

# Treasury Corporation of Victoria

“Will the real AAA please stand up?”

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Prepared by: Treasury Corporation of Victoria Economics Department

Presented by: William Whitford, Managing Director

Telephone: +61 3 9651 4824, e-mail: [w.whitford@tcv.vic.gov.au](mailto:w.whitford@tcv.vic.gov.au)

Mobile: 0409 341 549



Level 12  
1 Collins Street  
Melbourne VIC 3000  
Australia

## **Introduction**

The implosion of the US housing market last year and the subsequent reverberations it has generated through world financial centres, marks yet another chapter in financial history. While it enjoys open, dynamic and highly efficient financial markets, Australia has not been spared from the ensuing fall-out.

The primary purpose of this paper is to review the growth and development of the Australian and Semi-government bond market, particularly in the context of a period in which markets continue a long, slow and at times painful adjustment process. Impacts on the pricing of AAA rated bonds are also reviewed both pre and post the meltdown in the US mortgage market and ensuing financial market turmoil.

## **Structure of Australian Bond Market**

According to the Reserve Bank of Australia, the Australian bond market can be divided into five categories. Firstly, there are bonds issued by the Australian Government (CGS) and the borrowing authorities of the State governments (Semi's). Secondly, there are the bonds issued by Australian financial institutions, then those issued by Australian corporates. There follows asset-backed bonds (ABS) issued by Australian-domiciled vehicles and finally Australian dollar bonds issued in Australia by non-residents – so called 'Kangaroo' bonds<sup>1</sup>.

The stock of CGS and Semis outstanding in Australia has been relatively stable since 2003 after the Australian Government, despite running budget surpluses at the time, elected to maintain a stock of CGS on issue of around \$50 billion to support the Australian financial market. In a similar vein, the State governments have also elected to maintain stock on issue notwithstanding the running of budget surpluses, with the prospect of increased issuance to raise funds for various infrastructure projects.

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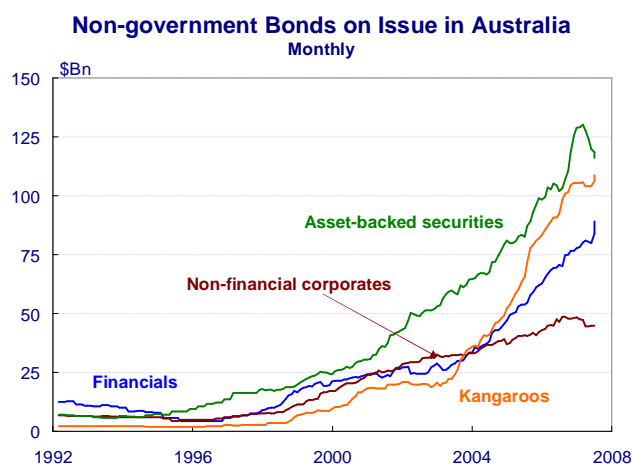
<sup>1</sup> Debelle, G., *Recent Developments in the Australian Bond Market*, Reserve Bank of Australia, Sydney, 5 March 2008

## Domestic Bonds Outstanding

	Outstanding (\$ billion)		Share (per cent)		Average annual growth
	1998	2008	1998	2008	1998-2008
CGS*	86.6	54.3	52.6	11.3	-4.6
Semi-government	44.9	66.0	27.2	13.8	3.9
Financials	7.2	89.3	4.4	18.6	28.7
Corporate	7.2	44.8	4.4	9.3	20.0
ABS	16.2	116.0	9.9	24.2	21.7
Kangaroos	2.6	108.7	1.6	22.7	45.3
<b>Total</b>	<b>164.7</b>	<b>479.2</b>	<b>100.0</b>	<b>100.0</b>	<b>11.3</b>

Source: RBA & AOFM. Outstandings as at end Jan/Feb 2008. \*Includes Commonwealth fixed coupon and indexed bonds but excludes Commonwealth holdings of CGS.

