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ECONOMICS LEGISLATION COMMITTEE

Reference: Guarantee of State and Territory Borrowing Appropriation Bill 2009

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**SENATE ECONOMICS
LEGISLATION COMMITTEE
Wednesday, 10 June 2009**

Members: Senator Hurley (*Chair*), Senator Eggleston (*Deputy Chair*), Senators Cameron, Joyce, Pratt and Xenophon

Participating members: Senators Abetz, Adams, Back, Barnett, Bernardi, Bilyk, Birmingham, Mark Bishop, Boswell, Boyce, Brandis, Bob Brown, Carol Brown, Bushby, Cash, Colbeck, Jacinta Collins, Coonan, Cormann, Crossin, Farrell, Feeney, Ferguson, Fielding, Fierravanti-Wells, Fifield, Fisher, Forshaw, Furner, Hanson-Young, Heffernan, Humphries, Hutchins, Johnston, Kroger, Ludlam, Lundy, Ian Macdonald, McEwen, McGauran, McLucas, Marshall, Mason, Milne, Minchin, Moore, Nash, O'Brien, Parry, Payne, Polley, Ronaldson, Ryan, Scullion, Siewert, Sterle, Troeth, Trood, Williams and Wortley

Senators in attendance: Senators Bushby, Cameron, Eggleston, Hurley and Pratt

Terms of reference for the inquiry:

To inquire into and report on: Guarantee of State and Territory Borrowing Appropriation Bill 2009

WITNESSES

**BAZEN, Mr Derek John, Analyst, State Finances Unit, Commonwealth-State Relations Division,
Department of the Treasury 1**

**JOLLY, Mr Peter, Head of Research Group, Wholesale Market Division, National Australia
Bank 7**

**PURVIS-SMITH, Ms Marisa, Manager, State Finances Unit, Commonwealth-State Relations
Division, Department of the Treasury 1**

**VROOMBOUT, Ms Sue, General Manager, Commonwealth-State Relations Division,
Department of the Treasury 1**

Committee met at 2.32 pm

BAZEN, Mr Derek John, Analyst, State Finances Unit, Commonwealth-State Relations Division, Department of the Treasury

PURVIS-SMITH, Ms Marisa, Manager, State Finances Unit, Commonwealth-State Relations Division, Department of the Treasury

VROOMBOUT, Ms Sue, General Manager, Commonwealth-State Relations Division, Department of the Treasury

CHAIR (Senator Hurley)—Welcome. I ask the Department of the Treasury, which is responsible for the Guarantee of State and Territory Borrowing Appropriation Bill 2009, to come to the table. I declare open this hearing of the Senate Economics Legislation Committee into the provisions of the Guarantee of State and Territory Borrowing Appropriation Bill 2009. The bill was referred on 27 May 2009 and the committee is due to report on 16 June 2009. The purpose of the bill is to provide a standing appropriation to pay any possible future claims made under the Australian government's guarantee of state and territory borrowing. The guarantee aims to underpin state and territory borrowing to fund infrastructure development.

These are public proceedings, although the committee may agree to a request to have evidence heard in camera or may determine that certain evidence should be heard in camera. I remind all witnesses that in giving evidence to the committee they are protected by parliamentary privilege. It is unlawful for anyone to threaten or disadvantage a witness on account of evidence given to a committee and such action may be treated by the Senate as a contempt. It is also a contempt to give false or misleading evidence to a committee.

I remind members of the committee that the Senate has resolved that departmental officers shall not be asked to give opinions on matters of policy and shall be given reasonable opportunity to refer questions to superior officers or to a minister. This resolution prohibits only asking for opinions on matters of policy and does not preclude questions asking for explanations of policies or factual questions about when and how policies were adopted. If a witness objects to answering a question the witness should state the ground upon which the objection is taken and the committee will determine whether it will insist on an answer, having regard to the ground on which it is claimed.

If the committee determines to insist on an answer a witness may request that the answer be given in camera. Special requests may, of course, also be made at any other time. A witness called to answer a question for the first time should state his or her full name and the capacity in which he or she appears, and witnesses should speak clearly and into the microphones to assist Hansard to record proceedings. Mobile phones should be switched off. I welcome officers from Treasury.

CHAIR—Do you wish to make an opening statement?

Ms Vroombout—No, we do not have an opening statement to make.

CHAIR—Thank you. I will ask a question and give you a bit of history about guarantees of state borrowing. Has this been done before, and in what circumstances.

Ms Vroombout—As I understand it, this is the first time in Australian history that the Commonwealth government has guaranteed state borrowing, but I do not know whether my colleagues have a different recollection.

