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Public Debt management and Australia's macroeconomic priorities

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1. Introduction

Federal Treasurer Costello has invited input into the "Review of the Commonwealth Government Securities (CGS) Market" (hereafter Review) saying "The success of the Government's fiscal strategy … has reduced Commonwealth general government net debt as a proportion of GDP from almost 20 per cent in 1995-96 to 5 per cent in 2001-02" (Treasury, 2002: iii). He also claims "The fiscal strategy contributes to the current low interest rate environment, a key factor underpinning Australia's recent economic strength."

We expect most submissions will come from financial intermediaries and institutions emphasising their own areas of specialisation (vested interest). However, we aim to focus on broader macroeconomic issues, in particular the relationship between the financial sector and the real economy and the concept of financial stability, while questioning whether CGS have public good aspects.

There has been a wide-ranging discussion in the financial and academic literature in recent years concerning the role of public debt markets and the costs and benefits of maintaining them (see BIS, 2001). The IMF (2002: 85) says these roles "may not be easily played by private financial products and their markets." Underlying most of the advocacy for maintaining CGS and derivative markets is a 'public good' argument.

The Treasury (2002: 2) identifies several functions that CGS serve 'even when' the budget is in surplus. Purported CGS benefits include "assisting the pricing and referencing of financial products; facilitating management of financial risk; providing a long-term investment vehicle; assisting the implementation of monetary policy; providing a safe haven in times of financial instability; attracting foreign capital inflow; and promoting Australia as a global financial centre." The SFE (2002: 4) considers these roles equivalent to public goods.

The public good argument has to be distinguished from argument tantamount to special pleading for sectional interests. Private markets under-produce public goods. When economic activity provides benefits beyond the space defined by the immediate 'private' transaction, there is a *prima facie* case for collective provision. If CGS markets can be shown to produce public goods that enhance national interest, which cannot be produced in any other (more efficient) way, then this would be a strong, pro CGS argument. We argue that the benefits identified by Treasury (2002) above which

are used to justify the retention of the CGS market can be enjoyed without CGS issuance. Further, these benefits cannot be conceived as public goods, and rather, at best, appear to accrue to narrow special interests.

Our approach is fundamentally 'market oriented.' Some markets, including the labour market, exhibit cyclical asymmetries and high degrees of persistence following negative shocks that are so costly in terms of foregone output and employment that government intervention is compelling. However, financial markets in general, allowed to operate within appropriate regulatory frameworks, are much closer to the parameters outlined in competitive theory and can generate reasonably efficient outcomes without direct government interference. Government intervention into private markets is a serious matter and must be justified with a proper cost-benefit analysis.

The paper is laid out as follows: Section 2 argues that financial stability is a public good and ties this conclusion into the political priority of maximising real output and maintaining full employment with price stability. The properties of financial stability (including prudential management and the regulatory environment) are outlined in terms of these priorities. Section 3 examines the proposed benefits of CGS issuance, focusing on how the proposed benefits affect the real economy at the macro level. Section 4 examines the macroeconomic costs of CGS issuance and we weigh up the evidence in Section 5. Section 6 reviews the various policy options set forth by the Treasury. Section 7 then assesses the Review in a broader macroeconomic framework and extends the model to its logical conclusions.

2. Financial stability as a public good

2.1 Macroeconomic priorities

We begin with the political statement that the fundamental responsibility of government macroeconomic policy is to maximise real national output in a way that is sustainable (social, economic and environmental). In a monetary economy this requires aggregate spending levels such that all those who wish to work have that opportunity. We further recognise the citizenry demands price stability as a matter of fairness and thus accept it as a legitimate political goal.

The political priorities of the Australian government in the early WWII period are listed in the Reserve Bank of Australia (RBA) Act 1959. Section 10, Subsection 2 says:

It is the duty of the Reserve Bank Board … to ensure that the monetary and banking policy of the Bank is directed to the greatest advantage of the people of Australia and … will best contribute to:

(a) the stability of the currency of Australia;

(b) the maintenance of full employment in Australia; and

(c) the economic prosperity and welfare of the people of Australia.