The Federal Budget 2008-09 outlined that the supply of fixed coupon bonds in financial year 2009 will be \$5.3 billion, including a new June 2014 bond, leaving “hot stock” on issue at 30 June 2009 of \$49.6 billion<sup>2</sup>. While the stock of public debt has to this point been fairly static, particularly at the Federal level, the stock of bonds issued by non-government entities in Australia has grown rapidly over the period 1998-2008<sup>3</sup>. This growth has been relatively broad-based across the four non-government segments of the market but has been particularly noticeable in the Kangaroo bond category, which has seen its share of the total market rise from 1.6% ten years ago to just under 23% as at 2008.



Source: RBA

<sup>2</sup> Budget Paper no.1, Statement 7: Asset and Liability Management, *Commonwealth Budget papers 2008-09*. The Federal Treasurer announced on 20 May 2008 an additional \$5 billion in issuance in 2008-09, (leaving stock on issue at about \$55 billion) with bond issuance potentially being increased by up to \$25 billion over the next four years.

<sup>3</sup> Debelle, op cit.

## CGS and State-government bond supply

The volume of State-government bonds on issue has moved sharply above that of CGS over the past few years. Research by Citigroup showed that as at January 2008, there was a total of just under \$60 billion in CGS on issue (inclusive of Commonwealth holdings of Treasury bonds) but around \$97 billion in State-government bonds.

State entity	Domestic Stock (\$billion)	Global Exchangeable Stock (\$billion)
New South Wales Treasury Corporation	13.2	15.9
Treasury Corporation of Victoria	10.8	-
Queensland Treasury Corporation	22.4	14.4
Western Australian Treasury Corporation	9.8	-
South Australian Treasury Corporation	3.4	-
Tasmanian Treasury Corporation	2.4	-
"Off-the-run" *	5.0	-
<b>Total</b>	<b>67.0</b>	<b>30.3</b>

\*Note: "Off-the-run" stock is estimated by TCV given total outstandings less domestic "hot stock" lines

Source: Citigroup

The total for the latter category was split between \$67 billion in domestic issuance and around \$30 billion in New South Wales Treasury Corporation (NSWTC) and Queensland Treasury Corporation (QTC) "global" bonds<sup>4</sup> (see table). The offshore State government bond market has experienced substantial growth in recent years, with the stock outstanding increasing at almost twice the rate of the domestic market in dollar terms since 2004<sup>5</sup>. These global exchangeable bonds are Australian dollar securities and have the same coupon and maturity as their domestic bond equivalents but are interest withholding tax exempt. The key drivers of increased issuance into global markets has been an expansion in the borrowing programmes of NSWTC and QTC and a very strong level of offshore demand for Australian dollar denominated bonds by global investors. Much of this global demand emanated from retail investors in Japan and from central banks across the Asian region.

The domestic State-government bond market is very liquid and operates largely for the benefit of Australian investors. Further, the market for Semi-government bonds issued in Australia has

<sup>4</sup> Citigroup, Australia Special Research, "State of the States" Update – Changing C'wealth-State Financial Relations", 2 April 2008.

<sup>5</sup> Australian Financial Markets Association, Pre-Budget Submission, 18 January 2008.

exhibited a gradual increase in the amount on issue in recent years. The Australian Financial Markets Association (AFMA) notes that while “State government budget projections imply solid annual growth in the stock outstanding.....the actual amount issued domestically will depend upon the amount raised on the offshore market, amongst other things”<sup>6</sup>.

AFMA survey data indicates that over the period since 2000, turnover on the market fell slightly, with some volatility in the intervening years. In comparison, “the value of Commonwealth government bonds traded has declined markedly in recent years, the liquidity ratio has fallen to its lowest level in modern times and the amount on issue has declined in real terms”<sup>7</sup>.

