Australian Government
The Treasury

FILE No
DOC: D12/109869
MARS/PRISM:

18 July, 2012
File: COR2012/00595

Mr Joe Dimasi
Commissioner
Australian Competition and Consumer Commission
Level 35
360 Elizabeth Street
Melbourne VIC 3000

AUST. COMPETITION & CONSUMER COMMISSION
MELBOURNE
24 JUL 2012

Dear Mr Dimasi

THE COMMONWEALTH GOVERNMENT SECURITIES MARKET

Thank you for your letter of 26 June 2012 regarding current conditions in the market for nominal Commonwealth Government Securities (CGS).

As you noted in your letter, CGS yields have fallen substantially across the yield curve over the past year, with 10-year bond yields at historical lows. The movement in the Australian yield curve reflects a range of factors, including the changed stance of monetary policy and global financial market instability.

The weak and fragile global economy has put downward pressure on benchmark global long-term bond yields, and is driving investors into high quality government debt. As a result, Australia is reaping the benefits of a deep and liquid AAA-rated CGS market that is attracting strong demand from international investors.

The demand from international investors is not placing undue stress on the CGS market. The various measures of liquidity in bond markets, such as bid-offer spreads and bond turnover, all indicate that the CGS market is liquid and that investors are able to trade CGS with confidence.

More broadly and consistent with our advice to the ACCC in 2007, the view of the Treasury and the AOFM is that the CGS market displays the attributes of a well-functioning market and we expect this will continue in the foreseeable future. This is consistent with the Government's statement in the 2012-13 Budget that it is committed to ensuring the CGS market remains of a sufficient size to meet its objective of maintaining liquidity to support the futures market.

Responses to your specific questions are attached.

Should you have any further questions, please feel free to contact myself or Rob Nicholl. I have copied our response to the RBA.

Yours sincerely

Jim Murphy
Executive Director
Markets Group

R B Nicholl

Rob Nicholl
Chief Executive Officer
Australian Office of Financial Management

Responses to specific questions

Can you provide any explanation/s for why the spread between yields on CGS and other debt securities has widened in recent years? What impact is demand from foreign investors having on the CGS market?

The spread between CGS and other debt securities has widened over recent years, particularly the spread to Semis. While the absolute yields on Semis have fallen by around 180 to 200 basis points since mid-2011, the spread to CGS has increased by around 40 to 60 basis points owing to the more substantial fall in CGS yields over the same period.

The fall in yields on CGS across the yield curve reflects a range of factors. The weak and fragile global economy has put downward pressure on benchmark global long-term bond yields.. It has also driven investors into high-quality government debt.

Supported by a strong balance sheet, Australia has benefited from this flight to quality as it is one of only eight countries to have a AAA credit rating with a stable outlook from all three major credit agencies. Australia is also one of only a handful of countries within the OECD group that provides positive real returns on its debt.

Australia's relatively strong position in global bond markets has contributed to an increase in demand for CGS, particularly from offshore investors. Offshore holdings of CGS have increased markedly from around 50 per cent in mid-2009 to around 76 per cent as at March 2012.

Further, the volume of CGS on issue has increased in recent years to levels that have given large international investors confidence in their ability to enter the market at levels that do not significantly affect the price. CGS on issue has grown from around $50-55 billion in 2007 to around $235 billion in early July 2012.

Other issuers of Australian dollar-denominated debt may not have benefited from this increased demand to the same extent as the Commonwealth owing to investment mandate limitations and/or perceived or actual lower levels of liquidity in other types of debt. That said, the offshore holdings of Semis have been increasing, but not to the same extent as for CGS. These differences in relative demand have driven the spread between other debt and CGS higher.

Is the CGS market liquid and if so, do you consider that it is likely to remain so for the foreseeable future?

The nominal CGS market is liquid and continues to display the attributes of a well-functioning market. A number of measures point to this such as turnover, bid-offer spread and repo (repurchase) margins.

The turnover of Treasury Bonds has steadily increased from around $60 billion per month in early 2009 to almost $300 billion per month in June 2012 (inclusive of repo transactions). The high volume of turnover in Treasury Bonds indicates that the market is liquid as investors and other market participants are able to transact in large volumes. There are currently 18 Treasury Bond lines on issue, with 11 lines having more than $10 billion on issue. These large, deep and liquid lines are likely to provide participants with the confidence that the Treasury Bond market is able to efficiently absorb large transactions.

Another measure of liquidity, bid-offer spreads, has fallen across all nominal lines since 2008. In fact, the spread on the 10-year nominal Treasury Bond has averaged around 1.1 basis points since early 2011, indicating that investors and market participants are able to transact in Treasury Bonds with tight two way prices.

In your letter you note that the Basel III regulations could reduce the liquidity of the CGS market in the near term. In recognition that there is insufficient high-quality liquid assets for the banking system to be able to meet the Basel III liquidity reforms, APRA and the RBA have effectively expanded the pool of available assets through the provision of the Committed Liquidity Facility. This facility enables ADIs to access a pre-specified amount of liquidity by entering into repurchase agreements with the RBA of eligible securities (e.g., self-securitised residential mortgage-backed securities). This facility should therefore ensure that demand for CGS will not materially increase and therefore is not expected to affect the liquidity of the CGS market.

In the 2012-13 Budget, the Government reaffirmed its commitment to a liquid CGS market and that it would continue to monitor the market to ensure it remains of a sufficient size to meet this objective.

Is there a shortage of supply in the CGS market?

In the context of the 2011-12 Budget, the Government consulted a panel of financial market participants and financial regulators as part of its deliberations on the future of the CGS market. The panel concluded that to maintain a liquid and efficient bond market that supports the futures market and the requirements of the new global bank liquidity standards, the CGS market should be maintained at around 12 to 14 per cent of GDP over time. The projected amount of CGS on issue over the forward estimates should remain marginally higher than these levels.

The AOFM issued around $58 billion of nominal bonds in 2011-12 with issuance in 2012-13 and in later years expected to reduce owing to the strengthening fiscal position. The issuance levels in these years, however, will be consistent with the Government's objective of maintaining a deep and liquid CGS market.

It is worth noting that if any imbalance between supply and demand were to arise in the CGS market it is likely to be greatest for relatively short maturities, say of less than five years, due to the preferred time horizon of investors. Indeed we note that the spread between swap rates and CGS yields peaks at the February 2017 bond maturity. We would expect any imbalance to be less pronounced for longer bond yields of 10 years or more.