



Thank you to Euromoney for inviting me here to speak to you today.

Australia seems truly to have in view the end of its transition out of the global recession and having only several weeks ago released a Budget that reflects this, it is an opportune time to update the so-called 'Australian Story'.

I will use the time available to take you through the three overviews:

- The current status of its economic fundamentals;
- Its forecast fiscal position; and
- The context for the future of the Commonwealth bond market and the main elements of our program for the coming year.

But let me first give you a snapshot.

The Australian economy is in a strong position with a favourable outlook. Without doubt there are domestic and international challenges ahead for Australia, but these challenges have been anticipated and are closely monitored.

The strength of Australia's economy and financial position are recognised by the fact that it enjoys 'triple A' status. Australia is one of only 19 S&P AAA (stable) rated sovereigns in the world and is one of only seven S&P AAA (stable) rated sovereigns with more than \$190 billion of bonds on issue.

Although a relatively small population by international standards, it has been growing at an average annual rate of 1.5 per cent for the past two decades.

Prior to the global recession Australia's unemployment rate was around 4 per cent, peaked in 2009 at 5.2 per cent, and has now declined to a current level of 4.9 per cent.

Monetary policy was relaxed in Australia ahead of most other countries, and from an overnight cash rate low of 3 per cent in April 2009, there have been seven rate rises to the current level of 4.75 per cent, with only two increases in the last 12 months. A steady but effective monetary policy has served Australia well.

Australia will face the challenge of managing inflation in the years ahead with some of that pressure emerging domestically, but the impact of global inflationary pressures more generally will also emerge. The current headline rate is at 3.3 per cent (with an underlying rate of 2.3 per cent).

The Australian dollar remains strong at around a post-currency float high. The \$AUD has been gaining a 'reserve currency' status and is now the fifth most traded currency – with the \$AUD/US being the fourth most traded currency pair.



Australia

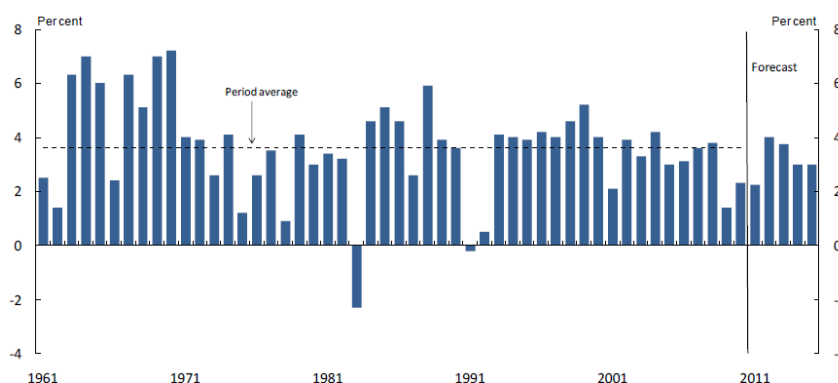


- World's 13th largest economy with a GDP of USD 1.4 trillion
- AAA rated issuer
- *Population*: 22.6 million
- *Unemployment rate*: 4.9%
- *Cash rate*: 4.75%
- *Inflation rate*: 3.3% (yoy headline), 2.3% (yoy underlying)
- The AUD is the 5th most traded currency and the AUD/USD is the 4th most traded currency pair

Recent natural disasters in Australia will have had temporarily held back domestic economic growth. Together with the impacts of disasters in Japan and NZ, these effects will have taken about ¾ of a percent off GDP in 2010-11. However a return to above-trend real GDP growth is forecast for the coming two years and this will be led by a substantial uplift in resource sector investment, together with growing exports.

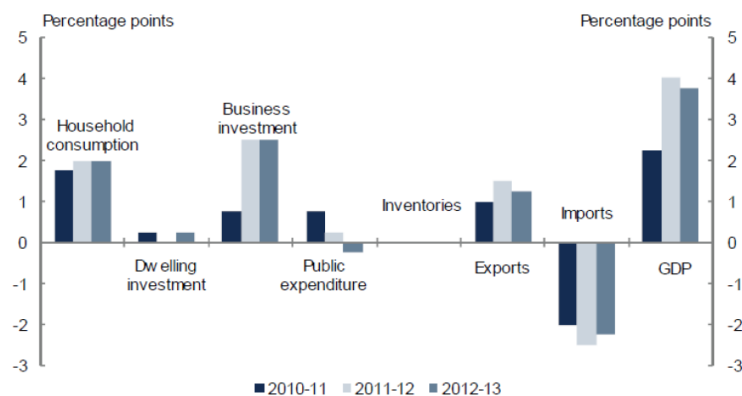
Although from a global perspective the post-recession economic recovery is uneven, the favourable economic outlook for Australia is supported by improving conditions for its major trading partners, which are expected to grow collectively at 4.5 per cent this year and 5 per cent next year. As the chart shows, this will contribute to an expected GDP outcome for Australia this year of 3.75 per cent - with a 4 per cent growth outcome forecast for the coming year.

