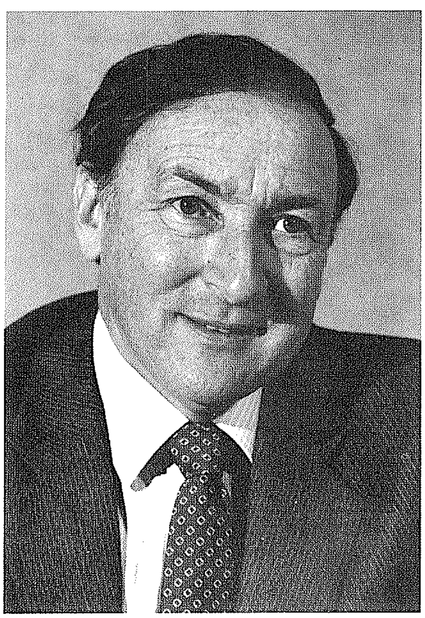
# CGS: A MARKET FACING CHANGE

## RBA CONSIDERS THE ALTERNATIVES



*by R.A. JOHNSTON*

***Continuing financial deregulation, other changes to the banking system and the phenomenon of fiscal surpluses could have sweeping effects on the tools of monetary policy. Is a new Reserve Bank security on the horizon?***

In discussing recent developments in the government securities markets I would like to talk generally about the effects of recent deregulatory changes in the banking system and some implications of the switch to fiscal surplus.

The deregulatory measures I am referring to are those contained in the Treasurer's recent Budget speech:

- the phasing-out of Statutory Reserve Deposits (SRDs) and the introductionof non-callable deposits with the Reserve Bank by member banks (i.e., banks subject to the Commonwealth Banking Act);
- the removal of distinctions between trading and savings banks.

We also have the guidelines issued by the Reserve Bank for the future measurement of capital adequacy of Australian banks.

**SRDs/non-callable deposits**

The objective is that in three years, all member banks will have 1 per cent of their Australian liabilities (excluding shareholders' funds) on deposit with the Reserve Bank. For some banks, there will be repayments from present balances and others will have to lodge funds with the Reserve Bank.

On present figuring, the result will be a net repayment by the Reserve Bank of about $2 billion or, say, about $50 million a month over 36 months. The amount will be reduced to the extent that banks' balance sheets grow over that period. The adjustment began in September.

The amounts involved monthly are unlikely to have much effect on the Commonwealth Government securities (CGS) market. Note also that the SRD-related repayments are explicitly said to be subject to the exigencies of monetary policy over the period.

One point I would like to emphasise is that the 1 per cent of liabilities to be held at the Reserve Bank is not any kind of insurance premium establishing some sort of contractual relationship between us and individual banks. We believe, however, that all banks should have a banking relationship with the Reserve Bank.

**Unification of savings and trading banks**

Hitherto, savings banks have been closely constrained on the assets side of the balance sheets – virtually to loans on the security of land and public securities, except for the 6 per cent so-called "free tranche." The intention is to remove these constraints but legislation will need to be amended. In the meantime, since, in effect, the "free tranche" ratio can be varied by regulation, that tranche has been increased to 40 per cent. There is scope *in theory* for savings banks to reduce their CGS investments as a result of this.

Perhaps of greater significance is the unification of the trading banks' Prime Asset Ratio (PAR) and the savings banks' Reserve Asset Requirement (RAR). For

*Mr R.A. Johnston is Governor of the Reserve Bank of Australia. This is an edited version of his address in October to the NSW Division of the SIA.*

the savings banks, this has meant a widening of the numerator from deposits to broader liabilities on the same footing as PAR. For all banks the ratio was reduced to 10 per cent on September 30.

These changes in PAR and RAR will initially "free" some $4 billion of CGS. Balance-sheet growth would work against this. It is not clear how the balance of forces will work out. So far, there does not seem to have been heavy quitting of government securities by the banks.

**Capital adequacy requirements**

From the viewpoint of the CGS market, the important requirements are the weightings to be applied to banks' investment in CGS. These are:

- zero for Commonwealth securities with less than one year to maturity;
- 10 per cent for all other claims on the Commonwealth (and States).

This is a considerable inducement to investment in CGS: only cash, bullion and balances with the Reserve Bank also rate zero weighting, and only deposits with the short-term money market also rate 10 per cent weighting. Claims on banks, bank bills and claims backed by a bank guarantee are weighted as 20 per cent.

There are a number of other consequences which have long-term importance. They include the impact on financial sector efficiency and service; on competitiveness among institutional groups; on the future of commercial bills.

Needless to say, the objective of the reforms is to improve service to the community and not primarily to improve the fortunes of particular institutional groups.

But most of the deregulatory changes, in theory at least, reduce the banking demand for government securities. The capital adequacy requirements potentially work in the other direction.

Against this, however, balance sheet growth will work in the opposite direction. PAR, in particular, is a factor boosting demand for Commonwealth Government securities. Banks currently hold about half of the outstanding CGS and are the dominant holders of short maturities.

The reduction in PAR from 12 to 10 per cent should mean that, for a time at least, we have greater depth in the CGS market. Of course, in the longer run, at any given ratio, PAR in its present form would absorb an increasing proportion of securities on issue if the budget continues in surplus. It is clear that in that case, banks and the Reserve Bank would need to think carefully about appropriate arrangements.

***The reversal of the Government's funding requirement is welcome and necessary if we are to solve our balance of payments and debt problems.***

Even if there were no formal PAR requirements, it is likely some informal convention about banks' holdings of liquid assets would emerge. This is because banks need to hold a substantial tranche of highly-liquifiable high-quality assets so that their balance-sheet adjustments can be made without disruption.

