Chapter 2

A Brief History and Implicit Guarantees

A short history of federal government involvement with state borrowings

2.1 The May 1923 Premiers' Conference agreed to form a voluntary Loan Council, under which the federal government would borrow on behalf of the states but the Council would set limits on states' borrowings. In the 1950s, the federal government effectively agreed to underwrite state borrowings. However, during the 1970s and 1980s the states started borrowing outside the Council's limits. In 1992 it was agreed the states could borrow in their own name. The 1993 Budget Papers characterise this as being 'to enable the individual states to assume responsibility for managing their own borrowings and to be accountable to financial markets for their actions'.[1]

2.2 Treasury have noted:

> …the Australian Loan Council do still meet following the Ministerial Council on Federal Financial Relations, and they consider the aggregate borrowing requirements of all Australian governments. I would anticipate that, should there be borrowings at levels that are ringing those sorts of alarms, that would be the forum at which those issues would be raised and dealt with.[2]

2.3 The only time a default by a state has been an issue was in NSW under Jack Lang during the Great Depression. Two successive federal governments (under Prime Ministers Scullin and Lyons) covered overseas interest payments on the NSW government's behalf, with Prime Minister Lyons introducing legislation which allowed the Federal Government to recover money directly from NSW revenue and establishing that the Federal Government would take responsibility for meeting foreign interest payments by the states. Lang challenged the legislation in the High Court and lost. Shortly after, Lang was dismissed by the state governor and defeated at the subsequent election.[3]

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1 This paragraph is based on Select Committee on State Government Financial Management, *Report*, pp 38-42.

2 Mr Derek Bazen, Analyst, State Finances Unit, Department of the Treasury, cited in Select Committee on State Government Financial Management, *Report*, p 43.

3 This account draws on CB Schedvin, *Australia and the Great Depression*, 1970; F Cain, *Jack Lang and the Great Depression*, 2005; and R Gilbert, *The Australian Loan Council*, 1973.

An implicit guarantee?

2.4 This example demonstrates the high price that a state government is likely to pay for defaulting on debt. Some point to this example as evidence of an implicit federal guarantee of state debt. The argument is that no federal government would be willing to allow a state to default on overseas debt because of the potential damage to its own reputation and credit rating and that of other Australian states and other borrowers.[4]

2.5 Mr Peter Jolly, Managing Director of nabCapital, agreed that historically the market has factored in some sort of implicit Commonwealth guarantee of state debt in the bond markets. He pointed out that, before the collapse of Lehman Brothers, state bond markets were attractive to investors because of their relative stability and typically higher returns:

> 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.[5]

2.6 Ms Sue Vroombout, General Manager of Treasury's Commonwealth-State Relations Division, 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.[6]

2.7 As each state has taken increasing responsibility for their own fiscal position and borrowing programme, it could be argued that any implicit guarantee has eroded over time.

2.8 The Treasurer’s press release states that the Commonwealth guarantee will only cover securities which the states choose to make subject to the proposed guarantee.

2.9 In discussing that point, Mr Jolly pointed to the fact that, although the market may factor in some sort of implicit guarantee in times of greater liquidity, the difference between state debt issued bonds that are subject to this guarantee and those that are not will certainly be obvious.

> 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

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4 Ratings agencies generally do not allow subordinate governments or companies a credit rating above that of the sovereign, so a downgrading of the national government will likely raise costs for all Australian borrowers.

5 Mr Peter Jolly, *Proof Committee Hansard*, 10 June 2009, p 9.

6 Ms Sue Vroombout, *Proof Committee Hansard*, 10 June 2009, p 2.

> two-tier market. It is manageable but there would definitely be a difference in pricing.[7]

2.10 This assertion that explicitly guaranteed debt will be priced differently from other debt indicates that there is less than total confidence in any implicit guarantee.

7 Mr Peter Jolly, *Proof Committee Hansard*, 10 June 2009, p 9.