Growth in real GDP



While the strong overall domestic growth for Australia will mask differential performances between sectors and regions within the country, the main contributors to GDP growth for the coming years will reflect an expected picture. This chart indicates the significant pick-up in business investment and modest improvement in household consumption that will contribute to this growth. Also of significance will be a higher level of exports dominated by non-rural commodities, such as liquefied natural gas, iron ore and coal. As the Government continues to wind down its stimulatory fiscal policy, public expenditure will have a sharply reduced contribution to GDP growth.

Contributions to real GDP growth

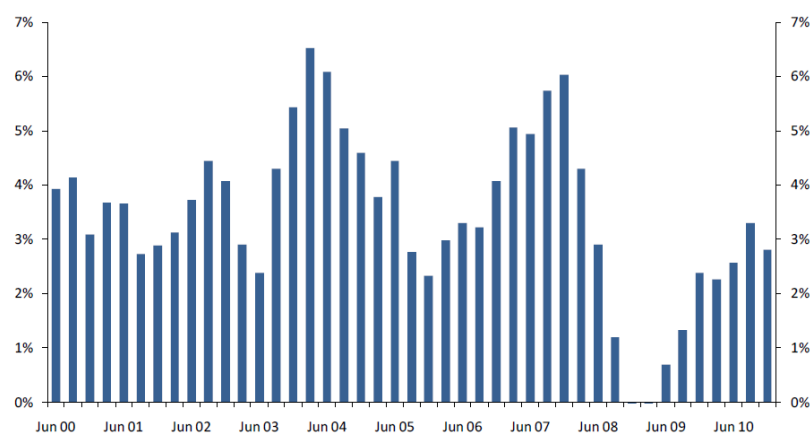


Household consumption declined sharply in Australia during the onset of the global recession. This was in response to falling incomes, rising unemployment, a large and rapid growth in savings (in order to reduce outstanding credit balances), and uncertainty at the time for near-term employment prospects.

That said, the Government responded quickly with fiscal stimulatory measures aimed in large part directly at households. This action primed a relatively quick recovery in consumption, even if it was at more modest levels.

In the medium to long-term, a more robust domestic sector will result from stronger household balance sheets. In the meantime, lower demand for retail sales and consumer services will facilitate a shift in resources towards the expanding mining and energy sectors in particular.

Household consumption yoy change

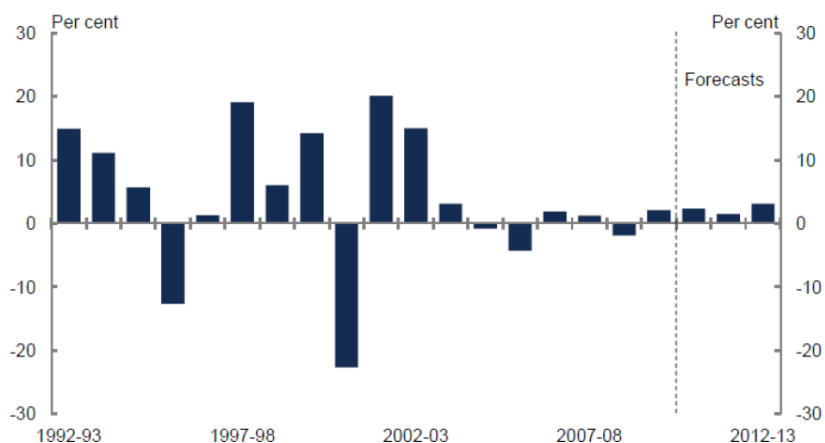


Source: Australian Bureau of Statist

Investment in residential dwellings was highly variable up until 2003, after which growth has been significantly weaker. A general caution exercised by the household sector in recent years, together with tightening credit conditions and a slowdown in land releases for residential development, have all contributed to low growth in housing supply.

The improving outlook that will underpin employment and income growth, and a general improvement in household confidence, will give rise to a medium-term increase in dwellings investment. This growth will in part also be due to a lagged response to recent increases in population growth.

Growth in dwelling investment

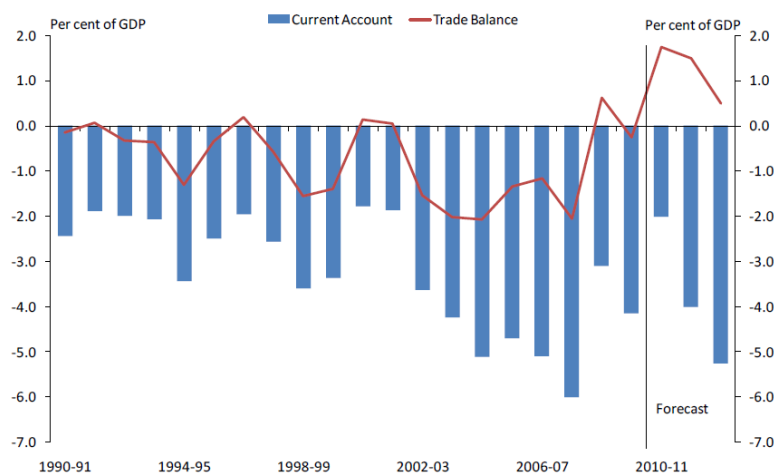


A long series of negative trade balances was reversed sharply in 2008-09, due mostly to the large growth in exports of that time. During the global recession, domestic income and employment effects resulted in a greater downward impact on imports than did the slowing of export growth. As a result the current account deficit has narrowed markedly over this period, contracting to about 2 per cent of GDP this year.

