# OUTLOOK FOR THE MONEY MARKET

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I think, in this talk, I was really supposed to give views on forward trends in interest rates - an impossible task. Witness our most recent money market review. 400 words walking all round the question and end with a "don't know". Copies of the Review have been donated to the Chairman for resale, with any profits to go to the Society! If he can sell them and make a profit, there's always a position for him as a dealer, anytime he says the word.

## OUTLOOK FOR INTEREST RATES

There is some uncertainty about the outcome of the Election - but it is increasingly likely there will be a Liberal victory, and less unlikely Labor will win!

In truth, interest rates should now be much lower than they are. The fact that they are not is disconcerting - not only because it detracts from the profitability of certain well-deserving enterprises - but also because the forward look has to be from the wrong base.

One is really astonished to find in an election year that money costs to the individual for housing, consumer durables and bank overdrafts are only marginally below what they were at the height of a boom - and when money is almost running down the gutters in Australia.

People tell me that this is right and proper, because there is an unsatisfied demand for money at these rates, and therefore they should not be reduced in case the peasants become improvident and over-committed by buying a luxuriously appointed fibro mansion at Blacktown.

There may well, therefore, be marginal reductions in some interest rates before the Election, but they will not stay down for long. Overseas rates are beginning to move upwards, as the industrial economies start their recovery. The Australian economy is also beginning to move - and don't be misled if unemployment stays high or even rises further. Labor is busy pricing itself out of a number of markets, and it may be some time before we get back to only 1% unemployed, even with our economy expanding at 5 or 6% per annum.

In summary, therefore, one should expect lower interest over the next three months, but then a firming trend. If Mr. Crean becomes Treasurer, they may come even lower for twelve months - and after that a question mark.

Remember that there is going to be an enormous increase in the money supply this year - about 15%, June to June, on current figuring - and the Central Bank will be mopping it up like a Russian prawn ship as soon as the Election is out of the way and the economy is clearly expanding. There is, as you know, some sort of correlation between growth in money supply and inflation. As a rough guide, if we are achieving a real growth rate of 6% by next January/June, and the money supply is to rise by 15%

price increases will be rushing towards 10% per annum. The Central Bank is obliged not to sit idly by while that happens.

## OFFICIAL AND UNOFFICIAL

Now I want to talk more about structures and the misuse of the expressions "Official and Unofficial".

I was once introduced as "an authorised dealer in the unofficial money market". The expressions "official and unofficial" should not be used, if you want to analyse properly the structure and functions of the markets. They are both emotive and superficial, not to say misleading.

If you go back to the late 1950's in Australia, you will find that the whole emphasis was on deposit-taking facilities - and how to improve the scope for holders of cash to earn interest on surplus funds for short periods. The banks took deposits, but could not pay interest on current accounts. So brokers, finance companies, authorised dealers and some industrial companies offered a facility whereby interest could be earned on call money on an overnight basis. As a matter of convenience, a deposit with an authorised dealer became known as official, and any other deposit, repurchase agreement, inter-company loan or whatever was labelled unofficial. Proper distinctions of function were lost as lenders experimented in various market techniques, coyly admitting to being sometimes involved in the "grey" market instead of the persil-whiteness of the authorised dealers. A right and proper attitude, of course, but not conducive to the promotion of sound development of the capital market.

In the mid-sixties, the emphasis was beginning to shift away from the deposit taking function of the market towards that of fund-raising. Companies became used to being able to raise short-term cash from the market, and the Government was beginning to talk about open-market operations. The banks were becoming increasingly uneasy about loss of deposits.

With the advent of commercial bill companies and merchant banks, it became possible for companies to have guaranteed continuity of borrowings from the market. In later years, there evolved the guidelines policy, the flood of overseas banks and merchant banks into the Australian capital market, and the sharper edge of Government monetary policy involvement in the market place. At this time, too, the banks began issuing certificates of deposit and this put the seal on the conversion of the market from a deposit market to a fund raising market.

It is interesting to note, however, that the banks' original policy was to issue their CD's through branches to their existing clients to stem the loss of deposits to the market place. With respect to the banks, this was a complete mis-reading of the situation. The CD is a market instrument for raising cash in large lumps, through intermediaries, and is not a client service at all. This has now become recognised by at least some of the banks, who have acquired wide new freedoms to compete in the market.

