Presentation to the Australian Business Economists luncheon Sydney, 7 June 2011 –

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Thank you to the ABE for hosting this function today and for inviting me to speak. I realise it has become something of a tradition for the AOFM to provide a speaker to closely follow the Secretary of the Treasury, to closely follow the release of the Budget. You get two new identities this year, not that I hope you see that as a bad thing.

Let me first say that on arriving recently in Canberra, I was indeed relieved to have my prior expectations of the AOFM confirmed, in that the agency remains extremely well placed to meet its tasks. In fact the very high degree of competency and professionalism displayed by the agency are a clear reflection of the efforts of my predecessor Neil Hyden, and the staff who work there. I do not underestimate the significance of having been handed the baton.

In the past the ABE has nominated a topic to speak on but this year as an alternative Stephen Halmarick has basically posed a series of questions. These were:

- “*what’s happening to the CGS market particularly with the budget expected to return to surplus in 2012-13*;”

- “*with the forecast surpluses and growing demand for CGS, will there still be a government bond market of practical and sufficient size around in the future?* “ and

- “*will the inflation linked market continue to be supported by the AOFM?*”

The context which has given rise to these questions is obvious. Four years ago the CGS market was under a care and maintenance program. The outstanding stock on issue was maintained within a range of $50-$55 billion and the issuance program was about $5 billion per year. There were 10 bond lines the largest of which was about $6 billion, with the average bond line being just over $4.5 billion. On average the outstanding stock of

Government bonds on issue had been reasonably constant at around 5% of GDP for the preceding seven years.

In the following year there was an inevitable uplift in issuance in response to deterioration in the Budget position because of the Global Financial Crisis. Over the next three years – up to and including this year, the annual issuance program has increased 10-fold and the stock of bonds outstanding has increased accordingly. Obviously this has had a substantial impact on the Office, which has adapted quickly and nimbly in response.

The recent Federal Budget did much to address the questions concerning the future of the CGS market, in addition to covering other issues surrounding the Government's forthcoming bond program. The Budget also made mention, of Australia's comparatively strong fiscal position when viewed in an international setting. You should be heartened to hear that this is an issue that features in our presentations to investors and potential investors.

Australia's debt position has attracted intense scrutiny over the past year in particular – there are several reasons why this is the case, but I will take a few moments to highlight two of them because they provide an important backdrop to the debate about the future of the CGS market.

On the one hand we have what I would describe as political concern – which, at least on the face of it, is based on the broad premise that sovereign debt is a bad thing; we have and continue to accumulate too much of it; and this will result in financial stresses beyond our capacity to manage them.

On the other hand we have close financial market interest in a decision by Government to maintain a considerable stock of debt (at least relative to what was outstanding just a few years ago); the range of considerations here boiling down to objectives about risk-free pricing and maintaining liquidity in the bond market.

Let me discuss each briefly in turn, but it should go without saying that both give rise to the need for careful policy consideration by Government.

I refer to the former concern as 'political' because its public manifestation in the form of community debate is based on a range of arguments, some of which have questionable relevance. It is far from clear the value that many of the so-called 'debt negative' arguments add to informing the debate. However, what is important for the purpose of our discussion today is whether or not in broad terms a reasonable assumption can be made as to the appropriateness of Australia's current and forecast debt position. Even more relevant is consideration as to whether Australia's sovereign debt level is one that permits a sensible judgement of how to maintain a CGS market into the future.

So, how could we do this? Well there is any number of ways in which sovereign debt positions are assessed. They range from measures of current gross debt in absolute terms in isolation of any comparison – to inter-country historical comparisons of net debt relative to economy size. The choice of measure I would suggest is probably more dependent on judgement than science.

