at the Reserve Bank – see chart.

Commonwealth's Position with RBA



Source: RBA

The growth in the Government's deposits at the RBA has allowed it to use these rather than Treasury notes as a buffer for short-term fluctuations in the timing of tax receipts and outlays. But there will be a limit to how far the Government will want to go down this path (i.e. placing funds on deposit at the Reserve Bank earning interest below that of the debt it is supporting). *Whether or not Telstra III proceeds, the related issues of the future of the bond market and the virtues of Governments holding a portfolio of assets need to be confronted.*

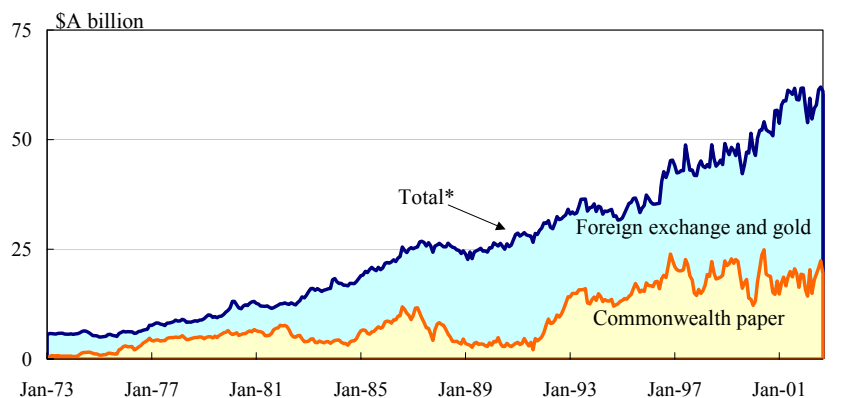
2.2 The Reserve Bank's Balance Sheets

The implementation of monetary policy will be affected by the absence of CGS.

One aspect of the economy already adjusting to reduced CGS is the implementation of monetary policy. Two Reserve Bank economists, Edey and Ellis, document some of the changes that have taken place including the growing use of foreign exchange swaps to complement the use of (CGS) repos.¹ As they say, if the operations involving foreign exchange swaps in recent times *"had had to be replaced by domestic repos this would have represented a major source of additional pressure on the stock of available securities."*

The Reserve Bank continues to hold essentially two forms of assets, foreign exchange and CGS. A fundamental rethink of this strategy would be demanded in a non-CGS world.

Reserve Bank's Assets



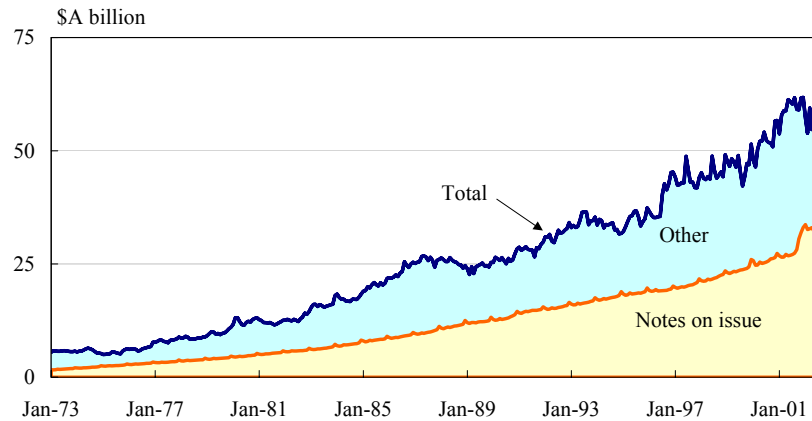
Source: RBA

* Total slightly exceeds sum of CGS and FOREX

Moreover, the Bank does not have the luxury of simply reducing the size of its balance sheet. The inexorable increase in the amount of cash the economy needs to run smoothly dictates a similarly rising balance sheet.

¹ See M. Edey and L. Ellis (2002), *"Implications for declining government debt for financial markets and monetary operations in Australia"*, in *Market Functioning and Central Bank Policy*, BIS Papers No 12.

Reserve Bank's Liabilities



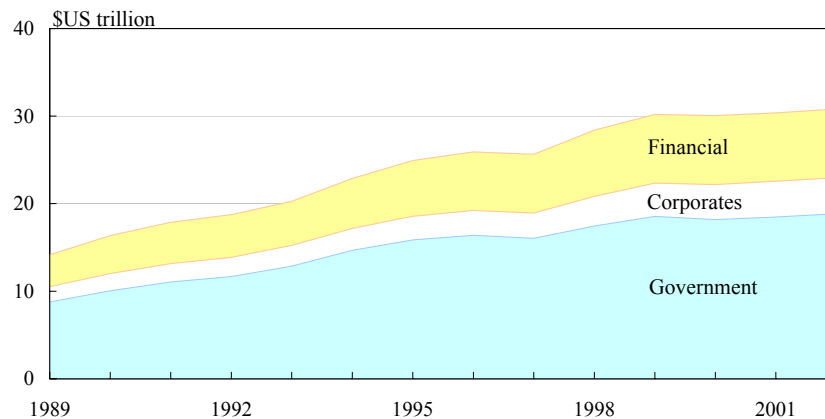
Source: RBA

2.3 Trends in Securities Markets

Investor's attitudes need to be considered.

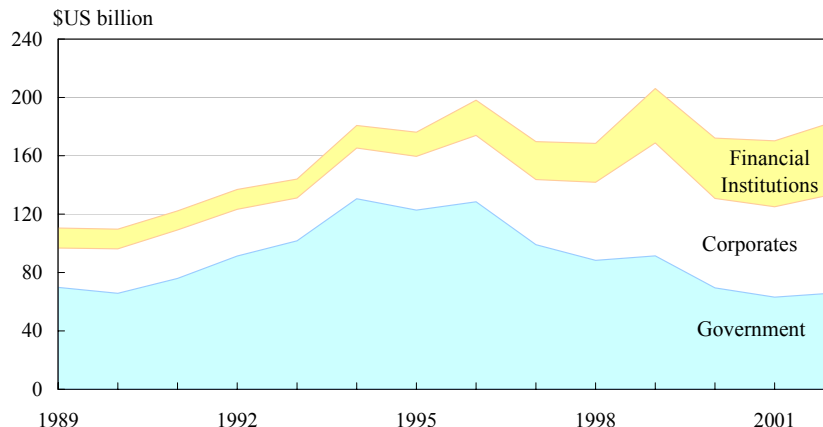
Already, the decline in the share of Government securities is pronounced and makes Australian financial markets stand out on an international scale. This is evident from the following charts using BIS data.