The battle is therefore about to be joined with major forces seeking to raise funds in the market. The fund-raisers will be the Commonwealth Government and semi-government authorities (for their cash management), trading banks and finance companies (as major financial intermediaries), the Reserve Bank (for monetary control), industrial and commercial companies (for working capital), building societies (converting short borrowings to longer ones) and statutory boards and their like (for such things as purchase of primary commodities prior to shipment).

It is totally misleading to suggest that expressions like "official" and "unofficial" can be applied to these various activities. For the sake of making full use of our capital market to promote Australia, it is highly desirable that these newer and more flexible forms of financing be promoted on a sound and efficient basis.

The money market, bill dealers and merchant banks have a great opportunity to provide the facilities for these developments. But the competition from banks, finance companies and multi-national banks is going to be intense - which is healthy - and the need for skilful management of liquidity and risk gearing ratios is going to be acute.

Let me pose a few questions about how these changes can be brought to fruition on a sound footing - if that's not mixing a metaphor.

1. What kinds of paper should be issued by the various participants?

2. How is the liquidity of the whole system to be guaranteed?

3. What gearing ratios should be observed by intermediaries providing underwriting or placement facilities?

4. What restrictions have to be lifted by governments to permit these natural developments?

TYPES OF PAPER

1. We have Commonwealth Government Paper. I would prefer that the Commonwealth was not permitted to finance deficits by borrowing from the Central Bank, and had to borrow directly from the market. This would serve to iron out the seasonal swings in liquidity.

2. Reserve Bank uses Commonwealth paper and SRD's for its open market operations. I have suggested that SRD's be abolished and that the Reserve Bank issues its own term CD's to an amount necessary for monetary control. But they decline, for the moment.

3. Semi-government authorities have no instrument for borrowing from the money market, and are losing their advantage. A yearling bond must be marketed by semis if they are to compete and improve their cash management. But Loan Council is reported to be unimpressed.

4. Trading banks have their CDs but there is much more to be done to improve their wider acceptability as security for loans.

5. Finance company paper is not yet specifically designed for market penetration.

6. The inter-company market for commerce and industry is largely undocumented, but increasingly is being converted to accommodation bill finance to provide a secondary market. Are promissory notes a future likelihood in this market? What sort of paper should or would an industrial company issue to the market for a two-year loan?

7. Building Societies are trying to create a market in paper supported by mortgages.

8. Organisations like the Wheat Board and Wool Commission are financed mainly internally by the Central Bank or Government. There would be lesser oscillations in the money supply if these were financed from the market.

## LIQUIDITY

The only really liquid asset in the market place is government paper, rediscountable with the Central Bank. All other paper, or intercompany loans must be supported by the trading banks - or by overseas stand-bys - and of course the trading banks have access to the Central Bank in a number of ways. But you might like to put your mind to how big a market you could create without far more clearly defined lines of credit. How many bank CD's could the market support? How many millions of commercial or finance company paper could be kept in circulation?

## GEARING RATIOS

Apart from liquidity, prime risk situations accepted by merchant banks need to be very carefully watched while they are promoting market facilities for their clients. Let me give a couple of examples. A merchant bank with $200,000 of capital offered a bill line of $15 millions to a company, on the grounds that it was a first class name. Another merchant bank with $1 million of capital takes, as part of his activities, $20 million of deposits from the inter-company market and on-lends them as principal to take an average $\frac{1}{4}$ to $\frac{1}{2}$% margin. His liquidity is well managed, but what about his risk if he gets locked in on a couple of situations? As security analysts, what sort of interest do you or should you take in matters like this?

## RESTRICTIONS

Stamp duties are still - and increasingly - the greatest hindrance to sound practices in the development of these markets. But no successes have been recorded in having them removed - or even in having to pay only one amount of duty if the paper has to be transferred from one State to another. Transfer duty on debentures prevents the growth of a good market in one to two year paper.

The Securities Industry Acts, differing from State to State, and drafted by someone unaware of the existence of the money markets, are a problem - and I do not propose to discuss them, if only because I can't properly understand them.