Ms Purvis-Smith—No.

Ms Vroombout—This is the first time we are aware of that the Commonwealth has guaranteed state and territory borrowing.

CHAIR—Have the states ever loaned from the Commonwealth or been in any position such as that? Have there ever been defaults on those loans?

Ms Vroombout—The states have borrowed money from the Commonwealth in the past and, as I understand it, back in time the Commonwealth borrowed on behalf of the states. Even now the Commonwealth currently has a number of loans outstanding with the states. I am not aware as to whether the states have ever defaulted on any of those loans. We would have to take that question on notice.

CHAIR—If you could that would be good, thank you. This borrowing is to support infrastructure developments in the states. It is my understanding that the government is keen that that be facilitated. Is that the reason for this bill, and the reason for it needing to be passed quickly?

Ms Vroombout—Yes, it is. It is part of the government's response to the global recession and, I guess, part of the government's economic stimulus responses. For those responses to be effective it is essential for the states also to continue their infrastructure programs. The Commonwealth's stimulus would not be effective if the states then cut back on their spending. It is part of the government's response to the global recession.

CHAIR—The Treasurer's press release, in announcing the guarantee on 25 May, said that the guarantee would be time limited. Can you tell us a bit about that? In what sense are we time limited? It is not reflected, I think, in the legislation.

Ms Vroombout—No, it is not reflected in the legislation. All the legislation does is provide the standing appropriation, should there be a call on the guarantee. The actual details and mechanics of the guarantee, like the wholesale funding guarantee for the banks, will be given effect to by a deed of guarantee that will be executed by the Commonwealth. So all the details will be in that. Referring to the time limited issue, like the wholesale funding guarantee for the banks, the deed of guarantee will outline that the guarantee will continue to operate until market conditions normalise. There will not be a specific time limit in the deed of guarantee. The language 'market conditions normalised' will be used in the same way as was done for the wholesale funding guarantee for banks.

CHAIR—Thank you. Senator Eggleston, do you have any questions?

Senator EGGLESTON—I am interested in the justification for this measure. What factors led to it being deemed necessary to introduce this measure?

Ms Vroombout—It is part of more general financial market turmoil and difficulties in credit markets which saw the states and territories having difficulty accessing funding in semigovernment bond markets.

Senator EGGLESTON—Yes, I see. The states have not been able to borrow, or have they borrowed beyond their prudent limitations?

Ms Vroombout—In our conversation with the states and territories it appeared to be an issue of not being able to borrow—so not being able to access borrowing to meet their funding requirements and to meet their infrastructure programs.

Senator EGGLESTON—And this is—

Ms Vroombout—It probably varied across the states and territories, depending on the size of their borrowing programs.

Senator EGGLESTON—And also their credit ratings, I presume?

Ms Vroombout—I think credit ratings did have an impact, but following the downgrade of Queensland's credit rating, all states and territories were having difficulties accessing credit markets, not just Queensland. There was a flow through from the Queensland downgrade to the capacity of other states and territories to be able to access funding.

Senator EGGLESTON—What you are saying is that with the downgrade of the Queensland credit rating other states going into the money market found it difficult to borrow? Was this domestically or was it the international market?

Ms Vroombout—Both, Senator Eggleston.

Senator EGGLESTON—I understood the purpose of it was that to some degree there is a limitation on the extent to which states can borrow in any case. Was there no implied guarantee of state borrowing previously by the Commonwealth?

Ms Vroombout—When you talk to credit rating agencies you find that they regard it as being some form of implied guarantee, but there was never an explicit guarantee of state borrowing.

Senator EGGLESTON—In a way I am asking whether this is formalising an informal assumption that the Commonwealth would stand as a guarantor for the states if they were not able to meet their debt requirement?

Ms Vroombout—It is hard for me to comment on what might be an informal assumption. As I said, credit rating agencies have indicated that they believed there was an implied assumption that the Commonwealth would step in. But the Commonwealth never expressed that view.

Senator EGGLESTON—Now that we have this in place, in effect we have made the Australian financial system more secure because of the limits on debt in various states. Would that be a fair conclusion?

Ms Vroombout—The guarantee enables the states to access funding with the backing of a Commonwealth government guarantee, whereas prior to the announcement of the guarantee the states and territories were having difficulty accessing funding.

Senator EGGLESTON—Is the Commonwealth applying limitations on states? Is it possible to know what those limitations are, if they exist?

Ms Vroombout—There is a longstanding Loan Council process in which the Commonwealth and the states and territories provide their nominations as to the amount of borrowing. If they breach that cap within a two per cent margin they have to go back to the Loan Council members and indicate their new borrowing requirement.

