Submission
No 1

INQUIRY INTO DEBT RETIREMENT FUND

Name: Mr Christopher Joye

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Dear Director,

Pls find enclosed multiple articles that I have written on the Debt Retirement Fund, which you should consider in your view.

Christopher Joye

NSW's NGF makes taxpayers the losers, TCorp fundies the winners

The plan to turn NSW's balance sheet into a large leveraged hedge fund doesn't add up.

Christopher Joye
Aug 13, 2021 – 11.33am

What do you get when politicians hire bankers to run their treasury and fund managers to lead their debt issuance agency? A public balance-sheet that starts resembling a leveraged equity hedge fund: the pollies are persuaded to divert tens of billions of dollars of taxpayer revenue into shares and other high-risk strategies, funded by a huge increase in debt.

The winners are the former fundies paid handsomely to run the money at the debt issuance agency, and the managers they farm the cash out to, collectively reaping over $150 million annually in fees on the billions of dollars of taxpayer capital they oversee. The bankers also make out like bandits as advisers on all the debt issues.

The losers are taxpayers who bear the downside of having their balance sheet leveraged up to the gills with stocks and other high-risk strategies that can blow up in any recession or external shock, dramatically increasing the fiscal hazards they face. Pity the poor future generations that have to pick up the tab when interest rates normalise, crushing the value of all asset-classes as discount rates climb.

NSW Treasurer Dominic Perrottet took a different approach to managing the state's money at the 2021 NSW budget. ***Dominic Lorrimer***

The Australian Financial Review's John Kehoe observed that this is similar to the "moral hazard" Macquarie Bank succumbed to during the global financial crisis, when it borrowed $13 billion of government-guaranteed money and embarked on a huge "carry trade" by gambling this cash on foreign junk bonds. The premium yields on these securities came with the risk that had they defaulted it could have blown up the bank, leaving taxpayers to foot the bill.

That is precisely the problem NSW Treasurer Dominic Perrottet confronts. Back in 2018 the widely admired Perrottet had an inspired idea: the NSW budget was running a circa $4 billion surplus and its balance sheet reported negative net debt.

To his immense credit, Perrottet announced that he was creating a rainy-day fiscal buffer called the NSW Generations Fund (NGF), which would have two subsidiary funds. The first, known as the Debt Retirement Fund (DRF), has the sole legislated purpose of "reducing the debt of the state".

The DRF has to be run in a way that maintains NSW's AAA credit rating and lowers the cost of taxpayer debt. It also has to be fair on future generations, or "intergenerationally equitable".

'Not an investment business'

There was no reference at all to growing the Debt Retirement Fund's assets forever to act as an offset against gross debt (or to reduce net debt). There was certainly never a plan to materially increase taxpayer debt to allow Perrottet to funnel even more money into the NGF in the hope that by punting this on risky strategies that earn more than 4.5 per cent above inflation (over 7 per cent annually), the NGF could outperform the cost of NSW's debt.

As former treasurer and federal Future Fund boss Peter Costello has argued, that's a crazy idea. The Future Fund was seeded by budget surpluses and privatisations: inflows halted once the budget plunged into deficit during the GFC.

Costello anticipated Perrottet's problems, writing that because governments can borrow more cheaply than anyone else, "on a long-term basis it should not be difficult to exceed the long-term [government] bond rate" by gambling on riskier assets.

"Taken to its logical extreme, this process could enable the government to become an investment business. But a government is not an investment business, and we were not doing this as a money-making scheme."

Where would you stop? Why not issue infinite amounts of debt and buy all the equities in the world?

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NSW government is not playing at the Wolf of Wall Street

Perrottet clarified this week that the only purpose of the DRF is "is to help *retire* debt and guard against intergenerational budgetary pressures".

When launching the fund in 2018, Perrottet said governments have an obligation to leave finances in a better position for future generations – the new NGF would secure the State's finances. "We owe it to our children to prepare for the challenges they will face in the decades to come, not saddle them with debt," Perrottet said.

Yet his advisers had other ideas in mind, as we will see shortly.

The NGF has a second subsidiary fund, called the Community Services and Facilities Fund, which Perrottet promised would pay for local infrastructure under a "My Community Dividend program". More specifically, Perrottet said that "up to half of the investment returns [from the NGF] will enable the new My Community Dividend program".

Under its legislation, this second fund's sole purpose is to "provide funding for cost-effective facilities and services throughout NSW".

In practice, Perrottet's advisers have spent virtually nothing on infrastructure, with almost all the NGF's returns kept inside the DRF.

