STATEMENT 7: DEBT MANAGEMENT

This statement discusses debt management, including maintaining the Commonwealth Government Securities (CGS) market and the proposed investment of financial assets in the Future Fund.

As announced in the 2003-04 Budget, the Government has decided to continue to issue Treasury bonds, despite the Australian Government's strong fiscal position, in order to support low cost interest rate risk management throughout the economy. Treasury bond issuance will be tightly targeted to support the Treasury bond futures market — a key interest rate risk management market.

The Government's decision to establish the Future Fund for the purpose of offsetting unfunded Government superannuation liabilities will not affect the issuance strategy for CGS. Issuance in 2004-05 and planned issuance for 2005-06 reflects the Government's continuing policy stance of maintaining around $5 billion per bond line, which is consistent with continued liquidity. The issuance of Treasury Notes to meet within year financing requirements may increase as a result of transfers of assets to the Future Fund in 2005-06.

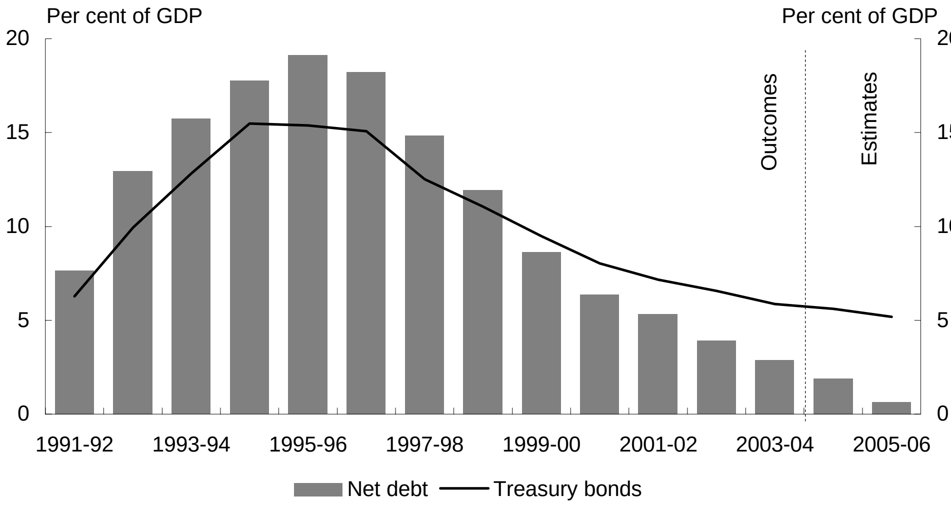
STATEMENT 7: DEBT MANAGEMENT

BACKGROUND

The Government's strong fiscal management since 1996 has significantly reduced Australian Government general government sector net debt. Net debt has fallen from a peak of 19.1 per cent of gross domestic product (GDP) or around $96 billion in 1995-96 to an estimated 1.9 per cent of GDP or around $16.3 billion in 2004-05.

Reductions in gross debt outstanding have accompanied the fall in net debt. This is reflected principally in declining Commonwealth Government Securities (CGS) on issue. In particular, Treasury bonds on issue have fallen from around 15 per cent of GDP in 1995-96 to an expected 5 per cent of GDP in 2004-05.

Chart 1: Australian Government general government sector net debt and Treasury bonds on issue(a)



(a) Treasury bonds on issue are net of Australian Government holdings and debt on issue for the states and territories.
Source: Australian Bureau of Statistics Cat. No. 5513.0, Australian Government Final Budget Outcomes, Australian Office of Financial Management, and Treasury estimates.

In line with the public review of the CGS market in 2002-03 the Government will continue to issue debt, despite a strong fiscal position, in order to maintain a liquid and efficient Treasury bond and Treasury bond futures market. The strategy remains focused on moving towards an issuance pattern that results in around $5 billion in each bond line with a new long and a mid-term bond being issued in alternate years. This will see maturities exceed issuance in some years as the issuance strategy moves towards its long-term steady state.