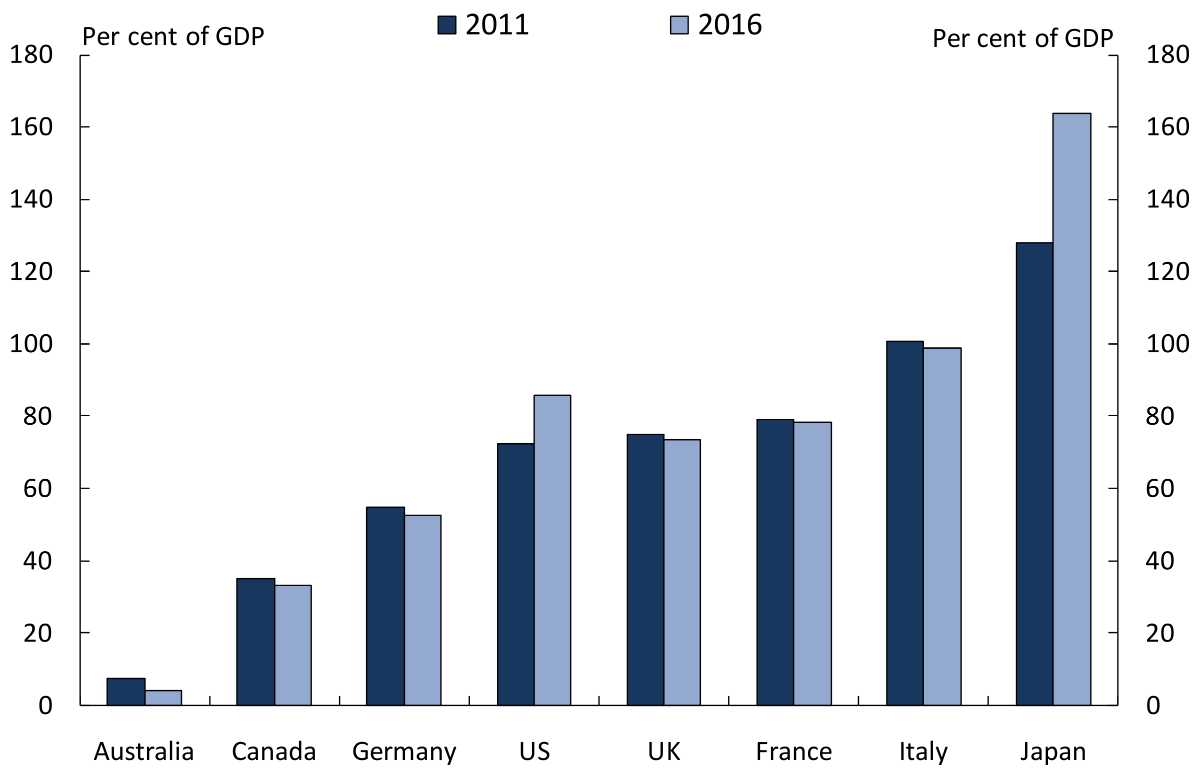
I do not want the issue of appropriate sovereign debt levels more generally to be the central topic of the presentation, so I will move fairly quickly over a few perspectives and leave you to draw your own conclusions. The key questions to ask, however, are these:

- does Australia's debt position look reasonable in comparison with key advanced nations;
- does the current and projected level of debt look to be under control given Australia's history of managing it in response to our changing fiscal and economic circumstances overtime; and
- how should we assess Australia's capacity to service its debt?

Let's take the last part first, and I will simplify this by confining our consideration to the interest outlays on CGS, which comprise about 95 percent of debt. Interest cost on CGS as a proportion of total outlays will be 3.2 per cent for the coming year. It will increase to 3.3 per cent in the following year before it is projected to decline to about 3 per cent by 2014-15. In other words, for every $100 of outlays over the next four years the Government will direct a little over $3 of that on average towards servicing the costs of outstanding CGS. This compares broadly with 12 per cent for the US; about 11 per cent for Canada; and about 7 per cent for the UK.

If we look to indicators of sovereign debt on the basis of international comparisons, we can choose gross or net debt as the basis for analysis. Once again, in order to avoid turning this into the focus of my presentation I will look only briefly at a few indicators. In gross terms, Australia's debt is forecast to peak at about 16 per cent of GDP in 2011-12, which according to Standard and Poor's compares with a current 'AAA' median of just over 46 per cent. We should also note that Australia is one of only 19 AAA (stable) rated sovereigns in the world.