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NSW not ‘punting on equity markets’, Perrottet says

In seeding the NGF, Perrottet initially put $3 billion of budget surpluses into it, combined with $7 billion from the sale of the first half of WestConnex. The second half will be sold next month, reaping NSW taxpayers as much as $13 billion. All this money is going into the NGF.

Perrottet explained that “proceeds from any potential [WestConnex] transaction will be invested into the NGF and allow us to continue to build world-class infrastructure such as the Metro West train line from Sydney to Parramatta”. He repeated that promise this week.

Speaking to *The Sydney Morning Herald*, Perrottet said “our priority is providing the schools, hospitals, roads and rail NSW needs”.

“The Government’s asset recycling strategy has enabled us to do that and create tens of thousands of jobs in the process.”

Anyone reading that would believe the WestConnex money is going to fund new infrastructure construction. But it’s not clear it will pay for one cent.

The second half of the WestConnex tollway business is due to be sold. ***Dean Sewell***

To date, Perrottet’s promises have not been met. And experts like former NSW parliamentary budget officer Dr Stephen Bartos believe the NGF’s Debt

Retirement Fund and Community Services and Facilities Fund (CSFF) have been used in a manner that conflicts with both Perrottet's and the legislation's intent.

The DRF has not retired a single cent of taxpayer debt, despite the fact the budget has been punching out record deficits and debt has exploded from $35 billion in 2018, when the DRF was created, to a record $120 billion this financial year.

Even more remarkably, Perrottet's advisers want to direct over $10 billion of taxpayer revenue to the DRF, and $20 billion in total to a range of investment funds with the TCorp, which has to be replaced with taxpayer debt because NSW is in deep deficit. They have already done this, shifting $2 billion of revenue into the DRF in October 2020, which was debt-funded due to the record deficit.

So the DRF is perversely contributing to significantly increasing NSW taxpayer debt, not reducing it, because of the revenue it is hijacking at a time when NSW's budget is in the red.

This is exacerbated by the fact that NSW has yet to use any of the DRF's $15 billion, which will rise to more than $27 billion once the second half of Westconnex is sold, to pay for the unprecedented $108.5 billion of infrastructure Perrottet has committed to build. Because the former fundies and bankers running NSW want to keep all this money in TCorp's funds, NSW has to raise more debt to replace it.

Since 2018, the NGF's CSFF has funded a grand total of $19.7 million of community infrastructure. Perrottet this week boasted that the NGF had made $2.8 billion of returns since 2018 (it actually lost money in 2020), and yet his previous promise that up to half of this, or $1.4 billion, would flow into local infrastructure remains missing in action.

So why has the NGF run off the rails? What is Perrottet going to do about it? And why do I care?

Since 2018, the only people profiting from the NGF appear to have been the fund managers running it. NSW's debt issuance agency TCorp is a private, for-profit entity that made a $75 million profit in 2020, and is led by former fund managers.

TCorp is paid by NSW to run the NGF's $15 billion-going-to-$27 billion, which represents a material share of both TCorp's funds and the asset management fees that are used to pay TCorp's executives.

TCorp has a theoretical interest in keeping all the money in the NGF, and not paying back NSW debt, which would result in TCorp losing substantial fees, or the NGF funding new infrastructure, which would also see the money walk out TCorp's doors.

TCorp's 184 executives were paid a chunky $53 million in 2020, and can earn significant bonuses, which are influenced by TCorp's profitability. The more money TCorp manages, the more revenue it captures, the more salaries and bonuses TCorp can afford to pay its staff and (many) high-flying board members.

Future Fund chair Peter Costello says Dominic Perrotet's strategy doesn't add up. ***AFR***

TCorp is paid to both manage NGF money in-house and to choose the global fund managers that it farms the remaining cash to. There are many hands in the till capturing what would be total fees of more than $150 million per year on the NGF's $15 billion, going to over $270 million per year once the $13 billion from WestConnex is put into TCorp's kitty.

TCorp also runs NSW's debt issuance. That means TCorp issues NSW government bonds, and, alongside the bankers leading NSW Treasury, are key advisers to Perrottet on his debt strategy.

At the official lunch outlining NSW's 2022 budget, TCorp's CEO, a former funds management executive, advised his surprised audience that NSW could issue as much debt as it wanted to as long as the returns on the NGF's portfolio beat the cost of this funding. It sounded like Peter Costello's worst nightmare.

NSW had shocked markets with its proposal to issue $35.5 billion of debt in 2022, 50 per cent more than it did in the COVID-induced recession in 2021, and a similar burden to the total debt issuance of the other Australian states combined.

About $7.2 billion of that money was for funding investments in TCorp funds, with another $12 billion slated over the next three years. That's almost $200 million in asset management fees.