A key feature of the 2007-08 State Budget season was a significant increase in State infrastructure spending. Based on the various State Budgets and indications from various State Treasury corporations, the likely size of the State-government bond market in the years ahead is estimated to climb to around \$100 billion by June 2011. Including global issuance, total State-government bonds would rise to near \$137 billion by June 2011<sup>8</sup>. It should be noted that this analysis precedes the Federal Treasurer’s announcement on 20 May 2008 of an increase in CGS issuance of \$5 billion in 2008-09 and up to an extra \$25 billion over the coming years, depending on market conditions<sup>9</sup>. Notwithstanding this announcement, the rise in State-government bonds in recent years still raises the prospect of the latter market developing into “the” liquid government bond market in Australia<sup>10</sup>.

The above estimates are subject to revision, depending on any announcements made as part of the 2008-09 State Budget reporting season but also as a result of the Federal Budget. The latter announced three new investment funds, the Building Australia Fund, the Education Investment Fund and the Health and Hospitals Fund, with each being funded out of current and future budget surpluses<sup>11</sup>. The States will now potentially have access to \$40 billion of Commonwealth money, via the Funds to invest in infrastructure and nationally significant reforms. Depending on

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<sup>6</sup> Australian Financial Markets Association, op-cit, 18 January 2008.

<sup>7</sup> Australian Financial Markets Association, op-cit, 18 January 2008.

<sup>8</sup> Citigroup, “*State of the States*” Update, No.2, 2008, “*Change is Here!*” 21 May 2008.

<sup>9</sup> Treasurer of the Commonwealth of Australia, “*Increasing Commonwealth Government Securities to Bolster Australia’s Financial Markets*”, Media release, No. 58, 20 May 2008.

<sup>10</sup> Citigroup, op cit, 2 April 2008.

<sup>11</sup> ANZ Banking Group, ANZ Federal Budget Report, 13 May 2008.

the projects to which this is allocated, this may result in slight a reduction in the expected build-up of State net debt and State bond issuance.

## **Recent developments in international financial markets**

The past nine months has certainly been a very challenging time in international financial markets, in which a significant reappraisal of certain categories of risk has occurred and in the process triggering considerable international financial turbulence. There is little doubt that a prolonged period of broadly based and aggressive risk-taking preceded the present upheaval. This was facilitated by unusually low global interest rates and volatilities across asset classes, which gave the impression that risk had disappeared when in fact it was merely hiding its dangerous accumulation<sup>12</sup>.

The situation prevailed until July 2007, notwithstanding the fact that for some time, it had been apparent that markets had held an overly optimistic view on risk, with spreads at historically low levels and with central bankers warning of the strong build-up of risk-taking and leverage in the global financial system. Indeed, “the period since the late 1990s has been characterised by low interest rates, leading to an excessive search for yield, an increase in leverage throughout the financial system and to a sustained rise in the prices of a broad spectrum of financial and real assets<sup>13</sup>”, most publicly in the US housing market.

Nonetheless when booms burst, the moment of change tends to arrive unexpectedly. The RBA noted that a catalyst for the general reassessment of risk in structured credit markets was the announcement by French bank, BNP Paribas, on 9 August 2007 that it was suspending withdrawals from two of its hedge funds with large exposures to US sub-prime debt<sup>14</sup>.

As is the case with most market adjustments, the transition to a new equilibrium is not often smooth and the possibility of overshooting is present, given investor uncertainty can quickly

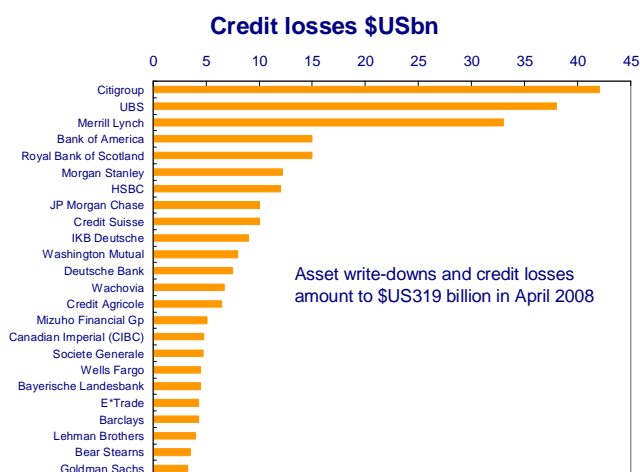
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<sup>12</sup> Bank for International Settlements, “Now you see it, now you don’t; the nature of risk and the current financial turmoil”, 26 February 2008.