Domestic Securities on Issue - World



Source: BIS

Domestic Securities - Australia

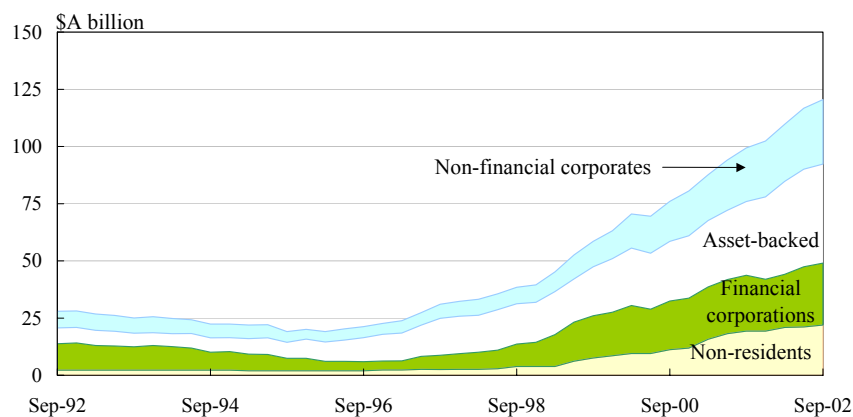


Source: BIS

The private sector debt market is very fragmented ...

Private sector debt securities have grown to a level where they now match Government paper in total value outstanding. It is important to stress, however, that private sector paper is a much more fragmented and idiosyncratic market. It is made up of asset-backed securities as well as paper issued by financial institutions, non-financial institutions and non-residents – see chart.

Domestic Non-Government Bonds



Source: RBA

Moreover, within each category of private sector debt, there is a range of credit profiles. Given this fragmentation of the market, it is not surprising that the securities are still not heavily traded and derivative products have been slow to take hold.

This is reflected in the following turnover data for various financial products. The table reflects:

- a decline in the turnover of Commonwealth bonds (broadly in line with the pace of decline in bonds outstanding);

- a steady increase in trading in bond futures (thereby maintaining reasonable liquidity in the combined market for physical bonds and futures); and
- growth in the volume of private sector securities, but from a low base. The aggregate figures masks the range of securities bundled into this category.

Turnover in Australian Financial Markets
(Annual turnover in \$A billion)

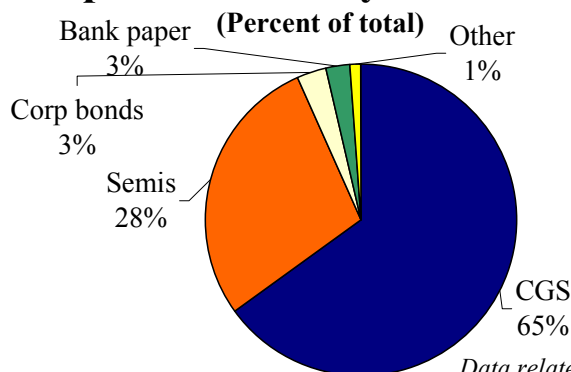
		97-98	98-99	99-00	00-01	01-02
Commonwealth Gov't bonds		738	662	624	606	552
State Gov't bonds		317	334	350	359	308
Non-Gov't debt securities		82	150	205	257	222
Bills, PNs, etc		1599	1872	2063	2448	2409
Repos		3117	3918	5498	4208	6711
Swaps and FRAs		949	1104	1928	3145	4832
Bill futures		6829	7551	7460	8560	8647
Bond futures		1646	1609	1701	1845	2173

Source: AFMA (2002) where the data refer to survey information from OTC participants and SFE futures data.

... and CGS underpin the high-turnover sectors of the market.

It needs to be stressed that those areas where turnover is both high and has been expanding rapidly, especially repos and swaps, either involve or rely heavily on CGS. The issues involved in swaps (and FRAs) are discussed in more detail in the next section, but it is readily illustrated for repos in the following chart.

Repo Turnover by Instrument

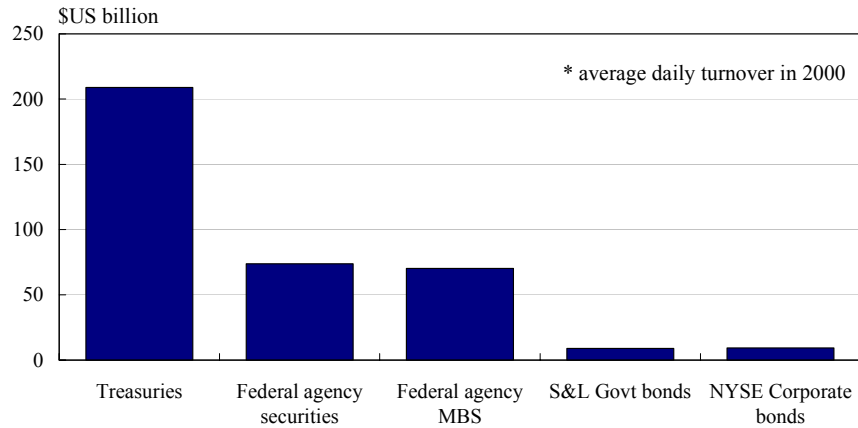


Source: AFMA

Data relate to 2001-02

It may be thought that turnover in corporate paper will rapidly increase and rival that in CGS within a few years given the recent expansion of corporate paper on issue. However, developments overseas caution against such optimism. For example, turnover in government or government-guaranteed paper in the United States dominates that of corporate paper.

Turnover in US Fixed Interest Markets*



Source: FRBNY

2.4 Conclusion

The decline in the amount of CGS on issue is being felt in the domestic capital markets. Nevertheless, from the above, it is clear that CGS continue to provide the ballast for the entire system. It is true that the total amount of corporate paper rivals that of CGS, but it is inevitably extremely fragmented. Accordingly, the turnover in CGS is considerably higher and, more significantly, it forms the basis of the actively traded markets in repos, swaps and futures.

It is against this background that Part 3 analyses some of the major implications of life without Government paper.

THE BOND MARKET: Part 3. Life without CGS

Part 2 provided a broad overview of the place assumed by Government securities in the Australian financial market and, in turn, the overall economy. But to obtain a clear assessment of their real importance, and a view of how life might be without CGS, a more detailed evaluation of the various roles played by government bonds is needed. That is the purpose of this section.

CGS are vital to the financial system in normal times and critical in times of crisis.

Government bonds have a number of unique characteristics including, especially, that they are virtually free of default risk and they are sufficiently integrated and liquid at various maturities for imbalances in supply or demand for individual issues to have a minimal impact on prices. These special characteristics have made bonds ideally suited to form a range of roles including:

1. for pricing other securities along the yield curve;
2. enabling financial institutions to manage hedging demands in a cost effective manner;
3. in the conduct of monetary policy;
4. as a (credit) risk-free asset in portfolio management;
5. in raising finance efficiently for government; and
6. as a safe haven in times of crisis.