Even though this most recent year has been one of rising resource sector export prices and volumes, large offshore repatriation of mining profits has contributed to a net negative income balance sufficient to offset the positive trade balance.

A forecast widening of the current account deficit over the near term reflects the expected impact of a large increase in business investment, particularly in the mining and energy sectors. Households maintaining high levels of saving, and the Government's policy to achieve a rapid fiscal consolidation, will together support national savings.

Current account and trade balances



Source: Australian Bureau of Statistics, Bloomberg

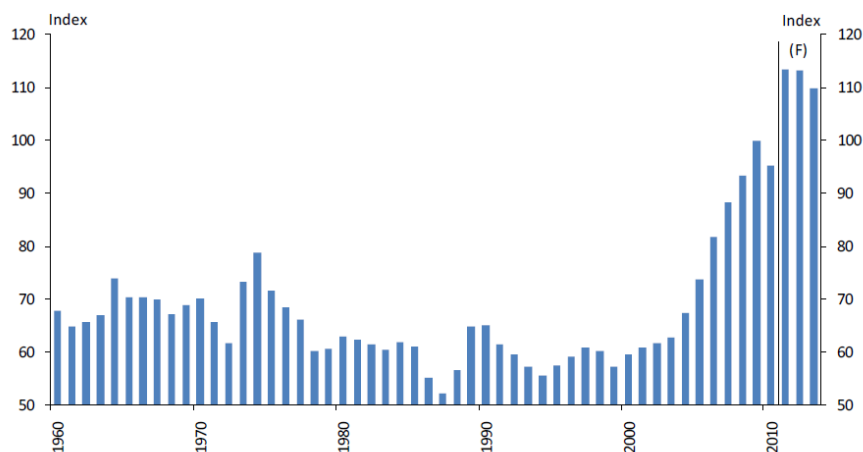
Over the past five to six years Australia has experienced a steep increase in its terms of trade as the global demand for and the prices of its resources have risen appreciably. This year the terms of trade will be at an historic high – about twice the average level experienced over the preceding four decades.

However, the prices of key commodity exports are not expected to remain at current levels, with a global commodity supply response to this record high demand for resources expected to take effect over the next two years. While this will begin to dampen Australia's terms of trade, they are expected to remain at high levels for quite some time.

In the meantime, the high terms of trade are supporting high national income and domestic economic growth more broadly.

Together with a strong economic performance (relative to other advanced economies) and tightening macroeconomic policy, the high terms of trade have provided the circumstances for a strong appreciation in the \$AUD.

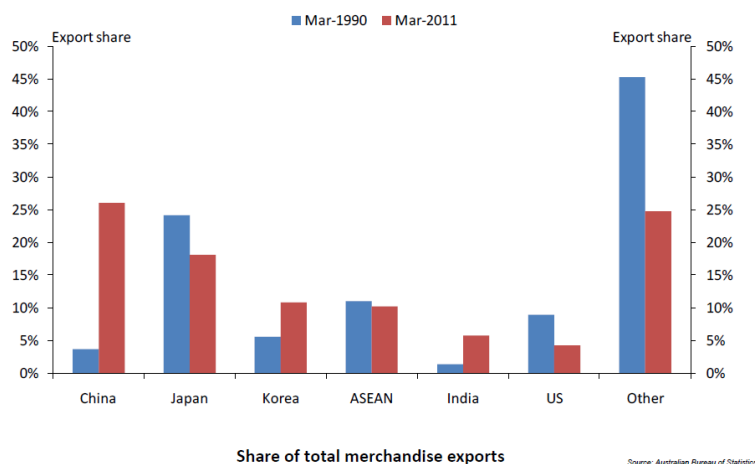
Terms of trade



There is much commentary at present about the reliance of Australia on China and India as rapidly expanding and emerging economies. As this chart shows, China as an export destination has increased its share from about 4 per cent in 1990 to over 25 per cent this year. During the same period Korea's importance has doubled to about 12 per cent, and India's has increased almost five-fold to about 6 per cent.

Japan remains an important trading partner and the outlook is for this to remain the case. Continued strong growth in China, India and Australia's Asian trading partners is set to underpin the growth in demand for exports, to which I have already referred. This part of the Australian story ties closely with the planned mining capacity and port facility expansions that will facilitate a further uplift in resource sector exports.

