STATEMENT 7: BUDGET FUNDING

This statement discusses budget funding mechanisms and outlines the Government's intentions on issuance of debt instruments.

As announced in the 2003-04 Budget, the Government has decided to continue to issue Treasury bonds, despite the strong fiscal position, in order to support low cost interest rate risk management throughout the economy. Treasury bonds issuance will be tightly targeted to support the Treasury bond futures market — a key interest rate risk management market.

Late in 2003-04, issuance of a new 13-year Treasury bond (maturing in February 2017) will commence to support the 10-year bond futures contract. In addition, $600 million will be issued in August 2008 Treasury bonds in order to bring that bond line up to the size of other key benchmark lines.

In 2004-05, issuance of the February 2017 Treasury bond will continue. Issuance of a new 5-year Treasury bond will commence around the middle of the financial year.

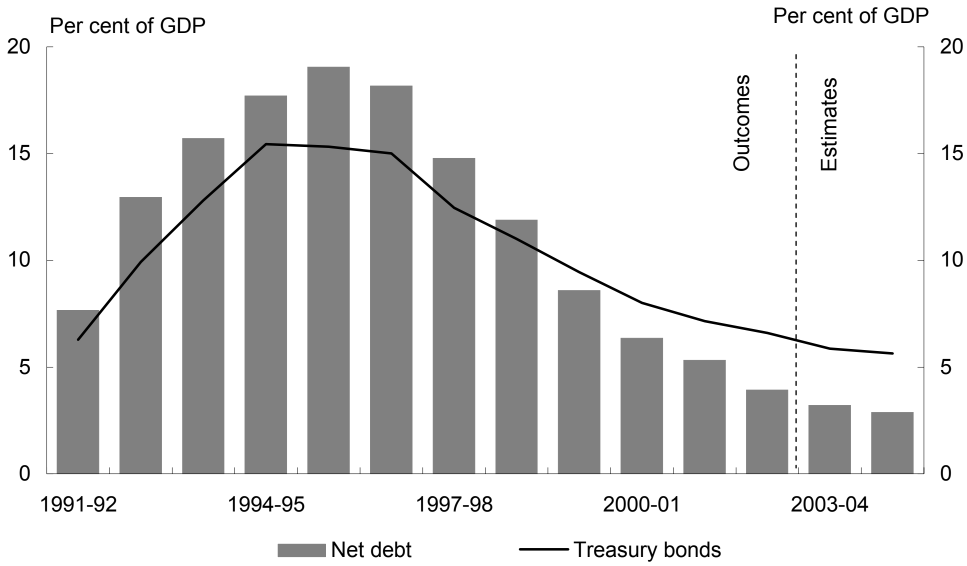
STATEMENT 7: BUDGET FUNDING

BACKGROUND

The Government's strong fiscal management since 1996 has significantly reduced Australian Government general government sector net debt. Net debt has fallen from a peak of 19.1 per cent of gross domestic product (GDP) or around $96 billion in 1995-96 to an estimated 3.2 per cent of GDP or around $26 billion in 2003-04. Net debt is expected to fall to 2.9 per cent of GDP or around $25 billion in 2004-05.

Reductions in gross debt outstanding have accompanied the fall 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 an expected 5.9 per cent of GDP in 2003-04 (Chart 1).

Chart 1: Australian Government general government sector net debt and Treasury bonds on issue[(a)]



(a) Treasury bonds on issue are net of Australian Government holdings and debt on issue for the States and Territories.
Source: Australian Bureau of Statistics Cat. No. 5513.0, Australian Government Final Budget Outcomes, Australian Office of Financial Management, and Treasury estimates.

As a result of the reduction in net debt, and concerns raised by key financial market stakeholders, the Australian Government undertook a public review of the CGS market in 2002. This review set out to determine whether there was a case for the Government to continue to issue debt despite a strong fiscal position.

The review concluded that closing the CGS market would lead to slightly higher interest rates, given the current state of development of Australian financial markets. This would result primarily from the higher costs associated with managing interest rate risk without a Treasury bond futures market. Further, the Australian financial markets may become less diversified and more vulnerable during periods of instability if the CGS market were eliminated. Accordingly, the Government announced in the 2003-04 Budget that it would maintain sufficient CGS on issue to support the Treasury bond futures market.

