AUSTRALIAN FINANCIAL SYSTEM

FINAL REPORT
of the Committee of Inquiry

SEPTEMBER 1981

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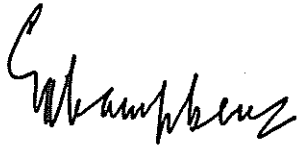
29 September 1981

The Hon. John Howard, M.P.
Treasurer
Parliament House
Canberra, A.C.T. 2600

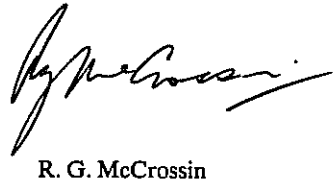
Dear Treasurer,

We are pleased to present the Final Report of our Inquiry into the Australian Financial System.

Yours sincerely,



J. K. Campbell (Chairman)



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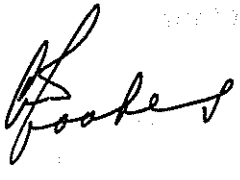

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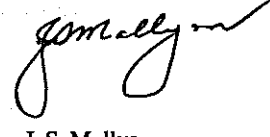

J. S. Mallyon

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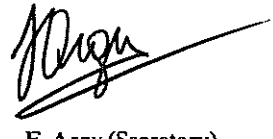

F. Argy (Secretary)

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PREFACE

1 On 18 January 1979, the Treasurer, the Hon. John Howard, M.P., announced the establishment of a Committee to inquire into the Australian financial system.

2 The Treasurer advised that the members of the Committee would be:

- Mr J. K. Campbell (Chairman)
  Chairman and Chief General Manager,
  Hooker Corporation Limited
- Mr A. W. Coates
  General Manager, AMP Society
- Mr K. W. Halkerston
  Financial Adviser
- Mr R. G. McCrossin
  General Manager, Australian Resources Development Bank Limited
- Mr J. S. Mallyon
  Chief Manager, Reserve Bank of Australia

3 Mr F. Argy, formerly First Assistant Secretary, Department of the Treasury, was appointed Secretary.

TERMS OF REFERENCE

4 The Terms of Reference are:

In view of the importance of the efficiency of the financial system for the Government's free enterprise objectives and broad goals for national economic prosperity, the Committee is asked to:

(a) Inquire into and report on the structure and methods of operation of the Australian financial system including the following institutions:
  (i) banks and non-bank financial institutions, including in relation to foreign exchange;
  (ii) the securities industry generally;
  (iii) the short-term money market, both official and non-official segments;
  (iv) specialist development finance institutions including the Australian Resources Development Bank, the Australian Industry Development Corporation, the Commonwealth Development Bank and the Primary Industry Bank of Australia; and
  (v) the Reserve Bank of Australia.

(b) To inquire into and report on the regulation and control of the system.

(c) To make recommendations:
  (i) for the improvement of the structure and operations of the financial system;
  (ii) on the regulation and control of the financial system; and
  (iii) concerning the existing legislation relating to the financial system including more importantly the Reserve Bank Act, the Banking Act and Regulations, Financial Corporations Act etc.

(d) To inquire into and report and make recommendations on such other matters as the Inquiry believes relevant to the generality of its inquiries.

APPROACH TO THE INQUIRY

5 The Treasurer tabled the Interim Report of the Committee in Parliament on 28 August 1980. It surveyed the present structure and methods of operation of the financial system and the levels and methods of government intervention in the financial system. In addition, it identified the issues that had emerged from submissions to the Inquiry and from the deliberations of the Committee to that stage.

6 Since the release of the Interim Report, the Committee has received considerable further information in the form of:

- new and supplementary submissions;
- written responses to questions from the Secretariat;
- reports from consultants commissioned by the Inquiry;
- discussions with many individuals, corporations, industry groups and government officials both in Australia and overseas.

7 Unless the Committee has been asked to treat a particular document as confidential, all documents have been made available to the public. The release of such information and the Interim Report has enabled wider discussion of the facts and issues.

8 The Committee's main conclusions and recommendations are set out in summary form at the end of the main body of the Report. They need to be seen as an integrated package of proposals for reform of the financial system by government; they reflect, in the view of the Committee, a consistent approach to the reform of the financial system and its future efficient operation and development.

9 In many instances, adoption of the Committee's recommendations will entail substantial changes to present legislation bearing on the financial system; except in some specific instances, the Committee has not generally sought to detail the particular legislative changes required.

10 In addition to releasing all the public submissions, the Committee has also published the papers prepared for it by a number of consultants and the discussion papers presented at the Inquiry's public seminars. These are available in four volumes of Commissioned Studies and Selected Papers.

ACKNOWLEDGMENTS

11 The Committee expresses its appreciation to all members of the Secretariat (listed in Appendix 1) for their invaluable assistance. The ground that had to be researched and analysed was quite extensive, as is clear from this Report and its companion volumes. Perhaps less obvious but equally important has been the task of technical preparation.

12 The Committee especially acknowledges the contribution of Mr F. Argy to its deliberations and his able, inspiring and industrious leadership of the Secretariat.

13 While much of the work of the Inquiry has been undertaken by members of the Committee and Secretariat, the task could not have been completed without extensive detailed assistance, in the form of written submissions, commentaries and technical papers, from a large range of individuals and organisations — in government, universities and the private sector. The Committee records its appreciation for their most valuable contributions.

INTRODUCTION

A. THE CHANGED ENVIRONMENT

1 The last inquiry into the Australian financial system was the Royal Commission into the Monetary and Banking System, which reported in 1936. At the time of the Commission's deliberations, the Australian economic environment was very different from now. The rural sector was more dominant, mining played only a modest role, and manufacturing was still narrowly based and largely confined to the south-eastern seaboard. Economic and financial ties with the United Kingdom were almost as close as they had been at the time of Federation but international economic co-operation was otherwise at a very low ebb. The economy still bore the scars of the world-wide depression. Unemployment was still high but prices relatively stable. The direct involvement of governments in economic affairs was small.

2 Today, the economic environment is far more complex. Australia is more industrially diversified, and mineral resources have assumed a more prominent role. The international economic environment has altered greatly, and world financial markets have become more closely integrated. Unemployment has re-emerged as a major problem but in conjunction with high rates of inflation. Over these four decades, governments have become much more active in managing the economy, making use of a wider range of policy instruments and techniques than in the 1930s.

3 In keeping with these economic developments and in response to them, the Australian financial system has undergone a major transformation. In the 1930s, the financial system consisted primarily of the Commonwealth Bank, trading banks, state savings banks, life offices and pastoral finance companies. Since then the central banking functions have been assumed by the Reserve Bank of Australia. Institutional groups which were of little significance forty years ago have since developed into positions of considerable importance (e.g. building societies, finance companies, credit unions and superannuation funds), whilst important new financial institutions have emerged (e.g. private savings banks, merchant banks, authorised short-term money market dealers, unit trusts and special purpose banks).

4 With these changes in institutional structure have come a broadening and diversification of financial instruments and techniques.

5 More recently, there have been some developments with important implications for the future structure of financing in Australia. The Committee notes in particular:

- A notable acceleration in the rate of innovation in financial technology and markets. Apart from the rapid application of computer techniques to financial

operations, the last few years have seen the development of the plastic credit card, the futures markets, secondary mortgage markets, cash management funds etc.

- A trend towards consolidation of financial intermediaries, both within and across traditional institutional structures. This is illustrated by the current mergers between banks and between building societies, and the trend for individual institutions to broaden their range of activities, e.g. the moves by life insurance companies into merchant banking and building societies. This trend follows similar developments overseas.
- Against a background of continuing inflation, there has been an increase in interest rate awareness on the part of household savers, with an associated increase in the intensity of competition for deposits.

6 Perhaps the most significant factor shaping the character of the financial system over recent decades has been the growing level of government involvement.

7 There is no doubt, for example, that the regulation of banks has assisted the development of building societies, merchant banks, finance companies and credit unions, especially in the 1960s and early 1970s. At the same time the banks have reacted to the controls by forging ownership links with non-bank intermediaries, and by turning to less regulated activities such as bill acceptance and endorsement.

8 The extensive influence of government in the financial system was detailed in the Committee's Interim Report[1] and its various facets were debated at public hearings and seminars organised by the Committee. This exposure helped to confirm the Committee's view that the community, while recognising a government responsibility to ensure stability and confidence, was nevertheless receptive to the prospect of a more open and flexible financial system, substantially free of intrusive government controls and regulations.

9 During the period of two and a half years since this Committee of Inquiry was established, government policy has not remained static. Major changes have taken place. In part this has been a natural response to the dynamic character of the financial system which this Report addresses; but it may also have reflected to some degree the impact of public discussion of the major issues of the Inquiry.

10 The most important change in public policy has been a clear shift in the overall emphasis away from direct intervention towards greater reliance on free market processes. Examples of this trend include:

- the introduction of a 'tap and tender' system for the issue of Commonwealth Bonds and Treasury notes;
- the removal of ceilings on bank term deposit interest rates;
- a relaxation of long-standing exchange control restraints on portfolio investment overseas;
- an emerging concern over the need for continued government involvement in commercial business enterprises — reflected, for example, in the decision to sell the Housing Loans Insurance Corporation to private investors.

11 While these developments generally signify lesser government intervention in the financial system, it is important not to exaggerate their significance. In particular:

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1 *Australian Financial System*, Interim Report of the Committee of Inquiry, AGPS, Canberra, 1980.

- There are still many government controls bearing heavily on private financial institutions. For example, the concession implicit in the maximum interest rate on 'small' overdrafts is now greater than it was in the 1970s; the burden implicit in the SRD ratio is also greater; the direct quantitative restrictions on trading bank lending remain; and greater influence has been brought to bear on some non-bank intermediaries.
- There appears to be a perception in some states that government financial institutions should be competing more actively for commercial financing business.
- In the area of investor/borrower protection the trend has been in the direction of increased government involvement, e.g. a strengthening of formal regulation and supervision of securities markets.

B. OUTLINE OF THE REPORT

12 When announcing the establishment of the Committee of Inquiry on 18 January 1979, the Treasurer:

- referred to the Government's '**free enterprise objectives** and broad goals for economic prosperity';
- described 'one of the important issues to be canvassed by the Inquiry' as being 'whether present levels of regulation and government involvement were appropriate', pointing out that '**the objective of the Inquiry was not more regulation by the Government**';
- noted that the Inquiry 'should be seen as a positive attempt by the Government to improve the efficiency and flexibility of the Australian financial system . . .'

13 It is not surprising therefore that the Committee has concentrated on the aims and methods of direct government intervention in the financial system. In its consideration of the issues of the Inquiry, the Committee has been guided by some basic principles relating to the appropriate role of government. These principles are outlined in Chapters 1, 18, 26 and 36 and form the underlying basis of the Committee's recommendations.

14 Within this framework, the Committee's main concern has been to promote a financial system that is **efficient, competitive** and **stable.**

Efficiency

15 The Committee's examination focused on those existing areas of government intervention which bear significantly on the efficiency of the system — and in particular:

- the heavy reliance on direct banking controls in the pursuit of monetary policy (Chapter 4);
- the administration of the Australian dollar exchange rate and the ongoing use of exchange controls (Chapters 7 and 8);
- the imposition of captive market portfolio requirements on certain institutions (Chapter 10);
- the uneven impact of some forms of taxation on the pattern of funds flows (Chapters 13–17);

- the conditions of entry into banking and the payments system (Chapters 23–25);
- the involvement of government-owned financial institutions in commercial markets (Chapters 26–31);
- the use of interest rate, lending and portfolio controls for sectoral assistance purposes (Chapters 36–41);
- government barriers to the flow of investment capital from overseas and across state boundaries (Chapters 35 and 42).

16 The Committee's study of the efficiency aspects of these issues has led it to recommend the immediate or ultimate abandonment of a wide range of direct controls and a shift to almost total reliance on open market methods of intervention in domestic financial markets. It has also recommended reduced levels of intervention in foreign exchange markets, freer entry conditions to banking, and the disposal of some goverment-owned financial institutions. **In these areas the Committee is, in effect, asking that more confidence be placed in the disciplines and processes of the market.**

17 Where government involvement is considered necessary, the Committee has sought to minimise its effects on the neutrality of funds flows. For example, it has recommended a more functional, uniform approach to prudential regulation (within a consistent national framework), the application of more stringent efficiency and neutrality tests to commercial government-owned financial institutions, and a program of tax reform designed to achieve greater fiscal neutrality.

18 In making these various recommendations the Committee is not questioning in any way the underlying economic, social or prudential objectives being rightfully pursued by governments. What is being questioned is the **cost-effectiveness** of the particular **methods** of intervention being pursued.

Competitive Structure

19 The Committee is conscious that markets are more likely to allocate funds efficiently if they are competitive and participants are numerous and well informed. It has therefore examined closely aspects of these issues in Chapters 32, 33 and 44. In these chapters it draws attention to:

- some areas of inadequate competition;
- the declining role of individual investors in securities markets;
- high and rising levels of market concentration; and
- some gaps in the dissemination of information.

20 By and large, however, the Committee is confident that if official barriers to entry and participation are removed (and if the Trade Practices Commission operates effectively) the financial system will be strongly competitive. This will ensure that funds are generally allocated in an 'efficiently neutral' fashion to all groups and sectors in the economy and that priority is given to areas of highest investment return.

21 The declining role of individual investors in securities markets is discussed in Chapter 33. The Committee does not view these trends with concern on **efficiency** grounds, but recognises that there are other considerations.

22 The high and increasing share of financial business held by a few large

institutions (discussed in Chapter 32) may raise more difficult issues for policy. The Committee sees no threat to the competitive vigour of financial markets, so long as its package of recommendations is adopted, but the authorities will need to monitor concentration trends closely.

23 Information deficiencies are identified throughout the Report and are drawn together in Chapter 44. Again, the Committee, while making some important recommendations, does not see these deficiencies as a major impediment to the efficient operation of financial markets.

Stability

24 Confidence and stability are essential ingredients of any effective financial system. These in turn hinge crucially on the stability of the overall monetary environment. The Committee has therefore devoted a number of chapters to the issues bearing on overall monetary stability. In particular, it has examined:

- whether the Reserve Bank, as presently constituted, is able to exercise a fully effective role, both in the development and application of monetary policy and as 'guardian' of the stability of banks in particular, and more generally of the financial system (Chapter 2);
- the contribution that monetary targeting might make to the promotion of a stable climate of expectations (Chapter 3);
- the adequacy of existing liquidity support facilities (Chapter 5);
- possible ways of reducing the incidence of seasonal liquidity fluctuations (Chapter 6); and
- whether a more market-oriented, innovative approach to the sale of public securities might be developed, given the importance of public sector borrowings for monetary conditions and the pattern of funds flows (Chapters 9, 11 and 12).

25 A stable overall environment is important — but it will not ensure that adequate prudential disciplines are observed by individual institutions. For this reason, and because of community concern for the small, risk-averse household investor, the Committee has looked critically at the effectiveness of the present system of prudential regulation of banks and other financial intermediaries, and in some areas has suggested **more** rather than less government involvement, although with emphasis on increased **flexibility** of regulation wherever possible (Chapters 19 and 20).

26 The regulatory framework affecting investors in companies and securities is analysed in Chapter 21 and the developing structure of regulation for the protection of borrowers is covered in Chapter 22.

27 The effects of inflation on the tax base, the structure of business financing, efficiency of securities markets etc. are analysed in Chapters 17, 34 and 43. In these and other chapters, the Committee has expressed concern about the implications of sustained inflation for the stability of corporations and securities markets.

28 On all these various issues, the Committee has made specific recommendations, **the cumulative effect of which will be (in its opinion) a more stable, better informed and fairer financial system — yet one that is adequately flexible and responsive to changing needs and conditions.**

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C. IMPLEMENTATION

29 The Committee is aware that many of its proposed changes will, if implemented, have significant effects on:

- the competitive structure of financial intermediation; and
- the distribution of income between different groups of lenders and borrowers in the system.

30 Many people in the community will be concerned about these structural and distributional effects and may wish to see a much more 'gradual' process of reform, together with a policy of systematic compensation. The Committee fully understands the basis for such concern, and has given considerable thought to the potential disruption and the implications for particular groups.

31 In regard to structural effects it has accepted the need for gradual change in some areas.

32 In regard to the distributional effects, the practical difficulties of identifying 'winners' and 'losers' have led the Committee to reject the principle of compensation. Any personal hardship to individuals arising directly or indirectly out of the Committee's recommendations can be most effectively and efficiently dealt with through general welfare policies.

33 The Committee recognises the interrelationships between a number of its recommendations, and sees dangers in a piecemeal, fragmented approach to reform. Where interrelationships exist, it may be counter-productive if the Government were to implement certain recommendations while indefinitely deferring others.

34 This Report is submitted at a time of world economic uncertainty and unsettled financial markets. The Committee acknowledges this situation and the special responsibility this imposes on governments for stable and effective economic management. In the Committee's view, such a responsibility can be more effectively discharged within a flexible, responsive and efficient financial system.

35 The Committee commends the proposed reforms to those concerned with the efficiency of the Australian financial system.

CHAPTER 1: GOVERNMENT INVOLVEMENT IN THE FINANCIAL SYSTEM

A. INTRODUCTION

1.1 The Committee starts from the view that the most efficient way to organise economic activity is through a competitive market system which is subject to a minimum of regulation and government intervention.

1.2 The Committee is conscious that unregulated financial markets do not always work perfectly: they may not be sufficiently competitive and information may be costly or difficult to obtain. As well, free markets might not ensure stability and confidence — essential prerequisites of an effective financial system.

1.3 It nevertheless holds firmly to the view that the discipline of the market remains the most economically efficient basis for allocating funds and resources, from the viewpoint of the community as a whole.

1.4 A competitive market unfettered by government regulation is **economically neutral** in the way it allocates funds to different groups and sectors: investments which offer equal risk/return combinations are priced equally and borrowers with equal risk are offered similar terms and conditions. While, in practice, financial markets do not always achieve this ideal degree of economic neutrality, they approximate it more closely than any non-market system.

1.5 Moreover, where it seems that markets are failing to allocate funds efficiently, a closer analysis usually shows that the problem arises not from within the market mechanism but from factors external to it. For example, where the market is not responding effectively to demands for particular forms of finance — such as from small businesses or home buyers — the fault may well lie with government regulation, especially of interest rates. Again, the weaknesses and gaps in longer term debt markets at present are importantly a reflection of the high and uncertain levels of inflation; they are not a symptom of technical failure of the financial system itself. Indeed, the system has shown considerable ability to adjust and adapt to the problems created by inflation.

1.6 The Committee is well aware that an 'economically neutral' flow of funds may not be consistent with the community's **social priorities.** Even if there were perfect competition and perfect knowledge, a social misallocation of resources could occur to the extent that **private** costs and returns — the basis of competitive decision making — may not fully reflect **social** costs and returns.

1.7 Clearly governments must have regard for important objectives besides economic efficiency. The growth in government intervention in the financial system over the last few decades can be explained largely in terms of these other objectives. The Committee in no way questions the social priorities of governments. What it seeks to do in this Report is to draw attention to the

implications for efficiency of the various methods of intervention applied by and available to governments. **It is not clear to the Committee that efficiency implications have always been adequately taken into account in the past.**

B. OBJECTIVES OF INTERVENTION

1.8 The rationale for government intervention in the financial system may be viewed from a number of standpoints:

- efficiency;
- diversity of choice;
- competitive neutrality;
- stability of the financial system;
- macroeconomic stability; and
- social objectives.

(a) Efficiency

1.9 The efficiency of the financial system can be assessed on the basis of three criteria:

- *Allocative Efficiency* — i.e. the extent to which the system is successful in directing savings into the highest yielding forms of investment.
- *Operational Efficiency* — i.e. the extent to which resource costs are minimised for any given level of service provided.
- *Dynamic Efficiency* — i.e. the capacity of the system to adapt to changing needs, generate innovations in financial services and raise productivity.

1.10 Apart from the possible distorting effects of government intervention itself (discussed in Section C), the two factors most likely to impair the efficient functioning of the financial system are:

- inadequate competition; and
- imperfect information and knowledge.

(i) Barriers to Competition

1.11 Effective competition is important for the efficient operation of the financial system. This applies whether the transfers of funds between savers and borrowers take place **directly** — e.g. through stock exchanges, intercompany lending, the commercial paper market etc. — or **through intermediaries.**

1.12 Generally, the Committee formed an impression of a highly competitive financial system, but it became aware of areas where competition could be stronger (and recommended appropriate action), or where the market was dominated by a few institutions.

1.13 The Committee notes that the existence of only a small number of effective competitors in an industry does not necessarily justify government intervention. Specifically:

- The intermediary group in question may face effective competition from other intermediaries; banks, for example, are subject to keen competition from building societies and credit unions, and from money market dealers and merchant banks, in some of the markets in which they deal.

- In certain areas, economies of scale in financial intermediation may make larger units more efficient in an operational sense than smaller units. In such a case, the Government would need to have regard for potential losses in operational efficiency when considering whether to intervene to increase the number of competitors.
- Smallness of numbers does not necessarily mean ineffective competition — indeed the opposite is often the case; nevertheless, there may be a tendency for a small number of existing firms to engage in various forms of collusion — explicit or implicit. **These tendencies are minimised if there is opportunity for new entry, supported where necessary by effective trade practices legislation.**

1.14 The Committee recognises that a policy change cannot be supported simply because it represents a move towards freer competition. What is first required is a careful analysis of all the likely ramifications of the proposed change. Attention is drawn to the dangers of carrying out economic reforms in an ad hoc, piecemeal fashion — more specifically, in the context of this Inquiry, of implementing only some of the Committee's recommendations without due regard for the others.

(ii) Information Gaps

1.15 It is important that adequate information be available to assist investors in assessing the risks and expected returns attached to various financial assets.

1.16 It has been argued that there are some impediments to the effective flow of information between potential borrowers and lenders, and that governments should take action to rectify the situation. The Committee accepts that it is legitimate for governments to intervene in some cases (e.g. to ensure adequate and accurate disclosure of financial information by companies raising funds from the general public or to prohibit 'insider' trading). However, before government intervention can be justified it must be demonstrated that:

- the benefits of the required additional information clearly outweigh the costs of collection and compliance; an
- the problem could not be better handled within the private sector; the call for intervention is often no more than an attempt to have government meet the costs inherent in the search for investment or borrowing opportunities.

(b) Diversity of Choice

1.17 A major desirable characteristic of a financial system is that it present investors with a wide choice of financial instruments.

1.18 There are three important characteristics of financial instruments which are relevant to this discussion:

- risk (arising from variability in the overall return);
- return (income plus capital gain); and
- liquidity (the ease with which a financial instrument can be turned into means of payment).

1.19 In general it can be anticipated that the market will, over time, equalise expected real returns on alternative investments after some allowance is made for the different characteristics of various assets — particularly the different risks involved — and the incidence of tax.

1.20 The existence of a diversity of choice for investors has two major advantages:

- it allows investors to choose the portfolio mix most appropriate to their risk/return/liquidity preferences and planned patterns of expenditure; and
- it permits diversification over a number of assets involving different types of risk and gives investors the opportunity to reduce the average overall risk of their portfolio by including in it investments the outcomes of which are not closely related.

1.21 Provision of a suitable range of choice to investors requires the existence of a completely riskless asset[1] — including, ideally, one which yields a secure real return. Governments can facilitate the provision of a riskless asset (at least in terms of nominal returns) by either issuing it directly or by protecting the intermediary providing the asset. Currently, the assets most commonly seen as providing secure nominal returns are government obligations and bank deposits.

1.22 Although the Committee does not question the desirability of having appropriate 'safety havens' for small, risk-averse investors, it is just as important for the financial system to offer less safety-conscious investors an adequate diversity of choice. Indeed, it has been suggested that, due to over-regulation, a 'risk' gap exists for small investors in some countries because they do not have available to them an asset which involves a moderate degree of risk.

1.23 The Government can play a role in ensuring that a diversity of choice exists by removing any factors (such as over-restrictive or excessively wide-ranging prudential regulation) which inhibit private financial institutions from providing assets with the characteristics demanded by investors — this is, of course, one aspect of ensuring the dynamic efficiency of the financial system. Once this is done the interaction of supply and demand in the market will provide the most appropriate mix of assets of various types.

(c) Competitive Neutrality

1.24 Since governments, in the proper exercise of their responsibilities, will inevitably have an impact on the financial system, a question of crucial importance is how they might ensure that their actions have a fairly neutral impact on funds flows. The Committee is strongly of the view that a move towards greater 'competitive neutrality' would enhance the allocative and operational efficiency of the financial system. **In particular, it stresses the need for consistency in the regulatory and taxation burdens imposed on different intermediaries.**

1.25 Neutrality of the taxation system is a basic underlying theme of Chapters 13–17, where several recommendations are made that would achieve progress in this direction. Chapter 4 proposes a more even-handed approach to monetary policy regulation. Chapters 18–21 point the way to a more consistent system of prudential regulation.

1.26 Equality in the regulatory burden raises especially difficult problems — both conceptual and practical. It can be achieved in three ways:

- every financial intermediary could be subject to the same monetary policy and prudential regulation;
- each class of intermediary could be subject to different regulation, but with the balance of benefits and burdens being the same across all intermediaries; and

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1 At least in the sense that contractual obligations with regard to capital and nominal return are certain to be met.

- functionally similar operations could be subject to similar regulation.

1.27 Given the wide variation in the type of business done by different types of intermediary, the first approach is not feasible.

1.28 The second approach (which has been referred to as 'a balancing act') involves two fundamental problems. Firstly, it is doubtful that such an approach can ever successfully achieve competitive neutrality in practice, especially in areas where entry is restricted.

1.29 Secondly, even where a balance is achieved, the regulatory arrangements may have indirect effects on the efficiency of the system. For example, if an intermediary is given a government 'guarantee' on its borrowings but allowed to invest only in a very restricted range of assets, both forms of government intervention may reduce the allocative efficiency of the system.

1.30 In principle, the best way of achieving equality in the regulatory burden is by a functional approach — a group of intermediaries performing a particular activity (e.g. competing for household deposits) should generally be subject to comparable monetary controls and prudential regulation, having regard to the differing characteristics of their assets and general perceptions of risk. It is, of course, true that it is not always easy to draw precise lines around different 'activities' or segments of the market. Ultimately, every borrowing or lending activity is in competition with every other and this will be especially true in the more integrated financial system envisaged by the Committee.

1.31 Freedom of entry to each activity would help to ensure that, over the longer term, there is a balance of burdens and benefits (regulatory or otherwise) across activities, and that users of financial services receive neutral treatment. However, there may be reasons (e.g. on stability grounds) for imposing requirements on entry to certain types of activity. Particular examples of this include the cheque payments system and foreign exchange dealing. In some cases, for example entry into banking, the Committee accepts that a change to freer entry may appropriately involve a number of steps.

(d) Stability of the Financial System — Investor Protection

1.32 The stability of the financial system as a whole is of vital importance. The system could not operate efficiently unless investors at large have confidence in the underlying solvency of financial institutions as a group and in the stability of financial markets overall. Governments therefore have a responsibility to ensure that there is public trust in the soundness and fairness of the financial system.

1.33 As explained in Chapter 23, the Committee attaches special importance to the maintenance of confidence in the core of the payments mechanism, because of the integral role it plays in facilitating economic activity.

1.34 It is also recognised that knowledge of the existence of prudential regulation can provide either a substitute for, or a useful basis for, the assessment of risk by individual investors; an assessment which would otherwise have required costly and time-consuming effort of a duplicative kind. Similarly minimum disclosure requirements can prevent the duplication of basic information search costs, as well as helping to ensure that savers have proper and reasonable opportunity to measure and assess risk. More generally, the Committee accepts that governments have a responsibility to ensure that small investors have an adequate range of 'safe' outlets for their savings.

1.35 To some extent, therefore, government prudential regulation of financial institutions and markets is both necessary and desirable. What is at issue is the **degree** of government involvement (as well as its form).

1.36 One view is that the stability of **all** institutions, or at least all those which deal with small savers, should be protected by government. The Committeee does not accept this view.

1.37 Full protection of most individual financial institutions would lead to a significant reduction in the diversity of investor choice and tend to create the 'risk gap' referred to earlier. It would also encourage the growth over time of new, unregulated but possibly less efficient institutions to fill this gap. The authorities would then have to decide whether those institutions should be subject to the same protective regulations.

1.38 The Committee considers that, except where there are strong reasons for believing that the overall stability of the financial system would be impaired, it is in the interest of a competitive and efficient financial system for non-viable financial intermediaries to be allowed to fail in the same way as non-financial businesses — although the manner in which the failure is handled is, of course, important.

(e) Macroeconomic Stability

1.39 A major concern of governments is to attain high levels of employment and rates of economic growth consistent with stable prices. Accomplishment of these aims will contribute to community well-being in a number of ways, not least through creating an economic environment which allows the financial system and other markets in the economy to function more effectively. For example, the removal of inflation would relieve many of the stresses currently placed on the financial system; the implications of inflation for financial markets are discussed in Chapter 43.

1.40 Given the importance of the financial system as a channel for implementing monetary policy, it is of course legitimate for governments to intervene through the system in pursuit of macroeconomic objectives.

1.41 However, governments must attempt to ensure that any costs imposed on the financial system by way of loss of efficiency and equity are minimised. It is the Committee's view that these costs will be lower if governments rely to a greater degree on market-oriented instruments to implement monetary policy. The alternative techniques of monetary control, and their costs and benefits, are discussed in Chapter 4.

(f) Social Objectives

1.42 Government intervention in pursuit of social objectives may aim to:

- assist particular sectors in the community;
- influence the ownership structure of financial institutions; and
- alter saving behaviour.

(i) Sectoral Assistance

1.43 For equity or other social reasons, governments may choose to assist particular classes of savers or borrowers. In Australia, savers through superannuation funds have traditionally received special concessions, while

'preferred' borrowers have from time to time included the housing, rural, small business, export and government sectors. For example:

- government measures to increase the availability and reduce the cost of housing finance aim to make it easier for those on low and medium incomes to purchase homes and to encourage home ownership generally;
- the interest rate ceiling on small overdrafts has been perceived as a form of positive discrimination to provide 'cheap' finance to small businesses, including farmers;
- 'captive market' borrowings have their origin in a government desire to obtain an assured market for its securities, generally at less than market interest rates.

1.44 Social priorities are basically matters for governments to determine. Nevertheless, as previously mentioned, a valid question for the Committee is how far the basic objectives of sectoral intervention could be realised through methods of assistance which produce less interference with the functioning of the financial system. This important issue is taken up again later in this chapter and is examined more fully in Chapter 36.

1.45 Sectoral objectives have been pursued through various means, but the techniques of most concern to this Inquiry are interest rate controls and portfolio requirements imposed on banks and other financial institutions. Also worthy of some consideration is the role of government financial institutions as a channel for sectoral assistance. Chapters 37–42 discuss these issues in relation to specific sectors of the economy.

(ii) Dispersion of Ownership

1.46 Governments may seek to influence the ownership structure of financial institutions for social reasons, e.g. in order to avoid what they regard as an undue concentration of financial power, or because of concern, on economic grounds, about the implications of such concentration for the competitive environment and the efficiency of securities markets. This issue is principally discussed in Chapter 32.

1.47 Governments may also wish to restrict the growth of foreign ownership and control of financial institutions. This desire may have a social basis, but it has also been suggested that the extension of financial linkages with the international economy would reduce the effectiveness of monetary policy and increase Australia's sensitivity to overseas financial disturbances. These matters are raised in Chapter 25.

(iii) Saving Behaviour

1.48 An efficient financial system will assist savers to make more rational judgments about how much to save and also help to ensure that savings are put to the most productive use and this will in turn encourage saving. However, governments will not always be satisfied with the saving ratio produced by an uncontrolled financial market; they may, for example, desire to stimulate the long-term rate of saving in order to increase the proportion of resources devoted to investment (public or private) or to reduce dependence on foreign capital — an issue covered in Chapter 35.

1.49 Governments may also wish to influence the structure of savings, e.g. by providing special encouragement to long-term contractual saving; some aspects of this issue are discussed in Chapter 15.

1.50 In this context it is appropriate to note that often in the past governments have pursued their sectoral or social objectives by methods which do not have sufficient regard for their adverse effects on the returns available to savers and hence, perhaps, on the community's overall propensity to save. Interest rate controls are a case in point.

C. METHODS AND COSTS OF INTERVENTION

1.51 For the various reasons outlined above, governments have sought to influence the relative cost and availability of funds in the economy.

1.52 The methods of intervention used have varied according to the nature of the objectives being pursued, as well as the prevailing economic and political circumstances. They can be grouped under six basic headings:

- market-oriented intervention, where the Government actively participates in the market as a buyer or seller of financial assets;
- direct regulation of financial intermediaries and markets, which may take such forms as interest rate controls, portfolio or balance sheet restrictions, licensing and entry restrictions;
- extension of official protection to investors, e.g. through government 'guarantees' or through official liquidity support facilities;
- public ownership, i.e. the establishment of partly or fully government-owned financial intermediaries to provide particular facilities or services, either exclusively or in competition with private enterprise;
- direct subsidies, grants or tax concessions to ultimate borrowers or investors, e.g. income tax deductibility for interest on home loans; and
- loans or subsidies channelled through commercial rmediaediaries, e.g. the provision of additional housing finance through savings banks in 1974.

1.53 Many of these methods of intervention have detrimental side effects on efficiency and competitive neutrality in financial markets. These effects are fully discussed throughout this Report.

1.54 The aggregate efficiency costs of government intervention in the financial system are difficult to quantify. Studies in this area have produced varying estimates of the costs involved; in no case are they negligible and in some cases they are quite substantial (see Appendix 4.1 of Chapter 4). The Committee accepts that some of the costs involved are intangible and may involve non-economic judgments, but it is firmly of the view that the overall impact of regulation on national productivity and welfare is highly significant, especially if the 'dynamic' effects are taken into account.

1.55 The potential impact on efficiency will depend crucially on the **method** of intervention employed.

1.56 As a general proposition **market-oriented intervention** is most desirable on efficiency grounds because it influences the broad conditions of supply, demand and cost of credit across the entire financial system. Also, it can be designed so as not to distort the relative competitive standing of different lenders and borrowers. By contrast direct regulation not only interferes with the allocation of funds but reduces the ability of the financial system to respond flexibly to changes in the operating environment.

1.57 However, market intervention by the authorities — as a buyer and seller of financial assets — is not always an appropriate or effective method of achieving the objectives of government. It has application to objectives such as macroeconomic stability and the general stability of financial markets but it has very little relevance for other objectives such as sectoral assistance, competition and the stability of individual institutions.

1.58 **Direct regulation** may be the most effective method of pursuing certain prudential objectives; e.g. it is necessary to prescribe rules on disclosure and reporting requirements, if governments are seeking to minimise the exposure of investors to fraudulent practices and to ensure they have adequate information.

1.59 Unfortunately, direct regulation has been used for objectives other than investor protection. Even where designed to protect investors, regulation has often taken forms less conducive to efficiency. For example, portfolio restrictions have the effect of interfering with the operational and dynamic efficiency of the private intermediaries affected.

1.60 **Official protection,** e.g. through 'guarantees' or similar commitments, may provide an alternative method of protecting investors. Here too there will often be costs for the financial system, e.g. if carried beyond a point, it will excessively reduce the diversity of choice available to investors/borrowers and possibly discourage the exercise of commercial prudence.[2] Allocative efficiency may also be seriously affected.

1.61 However, these consequences of official protection policies may be reduced where:

- the protection is limited in scope and coverage;
- a functional approach[3] is adopted (where practicable), so that it causes minimal disturbance to the relative competitive standing of different institutions; and
- the costs of government protection are commercially assessed and fully paid for by the beneficiaries.

1.62 The provision of liquidity support facilities by the central bank (lines of credit or discount window arrangements) can be viewed as a special kind of official intervention to protect investors in particular circumstances. Unless applied with great restraint, this approach would raise similar reservations, e.g. in relation to 'moral hazard' and the possibility that it might discourage adequate self-reliance.

1.63 **Public ownership,** as a method of intervention, has most relevance where the aim is to promote effective competition, discourage monopolistic practices in financial markets, or fill 'gaps' which would not be filled by private enterprise. However, from the point of view of efficiency, the Committee believes that it should be regarded as a last resort device and not attempted until other appropriate measures have been taken, including:

- removal of unnecessary restrictions on entry;
- removal of controls that unnecessarily restrict competition and diversification; and

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2 This is an example of 'moral hazard', a term which refers to the incentive for guaranteed investors or borrowers to engage in risky behaviour unless a fee is charged for the guarantee which is proportional to the risk involved.

3 In the functional approach to regulation, the focus tends to be on activities rather than intermediaries.

- appropriate action through trade practices legislation.

1.64 Government intervention in pursuit of sectoral assistance objectives can be implemented through a wide range of options, possibly covering the full spectrum of methods listed in paragraph 1.52.

1.65 Nonetheless, the Committee believes that if a government considers that a particular sector or activity should be assisted because social returns are not being adequately captured in private investment calculations, it is best done through a **direct subsidy, grant or tax concession** to that particular sector or activity.

1.66 The merits of this approach are that the costs of the subsidy are visible and quantified, providing a basis for continuing assessment of the appropriateness of the levels of assistance; its burden is spread equitably over all taxpayers; it runs less risk of being ill directed and can be structured in such a way that it does not distort the use of credit relative to other productive inputs.

1.67 Where it is intended that the assistance take the form of concessional credit, the Committee generally prefers that such assistance be transmitted through the medium of existing commercial institutions rather than through a government-owned intermediary. This is further discussed in Chapter 36.

1.68 As a general rule, the Committee has preferred those methods of intervention which act directly on the policy objective or target group.[4] Indirect methods of intervention tend to produce new distortions elsewhere in the system. They also tend to be more costly as the benefits cannot be confined to the target group.

D. GUIDELINES FOR REFORM

(a) Basic Approach

1.69 Two key points which emerge from the foregoing discussion are that:

- some methods of intervention impose greater efficiency costs than others; but
- methods of intervention that are desirable on efficiency grounds may not always be the most effective in achieving their specific objectives.

1.70 Under its Terms of Reference, which refer to 'the importance of the efficiency of the financial system for the Government's free enterprise objectives', the Committee is expected to give the efficiency of the financial system a high ranking in its order of priorities. At the same time, it recognises that a narrow focus on efficiency would be too restrictive. Therefore, in evaluating the various forms of government intervention in the financial system, the Committee has tried to carefully weigh up the efficiency costs of each method of intervention against its effectiveness in achieving its principal specific objectives.

1.71 Frequently in this Report, the Committee refers to the 'most cost-effective' method of achieving any given policy objective. By that, it means the one that achieves the appropriate balance between effectiveness (in the attainment of the desired objectives) and efficiency (in the flow of funds).

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4 Some of the issues involved are discussed in R. Albon and A. Cheok, 'The Economics of Sectoral Assistance', Australian Financial System Inquiry, *Commissioned Studies and Selected Papers*, Part 4, AGPS, Canberra 1981.

1.72 Reform of the financial system can be tackled in two distinct ways:

- The first way would be to take as a starting point a hypothetical financial system totally free of government intervention. The usefulness of any particular example of government intervention is then measured by asking whether it would be advantageous to **introduce** it into such a system; if the answer is in the negative and this type of intervention is already taking place, it should be removed.
- The alternative — more 'evolutionary' — course of reform would be to take the present system as its starting point and to assess the usefulness of each existing case of government intervention by asking whether it would be advantageous to **remove** it from the system (having regard for other reforms proposed).

1.73 The Committee has rejected the first alternative because the totally 'free' financial system postulated does not exist, and a real-life counterpart to it has never existed; this makes it particularly difficult to estimate the costs and benefits of proposed changes from such a system.

1.74 A further major objection is that it does not take account of the costs of disruption to the existing institutional and social structure caused by the removal of an existing form of government intervention. For example, it is uncertain what type of institutional structure would exist in the hypothetical financial system, but it is clear that the existing system includes a complex and interrelated set of financial institutions. While the Committee does not regard this structure as immutable, it feels that the costs of transforming it must be taken into account in formulating any recommendations, especially as any disruption is likely to be fairly immediate while the benefits probably extend over a much longer period, and may be seen to be less certain.

1.75 For these various reasons the Committee believes the second approach to reform is the more responsible and realistic one to adopt.

1.76 This has caused it to recommend, in one or two instances, the **retention** of government involvement even though such involvement might have failed the 'cost-effectiveness' test if its **introduction** were being considered. However, the Committee has been mindful of this danger and has subjected existing forms of government intervention to stringent tests. In particular, in judging whether an existing piece of government intervention should be retained or whether a suggested regulation should be introduced, the Committee has taken the attitude that the onus of proof rests on those who support the government regulation or intervention in question. That is, where the balance of benefits and costs has seemed fairly even, it has recommended against government intervention. This approach arises out of a basic predilection for less rather than more government involvement in the economy.

1.77 The Committee also points out that it has not hesitated to recommend a change in the system which it has judged to be, on balance, beneficial even where it was expected to have **incidental** effects on the distribution of income (business or personal), i.e. effects unrelated to its major objective. In most cases the incidental distributional effects on society of the reforms proposed should not be large; and any personal hardship that may arise out of the process of reform would in the Committee's view be appropriately dealt with through the welfare process.

1.78 This is not to say that the Committee has been insensitive to distributional effects. Firstly it has, wherever possible, drawn attention to some of the more

significant distributional implications of its recommendations, even when these have been incidental in character. Again, where it has recommended removal of a government control or regulation the **principal objective** of which was to redistribute income in a particular way, the Committee has sought, whenever possible, to point to more cost-effective means of achieving this objective. Finally, where it was feared a change might cause considerable disruption but the long-run benefits were considered to be sizeable, the Committee has recommended the change but has suggested appropriate transitional arrangements.

(b) The Role of Government

1.79 Subject always to the most cost-effective method of intervention being used, the Committee sees a proper role for government intervention in certain circumstances.

1.80 ***Firstly,*** **there is a clear justification for government intervention where it is necessary to ensure free, fair and competitive markets.**

1.81 In this regard, governments have an obligation to provide:

- an appropriate legal framework for contractual arrangements, and to minimise the scope for fraud, malpractice and misinformation; and
- an economic and legal climate that encourages competition and adequate freedom of entry.

1.82 Given the adoption of its recommendations in this Report, the Committee does not see the need for a more extensive or active government role in promoting the efficient performance of financial markets.[5] At the same time, it would not wish to see the Government's present role in providing the basis for a competitive framework significantly reduced.

1.83 ***Secondly,*** **the Committee sees a limited but vital role for direct government intervention to safeguard the underlying stability of the financial system.**

1.84 The Committee is satisfied that the financial system is fundamentally sound and stable. It does however propose some changes in the structure of prudential regulation, and puts forward a number of significant suggestions as to methods of regulation. While emphasising flexibility in terms of requirements imposed by various authorities, it also points to the need for greater consistency in the interests of competitive neutrality.

