CHANGES IN THE AUSTRALIAN SHORT-TERM MONEY MARKETS

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Introduction

Since the establishment of the official short-term money market in February 1959, monetary authorities have seen their position of control over the short end of the financial spectrum shift from one of strength in the mid-sixties to one of uncertainty by the mid-seventies. Yet with this shift in their direct control over the market has developed a greater flexibility in their approach to intervention in the market. The evolutionary nature of the change in the monetary authorities' responses to control of a growing and maturing money market has led to a situation where a return to boom conditions could leave the authorities with greatly reduced control over market forces. Rather than resorting to direct controls, such as those possibly available through the *Financial Corporations Act 1974*, this article looks at possible ways in which the monetary authorities might strengthen their control via market mechanisms. It begins with a brief description of the money markets themselves, followed by an outline of structural change since the early 1960's. Given this background to the markets and their growth patterns, some suggestions for revision of the markets are made in the concluding sections.

Structure and Role of the Money Markets

The term "short term money markets" is a nebulous one, but for the purposes of this article it will be used to encompass those intermediaries actively engaged either as principals or agents in bidding for funds at call or for short periods. These funds are then either invested in securities or re-lent to other firms. In terms of their economic significance, and from the viewpoint of the monetary authorities, the money markets have four important functions:

(1) the creation of additional liquidity, which affects the liquidity preference schedule of firms by allowing them to hold less in cash and more in call or short-term deposits

(2) the provision of a market in fixed-term securities, including government bonds and bills of exchange. The money markets help to reduce transaction costs through specialisation, and provide depth in otherwise shallow markets. This increases the velocity of circulation both of securities and of the money supply

(3) the absorption and distribution of financial shocks, particularly through the official short-term money market and the money market corporations

(4) the provision of a series of non-money (indirect) securities which add to the flexibility of the financial sector.

In the Australian context, the short-term market can be sub-divided into four separate though very much inter-related groups —

(1) Official (or authorised) short-term money market (OSTMM)

(2) Money market corporations (MMC)

(3) Gilt-edge brokers (GEB)

(4) Intercompany market (Inter-Coy)

These can be briefly described as follows:

(1) The official short-term money market consists of nine dealers who have been accorded lender of last resort privileges by the Reserve Bank of Australia. In return for this right to borrow against government securities virtually on demand (although usually at a penalty rate and for a minimum of seven days), the dealers follow prescribed guidelines. The most important of these is that they must maintain a maximum gearing ratio which is currently 33:1 and also hold at least 70% of portfolio limits in government securities. The latest available figures showed that in February 1978 these nine dealers had total Australian and overseas assets of $1,420 million.

(2) In comparison, at the same date there were 47 major[1] money market corporations (MMC) with assets totalling $3,652 million.

These money market corporations have averaged a rate of growth in total assets of 38% p.a. in the 14 years to December 1977

— compared with a rate of growth of 8.5% p.a. by the official STMM. In June 1964, shortly before the Reserve Bank removed the deposit ceiling imposed on authorised dealers since 1959 the official STMM controlled seven times the amount of assets controlled by the MMC. By early 1978 they controlled less than one-third — as indicated in Graph 1.

The extent of the present dominance of MMCs in the market provides some indication of the loss of direct control by the RBA over a large part of the short-term money markets.

(3) The intercompany market is the least controlled and the least understood of the major sectors of the many markets. Dealers may act as agents, matching firms having excess cash flow with those requiring short-term funding, but often this is done directly between companies. The market's twin advantages of speed and secrecy have led in the past to serious problems. Inter-company loans are often unsecured, backed only by unused overdraft limits, and it is possible for firms to borrow several times more than is covered by these limits. The size of the inter-company market is very difficult to estimate, but market operators agree that it is at least as large as the official STMM in normal times. It shrank to almost insignificance in the post-Minsec era of 1972-73 after a boom period in the first two years of the 1970's when it was estimated to be three times the size of the official market.

(4) The gilt-edged market is a small market consisting of less than half a dozen stockbrokers who lend on the security of government bonds, usually for fixed periods and often under a buy-back arrangement. This involves securities being sold to lenders on the understanding that the broker will re-purchase the bonds at a certain fixed date and at a specified price. While the market has important historical connotations, it has had only minor strategic importance within the money markets over recent years.