Slide 1: Australia v G7 net debt to GDP comparisons 2011 & 2016

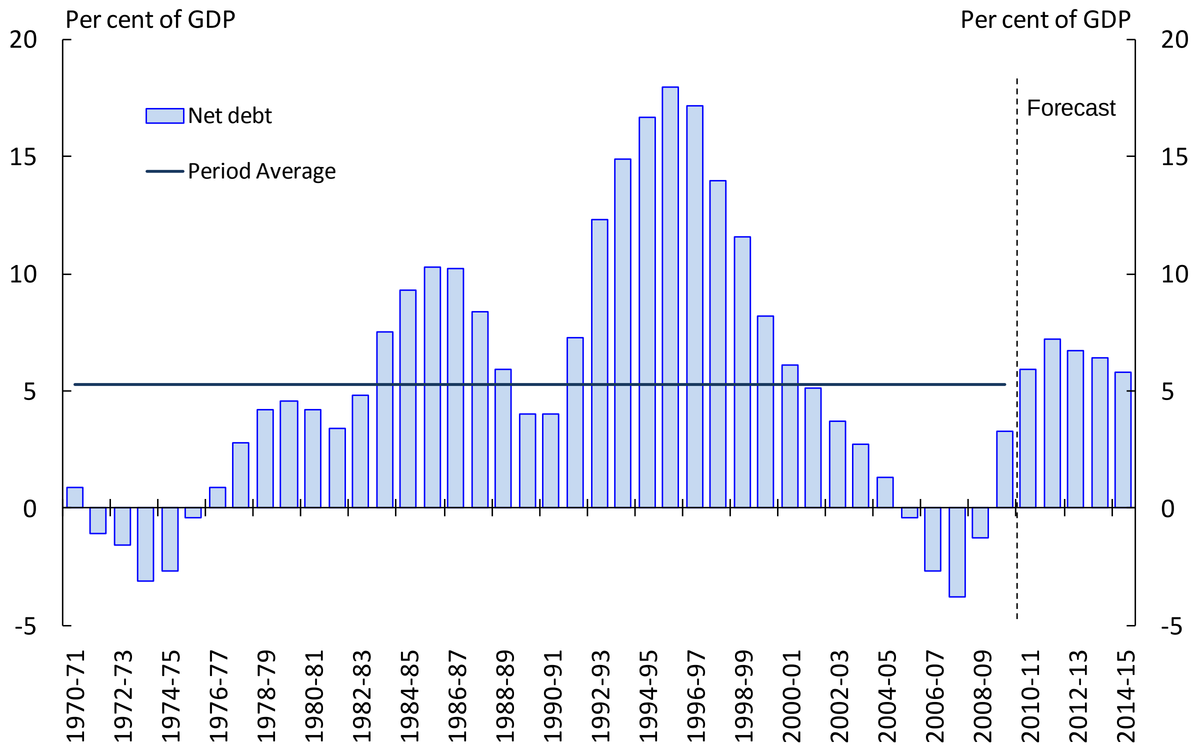


Source: Treasury, IMF Fiscal Monitor

This first slide shows net debt for selected advanced nations – being the G7 countries. The darker bars show the estimated net debt positions for each this year, while the lighter bars show their projected positions five years hence. Noticeable improvements are projected for Australia, Canada and Germany, but the outcome expected for Australia is proportionately the greatest by far.

As you can see, Australia's sovereign debt position is dwarfed by the average across the G7 countries. Based on current estimates Australia's net debt will peak at less than one tenth that of the major advanced economies.

Slide 2: Australia's net debt as percentage of GDP 1970-71 to 2014-15



Source: Data from Treasury

However, regardless of whether we consider Australia's current debt position to be low by international standards, this doesn't tell us much about our track record in managing it overtime. To do this we need an historical perspective.

How far we should look back to gain a relevant picture is of course as open to debate as any of the other indicators I will present to you today. I have chosen to look back to the beginning of the 1970s because it covers a period over which Australia has faced a range of economic growth challenges; it spans decades through which the country has undergone some substantial reforms (many of which have required fiscal support); and most attractively - because we had the data readily to hand. Once again a measure relative to GDP is used to account for the impacts of economic expansion over time.

What is immediately obvious is that the current and near-term levels of net debt are not at recent historical highs, with 14 out of the last 40 years showing net debt as a percentage of GDP greater than its current forecast peak in 2011-12. The chart also indicates that

Australia's net debt position has varied markedly, with periods of low debt, comparatively high debt, and periods of negative net debt.

From now until the end of the forecast period the net debt position will be either at or just above the average for the period, with the Budget showing projections of net debt to be back to 1 per cent of GDP by 2018-19. Budget projections also anticipate Australia entering a new period of negative net debt from 2019-20. No doubt there will be considerable positive and negative influences on this projected debt trajectory over the coming years, but these will of course be a matter for Governments of the day to read and manage.

What is significant about the picture portrayed by this chart though is that it shows that Australia has managed on several occasions to reverse its debt position. This will have been through fiscal consolidation, asset sales, and a combination of the two. It is also important to note that successive Australian Government's have set fiscal strategies to guide and underpin their budget positions, and in turn their exposure to debt. Fiscal strategies as a means of giving public expression to a credible plan for managing fiscal outcomes as an indication of budget sustainability are now expected of all Australian governments. Together with improved financial reporting standards overtime, fiscal strategies have greatly enhanced transparency and accountability.

It should come as no surprise that when the AOFM travels overseas to meet with our off-shore investor and potential investor base, Australia's fiscal strength and discipline is often remarked upon.

Yet another perspective on how to assess relative sovereign fiscal positions was recently devised by a group of Stanford University PhD students. They created a Fiscal Responsibility Index (the Stanford FRI), which got some media coverage here at the time it was released.

Their work covers three areas; measuring a country's debt headroom; assessing its budget sustainability through projecting a fiscal path; and judging its relative fiscal transparency and accountability.