Therefore we assess the role of CGS in relation to how CGS impacts on the achievement of these macroeconomic public policy goals.

2.2 Financial stability

The current financial system is linked to the real economy via its credit provision role. Both households and business firms benefit from stable access to credit. An economy's financial system is stable if its key financial institutions and markets function 'normally' (Crockett, 1997). To achieve financial stability: (a) the key financial institutions must be stable and engender confidence that they can meet their contractual obligations without interruption or external assistance; and (b) the key markets are stable and support transactions at prices that reflect fundamental forces. There should be no major short-term fluctuations when there have been no change in fundamentals (Crockett, 1997: 6).

In this regard, Crockett (1997: 6) states "Stability in financial institutions means the absence of stresses that have the *potential* to cause measurable economic loss beyond a strictly limited group of customers and counterparties. Occasional failures of smaller institutions and occasional substantial losses at larger institutions are part and parcel of the 'normal' functioning of the financial system. Indeed, they serve a positive function by reminding market participants of their obligation to exercise discipline over the activities of the intermediaries with whom they do business."

Financial stability requires levels of price movement volatility that do not cause widespread economic damage. Prices can and should move to reflect changes in economic fundamentals. Financial instability arises when asset prices significantly

depart from levels dictated by economic fundamentals and damage the real sector. Collapses brought on by injudicious speculation that do not affect the real sector or that can be insulated from the real sector by appropriate liquidity provisions are not problematic.

The essential requirements of a stable financial system are:

1. Clearly defined property rights;
2. Central bank oversight of the payments system;
3. Capital adequacy standards for financial institutions;
4. Bank depositor protection;
5. An institutional lender-of-last resort when private institutions refuse to lend to solvent borrowers in times of liquidity crisis;
6. An institution to ameliorate coordination failure among private investors/creditors;
7. The provision of exit strategies to insolvent institutions.

While some of these requirements can be provided by private institutions, all fall in the domain of government and its designated agents. However, we argue that none of these requirements rely on the existence of a viable CGS market.

2.3 Financial stability as a public good

Private goods are traded in markets where buyers and sellers exchange at prices that reflect the margin of their respective interests. At the agreed price, ownership of the good or service transfers from the seller to the buyer. A private good is 'excludable' (others cannot enjoy the consumption of it without being party to the transaction) and 'rival' (consuming the good or service specific to the transaction, denies other potential consumers its use).

Alternatively, a public good is non-excludable and non-rival in consumption. Private markets fail to provide socially optimal quantities of public goods because there is no private incentive to produce or to purchase them (the free rider problem). To ensure socially optimal provision, public goods must be produced or arranged by collective action or by government.

We conclude that financial system stability meets the definition of a public good and is the legitimate responsibility of government.

3. The purported benefits of Commonwealth Government Securities issuance

3.1 Overview

We argue that the roles identified by IMF (2002), Treasury (2002) and SFE (2002) among others for the CGS market are not justifiable on public good grounds. They appear to be special pleading by an industry sector for public assistance in the form of risk-free CGS for investors as well as opportunities for trading profits, commissions, management fees, and consulting service and research fees.

Furthermore, and ironically, their arguments are inconsistent with rhetoric forthcoming from the same financial sector interests in general about the urgency for less government intervention, more privatisation (for example, Telstra), more welfare cutbacks, and the deregulation of markets in general, including various utilities and labour markets.

Specifically, government price level intervention into private markets is typically challenged by economists on efficiency grounds. CGS issuance is a form of government price level intervention in interest rate markets. The burden of proof falls on those arguing in favour of CGS issuance to show that the market in question is incapable of viable operation without government intervention and will, unassisted, produce outcomes detrimental to the macro priorities outlined in Section 2.1.

There is also a larger irony to the entire discussion, as all parties to the debate, including the Treasury (2002) have omitted discussion of the primary role of CGS in the context of a flexible exchange rate system – that is, to support the term structure of interest rates rather than to fund government expenditure. This omission subsequently undermines much of the validity of the arguments advanced.