Exports by destination

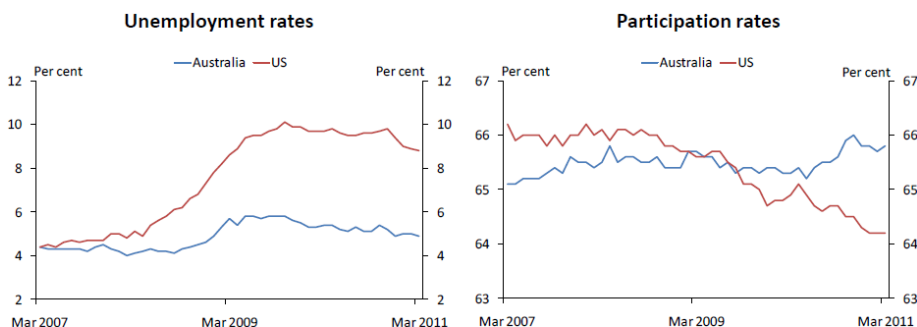


The labour market picture in Australia is very healthy, with unemployment peaking at well below an anticipated global recession high of over 8 per cent. This contrasts with experience in the US, for example, where substantial job losses over the past two years are only just beginning to abate and where the current unemployment rate is more than twice that of Australia.

In what is also a very positive sign for the Australian labour market, the participation rate has continued to rise steadily over the last two years, this reflecting strong confidence about the prospect for an expanding jobs market.

With a natural unemployment rate in the range of 4.5 - 5 per cent, forecasts for an unemployment rate of 4.75 per cent in the coming year and 4.5 per cent in 2012-13 indicate tightening labour market conditions over the coming years. This will become more evident with the expansionary impact of the uplift in exports.

The labour market



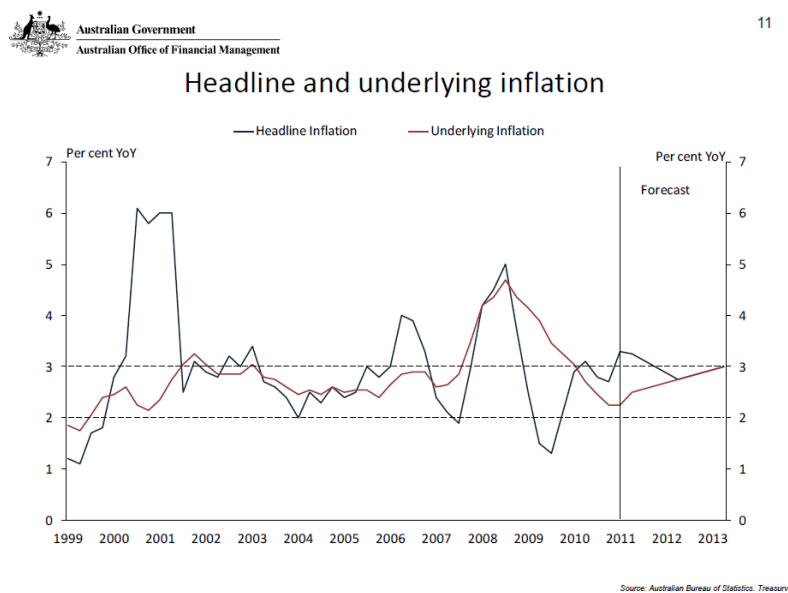
Source: Australian Bureau of Statistics, Bloomberg

As the labour market tightens, inflationary pressure will build, although forecasts are for inflation to be contained within a target range of 2-3 per cent. Winding down of the Government's recent fiscal stimulus, together with a less accommodating monetary policy will of course moderate these inflationary pressures.

Inflation over the past decade arose largely from persistent increases in domestic prices for goods and services. Therefore, a tighter labour market and upward pressure on the costs of health and utilities in particular will present a renewed inflationary threat. And, while the high \$AUD will have a dampening effect on prices in the tradeable sector, this effect will lessen as wages in emerging economies increase and a continuation in the international recovery more generally adds to the global demand for food and other consumables.

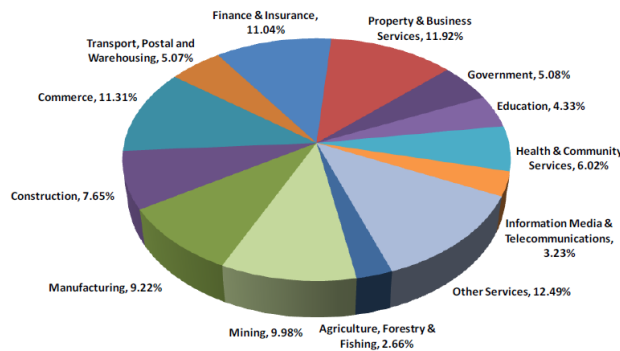
As this chart shows, underlying inflation is currently at around a 10-year low of 2.5 per cent but is forecast to rise to 3 per cent by the end of 2012-13.

