

STATEMENT 7: BUDGET FUNDING

The Government indicated in the 2002-03 Budget that it would consider the future of the Commonwealth Government Securities (CGS) market, in consultation with key stakeholders. Following a public review, the Government has decided to maintain the CGS market. This will entail ensuring sufficient CGS remains on issue to support the Treasury bond futures market.

Financial assets will continue to be held on deposit with the Reserve Bank of Australia to meet short-term liquidity needs. These needs are assessed to be up to \$25 billion over the course of a year. If deposits held at the Reserve Bank exceed that sum for a sustained period, the Government will consider arrangements to allocate some funds to other liabilities, possibly superannuation. However, this would be the subject of further consultation. Retaining the CGS market to support the Treasury bond futures market will require ongoing issuance of Treasury bonds, both at the middle and long-end of the yield curve.

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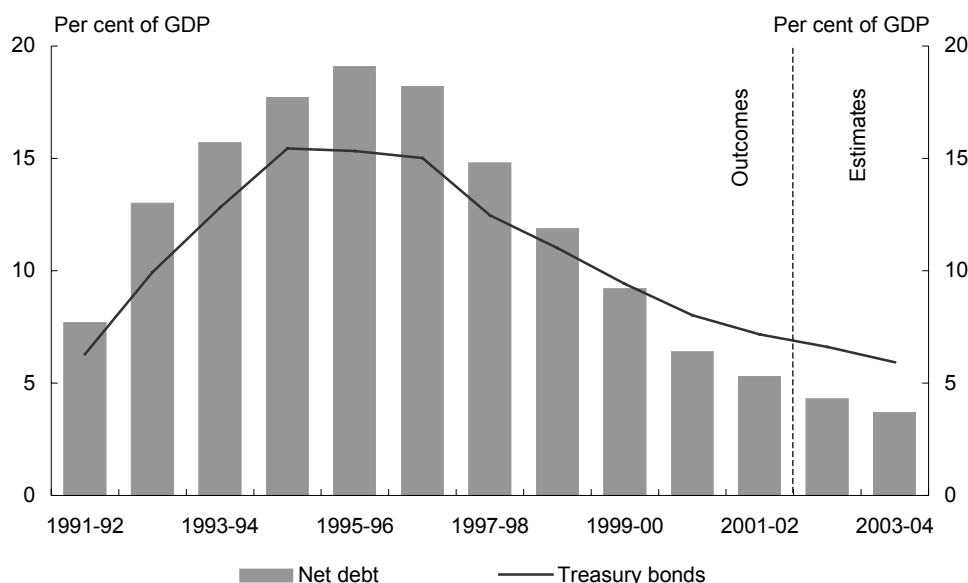
REVIEW OF THE COMMONWEALTH GOVERNMENT SECURITIES MARKET

Background

The Government's fiscal management has significantly reduced Commonwealth general government net debt. Net debt has fallen from a peak of 19.1 per cent of GDP or around \$96 billion in 1995-96 to an estimated 4.3 per cent of GDP or around \$32 billion in 2002-03. Net debt is expected to fall to 3.7 per cent of GDP or around \$30 billion in 2003-04.

Reductions in gross debt outstanding have accompanied the decline in net debt. This is reflected principally in declining Commonwealth Government Securities (CGS) on issue. In particular, Treasury bonds on issue have fallen from around 15 per cent of GDP in 1995-96 to around 7 per cent of GDP in 2001-02 (Chart 1).

Chart 1: Commonwealth general government net debt and Treasury bonds on issue^(a)



(a) Treasury bonds on issue are net of the Commonwealth's own holdings and debt on issue for the States and Territories.

Source: ABS Cat. No. 5501.0 and 5513.0, Commonwealth Final Budget Outcomes, Australian Office of Financial Management and Commonwealth Treasury estimates.

The reduction in net debt has been managed in accordance with the objective of maintaining a viable CGS market. Nevertheless, reductions in CGS on issue raised questions among some market participants about the future viability of the CGS

market. The Government acknowledged these concerns in the 2002-03 Budget and undertook to examine the issue in consultation with key stakeholders.