Bonds assume a vital place in the financial system in normal times. Perhaps even more essentially, government bonds provide a critical underpinning to the system in times of crisis.

The Australian economy's ability to cope relatively smoothly with the Asian financial crisis attests to the benefits of having a deep and sophisticated financial system (as does the United States' ability to ride through the crisis arising from Russian debt and LTCM). Just how important the safe haven of government bonds is at such times is intrinsically difficult to judge, but they clearly provide ballast.

3.1 On the role of government – the big picture!

Before examining the various functions performed by government bonds, it is worth standing back and considering the broader picture – how does the issuance of debt contribute to a government's overall objectives?

CGS help the management of risk

The crucial element is effective risk management. It's ironic. The lesson from recent financial crises has been the need for better risk management throughout economies. Yet, we are now contemplating the end of a key risk management institution – the

*throughout the
entire
economy.*

Commonwealth bond market.

Treasury's Discussion Paper invites a debate on minutiae rather than the big picture. But the bond market is crucial to the entire economy.

Governments exist to improve welfare, including by assisting the management of risk throughout the community and not just narrowly managing the risk associated with government finances. A myriad of risks come to mind, from the micro-risks that face each of us – our incomes, our health and security – to the collective risks involved in economic crisis.

We must all exercise prudence as best we can, but government has an integral role in helping manage these risks. It can pool and smooth fluctuations in fortunes over time, and across different parts of the society in ways that cannot be done privately. Governments can borrow more cheaply than others, and virtually free of default risk.

These unique benefits can be shared through a strong financial system. World best practice demands a robust banking system operating alongside well-developed capital markets. For Australia, Commonwealth bonds underpin the capital market especially in the management of long-dated risk and at times of financial crisis.

The bond market, then, is part of our economic infrastructure – an institution. It and other financial institutions meld the advantages of government in assuming community wide risks with the ability of the private sector to deliver at an individual level. *Private financial instruments cannot do the job as well.*

The following sections attempt to make some of these ideas more concrete and analyse the benefits that Government bonds afford to the various aspects of the financial system.

3.2 Evaluating the costs and benefits

*CGS are the
cheapest form
of risk
management
available.*

Unfortunately, economic theory and its models are not well designed to analyse the costs or benefits of financial systems in the overall operation of an economy. For the most part, economics treats financial markets as a veil and, instead, considers the actions of the ultimate players – eg individuals as either consumers or labour. An efficient financial market may provide benefits throughout the economy, but these are simply not modelled.

In light of this, it is understandable that two RBA economists in a recent paper stated:

“Theory has to date contributed little to our understanding of the workings of an economy without sovereign debt or some other proxy for a risk-free asset. Moreover, given that governments in modern economies have generally retained a continuous presence in the bond market, it is difficult to assess how markets would function in a world where that was no longer the case.”

Edey and Ellis (2002)

So, our task is difficult. However, we do have a starting point. We do know that there will be costs. Otherwise, if there is a better alternative to Government bonds in its various roles, why isn't it being used already?²

Moreover, the suspicion is that the costs involved may be large. To jump ahead a little, the market could cope with all the functions played by CGS outlined above, but at a cost. The costs associated with a few, such as pricing and hedging at the short and maybe middle part of the curve should not be excessive. On the other hand, there would be significant costs in managing longer-dated risk and a greater exposure for the entire economy at the next occurrence of global (or domestic) financial crisis.

3.3 Pricing along the yield curve

CGS provide the best benchmark for pricing along the length of the yield curve.

The breadth and uniformity of the CGS market make it ideal for establishing benchmarks for prices throughout the market:

“No other interest rate product trades on narrower spreads, has a wider group of participants, has transaction costs as cheap, or is as competitive as is the CGS market.”

Paul Bide, Head of Debt Markets at Macquarie Bank

A clear and reliable benchmark yield curve is needed for a range of functions including providing a starting point for price discovery in other markets and the mark to market of bonds for risk management purposes.

Any alternative to CGS – for example, yield curves based on the swap market or corporate bonds – would not provide as transparent pricing. At a minimum, the alternatives would suffer from credit risk that could vary over the cycle or according to the fortunes of the underlying institution. Price discovery would be more costly.

But how much more costly? It is simply not possible to assess the magnitude of any such efficiency losses. Nevertheless, at least for shorter-dated securities, it appears that *the costs may be relatively modest* with the swap curve, in particular, assuming a more prominent role.³ The costs would be larger the further out one moves along the curve, as discussed in Section 3.3.

Already, swap curves are assuming a greater role in pricing in various financial markets around the world as liquidity in swap markets expands. At this stage, Government bonds continue to provide the underlying reference for swaps but, with the volume of swaps being traded far outstripping that in bonds, the swaps prices are becoming a convenient point on which to base other prices. See Box 1 for a fuller discussion on swaps.

² This idea is simply an example of revealed preference for an audience of economists or the survival of the fittest for naturalists.

³ In overseas markets, agency paper such as Fannie Mae and Fannie Mac in the United States would be a further alternative to Government bonds. Australia, however, does not have an equivalent in any depth.

In a similar vein, new corporate issues are generally priced with reference to comparable issues in the corporate bond market rather than Government bonds that would have a different risk profile.⁴

3.4 Role in efficient hedging

CGS are ideal for hedging financial risks.

The volatility seen in global financial markets in recent years serves to emphasise the need for efficient and effective risk management in financial and non-financial corporations alike. Suitable hedging of financial risks will be integral.

At present, Government bonds, either directly or through derivative products, play a central role in all hedging. The ideal hedging instrument will be liquid, have an active repo market (or equivalent) and a low cost of execution. It also needs to provide an accurate reference point for credit risk. CGS is (virtually) free of default risk and thereby provides such a reference point.

Box 1

The Swaps Market as an Alternative to CGS

Swaps appear to be able to perform the roles of CGS, but there are major concerns.

In Australia, the main alternative to Government bonds in their roles in *pricing and hedging* appears to be the swap market. The private bond market is too underdeveloped and fragmented while Australia doesn't have a developed parallel to the agencies in the US.

