

**Australian Government Debt in a Changed Financial World**  
**Presentation to Australian Business Economists luncheon, Sydney, 8 April 2009**

I thank the ABE for this opportunity to speak to you. I spoke at ABE functions similar to this one in 2005 and 2006. The situation was very different then. The Australian Government's Budget was in surplus; bond issuance was not required to fund the Budget but was being undertaken to maintain the market; and this picture seemed likely to continue indefinitely.

It has since changed dramatically due to the global financial crisis that began in 2007 and gathered pace in 2008. However, the impact on the AOFM, and on our management of Australian Government debt, emerged only slowly.

Initially we saw an increased demand for our bonds, which we met with increased issuance. The proceeds of the increased issuance were not needed for Budget funding, but were invested to offset the cost and risk of the additional debt.

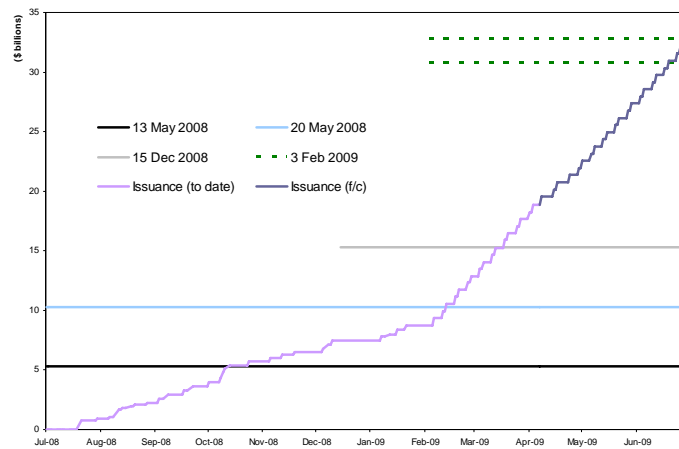
The markets for asset-backed securities in Australia were dislocated by contagion from the problems in these markets overseas. The Government directed the AOFM to invest in residential mortgage-backed assets with the aim of maintaining competition in lending for housing in Australia. We quickly geared up to do so.

The Government's announcement, on 3 February 2009, of revised fiscal projections in the Updated Economic and Fiscal Outlook (UEFO) and further economic stimulus measures, brought a more dramatic change. In place of issuing relatively small amounts of bonds to a market characterised by strong demand for stock, we have moved to issuing a much greater volume of bonds, driven by Government funding requirements. We now face a very different financial world.

**Treasury Bond issuance in 2008-09**

Chart 1 shows how the program for the issuance of Treasury Bonds has changed over the course of the current financial year.

## Chart 1: 2008-09 Treasury Bond Issuance



In the 2008-09 Budget, less than a year ago (on 13 May 2008), planned issuance was set at \$5.3 billion. This continued the practice of issuing enough bonds to cover maturing debt, maintaining the volume on issue broadly constant.

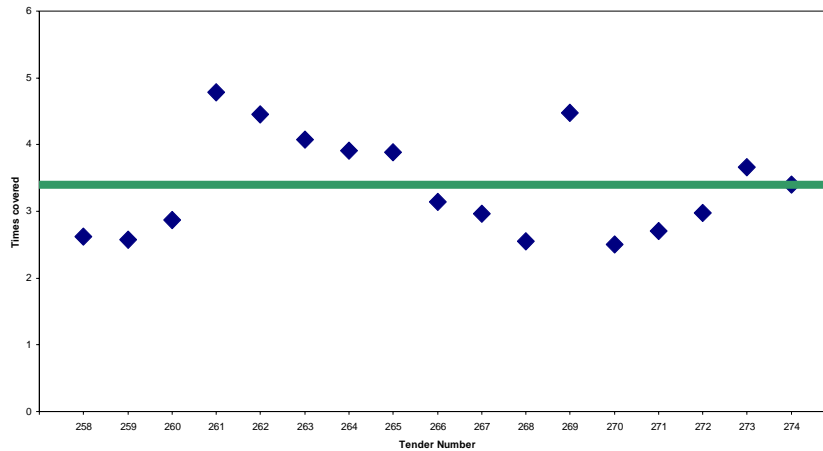
A week later, the AOFM was authorised to issue up to \$5 billion in additional issue, to maintain the liquidity of the market in the face of increased demand. The authorised amount of additional issuance was further increased to \$10 billion in December. This was enough to cover the then rate of issuance if it continued until the end of the financial year.