Developments in the Money Markets 1960-1978

An important factor in understanding the development of the money markets in Australia has been the changing pattern of the flow of funds. Table 1 indicates that while there has been little change in the uses of funds between the last six years of the 'sixties and the first six years of the 'seventies, there has been a very significant increase in the importance of household savings as a source of funds. In the former period household savings accounted for on average, 20.6% of total funds available to the market. In the first half of the 'seventies, this has increased to average 38.2%. Thus the importance of tapping the household sector has become of primary importance, and the role of the financial intermediary appears to be replacing that of the individual entrepreneur or capitalist in the dissemination of funds. The majority of this increased percentage has been tapped by the building societies and finance companies — as indicated in Table 2 and by Graph 1. The role of the non-bank financial intermediary has increased dramatically in importance, and even should current trends be halved, will continue to increase in relation to the banking sector.

This trend to reduced direct control applies also at the short-end of the money market, and it is instructive to briefly trace the history of this movement, as it has a direct bearing on current recommendations for change in the markets.

The official STMM was established to assist in the development of both the financial sector and the secondary market for government securities. Government support was at the price of restrictions on portfolio levels and composition, and this restricted both the amount dealers were able to bid for and the rate at which they bid (given the relatively low return on government securities). However, as both the dealers and the potential lenders became more aware of the possibilities for a short-term money market there developed in the early 1960's an unofficial market accepting deposits at call or for short periods, often based in the same office or trading room as the official dealers. The introduction of 'tap' issues of Treasury notes in 1963 and the recognition (after considerable pressure) of bank-accepted bills of exchange as an authorised money market security in 1965 increased the range of securities available, and laid the basis for the establishment of more unofficial dealers — although by June 1968 the total assets of the money market corporations were only \$152 million, or 28% of those controlled by the official STMM.

With the mining boom in the late 'sixties and early seventies, there was a surge in the growth rate of the MMC's — assisted by the near-total ban on direct competition by overseas banking interests in Australia. By 1968 the MMC's had outstripped the official STMM in total size, and continued to expand, chiefly through their operations in the bill and the inter-company markets, throughout the early 'seventies. In this period the trading banks began to compete more effectively, particularly through their negotiable certificates of deposit (NCD's). With the lifting of the interest rate ceiling on these NCD's in September 1973, plus the market restrictions in early 1974, interest rates on money market securities reached record levels in mid 1974. In spite of this, the MMC's continued to grow, albeit at a reduced rate, and in June 1964 they controlled over four times the assets controlled by the official STMM ($2249 million c.f. $461 million). Since 1974 the MMC's have diversified further, and with increasing internal and international mobility of funds the range of securities offered has also expanded.

Clearly in some areas the discrimination against the banks has been a major factor in explaining the at times spectacular growth of financial intermediaries. The clearest case is the importance of restrictions placed on the portfolio and interest rate behaviour of savings banks in accounting for the extremely rapid growth of building societies. In relation to trading banks the prohibition on permitting interest to be credited on funds deposited for less than 30 days created a natural area for the growth of the short-term money markets, and interest rate ceilings, plus other direct controls continued to impinge on the trading banks' ability to compete successfully against non-bank intermediaries.

In the light of the current type of controls and the present relative strengths of the various operators in the money markets — the short-term market in particular — the monetary authorities' ability to control a period of rapid economic expansion becomes increasingly questionable. Under the *Financial Corporations Act 1964* the Authorities have the power to exert direct control over all the intermediaries listed in Table 2, assuming that the Act is constitutionally enforceable. However, in the past direct regulation has tended to fragment the money markets as operations have attempted to avoid or circumvent these controls. With the present structure of inter-related markets and the relative maturity of the security markets compared with the period when direct controls were introduced, it is an opportune time to examine the structure of government control over monetary instruments and the markets themselves, with a view to increasing the effectiveness of market-oriented stabilisation policies.

Recommendations for Revisions in the Money Markets

Recommendations for future development of the markets can be subdivided into two categories — those relating to the institutions involved and those aimed at the securities themselves. This section will concentrate on the former area, leaving reform of money market securities to the following section.

There are two primary areas through which the efficiency of the money markets may be improved. The first concerns an extension of the present lender of last resort privileges to embrace a wider range of intermediaries, while retaining the special characteristics of the official STMM. It is not recommended that the government utilises its potential power under the *Financial Corporations Act 1974* to restrict the present financial markets. It is likely that such a policy would discriminate against certain groups, and that an unnecessary and possibly detrimental advantage (in terms of market stability and control) would be given to such uncontrolled areas as the inter-company market. If the stability and efficiency of the short-term money markets is to be improved it is better to control rather than to divert market forces.

