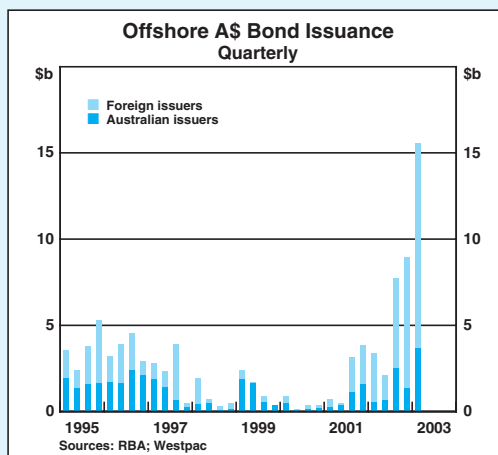


Box D: Offshore Issuance of Australian Dollar Denominated Bonds

The first quarter of 2003 saw unprecedented offshore issuance of Australian dollar denominated bonds. In total, \$15.5 billion of Australian dollar Eurobonds were issued, about three times the quarterly average of the previous year. Three-quarters of the bond issues were by non-Australian borrowers (Graph D1), and approximately two-thirds of the bonds were sold to Japanese retail investors in the so-called *uridashi* market (Graph D2).

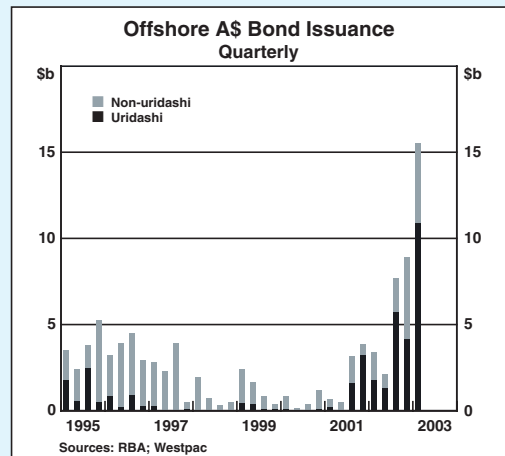
The strong offshore demand for Australian dollar bonds reflects the relatively high yield on Australian bonds and the perceived undervaluation, and expected appreciation, of the Australian dollar. The historically low interest rates in Japan have made Australian dollar bonds particularly attractive to Japanese retail investors.

Graph D1



The strong demand by offshore investors has allowed borrowers issuing bonds offshore to obtain cheaper funding than would have been available had they issued bonds in the domestic market. Indeed, a number of highly rated borrowers have issued *uridashi* bonds at lower yields than those prevailing on

Graph D2



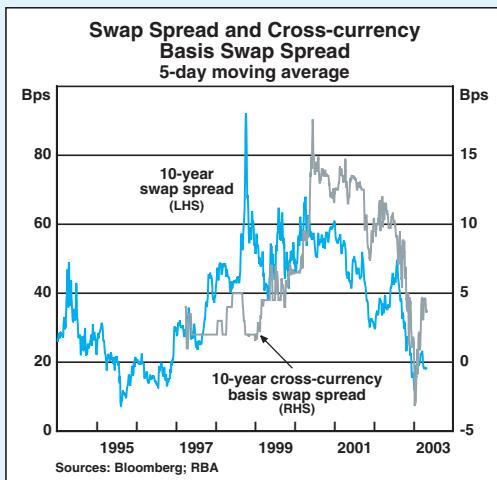
Australian government bonds. Even after the additional costs incurred in marketing an issue through the retail network of a Japanese broker are taken into account, *uridashi* funding has been cheaper than other forms of Australian dollar denominated finance. Consistent with this, there has been some substitution away from the domestic bond market, particularly by highly-rated non-resident borrowers.

Many issuers of fixed-rate bonds (which includes most Australian dollar Eurobonds) look to swap the fixed interest rate into a floating interest rate. In addition, non-resident issuers may also look to swap the proceeds into their domestic currency.¹ With Australian dollar bond issuance by non-residents rising sharply in recent months, there has been a commensurate increase in swap market activity which has had an impact on rates in the swap markets.

The increased volume of offshore Australian dollar bond issuance has increased the demand to receive fixed interest in the domestic interest rate swap market, causing the swap rate to decline. The

downward pressure has flowed through to government bond yields as the swap counterparties, in turn, have hedged their interest rate risk by buying government bonds. This effect has been less marked than the effect on the swap rate, so the differential between the swap rate and the government bond yield (the ‘swap spread’) has fallen (Graph D3).

Graph D3

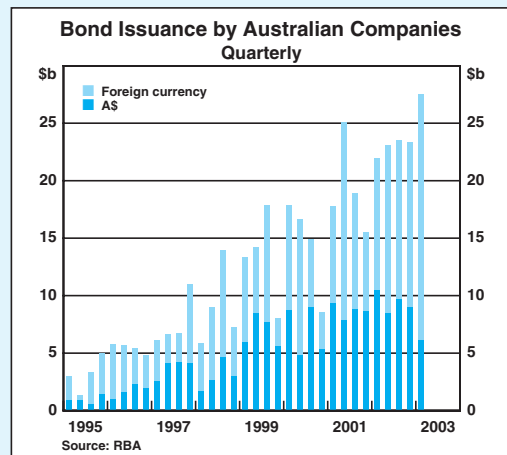


Similarly, strong issuance by non-Australian borrowers has affected pricing in the cross-currency swap market. Historically, there has been more demand for swaps where the counterparty pays an Australian dollar interest rate and receives a US dollar interest rate than the other way round. The balance of demand stems in part from the smaller size of the Australian dollar market relative to that of the US dollar. As a result,

the counterparty paying the Australian dollars generally has had to pay a small premium (known as the “basis swap spread”) over the Australian floating rate. Increased demand from *uridashi* and other Eurobond issuers to pay US dollars and receive Australian dollars in the first quarter of 2003 caused the basis swap spread to decline to the point where it became negative, although it has subsequently recovered somewhat.

Other things equal, the decline in the basis swap spread has made it more attractive for Australian borrowers to issue in foreign currency and swap the proceeds into Australian dollars than to borrow in Australian dollars. Consistent with this, the first quarter of 2003 also saw record foreign currency issuance by Australian companies. At least some of the issuance appeared to be substitution away from Australian dollar bonds (Graph D4). ↗

Graph D4



1. An *interest rate swap* agreement can be used to convert a fixed-rate obligation into a floating-rate obligation (or vice versa). An issuer of a fixed-rate bond entering into an interest rate swap contract agrees to pay the floating Australian dollar interest rate to the swap counterparty on a regular basis (e.g. semi-annually). In return, the issuer receives the fixed swap rate, which is then used to pay the bond coupons. A *cross-currency swap* transforms the currency denomination of a debt obligation, for example from Australian dollars into US dollars. Analogous to the interest rate swap, the borrower makes regular payments of the US dollar floating interest rate and receives the Australian dollar floating interest rate. In addition, the Australian dollars obtained via the bond issue are exchanged for US dollars at the beginning of the agreement and re-exchanged at a pre-determined exchange rate at the expiry of the contract.