Senator EGGLESTON—I understand that it is because of the fact that the Loan Council existed. That is why I asked about the implied Commonwealth guarantee of state borrowings. It would seem that there was that implication through the mechanisms of the Loan Council, which has now been made much more explicit. I suppose that is in reaction to the current global financial situation so that there is more certainty.

CHAIR—Thank you, Senator Eggleston. Do you have any more questions?

Senator EGGLESTON—No, that is all, thank you.

Senator BUSHBY—Moving on from what we were just talking about, as I understand it the states have to nominate particular projects or particular amounts of money that they want guaranteed. It is not as though they have to submit all their borrowings that they currently have guaranteed and state, ‘We want this parcel covered’ and then they pay the appropriate fee. Is that right?

Ms Vroombout—They have to apply to the scheme administrator, which in this case will be the Reserve Bank, to have particular bond lines—not particular issues but particular bond lines—covered by the guarantee.

Senator BUSHBY—And then it will be up to a maximum amount each time they make that application?

Ms Vroombout—No. They do not have to nominate a maximum amount. They can say, for example, ‘We want to guarantee our Q23s’, so all the bonds that we issue into a Q23 line will be guaranteed.

Senator BUSHBY—So that line could be unlimited in relation to contingent liability for the Commonwealth?

Ms Vroombout—It could be.

Senator BUSHBY—What about if they wanted to do a particular project, it was going to cost multimillions of dollars, and they were going to borrow for that? Could they make an application for the money they borrow for that to be covered? Is that how it works?

Ms Vroombout—No, they will not be applying on a project-by-project basis; it will be an application on a bond line basis, which will not necessarily be linked to a particular project.

Senator BUSHBY—So the Commonwealth will not be able to calculate what its exposure is to each state in relation to its contingent liability, effectively, because it is uncapped on each line.

Ms Vroombout—That is right.

Senator BUSHBY—They cannot sit down and say, ‘We are exposed to \$100 billion worth of guaranteed debt?’ At any particular time they might be able to do an assessment and work out how much their exposure is?

Ms Vroombout—Yes. On a monthly basis the Commonwealth will know what has been guaranteed, but it will not know going forward—

Senator BUSHBY—Or what its ultimate contingent liability could be as a result of that application, or the applications that it has approved?

Ms Vroombout—Which is the purpose of the Loan Council process and the transparency through the Loan Council process.

Senator BUSHBY—Is that to keep an eye on things?

Ms Vroombout—Yes.

Senator BUSHBY—Is there any internal limit? Would any triggers exist whereby you would stop issuing or approving applications from states on that monthly basis as it came in and somebody sitting there was

thinking, 'We are getting a bit too much here. It will threaten the Australian ratings.' Is there any trigger that prompts them to say, 'We have to stop this. There will be no more applications?'

Ms Vroombout—There are a number of mechanisms for the Commonwealth. One is the capacity to vary the fee charged for the guarantee.

Senator BUSHBY—If the Commonwealth starts finding it is encouraging a lot of debt, it might start saying, 'We will put up the price', basically?

Ms Vroombout—Yes.

Senator BUSHBY—Theoretically, coming back to my implicit statement a minute ago, I want to obtain your view. Each month the Commonwealth will be able to look to see how much it is guaranteeing for the states?

Ms Vroombout—Yes.

Senator BUSHBY—We are in a situation where the direct debt of the Commonwealth is also going up. Presumably ratings agencies will look at what amount has been guaranteed for the states, together with what the Commonwealth's actual debt is as well. That will be quite easy for them to look at?

Ms Vroombout—Yes. On a website that the Reserve Bank will operate on our behalf there will be details on a monthly basis of what has been guaranteed.

Senator BUSHBY—Is there a capacity over a period of months if it appears that the bond lines that have been guaranteed for the states are getting larger and larger and the Commonwealth is getting concerned about the extent to which the states are borrowing under those guaranteed lines? Is there a capacity to put up the price on those lines at that point, or once the application is in place and running there is no scope to vary that?

Ms Vroombout—On issues relating to those lines after a particular date the fee could be increased. On issues that have already been made into a line prior to that date, the fee cannot be increased.

Senator BUSHBY—So you can say, 'The issues on these lines have gone far enough at that price. We want to put up the price for any further lines' to try to put a damper on the attractiveness of states continuing with that course of action?

Ms Vroombout—For issues under that line, yes.

Senator BUSHBY—We have seen Queensland's ratings downgraded and we know that New South Wales is on negative watch?

Ms Vroombout—Negative watch, yes.