The current spike in headline inflation is largely due to the impacts of recent flood and cyclone devastation of fruit and vegetable crops, together with the influence of higher oil prices.



As the chart on relative contributions to GDP growth indicated earlier, Australia will not rely on export expansion alone for its economic growth in the coming years. Although this will be an important component, it should be noted that Australia’s economic base is quite diverse and this provides some protection in times of either domestic or internationally sourced risk.

A diversified economic base



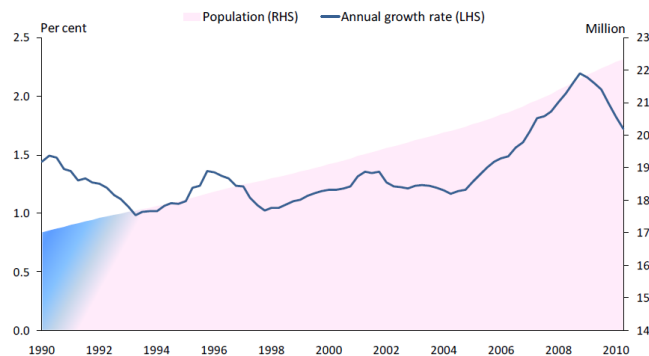
GDP contributions

Source: Australian Bureau of Statistics

Population growth in Australia has been steady, with total population having increased by about 25 per cent over the past two decades to a current level of 22.5 million. More than half of this growth has been in the last decade, with a clear acceleration in growth having occurred between 2004 and 2009.

Continued population growth will be important to support a growing demand for labour and to maintain a healthy demand for domestic consumption.

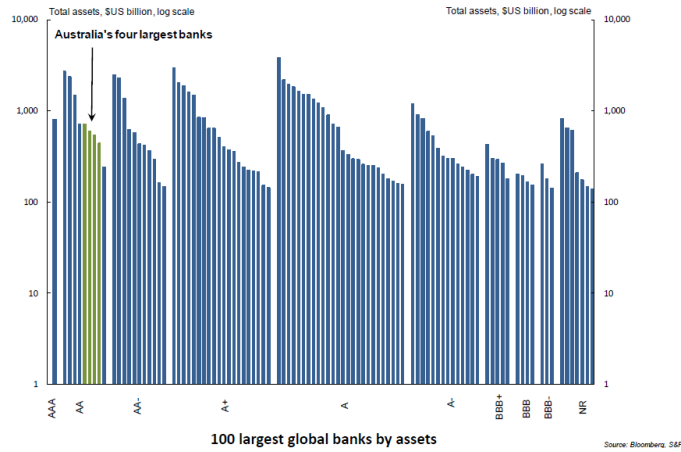
Population growth



Source: Australian Bureau of Stat

Domestic savings, consumption and investment are of course reliant on a healthy and robust financial sector. In this regard Australia’s banking sector has proved to be as resilient, if not the most resilient, of any banking sector in the world. Australia’s four main domestic banks are well capitalised and rank amongst the top 10 of the largest 100 global banks – all of these top 10 are rated AA by S&P.

Healthy domestic banks



In addition to Australia's solid economic position, its fiscal and national debt positions are also sound by international standards. Successive Australian Government's have set fiscal strategies to guide and underpin their budget positions, and in turn their exposure to debt.

The current Government's fiscal strategy takes account of the significant impacts felt by the recent global recession, but having run a series of budget deficits that at worst reached just over 4 per cent of GDP last year, it plans a relatively rapid fiscal consolidation.

This fiscal consolidation, while sensitive to the economic recovery period, is based on three fundamental constraints:

- Allowing tax receipts to recover with GDP growth instead of pursuing widespread revenue raising measures;
- Maintaining real growth in Government spending to just 1% per annum until the economy returns to above trend growth AND the Budget is in surplus; and
- Keeping long-term real growth Government spending to 2% per annum.

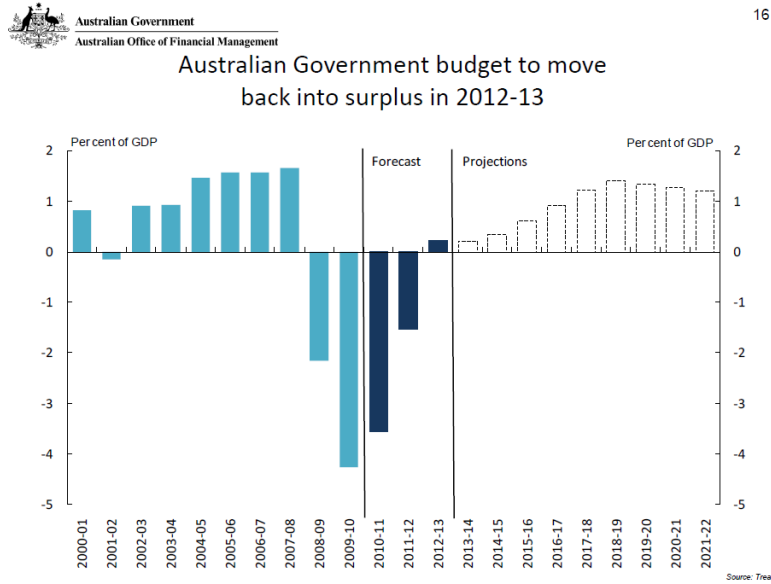
As this chart shows, the Budget is forecast to return to surplus in 2012-13, with projected modest but steady increases in the surplus thereafter.

