Box E

Yields on Sovereign Debt

In recent months, interest rates on Australian government securities have declined to historically low levels. The yield on 10-year Commonwealth Government securities (CGS), for example, is around its lowest level in more than 60 years. This is indicative of the overall interest rate structure in Australia – the overnight cash rate is currently at 3.75 per cent, with market participants expecting further declines. Anchored by the low policy interest rate, and in line with global developments, bond yields for a range of issuers including the states and territories and many corporate issuers are also at historically low levels.

A standard benchmark for comparing yields on debt securities is the interest rate swap curve. Interest rate swaps are contracts whereby one party exchanges fixed (swap) rate payments on a notional amount for receipts determined by a floating (or reference) rate applied to the same amount. Within the Australian market, bank bill swap reference rates (BBSW) are generally used to determine floating rate payments. For example, a 5-year floating rate corporate bond may pay a coupon every six months where that coupon is set at a specific margin above (or below) 6-month BBSW.

Table E1 shows yields on a range of sovereign debt, as well as spreads on sovereign debt when swapped against 6-month interbank rates in the respective local currencies. For most countries the absolute level of yields is lower than for Australian government debt reflecting the abnormally low interest rate structures prevailing in these currencies. Relative to swap rates, however, yields on Australian government debt are noticeably lower than in other countries.

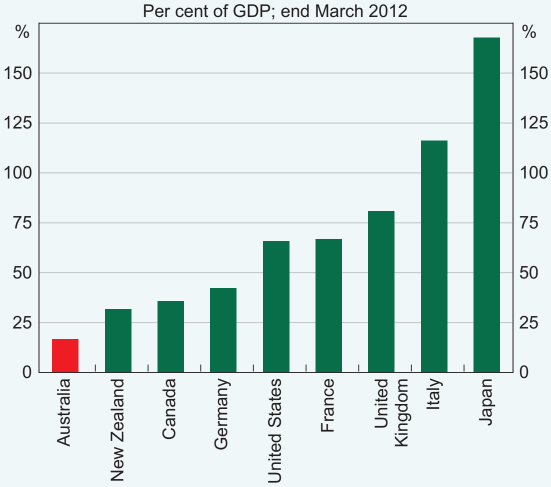
Several factors are likely to have contributed to this outcome. First, although the supply of CGS has expanded significantly since 2008, the level of debt issued by the Australian Government remains very low by international standards (Graph E1). The Australian Government also has a AAA credit

Table E1: 10-year Government Bond Yields
2 May 2012

	Credit rating[a]	Yield	Spreads to swap
		Per cent	Basis points
Australia	**AAA**	**3.64**	**–83**
Canada	AAA	2.02	–43
Germany	AAA	1.61	–52
United Kingdom	AAA	2.05	–32
France	AA+	2.96	82
New Zealand	AA+	3.71	–25
United States	AA+	1.93	–13
Japan	AA-	0.89	–2
Italy	BBB+	5.53	324

(a) Minimum long-term local currency issuer rating from Moody's, Standard & Poor's and Fitch
Source: Bloomberg

Graph E1
Gross Central Government Debt Securities
Per cent of GDP; end March 2012



Sources: Agence France Tresor; AOFM; Bank of Canada; Deutsche Finanzagentur; IMF; Ministry of Economics and Finance Italy; Ministry of Finance Japan; New Zealand Debt Management Office; United Kingdom Debt Management Office; US Department of the Treasury

rating with each of the three major ratings agencies (for both local and foreign currency issuance) while many other sovereign issuers have been downgraded in recent years. This status appears to have attracted new international investors to the market, such as central banks and sovereign wealth funds. As at the end of 2011, 75 per cent of CGS were held by non-residents, up from 60 per cent five years earlier. To date, the strong demand for CGS relative to their supply seems to have only brought about a reduction in yields and does not appear to have impaired trading conditions within the market, which remains very liquid.