On 4 February 2009, following UEFO, we announced an increased program of Treasury Bond issuance, with two tenders in most weeks, each of \$500 – 700 million. This was projected to amount to \$22 – 24 billion over the remainder of the financial year. As issuance up to then amounted to \$8.9 billion, this implied total issuance for the year of around \$32 billion.

We are currently well on track to achieve that outcome. Tenders have been well covered (chart 2) and the range of bids accepted has been reasonable.

## Chart 2: Tender Coverage Ratios

Average coverage ratio 3.39x, minimum 2.5x

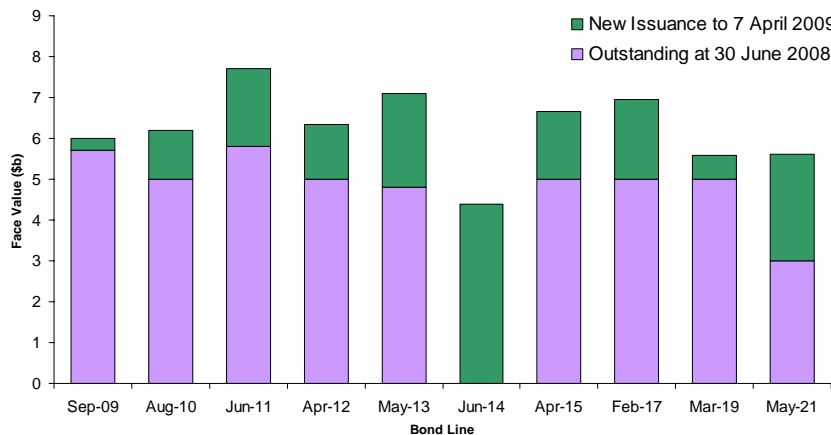


The range of bids accepted in today's tender for the 2021 Bonds was 1.5 basis points, but the range has been larger in others. We are comfortable with this. Longer tails are to be expected in circumstances when financial markets are volatile; indeed this is part on the price discovery and dynamic process by which markets adjust to changing conditions.

We have been issuing into the existing bond lines, taking account of our assessment of relative demand. As chart 3 indicates, demand has been evident across all the existing bond lines. We aim to build up the liquidity of these lines, rather than starting new lines.

## Chart 3: Treasury Bonds

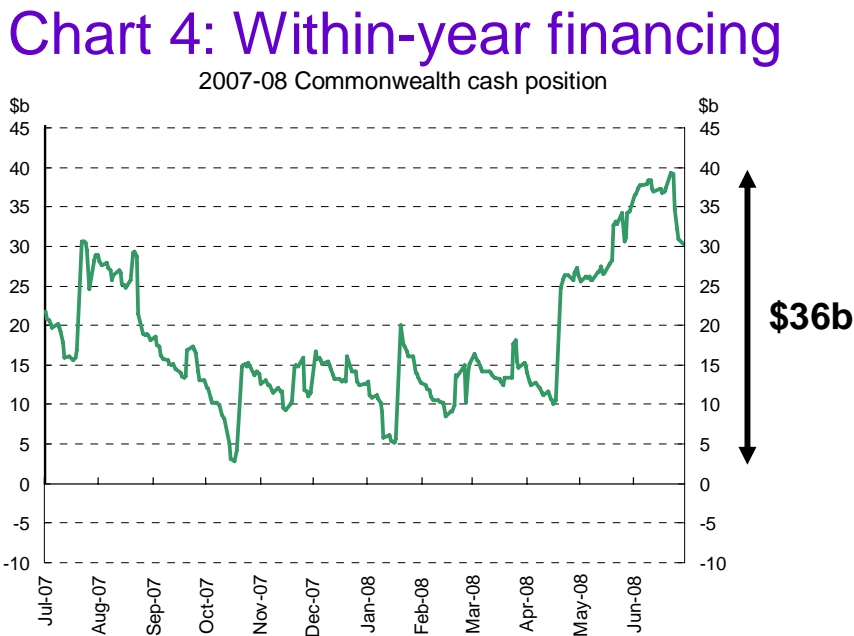
Treasury Bonds outstanding



## Treasury Notes

We have also resumed issuance of Treasury Notes. These are short term instruments that we use primarily for within year financing.