1.85 ***Thirdly,*** **it is acknowledged that the implementation of monetary policy aimed at achieving such objectives as price stability and high employment requires a degree of government intervention in the financial system. For example, it may be necessary on occasion to supplement open market operations with a form of direct control.**

1.86 However, direct controls must be used sparingly because they generate costs in other directions and these must be set against any gains in terms of more effective economic policy. In addition, there is real doubt about the long-term effectiveness of financial regulation, exchange controls and 'captive market'

5 The qualification made about adoption of the Committee's recommendations needs to be emphasised. Unless, for example, many of the present barriers to entry are removed, as recommended by the Committee, there is no guarantee that competition will be adequate in all areas of the financial system.

arrangements as instruments of economic policy. **The Committee believes that existing levels and methods of intervention in the financial system for economic policy purposes need to be fundamentally re-evaluated.**

1.87 ***Fourthly,*** the Committee accepts that if a government wishes to influence the spread of ownership in the financial system (whether as a means of avoiding undue concentration of power or for the purpose of limiting foreign control), there may be no alternative to direct intervention in the system. The Committee has pointed to some of the implications of such intervention for the efficiency of the financial system, but recognises that it is ultimately a matter for political judgment.

1.88 ***Fifthly,*** and in similar vein, it is fully recognised that governments may wish at times to redeploy resources to particular regions, sectors or groups where it does not feel the market is allowing adequately for 'externalities' or producing a socially acceptable distribution of finance and resources. **In this area, the Committee's broad conclusion is that the social objectives may be better achieved by means other than through intervention in the financial system.**

1.89 ***Sixthly,*** **it is clear that the need for government intervention and the appropriate methods of intervention change over time. Consequently it is incumbent on the authorities to maintain a continuing oversight of the benefits and costs.**

CHAPTER 2: ROLE OF THE RESERVE BANK

A. INTRODUCTION

2.1 The functions of the Reserve Bank are set out in the *Reserve Bank Act* 1959, the *Banking Act* 1959 and the *Financial Corporations Act* 1974, and regulations under those Acts. A summary is provided in Chapter 4 of the Committee's Interim Report. In brief, the Bank has been chartered by Parliament with a range of powers and responsibilities especially with regard to monetary policy, external policy and stability of the financial system. The Bank also provides various banking and financial services for the Government, financial organisations and the community generally.

2.2 The Reserve Bank Act gives the Bank extensive powers with regard to the formulation and implementation of monetary and banking policy. Section 10 of the Act states that:

> It is the duty of the Board, within the limits of its powers, to ensure that the monetary and banking policy of the Bank is directed to the greatest advantage of the people of Australia and that the powers of the Bank...are exercised in such a manner as, in the opinion of the Board, will best contribute to:
>
> (a) the stability of the currency of Australia;
>
> (b) the maintenance of full employment in Australia; and
>
> (c) the economic prosperity and welfare of the people of Australia.

2.3 The Reserve Bank's responsibilities[1] may be broadly summarised as:

(a) *Economic stabilisation policy*

- advise the Government on economic stabilisation policy generally and on other aspects of policy bearing on monetary and financial conditions;
- subject to keeping the Government informed and within the powers conferred in the Reserve Bank Act, formulate and implement monetary and banking policy;
- advise on the formulation and conduct of external policy and administer the policy determined with regard to both foreign exchange and exchange control.

(b) *Stability of financial system*

- to protect the stability of the financial system by:
  - acting as a central bank;

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1 Chapters 4 and 11 of the Interim Report gave details of the broad range of functions the Bank is required to perform, in addition to its monetary and banking policy functions; Chapter 24 noted issues that have been put to the Committee concerning the role of the Bank. (See *Australian Financial System*, Interim Report of the Committee of Inquiry, AGPS, Canberra, 1980.)

— determining appropriate standards of financial practice and management for banks and authorised dealers;

— acting, at its discretion, as banker and financial adviser to certain financial institutions;

— influencing the operation and development of the financial system — including some non-bank financial intermediaries.

(c) *Banker and financial agent of government*

- to provide banking services to government;
- to provide other financial services to government;
- to manage the currency note issue;
- to distribute coin on behalf of government;
- to assist the marketing and management of government debt;
- to assist in the financing of government by the acquisition of government securities including Treasury Bills;
- to manage the investment of the nation's foreign exchange reserves.

(d) *Banker to others*

- to undertake lending to specific rural sector bodies;
- to provide selected banking services to banks.

(e) *Financial intelligence and accountability*

- to monitor economic and financial conditions using powers conferred in both the Banking Act and Financial Corporations Act and inform the community;
- to report to the Parliament and to the community generally on the operations of the Bank and its role in the determination and execution of policy.

2.4 These various functions could be separately institutionalised but, for reasons discussed later, there is a strong case for their co-ordination within the framework of a single institution.[2] Therefore in considering the appropriate role and level of independence of the Reserve Bank in discharging its responsibilities — the subject matter of this chapter — the Committee envisages that the Bank will continue to perform each of these functions.

2.5 Attention is initially focused on the Bank's **policy** functions, embracing its monetary policy, external policy, financial stability and intelligence roles. The Bank's functions as financial agent of government and a short-term lender to the rural sector are then discussed.

B. POLICY FUNCTIONS

(a) Reserve Bank Independence

2.6 Sections 8, 10 and 26 of the Reserve Bank Act specify the major powers of the Bank. The Bank's position vis-a-vis government, as assessed by the Committee, is summarised in the following paragraphs.

2 The specific question of whether prudential and monetary policy responsibilities should be carried out by separate institutions is discussed later in this chapter.

2.7 Firstly, the Bank is an important independent **source of economic policy advice** to government; one would expect its advice to carry substantial weight in the overall policy decisions of government in relation to financial matters. The Bank's advisory capability is strengthened by its independent research and intelligence-gathering capacity.

2.8 Secondly, in the **determination of overall monetary and banking policy** the Bank, while having the power to formulate policy, is ultimately subordinate to government. Section 11 of the Act:

- requires the Board of the Bank to inform the Government, from time to time, of the monetary and banking policy of the Bank;
- requires, in the event of a difference of opinion between the Government and the Board of the Bank (as to whether that policy is directed to the greatest advantage of the people of Australia), that the Treasurer and the Board endeavour to reach agreement;
- gives the Government ultimate power, where agreement cannot be reached, to direct (and take responsibility for) the Bank to pursue the Government's chosen policy.

2.9 Where such a direction is given, the Treasurer must notify the Parliament of the views of both the Government and the Bank. This provision of the legislation is seen as protecting the integrity of the Bank in balancing its duty as a vehicle for government policy with its central banking responsibilities to the financial and general community.

2.10 The interaction of the Bank with government in the formation of policies has worked to ensure that, up to the present, there has never been an irreconcilable difference of opinion of sufficient magnitude as to require reference to the Parliament. It is to be expected that the consultation and discussion provisions should, in all but extreme situations, lead to an accommodation of any differences of point of view.

2.11 Thirdly, the Bank has substantial independent powers of action in the **ongoing implemeutation of monetary, external and prudential policy.**

2.12 In the area of monetary policy while the Banking Act allows the Bank to make regulations in respect of bank interest rates only with the approval of the Treasurer, it does not impose any similar formal limitation on the Bank's scope to determine policy in respect of Statutory Reserve Deposits or bank lending or on its stance in the open market for government securities; of course, in relation to the latter, regard must be had to the Loan Council's position concerning issues of government debt.

2.13 In respect of external policy operationally, the level of the exchange rate is monitored (within the Treasurer's responsibility) by a group of four senior government advisers, including the Governor of the Reserve Bank and the Secretary to the Treasury. Subject to that review, the Reserve Bank sets exchange rates each day.[3] Similarly, the Reserve Bank administers the implementation of the Government's exchange control policies.[4]

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3 Section 31 of the Reserve Bank Act requiring the publication of Australian currency rates of exchange for sterling is currently (and in the scheme proposed by the Committee) obsolete and hence should be repealed.

4 More details are set out in Chapters 8 and 14 of the Committee's Interim Report.

2.14 The Banking Act imposes a duty on the Bank to exercise certain powers for the protection of the depositors of banks within its jurisdiction.

2.15 In discharging its responsibilities for prudential supervision, the Bank has entered into various contractual arrangements and other understandings with a number of financial institutions. These arrangements include the LGS convention with the major trading banks, the accreditation of authorised short-term money market dealers and the general undertaking to support the liquidity of the banking system at times when the banks are giving temporary liquidity support to viable, well-managed financial institutions.

2.16 In implementing policy, the Bank is required to keep government informed of the policy it is pursuing and the Bank would, of course, be responsive to the views of government.

2.17 **Finally,** the Bank is an important **vehicle through which government 'policy'** is **communicated** to banks and other financial corporations, and through which ongoing official **consultation** with these groups takes place.

(b) Central Bank Independence Overseas

2.18 Central banks overseas have a variety of roles and differing levels of independence from government with respect to the formation and implementation of policy. This is borne out in a recent UK survey[5] of relationships between the central government and the central bank in twenty countries; the results of that survey are reproduced in the Appendix to this chapter.

2.19 The common role of central banks is substantial responsibility for the formulation and execution of monetary policy (including, in many cases, exchange rate and some other aspects of external policy). Many central banks, including the Bank of England, have additional roles which include such matters as serving as banker to government, providing specialist banking facilities, printing and issuing of banknotes, issuing and registering government securities, operating (when applicable) exchange control, controlling foreign exchange reserves, and undertaking the day-to-day prudential supervision of financial institutions. By contrast, the United States has a variety of separate agencies to carry out the different functions, including the Federal Reserve Banks, the Comptroller of Currency and the Federal Deposit Insurance Corporation.

2.20 There are varying institutional arrangements including private ownership of central banks in such countries as South Africa, Switzerland, Italy and the United States. In many cases the legislation defining the relationship between the central bank and government has not been adjusted to reflect changing circumstances; adaptation is likely to have occurred but the new relationships are not always easy to identify or categorise.

2.21 In most countries central banks are either required to keep government informed of their policies or are subject to general directions of government or must obtain specific government approval for particular policies. Only in West Germany and Switzerland is the central bank largely independent of government in pursuit of its statutory duties. In the United States, the central bank can set and implement its own monetary objectives and largely operates independently of the

5 UK Committee to Review the Functioning of Financial Institutions (Wilson Committee), June 1980.

Executive; however, it is ultimately accountable to, and subject to direction from, Congress.

2.22 The formal arrangements for the co-ordination of government and central bank policy in other countries vary widely. In all countries the central bank operates in consultation with government generally and the Treasury (Ministry of Finance). In some instances provision is made for the representation at Board level by representatives of government (such as the Secretary to the Treasury) variously entitled to participate as an observer, a non-voting member or a member with full voting rights.

(c) Issues

2.23 The Committee has had to address itself to a number of issues in connection with the Reserve Bank's role in performing its policy functions. These concern the relationship of the Bank to:

- government;
- other administrative arms of government;
- banks and other financial institutions; and
- the wider public.

2.24 Aspects of the Bank's relationship with these groups are analysed below.

2.25 The Committee is aware that, at times, it may be difficult for the Bank to reconcile its chartered responsibilities to seek, concurrently, price stability, full employment and the economic prosperity and welfare of the people of Australia. However, the Committee does not consider it appropriate to seek to confine the Bank to a narrower, more exclusive objective, such as price stability. The various objectives of the Bank are inextricably linked. They are also affected by policy decisions and responsibilities which extend beyond the limits of the Bank's powers. Discussion of the role of the Reserve Bank, particularly its relationship to government, needs to reflect these interdependencies.

(i) Monetary Policy

2.26 How far should the Reserve Bank be independent of government in matters of monetary policy and what form should that independence take?

Policy Formulation and Implementation

2.27 Some submissions have argued that the Reserve Bank should be given absolute statutory independence from government in both the determination and implementation of monetary policy. Underlying this view is a belief that governments may at times be reluctant to pursue appropriately tight monetary policies, because of political constraints.

2.28 However, proposals to make the Bank fully independent of government would, in the Committee's view, amount to the substitution of bureaucratic for political discretion which would be inconsistent with the processes of democratic government. Quite apart from constitutional limitations[6], it would be thoroughly undesirable for the Bank to hold to a monetary policy which did not have the support of the Government and the Parliament.

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6 In the absence of constitutional change, independence granted to the Bank to decide and execute policy would continue only at the discretion of government.

2.29 In short, the Committee is firmly of the view that ultimate determination of and responsibility for overall economic policy — including monetary policy — cannot be effectively divorced from government and Parliament. It is also important that the monetary authorities be effectively accountable to the public and the Parliament. This requires a clear indentification of responsibility. To the extent that the present arrangements create uncertainty in the public's mind as to where responsibility lies for overall monetary policy, it is desirable that they be clarified. Similarly, it is desirable that the community be kept well informed of the objectives underlying the Bank's monetary policy and any constraints on the implementation of that policy. This issue is taken up later.

2.30 The Committee recognises that the policies desired by government may cut across, to some extent, the Bank's statutory responsibility to the general community. Thus a government may wish to see official interest rates held at a level which is not realistic in the view of the market; this may impinge on the Bank's responsibilities, as a central bank, to protect the stability of financial institutions and markets; it may also bear heavily on the Bank's obligation to pursue monetary and banking policies designed to preserve the stability of the currency and to promote the Bank's full employment and community welfare objectives.

2.31 Conflicts of this nature may arise less frequently in the regulatory and policy environment envisaged by the Committee; however, there will inevitably be occasional differences of opinion on the aims or techniques of policy. The question therefore arises whether existing processes for resolving differences of opinion between the Reserve Bank and the Treasurer are appropriate.

2.32 The Committee has closely examined this question and sees no need to change the existing provisions in the legislation governing policy relationships between the Reserve Bank, the Government and the Parliament. The present arrangements appear to have provided a good framework, and are appealing from a number of viewpoints:

- The Government properly has ultimate responsibility for the determination of overall monetary policy.
- Subject to this, the Reserve Bank Board has all the formal powers it needs to effectively formulate and implement monetary policy. In this respect it should be noted that adoption of the Committee's recommendations in other chapters of this report will tend to shift the emphasis of monetary policy away from instruments such as bank interest rates — which, at present, formally require the approval of the Treasurer before change is effected — towards instruments such as open market operations, which are matters where greater discretion has already been given to the Bank.
- There is a sensible presumption in favour of the Bank, Government and Parliament reaching consensus on important issues of monetary policy. The Board is required to keep the Government informed of the policy it is implementing and there is provision for ongoing liaison between the Governor and the Secretary of the Department of the Treasury (section 13); the Secretary is also a member of the Board. The parties have a strong incentive to maintain close dialogue and, in all but extreme situations, differences will be resolved by consultation. The legislation nonetheless provides for either party to make its position clear to Parliament and the public generally where it believes it is justified either short of, or as part of, the Section 11 process.

2.33 In the Committee's view, therefore, the Bank's broad legislative powers are both appropriate and sufficient to enable it to pursue effectively its chartered objectives. The system as a whole encourages consultation and co-operation between the Bank and the Government; if the Bank believes it is being pushed beyond reasonable limits it has the discretion and obligation to hold firmly to its view and ensure its concerns are brought to the attention of the Parliament. Ultimately, however, the Bank cannot rise above the source of its powers — government and Parliament — and must be responsive to the direction which governments may deem fit to give.

2.34 As previously mentioned, adoption of the Committee's recommendations in Chapter 4 will tend to shift the emphasis of monetary policy towards instruments such as open market operations. In this area, the Bank is subject to no legislative constraints, but it may be that less formal, but just as inhibiting, restraints apply. The Committee believes that, over time, some of the fetters on Reserve Bank responses to day-to-day market developments have been reduced, but it is not clear that they have been eliminated. In line with its suggestion of a market-oriented approach to monetary and external policies, the Committee can only encourage that process to continue.

2.35 Accordingly the Committee ***recommends*** that:

(a) **Existing provisions of the Reserve Bank Act defining the overall policy relationships between the Bank, the Government and the Parliament be retained.**

(b) **In particular, the Committee sees no need for change in the present provisions for resolution of differences of opinion between the Reserve Bank Board and the Treasurer (Section 11).**

(c) **Arrangements relating to the implementation of monetary and banking policy should be such as to ensure that the Bank has clear capacity to respond to market developments.**

Policy Advice and Co-ordination

2.36 A number of submissions, while accepting that ultimate responsibility for monetary policy should rest with government, have sought a more evident degree of independence for the central bank as a policy adviser. They are, in fact, asking whether this advice might not be improved if the Bank had somewhat more independence from the other advisory departments, and in particular from the Treasury.

2.37 Independence within government would not remove the Bank's responsibility to take account of the general economic policies of government in formulating its own advice. Nor would it reduce the need for harmonisation of the different arms of economic policy. This, however, is a two-way responsibility. The Bank must be fully aware of and take proper account of fiscal, debt management, wage and exchange rate policies. Equally, the Government needs to fully consult the Bank where these other policies may have implications for monetary management.

2.38 The Bank's current sources of contact with government and its other advisers bearing on its role as policy adviser include:

- frequent consultation with the Treasurer;

- the Governor's attendance from time to time at discussions in various forums with Ministers;
- close liaison between the Governor and the Secretary to the Treasury, each keeping the other fully informed on all matters of joint concern;
- the Secretary to the Treasury's (and in his absence, the Deputy Secretary's) *ex officio* membership of the Board; and
- regular communication between officers of the Bank and officers of various economic policy departments in the Public Service, generally via the Treasury.

2.39 In the Committee's view, it is highly desirable that close liaison be maintained between the Bank and other policy agents of the Government — particularly the Treasury — as the basis for efficient co-ordination of economic policy, especially in policy matters of mutual or overlapping responsibility. The Committee endorses, as appropriate to this end, the continued presence of the Secretary to the Treasury as a member of the Board. Liaison at the working level between officers of the Bank and Treasury and other areas of the Public Service should not only lead to greater co-ordination of overall policy, but also minimise the use of resources in areas of mutual responsibility including advice to the Treasurer or the Government. Liaison between the Bank and other areas of the Public Service should not always require the direct intermediation of the Commonwealth Treasury.

2.40 The Committee ***recommends*** that:

(a) The Secretary to the Treasury should continue to be, *ex officio*, a member of the Board of the Reserve Bank.

(b) There should continue to be regular liaison between the Reserve Bank and the Treasury, and appropriate liaison between the Bank and other economic policy areas in the public sector.

2.41 The Committee believes that the general climate of government in Australia would be enhanced if there were greater opportunities for meetings between the Reserve Bank and members of Parliament, especially the Leader of the Parliamentary Opposition. Such meetings, which would be consistent with the Committee's proposals for a more open relationship between the Bank and the community at large, would be restricted to essentially technical dicussion of economic conditions and prospects with particular emphasis on financial markets. Without prejudice to the Bank's responsibilities to the government of the day, the discussions could reasonably embrace the background implications of announced decisions bearing on monetary and financial policy.

2.42 In putting forward such a proposal, the Committee is aware that Parliamentary committees can and sometimes do seek advice and assistance from the Public Service and institutions such as the Bank. However, the arrangements are less open than those that exist in some other countries. In the United States, for example, the Chairman of the Federal Reserve Board reports to Congress and regularly appears before Congressional committees. In such reports and appearances, the views of the Federal Reserve on various issues are debated in a public forum.

(ii) Stability of Financial System

2.43 Division 2 of the Banking Act imposes on the Reserve Bank particular responsibilities (and courses of action) with regard to the provision of certain

protection for depositors of banks authorised under the Act. The Division has relevance for prudential requirements discussed in Chapter 19 and competitive balance discussed in Chapter 32. In this chapter the relevant issue is the role of the Reserve Bank in such a service.

2.44 The Reserve Bank Act specifies more generally that the Bank 'shall carry on business as a central bank'. Section 8 gives the Bank powers to borrow and lend money, buy and sell securities, give guarantees, underwrite loans etc. These powers, together with Division 2 of the Banking Act, legislatively invest the Reserve Bank with broad-ranging influence over individual financial institutions, especially banks and authorised dealers, with a view to ensuring the stability of the financial system.

2.45 This raises a number of pertinent issues, including:

- whether both the prudential and monetary policy responsibilities should reside in the single authority of the Bank;
- whether the Bank's prudential responsibilities should be formally extended to encompass other institutions besides banks and authorised dealers;
- the appropriate degree of independence the Bank should have from government in the exercise of its powers of prudential regulation.[7]

2.46 The Committee accepts that there may at times be a degree of conflict between the bank's prudential responsibilities and its obligations in respect of monetary policy. It may be that changing interest rates at a pace fully consistent with monetary policy objectives may have an unsettling effect for a time which is not consistent with short-run stability of financial markets. In such circumstances, a balance between the two objectives needs to be sought. The Committee believes that conflicts of this kind will be less likely to arise as markets become more accustomed to interest rate fluctuations.

2.47 The Committee has not received any submissions proposing that prudential and monetary policy responsibilities be handled by separate authorities. In a number of countries overseas where there are separate authorities it is, for the most part, a matter of historical circumstance rather than current preference.

2.48 Indeed, the Committee is of the view that the interaction between the overall monetary environment and the stability of the financial system is such that it is vital that the two policy responsibilities be closely co-ordinated. This could be achieved by maintaining a close dialogue between two independent authorities, but this is not likely to work as effectively as a single institutional framework.

2.49 The Committee does not see a need to extend at present the Bank's formal responsibilities for prudential regulation beyond banks (and authorised dealers). Other intermediaries are subject to supervision by various state authorities and there seems to be no need to extend detailed oversight to a Federal body.

2.50 However, the Committee favours a more co-ordinated national approach to prudential regulation. Some specific proposals in regard to deposit-taking institutions are made in Chapter 19. The Reserve Bank should seek to ensure that various prudential requirements which may be imposed on banks and authorised dealers are consistent and in harmony with other requirements imposed on them as well as requirements imposed on competing intermediaries.

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7 The discussion in paragraphs 2.43–54 should be read in conjunction with that on prudential regulation and supervision of banks in Chapter 19.

2.51 In regard to the third issue raised in paragraph 2.45 — the degree of independence the Bank might have in this area of policy — the Committee would envisage that:

- the Bank and the Government would jointly agree on the general principles of prudential policy; but
- it would be the Bank's responsibility to formulate and implement the policy, e.g. the Bank would specify, for individual banks (and dealers), and for banks (and dealers) as a group, the appropriate techniques, ratios, definitions etc. and the procedures for reporting and surveillance.

2.52 Such division of responsibility would follow broadly similar lines to that for monetary policy. The Committee is conscious that its proposals for the prudential regulation of banks in Chapter 19 will allow, as now, the Reserve Bank considerable flexibility in the formulation and implementation of prudential regulation. Given the nature, including confidentiality, of this operation it feels such a degree of discretion is quite appropriate.

2.53 The Committee is conscious that, by its nature, the application of prudential oversight can bear significantly on the operation of individual banks (and other intermediaries). The Banking Act provides for an appeal to the courts if an institution is dissatisfied with action taken by the Reserve Bank under the depositor protection provisions of the Act. Again, as in all of these areas, the Reserve Bank is accountable to the Government for its administration of policy. The Committee sees these matters as providing adequate safeguards in a democratic society.

2.54 Accordingly, the Committee ***recommends*** that:

(a) The overall principles of prudential regulation should be agreed between the Treasurer and the Reserve Bank.

(b) The Reserve Bank should be responsible for the formulation and implementation of policy and the principal characteristics of the policy should be publicly recorded.

(c) The Reserve Bank should keep the Treasurer informed of, and its Annual Report should make appropriate reference to, the administration of these prudential responsibilities.

(iii) Board and Management

2.55 The present management structure of the Reserve Bank comprises a Board linked to the executive functions of the Bank through its Chairman and Deputy Chairman, who are concurrently Governor and Deputy Governor of the Bank.

2.56 Consistent with the Bank's public ownership and policy responsibilities, members of the Board are appointed by the Governor-General on the advice of the Government. The Board comprises ten members of whom three — the Governor, the Deputy Governor and the Secretary to the Treasury — are *ex officio*. Of the seven other members, two may be officers of the Bank or the Commonwealth Public Service; however, it has been the practice in recent years for these seven positions to be filled by persons from outside the Bank and Public Service; these persons typically combine their responsibilities to the Bank with other full-time employment.

2.57 Issues relating to the position of the Secretary of the Treasury on the Board

were dealt with earlier in this chapter. Some of the considerations there are relevant to the appointment of other members of the Public Service, particularly from senior levels such as departmental heads. Obviously the contribution to co-ordination of a second or third member of the Public Service would be less than the first. At the same time there could be a greater undermining of the appropriate independence of the Bank. Nevertheless, the Committee is reluctant to recommend changes which might preclude the appointment of individuals with an obvious capacity to contribute to the work of the Reserve Bank. It therefore makes no recommendations but draws attention to the need for careful assessment of the issues before any such additional Public Service appointment is made.

2.58 The Committee notes that the present governing legislation disqualifies from Board membership directors, officers and employees of corporations (other than the Bank) the business of which is wholly or mainly that of banking.

2.59 In criticism of this provision it is said that to deny representation on the Board of persons with ongoing responsibilities in banking runs the risk of excluding individuals particularly qualified to assess conditions in financial markets and advise on matters of financial policy.

2.60 In the Committee's view it would not be appropriate for a Board member to be closely associated with a business with which the Bank had a banker–customer relationship or which came (or might come) within the Bank's purview for the purpose of monetary policy or prudential regulation and supervision. In this context, the Committee notes that although persons actively engaged in banking are presently precluded from appointment, the Board has the discretion to take advice from such individuals.

2.61 The Committee ***recommends*** that **the present provisions of the Reserve Bank Act designed to preclude from Board membership persons involved wholly or mainly in the business of banking should be extended to apply to persons associated with the operation or management of businesses which are wholly or mainly financial intermediaries.**

2.62 During the course of its deliberations the Committee also considered the merits of:

- allowing a member of the Board other than the Governor to serve as Chairman (under present legislation, the Governor is Chairman of the Board);
- increasing the size of the Board to enhance its overall range of expertise;
- prescribing the membership of the Board to ensure the representation of specific sectors and interest groups in the community;
- prescribing that more than two members of the Board — the Governor and Deputy Governor — be engaged full time in the work of the Bank;
- extending the term of non-executive members from five to seven years.

2.63 In deciding not to recommend in favour of any of these changes, the Committee judged that:

- while many corporations, both privately and publicly owned, prefer that the chairman of their boards be dissociated from executive responsibilities, it is particularly important that the central bank be so structured that there be one unequivocal spokesman and focal point of contact; it is appropriate that the Chairman be the Governor and chief executive officer of the Bank;
- the Board is not limited in respect of the advice it may seek before deciding

policy; indeed it has an obligation to obtain the best advice it can to ensure that it is fully informed;

- the present legislation admits a balance of executive and non-executive members and would allow the appointment of additional **full-time** Board members at the Government's discretion; two additional full-time Board members (making four in all) could be drawn from either the Bank's executive staff or from outside the Bank and Public Service, to assist the Governor and Deputy Governor with the management of the Bank in addition to their responsibilities as Board members; in not recommending changes to the legislation the Committee is not suggesting that additional executive members would necessarily be beneficial, it simply wishes to have open an option that could be useful;
- the present provision for non-executive members to be appointed for a term of five years and be eligible for reappointment at the expiration of that period allows adequate flexibility and security of tenure.

2.64 In summary, the Committee sees no particular benefits flowing from any changes to the legislative prescription of the Board's composition. While endorsing the nexus of the positions of Governor and Chairman of the Board and accepting the legislative possibility of other executive members, the Committee considers that a majority of the Board should continue to be drawn from outside the Bank and Public Service.

(iv) Operational Relationships

2.65 In regard to the Bank's dealings with financial institutions, concerns have been expressed to the Committee that:

- the Bank is relatively isolated from the market place, which hampers its capacity to formulate policy advice and administer policy effectively;
- its communication and dealings with financial institutions are not wholly impartial;
- its general and specific central banking powers give it a capacity to bring influence to bear without following the prescribed form set down in legislation for the exercise of such power.

2.66 The Committee understands the basis of these concerns but notes the Bank's view that, in the pursuit of its total responsibilities, apparent inequities and shortcomings of these kinds are to some extent unavoidable.

2.67 The Committee would naturally expect the Bank to ensure, at all times, it is well placed to understand the commercial environment on which it seeks to impose policy demands. Clearly resources must be expended to gain and maintain such expertise.

2.68 The theme of impartiality and competitive equality is prominent in the Committee's recommendations on techniques in all areas including monetary policy and prudential supervision. The quest for impartiality in the application of policy must be especially binding on the Reserve Bank, which — as the central bank — needs to make many important decisions bearing on individual institutions and groups of institutions, while at the same time maintaining the respect of the financial community. Should its policies be implemented in a way which is not seen to be impartial, the bias ought to be fully justified.

2.69 Where discretion is exercised it should be as fully disclosed as is practicable

and desirable: this principle needs to have regard for the relationship of a banker with its customer and the inherent responsibility on the Bank to preserve the confidentiality of certain of its dealings with such customers.

2.70 The Committee would suggest, for example, that the Bank regularly disclose:

- all policy directions and requests made by the Bank;
- at appropriate intervals, the Bank's day-to-day dealings in Commonwealth securities and other debt instruments, particularly dealings in private sector paper;
- the overall usage of lines of credit or other borrowings from the Bank and their general terms and conditions.

(v) Financial Intelligence and Accountability

2.71 Submissions to the Committee ask that the Reserve Bank adopt a more 'open' public stance and inform the community more fully about such things as:

- past and prospective conditions in financial markets;
- the reasoning underlying policy decisions including the choice among alternative policy options;
- the financial system and its role in the economy.

2.72 The Committee is of course aware that:

- the Australian Statistician has a general responsiblility for the collection and dissemination of broad-ranging statistical information;
- financial businesses themselves have considerable capacity, and incentive, to inform the community of the state of financial markets in which they operate and the impact of government policy decisions on those markets; and
- much of the information collected by the Bank, other than in conjunction with the Australian Statistician, is of a confidential nature; while needed in terms of prudential or other responsibilities of the Bank, it is not of a nature that should be generally disclosed.

2.73 Nevertheless, the Bank's concurrent responsibilities to government, financial institutions and the general community argue for the Bank taking a positive co-ordinating role in informing the community fully of monetary policy and related aspects of the operation and development of the financial system. This would assist markets to respond and adjust more intelligently to policy changes; no less importantly, it would enable the community to better appraise the performance of the monetary authorities and make them more effectively accountable.

2.74 The Committee ***recommends*** that **the Reserve Bank should:**

- **through its Annual Report, and elsewhere as appropriate, inform the community clearly of the *monetary policy* it is seeking to implement, its underlying rationale and any specific constraints on the Bank's capacity to implement that policy;**
- **provide ongoing analysis and commentary concerning *current economic and financial conditions* and the interplay of market forces and policy influences leading to those conditions; and**
- **undertake a *continuing review* of the structure, regulation and operation of**

the *financial system* with the object of, from time to time, canvassing options for change.

2.75 These proposals are designed to promote public understanding of (and debate on) the aims and direction of monetary policy and longer term financial developments. They should also help to ensure that the Bank's operations are open to adequate Parliamentary and public scrutiny.

(vi) Fees for Services

2.76 The Committee believes that, as a general proposition, it would be appropriate for the banking and other services offered by the Bank to be priced so as to recover the costs incurred and in some instances to return an appropriate commercial 'profit' on the usage of the resources involved. The Committee believes it appropriate that this principle should extend to the banking services provided to government as well as to financial institutions banking with the Reserve Bank.

2.77 The object of this proposal is not primarily to secure extra revenue for the Bank's central banking operations, although this will be one of its consequences. Rather, it is designed to ensure that the costs of the general banking and other services provided by the Bank are fully taken into account by both the Bank and its customers in deciding the nature and extent of the services demanded and supplied. Again the approach would provide a sound basis for determining whether the various services are best provided by the Reserve Bank or might alternatively be undertaken by the private sector.

2.78 The Committee has not sought to identify the particular areas where services are currently being provided by the Reserve Bank at less than full cost. It suspects however that there may be many examples. They could well include:

- the facilities provided to authorised dealers (see Chapter 9);
- the support provided to the cheque clearing system (see Chapter 23);
- at least some of the services associated with the processing and distribution of notes and coin.

The Committee acknowledges that in some cases the arrangements may have arisen because of an acceptance of a desire to balance certain costs and burdens in terms of some arrangements between the authorities and particular groups. The Committee's wariness of that concept is noted many times in this Report.

2.79 The Committee therefore ***recommends*** that **the Reserve Bank should adopt the practice, wherever reasonably practicable, of recouping costs for services provided.**

2.80 The Committee notes that consistent application of the same principle could have implications for the liabilities side of the Bank's balance sheet and in particular deposit arrangements. In Chapter 4 there is a specific recommendation that a near-market rate of interest should be paid on required reserve holdings. In Chapter 11 the view is put that the Reserve Bank should not actively market deposits and securities in competition with government paper and the facilities offered by authorised dealers. Even so it will still have some accounts of banks, dealers and perhaps some other private sector customers. The Committee makes no formal recommendation on the question but notes that the payment of a near-market interest rate on such balances would be consistent with its general approach

in this Report for dealings where practicable to be on commercial terms and conditions.

2.81 The Committee equally believes that financial services provided for governments should also be charged for at full costs. Again it has not sought to identify all such arrangements where application of such a principle would require a change from present practice. It believes that can be left to the authorities. However, specific mention might be made of the Bank's involvement in the initial and residual funding of government by holding Treasury Bills and the acceptance of government working balances on current deposit account. The Committee understands that interest at 1% per annum is paid by the Bank on government working balances and that the Treasury Bills issued by the Government to the Reserve Bank yield the same rate. In important respects, these matters are within the overall framework of the government sector; for that reason their particular implications for monetary policy can involve considerations beyond economic issues and be the subject of some debate. Some mention of the matter is made in Chapter 4 in the context of monetary policy and Chapter 9 in the context of debt management. The Committee believes that the functional independence of the Reserve Bank, and efficiency generally, would be enhanced by a more financially independent relationship with government. Consistent with this the Committee sees advantage in the Government both paying a market interest rate on all government securities held by the Bank and for the Bank to pay a market rate of interest on deposits held in government account.

2.82 The Committee ***recommends*** that, **as far as possible, the financial dealings of the Government with the Reserve Bank should be on a commercial basis. In particular:**

- **the Reserve Bank should pay a market interest rate on government account balances; and**
- **the Government should pay a market rate of interest in respect of its indebtedness to the Reserve Bank.**

(vii) Legislative Separation of the Note Issue Department and the Central Bank

2.83 The Reserve Bank Act requires that there be a separate Note Issue Department of the Bank. The Act not only provides the legislative authority under which various notes are issued. It also specifically requires:

- the funds of the Department be invested in a very limited range of securities[8];
- the net profits of the Department, in each year, be paid to the Commonwealth.

2.84 These provisions seem to reflect in part at least historical arrangements and attitudes with regard to the note issue. In the current and prospective environment, they seem to be more likely to give rise to unnecessary administrative arrangements without providing any counterveiling benefits. For example, the Committee can see little benefit or indeed logic in confining the investment of the funds resulting from the note issue to the narrow range of assets listed. The Reserve Bank's portfolio generally covers a considerably wider range of assets both within Australia and overseas. There seems to be little need for greater concern about the security of funds with regard to the note issue than funds

8 Section 38 of the Reserve Bank Act limits investment of Note Issue Department funds to land, plant, equipment, stores and the like, gold, deposits with a bank or securities of the Government of the United Kingdom or of the Commonwealth or a State.

resulting from other operations of the Bank. Similarly the accounting for the profits of the note issue separately from other operations of the Bank seems to have little obvious advantage. Integration of the investments and accounting for profits would of course carry with it the associated advantage of providing the central bank with a more secure independent funds base. This would be consistent with the Committee's view of the degree of independence appropriate for the Bank and is a matter taken up in the following section.

2.85 The Committee ***recommends*** that **the Reserve Bank Act be amended to remove the legislative requirement for a separate Note Issue Department and, in particular, the need for a separation of related investments.**

(viii) Funding the Reserve Bank

2.86 In the opinion of the Committee, it is important that the Bank be clearly seen to be independent and its financial independence is an important element to that end. It would be inappropriate for the Bank to be in any way constrained in its choice of policy instruments and techniques by a need to protect its own financial independence.

2.87 The principal recommendations of the Committee with respect to monetary policy instruments and techniques, foreign exchange markets and the banking business dealings of the Reserve Bank will have a significant impact on:

- the size and composition of the Bank's balance sheet; and
- the associated cash flows and overall surplus generated by the Bank's central banking business.

2.88 For example, balance sheet and revenue effects will arise from:

- greater reliance on open market operations in the pursuit of monetary policy objectives and the 'cashing' arrangements proposed for short-dated government paper;
- the establishment of a more market-oriented foreign exchange market;
- the payment of interest at a market-related rate on any accounts held with the Bank (including required reserves).

2.89 It is not easy to predict the overall net effect of these various changes. However, the changes suggested above with regard to charging for services and integration of the accounts of the central bank and the Note Issue Department should do much to ensure that the Reserve Bank can generate the income necessary to independently finance its operations. Failing that there would, of course, be a potential need for funding from the Budget.

2.90 The Committee's recommendation with regard to permitting the integration of the profits of the Reserve Bank as a whole would mean that section 40 of the Act (requiring payment to the Commonwealth of the total profits of the Note Issue Department) would be superseded by section 30, which provides for the Bank's net profits to be distributed between the Reserve Bank Reserve Fund and the Commonwealth on a basis determined by the Treasurer after consultation with the Board of the Bank. The Committee offers the view that it **might be more appropriate for section 30 to provide for the distribution of the profits to be determined by the Board subject to the agreement of the Treasurer.** Such a change would be consistent with the suggested independence of the Bank.

2.91 The Bank should be required to be efficient in the sense that it operates at

least cost. The Bank is responsible to the Parliament and subject to audit by the Commonwealth Auditor-General; the nature and extent of that audit and review are at the Parliament's discretion.[9] The Committee suggests that **it is also important that the cost of operating the Bank be openly disclosed and in sufficient detail to allow a reasonable assessment of its performance; the Bank's annual accounts are the appropriate vehicle for this accounting.**

C. CURRENCY ISSUE, BANKING AND OTHER FUNCTIONS

2.92 The Reserve Bank has a range of operational responsibilities extending beyond a purely central banking role. Aspects of some have already been touched on. For the most part these other responsibilities are conducted on behalf of government or are functionally related to central banking, but it is not essential that the Bank be involved. These non-central banking operations include:

- the production and distribution of Australian currency, as distinct from the formal issue of currency as a liability of the central bank;
- the provision of primary produce marketing finance through the Rural Credits Department of the Bank;
- participation in the Australian payments system.

(a) Currency Issue and Distribution

2.93 The Committee recognises that responsibility for the issue of currency notes is appropriately vested in the Bank. It is a traditional function of central banks and fits in well with some of its other responsibilities. Among other things, that responsibility implies some considerable authority to determine the technical features of notes produced. Nonetheless, the Bank need not be directly involved in either the printing of notes or their distribution beyond its own issuing centres in the community.

(i) Currency Issue

2.94 The Committee is of the view that the issue of both currency notes and coin, as distinct from their production, should be vested in the Reserve Bank since, from the public policy standpoint, coin and notes issued by government have become such close substitutes as to approximate the one commodity.

2.95 Perhaps more importantly, many of the issues relating to the issue of notes and coin and their distribution, in so far as the authorities are involved, are interrelated. An obvious example is whether to replace the current dollar note by a coin.

2.96 The Committee earlier recommended that the Bank should have direct access to the revenue generated by the currency issue. The Committee ***recommends*** that **responsibility for both note and coin issue should be vested in the Reserve Bank.**

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9 The Auditor-General has the power to carry out 'efficiency audits' of areas within his purview. Some have questioned whether action under those arrangements or alternative ones, perhaps involving experts from the private sector, would be the most effective basis for any such oversight felt necessary by the Government.

(ii) Currency Distribution

2.97 The Reserve Bank currently distributes notes to the banking system through its branches, as well as through selected branches of the Commonwealth Trading Bank acting as its agent; the commercial banks bear the cost of distribution between these points and their own premises. In addition, the Bank operates a centralised currency distribution system which services individual branches of banks in both metropolitan and country areas; the banks bear the associated cost of transport and insurance on a pro rata basis.

2.98 The Australian Bankers' Association has put the view that the function of the commercial banks in currency distribution is akin to an agency function on behalf of the currency issuing authorities. Accordingly, the Association argues that all costs of currency distribution should be borne by the monetary authorities and the commercial banks be reimbursed for their involvement.

2.99 However, there is a contrary view that:

- currency distribution beyond basic issue is a service for which the ultimate users of currency should pay; the appropriate point for collecting payment is at the retail end of the process, particularly through bank branches;
- the banks obtain collateral benefits from supplying currency services.

2.100 The Committee's approach to this issue has been guided by the principle that currency services should be supplied on terms and conditions which are conducive to efficiency. The Committee is concerned that if the cost of currency distribution were shifted to the government sector then the demand for that service would increase and the incentives to conduct money-based transactions in more cost-efficient ways would be reduced; this is an important consideration in a financial system where technological developments have the potential to reduce substantially the economy's reliance on currency.

2.101 The Committee is therefore of the view that currency supply and exchange services should be provided without subsidisation. It is recognised that there may be classes of transactions where it is not practicable to recoup costs; this is a matter for those supplying the service to decide.

(b) Primary Produce Marketing Finance

2.102 The Reserve Bank Act provides for a Rural Credits Department (RCD) through which the Bank may make advances for periods of up to one year to government authorities and co-operative associations for the purpose of assisting the marketing of primary produce or its processing or manufacture.

2.103 The question of whether primary producers should have **preferential** access to funds at **concessional rates of interest** is not one on which the Committee feels able to pass ultimate judgment. It does have, however, an interest in the **method** of government involvement. The matter is discussed in some detail in Chapter 39.

2.104 It is clear from Table 2.1 that the magnitude of RCD advances, even at their seasonal peak, is modest in relation to the total capacity of the financial system. Moreover, their relative importance is much less than it was.

TABLE 2.1: RURAL CREDITS DEPARTMENT: ADVANCES OUTSTANDING[a]

Year ended 30 June	$m	%	Year ended 30 June	$m	%	Year ended 30 June	$m	%
			1962	221	(1.3)	1972	401	(0.8)
1953	191	(2.0)	1963	271	(1.4)	1973	348	(0.6)
1954	148	(1.4)	1964	239	(1.1)	1974	363	(0.5)
1955	172	(1.6)	1965	318	(1.4)	1975	354	(0.5)
1956	227	(2.0)	1966	275	(1.1)	1976	468	(0.5)
1957	146	(1.2)	1967	430	(1.6)	1977	643	(0.6)
1958	96	(0.8)	1968	357	(1.2)	1978	811	(0.7)
1959	197	(1.4)	1969	530	(1.6)	1979	1 189	(0.9)
1960	189	(1.2)	1970	616	(1.6)	1980[b]	910	(0.6)
1961	232	(1.4)	1971	515	(1.2)	1981[b]	403	(0.2)

(a) The dollar value shown is the peak monthly average of RCD advances outstanding in each year. The (%) records the peak RCD advance level during the year as a percentage of the total assets of all financial institutions at end June.

(b) If Australian Wheat Board issues of commercial paper are included, the 1979–80 percentage becomes 1.0 and, on preliminary indications, a little less in the year to June 1981.