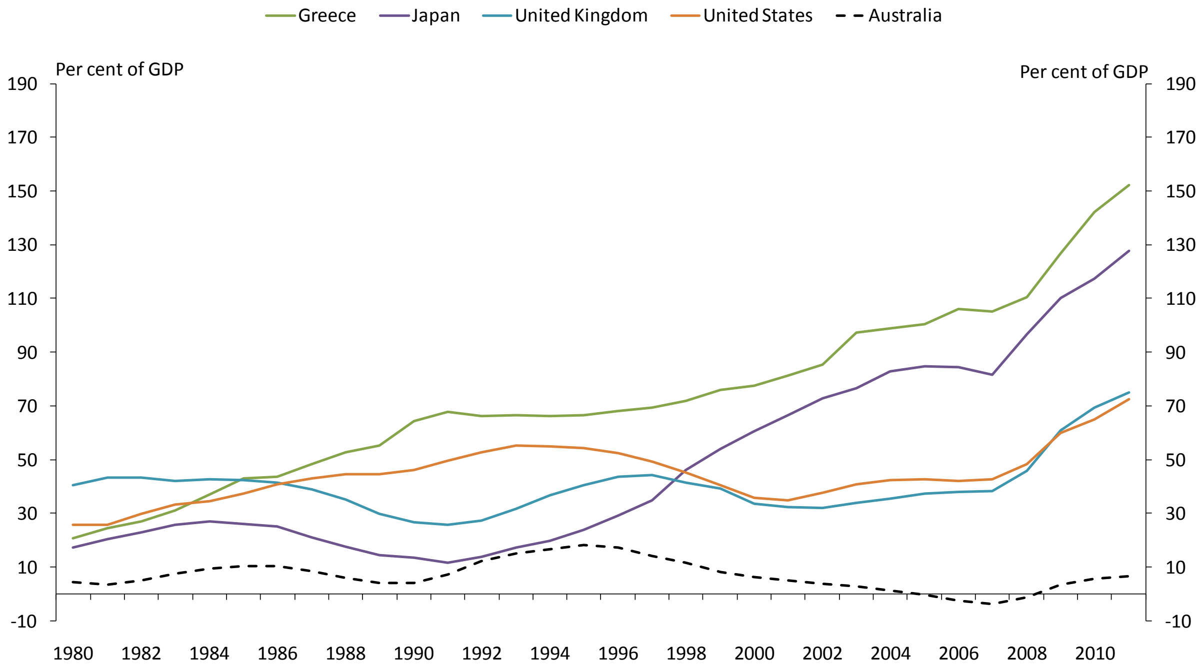
The concept of fiscal headroom covers total debt to GDP and a ratio of foreign held debt – all relative to an absolute 'debt ceiling'. Australia's absolute 'debt ceiling' was assessed at

192 per cent of GDP; and even if they have got this out by a factor of four or five, it still shows Australia to be well placed – Australia ranked 5th for this category.

They then used the Fiscal Path concept to assess how close each country is to a debt default risk zone given its current and future fiscal position – Australia was one of 10 countries assessed as not projected to reach its debt default risk zone prior to 2050. The Fiscal Governance measure covered a wide range of criteria such as a country's debt rules, fiscal targets, the transparency of these rules and the enforceability of them – Australia also ranked 5th for this category.

Together 34 countries were included in the analysis, which comprised predominantly OECD nations. Australia's high ranking in each of the three categories resulted in an extremely high overall ranking for the exercise.

Slide 3: Historical comparison net debt to GDP, various advanced nations



Source: Treasury, IMF Fiscal Monitor

Before leaving the issue of Australia's debt position it is also worth commenting on the proposition that Australia has managed its debt position in response to changing economic and fiscal circumstances. This chart shows a comparison of net debt to GDP for various advanced nations over about the last 30 years. Apart from Australia as the stand-out case, the UK and the U.S. have also demonstrated a capacity to influence their net sovereign debt positions over time, although recent trends for both suggest a sharp uplift as a result of the GFC. Greece looks to have had a poor long-term fiscal discipline – this of course highlighted by the fact that it now finds itself at the centre of the European sovereign debt story.

Together, the preceding indicators, albeit it high-level and presented as an overview, suggest that Australia's sovereign debt position is not onerous in terms of servicing costs; is low by international standards and about average as compared with the Australian fiscal experience over the last 40 years; and it sits within a range of influence given the ability of successive governments to manage the country's balance sheet within reasonable periods of time.

This I think gives us a basis on which to consider the future of the Government Bond market.

In broad terms at least, a presence by the Commonwealth in the bond market serves two prime objectives. One is to support financing of the day-to-day operations of Government including the re-financing of bond lines as they mature. The other is to support a proper functioning and efficient financial market through providing an interest rate risk transfer mechanism that will overtime lead to lower long-term interest rates across the economy. The relative importance of CGS in determining prices will of course vary depending on market conditions at any point in time.

