Keep risk focus on big picture

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It's ironic. The lesson from recent financial crises has been the need for better risk management throughout economies. Yet, we are now contemplating the liquidation of a key risk management institution – the Commonwealth bond market.

Treasury's Discussion Paper on the issue invites a debate on minutiae rather than the big picture. But the bond market is crucial to the entire economy.

Governments exist to improve welfare, including by assisting the management of risk throughout the community and not just narrowly managing the risk associated with government finances. Myriad risks come to mind, from the micro-risks that face each of us – our incomes, our health and security – to the collective risks involved in economic crisis.

We must all exercise prudence as best we can, but government has an integral role in helping manage these risks. It can pool and smooth fluctuations in fortunes over time, and across different parts of the society in ways that cannot be done privately. Governments can borrow more cheaply than others, and virtually free of default risk.

These unique benefits can be shared through a strong financial system. World best practice demands a robust banking system operating alongside well-developed capital markets. For Australia, Commonwealth bonds underpin the capital market especially in the management of long-dated risk and at times of financial crisis.

The bond market, then, is part of our economic infrastructure – an institution. It and other financial institutions meld the advantages of government in assuming community wide risks with the ability of the private sector to deliver at an individual level. *Private financial instruments cannot do the job as well.*

Consider just two examples. First, bonds currently underpin the management of long-dated risk including in insurance and superannuation. Quantifying these benefits is difficult, but a US Federal Reserve economist suggests that the welfare losses associated with removing the risk-free asset from optimal portfolios for retirement incomes could be *billions* of dollars – an amount micro-economic reformers would envy. Similar considerations apply in insurance.

Secondly, bonds play a vital role in times of financial danger. Financial crises can undo years of economic progress. Such risks must be assiduously minimised. The lessons of the Asian financial crisis should not be forgotten. In Alan Greenspan's words:

> "The addition of capital market alternatives [ie to banks] is possible only if scarce real resources are devoted to building a financial infrastructure – a laborious process whose payoff is often experienced only decades later."

Australia has made this investment over the last century, intensifying since the 1980s. The pay-off has been, according to Greenspan:

> "Despite its close trade and financial ties to Asia, the Australian economy exhibited few signs of contagion from contiguous economies, arguably because Australia already had well-developed capital markets as well as a sturdy banking system. But going further, it is plausible that the dividends of financial diversity extend to more normal times as well. The existence of alternatives may well insulate *all* aspects of a financial system from breakdown."

Strong – big picture – stuff!

Following the crisis, Korea, Singapore and Hong Kong have all expanded their bond markets precisely to strengthen their overall financial systems. Neither Singapore nor Hong Kong needed to borrow more; to the contrary, both already hold substantial net assets through their respective agencies.

We would could concede that our capital markets would be strong without bonds. But they would be weaker than they are now. Bank bonds would form the basis of the key swaps, futures and repo markets. So if ever a major bank got into trouble the whole system would be compromised. Hardly prudent economy-wide risk management!

However, Government has focused on narrow conceptions of risks to the public accounts. It wants to avoid responsibility for owning a portfolio of assets, which would be forced upon it by the Telstra sale, if it were not to use the proceeds to liquidate the bond market.

Done directly government investment in equities would be a retrograde step for both parties. Would the government vote for or against Solly Lew on the Coles Myer Board? But this is a straw man. These investments should be administered on an arms-length basis.

Indeed, like other governments, our own has years of experience with arms length asset management. Its CSS and PSS superannuation schemes have not produced serious governance issues, nor have their investments distorted the market. And over the years they have hugely outperformed bond yields.

So let's ensure that the debate is placed squarely on the big issues. How can we optimise the efficiency of our capital markets in the good times? And more important still, how can we protect assets critical to individuals' wellbeing – like superannuation and insurance – as well as the whole economy, the next time a global financial crisis hits?

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