WHY A MONEY MARKET?

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The present position

- Change is the operative word in any serious assessment of the present market, and it is with this thought in mind that one can address the question – "why a money market?".
- Money markets themselves have existed in one form or another since man first devised a monetised value system, but they have all had one aspect in common, the market exists to facilitate the transmission of money from surplus to deficit units within the financial system served by the market. The transmission process only survives if the lender has security of repayment, ability to liquidate his claim, and he earns an adequate rate of return commensurate with the risk of his investment.
- This transmission process applies whether the movement of funds is by the Government — in and out of the total system for liquidity management, government debt management, or overall monetary policy objectives,
- or is by the private sector — in reacting to such government policies or for funding short term needs (such as seasonal cash flows) or long term needs (such as resource and industrial development).
- The transmission process requires:
  a) intermediaries to put surplus and deficit units together.
  b) an efficient method of recording claims and liabilities and of monetising those claims if the holder of surplus funds requires to be refinanced earlier than originally anticipated.
  c) an efficient communication and settlement procedure backed by a logical body of law.
  d) an effectively defined role for the monetary authorities.
- These characteristics apply to all money markets including the stock exchanges, currency markets, and long and short term money markets. I shall confine my on-going comments to the short term money market which has distinctive, but inter-related sub-divisions which have been developed to meet the needs of the Australian financial system.
- It is fair to observe at this stage that although the form and structure of the short term money markets varies from country to country, the bases upon which they are founded are the same in all mature, modern financial systems — which description includes (for those here with doubts born out by events over recent weeks) Australia!
- The Australian short term money market today is vastly different from that of twenty years ago, and the same will be said of today's market in another twenty year's time. But the differences will merely reflect more effective ways of transmitting surpluses to deficits for reward relative to risk, with increasing ability to reliquify investments. From the point of view of the authorities, their concern will be to ensure, and perhaps even underwrite, the stability of the total system through the use of government securities for liquidity, debt, and monetary policy management.
- The Australian short term money market is conveniently divided into the authorised (or official) market and unofficial market. Unfortunately most commentary ceases at that point and differences between the two are often restricted to security and the interest rate paid. Such a comparison is entirely superficial.
- Historically the unofficial market was in existence in a simple form long before 1959, when the official market was established under the auspices of the Reserve Bank. So, why have two seg-

ments of a short term money market? I do not propose to bore you with a lot of history, but rather concentrate upon the complementary, yet separate, roles of the official and non-official markets today.

- Both are effective in the transmission of funds within the financial system. However, an analysis of the portfolios of the two groups indicates a fundamental difference in their ultimate role and impact.
- The non-official market is almost entirely made up of securities and investments which are claims upon other members of the private corporate sector (or semi-government sector), with minimal or nil holdings of Commonwealth securities. That is the non-official market's main concern is with the transmission of surpluses within the total financial system by developing markets in commercial — not Commonwealth Government securities.
- However, while the authorised dealers are in this business too, there is a portfolio requirement that at least 70% of their assets be invested in short dated (under 5 years) Commonwealth Government securities. Because of this, and their special relationship with the Reserve Bank, they provide the monetary authorities, in addition to the banking system, with a vehicle for the implementation of monetary policy objectives, and of controlling liquidity flows in and out of the total system with less disruption than might otherwise occur.
- That is, while commercial securities are a store for liquidity for individual market users within the financial system, they are not, as can be claimed for Commonwealth Government securities, a store of liquidity for the financial system as a whole. This is a most important fundamental point in understanding recent and future developments in the short term money markets in Australia. Increasing concern has been expressed that the rapid growth in holdings of commercial securities at the expense of Commonwealth Government securities is leaving the Australian financial system with too narrow a liquidity base. A concern which has been reinforced for quite separate reasons in recent times with the singular lack of success by the Government in selling its own securities in competition with other competing investment opportunities.
- One could argue that the division in the market between official and unofficial is basically a product of this fact — that Commonwealth securities have been unattractive relative to private sector securities — and that the divisions of the two markets will change as Commonwealth Government securities become more competitive. I do not believe this to be so. Certainly, the unofficial market may hold more Commonwealth securities in portfolio if they were competitively priced, but it is just not the primary function of the unofficial market to interact with the authorities on matters of liquidity, debt and monetary policy management for the system as a whole. It is open to debate whether the number of official dealers with their specific responsibilities in this field, as well as making active markets in Government securities, should be three, nine, or nineteen. In all overseas economies the authorities have elected to identify a small number of dealers (the actual number bearing some relation to total market size; e.g. U.K. has 11 discount houses, U.S. around 35 identified dealers) which perform a special role for the authorities outside the official banking system. The unofficial market provides very real and necessary services to the corporate sector, and I believe Australia has been, and will be well served, by the evolution and development of both the official and unofficial markets.
- It is this fundamental difference in the nature of the official and unofficial dealers which puts the ultimate questions of security, rate of return, and liquidity, into practical perspective.
- Earlier in my comments I alluded to the constant process of change in the money market. The changes observed to date are, in the main, the product of changes in investors' and borrowers' preferences over time.
- It is instructive to look at some of the more significant of these influences over recent times and link them to market developments that have taken place, as a prelude to forecasting potential changes for the future.