3.2 Pricing other financial products

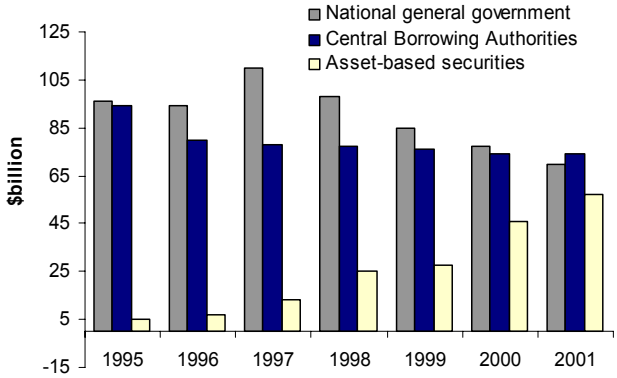
Treasury (2002: 2) note that the yield curve supported by CGS is used by financial markets as the "best available estimate of the rate of interest on a risk-free asset of that maturity", which, in addition to academic interest, provides a benchmark for pricing any other debt security. Treasury (2002) identifies two pricing alternatives: (a) the market could price securities against other securities with similar characteristics;

and (b) market participants could price securities with respect to the interest rate swap curve.

Market participants already use the interest rate swap curve to price securities. Regardless, the term interest rate structure remains a meeting of supply and demand. Buyers and sellers of bonds desire to attract each other and meet at a price. Are the proponents of retaining CGS claiming that without government intervention in the credit markets via CGS issuance borrowers and investors cannot sufficiently come together at a price? Are they saying that the interest rate market does not have sufficient levels participation, information and competition to adequately determine price without government intervention? It is doubtful that either position can be substantiated, and certainly not to the degree needed to support the issuance of CGS with their high real macro costs as subsequently discussed.

Furthermore, markets can adapt to declining CGS supply as evidenced by the rapid growth in supply-side innovations in the Australian home mortgage market in the form of securitisation (ABS, 2002). The growth has been supported by two major developments one of which is relevant here. The ABS (2002: 15) notes the decline in supply of high quality fixed interest public securities occurred at the same time as "institutional investors had an increasing demand for fixed interest securities driven by the growth in superannuation balances which they manage." In Figure 1 we show "the substitution of asset-backed bonds for government bonds in the long-term bond issuance market over the period" since 1995 (ABS, 2002: 15).

Figure 1 High quality bonds on issue, Australia, 1995-2001



Source: ABS (2002, Figure 4)

As a consequence, we argue that financial markets will function well enough without CGSs.

3.3 Referencing other financial products

Treasury (2002: 41) claims "Some financial market participants may use the CGS yield as a reference benchmark for comparing the yields on different debt securities of a similar maturity." Again, we question if this is an appropriate area for government intervention and support. It seems unlikely that any unbiased cost/benefit analysis would conclude government intervention to make it easier for traders to exploit occasional 0.25 per cent differences in securities' yields worthwhile.

3.4 Managing financial risk

Treasury (2002: 43) argues "The CGS market underpins a number of important derivative markets that play a crucial role in managing financial risk. Winding down the CGS market could result in significant changes to a number of these markets." They note 'businesses' use these markets to manage interest rate risk (Treasury, 2002: 43).

What are their real interest rate risks of these businesses? What are the real economic costs of these feared changes? The direct interest rate management tools for businesses are actual term borrowings. Using bond futures is an indirect method that introduces additional risks to businesses whose funding costs often vary substantially from CGS rates, with spreads widening and narrowing constantly, while other forward and futures markets, such as Eurodollar futures and swap markets, more directly reflect high grade corporate borrowing costs. In fact, before long term US Treasury Bonds were issued corporate bonds were the liquid benchmark securities, more accurately reflecting corporate borrowing costs.

The Treasury (2002: 3) then says "Businesses use these markets as movements in CGS yields are highly correlated with yields on other securities and the liquidity of the market enables businesses to take positions without significantly affecting market yields." While this is true, no evidence is provided that it results in a sufficiently superior macroeconomic outcome to justify a government presence in the credit markets. Furthermore, there is no evidence presented that businesses could not function at least equally well without the issuance of CGS and instead use corporate securities and other futures and swap markets as yield bench marks and hedging vehicles. To the contrary, the introduction of CGS at any given maturity raises relative yields at that maturity (Mitchell and Mosler, 2002).