<sup>13</sup> Bank for International Settlements, *op-cit*, 26 February 2008.

<sup>14</sup> Reserve Bank of Australia, *Statement on Monetary Policy*, November 2007, p.21.

morph into outright panic. The repricing of risk has been complicated both by the difficulty in valuing complex or illiquid financial products and the uncertainty about the exposures of major financial institutions to credit losses. As noted by the Bank for International Settlements, “the current turmoil has shown that the financial system had become leveraged to a greater extent than one could have guessed from looking at the balance sheets of regulated banking institutions alone”<sup>15</sup>.



Source: Bloomberg & Economics@ANZ

The subsequent drip feeding of bad news on credit losses, ratings downgrades and asset write-downs by several prominent financial institutions in the following months, only served to perpetuate feelings of distrust and fear across financial markets. In such an environment, investor confidence in asset valuations began to dissipate triggering another round of losses and the reinforcement of such negative feelings. Indeed, a generalised distrust of counterparties resulted in an increase in risk aversion, as market participants pondered the size and scope of credit and liquidity exposures, both in their own balance sheets and in those of others<sup>16</sup>.

In such an environment, the reluctance to provide credit saw market liquidity for the most opaque and complex instruments and for those institutions that were suspected of being heavily exposed to these instruments, quickly dry up<sup>17</sup>.

<sup>15</sup> Bank for International Settlements, op-cit, 26 February 2008.

<sup>16</sup> Bank for International Settlements, op cit, 26 February 2008.

<sup>17</sup> Bank for International Settlements, op cit, 26 February 2008.

Before long, tensions started to affect broader portions of the financial system that had initially appeared to escape the worst of the turmoil<sup>18</sup>. At the short end of the inter-bank market, a sizeable and lasting risk premium emerged. Domestically, this has been evident in the widening of the spread between the 3 month bank bill swap rate (BBSW) and the overnight indexed swap rate (the latter is where markets expect the official cash rate to be over the next 3 months).

Before the onset of the turmoil in financial markets, the BBSW-OIS spread averaged around 8-10 basis points. But from July 2007 it widened significantly reflecting a mixture of liquidity concerns and uncertainties about counterparty credit risk. After abating somewhat towards the end of last year, pressure re-emerged in this market in the new-year. The spread since July 2007 has averaged around 44 basis points.

Events in financial markets have provoked a determined and coordinated policy response by central banks, including the RBA. These responses have included substantial monetary policy easing in the US and liquidity enhancement initiatives such as extending the range of collateral against which central banks would normally lend against to ease liquidity strains.



Source: Bloomberg

These actions have assisted in restoring some stability to financial markets. However, no one knows how long the present deleveraging process will take nor how it will unfold exactly. It

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<sup>18</sup> Bernanke, B, *The economic outlook*, Testimony before the Joint Economic Committee, US Congress, 2 April 2008.

seems it will simply have to run its course until a new equilibrium is found in asset prices. Prior adjustment episodes imply this is unlikely to be a painless process<sup>19</sup>.

### **Impact on the CGS and Semi-government bond market**

The Australian and State government bond markets have obviously been affected by these global developments.

The subsequent flow of negative information from the US sub-prime mortgage market and the flow on effects to credit markets generally resulted in credit spreads continuing their widening path throughout July 2007 onwards. A general repricing of credit risk occurred in all asset classes relative to the risk-free asset class with the State government market seeing its spread to CGS widen to levels not experienced in over 13 years.