- For example, the latter part of the '70's has been characterised by improving corporate cash flows and a renewed consciousness of productivity in the private sector (which has included monetary resources as well as labour and equipment); against a basically flat economy, economic uncertainty at home and abroad, and unprecedented growth in public sector funding requirements. In addition, the management of monetary policy has been variable, to put it in the kindest way, and the marketing of Commonwealth securities had (up until this year) undergone little or no change. Also demand for longer term development capital in the late '70's has been limited to relatively small absolute amounts.

- The net result of these influences has been the rare experience (but enjoyable from a short term money market viewpoint) where both investor and borrower preferences have been close together. Namely, invest short and borrow short, and maintain liquidity options until some of the major uncertainties have been resolved and longer term planning and expenditure can be justified.

- The outworking of this situation is already in the statistical records and observed in the market. The non-official market has grown from a deposit base of $252m. in 1969, when the first statistics were available, to $4.6b. and some 50 operating companies in 1979. These figures exclude the large inter-company market. The official dealers deposit base has grown only from $595m. to $1.4b over the same period. This disparity in growth is attributed to the successful development of flexible short dated commercial instruments in the primary market backed by an effective and viable secondary market which met investors' and borrowers' preferences to stay short.

- In growth terms (not profit terms), I submit the money markets have had it easy. That is, natural forces have coincided to ensure that their growth in size has been automatic. I also believe the market can take some pride in the innovations for which it has been largely responsible to enable it to capitalise on this growth opportunity.

- However, I now believe it is right to pause, and ask seriously what will be the likely future growth rates of the short term market if:
  a) longer term capital demand increases sharply in the 1980's, for example, to fund resource and infrastructure developments.
  b) the authorities attempt to widen the liquidity base of the economy by active competitive marketing of Government securities.
  c) the authorities are successful in reining in excess liquidity which has been experienced, off and on, since the mid-seventies.

- To be explicit I am talking about the growth rate of money books, not the growth of other financial services which, as commercial and economic life increases in complexity, will grow just as fast as has been observed to date.

- It is necessary to contemplate these issues in respect of:
  a) the number of short term money market intermediaries running money books now in existence, 9 official and over 50 unofficial, together with those providing separate money broking services.
  b) the margins available between deposit rates and security yields in a fiercely competitive market — i.e. profitability.
  c) the educative role of the market in widening the range of clients who will deal in the market in money and securities — i.e. business opportunity.
  d) the capital base required to soundly underwrite the markets for the 1980's — i.e. shareholder interest.
  e) for staff — the development of the right skills for the 1980's.

- Returning from that brief excursion into the future, I would like to labour again the outlook for liquidity management. It is observed that many intermediaries and corporations now rely heavily on private sector securities as liquid investments, rather than on treasury notes and other short dated government securities. This approach is fine while domestic liquidity is maintained at present levels, but it will cause disruptions when liquidity overall is reduced. As I have indicated, this is a distinct possibility in the near future. There have been brief periods between 1974 and 1977 when we have seen just how narrow the liquidity base was and the Reserve Bank was required to assist in liquidity management by purchasing bank bills. While this works for specific once off situations, I do not believe that the system should rely upon such intervention as a longer term policy. Simply, because a maturing commercial instrument in the hands of the authorities takes funds out of the system at maturity, which is not the case for Commonwealth securities. If bills become part of the authorities' liquidity management techniques, based on the above observation alone, we would have to contemplate a very complicated system for active and continuous Reserve Bank participation in the bill market for liquidity management purposes. I am sure that such a permanent addition to the scene would cause even greater volatility of rates in the bill market, to say nothing about how one would ensure a permanent and adequate supply of bill paper. Also such an operation would compete directly with the market attractions of Treasury notes.

