

STATEMENT 7: ASSET AND LIABILITY MANAGEMENT

The Australian Government will improve its financial position by accumulating assets and limiting the growth in liabilities. This leaves the Government with the capacity and flexibility to absorb and respond to changes in economic circumstances as well as address longer-term fiscal pressures. A detailed balance sheet for the Australian Government general government sector is provided in Statement 9.

The Government’s net financial worth position is estimated to become positive in 2009-10 and is projected to improve over the forward estimates period. The main drivers for this improvement are strong budget surpluses forecast over the forward estimates. The Government is taking a strategic approach to the allocation of these surpluses by investing most of the 2007-08 and 2008-09 Budget surpluses in three new nation building funds for education, health and infrastructure. These funds will address the nation’s capital and infrastructure shortages, build the platforms for economic growth into the future, and help to build a modern nation.

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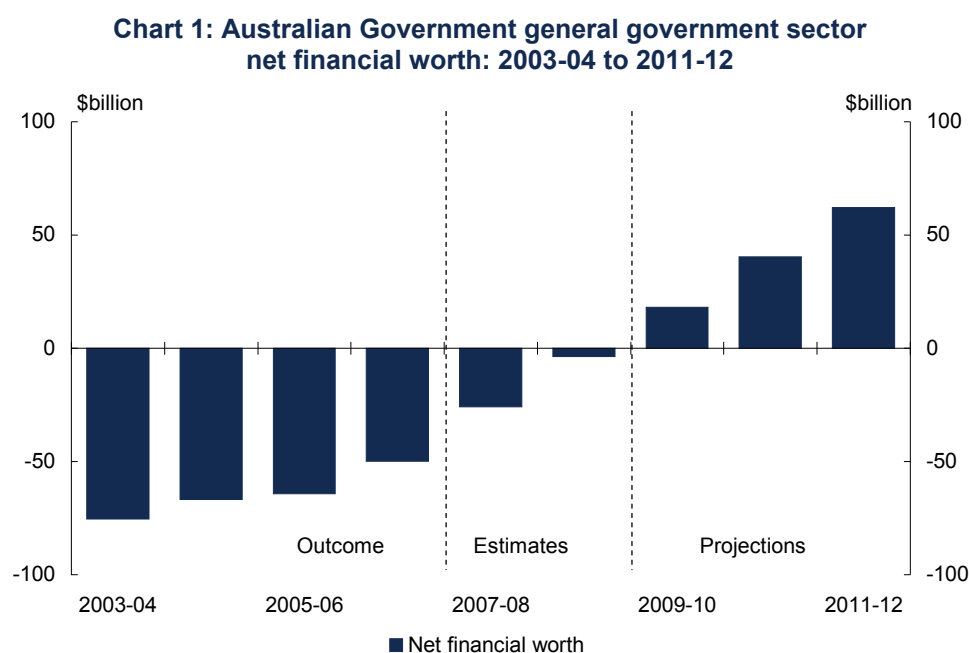
STATEMENT 7: ASSET AND LIABILITY MANAGEMENT

The Government is forecasting strong surpluses over the forward estimates and will invest these in Australia's future by creating three new nation building funds. The establishment of these funds will substantially improve the Government's financial position, make provision for building the nation's assets, and leave the Government well placed to deal with emerging fiscal pressures from an ageing population.

THE AUSTRALIAN GOVERNMENT'S MAJOR ASSETS AND LIABILITIES

The Government reports on a range of financial measures including net debt, net worth and net financial worth. While previous budget statements addressing the Government's assets and liabilities have focused on net debt and net worth, these measures have limitations as indicators of the Government's financial position (see Box 1). By contrast, net financial worth is a more effective and intuitive indicator of the sustainability of the Government's finances.

A summary of the Government's net financial worth position is provided in Chart 1.



The projected improvement in net financial worth is primarily driven by forecast budget surpluses, reflecting the strength of the economy, budget discipline, and the returns from existing and newly created investment funds. The increase in total

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financial assets over the forward estimates period significantly outweighs the growth in the Government's liabilities.

Box 1: Measurement of the Government's financial position

Net debt is the sum of selected financial liabilities *minus* the sum of selected financial assets. Net debt does not include accrued employee superannuation liabilities, which is the largest liability on the Australian Government's balance sheet. It does not provide information on whether the Government's net debt position is being used to finance the accumulation of assets or recurrent expenditure. This additional information is important in gauging the strength of the Government's financial position.

Net debt is currently estimated at -\$43 billion for 2007-08 and is expected to remain below zero over the forward estimates.

Net worth is calculated as total assets (both financial and non-financial) *minus* total liabilities. Net worth incorporates non-financial assets such as land, as well as financial assets and liabilities not captured by the net debt measure, most notably accrued employee superannuation liabilities and equities.