The magnitude of the spread move is clearly evident in the left hand chart below, which respectively shows a blended 5 and 10-year State government spread to CGS (or 'bond'). From July, the Semi/bond spread widened from pre-'crisis' levels of around 25-30 basis points to in excess of 80 basis points in early March 2008. On average, the Semi/bond spread has probably doubled. Although there has been some retracement from earlier highs, Semi/bond spreads remain elevated, likely reflecting lingering risk aversion in financial markets. The right hand chart shows the ten-year Treasury Corporation of Victoria spread to bond since March 1996.

As shown, the 10 year TCV/CGS spread has only traded at such elevated levels during the Asian credit crisis in late 1998, and in early 2000, when global equity markets peaked at the end of the technology boom causing a short-term flight to quality to CGS, i.e. the flows pushed yields on CGS lower relative to yields on Semi-government debt thereby increasing the difference (or spread) between the debt classes.

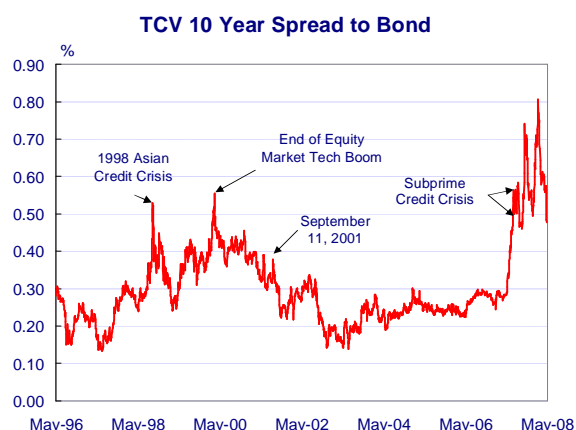
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<sup>19</sup> Bank for International Settlements, op-cit, 26 February 2008.

In the most recent episode of market upheaval, yields on State government debt have tended to move with the swap rate rather than CGS yields.



Source: CBA Spectrum; Commonwealth Bank of Australia



Source: TCV

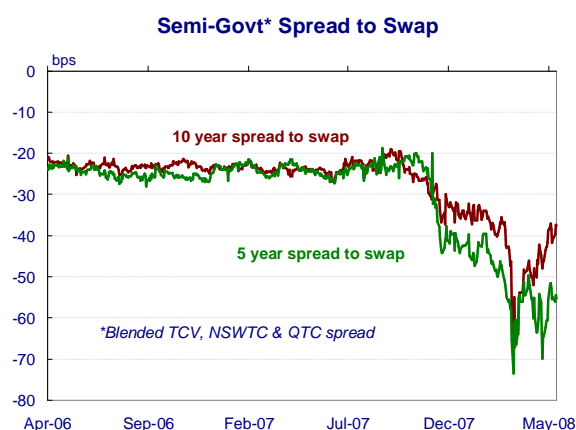
In July the spread between yields on 10-year swaps and CGS widened significantly to around 70 basis points after having been steady at around 50 basis points over the past few years. A widening in this spread is generally associated with phases of heightened financial uncertainty, when investor risk aversion rises and demand for risk-free assets increases<sup>20</sup>.

Unlike previous periods, when bond (CGS)/swap spreads have moved to historical lows, i.e. they become more negative, the spread between TCV/swap did not improve when usually the latter spread benefits from flight to quality flows in a stressed market environment. With most States' credit ratings at AAA (including Victoria's) credit risk considerations did not appear to be a factor behind the widening of the Semi spread to CGS<sup>21</sup>.

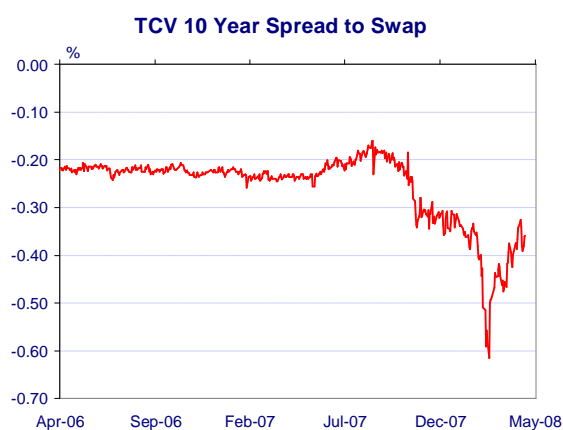
Since those initial months last year, Semi/swap spreads have widened (see left chart below) as markets have periodically reassessed the embedded risk in Semi-government debt relative to swap, i.e. on-going risk aversion has benefited Semi-government debt via flight to quality flows. More recently, as financial markets have exhibited greater stability the spread has contracted somewhat but remains about double the level prior to the beginning of market turmoil.