- The short term money market has come a long way since the tentative buy back markets of the 1950's, and now provides a very wide range of borrowings, lending and secondary market services to individual and corporate clients.
- For example, lenders of surplus funds now have available:
  - from 11 a.m. call deposit facilities with maximum security with authorised dealers
  - from 24 hour call facilities — secured or unsecured with unofficial money market corporations — (here the credit risk is the money market corporation itself, which in turn is determined by the quality of its own investment portfolio)
- from 24 hour call facilities in the intercompany market (here the credit risk is the borrowing company — not the intermediary. In this situation, there is no spread of risk and in my view loans should be restricted to first class names only).
- Purchase and sale facilities, at prevailing market yields, of a full range of money market instruments of varying maturities including:
  - Treasury notes and Commonwealth and Semi-Government securities
  - bank bills and NCD's
  - bills bearing acceptances by leading accepting houses or other industrial and commercial corporations
  - promissory notes issued by leading companies and institutions.
- On the other hand, borrowers can supplement short term cash flow deficits, or obtain bridging finance and capital funds of up to three or five years from the market. These activities provide the primary transactions which create instruments for sale in the secondary market.

How to use the market

- The permutations and combinations now available to meet investors' and borrowers' needs are too numerous to expand in detail. All I can assure the potential market user is that competition is such that a couple of phone calls to dealers in the market will ensure a speedy, highly professional response which will enable each client's individual needs to be assessed, and practical suggestions offered, as how best he can use the market given his particular requirements, be he a depositor in the market or a credit worthy borrower.
- A question often asked is, "which segment of the market should one use?" There is no single answer. What is right for a client is a function of a wide range of highly individual factors. In addition many of my companies' clients alternate between a lending function and a borrowing function in sympathy with the business cycles in their industry.
- Some of the more important considerations which should be discussed with a client in response to this question include:

  a) *for a depositor/investor*
  - the objectives of employing the surplus
  - the size and variability of his cash flow
  - the reliability of cash flow forecasts

- the relationship of cash surpluses to
  1) the net increase expected in cash requirements for the next three years.
  2) shareholders' funds.
- the length of time the surpluses will exist.
- the level of contingencies which could upset basic cash flow forecasts.
- the staff available to monitor market trends and interest rate movements.
- the companies main line of business (is it to play the money market in competition with the professionals, or use the services of the market while getting on with the job of manufacturing or providing other services).

- The balanced assessment of these matters will enable a dealer to advise a sensible approach to the market and a risk exposure which is sensible for that client. Often, the result for a large corporation is the use of the services offered from all sections of the market. The larger the corporation, the easier it is for the finance division to maintain a wide range of contacts and manage a large cash flow. However, the structural costs should be offset against interest revenue to calculate the true rate of return from short term investments. Smaller clients must use the market professionals as advisers. It is my firm belief that the market would be failing in its basic moral responsibilities if it did not tailor all advice in the interests of the client, irrespective of size. This approach is in no way unrealistic, rather it is selfish, for a client who progressively enlarges his use of market services in parallel with the growth of his company, is better than a client who enters into a risk exposure level in the market quite out of keeping with his own corporate resources of staff to monitor, and shareholders' funds to cover, if something went wrong. The problem here is that if he gets burnt he will never return to the market, to his own long term detriment, and certainly to the market's detriment.

- One other point perhaps should be reinforced now for those who buy and sell money market securities. In 1974, '76 and '77 when the Reserve Bank purchased bills to assist the management of the system's total liquidity base, there was a severe interest rate penalty for early sale for liquidity. Consequently I would commend treasury notes (with rediscount facilities) for consideration also in large liquid portfolios.

- In summary, in answer to the question as to which segment of the market is best, I am merely saying they all have a place and there is a wide range of securities, but please consider the practical implications of each service in respect of your own company's individual characteristics. To dealers in the market, we must never fail in our responsibility to ensure that our advice also takes into account these same factors and that the advice given is in the best interests of the client. If we do not adopt this approach we will lose the right to call ourselves a service industry.

Future influences

- It now seems appropriate to return to some of the major current influences which appear to be bearing upon the market and to speculate further on what changes they in turn might produce.

- The main influences which I see emerging which will affect the course of development in the money markets are:—
  a) increasing demand by the public sector for its funding requirements.
  b) a large increase in demand for private sector capital in Australia — especially in the 1980's.
  c) increased effort by the authorities to reduce excess liquidity in the system.
  d) a greater need to underpin the liquidity base of the system with Government securities (particularly if there is any relaxation in foreign exchange rules).
  e) more innovation in the type and range and volume of commercial securities being written at the shorter end of the market.
  f) the observed slower rates of growth in the traditional captive markets for Government securities.
  g) some relaxation in current attitudes to overseas finance and further encouragement (rightly or wrongly) of offshore funding by semi-government and statutory authorities.

h) progressive relaxation of Australia's present foreign exchange rules.

i) a wider range of services available including hedging mechanisms for traders and speculators through futures markets.

j) continuous reassessment of legislative and regulatory controls.

k) the Campbell Committee Inquiry.