Currently, the system is **not** well-positioned for swaps to take over from CGS:

- Swaps are priced as a spread over CGS.
- In principle, swaps could be priced directly, and this in fact was how the market operated in the distant past. However, to move away from pricing based on spreads today would involve significant transitional disruption.
- “*Liquidity is constrained by swap counterparty credit exposure, which is balance-sheet intensive, in that it is a bilateral contract.*”⁵ Liquidity is in fact improving quite rapidly. However, liquidity in a swap market, without Government bonds to underpin it, really requires futures contracts to be developed. As it is, the supply of swaps is dependent on the number of counterparties wishing to transact at a given time and the availability of CGS as an underlying asset with supply along the curve can help to resolve any imbalances.

The SFE has just launched a futures contract for swaps, although in its current form it is

⁴ See Schinasi, G.J., C.F. Kramer and T. Smith (2001), “*Financial Implications of the Shrinking Supply of US Treasury Securities*”, IMF, p40.

⁵ Uri Ron (2000), “*A Practical Guide to Swap Curve Construction*”, Bank of Canada Working Paper No 2000-17.

dependent on Commonwealth bonds. Increased depth and the resolution of some technical issues (including various credit-enhancements of the basic contracts) will be needed. The extent of the hurdles to be overcome is highlighted by the failure of a futures contract for semis to be established in an attempt in the early 1990s.

In summary, swaps are well placed to be used for pricing and hedging *but*, at this stage, by relying on the CGS market as a base. The major concerns in being dependent upon swaps, in their own right, for pricing and hedging are:

- the significant adjustment costs;
- inherent problems at the long-end of the curve – see Section 3.5; and
- the greater reliance of the whole financial system, and the economy, on the health of the balance sheets of the banking sector (on which, credit risk is embedded in the swap curve). In most periods, this will not be an issue, but it can become one in times of stress. Institutions can become ‘too big to fail’ – see Section 3.9.

Swaps are the obvious candidate as an alternative hedging instrument. Indeed, for some purposes, the fact that swaps have a credit risk embedded in them can make for a convenient matching of credit risk for the exposure to be hedged.

3.5 Concerns at the long-end of the curve

No market offers similar depth at the long end of the yield curve.

Despite the growing role being assumed by swaps in pricing and hedging, there is serious doubt over how efficiently they will carry out the task for long-dated exposures. The ultimate counterparty for swaps is a bank. How much exposure would they be prepared to carry out to, say, 10 years that they couldn’t lay off via, say, CGS? And how might fluctuations in the major banks’ particular circumstances affect the transparency of pricing?

Al Wojnilower, a long-time observer of the US market, expressed such concerns when the US was debating life without treasuries:

“Market makers rely on Treasury obligations to hedge a great variety of transactions and positions. Dealers have been net short Treasury coupon issues most of the time. In mid-January 2000, reporting dealers were net short (i.e. had borrowed and sold) \$US77 billion of Treasury coupon issues, \$US33.6 billion of this in over-five-year obligations. Presumably, many or most of these short sales were meant to balance related long positions in corporate, agency and other debt. What market is going to offer comparable depth? Without Treasuries, it is questionable whether derivatives activity in general, and the volume and profit it generates, can be maintained to the present extent.”

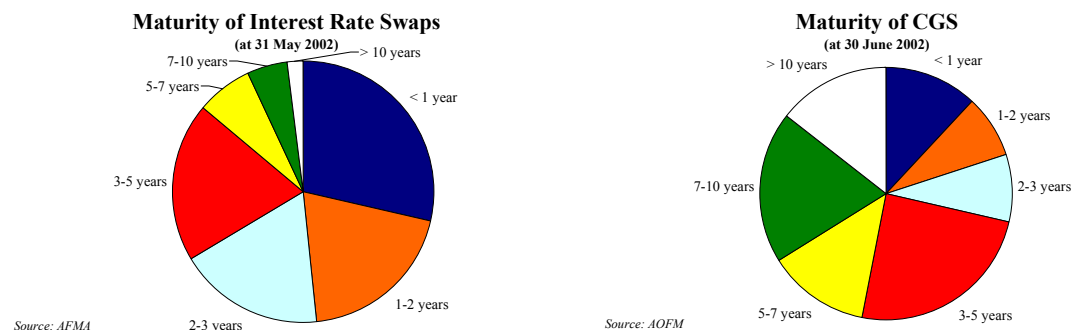
And:

“Whether any market, even yesterday’s Treasury market, can handle the transactions surges generated by ‘dynamic hedging’ in times of stress may be questioned.”

Al Wojnilower, 2000.

Detailed evidence on the relative positions at different maturities of the various sectors in Australian markets is unavailable. Liquidity at the longer end of the market has increased recently particularly with flows from Japan, and the expectation is that liquidity will continue to improve.

On the other hand, as the following chart illustrates, the starting point is one where less than 15 per cent of interest rate swaps have maturities greater than 5 years. The comparable figure for CGS with maturities greater than 5 years is almost 50 per cent. And remember, CGS underpin the interest rate swap market.



No doubt, alternative long-term securities (or other obligations) may emerge. For example, there could be a shift to more long-dated mortgages as in the US. However, as it stands, concerns over maturity mismatches remain potentially making, for example, hedging more costly and pricing less transparent.

3.6 A (credit) risk-free asset in portfolio management

There are costs associated with removing risk-free assets from portfolios.

Government bonds play a central role in the risk management in a range of situations, from prudential regulation in the treasury areas of private corporations to the management of long-lived exposures in various parts of the economy:

“Many pension funds and insurance companies have long duration liabilities that require a liquid dollar denominated long duration asset.”

The Bond Market Association

There are simply no ready alternatives for long-dated Government bonds. For example, the corporate bond market is far too fragmented, lacks depth and will always have credit

risk to be priced. *Even under the most optimistic scenarios where there is considerable issuance of corporate paper and derivative products are developed to form a more complete market – developments that will take many years – the end result would be a more costly market to run and one where the lack of a virtually credit free asset would still result in significance welfare losses.*

Does it matter that a long-dated risk-free asset is not available? Financial intermediaries already provide plenty of products with maturities extending well beyond that of the underlying collateral (eg witness the gold lending market). But the more that such duration mismatches are to be passed on to someone who is not in a natural position to bear that risk, the greater the costs that will be charged.

These costs are innately difficult to quantify. Indeed, the real cost of not being able to efficiently manage such long-dated risk may only be evident at times of crisis.⁶

Another aspect of portfolio management that would be affected – and affected in a fundamental way – relates to the optimal portfolio for individuals saving for, primarily, retirement. That is, how can individuals maximise their expected wealth given a certain tolerance for risk?

A recent study by a Federal Reserve economist, in fact, makes an attempt to quantify the cost to the optimal portfolio of removing treasuries from the basket of possible investments – see Box 2. Applying these results to Australia and the benefits of having an asset virtually free of default risk in the form of CGS run well into the *billions of dollars*. Sizeable benefits would also appear to accrue to other risk management activities throughout the economy such as insurance.

