Good news for the Australian economy

James Shugg of Westpac charts the developments that are shaping the Australian debt markets and contributing to a healthier business climate.

Australian economic growth has averaged 5% over the past three years, although 2001 is likely to see the economy's momentum ease back modestly to about a 4% pace. The past year's interest rate rises are already constraining consumer spending and housing investment. But this will largely be offset by the strong export performance that is now emerging, thanks to the competitiveness boost from the low Australian dollar.

Accelerating profit growth in primary and secondary industries will fuel a solid recovery in business investment and help maintain healthy employment growth, which may see the jobless rate dip below 6% for the first time in more than 10 years.

The tight labour market is now putting some upward pressure on wages growth. The headline inflation rate recently jumped to over 6%, reflecting the introduction of a new taxation system, which included for the first time a value added tax on goods and services (excluding this GST impact, inflation would be about 3%).

However, the Central Bank Governor, Ian Macfarlane, recently signalled that with the official cash rate at 6.25%, monetary policy was in a neutral zone, and there was "no overwhelming case" to move rates in either direction, a clear sign that rates will be on hold for some time. None of the imbalances that have derailed the economy in previous cycles, such as persistently high inflation, an unsustainable current account deficit, excessive credit growth or asset price bubbles, are threatening the current expansion, which is already in its ninth year.

Substantial budget surpluses to squeeze the bond supply?

Reflecting this favourable economic background, the government's budget position is in good shape, despite this year's large income tax cuts that were required to 'sugar the pill' when the new tax system was introduced.

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For 2000-01, a headline budget cash surplus of A$11bn has been estimated by the government, including asset sales of more than A$6bn, mainly reflecting the second tranche of the recent sale of 16% of the telecoms giant Telstra.

While there has been growing interest from offshore investors the major supporters of these issues are domestic institutions. Capital markets will force a merging of the margins for corporate borrowers between bond and bank funding, and further disintermediation in corporate banking can be expected.

The government's estimates reveal even larger surpluses for the future, rising to A$20bn or more by 2002-03. These figures assume the sale of the remaining 50.1% of Telstra.

As at 30 June 2000, total fixed coupon Treasury Bonds outstanding amounted to A$63.2bn.

If all the proceeds from the projected budget surpluses were applied to the retirement of fixed coupon debt, the Australian government bond supply would be entirely eliminated by June 2003.

There are, however, a number of reasons why such a squeeze on supply should not occur:

- part of the rundown could be expected to be absorbed by the A$17bn in other outstanding government securities, including treasury indexed bonds, and treasury notes;
- it is unlikely that the government would be able to sustain such large surpluses, given normal political expediencies. Tax cuts and more generous spending programmes are likely to be favoured during that period. To this end, the government has recently announced extra infrastructure spending in rural areas, coinciding with the next election, which is likely before the end of 2001; and
- the expected revenue in 2001-03 from the sale of 50.1% of Telstra (A$28bn) is not guaranteed given the strong opposition to the policy from the Opposition and uncertainty about the Australian Democrats' position on the issue. Both parties jointly control the majority vote in the Australian Senate (Upper House) and specific Senate approval is required for the sale to pass the political process.

The government also appears to accept the need to maintain a liquid bond curve and has established the Australian Office of Financial Management (AOFM), with the intention that it invest surpluses, allowing net debt to decline while gross debt holds steady.

While we are still awaiting a clear indication of the government's policy intentions in this regard, the AOFM appears to recognise the need for about A$50–55bn in total outstanding fixed coupon stock in eight to nine lines of A$5bn–6bn each.

In the event of the government achieving its underlying surplus targets and/or proposed full privatisation of Telstra, the proceeds would be reinvested in highly rated fixed coupon issues, rather than retiring Commonwealth government debt. At this stage, AOFM's policy seems to be biased towards highly rated credits and investment in foreign (government) fixed income assets. The bias appears to extend to non-Australian dollar issues.