- The Campbell Committee Inquiry into the financial systems has come at a most strategic time as some of the fundamental issues listed above are already affecting traditional cash flows through the system. Perhaps the most significant influence is the expected competition between the private and public sectors expected in the 1980's when, concurrently, increased effort is required to reduce the volume of excess liquidity in the economy. The other issue which will affect our industry is the impact of inflation upon savings patterns by individuals, and hence the intermediaries who hold those savings.

- If nothing else comes out of the inquiry, one very real benefit has already been achieved. Namely, that every financial intermediary has had to look closely at where it came from, where it is now and where it hopes to go, identifying its objectives and also reassessing its own basic liquidity requirements. Having gone through this stimulating exercise and confronting the many chastening issues which such an exercise raises, each intermediary has then had to present itself and its aspirations in a written, coherent, sustainable argument consistent with presentations from other industry groups.

- As a result I believe that most intermediaries now have the best considered view of the next decade and its challenges as a basis for forward planning than on any previous occasion in our post war financial history. Consequently at least as far as the private sector is concerned, the Campbell Committee Inquiry has already performed a useful task for the financial community, even before it has opened its hearings for public discussion. However, one thing is for sure, Campbell Committee notwithstanding, the list of current influences which has been mentioned will bring subtle and significant changes to the money market.

- However, if one looks at the conflict between government and private sector demand for funds in the 1980's, and at the necessity to have an adequate liquidity base in Government securities to underwrite the stability of the system, the inescapable conclusion is that the Government (through the Reserve Bank) will have to update the terms, conditions and marketing methods of Government bonds and Treasury notes just to enable them to compete more effectively with alternative private sector securities — particularly bank bills and NCD's.

- How they will do this must remain the subject of speculation, but the announcement of the tap and tender system is definite notice that the authorities are forseeing the same trends which I am presenting to you today. I believe that they will need to experiment with variable terms for Treasury notes on tender, and move interest rates much more frequently in response to market conditions; but only after having full regard to current liquidity management and monetary policy objectives.

- I stress that adjusting to market conditions in this scenario is not the blind abandonment of the management of yields to market dictates, which some commentators are currently suggesting, but is a very positive situation where the authorities manage rates within policy objectives, but reflect movements in yields from other competitive securities more frequently than has been the experience in the past.

- If this occurs I believe we will see greater and more frequent fluctuations in yields for very short dated Government securities, in line with those experienced already for bills. This scenario does not have traumatic implications for medium and long term rates, for if I stay with the reference to bills, seasonal fluctuations in bill rates have had little influence on ten year debenture rates. It is just that in the past, all sorts of extrapolations have been made from the slightest change in official yields — whether in short yields or long yields. This was merely a function of the old system of managing Commonwealth securities where, because changes were infrequent, they did have some interpretative significance. One cynic commented to me recently that it merely meant the Government was catching up with basic market changes. I believe that that understates the workings of the "old system" in less complicated periods of economic management. Just as current circumstances require a changed approach to the marketing of Government securities in competition with other private sector securities, so too, interpretative comment will need to be updated.

- In particular, the marketing of Treasury notes under the new tender system will not be entirely successful until there is widespread acceptance in Australia that we are now operating a distinctive short term market subject to seasonal and basic liquidity management changes which can, at times, act differently to medium and longer term security yields. I would like to see future press commentary, which is an important part of the market's communication process, reflecting these developments.

- When Government securities are marketed on more competitive terms in future, I would expect that a wider cross section of investors will hold such paper voluntarily. This is decidedly a preferable approach to the marketing of securities — particularly Government securities — than the reliance upon force, through nominated captive markets or by introducing compulsory LGS ratios for financial intermediaries. The speed with which more competitively priced Treasury notes and short dated Government securities penetrate a wider range of investors in the primary and secondary markets will be one of the major challenges facing the short term money market over the next three years, and in particular the authorised dealers.

- I mentioned earlier that another interesting influence for us to ponder upon in this industry is the impact of inflation upon saving patterns. Individual investors have also been preoccupied with liquidity, and savings have moved away from longer term savings institutions. For example, the growth in building society deposits, with its apparent cash withdrawal facility, has been a favourite repository for individual savings. As future housing demand slackens, (because of demographic and other trends) and demand from other industry and from resource development grows in the 1980's, the intriguing question is whether savings will still accrue in building societies which, taken to an extreme, will result in their becoming more and more liquid.