The Government initiated a public review on the future of the CGS market, releasing a discussion paper in October 2002 and inviting written submissions from interested stakeholders. The Review involved an extensive and broad-based consultation process. During the Review, a wide range of stakeholders lodged over 40 written submissions and over 120 consultation meetings were held involving more than 90 domestic and international market participants and organisations. In addition, a reference committee, comprising representatives of key industry associations and an academic, met on a number of occasions to discuss a range of technical issues.

The context in which the question of whether to maintain Commonwealth debt outstanding has changed. The question arose in the context of the further sale of Government equity in Telstra. That sale has been delayed, and as a consequence, the capacity to retire all outstanding debt is not imminent.

Outcome of the Review

The Review concluded that, while financial markets may innovate in the absence of CGS, it was more likely that closing the CGS market would lead to slightly higher interest rates given the development of Australia's financial markets and current lack of effective alternatives to CGS. This would result primarily from the higher costs associated with managing interest rate risk without a Treasury bond futures market. Further, the Australian financial market may become less diversified and more vulnerable during periods of instability. Accordingly, on the basis of these findings, the Government has decided to maintain sufficient CGS on issue to support the Treasury bond futures market.

Interest rate risk management

The CGS market plays an important role in managing interest rate risk (that is, the risks associated with adverse movements in interest rates). This capacity to manage interest rate risk contributes to a lower cost of capital in Australia. For example, investors may accept a lower yield from a corporate bond if they can hedge the interest rate risk associated with holding this bond. In addition, the ability of financial institutions to manage interest rate risks associated with their balance sheets also may contribute to lower costs for consumers on a range of products including retail loans. Changes that increase the difficulty of managing interest rate risk could, therefore, lead to an increase in the cost of capital. The magnitude of any increase would depend on the extent of the increased cost of new hedging arrangements.

Financial market participants in Australia currently use two main markets to manage their interest rate risk, the Treasury bond futures market and the interest rate swap market. The Treasury bond futures market is the primary vehicle for managing outright interest rate risk, reflecting its high liquidity, low transaction costs and

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accessibility to a wide range of participants. The interest rate swap market generally is limited to large financial institutions and is used to establish customised arrangements for interest rate risk management. Interest rate swaps can be specifically tailored to meet the requirements of the participant, whereas Treasury bond futures contracts have standardised parameters. Interest rate swaps also may be more effective in managing the interest rate risk associated with instruments that incorporate credit risk, as the yield on swaps also includes an element of credit risk. Without a Treasury bond futures market, the interest rate swap market would likely become the main interest rate risk management tool.

Interest rate swaps generally are a more expensive hedging instrument than Treasury bond futures. A number of factors currently contribute to the higher cost of interest rate swaps including a lower level of market liquidity, less transparent pricing of the 'over-the-counter' market relative to Treasury bond futures (which are exchange traded), and the concentrated nature of the swap market. The cost of using interest rate swaps often is higher due to administration costs and the need to actively monitor and manage the risks associated with these instruments, including operational risk and counterparty credit risk.

The costs associated with interest rate swaps could increase if the CGS market were closed. The interest rate swap market heavily depends on the Treasury bond futures market, as participants in the swap market extensively use Treasury bond futures to hedge interest rate exposures associated with providing swaps. Without Treasury bond futures, swap market participants would likely require a higher premium as compensation for taking significant additional risk on their balance sheet.

Financial market diversity

In the absence of CGS, the interest rate swap market would likely substitute for CGS in a number of roles. However, as banks presently play a significant role in the swap market, this may increase concentration of financial market activity in the banking sector. Given the soundness of the Australian banking system, this may be of little consequence. However, in times of major economic and financial instability, it could add to the risk in the financial system. Although major shocks are rare, experience suggests the consequences can be more severe in less diversified financial systems.