Risky business

The tripling of NSW government gross debt since 2018, partly driven by the refusal to use the DRF's savings to retire debt and expectations of explosive debt increases, resulted in NSW losing its prized AAA credit rating in December in conflict with the NGF's legislated goals.

The interest spreads on NSW government debt have soared, and are now for the first time higher than all the other major states because of NSW's debt funding shock undermining another key NGF objective.

NSW's use of the NGF directly increases fiscal risks in all downside scenarios, and only reduces risk if we assume equities always go up. In a recession when equities and other risky assets are clobbered 30 per cent to 60 per cent, NSW's net debt will spike by many billions, increasing its debt servicing costs, and threatening its credit rating.

It's preposterous that NSW taxpayers should load up on equities when valuations are at 100-plus year highs precisely because interest rates are at record lows. As Dr Bartos has shown, it is also intergenerationally inequitable to leave future taxpayers with the risk of servicing all this debt when interest rates inevitably normalise and equities valuations correspondingly decline as discount rates rise.

The encouraging news is that Perrottet has signalled he will course-correct NSW Treasury and TCorp following criticisms from Standard & Poor's, banks such as CBA and NAB, former treasurer secretaries, sovereign wealth fund bosses, current and former state government debt agency heads, the bond market, and [NSW's impressive shadow treasurer, Daniel Mookhey](#).

This week Perrottet said he was diverting the $13 billion in WestConnex sale proceeds to the NGF to "allow us to continue to build world-class infrastructure". Let's hope that means the DRF will buy a $13 billion bond issued by TCorp, which it is permitted to do, to allow NSW to use that money to pay for new infrastructure and COVID-19 spending, reducing NSW's external debt issuance by the same amount.

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Perrottet further revealed that "in light of the mounting challenges faced by the NSW economy and budget, we'll continue to review our NGF strategy", particularly in respect of its "optimal fund size and debt clearance" to ensure it is "working to the benefit of current and future generations".

This extends his comments earlier in the week that the NGF's strategy could "adapt" to allow NSW to "choose to pay down debt in some years".

Perrottet will likely dump the $7.2 billion of debt funding his advisers proposed this year for TCorp's funds, and the additional $12 billion over coming years. And it is equally easy for Perrottet to have the DRF retire debt and/or buy new NSW bond issues to fund his COVID-19 spending needs.

After all, his "rainy day" fund's hurricane has arrived. In fact, if he committed all the DRF's $27 billion to replace past and future debt issuance, he would be a good chance of recovering his lost AAA rating.

Perrottet in Parliament: borrowing to buy shares.

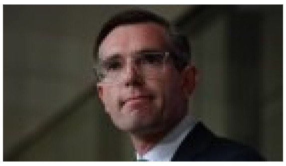
Perrottet did retort that diverting taxpayer revenues into TCorp funds, and replacing that cash with extra NSW debt, is not borrowing to gamble on stocks. While the likes of S&P and CBA disagree, Perrottet claimed that "by that logic, anyone who borrows money to buy a house while topping up their super is also 'effectively' borrowing to invest in the stock market".

The correct analogy would be a person with expenses greater than their income, running negative cash flows (or a deficit). While no bank would lend to this person, if they *did* borrow to buy a house, and further topped up their super, they would be replicating the current NGF strategy.

No financially literate person would actually do this, and in the real world they'd be lodging a hardship application with their super fund to withdraw money, as Perrottet should be doing with the DRF.

My interest in this matter is that we lend billions to governments – including the Commonwealth and the states – companies, and banks, and require them to behave in a manner that meets our strict environment, social and governance (ESG) expectations.

The proposal to voluntarily boost NSW's debt burden by some $20 billion to $47 billion to punt on stocks via a "pay fund managers forever fund" is a serious ESG concern, specifically around potential governance dysfunctions. We cannot have the "heads fund managers and bankers win, tails taxpayers lose" moral hazard in play.



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[NSW Generations Fund is a moral hazard]

While the market has rationally priced in NSW's reckless behaviour via much higher interest rate spreads on its debt, which we and other investors are happily capturing after wearing a price adjustment in June, our governance expectations are not-negotiable.

This is not easy to publicly advocate. TCorp manages over $100 billion in assets and is one of the five largest feeders of fund managers in the land. I've been warned by my investors that speaking out will mean we never have a chance of winning TCorp mandates. I've also been warned by many banks that TCorp will discriminate against us in future bond issues. But activism is never easy.

Perrottet knows what he needs to do: deliver on his brilliant, original vision of building a rainy-day fund to reduce future debt and fiscal risk, and seriously question the dodgy advice he has been rendered in the past.

Christopher Joye is a contributing editor who has previously worked at Goldman Sachs and the RBA. He is a portfolio manager with Coolabah Capital, which invests in fixed-income securities including those discussed in his column. *Connect with Christopher on Twitter*.