The Government's medium-term fiscal strategy

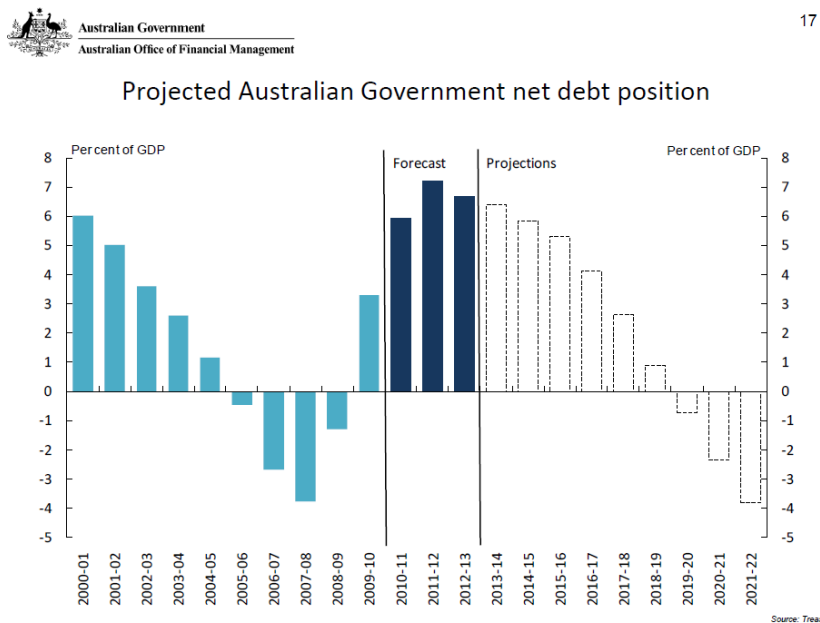
Return the budget to surplus by:

- Tax receipt recovering with economy improvement, while keeping taxation as a share of GDP below the 2007-08 level on average.
- Real growth in Government spending kept to 1 per cent per year until the economy is growing above trend and the budget returns to surplus.
- Long-term real growth in Government spending to be 2 per cent a year.

Australia’s negative net debt position of about 4 per cent of GDP in 2007-08 was very quickly eroded by the onset of the global recession, with net debt forecast to peak at about 7% of GDP in the coming year. Current Budget projections, however, show an anticipated return to negative net debt by 2019-20.



As we can see from this next chart, Australia’s net debt position in global terms is indeed small reflecting the strong fiscal position Australia had going into the global recession. The fact that it will remain very low by international standards - and actually decrease during a period in which the debt positions of many of the major advanced economies will either be maintained at best, or worsen - also reflects the underlying resilience of the economy and its relatively rapid return to expansion.

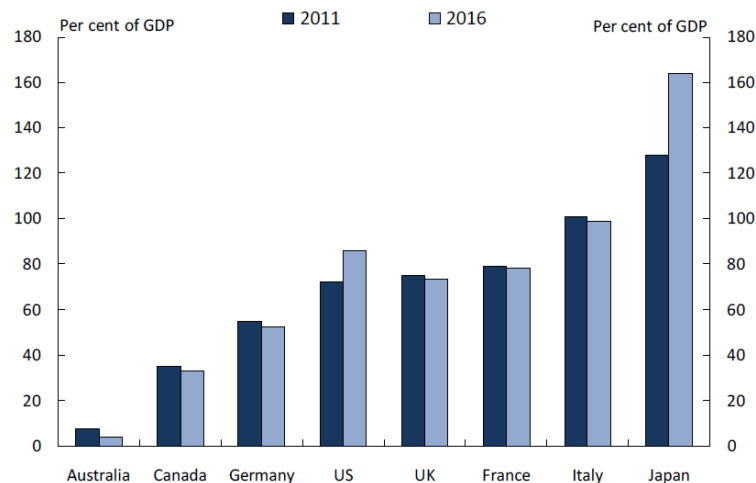


In 2003 the Australian Government reviewed the need to maintain a stock of Commonwealth Government Bondson issue. It has again reviewed this in light of the experiences arising from the global recession, and as a result has renewed its commitment to maintain a presence in the bond market.

In particular it has committed to supporting the 3 and 10 year futures markets; is considering what stock of gross issuance will promote liquidity, while at the same time supporting new international banking regulations; and has announced that it will maintain liquidity in the Inflation Indexed Bond market.