However, the importance of CGS has never been more apparent than it was during the worst of the GFC, when liquidity almost completely evaporated in sectors of the financial market, some of which had previously been considered ready substitutes to the market for CGS. Had it not been for the policy decision of successive governments to maintain a CGS market following the 2003 review, it is likely that Australia too would have experienced low liquidity extremes in its financial markets. Furthermore, it is difficult to gauge how severe the challenge would have been for Australia to raise new debt at reasonable cost, at a time when it was required the most, and in the absence of a ready investor base familiar with our tried and tested processes and the 'AAA' quality of Australian Government paper. For the relatively low Budget cost of servicing an ongoing stock of debt in the form of CGS, this has arguably provided sound insurance against unanticipated events such as those arising from the GFC – something not to be overlooked as we consider the years and decades that lie ahead.

In view of these recent experiences the Government had Treasury convene a consultative panel consisting of the RBA, APRA, the AOFM, two State Government central borrowing authorities, and a number of private sector market participants. The forum was specifically created to discuss the various perspectives on what could be learned from the GFC experience. A summary if this consultation was published in the Budget and this should set the context for further debate.

The issuance program for 2011-12 announced by the AOFM on Budget day, along with commentary in the Budget on the experience highlighted through the panel discussions provide an answer in part to the initial questions I set out at the beginning. This should also give comfort on certain aspects for a future CGS market.

In short the Government has indicated a commitment to maintaining a liquid Commonwealth bond market. In fact ongoing liquidity in the market was again recognised as the primary objective of the Government maintaining a presence in the market.

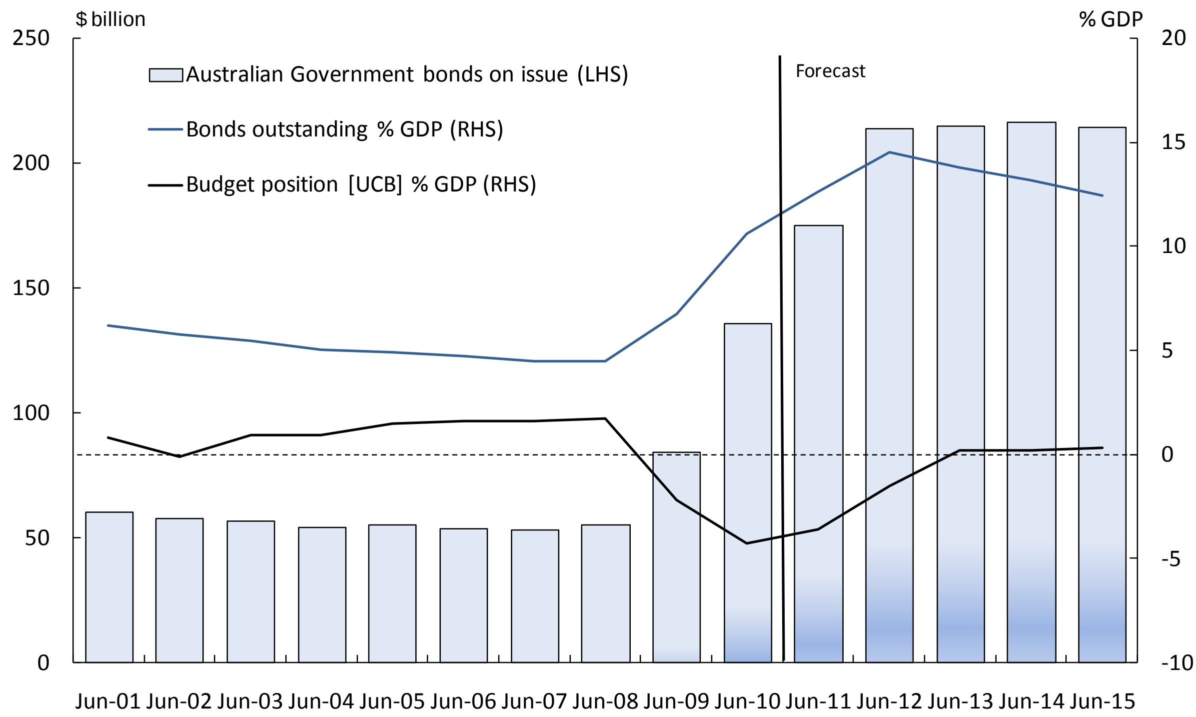
The Government's acknowledgment that a liquid CGS market is necessary to support the '3' and '10' year Treasury bond futures markets was also specifically mentioned. The CGS market has also been shown to provide for a reliable source of pricing and hedging of other financial instruments in times of financial crisis or dislocation, and a readily available market to manage a range of financial risks.

The panel discussions also emphasised that a diversified investor base was important in supporting and maintaining a liquid CGS market. Further diversifying the CGS investor base will be an important focus of the AOFM's investor relations activity over the coming year.