The benefits from most micro-economic reforms that have been rightly lauded in recent years are far smaller.

⁶ For example, maturity mismatches were a major element of the S&L crisis in the United States in the late 1980s. The strength and flexibility of the rest of the system facilitated the resolution of the crisis. In contrast, the problems facing Japanese banking today are proving less tractable given the dominance and cumbersome nature of the big banks. Alternative resolutions to the difficulties being encountered in Japan are not as readily available.

The portfolio management costs of removing CGS could run into billions of dollars.

Box 2

Portfolio Management without a Risk-free Asset

A Fed economist, Antulio Bomfin, has estimated the costs involved in removing treasuries from optimal portfolios.⁷ The removal of any asset from the portfolio will definitely not leave the optimising investor better off – i.e. otherwise, the investor could have chosen to hold none of the asset in question in the original portfolio. The question, instead, is how large the costs could be? Moreover, is the removal of an asset a greater issue when that asset is free of credit risk?

Bomfin concluded that the costs were “small” for most investors, but it is interesting to note how large even seemingly “small” costs turned out to be:

- the estimated costs ranged from a touch above zero to 5.5 per cent of wealth
 - the central cases tended to find a cost between 0.2 and 0.9 per cent of wealth.
- ballpark estimate;
- if we apply this to total funds under management in Australia (i.e. around *the total cost*, possibly by a considerable amount, given that funds under management represent only a small part of private sector wealth (which is of the order of \$3,500 billion).

be regarded as precise. However, the dimensions involved should give cause for reflection. \$3.25 billion is much larger than the most optimistic of the model-based estimates of the benefits of the GST, or larger than the estimated benefits of most trade reforms.

3.7 The conduct of monetary policy

Monetary policy without CGS is feasible ...

The Reserve Bank has already had to significantly modify how it implements policy as the stock of CGS declined. Among the steps taken have been the RBA’s decisions to hold semis (July 1997), A\$ securities of supranationals (Oct 2000), and semis traded as euro entitlements (June 2001). Also very important was the decision to remove PAR requirements. And, as noted in Part 2, it has increasingly relied on operating in the

⁷ Antulio Bomfin “*Optimal Portfolio Allocation in a World without Treasury Securities*”, Federal Reserve Board, 2001. Bomfin estimated the welfare loss based on a CAPM model using up to seven asset classes. In particular, the question being asked was what is the extra wealth needed to make the investor’s ‘utility’ indifferent compared with the original portfolio.

⁸ The key assumptions were the degree of risk aversion and whether short selling was permissible.

market for foreign exchange swaps because of the difficulties it would have had if it had just acted through repos.

... but gives rise to new costs and management issues.

These adjustments to the implementation of policy have not caused noticeable problems for the markets, nor has any loss of efficiency been evident. The message that incremental change in financial markets can generally be handled smoothly is one that applies more broadly.

However, what is being considered here is radical change – no more CGS. Monetary policy without government bonds is obviously feasible – witness policy in the many countries around the world with less developed financial markets. But would there be efficiency losses, and are there other important implications?

Just how policy would be conducted has to be speculative. However, an ex-Fed Governor, Laurence Meyer, gave a speech on just this subject a few years ago when the US was facing the prospect of the stock of treasuries being run down over the next decade.⁹ As it has evolved, such a situation now looks remote indeed. Still, the concepts he was toying with were very instructive – see Box 3.

3.8 An economy's ability to cope with crises

From the above, it should be clear that there could be quite substantial costs involved in the *regular* conduct of the economy if the Government were to redeem all its debt. Of even greater concern will be an economy's ability to cope with stress. Consider, for example, comments made recently by a leading Finance Professor from Wharton on the role of central banks:

“The role of central banks in preventing crises is their most important job. It is, for example, much more important than whether the inflation rate is 1% or 3%.”

Franklin Allen, 2001.

Exactly the same comment can be applied to macroeconomic management at a national level embodying the actions of both government and its central bank.

At best, only patchy consideration appears to have been given to just how the market would respond to life without CGS. Some researchers at the IMF likewise found a lack of awareness of potential changes when they conducted a study of the potential life without treasuries:

Consideration needs to be given to what life would be like without the 'safe

*“Based on our discussions with a wide variety of market participants, it appears as if many of them have not yet grappled with some aspects of how their portfolio and risk management might be affected and transformed, and how market dynamics might be affected, **particularly during times of stress and turbulence.**”*

⁹ Laurence Meyer “*Executing Monetary Policy without Treasuries*”, Federal Reserve Board (2001)

haven' of
CGS.

dynamics might be affected, *particularly during times of stress and turbulence.*"
(emphasis added)

Schinasi, Kramer and Smith (2001), *ibid.*

The research on this subject may be still in its infancy, but two crucial conclusions have emerged:

- the need for a robust, transparent system of regulations and governance practices; and
- the desirability of having *breadth* in financial markets based on *both* strong banks and deep securities markets.

Box 3

Monetary Policy without Government Bonds

During his period as a Federal Reserve governor, Laurence Meyer delivered a considered speech on how monetary policy could best be conducted if the US were to continue to run substantial surpluses and redeem all treasuries. He argued for a multifaceted approach that included:

- A "*permanent portfolio*" of assets that would balance long-term secular increases leant towards a broad, diversified portfolio of *private sector debt and equity securities* with acceptable liquidity. He suggested that the portfolio be managed externally.
- An "*intermediate portfolio*" to handle seasonal fluctuations in currency and allow for injections of liquidity in times of stress. He suggested repos (against a wider range of collateral than is currently the case) and discount window loans.
- A "*liquidity portfolio*" for day-to-day shocks. Overnight or short-term repos permanent portfolio are suggested.

is a useful starting point for Australia. Of course, some of the details would have to be modified, including introducing a greater role for foreign exchange swaps. Also, the Reserve Bank does not have the same scope to make use of agency paper and would presumably operate largely through bank paper.

Three features of the framework are especially relevant to the current debate:

- Monetary policy can be effectively implemented without CGS, although there financial institutions. There would also be ongoing costs associated, for example, with the need for the RBA to manage credit risk, and ensure neutrality and liquidity, for the private paper it held.
- The inclusion of equities in the central bank's "permanent portfolio" comes about currency (see Part 2) that should be as broad as possible thereby limiting any distortionary effects on financial markets. A logical alternative to this is for the Government to hold this portfolio of assets and continue to issue bonds.
- The "intermediate" and "liquidity" portfolios will tend to rely heavily on concerns about creating institutions that are "too big to fail" as discussed below.