The recommendation is that the present last resort rate becomes a "prime" rate, and that while the present arrangements between authorised STMM dealers and the Reserve Bank continue fundamentally as at present (except that the last resort rate itself would become known publicly) other Money Market Corporations could also apply to the Reserve Bank for lender of last resort privileges. The rate and conditions applicable to the MMCs would be commensurate with their portfolio structure. For example, if a firm was willing to hold 20% of its portfolio in the form of government securities, then it would be entitled (if accepted as a registered dealer by the Reserve Bank) to borrow against government securities at prime rate plus 0.75%. The rate chosen is not designed as a subtle form of increasing the "captiveness" of the market; rather it is based on the level of risk attached to the dealer's portfolio, reflecting the additional risk implicit in a portfolio with a smaller proportion of gilt-edged securities. The rate would be adjustable, and the Reserve Bank would be in a position to alter it so as either to encourage or discourage activity within the short-term money markets[2].

There are several advantages in this system. Firstly, it widens the liquidity base of the money markets, providing greater stability and therefore greater buffering against the impact of random shocks to the financial market. Secondly, it reduces the risk of financial failure by firms operating within the system without assuring the profitability of any firm. Thirdly, it extends the control of the Reserve Bank over the money market as a whole through the possible utilisation of the last resort rate as a policy variable with a propensity to lead rather than lag market trends as necessary.

A second revision of money market operations relates to the control of the inter-company market. It is a difficult market to contain, but more stringent Companies Act provisions from each state requiring the registration of all prospectuses and all borrowing by a company should assist in the reduction of future destabilising behaviour within the inter-company market. Prospectuses would require periodic (semi-annual) updating, and any company borrowing short-term funds from non-bank sources exceeding 5% of their total assets (with a minimum of, e.g., $100,000) should be required to lodge monthly details with the Companies Office. It is very doubtful that such companies as Mineral Securities Ltd or Cambridge Credit Ltd would have risked borrowing so much in short-term funds if they had known that their borrowing patterns were being monitored.

Both these recommendations are designed to increase the information available within the market as well as using market forces rather than direct intervention in order to stabilise and regulate the market. The cost of implementing the former recommendation is negligible, while in the latter it would fall principally on the companies directly involved in what is potentially the most unstable part of the money market framework.

Recommendations for Revisions of Money Market Securities

The most substantial recommendation in this area is that of changing the method of issuing Treasury notes from the present "tap" (or unlimited supply) system to a tender system, where a fixed supply of notes is periodically auctioned — for example, fortnightly. The arguments used against tendering when the tap issues were introduced in 1963 included the inexperience of the official dealers — and the Reserve Bank — the shallowness of the bond market and the difficulty in assessing demand for Treasury notes. In the fifteen years since that time these arguments have lost much of their persuasiveness. Further, the practice of the Reserve Bank of not reselling the Treasury notes it has purchased in the market has inhibited the growth of a secondary market in these notes. A tender system would enable a secondary market to develop naturally, and if necessary allow the monetary authorities to both buy and sell notes in order to influence market rates between tenders (as in the British and Canadian systems).

The overall effect should be to improve both the marketability of Treasury notes and their competitiveness with respect to short-term securities. Government influences over the commercial bill and certificate of deposit markets would also be strengthened through market rather than regulatory forces[3]. There would have to be other minor changes in the operation of government security markets, such as the discontinuance of advance subscriptions to government loans, if government short-term rates were to more truly reflect current market forces.

A second recommendation is that the present stamp duty provisions be completely revised and updated. From a purely theoretical point of view, the optimal solution would entail total removal of stamp duty, as this would virtually eliminate the inter-company market as it operates at present. Unfortunately this is impractical given the importance of stamp duty to state government finances. Rather, future legislation should ensure that the states agree to uniform stamp duty provisions, and that legislation does not discriminate against secure market instruments (such as bank-accepted bills) and in favour of riskier securities (such as promissory notes).

Should these recommendations be implemented, the Australian short-term money markets will still remain heavily constrained by government control. Foreign exchange regulations, "30:20" provisions, interest rate ceilings and other forms of direct and indirect control will each continue to influence operations within the money markets. However, they are less directly related to the short end of the market than those areas which have been dealt with specifically, and encompass issues beyond the scope of the present article. These few tentative steps should therefore be seen in context, and although the journey is far from complete, hopefully they bring us considerably further along the proverbial thousand mile path.