Senator BUSHBY—Presumably the guarantee by the Commonwealth is that it will limit the potential for further downgrading of the states?

Ms Vroombout—I am not sure whether there is a direct link between the guarantee and the credit rating of the states. Credit agencies take into account a range of factors. I guess the biggest one is the fiscal position within the state itself.

Senator BUSHBY—But also, I would have thought, the ultimate likelihood that they can get back their money if everything falls over. That would also be a relevant factor. If you have the Commonwealth guaranteeing the states, even if the states cannot meet their debts, that must also be a factor?

Ms Vroombout—Do you want to comment on that, Marisa?

Ms Purvis-Smith—The credit rating will look at each individual state and the balance sheets and fiscal positions of each state. The guarantee over state and territory borrowing will ensure that the securities of each state will have a triple-A rated guarantee. But the credit rating agencies will still rate the state based on each individual balance sheet and fiscal position of the state. So the Commonwealth guarantee does not necessarily ensure the credit rating of the state itself.

Senator BUSHBY—Might they still be downgraded?

Ms Purvis-Smith—Yes.

Senator BUSHBY—That would make the bond lines that they are issuing that are guaranteed by the Commonwealth far more attractive than other sources of potential borrowings because they would be—

Ms Purvis-Smith—If a state were downgraded one of the impacts would be that the use of the guarantee would become more expensive because the fee is related to the credit rating.

Senator BUSHBY—Similarly, it would be more expensive for them to go out and find money elsewhere?

Ms Vroombout—That is right.

Ms Purvis-Smith—The market, in pricing guaranteed securities, tends to price it on the issuer rather than just on the guarantor. The market tends to have a differentiation based on the state and the issuer rather than to have a generic price based on the guarantor.

Senator BUSHBY—But the guarantee does have an effect on the market, from what I understand it. Just the fact that the guarantee will be provided has had an effect on the states already, even though the guarantee is not in place?

Ms Purvis-Smith—Yes.

Senator BUSHBY—That is a factor that must be taken into consideration?

Ms Vroombout—Yes.

Senator BUSHBY—What about the moral hazard? To what extent has the Commonwealth considered the possibility that the states might relax their level of fiscal responsibility because they know that they will be backed up and they do not have to worry too much about things themselves?

Ms Vroombout—As Ms Purvis-Smith has just pointed out, the credit rating agencies will look at the balance sheets and fiscal positions of the states. So there is the potential, if they do not exercise fiscal discipline, for their credit rating to be downgraded. Not only will the market charge them a higher price; the Commonwealth will charge them a higher price for the use of the guarantee.

Senator BUSHBY—That leads me to another question. Queensland does not exercise fiscal responsibility, just to use it as an example, because it has already been downgraded, and it will be downgraded further. What fee would the Commonwealth charge at that point because I do not think that is in the information that I have seen.

Ms Vroombout—No, it is not. At present it is not outlined in the deed of guarantee. At present we do not have a benchmark for a state that is rated below AA plus because we have not had a state rated below AA plus.

Senator BUSHBY—But you may well have.

Ms Vroombout—We may well have. We will then develop a fee structure for a state with a rating below AA plus, based on what we observe in the market as a consequence of the downgrade.

Senator BUSHBY—I refer to comments that you made earlier about the states having trouble borrowing money. Why are the states having trouble when the Commonwealth is not at this point? From what I understand from the AOFM, we have had no trouble filling any of our issuances. Is the standing of the national government that much greater than the standing of a sovereign state? We have no trouble at all, but they cannot even get it?

Ms Vroombout—That seems to be the position of financial markets.

Senator BUSHBY—Is it simply that the national government is viewed in a much better light than a sovereign state?

Ms Vroombout—I cannot comment on the way in which financial markets react, but that is how they have reacted in this circumstance.

Senator BUSHBY—My final question at this point is: have you conducted any projections of how much money you will raise from the fees?

Ms Vroombout—No, we have not. Until we get a sense of the likely use of the guarantee by the states and territories it is difficult for us to make that sort of assessment. When we know how much they currently have on issues we will have an idea of what they might issue over the coming year—

Senator BUSHBY—So you can work out what the maximum could be and you can work back from there to establish what they take up? Have the states taken up or indicated that they wish to take up any of the guarantee at this point?

Ms Vroombout—I think New South Wales is the only jurisdiction that has made a public statement in relation to the use of the guarantee. It has indicated that it will use it, but I am not sure whether that statement is that they will use it to the full extent possible. However, they have indicated that they will use it.

Senator BUSHBY—Thank you, Madam Chair.