Further, we ask which businesses 'need' to 'take positions' in interest rate futures? Close examination will likely reveal it is the risk of speculators that may be more easily managed, and the proposed public policy would support and encourage speculation, rather than real investment behaviour. Can the support of particular businesses in this manner be an appropriate use of public policy?

But underlying the risk management claims is another argument. Treasury (2002: 3) claims that investors who can manage interest rate risk "may be prepared to accept a lower yield on a corporate bond" (see also SFE, 2002). The implication is that if CGS were unavailable, the cost of capital would be higher than otherwise, adversely affecting the macroeconomic goals specified above. This at least attempts a public goods argument. But even though we disagree with it operationally (given that CGS issuance serves to support the term structure of rates), the contention fails at the macroeconomic level, since for every $A borrowed there is an $A saved. If rates are a bit higher or lower due to CGS, one group benefits while another loses. There is no analysis presented of these distributional impacts. The assumption that marginally lower rates represent a real macroeconomic benefit is unsupported.

The Treasury indicates that in the absence of outstanding CGS, businesses could use one of three possible alternatives to manage interest rate risk (Treasury, 2002: 46-48). First, businesses already use interest rate swaps for managing some interest rate risks. Second, the private sector could further develop interest rate swap futures markets, which already exist both directly and in the form of 3-month London Interbank Offered Rates (LIBOR) future markets in most currencies (a futures exchange is merely another counterparty that adds 'liquidity'). So we agree with Treasury (2002: 48) that "an interest rate swap futures market may be a viable alternative." We further note, however, that LIBOR settings are based on the costs of funds for major banks, and that these banks are directly and indirectly supported by government through the likes of deposit insurance and membership benefits from the RBA. Therefore, the current LIBOR swap market is already the beneficiary of substantial government support. Third, continued development of the corporate bond market may lead to the growth of a corporate bond futures market as private agents can be expected to respond to profit making opportunities. While the corporate bond market is not currently liquid enough to support a futures market (Treasury, 2002: 48), it can only be because there is currently not a need. If the CGS market was abandoned, and a

need arose, that need would lead to the emergence of a market. For example, before the US Treasury Futures market opened in 1978, the Government National Mortgage Association (GNMA) futures contract attracted all the liquidity. Liquidity soon transferred to the Treasury Futures market and GNMA market activity rapidly declined and was subsequently discontinued.

3.5 Providing a long-term investment vehicle

It is argued if superannuation and life companies "could not invest in CGS, then they may face more difficulties matching their relatively long-dated liabilities with their financial asset holdings" (Treasury, 2002: 50). SFE (2002: 5) claims eliminating the CGS market would "deny superannuants an A$ denominated (default) risk free investment for their retirement planning at a time of an ageing population and in a mandatory superannuation environment."

What is not often understood is that CGS are in fact government annuities. Do the proponents of CGS really want the private sector to have access to government annuities rather than be directing real investment via privately-issued corporate debt, as an example? This point is also applicable to claims that CGS facilitate portfolio diversification. Why would Australians want to provide government annuities to private profit-seeking investors? Without going into detail, we simply suggest that this interferes with the investment function of markets, and that direct government payments be limited to the support of private sector agents when failures in private markets jeopardise real sector output (employment) and price stability.

We would also require a comparison of this method of retirement subsidy against more direct methods involving more generous public health and welfare provision and pension support.

3.6 Implementing monetary policy

Treasury (2002: 54) notes "the CGS market has played a central role in the … RBA's … implementation of monetary policy. A key issue is whether a decision to wind down the CGS market would affect adversely the RBA's ability to implement monetary policy."

Treasury (2002: 4) claims that monetary policy works in Australia via the RBA "undertaking open market operations … to inject and remove cash from the

economy." What is more nearly correct is that the RBA alters member bank balances in their Exchange Settlement accounts. While this may seem a trifling distinction, it is telling that in public documents, the Treasury rehearses an intermediate macroeconomics textbook description which displays a lack of knowledge of the operation of the payments system itself. This misunderstanding, in turn, contributes to the errant fiscal policy analysis which we discuss in Section 6.