Alan Greenspan summarised the case in a speech given in the wake of the financial crises seen in 1998:

"Developments of the past two years have provided abundant evidence that where a domestic financial system is not sufficiently robust, the consequences for a real economy of participating in this new, complex global system can be most unwelcome."

"A recent study by Ross Levine and Sara Zervos suggests that financial market development improves economic performance, over and above benefits offered by banking sector development alone. The results are consistent with the idea that financial markets and banks provide useful, but different, bundles of financial services and that utilising both will almost surely result in a more efficient process of capital allocation."

Alan Greenspan, 1999¹⁰

Of course, capital markets can continue to exist without government paper, but less efficiently and without the safe haven asset for times of stress. As the next section elaborates, they would have quite a different character than those operating today.

Greenspan made two further comments directly relevant to the current policy considerations in Australia:

¹⁰ Alan Greenspan, "Do efficient financial markets mitigate financial crises?" Federal Reserve Board (1999)

“The addition of capital market alternatives [to banks] is possible only if scarce real resources are devoted to building a financial infrastructure – a laborious process whose payoff is often experienced only decades later.”

Australia embarked on just such an investment over the past couple of decades. The payoff has been, in Greenspan’s words:

“Despite its close trade and financial ties to Asia, the Australian economy exhibited few signs of contagion from contiguous economies, arguably because Australia already had well-developed capital markets as well as a sturdy banking system. But going further, it is plausible that the dividends of financial diversity extend to more normal times as well. The existence of alternatives may well insulate all aspects of a financial system from breakdown.”

Strong stuff!

3.9 Implications for the structure of the financial market

The financial market would become more reliant on the commercial banks ...

The logical result of the abolition of CGS would be a financial system that is more heavily dependent on the large commercial banks. This could occur from either:

- a waning in the level of activity in the domestic securities markets. Note that the ultimate demand for, say, hedging or portfolio management would remain, but many of the financial services in this scenario would be shifted offshore (with a resultant increase in imports of services); or
- by the commercial banks assuming more dominant positions in the domestic securities markets. From the above discussion, it is clear that they would be pivotal for pricing, hedging, overall risk management and the conduct of monetary policy. Obligations by the ‘big four’ banks would underpin the repo, swaps and futures markets.

... and financial services from overseas.

There has been an ongoing debate over many years whether largely institution-based financial systems (eg those in Germany or Japan) are better than market-based ones (as in the US or UK). As inferred by Greenspan, the consensus now appears to be that the two should be viewed as complements.

Banks may become ‘too big to fail’.

The situation being envisaged here is one where Australia risks ending up with that balance in appearance but not reality. The banks would have a dominant position raising concerns over such issues as competition, transparency of pricing, and the like.

Of even greater concern would be a situation where the major banks were to come under pressure as a couple did in the late 1980s. The impact would automatically be felt throughout the capital markets. The concern over ‘too big to fail’ situations would arise and the Government of the day would be forced to help to find a resolution.

It is likely that the market would act as though this were the case in other times also, and bank paper, for example, may increasingly be priced as though it was supported by an implicit government guarantee. Officials would of course point out that this would not be the case, but how far would the Government of the day go in sticking to a principle if it risked a major financial collapse?

“The changes will include greater riskiness of the credit structure, an economy more vulnerable to financial panic, and a reduced role for securities markets in favour of giant financial institutions.”

Al Wojnilower

3.10 Adjustment costs

There are costs involved in killing off the Commonwealth bond market ...

There are important adjustment costs associated with any major policy change. These costs are difficult to ascertain ahead of time for there is often little to guide policy-makers in terms of precedence or relevant economic theory.

... and in bringing it back to life.

The introduction of the GST is a case in point. Tax experts were reasonably well placed to debate the merits of the new tax system fully implemented, but the extent of the transitional costs was mere guesswork. As it turned out, the adjustment costs associated especially with compliance appeared to have been grossly underestimated (and, indeed, compliance continues to represent an ongoing burden). In such circumstances, it is imperative to have confidence that the long-term benefits of any policy change are sizeable.

Potential adjustment costs associated with the demise of CGS relate both to the costs of transforming the financial markets initially and the possible need to re-establish a Government debt market in the future.

The initial adjustments, in increasing order of cost, will range from:

- retraining existing staff; to
- reconfiguring products, systems, risk management tools, and so on; to
- the flow on effects that such disruption in financial markets may cause to customers in the broader economy.

Y2K kept a lot of computer specialists employed. The end of CGS and the replacement with other instruments would see a level of (generally unproductive) activity that would be larger still.

If CGS were abolished, a future Government conceivably could face circumstances where it would like to re-establish the market. Such circumstances may include a crisis or simply relate to the changing demographics of the population after the bulge

associated with the ‘baby boomers’ passes through. Ideally, Government will be managing such contingencies ahead of time:

“Unless some efforts are made to sustain a continued positive gross debt position, such a government would be forced to re-establish a market for government debt in every cyclical downturn. This is likely to be difficult at the very time investor confidence is weak.”

Edey and Ellis, 2002

An OECD study makes a similar point:

“Maintaining a minimum level of gross debt would also eliminate the costs of re-establishing the government bond market in the second half of the 21st century, when the needs of an ageing population are expected to result in an increase in net debt.”

Mylonas, Schich, Thorgeirsson and Wehinger (2000):

Note that the only real alternative Governments will have to manage the risks associated with tough times will be to accumulate a sizeable pool of assets in the good times. The issues relating to managing such a portfolio of assets are discussed in the following chapter.

3.11 Conclusion

The former Secretary of the Treasury concluded that Government bonds continued to play a crucial role in ensuring the health of the financial system:

“... we value the role the CGS market plays in providing a risk-free pricing benchmark for the rest of the market. That role is critical in developing and maintaining the market instruments that underlie the intermediation alternatives, to which Dr Greenspan referred as providing some of the strength of the Australian markets. We therefore intend to maintain the maturity and liquidity of the CGS bond market. It may be that, one day, market innovation will permit another approach; but we shall await that development. In the meantime, we shall meet the Government’s net debt objectives through portfolio development in a manner that minimises Commonwealth funding costs and risks.”

Ted Evans, Feb 2000

The private sector will never be in a position to offer equivalent

From the above discussion, we have come to the firm conclusion that the day that “market innovation will permit another approach” is a long way off. The private sector will never be in a position to offer securities with the same risk profile of government bonds. Indeed, government will always be better placed to manage risk for the entire economy than the private sector and, by issuing long-dated securities, it is able to allow

*alternatives to
CGS.*

the private sector – individuals and companies – to manage their own positions in a cost-effective manner.