- Fortunately, the old fashioned, but basic, laws of supply and demand would start to work to prevent this imbalance from perpetuating itself. This is true as long as artificial controls are not introduced. In the absence of controls, building society deposit rates would need to adjust to a level to attract only sufficient deposits necessary to fund the changed level of housing demand. By contrast, intermediaries funding other industry needs would raise their rates, in a relative sense, to attract funds to the growing area of demand. An efficient short term money market will have great opportunities in the interim, borrowing from highly liquid savings intermediaries to recycle the savings for other investment needs.

- There are many factors at work which will necessitate increased attention to developments overseas and to foreign currencies. International economic factors are increasingly important in our domestic economy, particularly interest rates. In addition, offshore borrowing by both public and private sector corporations is receiving increased attention. Australia's trading interests alone are nearly sufficient justification for a move towards a more efficient foreign exchange market in Australia, but with increased offshore borrowings and the large capital requirements expected in the 1980's, significant developments in foreign currencies and associated securities will occur. The large representation of overseas bankers in Australian money market institutions is not an accident. I foresee the internationalisation of the Australian money market as another major development which will occur during the 1980's, and the leading houses will be those providing a global service in currencies as well as other traditional financial services.

- The development of future markets will, in themselves, provide an additional range of hedging services for investors as well as providing a useful market mechanism for those speculators in our midst.

- This brief look at some of the developments likely to occur in the money markets over the next decade is, of course, based upon the assumption that legislative and regulatory control will be limited across the entire system to what is necessary only to promote universal acceptance of sound principles of financial management. One of the principal areas would be the establishment of sensible minimum liquidity levels for each industry on a voluntary basis. What would be disturbing, would be the application of qualitative, quantitative and interest rate controls which would have the effect of constraining initiative and containing the evolution of the market in response to constantly changing circumstances.

Concluding comments

- As I said at the beginning, the market today is vastly different from the market in 1959, and today's market will be different from the market in 1999 — given the freedom to respond to fundamental changes.
- Why, then, a short term money market? Because an efficient transmission mechanism to service surplus and deficit units is essential in any mature financial system, particularly one which is subject to considerable ongoing change in internal and external cash flows, and where long term investment opportunities are large and irregular by nature. The short term money market permits funds to be accrued in a secure way, for profit, until redirected into other private sector requirements. The official arm of the market is more directly concerned with assisting in the implementation of the Government's liquidity, debt and monetary policy objectives●

BOOK REVIEW

AUSTRALIA'S MINERAL RESOURCES — POLICY ANALYSIS

Australian Minerals and Energy Policy, by Dr. Susan Bambrick, Australian National University Press, 1979 pp. 240. Paperbacked at $9.95

Mineral economics is a fairly recent addition to the curriculum at Australian universities, and it is therefore interesting and timely to see two books on Australia's mineral industry published within a month or two of each other by two academic mineral economists. Whereas Don Barnett's book, "Minerals and Energy in Australia" (reviewed in JASSA June 1979) was largely descriptive on a commodity-by-commodity basis, Susan Bambrick's work as its principal aim provides the essential background on the place of the minerals and energy sector in the Australian economy, and analyses its inter-relationship with other sectors.

Dr. Bambrick who has lectured in resource economics at Australian National University since 1972, discusses at some length the important policy issues with which the mining sector has confronted the government — foreign ownership, taxation, Aboriginal land rights, environment, further processing, regional development, and provision of infrastructure. The development of an integrated energy policy for Australia is considered in particular detail and this chapter is especially relevant for readers swamped by superficial repetitious articles in the daily press which provoke an unavoidable feeling of deja-vu.

While there is much factual content included (and a lengthy list of questions for discussion), the book is essentially analytical in character, and in true economist's fashion puts both sides of any contentious question clearly to the reader in a balanced manner.

The author's special interests are fortunately given greatest emphasis. The largest and most fruitful chapters are those devoted to policy issues, on energy, the environment, government support and involvement in mining including foreign ownership and federalism, and inter-sectoral linkages and multipliers. The Gregory thesis is examined in detail.

This latest addition to the literature on Australia's mineral industry should not be seen as being an alternative or substitute for Don Barnett's worthy book. Rather both should be seen as providing welcome and penetrating insights in their own separate ways into this very important sector of the Australian economy.

The two books could certainly be read with profit by those from both the securities and the mining industry.

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