## OVERSEAS DEVELOPMENTS

I have heard it said that Australia - and especially Sydney - should become the financial centre of the South Pacific. That would be good. But it would involve a complete turnabout in government policy on overseas investment, and investment overseas, exchange control, allowing overseas banks into Australia, foreign exchange dealings and so on.

I would like to see it happen, but at present the forces stacked against it are very great and unyielding.

You have only to get on a plane and visit countries to the north of Australia to see Australia as others see it. Highly nationalistic, introverted, restrictive and even racist, to realise that any thought of Sydney as a financial centre is a joke.

It may be some time, therefore, before our markets here are dealing in Asian bond issues and arbitraging Treasury bills and currencies of neighbouring countries.

A SIX MONTHS FORWARD HYPOTHESIS

Let us assume that the Election is over by early November, and that by December, it is becoming clear that the economy is moving ahead to a 5-6% growth rate. The money supply, due to capital inflow, export surpluses and Commonwealth deficit spending will be enormous. The Reserve Bank, therefore, takes prompt action in December/January and makes a heavy call on banks' SRD's, to the tune of even 3% - about $250 millions. Watch for the timing and size of the SRD call.

The banks meet this quite comfortably by rediscounting Treasury Notes back to the Reserve Bank, since there will be well over $1,000 million Treasury Notes in the system by then. Nevertheless, the banks who have been writing up to $80 millions of overdrafts per week recently, and by that time will find those overdrafts being used, draw in their horns. In February, company tax payments of about $300 millions per month start going into Treasury, the inter-company market rates edge up and overdraft utilisation rises further. Market rates begin to rise, there is more rediscounting of Treasury Notes and then of bonds to the Central Bank.

But the bank is on the other tack now, and wants to sell paper not buy it, and so drops its buying prices - and up go the yields on short government paper. The trading banks decide to protect their position and start selling bills and CD's in competition, trying to displace other people's holdings of government paper. They must succeed, for the only ways to relieve the situation are for the Reserve Bank to buy government paper, make last resort loans to authorised dealers, or for the funds to come in from overseas.

Now I simply cannot guess at what the overseas position will be at that time - what restrictions might have been imposed, whether any change has been made in the exchange rate, or whether there have been any special external movements resulting from the Election outcome. But it seems likely that overseas borrowings will be less easy and more expensive than they are today.

How much paper will the banks be able to issue? How much can the market digest? In this situation, what will be the place of all the borrowings, stand-by facilities, and bill lines guaranteed by the merchant banks for their customers. Certainly, they will be more heavily utilised, and they will have to be marketed in competition with the new-found market power of the trading banks. Liquidity and gearing ratios will be very much in focus.

How far would all this go? And what would be the impact on market rates and structure? No one at this moment can hazard a guess, for it will depend mostly on the performance of the economy. Some foresee it as an inevitable post-Election credit squeeze - but I don't. Some would suggest that monetary policy would be going into reverse, but this is not so, for the expression "monetary policy" is misused. The monetary policy of this country is quite clearly laid down in terms of stability of employment, prices and the currency. The tactical achievement of this policy must vary from time to time. The current tactics are to have high availability of credit to recover to a 5% growth rate, with fiscal tactics as seen in the Budget aimed at the same goal, combined with an attempt to moderate wage claims to keep down prices.

But you simply cannot allow the money supply to grow at 15-20% p.a., no matter whether you have good economic growth or not - for it must spill over into higher prices. So there must be a positive move to skim off the surplus, to the tune of the odd few hundred millions. The misunderstandings which are likely to occur are not on the Reserve Bank's side - their obligations and responsibilities are quite clear. It is more likely that organisations having been used to easy money have forgotten what the normal situation is.

Let me draw an analogy - rather like myself when motoring through Queensland a few years ago, travelling long stretches at 80 mph, and coming to a wooden bridge with a sign saying "35 mph". I slowed right down and blamed the bridge when I hit my head on the roof. A check of the speedometer told me I had gone through the bridge at 55 mph. Worse than that, on recounting the incident in the pub that night, a stranger chipped in and asked whether I was aware there was a universal limit of 50 mph in Queensland. When I expressed disbelief, he said that although he was off-duty, he would be quite happy to take me around to the Station and show it me in writing. There may be a moral in that story!