2.105 The Committee accordingly believes that private markets can cope comfortably with rural marketing financing needs and sees no reason for the Government to continue to provide a special rural marketing finance facility through the Reserve Bank. A further factor disposing the Committee to this view is that the Bank's involvement may slightly aggravate seasonal fluctuations in liquidity; this aspect is examined in Chapter 6.

2.106 The Committee ***recommends*** that **the Rural Credits Department of the Reserve Bank should be phased out, with appropriate transition arrangements to enable existing customers to make alternative arrangements.**

2.107 The disbanding of the Rural Credits Department would also mean the termination of operations of the Rural Credits Development Fund as a responsibility of the Bank. This matter is discussed more fully in Chapter 39 in the context of assistance to the rural sector; it is sufficient to note here that appropriate provision for the finance of such research and development could be made from the Budget. More generally the question arises as to whether the Reserve Bank is best placed to decide on the allocation of funds for rural research.

(c) Payments System

2.108 The Reserve Bank, as banker to the Commonwealth and some State Governments, is a substantial participant in the payments system and the associated 'clearing house' infrastructure. Additionally, as central bank, it is banker to the banks and conducts the banking system's exchange settlement accounts. While the Committee readily accepts the desirability of some flexibility in these relationships, it sees the Bank continuing to have a substantial operational involvement.

2.109 The structure and operation of the payments system is discussed at Chapter 23. It is argued there that it is appropriate for the Bank to have a general responsibility to monitor its operation and development.

2.110 In broad terms, the Bank would have a co-ordinating role on matters connected with the technology of the payments system, the terms and conditions

of participation and of the rights to participate. While it is not envisaged the Bank would have the power to decide issues in dispute, it is hoped that the Bank would be in a position to make an informed judgment on the issues and make its views known — both to the parties directly involved and to appropriate authorities (such as the Trade Practices Commission).

RELATIONS BETWEEN GOVERNMENT AND CENTRAL BANK: A SURVEY OF TWENTY COUNTRIES[1]

(Reprinted from the Appendices to the *Report* of the United Kingdom Committee to Review the Functioning of Financial Institutions, HMSO, London, June 1980)

1. IS THE CENTRAL BANK THE CHIEF EXECUTANT IN THE MONETARY FIELD OF CURRENT ECONOMIC POLICY? (Regardless of whether policy is determined by the central bank or elsewhere.)	In all the countries, the central bank is the chief executant in the monetary field of current economic policy. However, in some countries, certain functions are shared with other institutions: AUSTRALIA — Exchange rate fixed by triumvirate consisting of Governor of the Reserve Bank, Secretary of the Treasury and Secretary of the Prime Minister's Department. BELGIUM — Responsibility for open market operations shared jointly with Ministry of Finance. GERMANY — Regulation of inflows of foreign capital shared with government.

1 Australia, Austria, Belguim, Canada, Denmark, Finland, France, Germany, Hungary, Italy, Japan, Netherlands, New Zealand, Norway, South Africa, Spain, Sweden, Switzerland, UK, USA. The Committee is indebted for this appendix to Mr D. E. Fair of the Royal Bank of Scotland Group.

2. DOES THE CENTRAL BANK HAVE A STATUTORY DUTY TO PURSUE CERTAIN STATED ECONOMIC OBJECTIVES?	
Countries where the central bank has no statutory obligations	BELGIUM, ITALY, NORWAY, SWEDEN.
Countries where the central bank has a general statutory duty to promote the welfare of the country or the government's policy	AUSTRALIA, CANADA, GERMANY, HUNGARY, JAPAN, NETHERLANDS NEW ZEALAND, SOUTH AFRICA, SPAIN, SWITZERLAND.
Countries where specific goals are set for central banks by statute:	
(i) Maintaining domestic value of the currency	AUSTRALIA, AUSTRIA, CANADA, DENMARK, GERMANY, NETHERLANDS, SWITZERLAND, USA.
(ii) Controlling external value of the currency	AUSTRALIA, AUSTRIA, CANADA, DENMARK, NETHERLANDS, SWITZERLAND.
(iii) Control of credit expansion	AUSTRIA, DENMARK, FRANCE, HUNGARY, JAPAN.
(iv) Supervision of banking system	FRANCE, GERMANY, NETHERLANDS, UK, USA.

(v) Other	AUSTRALIA and SWITZERLAND — full employment; CANADA — stability of production, trade, prices and employment; FINLAND — stability and security of monetary system and facilitation of money circulation; GERMANY and NETHERLANDS — facilitation of money transmission; HUNGARY — supporting government's five-year plan.
3. ARE THE CENTRAL BANK'S ACTIONS IN PURSUING THESE OBJECTIVES SUBJECT TO REFERENCE TO OR APPROVAL BY ANY BRANCH OF GOVERNMENT?	In all countries, the central bank operates at least in consultation with the Ministry of Finance/Treasury/government.
Countries where central bank must keep government informed of its policies	AUSTRALIA — Legal obligation to keep government informed of its policies. CANADA — Legal obligations to consult regularly with Department of Finance. DENMARK — Must report to government via Minister of Economic Affairs on major changes in monetary policy. SOUTH AFRICA — Must consult with the Treasury/Department of Finance. USA — Federal Reserve must report twice a year to Congress on its policies — *not* to President or Executive; in practice it is in continuous contact with all policy making bodies of the government.
Countries where central bank subject to general directions of government	AUSTRIA — Central bank must pay due regard to economic policy of federal government. FRANCE — Ministry of the Economy through the Treasury Directorate dictates even the day-to-day conduct of monetary policy. HUNGARY — Central bank is responsible to President of the Council of Ministers; in practice credit policy first agreed with Minister of Finance. ITALY — Supervised by Treasury; any monetary policy measures must be approved by the Interministerial Committee for Credit and Savings (CCS) to which central bank is subordinate. NEW ZEALAND — In carrying out economic policy, actions may be subject to direction by Minister of Finance. SPAIN — All measures subject to approval of Ministry of Economy. SWEDEN — Formally central bank is an agent of the Riksdag and independent of the government. In practice measures taken are subject to the approval of Ministry of Budget and Economics (in addition central bank collaborates with National Debt Office which is also directly subordinate to the Riksdag). UK — Subject to directions of Treasury, in practice decisions reached jointly.

Countries where central bank must obtain specific government approval for particular policies	BELGIUM	— Open market policy carried out jointly with government — which may impose its views. Minister of Finance has right to veto in certain limited cases.
	FINLAND	— Changes in official discount rate require approval of Parliamentary Banking Committee; otherwise central bank independent of government.
	JAPAN	— Changes in banks' reserve ratios require approval of Minister of Finance, discount rate and open-market operations policy independently determined — in practice the Ministry of Finance is likely to exercise a strong influence on all policy aspects.
	NETHERLANDS	— Exchange rate and note issue fixed by Minister of Finance with central bank advice. In other respects the Bank is independent, although its actions must not conflict with government objectives.
	NORWAY	— Changes in banks' reserve ratios must be approved by the King in Council; discount rate in theory fixed by central bank, but in practice after consultation with Ministry of Finance.
Countries where central bank is largely independent of government in the pursuit of its statutory duties	GERMANY	— Bundesbank independent of Federal Government in determining e.g. discount, credit, open-market and minimum reserve policies. Federal government may ask for decisions to be deferred for up to two weeks.
	SWITZERLAND	— Constitutionally central bank is completely independent of Bundesrat. The bank and the government are legally obliged to consult each other before implementing policies, although in neither case is approval necessary in pursuit of specific policies.
4. IF THE CENTRAL BANK IS INDEPENDENT IN ANY IMPORTANT RESPECT IS IT ABLE TO PURSUE OBJECTIVES THAT CONFLICT WITH THOSE OF THE GOVERNMENT? DOES IT DO SO? IF SO, HOW IS THE CONFLICT RESOLVED?		
Countries where central bank has openly acted contrary to the government's economic objectives	CANADA	— Following the forced resignation of the Governor of the Bank of Canada in 1961 (due to his pursuing a tight monetary policy in opposition to the government's wishes) the power to issue directives to the Bank was conferred on the Minister of Finance by the addition of s.14 to the Bank of Canada Act 1967; such directives must be published in the *Canada Gazette* and laid before Parliament within 15 days — this procedure has never been invoked, as in

		practice the Bank does not pursue policies that conflict with government objectives.
	GERMANY	— Bundesbank's obligation to support government's general economic policy is limited by the proviso that it has its own duties to discharge in safeguarding the currency. Conflicts have occurred but these have not been major or prolonged and are kept to a minimum by the division of roles — the government being mainly responsible for fiscal and exchange rate policy and the Bundesbank for monetary policy. Thus although the government has temporary blocking power in Bundesbank decisions, this has only been used on a few occasions.
Countries where such a situation is unlikely to arise:		
(i) Because the government has complete authority over the central bank	AUSTRIA, DENMARK, FRANCE, HUNGARY, ITALY, JAPAN, NEW ZEALAND, SOUTH AFRICA, SPAIN, SWEDEN.	
	AUSTRALIA	— Should differences of opinion exist the government has statutory power, after due process of consultation to direct Reserve Bank to carry out a given policy, Parliament being informed within fifteen sitting days.
	BELGIUM	— Although forbidden to pursue targets conflicting with general objectives of government, in practice National Bank is largely independent; e.g. in 1978 it reduced its financing of the government and thus forced it to finance its budget deficit by borrowing abroad.
	NETHERLANDS	— Minister of Finance may issue binding directives to Nederlandsche Bank in order to co-ordinate the policies of the two bodies.
	NORWAY	— No independent *action* in conflict with government policies by central bank since 1920s, but its staff have publicised their disagreement with government policies, e.g. recently on prices and incomes policy.
	UK	— Although general policy subject to Treasury approval a measure of independence is maintained and disagreement with government policies has occasionally been publicised.
(ii) Because the central bank is independent of government	FINLAND	— In theory the central bank could act in conflict with the government; in practice close co-operation makes such a situation most unlikely.
	SWITZERLAND	— Potential conflicts limited because directors of the Swiss National Bank are elected by the Bundesrat.
	USA	— Although formally independent of government, the Chairman of the Board of Governors represents the Federal Reserve in

	discussions with the government; possible policy conflicts are discussed in various forums that typically include the Secretary of the Treasury, Chairman of the Council of Economic Advisers and the Director of the Office of Management and Budget.
5. POWERS OF GOVERNOR AND DIRECTORS: TERMS OF OFFICE, INTERESTS REPRESENTED, METHODS OF REACHING DECISIONS	
AUSTRALIA	— Governor and Deputy Governor appointed by the government (Governor-General) for seven years. Seven other Board members similarly appointed for five years except that not more than two of the seven may be officers of the Reserve Bank or public service and hold office for an unspecified period. None may be directors or employees of any other bank. All are eligible for reappointment. Board members are usually selected for their eminence in academic, agricultural or general business activity. The Secretary of the Treasury is an *ex officio* member of the Board. Six members, including the Governor or Deputy Governor, are required for a quorum of a meeting of the Board. Decisions are by a simple majority of members present. The Chairman of the meeting has both a deliberative and a casting vote.
AUSTRIA	— President: appointed by Federal President for a five-year term, may be reappointed. Two Vice-Presidents and 5 of the 11 other directors similarly appointed. Six remaining directors elected by the General Assembly of Shareholders for periods of five years; they may be re-elected. Directors must be economic experts or outstanding persons in the business community. The Board must include at least one representative of: banking institutions, savings banks, industry, trade and small business, agriculture and one representative each of salaried employees and labour. In practice, balance is also maintained between the political parties. Board of Directors supervises and directs Bank's entire conduct of its business. President has casting vote. A separate Board of Managers (consisting of a General Manager, Deputy General Manager an 2—4 other managers) is charged with the operation of the Bank. It is appointed by and reports to Board of Directors. President may attend its meetings and has the casting vote.
BELGIUM	— Governor: appointed by the King (i.e. the government) for five years (although he may be suspended for up to three months during this period or dismissed). He may be reappointed. 3—6 directors appointed by the King on the proposal of the Council of Regency for six years, renewable. Governor presides over Board of Directors, Council of Regency and General Council. The Bank is managed by the Board of Directors which may change the discount rate and rate for advances in a case of emergency but must refer the matter to the Council of Regency. The Council of Regency is composed of the Governor, the Directors and 10 Regents representing wide socio-economic interests (it is legally required to include three Regents nominated by the

	Minister of Finance, two executives from financial institutions of public interest, two Regents proposed by trade unions, and three proposed by organisations most representative of industry, commerce and agriculture). Balance is also maintained between the two linguistic groups. The Council deals with general questions pertaining to the Bank, currency, credit and the economy. It fixes the rate and terms of discounts, advances and loans. Its decisions are by majority vote, with the Governor having a casting vote. Its members are elected for terms of three years by AGM of shareholders (which otherwise has a purely formal role). The Board of Censors consists of 8 – 10 members specially qualified in the field of financial supervision, similarly elected. The Censors approve the balance sheet and expenditures by majority vote. General Council formed from Governor, directors, regents and censors and considers the general administration of the Bank and the issue of bank notes. Governor has the deciding vote. Government Commissioner: The Minister of Finance has the right to control all the Bank's operations; this control is entrusted to a Government Commissioner who is entitled to attend the AGM and meetings of the Boards, Council and Committees in an advisory capacity.
CANADA	– Governor: appointed by directors (with approval of Governor-General in Council i.e. the Government) for seven years during 'good behaviour'. He is eligible for reappointment. Twelve Directors appointed by Minister of Finance (with approval of Governor-General in Council) for terms of three years; they may be reappointed. There is a general requirement that directors be selected from 'diversified occupations', in practice different regions of Canada also represented. Directors or officials of chartered banks and of investment houses acting for the Government may not become Bank of Canada directors. Responsibilities stop short of technical decisions with respect to monetary policy (which are left to the Governor), the directors being more concerned with the internal functioning of the Bank.
DENMARK	– Governor: appointed by the Sovereign (i.e. the government), remains in office until 70 years old. Two Deputy Governors: appointed by Board of Directors. None of the Governors are on the Board of Directors. Twenty-five Directors: eight with seats in Folketing; one economist and one lawyer appointed by Minister of Trade, Industry and Shipping (who in his capacity as Royal Bank Commissioner presides over meetings of the Board of Directors). Fifteen elected by the Board of Directors in rotation (three per year). All directors serve five-year terms. The elected Board members are required to represent all sectors of the economy, including labour and regional areas, but may not attend to the interest of any particular group of the community. The three-man Board of Governors reports to the Board of Directors. This latter elects a chairman (who has a casting vote) annually from amongst its 25 members and deals with more fundamental issues affecting the Bank. A Committee of Directors, which must comprise the two nominees of the Minister (who will also attend its important meetings) and five other members of the Board of Directors, elected

	annually from among the members, keeps itself informed of the more important aspects of the Bank. The Chairman of the Committee of Directors is also elected annually. All three bodies reach decisions by a majority vote, the Chairman having a casting vote in the event of a tie.
FINLAND	— Governor: appointed by President of the Republic at the suggestion of the Parliamentary Banking Committee, for an indefinite term. Four members of the Board of Management, similarly appointed, may be suspended by the group of nine Parliamentary Bank Supervisors selected by the Diet from among its members. There is no requirement that particular interests be represented. Administration and management in the hands of the Board of Management, subject to review by the Bank Supervisors. The Chairman (Governor) of the Board of Management has the casting vote.
FRANCE	— Governor: appointed by President in consultation with the cabinet, for an indefinite period and may be dismissed by the President. (In the past Governors have served until retirement but, departing from tradition, the present Governor has been appointed for a term of five years.) Two Deputy Governors, similarly appointed. There are 13 members of the General Council: the Governor and the deputy governors and 10 others. The latter 10 consist of nine appointed by the Council of Ministers on nomination by the Minister of the Economy and one elected from and by the personnel of the Bank. They are appointed for six years. All councillors may be reappointed until the age of 65. An auditor and his assistant also sit with the Council in an advisory capacity. The 46 man National Credit Council has a similar role to Boards of Directors in other countries. It is presided over by the Minister of the Economy, the Governor of the Bank of France acting as vice-president, and comprises, in addition to these 13 members appointed by the Minister of the Economy, seven representing government departments, nine trade union representatives, eight representatives of financial and banking institutions and seven from public credit institutions. Management of the Bank's business is in the hands of the Governor and two Deputy Governors. The General Council supervises all branches of the Bank's activities. Decisions are taken by a simple majority. Although the two auditors cannot vote, their approval is generally necessary.
GERMANY	— Governor: appointed by President on nomination by federal government, which in turn consults Central Bank Council, for a term of eight years (exceptionally for a shorter period but in no case less than two years). The Directorate comprises not more than 10 members, similarly appointed. The Central Bank Council consists of the Directorate together with the presidents of the 11 'Land' central banks, who are nominated by Parliament on proposals from the appropriate authority of the Land concerned, for eight-year terms subject to the possibility of reappointment. Regional representation is effected through the Land Central Bank Presidents, other directors are required to be particularly qualified in their field.

	The Central Bank Council determines monetary and credit policies of the Bank and may issue instructions to the Directorate or Boards of Management of the Land Banks; it takes decisions by simple majority. The Directorate implements the decisions of the Central Bank Council, and deals with the administration of the bank, its decisions are also by simple majority, the President having a casting vote.
HUNGARY	— President of the Bank and his deputies appointed by the Council of Ministers, for an indefinite period. The President of the Bank in turn appoints the directors, who hold their office for an indefinite term. The Board of Management typically includes representatives of the National Planning Office, Ministry of Trade etc. It has a particularly important role in deciding whether the country should borrow substantially from abroad. In all decisions of the Board the President has an overriding power.
ITALY	— Governor: appointed by Board of Directors (not necessarily from amongst their number) subject to approval of Council of Ministers and President of the Republic, for an indefinite term. Thirteen directors elected by General Meetings of Shareholders at 13 regional offices of the Bank, for three-year terms, the directors are eligible for re-election. Board of Directors is charged with general administration of the Bank under the chairmanship of the Governor who has a casting vote. The business of the Bank is managed by the Governor and a Committee of the Board of Directors comprising the Governor and four of the Directors appointed annually by the Board. A representative of the Minister of the Treasury may participate in meetings of the Board of Directors as an observer; he is empowered to suspend the implementation of any decision which he considers contrary to the law, regulations or statutes of the Bank for up to five days.
JAPAN	— Governor: appointed by the Cabinet for a term of five years, he may be reappointed. Vice-Governor, similarly appointed. Seven Policy Board members include the Governor and two representatives of the Economic Planning agency and the Ministry of Finance. The other four members must consist of two with financial experience, one with industrial experience and one with agricultural experience. They are appointed by the Cabinet with the consent of both houses of the Diet for four-year terms; they may be reappointed. The policy Board directs and supervises the business of the Bank. The two government representatives on the Board do not have voting rights, and decisions are taken by majority vote of those having voting rights.
NETHERLANDS	— President: appointed by the Queen on the advice of the Minister of Finance (from a choice of two candidates put forward by a joint meeting of the Governing Board of the Bank and the Board of Commissaries) for seven years; he may be reappointed.

	Governing Board consists of the Governor, the Secretary and 3–5 directors similarly appointed for seven years. Twelve members of the Board of Commissaries are appointed by the Queen from a short-list of three for each place, drawn up by a joint meeting of the Governing Board and Board of Commissaries. Seventeen members of the Bank Council include a Royal Commissioner, representing the government, and four Commissaries; the 12 other members must include representatives of the government, commerce (including transport), industry and agriculture, labour unions and the monetary and credit sector. The Governing Board is charged with the administration of the Bank, and is supervised by the Board of Commissaries. Governor of the Bank reports to the Bank Council on Bank policy and general economic and financial conditions. The Bank Council is authorised to offer independent advice to the Minister of Finance on Bank policy.
NEW ZEALAND	– Governor: appointed by the Governor General in Council on the recommendation of the Minister of Finance, for a term of five years he is eligible for reappointment. Deputy Governor similarly appointed. Seven Directors similarly appointed. The Secretary of the Treasury is a member of the Board. Appointments are intended to reflect a diversity of interests, including industrial or commercial experience. Decisions are by consensus.
NORWAY	– Chairman of the Board of Directors: appointed by the King on the advice of the Supervisory Council (in effect by the government), for an indefinite term but subject to dismissal. Vice-Chairman, similarly appointed. Three other directors are elected by the Storting for six year terms; they may be reappointed. Fifteen members of the Supervisory Council are also elected by the Storting for six year terms. There is no requirement that particular interests be represented on either the Board of Directors or the Supervisory Council. Administration of the Bank is in the hands of the Board of Directors, but subject to decisions of the Supervisory Council. The Chairman (Governor) of the Board of Directors has a casting vote. The Chairman of the Supervisory Council (elected annually from amongst its members) also has a casting vote.
SOUTH AFRICA	– Governor: appointed by President on advice of Minister of Finance for five years; he may be reappointed. Three Deputy Governors similarly appointed. Two Directors similarly appointed for three-year terms. Six remaining directors elected for three year terms by Annual General Meeting of Shareholders; they are eligible for reappointment.

	Traditionally a wide spectrum of interests is represented. Directors are expected to resign if a conflict of interest arises. Decisions are taken by a simple majority of the Board with the Governor having a casting vote.
SPAIN	— Governor: appointed by the government on the proposal of the Minister of Finance, for an unspecified term. Two or more Deputy Governors, also appointed by the government on the proposal of the Minister, for three-year terms, renewable. Administration is in the hands of the Board of Directors which comprises the Governor, his Deputies and three members of the General Council selected by the Minister of Finance from amongst those Councillors designated by the government. General Council consists of the Governor and his Deputies plus 14 others: five members designated by the government representing the general interests of the national economy, two representatives of credit institutions, two representatives of the savings banks, four representatives of the trade unions, one representative of the Bank's staff. All are appointed for an unspecified term. The General Council approves the balance sheet and advises the government. The Governor is chairman of both bodies and has a casting vote on each.
SWEDEN	— The Governor of the Bank is elected by the Board of Directors from amongst their members. He is not the Chairman of that board. No fixed term but up to age 70. Deputy Governor elected by Directors either from among themselves or from outside. The Chairman of the Board of Directors is appointed by the King in Council for a term of three years; he may be re-elected. Deputy Chairman similarly appointed. Five directors elected by the Riksdag, also for three-year terms, subject to reappointment. There is no legal requirement that particular interests be represented on the Board. A Cabinet Minister or Director of the National Debt Office may not be a member of the Board. The Bank is administered by the Board of Directors. Five directors constitute a quorum; but if a motion is opposed all must attend the meeting, the decision being taken by a simple majority vote, the Chairman having a casting vote in the event of a tie.
SWITZERLAND	— The three members of the Board of General Managers (the Governor and two deputies) are appointed by the Bundesrat for six years; they may be reappointed. Twenty-five members of the Bank Council are similarly appointed for four years; 15 other members of the Council are elected by shareholders of the Bank; all are eligible for reappointment. The 40 members of the Bank Council must be chosen to represent geographical regions and various sectors of the economy. Supervision and control is in the hands of the Bank Council (which is responsible to General Meeting of Shareholders). More detailed day-to-day supervision and control of the Bank's management is carried out by the Bank Committee, which consists of the Chairman and Deputy Chairman of the Council together with some eight other members appointed by the Council.

	The Chairman of the Bank Council is also Chairman of the Bank Committee, and in the case of a tied vote in the Committee, the Chairman's vote counts double.
UNITED KINGDOM	— Governor: appointed by the Crown (i.e. the government) for five years, he may be reappointed. Deputy Governor similarly appointed. Sixteen directors similarly appointed by the Crown for four-year terms; four retiring in rotation each February, not more than four of these may be full-time (executive) directors. The 12 non-executive directors are appointed from a variety of interests in industry and commerce, trade union affairs and banking (they may not be a member of the House of Commons, a minister of the Crown or working in a government department). The Governor plays the most important role in instituting and formulating advice or proposals to the government, and in the day-to-day business of the bank. The Governor may call for advice from individual directors or from standing committees of the Court of Directors.
USA	— The seven members of the Federal Reserve Board are appointed by the President, with the approval of the Senate, for fixed terms of 14 years, non-renewable. The President designates two members of the Board to be Chairman and Vice-Chairman respectively, for four-year terms, renewable. By tradition, the members of the Board are selected in order to maintain a geographical balance and both bankers and non-bankers are included. They must all be members of a Federal Reserve district bank board. The directors of these regional Reserve Banks are composed of equal numbers of Class A directors (representing member banks), Class B directors (non-bankers) and Class C directors. Classes A and B are elected by member banks, but Class C are appointed by the Federal Reserve Board, and of these Class C directors the Board appoints the regional Chairmen and Vice-Chairmen. Major monetary policy decisions are made by the Federal Open Market Committee, which consists of the members of the Board, plus the Presidents of five regional Reserve Banks who serve one-year terms on a rotating basis (except the President of the Federal Reserve Bank of New York, who is always a member and, by tradition, the Vice Chairman of the FOMC). The Chairman of the Board is also Chairman of the FOMC. In theory, each regional Reserve Bank can determine the discount rate applicable to the short-term loans it makes to its members, subject to review and determination by the Board; when the system was first set up it was thought that differing regional credit conditions would lead to differing rates. In practice, however, the integration of regional markets into one national market and the establishment of national economic goals have meant that the Board accepts only one national discount rate. The regional policies on the use of the discount window are also co-ordinated by periodic meetings of the Reserve Banks' lending officers. The decisions of the Board are reached by a simple majority vote.

6. IS THERE AN INTERCHANGE OF STAFF OR LIAISON BETWEEN THE STAFFS OF THE CENTRAL BANK AND THE TREASURY/MINISTRY OF FINANCE?

Countries where this takes place

AUSTRIA	— Occasionally on a personal basis. Also the Ministry of Finance frequently relies upon the National Bank's expert advice.
CANADA	— Considerable informal liaison and although no formal interchange of staff this does occur infrequently; two of the most senior Finance officials at present had earlier been in the Bank.
FRANCE	— Little liaison occurs, although it has become established that one the two Vice-Governors will be appointed from the Treasury.
HUNGARY	— Constant liaison.
ITALY	— Central bank staff are frequently loaned to government departments, as well as taking personnel from them on secondment.
JAPAN	— In addition to the Minister of Finance's representative on the Policy Board, a number of Bank directors have also come from the Ministry.
NETHERLANDS	— Limited contact takes place at the highest level at informal meetings, and among lower echelons, by means of *ad hoc* committees.
NEW ZEALAND	— Some short-term secondments for experience.
SOUTH AFRICA	— Liaison and interchange of staff.
UK	— No formal agreements for an interchange of staff between the Bank of England and the Treasury. However, there is constant liaison between them at all levels and secondment of staff is fairly common.
USA	— There is some interchange of staff between the central bank and the US Treasury. In addition there are numerous committees that provide formal liaison between the two organisations.

Countries where contact is limited

BELGIUM, DENMARK, SPAIN.

AUSTRALIA	— To a limited extent, also the Secretary of the Treasury is a Board member.
FINLAND	— Insignificant, though close high level contact with the Ministry of Finance exists.
GERMANY	— No formal liaison or interchange of staff; however, members of the two institutions work closely together in national and international bodies such as the IMF.
NORWAY	— Contact limited to joint membership of inter-ministerial committees.
SWEDEN	— Some members of staff have worked in both institutions.
SWITZERLAND	— Some members of staff have worked in both institutions but there are no formal arrangements for exchange or liaison.

7. IS THE CENTRAL BANK OR ITS GOVERNOR MADE ACCOUNTABLE TO PARLIAMENT? IN WHAT WAY?

Countries where central bank is directly accountable to Parliament	CANADA	— The Governor is frequently asked to appear before Committees of both House of Commons and the Senate to explain and defend his policies. Other witnesses may be summoned to verify his evidence.
	HUNGARY	— The Governor is responsible to the Council of Ministers, to Parliament and to the Presidential Council of the People's Republic for the Bank's internal and external policies and may be examined by Parliamentary Committees. He is under no obligation to submit an Annual Report to Parliament.
	JAPAN	— The Governor can be and often is called to explain the conduct of monetary policy to the Diet. The Policy Board must also submit an annual report to the Diet, through the Minister of Finance — this must cover the financial condition of financial institutions, changes required in the law, changes in supervisory policy during the fiscal year and policies conducted and the reasons for their implementation.
	SOUTH AFRICA	— The Governor is accountable to Parliament and the Bank's annual report and financial accounts are tabled in Parliament. The Governor is also examined by commissions of inquiry into financial matters appointed by the State President.
	USA	— The Fed. Chairman is required to report twice a year to both Houses of Congress on the goals and conduct of monetary policy. In addition, both he and members of the Federal Reserve Board of Governors frequently testify before the Joint Economic Committee of Congress and other Congressional committees. From time to time the Chairman also sits on various government policy bodies. The Board as a whole meets with the Council of Economic Advisers at regular intervals; and Fed. staff also discuss policy problems with Administration staff at various levels. The Annual Report is published.
Countries where the Governor reports to Parliament largely for purposes of information	FINLAND	— Governor can be summoned to appear before Parliament only in a consultative or advisory capacity.
	ITALY	— Governor can be examined by Parliament for purposes of information.

Countries where the Governor is not examined by Parliament but is required to submit an annual report	AUSTRALIA	— Annual report and financial statement presented to both Houses of Parliament.
	DENMARK	— The annual report is published and presented to Parliament, although this is not a requirement.
	GERMANY	— The Bundesbank is independent of Parliament. It publishes an annual report.
	NEW ZEALAND	— Annual report is submitted to Parliament but Governor not examined by Parliament. He is however subject to questioning by Treasury officials in private sessions of inter-governmental committee.
	NORWAY	— The Central Bank submits an annual report which is sent to Parliament and traditionally includes the Governor's broad views on the economy.
	SWEDEN	— An administration report is submitted to the Riksdag by the Board of the Bank.
	SWITZERLAND	— An annual report must be submitted to the Bundesrat.
	UK	— The Bank's Annual Report is laid before Parliament, but has never been debated. The Governor and other Bank members are examined on matters concering the administration of the Bank by the Parliamentary Select Committee on Nationalised Industries and on financial and monetary policy by specially convened Committees of Enquiry. In general Parliament holds the Chancellor of the Exchequer responsible for the Bank's policies.
Countries where the Minister of Finance is directly responsible for central bank's conduct of monetary policy	BELGIUM	— Minister of Finance, who has the right to control all the Bank's operations, is subject to examination by Parliament.
	FRANCE	— Bank's policy is examined, criticised and approved by Parliament through the Minister of the Economy. Exceptionally, the Governor may be questioned by Parliament. An annual report is submitted to the President of the Republic and its accounts are controlled by the Public Corporations' Audit Commission.
	NETHERLANDS	— Minister of Finance accountable to Parliament for Bank's enforcement of the Bank Act and measures taken under it. In addition, Bank must publish a weekly summary of its balance sheet and submit its annual accounts to its Supervisory Board.
	SPAIN	— Minister of the Economy responsible to Parliament for the activities of the central bank. The published accounts have to be approved by the Minister.
Other	AUSTRIA	— The Bank is not accountable to Parliament in any way.

8. WHO OWNS THE STOCK OF THE CENTRAL BANK?

Countries where the stock is 100% owned by the state	AUSTRALIA, CANADA, FRANCE, GERMANY, NETHERLANDS, NEW ZEALAND, NORWAY, SPAIN, UK.	
	DENMARK	— The Bank is an official government body, and no private body has a share in the General Capital Fund. Profits not allocated to the Reserve Fund or to special guarantee funds shall go to the Treasury.
	FINLAND	— No private body may own any share in the capital of the Bank. At least one-third of profits to be transferred to the Reserve Fund; the remainder may be used according to the decision of the Diet, for public purposes.
	SWEDEN	— No private body may own a share in the capital of the Bank. Profits are at the disposal of the Riksdag — generally part goes into an exchange adjustment account and the remainder into the state budget.
Countries where the state holds only part of the stock	AUSTRIA	— Fifty per cent by Federal Republic; 50% by persons and enterprises authorised by the federal government. Voting at General Assembly limited to minimum holding of 100 shares. Profits accruing are distributed to shareholders.
	BELGIUM	— Fifty per cent by the State; 50% sold to the public — quoted on the Stock Exchange. General Meetings of shareholders can elect or dismiss Regents and Censors. Each share counts as one vote. Profits distributed proportionately to shareholders.
	JAPAN	— Fifty-five per cent government; 45% privately owned, the private shareholders receive a small dividend but have no voting rights. Shareholders may transfer their holdings with the consent of the Bank, but the shares are not quoted on the Stock Exchange.
Countries where the stock is 100% in the hands of the public	SOUTH AFRICA	— Votes are limited to maximum individual stockholding of 10 000.
Other	ITALY	— Shares can only be held by 'public law' banks, national interest banks, social security institutions, savings banks and insurance institutions. The government however holds a significant share in some of these institutions. Up to 20% of net profits shall go to the Reserve Fund; of the remainder a dividend not exceeding 6% of the capital shall be declared. Any excess to go into extraordinary reserves.

SWITZERLAND	— The Confederation as such holds no shares. The shareholders are the cantons (38%), cantonal banks (17%), various other public bodies (3%), and over 5 000 private shareholders (42%). The shares are listed on the Swiss Stock Exchange. Part of the profits shall be allocated to the Reserve Fund, of the remainder a dividend not exceeding 6% of basic paid-up capital shall be declared.
USA	— The Federal Reserve System is a federal government agency. The stock of the 12 Federal Reserve Banks is owned by commercial banks who are Federal Reserve members and are paid a dividend of 6%, any remaining profits being paid into the US Treasury. Ownership of the stock, however, does not carry with it the usual attributes of control and financial interest.

DOMESTIC ECONOMIC POLICY

CHAPTER 3: POLICY OBJECTIVES AND MONETARY TARGETING

A. OBJECTIVES

3.1 Effective economic management requires a recognition of the interdependencies of monetary, fiscal and external policies. An inappropriate setting in one area, say the Budget, can place heavy burdens in other areas, such as interest rates. Similarly, if exchange rates are not allowed to respond adequately to market forces the maintenance of an effective monetary policy may not be feasible.

3.2 A traditional view is that the various arms of economic policy — monetary policy, fiscal policy, exchange rate policy and wages policy — should be used collectively to achieve a balance of policy objectives — full employment, growth, external balance, price stability etc. An alternative view is that the authorities should assign individual policy arms to policy objectives on the basis of comparative advantage; that is, each arm should be assigned to that objective on which it has the relatively greatest effect. This approach, for example, would assign exchange rate policy to external balance, fiscal and wages policies to employment and growth objectives, and monetary policy to the preservation of price stability.

3.3 There has been much lively discussion of the two approaches, and in particular the merit of assigning monetary policy to the maintenance of price stability. The Committee has not examined the technical issues in detail. However, for purposes of the later discussion of monetary targets and techniques, it is sufficient to note that the Committee accepts that:

- If economic stabilisation policy is to be effective it must involve a balanced mix of fiscal, monetary and external policies.
- Monetary policy — and indeed general economic policy — should have, as one of its principal objectives, the maintenance of long-term price stability; a relatively stable standard of value is of fundamental importance, not only to the stability and efficiency of the financial system, but also to the economic vitality of the economy.
- The authorities can make a major contribution to the achievement of long-term price stability, and the overall stability of financial markets, by maintaining a relatively steady and restrained growth in monetary and financial aggregates. This does not imply that the Committee sees inflation as being caused solely by monetary and financial factors, but reflects a belief that inflation cannot persist for long without an accommodating growth in monetary and financial aggregates.
- In pursuing a steady and restrained growth in monetary aggregates,

governments of course will need to show proper concern for the short-term economic and social tensions it may generate.[1]

- From the viewpoint of efficiency, monetary policy should not be assigned to micro policy objectives of a distributional, sectoral or regional character. These are, in the Committee's view[2], preferably handled by fiscal or similar policies.

B. MONETARY TARGETING[3]

3.4 Monetary policy can be directed towards promoting the ultimate targets of policy (price stability, full employment etc.) without a particular intermediate focal point, or it can seek to achieve these objectives **indirectly** through pursuit of a related **intermediate or proximate** target of policy.

3.5 The Committee believes there are advantages in the authorities adopting an **intermediate target** and **publicly announcing it,** provided there is a reasonable expectation, perhaps importantly based on past experience, that it will be approximately achieved. In other words, it must be credible. Subject to this, intermediate targeting can offer many benefits. In particular:

- it provides an additional encouragement to the authorities to control the budget deficit — or at least its monetary effects;
- it provides market participants with information concerning policy intentions which is useful in formulating investment plans;
- to the extent that it is taken as an affirmation of the Government's resolve to pursue a disciplined monetary policy, it can contribute to a favourable climate of expectations — and, in particular, it can influence significantly the process of wage and price determination — thus positively assisting the control of inflation[4];
- it gives the public an early standard by which to judge the performance of the authorities (information on the intermediate target is available faster than information on the **ultimate** targets of policy); and
- it can promote a general economic environment conducive to stability in financial markets and institutions and to international confidence in the Australian dollar.

3.6 A large number of intermediate targets have been suggested; they can be grouped as follows:

- a monetary variable — such as the monetary base[5], a broader monetary aggregate (e.g. M3), or an interest rate; and

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1 The short-term conflicts between the objectives of price stability and other objectives, such as high employment, have been especially evident in the Australian institutional wage-setting environment. For reasons discussed later, the Committee believes that a policy of monetary targeting can help to a significant degree in the resolution of such conflicts.

2 Developed more fully in Chapter 36.

3 In forming its views on monetary targeting, the Committee has had the benefit of a special study commissioned from Professor M. G. Porter of Monash University ('Monetary Targeting', AFSI, *Commissioned Studies and Selected Papers*, Part 1, AGPS, Canberra, 1981). It has also received a great deal of other material on this question. Some is reproduced in the same publication.

4 The study commissioned by the Committee places considerable emphasis on monetary targeting as evidence of an intent by the authorities to pursue a disciplined stabilisation policy (Porter, op. cit.).

- a higher level economic variable — such as nominal Gross Domestic Product (GDP).

3.7 In choosing between these two groups of targets a number of criteria must be kept in mind:

- **predictability,** i.e. the strength and consistency of the target's relationship with the ultimate objectives of policy;
- **controllability,** i.e. the extent to which the authorities are able to influence the target; and
- the extent to which pursuit of the target imposes a **discipline** on governments and on various groups of decision makers in the economy.

3.8 Intermediate monetary targets satisfy these criteria to varying degrees. Although the predictive value of monetary variables is suspect in the short run, there is an observed long-run association between monetary growth and the rate of inflation. At the same time, it must be accepted that nominal GDP normally has a closer relationship with the ultimate targets of policy. However, monetary aggregates are generally more controllable than nominal GDP. As well, information on monetary aggregates is usually available earlier than on GDP and is subject to less statistical revision. For this reason it can be expected to have greater favour as a policy discipline.[6]

3.9 The following discussion focuses on cases in which a **monetary variable** is chosen as the intermediate target. It should be noted, however, that any policy directed at the ultimate targets or at higher level intermediate targets (such as nominal GDP) will almost certainly involve some restraint on monetary growth. These questions are discussed in greater detail in Appendix 3.1.

3.10 The Committee does not see merit in a policy which seeks to maintain a **fixed percentage rate** of growth in any monetary variable over a **fairly lengthy period.** Such an approach to monetary targeting is in its view unduly restrictive.

3.11 The need for a flexible approach — allowing movement within a 'band' — is illustrated by the following points:

- The ultimate targets of policy are affected by many variables besides the intermediate target.
- In certain circumstances, deviations from the target variable may be justified. For instance, an increase in the money supply reflecting an increase in money demand stemming from an unexpected but sustainable rise in **real** output would not normally require offsetting action aimed at bringing it back to the

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5 The monetary base is commonly defined to be the sum of the cash holdings of the non-bank public and the cash holdings (including reserves) of the banks. M1 is equal to cash in the hands of the public plus current deposits with the trading banks (excluding Commonwealth and State Government and interbank deposits). M3 is equal to M1 plus non-government, non-bank fixed deposits with trading banks, certificates of deposit and all savings bank deposits. M4 is then defined as M3 plus the liabilities of permanent building societies; M5 also includes the liabilities of finance companies. DCE is equivalent to the change in M3 plus or minus the deficit or surplus on private sector foreign exchange transactions.

6 Announcement of a monetary aggregate target provides a substantial discipline on budgetary decisions, but an announced nominal Gross Domestic Product target may apply a firmer discipline on the determination of wages. This latter possibility gives a GDP target a conceptual appeal from certain points of view, but the practical problems mentioned above must be weighed against it.

original target level; indeed such offsetting action could give rise to inappropriately tight conditions.

- Preoccupation with one particular intermediate target can lead the authorities to neglect other economic variables relevant to the health of the economy. For instance, other leading indicators may contain information on the final targets which is at least as useful as that provided by the intermediate target.
- Policies directed to the achievement of one monetary target may lead to offsetting movements in other financial aggregates, i.e. there may be shifts in financing to circumvent the policies.
- Holding firmly to a target in short periods (say on a monthly or quarterly basis) can lead to substantial costs arising from the variability induced in other economic magnitudes (e.g. short-term interest rates).
- At the other extreme, a long-term monetary target (for example, for three to five years), although involving a firmer commitment to reducing inflation, is unrealistic. It is difficult to decide the most desirable target values far ahead of time, e.g. there may be a case for adjusting the target in response to 'exogenous' changes such as changes in the rate of productivity increase and in the terms of trade. To the extent that the authorities are forced to alter the targets frequently, one of the major advantages of targeting is lost — viz. the provision of reliable information to the private sector.

3.12 Subject to the credibility of the target being accepted and subject to the need for a degree of flexibility, the Committee believes that the benefits of targeting outweigh any potential disadvantages. The Committee therefore favours, in principle, the adoption and announcement of monetary targeting, with the target expressed as a band of growth rates for a period of say twelve months. Some important qualifications are, however, discussed later.

What variable?

3.13 If there is to be monetary targeting, the relevant questions are:

- whether the authorities should target the price of money (or credit) or the quantity of money (or credit) in the system[7]; and
- if quantity, the most appropriate monetary variable to target.

3.14 **The Committee clearly favours a quantity target.** In its view, the adoption of an **interest rate target** would present many difficulties. Nominal interest rates are markedly influenced by inflationary expectations and can give quite ambiguous signals as to what is happening in the real economy. Such a target would therefore tend to score poorly on the 'predictability' test. Moreover, a policy of interest rate targeting is liable to lead to interest rate rigidity. Experience has shown that it is all too easy to be preoccupied about price, with insufficient regard for the movement in financial aggregates. This is not to deny, of course, that movements in interest rates have a significant bearing on policy assessments.

3.15 As to the choice of monetary aggregate (the volume of money or credit), M3 is the particular variable preferred by some because it has in the past had a

7 It is almost an economic dictum that 'you cannot determine both a price and quantity'. This proposition is true in essence but needs some qualification. If the authorities had available to them effective and independent instruments which allowed them to influence both money supply and money demand, they would be able to choose between a number of interest rate/money supply outcomes. The difficulty is that they do not possess such instruments.

fairly close relationship with nominal income. It has also appealed because it has embraced a large part of the private sector's liquid assets and the authorities could regulate it through the use of direct controls on the banking system.