Regarding monetary operations and CGS, note that the RBA has "moved to accept a broader range of instruments in its open market operations" (Treasury, 2002: 4-5). In fact, the RBA can loan banks any needed funds, including actual cash, at any interest rate, and require any other bank assets as collateral with no aberrant effect on the monetary system.

3.7 Providing a safe haven

Government securities are alleged to provide a 'safe haven' for investors when there is financial instability (Treasury, 2002: 57-62). The 'flight to quality' argument suggests that it is beneficial to the macro economy for investors to have a risk free domestic asset available to avoid capital losses on other assets. However, in addition to the previous point regarding subsidy through government annuities, we note that CGS compete directly with these other assets, thereby driving down their prices and exacerbating matters during 'flights to quality'.

In a monetary economy, investors can always hold money balances by increasing actual cash holdings or banking system deposits. Deposit insurance makes bank deposits equivalent to CGS for all practical purposes. That passes the 'risk' to private banks when they select their assets and selection of assets is regulated by the RBA. There is no compelling real macroeconomic reason why risk and return decisions by private maximising agents should be 'further protected' by retreat to a market distorting government annuity.

We also note no one is proposing that the Treasury issue new CGS in response to a 'flight to quality'. As a consequence, during a 'flight to quality' only relative prices of various fixed income securities can change, not the quantity, as investors compete for the existing stock of outstanding CGS. At the macro level, this process does not reduce risk.

3.8 Domestic capital flight

The Treasury (2002: 5) also claims that without a CGS market domestic investors will have to seek safe assets offshore. But there are no government offshore competitors in Australian dollars. So this argument must relate to residents selling Australian dollars and buying foreign exchange, thereby driving the currency down and imported prices up. If so, what is being proposed is in fact the offer of a 'premium' in the form of CGS to attract residents to $A financial assets. Again the question becomes one of government intervention in the form of CGS, this time to influence the foreign exchange rate.

First, the reduction of CGS under current policy is equal to the reduction of net financial assets of the non-government sector. Therefore, at the macro level the reduction in CGS outstanding reflects the reduction in net funds available to purchase CGS. This is but another way of stating that CGS issuance functions to offset operating factors that result in 'extra' reserves balances for RBA member banks, with the primary operating factor being reserve balances added by net government spending. Thus, the reduction in CGS does not result, at the macro level, in what is conceived as 'excess funds looking for a home'.

Second, proposing that the existence of CGS will alter the exchange rate due to action by domestic investors is at best a very weak argument, since, as previously discussed, the Australian population has the option of insured deposits, which are direct substitutes for CGS.

Third, the actual level of the $A has distributional effects within Australia, but does not alter the total real wealth of Australia. For example, a lower $A can shift purchasing power from those associated with imports to those associated with exports, but the total physical exports of Australia will continue to be exchanged on world markets for the same quantity of imports, and domestic production and employment is not inherently restricted by trade considerations (this is not to say that policy response does not from time to time result in declining output and rising unemployment).

3.9 Attracting foreign capital inflow

Treasury (2002: 5, 63-65) claim Australia requires "a continual supply of foreign capital to finance the … [current account] … deficit" and that the CGS market may help to attract such finance by keeping interest rates higher than otherwise. This

supports our contention that CGS function to support rates and contrasts to the previous contradictory claims by Treasury that CGS keep interest rates lower than otherwise (for example, Treasury, 2002: 3). The Treasury does not favour making the capital inflow level a policy target. However, in arriving at that conclusion, we question their logic.

First, it is the desire of non residents to net save in Australian dollars (accumulate $A financial assets) that results in trade deficits. In that context, do Australians want to provide Australian government annuity payments to non residents? It is possible that the trade deficit would disappear if non resident $A are spent on Australian products. The Treasury would not likely consider this a negative outcome. The non resident sector has only two choices when it sells its goods and services in Australia – to save or spend the $A payments it receives.