As to an appropriate size of the CGS market after the Budget returns to surplus, this will also be a matter for further debate, although I think it is safe to assume that the debate should not be dictated by concerns that current or projected debt levels will of themselves be a constraining factor. I note here that the Government has indicated through the Budget papers that it is considering a view put forward that the CGS market be maintained for the long-term at around 12-14 per cent of GDP.

Consistent with judging sovereign debt levels, it also seems sensible to contemplate the size of the CGS market relative to the size of the economy. CGS in the form of nominal bonds currently constitutes about 30 per cent of the overall bond market. However, if the CGS market is to be maintained long after the Budget has been returning consistent surpluses, it is likely to be some years before the Government is faced with the practical choice as to determining an appropriate balance between consistently reducing outstanding debt and accumulating financial assets. This suggests that a firm policy decision on the future size of the CGS market may not be urgently required.

Slide 4: Gross Bonds on issue relative to Budget position and GDP



Source: Australian Office of Financial Management, Treasury

As this chart shows, the amount of CGS on issue by the end of this month will represent just under 12 per cent of GDP, with it forecast to peak by the end of June next year at just under 15 per cent of GDP. With the underlying cash position of the Budget forecast to return to surplus in 2012-13 – as shown by the black line – no longer will there be a need to issue new bonds to finance a deteriorating Budget position as was the case over the past few years. This will mean that the AOFM’s issuance task can be scaled back to about $30 billion per annum, sufficient to re-finance existing bond lines as they mature, together with some other relatively minor funding tasks, such as the need to support infrastructure spending and other commitments.

This will result in a constant outstanding stock of CGS over the coming years at around $220 billion on a year-end basis. As the chart shows, a plateau in the amount of outstanding CGS will also result in a gradual drift downwards in CGS as a proportion of GDP. Over the forthcoming years to the end of 2015-16 it will remain between 13-15 per cent. On current Budget projections this implies that 2016-17 will arrive before the outstanding stock of CGS will fall below the suggested range of 12-14 percent of GDP. In the meantime, the Government has announced that it will continue to monitor the situation with a view to tracking liquidity. This will be done primarily through our ongoing contact with intermediaries and investors.

Before discussing the specifics of the planned issuance for 2011-12, it is worth noting that during the impact of the GFC and the consequent ramp-up of the issuance program, some recent investors that were attracted to the CGS market, have taken to investing in a new series of Treasury Indexed Bonds (known as TIBs). The Government has recognised the importance of maintaining consistency in the availability of these new bond lines and as such has committed for the AOFM to ensure that 10-15 percent of the total outstanding CGS will be maintained as TIBs. This will translate into about 5 per cent of the annual issuance program.

The issue of whether to extend the CGS yield curve for nominal bonds also remains under consideration. The Government has indicated support for the AOFM to extend the yield curve to the extent that this reflects prudent debt portfolio management and is facilitated by market conditions. Of course other things being equal a guiding objective for us remains the issuing of bonds in a manner consistent with minimising the cost to Government of doing so. Therefore we will not be seeking to issue bonds much beyond our current longest line if we do not assess it as prudent from the Government's perspective, but I will return to this shortly.

<u>Planned Issuance 2011/12:</u>

Looking into next year the AOFM still has a relatively large issuance program ahead of it. Let me take you through this program.

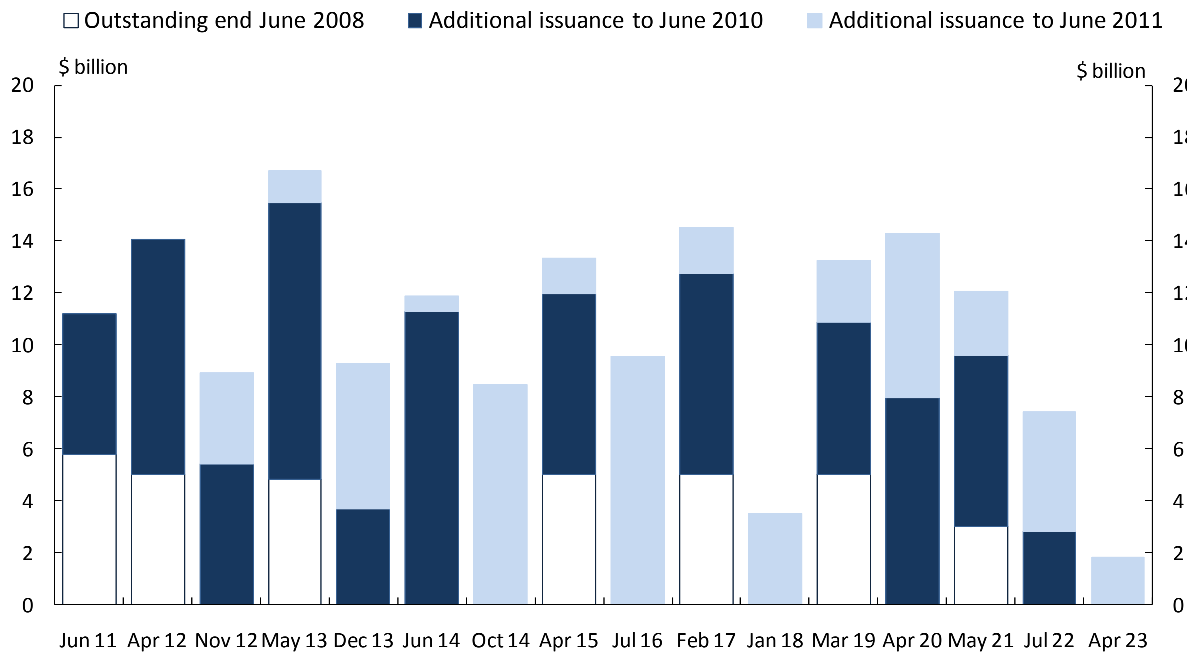
The prior two years have been a busy period for the AOFM with the conduct of two nominal bond tenders and one Treasury note tender most weeks. In addition to Treasury bonds and notes, we have are also been tendering inflation-linked bonds most months of the year, with the re-opening of the TIBs market in 2009 on the back of a syndicated deal to launch a new 2025 line, followed by another this year for a new 2030 line.