NSW is degenerating into one of the worst run states in Australia

NSW promised to spend $15 billion on infrastructure and debt repayments that it is instead gambling on global financial markets.

Christopher Joye
Jun 24, 2022 – 11.03am

After 12 years of Liberal leadership, encompassing four premiers and four treasurers, NSW is sadly degenerating into one of the worst run states in Australia.

Since Premier Dominic Perrottet was appointed NSW treasurer in January 2017, he has presided over an unprecedented, $106 billion surge in taxpayer debt. That means Perrottet and his fierce internal rival, Treasurer Matt Kean, will have saddled NSW residents with $13,000 of extra debt per person. One day, that debt has to be repaid.

NSW Premier Dominic Perrottet promotes himself as the great "asset recycler". ***Rhett Wyman***

In the budget this week, Kean revealed that NSW debt will have exploded from the relatively modest $55 billion that Perrottet inherited as treasurer in 2017 to a difficult-to-comprehend $160 billion by June next year.

If the annual interest rates on this debt converge to current levels around 4.2 per cent, NSW taxpayers will be paying almost $7 billion a year in interest alone. Put differently, NSW residents will be spending the equivalent of seven new hospitals each year in interest.

It is ironic that supposedly imprudent Labor leaders are running rings around NSW. Resource-rich states such as Western Australia and Queensland have reported budget surpluses, which has allowed them to slash debt issuance as the economy rebounds post-pandemic.

Even Victoria is starting to look more fiscally conservative. In the coming financial year, NSW will issue twice as much debt as Queensland, one-third more than Victoria, and about six times more than Western Australia. It is also more than quadrupling South Australia's debt supply.

Kean has blown a $7.1 billion improvement in NSW's budget with $8.8 billion in new spending next financial year alone.

This means that NSW will issue almost $10 billion more debt in the 2023 financial year than it did in 2022 when the budget was smashed by COVID-19.

On one view, Perrottet and Kean are figuratively stealing from future generations to bribe the current one to allow them to remain in power.

While some of this debt was unavoidable because of the pandemic, Perrottet's government increasingly resembles a degenerate gambler, addicted to spending money they don't have.

As a lender to the state, my worry is that this tale of mismanagement gets worse. It seems as though Perrottet's government has been systematically misleading taxpayers.

The 39-year-old premier promotes himself as the great "asset recycler".

Perrottet claims he is selling taxpayer-owned infrastructure to invest this money in new infrastructure. It seems, however, that Perrottet has sold billions of dollars of NSW infrastructure only to pay his mates extraordinary sums to gamble this money on global markets.


NSW's debt burden has ballooned. ***Oscar Coleman***

WestConnex proceeds go into speculative fund

When Perrottet sold the first half of Sydney's WestConnex motorway in 2018, he told us that the $9.3 billion in proceeds would be used to "fund the vital M4-M5 Link - the final stage of WestConnex – and contribute to future infrastructure projects across NSW".

"We are not only funding the completion of the congestion-busting WestConnex but injecting billions more towards critical projects like new schools, roads, public transport and hospitals," he said.

"[Labor] opposed this sale, which has allowed us to get on with the job of not only funding the vital M4-M5 Link, but has given us billions more to continue to build the infrastructure NSW so very badly needs."

But, as it turns out, this was untrue. Instead of funding new infrastructure, Perrottet took $7 billion of the $9.3 billion in WestConnex proceeds and put it in a speculative investment vehicle called the NSW Generations Fund. Technically, the money was actually allocated to a subsidiary fund inside the NGF called the Debt Retirement Fund.

Since 2018, not a single cent of the $7 billion has been used to pay for infrastructure.

Instead, it has been gambled on stocks and illiquid junk bonds, among other risky assets. Amazingly, this has involved lending money to Russia ($75 million), Saudi Arabia ($45 million), China ($225 million), UAE ($15 million), Cayman Islands ($30 million) and Angola ($15 million).

Perrottet might have actually *indirectly* helped build Russian President Vladimir Putin's new palace rather than NSW roads, schools or hospitals. (Since we expressly warned this was nuts last year, NSW has had to write-off $30 million of the money it lent to Russia.)

The NGF is managed by Perrottet's pals in NSW's investment arm, which is called TCorp. Last financial year, Perrottet and TCorp tried to take this misadventure one crazy step further: they wanted NSW taxpayers to take on tens of billions in extra debt to expand TCorp's gambles on global stocks and other high-yield (risk) assets.

The explicit goal, which TCorp acknowledged, was the hope that stocks and junk bonds paid higher returns than the cost of NSW debt. In other words, they wanted to put on a "leveraged carry trade".