CHAIR—Referring to the states and to the overuse of this facility, the Treasurer in a media release, said:

The Commonwealth will charge a fee for the use of the guarantee. The fee has been set according to historical experience of borrowing spreads and at a level that provides an incentive for states to cease utilising the guarantee when market conditions normalise ...

I take it that would mean that the fee is set a bit above what the states would be able to go out and get when conditions normalise?

Ms Vroombout—It is round about the historical average. The 30 basis points is round about the historical average spread between CGS and semi-government bonds. As Ms Purvis-Smith noted, financial markets are pricing not just based on the guarantee but also on the underlying issuer. So the states will be paying more than the 30 basis points for borrowings in the marketplace.

Senator PRATT—I am not sure whether you are familiar with the comments of Matthew Johnson from the *Australian* who said:

Ironically, the worse your credit, the better the bonds are trading because people are confident that you'll take up the guarantee because you'll need it ... If you're any good, you don't use it at all.

Does that statement imply that there is a risk in not taking out the guarantee, and that people are misjudging their liability? Can you unpack that statement and indicate what Mr Johnson might mean by it?

Ms Vroombout—The way I interpret what he is saying—it is a little difficult not having his words in front of me—is that if a state could borrow without the benefit of the guarantee for a price close to what it could borrow with the guarantee, taking into account the fee, then it may not be worth its while taking up the guarantee. If it cost it more or it could not access markets at all without the guarantee, then there would be benefits in it taking up the guarantee.

Senator PRATT—I might provide this statement to you so that you can have a look at it.

Ms Vroombout—It is hard without having the words in front of me.

Senator PRATT—Thank you.

CHAIR—Thank you, Treasury, for coming in this afternoon.

[2.58 pm]

JOLLY, Mr Peter, Head of Research Group, Wholesale Market Division, National Australia Bank

CHAIR—Would you like to make an opening statement?

Mr Jolly—I have some comments that I would like to make at the start. Our group looks at providing clients with what we call independent research covering macroeconomics, currencies and bond markets. I am sitting here today not so much on behalf of the bank but as a researcher within the financial market. As such, my comments may not necessarily be those of the National Australia Bank, as you would expect.

This is a good opportunity for me to speak to the legislation, so I thank you for that. I wish to make a few comments, which I hope will not take too long. I did not hear all the comments from Treasury, so forgive me if I repeat a bit of work. The background to this bill is that since the financial crisis and in particular immediately after the collapse of Lehman Brothers, many of the normal companies, and even governments that would access bond markets, have had some difficulty in doing that.

Investors are pretty nervous and favour safety and certainty over almost everything else at this juncture. As a guide to this loss of investor confidence, in the decade prior to the crisis the margin—and I am using New South Wales as an example—between its 10-year debt and that of the Commonwealth was around 25 or 30 basis points, or 0.25 or 0.3 per cent. As the crisis developed, that spread widened and by November, just after Lehman Brothers failure, that spread reached about 80 basis points. There were a series of events that complicated the states' position. The first of those were that the Commonwealth rightly extended to Australian banks the offer to guarantee their wholesale debt. As is well understood, the Commonwealth needed to do that because governments and other jurisdictions were offering their own banks the same guarantee.

The states' problems were then further complicated by the growth in its own funding task due, in the first place, to a cyclical decline in economies and its own fiscal positions, as well as the fact that the states needed to fund reasonably ambitious infrastructure programs. Part of that will be done via the Commonwealth fiscal stimulus, but part of that will need to be debt funded. Finally, the downgrade of the Queensland government earlier this year exacerbated investor concern. Let me again use in New South Wales as an example. The spread between its 10-year debt and the Commonwealth's debt reached about 1.4 per cent in March this year. Since March, these funding margins have definitely improved.

We have seen a pretty broad based improvement in financial markets and a spread, as we mark it now, of around about 90 basis points, so 0.9 per cent between the Commonwealth and New South Wales is an example. But I think it is important to note that part of that narrowing actually relied somewhat on the Treasurer's comments in March that they would in fact give this offer to guarantee the states' debt. Many of the investors to whom I speak are very hopeful and even expect this legislation to pass.

Looking ahead, to me, the funding task of the states is expected to remain pretty significant. We still have some state budgets to be delivered over the next few days, but our estimates are that in 2009-10 the states will need to issue something near \$30 billion in bonds. That is up from where we were last year. At the same time the Commonwealth's budget anticipated that it will need to issue around \$60 billion of bonds in 2009-10, which is basically double what they did in the current year.