Second, the private balance (saving less investment) plus the public surplus equals net exports. The Treasury argues that when there is a public deficit, capital inflow is required to fund the deficit. But with a public surplus the government "does not require additional foreign capital inflow. Instead, private sector savings and investment decisions will determine whether additional foreign capital inflow is required" (Treasury, 2002: 64). First, in an accounting sense a public deficit will only correspond one for one to negative net exports if the private sector is in balance. This would also require the non-resident sector electing to be in surplus by the same amount as the public deficit as previously stated. Second, the Treasury fails to understand that CGS issuance serves to support the term structure and that there is no such thing as a 'funding requirement' for Commonwealth spending.

However, in spite of the convoluted logic, the statement contains an element of truth. A government surplus is equal to the non-government deficit, as net taxation drains both income and net financial assets from the non-government sector. This contractionary force can result in a fall in non-government resident consumption, including imports, as residents react to their loss of net income and financial assets to net government taxation. Along with subdued output and employment, this policy is deflationary as corporate pricing power is removed and the latent desire to hold financial assets leads to sales of non-financial assets. This introduces by definition an upward bias on the purchasing power of the currency. Therefore one can expect the

reduction of CGS due to a budget surplus to be associated with increased purchasing power of the currency.

3.10 Reduced cost of capital

The Treasury (2002: 6) says a "more desirable policy goal is to keep the cost of capital in Australia as low as possible". This statement doesn't seem to recognise that the RBA sets the Interbank rate, and can set long term rates if it so desires. If it is desirable to have lower interest rates why not lower them at once? Why not set the cash rate at zero like Japan has done? Japan keeps rates at 0 by not paying interest on reserves and net-issuing fewer CGS than would be required to offset operating factors at the Bank of Japan. Thus, operationally, a designed deficiency of CGS relative to net government spending necessarily results in a 0 bid for government funds when the central bank does not pay interest on reserve balances.

Our second response comes from Treasury itself (2002: 118) when it argues that yields on scarce CGS fall as less of them are available and their prices rise. This supports our claim that CGS issuance raises the term structure of rates, as a matter of logic.

In summary, it seems that the government is being asked to consider the benefits of CGS issuance assuming CGS lower rates, on the one hand, and then on the other, that CGS raise rates. It's hard for us to see how one can have it both ways. Additionally, our previous discussion of the distributional aspects of interest rates remains relevant.

3.11 Reduction of volatility

Treasury (2002: 5) concludes, however, that "during periods of financial instability any factor that reduces volatility may be valuable". It remains to be seen how CGS issuance contributes to reduced volatility. If anything the evidence supports the opposite, as the highest levels of volatility have been experienced in a myriad of nations with very high levels of government securities outstanding such as Brazil, Argentina, Russia, Mexico, to name but a few.

4. The real economic costs of CGS

4.1 Raising the term structure of rates

The analysis has shown that the issuance of CGS increases the term structure of interest rates which has distributional outcomes for borrowers and lenders. The link between the term structure and the real sector is not well established although it is usual to argue that the higher than otherwise rates damage investment spending. The evidence is weak (Nevile and Kriesler, 2002). Thus, we do not consider this impact of CGS issuance to be a significant real sector cost, in the range of interest rate effects that are observed.

4.2 Opportunity costs of CGS

The operation of CGS market absorbs a diversity of real resources deployable elsewhere. The real costs of any resource-using activity are measured by the opportunity costs of not using these resources in alternative activities. While this is difficult to assess in the context of an economy without CGS, some points can be made to structure the debate.

The opportunity costs in terms of the labour employed directly and indirectly in the CGS 'industry' are both real and large. The 'cottage industry firms' that characterise the CGS industry use resources for CGS issuance, trading, financial engineering, sales, management, systems technology, accounting, legal, and other related support functions. These activities engage some of the brightest graduates from our educational system and the high salaries on offer lure them away from other areas such as scientific and social research, medicine, and engineering. It could be argued that the national benefit would be better served if this labour was involved in these alternative activities. Government support of what are essentially distributional (wealth shuffling) activities allows the CGS market to offer attractive salaries and distorts the allocation system. While this labour may move within the finance sector if CGS issuance terminated, the Government could generate attractive opportunities by restoring its commitment to adequate funding levels for research in our educational institutions.