ESTABLISHMENT OF THE FUTURE FUND

The decision to maintain a CGS market while continuing to achieve a number of budget surpluses has allowed the Australian Government to accumulate significant financial assets, which have been used to assist in meeting within year financing requirements and to reduce the cost of its debt portfolio.

The outstanding stock of CGS is not the only significant liability on the Australian Government's balance sheet. The Australian Government has never fully funded its superannuation liabilities which are now valued at around $91 billion. To offset these superannuation liabilities, the Government will use budget surpluses to build a dedicated financial asset fund — the Future Fund (the Fund). This will reduce calls on the budget in the future, at a time when significant intergenerational pressures are expected to emerge.

The Fund is expected to be established later this year with seed capital sourced from the 2004-05 Budget surplus and from previous surpluses held on deposit at the Reserve Bank, once the Final Budget Outcome for this financial year is known. The Fund will be invested in a broad range of financial assets and will be managed by an independent statutory agency governed by an appropriately qualified board. Contributions to the Fund will be made from future budget surpluses and assets sales with the aim of offsetting the superannuation liability by around 2020. Details of the financial implications of the Fund are in Statement 2.

The decision to establish the Future Fund will not affect the issuance strategy adopted by the Government as a result of the review of the CGS market in 2002-03. Issuance in 2004-05 and planned issuance for 2005-06 reflects the continuing policy stance consistent with maintaining liquidity in the CGS market. The transfer of assets to the Future Fund is likely to necessitate some additional use of Treasury notes to manage the Government's within year financing requirements.

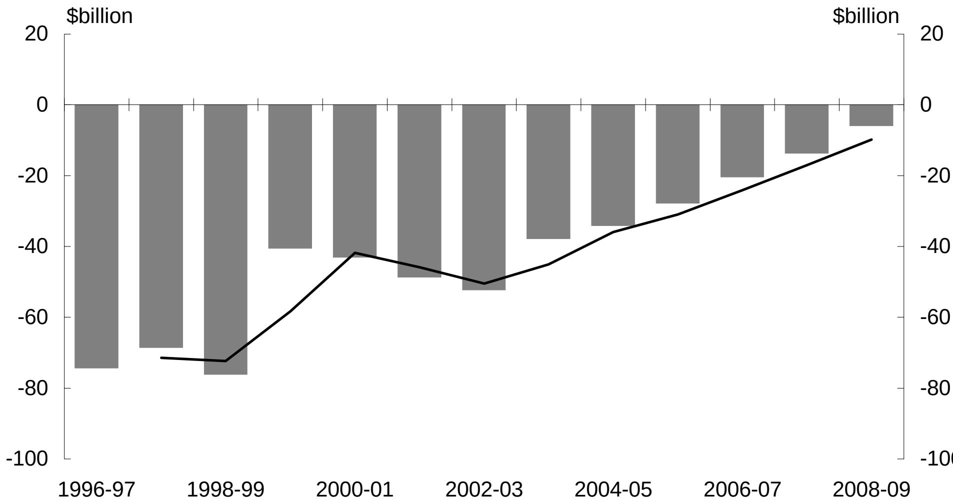
Implications for net debt and net worth

The investment strategy adopted in relation to the Fund will affect the exact impact on the Government’s balance sheet. As the Fund and its managing board have not yet been established, standardised assumptions have been made about asset returns for the purposes of this budget. This could mean there will be marginal changes across the forward estimates when the actual initial transfer to the Fund is determined and an asset allocation is set.

Assuming a diversified holding of financial assets, net debt would be expected to rise slightly in the early years. This is because the Government's holdings of cash and fixed-interest securities, including realised budget surpluses, would be converted in part into equities, which will not be offset against gross debt. Beyond the forward estimates period, net debt is expected to fall slowly due to compound growth in the overall asset portfolio, including fixed interest and cash holdings.

Net worth over the forward estimates is likely to improve modestly due to the establishment of the Future Fund because this broader measure includes all assets and liabilities. In addition, transfers of funds between asset classes as the Fund establishes itself will have no impact on net worth. Beyond the forward estimates, net worth is expected to rise steadily due to an expectation of higher average returns on the Fund than current arrangements.