This column and others, including former NSW Treasury secretary Rob Whitfield, who resisted the idea when it was being developed, and NSW shadow treasurer Daniel Mookhey, told Perrottet to dump the proposal, which had the potential to blow up the state's finances.

After months of moral suasion, Perrottet relented. And thank heavens: global equities have since crashed up to 30 per cent while the interest rates on NSW debt have almost quadrupled from 1.3 per cent last year to 4.3 per cent this year.

Yet in 2022, NSW taxpayer's $7 billion still sits in the NGF. It is still invested in listed equities, private equity, and junk bonds. And it has lost money in 2022 (as it did in 2020) as markets have tumbled.

In fact, since its 2018 inception, the NGF has now formally failed to meet its own performance benchmark of a return in excess of inflation plus 4.5 per cent.

The question is who has benefitted from this scheme? Who has a vested interest in it? Unsurprisingly, it is the folks punting the money. That is, TCorp.

The NGF represents about 15 per cent of TCorp's assets. Former Perpetual chief executive David Deverall, who runs TCorp, has been desperate to turn it into a global asset manager, and aggressively grow its capital.

While TCorp blames NSW Treasury for the now-discarded plan for NSW to issue tens of billions in extra debt to enable TCorp to speculate on markets, the truth is that TCorp is the entity that benefits directly.

Across TCorp's 180 staff, the average compensation cost in 2021 was a staggering $323,000 per person. That is almost double the average pay of the Reserve Bank of Australia's 1300-plus employees.

The NGF is currently worth $15 billion, partly because it has been bolstered by the asinine decision to divert billions of NSW taxpayer royalties and income to it, and due to a debt-funded transfer of more than $2 billion to the fund in 2020, despite the NSW budget being in record deficit.

Strategy draws widespread criticism

This revenue had to be replaced with extra NSW debt, which explicitly contradicts the legislated objectives of the Debt Retirement Fund. These focus on three goals: maintaining NSW's AAA rating, which Perrottet lost in 2020; reducing the cost of NSW borrowing, which has soared; and repaying NSW debt.

After widespread criticism last year, NSW suddenly stopped diverting taxpayer revenue to the NGF and then belatedly committed to using $11 billion from the sale of the second half of WestConnex in 2021 to repay taxpayer debt.

Yet Perrottet and Kean still refuse to invest the original $7 billion from the sale of the first half of WestConnex in 2018 into the infrastructure they promised.

They also refuse to use this money, and the NGF's remaining (partly debt-funded) $8 billion, to meet the Debt Retirement Fund's legislated mission of repaying taxpayer debt.

We can quantify the cost of this madness: Perrottet and Kean would rather NSW taxpayers spend $630 million a year in extra interest on the $15 billion in new debt they will issue next year (but could have avoided) just to allow their TCorp pals to gamble this money on markets.

To be fair to Kean, this was never his idea. In fact, left to his own devices, Kean would get rid of the NGF. Asked about it during the week, Kean prudently stated he would "always act in the best interests of all NSW taxpayers", leaving every option on the table.

TCorp has told him that repaying debt now would force a "fire sale" of the NGF's assets, which should be avoided at all costs. But they would say that.

Every dollar of NGF money that leaves TCorp means NSW is paying less in fees to TCorp to run the money, which makes it harder to pay every person at TCorp $323,000 a year, on average.

If they had sold the assets in 2021, as we proposed, they would have done so at the top of the market. The ongoing risk is equities fall further as rates continue to climb, costing NSW taxpayers billions in losses.

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This reckless NSW budget is a gob-smacking spendathon

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Our interest in this matter is that as a fund manager, we lend money to all Australian states, including NSW. And we expect them to behave ethically from an environmental, social and governance perspective (specifically the "g" or governance).

The huge ESG issue at the heart of the NGF – whereby NSW taxpayers have to pay $630 million a year in extra interest to allow TCorp to continue to punt their money—is unacceptable to all stakeholders.

Kean says he cares about ESG concerns. Time will tell if this is actually true. **Christopher Joye** is a contributing editor who has previously worked at Goldman Sachs and the RBA. He is a portfolio manager with Coolabah Capital, which invests in fixed-income securities including those discussed in his column. *Connect with Christopher on Twitter*.

States need fiscal revolution to avoid debt bomb

NSW Treasurer Daniel Mookhey is laying the groundwork for a revamping of state government finances.

Christopher Joye
Apr 21, 2023 – 12.51pm

At a time when the global economy could be heading for a recession, and Australia risks following suit, it is particularly disappointing that some of our state governments have done such an awful job preparing a buffer for this downturn.