Investment vehicles

The Government's decision to maintain the CGS market to support the viability of the Treasury bond futures market will avoid the slightly higher cost of capital that would be likely to result from removing government bonds from the financial system, and will maintain the diversity of the financial sector. It also will maintain opportunities for superannuation funds and other investors to hold government bonds. However, the decision to maintain the market is not specifically targeted at meeting investor demand for risk-free financial assets. Alternative low risk investment options are available in domestic debt markets, including State government debt and highly rated supranationals. The continued development of markets for securities backed by assets

such as residential and commercial mortgages (asset-backed markets) also may provide alternative investment options.

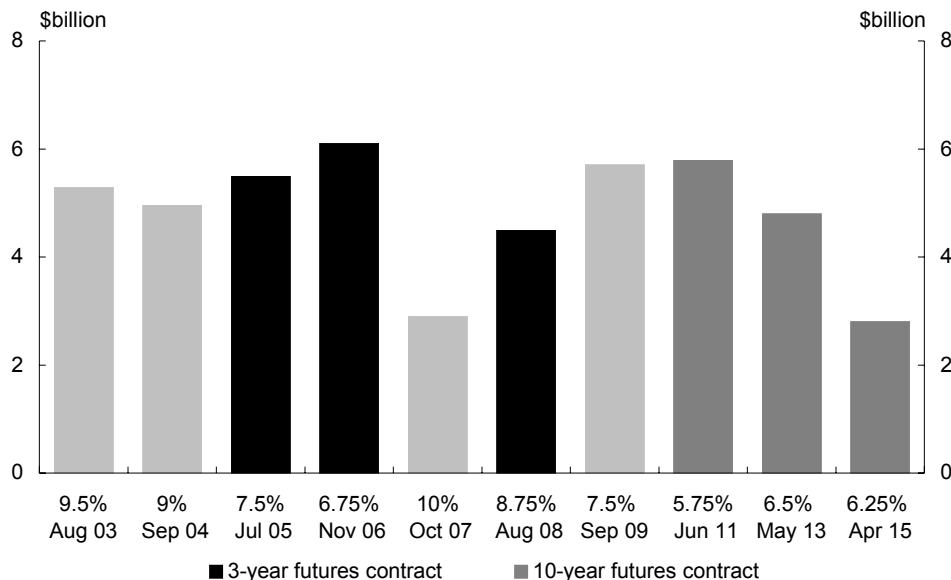
Implications for Commonwealth debt issuance

Retaining the CGS market to support the Treasury bond futures market will require ongoing issuance of CGS. This issuance will need to be structured to underpin the 3-year and 10-year Treasury bond futures contracts. Continuing the 3-year futures contract will allow participants to manage the interest rate risk associated with short-dated positions, while the 10-year futures contract will allow management of longer-dated interest rate risks.

The Treasury bond futures contracts are supported by an underlying basket of Treasury bonds. This basket provides a price against which the futures contracts can be settled. Each basket generally is comprised of three or four Treasury bonds determined on the basis of their liquidity, amount outstanding and term to maturity. The 3-year futures contract requires the basket of bonds underpinning the contract to have an average remaining period to maturity of around 3 years. Similarly, for the 10-year futures contract, the underlying basket of bonds should provide an average remaining period to maturity of around 10 years.

Chart 2 illustrates the profile of benchmark Treasury bonds currently outstanding and highlights those bonds included in each of the current futures contracts.

**Chart 2: Profile of benchmark Treasury bonds outstanding
(May 2003)^(a)**



(a) Treasury bonds on issue are net of the Commonwealth's own holdings and debt on issue for the States and Territories.

Source: Australian Office of Financial Management.

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The current basket of Treasury bonds underpinning the 10-year futures contract comprises bonds maturing in June 2011, May 2013 and April 2015, providing an average term to maturity of around 10 years. This profile of around 2 years between maturity dates of bonds in the basket effectively supports the 10-year futures contract. The 2 year spacing of bonds may result in some fluctuations in the average term to maturity of the basket around the notional target of 10 years. However, given the long-dated nature of the contract, these divergences are relatively minor and should not impact on the contract's efficient operation.