A potential positive, I have to say, for the state funding issue, if you like, is that if these recessionary conditions across the world abate, the banks' reliance on the government guarantee should reduce. I mean, there is already some evidence of this, I would say. In recent months, Australian banks have been able to issue bonds in their own name without the government guarantee, which is good. But it had only really been the larger double-A banks that have been able to do that. I would add that they have only been able to do this really in the domestic where investors know them very well. It has been difficult to go to foreign markets without the government guarantee.

All up, it strikes me that the funding maths remains quite difficult for the state governments—that is, unless we see a very dramatic improvement in investor confidence. To me, that seems quite unlikely. Although conditions in financial markets have improved, they remain far from normal. Moreover we would argue that in some cases of the senior government bonds or the state government bonds, investor confidence there will take longer to heal than in some other markets. The traditional investor who bought state government bonds did so because they were of high quality, offered a margin over the Commonwealth and, I stress, they were liquid. The illusion of that liquidity was shattered in the post-Lehman experience because investors who needed to sell their senior government bonds as their own funds were being redeemed really struggled to get a bid or to

find a willing buyer. It will take some time for those investors to return to the market and for confidence to return.

To sum up—state governments have struggled to fund themselves at anywhere near reasonable levels in recent times. Competition for funds and the triple-A government space has really hotted up with the Commonwealth increasing its own issuance while banks have needed to utilise the government guarantee. Moreover across the globe, all sovereigns are raising more funds ahead. Meanwhile, investor confidence in the semi-government bond market has been reduced. I do not think there is a very quick fix to this situation. To me, though, the Commonwealth providing a government guarantee for state government bonds would seem to be a step in the right direction. It is likely to directly lower the borrowing costs of the states. Second, it would broaden and deepen the demand for state government debt. This would be particularly important for foreign investors who now need an extra incentive to invest away from their home shores.

If, on the other hand, investor confidence surprises us and improves very rapidly, the states basically will not need to utilise the guarantee. So effectively this legislation, it seems to me, provides the states with a good fallback position. I am happy to stop there and take any of your questions.

CHAIR—Thank you, Mr Jolly. Both the state and the Commonwealth bond market, as you have described, have been under a bit of pressure simply because there is not the money out there. People or investors do not have the money to invest, but government bonds, whether Commonwealth or state in themselves are seen as a reasonably safe liquid form of investment, I think you said.

Mr Jolly—Yes.

CHAIR—It is quite possible, is it not, that as liquidity returns to the market that bonds will be among the first. Because they are a safe first form of investment, bonds will be one of the first investments made.

Mr Jolly—I agree with those comments. I would just tease out a difference between the Commonwealth and the states. Through the crisis, which we are still going through, the Commonwealth's securities remained more liquid than anything else, effectively. They are the highest quality bonds on offer in Australia. That is why we saw investors rush to own the Commonwealth bonds. What got trampled in that rush, if you like, was everything else, of which the state governments were one.

It is right that liquidity, even liquidity in the Commonwealth bond market, shrunk to a degree; but in the state government bond market, which I must say investors relied on a lot because they always felt you were basically near the Commonwealth and there was always a willing buyer for those bonds, they found through the fourth quarter and the first quarter of this year that really was not the case, and certainly not at anything like reasonable levels. It is an important point that some of the traditional investors in the state government bond will be pretty disillusioned.

I was on a recent trip through Europe and I saw some of these investors. They are pretty reticent. I do not want to exaggerate it because some will still be here for sure. But there are some who will be reticent about coming back because of that experience.

CHAIR—Having been in the South Australian state government during the recession of the early nineties and seeing the state without the funds to try to spend ourselves out of that recession, we found that South Australia was pretty hard hit by that recession, and took a long time to recover—more than most other states, I think. Certainly from the South Australian government's point of view it is very important that they get these funds at a reasonable rate so that they can maintain their economy and spend on this infrastructure during this period. I guess that is a long way of asking you: do you think the underlying reason why this has been done, in order to stimulate the economy by building infrastructure, is a reasonable thing in the light of the global economic situation?

Mr Jolly—In terms of a macroeconomic consideration, of course governments generally have a very important counter-cyclical role to play in economies. I guess that is what you are asking. To the extent that it supports growth, yes, being able to raise the money is pretty important, yes.

CHAIR—Senator Bushby?

Senator BUSHBY—Thank you. Thank you, Mr Jolly. You touched on this, but why, in your opinion, do investors have so much more confidence in bonds issued by the Commonwealth than by bonds issued by a sub-national government?

Mr Jolly—Historically it goes back to the taxing powers of the Commonwealth, which are more vast than even those of the states. Certainly if you go down the credit spectrum, it is certainly more vast than companies

who have very limited revenue raising abilities, in a sense. That is why it has always historically been seen that it the Commonwealth or the sovereign who has the greater or more vast taxing ability and is always at the top of the pole, if you like, in terms of where investors see the zero risk, if you like, in terms of getting their money back.