There is, sadly, a chance that the Commonwealth's budget deficit this year will actually be smaller than those reported by NSW and Victoria (notwithstanding that all three budgets will materially outperform their original forecasts).

Daniel Mookhey seems deeply committed to fiscal reform and making NSW a stronger and more viable place to live and work. ***Dominic Lorrimer***

The good news is that the election of Chris Minns' government in NSW appears to be heralding a revolution in fiscal responsibility that has otherwise been missing in action in Australia's two largest states since the advent of the pandemic.

Egged on by the Reserve Bank of Australia promising not to raise interest rates until 2024, the states were encouraged to borrow and spend aggressively. But it turned out that rates did, in fact, start rising at an unprecedented pace in May last year. And given the strongest inflation in more than 30 years, it has proved to be the worst possible time to be building infrastructure.

In 2016, the budgets of NSW and Victoria were in surplus (NSW delivered another one the next year). In 2018, Victoria had just $46 billion of total government debt; NSW taxpayers owed only $58 billion.

In that year, then-NSW treasurer Dominic Perrottet had the prescient idea of setting aside his surpluses and any asset sales in a rainy-day Debt Retirement Fund (DRF), held within his newly established NSW Generations Fund (NGF). This was to be managed by NSW's investment arm, TCorp.

Under the NGF's legislation, the DRF would be used to reduce NSW's gross debt to protect the state's AAA rating and to alleviate the interest bill that taxpayers have to pay. Through consistent budget surpluses and the proceeds of the sale of WestConnex, the DRF eventually exploded to almost $26 billion in size.

But even after NSW lost its AAA rating in December 2020, and the cost of debt servicing rocketed, the Liberal government did not want to use the NGF to pay back a cent of debt. In 2021, it was advised by TCorp and NSW Treasury that it would be better off gambling this money on global markets in the hope that equities would climb while rates remained low for a long time.

More scandalously, TCorp and Treasury advocated that NSW should issue $20 billion in extra taxpayer debt to put into the DRF to punt stocks. Of course, TCorp's staff would be paid handsomely for the privilege of managing this money.

Debt explosion

Since 2018, Victorian taxpayer debt has exploded by $119 billion to what will be $165 billion this financial year. NSW has not done much better: debt has leapt by $102 billion to $160 billion in just five years.

During the pandemic when rates were at all-time lows, and the RBA promised to keep them there, taking on debt seemed smart. NSW and Victoria paid only 0.94 per cent in annual interest to issue a standard 10-year government bond in late 2020. But today that interest rate has jumped to 4.3 per cent.

If NSW and Victoria refinanced all their current debt at prevailing 10-year interest rates, which they will have to do over time, they will be forking out almost $7 billion a year just in interest repayments (forget actually repaying the principal they have borrowed).

Both states forecast that their debts will rise to $226 billion by 2026, which means the annual interest bill using current 10-year interest rates would be almost $10 billion a year each.

Victoria's structural deficit worry

There is clearly a case that Victoria is the worst-run state in the country. Since Dan Andrews' government came to power in 2014, Victorian government debt has increased 194 per cent, substantially more than any other big state, including NSW (116 per cent), Queensland (60 per cent) and Western Australia (45 per cent).

In dollar terms, Victoria has been borrowing as much, if not more, than NSW notwithstanding that NSW has a 35 per cent larger economy and a 23 per cent larger population.

Victoria's budget deficit as a share of state output (or gross state product) was 4.8 per cent in 2021-22, strikingly larger than NSW (3.7 per cent), South Australia (2.0 per cent) and WA and Queensland, which reported surpluses of 1.2 per cent and 0.3 per cent, respectively.

What is especially worrying is that most of Victoria's budget deficit appears to be structural, or discretionary, in nature given the state's unemployment rate is the lowest in decades. That suggests there is no spare capacity left in the economy: public demand is exceeding supply.

Last year, Victoria sold part of VicRoads for $7.9 billion, which Premier Andrews and Treasurer Tim Pallas repeatedly told taxpayers would be used to repay the enormous pandemic debts they have accumulated. Yet none of this money has been used to repay a dollar of debt. Like NSW's NGF, it appears Victoria intends to punt this money on global markets, which is madness given the fiscal challenges the state faces.

Mookhey debt reduction

NSW's new Treasurer, Daniel Mookhey, might be about to change all this. In 2021, Mookhey, who was shadow treasurer at the time, ran an activist ESG campaign in concert with this columnist to convince NSW's Liberal government to use the NGF's DRF for its legislated purpose. That included not allowing it to lend money to Russia and Saudi Arabia.