Although a decision is yet to be taken on the future size of the Commonwealth Government Bond market, careful consideration is being given to a proposal from industry to maintain an ongoing stock of gross issuance at about 12-14 per cent of GDP. This of course would allow for the market to grow in line with future expansion of the economy. The Government has also acknowledged that the opportunity should be taken to extend the government bond yield curve as market demand allows and to be consistent with prudent sovereign debt management.

Government net debt



Source: Treasury, IMF Fiscal Monitor

Following the release of the Commonwealth Budget two weeks ago, the Australian Office of Financial Management has announced its issuance program for 2011-12.

For nominal bonds this will involve face value gross issuance of \$51 billion; with two new mid-curve bond lines; and the launch of a 15-year bond to occur either this year or next year – depending on market demand.

The Government's commitment to maintain about 10-15 per cent of the gross outstanding stock of bonds as Inflation Indexed Bonds will translate into face value issuance in the coming year of about \$2 billion. However, no new Inflation Indexed Bond lines are planned for 2011-12.

Finally, a minimum of about \$10 billion of Treasury Notes will be kept on issue so as to support the market for this paper.

Future of the CGS market

- The Government understands role of liquid, AAA-rated CGS market and associated futures market.
 - ❖ Committed to support the 3 and 10 year bond futures market.
 - ❖ Considering maintaining the CGS market around its current size - 12 to 14 per cent of GDP over time.
 - ❖ Support liquidity in the Treasury Indexed Bond market - around 5 per cent of gross issuance for the foreseeable future.
- The CGS yield curve to be extended, consistent with prudent sovereign debt management and market demand.

Three years ago gross issuance was about \$5-6 billion per year. This year Australia’s gross government bond issuance will be about \$55 billion in order to support what has been a sharply deteriorating underlying cash deficit. Although gross issuance will peak this year, an annual bond program of about \$30 billion will be required to support the government’s forecast budget position.

Planned issuance in 2011-12

Nominal Bonds

- Total gross issuance around \$51 billion in face value terms.
- Will include one or two new mid-curve lines.
- Extending the yield curve out to 15 years within the next two years depending on market conditions.

Treasury Indexed Bonds

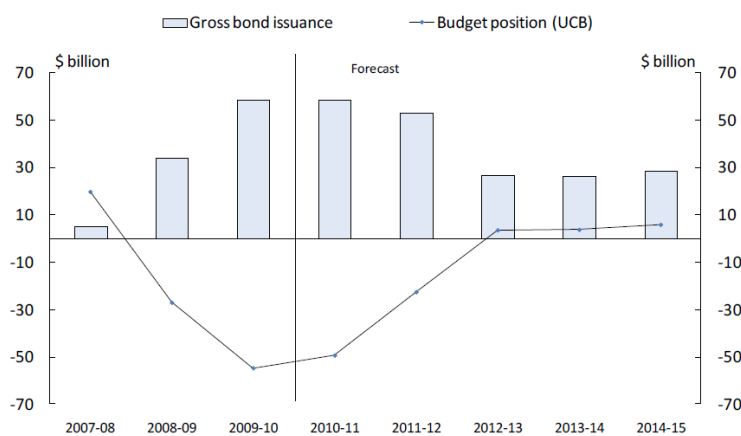
- Issuance is expected to be around \$2 billion in face value terms.
- No plans to issue any new Treasury Indexed Bond lines in 2011-12.

Treasury Notes

- At least \$10 billion to be kept on issue at all times.

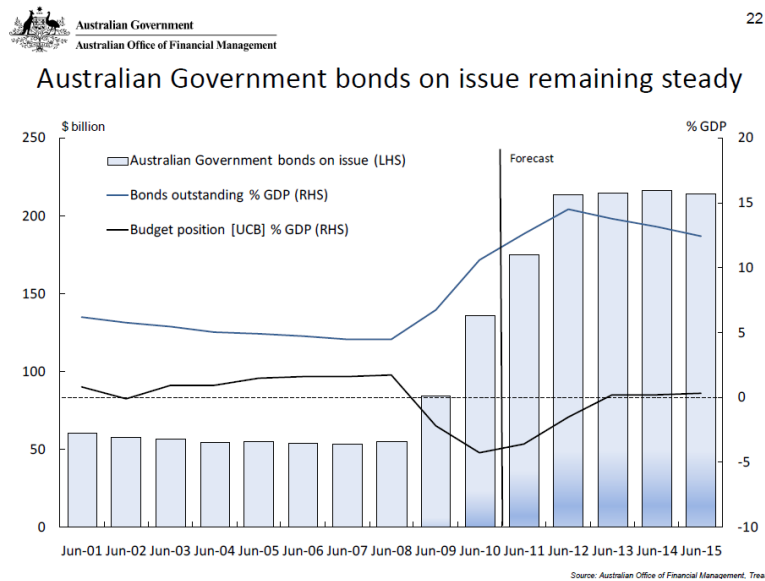
In terms of the stock of government bonds, by 30 June this year, it will have increased almost four-fold in only four years to plateau at just over \$200 billion. This will equate to about 15 per cent of GDP. Through the expected fiscal stability of the years to follow, the gross stock of Commonwealth Government Bonds on issues will represent between 13-14 per cent of GDP.