There is a large within year financing task because of timing differences in the Government's cash receipts and outlays. Chart 4 shows our short term asset balances over the course of last financial year. The range from peak to trough was \$36 billion in that year. It is likely to be similar in subsequent years.



Over recent years we have used our cash balances – largely term deposits with the Reserve Bank, together at times with some holdings of money market instruments – to manage these within year swings. We are now running down the cash balances, so we will in future manage them by using a combination of Treasury Notes and short term assets.

So far we have raised \$4 billion in five T Note tenders. Demand for the Notes has been strong.

The Notes have had maturities of 5 weeks, 3 months and 6 months. We will issue Notes with a 9 month maturity next week, thereby extending the curve.

We expect to have around \$10 billion on issue by the end of the financial year.

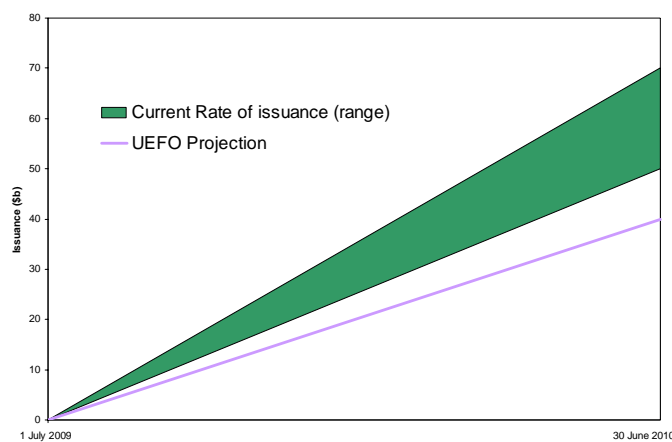
## Treasury Bond issuance in 2009-10

The Treasury Bond issuance program for next financial year will depend on Budget decisions and projections, and has not been set yet. Nothing in this presentation should be interpreted as anticipating the Budget.

However, one observation may be of interest. If we were to continue our current pattern of bond issuance at the rate of \$1 – 1.4 billion per week, this would provide \$48 – 67 billion over the course of 2009-10 (allowing for non-issuance over holiday periods).

This is shown in Chart 5, together with an estimate of bond issuance that corresponds to the latest official forecast of the Budget outcome.

**Chart 5: 2009-10 Treasury Bond Issuance**



The UEFO forecast an underlying cash balance of -\$35.5 b in 2009-10. The underlying cash balance does not translate directly to bond issuance because of other factors, including the use of cash balances, and bond maturities. But taking these factors into account, we estimate bond issuance in 2009-10 would need to be of order of \$40 billion, based on UEFO.

As the Chart indicates, a bond issuance task of this magnitude would be more than met by continuing to issue at our current rate.

### **Treasury Notes in 2009-10**

The issuance of Treasury Notes next financial year will depend on the size and profile of the within year funding flows. The volume of Notes on issue will therefore vary over the course of the year.

However, I expect the volume of Notes on issue at end of the year to be similar to that at the start. That is, the Notes will make no major contribution to overall funding for the financial year as a whole.

We will aim to keep at least \$10 billion on issue at all times so as to maintain a liquid on-going market in the Notes.

### **Additional bond lines**

In the past we have issued a new Treasury Bond line each year, alternately in mid-curve and at the long end. This maintains the number of lines on issue as existing bond lines mature.

We will continue this practice in 2009-10, with a new 2023 bond line.

### **Infrastructure bonds**

Yesterday the Government announced its decisions on the National Broadband Network. It indicated that it would finance part of its equity contribution to the Network through the issue of Aussie Infrastructure Bonds to wholesale and retail investors.

The details of the arrangements for the issue of these bonds remain to be worked out. Depending on the financing arrangements to be agreed with other partners in the Network, this could involve issuance of around \$8-9 billion over a period of years.

The bonds could have longer maturities than existing bond lines, up to 30 years.

### **Longer maturities**

There is a broader case for extending the yield curve by issuing longer maturities. Other sovereigns typically have maturities up to 30 years, and some even longer. These maturities play a useful role in the overall functioning of their financial markets.

In Australia, the value of maintaining an active market for sovereign debt has been amply demonstrated over the last few months. Our ability to ramp up bond issuance at very short notice allowed the Government to act quickly and decisively in providing fiscal stimulus.