Senator BUSHBY—What if the Commonwealth was downgraded? What impact would that have on the bond markets in the context of the guarantee as well? It was only a few years ago that we were downgraded.

Senator CAMERON—Or it could just be that we just get old.

Senator BUSHBY—It was only a few years ago that we were at a lower level.

Mr Jolly—Yes. It is not always strictly true now, but you tend to find that the sovereign acts as some kind of ceiling on a rating within a country. Rating agencies differentiate between those two these days, though they differentiate particularly in the case of Japan. The sovereign Japanese government is rates lower than some companies within Japan because they have a very large debt, but generally you would say that if the sovereign was downgraded in Australia's case, that would just flow through to the borrowers below. Effectively that means that your borrowing costs would rise.

Senator BUSHBY—So it is right across the board, effectively.

Mr Jolly—Effectively, yes.

Senator BUSHBY—The Commonwealth and so on. Does the market not already factor in an implicit guarantee from the Commonwealth?

Mr Jolly—That is an interesting point. I think that is right. Markets do to a degree work on the basis—people who buy semi-government bonds probably feel they are implicitly guaranteed by the Commonwealth. Rating agencies to a degree rate the Commonwealth itself on some assumption of liability for the states and others. They do that on a wider spectrum as well, I should add. They tend to rate sovereigns based on, for instance, even the banks to some degree these days, if they were to pick up those liabilities.

Senator BUSHBY—You would have to be looking at what most sovereigns around the world have been doing with banks lately.

Mr Jolly—And that was a reasonable assumption to make, I guess.

Senator BUSHBY—Yes.

Mr Jolly—So you are right: there is something of an implicit guarantee. For investors I guess the question would be: would it make any difference whether it was made explicit or not? I think it probably does. I mean, it brings on board potential buyers perhaps who can only buy, for instance, triple-A guaranteed debt. There are certainly investors whose mandates will not allow them to buy state government debt, for instance. By broadening that, presumably you will widen the investor base.

Senator BUSHBY—That leads onto my next question: if we move on to providing explicit guarantee for particular bond lines that are issued by the states, what does that mean? What will the market then assume about those bond lines that are not guaranteed by the Commonwealth? Will they assume that the implicit guarantee is still there, or will the fact that there is an explicit guarantee provided for some bond lines suggest to them that those that are not explicitly guaranteed do not have the same degree of protection?

Mr Jolly—The market will certainly differentiate between the two. I think there is no doubt.

Senator BUSHBY—There will be some—

Mr Jolly—There will definitely be a price difference. In a practical sense, it is neater for the market if all the lines are the same. In a sense, they are fungible. If some states choose not to guarantee their existing loans and some do, then we may end up with something of a two-tier market. It is manageable but there would definitely be a difference in pricing.

Senator BUSHBY—If that occurs, the states will be looking at the cost of buying the guarantee and seeing how that compares and how the market is treating it, and whether they are better off to buy the guarantee or not?

Mr Jolly—That is right. I think that is what the states would do, or I presume so. Presumably they would also have to factor in their future funding costs as well. Although we do appear to be through the storm, if you like, to some degree we are still on a pretty uncertain path out of here. They would have to factor that, I presume, as well.

Senator BUSHBY—Okay. Thank you.

CHAIR—Just to follow on from that, there was an article from the Dow Jones news wire that said that there was a split in the market for state bonds as it is. It states:

Perversely, yield spreads on debt issued by New South Wales and Queensland, which have experienced a significant deterioration in their fiscal position and are expected to use the federal [government] guarantee, have outperformed some other states. Meanwhile, spreads on debt issued by Victoria, which forecast a budget surplus for the fiscal year starting July 1 earlier this month and has suggested it has no immediate desire to use the federal guarantee, have underperformed NSW and Queensland.

The explanation for that was that the market is already starting to differentiate. They are saying that those states that are likely to use the guarantee are a better proposition than states that are not. The article goes on to state:

If the guarantee legislation is delayed, spreads on debt from states most expected to use the guarantee are likely to blow out again. "If it gets delayed that may turn out to be quite expensive for some states," Deutsche Bank head of debt research David Plank said.

Would you agree with that position?

Mr Jolly—I guess there are several elements to that. I was talking earlier primarily about debt that already has been issued by the states. There is a presumption in terms of new issuance that states will weigh that up and decide to use it on a case-by-case basis, presumably, but we would expect all states to use that or to certainly consider that guarantee. What the market is wrestling with to a degree in differentiating is what states do with the existing debt. Of course the legislation gives to option to states to guarantee their existing line of stocks. They already have raised the money. Will they go and provide a guarantee to those existing loans?