Complete quantification of all the costs involved is not possible, in part because of the immature status of economic analysis and research in this area. However, from the above, it appears that the benefits to accrue from maintaining the Commonwealth bond market will run well into the billions of dollars (with benefits especially to those who need to manage long-dated risk, i.e. *every individual*). Moreover, bonds are critical to ensuring breadth in the domestic financial markets, a feature that appears to be vital at times of financial crisis.

The final leg in the argument is what are the costs or benefits associated with government holding assets to balance a stock of bonds? This is taken up in Part 4.

THE BOND MARKET: Part 4. Managing a Portfolio of Assets

Most of the claimed costs of keeping the CGS market open do not stand up to scrutiny.

The preceding section highlighted the costs involved in liquidating the bond market especially as they relate to effective and efficient risk management throughout the economy. But what about the costs involved in keeping the market open? And what about the risks involved in the Government establishing a portfolio of assets if that is needed to balance at least \$50 billion worth of bonds?

Most of the costs that are identified do not stand up to scrutiny. However, it is worth analysing the main arguments being used by those advocating the liquidation of the bond market because they keep cropping up in the debate. As discussed below, the real concerns with the idea of maintaining a bond market are political in nature. That does not mean that they can be ignored; to the contrary. *But if short-term political dynamics compromise good policy, such decisions must be challenged.*

If the Government were to sell the remainder of Telstra and decide to maintain the bond market, it would need to acquire a portfolio of assets.¹¹ It should be stressed, however, that a strong case can be made for the establishment of such a portfolio even without the sale of Telstra:

- already, the Commonwealth's net debt position (around \$36 billion) is well below the stock of outstanding CGS (\$67 billion). Moreover, ideally, something closer to \$100 billion of bonds would ensure that a healthy financial sector is best placed to assist in managing risk throughout the economy and community; while
- there is a continuing need to increase national saving for the long-term strength of the economy, i.e. to help reduce the current account deficit and/or increase investment. Thus, ideally, the Commonwealth should be running budget surpluses on average, thereby eating into any net debt.

With the above in mind, the following examines possible costs of maintaining the bond market and then addresses the design of a fund or reserve that the Government could set up with the proceeds from its bond issuance.

4.1 Possible costs to be considered

4.1.1 What about the interest payments?

Arguments based on gross interest savings are misleading.

At the simplest level, bonds attract interest that needs to be serviced:

“The elimination of the bond market would mean big savings for taxpayers. For every \$1 billion of bonds on issue, there is a gross annual interest cost of about \$55 million. If, as has been asserted, the government bond market ‘needs’ to have

¹¹ Of course, it could use some of the proceeds to fund some direct investments in, say, environmental projects as some have advocated. But even if it were so inclined, establishing a portfolio would also be needed.

\$50 billion of securities on issue, the annual interest cost would be about \$2.75 billion.”

Stephen Koukoulas, article in the AFR.

This comment is disingenuous in the extreme. As any individual investor knows, it is the *net* costs or benefits that matter.

Selling Telstra will not improve the Government's net worth.

At the next level of sophistication, it has been noted that using the proceeds of a Telstra sale to pay off debt should improve the bottom-line Commonwealth budget, at least as reported. This simply reflects the fact that the Budget reports Telstra dividends and these have been paid at a rate below bond yields.

Again, the dividend yield is only part of the return on equity. And the expected return to Telstra's equity holders will exceed the (risk-free) bond rate. The quirks of accounting practices should not disguise the fact that selling Telstra does *not* improve the Government's net worth.¹²

Over time, the Government's position will be improved by holding a portfolio of assets to balance the stock of CGS.

For the current debate, however, the appropriate comparison is a broader one, namely between bond yields and average returns from a portfolio that the bonds would support. Both theory and history say that, again, the returns to Government over time should comfortably exceed the interest on the (risk-free) bonds:

- the market will demand higher returns on other investments, including in equities, to compensate for the greater risk;
- for example, the equity risk premium has averaged perhaps as high as 6-8 per cent over many decades. Even if the premium is lower in the future as some academics have argued, it will still easily exceed bond yields;
- in part, this is a manifestation of governments being inherently advantaged in managing risk over time.

The bottom-line is that the true position of the Government's accounts will be improved by holding a portfolio of assets. If the portfolio matches, say, \$50 billion of bonds, *the improvement could easily exceed \$1 billion a year.*

4.1.2 Costs of running the portfolio

Of course, the portfolio needs to be managed by someone and they would have to get paid. And no doubt the management would be conducted by someone in the financial markets – another example of vested interests pursuing their own grubby objectives!¹³

¹² Indeed, the decision to sell Telstra should be based on whether it improves the overall efficiency and pricing of the provision of telecommunications services, not on a narrow notion of reducing debt.

¹³ See, for example, Brian Toohey's article in the AFR on 2 Nov 2002.

The costs of running the Government's portfolio would not be prohibitive.

Any such portfolio should be managed on an arms-length basis that would accrue fees. But these fees shouldn't be nearly as high as those applying to existing funds under management since the administration needs would be minimal by comparison. Moreover, the Government – or rather, its arms-length manager – would be in a perfect position to ensure that any fees are negotiated to a low level.

The overall cost of running the portfolio would, thus, not alter the conclusion that the net financial benefits to the Government's accounts would be substantial.

4.1.3 Costs of keeping financial market screen jockeys in jobs

Replacing CGS with private paper or foreign securities would not save on labour costs.

The other source of 'vested interest' in the financial sector would seem to be those currently employed in the bond market. Their jobs are under threat.

A little thought, however, shows that any savings to the economy from liquidating bonds are ephemeral. The services provided by capital markets to the rest of the economy will still be needed and alternatives to Commonwealth paper will be forthcoming. Two scenarios illustrate the point:

- first, Commonwealth bonds could be replaced by domestic private paper. In this case, the amount of monitoring and research needed for the uses of the paper, and its derivative products, would be far greater than that required for CGS. That is, if, as some seem to hope, the only upshot of the liquidation of Commonwealth bonds would be the more rapid evolution of private debt instruments, *more* people would be employed in the financial markets and the direct costs – as well as the risk – would be higher; or
- secondly, the demise of the bond market might see this activity shift offshore. Foreign sovereign paper could play a greater role underpinning our market. In this case, employment in the various parts of the domestic financial markets may larger or smaller than currently is the case. For example, the management of, especially, currency risk would entail greater domestic resources. But this may be dominated by more of the domestic capital markets heading offshore. In effect, the financial services would still have to be paid for, but more would accrue as an import of a service, i.e. there would be negative consequences for GDP.

Thus, in neither case would there be economy-wide savings. These ideas are simply a further manifestation of the fact that Government bonds are very transparent and uniform in nature, cutting monitoring and management costs considerably.