Chart 2: Australian Government general government sector net worth



Source: Australian Bureau of Statistics Cat. No. 5513.0, Australian Government Final Budget Outcomes, Australian Office of Financial Management, and Treasury estimates.

ISSUANCE IN 2004-05 AND 2005-06

The debt issuance programme is directed at maintaining liquid and efficient Treasury bond and Treasury bond futures markets. Accordingly, the volume and timing of 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 programme is moving towards a pattern where new 5-year and 13-year Treasury bonds are launched in alternate years, with total issuance over two years of around $5 billion in each line.

In 2004-05, two new stocks were launched — the February 2017 and August 2010 Treasury bonds. The volumes currently on issue are $3.2 billion for the February 2017 Treasury bond and $2.6 billion for the August 2010 Treasury bond. It is intended to issue a further $600 million of the August 2010 Treasury bond in the period remaining to 30 June 2005.

In the first half of 2005-06, issuance will be focused on the February 2017 Treasury bond and the August 2010 Treasury bond to support the operation of the 3-year and

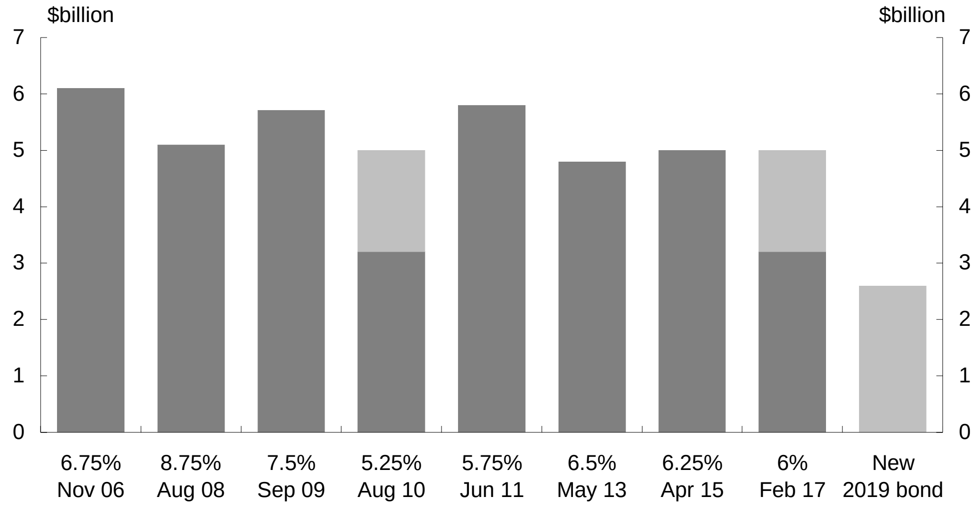
10-year Treasury bond futures contracts. Additional stock will be issued to bring the total volume on issue for each of these bond lines to $5 billion by December 2005.

In early 2006 a new 13-year Treasury bond, a March 2019 bond, will be issued to support the operation of the 10-year Treasury bond futures contract. It is planned to issue $2.6 billion of this new 13-year Treasury bond during 2005-06. The remaining issuance necessary to bring this bond line up to $5 billion will be undertaken in the first half of 2006-07.

Total Treasury bond issuance during 2005-06 will be $6.2 billion, while scheduled maturities during this period, net of Australian Government holdings, are $6.7 billion. As a result, the total stock of Treasury bonds on issue, net of Australian Government holdings, will be around $48 billion at 30 June 2006.

Treasury notes may need to be issued during the financial year to meet within year financing requirements. The magnitude of this issuance will depend on the size and timing of the transfer of assets to the Future Fund.

Chart 3: Benchmark Treasury bonds outstanding expected at 30 June 2006[(a)]



(a) Treasury bonds on issue are net of Australian Government holdings. The October 2007 Treasury bond is excluded from the chart as it is not considered a benchmark bond line.
Note: The dark grey columns represent bonds outstanding at the beginning of the 2005-06 financial year. The light grey columns indicate new issuance in 2005-06.
Source: Australian Office of Financial Management and Treasury estimates.