

SEASONAL LIQUIDITY SWINGS WITH A FLOATING DOLLAR

An Address by

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of Australia, New South Wales Division, September 14, 1984.

Introduction

There have always been seasonal liquidity swings in Australia. For 100 years or so they were associated with the receipt of wool proceeds. For the last 40 years they have been due largely to the timing of company tax and, more recently, provisional tax.

At this time of the year a lot of people start wondering what the seasonal pattern might be like for the rest of the financial year.

I am not going to give you the Reserve Bank's guesses today. For two reasons: first, we will be having our say on that matter in the September issue of the Reserve Bank Bulletin; and second, I would rather share with you some thoughts on the underlying issues.

These issues, as I see them, are mainly whether the markets can handle the seasonal swings; how far the authorities should take them into account in tenders and market operations; whether they make the influencing of monetary aggregates more difficult; and whether we should try to reduce them at the source or by other official actions.

A Few Figures

A few figures may help to set the stage. As you know, the Commonwealth Government last year had a deficit of about \$8 billion. If this had been spread evenly over the year there would have been a deficit of \$2 billion in each quarter. In fact, there was a deficit of \$4 billion in both the September and December quarters, a deficit of \$2 billion in the March quarter and a surplus of \$2 billion in the June quarter. This unevenness is because about 75 per cent of provisional tax and 40 per cent of company tax is collected in the June quarter.

The other side of this coin is that LGS assets rose strongly in the September and December quarters, less strongly in the March quarter and fell in the June quarter. The growth in M3 followed a somewhat

similar track. Interest rates fell in the first half of the year and then rose to a peak in April. I will talk later about how far these movements are a necessary part of the seasonal liquidity swings. Incidentally, you will appreciate that for ease of discussion I am ignoring the impact of LGS factors other than Commonwealth Government finance.

The Role of Markets

For most of Australia's history the handling of liquidity swings was left to the banks. Very simply they took in deposits in flush periods and let customers draw against their overdrafts in lean times. The corresponding assets which they built up and ran down were overseas funds and Government securities, including Treasury bills.

For the past quarter century or more, we have had the short term money markets playing an important role. However, the shuffling of short term funds, by itself, does not remove the liquidity swings. There still has to be a massive transfer to Treasury coffers in the June quarter. All the markets can do is ease this transfer by holding financial assets that will mature at that time.

The Role of the Authorities

This brings me to the role of the authorities.

As well as being the cause of the swings, the Government (or the central bank) has to provide the LGS assets to absorb the liquidity run-up and then has to buy some of them back or allow them to be run off. To a large extent the impact of the seasonal swings on financial conditions depends on the terms on which these assets and funds are provided.

It is tempting to say that if the Government's deficit in the first eight or nine months of the year were matched exactly by its sales of paper to the public, and if its surplus over the remaining months were matched exactly by maturities, then the swing in the

Government accounts need not have any effect on markets. The paper would not even have to mature within the same year. It could be a mixture of short and longer term paper, so long as the amount maturing in the June quarter matched the Government surplus in those months.

The Government's net financing from the public does not *exactly* offset its net spending, though there is a strong tendency in this direction. Bond and Treasury note tenders are much larger during the part of the year when the Government runs its deficit.

It is one of the jobs of the central bank to look after these differences in timing between the Government's net spending and borrowing and try to see that they do not cause unnecessary swings in financial markets, within the year, within the month, or from day-to-day. The Bank's daily market operations in domestic securities markets (principally, but not only, the short-term money market) are directed towards this end.

A Floating Dollar

Until last December, actions by the authorities could be either helped or thwarted by flows of funds across the foreign exchanges. If, by accident or design, cash was scarce in the June quarter, funds could be brought in from overseas.

Local institutions, especially merchant banks, became active in arranging overseas financing and many firms came to rely on it. Individual firms, of course, can still borrow in this way, but under a floating exchange rate the foreign currency is sold to someone other than the Reserve Bank, and so the liquidity of the system as a whole is not augmented.

It can be said, then, that this relief valve has been closed off. However, we should not exaggerate the efficiency of that valve. In 1982, for example, the safety valve did not start to relieve the system until 90 day bank bill rates reached 22 per cent. This year, without the help of the foreign exchange window, the peak was less than 15 per cent.

One of the main arguments for floating, of course, was to take some of the volatility out of domestic financial conditions. Experience to date suggests at least modest success.

Seasonality in Interest Rates

Does there need to be seasonality in interest rates?

If the seasonal pattern were perfectly known, and if the markets believed that the authorities would provide

exactly the right amount of assets or cash, then it is hard to see why financial conditions and interest rates should vary over the year. That is, of course, if seasonal fluctuations were all that occurred.

In practice, there is less than perfect knowledge and less than perfect confidence in the omniscience of the authorities. I can understand this. But I would also like to think that over time the authorities will handle it better and that the market itself will come to see that "seasonality" is to some extent a self-fulfilling prophecy.

Of course, even with perfect foresight, seasonal liquidity swings involve a shuffling of portfolios. Those with large tax commitments might not be those with the liquid assets.

Monetary Aggregates

Seasonal liquidity swings reflect directly in the money supply. With perfect knowledge we could seasonally adjust all the figures, and keep on (say) an 8-10 per cent M3 path for the whole year, but it is not easy to do this.

Does Seasonality Matter?

Let me try to draw the threads together.

- Seasonal liquidity swings have been with us for a long time.
- They are due mainly to Government operations — especially the timing of provisional tax.
- Careful matching of Government borrowing and net spending, supplemented by the Reserve Bank's market operations, can go a long way towards dampening the effects on financial conditions and interest rates. We are heading in that direction.
- The floating of the dollar makes it easier for us to keep financial conditions on an even keel over the year.
- The money markets and securities industry have an important role to play in the transfers of funds. The better prepared they are for the seasonal swings the less effect there will be on market conditions.
- However, so long as there are seasonal liquidity swings there is likely to be *some* seasonality in financial conditions and interest rates.
- Seasonality has nothing going for it, and a few things against it.

- Should we try to reduce it? Yes. For several reasons:
 - (i) the “static” it causes makes underlying trends hard to read;
 - (ii) it is costly to Government; and
 - (iii) it is wasteful of market resources.

Reducing Seasonality at Source

The main step which has been taken so far to reduce seasonal swings is quarterly collection of company tax.

There are also strong national arguments for spreading provisional tax — which is about the same size as company tax — in the same way. Of course, not all provisional taxpayers would agree!

Other Ways of Reducing Seasonality

If we cannot alter provisional tax arrangements, there are Campbell's other two suggestions for reducing the impact of the transactions on liquidity, namely a form of tax and loan accounts held by Government with commercial banks and longer-dated Treasury notes. These questions deserve more time than is available

today. However I would make a couple of quick points.

Government accounts with commercial banks would not cure seasonality in M3, which reflects the time of tax payments to the Government irrespective of where the Government banks its receipts. Of course, such accounts might be welcome to the recipient banks!

As to Government securities, there is already a wide range of maturities on issue. Nevertheless, minds certainly are not closed to issues for which there is a demand.

Epilogue

It would be an overstatement to say that seasonal fluctuations in liquidity frustrate monetary policy. But they certainly complicate it. Seasonal fluctuations are costly in terms of Government expenditure and market resources.

Our commentator said recently that seasonality is one of the more stupid features of the system, and one which seems doomed to a life in the bureaucracy's too-hard basket. I can agree with the first half of the proposition, but I am a bit more hopeful about the second.