Maintaining this profile of outstandings will require issuance of a new long-dated Treasury bond every 2 years with a term to maturity of around 13 years. It is envisaged that around \$5 billion will need to be issued into each new line of Treasury bonds over the 2 year period.

The current basket of Treasury bonds underpinning the 3-year futures contract comprises bonds maturing in July 2005, November 2006 and August 2008, providing an average term to maturity of around 3 years. This profile of around 1 to 2 years between maturity dates of bonds in the basket effectively supports the 3-year futures contract.

The efficiency of the 3-year futures contract could be undermined if the bonds in the underlying basket had intervals of 2 years. This profile would at times result in the average term to maturity of the basket being significantly higher than the notional target of 3 years. Departures from the notional maturity target are proportionately larger for the 3-year futures contract (compared to the 10-year futures contract) and are likely to have a more significant impact on efficiency. Therefore, given the expected issuance pattern of long-dated benchmark lines, additional issuance of Treasury bonds needs to be undertaken in the mid-section of the yield curve. This issuance will reduce the interval between the benchmark lines to around 12 months. To achieve this, a new Treasury bond line with a term to maturity of around 5 years will need to be issued every 2 years. Issuance of around \$5 billion will be undertaken over the course of the 2 year period.

Charts 3 and 4 provide a stylistic illustration of the broad pattern of issuance and debt profile outstanding that will likely be required over time to support the Treasury bond futures market. The issuance pattern of commencing new benchmark lines of Treasury bonds every 2 years will be phased in as current benchmark lines of Treasury bonds progress down the yield curve. In the first year, Treasury bonds with terms to maturity of 5 and 12 years would be issued, while in the alternate year, Treasury bonds with terms to maturity of 4 and 13 years would be issued.

Chart 3: Treasury bonds outstanding and issuance in alternate year 1

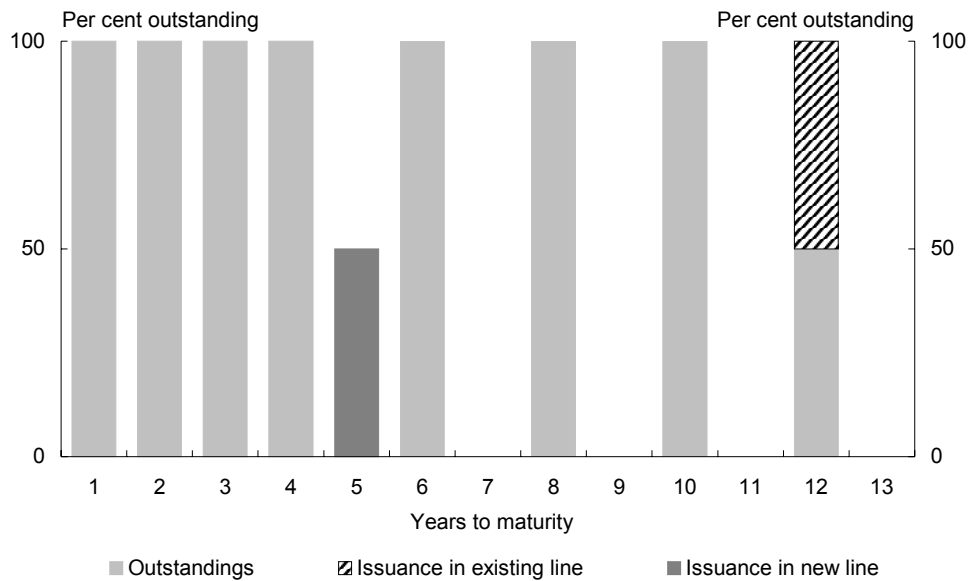
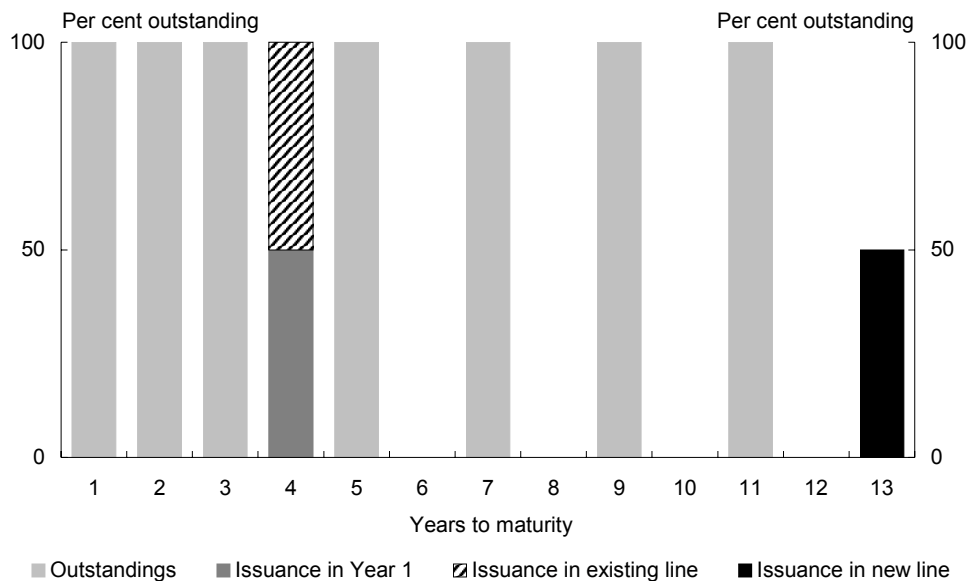