We argued that it would be crazy to issue $20 billion of extra debt to punt on markets as TCorp and NSW Treasury had proposed. We called on Perrottet to stop diverting billions of dollars of state royalties into the DRF at a time NSW was running huge budget deficits, which meant he was debt funding risky investments in global equities when taxpayers could not afford to do so. And we asked Perrottet to start drawing down on the DRF for prudent debt repayments.

To Perrottet's great credit, he did all these things, dumping the debt issuance plan, halting the royalty diversions then using $11 billion from the DRF for debt repayments. The problem is that NSW has kept on spending like a drunken sailor, burning through massive improvements in the budget deficit through relentless pork-barrelling.

We need to have a conversation about what are fair choices for current and future generations.

Minns and Mookhey actively campaigned on fiscal responsibility and the need to balance the state's books given higher rates and a soaring cost of living. And the new treasurer has not disappointed. In several interviews this week, Mookhey has signalled that he will look at using the remaining $15 billion in the DRF for aggressive debt reduction. There is more than $10 billion in other special TCorp investment funds that Mookhey could also use to help cauterise the state's fiscal crisis.

If Minns and Mookhey deliver on their promises, it will in time put enormous pressure on Victoria to do the same and use the $7.9 billion it raised last year from the partial sale of VicRoads to repay debt.

More fundamentally, we need to have a conversation about what are fair choices for current and future generations. The increasingly reflexive desire of politicians to burden future Australians with massive amounts of unsustainable debt just to satisfy the hedonistic needs of current voters is not tenable in the long run.

And, as we have seen in NSW, the electorate cannot be continuously bribed into systematic stupidity. At some point, voters will call your bluff.

The hope is that Mookhey and Minns chart a course back to responsible government that others such as Andrews can emulate. This is not just fanciful speculation. Mookhey is the smartest and hardest-working politician I have dealt with. He seems deeply committed to fiscal reform and making NSW a stronger and more viable place to live and work. All power to him if he can pull it off.

Christopher Joye is a contributing editor who has previously worked at Goldman Sachs and the RBA. He is a portfolio manager with Coolabah Capital, which invests in fixed-income securities including those discussed in his column. *Connect with Christopher on Twitter*.

Bank of England shows why RBA is odd man out

While Martin Place has to convince the public it will crush this inflation crisis, NSW Treasurer Daniel Mookhey shows the real cost of NSW's debt fund.

Christopher Joye
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If inside-the-beltway experts are to be believed, Treasurer Jim Chalmers will announce in July a new female Reserve Bank of Australia governor, likely insider Michelle Bullock, to succeed incumbent Phil Lowe.

Precisely when Lowe goes, nobody knows. There is a school of thought that he should be left to complete this cycle. Either way, time is not Lowe's friend with core inflation running about double the mid-point of the RBA's 2 per cent to 3 per cent target band and its own research suggesting it will not return fully to target until 2026.

RBA credibility could be deteriorating faster than global peers given its comparatively sluggish tightening cycle. ***Louie Douvis***

Pressure on the RBA to catch up to global peers intensified overnight with the Bank of England shocking economists with a half-percentage-point increase in its policy rate. This brings the BoE's policy rate to the 5 per cent threshold that the US Federal Reserve and the Reserve Bank of New Zealand have already passed. The Bank of Canada is not far behind at 4.75 per cent.

One interesting facet of the BoE move is that long-term interest rates declined after the surprise 50 basis point increase. This is because investors are starting to price in recessions more aggressively in response to the higher-than-anticipated jump in the short-term rates controlled by central banks. In the financial lexicon, the yield curve is inverting as the level of long-term rates falls below the central banks' overnight policy rates.

The odd man out is, of course, Australia with its 4.1 per cent cash rate and house prices that every day storm higher after the second-largest correction in history between May 2022 and February 2023.

The RBA is undoubtedly concerned about its eroding credibility, which could in theory be deteriorating faster than global peers given its comparatively sluggish tightening cycle and the fact that Lowe himself has been lambasted harder than other central bankers because of a series of perceived mis-steps that have precipitated his early removal.

In the US, the Gallup poll shows that public confidence in the Fed had plunged to its lowest point since the survey began in 2001. The worry for the RBA will be that consumers and businesses don't believe it has the fortitude to snuff out this inflation crisis, entrenching expectations of higher future inflation that will further amplify the nascent wage/price spiral.

NSW debt punt

Escalating interest rates are also perturbing Australia's best treasurer, NSW's Daniel Mookhey, who revealed during the week that the previous Perrottet government had indeed hatched an extraordinary plan to issue $25.3 billion of extra taxpayer debt purely to allow its investment arm, TCorp, to punt this money in global stock, junk bond and property markets.

The Australian Financial Review was the first to unearth the proposal back in mid-2021.