4.2 Managing a Portfolio of Assets

Government share ownership is already practised widely and

The notion of governments owning shares in private businesses seems to conjure up horrible images for some. Governments should stick to fixing hospitals and roads and leave the private sector to get on with employing, producing and turning a profit.

appropriately ... Yet the idea is hardly revolutionary. Numerous countries already own sizeable funds for various purposes including Norway, Sweden, Singapore and Hong Kong. Others are in the process of developing funds in order to prepare for what will be growing obligations as populations age. Canada, New Zealand and Ireland fall into this camp.

Closer to home, the Commonwealth Government has had a long experience in similar exercises with superannuation funds for its employees including the CSS and PSS schemes.

Nevertheless, there are issues to be addressed, especially given the scale of the fund being envisaged. The first issue is precisely what would the fund be designed to do?

4.2.1 Would it be a “fund” or a “reserve”?

The polar cases are:

... with defined goals ...

- a ‘fund’, the proceeds of which would be set aside for a specific purpose. The obvious candidate is the Commonwealth’s unfunded superannuation liabilities that, in July 2001, amounted to \$85 billion.¹⁴ However, many more future liabilities can be identified for the Commonwealth and other candidates are possible; and
- a ‘reserve’, established to narrowly match a targeted stock of bonds. The idea behind such a reserve would be that it would be set up essentially as a prudential exercise to facilitate effective economy-wide risk management.

A range of alternatives between these two cases can easily be envisaged. Importantly, note that the net financial position of the Commonwealth would be influenced by more than just the difference between the funds under management and bonds outstanding. The Government would still require scope to adjust due to fluctuations in revenues and expenditures over the course of a year and, to some extent, over the cycle. Accordingly, it would continue to operate an account with the RBA and it could continue to issue Treasury notes.

Flows into, and distributions out of, such a fund/reserve could be the subject of broader fiscal considerations. For example, to the extent that it is decided that distributions should be returned to the Budget, the timing may be better matched to the economic cycle rather than the earnings of the fund for a particular year. These are not especially difficult concepts to make operational, but they take us beyond the scope of the current discussion and so we won’t pursue them further here.

¹⁴ These liabilities will be reduced steadily over the next few decades given the changes in the design of the Commonwealth’s superannuation schemes.

4.2.2 Governance

... and arms-length management.

The governance issues involved in managing such a fund can be handled relatively comfortably. Some of the elements would be professional boards, external audits, the bulk of the funds to be managed externally, etc. The Federal Government has essentially such an arrangement in place for the CSS/PSS funds, with a solid track record.

Among the rules, clear benchmarks for investment in different asset classes would have to be established. Foreign assets would be included (for strong economic reasons associated with raising national saving). The fund would end up with some ownership of publicly listed companies, but ceilings can be selected and the funds' voice as a shareholder delegated to an independent manager.

For a fuller discussion on some of the governance issues, the interested reader is referred two recent papers (by authors who are generally pro the private sector):

- Gregorio Impavido, *"On the Governance of Public Pension Fund Management"*, The World Bank, 2002, *mimeo*.
- Robert Palacios, *"Managing Public Pension Reserves, Part II: Lessons from five Recent OECD Initiatives"*, Social Protection Discussion Series, No 0219, *The World Bank*, 2002.

4.2.3 The inevitability of the Government acquiring a portfolio of assets

In any case, issues associated with owning a portfolio of assets will still have to be addressed.

We think that the above is not especially difficult or costly to set up; indeed, as noted earlier, it should provide a healthy contribution to the Government's financial accounts in any underlying sense.

But it should be emphasised that even if the Government were to decide to liquidate the bond market, responsible policy would force it to establish a fund at some stage, and to do so soon if Telstra were sold:

- following the sale of Telstra, net debt would be roughly zero;
- as noted above, the Government should desirably be running surpluses on average for national saving reasons; and
- without a bond market, the Government would need a kitty of perhaps \$30 billion or more if it wished to be in a position to provide effective fiscal support in the face of a major economic downturn (i.e. one that could persist for a few years).¹⁵ It would not wish to have to try to re-establish a bond market in the midst of such an event.

¹⁵ The risk of such an economic downturn is ever present even if the government of the day is operating responsible monetary and fiscal policies. Having the wherewithal to alleviate the fallout from such events is an integral part of the principles articulated in the Government's "Charter of Budget Honesty".

So, one way or another, the governance and related issues associated with owning a portfolio of assets will need to be addressed.

4.2.4 Transitional issues

Markets can accommodate incremental change ...

It was noted above that the CSS and PSS funds have operated without causing either serious governance issues or any noticeable impact on the markets. However, these are modest in scale compared with the envisaged fund. Surely \$50 billion will be hard to absorb!

Yes, but note that the impact could be readily spread. A possible strategy would be to establish a \$10–20 billion fund over the next year or two and only expand it further at the time that any Telstra proceeds flowed into the Government's coffers. At that point, fund managers would have to sell other assets in any case to purchase Telstra, and the net effect would be the Government exchanging a Telstra asset for a broader portfolio.

In addition, the Government could use its accounts at the Reserve Bank to further smooth any impact on the market.

... and a one-off hit to the budget.

The other major transitional issue relates to how establishing such a fund would be treated in the budget. It appears that the Government's accounting treatment would require it to show a hit to the bottom-line in the year the fund is established. For one year, there might be a deficit of, say, \$50 billion!

The fact that the recorded deficit is so large makes it quite easy to sell. It would be an anomaly incurred in the cause of prudent government – a *positive* for a Government wishing to seem responsible. If the markets and broader community were happy to look through hit to inflation caused by the GST, this will be a much easier sell.

4.3 Conclusion

The major problems are political rather than about 'best practice'.

The potential problems associated with establishing a fund as a counterpart to maintaining the bond market in no way match the benefits of having bonds continue as a vital risk management infrastructure for the whole economy. In fact, there should be a significant financial benefit to the public purse while the governance issues are, at most, irritants rather than overriding concerns.

The major problems do appear to be political rather than relating to best economic or financial practice. The debate is susceptible to the one-liners – we can't trust politicians; all debt is bad; and so on. This isn't only a modern phenomenon:

"The public debt is a public curse."

James Madison, fourth US President, 1790

Quite possibly, Madison as a politician was speaking to a populist audience. Compare this to the view of the man directly responsible for establishing an effective financial system:

“A national debt, if it is not excessive, will be to us a national blessing.”

Alexander Hamilton, first Secretary to the US Treasury, 1791

The Commonwealth bond market does indeed seem to have been a blessing in strengthening domestic capital markets over recent times. *A cost/benefit analysis comes down squarely on the side of keeping government bonds.*