After an active 2010-11 where total issuance is expected to top over $58 billion, there will still be a busy issuance program commencing in July. Total bond issuance for 2011-12 is expected to be $53 billion, of which $14 billion will cover maturities and $39 billion will reflect net new issuance. Most of this issuance will of course be through Treasury (nominal) Bonds - approximately $51 billion.

Treasury Bonds:

In the coming year, the AOFM's issuance strategy will be to continue to build up the liquidity of our smaller bond lines while limiting the growth of our largest lines. This latter focus allows us to manage our refinancing risk, but necessitates a continued issuing of new lines in order to maintain the current length of the yield curve. This was done recently with the issue of a new April 2023 line. The strategy of building up current lines, while maintaining the curve and adding new bond lines to reduce the Government's refinancing risk, has proven to be an effective strategy. It has also allowed us to attract and retain the sector where our strongest investor base emanates from, the offshore public sector. However, as we look to establish bond lines beyond our current 12-year lines, we will be looking to attract a new type of investor, who will not be constrained by 10-year benchmarks.

Slide 5: Treasury Bonds



Source: Australian Office of Financial Management

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. Apart from the most recent April 2023 line, other new lines this year included the October ’14; the July ’16; and the January ’18. For the upcoming year we have also announced that two new mid-curve bonds will be established.

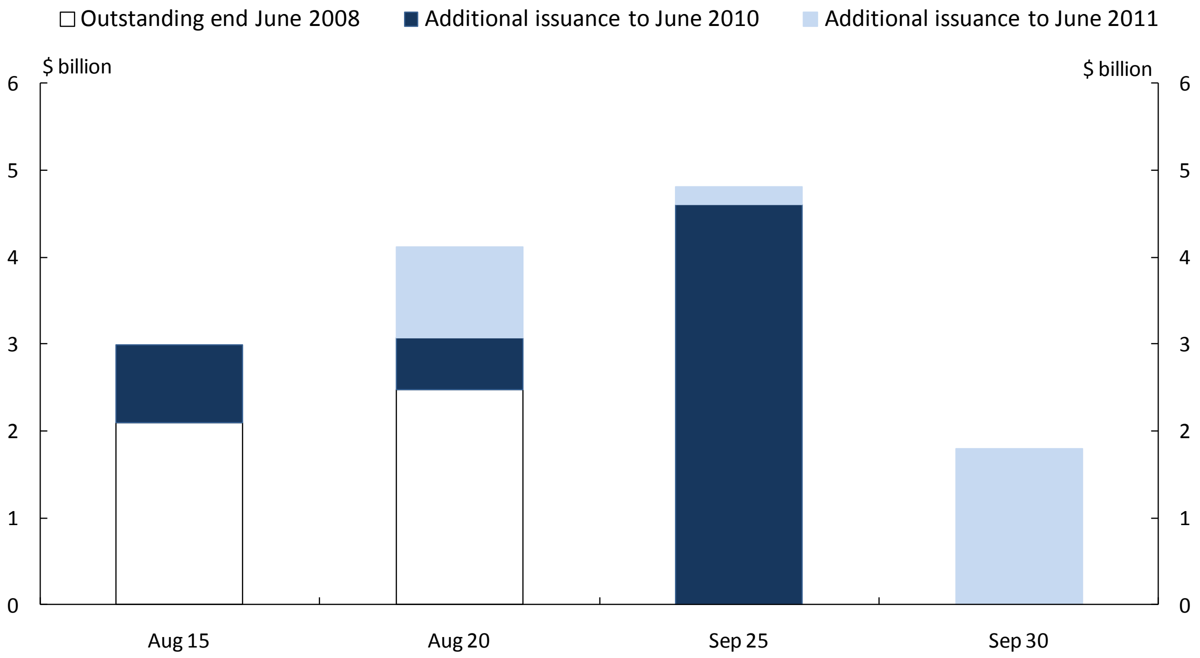
We are taking a larger leap this year by announcing our intention to extend the curve to 15 years. Consistent with what I said earlier we will be sounding the market carefully before doing this and have given up to two financial years to achieve this. That said, we felt confident including this aim in our most recent Operational Notice as we perceive that market conditions are becoming more favourable for establishing a true 15-year nominal bond. We believe that this will attract a new investor base of longer fixed income investors as well as providing some support to our TIB investors who will benefit from having a long nominal bond of similar maturity (duration).