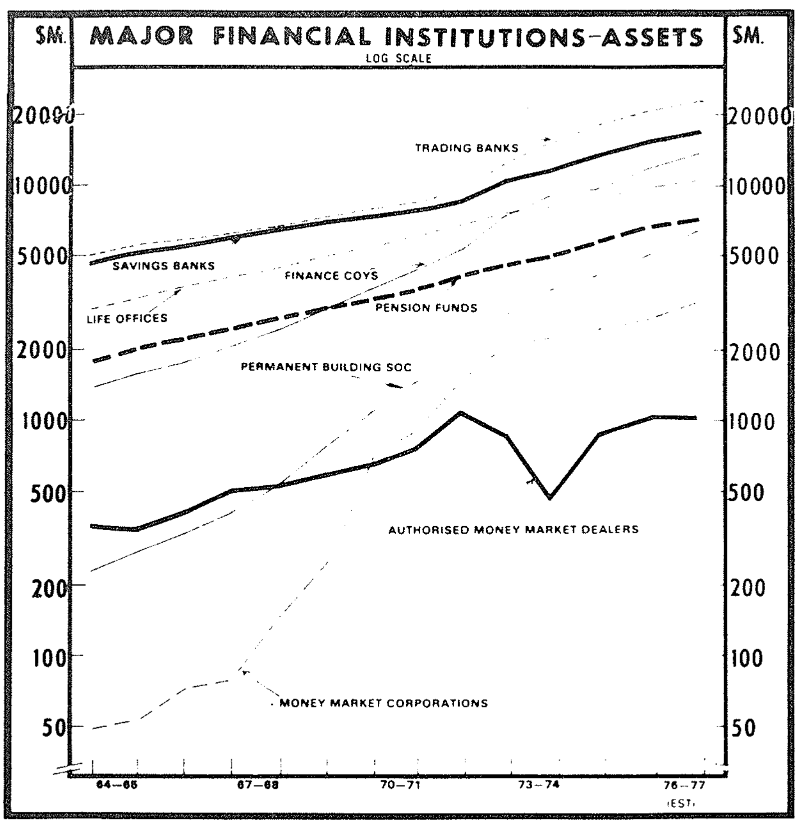
FOOTNOTES

1 each with assets in excess of $5 million

2 extensions of this scheme may include the following:
  (a) for lower levels of gilt-edged holdings, a higher rate above prime would apply. For example, a firm holding 15% in government securities may pay 1.0 percentage point above prime rate
  (b) a minimum amount as well as term of the loan could apply (e.g. $1 million and 7 days)
  (c) if a firm borrowed above a certain percentage of its total assets, e.g. 10%, an additional penalty rate may apply.

3 There is no prima facie reason why government bonds should not also go to tender, both for short and long-term issues. However, in practical terms this would be dependent on the successful operation of a Treasury Note tender.

Graph 1



Source: RBA *Statistical Bulletin* Graphs of the Australian Economy Supplement Feb. '78.

TABLES FOR CHANGES IN THE AUSTRALIAN SHORT-TERM MONEY MARKETS

Table 1

Australia: Source and Uses of Funds 1964-1976

SOURCES OF FUNDS

SOURCES	YEARS 64-65 69-70 %	YEARS 70-71 75-76 %
Depreciation Allowances & Increased Tax Provisions	34.1	31.4
Undistributed Company Income	12.4	7.6
Public Authorities Current Surplus	21.5	19.6
Household Saving	20.6	38.2
Overseas Capital Inflow	10.6	2.0
Other	0.9	1.3
	100.0	100.0

USES OF FUNDS

USES	YEARS 64-65 69-70 %	YEARS 70-71 75-76 %
Gross Fixed Capital Expenditure		
(a) Dwellings, Building & Construction	28.9	32.6
(b) Other	32.0	30.9
(c) Government (incl. public enterprises)	33.5	35.6
Increase in stocks	5.6	1.0
	100.0	100.0

Source: ABS, Australian National Accounts,

Table 2

Finance Corporations: (assets exceeding $5 million) Assets, Borrowing lines and Stand-by Facilities Unused 30 Dec. 1977

	No. of companies	Assets in Australia $ M	Standby Facilities $ M
Building Societies	96	6807	268
Credit Co-operatives	53	677	6
Authorised Dealers	9	1362	0
Money Market Corporations	49	3701	855
Pastoral Finance Companies	14	797	42
Finance Companies	82	13843	944
General Financiers	57	794	98
Intra-Group Financiers	9	345	6
Total	368	28378	2213

Source: ABS Financial Corporations Statistics