“Upon becoming treasurer, I learnt about a plan concerning the state's Debt Retirement Fund,” Mookhey exclaimed during the week.

“I was told that the previous government intended to raise $25.3 billion of debt to deposit into the Debt Retirement Fund. That money would go towards buying foreign and domestic stocks and bonds. It would be used to invest in property, here and abroad, and it would be invested in hedge funds, high-yield funds, bank loans and other alternative assets.

“The hope was that we would gain more from owning those [risky] assets than we would have to pay for the debt needed to buy them. Simply put, NSW would play around in financial markets using its credit card.”

Mookhey highlighted that $25.3 billion is nearly enough to build the entire Sydney Metro West project. “It is enough to build three more tunnels under Sydney Harbour. That money could be used to build 300 public schools or more than 40,000 social and affordable homes.

“Yet we are raising that much debt to bankroll Australia's biggest-ever carry trade. That plan is exceptional because NSW will have soon used borrowed money to artificially build the biggest sovereign wealth fund owned by a state government worldwide.”

There was only one vested interest that benefited from turning NSW into a huge leveraged hedge fund: the people that taxpayers were paying fees to run the money. This included TCorp and the fund managers they farm cash out to. The average total compensation per person across TCorp's 204 staff was $283,078 last financial year. That is 81 per cent higher than the average compensation the notoriously generous RBA paid its staff over the same period.

When this newspaper first disclosed Perrottet's plan to borrow more than $25 billion to put into a Debt Retirement Fund (DRF) that he established in 2018 to, ironically, reduce debt, the government acknowledged the scheme but denied it wanted to borrow anything like this amount. It countered borrowings would only be about $10 billion. This has proven to be false, as [we had argued at the time](#).

After enormous pressure was brought to bear on Perrottet to use the $26 billion in the DRF, which was originally funded by the sale of NSW's infrastructure, for its legislated purpose of alleviating NSW's soaring debt burden, he belatedly drew down on $11 billion for debt repayments in late 2021, which was unprecedented.

Yet despite losing NSW's AAA credit rating from Standard & Poor's in 2020, which the DRF was expressly designed to protect, and NSW's debt exploding from $58 billion in 2018, when Perrottet established the DRF, to more than $163 billion this year, he refused to use the remaining $15 billion in the DRF for additional debt reduction.

Of course, the interest bill on this debt was also multiplying from about 1 per cent annually on a new 10-year NSW loan in 2020 to 4.8 per cent today.

And as Mookhey has discovered, Perrottet's government proposed to issue another $25 billion of debt to (paradoxically) put in a debt-reduction fund purely because he had been convinced by TCorp and others that gambling this borrowed money on global markets was a good trade. Heads fund managers win, tails taxpayers lose!

Mookhey explained that there was, in fact, more to this story. "It turns out that swelling the size of the DRF with debt makes the budget look healthier than it is because the budget assumes we earn a return of 7 per cent on every dollar we deposit into the fund, even when it is losing money," he said. (It lost money last financial year.)

"If those returns are stripped out of the budget forecasts, NSW will not post a budget surplus any time soon. In fact, we will record deficits every year over the forward estimates.

"The plan to deposit $25.3 billion more into the DRF using debt will increase our gross debt levels by $27.8 billion by June 30, 2027. By June 2026 we will owe our creditors a total of $188 billion. This is the largest debt any incoming state government has inherited from its predecessors in more than three decades.

"In three years' time the state will be handing our lenders $7 billion in annual interest payments. This is billions more than we spend to fund the entire NSW Police Force."

Bondholders score

The only constituency that benefits from higher interest rates is, of course, the bondholders. On Monday, Westpac issued $2.9 billion of five-year, and 10-year Tier 2 bonds that paid incredible interest rates of 6.5 per cent and 6.9 per cent annually. There was some speculation that the Future Fund might have been getting in on this action. (We bought $236 million.)

Those Westpac rates are more than you earn on the dividends on Aussie equities, even if you gross up those dividends with franking credits. Naturally the banks do not like having to pay stonkingly, high interest rates on their bonds – but they have no choice.

The regulator prescribes very precisely how they fund themselves. Most of their money comes via bank deposits, which is the cheapest funding a bank can source. They are then required to issue a certain percentage of funding via long-term bonds to provide a minimum level of financing stability.

The regulator also insists a certain share of their funding must come from first-loss equity, followed by second-loss hybrids, and then finally higher-ranking Tier 2 bonds that sit above hybrids but below senior bonds in their capital structure priority.

For decades, borrowers made out like bandits. Today savers are in the ascendancy.

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THE INTELLECTUAL EDGE: MAKING EVERY BASIS POINT COUNT

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ALPHA MANAGER 2019 Christopher Joye

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