Although the net worth measure provides a more comprehensive picture of the Government's overall financial position than net debt, it is not without limitations. For example, the valuation of physical assets can be problematic as they are typically valued without consideration of their potential use. Also, the Government may not be in a position to sell certain non-financial assets, and therefore these assets would not be available to meet the Government's financing requirements.

Net worth is currently estimated at \$61 billion for 2007-08 and is expected to remain positive over the forward estimates.

Net financial worth measures the Government's net holding of financial assets. It is calculated as total financial assets *minus* total liabilities. Net financial worth is a broader measure than net debt as it includes government borrowing, superannuation and all financial assets, but is narrower than net worth since it excludes non-financial assets. There are advantages from excluding non-financial assets since they are often illiquid and cannot easily be drawn upon to meet the Government's financing needs.

Net financial worth is currently estimated at -\$26 billion for 2007-08 and -\$4 billion in 2008-09, and projected to become positive in 2009-10 and remain positive over the forward estimates.

The outlook for the Government's balance sheet, including the aggregates of net debt, net worth and net financial worth, are based on a range of assumptions. If the basis for these assumptions change they are likely to impact the projected value of assets and liabilities, and hence change the projected path of net financial worth.

Statement 3: Fiscal Strategy and Outlook examines the impact of altering key economic assumptions on expenses and/or revenue. Since the budget outcome is one of the main drivers of the movement in the Government's asset and liability position, changes in the economic assumptions will also impact on net financial worth.

The Government reports on a range of other fiscal risks in Statement 8: Statement of Risks. These risks comprise general developments or specific events that may affect the fiscal outlook. Fiscal risks may affect expenses and/or revenue and, as a result, may contribute to variability in the Government's projected net financial worth position.

ASSET MANAGEMENT

Based on current assumptions, the Government's financial assets are expected to increase by around \$100 billion over the budget year and forward estimates to \$284 billion. This is largely due to strong budget surpluses over the forward estimates, as well as growth in Future Fund assets. Subject to final budget outcomes, the Government intends to make initial contributions to three new nation building funds from the 2007-08 and 2008-09 Budget surpluses.

Investment funds

The Government is meeting its commitment to Australia's future by drawing on current and future surpluses to invest in three nation building funds. The Building Australia Fund, the Education Investment Fund and the Health and Hospitals Fund will be established to finance infrastructure investment in the transport, communications, education and health sectors. The Government will initially allocate around \$40 billion to these funds in 2007-08 and 2008-09, subject to final budget outcomes, and make further contributions from future surpluses as appropriate. Where funds are used to finance state and territory projects, they will be channelled through a new Council of Australian Governments (COAG) Reform Fund. The COAG Reform Fund will also channel funding provided in future budgets to the States for recurrent expenditure in areas of COAG national reforms through National Partnership payments.

The new funds will all be established by January 2009 and will be managed by the Future Fund Board of Guardians. The capital and earnings of these funds will be available over time to finance appropriate projects. All projects will need to satisfy rigorous evaluation criteria. These arrangements will ensure substantial funding will be available for capital investment in each of the three national priority areas over the years ahead.

Building Australia Fund

The Government will create the Building Australia Fund (BAF) to help finance the current shortfall in critical economic infrastructure in transport and communications such as road, rail, ports and broadband, particularly where infrastructure requirements

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in these areas are not provided by the State and Territory governments or by the private sector. Subject to final budget outcomes, the Government will commit funds to the BAF from the 2007-08 and 2008-09 Budget surpluses. With the inclusion of communications priorities within the scope of the BAF, the Government will close the Communications Fund and transfer its assets (currently valued at around \$2.4 billion) to the BAF. The BAF will also receive \$2.7 billion from the Telstra 3 sale process.

The BAF will meet the Government's commitment to invest in a National Broadband Network, with disbursements dependent on the final outcome of the recently commenced Request for Proposals process and the Government's consideration of the Glasson Review. On current projections, the initial Government contributions to the BAF from the above sources will be in the order of \$20 billion.

Education Investment Fund

To ensure that Australia's education and training systems deliver the skills the economy and individuals need to continue to prosper, the Government will establish the Education Investment Fund (EIF). The EIF, which will subsume the Higher Education Endowment Fund (HEEF), will provide financing for capital investment in higher education and vocational training. Subject to final budget outcomes, the Government will make an initial contribution to the fund of around \$11 billion, comprising around \$6.2 billion that is currently invested in the HEEF, and a further contribution of around \$5 billion from the 2007-08 and 2008-09 Budget surpluses.

In the future, the EIF could be extended to include schools infrastructure as further finances are added to the Fund.

Health and Hospitals Fund

The Government will establish the Health and Hospitals Fund (HHF) for capital investment in health facilities, including renewal and refurbishment of hospitals, medical technology equipment and major medical research facilities and projects. Subject to final budget outcomes, the Government will make an initial contribution of around \$10 billion from the 2007-08 and 2008-09 Budget surpluses.