The outcome of the review means that the debt issuance programme is now tightly targeted at maintaining liquid and efficient CGS and Treasury bond futures markets. The outcome of the CGS review concluded Treasury bond outstandings of around $5 billion per line would be consistent with continued liquidity. In general terms, issuance of a long-dated bond will commence every second year to support the 10-year futures contract. Issuance of new mid-curve bond will commence in the year between commencement of new long-dated bonds, in order to provide better coverage of the short end of the yield curve.

As a result, around $5 billion of Treasury bond issuance will occur each year. However, because the current profile of Treasury bonds outstanding does not match the intended profile of outstandings, there will be a transition period to the new issuance strategy. During this transition period, which is expected to be two to three years, Treasury bond issuance may be slightly higher than $5 billion per year.

In addition, the issuance programme in any one year will be designed to focus mainly on the new bond that is being issued that year. While a total of $5 billion will be issued each year (once the transition period is complete), around three quarters of this issuance will be targeted at the new bond. That is, in the year that a new long-dated bond is commenced and the previous year's short-dated bond is being completed, priority will be given to bringing the new long-dated bond to a liquid level quickly.

DEBT ISSUANCE IN 2003-04

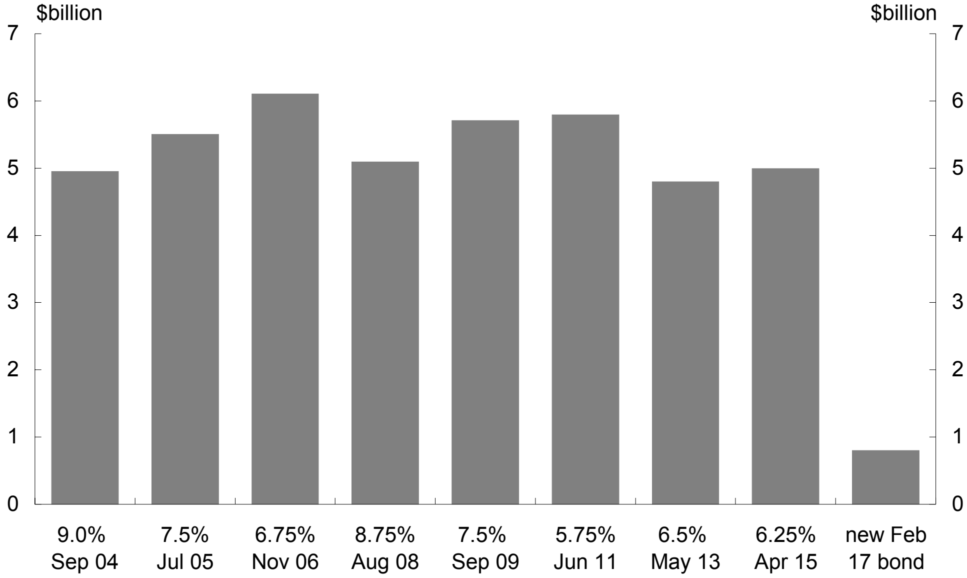
In the 2003-04 Budget, the Government announced its intention to issue between $2 billion and $3 billion of new Treasury bonds. To date, $1.5 billion of April 2015 Treasury bonds have been issued via five tenders this financial year. Taken with previous issues of April 2015 bonds, the total outstanding of April 2015 bonds is $4.7 billion. There is one further tender planned for this bond line in the remainder of this financial year. This tender will complete the issuance of this bond line.

A tender is planned to begin a new long-dated Treasury bond before 30 June 2004. In early June, the Australian Office of Financial Management will conduct the first tender of a new February 2017 Treasury bond. The initial tender will be between $800 million and $1 billion in size.

In order to ensure outstanding benchmark lines of Treasury bonds are all around $5 billion, an additional $600 million of Treasury bonds will be issued into the August 2008 Treasury bond line.

With the issuance outlined above, all benchmark Treasury bond lines (apart from the new February 2017 line) will have around $5 billion outstanding (Chart 2).

Chart 2: Benchmark Treasury bonds outstanding expected at 30 June 2004(a)



(a) Treasury bonds on issue are net of Australian Government holdings. Several smaller Treasury bond lines currently on issue, including the February 2006 and October 2007 Treasury bonds, are excluded from the chart as they are not considered benchmark bond lines.
Source: Australian Office of Financial Management.

Short-term deposits that the Australian Government holds with the Reserve Bank of Australia are mainly used to finance short-term imbalances between expenses and revenues. When there are insufficient short-term deposits, Treasury notes (which are a short-term debt instrument) are issued to assist with the Australian Government's within-year financing task. During 2003-04, there have been two Treasury note tenders totalling $1.1 billion. These Treasury notes matured in early November 2003. It is expected that term deposits will be sufficient to cover short term funding requirements for the remainder of 2003-04 so no further Treasury note tenders will be required.