<sup>20</sup> Reserve Bank of Australia, *Statement on Monetary Policy*, August 2007, p.48.

<sup>21</sup> Reserve Bank of Australia, *op-cit*, August 2007, p.48.



Source: CBA Spectrum; Commonwealth Bank of Australia



Source: TCV

Semi-government spreads to supranationals (“supras”) are also worthy of examination. Supras are generally multilateral lending institutions, which are typically set up and owned by sovereign states. Issuers in the Australian market include names such as the European Investment Bank, Asian Development Bank and Inter-American Development Bank and such issuance has contributed to the growth of the Kangaroo market.

These institutions include some of the largest borrowers in international capital markets and, as a borrower class, have an unsurpassed credit rating<sup>22</sup>. Thus, supras are invariably AAA rated reflecting strong financials, especially capitalisation, strong shareholder support, and the fact they ordinarily do not pay taxes or dividends<sup>23</sup>.

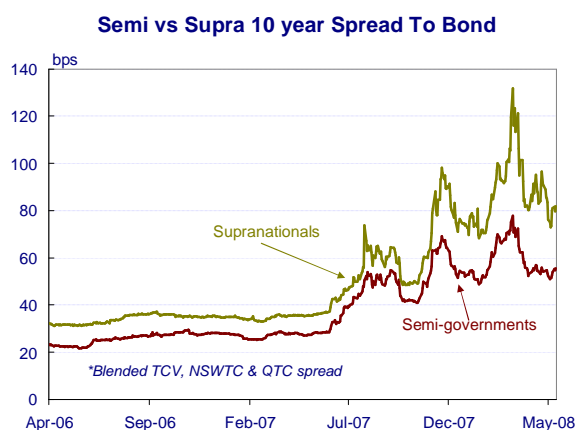
Despite their AAA status, under ‘normal’ conditions, supras might be expected to trade at a spread marginally above Semi-government debt because they are not officially part of government, although they are very close because they are almost always guaranteed by the governments that have established them. In practice, the spread may not always conform to normal expectations for range of reasons.

One key reason is that issuance trends are influenced by changes in the basis swap. Typically, a narrowing of basis swap spreads means that offshore issuance becomes more attractive for

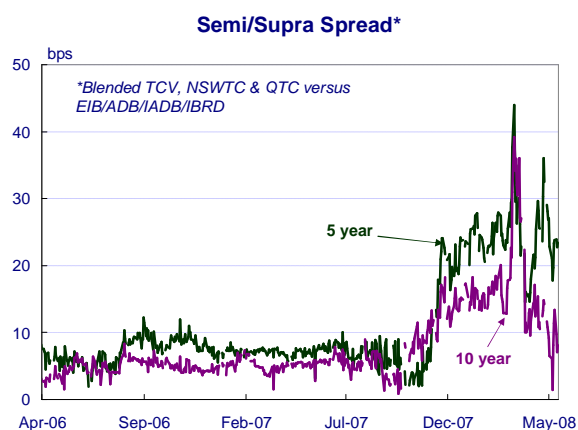
<sup>22</sup> Insto, *Submission to the Review of the Commonwealth Government Securities Market*, December 2002, citation from Standard & Poor’s, *Supranationals Special Edition 2002*.

Australian banks, while it becomes less attractive for supras. The left hand chart shows the spread of Semi-government debt and supranational debt to bond (CGS). As can be seen, this spread widened significantly from July 2007 as volatility and risk aversion increased in global financial markets.