3.16 However, more recently, the choice of M3 has been criticised on the grounds that:

- other financial aggregates are more closely related to economic activity, since M3 excludes some very liquid assets (such as deposits with building societies, which are close substitutes for at least some bank deposits): if other aggregates are out of control, it will not be useful to control the rate of growth of M3[8]; this point is related to the apparent instability of the velocity of circulation of M3 (as noted in Treasury Submission No. 2);
- by encouraging the authorities to focus heavily on bank credit, the use of an M3 target can easily lead to an inappropriate reliance on direct controls and may raise questions of competitive equity and allocational efficiency; and
- the use of a monetary aggregate such as M3 can be particularly hazardous when there are changes occurring in financial structure, payments technology and relative interest rates.[9]

3.17 These reservations have led some economists to advocate the use of a much broader monetary aggregate as a target variable. Such a variable (which could include currency, bank deposits and the desposit-type liabilities of non-bank financial corporations) is certainly more relevant than M3 in circumstances where bank deposits are subject to discriminatory controls. On the other hand:

- M3 is generally more controllable by the authorities than a much broader aggregate and information on it is more quickly available;
- M3 is now widely recognised;
- placing some reliance on an M3 target does not preclude the authorities from monitoring at the same time a wide range of economic variables in addition to M3; and
- most importantly, it is not envisaged by the Committee that the regulatory environment within which monetary targeting would operate in the future would be 'biased' heavily against the banks: in a more competitive financial system, in which open market operations are the primary instrument of monetary policy, M3 would be expected to move more closely in line with other monetary aggregates than has been the case in the heavily regulated environment of the past.

3.18 The Committee notes that the authorities could be presented with special difficulties in the transitional period of adjustment following the deregulation process suggested in this report. In this period the relationships between the

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8 The studies by Professor M. G. Porter (op.cit.) and by Kevin Davis and Mervyn Lewis 'Money and Income: Evidence from Simple Models' in *The Australian Monetary System in the 1970s* (ed. M. G. Porter, 1978) have found that M1 has a closer relationship with nominal income than M3. This result must cause some concern because M1 and M3 often grow at markedly different rates.

9 Changes in financial structures and payments technology can significantly alter the pattern of financial flows and the 'traditional' relationship between the various monetary aggregates and the level of economic activity. Moreover, the Committee recommends in Chapters 4 and 19 that for monetary policy and prudential regulation purposes the elements of a banking group be regarded as a consolidated unit; such consolidation would have implications for the appropriate measurement of monetary aggregates such as M3.

various monetary aggregates and between them and the ultimate targets of policy will be changing. In such a situation use of a single monetary target would be particularly hazardous and the authorities would need to make use of the widest possible range of economic information in formulating their policies. These points are illustrated by the changes in 'money supply' which occurred in the UK after the introduction of 'Competition and Credit Control' (1971) and the removal of the 'corset' (1980) and in New Zealand after the deregulation initiatives of 1976.[10] However, these examples suggest that the problems are temporary in nature and by no means insurmountable.

3.19 Given the difficulties in interpreting broader monetary aggregates during the adjustment period, it is particularly important that the authorities keep in check the supply of 'high powered' or 'base' money, on which financial intermediaries can gear their provision of credit, even though it may have a less stable linkage with ultimate objectives than other monetary variables.

3.20 Specifically, this points to the need for a close examination of the technique of **monetary base control,** especially if greater reliance is placed on open market operations.

3.21 The monetary base[11] is determined by the size and method of financing of the domestic budget deficit, by open market operations and by the balance of payments (private sector foreign exchange transactions with the authorities).

3.22 It appears to the Committee that the monetary base could well have advantages as an intermediate target, particularly in a deregulated environment:

- The monetary base is responsive to budgetary and exchange rate policies; its use as a target therefore offers less 'encouragement' to the authorities to apply direct controls and greater encouragement to maintain responsible budgetary, debt management and exchange rate policies.
- All monetary aggregates are related to the monetary base; the ratios of the aggregates to the base are known as money multipliers. Provided these money multipliers are fairly stable over the medium to long term, it is likely that monetary base control will imply a certain amount of control over all other monetary aggregates.
- Control of the base would still allow short-term variations in the money multiplier caused by demand factors.

3.23 Some disadvantages of the monetary base approach can also be noted:

- The monetary base is not yet as well recognised by the community as monetary aggregates such as M3.
- Control of the monetary base may result in increased volatility of interest rates. It is not clear, however, that this would be any greater than, or even as great as, that which would be generated by, for example, an M3 target pursued

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10 It should be noted that to the extent that an expansion in the 'money supply' reflects an increase in banks' share of financial flows, its significance may be overstated. This illustrates the difficulties involved in making policy judgments in the transition period.

11 As defined in footnote 5. In a system in which the Government is attempting to peg the interest rate, government paper is a perfect substitute for base money, and the **liquidity base,** which includes government debt, would be a more relevant measure. This would not, of course, be the case in the system which would result from the implementation of the Committee's recommendations. This problem is discussed in greater detail in Appendix 3.1.

with the same degree of persistence. As noted in the previous paragraph, the possibility of variations in the money multiplier gives the system some additional adjustment channels which might, in some circumstances, reduce short-run pressure on interest rates.

- The relationship of the monetary base to the ultimate objectives of policy may not be as strong or as predictable as the relationship between broader monetary aggregates and the ultimate objectives. For example, one could conceive of a situation in which money multipliers are adjusted to largely neutralise the effects of any changes in the monetary base on real activity. This is an extreme possibility, however, and the true nature and relative strength of these relationships are questions which need to be settled empirically. It is clear that further work remains to be done in this field.

3.24 The Committee, therefore, does not feel able to recommend the adoption of monetary base control at the present time. However, it believes the authorities should give this possibility careful consideration for the future.

3.25 It should be pointed out that the technique of monetary base control cannot succeed if the authorities allow the market to have access too readily to central bank liquidity facilities. As explained in Chapter 5, the authorities can discourage tendencies to excessive use of the facilities by raising the 'cost' of usage when they are attempting to restrict the economy.[12] They have the means to ensure that usage of the facilities is compatible with their monetary targets.

3.26 In summary, the Committee is of the view that the authorities should have a firm and well-publicised commitment to 'target' rates of growth for a key monetary indicator. The way in which the 'target' is specified is a technical issue of some complexity on which the Committee does not feel able to make firm recommendations. The Committee also recognises that the substantial changes it proposes be made to the financial system will probably make the task of relevant 'target' specification more difficult, at least for a time.

3.27 The Committee ***recommends*** that:

(a) The authorities should formulate, announce and seek to achieve a monetary target expressed in terms of a band of growth rates for a period of, say, one year.

(b) The authorities should examine alternatives to M3 as a target — including broader monetary and credit aggregates and 'monetary base'.

(c) Whatever target is chosen, other variables should be closely monitored.

(d) It is recognised that special problems will occur during the transitional period of deregulation.

3.28 A few commentators have suggested that it would be a useful support for monetary targeting and encourage firmer budget disciplines if the Commonwealth Government were prohibited from financing its budget deficit by the sale of Treasury Bills to the Reserve Bank.

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12 This does not mean that the authorities need always react in this way to restrict use of the facility. In some circumstances, they might prefer to let rates 'float' in concert with market rates. Some of these issues are discussed in A. Cheok and T. J. Valentine, 'Central Bank Liquidity Support Facilities — Some Issues', AFSI, *Commissioned Studies and Selected Papers*, Part 4, AGPS, Canberra, 1981.

3.29 The Committee has noted elsewhere in this Report (Chapter 2) that the Treasury Bills currently bear an interest rate of 1% and has recommended that a market rate be paid. A complete prohibition on Treasury Bill financing would be another step again. The Committee notes that such a prohibition would not prevent the Bank from purchasing Treasury notes on the open market and, in such circumstances, would have no great bearing on the monetary outcome of any given budget deficit. It might, nevertheless, be seen as a declaration of the Government's acceptance of the desirability of not financing deficits by monetary expansion. However, the Committee has not received any submissions on this subject and has not explored its full ramifications. It therefore makes no specific recommendation but draws the matter to the Government's attention.

APPENDIX 3.1

MONETARY TARGETING

Definition

1 In the consultancy study commissioned by the Committee[1], monetary targeting is defined as an official commitment to pursue policies designed to constrain the growth of one or more monetary aggregates to a particular rate, or within a range of growth rates. It represents an acceptance of some obligation by the monetary authorities to conduct open market operations, constrain government deficits and allow adjustment of interest and exchange rates etc. so that the target which is publicly announced is achieved. Supporters of this approach to policy making argue that the most important benefit of the acceptance of a binding commitment to monetary restraint by the authorities is a dampening of inflationary expectations.

2 The money supply projections made in the Treasurer's Budget Speech fall outside this definition on a number of counts. Indeed, the authorities have avoided the label 'money supply targeting', preferring their own terminology — 'conditional projections'. It is fair to say, therefore, that Australia does not have a monetary target of the type defined in the previous paragraph. Certainly, the practice in recent years does not appear to represent a binding commitment to the achievement of a given monetary growth rate.

3 Table 3A.1 compares the 'projections' made in budget speeches from June 1976 to June 1981 and the actual monetary growth in the corresponding years. It is clear that the projections represented underestimates for 1978–79, 1979–80 and 1980–81.

TABLE 3A.1: MONEY GROWTH AND MONEY TARGETS IN AUSTRALIA (%)

	M3		
		Actual	
Year ended 30 June	*Target*[a]	*Reported Contemparaneously*[b]	*Reported August 1980*[c]
1976	15[d]	13.8	14.4
1977	10–12	10.6	11.0
1978	8–10	8.0	8.0
1979	6– 8	11.8	11.8
1980	10	12.9	12.3
1981	9–11	12.7	12.7
1982	10–11		

(a) As announced in the annual Budget speech by the Federal Treasurer around August of the preceding year. See various issues of Budget Paper No. 1 since 1976 for these statements.
(b) As reported in the July issue of the *RBA Bulletin in the year for which the target applied.*
(c) Revised figures reflecting improved data and estimation methods for a component of M3 (certificates of deposit) were published in the August 1980 edition of the *Statistical Bulletin;* the growth rates for M3 reported in this column are based on the revised figures for M3.
(d) This target was announced in January 1976, soon after the present Government assumed office.

Source: W. Poole, 'Australian Monetary Policy: An Outsider's View', paper presented to the 51st ANZAAS Congress, Brisbane, May 1981.

1 M. G. Porter, 'Monetary Targeting', op. cit.

4 Variations in attitudes towards the mechanism, or rule, for setting the target rate of growth of the money supply create further definitional problems. It has been suggested that there are:

- those who believe the Government and the central bank should adhere to a fairly rigid rate or range of rates of growth regardless of short-term economic conditions;
- those who would adjust the target rate or range in the short run in the belief that anti-cyclical policy is effective; and
- those who regard fine-tuning of monetary policy as largely ineffective, but also consider that the authorities should retain in reserve the power to inflict a sharp monetary contraction so as to be able to stifle inflationary impulses before they become entrenched, and to inject credit when faced with transitory disturbances to supply and demand which would otherwise cause large temporary increases in interest rates;
- an additional group includes those who wish to set monetary instruments to achieve ultimate targets of policy (such as the rate of inflation and unemployment) or higher level intermediate targets such as nominal gross national product, but who feel that this generally involves stable behaviour of monetary aggregates.

This list is probably incomplete and tends to overcompartmentalise because views on monetary targeting actually fall along a more or less continuous spectrum.

5 While the submissions to the Committee generally avoided explicit definitions of monetary targeting, they implied a similar definition by their criticisms of the current 'conditional projections' approach. They do, however, express some concern about the disruptive effects in the past of attempting to realise money supply projections which are not realistic when compared with actual movements in other economic aggregates. These views are consistent with the Committee's approach to monetary targeting as developed in the text.

Rolling or Moving Average Targets

6 Monetary targeting has been adopted in a number of countries in the past decade. Targets have been expressed as a single figure or a range, in terms of the growth over the succeeding twelve months, or average year-on-year growth, or growth between the final quarters of successive years.

7 The most complex example of monetary targeting occurred in the United States — the Federal Open Market Committee started in 1975 to establish four-quarter growth ranges for M1, M2 and M3 with an associated range for bank credit. These targets were on a rolling basis, the twelve-month tolerance ranges for the quarterly growth of each of the aggregates being set or reaffirmed on the basis of the average level of each of these aggregates in the full quarter preceding each meeting of the Committee.

8 Passage of the Full Employment and Balanced Growth Act of 1978 (the 'Humphrey–Hawkins' Act) caused the Federal Reserve to review its method of establishing ranges for monetary and credit aggregates. The rolling element of the targets has been removed and ranges for the growth of aggregates are now set early in each year to be applied to that year on a fourth quarter to fourth quarter basis, but they are revised half-yearly. From early 1980 the monetary targets have been set in terms of redefined monetary aggregates consisting of M1A and M1B, which replace M1, and new concepts of M2 and M3.[2]

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2 New monetary aggregates were adopted by the Federal Reserve Board on 7 February 1980. By way of comparison:

Previously defined aggregates:

M1: Currency held by non-bank public + demand deposits at all commercial banks, held by non-bank public.

M2: M1 + savings deposits at commercial banks + time deposits at commercial banks other than negotiable CDs at large banks. *(continued next page)*

9 An OECD review of US policy performance from mid 1975 to end 1978 shows that while the tolerance ranges for the growth of the monetary aggregates were progressively lowered, the actual rates of growth of the aggregates edged progressively higher. The review asked whether the overshooting of the aggregates was communicating information about the persistence of higher inflation, and whether a more aggressive stance might have been justified. It concluded by stating that the US experience underlined the central question involved in implementing money policy geared to aggregate monetary variables: how quickly, in practice, should deviations from monetary objectives be corrected?

10 While one has to be wary in drawing conclusions from this experience for Australia in view of the marked differences in the institutional framework, the US experience with the rolling target system suggests that:

- It may be biased towards progressively lowering the tolerance ranges for the growth of monetary aggregates. It is true that raising the tolerance ranges would fuel inflationary expectations, but the US experience of attempting to dampen inflationary expectations by progressively lowering the tolerance ranges proved to be self-defeating because of consistent overshooting of the targets. Given that it is possible to alter the tolerance ranges quarterly, even leaving them unaltered implies little progress towards meeting final policy goals, particularly controlling inflation.
- The increased risk of setting unrealistic tolerance ranges under a rolling target system could prove destabilising because economic decision makers might anticipate a strong reaction from the authorities later in the planning period.
- A new rolling target is always announced before the end of the target period is reached. It is therefore difficult to evaluate the performance of the monetary authorities. Not being required to meet a target at a set time, the authorities are less constrained to reduce an above-target growth rate in the money supply.
- Where the new rolling target incorporates a change in policy, the change has to be seen to be sustainable. This requires expectations to move in the direction implied by the new policy stance, but for this to occur, past policy implementation has to have been successful.

11 Those who favour the rolling target approach have argued that it would give the authorities more flexibility in reacting to changing economic conditions and policy aims than, say, a target which is specified on a June to June basis. However, the points in the previous paragraph suggest that this 'flexibility' can give rise to persistent overshooting. Moreover, the authorities would have to accurately assess current economic conditions and policy requirements several times each year to frame new money supply targets. Current thought tends to reject such a 'fine-tuning' approach to economic policy making as is inherent in this argument. The Committee accepts that there are inherent dangers in taking an overly short time frame in setting policy.

Tolerance Bands and Seasonal Adjustment

12 Framing targets as a range reflects a view that the use of a single figure gives a money supply target an unnecessary and unrealistic degree of precision. While expressing the

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2 *(cont.)*

M3: M2 + non-bank thrift institution deposits (savings and time deposits).

New aggregates:

M1A: Previously defined M1 *minus* demand deposits of foreign commercial banks and official institutions.

M1B: M1A + other chequable deposits (NOW accounts, savings accounts subject to automatic transfer, share drafts and demand deposits at thrift institutions).

M2: M1B + non-chequable savings and small time deposits at all depository institutions + overnight reverse purchases at commercial banks + overnight Eurodollars at Carribean branches + money market mutual fund shares.

M3: New M2 + large-denomination time deposits at all depositary institutions + term reverse purchases at commercial banks and savings and loans associations.

target as a range or band provides monetary authorities with a greater capacity to meet the target, the practice has been to announce an optimistically narrow tolerance band.

13 Some submissions have criticised the excessively restrictive money supply projections which have resulted from inaccurate budget forecasts of economic variables. It is clear that if projections of the monetary growth rate are to be useful policy aids they must be based on clearly defined policy aims and accurate economic forecasts. They must also normally be complied with. There is however a real risk that the authorities become preoccupied with achieving the money supply target at the expense of other economic variables more closely related to ultimate policy targets. In addition, further economic disturbances may result when failure to achieve the monetary target range leads to expectations of a strong corrective reaction by the authorities.

14 A separate issue is whether the tolerance band should be wide enough to allow for seasonal variability in money supply growth. Relying on seasonally adjusted data only partly solves the problem although these provide an approximate indication.[3] The consultant in this area points out that 'while there are predictable seasonal patterns in rural, foreign and tax payments, the volume of these payments varies significantly over time, making the data difficult to adjust. Other factors complicating seasonal adjustment include strikes, cash requirements and the remission of profits overseas'.

15 Also, making tolerance bands wide enough to encompass all seasonal fluctuations risks allowing trend movements within the tolerance band to destroy any intrinsic benefits of a targeting approach to monetary policy.

16 It should be noted that in Chapter 6 the Committee makes recommendations which are likely to reduce the seasonality of the Australian financial system. The adoption of these recommendations would go some way towards reducing the seasonality problem in a monetary targeting context.

Choice of Target

17 A number of criteria for the choice of a monetary target have been suggested. For example:

- it should be **controllable** — that is, the authorities should be able to determine its movements with some degree of exactitude;
- the relationship between the monetary aggregate and the ultimate targets of policy should be fairly stable and predictable;
- it should have a strong relationship with the ultimate targets of policy;
- information on the target should be available at a fairly early stage so that the authorities can react more quickly to any undesirable trends;
- the target should be easily understood by the general public so that maximum amount of information is provided by the announcement of target values and observations on the extent to which these have been achieved.

Some comments on the extent to which various aggregates satisfy these criteria follow.

18 Doubts about the M3 target have been raised in the text. In particular, it was suggested that its relationship with the ultimate objectives of policy has been eroded (in part at least) by attempts to control it and that broader definitions of the monetary supply might be more relevant at present. If the erosion is predictable then the authorities might be able to work with a target such as M3 until the loss of effectiveness reaches unacceptable proportions. It was also noted that concentration on this aggregate may at times have led the authorities to pay insufficient heed to the high growth rates in other aggregates, including both narrower aggregates (such as M1) and broader ones (such as M4, which includes the liabilities of permanent building societies). To the extent that the liabilities of financial institutions outside the M3 classification have grown because of M3 targeting, the allocation of funds among financial institutions has been distorted, implying an efficiency cost to the economy as a whole and an inequitable burden of monetary policy on particular institutions.

3 A more detailed discussion of seasonality is contained in Chapter 6.

19 Table 3A.2 illustrates the further point that, the broader the definition of money supply used for monetary targeting, the better the statistical chance of achieving a target value for it (i.e. the smaller are the deviations around the average level of the series). Again, use of a broader aggregate eliminates shifts (for example due to changes in relative interest rates) between various components which may have no significant influence on the ultimate objectives of policy.

TABLE 3A.2: COEFFICIENT OF VARIATION OF ANNUAL MONETARY GROWTH RATES[a]
(Standard deviation divided by mean)

	Selected periods						
	Monetary base	*Currency outside the banks*	*M1*	*M2*	*M3*	*M4*	*Domestic[b] credit*
1965–69:12	2.09	1.03	.73	.28	.17	n a	.18
1965–79:9	1.37	2.12	.73	.55	.44	n a	.45
1970–79:9	1.14	2.31	.62	.51	.43	.38	.47
1976–79:9	1.09	8.48	.37	.35	.26	.22	.24

(a) Growth rates are computed from monthly data over twelve-month time periods.
(b) Total credit extended by trading banks, savings banks and Reserve Bank.
Source: M. G. Porter, 'Monetary Targeting', op. cit.

20 On the other hand, the wider the definition of the money supply the less control the authorities have in the present environment in terms of determining the average level of the series because they do not have instruments which allow them to directly influence the aggregate in the way that M3, for example, can be influenced. If it is accepted that the authorities should only be held accountable for what they are able to control, the choice of intermediate target must rest heavily on the controllability of the intermediate policy variable.

21 A number of commentators have recommended that a monetary base target be adopted. The Committee notes here that a wide range of 'base' concepts exist and that a number of them have received support from Australian economists, including:

- the narrowly defined **monetary base,** which consists of the sum of the cash holdings of the non-bank public and the banks' cash holdings and deposits with the Reserve Bank;
- **primary liquidity,** which is the monetary base plus government securities on issue to the private sector;
- the **augmented monetary base,** which is the monetary base plus trading banks' holdings of government securities.[4]

22 The Committee realises that the debate on the appropriate choice between these and other measures is by no means settled. Nevertheless, the crucial question appears to be the degree of substitutability between the assets which are being aggregated. In a regime where the interest rate is being pegged, bonds can be freely exchanged for cash (i.e. they are perfectly substitutable) and the primary liquidity concept is most appropriate. It has been suggested that this was the case in Australia in the 1950s and 1960s. However, the important task for the Committee is not to choose the measure which gives the best historical explanation of movements in monetary aggregates or ultimate targets such as income and prices, but to determine which measure is likely to be most relevant in the future. It is this measure which should be used if monetary base targeting is to be adopted. This problem cannot be solved without a great deal of additional work, but it appears that, of the three 'base' measures mentioned above, the 'narrow base' concept could well be the

4 These measures can also be adjusted for changes in the SRD and LGS requirements applicable to trading banks and the reserve requirements of savings banks. See Australian Bankers' Association, Submission to the Committee of Inquiry into the Australian Financial System, 1979.

most relevant one in the environment which would result from acceptance of the Committee's recommendations. In particular, interest rate flexibility would lessen the substitutability between government paper and cash and therefore lessen the usefulness of the other two base concepts. One possible extension of the narrow base measure would be to include those assets eligible for rediscount. Crucial to the issue is the degree of 'penalty' in the use of the discount facility.

23 Another possible target, given some attention in Treasury Submission No. 2, is **domestic credit expansion** (DCE), which is the change in M3 plus or minus the deficit or surplus on private sector foreign exchange transactions. A related concept is the **domestic monetary base,** which is the monetary base net of bank reserves created by transactions in foreign currency. Domestic credit expansion has particular relevance for countries in which the balance of payments plays an important role in the monetary outcome. The usefulness of this measure arises out of its capacity to give some indication of balance of payments problems.

24 If exchange rates are market-determined, the monetary base is not affected by transactions in foreign currency and targeting M3 is equivalent to targeting DCE. In the deregulated system envisaged by the Committee much of the special significance of DCE would be lost.

25 It is argued by the consultant that, even in the framework of a relatively fixed exchange rate, DCE is inadequate as a **sole** measure of the stance of monetary policy because it has a weaker capacity to explain the behaviour of nominal expenditure than other monetary aggregates. Nevertheless, he suggests that the authorities should monitor it as a supplementary indicator of the stance of monetary policy. He notes three periods in the past decade when this would have provided information which would have assisted the authorities in formulating appropriate policies:

- Modest 5% growth in M1 in 1971 compared with growth rates of 7–7.5% in the mid 1960s gave little warning of the impending period of inflation in the early 1970s. By mid 1971, however, domestic credit was contracting by 5% per annum because of Reserve Bank purchases of foreign exchange, which in turn reflected interest rates above those overseas and a strong Australian dollar, and which were the forerunner of a massive speculative capital flow into Australia which caused a monetary expansion and, therefore, an increase in the rate of inflation.
- The reverse situation had arisen by mid 1974 when M1 was falling by 5% per annum but domestic credit expansion was in excess of 15%. The low growth in M1 was not a reflection of modest credit creation in Australia; it was due to a sizeable monetary leakage through the balance of payments.
- A similar situation arose in 1976. In fact, in both the 1974 and 1976 period growth in M1 (and M3) understated the monetary growth situation and domestic credit was expanding at a rate between 15 and 20%.

26 This suggests that it would undoubtedly be useful for the authorities to monitor more than one aggregate. This view has found favour with a number of economists and is, at the moment at least, supported by Australian policy makers. For example, the 1980–81 Budget documents contain this statement:

> The Government's aim in 1980–81 will be to secure a smaller increase in the growth of monetary aggregates than in 1979–80 and it has indicated that an outcome for growth in M3 of about 9% to 11% over the course of 1980–81 would be consistent with that.
>
> M3 is not, of course, the only available measure of the money supply and cannot alone provide a comprehensive indication of monetary developments ... more broadly defined measures of the volume of money have shown faster growth than M3 in recent years. For policy purposes it will remain necessary to monitor the whole range of monetary aggregates and indicators.[5]

5 1980–81 Budget Paper No.1, Statement No.2 — The Budget and the Economy, p. 61.

CHAPTER 4: INSTRUMENTS OF MONETARY POLICY

A. INTRODUCTION

4.1 This chapter discusses the instruments and techniques of monetary policy and evaluates the range of existing direct controls. A central issue is the relative merits of open market operations and direct controls in the implementation of such policy.

4.2 There are substantial interconnections between the issues discussed in this chapter and those relating to external policy (Chapters 7 and 8), and public finance (Chapters 9 to 12).[1]

4.3 A large number of submissions have strongly supported the removal of all or virtually all direct controls from the financial system and a substantial reliance on open market operations in the implementation of monetary policy. In brief, the arguments in favour of deregulation flow from the effects of controls on the allocational and operational efficiency of the financial sector, their long-run ineffectiveness as instruments of monetary policy (since they tend to transfer business to competing intermediaries and securities markets) and the differential effects they have on various types of financial institutions.

4.4 On the other hand, the monetary authorities have argued for the retention of at least some direct controls as instruments of monetary policy. They claim there are situations where direct controls may assist the speed of implementation of policy as well as possibly cushioning the effects on interest rates and financial markets.

4.5 In the view of the Committee, the validity of their claim depends importantly on the state of development of capital markets. A central theme in this Report is the need for further development of those markets and, in particular, the market for government securities, which is the fulcrum for open market operations.

B. DIRECT CONTROLS

4.6 For some years, and especially during the 1970s, the authorities have sought to increase their reliance on market-oriented policies and to relax their restrictions on banks' operations. Some of the manifestations of these efforts have been:

- the virtual abandonment of qualitative lending controls;

1 There are also important overlaps between regulatory intervention designed to effect monetary policy and that designed to promote stability in financial markets (Chapters 5 and 6) and to encourage appropriate prudent funds management (Chapters 18 to 21). There are associated implications for the competitive structure of the financial system (Chapter 32).

- a somewhat freer approach to the determination of interest rates; and
- the recent review of legislation affecting savings banks.

4.7 However, policy instruments such as changes in the SRD ratio and bank lending controls have been consistently used in the 1970s and still appear to be bearing heavily on the banks.[2]

4.8 Numerous submissions, while acknowledging that there has been some progress in moving to a market-based policy, have nevertheless argued that open market operations represent an adequate tool for the implementation of monetary policy and that, therefore, direct controls should be abandoned altogether.

4.9 The authorities and some professional economists, although accepting that there might be scope for some further reduction in direct controls, have contested this view on a number of grounds:

- Firstly, they put the general proposition that it may at times be useful to have more than one instrument to achieve a single target. For example, it may be better to achieve a given target value by altering two instruments by small amounts than by changing a single instrument by a large amount.
- Secondly, they argue that (especially as Australian securities markets are seen by some to be narrow and segmented) reliance solely on open market operations would generate excessive interest rate variability.
- Thirdly, the authorities claim that some direct controls are necessary to deal quickly with very difficult situations, e.g. the funding of a large domestic budget deficit, or the effects of a sharp increase in capital inflow.

4.10 For reasons discussed later, the Committee believes these arguments are only partially valid[3] and, in any case, do not justify the retention of the very extensive set of regulations to which the financial system is still subject. Supplementary instruments are useful only if:

- they are effective in achieving their limited objectives;
- they do not reduce the effectiveness of other instruments; and

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2 It has been argued that the SRD ratio has **not** borne heavily on banks over this period because the ratio determined has, on average, been reduced. However, in evaluating the incidence of SRD requirements, it seems appropriate to form judgments in the broader context of the opportunity cost of the funds held in this form. Assessing for illustrative purposes the cost of the SRD requirement as the product of the SRD ratio and the difference between the yield on two-year government bonds and the rate of interest paid on these deposits, it could be argued that SRD requirements are currently bearing as, or perhaps even more, heavily on banks now than they have done in the past.

Measured in this way the 'cost' of SRD requirements expressed as a percentage of each $100 of major trading bank deposits has varied as follows (the SRD ratio applicable at the time is shown in brackets):

June 1960	0.62	(17.5)
June 1965	0.58	(13.8)
June 1970	0.57	(10.0)
June 1975	0.23	(3.0)
June 1980	0.54	(6.0)
June 1981	0.74	(7.0)

3 For example, while reliance on open market operations in the implementation of monetary policy would certainly increase the short-term variability of **official** and bank interest rates, it may well lead to a reduction in the variability of **other,** more market-determined, rates. It is not clear, therefore, what the ultimate outcome of a shift to open market operations would be in terms of interest rate variability.

- the costs of their use, in terms of efficiency losses and diminution in competitive equity, are not greater than the benefits obtained from improved monetary control.

4.11 On the basis of these criteria, the following discussion attempts to evaluate existing direct controls, i.e.:

- **interest rate** controls, e.g. ceilings on deposit and loan rates of banks;
- **maturity** controls, e.g. the restriction that banks cannot accept interest-bearing deposits for periods less than thirty days or greater than four years;
- **lending** controls, e.g. limits on the growth in bank advances (in aggregate or in particular categories); and
- **reserve asset** controls such as the SRD ratio.

(a) Interest Rate Controls

4.12 Interest rate controls have a number of aims in addition to any potential they may possess as instruments of monetary policy. In particular, it has been argued that:

- Controlled bank interest rates benefit low income borrowers and assist the spread of home ownership, the operation of small businesses etc. These are regarded by some as desirable on social grounds.
- Interest rate controls also have a prudential aspect in that they limit the degree of interest rate competition for bank deposits. This form of competition is regarded as undesirable because it may become 'cut throat' at times and encourage banks to undertake risky investments in order to cover the costs of their deposits.
- Sharp fluctuations in interest rates may at times strain financial markets and threaten the stability of individual institutions.

4.13 In various parts of this Report the Committee examines these suggested social and prudential benefits of interest rate controls. It concludes that they are not substantial — if they exist at all. It is useful to summarise a few key points here before addressing the more substantive monetary policy considerations.

4.14 Firstly, it is unlikely that low income earners are favoured by the controls. Faced with an excess demand for funds, the institutions subject to controls have an incentive to favour borrowers of lower risk, those who have a savings record with the lending institution, those who can bring new business etc. Evidence suggests, for example, that a relatively small proportion of low income earners benefit from low interest housing loans and, on the other side of the balance sheet, a high proportion of them are disadvantaged because they tend to hold their savings in low-yielding bank deposits (such as savings bank pass book accounts). Large depositors have access to more alternatives for investing their money than small depositors and are generally better placed to obtain a preferred mix of return and safety. Thus small savers are likely to receive a lower rate of return on their savings and pay a higher rate on their loans or have difficulty in obtaining finance. This issue is further discussed in Appendix 4.1 and, more particularly, in Chapter 37.

4.15 Secondly, there is some doubt as to whether the provision of low interest housing loans effectively increases home ownership. The fact that rates paid by major housing financiers are controlled could have the effect at times of restricting the total volume of housing funds and adding to the instability of the housing industry. In any case it can be questioned whether interest rate controls represent

the most efficient and equitable means of assisting particular groups, given the costs involved (see Appendix 4.1).

4.16 The Committee does not support the argument that interest rate ceilings act as a prudential control. Studies have suggested that competition for deposits is not a destabilising factor in the banking system.[4] Indeed, it can be argued that permitting individual banks to bid for deposits when they face temporary liquidity difficulties increases the stability of the system. In that case, an individual bank, building society etc. can bid its way out of its immediate problems (assuming that all banks etc. are not in the same situation) but at a cost. As the normal commercial disciplines would apply, banks would have an incentive not to get caught in this position too often.

4.17 The Committee accepts that more variable interest rates in certain areas may create some initial problems for institutions (because of the fluctuating value of their assets). However, institutions have shown in recent years an increasing ability to adjust to a fluctuating interest rate environment. Moreover, while it is true by definition that **bank** and official interest rates will show greater variability in a deregulated system, this may not be true of interest rates on average. Decontrol of bank rates would mean that less of the pressure for adjustment would fall on market-determined rates and these rates may become **less variable.**

4.18 It is argued by some that interest rate controls are a useful instrument of monetary policy because they inhibit the banks from expanding their level of lending at times when the authorities are seeking to restrict the growth of M3. However, the Committee believes that banks **as a group** can expand their level of lending only to the extent that they can attract base money from outside the banking system and/or are willing to reduce their excess reserves. Non-bank holdings of base money are generally very insensitive to changes in interest rates and banks may be reluctant to reduce their liquidity buffers in uncertain times.[5] There is, therefore, reason to doubt that the removal of interest rate controls would, per se, lead to a rapid and substantial change in the level of bank advances.[6]

4.19 Indeed, by allowing the banks greater interest rate flexibility the authorities, to an important degree, would be limiting the potential for non-bank financial intermediaries (NBFIs) to frustrate policy in a period of monetary restraint. Concern about an expansion of banks' deposits appears to arise from a preoccupation with M3 control. To the extent that they divert funds away from the controlled sector, interest rate controls whittle away the base which they influence and are in that sense self-destroying. They also reduce the potential effectiveness of open market operations as an instrument of monetary policy.

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4 The standard reference on this subject is G. J. Bentson, 'Interest Payments on Demand Deposits and Bank Investment Behaviour', *Journal of Political Economy,* October 1964.

5 Of course, if bank interest rates are attractive enough, holders of Treasury notes might be induced to cash them with the Reserve Bank and direct their funds to the banking system, thus adding to the monetary base of the system. It must be presumed, however, that if the authorities are seeking to restrain the volume of money they will ensure that the rediscount rate on Treasury notes is such as to discourage such behaviour. Similarly the higher level of interest rates may attract capital from overseas and this too might add to the monetary base, but this is a matter of ensuring an appropriate exchange rate policy.

6 It is even possible that during the transitional period, because of important shifts in funds flows between intermediaries, the growth of total credit will contract or slow down excessively, and require an easing in monetary policy.

4.20 The Committee believes that controls on the rates charged on bank advances may actually weaken monetary policy. If the ceiling rate is not raised in line with market-determined rates, there is an incentive for bank borrowers, particularly holders of unused overdraft rights, to exercise them and on-lend the funds to the short-term money market. This process — called 'round tripping' — can lead to an increase in the volume of money — at least in the short run. One way of reducing this particular problem would be to require the banks to abandon the overdraft method of lending. The Committee does not, however, favour such a restriction — both in principle[7] and because it believes that access to overdraft facilities allows greater flexibility in the management of funds. It believes that a far better approach would be to remove the controls on bank lending rates so that they can be kept in line with market rates.

4.21 It has also been argued that control over bank interest rates may sometimes facilitate government loan raising and debt management. However, the Committee's view (discussed in Chapter 11) is that there is little reason to allow the Government to borrow at concessional rates at the expense of bank depositors.

4.22 Apart from being relatively ineffective as a monetary policy instrument, interest rate controls on financial intermediaries have a number of undesirable by-product effects which reduce the efficiency of the financial system. These costs are discussed in detail in Appendix 4.1. For example, such controls generally lead to underrepresentation of bank deposits in investors' portfolios, impact unequally on different customers, divert funds to possibly less efficient unregulated intermediaries, blunt the competitive and innovative drive of controlled institutions, and cause an uneconomic degree of market fragmentation.

4.23 Perhaps even more significant is the encouragement given to disintermediation, with funds flowing into direct financing via the intercompany market, the solicitor-based mortgage finance market etc. This tendency is likely to be greatest when inflation is high and rising because of the associated volatility in nominal market interest rates and because controlled rates generally respond slowly. In such circumstances, the gap between controlled and market-determined rates tends to widen. The experience in the 1970s is shown in Table 4.1.

4.24 It is difficult for the Committee to gauge the magnitude of disintermediation that has occurred as a result of interest rate controls, because very little information is available on the extent of direct financing. It is noted, however, that when interest rate controls were removed in New Zealand in 1976, a substantial reintermediation occurred. Allowance must be made, of course, for the different circumstances in each country, but the Committee would expect a similar outcome in Australia.

4.25 The Committee endorses the recent relaxation of interest rate controls, and especially the abolition of ceilings on deposit rates in respect of both savings and trading banks. It notes, however, that the power to reimpose controls on deposit rates is still in the Banking Act and in the unproclaimed Part IV of the Financial Corporations Act, and that some controls on bank interest rates remain in existence, including in respect of:

- trading bank overdraft loans drawn under agreed limits of less than $100 000 (the maximum 'small' overdraft rate) and related limits on term loans;
- savings bank housing loans to individuals for owner occupation;

7 It is really a matter to be resolved between a bank and its clients.

- banks' personal instalment loans; and
- the payment of interest on most current acounts of banks.

TABLE 4.1: CONTROLLED AND MARKET INTEREST RATES IN AUSTRALIA (%)

June	*Trading banks' maximum fixed-deposit rate*	*Short-term money market maximum rate on call deposits*	*90-day bank bill rate*[a]	*Banks' certificate of deposit issue yields*[b]
1960	3.50	3.50		
1961	4.50	4.88		
1962	4.00	4.00		
1963	3.50	4.25		
1964	4.25	4.50		
1965	4.50	6.00		
1966	4.50	6.10		
1967	4.50	6.50		
1968	4.75	6.75	5.50	
1969	4.75	7.50	5.90	4.75
1970	5.50	8.80	8.70	5.50
1971	6.50	9.50	8.15	5.44
1972	6.50	8.25	5.75	5.44
1973	6.50	8.75	6.40	6.37
1974	8.00	13.00	18.80	17.26
1975	10.00	14.10	8.80	9.27
1976	10.00	14.00	10.45	10.15
1977	10.00	15.30	11.10	10.51
1978	10.00	18.86	10.80	10.16
1979	10.00	18.25	10.35	9.84
1980	10.00	18.80	13.85	13.23

(a) Average of daily market bill-buying yields reported to Reserve Bank for week ended Wednesday of month; bank bills are those accepted or endorsed by a bank.
(b) Weighted average issue yield for month; a ceiling applied to those issue yields from inception (March 1969) to 17 September 1973.

4.26. The Committee therefore ***recommends*** that:

(a) All official intervention in the determination of bank deposit and lending interest rates should cease and existing controls should be abolished.

(b) As part of this deregulation process, banks should be permitted to pay interest on all current account balances at their individual discretion.

(c) The power to impose direct interest rate controls should be removed from section 50 of the Banking Act and from section 15 of Part IV of the Financial Corporations Act.

(b) Maturity Controls

4.27 The maturity restrictions on interest-bearing bank deposits are favoured by some because:

- to a degree they shelter the public sector from competition; specifically, the four-year maximum prevents banks from competing with government and semi-government paper of medium to long-term maturity;
- they limit the range of activities of the banks and lead to a more diversified financial structure; specifically, the thirty-day minimum restricts the extent to which banks can compete with merchant banks and authorised dealers in the short-term money market; and
- it is argued that the thirty-day minimum maturity restriction reduces the

volatility of banks' deposits and thereby contributes to the stability of the banking system.

4.28 Elsewhere in the Report, the Committee argues against the use of direct financial regulation as a means of protecting or segmenting financial markets and it advocates removal of restrictions on entry, other than prudential (see for example Chapters 11, 19, 24 and 32). Nor is it clear that maturity restrictions necessarily reduce the volatility of banks' deposits. Indeed, it is possible that such controls add to volatility because banks are prevented from bidding for deposits in certain parts of the market. The Committee is not satisfied that these controls produce any important benefits and they certainly reduce the efficiency of financial markets.

4.29 The Committee therefore ***recommends*** that **maturity controls should be abolished.**

4.30 This recommendation has particular implications for the authorised dealers. These are discussed in Chapter 9.

(c) Lending Controls

4.31 The Committee understands that **qualitative** lending controls involving direct instructions as to the classes of lending which are preferred by the authorities have not been used recently. The Committee endorses this situation and would strongly recommend against their reintroduction. Experience has shown that they tend to have very limited effect.

4.32 Persistent use has been made of **quantitative** lending controls — requests to banks to restrict their lending to specified levels — in recent years. Some spokesmen for the authorities have argued that lending controls allow them to keep a tight rein on bank lending, that they provide the banks with precise information on what is required of them, and that they work faster and more predictably than other techniques for regulating bank advances.

4.33 The evidence suggests that there has been a significant lag between the initiation of a lending request and the reaction of bank advances to it.[8] This lag arises largely because banks cannot control their advances very precisely when they lend by way of overdraft. There is no evidence that this lag is any shorter for lending controls than for other techniques for influencing bank lending, e.g. reserve requirement changes.

4.34 More fundamentally, the persistent use of this instrument of control reflects again isolated concern for the M3 target. When broader targets are considered it is not clear what purpose lending controls serve. Like other direct bank controls, lending directives are self-destroying in the long run because they stimulate the growth of fringe institutions outside the area of control. They also impact inequitably on particular groups of borrowers, such as small business, which are relatively more dependent on bank finance. Lending controls also impose substantial efficiency costs on the financial system (apart from the direct costs of administration).

4.35 Firstly, they give the banks very little discretion in choosing the composition of their free portfolio — that part which remains after they satisfy their reserve requirements. Secondly, they reduce the incentive for the banking

8 See K. T. Davis and M. K. Lewis, 'Monetary Policy', in *Surveys of Australian Economics*, 1978, edited by F.H. Gruen.

system to compete for deposits against non-bank institutions, with consequent inefficiencies in the structure of financial intermediation.

4.36 Thirdly, lending controls have the effect of virtually freezing market shares of individual banks, thereby reducing their incentive to compete **amongst themselves.** This encourages and facilitates non-competitive and discriminatory pricing of services. It may also slow down the pace of innovation. (It is noted in Chapter 23 that electronic funds transfer systems have not developed as rapidly in the Australian payments system as they have overseas.)

4.37 It would appear that any degree of restriction of advances that can be achieved by lending controls can also be achieved by variations in required reserve ratios. This point is discussed in detail in the following section; but it may be noted here that changes in reserve asset ratios would not generate the same efficiency costs as lending controls.

4.38 The Committee therefore ***recommends*** that **the power to impose quantitative or qualitative lending controls should be removed from section 36 of the Banking Act and section 14 of Part IV of the Financial Corporations Act.**

(d) Reserve Asset Controls

(i) Variable Reserve Asset Ratio

4.39 The requirement for banks to deposit a certain proportion of their deposits in Statutory Reserve Deposits (SRDs) with the Reserve Bank is the primary reserve requirement to which trading banks are subject. The ratio has been varied frequently for monetary policy purposes. In a number of respects it is closely related to the minimum Bank Cash Reserve Ratio (BCR) suggested to the Committee by the Australian Bankers' Association (ABA). The ABA, however, saw the BCR Ratio as being much less variable and earning a higher return than has been the practice in the past for SRDs.