Future Fund

In addition to creating new funds, the Government will ensure that the Future Fund has sufficient resources to meet its objectives. The Future Fund was established to finance the Government's unfunded public sector superannuation liability. With a further contribution of \$3.9 billion from the \$6.6 billion that is to be received from the Telstra 3 sale process (due in May 2008), the Future Fund will now be on track to fully fund superannuation liabilities for Australian Government employees by the target date of 2020.

Overall, earnings generated from fund assets contribute to the growth in net financial worth. The Future Fund in particular is expected to make a substantial contribution to net financial worth over the forward estimates due to its projected strong investment

earnings and the retention of those earnings. The contribution of other investment funds to net financial worth will depend on their earnings rate and the rate at which funds are drawn down.

Term deposits

Term deposits are held at the Reserve Bank of Australia and are estimated to amount to around \$24 billion for 2007-08. Term deposits are projected to rise to around \$50 billion by 2011-12 reflecting the strength of expected budget surpluses over the forward estimates (assuming these surpluses are not otherwise invested). This increase in term deposits will improve net financial worth.

Higher Education Loan Programme

The Higher Education Loan Programme (HELP) comprises concessional loans to students that enable them to meet their education costs prior to earning an income.

The value of HELP is estimated to be around \$13 billion as at 30 June 2008 and is estimated to grow to around \$16 billion by 2011-12. The steady rise in outstanding loans represents a higher uptake by eligible students and an increase in the number of university placements over the forward estimates.

LIABILITY MANAGEMENT

The major liabilities on the Australian Government's balance sheet relate to unfunded public sector superannuation and government debt securities. Together these liabilities comprise more than three quarters of total Australian Government liabilities.

Total liabilities are expected to increase by \$12 billion over the budget year and forward estimates to around \$221 billion, mainly due to the continued growth in unfunded public sector superannuation.

Public sector employee superannuation liabilities

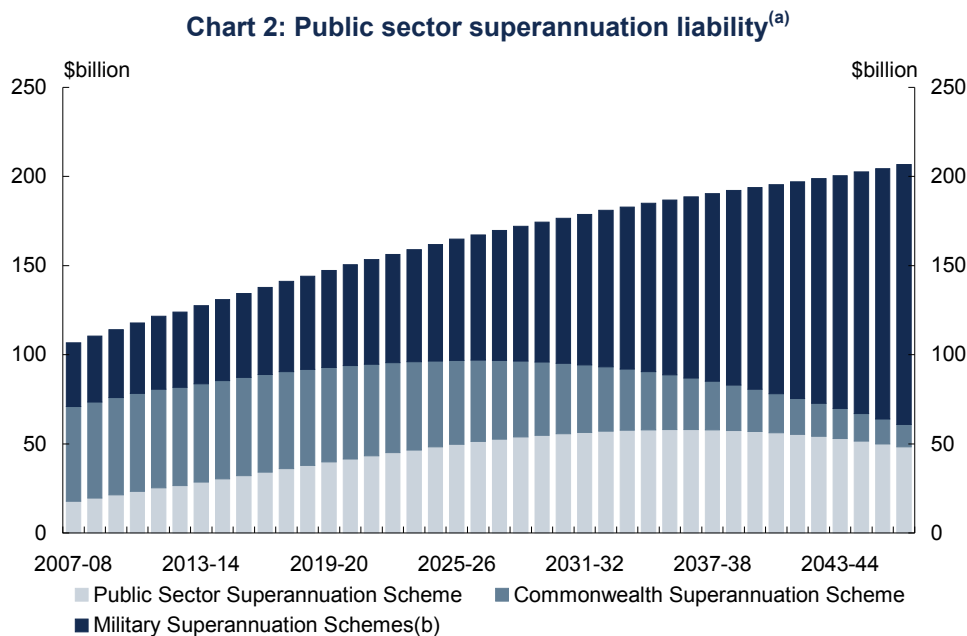
Public sector employee superannuation entitlements relating to past and present employees constitute the largest financial liability on the Government's balance sheet. The Government's superannuation liability is estimated to be around \$108 billion as at 30 June 2008.

The Australian Government has never fully funded its superannuation liabilities. However, the Commonwealth Sector Superannuation Scheme and the Public Sector Superannuation Scheme were closed to new members in 1990 and 2005 respectively. From 1 July 2005, the Public Sector Superannuation Accumulation Plan was introduced and provides fully-funded accumulation benefits for new civilian employees.

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Despite these reforms, the value of the Government's existing superannuation liability is projected to continue growing (in nominal terms) into the future, reaching \$124 billion by the end of the forward estimates and around \$147 billion by 2020. This is largely due to growth in the membership of the Military Superannuation and Benefits Scheme and continued growth of entitlements accruing to existing members of the closed civilian schemes and previous military schemes.