The right hand chart shows the path of the Semi/supra spread over the same period. It can be clearly seen that up until the latter part of last year the Semi/supra spread at both the 5 year and 10 year maturities oscillated, on average, between zero and ten basis points. In the aftermath of the US sub-prime meltdown and ensuing financial market volatility, the Semi/supra spread for the 5 year maturity expanded to around 44 basis points, while the spread at the 10 year maturity widened to around 39 basis points.



Source: CBA Spectrum; Commonwealth Bank of Australia



Source: CBA Spectrum; Commonwealth Bank of Australia

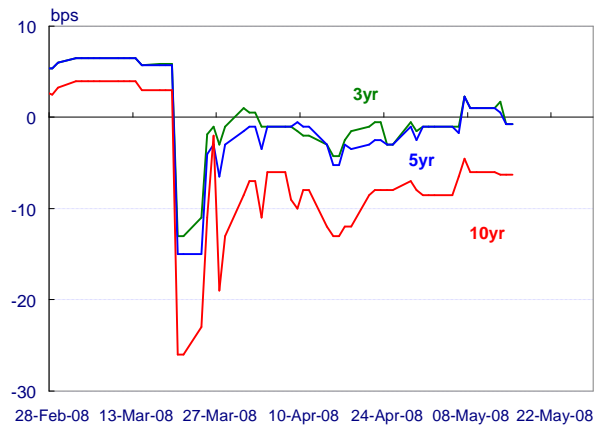
As at mid-May 2008, the spread was down dramatically from the levels seen just a few months ago and was as tight as at any stage over the past few years. This seems due to the reduction in supra issuance following a contraction in the basis swap (see AUD basis swap chart).

The contraction in the basis swap has been attributed to increased Kangaroo bond issuance in early 2008 (which itself was in response to increased demand driven by flight to quality sentiment) and to a fall in the AUD/JPY exchange rate<sup>24</sup>.

<sup>23</sup> Insto, op cit.

<sup>24</sup> The reasons behind the contraction are expanded upon in ANZ Interest Rate Strategy Weekly, 27 March 2008.

### AUD Basis Swap



Source: Bloomberg

Overall, the preceding discussion suggests that the flight to quality dynamic will generally drive CGS yields lower. While it might be expected that Semi-government yields would follow, given their Semi-sovereign status, they do not always and even sometimes follow movements in swap yields. This perhaps suggests that during times of market stress participants will fly, at least initially, to what is perceived to be the ‘best of the best’ quality, which is ‘pure’ sovereign rated debt. Relative to supras, Semi-government debt generally trades at a small premium, however recent market volatility and movements in the basis swap can significantly influence issuance trends for supras and thereby spreads between these two AAA rated asset classes. The relative movement in spreads between different asset classes is summarised numerically in the table below.

10yr maturity	Pre-July 2007* spread to bond (average)	Post-July 2007** spread to bond (average)	Pre-July 2007 spread to swap (average)	Post-July 2007 spread to swap (average)
Semi <sup>^</sup>	27	54	-23	-33
Range	(22 to 39)	(39 to 78)	(-27 to -20)	(-64 to -19)
Supra	35	74	-15	-13
Range	(31 to 47)	(46 to 132)	(-18 to -11)	(-23 to -4)