4.40 If the authorities wish to influence the level of bank advances, it appears that a **variable** reserve ratio may be a more appropriate policy tool than lending controls. In particular, it gives the banks greater incentive to compete amongst themselves; an aggressive and effective competitor would be able to improve his market share. The Committee accepts that it may not work as predictably in the short run as lending controls. Nevertheless, it seems likely that any desired reduction in bank lending can be achieved over the medium term by open market operations — supplemented, if necessary, in the short run by variations in the primary reserve requirement.

4.41 There are, of course, some costs involved in the use of a variable reserve ratio. It restricts the form of the banks' portfolios to some degree and therefore reduces the allocative efficiency of the system. Viewed in isolation, it may also adversely affect the competitive position of the banks. Nevertheless, the Committee judges these effects to be small compared to those of the other direct controls examined in this chapter, especially if the recommendation that a market rate of interest be paid on required reserves were to be adopted.

4.42 Apart from being a less costly means of influencing bank advances, a variable reserve asset ratio may be required at times to usefully complement open market operations:

- There will be occasions when the state of expectations in the bond market hinders open market operations.

- The two techniques have their initial impact on different parts of the system — open market operations on the market for government securities and changes in reserve requirements on the banks.
- The two approaches differ slightly in their effect on private sector (including bank) portfolios. In the case of an increase in the reserve ratio, portfolios will include more deposits with the Reserve Bank and less government paper than would be the case with an open market operation. This is likely to be significant if banks, for example, see these assets as imperfect substitutes.
- Even if the ultimate effects of the two techniques are similar, the initial impact on the structure of interest rates, the channels through which the adjustments occur, and the time taken to reach a final position may all differ.

4.43 It is clear from the previous paragraph that the two instruments are most likely to have differential effects when financial markets are narrow and segmented. This situation exists in Australia at the moment and can be attributed largely to the extensive range of regulations to which the financial system is subject. The effects of the two instruments may also differ in the transition stage to a deregulated system because it may take some time for market participants to adjust their behaviour to the new environment.

4.44 Therefore, given that the efficiency costs of maintaining a variable reserve ratio do not appear to be large (having regard also for the later recommendation that a market-related interest rate be paid on reserve assets), the Committee ***recommends*** that **a variable reserve ratio on banks should be available to the authorities as an instrument of monetary control.**[9]

4.45 This recommendation, however, must be viewed in the context of an overall reduction in the emphasis on direct controls and an increasing reliance on open market operations as financial markets complete their adjustment to other deregulation measures. When the process of deregulation (and the adjustment of the system to it) has been completed, and securities markets have developed greater depth, there should be little need for an instrument to supplement open market operations.

(ii) Coverage of Reserve Assets

4.46 It has been suggested to the Committee that the definition of reserve assets should be extended to include assets eligible for discount (e.g. Treasury notes) on the grounds that such assets are close substitutes for cash; given the existence of the discount facility, it is said to be difficult for the authorities to control the cash base, but they can control the magnitude of the cash base plus discountable assets.

4.47 Nevertheless, the Committee would not favour extending the definition of reserve assets beyond cash (i.e. notes and coins and deposits with the Reserve Bank), since:

- where interest rates are basically market-determined, and the cashing facility generally involves a penalty, cash and discountable assets are not perfect substitutes, as the terms on which the assets will be convertible into cash at some time in the future are unknown to the holder; and
- as explained in Chapter 5, the Committee sees the rediscount facility as a

9 Subsequent discussion and related recommendations imply changes to Division 3 of the Banking Act.

safety valve for the financial system, and this purpose would be defeated if discountable assets were to be included in required reserves.

(iii) Government Security Tranche

4.48 The LGS ratio is a secondary reserve requirement which is applied to Australian trading banks. The issue to consider here is whether a fixed government security tranche is required over and above the cash reserve ratio.

4.49 The LGS ratio has served a monetary policy role in the past, especially in periods when authorities were subject to an interest rate constraint. At a time when the authorities wanted to restrict credit, but were also attempting to peg interest rates, it would have been possible for the banks, in the absence of the LGS ratio, to offset their restrictive policies by selling bonds to the Reserve Bank, thereby forcing the authorities to provide liquidity to the system. The LGS ratio restricted this type of behaviour, although banks were, of course, still able to dispose of any LGS assets they held in excess of the required amount.

4.50 The Committee has argued elsewhere in the Report that the authorities should adopt a more flexible approach to interest rates. If this approach were implemented, the monetary policy advantage in having a mandatory government security requirement would disappear, and a less onerous cash reserve ratio, coupled with open market operations, would be adequate for monetary policy purposes.

4.51 In a flexible interest rate environment, the only purpose served by having a 'government security tranche' in the banks' reserve ratio is to provide yet another captive market provision for government securities. In Chapter 10, the Committee has argued that the captive market provisions should be abandoned and the authorities should accept greater variability in public sector interest rates.

4.52. The Committee therefore ***recommends*** that **a fixed government security tranche, over and above the cash reserve ratio, should not be prescribed for monetary policy purposes.**

4.53 It should be noted that, as with captive markets, there may be transitional problems for monetary policy arising out of the abandonment of the LGS connection — unless interest rates on government paper are allowed to reflect market forces to a reasonable degree.

4.54 In the formal sense, the LGS convention is a voluntary agreement and open to renegotiation at the initiative of either the Reserve Bank or the banks which are subject to it; it was for example varied temporarily in February 1976 until March 1977. The convention, while not part of the banking legislation, could nonetheless be seen as drawing support from it. It may also be assessed as having some characteristics of prudential regulation; as discussed more fully in Chapter 19, it is expected that banks (and others) will hold a prudent level and maturity structure of claims on government. Any such requirement would be based on prudential considerations, although it would also serve as a 'fulcrum' for variations in monetary policy.

(iv) Liability to Hold Required Reserves

4.55 There are two issues arising from the question of a bank's liability to hold required reserve assets:

- **the range** of liabilities which would appropriately be subject to reserve requirements; and

- whether reserve requirements should **differentiate** between different classes of liability.

4.56 As to the first matter, the Committee is of the view that for monetary policy purposes all elements of a banking group should be regarded as a consolidated unit. (As discussed in Chapter 19, this principle of consolidation is appropriately carried through to prudential regulation.) Accordingly, it is the Committee's preference that the liability to hold reserve assets should extend to the specified liabilities of banks and their subsidiaries.

4.57 The reasoning underlying this preference of the Committee for consolidation is essentially a concern to avoid the situation, such as has existed, where partial regulation gives banking groups artificial incentives to diversify their corporate structures to circumvent the monetary policy obligations deemed applicable to banking operations. It is important to recognise however, that, read in conjuction with other related proposals for change, the burden implicit in such reserve requirements will be substantially less than it has been.

4.58 Beyond that, the Committee is concerned also to bring within the ambit of reserve requirements all of the appropriate Australian liabilities of banking groups. These could well include such actual liabilities as bank acceptances and bills payable and in some circumstances even such contingent liabilities as bill endorsements. The appropriateness of any inclusion, for this purpose, will depend of course on the contribution made to the monetary policy objective. Their inclusion for prudential and related considerations is another matter.

4.59 As to the second question posed above, it has been the practice in the past for the determination of trading bank reserve asset requirements to be a single uniform ratio in respect of Australian deposits. It could be argued, particularly in the light of the proposals in the previous paragraph, that the specification of the reserve asset requirement should be suitably differentiated according to the different classes of liability. For example, in some other countries, a higher reserve requirement applies in respect of current account deposits and a lower ratio in respect of 'savings' deposits. This is a complex policy issue and the Committee does not proceed to a firm judgment of it. Nonetheless, it is a possibility that needs to be explored. It would, of course, be the Committee's view that the same reserve requirement would apply to deposits of the same character (in respect of maturity, rate of turnover etc.).

4.60 The Committee ***recommends*** that:

(a) Banking groups be appropriately considered as consolidated units for the purpose of determining their minimum reserve requirements.

(b) The reserve requirements be extended beyond deposits to embrace all appropriate liabilities of the banking group.

(c) The monetary authorities give careful consideration to the desirability of differentiating reserve deposit requirements according to different classes of deposit and other liabilities.

(v) Interest on Reserve Assets

4.61 The major difference between the existing SRD system and the BCR suggested by the Australian Bankers' Association is that it is envisaged with the latter that a comparatively high interest rate would be paid on reserve assets — high, that is, compared with the present rate.

4.62 Some observers argue that the requirement that banks immobilise part of their deposits in very low-yielding reserve assets acts as a tax which offsets the privileges granted to them. While this is a possible use of the primary reserve requirement, it can conflict with its use as a monetary policy instrument. Variations in the ratio which are desirable for monetary policy purposes will change the amount of the 'tax' in a way which is often unrelated to the benefits the banks are receiving. Since the Committee has argued above that the authorities may need an additional policy instrument to complement open market operations during a transitional period after deregulation and since there are other ways of taxing banks (if the authorities consider this desirable)[10], it appears to the Committee that the monetary policy use of required reserve ratios should take precedence over their use as a taxing device.

4.63 The question, then, is what influence the payment of a higher rate of interest will have on the effectiveness of changes in required reserve ratios in the determination of bank advances.

4.64 One argument can be quickly dismissed. The authorities have claimed that the threat of a call to low interest SRDs has been a factor keeping banks close to the lending guidelines laid down by the Reserve Bank. This was never a completely convincing argument because it was always open to the authorities to make **larger** calls at **higher** interest rates and to keep the banks on a tighter rein as regards their liquidity. But the issue loses its relevance in any case, given the Committee's recommendation that lending controls be abolished.

4.65 It has been suggested that the payment of a higher interest rate on reserve assets would weaken monetary policy because it would reduce the effective cost of additional deposits and give the banks a greater capacity to expand their lending whenever the reserve ratio is increased.[11] The Committee has already commented on some related propositions above, but a few points bear repeating:

- The banks **as a group** can expand their lending levels only to the extent that they can attract additional base money or already have surplus reserves. It is not likely, therefore, that a substantial expansion will occur in the circumstances being considered.
- Payment of a higher interest rate on reserve assets may allow **individual** banks to compete more readily with non-bank financial intermediaries (NBFIs) for deposits when the authorities are attempting to institute a restrictive policy. This will have the effect of inhibiting the activities of NBFIs, thereby reinforcing the contractionary policy.

4.66 The view has also been expressed that an increase in the interest rate paid on reserve assets might lead to 'excess' profits being earned by the banks. This tendency will be offset by the implementation of the Committee's recommendations in Chapters 24 and 25, which envisage a substantial

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10 The most effective ways to ensure that banks do not make excessive profits are to remove artificial barriers to entry of new banks, and to eliminate interest rate controls on current account deposits.

11 Work by Sharpe, Volker and Hogan (reported in W. Hogan, 'Self-fulfilling Orthodoxy and Economic Management' presented to the Inquiry seminar on Open Market Operations and Direct Controls, June 1980, and published in AFSI *Commissioned Studies and Selected Papers*, Part 1, AGPS, Canberra, 1981) indicates that SRD policy has had a significant effect on the returns on bank shares. To the extent that this effect is removed by the payment of a higher interest rate on reserve assets, it may encourage individual banks to seek to expand their activities.

liberalisation of entry to banking, and the earlier recommendations on interest rate controls. In this environment unusually high profits should be quickly eroded by competition. To the extent that it does lessen the short-run impact on bank income and profits, a higher interest rate will make the variable reserve ratio instrument more acceptable to the banks and therefore facilitate its use and strengthen its effectiveness in practice.

4.67 The impact of changes in the reserve asset ratio partly arises out of the 'announcement' effects. To the extent that this is true, the effectiveness of this instrument will not depend on the interest rate paid on reserve assets.[12]

4.68 The Committee therefore ***recommends*** that **a near-market interest rate should be paid on required deposits with the Reserve Bank.**

4.69 The authorities might choose to tie the interest rate on reserve assets to the Treasury note rate. The precise determination of the rate is a matter on which the Committee does not feel it necessary to comment.

(vi) Lagged and Current Reserve Accounting[13]

4.70 The present SRD arrangements are an example of a lagged accounting system. Banks are required, on the second Wednesday of each month, to adjust the amount deposited with the Reserve Bank in their SRD account to a sum equal to the required ratio multiplied by the average level of their Australian deposits on the Wednesdays in the previous month.[14] In a current reserve accounting system reserves are related to deposits contemporaneously.

4.71 The advantages claimed for the lagged accounting approach are that it:

- gives the authorities and banks time to collect the required data on deposits; and
- removes from banks the uncertainty about the amount of reserves they are required to hold.

4.72 Against this, it has been argued that lagged reserve accounting induces greater fluctuations in short-term interest rates and reserve flows.[15] It is claimed that the costs of the uncertainty about short-term interest rates generated in this way more than offset the benefits gained by the removal of uncertainty about the magnitude of required reserves.

4.73 The practical problems of data collection which may have played an important role in the choice of lagged reserve accounting when the SRD arrangement was introduced are no longer as significant. Indeed, given modern computer technology, there may be less objection to current reserve accounting on this ground. However, the Committee makes no recommendation as further study may be necessary before a firm judgment can be made.

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12 Another argument put forward in favour of the payment of a higher interest rate on required reserves is that it would reduce the incentive for the development of an offshore market in SA. See J. R. Hewson, 'Offshore Banking in Australia', AFSI *Commissioned Studies and Selected Papers*, Part 2, AGPS, Canberra, 1981.

13 The discussion in this section draws heavily on the study on this subject commissioned by the Committee. See I. G. Sharpe, 'Lagged and Current Reserve Accounting Schemes', AFSI *Commissioned Studies and Selected Papers*, Part 4, AGPS, Canberra, 1981.

14 Calls or releases from SRDs in any period are also based on average deposits for the month prior to the preceding second Wednesday.

15 See Sharpe, op. cit.

(vii) Supplementary Reserve Ratios

4.74 Supplementary reserve ratios have been used in a number of countries as a tool of monetary policy. These generally require banks (and sometimes other institutions) to make special deposits with the central bank proportional to the amount by which their assets or liabilities have been expanding faster than a prescribed rate. Two examples are:

- The supplementary special deposit scheme (the 'Corset') in the United Kingdom. Institutions subject to this control were required to make a non-interest-bearing deposit with the Bank of England of a size related to the extent to which the growth in interest-bearing eligible liabilities exceeded the penalty-free rate of growth in the previous month. This control, introduced in 1973, was terminated in March 1980.
- The measures introduced in the US Federal Reserve System in March 1980 which included a 15% special deposit requirement on increases in certain types of consumer credit and a 15% special deposit on increases in assets of money market mutual funds.

4.75 These examples differ in two respects from the variable reserve ratio proposed earlier in this chapter:

- they relate to the increment in deposits (advances etc.), and not to the level; and
- they are applicable in a fashion which discriminates against individual banks rather than the banking industry as a whole.

4.76 It is clear that in cases of this kind the payment of a low interest rate on special deposits may at times increase their effectiveness.

4.77 It is also clear, however, that to the extent that these controls are effective, they are very similar to lending controls and suffer from the same weaknesses. In particular, they penalise the institutions which are competing most aggressively and effectively and contribute to the freezing of market shares. The Committee feels, therefore, that such instruments should not be used in the implementation of monetary policy.

C. EXTENSION OF MONETARY CONTROLS TO NON-BANKS

4.78 The Committee argued above that during the transitional period the authorities should have the capacity to apply variable reserve ratios on banks to supplement open market operations in the implementation of monetary policy. This raises the question of whether similar controls should be extended to other financial institutions.

4.79 It has been submitted that such an extension, other things being equal, would contribute to the maintenance of competitive neutrality in the financial system. However, as was noted in the previous section, the 'penal' element in variable reserve ratios would be reduced if a higher interest rate were paid on reserve assets; in any case, other things will not remain precisely equal under the system of reforms proposed by the Committee, e.g. the banks will still enjoy a unique relationship with the Reserve Bank in respect of depositor protection.

4.80 The other major reason often given for extending the requirement would be to prevent NBFIs from varying the size and composition of their balance sheets in

such a way as to offset the effects of a restrictive monetary policy. At the present time:

- most NBFIs hold a very small proportion of their reserves in the form of base money and, therefore, open market operations tend to have a less **immediate direct** effect on them;
- it is possible for NBFIs to offset monetary policy either by varying their liquid reserve ratios or (more commonly) by bidding away deposits from the banks; this might enable them to expand lending at a time when the monetary authorities are attempting to restrict credit, without any corresponding reduction in bank lending, at least in the short run.[16]

4.81 However, in the kind of environment envisaged by the Committee, the scope for NBFIs to offset monetary policy will be very limited:

- Once banks have been freed from interest rate and lending controls, NBFIs will be less able to attract deposits away from them at times when banks are experiencing tight liquidity.[17]
- In some cases, open market operations may have just as immediate an effect on some NBFIs as on banks. For example, the sale of government securities directed at households would tend to impact heavily on institutions like building societies.
- Any deposit-taking institution can be expected to maintain some minimum liquidity ratio and, to that extent, their scope to act independently of the thrust of monetary policy by running down their liquid reserves is limited.

4.82 This is not to say that the extension of some controls to NBFIs would have no effect at all on monetary policy. For example, if these institutions were subject to a variable reserve ratio which was altered along with the ratio affecting banks, the effect of such a change on broad credit and monetary aggregates may be initially greater than that of a change in the bank ratio alone. Also, monetary policy might be strengthened by a requirement that non-bank intermediaries hold part of their reserves in the form of base money.[18]

4.83 The Committee, however, has had to consider several major problems in extending variable required reserve ratios beyond the banks:

- The administrative complexity of defining and enforcing the controls — given the variation in the composition of the balance sheets of different intermediaries, it would be necessary to set a different but consistent base ratio for each class of financial institution; the magnitude of changes in the ratio might also have to vary between institutions. As well, there would be some costs involved in the extra supervisory activity required of the authorities.

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16 This is because bank deposits form part of the reserve base of NBFIs and the non-bank public. There is therefore no immediate reduction in bank deposits when funds are transferred to NBFIs (apart from cash 'leakages'). It must be recognised, however, that in the longer term the monetary authorities may well apply a more restrictive policy on the banks in order to neutralise the effects of NBFI activities on velocity of circulation.

17 In the present framework of monetary policy, which includes controls on bank interest rates and advances, this is not the case.

18 This proposition is discussed in some detail in: T. J. Valentine and P. J. Williamson, 'Open Market Operations v. Direct Controls', AFSI *Commissioned Studies and Selected Papers*, Part I, AGPS, Canberra, 1981; and K. T. Davis and M. K. Lewis, Monetary Policy in Australia (Melbourne, Cheshire, 1980), Chapter 10. The variable reserve ratio, if applied to banking groups on a consolidated basis (as recommended above), would of course enhance the effectiveness of this policy instrument as compared with the present situation.

- The incentive which the controls would provide for the growth of institutions and markets outside the network of controls — it would be impossible to 'fence' the controls so effectively that they would prevent significant leakages occuring. The effect of the extension on the strength of monetary policy would therefore be eroded over time. As well, any widespread tendency to 'disintermediation' would have obvious efficiency costs.

4.84 The Committee feels that the practical problems of extending required reserve ratios to NBFIs mentioned in the previous paragraph would greatly limit the potential monetary policy gains. While it is desirable for most NBIs to maintain an appropriate liquidity ratio for prudential reasons (see Chapter 19), its magnitude and form should not be influenced by monetary policy considerations. The Committee concludes that **a variable reserve ratio should *not* be extended to NBFIs.**

4.85 This conclusion does not apply to those NBFIs which are subsidiaries of authorised banks. As noted elsewhere, these will be consolidated for both prudential and monetary policy purposes and, as such, subject to reserve requirements.

D. THE ROLE OF SUASION

4.86 A number of submissions have proposed the use of 'suasion' as a supplement to open market operations in place of direct controls.

4.87 The word 'suasion' can have two distinct meanings:

- at one extreme it relies on wide-ranging latent powers conferred by legislation, in which case it is virtually indistinguishable from coercion;
- at the other extreme it involves giving broad guidance but without formal powers to enforce these suggestions and without any legal obligation on the part of the recipients to accept them. In this form it is an attempt to influence the actions of private institutions by education and moral pressure rather than by coercion.

4.88 Suasion in both these senses has been used by the Reserve Bank and other authorities in recent times. **The Committee sees no case at all for the first, *coercive*, type of suasion;** it views it as equivalent to, and in many respects more undesirable than, direct controls, especially where it is centred on the prescription of detailed and specific lending restrictions.

4.89 Suasion of the second, *non-coercive*, kind also creates difficulties. The primary concern of the monetary authorities is with the **aggregate** volume of money and its rate of growth. This can be called the 'target'. If the rate of asset growth of an individual institution is above or below the rate of growth of the 'target' it may mean that the institution is pursuing a policy inconsistent with the target; on the other hand, it may simply reflect a change in market shares, in which case it might well be consistent with the aggregate growth rate desired by the authorities. It is very difficult for an individual institution to know which of these two things is happening, particularly where market shares are naturally volatile.

4.90 It is also very difficult, and of doubtful economic benefit, to use 'suasion' to keep individual institutions within some 'appropriate' range, particularly where the market is competitive and each institution is seeking to protect or expand its

market share. Suasion based on precise 'growth guidelines' is therefore either ineffectual or, if made effective by virtual 'coercion', almost indistinguishable from quantitative lending restrictions.

4.91 Non-coercive suasion may perhaps contribute to monetary policy in certain special circumstances, e.g. where:

- a few large institutions dominate the industry;
- market shares have a high degree of stability;
- information regarding the actions of each institution in the market place is normally available promptly; and
- there is general support within the industry for the Government's monetary policy aims and objectives.

4.92 In such special circumstances, industry participants may be persuaded to take a longer term view of the effects of their actions on the stability of the system or the rate of inflation. A number of other advantages may also flow:

- the process of suasion may provide opportunities for frequent consultation and the development of a closer rapport between the authorities and financial institutions;
- because it does not require the precise specification which is necessary for legislative controls, the intended policy can be applied and administered flexibly;
- when applied to non-bank financial intermediaries, it does not run the same risk of legal challenge as would implementation of the control powers of the Financial Corporations Act; and
- it can serve as a useful back-up to open market operations and variable reserve ratios by giving a particular group of key institutions in the market place clearer guidance on the ultimate intent of monetary policy as it relates to that group. In this respect it is often welcomed by the institutions themselves.

4.93 On the other hand non-coercive suasion is both inequitable and ineffectual in controlling the supply of money and credit in the more common situation where:

- the industry is fragmented;
- industry information is out of date;
- there is no industry consensus on an appropriate monetary policy stance;
- market shares are volatile; and
- the links between actions of individual institutions and the aggregate outcome are difficult to discern.

4.94 One particular danger needs to be stressed. While suasion may at times provide a useful means of conveying information to a particular group of institutions about the ultimate intent of monetary policy **as it affects that group,** the Committee believes that monetary policy information of **general interest to the market** should be provided publicly rather than to selected institutions.

4.95 While suasion has a very limited role in the area of monetary policy, it may have a useful role in helping to maintain **prudent behaviour** in capital markets. The Committee is aware, for example, that the Life Insurance Commissioner at various times has provided guidance to the industry or to individual offices on a number of practices and has generally had a positive response. No doubt the other regulatory

authorities have adopted similar policies. Suasion is particularly appropriate where sensitive policy issues are involved which cannot be discussed publicly without affecting investor confidence.

4.96 The Committee sought the views of a number of organisations on the role of suasion and the replies received are included in Part 1 of the *Commissioned Studies and Selected Papers*. The main theme emerging from these replies is broadly consistent with the views of the Committee, as expressed above.

APPENDIX 4.1

DIRECT CONTROLS: EFFICIENCY COSTS AND DISTRIBUTIONAL EFFECTS

Costs

1 The purpose of this Appendix is to survey some of the costs which are generated by regulation of the financial system. Special attention is given to the controls which have traditionally applied to banks. The benefits which such regulation is intended to produce are discussed elsewhere in the Report.

2 **Firstly,** controls reduce the **allocational** efficiency of the system:

- In an efficient financial system differentials amongst various interest rates in the market will adjust in a way which ensures that funds are allocated to those purposes offering the highest rate of economic return after adjustment for risk. Interest rate controls prevent at least part of this adjustment from taking place. The regulated institutions are forced to resort to various rationing devices to allocate their funds between alternative uses; the outcome is generally a less effective allocation of funds; for example, where emphasis is placed on collateral, funds may not always be allocated to purposes offering the highest prospective rates of return adjusted for risk.

- Interest rate or portfolio controls impinge particularly on the regulated institutions' capability to attract funds for on-lending. This will lead to a shift in business from these institutions to those which may be less efficient, less able to spread risks and less able to cope with fluctuations in liquidity. When carried beyond a point, financial regulations lead to disintermediation as borrowers and lenders begin to deal directly with one another.[1] Disintermediation will reduce the allocative efficiency of the financial system because there are often substantial advantages in having savings flows directed through intermediaries.

- The community's portfolio choice is also distorted as deposits and investments subject to discriminatory regulation will be 'underrepresented' in lenders' portfolios. For example, rules such as those preventing the payment of market rates of interest on current accounts reduce the current account deposits in the public's portfolio below the amounts which would be held in an unregulated system.

- Prudential regulation of financial intermediaries will, to the extent that it contributes to stability, enhance efficiency. However, when carried beyond a certain point, it too can distort the allocation of funds. For example, if intermediaries are only able to lend for 'safe' purposes, the supply of risk capital may be adversely affected.

3 **Secondly,** the controls reduce the **operational** flexibility and efficiency of banks and the financial system generally:

- Controls such as the SRD requirement, the LGS convention and direct lending controls may prevent banks from achieving their preferred portfolios.

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1 The data on direct financing available in Australia are very sketchy. As one example, the Committee has noted that the McNair Anderson survey commissioned by it showed that 18% of respondents who had a housing loan obtained it from a source other than a bank, building society, credit union, life office or finance company. (See McNair Anderson, 'Investments and Savings, Australia 1980', in AFSI *Commissioned Studies and Selected Papers*, Part 4, AGPS, Canberra, 1981.)

- Bank controls can cause fragmentation of the intermediation industry. Banks are 'forced' to diversify into uncontrolled sectors; in effect operating in a fragmented structure rather than under a common operating umbrella.
- The overall cost of financial intermediation to the community is increased; in a regulated environment banks, for example, have tended to lose business to less regulated (often smaller) non-bank institutions. Depending on the nature and extent of economies of scale in financial intermediation, such a diversion of funds may increase the total costs involved in producing a given volume of financial services. Duplication of branch networks, as new intermediaries grow at the expense of existing controlled institutions, is a case in point; the effects on the cost structure may often outweigh the benefits to consumers through greater diversity of choice.

4 **Thirdly**, unlike some prudential controls, interest rate or portfolio controls are unlikely to be conducive to promotion of **stability** in banking, and more generally, of the financial system:

- the volatility of market-determined interest rates may be increased by the inability of banks to adjust their rates according to circumstances — i.e. the pressure of adjustment may fall disproportionately on uncontrolled rates;
- institutions that are prevented from bidding competitively for deposits may become more prone to instability in deposit flows and hence more vulnerable to liquidity problems;
- if banks are prevented from investing some of their deposits in the most profitable manner, they may be tempted to invest the remainder in riskier, higher yielding projects in order to recoup some of this loss.

5 Regulations which restrict entry or otherwise inhibit interest rate competition will often have the effect of increasing the margin which intermediaries receive over the cost of providing their services.

6 The difference between the margins which would arise in a competitive situation and the apparently larger margins applying in the present highly regulated situation can be divided into three parts:

- To some extent the higher margin may reflect the cost of providing ancillary services involved in the non-price competition necessitated by the pressure on regulated institutions to retain deposits. As customers will usually prefer to control the way in which their 'additional income' is spent, this in effect represents a forced levy on consumers of these financial services.
- Some of the margin may be dissipated by the development of various forms of inefficiency — **operational** and **dynamic.** For example, management may hire staff beyond the point which is profitable.[2] Controls may interfere with normal business decision making and reduce the incentive for financial intermediaries to introduce innovations in the services they offer and in the financial instruments they deal in. For example, banks may have less incentive to introduce innovations because the nature and extent of their business is constrained by government regulation.
- The extra return may also be distributed to the intermediary's employees or shareholders as 'rents'.[3]

7 Two important illustrations are:

- The adoption of pricing structures which distort the allocation of funds. Controlled institutions attempt to increase the effective interest rate in other ways, e.g. via

2 See K. T. Davis and M. K. Lewis, 'Economies of Scale in Financial Institutions' AFSI, *Commissioned Studies and Selected Papers*, Part 1, AGPS, Canberra, 1981. It is difficult in many cases to distinguish between the first two categories mentioned here; extra staff may provide services to customers (for example, reduce waiting time).

3 A 'rent' is a payment in excess of the amount necessary to keep the factor — labour or capital — in the avenue of employment in question.

processing and establishment fees. On the deposit side, the most important example is the payment of 'implicit interest' on current accounts by not charging customers the full cost of administering the accounts.

- The proliferation of bank branches.

8 The payment of 'implicit interest' involves some waste of resources from the community's point of view:

- it forces recipients to consume the interest in the form of the services provided rather than in the form they would prefer; and
- the rates charged are not closely related to the usage of current acounts and, therefore, customers draw more cheques than they would have done had they been charged the full cost of each transaction.

9 Although international comparisons need to be treated with great caution (e.g. the definition of banks varies), Table 4A.1 suggests that Australia may have a larger number of bank branches relative to population size than most other countries. An increase in the number of branches provides benefits to customers (for example, in the form of added convenience), but it may add to the average costs if there are increasing returns to scale in banking with respect to branch size.[4] In that case, services provided through a large network of small branches would involve average costs which are higher than those which will be incurred when the services are provided through a more concentrated branch network. The evidence available to the Committee[5] indicates that average costs fall as branch size increases, but only slightly, suggesting that branch networks might be more concentrated in a deregulated system. The question of the most efficient size may acquire new dimensions with changing technology. In some cases, branches are likely to be replaced by agencies or automatic banking terminals.

10 Deregulation should tend to reduce the margins obtained by controlled intermediaries.[6] This would lead to gains to the community:

- the original volume of business would tend to be carried out at finer margins leading to higher rates for depositors and/or lower rates for borrowers; and
- there is likely to be an expansion of financial intermediation because of the narrowing of margins.

11 In assessing these gains, it is necessary to allow for two factors:

- some of the gains to customers are at the expense of the bank shareholders or employees; and
- direct interest benefits received by customers replace non-price benefits. As noted above, however, this will move the community to a preferred position.

12 A crude estimate of the gains from deregulation can be obtained by assuming that the first group of gains mentioned in paragraph 10 are completely offset by the factors mentioned in paragraph 11; that is, only the second source of benefits listed in paragraph 10 is included in the estimate. Such an estimate must be regarded as a lower limit for the gains to be derived from deregulation.[7] The estimate of the benefits from an expansion of business depend on:

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4 For a detailed analysis of this question see P. L. Swan and I. R. Harper, 'The Welfare Gains from Bank Deregulation', AFSI, *Commissioned Studies and Selected Papers*, Part 1. See also Davis and Lewis, op.cit.

5 See Swan and Harper, op. cit.

6 The practices described in the previous paragraphs may not disappear completely in a deregulated environment. For example, customers may prefer implicit interest because it is not taxed (although bank charges are tax deductible for some). If this is the case, one can expect banks to continue to offer it.

7 It has been suggested that the actual gains could be substantially above this lower limit. See Swan and Harper, op. cit.

TABLE 4A.1: INTERNATIONAL COMPARISONS OF BANKING OFFICES, 1977

	Population per banking office
Australia	2 945
Belgium	2 681
Canada	3 204
Denmark	2 365
Finland	5 505
France	5 153
Germany	10 059
Italy	4 414
Netherlands	5 782
Norway	7 143
Spain	3 550
Sweden	5 298
Switzerland	11 462
USA	4 596

Source: K. T. Davis and M. K. Lewis, 'Economies of Scale in Financial Institutions', op. cit.

- the sensitivity of the demand for the intermediary's services (including deposits and loans) to changes in the prices charged for them; and
- the extent to which deregulation will change the margin.

13 The estimates will, of course, vary with the assumptions made. Two estimates of this type for the banking industry have been prepared for the Committee.[8] Both of these studies, however, support the view that there are possibly substantial gains to be made from the deregulation of banking.

14 A study commissioned by the Committee on 'sectoral assistance' analysed the distributional effects of the regulation of the interest rates of specialist housing finance intermediaries.[9] It concluded that these controls generate significant redistributions of wealth; the major losers are certain 'would be but can't be' borrowers and depositors with regulated intermediaries; the gainers are mainly those borrowers who are successful in obtaining housing finance.

15 The last of these three groups is identified as enjoying the benefits of what is effectively a subsidy delivered by means of the interest rate concessions, and the other pecuniary benefits arguably associated with home ownership.[10]

16 The second group loses because the interest income received from their savings is below what it would be in the absence of controls. The consultant provides rough calculations suggesting that the sums involved are quite substantial.

17 The first group includes those prospective borrowers who are unable to obtain finance (or at least, their total requirements), but who would have been successful without the controls on the intermediaries' borrowing rates. It is argued that these controls decrease the amount of funds that can be raised by them, and thus they have less than a free market level of funds for on-lending. They are forced to ration these funds on a non-price basis,

8 See G. Withers, 'Efficiency Gains from Banking Deregulation', *Australian Economic Review*, 1st Quarter, 1981 (this is a revised version of the paper reprinted in Part 1 of the *Commissioned Studies and Selected Papers*); and P. L. Swan and I. R. Harper, 'The Welfare Gains from Bank Deregulation', op. cit.

9 Judith Yates, 'The Distributional Impact of Interest Rate Regulation on the Household Sector', AFSI *Commissioned Studies and Selected Papers*, Part 4, AGPS, Canberra, 1981. The study focused on savings banks and permanent building societies.

10 See Chapter 37, Part I for a discussion of some of the possible benefits.

'squeezing' some prospective borrowers of housing finance out of the market — and thus forcing them to forgo the benefits associated with securing concessional finance and the other benefits associated with home ownership.

18 Although the consultant study concludes that the empirical evidence does not conclusively support the proposition that the **overall** impact of borrowing and lending rate controls on income distribution is regressive in incidence, it observes that:

- there is 'clear evidence to show that regulation does result in low income groups earning a lower average rate of return on their asset holdings than high income groups' (Part I, Conclusions); and that
- 'the results from the two largest lenders of housing finance . . . clearly show that lower income households have effectively been restrained from obtaining finance for housing in the open market' (Part II, Conclusions).

CHAPTER 5: CENTRAL BANK LIQUIDITY SUPPORT FACILITIES

A. INTRODUCTION

5.1 This chapter looks specifically at the question of access to liquidity support from the Reserve Bank. The extent and price of central bank credit has broad-ranging implications for monetary policy, stability of the financial system, depositor protection and competitive equality. Detailed discussion of many such aspects is to be found at other points in the Report.[1]

5.2 Section B of this chapter deals with funds provided by the Reserve Bank but basically available, insofar as individual transactions are concerned, at the discretion of specific participants in financial markets. Section C examines ultimate contingency funding arrangements; i.e. liquidity support provided to individual financial institutions, or the market generally, at the discretion of the Reserve Bank in circumstances of extraordinarily disturbed financial markets.

5.3 This chapter is not concerned with transactions which reflect the Bank's pursuit of monetary policy objectives through such measures as open market purchases of government securities and reductions in required reserve ratios; these are discussed in Chapter 4. They have, of course, important implications for the liquidity of individual institutions. The Committee appreciates that open market operations and central bank liquidity support facilities need to be carefully co-ordinated and priced accordingly.

B. MARKET-INITIATED FACILITIES

(a) Purpose

5.4 In the normal course institutions must be expected to meet their liquidity requirements by borrowing or selling assets, including government securities, in financial markets at the market prices prevailing. The Committee's suggestions regarding the operation of monetary policy, and in particular its advocacy of greater reliance on open market operations,[2] should enhance the capacity of financial markets to provide for the liquidity needs of individual participants.

5.5 Beyond this, official liquidity support facilities (which are activated in the normal course of business, and effectively at the initiative of the market):

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1 See in particular the chapters on 'Domestic Economic Policy', 'Public Sector Financing', 'Protection of Investors and Borrowers', and 'Competitive Structure'.

2 In the environment suggested by the Committee the authorities would help strengthen the depth of the government securities market by being participants, on both sides of the market, more frequently than has been the case in the past.

- assist the market's adjustment to those fluctuations in the liquidity base which, while broadly predictable, are uncertain as to precise timing;
- represent a source of liquidity to sound, viable institutions which may be disproportionately affected by unexpected short-term liquidity fluctuations (e.g. those flowing from changes in monetary policy, from external shocks or from domestic market developments);
- can help to remove extreme fluctuations in short-term interest rates; and
- can particularly assist the market in the government paper to which the facilities are uniquely attached.

5.6 These facilities are therefore seen as an additional stabilising mechanism, supplementing monetary policy and prudential requirements, rather than in any sense replacing them. The Committee accepts that a stable, practical and efficient financial system needs such facilities.

(b) Present Arrangements

5.7 At present there are two channels of access to Reserve Bank funds, basically 'on request' from private sector participants:

- Through the Bank standing ready to rediscount certain Treasury notes. This may be called a **'cashing' facility.**[3]
- Through the provision of direct loans against collateral under **line-of-credit arrangements.** The authorised short-term money market dealers are the primary channel of such flows; technically, banks subject to the LGS convention also have access in specified circumstances.

These channels are, conceptually at least, quite distinct from discretionary responses of the Reserve Bank to market offers of securities.

5.8 The Committee considered the ways in which these existing central bank liquidity support facilities operate in practice with a view to determining how far they serve their purpose of adding to the stabilising mechanisms in the system.

5.9 With respect to the **'cashing' facilities**, the present position is that the Reserve Bank undertakes to rediscount Treasury notes with 90 days or less to maturity on demand at a variable, though pre-announced, rate.[4] The rediscount rate is generally set at a margin above current yields in order to provide an incentive for holders to liquidate them on the open market but is not normally at such a high level as to damage the inherent liquidity of the notes.

5.10 The Treasury note is the only government security that traditionally has a firm 'cashing' facility attached to it. In respect of other securities, the Reserve Bank's role can be summarised as follows:

- The Bank is often in the market as an active buyer of government securities generally, purchasing at its discretion as to price and volume. The Bank is more willing to buy such securities as they approach maturity; subject to liquidity conditions it is nearly always prepared to buy bonds within about one month of maturity, from banks and authorised dealers.

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3 The capacity to redeem Australian Savings Bonds may be seen as a somewhat similar facility, though not of equal relevance in this context because of the notice provisions for redemption and the fact that individual holdings are typically small and in household sector portfolios.

4 Until 15 September 1981, all Treasury notes (i.e. with maturities out to 180 days) were rediscountable at the Reserve Bank; thereafter only notes with 90 days or less to maturity are eligible for rediscount at the holder's option.

- The Bank has also made substantial purchases of bank-accepted commercial bills on occasions when market conditions were very tight.

5.11 In addition, some authorised dealers are willing to bid, as principals, for short-dated government securities at all times, provided they are not in danger of breaching their gearing limits; when the market is very unsettled, however, some dealers may not bid or their prices may reflect the uncertainty in the market; for example many of those wishing to sell government securities in 1974, when liquidity was particularly tight, found it very difficult.

5.12 In summary, very short-dated Commonwealth securities can be viewed as highly 'liquid', but as maturities lengthen, this characteristic becomes less certain.

5.13 In regard to **line-of-credit facilities**, the Committee notes that:

- The line of credit from the Reserve Bank to the group of authorised short-term money market dealers, which is provided against the security of government securities maturing within five years, is available to them at all times. Loans generally must be taken for a minimum of seven days, although occasionally and in particular situations, overnight loans are provided; the interest rate is varied at the Bank's discretion but is known to dealers in advance of their borrowing. The facility is used by the dealers in the ordinary course of their business but subject to a general understanding that recourse to it will not be 'excessive'.
- By contrast, resort to Reserve Bank credit by trading banks is extremely infrequent; banks subject to the LGS convention[5] do not have automatic rights to borrow from the Bank while they hold LGS assets in excess of the conventional 18% minimum and the understanding is that they will manage their affairs so that they can cope with liquidity fluctuations without breaching the requirement; when in danger of such a breach they are expected to exhaust all market sources of funds before approaching the Reserve Bank. In turn the Bank has undertaken to administer SRD policy so that if bank lending were in accord with its policy, trading banks generally will be able to maintain their LGS ratios above the agreed level.

The intent of the LGS convention is that banks do not resort to central bank credit in the ordinary course of business. If, however, due to sudden and unexpected developments, a basically sound bank were to find itself otherwise unable to maintain its LGS ratio at the end of a day, the Reserve Bank has undertaken to lend to that bank; the rate of interest charged and other terms of the loan are at the Bank's discretion and are influenced by the current setting of monetary policy and the extent to which the bank's lending had complied with general policy. It is understood that loans have generally been for a minimum of thirty days, but in some circumstances earlier repayment may be made.

5.14 The extent to which, under current arrangements, banks are in a privileged position with regard to rights of access to central bank credit is a contentious issue. Many non-bank participants in financial markets see this right as giving the banks an important competitive advantage. The banks, however, see their right of access as being available to them only in certain well-defined circumstances and generally on 'penal' terms. They believe it is particularly necessary for them to have access to central bank credit in a situation where they are subject to strong interest rate constraints, as was the case when the arrangements were implemented.

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5 The LGS convention is described in paragraphs 11.23–27 of the Interim Report.

5.15 The Committee understands that in practice the banks' lender of last resort facilities have been used infrequently. Changes in the banks' operating environment since the 1960s — particularly the removal initially of issue yield ceilings on bank certificates of deposit and more recently other fixed-term deposits, together with the emergence of an interbank market — have reduced the likelihood of the need arising for a bank to borrow from the Reserve Bank in any but very exceptional circumstances.

5.16 Nevertheless, the fact that under the LGS convention the Reserve Bank has undertaken, subject to arrangements, to lend to the banks when their liquidity is under pressure does, in the opinion of the Committee, confer some advantages. Specifically:

- it improves the risk rating of bank deposits in the public estimation; and
- the availability of such loans can, more generally, assist banks' liquidity management.

5.17 The Committee is mindful, of course, that the LGS convention, while conferring on the banks restricted access to lines of credit, also imposes on them certain obligations[6] and this is seen as justifying special access to liquidity facilities. Generally the Committee cautions against seeking to balance regulatory benefits and burdens. In addition, elsewhere in the Report, the Committee recommends the substantial deregulation of the banking system, including the abolition of the LGS convention. If the general thrust of these proposals is adopted, restraints on banks would be considerably reduced. In these circumstances the need for a central bank line of credit to banks would have to be re-examined. The question is taken up later in this chapter.