In keeping with our aim to be as predictable and transparent as possible, the timing of our bond tenders in 2011-12 will remain the same as this year; that is on a Wednesday and Friday. The size of the weekly tenders will be between $500m and $1.2billion. Consistent with our need to maintain flexibility, we will continue to take market soundings each week and announce details of the tenders for each week at noon on the Friday prior.

<u>Treasury Indexed Bonds:</u>

The issuance plan for TIBs is for us to tender around $2 billion in 2011-12. With this volume of issuance it is unlikely there will be a need for a new TIBs line this year and we have indicated this in our most recent Operational Notice. However the regular monthly issuance (with the exceptions of December and January) should go a long way to allaying any investor concerns about an ongoing commitment to these bonds.

Slide 6: Treasury Indexed Bonds



Source: Australian Office of Financial Management

This slide shows where TIBs issuance has been targeted since 2008, with the dark blue bars showing issuance last year and the light blue showing issuance for this year.

Although we will look to build up the liquidity of our four existing lines we will take in account indications for demand from the market. Tenders will again be held on Tuesdays usually later in the month with the details announced, as is the case for the Treasury bonds, on the Friday at noon prior to the tender.

For TIBs as well as Treasury bonds the regular and consistent nature of our tenders, along with our regular market soundings should provide confidence to our primary bidders, market makers and investors that this market remains an important part of the AOFMs debt management activity.

Treasury Notes:

The volume of Treasury notes will by their nature and use, vary over the year, but we will endeavour to keep a minimum of $10 billion on issue throughout the year. Past practice has been to maintain around 4-7 maturities extending out to 6 months. We see no reason to change this practice. Currently there are five maturities with around $13 billion on issue.

RMBS Investing:

Before finishing I will take a few moments to comment on the RMBS program, which the Government asked the AOFM to implement in late 2008 to support competition in mortgage and small business lending. Since its inception in November 2008, the AOFM has invested $13.2 billion across 48 transactions. This has allowed 19 issuers to raise over $31 billion in funding, keeping them competitive in the process, as well as keeping this important market infrastructure alive during very difficult times.

The proportion of AOFM involvement in the deals we have supported continues to decline. For example, in the first half of calendar year 2009, the AOFM purchased 78 per cent of the deals it agreed to support. In 2011 to date, this proportion has fallen to only 17 per cent. Most notably, in one of the transactions we agreed to support in March, the AOFM was scaled out entirely. A number of RMBS deals ineligible for AOFM support have also come to market this year. If we include them in the above calculation, the proportion of AOFM involvement required to support the RMBS market in the year to date falls to around six per cent.

Pricing has also improved, with margins tightening by around 30 basis points since late last year. That said, we see room for a further tightening in spreads in the year ahead and we will be monitoring the situation closely.

It would be hard to describe these developments as anything but positive. Furthermore, the Treasurer has announced last December that the programme would be extended by making another $4 billion available – this taking the total in investment available to $20 billion.

Finally, let me briefly anticipate interest in recent developments regarding mortgage arrears and how this may be affecting our portfolio.

It should go without saying that Australian RMBS arrears would have to be considered the envy of the rest of the world. Even after some significant natural disasters in Qld and Vic, 30 day **+** arrears are still tracking below two per cent. The AOFM portfolio is holding up particularly well, with 30 day **+** arrears at less than one per cent. Furthermore, with the level of credit support through loan mortgage insurance and subordination, we are very comfortable with our investment.

In conclusion, we believe that our RMBS investments on behalf of the Government have been sound and they have made a solid contribution to the policy aim of the programme. While we are closely monitoring the emergence of increasing arrears we see no reason at this stage for alarm or re-evaluation of our current approach to undertaking our investment task.

Thank you