Gross issuance of Australian Government bonds

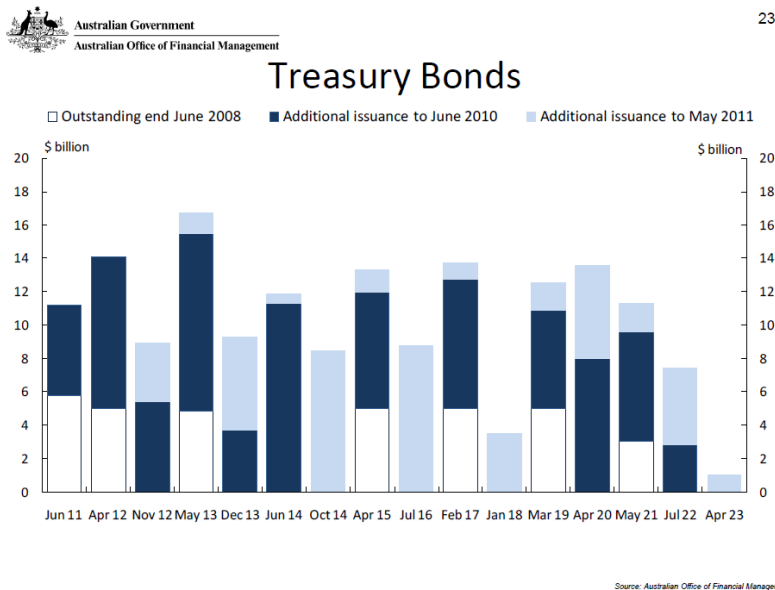


Source: Australian Office of Financial Management, Treasury

This chart shows where new nominal government bond issuance has been targeted over the last three years – with the white bars showing bond line levels at the end of June 2008; the dark blue bars showing gross issuance last year; and the lighter shaded bars showing gross issuance so far this year. A new April 2023 line was just launched by tender last week, with other new lines this year having been the October 2014; the July 2016; and the January 2018.

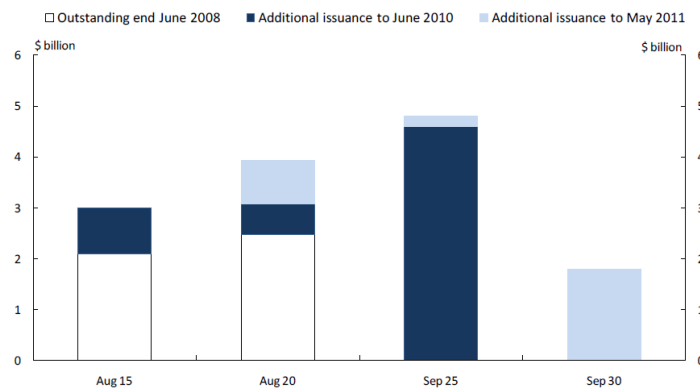


In terms of Treasury Indexed Bonds a new 2025 line was launched last financial year and a new 2030 line was launched this financial year. Indications from market participants seem to suggest that bond lines of \$4-5 billion are sufficient to maintain liquidity in this segment of the market.



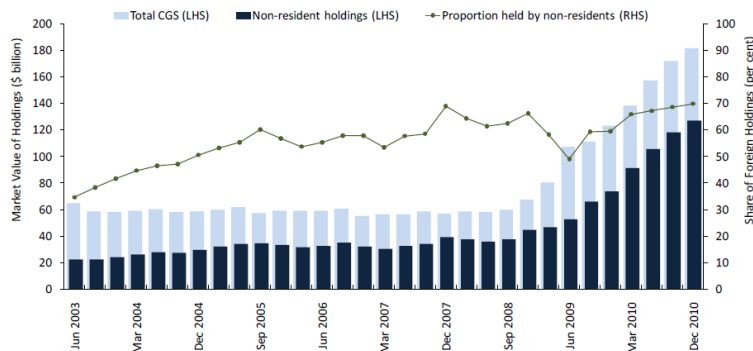
I will conclude by pointing out that offshore interest in Australian Government Bonds has been building steadily and holdings are currently estimated at about 70 per cent. While there was a brief lag in the pick-up of offshore holdings as the Government bond market expanded quickly in 2009, the representation of foreign holdings soon recovered to recent previous levels. This would in large part have been as a result of relatively high yields; Australia’s strong credit standing; the emerging status of the \$AUD as a reserve currency; strong liquidity; and growing prominence more generally of the Australian Government Bond market in international settings.

Treasury Indexed Bonds



Source: Australian Office of Financial Management

Strong international interest



Source: Australian Office of Financial Management, Australian Bureau of Statistics

Thank you.