(c) Background Considerations

5.18 In assessing the adequacy of the existing rediscount and line-of-credit facilities and possible reforms, the Committee has been guided by certain broad considerations. These are that:

- Financial institutions should have access to a liquidity safety valve to facilitate quick relief from transient shortages of cash arising in the 'normal' course from unexpected developments or from their own or the authorities' temporary miscalculations.
- As part of this safety valve, it is necessary for some official rediscount and line-of-credit facilities to be available at the market's initiative under certain prescribed conditions.
- Consistent with the Committee's general preference for market-based relationships between the monetary authorities and commercial financial institutions, the price of liquidity and credit should be the principal mechanism regulating the level of usage of the facilities.
- In general, the facilities should be provided in a way which involves a minimum of disturbance to competitive balance between various groups of intermediaries. This suggests that the arrangements should be available — although not necessarily directly — to all intermediaries on much the same terms.

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6 For example, the interest rate fixed on last resort loans depends at present on the degree of compliance with Reserve Bank lending guidelines. In the event of non-compliance the interest rate can be 'penal'.

- The facilities should not distort flows of funds within the private sector. For this reason there is a need to be wary about providing liquidity in exchange for private sector paper because any such commitment, explicit or implicit, would enable the issuer of that security to raise funds at a lower cost than otherwise.
- The arrangements should not prejudice the scope for effective overall monetary policy (e.g. by allowing undue slippage in monetary aggregates) — indeed they should seek to promote it (e.g. by fostering the status of government debt instruments).

(d) The Issues

5.19 With these considerations in mind — in particular acceptance of the need for a central bank liquidity facility available 'on request' at the market's discretion but at prices of the Reserve Bank's choosing — the Committee addresses itself to two key issues:

- the form of such liquidity facilities; and
- whether the facilities should be directly available to all final users or only channelled through specialist intermediaries.

(i) Form of Liquidity Support Facilities

5.20 An essential difference between a 'cashing' facility and line-of-credit arrangements is that use of the 'cashing' facility involves parting with ownership of the eligible securities whereas utilisation of a line of credit does not; in the latter case, security requirements simply involve forgoing possession of the assets.

5.21 In practice of course both types of facility can resolve to essentially the same loan process; proceeds from the sale of securities could, for example, be reinvested if the need for cash was only temporary; a short-term loan could be refunded by proceeds of sale of securities.

5.22 Although they serve similar purposes, the Committee accepts that, at least in the transitional period, there may be a continuing need to provide both channels of access. For reasons set out in paragraphs 5.30–38, the Committee envisages that direct line-of-credit facilities will be available only to specialist dealers in government securities. The form of such facilities is discussed in Chapter 9.

5.23 The present 'cashing' and related arrangements were described in paragraphs 5.9–12. The Committee's impression is that these arrangements can offer an effective safety valve for financial institutions (and others) but only if:

- institutions maintain an appropriate liquid asset portfolio consisting principally of Treasury notes and other very short-term government paper; and
- the 'penalty' implicit in the lower price for encashment on demand is not prohibitively discouraging to its use.

5.24 Until recently, Treasury notes were not consistently competitive with short-dated paper; as a consequence, financial institutions, other than authorised dealers and banks, appear to have placed little emphasis on Treasury notes in the management of their liquidity. However, under the present 'tender' system, the interest rate available on Treasury notes is more responsive to free market forces.

5.25 The Committee therefore believes that present 'cashing' and related

facilities are generally working well.[7] Nevertheless, the Committee is not satisfied that they fully meet the legitimate needs of banks, government security market makers and other sound institutions faced with severe, unexpected liquidity strains.

5.26 The Committee feels that such institutions should be able to hold a range of liquid assets with a broader maturity spectrum than the presently issued Treasury notes, while still retaining the capacity to obtain funds quickly in an emergency. It believes that the Government could issue a special class of security, of longer term than the present six-month Treasury note, which would carry a facility enabling it to be rediscounted before maturity at the holder's option. It sees benefits both in terms of liquidity management and debt management for that security to be of an initial maturity extending perhaps out to two to three years, with a cashable characteristic during say the last twelve months of its term. The precise terms and conditions will of course be a matter for judgment by the authorities and the market. The Committee does not wish to be too precise about these.

5.27 The Committee emphasises, however, that in its view the cashing facility should not encompass long-dated government stock (or, as noted earlier, private paper). If the Reserve Bank were always prepared to purchase such stock (even at its own price), it would replace some of the need for discipline and prudence in the management of portfolios, as well as complicate the operation of monetary policy. It should be accepted that institutions opting for a longer maturity portfolio would expose themselves to a greater risk of capital loss (arising out of interest rate fluctuations) in a forced liquidation.

5.28 The price at which securities can be 'cashed' at the discount window will require careful consideration by the authorities. Two forces need to be balanced. On the one hand, a heavily penal rate would substantially undermine the usefulness of the facility; it would also contribute to sharp day-to-day fluctuations in market interest rates. On the other hand, the 'cashing' facilities should normally be available on less favourable terms than is offered by the market. Again the Committee would expect that normally discount costs would increase with maturity of the security involved.[8]

5.29 The Committee is of the view that the official liquidity support facilities should not entail any obligation by the Reserve Bank to acquire 'private' paper. This judgment takes into account that:

- government securities (and other claims on the monetary authorities) are the natural liquidity base of the financial system because the solvency of the debtor is most certain;
- there are substantial monetary policy implications in 'monetising' private sector debt;
- broadening the range of eligible debt instruments beyond government securities may impede competitive neutrality among financial institutions; and

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7 It is argued in Chapter 11 that the authorities should try to meet the market demand for paper with maturities of less than three months. Whether they do so by issuing a new security or by selling Treasury notes or bonds from their portfolio is a matter which the Committee does not feel a need to determine. In the present context it need not go beyond emphasising the desirability of such paper being readily available.

8 It could well be that to achieve an adequate penalty the discount expressed as an annual rate may have to increase with term to maturity.

- the cost to the Government of its debt financing is likely to be reduced if government debt instruments such as Treasury notes and short-dated bonds have unique and valuable attributes relative, say, to private sector paper.

(ii) Availability of Facilities

5.30 The second key issue posed in paragraph 5.19 is whether any central bank liquidity facility should be available to all or virtually all final users directly or only through select intermediaries — such as 'banks' or institutions specialising as market makers in government securities.

5.31 The Committee envisages that the 'cashing' facility attaching to nominated government securities would be available to anyone holding such paper.[9] There remains the question of whether specific line-of-credit arrangements should be provided to specialist dealers and banks.

5.32 *Specialist Dealers* — The role of specialist market makers in government securities is discussed in Chapter 9. In summary the Committee has a clear preference for the market in government securities to be conducted, as far as possible, in a private commercial environment independently of the Reserve Bank. It is expected that among the institutions making the market there will be specialist dealers. The Committee has not been able to satisfy itself that in the early stages of adjustment to a less regulated environment, the specialised dealers would be able to appropriately make a market without a continuation of at least some of the special privileges currently available to them. It has therefore recommended in that chapter that active dealers in the government securities market performing a wholesale function continue to be recognised and for a time encouraged by the Reserve Bank. In particular such dealers would, until it was judged unnecessary, retain:

- access to a line of credit from the Bank; and
- along with suitably accredited stock exchange brokers, exclusive rights of direct dealing in government securities with the Reserve Bank (other than for rediscount).

5.33 The Reserve Bank should, however, keep these privileges under active review; they should be maintained only as long as they are necessary to underpin a competitive and efficient market.

5.34 *Banks* — The Committee has given close attention to the question of whether banks might also need special access, at their own initiative, to a Reserve Bank line of credit.

5.35 Sharp changes in demands on an individual bank's liquidity can arise from:

- a general liquidity drain on the system, the result of a net leakage either to the government or through a balance of payments outflow;
- an unexpected redistribution of bank deposits; more or less random factors can affect the distribution of cheque payees and drawers on a particular day;
- mismanagement of cash; and

9 The Committee, however, accepts that open market dealings of the Bank will be basically confined to authorised dealers and some stockbrokers. It also accepts that in the normal course, market channels would be the first recourse of those seeking to cash eligible paper.

- an unjustified loss of public confidence in the solvency of a particular institution.

Some of these factors can have a particular (and rapid) impact on individual bank liquidity positions.

5.36 Nonetheless, the Committee is **not** persuaded that a formal central bank liquidity facility, **at the initiative of banks, is necessary or appropriate** to cope with these problems:

- Where the system **as a whole** has suffered a liquidity drain, the Reserve Bank has a responsibility to promptly restore a level of liquidity consistent with effective operation of the financial system; pending action by the Bank, the clearing institutions would, like all other institutions, have access to official liquidity either directly through the cashing facility or indirectly by selling securities to the authorised dealers.
- In the event of a temporary (random) redistribution of deposits between clearers arising from the day-to-day working of the payments system, or in the event of mismanagement of cash by one institution, the market should normally be capable of redistributing liquidity; it would be up to the individual bank to obtain additional liquidity by selling assets (accepting any capital loss associated with the sale), or by borrowing at the going interest rate.
- If an unjustified loss of public confidence in the solvency of a particular institution or group were to occur it need not create a liquidity crisis, given the kinds of safeguards proposed by the Committee for the handling of contingency situations (see Section C).

5.37 It might be noted that the form of prudential regulation can have an important bearing on banks' funds management policies and the need for short-term safety valves of liquidity. The need for access to a central bank credit facility is greatest where the prudential liquidity requirement imposes a rigid minimum that must be met at all times. Market arrangements are more likely to prove adequate where the prudential arrangements have sufficient flexibility to permit adjustment over a short interval of time. These issues are discussed in Chapter 19.

5.38 Provided there is an active market for short-dated government paper, backed by cashing facilities and special lines of credit available to authorised dealers, the financial system as a whole will have all the liquidity support it needs. In this situation the Committee sees no need for a separate direct line of access by the banks to the Reserve Bank, as a matter of right.[10]

(e) Some Policy Implications

(i) Competitive Neutrality

5.39 As already noted, Reserve Bank liquidity support facilities can bear on both the institutional structure of the financial system and on the competitive balance between different groups of intermediaries.

5.40 In the past, the approach has been to recognise differential rights of access to Reserve Bank credit but to impose obligations, which to a broad degree offset the advantages, such as more prudent funds management standards and the bearing of a more direct burden in the application of monetary policy. Although the

10 The related issue of whether government working balances should be kept with private sector banks is discussed in Chapter 6.

Committee understands the reasons behind such an approach, it recognises that balance is difficult to strike and will be greatly affected by changes in the regulatory environment envisaged by the Committee.

5.41 Fundamentally therefore, the Committee has sought to frame its recommendations so that all financial institutions would have access directly or indirectly at their initiative to Reserve Bank liquidity support on broadly comparable terms.

5.42 The one significant exception to this principle with regard to market-initiated practices is in respect of the accredited dealers in government securities which are cast as market makers, at least during the transitional stage. The implications of this are discussed further in Chapter 9.

5.43 As already noted, other institutions would have effective and 'equal' access to central bank liquidity to the extent of their own holdings of assets eligible for direct rediscount or repurchase through the accredited dealers. This equality of treatment relates to **market-initiated** facilities. The involvement of the Reserve Bank in the provision of credit in contingency situations is discussed below.

(ii) Market for Government Debt

5.44 It can be argued that the effect of making certain nominated short-dated bonds more automatically eligible for sale at the discount window would be to render such government paper more 'liquid', in the sense that there would be less uncertainty than at present about its immediate 'cashability'.

5.45 The impact on liquidity would depend importantly, of course, on the prices at which the facility was offered. The Committee envisages that use of the facility by sale of bonds would be generally at a penal rate, perhaps increasing with the term to maturity. In this way there would be discouragement of any tendency for the market to liquefy short-term government securities too readily.

5.46 Fears have been expressed that during periods of uncertainty, variations in the Reserve Bank's purchase price of government paper could have an unsettling effect on markets. The Committee recognises this possibility but the problem arises even more acutely in the present situation where the Reserve Bank can (and sometimes does) stand totally aside from the market during such periods of uncertainty. On balance, the Committee believes that a willingness by the Bank to bid at all times for short-dated stock should enhance rather than disturb the stability of the bond market and so reduce rather than increase yield and price fluctuations.

5.47 The way in which the Bank communicates its reluctance to buy in an unsettled market is important. There is a risk of the facility being misused, but only if the authorities were not sufficiently flexible in their response.

(iii) Monetary Policy

5.48 Within the context of a monetary policy emphasising open market operations, the existence of a broader 'cashing' facility might confer the following advantages:

- It would provide an automatic response to unintended liquidity pressures in the sense that the Reserve Bank would be **continuously** prepared to buy a defined and sufficiently broad range of 'eligible' paper at a price. The initiative for use of the facility would lie with the market — a particularly important characteristic in smoothing out **unexpected** fluctuations.

- It might enable a more active and aggressive pursuit of monetary restraint in the knowledge that any particular institutions or groups within the market which were disproportionately affected would have a more readily accessible 'safety valve'.
- The level of usage of the facility can at times serve as a 'warning light' for a review of monetary policy.

At the same time it must be clearly recognised that the proposal could be positively disadvantageous to the effective pursuit of monetary policy objectives if there were any reluctance to allow interest rates to change to required 'market clearing' levels.

5.49 The Committee believes that its recommendations on other issues, including measures to ease the seasonal instability problem (discussed in Chapter 6) and a flexible interest rate policy (recommended in Chapter 4), will contribute to a more stable monetary environment.

5.50 The Committee accepts, however, that monetary conditions will continue to be subject to sharp day-to-day fluctuations with their incidence bearing on individual institutions in a way which cannot be fully anticipated by the authorities. In such circumstances the proposed access to cash from the Reserve Bank will provide an adequate cushion for individual institutions and concurrently provide the authorities with time to appropriately assess whether the developments have more general implications for the impact of overall policy.

5.51 At the same time, it should be possible to avoid undue seepage of base money into the system in restrictive monetary periods by raising the cost of access. This would allow the institutions which bore the initial impact of the policy to solve their immediate liquidity problems, albeit at a price, and smooth out the reaction of the financial system to the change in policy stance.

5.52 If the discount rate were used as an instrument in the way described in the previous paragraph, it could not be regarded as an **independent** instrument of policy. It would be a subsidiary instrument which the monetary authorities used to make their control of monetary aggregates more effective and, in particular, less destabilising.[11]

5.53 The proposed extension of existing cashing facilities would also assist monetary policy by enhancing the attractiveness of shorter dated government securities and strengthening their role in the liquidity base of the financial system. An improved secondary market would facilitate open market operations. Moreover, non-bank financial intermediaries might be encouraged to hold an increased proportion of government securities for liquidity management.

(f) Conclusions and Recommendations

5.54 The Committee concludes that:

(i) The main liquidity needs of individual institutions should be met from the market.

(ii) For the system as a whole, the provision of an automatic liquidity safety valve is essential.

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11 Some countries have employed the discount rate as the instrument of policy by which they influence short-term interest rates and/or international capital flows. In Chapter 4 the Committee has recommended that the authorities pursue monetary policies within a flexible interest rate environment and that any intervention necessary for monetary policy purposes should be by trading in the market rather than by bureaucratic specification of yields on government securities.

(iii) The present direct 'cashing' facility, being restricted to Treasury notes, may not be optimal (especially if it is confined to Treasury notes with less than 90 days to maturity).

(iv) Pricing of the facility by the Reserve Bank is critical. The Committee believes that a penalty is generally appropriate. The degree of penalty should not however be such as to destroy the 'safety valve' characteristic of the facility.

(v) There appears to be no justification for allowing banks access to lines of credit at the Reserve Bank. On the other hand, it may be beneficial to maintain, at least for a time, such facilities for authorised dealers, subject however to ongoing review to ensure their appropriateness.

5.55 The Committee ***recommends*** that:

(a) **A Treasury note rediscount facility should be offered by the Reserve Bank on all Treasury notes, with the rediscount prices set so as not to conflict with the Reserve Bank's open market operations.**

(b) **A cashing facility should be available for certain nominated government securities with initial maturities perhaps up to two or three years. The Reserve Bank should be willing at all times to purchase such nominated securities — but only when they have, say, twelve months or less to maturity. The purchase prices should be determined by the Bank, having regard for market conditions and the stance of monetary policy, and should be free to vary in the course of the day.**

(c) **The banks should not have direct rights of access at their discretion to Reserve Bank credit.**

(d) **The Reserve Bank should continue to extend a line of credit to the authorised dealers, at least in the initial stages of deregulation (see Chapter 9).**

5.56 The recommendations do not represent a fundamental change in present arrangements. Rather, they are seen as changes designed to make the facilities more reliable and more neutral in their impact on competitive balance. The Committee is clear that the private sector should have the capacity to obtain funds by means of reliable and well-understood processes. The processes suggested are seen as being consistent with monetary policy and indeed could assist it.

5.57 It is important that information be published on acquisitions of Treasury notes and other cashable securities in terms of rediscounting arrangements. This could be done in conjunction with the publication of secondary market transactions in government securities including Treasury notes.

C. CONTINGENCY FUNDING ARRANGEMENTS

(a) The Issues

5.58 If monetary policy were soundly administered, clearly understood and consistently applied, and if all financial institutions pursued prudent fund management policies, individual commercial organisations should be able to manage their cash needs effectively. However, such circumstances do not always exist; financial conditions can vary markedly from day to day with unexpected and differing impacts on individual institutions.

5.59 Section B discussed the scope and range of liquidity support facilities that should be available to the market **at its discretion**, to 'smooth' sharp fluctuations in liquidity.

5.60 The Committee believes there should be further arrangements to ensure financial stability — namely **contingency funding** for individual institutions, for use in emergencies. This may involve providing finance to the system as a whole[12] but more particularly the funding of some individual institutions to cover 'force majeure' type emergencies.[13] Such 'force majeure' type arrangements are designed to prevent in particular a general loss of confidence in the stability of sound, viable financial institutions which might, for example, be triggered off by difficulties, or perceived difficulties, of one or two institutions.

5.61 The Committee endorses the well-established tenet of central banking practice that, above all else, **it is the function of a central bank to ensure a sufficient availability of liquidity to preclude a financial crisis stemming from a loss of confidence in the capacity of viable financial institutions to meet their obligations.**

5.62 There is a delicate balance between maintaining a disciplined policy stance, consistent with the general soundness of the economy, and providing necessary relief for otherwise sound individual institutions experiencing liquidity difficulties. The Reserve Bank, as the central bank, has the responsibility of achieving an appropriate balance between these two objectives.

5.63 Demands for contingency funding, arising from some emergency, may generate strong pressures — particularly where the institution under pressure is large and many investors or depositors are involved. What is often not recognised, however, is the very real danger that relief for one troubled institution could both prejudice decisions in other instances and, by encouraging institutions to adopt a less disciplined approach to prudential management, perhaps increase the likelihood of others needing similar assistance. An important objective for the authorities is to ensure that the system, including its individual parts, has every incentive to be self-protective of its viability. This is a basic requirement of stability in the long run.

5.64 The general question of liquidity support arrangements for deposit-taking institutions is explored in some detail in Chapter 19. The Committee is concerned, at this point, merely to lay down the general principles it sees as appropriate for the temporary provision of Reserve Bank credit in emergency situations. Specifically, the Committee is of the view that:

- **There should be no automatic access to the Reserve Bank for contingency funding.**
- **The provision of such relief could typically be associated with rare and unusual circumstances.**
- **The Reserve Bank should be prepared to be associated with the provision of credit at its discretion, directly or indirectly, to *viable*, well-managed**

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12 Illustrations include the Bank's purchase of substantial volumes of bank-accepted commercial bills in 1974 and 1976, and the special line-of-credit loans to trading banks in 1974.

13 Examples include the support for a bank in 1979 and the loans made to trading banks to support loans to some building societies under the long-standing undertaking of the Reserve Bank to support the liquidity of banks standing behind other viable, well-managed financial institutions in temporary liquidity difficulties.

financial intermediaries experiencing temporary liquidity difficulties. (In the case of non-viable intermediaries, the appropriate solution is to facilitate their exit from the industry in a manner that does not cast doubt on the viability of others.)

- **Arrangements should be consistent with overall monetary policy, and with the maintenance of high prudential standards.**
- **To the maximum extent possible, financial intermediaries should have consistent access to central bank credit on comparable terms; that, of course, does not mean identical arrangements for all groups.**
- **The terms on which central bank credit is given should generally entail a penalty (except perhaps where the circumstances giving rise to the emergency were clearly beyond the influence of the institution in difficulty).**

5.65 The Committee is also of the view that any Reserve Bank contingency funding should, wherever possible, be publicly disclosed but with a discretionary lag, and be subject to a full follow-up investigation to reduce the likelihood of a recurrence.

5.66 In Chapter 19, the recommendation is that the only intermediaries which would be eligible for direct access to Reserve Bank liquidity in an emergency would be the banks, approved national industry bodies such as the proposed Building Societies Deposits Insurance Corporation, and accredited dealers in government securities — all of which would be subject to Reserve Bank supervision on a continuing basis. Other institutions would have indirect access through their banks, national industry body, or both, as these would normally be in the best position to assess their viability.

5.67 The Committee cannot exclude the possibility, however remote, that the foregoing arrangement will be found inadequate on rare occasions — for example, the extent of support required may exceed prudent limits on an individual bank's credit risk in respect of one borrower or group of borrowers. Accordingly, it is conceivable that circumstances may require the direct support of a sound intermediary by the Reserve Bank (even where it does not have an established banker–customer relationship with the Reserve Bank).

5.68 The Committee expects that recourse to a contingency funding facility would only occur if the other elements of policy bearing on financial stability — prudential funds management standards, monetary policy and automatic liquidity support facilities — prove unable to relocate existing liquid resources quickly to those needing it. To avoid raising undue expectations in the market, and to encourage sound liquidity planning, the authorities should make it clear that recourse to contingency funding facilities at the Reserve Bank would be quite exceptional.

CHAPTER 6: SEASONAL FLUCTUATIONS IN LIQUIDITY

A. BACKGROUND

6.1 Many financial variables are subject to marked seasonal fluctuation.[1] Table 6.1 provides an illustration, showing seasonal fluctuations in what is commonly called primary liquidity (i.e. private sector holdings of cash, deposits with the Reserve Bank and government securities).[2] Similar (but not identical) seasonal variations are evident in a number of other monetary indicators, including components of primary liquidity.[3] Commonly, the broader the monetary aggregate, the smaller the seasonality since forces acting to produce such variation tend, to a degree, to be diffused.

6.2 Many of the so-called seasonal influences vary both in magnitude and timing from year to year.[4] This irregularity represents in many ways the most important dimension of the seasonal liquidity problem, e.g. uncertainty of timing poses special difficulties for financial management.

6.3 There are some sources of seasonal fluctuation in financial variables which the authorities may not wish to eliminate. For example, in the period before Christmas there is normally an increase in the demand for credit, associated with a build-up of stocks, and in the demand for money balances for transaction purposes. Authorities would not wish to smooth out variations in interest rates arising from pressures of this sort, as such smoothing may only intensify the seasonal fluctuations in economic activity.

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1 That is, fluctuations within the course of a year which can be regarded as deviations from the average or trend level of the series for the year and which broadly recur from year to year. They usually are associated with systematic factors connected in some way with the calendar, e.g. certain tax collections, crop seasons and Christmas.

2 The table is purely illustrative and designed to give an indication of the extent of seasonal fluctuations. It shows the deviation of the quarterly change in primary liquidity from the average change for the year as a whole, expressed as a percentage of its level at the end of the previous financial year. There are more complex techniques for isolating the seasonal component of an economic series; the approach adopted here has the advantage of assessing each year separately over a period when the within year pattern of some key influences has changed substantially; at the same time, it has the disadvantage that the values obtained for a particular year may be dominated by erratic factors peculiar to that year. A more detailed illustration of the sources of seasonality in primary liquidity is given in the paper entitled, 'Seasonal Fluctuations in Liquidity' in AFSI *Commissioned Studies and Selected Papers*, Part 1, AGPS, Canberra, 1981. In the main the illustrations confine themselves to quarterly variations. Seasonality, in its broadest connotation, can be important within quarters, within months and indeed within weeks.

3 See AFSI commissioned studies op.cit.

4 Thus, the amount of finance needed to fund the wheat crop varies in magnitude from one year to the next; similarly, the precise timing of impacts on the financial system from company and provisional tax differs from year to year.

TABLE 6.1: SEASONAL VARIATION[a] IN PRIMARY LIQUIDITY

	September quarter	*December quarter*	*March quarter*	*June quarter*	*Annual % increase in primary liquidity*
1970–71	2	3	1	−6	7
71–72	4	5	−1	−8	13
72–73	5	7	−2	−10	15
73–74	5	6	—	−10	2
74–75	−4	4	7	−6	11
75–76	3	4	5	−13	15
76–77	2	6	7	−15	12
77–78	—	5	3	−8	3
78–79	3	1	5	−9	10
79–80	—	4	4	−8	6
80–81[p]	1	5	3	−8	11

(a) Deviation of quarterly movements from the average quarterly movement over the year expressed as a percentage of the level of primary liquidity at the end of the previous financial year; primary liquidity — claims on the monetary authorities — is defined as private sector holdings of cash, deposits with the Reserve Bank and government securities.
(p) Preliminary.

6.4 On the other hand, as explained later, it is desirable for the authorities to seek to remove seasonal movements which are purely financial in origin and which could have a more general impact on the economy. In particular, there are strong reasons for eliminating, to the maximum extent possible, financial arrangements of government which introduce seasonality to the private sector.

6.5 A large element of the seasonal fluctuations in financial variables is associated with transactions by the Government and the Reserve Bank. In broad terms, primary liquidity changes in response to a number of factors:

- the domestic budget outcome — which in turn reflects the pattern of government cash outlays and taxation receipts;
- the balance of private sector foreign exchange transactions with the Reserve Bank;
- Reserve Bank Rural Credits Department advances; and
- 'other factors' affecting the net consolidated balance of cash flows between the authorities and the private sector — such as lender of last resort loans to authorised dealers, movement in deposits held with the Reserve Bank etc.

6.6 Among these different elements, the domestic budget outcome is the major source of the seasonal fluctuations in primary liquidity. The other factors have a smaller net effect. Rural Credits advances add to the basic pattern imposed by variations in the domestic budget outcome, but private sector foreign exchange transactions and 'other factors' tend to offset it to some extent.

6.7 The main source of the seasonal pattern in the domestic budget outcome is the seasonal variation in tax collections. Company tax and, more importantly in recent years, non-PAYE income tax are of particular note; there is also a minor seasonal variation in government outlays.

6.8 Tables 6.2 and 6.3 show some illustrative figures comparing the recent situation with that a decade earlier.

TABLE 6.2: COMMONWEALTH GOVERNMENT EXPENDITURES: OVERALL SEASONALITY[a]

	1969-70 and 1970-71	*1979-80 and 1980-81*
September quarter	−9	−1
December quarter	3	2
March quarter	−6	−3
June quarter	12	3

TABLE 6.3: COMMONWEALTH GOVERNMENT RECEIPTS: COMPONENT CONTRIBUTIONS TO OVERALL SEASONALITY[a]

	1969-70 and 1970-71				*1979-80 and 1980-81*			
	Sept. qtr	*Dec. qtr*	*Mar. qtr*	*June qtr*	*Sept. qtr*	*Dec. qtr*	*Mar. qtr*	*June qtr*
Customs, Excise Sales tax and Other revenue	−4	3	−3	5	−4	—	−1	6
Personal PAYE	−11	−3	5	9	−8	−2	3	7
Other personal	−6	−9	−5	20	−8	−9	−3	20
Company tax	−15	−16	4	28	−4	−4	−3	11
Total	−36	−25	—	61	−24	−15	−4	43

(a) These tables were compiled by calculating for total revenue and expenditure flows (and for major revenue components) the quarterly deviation (+ or −) from an even quarterly flow, and expressing that as a percentage of the average quarterly flow of revenue (or expenditure) for the two years.

6.9 The relative contributions of different elements to the outcome have varied quite considerably. Thus:

- Recently there has been no pronounced seasonal pattern in Commonwealth Government expenditure flows; an earlier tendency for a substantial seasonal pattern to exist has been removed. Since that pattern tended to offset seasonal fluctuations in revenue the more even expenditure flow now leaves seasonal swings in government revenue flows largely undampened.
- In respect of revenue collections there has been a substantial reduction in the extent of seasonal fluctuations, mainly because of the introduction of quarterly company tax collections; the reduction in quarter to quarter seasonal fluctuations in overall revenue has been about one-third.
- Despite administrative changes to smooth the net flow of personal PAYE collections some seasonality remains: the factors contributing to this include the concentration of tax rebates in the September quarter, growth in employment over the year, and within year growth in nominal wage and salary income payments and related tax collections.
- The seasonal pattern of other personal tax collections — i.e. provisional tax — remains pronounced and now accounts for about half the remaining seasonal fluctuation.
- The seasonal fluctuation in other revenue — customs, excise, sales tax etc. — is largely unchanged. It is not insignificant in size, but presumably reflects seasonality of such basic variables as retail sales and imports etc.

6.10 It should also be noted that while the amplitude of the seasonal fluctuation

in both revenue and expenditure has been reduced, the net injection of such fluctuations to the private sector from the Budget has in fact been greater during the second half of the 1970s than in previous years; this critically reflects an increased relative importance of government activity.

6.11 Individual private sector institutions provide for seasonal liquidity pressures by holding marketable assets or claims on others, such as unused bank limits. For many individual institutions their needs are met by the market. For the private sector as a whole, however, there is a need for access to cash from the authorities. Such access can be obtained (directly or indirectly) through:

- the holding of certain government securities and, in particular, the holding of discountable assets, such as Treasury notes;
- institutions (such as the authorised dealers) with access to a central bank credit facility;
- drawing on overseas lines of credit and sale of such foreign funds to the Reserve Bank.

B. COSTS OF FLUCTUATIONS

6.12 Although the private sector can partly insulate itself from the effects of seasonal fluctuations in financial variables, they can nevertheless generate a number of costs:

(i) They can induce seasonal fluctuations in economic activity (e.g. employment) — with social and economic costs for the community.

(ii) They can complicate the formulation and implementation of monetary policy by making it more difficult to interpret monetary trends. An observed increase in the money supply could:

- reflect seasonal (and therefore transitory) pressures; or
- indicate a possibly undesired trend movement in the money supply.

To formulate appropriate policies, the authorities must decide between these possibilities, i.e. they must decide whether the increase needs to be offset. This problem is compounded by:

- the variability of the amplitude of seasonal fluctuations in liquidity from year to year; and
- a possible tendency for private institutions to over-extend lending during the period of easy liquidity.

(iii) They may stimulate short-term movements of foreign capital and the exchange rate. This variability may involve costs in itself and often creates related problems for policy makers.

(iv) They generate uncertainty for private funds management and as a result may encourage financial institutions to hold larger precautionary reserves of liquid assets than they otherwise would. This is aggravated by the fact that, as Table 6.1 reveals, the pattern and magnitude of seasonal variation are not constant from year to year and can be difficult to predict. Moreover, even if the broad seasonal pattern is accurately predicted, there will still be uncertainty about movements from month to month or week to week.

C. SOLUTIONS

6.13 A number of possible ways of alleviating the seasonal liquidity problem (in its various manifestations) have been suggested to the Committee, including:

- changing the Government's financial arrangements in cases where they are a primary cause of the fluctuations; the predominant factor here is tax collection arrangements;
- the use of effective open market operations[5] (including the issue of seasonal securities) to offset the effects of the government Budget on the private sector;
- the deposit of government working balances with private financial institutions;
- a change in the arrangements for financing the marketing of rural produce to reduce the seasonal impact on liquidity; and
- the provision by the authorities of additional information to the private sector to aid it in managing its funds so as to minimise seasonal problems.

(a) Taxation Receipts

6.14 The Committee's clear preference is for the first of these suggestions. It is better to eliminate, as far as possible, inappropriate and unnecessary seasonal fluctuations at their source than to take action to offset their effects. **The Committee urges the Government to examine at an early date its financial arrangements and in particular its tax arrangements with a view to reducing their seasonal impact on private sector liquidity.**

6.15 Within overall tax collections:

- each of the major components has a similar tendency to be 'high' during the final months of the fiscal year and 'low' at other times;
- almost half the seasonal imbalance at present is accounted for by 'provisional'[6] income tax collections (see Figure 6.1).

6.16 Particular attention therefore needs to be given to the method of collecting provisional tax payments. Those liable for provisional tax pay 'no' tax in the first nine months of the year. Although they have to pay tax in advance for the last quarter of the financial year they are clearly better off than wage and salary earners operating on the pay-as-you-earn basis. The present arrangements therefore raise questions of neutrality quite apart from their contribution to seasonal liquidity problems.

6.17 Proposals to bring forward the date at which provisional tax is payable can cause cash-flow problems, at least temporarily, and are understandably resisted by those affected. Proposals to postpone the collection of tax are objectionable because they make the tax system even less neutral and because of the accompanying delay in flow of revenue when changeover is implemented. As between the two, the Committee has a strong preference for making the tax payable earlier, but with appropriate phasing-in arrangements.

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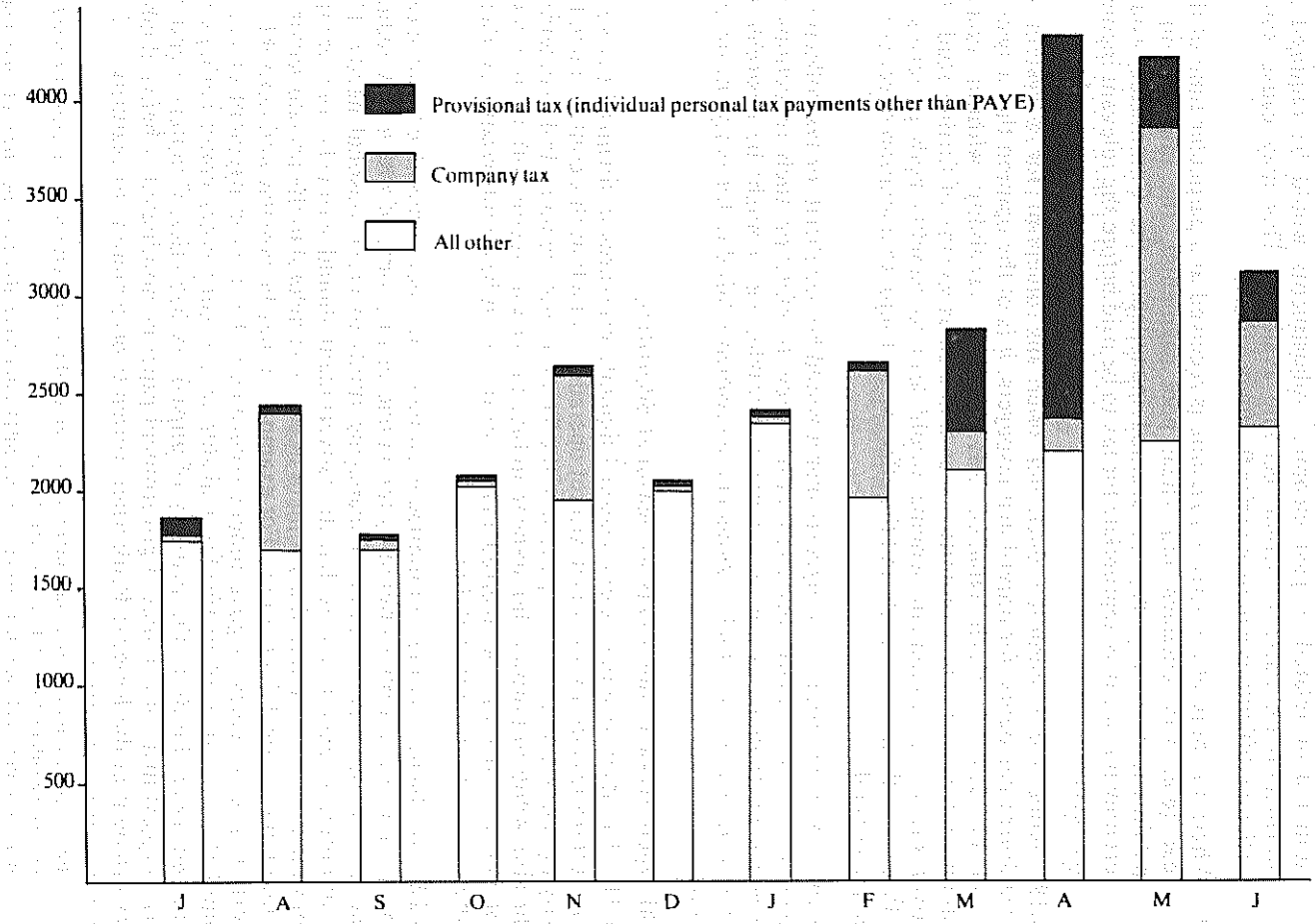
5 Here the Committee is distinguishing (as it has done elsewhere) between rediscount of Treasury notes etc. carried out at the initiative of holders and open market operations which are carried out at the discretion of the authorities.

6 The term 'provisional' tax is used to denote the tax liability of individuals in respect of income (other than wages, salaries etc.) which is not taxed at the source on a pay-as-you-earn (PAYE) basis.

FIGURE 6.1: COMMONWEALTH GOVERNMENT TAXATION COLLECTIONS – 1980-81 ($M)



Source: Department of Finance

6.18 The Committee recognises that there could be some practical difficulties involved in moving to a system of instalment payments for provisional taxpayers. For example:

- The size of instalments paid at the beginning of the year may have to be estimated or related to past income.[7] Adjustments would be required as information on current income become available. This may cause some particular difficulties where incomes fluctuate widely.
- Where the bulk of a taxpayer's income is received at a particular time of the year (e.g. wool cheques and wheat pool payments), the introduction of instalment payments may be deemed inequitable; the Committee would certainly not see it as appropriate for tax to be paid before the relevant income was received.

6.19 While the Committee does not offer any blueprint for a system of 'instalment payments' for provisional taxpayers, it is of the opinion that a system could be devised which entailed less seasonal variability without undue administrative cost. The Committee sees this area as worthy of further study by government. An instalment scheme would lead to benefits both in terms of efficiency of financial markets and the effective and smooth operation of economic policy generally.

6.20 The Committee also suggests that it would be beneficial for tax collections generally to be similarly reviewed with a view to effecting such reductions in seasonal fluctuations as are reasonably practicable, e.g. it might be desirable to review the degree to which various tax assessments fall due for payment on the same day.

(b) Open Market Operations — Seasonal Securities

6.21 To offset to some extent seasonal liquidity pressures in financial markets, the authorities already use open market operations which in this context includes varying the size and maturity pattern of the Treasury note tender.[8] In broad terms, the aim of the authorities should be to induce the private sector both to fully fund the budget deficit as it is incurred and to ensure that it has funds readily available when tax commitments fall due.

6.22 In Chapter 11, the Committee examines a number of possible innovations in the range of securities offered by the public sector, some of which may reduce the cost to the private sector of managing funds to meet seasonal needs. The Committee's general view is that the Government should seriously consider the introduction of any financial instrument likely to be helpful to the private sector in smoothing seasonal fluctuations. For example, it may be possible and desirable to permit specific issues of government securities to be used in payment of taxes. Similarly, the range of maturities available in Treasury notes could perhaps be tailored more closely to the maturity of unpaid tax liabilities. Chapters 5 and 11 also suggest that some issues of government paper be nominated as being eligible for discount at the Reserve Bank when within twelve months to maturity.

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7 This is the case now. Any requirement to pay earlier (by instalment) might impose the need to base the calculation on still yet an earlier year.

8 There is some evidence that changes in the SRD ratio have also had the effect of smoothing seasonal fluctuations. The ratio has been reduced over the 1970s, but many of the reductions contributing to this outcome have taken place in the June quarter. Increases in the ratio have been concentrated in the March quarter when private sector liquidity has tended to be at its high point for the year.

6.23 Provided it is not subject to artificial interest rate constraints, and it is resolutely pursued, the open market approach can prove a very useful instrument of contra-seasonal policy.

6.24 However, it is not a complete solution to the problem of seasonal liquidity fluctuations; in particular it should be noted that:

- it is difficult for the authorities to judge the optimum magnitude and timing of policy actions;
- to be fully effective this procedure still requires individual enterprises to be aware of their tax commitments and to provide adequately for them; open market operations, cashing facilities etc. would not replace the need for adequate anticipation of cash needs;
- while open market operations can be used to offset the effects of the budget cash deficit on the monetary base, such devices have no effect on the overall volume of primary liquidity — only on its composition; it does not eliminate any costs to the private sector of having to hold a larger amount of liquid assets than it otherwise would;
- by using the same instrument (open market operations) to simultaneously pursue both seasonal and longer term monetary objectives, the authorities run the risk of reducing the effectiveness of the instrument in achieving any one of them; in particular, there is a possibility that yields reflecting short-term financing pressures will be misread by the private sector as a change in the basic stance of monetary policy.

6.25 It should be stressed therefore, that while open market operations and sales of seasonal securities or tax certificates can be used to offset the effects of the budget cash deficit, they represent less fundamental solutions to the seasonal liquidity problem than the earlier suggestion to look at ways of reducing fluctuations in tax receipts.

6.26 If additional government intervention is needed, it could perhaps be done by raising and lowering bank reserve requirements in line with the liquidity build-up and rundown, although this would not normally be desirable. (A further approach is discussed in the next section.)

6.27 To the extent that the seasonality 'problem' is confined to the issue of day-to-day funds management difficulties arising from the uncertainty of the precise timing of transfers of cash to government, then these difficulties could be resolved either by:

- the private sector holding claims which at its discretion are 'cashable' with the Reserve Bank; or
- the Government being prepared to make very short-term loans to the private sector in anticipation of fixed-term securities maturing; last resort loans to dealers fulfil this function at least in part.

6.28 These two issues are largely aspects of a more general concern about the range of government securities and liquidity support facilities, which are discussed in Chapters 11 and 5 respectively.

(c) Government Working Balances

6.29 A proposal that the Government hold working balances with private sector banks was put forward by the Australian Bankers' Association. Such an approach

could be used to smooth out the impact of budget surpluses and deficits which, as has already been noted, are the major sources of seasonal liquidity fluctuations. In particular, the holding of government balances with banks would moderate and spread over time some of the large day-to-day funds flows that can arise from the payment of company and provisional tax.

6.30 The Committee is aware that variants of this approach are used in Canada and New Zealand:

- In Canada, the Government's receipts and expenditures flow through its account at the Bank of Canada. That Bank **at its discretion** makes transfers to special accounts with commercial banks so as to moderate the effect these transactions would otherwise have had on the banks' liquidity reserves. Transfers are also made to moderate the effect of other influences on banks' reserves.
- In New Zealand, under the Compensatory Deposit Scheme, the Reserve Bank of New Zealand redeposits daily with the trading banks approximately 75% of the net flow of funds from the private sector to the Government during tax flow periods (i.e. September and March). The funds are allocated between the banks on the basis of their annual average shares of deposits. When the tax inflow is over, the banks repay the deposits in equal daily instalments over the succeeding two months, with the final repayment also including the interest payable on the deposits. In September 1980, the rate of interest payable was based on the yield offered on 91-day Treasury bills.

6.31 While proposals of this general character have many attractions, implementation may pose a number of difficulties.

6.32 Firstly, although as mentioned in paragraph 6.12 (ii), measures which smooth liquidity fluctuations will tend to assist monetary policy, the ABA proposal could raise some difficulties for monetary policy with special implications during the period of introduction. A commitment to temporarily redeposit each year all or part of government tax collections with banks would effectively involve an addition to the liquidity of banks and the private sector. The transitional monetary problem could be overcome by phasing in the new arrangements over a period. To the extent that the arrangement results in a longer term addition to primary liquidity, it would contain an expansionary element — unless offset by other monetary policies. It is not clear that the mix of policies employed would impact neutrally on the financial system.