\*7 March 2006 to 30 June 2007 and \*\* 1 July 2007 to 14 May 2008

<sup>^</sup>Semi represents a blend of TCV, NSWTC and QTC

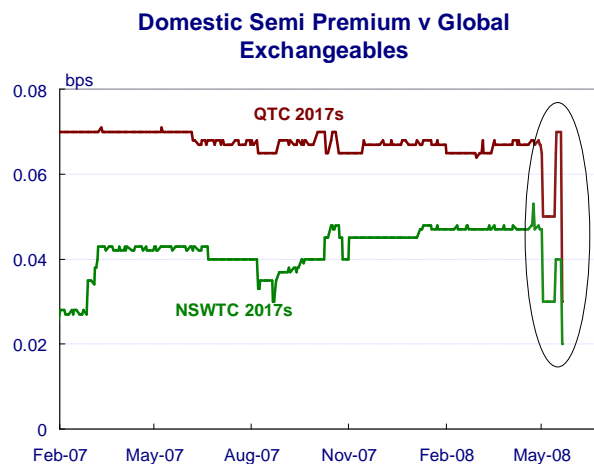
10yr maturity	Pre-July 2007* spread to supra (average)	Post-July 2007** spread to supra (average)
Semi <sup>^</sup>	5	12
Range	(2 to 8)	(1 to 39)

Source: CBA Spectrum

## Other Issues

As mentioned previously, issuance patterns implied from 2007-08 State Budgets mean that the Semi-government bond market could develop into the most significant liquid government bond market in Australia. Such a development would be assisted by the anticipated abolition of interest withholding tax (IWT) on all State-government bonds. However, the 2008-09 Federal Budget made no announcement on the IWT issue, as it relates to Semi-government debt.

The advantages and rationale for abolishing IWT are well-known but a clear advantage would be to instantly create one large pool of State-government bonds, rather than leaving the Australian dollar Semi-government bond market fragmented into segments to which IWT does and does not apply. The chart below shows that the spread between domestic issued and global exchangeable NSWTC and QTC bonds narrowed in the lead up to the recent Federal Budget amid speculation that the new Government would abolish IWT only to revert back when no news was forthcoming (see chart below).



Source: CBA Spectrum, Commonwealth Bank of Australia; TCV

## Post Script

As it has turned out, on 20 May 2008, the Federal Treasurer announced the abolition of IWT. The change is “expected to improve depth and liquidity in State Government bond markets and

improve price discovery”<sup>25</sup>. The aim is to pass legislation in the current sitting of Parliament to enable the suite of initiatives to be progressed quickly.

It can now be expected that TCV and Western Australian Treasury Corporation domestic debt will benefit as investors seek to diversify their holdings from NSWTC and QTC. In addition, it will likely assist in narrowing the Semi/bond spread and encourage greater offshore participation in the Semi market<sup>26</sup>. Immediately following the announcement, the 3-year Semi/bond spread narrowed by around 8 basis points, while the 10-year spread narrowed by around 3 basis points.

In addition, on the same day as the Treasurer’s announcement, NSWTC announced that once the law is enacted, it will offer “existing exchangeable bond investors a 1 basis point incentive to switch their holdings for the domestic benchmark bond of the same maturity”<sup>27</sup>.

This announcement begins the process of deepening the domestic Semi-government bond market.

## **Final Thoughts**

It would seem from the preceding review that the market for AAA rated debt securities is segmented into various groups. This segmentation is in part market determined insofar as investors appear to exercise a clear preference for sovereign rated debt during periods of market stress, as evidenced by the widening of the Semi/bond spread in the period post the US mortgage market meltdown and associated triggering of global volatility.

Differences in relative pricing perhaps also reflect minor credit risk considerations between “pure” sovereign debt, i.e. CGS relative to other top-tier AAA rated debt. However, some of the difference in relative pricing can also be attributed to the impact of institutional arrangements

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<sup>25</sup> Treasurer of the Commonwealth of Australia, “Increasing Commonwealth Government Securities to Bolster Australia’s Financial Markets”, Media release, No. 58, 20 May 2008.

<sup>26</sup> Commonwealth Bank of Australia, \$-Bloc Strategy, 12 May 2008.

such as IWT that bias one form of debt over another form, e.g. domestically issued Semi debt versus that issued offshore.

In light of the Federal Treasurer's announcement on increased CGS issuance and abolition of IWT, this issue no longer applies. These recently announced initiatives should continue to promote and support an efficient and liquid Australian bond market and make a greater contribution to financial market stability.

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<sup>27</sup> New South Wales Treasury Corporation, *"Notice to Investors in the Exchangeable Bond Programmes"*, Media release, 20 May 2008.

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