A more complete market with an extended yield curve would provide stronger backing for fiscal flexibility if it is needed again in the future.

An extended curve could also help financial markets by providing reference points for the pricing of other longer term instruments, such as for the private financing of infrastructure and the trading of emission credits.

Long maturity indexed bonds may be attractive to superannuation, insurance and other funds that have to manage long term liabilities that are correlated with price movements.

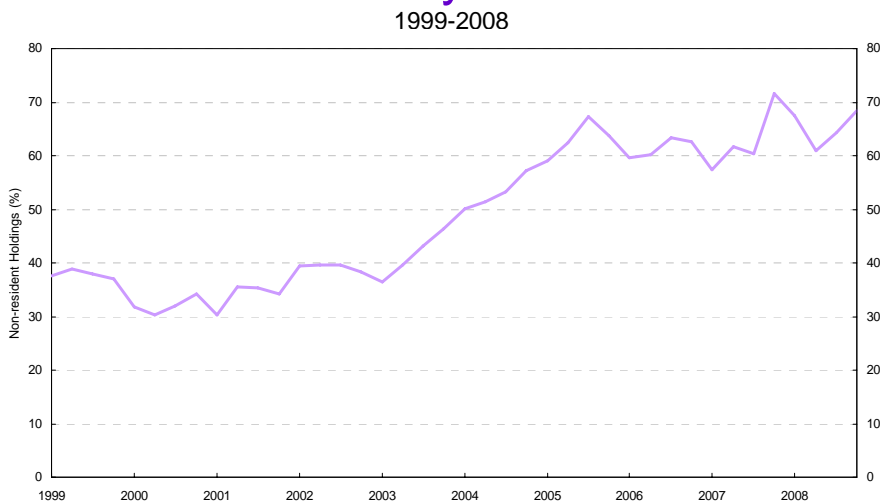
The funds available from the issuance of longer term and indexed bonds may be limited in current circumstances relative to the Government's immediate total funding task. Nevertheless these instruments could be valuable in broadening the range of investors and supplementing the funds provided.

### **Foreign currency issuance**

All our current issuance is denominated in Australian dollars. We expect this to continue. Our domestic market is liquid and efficient and there is a relative cost advantage for us to issue into it.

As indicated in Chart 5, over recent years a substantial part – over 60 per cent – of the CGS on issue has been held by non-residents. Non-residents are continuing to take up a major share of the new issuance and we expect this to continue.

## Chart 5: Non-resident holdings of Treasury Bonds



Also, issuance in foreign currencies is not covered by our existing legislation, which would require amendment. This is not a priority for us.

### Competition with other sovereign issuance

The governments of other developed countries have also increased their bond issuance as they respond to the impact of the current global crisis. This includes AAA rated governments that have large and well established debt issuance programs.

So far, this does not appear to have affected the take-up by investors of Australian government debt.

We have been helped in placing our bonds by Australia's strong credit standing, low level of debt and strong banking system, and by the resilience and flexibility of our economy.

Our debt, issued in Australian dollars, offers diversification benefits to overseas portfolio managers. And, given our strong trade linkages with Asia, our stocks are likely to benefit if Asian economies are in the forefront of the global recovery when it comes.

Australian government debt is only a small proportion of the global total of AAA sovereign debt, so managers allocating a small part of their portfolios to us can add substantially to the overall demand for our stock.

### **Competition with Government-guaranteed issuance**

We are also competing with Government-guaranteed debt issued by Australian banks and other deposit-taking institutions and, in the future, by state and territory governments.

The banks have been very active in issuing guaranteed debt, but this does not appear to have adversely affected the Government's own issuance so far.

There is a large pool of investor interest in Australia on which we can all draw.

We have yet to see what use the semis will make of the guarantees and what the impact will be.

Potentially the impact may be greater than with the banks.

- The semis are a closer substitute for CGS, with closer ratings, liquidity and maturity structures.
- Much of the guaranteed bank issuance has been offshore, whereas the guarantee will apply only to Australian dollar denominated semi debt.

The current spreads in the market reflect uncertainties about how far the semis will utilise the guarantees.

But when this uncertainty is resolved, and the semis resume issuing bonds, there could be some impact on the market for the Commonwealth's bonds, and some further narrowing of spreads.

### **Promotion activities**

We recognise that, in the new financial world in which we are now operating, we need to be active in promoting our debt to investors, both in Australia and overseas.