The issues involved in establishing appropriate liquidity arrangements have much in common with the issues involved in selecting the appropriate instruments by which to undertake monetary policy.

**The shift into fiscal surplus**

In the past 10 years, the stock of government securities outstanding has about doubled to $50 billion. In real terms, this represents a fall from 25 per cent of GDP to about 16 per cent. Yet, over that same period, turnover in the bond market has risen by a factor of 20. The acceleration in turnover coincided with the introduction of the tender system for the sale of securities.

We now have a CGS market that is strong and competitive. There are many active players. Activity and interest in the CGS market has encouraged development of a futures market for government securities. Turnover in that market is now about equal to that in the physical market.

**The fiscal turnaround**

Underlying conditions in the CGS market are being influenced by the fundamental swing in the accounts of the Commonwealth Government over the past several years.

The size of budget deficits over the years has been a source of concern for economic stability. At the same time, many tended to take for granted the growth in securities that flowed from those deficits. The reversal of the Government's funding requirements is welcome and necessary if we are to solve our balance of payments and debt problems; it frees funds for private sector investment. But, at the same time, it has important implications for the CGS market.

Last financial year, government securities on issue in Australia fell by about $2 billion. That fall would have been larger, had it not been that part of the Budget surplus was applied to redemptions of overseas debt. This year, even with repayment of a further $3 billion of overseas debt, securities on issue in Australia are likely to fall by a little more. Taking the two years together, we will have had a fall of 10 per cent in domestic securities on issue.

Another steady drain on the market is the regular increase in the public's holding of currency – by a little more than a billion dollars a year. To buy currency from the Reserve Bank, the public (including the banks) must provide assets to the central bank – usually CGS; other things being equal, this reduces the public's holding of CGS.

For completeness, in looking at market-based factors, we also need to take into account that the Reserve Bank's foreign exchange market operations tend to reflect in the securities market. When the bank buys foreign exchange, it gives in return Australian dollars which, in turn, are exchanged for CGS from the Reserve Bank, thus reducing the bank's portfolio. When the bank *sells* foreign exchange, the offsetting tendency will be for the bank to *buy* CGS from the market, thus reducing the public's holding of CGS further.

**A series of surpluses?**

If, in the ultimate, a succession of surpluses ran down the supply of CGS, should this be of concern?

The lower yields that would go with a diminishing stock of CGS should reduce the cost of government funding. That is a benefit not to be ignored.

On the other hand, one cannot foretell the future course of public finance sufficiently clearly to be confident that the strong and deep market in Commonwealth securities could be permanently dispensed with.

In any case, it is assumed that there would still be intra-year (seasonal) fluctuations in the government's accounts requiring at least a seasonal security, i.e. Treasury notes and an efficient market.

To be realistic, it would not be in the interest of anyone to allow the government securities market to become thin or otherwise disorderly – or for the run-down to become severe without some adequate alternative strategy for the markets.

Perhaps it would least of all suit the central bank, which relies on the cash and government securities markets as the mechanism for its monetary policy operations.

It is not practicable to assess what would follow from a series of fiscal surpluses without taking into account the general economic and financial conditions in which they were occurring. We might in passing consider briefly one hypothetical situation – where there was fiscal balance and the central bank was neutral in the foreign-exchange market. We could have a private-sector-dominated financial system.

Some might think this reminiscent of the nineteenth century. But it does not follow automatically that economic equilibrium would be achieved in such circumstances. There could still be work for monetary policy to do.

The Reserve Bank could get some mileage for its policy operations out of the seasonal issues; and the sale of currency would be a source of inflow of securities to the central bank for some time.

***It ought to be mentioned that some sophisticated economies get along quite well without a highly developed money market . . .***

But, if we were looking down the barrel of a much diminished stock and flow of government securities, the central bank might well have to consider alternative machinery or alternative instruments for giving effect to monetary policy.

Obviously, we would have to do this in good time! We would need to give careful thought to the essential requirement of an alternative instrument. These would include:

- undoubted security, so that credit-risk was not an issue;
- undoubted liquidity, which implies ease of transferability and a deep market and, of course, certainty of payment at maturity – issuers with taxing powers or cash-creating powers are the ultimate sources;
- an adequate but not unlimited supply, preferably subject to influence by the monetary authorities;
- a market-determined yield;
- homogeneity, yet with a good spectrum of maturities.

It is against these criteria that various suggested substitutes would need to be tested. These have included:

- bank bills;
- private sector bonds;
- other paper of Australian governments;
- central bank's own securities.

The substitute would need to be acceptable, not only to the monetary authorities but to the market generally.

In practice, the decision would be largely in the central bank's hands since any asset acceptable to it is likely automatically to be granted high status and widespread marketability. Central banks therefore tend to be cautious about on whom they confer their imprimatur.

It ought to be mentioned that some sophisticated economies get along quite well without a highly-developed money market or money market security, relying instead on the central bank as borrower and lender with the markets, and on foreign currency swaps.

The Reserve Bank has had some experience with some of these techniques.

The CGS market has grown dramatically over the past decade. For the most part, changes have involved improvements in the way in which CGS have been issued and progressive freeing-up of the financial marketplace.

The Reserve Bank has used the CGS market as the vehicle for its daily liquidity operations. If a sustained period of budget surpluses reduced the supply of CGS to the stage that the CGS market lost its depth, it could well become necessary to turn to other instruments or other methods.

The Reserve Bank will be monitoring developments closely. The liaison we have with market participants is a very valuable element in the process of evaluating markets and considering any further change that may be required. □

**Domestic, overseas and total volume of debt**
**at June 30**