Chart 4: Treasury bonds outstanding and issuance in alternate year 2



Issuance to support the Treasury bond futures market is likely to be less than the volume of bonds maturing over the forward estimates period. This will further reduce the volume of gross CGS outstanding. However, the Government will continue to monitor the liquidity and efficiency of the CGS market.

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Maintaining the CGS market to support the Treasury bond futures market will require issuance to be concentrated in Treasury bonds. The Government will also be seeking to minimise the level of financial assets it is required to accumulate to support the CGS market in order to limit the Commonwealth's exposure to financial risks. On this basis, the issuance of Treasury Indexed Bonds will be suspended.

Management of financial assets

Given the Government's fiscal strategy of maintaining budget balance, on average, over the course of the economic cycle, the Government's decision to maintain the CGS market will result in surplus funds that will need to be managed. That is, as it is important that the Government continues its prudent approach to fiscal policy, the Commonwealth will accumulate financial assets with CGS issuance proceeds.

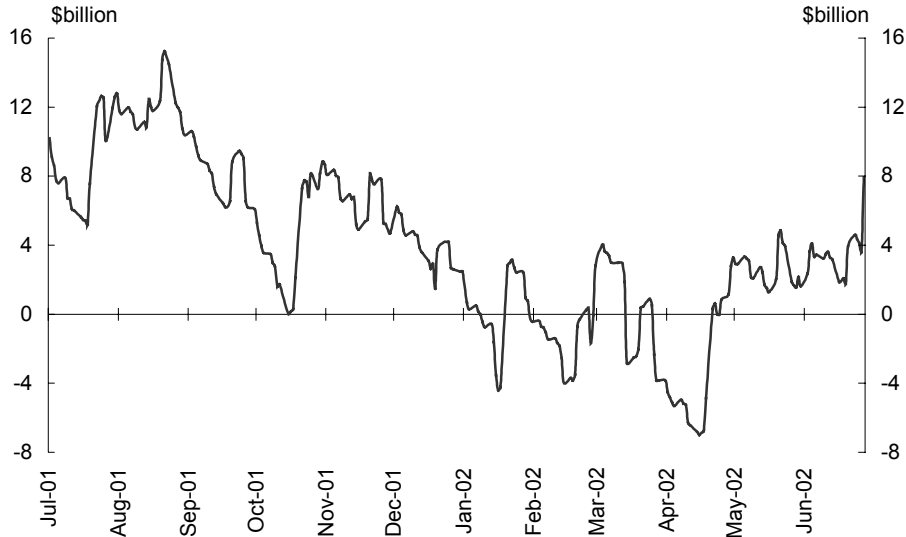
The issuance of CGS and accumulation of financial assets will lead to higher levels of assets and liabilities on the Commonwealth general government balance sheet than would otherwise be the case. This 'grossing' up of the balance sheet will increase the Commonwealth's exposure to financial risks. However, these risks are currently outweighed by the benefits of maintaining the CGS market.