During 2003-04, a total of around $5.4 billion in outstanding Treasury bonds (net of Australian Government holdings) is due to, or has, matured. Taking account of the total issuance outlined above, this means that there will be a net decrease in Treasury bonds outstanding of around $2 billion. As a result, the total stock of Treasury bonds outstanding (net of Australian Government holdings) will be around $48 billion at 30 June 2004. The reduction in Treasury bonds outstanding will be financed from the expected headline budget surplus and other financing transactions. The remaining surplus above this amount will be added to deposits at the Reserve Bank of Australia.

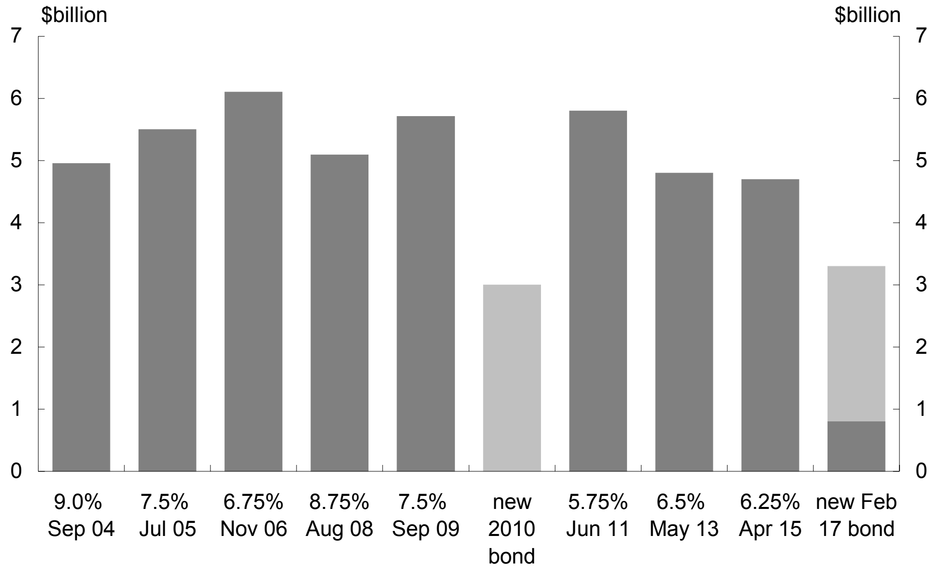
DEBT ISSUANCE IN 2004-05

Total issuance of Treasury bonds in 2004-05 is expected to be between $5 billion and $6 billion. In the early part of the financial year, issuance will be concentrated in the February 2017 Treasury bond, in order to bring that bond up to a liquid level of outstandings to facilitate trade in the 10-year futures contracts as early as possible. It is expected that around $2½ billion will be issued into the February 2017 line in 2004-05 to supplement the $800 million to $1 billion to be issued late in 2003-04. Further issuance of this line to bring it up to $5 billion outstanding will be undertaken in the first half of 2005-06.

Around the middle of the financial year a new 5-year Treasury bond will be issued. This bond will be required to support the ongoing efficient operation of the 3-year Treasury bond futures market. It is expected that around $3 billion of this new 5-year Treasury bond will be issued during 2004-05. The remaining issuance necessary to bring this line up to $5 billion outstandings will be undertaken in the first half of 2005-06.

During 2004-05, a total of around $5 billion in outstanding Treasury bonds (net of Australian Government holdings) is due to mature. Given the issuance outlined above and maturities during the year, the total stock of Treasury bonds outstanding (net of Australian Government holdings) will be between $48 billion and $49 billion at 30 June 2005. As Treasury bond issuance is likely to be equal to, or slightly larger than maturities, the entire amount of the expected headline budget surplus and other financing transactions will be added to deposits at the Reserve Bank of Australia.

Chart 3: Benchmark Treasury bonds outstanding expected at 30 June 2005[a]



(a) Treasury bonds on issue are net of Australian Government holdings. Several smaller Treasury bond lines currently on issue, including the February 2006 and October 2007 Treasury bonds, are excluded from the chart as they are not considered benchmark bond lines.

Note: The dark grey columns represent bonds outstanding at the beginning of the 2004-05 financial year. The light grey columns indicate new issuance in 2004-05.

Source: Australian Office of Financial Management and Treasury estimates.