On balance, CGS markets appear to serve minor functions at best and the interest rate support can be achieved simply via the RBA's current support rate policy without negative financial consequences. We conclude that CGS markets add less value to

national prosperity than their opportunity costs. A proper cost-benefit analysis would conclude that the market should be terminated.

5. Review of options discussed by Treasury (2002)

The Treasury (2002: 75) outlines three options for the future with respect to CGS: (a) slowly winding down the CGS market; (b) "consolidating Commonwealth and State government debt markets"; and (c) "maintaining the CGS market and funding the Commonwealth's unfunded superannuation liabilities." Treasury (2002: 75) further states that "Government will not consider proposals to build budget deficits so as to create the need for new CGS issuance." We concur that the Government should not build deficits to create CGS. However, we recommend it net spends to sustain aggregate demand, but in no case issue CGS, as previously concluded in the cost-benefit analysis. We therefore support Option (a).

But Treasury (2002: 8) suggests that in the event of a negative fiscal shock, the "Government may need additional funds … [and would] … would need to assess these re issuance risks and the likely costs of having to re establish a CGS market." We see no significant costs of re-entering the CGS market, beyond the real economic costs of CGS identified in Section 4. More importantly, there is no funding imperative for CGS. In the event of future deficits, we recommend a reliance on the RBA's support rate to offset operating factors.

The second option outlined by Treasury (2002) involves the consolidation of the Commonwealth and State government debt markets. While we understand the political inefficiencies that the Federal system engenders in the form of restricted co-operation between the levels of government, we would highly recommend this option.

The Treasury's third option "is to issue additional CGS and use the proceeds to fund the Government's unfunded superannuation liabilities. This could be achieved either through hypothecating a financial asset portfolio to the unfunded liability, or through transferring CGS issuance proceeds to a superannuation fund" (Treasury, 2002: 87). The proposed issuance of CGS to purchase superannuation funds merely adds one asset to the macro economy – CGS securities, and removes another – non-government securities purchased by the government. All that is accomplished is the substitution of CGS for non-government securities in the private sector's portfolio. We also note that should the proposed superannuation fund purchase the CGS issued by the

government, the government is in fact issuing CGS and indirectly buying them back, accomplishing nothing beyond transaction fees.

Furthermore, the Commonwealth's ability to make timely payment of its own currency is never numerically constrained by revenues from taxing and/or borrowing. Therefore the purchase of a superannuation fund in no way enhances the government's ability to meet future obligations. In fact, the entire concept of government pre-funding an unfunded liability in its currency of issue has no application whatsoever in the context of a flexible exchange rate.

The misconception that 'public saving' is required to fund future public expenditure is often rehearsed in the financial media. For example, an Access Economics spokesperson said recently that we needed bigger surpluses and hoped that "the Government will be able to get the message across that that surplus and more will be chewed up by, initially, the retirement of Australia's baby boomers and then the growing healthcare costs for them as they age further" (ABC AM transcript, May 9, 2002). In rejecting the notion that public surpluses create a cache of money that can be spent later we note that Government spends by crediting an account at an RBA member bank. There is no revenue constraint. Government cheques don't bounce! Additionally, taxation consists of debiting an account at an RBA member bank. The funds debited are 'accounted for' but don't actually 'go anywhere' and 'accumulate' (see Mitchell and Mosler, 2002: 255). The concept of pre-funding future liabilities does apply to fixed exchange rate regimes, as sufficient reserves must be held to facilitate guaranteed conversion features of the currency. It also applies to non-government users of a currency. Their ability to spend is a function of their revenues and reserves of that currency.

6 Conclusion – reviewing the macroeconomic strategy

The type of reasoning underlying the Review applies to a fixed exchange rate regime. With flexible exchange rate, where monetary policy is freed from supporting the exchange rate, there is no reason for CGS issuance. This section briefly outlines the policy options that are then available.