To this end, the Treasurer has had meetings with investors in New York, London and Tokyo and I have had meetings in Hong Kong, Beijing, Tokyo and Dubai.

The meetings in Dubai were with investors from around the world, mainly central banks and sovereign investment institutions, interested in AAA investment. A substantial part of our investor support comes from such institutions, in Europe as well as Asia. We are keen to foster this sector and to extend its participation in our issues.

We have also been meeting with investors in Australia.

I welcome the support that we have obtained from dealers and other market participants in arranging these contacts and for their efforts to expand the market.

### **Sales of Semi and Kangaroo bonds**

The AOFM acquired a portfolio of semi-government and kangaroo bonds from the proceeds of the additional bond issuance we undertook to support the market in the first part of 2008-09.

There is now no longer a need for us to hold these bonds and we will dispose of them, when convenient, to contribute to our budget funding task.

We have already sold some kangaroo bonds in response to approaches from market participants, where the prices offered were attractive. We will continue to do so.

We are not currently seeking to sell our holdings of semis, but will be prepared to do so when the market has settled down and we can do so without disruption.

### **Swap unwinds**

For many years the AOFM used interest rate swaps as a tool in managing the duration of our portfolio. We stopped doing this in 2007 as the flattening of the yield curve and the disappearance of the term premium reduced the benefits the swaps provided.

Existing swaps are being allowed to roll off as they mature.

In addition, towards the end of last year we commenced a program to unwind swaps through negotiations with counterparties. This process has proceeded steadily.

So far, we have unwound a total of 80 swaps, with a notional principal value of \$9.3 billion. The remaining swaps have a notional principal value of \$9.6 billion.

The unwinds have provided a positive return of \$680 million, so that the total direct savings from interest rate swaps since they began just over ten years ago has been over \$2.7 billion.

### **Residential mortgage-backed securities**

Last September the Government commissioned the AOFM to invest in residential mortgage-backed securities to promote competition in lending for housing. We are to invest up to \$8 billion, of which at least \$4 billion is for securities by issuers other than authorised deposit-taking institutions.

We are undertaking this commission by investing in new RMBS issues as a cornerstone investor, thereby bringing in other investors. So far we have participated in eight issues with a total value of around \$4.9 billion, of which the AOFM contribution is around \$3.75 billion. (These figures include the REDS issue by the Bank of Queensland which was priced on Friday.)

## AOFM RMBS Investments

- Settled:
  - FirstMac 2-2008
  - SMHL 2008-2
  - RESIMAC 2008-1
  - Challenger 2008-2
  - Harvey Trust 2009-1
  - TORRENS 2009-1
  - Progress 2009-1
- Pipeline:
  - REDS 2009-1
  - Liberty 2009-1
  - Challenger 2009-1

Two further mandates are likely to be priced in the near future.

The securitisation market has been hit hard by the financial crisis. Without the AOFM, there would have been little RMBS issuance over recent months.

The issuance of RMBS under the current program was affected by the holiday period over Christmas, but mandates are now being issued and priced at a faster rate. I expect that by the end of the financial year we will be well advanced through the \$8 billion allocated.

Issuers that are not ADIs depend on a steady stream of RMBS issuance to maintain continuity in their lending. They are therefore likely to need to make more than one RMBS issue with AOFM support.

The current round of mandates includes one for an institution (Challenger) that also participated in the first round. Further examples of this will occur in subsequent mandates.

Looking further forward, how will the RMBS market adapt to the changed global financial conditions? The market will not return quickly to its previous shape or size. New business models will need to be developed if RMBS is to continue to contribute vigorously to competition in lending for housing.

The AOFM is not seeking to pick winners in this regard. But in applying our selection criteria we do take account of the performance of issuers and the contribution they are making to competition in lending.

Our minimum requirements encourage RMBS based on high quality mortgages. In many respects, they are similar to the requirements the Reserve Bank applies to the

RMBS securities it will accept as collateral in its transactions. High quality mortgages provide the essential basis for a revived and active RMBS market in Australia.

### **Conclusion**

The AOFM's business in undertaking debt issuance and other financial activities for the Australian Government has changed dramatically over recent months in the wake of the global financial crisis and the downturn in the economy. We will face continuing challenges in the period ahead.

In doing so, we aim to maintain close liaison with investors and market participants. We will keep you informed on what we are planning. We look forward to your cooperation and support.