The Commonwealth has held limited financial assets in the form of term deposits with the Reserve Bank of Australia since December 1998. These assets resulted from policy action to maintain liquidity in the CGS market and have been used to assist with the Commonwealth's short-term funding requirement.

Short-term funding is required when the timing of the Commonwealth's cash receipts do not match the disbursement pattern of its outlays and debt repayments. At present, the short-term funding requirement is financed by a combination of running down Reserve Bank term deposits and issuing Treasury Notes. The latter usually have been issued where Reserve Bank term deposits were not available to meet short-term funding requirements.

The size and volatility of the short-term funding requirement is illustrated by changes in Commonwealth financial asset holdings at the Reserve Bank (overnight cash and term deposits). Chart 5 shows the Commonwealth's short-term funding requirement for 2001-02. In this period the Commonwealth's net short-term asset position was initially \$10.2 billion (2 July 2001). It improved to around \$16 billion (late August 2001) followed by a short-term funding requirement of around \$7 billion (mid April 2002), producing a fluctuation of around \$22 billion over the year.

**Chart 5: Net Commonwealth Financial Asset Holdings
at the Reserve Bank of Australia (2001-02)**



Note: Estimates of financial asset holdings at the Reserve Bank less Treasury Notes on issue. Changes in financial asset holdings represent the Commonwealth's short-term financing requirement over time.
Source: Australian Office of Financial Management.

The Commonwealth intends to continue to hold surplus funds in the form of term deposits to meet short-term funding requirements. In view of the historical fluctuations of the funding requirement, the Commonwealth may require around \$25 billion of term deposits to meet funding needs. However, given the volatility of the funding requirement, the average term deposit balance over the year would be considerably lower. The Commonwealth adopted the practice of issuing Treasury Notes on an as-required basis in May 2002. This practice will be continued. As the fiscal position of the Commonwealth has strengthened, the stock of Treasury Notes on issue has declined considerably in recent years.

Using the Reserve Bank term deposit facility will provide the Commonwealth with considerable flexibility in managing its financing requirements. To date, as the facility uses the infrastructure in place for managing the Reserve Bank's reserves, the Commonwealth has been able to utilise an established institutional framework for investment.

The expanded term deposit facility at the Reserve Bank is expected to accommodate the management of financial assets resulting from supporting the CGS market over the next several years. In the event financial assets exceed \$25 billion on an ongoing basis, the Commonwealth will consider allocating some funds to other liabilities, possibly superannuation. Such a decision will be announced well in advance and will be the subject of consultation with interested parties.

BUDGET FINANCING ACTIVITIES IN 2003-04

Total issuance of Treasury bonds in 2003-04 is expected to be between \$2 billion and \$3 billion. Further issuance into the existing April 2015 Treasury bond line will be undertaken to ensure the volume of this bond outstanding is similar to other benchmark lines. Issuance is likely to be in tranches throughout the year. It is expected a new long-dated bond will be issued towards the second half of 2003-04 with a term to maturity around 13 years. This bond is expected to support the 10-year futures contract in 2004-05.

Given the current profile of Treasury bonds outstanding it will not be necessary to issue a new bond with a maturity of around 5 years in 2003-04. There are currently sufficient bonds on issue with this maturity to support the 3-year futures contract. Issuance of a new benchmark with a term to maturity around 5 years will be reconsidered in the context of the 2004-05 Budget.

In light of the issuance strategy, the Commonwealth will not generally seek to undertake repurchases. However, transactions may be undertaken to improve the overall efficiency of the Treasury bond market.

No further repurchases or conversion tenders involving the 10 per cent coupon October 2007 Treasury bond will be undertaken. This will ensure an adequate level of liquidity is available around this maturity.