Funds under management growth

Under these circumstances, the bond supply would not contract much further, but there would still be a big shortfall because of the needs of superannuation fund managers. The dominant factor impacting the Australian funds management industry over the next two decades will be the growth in investment in superannuation, which is expected to increase by roughly A$50bn a year (see *Table 1*), with a likely annual requirement of about A$12bn in new fixed interest securities.

This is being driven by the Federal Government's desire to implement a national retirement income scheme, stemming from the realisation, in the early 1990s, that the Australian welfare system would be unable to provide a satisfactory level of retirement income for the country's ageing population.

The previous Labour Government introduced the superannuation guarantee charge, which compels a minimum contribution of employee wages to superannuation by all large employers. The minimum contribution commenced at 5% in 1993-94 and rises to 9% in 2002-03.

New issuers in the debt market

The shortfall in the availability of government paper to meet fund managers' needs is being met by other issuers. A$-denominated kangaroo and global bonds are issued by sovereigns, supranationals, large corporates and government institutions from investment grade OECD countries and development finance institutions that are backed by investment grade countries. The term 'global' relates to the unrestricted nature of the instrument in terms of the ability to sell into all key countries on launch, crossborder listing and multiple settlement system arrangements. The term 'kangaroo' refers to A$ bonds issued by a foreign entity in the Australian market and subject to Australian law.

This market grew rapidly in the late 1990s, with annual issuance more than doubling from about A$4.5bn in 1998. Many of these issues have been triple A rated, although this year, US life insurers, issuing at generous spreads above swap, have dominated the market.

TABLE 1

Total outstandings: superannuation funds

A$bn	2000	2005	2010	2015	2020
	426.0	643.0	931.0	1,280.0	1,699.0

Source: Association of Superannuation Funds of Australia

Annual issuance of A$-denominated bonds issued by domestic borrowers in the domestic market, including asset backed securities, has also more than doubled from roughly A$10bn back in 1998. These issues are typically highly sought after by domestic investors and issues are usually successfully placed in a short period. While there has been growing interest from offshore investors, the key supporters of these issues are domestic. Investors are particularly attracted to 'genuine corporate' borrowers rather than financial institutions, which now represent less than two-thirds of outstanding issues, down from 80% two years ago.

We expect healthy annual growth levels in these bond markets in the next few years. The successful launch and accelerating growth pace of most corporate issues shows strong investor demand for issues rated triple B and higher. Capital markets will force a merging of the margins for corporate borrowers between bond and bank funding, and further disintermediation of the banking system can be expected.

While domestic investors have clearly shown a preference for corporate issues over global ones, a significant proportion (estimated at 30%) of kangaroo and global issues has been placed with global investors. This support and supply is expected to continue as long as the swap arbitrage market makes A$ issues by these borrowers cost-effective. ■

James Shugg is Senior Economist at Westpac Banking Corporation.

Interest withholding tax (IWT)

IWT is charged at the rate of 10% on Australian-sourced interest paid to non-residents. The obligation for IWT collection is on the entity making the payment. The issuers of particular debt securities and the holders of these securities have been exempt from IWT if:

- a resident company issues debentures outside Australia;
- the interest payable on the debentures is paid outside of Australia;
- the debentures were issued for the purpose of raising finance outside Australia; and
- the issue meets the requirements of the 'public offer' test.

However in July 1998, to encourage development of the domestic corporate bond market, the Federal Government widened the IWT exemption. The requirement that debentures be issued outside Australia for the purpose of raising finance outside Australia, with interest payable outside of Australia, has been removed. This allows companies to issue the same registered debentures in Australia and offshore and both residents and non-residents are permitted to acquire the registered debentures. Interest payments made to non-residents qualify for the IWT exemption, provided the 'public offer' test is still satisfied and interest payments to residents will be subject to tax in the normal manner. This new regime has had the desired effect of promoting the use of the Australian capital markets by both domestic and foreign issuers. The changes have added to the depth of the investor market with supplementary benefits such as an increasing range of issuers and improved price tension. Typically, we would now expect off shore demand to take anywhere between 10% and 50% of an issue. ■