We began this paper with the self-praise of Federal Treasurer (Treasury, 2002: iii) linking the alleged success of his Government's fiscal strategy since 1996 with the strength of the Australian economy, further stating "The Government's fiscal strategy

is to maintain budget balance, on average, over the course of the economic cycle" (Treasury, 2002: 75).

In terms of the macroeconomic priorities outlined in Section 2.3, the government's fiscal strategy has failed. The most robust fact over the last 25 years is that actual GDP growth has not been strong enough to achieve and sustain full employment given the preferences of the labour force (Mitchell and Carlson, 2001). The problem of labour underutilisation is more severe than is portrayed by official unemployment. Mitchell and Carlson (2002) show that while the official rate averaged 7.5 per cent between 1996 and mid-2002, the average total labour wastage approximated 13.6 per cent once hidden unemployment and underemployment are included. This translates directly into large output losses.

Despite the government rhetoric that the "strategy has contributed to Australia's sound macroeconomic framework and continuing strong economic performance", the recent economic growth has been in spite of the contractionary fiscal policy. Growth since 1996 has largely reflected increased private sector leveraging as private deficits have risen. Further, the recent ability of the Australian economy to partially withstand the world slowdown is due to the election-motivated reversal of the Government's fiscal strategy, which generated the first deficit in 2001-02 since 1996-97.

A return to the pursuit of surpluses will ultimately be self-defeating. For all practical purposes any fiscal strategy ultimately results in a fiscal deficit as unsustainable private deficits unwind. But these deficits will be associated with a much weaker economy than would have been the case if appropriate levels of net government spending had have been maintained. Treasurer Costello says that by running budget surpluses the government is "saving" and these "resources" are then able to be used by the private sector (Costello, 1998). The government sees a virtue in retiring net government debt. But a government surplus is an equal reduction in non-government net income and net financial assets, as witnessed by the decline in CGS outstanding. This net income and resulting net financial assets serve as the 'equity' that supports the private sector's credit structure. By removing this net income and net financial assets, Government budget surpluses undermine the credit structure, which ultimately readjusts to its reduced equity base (Minsky, 1986). The economy will only sustain high levels of output after the government realises deficits sufficiently large to restore necessary income and equity to support an expanding private sector credit structure.

Further, the Government does not require budget surpluses to retire debt. The government can retire debt at any time it wants by using the RBA's support rate rather than CGS for interest rate support when it spends (credits member bank RBA accounts) more than it taxes (debits member bank RBA accounts). Additionally, the RBA always has the open option to purchase and thereby retire remaining CGS outstanding. Again, this simply exchanges one private sector asset, CGS, for another, RBA member bank balances. While net taxation revenue will also retire debt, we repeat that this will ultimately not reduce cumulative government deficit spending and therefore in the long term not retire debt.

We close by repeating the basis lesson of macroeconomics. Firms produce to meet expected spending. All output will be sold if spending equals the sum of all income. If an agent spends less than its income, output will go unsold unless another agent goes into debt and buys that output. If there is a generalised net desire to save – output will go unsold and the stock buildup will lead to declining production and employment. The reverberations of the lost incomes generate a downward spiral in output. In this situation, the economic outcome depends entirely on the policy response by government. If demand for private production falls but people still desire to work then there is no valid reason not to switch them to public goods production until private demand recovers. Unemployment results when the policy response inhibits this switch. Surprisingly, most commentators and public officials fail to realise that the unemployed, supported by welfare measures, are already 'in the public sector'. A sensible policy response would utilise this capacity to both attempt to produce socially beneficial outputs, and reduce socially detrimental reactions to unemployment.

In this regard, we have proposed to let market forces determine the level of government deficit spending. A fixed-wage Job Guarantee (JG) policy can attenuate any tendency towards financial instability and provide the 'switch' between private and public sector employment over the business cycle (see Mitchell, 1998; Mitchell and Mosler, 2002), as well as provide an 'anchor' effect to the price level. We find it ironic that during a time of heightened appreciation of market forces, the option to let market forces determine the size of the fiscal deficit has not been open to discussion. But we do not find it surprising, as the presumed fixed exchange rate assumptions and restrictions take precedence.

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