6.33 Secondly, if the balances were managed according to some pre-arranged rule, the Government would have to forgo the right to vary the level of its cash balances with the private sector; this may be unacceptable. However, if it used its discretion to vary these balances, such action could at times impinge on the authority of the Reserve Bank in the implementation of monetary policy.

6.34 Thirdly, it would be necessary to decide which private institutions were eligible to hold government balances. One approach might be to place them in interest-bearing demand deposit accounts with the trading banks, but questions would arise as to the equity of treatment with savings banks, near banks and other financial corporations; in particular, some of these institutions could see themselves as 'losing' funds when their customers pay taxes.

6.35 Thus, the competitive neutrality of the system could be affected. Effects of this kind could be minimised (although not entirely eliminated) if a market rate of interest were paid on the deposits.

6.36 Fourthly, it would be necesssary to decide how to allocate the funds between eligible individual financial institutions. Two possibilities are:

- The deposits could be allocated by tender; but the tender procedure would need careful consideration so as not to hinder the necessary flexibility of the arrangement.
- The funds could be allocated according to the existing market shares of the institutions involved. A weakness of this approach is that it would remove any incentive for the institutions to compete directly for the government funds. On the other hand, it is possible to argue that such an allocation would in fact provide the institutions with an additional incentive to expand their overall market share in order to obtain an increased share of government deposits.

6.37 This discussion suggests that the argument is not overwhelmingly against the proposal. While some practicable problems would need to be resolved, a workable scheme could be devised if specific direct intervention is judged to be needed. While it is not the Committee's preferred solution, it may well merit further attention if the problem of seasonality cannot be resolved at its source and if what seasonality is left cannot be handled effectively by open market operations and the more vigorous issue and repurchase of short-term government paper.

(d) Rural Marketing Finance

6.38 Typically, the major part of Rural Credits advances has been used to finance the wheat crop. As a consequence, the flow of liquidity from the Reserve Bank at the summer harvest time has frequently added to the seasonal expansion of liquidity arising from other factors.

6.39 In Chapters 2 and 39 the Committee recommends the withdrawal of the Rural Credits Department facility. This would entail greater recourse by the Australian Wheat Board and other rural produce marketing bodies to commercial funding. The Committee notes that the arrangements for financing the wheat crop have been changed in recent years to lessen but so far not to eliminate the injection of liquidity from the Reserve Bank. Fully funding the wheat crop from commercial markets would not eliminate all associated seasonality aspects from financial markets. Given present wheat marketing arrangements, characterised by large first advance payments, commercial funding would give rise to some seasonal upward pressure on interest rates.

6.40 While aware of the Government's desire to facilitate the marketing of rural produce (and wheat in particular), the Committee draws attention to the concentrated demand for finance, whether funded by the Reserve Bank or not, that arises. It may be that ways of achieving the Government's objectives in this area, that do not have the adverse effects for financial markets, could be set up. The Committee believes it is worth investigation by the authorities.

(e) Provision of Information

6.41 The role of the Reserve Bank in the dissemination of information on financial conditions is discussed in more detail in Chapter 2. Consistent with the recommendations there, the Committee endorses a general approach which would see the Bank actively informing markets to facilitate intelligent anticipation of seasonal liquidity requirements.

6.42 Nevertheless, there are limitations to this approach. The seasonal variation in liquidity is only one element of a complex range of influences on day-to-day demands for liquidity. For the most part, the monetary authorities are subject to

many of the same uncertainties of prediction as the rest of the financial community. More generally, the involvement of the monetary authorities in detailed forecasting of financial conditions could be prejudicial to their independence in changing policy.

D. CONCLUSIONS AND RECOMMENDATIONS

6.43 The Committee accepts that marked seasonal swings in the liquidity base which are unrelated to production patterns in the economy are an undesirable feature of the Australian financial system and that the present sharp contraction of liquidity towards the end of the financial year places particular strains on private sector portfolio management. It is clear that a major part of the seasonal fluctuations stems from present arrangements for the collection of 'provisional' tax. Significant modifications of these arrangements so as to reduce seasonal fluctuations would, in the view of the Committee, be feasible.

6.44 The Committee therefore ***recommends*** that in order to smooth the unnecessary seasonal impact of government sector transactions:

(a) **The Government should review as soon as possible:**

- **the arrangements for collecting provisional tax, with a view to early introduction of a system of instalment payments; and**
- **arrangements for the collection of other taxes.**

(b) **To the extent that a seasonal imbalance continues, the monetary authorities (consistent with not weakening their capacity to implement monetary policy) should seek to take offsetting action through open market operations and if necessary a broadening of the range of 'seasonal' securities available; the objective would be to tailor maturities of Treasury notes and other government securities held by the private sector to closely match dates on which taxes are payable. Enhanced discounting facilities could also play a part.**

6.45 If the Committee's recommendations cannot be put into effect or the manner of their implementation fails to substantially handle large, short-term liquidity fluctuations emanating from the Government's Budget, consideration should be given to introducing a variant of the Australian Bankers' Association proposal relating to government working balances. Again a prime consideration would be that the arrangements do not reduce the capacity of monetary policy.

6.46 The Committee has elsewhere (Chapters 2 and 39) recommended the withdrawal of the Rural Credits Department facility. This would contribute to a reduction in the seasonal swing in liquidity.

EXTERNAL ECONOMIC POLICY

Ch. 7 Exchange Rate Policy
Ch. 8 Exchange Control Policy

CHAPTER 7: EXCHANGE RATE POLICY

A. INTRODUCTION

7.1 Exchange rate policy[1] raises important issues for the Inquiry because:

- the financial sector is very sensitive to external developments; and
- external policies have a direct bearing on the effectiveness of monetary policy.

7.2 The way in which the exchange rate — the price of foreign exchange — should be determined has been the subject of a long debate in academic and policy circles. The Committee has not attempted a comprehensive review of the technical literature on exchange rate policy in this chapter. Various studies and papers prepared for the Inquiry cover the issues and arguments in great detail; they are available in Part 2 of the Inquiry's *Commissioned Studies and Selected Papers.*

7.3 An assessment of the present exchange rate system is complicated not only by the lack of firm theoretical guidelines but also by the rapidly changing and unusually turbulent international economic environment over recent times, which makes it difficult to draw firm conclusions from the experience of other countries. Factors contributing to this include:

- large increases in the real price of oil, leading to major structural changes in the balance of payments and sizeable financial transfers between countries;
- differential rates of inflation, generating continuing and sometimes substantial pressures for domestic and external adjustments;
- development of offshore currency markets, facilitating international movements of short-term capital;
- important policy changes in foreign exchange and related areas (especially monetary policy) and market reactions to these changes.

7.4 Because it does not have a central position in the international capital market, Australia has not felt the full impact of these developments. However, it has not been immune from exchange rate instability at times. Large discrete adjustments to the exchange rate occurred in 1972, 1974 and 1976, each being preceded in varying degrees by flows of capital in anticipation of the change. Since 1976 the more flexible exchange rate system has created a mechanism by which more gradual (but cumulatively significant) adjustments have been made, both in nominal and effective terms.[2]

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1 A full description of present foreign exchange arrangements in Australia is to be found in Chapters 8 and 14 of the Interim Report.

2 The post-war changes in Australia's exchange rate arrangements are outlined in Table 8.1 of the Interim Report.

7.5 In this chapter, the Committee first discusses the institutional arrangements for intervention presently in force in the Australian foreign exchange market. It then examines the levels of government intervention that might be appropriate in spot and forward markets and argues the case against sustained, large-scale, one-sided intervention. Finally, it addresses itself to the issue of who should be eligible to deal in foreign exchange.

B. PRESENT INSTITUTIONAL STRUCTURE

7.6 Under the present institutional arrangements:

- The level of the exchange rate is monitored by a group of four senior government advisers within the reponsibility of the Treasurer. The $A exchange rate is continually reviewed and may be moved from day to day — in this sense it is not a 'fixed' exchange rate system. Although the rate could be maintained unchanged over an extended period should the authorities so decide, the stated intention of the authorities is that movements in the level of the exchange rate take place by means of frequent small shifts.
- Subject to this review by the group of four, the Reserve Bank each morning sets both the spot and forward rates at which it will deal with Australian trading banks for US dollars, as well as outer limits at or within which banks must set rates for their spot transactions with the public in US dollars.[3]
- Currently the rates announced are set for a day. The Reserve Bank operates as a residual supplier/purchaser in US$ and accepts whatever daily volume of business may result (at the rates chosen).

7.7 As well, dealings in foreign exchange are essentially restricted to authorised banks — an aspect discussed in Section E of this chapter. A further important characteristic of the present institutional structure — the presence of exchange controls — is considered in detail in Chapter 8.

7.8 The characteristics of the present institutional structure mentioned above are not of crucial significance for exchange rate policy. Oversight by the senior officials is essentially an administrative arrangement and (with new intervention guidelines) could be used under an entirely different exchange rate regime. For example, it could equally set guidelines about the level of central bank intervention in foreign exchange markets. The fixing of the rate for a full day also seems to be a convenient administrative device; it has particular operational implications but it does not preclude substantial variations in the exchange rate on a month-to-month basis. Again, the use of the trade-weighted basket is simply an averaging process (i.e. its purpose is to average out movements in foreign

3 With regard to forward transactions, the Reserve Bank informs the banks each morning of the rates (buy and sell for periods ranging to six months ahead) at which it is prepared to deal with them in the course of the day in US dollars. The Reserve Bank also stands ready to quote rates beyond six months 'on application'.

currencies); it does not imply anything about the particular balance of payments objective being pursued by the Government.[4]

7.9 Nonetheless, the Committee is not inclined to favour continuation of the present method of intervention, which may be called a 'flexible peg' system. It believes that any desired level of intervention may equally well be achieved through what might be called a system of 'managed floating'.[5] Under such a system the rate would be determined in the market and could change continuously; the authorities would not peg the rate but could (if they wished) intervene actively, through open market purchases and sales of foreign exchange, to influence it.

7.10 Although the present flexible peg approach could be adapted to give the authorities more flexibility in altering their market stance during the course of each day, the Committee is of the view that **the degree of flexibility available to the authorities would be greater under a system of managed floating.**[6] Moreover, under such a system, exchange rates might be less susceptible to non-market presures and the capacity of the authorities to assess underlying market sentiment might be enhanced. More generally, the Committee favours a much smaller level of official intervention in the future, and an 'open market' system would appear to be more consistent with such a scenario.

7.11 The official view is that to maintain any given non-market exchange rate the authorities would need to hold a larger quantity of international reserves under a system of managed floating than under the present flexible peg system. The Committee does not accept this as a general proposition. It notes that under a system of open market intervention, the authorities would be less 'exposed' during the day,[7] they would generally have more manoeuvrability, and the market

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4 There appears to be a misconception that the present system has some implicit trade balance target because it uses trade shares as weights. As the Treasurer's Press Release announcing the adoption of the basket arrangement (25 September 1974) made clear, the purpose was simply to 'average' movements in foreign currencies.

5 As explained in the Appendix, a study by the Committee's consultants suggests that over the period 1976–79 the same exchange rate outcome could have been achieved through 'open market' intervention. (E. Sieper and G. Fane, 'Exchange Control and Exchange Rate Policy', AFSI, *Commissioned Studies and Selected Papers*, Part 2, AGPS, Canberra, 1981.)

6 With respect to this point, the following observations by Professor W. M. Corden are recorded:

> With the present system the policy makers fix a price (the exchange rate) and any sudden shocks are absorbed by quantity changes (in foreign exchange). Policy initiatives are required to change the price. By contrast, with managed floating, the policy makers fix the quantity and any sudden shocks are absorbed by price changes. Thus 'doing nothing' with the present system means keeping the exchange rate fixed while with managed floating it means not intervening, and so keeping the reserves fixed.
>
> ... In the present system...the tendency will be for the exchange rate to lag behind market forces ... By contrast, with managed floating, market forces will have an opportunity to express themselves. Of course the authorities could still intervene sufficiently to yield the same result as in the flexible peg case. But with managed floating intervention requires initiative, and political approval is not needed to allow the rate to rise ...
>
> In recent years there have not been strong sudden pressures in the foreign exchange market. It has hardly mattered whether a flexible peg or a managed float was being operated. But if capital inflow builds up rapidly, perhaps encouraged by expectations of appreciation, the distinction between the two systems might turn out to be crucial.

(Source: ANU Centre for Economic Policy Research Discussion Paper No. 23, March 1981 — Exchange Rate Policy and the Resources Boom, W. M. Corden.)

7 Under the present 'flexible peg' system, with the Reserve Bank holding the US$/$A exchange rate at the set rate for the day, opportunities can be created for the market to 'deal' against the Reserve Bank in the US dollar, when exchange rates move during the day.

would be less able to predict how the particular exchange rate being promoted by the authorities was likely to move the next day.[8]

7.12 Thus, other things being equal, if there are any effects in this regard from a changeover to a managed float, it would be more likely to **economise** on reserves than the reverse.[9] Broadly, however, the Committee does not believe that the required level of reserve holdings would be very different under the two methods of exchange rate intervention. In both cases, a substantial level of reserves would be needed to sustain an exchange rate that was out of line with market expectations. The issue of required reserves appears to be more relevant to the appropriate **level** of intervention (which is discussed later in this chapter) than to the appropriate **method** of intervention.[10]

7.13 The Committee ***recommends*** that, **at an early date, the present institutional arrangements for fixing the exchange rate should be terminated. The exchange rate should thereafter be determined in the market and the authorities should deal in the market if they wish to promote a particular rate.**

7.14 The Committee believes that, while a system of managed floating could coexist with present exchange controls, the foreign exchange market would have greater depth and range and hence would be more efficient if these controls were liberalised. As will be seen later in Chapter 8, the Committee envisages that the establishment of a freer foreign exchange market will be associated with such a liberalisation.

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8 A visiting US economist, Professor William Poole, warned of 'latent problems' with Australia's exchange rate system. He argued that 'the next exchange rate adjustment is somewhat predictable' and that this 'offered opportunities for speculative profits'. ('Australian Monetary Policy: An Outsider's View', ANZAAS paper, May 1981.)

9 For purposes of the discussion here the Committee is of course assuming that the exchange control framework, as well as the level of official intervention, is the same under both systems. In fact, it is recommending later a reduced level of intervention and a phasing out of exchange controls, but, in its opinion, these recommendations can be implemented under either a system of managed floating or a flexible peg system, although there would be greater tension in the latter case. It is true that there will be particular circumstances where the extent of intervention under managed floating may need to be greater than under the present flexible peg. Equally, there will be many other situations where the reverse is true.

10 It has been argued that, in view of all the uncertainties surrounding exchange rate predictions, the present 'flexible peg' system has the advantage that it enables the authorities to perform a price leadership role and thereby provide a firm base on which markets can formulate their judgments.

The Committee recognises that where foreign exchange markets lack sufficient range and depth, there might be a useful 'leadership' role for the authorities provided they are genuinely guiding and not **cutting across** market sentiment. Such leadership might well be needed, for example, in the early stages of development of an Australian foreign exchange market. However, it should not preclude an early move to a system of managed floating. Indeed by operating **through the market** the authorities would have the additional benefit of 'feed back' from the market to determine both what lead they should give and how it should be altered during the course of the day's trading. The fact that the authorities will give their lead through their market operations rather than by fixing a rate each day should not of itself require a greater level of intervention for any given degree of currency stability.

In a fully developed foreign exchange market, the Committee would expect the initiative and judgment of the market to increasingly assert itself and provide an independent base for exchange rate expectations.

C. PRINCIPLES OF EXCHANGE RATE MANAGEMENT

(a) Levels of Intervention

7.15 A central question on exchange rate management is the desirable level of official intervention in the foreign exchange market — i.e. to what degree and for how long the rate should be held away from its free market value.

7.16 The Committee does not view an absolutely free float as a realistic option. As it understands the situation, there are no totally unconstrained foreign exchange markets in the world.[11] The crucial question is not whether there should be intervention but the desirable extent and duration of such intervention.

7.17 There is broad agreement that in the present world environment of greater flexibility in foreign exchange markets, it would be most undesirable to return to the pre-September 1974 fixed exchange rate (par value) system, where the authorities firmly commit themselves over an extended period to a particular rate. Australia's experience in the final few years under that system was marred by speculative crises and dislocating jumps in the exchange rate. In the longer term, the exchange rate must be expected to adjust to reflect underlying economic forces.

7.18 In the Committee's view, the realistic options available are threefold, categorised in terms of the levels of intervention they envisage:

- A **relatively free float**, where only very short-term erratic market fluctuations are ironed out by the authorities. This is referred to as **technical smoothing**. Since it does not involve attempting to hold exchange rate substantially away from the underlying market rate, it should have no significant net impact on official reserves over any reasonable short period (say a few weeks).
- A **lightly managed float** where, in addition to technical smoothing, the authorities engage in **limited** intervention for short periods to deal with exceptional disturbances in foreign exchange markets; otherwise the exchange rate is left to be determined by the market.
- What might be termed **exchange rate targeting**, where there is substantial, prolonged, one-sided intervention, i.e. the exchange rate is held substantially away from the underlying rate for extended periods of time. It should be noted that exchange rate targeting does not imply fixed exchange rates: it is consistent with a moderate degree of flexibility. Nor should exchange rate targeting be interpreted to mean sustained one-sided intervention **for a period of years**; such intervention would be beyond the capacity of most governments. What is implied is one-sided intervention for a period extending **beyond a few months**. There is general agreement that the exchange rate cannot be used as an independent policy instrument in the long run.

7.19 Basically, technical smoothing is concerned with improving the operational efficiency of the foreign exchange market by ironing out random short-run fluctuations around the trend, whereas targeting seeks to use the exchange rate as a continuing instrument or even objective of economic policy. The difference between the various approaches will be reflected in the **extent** to which the actual

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11 It is reported, however, that the Federal Reserve and the US Treasury did not intervene for their own accounts in the foreign exchange markets in the May–July quarter; the first time since the early 1970s that no such intervention occurred (*Australian Financial Review*, 8 September 1981).

exchange rate diverges from the underlying market rate and the **length of time** for which this divergence is maintained.

7.20 In practice, however, it is not always easy to distinguish clearly between smoothing, light management of the exchange rate and targeting, since the options tend to shade into each other. For example, the choice of time period beyond which one turns into the other must involve some completely arbitrary assumptions.

7.21 It is widely agreed that technical smoothing, on a day-to-day basis, makes a necessary and desirable contribution to the efficient operation of a foreign exchange market. The Committee supports this view.

7.22 The Committee also recognises that intervention over relatively short periods but going beyond technical smoothing may be defensible in certain special circumstances, e.g. where:

- the foreign exchange **market** has **insufficient depth** and speculators are unable or unwilling to take a 'long' enough view of prospective developments;[12] or
- the authorities, because of **superior information**, are confident that market behaviour is based on a misunderstanding of the underlying economic fundamentals.

7.23 The problem of market depth (i.e. structural deficiencies in the foreign exchange market) largely reflects past regulations and is essentially transitional in character.

7.24 Nor does the Committee see the authorities often having superior information. By way of illustration, a few particular situations can be considered:

- Having regard to possible secondary effects of exchange rate changes on wages and prices and the potential disruption to industry, the authorities may feel justified in intervening if they are absolutely convinced that the **market is not having sufficient regard for certain economic developments under way or the expected effects of economic policy changes.** However, the Committee believes that if the authorities keep the market as fully informed as possible about economic trends and the aims of economic policy, speculation will generally have a stabilising effect on the market. In any case, the authorities will not often be in a position to distinguish between stabilising and destabilising speculation. This point is further discussed later.
- Because there are often significant **lags in the adjustment of the balance of trade** to changes in the exchange rate, it is possible that freely floating rates may initially move too far or too fast. Any such over-reaction in the exchange rate might subsequently have to be reversed. Such fluctuations in the

12 In this regard Paula Tosini noted that, 'the case for official intervention requires more than the existence of changing flows of interest-sensitive capital or lumpy transactions by exporters, importers or corporate treasurers hedging their foreign exchange exposure. It is necessary to posit, in addition, a degree of market imperfection or obstruction. Under such circumstances, other private participants in the market — speculators — are limited in the degree to which they can or will take the opposite side of the market and thereby reduce exchange rate fluctuations'. She went on to say that, 'if commercial banks are required to balance their positions, for example daily and by currency and maturity, as is sometimes the case, the banking sector will be constrained in providing elasticity to the exchange market. In such cases, thin market and large exchange rate flucuations are likely . . .' (Paula A. Tosini, *Leaning Against the Wind: A Standard for Managed Floating*, Essays in International Finance, No. 126, December 1977, Department of Economics, Princeton University.)

exchange rate, if allowed to flow through, could have disruptive effects on domestic prices, incomes and investments. Again, however, it is the Committee's view that for this situation to justify official intervention, one must presume that officials are able to perceive these adjustment lags more clearly or sooner than private sector participants in the market, and that it is not practicable to 'educate' the market.

- Intervention to offset exchange rate movements may be considered appropriate where these are caused by **temporary disturbances**, e.g. a rise in overseas interest rates or a 'bunching' of capital inflows which are expected to be reversed within a short time. The argument again depends on the authorities being able to distinguish between ephemeral and longer term pressures on the exchange rate and having better information than private speculators, who would otherwise perform the smoothing function themselves.

7.25 Another argument sometimes put forward for short-period exchange rate intervention is that even if the market is well informed and correct in anticipating a major movement to occur, the authorities are justified in intervening in order to **moderate the rate of change,** i.e. 'spread' the movement over a longer period. Such a policy may be motivated by a desire to alleviate the possible structural disruption to some export and import-competing industries.

7.26 The Committee sees dangers in pursuing such a policy — other than in rare circumstances:

- To the extent that it requires the authorities to underpin an unrealistic exchange rate, and the market is aware of this fact, it is likely to offer speculators 'a free ride', injecting potentially destabilising influences into the foreign exchange market, as well as enabling profits to be made at the expense of the authorities.
- Such a policy would often adversely affect the conduct of domestic monetary policies (and also risk rekindling inflationary expectations). For example, intervention to slow down the rate of appreciation of the $A would tend to generate additional inflows of capital from overseas. For reasons discussed elsewhere, any attempt to 'sterilise' the effects of this on money supply (by means of domestic action) — even with the aid of exchange controls — are not likely to prove completely effective.
- While exchange rate intervention may successfully avoid structural disruptions for some sectors, new inequities and distortions may be created for other sectors in the economy.[13]

7.27 In the Committee's judgment, therefore, situations which justify short-period intervention beyond technical smoothing are likely to be comparatively rare and there are often more effective ways of dealing with such situations than through intervention in the foreign exchange market.[14] In addition, the authorities

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13 For example, official intervention to prevent the exchange rate from appreciating as a consequence of heavy capital inflow into natural resource development may require a contraction of domestic credit to the private sector or a reduced budget deficit. Thus investment in private housing, in consumer durables and in manufacturing (other than that closely related to mining investment) would decline, crowded out by investment in natural resources. (See W. M. Corden, op.cit.)

14 For example, the pace of structural adjustment may well be better handled by fiscal or more specific industrial policies.

will not in general have sufficient information to determine whether the circumstances are such as to justify intervention.

7.28 It is even harder to justify exchange rate targeting proper, i.e. where the authorities seek to hold the exchange rate **substantially** away from the free market rate for **extended** periods of time, e.g. in order to achieve certain internal policy objectives. For example, in 1971–72 and perhaps during the current year, the authorities tried to hold the exchange rate **below** its free market level for an extended period of months. This was done to avoid certain distributional effects regarded by the Government as undesirable. Again, in the period 1976–79 the authorities sought to hold the rate **above** its free market level so as to restrain inflation[15] and to give the economy some 'breathing space' to carry through necessary structural adjustments, without the threat of further devaluation pressures.

7.29 The Committee's strong reservations about exchange rate targeting are principally based on two considerations:

- that it can impede the achievement of a stable monetary environment and lead to less autonomy in domestic economic management; and
- that it does not necessarily produce more stable exchange rates over a long period and may indeed add to instability.

7.30 There can also be costs involved in holding extra foreign reserves to finance intervention and in administering the policy.

(b) Exchange Rate Targeting: Key Issues

(i) Effectiveness of Monetary Policy

7.31 Exchange rate flexibility can assist a country to insulate itself from external monetary disturbances and from inflationary pressures in other countries. West Germany has been particularly successful in this regard throughout the 1970s. If a government seeks to maintain an 'artificial' exchange rate for any length of time, its control of domestic monetary conditions will be greatly weakened.[16] The effects can be mitigated if it has an extremely effective system of exchange controls in operation. However, the Committee believes that in today's world of closely interrelated financial markets, exchange controls could not prevent appreciable movements of capital into and out of Australia in pursuit of interest arbitrage or speculative foreign exchange gains, if the exchange rate is markedly out of line with market expectations. Exchange controls are discussed in the next chapter.

7.32 'Sterilisation' of external influences through domestic open market operations is often seen as a possible means of maintaining the independence of monetary policy from external influences, despite a 'fixed' exchange rate.

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15 It is worth mentioning briefly some of the major ways in which exchange rate movements can influence prices:

- Imports will cost more in terms of domestic currency following a devaluation.
- A devaluation will increase the competitiveness of domestically produced goods (import-competing or export) and add to pressures on domestic productive resources.
- If wage contracts are indexed to domestic prices, there will be a flow on from these influences directly into wage levels.

16 If domestic policy is based on a monetary target, as suggested in Chapter 3, consistency would demand a flexible exchange rate policy.

However, the Committee does not regard it as feasible for the authorities to fully 'sterilise' externally originated changes in the monetary base for any extended period. If, for example, the Australian dollar were undervalued, leading to a strong inflow of overseas capital, it might be very difficult to sell sufficient government paper to counter-balance quickly the domestic monetary effects of the capital inflow. Even if this were possible, it would not resolve the external imbalance; destabilising capital movements would continue and indeed could become more pronounced if the government's debt-selling operations created interest rate pressures in some areas and this generated additional capital inflow and increased speculation. The structural and interest rate effects of continued sterilisation, under such circumstances, would be sure to cause widespread concern. In general, therefore, complete sterilisation is not a viable option, other than for very short periods — although it may be possible to achieve **partial** sterilisation for longer periods.

7.33 There is therefore a strong presumption that exchange rate targeting impedes the effective implementation of monetary policy.

7.34 This general proposition is not lacking in empirical support. The Swiss experience of late 1977 to early 1979, the German experience in 1978 and the UK experience in late 1977 all seem to provide good illustrations of the point.[17] Nor is it hard to point to certain occasions in Australia (e.g. 1971, 1974, 1976–79 and 1980–81) when attempts to protect the exchange rate significantly impeded monetary management.[18] The monetary problems flowing from exchange rate rigidities could become more acute in the future as Australian financial markets become more highly integrated with world financial markets.

7.35 It has been argued that foreign exchange intervention can sometimes provide useful **support** for domestic monetary policy; for instance, in periods when monetary growth is in danger of overshooting the target, it may assist the restoration of monetary stability if the exchange rate were allowed to remain overvalued for a short time. The Committee believes, however, that monetary policy objectives should in general be pursued through domestic open market operations; among other things, this would avoid unnecessary by-product effects on the structure of industry and the distribution of income.

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17 In each case, heavy purchases of foreign exchange by the central banks led to substantial overshooting of the money targets.

	Money target	*Year*	*Outcome*
Germany	8%	1978	11.5%
UK	9.13%	1978 (y.e. April)	15.9%
Switzerland	5%	1978	16.2%

See OECD Economic Survey for Switzerland, April 1979, Annual Reports of the Deutsche Bundesbank (1978) and the Bank of England (year ending 1978). Both the Deutsche Bundesbank and the Bank of England acknowledge, in their Annual Reports, that it was the massive intervention that was responsible for the monetary overshoot.

18 See M. G. Porter 'Monetary Targeting', AFSI *Commissioned Studies and Selected Papers*, Part 1, AGPS, Canberra, 1981.

In reply to the Committee's question on this subject, the Treasury observed that:

> There were external shocks (in) the second halves of 1978 and 1979, following major monetary policy developments in the United States. **Although these developments undoubtedly did impede monetary management to an extent**, the net outcomes on PSFET (private sector foreign exchange transactions) in these periods were not unmanageable partly because of the restraints which exchange controls have on short-term capital flows.

The Committee discusses the effectiveness of exchange controls in chapter 8.

7.36 Many critics of fully flexible exchange rates have argued that a floating rate regime could generate 'vicious' or 'virtuous' circles arising from the price effects of exchange rate movements. In the so-called 'vicious' circle scenario (which often used to be applied to a country such as Great Britain), domestic price increases generated by devaluation trigger off further domestic inflation, thereby reducing international competitiveness and necessitating still further devaluations. A so-called 'virtuous' circle (of which West Germany was for long the most frequently cited example) arises when balance of payments surpluses lead to currency appreciation which dampens domestic inflation, leading to further balance of payments surpluses.

7.37 Floating rates are seen by such critics as creating not only short-term difficulties but also, in some circumstances, ongoing inflationary processes. This, it is argued, may justify sustained intervention (for more than just short periods). The Committee disagrees. In its view, inflationary processes initiated by a devaluation cannot be sustained unless accommodated by monetary policy; this suggests that the 'vicious' circle hypothesis is primarily related to the conduct of monetary policy. In brief, the Committee does not believe that the vicious/virtuous circle hypothesis constitutes an effective argument for exchange rate targeting.

(ii) Stability of Exchange Rates

7.38 A common criticism of floating exchange rate regimes is that they give too much freedom to market forces and thus allow excessive fluctuations in exchange rates. Figure 7.1 compares the movements of the MERM[19] effective exchange rate indices for Australian and selected major currencies. On this evidence, it is not clear that Australia has experienced markedly less variability in exchange rates than other countries, the currencies of which are more market-determined. Of course, no firm assessment is possible without regard for the special factors influencing the various exchange rates.

7.39 Figure 7.2 focuses on the movements in the value of the $A expressed in terms of the trade-weighted index (TWI) and in bilateral rates with related major currencies. In this case the trade-weighted index for the $A shows greater stability than bilateral exchange rates. However, since many traders deal mainly with customers in one or two countries, they would be influenced more by particular bilateral rates than by the trade-weighted result.

7.40 On the whole, the statistical evidence on exchange rate stability is difficult to interpret confidently, but it is not clear that variability is necessarily greater under more flexible exchange rate regimes.[20]

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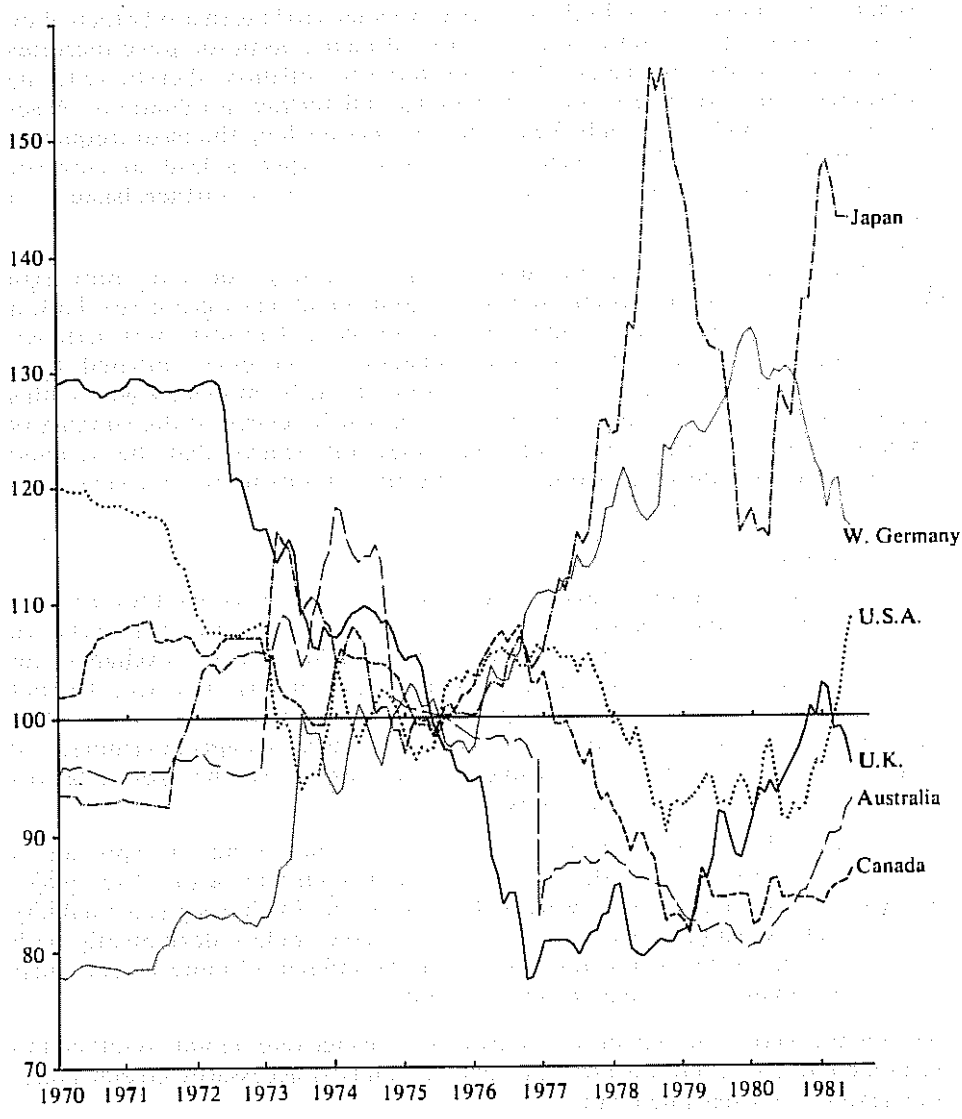
19 For a description of the IMF multilateral exchange rate model (MERM) and the MERM index of effective exchange rate, see, Rudolf R. Rhomberg, 'Indices of Effective Exchange Rates', *IMF Staff Papers*, Vol. XXIII, No. 1, March 1976, and Gerard Belanger, 'An Indicator of Effective Exchange Rates for Primary Producing countries', in the same volume.

20 There is limited evidence to suggest that exchange markets do not systematically produce overshooting. If exchange rates habitually overshoot, then exchange rates would habitually be more volatile than relative price levels, first moving more than price levels and then returning to them. A study by R. A. Batchelor and G. E. Wood found that while exchange rates in the 1970s were sometimes more volatile than national price levels, they were not more volatile in an earlier period of floating, the 1920s. **The only relevant systematic difference between the two periods was the much greater extent of official intervention in the 1970s.** ('Exchange Rate Behaviour in Historical Perspective', by R. A. Batchelor and G. E. Wood, in *Exchange Rate Policy: UK options for the 1980s*, eds R. A. Batchelor and G. E. Wood, Macmillan, 1981.)

FIGURE 7.1: MOVEMENTS IN THE MERM EFFECTIVE EXCHANGE RATE INDEX FOR SELECTED COUNTRIES 1970-1981



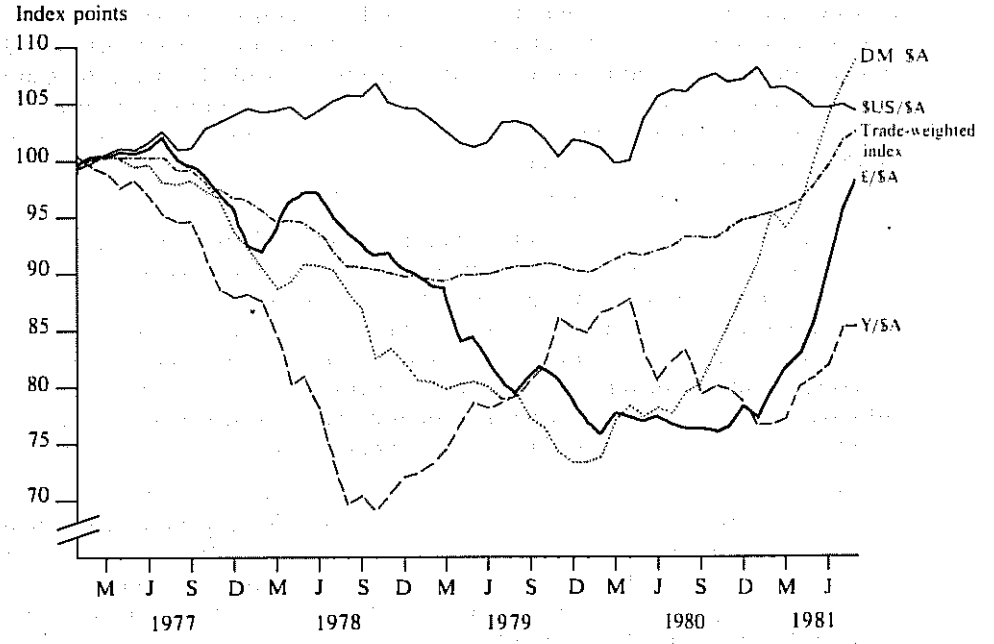
Base 1975 = 100

Source: IMF International Financial Statistics

7.41 High variability of exchange rates is seen by some as undesirable for several reasons:

- it may increase the uncertainty involved in international transactions and therefore discourage overseas trade; and
- it may impede the efficient working of financial markets and therefore reduce the efficiency of the resource allocation process.

FIGURE 7.2: MOVEMENTS OF THE AUSTRALIAN DOLLAR AGAINST SELECTED CURRENCIES AND IN THE TRADE WEIGHTED INDEX[a] (1977 March quarter = 100)



a) Average monthly rates. Upward (downward) movements represent appreciation (depreciation) of the $A against other currencies.

Source: Statement No. 2, 1981-82 Budget Paper No. 1

7.42 Of course, producers for the domestic market must also cope with changing input and output prices (e.g. in markets for some primary products), but it is argued that the size of exchange rate movements from one period to the next can be much larger and their direction less certain. Under the Bretton Woods regime in the 1960s, daily exchange rate movements were minimal[21] and the rare discrete adjustments were invariably preceded by speculative capital flows which were an indicator of the likelihood and timing of the policy move. Traders could thus economise on their purchases of forward cover while also being able to obtain cover when required. At the same time, firms subject to foreign competition could plan their investments with reasonable confidence about exchange rates. Today exchange rates are much more volatile and it is feared that a more market-determined system would increase this short-term volatility and unsettle overseas trade and industrial investment in some sectors.

7.43 Several factors suggest, however, that these concerns about floating exchange rates are greatly exaggerated.

21 Although this is true only with respect to the currency against which the exchange rate was pegged, this does not preclude substantial variations against other currencies.

7.44 International studies indicate that floating exchange rates have not slowed down the expansion of international trade or distorted the patterns of trade.[22] The studies also show that there are significant lags in the response of trade patterns to movements in relative prices of tradeable goods;[23] it takes time for importers and exporters to adjust their production and delivery plans, particularly where there are long-term contracts in place and a change in output mix is required to meet the changing demand patterns. Thus even in a market-oriented regime, traders — and presumably investors — can be expected to continue to focus on more enduring price movements rather than erratic short-term movements.[24]

7.45 Even if variability is greater under more flexible exchange rate regimes, it does not follow that traders and merchants necessarily face greater risk and uncertainty.[25] To begin with, hedging facilities should improve under a more market-oriented regime — once freed of the kinds of exchange controls which at present inhibit hedging. A number of submissions to the Inquiry and the commissioned study point out that exchange controls have limited the scope for forward covering, both via the official market and via various forms of offsetting transactions, and may have made the cost of forward cover more expensive.

7.46 Another reason why uncertainty may not increase is that market-determined exchange rate movements are not necessarily less predictable than those emanating from the application of discretionary bureaucratic judgments. For this reason, the present administered exchange rate system may generate, on balance, greater uncertainty than would be the case in the exchange rate environment favoured by the Committee.

7.47 Finally, since the issue is exchange rate targeting, those who argue that a more market-determined system would increase the volatility of exchange rates must be able to show that sustained official intervention generally has, over a period, a stabilising effect on exchange rates. The Committee has not seen any evidence to support such a view but it has seen some evidence that generally points the other way.

7.48 If the authorities were generally successful in stabilising the exchange rate, they should (in principle) be making a net 'profit' from their foreign exchange intervention activities. On this criterion of profitability, the experiences of a number of central banks since the floating of the exchange rates have been

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22 R. Blackhurst and J. Tumlir, 'Trade Relations under Flexible Exchange Rates', GATT Studies in International Trade (1980).

23 For evidence on the lagged effect of price changes in international trade, see J. R. Artus and J. H. Young, 'Fixed and Flexible Exchange Rates: A Renewal of the Debate', *IMF Staff Papers*, Vol. XXVI, No. 4, December 1979, pp. 654–98. They concluded that 'Econometric estimates of the time lags involved in price effects range widely in the literature from no lag to a mean lag of three or four years. The most persuasive studies tend to find a mean lag of about two years . . .' (p. 666).

24 A recent study on the behaviour of exchange rates concluded that exchange rate movements which reverse within a year will not significantly affect international trade, and thus will not thereby significantly affect the economy of any country. It argued that this is sufficient to demonstrate that any overshooting produced by exchange rate behaviour is of no importance. (G. E. Wood, 'Do exchange rates overshoot?', *The Banker*, May 1981.)

25 A survey of market opinion by the 'Group of Thirty' (a consultative group on international economic and monetary affairs formed in 1979) came to the conclusion that major corporations have accepted the floating rates regime as one that has led neither to large-scale disruption of their international activity nor to the disillusionment over future investment opportunities. (As reported in Otmar Emminger, 'The International Monetary System Under Stress: What Can We Learn from the Past', American Enterprise Incorporated, Reprint No. 112, 1980).

discouraging.[26] Various empirical studies[27] have been carried out overseas to determine whether the market is 'efficient' in anticipating future movements of the exchange rate. The findings are inconclusive but tend to suggest that while markets have frequently been wrong, they have (on average) been at least as efficient as governments in forecasting exchange rate movements over a long period. This is not surprising since traders and dealers have their own money at risk.

7.49 Indeed, one of the basic arguments for a floating exchange rate is that the market, on average, will pitch rates closer to their true underlying equilibrium than bureaucrats can hope to do. While bureaucrats might achieve greater 'stability' for a while, they are often forced into sharp, 'lumpy' adjustments at a later date.

7.50 The Committee is aware that among some countries which have crossed over to 'market-oriented' exchange rate regimes, there has recently been a degree of disenchantment with the operation of 'floating' exchange rates. Prior to the advent of floating regimes on a wide scale there were expectations that such a regime of floating rates would entail relatively smooth adjustments in exchange rates; experiences since the early 1970s have not fully borne this out.

