9 November 2022

SENATE ESTIMATES

Opening Statement to the Economics Committee

The last time the AOFM appeared before this committee was in October 2020. It has been an eventful two years since then. This statement focusses on the AOFM's borrowing activities, including some context; a description of the recent operating environment and bond issuance during the last two years; and some observations about the near-term future.

Some context

The AOFM regularly issues into Treasury Bond lines across the yield curve. Issuing into bond lines with a wide range of maturities assists market liquidity by supporting diversity in the investor base, stimulating active trading in bond lines, and ensuring that the 'free float' of all bond lines is of sufficient size. Bond market functionality and liquidity are important for investors and ultimately reduce the AOFM's borrowing costs. Spreading the volume of bonds that needs to be refinanced across many years also keeps future borrowing programs relatively steady, which reduces risk by avoiding large refinancing peaks.

The AOFM began extending the length of the yield curve around a decade ago. Over that time, the tenor of the longest Treasury Bond has increased from around 12 years to 30 years, and the weighted average maturity (WAM) of bond issuance has risen from around 6 years to around 10 years.

There are several benefits to the lengthening of the AOFM's debt issuance.

- Annual gross issuance requirements are lower, because less debt needs to be issued to replace maturing debt.
- The impact of interest rate volatility on budget outcomes is reduced.
- The investor base for Australian Government Securities is broader, encompassing investors with diverse preferences and needs, reducing the risk that all investors will seek to exit at once.
- A longer yield curve also offers more issuance options, which enhances the AOFM's operational flexibility.
- Lengthening the risk-free yield curve has also facilitated long-dated bond issuance by other entities, particularly state and territory borrowing authorities.

The yield curve was extended gradually in a 5-year process. First, 15-year benchmark bonds were established, then 20-year bonds, then 30-year bonds. The gradual approach enabled the market to become familiar with how long-dated Australian government bonds would trade over time.

Issuance of large volumes of ultra-long bonds is constrained by what the market can bear – only a subset of the investor base will buy bonds longer than 12 years. Although demand for ultra-long Australian dollar bonds has grown as the AOFM has developed the market, issuance primarily relies on demand from offshore private sector investors, since domestic investors and offshore central banks tend to heavily weight their portfolios towards 0-12 year bonds. There is insufficient demand for Australian dollar denominated bonds longer than 30 years to support further extension of the yield curve. Almost every other sovereign debt issuer faces similar constraints to those faced by the AOFM.

The AOFM has no control over the levels of bond yields and is in no better position to predict changes in yields than other market participants. Rather than attempting to concentrate borrowing at times when yields are perceived to be 'low', the AOFM aims to be transparent, regular and predictable. This approach will reduce borrowing costs over time and ensure consistent access to funding markets.

However, in order to meet its objective of facilitating an orderly bond market, the AOFM needs to be mindful of underlying demand dynamics. As I will shortly explain in greater detail, while the AOFM had a bias towards issuing long bonds when the cost of doing so was at historic lows, it needed to ensure that it did not issue them in volumes that exceeded the market's capacity to absorb them, lest it cause a dislocation.

The operating environment and bond issuance in the last two years

Amidst a backdrop of extremely accommodative monetary policy settings in Australia and elsewhere, bond yields remained low in 2020-21. The RBA's yield target regime was in place for the entire year; the bond purchase program began in November 2020.

The AOFM issued a large volume of long-dated bonds at historically low yields in 2020-21. The financing task for the year was met primarily via $207 billion of Treasury Bond issuance, with an extremely low average issuance yield of 0.99 per cent. The WAM of bond issuance in 2020-21 exceeded 10 years. $15 billion of a new 30-year benchmark bond was issued at a yield below 2 per cent.

2021-22 was a year of two halves for bond yields. The dominant market view until late-2021 was that emerging inflationary pressures would be transitory. This view, coupled with ongoing quantitative easing from the RBA and other central banks, ensured bond yields remained at relatively low levels. Yields rose significantly from the beginning of calendar 2022 as central banks began to react to a more sustained rise in inflation, which was driven by a combination of strong consumer demand, continuing supply shortages and rising energy prices. Economists and market participants, including the AOFM, did not anticipate the speed or magnitude of the increase in bond yields. 10 year bond yields increased by around 2 per cent over the year amongst bouts of extreme volatility.

Treasury Bond issuance in 2021-22 totalled $96 billion, significantly less than in the previous year. The average issuance yield was 1.9 per cent and the WAM of issuance was 8.6 years. Factors contributing to the lower WAM included some shorter-dated issuance to support market functioning for bond lines that had been the subject of heavy RBA purchases, which served to reduce the 'free float' of these lines. Moreover, there was limited investor demand for long-dated bonds at times because of significant market volatility.

2022-23 has thus far seen continued volatility and higher bond yields domestically and abroad, with markets reacting to more entrenched inflation and weighing the risks that central bank policy actions may tip some major developed economies into recession. Despite, or perhaps because of this, investor demand for our Treasury Bonds has remained relatively robust, albeit still limited for ultra-long tenors. $25.2 billion of Treasury Bonds have been issued at an average yield of 3.5 per cent and WAM of 8.8 years so far in 2022-23.

Looking forward

The market was updated on the expected size of the 2022-23 Treasury Bond program following the release of the Budget last month. Around $95 billion of bond issuance is planned.

Bond yields are higher than they have been for some years and are not expected to return to the extremely low levels that prevailed between 2019 and 2021. The yield curve is relatively flat beyond 2023 – the difference between short-dated bond yields and long-date bond yields has fallen significantly courtesy of the gradual unwinding of unconventional monetary policy settings, and several cash rate increases.

Large-scale RBA bond purchases, as part of extraordinary pandemic monetary policy settings, significantly reduced the 'free float' of some bond lines available for market trading. In the absence of sales from the RBA, which we understand to not be in prospect, AOFM issuance to assist liquidity in these bond lines can be expected to continue over the coming years.

The lengthening of the tenor of AOFM's debt portfolio undertaken over an extended period, means that it will take some years for higher bond yields to be fully reflected in the government's interest costs. Only a quarter of the current Treasury Bond portfolio will mature in the next three years, so the interest costs relating to the other three-quarters of the portfolio are 'locked-in' for the next 3-30 years. Only new issuance, to replace the maturing bonds and to meet additional government funding requirements, is subject to prevailing market interest rates.