The prevailing view is that the governments that have the largest funding tasks ahead and those that, in the case of Queensland that have been downgraded and New South Wales that is on negative watch, at those who probably have the greatest incentive to guarantee their existing debt. That is why you have seen this differentiation. Victoria, which has had its rating affirmed at triple-A after its recent budget, has existing debt that is trading in terms of its margins a little bit above Queensland and New South Wales, which many presume will guarantee the existing debt. The state treasurers have not given a guide as to what they will do with that, so we will have to see.

CHAIR—Yes, okay. Senator Cameron?

Senator CAMERON—Thanks. Mr Jolly, I have just noticed that the managing director of the IMF, Dominique Strauss-Kahn, spoke about continuing a view that there would be a recovery in early 2010.

Mr Jolly—Yes.

Senator CAMERON—But he indicated that that view was rife with risk. So there are still some real issues out there, are there not, in the global economy?

Mr Jolly—Yes, I think that is right. As has become well known, we have the green sheets in many countries, so there are signs that perhaps the recession is abating, but on the IMF reckoning we have just gone through the largest global downturn in 70 years. The risks around that do not dissipate rapidly. Although it is very encouraging to see signs that the depth of the recession is abating to a degree, I do not think we are out of the woods yet in that sense.

Senator CAMERON—One of the big problems early in the recession was de-leveraging.

Mr Jolly—Yes.

Senator CAMERON—According to this speech by the managing director of the IMF, he says that much still needs to be done to cleanse the banks' balance sheets around the world, and that countries are taking too long to cleanse toxic assets from their banking systems. Now that is not an issue for us here as it is in other countries, but if we go through another process of cleansing toxic assets from banks—and the IMF is now raising another issue which is not linked to the global financial crisis only on the basis that there are still bad loans in banks appearing now, though not directly linked—this would mean more de-leveraging and more uncertainty, would it not? [3.20 pm]

Mr Jolly—It is interesting. I am not too sure, though, whether he means that those loans were never identified in the past or whether they have existed on banks' balance sheets for a period. We need de-leveraging, or we might call it recapitalisation of the banking system, or something of that order. I think if he

is saying that the recapitalisation process of the global financial or banking system is still not complete, I agree. Typically that takes many quarters of banks with healthy profits to replenish capital bases.

Senator CAMERON—Yes. Can I just give you the quote from the IMF?

Mr Jolly—Yes.

Senator CAMERON—This is a report that has gone out. It states:

He later told reporters that for confidence to return, banks should disclose not only their losses related to the U.S. subprime mortgages but other losses linked to the economic slowdown.

"What we are noticing is that there still is a system of credits, or of losses, that are not made public. These are not things that are linked today to the original subprime crisis, but to the fact that the economic slowdown has rendered a certain number of assets of poor quality and that new losses were registered," he said.

Mr Jolly—I understand.

Senator CAMERON—This means that there are still a lot of uncertainty and unknowns out there, does it not?

Mr Jolly—Yes.

Senator CAMERON—What he goes on to say in this interesting speech is that countries, such as Mexico, Colombia and Poland are really doing it tough. The reason they are doing it tough is that they have huge financial gaps, and it is a drying up of in-flow of capital. That is what we are trying to avoid here, is it not—a drying up of an in-flow of capital?

Mr Jolly—Thankfully, the scale of the problem is not as great as some of those countries you mentioned. But, yes, the guarantees generally have tried to make sure that very important economic agents in an economy can fund themselves. There is a basic reality of Australia which is we do rely to some degree on foreign funding—either the banks, the state governments or the Commonwealth itself. So, yes, it is related to that.

Senator CAMERON—I want to be clear that there is no room for complacency from government at the moment in terms of the implications of the global financial crisis, and steps like this that would normally not be considered are appropriate in the context of the economic situation we are in at the moment.

Mr Jolly—Yes. If the question means, 'Is it all clear?', I think the answer is no, it is not all clear. There have been a lot of very encouraging developments over recent months. Financial markets to a degree, I will not say normalised, have come back from the brink, if you like. Risk spreads have narrowed to a degree and we have seen some green shoots in terms of the recession abating, but it is along path.

Senator CAMERON—Okay. Thanks.

CHAIR—As there any no other questions, thank you, Mr Jolly, for coming in this afternoon.

Mr Jolly—Thank you.

CHAIR—That concludes the discussion on the Guarantee of State and Territory Borrowing Appropriation Bill 2009.

Committee adjourned at 3.24 pm