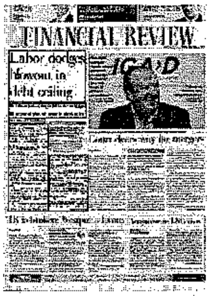
FINANCIAL REVIEW
Labor dodges blowout in debt ceiling

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Labor dodges blowout in debt ceiling

- Takes advantage of bond windfall
- Internal stoush over budget cuts

Pip Freebairn and **David Crowe**

The Gillard government may avoid breaching the $250 billion borrowing cap set by Parliament, thanks to decisions by the Treasury agency that borrows for the government.

Just six months after it increased the debt ceiling by $50 billion, Labor is again at risk of breaching the cap as it borrows to fund this year's $37.1 billion budget deficit.

But decisions by the Australian Office of Financial Management, which sells the bonds, have helped limit the rise in government debt when measured by its face value, even as the amount it raises from bond auctions soars.

The concerns over the debt ceiling come as Labor faces an internal row over its plans to return to surplus in the face of a weakening global outlook, and doubts from economists that it could return to surplus next year.

The party's Left faction will use the ALP national conference this weekend to urge a policy change to accept a deficit next year, if one is needed to protect growth and employment.

But Treasurer Wayne Swan stood by the forecasts in the mid-year budget update on Tuesday and insisted on the need to bring forward spending on infrastructure to support jobs, a funding shift the Coalition described as "trickery" to support the surplus.

Mr Swan also defended plans to cut funding to government departments, and said the $1.5 billion saving would not lead to forced redundancies, as unions stepped up their warnings of 3000 job losses.

Concerns that Labor could breach its debt ceiling come just six months after the government asked Parliament to raise its borrowing limit for the second time.

Interest rate strategists as well as those within government departments predict the debt ceiling will be breached again within the next few

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Debt ceiling blowout dodged

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years. UBS interest rate strategist Matthew Johnson estimated the government would need to issue $18 billion in bonds this financial year to keep pace as well as $9 billion, $6 billion and $4 billion in the subsequent three years.

Added to the $219 billion in bonds on issue at the moment, that would take the debt to about $256 billion and breach the debt ceiling.

But sources familiar with the Australian Office of Financial Management say it is issuing bonds in a particular way that could keep the face value of the bonds below the cap, sparing Labor from a political fight.

The AOFM is reportedly choosing to issue bonds that will minimise the face value – or the amount of debt ceiling used – by taking advantage of the fall in bond yields as investors around the globe have raced into the safety of bonds. Global central banks have been attracted to Australian bonds given the relatively low debt position of the government.

An example was yesterday's tender of $700 million of April 2023 bonds with a nominated interest rate of 5.5 per cent. The recent fall in bond yields around the globe means that investors were attracted to the bonds and were willing to pay $789 million for those bonds. Only $700 million will count towards the debt ceiling.

The debt ceiling triggered a political row earlier this year when Labor passed legislation to raise the cap to $250 billion, thinking that would be sufficient for future bond issues.

A spokesman for Mr Swan said it would not be necessary to raise the debt ceiling again because it was determined by the face value rather than the market value of the bonds.

Government sources insisted there was no instruction to the AOFM to adjust the way it issued securities and that any change in the impact of the bond program was the result of a shift in the market, with strong demand for Australian sovereign debt.

Another factor behind the AOFM issuance decisions was to take advantage of the lower yields, for instance by issuing a 12-year bond at an interest rate of 4 per cent. "You'd be mad not to do it," said one person familiar with the bond market developments.

Opposition finance spokesman Andrew Robb said yesterday any move to raise the ceiling would trigger a policy debate in Parliament over Labor's deficit and debt.

"Crashing through the debt ceiling, or nearly crashing through it, amply demonstrates that Labor has lost control of Australia's finances," he said.

"This would be a board's worst nightmare if they had a chief executive running amok like this, making predictions which aren't realised.

"To be this close to the wind within five or six months of bringing down the budget and raising the debt ceiling beggars belief."

Mr Robb said he would confer with his colleagues about whether to vote for or against any further increase in the cap, but said he was mindful of the responsibility to keep funding available for government operations.

UBS's Matthew Johnson said that in recent bond issuance, the government was raising $118 in cash for $100 of face value or debt ceiling. But he cautioned that the AOFM's practice involved issuing bonds with long maturities, which meant that it would pay a higher interest rate on the debt than it would if the bonds matured between 2013 and 2015.

"They are in the short term raising the average cost of debt by doing this," he said.

"But I happen to think it's cheap insurance. I think it's worthwhile having a longer maturity profile than a shorter one."

He said that amid fears about contagion from Europe, it made sense to issue bonds with long maturities.

"This is one of those happy occasions when the politics are driving them to do something sensible," Mr Johnson said.

But Westpac chief interest rate strategist Damien McColugh said one of the roles of the AOFM was to meet the demand of those banks that served as market makers that ensured a liquid and functioning bond market. Demand for yesterday's bond issue was the lowest since 1996.

"I think global investors are going to want commonwealth government securities regardless, but there is a definite preference for shorter maturities which are preferred to long-term bonds."

The most popular bond the AOFM has issued this year has been January 2018, which it has tendered at auction seven times since July 1, raising a total of $4.9 billion.

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How the bond deal works