Chart 2 illustrates the estimated growth profile of the Government's public sector superannuation liability over the next 40 years.



(a) The Public Sector Superannuation Scheme and the Commonwealth Superannuation Scheme (the main civilian schemes) and Military Superannuation Schemes form the dominant part of the Government's total unfunded superannuation liability.

(b) Includes the Military Superannuation and Benefits Scheme and the Defence Force Retirement and Death Benefits Scheme.

Source: Department of Finance and Deregulation and Australian Government Actuary.

Government securities

The Government will continue to issue Treasury Bonds because of the important role they play in the operation of the Australian financial system.

Over recent years, persistent fiscal surpluses have removed the need to borrow for budget funding purposes. However, Treasury Bonds have continued to be issued in order to maintain an active Treasury Bond market and to support the market in Treasury Bond futures contracts. These two markets are used in the pricing and hedging of a wide range of financial instruments and in the management of interest rate risks by market participants. They thereby contribute to a lower cost of capital in Australia. Without them, the financial system would be less diverse and less resilient

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to the shocks that can emerge from time to time either from domestic sources or from overseas. As demonstrated over recent months, the markets for Treasury Bonds and Treasury Bond futures contracts provided important anchors for Australia's financial system as it responded to the impact of credit and liquidity concerns sparked off by the sub-prime housing crisis in the United States of America.

The Government will continue to monitor closely the operation of the Treasury Bond and Treasury Bond futures markets to ensure they continue to function effectively.

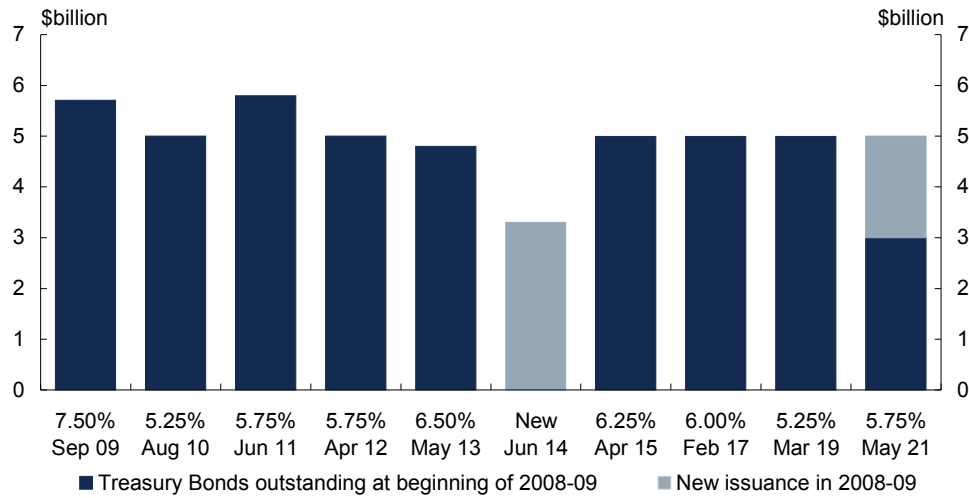
In 2008-09, the volume and timing of fixed coupon Treasury Bond issuance takes account of the need to have an appropriate range of Treasury Bonds available for inclusion in Treasury Bond futures baskets. The program maintains a pattern where new 5-year and 13-year Treasury Bonds are launched in alternate years, with total issuance over a 2-year period of around \$5 billion in each line to offset maturing bond lines.

In 2008-09, there will be \$2.0 billion of issuance into the May 2021 Treasury Bond line. This will bring the total volume on issue for this bond line to \$5.0 billion. In addition, a new June 2014 Treasury Bond line will be issued to support the operation of the 3-year Treasury Bond futures contract, of which \$3.3 billion will be issued during 2008-09. The remaining issuance necessary to bring this bond line up to \$5.0 billion will be undertaken in 2009-10.

Total Treasury Bond issuance during 2008-09 will be \$5.3 billion, while scheduled maturities during this period, net of Australian Government holdings, will be \$5.1 billion. As a result, the total stock of fixed coupon Treasury Bonds on issue, net of Australian Government holdings, will be around \$49.6 billion as at 30 June 2009 (Chart 3).

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Chart 3: Fixed coupon Treasury Bond outstandings expected at 30 June 2009



(a) Treasury Bonds on issue are net of Australian Government holdings.
Source: Australian Office of Financial Management.

The Government also has on issue three lines of inflation linked Treasury Indexed Bonds. The total original face value of Treasury Indexed Bonds on issue as at 30 June 2008 is expected to be around \$6 billion. These bond lines are expected to mature without replacement, with the first of these lines (with a face value of around \$1.5 billion) maturing in August 2010.