7.51 While it is true that foreign exchange markets have become more volatile,[28] so too have the underlying economic, monetary, and political variables and the sensitivity of expectations about exchange rates. Assessment and interpretation have become more difficult — **for officials no less than for markets**. A further

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26 In a recent study, Dean Taylor concluded that, 'since the floating of exchange rates in the early 1970s, major central banks have failed dismally when judged by Friedman's profit/loss criterion...None of the central banks in this study have succeeded in their objective of stabilising exchange markets. Some have incurred substantial losses, adversely affecting exchange rate movements. Some central banks have tried to maintain an existing exchange rate when there is a change in its fundamental equilibrium level. They are able to hold out for a limited period of time, but are eventually forced to allow the adjustment to take place, and lose substantial sums in the process'. (Dean Taylor, 'Official Intervention in the Foreign Exchange Market or Bet Against the Central Bank', forthcoming issue of *Journal of Political Economy*.)

Professor Victor Argy has also carried out an evaluation of official intervention. He concludes that, 'on the criterion of profitability, intervention (which summed to zero) was apparently successful when it was limited to relatively shorter periods but relatively unsuccessful over very long periods'. ('Exchange Rate Management in Theory and Practice', Victor Argy, CEDA Research Study, 1981.)

27 Recent theoretical and empirical contributions on the forecasting accuracy of the forward exchange rate were reviewed in an article by Richard M. Levich in the *Columbia Journal of World Business* in 1979. The study titled 'Are Forward Exchange Rates Unbiased Predictors of Future Spot Rates?' examined the experience of the United States, Canada and United Kingdom under a floating rate regime and concluded that the forward rate has been an unbiased forecast of the future exchange rate level, but noted that the forward premium has been a poor predictor of future exchange rate changes.

In the same journal a study by Jacob A. Frenkel, 'Efficiency and Volatility of Exchange Rates and Prices in the 1970s', concluded that foreign exchange markets during the 1970s have generally been efficient in taking into account all currently available and relevant market information. This information has been adequately reflected in the forward rate.

In another broad review of exchange rate studies, 'Exchange Rate Economics: Where Do We Stand?', Brookings Papers on Economic Activity 1980, Rudiger Dornbusch concluded that much of the observed instability in exchange rates has been due to unanticipated disturbances; forecasting errors have been made by governments and the public alike.

28 In footnote 20, reference was made to a study which suggested that the observed greater volatility in exchange rates could reflect the much greater extent of government intervention in foreign exchange markets in the 1970s.

consideration here is that different markets react at different speeds. Markets for foreign exchange, at one end of the scale, react extremely quickly, while markets for real goods are rather slower to adjust. Where this is the case, exchange rates will seem to over-react until other markets have adjusted.

7.52 The Australian 1976–79 experience in exchange rate intervention is briefly discussed in Appendix 7.1. As the Committee points out there, the exercise, on the face of it, achieved many of its aims. However, it notes that there may have been some fortuitous influences at work and that comparable results might well have been achievable under a more flexible exchange rate system.

7.53 More importantly, it is the view of the Committee that a similar exercise in the future would be fraught with risk, having regard to:

- the unsettled world financial environment;
- the growing size and mobility of international capital flows;
- the likelihood of strong pressures on theAustralian dollar in the next five to ten years because of the high level and generally uneven pattern of capital inflows arising out of the prospective resources developments; and
- indications that Australia's present system of exchange controls would only be able to play a limited role in effectively restraining capital flows; this is likely to be so even if such controls are strengthened.

7.54 In such a climate, a policy of sustained intervention with the aid of official overseas borrowing carries two major dangers:

- the authorities may well be wrong in their assessment of the underlying economic fundamentals; as was argued earlier, there is no reason to believe that the authorities are generally better at predicting future exchange rate movements than the markets; and
- even when intervention is soundly based, there is always a possibility that, if sufficient numbers of traders and speculators doubt the long-term viability of the intervention, market pressures will outweigh the degree of support the Government is willing to give to the exchange rate.

7.55 In either event, the net effect of official intervention may be to accentuate rather than dampen exchange rate instability, because:

- the Government may feel it needs to go for 'overkill' in adjusting the exchange rate, so as to avoid further rounds of speculation; and
- more fundamentally, a substantial, 'jerky' change in the exchange rate is likely to prove more unsettling to traders, borrowers and investors than a series of small, gradual changes.

7.56 The policy conclusion which can be drawn from this discussion is that critics of floating (or lightly managed) exchange rates have not established the case that they are inherently unstable. Stability of the exchange markets over the long term must ultimately rest on the capacity of Australia and its major trading partners to maintain stable monetary conditions and an effective anti-inflationary stance. This would in turn be assisted by a more flexible exchange rate policy.

(c) Conclusions

7.57 The Committee acknowledges that the authorities may well need to maintain significant levels of intervention in the early stages of development of the

foreign exchange market in Australia. Beyond this transitional period, the Committee is of the view that:

- There is a case for official intervention to smooth out (day to day or week to week) erratic market movements.
- There may also be a case for limited short-period intervention in circumstances (which the Committee believes will be infrequent) **where the authorities clearly have better information than the market** and this information cannot be imparted to the market generally.
- However, prolonged, one-sided intervention, designed to hold the exchange rate substantially away from the free market rate for extended periods (exchange rate targeting) is not favoured by the Committee, because:
  - monetary policy (and indeed, overall economic policy) is more effective under a regime where the exchange rate is not a target of policy itself but rather is allowed to respond flexibly to market pressures;[29]
  - it is not clear that variability is greater under a more flexible exchange rate regime, but even if this were so, it does not follow that traders would face more risk and uncertainty than under a fixed exchange regime, especially as hedging facilities are likely to be more limited in the latter case; nor is there evidence that short-term variability of the exchange rate discourages international trade;
  - the studies of official exchange rate intervention seen by the Committee suggests that while markets have frequently been wrong, they have (on average) been at least as efficient as governments in forecasting exchange rate movements; it is doubtful therefore that sustained official intervention generally has, over a period, a stabilising effect on exchange rates.
- 'Floating' (more market-oriented) exchange rates do not themselves give rise to 'vicious' or 'virtuous' circles of mutually reinforcing price and exchange rate movements; this depends on an accommodating monetary policy being followed. The price effects of exchange rate changes remains an area of difficulty under all exchange regimes.

7.58 In brief, the Committee has no objections to a system of 'lightly managed floating', but cautions strongly against 'exchange rate targeting'.

7.59 On the basis of these considerations, the Committee ***recommends*** that **any official intervention in foreign exchange markets (apart from technical smoothing) should be relatively light, infrequent and only for short periods.**

7.60 The move to a more market-oriented foreign exchange system should be implemented progressively but fairly rapidly. A phasing-out of exchange controls consistent with this approach is discussed in more detail in Chapter 8.

D. FORWARD COVER FACILITIES

7.61 Existing forward cover facilities are currently made up of three separate though related markets.

29 The role of exchange controls is taken up in Chapter 8.

- One is the so-called official market (see Chapter 8 of the Interim Report), in which facilities are provided by the Australian banks but are underwritten and regulated by the Reserve Bank. Restrictions on participation in the market (essentially limited to trade transactions and then only when covered within seven days of acquiring an eligible exchange risk) are described in Chapter 14 of the Interim Report.
- The unofficial hedge market, run mainly by the trading and merchant banks, which services a wide range of transactors including those not able to access the official markets.
- The currency futures market.

7.62 Prices in the non-official markets are freely determined by supply and demand, subject to exchange control limits on participation.[30] In the official market the Reserve Bank, as is the case for spot transactions, sets rates at which it will deal with banks in US$. Banks are authorised to set their own rates for dealing with customers.

7.63 Several controls presently apply in the official market. Only Australian traders with a definite foreign exchange risk may seek cover and they must do so within seven days of acquiring that risk (the '7 day rule'). Most invisibles and all capital account transactions are ineligible for official cover. In the unofficial markets, contracts can relate to any foreign currency, but settlement must be in $A in Australia. Regulations prohibit non-residents from taking out hedge contracts in this market. (However, there are a number of hedge markets in the $A operating overseas — notably in New York, San Francisco, London, Hong Kong and Singapore. Australian trading banks are the market makers in these centres, although a growing number of non-bank intermediaries have also established overseas branches or affiliates and are active in these markets.)

7.64 The forward market reflects, among other things, expected future spot rates, on the basis of existing information. Were forward rates to be left uncontrolled, while attempts were made to control spot rates, this could substantially increase market pressures on the authorities in the spot market. Hence, forward market arrangements must be consistent with those in the spot market; **under the present system**, this means the authorities must fix a daily price in both markets and accept whatever volume of business traders wish to do.

7.65 The Committee attaches considerable importance to the availability of adequate forward cover facilities for all foreign exchange transactions, including capital transactions; such facilities are an important element in any efficient financial system. Capital investors do not currently have direct access to the official market, and in their present forms the unofficial markets lack depth and range; they generally cannot handle large transactions easily and sometimes are unable to handle even those of moderate size. This is mainly because, firstly, the facilities are available only to Australian residents, and secondly, exchange controls restrict the ability of banks and others to offset imbalances in their forward book by holding foreign exchange spot balances abroad.

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30 In these markets short-term hedging for up to twelve months can be conducted on a firm basis. The short-term buy and sell quotes are generally comparable with spreads quoted by Reuters on European forward exchange markets. Hedging orders beyond twelve months are conducted on a 'best efforts' basis with cover available only to the extent that parties with opposing positions seek cover.

7.66 The Reserve Bank is clearly unwilling to embrace capital transactions in official facilities. This is not surprising given the history of the arrangements. At the same time, the Committee notes the interconnection between the various forward facilities and that the Bank appears unable to prevent transactors from passing imbalances in hedging demands onto the Bank in response to exchange rate expectations.

7.67 The deficiencies in present forward arrangements must be treated as a further cost, among other things, of existing spot exchange rate policies. The Committee believes that a sound forward market should be permitted to develop. As for spot transactions, the forward market should mainly involve private sector participants; Reserve Bank intervention should be possible in the same manner as the spot market.

7.68 Therefore the Committee ***recommends*** that:

(a) **A broadly based forward foreign exchange market, with non-resident participation and with the value of the $A being determined basically by market forces, should be allowed to develop simultaneously with the gradual freeing up of the spot market.**

(b) **The Reserve Bank should intervene in this forward market in a manner consistent with the principles adopted for the spot exchange market.**

7.69 The Committee stresses that the capacity of the private sector to participate is important for the development of foreign exchange markets. This raises issues which are the essence of the next chapter. Of particular significance is the ability of the private sector to hold foreign exchange balances. The Committee believes that, given the arrangements it sees as appropriate for the future, present restrictions are clearly too tight and should be modified at an early stage.

E. ENTRY TO THE FOREIGN EXCHANGE MARKET

7.70 A final issue to consider is the basis on which foreign exchange licences should be allocated. With minor exceptions, related to travel business, the Reserve Bank has to date authorised only banks in Australia to deal in foreign currencies. Therefore, a potentially large benefit is being accorded to these institutions (especially as margins are unlikely to be fully competitive in such a situation), although they also have certain obligations (including provision of services to customers and exchange control reporting functions).

7.71 The main case against limiting licences to banks is that it may disturb the competitive neutrality of the financial system and also restrict the level of competition. The Committee accepts that these points have some validity. Even so, it does not favour completely free entry to the foreign exchange market, because:

- confidence is an essential element of the international payments system (as it is for the domestic payments system); this makes it essential that prudential standards of a high level be observed by foreign exchange dealers;
- an institution involved in the foreign exchange market must have sufficient expertise to deal with complex foreign exchange transactions; and
- while some exchange controls are still in force, it would be easier for the Reserve Bank to establish an 'understanding' with the market on policy

matters and maintain effective notification procedures[31] when the number of transactors is limited.[32]

7.72 These arguments suggest the need for some restriction on entry to the market. Moreover, the Committee sees advantages in the present arrangement of confining entry to **banks**; banks are most likely to possess the required expertise and they are well placed to assess the risks involved; since they are already subject to official supervision and monitoring, it would not be necessary to set up another supervisory structure or extend the present area of official protection.[33] It is no doubt for such reasons that the tendency in most countries is to restrict primary dealing authorisation to banks.

7.73 The Committee notes that its recommendations with respect to lending and interest rate controls (see Chapter 4) and entry to banking (see Chapters 24 and 25) will serve to make all aspects of banking — including foreign exchange business — more competitive. The finer margins produced by this increased competitiveness will mean that possession of a foreign exchange licence will no longer be an important advantage to its owner and will not, therefore, significantly disturb the competitive neutrality of the financial system.

7.74 The Committee therefore ***recommends*** that **foreign exchange licences should be restricted to banks.**

7.75 Foreign exchange brokers at present undertake broking business between banks. Such arrangements would no doubt continue.

7.76 On the basis that these brokers would not act as principals (or dealers) but only as **agents**, and then only for bank principals, the Committee, consistent with its approach in Chapter 19, sees no need to prescribe any special licensing or prudential requirements for them.

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31 As explained in Chapter 8, the Committee envisages holders of foreign exchange licences as the foundation of an information collection system which could replace the one presently provided by the administration of exchange control regulations.

32 While the Committee does not generally favour the use of 'suasion', it was explained in Chapter 4 that there might be circumstances when it might be usefully applied.

33 In this context it should be noted that the Committee has elsewhere recommended that domestic cheque payment facilities be restricted to licensed banks.

APPENDIX 7.1

AUSTRALIA'S FOREIGN EXCHANGE POLICY 1976–79

1 In its submission on Foreign Exchange Arrangements, the Treasury argued that the exchange rate has been successfully used as an instrument to achieve domestic policy aims in recent years. An analysis of this period (1976–79) may therefore provide some useful insights.

2 Foreign currency borrowings played an important role in the implementation of policy over the period. From 1976 to 1979, the authorities sought to support the $A and borrowed some $A4.5 billion, with borrowings concentrated in the years 1977 and 1978 when substantial reserve losses were occurring (see Figure 7A.1).

3 The policy had a number of objectives:

- to avoid the price effects of a devaluation which would feed into domestic prices and wages;
- to avoid disturbing the industrial and financial structure through 'unnecessary' exchange rate fluctuations; pressures on the $A at that time were not seen as being consistent with the longer run strength of the balance of payments;
- to allow a 'breathing space' while the real structural adjustments resulting from the 1976 devaluation took place and the Government's anti-inflationary policies took effect fully.

4 An argument can be made that the targeting exercise did achieve many of its aims. The $A depreciated on a trade-weighted basis by 2.8% over 1977 and a further 6.5% over 1978. These adjustments occurred at a moderate and controlled pace over the two years. In the absence of official intervention, it is possible (although not certain) that the depreciation may have been much more severe. Since 1979 there has been a modest strengthening of the $A. On this argument official intervention did help to stabilise the exchange rate in the period 1976–79, and thus may have avoided some of the secondary inflationary effects.

5 The Committee's consultants express the view that: 'Given a rate of net government borrowing abroad equivalent to that actually undertaken in recent years, a free market exchange rate would have exhibited essentially the same medium-term behaviour as did the observed administered rate'.[1] One inference to be drawn is that, for any given level of official intervention, the same results could have been achieved through open market operations as through the present regime.

6 As to whether the extent of official intervention was justified, the Committee notes that if the authorities had explained the situation to the market, it is at least possible that the market might have acted to partially stabilise the exchange rate, without official intervention.

7 In addition, it is not clear that the structural adjustments mentioned in the third point of paragraph 3 actually occurred or that the processes which led to the eventual strengthening of the $A in 1979 were in accordance with the Government's predictions. Some evidence on these points is given in Figure 7A.2 which shows the size of the Australian export and

1 E. Sieper and G. Fane, op.cit.

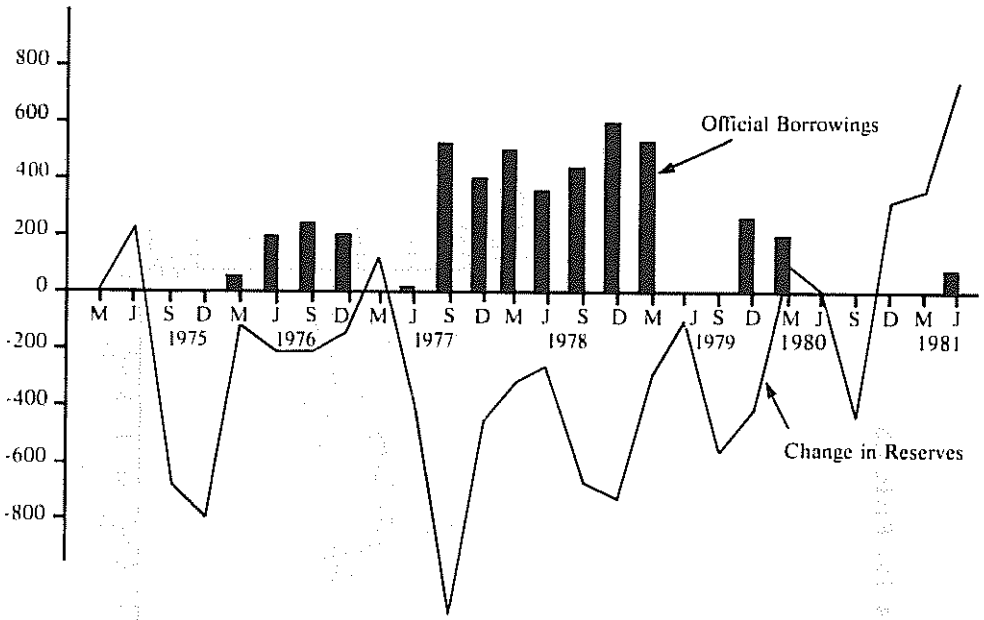
import sectors (as a percentage of GDP) in Australia between 1970 and 1980. Between the end of 1976 and 1979 there was no expansion of the export sector relative to the overall economy. Although obviously other factors were at work, the evidence does not, on the surface, suggest that — at least until 1979 — any real adjustments occurred as a result of the 1976 devaluation. After 1979, however, a marked growth in the export sector is evident. Possibly this arose from lags in the response of resource allocation to changes in relative prices, although it is difficult to draw more than partial support for this view from the data shown in Figure 7A.3(a). A more convincing explanation is that this growth in exports, rather than coming from a shift in resources, was due to a favourable shift in Australia's terms of trade (particularly for rural and mineral exports). In the four years to mid 1978 the price of Australia's exports (in terms of domestic currency) rose by 31 index points, with possibly one-third or more of this related to the 1976 devaluation. However, in the fifteen months to December 1979 the index increased by 48 points, without any large exchange rate movements. (See Figure 7A.3(b).) The strengthening of the $A (at least initially) would thus appear to have been due more to fortuitious developments than to delayed structural adjustments.

8 At the same time, there is little doubt that the post-1979 strength of the $A **did** reflect, to some extent, Australia's improved inflation performance relative to its trading partners, and exchange rate policy may have assisted in the control of inflation.

9 The Committee has frequently stressed in this chapter the risks inherent in a policy of exchange rate targeting — and in particular, the risk that if the authorities 'get it wrong' or the market simply doubts the long-term viability of the intervention, exchange rate instability will be accentuated rather than dampened. Moreover, it has pointed to the dangers for monetary stability.

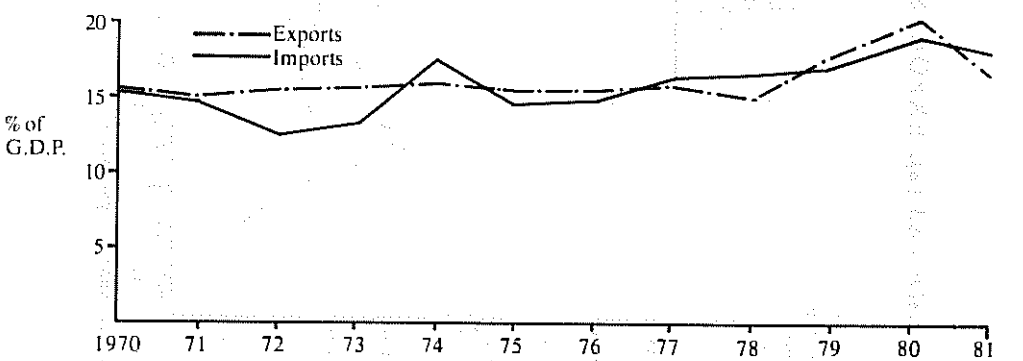
10 While in retrospect the exchange rate targeting exercise of 1976–79 appears to have achieved many of its objectives, this does not alter the Committee's view of the risks and uncertainties inherent in such a policy, and its doubts about the cost-effectiveness of exchange rate targeting as a macroeconomic policy strategy.

FIGURE 7A.1: CHANGE IN OFFICIAL RESERVE HOLDINGS (NET OF OFFICIAL BORROWINGS AND VALUATION EFFECTS) AND OFFICIAL BORROWINGS ($m)



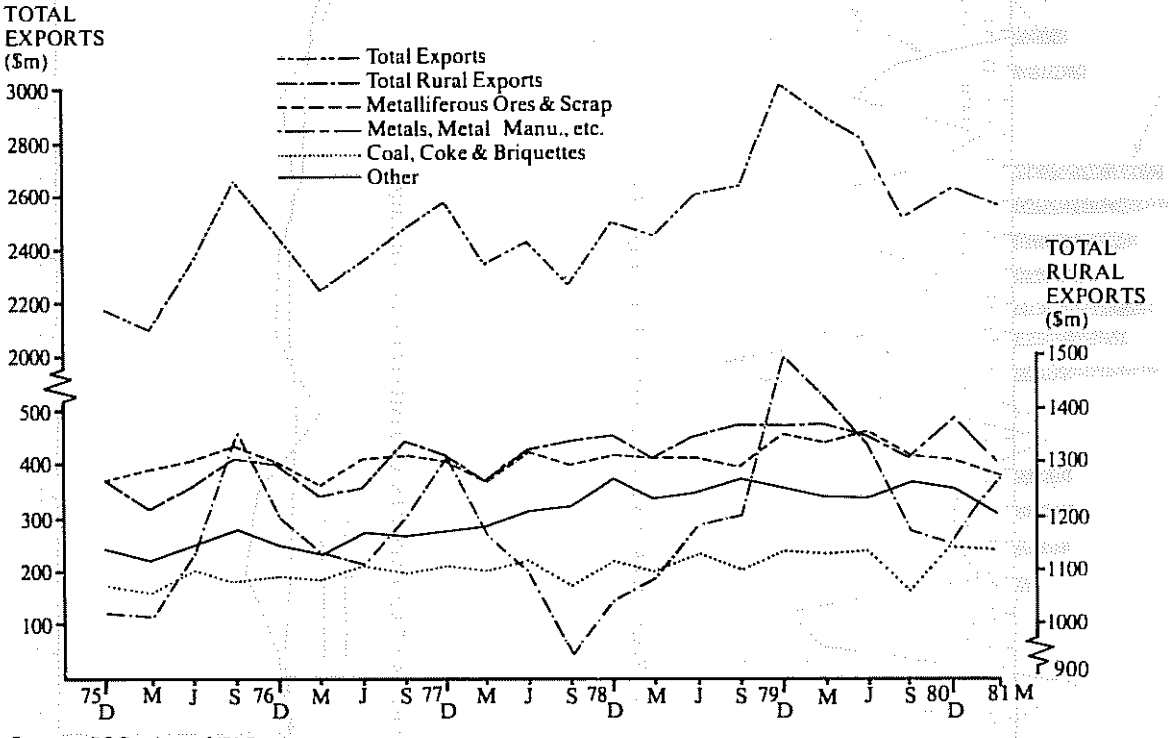
Sources: Reserve Bank of Australia: 1981-82 Budget Paper No. 6

FIGURE 7A2: EXPORTS AND IMPORTS AS % OF GDP



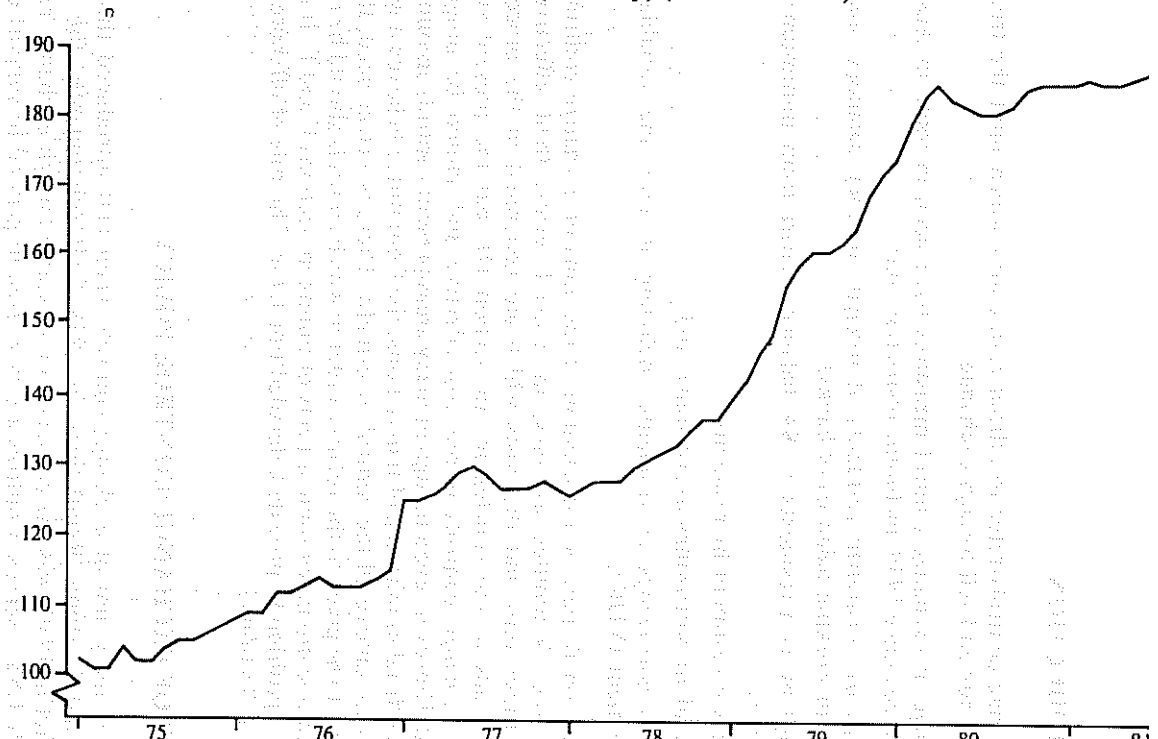
Source: ABS Balance of Payments

FIGURE 7A3 (a): EXPORTS AT CONSTANT (1974-75) PRICES



Source: ABS Catalogue 5421.0

FIGURE 7A3(b): EXPORT PRICE INDEX (Monthly) (1974-75 = 100)



Source: RBA Statistical Bulletin

CHAPTER 8: EXCHANGE CONTROL POLICY

A. INTRODUCTION

8.1 Exchange controls refer to official restrictions which limit the freedom of residents to buy and sell foreign exchange.

8.2 A range of exchange control measures have been in force in Australia in varying degrees since 1939, including restrictions on[1]:

- holdings by Australian residents of foreign currency balances (apart from minimum working balances of banks);
- holdings by non-residents of $A balances (apart from minimum working balances);
- overseas investment by residents;
- non-resident borrowings in Australia; and
- overseas borrowings by residents, including at times the variable deposit requirement (VDR).

8.3 In Section B there is a discussion of the aims of exchange controls and in Section C the Committee assesses, in general terms, their effectiveness in achieving these aims and the costs which are generated in the process. This discussion leads to the conclusion (in Section D) that the present system of extensive exchange controls is not cost-effective and should be progressively dismantled. However, even though in many areas present controls amount to little more than official monitoring of transactions, the Committee believes it would not be prudent to remove all the controls overnight. There is a clear need, therefore, for attention to be given to the relative order in which controls should be removed. The Committee discusses some aspects of timing in Sections E and F. It is not, of course, in a position to provide a detailed timetable. The role of offshore banks is discussed in Section G.

B. AIMS OF EXCHANGE CONTROL POLICY

8.4 The primary aim of exchange controls when first introduced through the Defence and Customs Regulations in 1938 (and subsequently the National Security Act in 1939) was the conservation of scarce foreign exchange resources, particularly US$ reserves. Controls are now used in general to support exchange rate policy.

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1 For a more complete discussion see Reserve Bank of Australia, *Foreign Exchange Arrangements*, Submission No. 11 to the Australian Financial System Inquiry, pp. 11.5–6, and Chapter 14 of the Interim Report.

8.5 The main potential attraction of exchange controls to the authorities is that such controls may enable a non-market exchange rate to be maintained for a period, without destabilising capital flows or sharp movements in reserves. Even if they are only partially effective, controls may cushion to some degree and for a period the effects of external disturbances on exchange rates, monetary conditions and/or international reserves.

8.6 Two other related advantages claimed for exchange controls are:

- conservation of domestic capital for investment within Australia; and
- collection of data (from exchange control returns) for economic intelligence purposes:

8.7 Exchange controls have also been used for certain ancillary purposes:

- prevention of tax avoidance through control and surveillance of direct overseas investment, loan agreements and debt-servicing payments;
- support of foreign investment policy; and
- protection of the environment.

8.8 These latter aims are secondary to the main objective of supporting exchange rate policy. The Committee's recommendations on exchange controls are based on the assumption that other direct and effective ways of achieving these ancillary objectives can be found.

C. EVALUATION OF EXCHANGE CONTROLS[2]

8.9 The continuing use of exchange controls as an instrument of economic policy is only justified if:

- there are significant macroeconomic benefits to be derived from maintaining an exchange rate substantially different from the free market rate for long periods;
- exchange controls are effective in regulating short-term capital flows, and therefore assist the authorities to manage the exchange rate with less monetary disruption; and
- the macroeconomic benefits of exchange controls outweigh the efficiency costs associated with their use.

8.10 In the preceding chapter the Committee has questioned the first of these three propositions and concluded that official intervention in foreign exchange markets, other than for technical smoothing, should only be necessary in limited circumstances — e.g. where the authorities clearly have better information than the market and are unable to impart the information to the market.[3] Even then, the intervention should generally only be relatively light and for short periods.

8.11 Leaving aside the question of the effectiveness of the controls, it is doubtful that official intervention of this nature requires the support of an **ongoing** system

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2 An extensive discussion of the present exchange controls can be found in Syntec, 'Exchange Controls and Forward Exchange Arrangements in Australia'; and E. Sieper and G. Fane, 'Exchange Control and Exchange Rate Policy', AFSI *Commissioned Studies and Selected Papers*, Part 2, AGPS, Canberra, 1981.

3 The Committee also acknowledged that significant intervention may need to be maintained in the transitional period.

of exchange controls. For example, it may be feasible, during such short periods of light intervention, to partly counter the domestic and balance of payments effects by appropriate monetary policies and official overseas borrowing, and if necessary by allowing some temporary 'slippage' of monetary targets.

8.12 In the rest of this chapter, the Committee looks critically at the two other propositions in paragraph 8.9.

(a) Role and Effectiveness

8.13 If exchange controls are to be used to insulate the economy from temporary overseas instability, they would need to be varied frequently. In fact this has not happened to any significant degree in Australia. This may be partly explained by the difficulty of applying them flexibly. The authorities have argued that because of their interlocking nature, it is difficult to relax or remove even a few controls without implications for the whole structure. They have also argued that controls cannot be repeatedly applied and removed as this disrupts the administrative mechanism and unsettles the market; they must therefore be in place on an ongoing basis. Since the ongoing controls have principally operated to restrict outflows rather than inflows, their effect may have been to maintain the $A at a higher average long-term level than would otherwise have prevailed.

8.14 Within the ongoing mechanism, a number of adaptations have been made by the authorities from time to time. They include the design of more flexible controls, e.g. the Variable Deposit Requirement (VDR), and the varying of thresholds on overseas portfolio investment. However, there are clear limits to the flexibility of the VDR, in part because of the type of market reaction created by its activation; and because overseas portfolio controls do not lend themselves easily to short-term variation. To the extent that controls are soft-pedalled at some times and applied strictly at others, uncertainty is created in the same way as if controls were being varied in a more formal way.

8.15 There are some major difficulties in assessing the cost-effectiveness of controls. This is partly because they obscure and distort underlying market trends.[4] Since the authorities do not know what capital flows would have occurred in the absence of controls, they are handicapped in gauging underlying market trends. For example, a low level of rejected applications could indicate either a weak market trend, an unwillingness of transactors to apply if they expect rejection, or widespread avoidance. Controls thus obscure an important source of information, compounding the difficulties of synchronising exchange rate movements in administered regimes with true underlying trends and possibly contributing to episodes of 'bureaucratic overshoot' in exchange rate adjustments.

8.16 Many parties, including the Reserve Bank and Treasury, have acknowledged that direct controls diminish in effectiveness the longer they are applied. Nevertheless, a meaningful degree of effectiveness, at least in the short run, is still claimed by the authorities.

8.17 Controls are sometimes claimed to be effective in influencing exchange rate expectations. By limiting the freedom of action of speculators and demonstrating the Government's resolve, they may act as a circuit breaker and allow more orderly market conditions to be restored.

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4 This applies even if controls do not succeed in substantially altering the volume of capital flows over time.

8.18 While controls may have a role in influencing expectations, it is the Committee's view that they are not an effective weapon for this purpose. The activation of controls can produce two possible responses:

- expectations may be moderated if the controls are seen as evidence of the resolve of the authorities; or
- a perverse reaction may occur if controls are interpreted as confirming the correctness of market expectations and as indicating the likelihood of further policy moves.

8.19 Which of these responses emerges will depend on factors such as the origin and extent of the market instability, the strength of existing expectations, the credibility of the Government's associated economic policies and the severity of the control measures.

8.20 Given the complex interaction between controls and market expectations, the use of controls to influence expectations would seem somewhat hazardous.

8.21 The principal purpose of controls is not to influence expectations, but to reduce the flow of capital transactions through the exchanges. However, most Australian and overseas studies suggest that while **controls may affect the transactions categories directly covered, they are (after a time) largely or completely offset by compensating adjustments in other categories.**[5] This is because an incentive is immediately created for transactors to seek new avenues for capital movements outside the exchange control net. In this process of diversion, substantial inequities arise, with large firms or those with overseas affiliations generally being better placed to minimise the impact of controls.

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5 A recent GATT study has argued that for capital controls to be effective restrictions would have to cover directly every aspect of a country's international transactions — a proposition that is inconsistent with a market economy. (GATT study, op. cit., Chapter 7.)

A full appraisal of the effectiveness of exchange control measures would require the assessment of their impact on the **overall balance of payments**, rather than simply on the particular flows to which they are directed.

While the Commitece is not aware of any study of the impact of controls on the overall balance of payments, there have been some studies of the impact of controls on **total capital flows** and these are listed below. The first study listed looks at the impact of US controls on capital outflows in the 1960s. The second examines the effectiveness of German controls on capital inflows between 1968 and 1973. The remaining studies examine Australia's experience in the early 1970s.

The broad conclusion that can be drawn from these studies is that particular controls generally have significant **short-term** effects on **the particular capital flows** (and corresponding interest rate differentials) **they were designed to influence.** However, capital flows through uncontrolled or less restricted items have acted partially or fully to undermine the overall effectiveness of these controls. The study by Carland and Valentine, for example, suggests that:

- the differential between Australian and overseas interest rates can be explained quite adequately by the factors which determine exchange rate expectations. An implication of this result is that existing exchange controls have been largely ineffective; and
- the only exception to this conclusion is the VDR, which was found to have an influence on the interest rate differential. Nevertheless, this effect appears to have diminished over the period in which the control was in force.

J. Hewson and E.Sakakibara, 'The Impact of US Controls on Capital Outflows on the US Balance of Payments: An Exploratory Study', *IMF Staff Papers*, Vol. XXII, No. 1, March 1975; J. Hewson and E.Sakakibara, 'The Effectiveness of German Controls on Capital Inflow', *Weltwirtshaftliches Archiv*, 1977; M. Porter, 'Capital Movements — A Further Note', *Economic Record*, June 1977; P. D. Jonson, E. R. Moses and C. R. Wymer, 'The RBA76 Model of the Australian Economy', Conference in Applied Economic Research, The Reserve Bank of Australia, December 1977; D. C. Carland and T. J.Valentine, 'The Relationship between Australian and Overseas Interest Rates', AFSI *Commissioned Studies and Selected Papers*, Part 4, AGPS, Canberra, 1981.

8.22 Diversion or avoidance of controls is, of course, greatly facilitated by the high degree of substitutability between many financial assets. It extends into many areas besides the link between debt and equity. For example, the leading or lagging of trade payments, which can provide very substantial amounts of short-term credit, are subject to only limited control. Also, subsidiaries have scope for considerable flexibility in their financing arrangements with their parent.

8.23 In assessing the role of exchange controls, the authorities have stressed their particular concern that, in the absence of controls on portfolio investments abroad, or on holdings of foreign currency balances by Australian residents, and in the absence of controls on non-resident $A balances, a pool of highly mobile funds would accumulate over the years and would be available for repatriation at any time. This 'speculative overhang' problem is discussed later.

(b) Costs

8.24 Exchange controls seek to centralise foreign exchange balances in official hands. This is done by placing strict limits on holdings of foreign exchange balances by individuals. One consequence is that the range of available opportunities for hedging (including through forward exchange cover) is restricted and transactors are forced into less efficient alternatives.

8.25 As an extension of this point, it can be argued that exchange controls amplify pressures on the management of the exchange rate by creating an insufficiency of privately held speculative and transactions balances which could be used to meet temporary imbalances in the market. Under a system which allowed significant private sector foreign exchange holdings by residents[6], transactors could absorb some of these imbalances by accumulating or reducing their own foreign exchange balances. At present, however, these pressures impact largely on official reserves. The value of allowing such speculative balances to develop depends, of course, on whether they would be used in a stabilising or destabilising fashion. The official apprehension about the speculative overhang was noted above. The alternative view, which the Committee is putting here, is that exchange controls inhibit the development of a broadly based, efficient foreign exchange market.

8.26 Another group of costs associated with exchange controls is the administrative costs of compliance and supervision. Trading banks, being the actual dealers in foreign exchange, claim that these regulations place particularly onerous burdens on them and the costs are no doubt passed on to their clients. Similarly, companies engaged in overseas business point to the large volume of liaison and reporting work that is generated by exchange controls.[7]

8.27 The Committee appreciates that some of the costs of administration and compliance will still have to be incurred to maintain a 'monitoring' or statistical gathering facility of the type recommended later in this chapter. However, these costs are likely to be reduced, and the usefulness of the information enhanced. As

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6 Such as the 'London funds' held by Australian trading banks prior to 1939 (see E. Sieper and G. Fane, op. cit.). The proposed spot against forward system would essentially duplicate these arrangements.

7 The Reserve Bank has estimated that about 150 of its officers are employed on exchange control matters. (A small percentage of these would be engaged in statistical work that the Committee sees as a continuing function.) Of course many times that number would be engaged on these matters in the private sector.

mentioned earlier (paragraph 8.15), controls tend to obscure and distort underlying market trends; they thus make it more difficult for the authorities to interpret the information on foreign exchange transactions.

8.28 The final and probably most important cost of exchange controls relates to the losses in allocative and dynamic efficiency arising, for example, from:

- restrictions on the flexibility of business and its capacity to take initiatives and grasp investment opportunities;
- distortions in the relative prices of financial assets; and
- attempts by private transactors to by-pass the controls.

Many commentators have particularly stressed the inhibiting effects on business risk management and investment planning. In the Committee's view these efficiency costs are substantial; however, as with other direct controls, they are difficult to quantify.[8]

8.29 The efficiency costs of exchange controls are compounded by the fact that they impact in a non-neutral manner on different groups. Exchange controls, in common with most direct controls, create incentives of one kind or another for subtle forms of avoidance, particularly with the continued use of the controls over time. As a result, a considerable burden falls in an inequitable fashion on the more unsophisticated foreign exchange transactors.[9]

D. OVERVIEW AND POLICY RECOMMENDATION

8.30 The previous paragraphs have given a very broad treatment of exchange controls. Even at this general level there is, in the Committee's view, good reason to question the cost-effectiveness of the present extensive exchange control structure. Two considerations deserve special emphasis.

8.31 Firstly, given the potential leakages, there is serious doubt about the effectiveness of exchange controls in regulating short-term capital flows, particularly given the continuing way in which they have been deployed. The controls would have more 'bite' when used infrequently and for short periods,

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8 See Syntec report, op. cit. One further indirect cost is worth noting specifically. In very broad terms, controls attempt to 'drive a wedge' between domestic and overseas financial markets and thereby between domestic and overseas interest rates. To the extent that they are successful, investment yields in Australia are less responsive to overseas financial trends and provide less effective information to both domestic and overseas investors on relative returns on capital in Australia and overseas.

9 Where reference to the Reserve Bank is required to gain approval for certain transactions, large firms with experience of the processes involved are often in a position, given their management resources, to more effectively present an application to the Reserve Bank for approval. Geographic position in Australia, particularly proximity to the Reserve Bank's head office in Sydney, may also determine how effectively firms can resolve particular difficulties which may arise. It should be remembered that virtually all current exchange controls **are not absolute prohibitions** and that the criteria that need to be met for approval are often imprecise and allow for an element of administrative discretion. In that sense exchange controls tend to impose unequal burdens on different market participants.

Apart from the ability of many larger firms to gain approval for most foreign exchange transactions there is a widespread belief that avoidance techniques are possible. A major area of avoidance is the disguising of capital transactions as trade finance through techniques such as transfer pricing and manipulation of trade finance facilities. Another area is the adjustment of the leads and lags of trade and other payments.

because the incentives and opportunities for private transactors to identify and exploit avenues of avoidance are considerably reduced.

8.32 Secondly, effectiveness aside, there are important efficiency costs associated with the use of controls.

8.33 Of course, if there were significant macroeconomic benefits accruing to the community from exchange controls, the efficiency costs would most likely assume lesser importance. In the Committee's view, however, ongoing controls are probably not needed to support a system of 'lightly managed floating'. Beyond that the risks associated with heavy and sustained foreign exchange intervention raise serious doubts about the macroeconomic benefits accruing from the use of controls for such a purpose.

8.34 Nonetheless, the Committee is conscious that if its recommendations throughout this Report were adopted, there would be a challenging interim period for the authorities. Moreover, it may take some time for the foreign exchange market to develop sufficient depth and maturity to enable the authorities to substantially reduce the extent of exchange rate 'management'. There would be justification, therefore, in moving cautiously on exchange controls. It would also be necessary to maintain for some time an ongoing monitoring and reporting system to ensure the authorities were fully informed on both inward and outward capital movements. These issues are taken up again later.

8.35 In the light of the foregoing, the Committee ***recommends*** that **the present exchange control mechanism should be progressively dismantled.**

E. PARTICULAR CONTROLS

8.36 As the Committee's recommendation implies that some controls would continue to be available during a transitional period, the controls would need to be evaluated individually in terms of their usefulness in this period. This approach may also indicate in what ways the existing control structure could be rationalised in the event that the Government were to choose, contrary to the Committee's recommendation, to maintain an ongoing system of controls.

(a) Approvals v. Notification System

8.37 The current approach to exchange control is a general prohibition on all foreign exchange transactions unless approved. The authorities claim that this approach is more comprehensive than one that permits all foreign exchange transactions freely except those specifically designated; it is also thought to avoid problems of definition and identification, and to provide capacity for flexible administration.

8.38 The Committee views a comprehensive system of exchange controls as inappropriate. It would like to see only the most critical exchange controls left in place during the transitional period; in its view, all other transactions should be freely permitted. Such a shift in approach would reduce uncertainty for private transactors and reduce the element of bureaucratic discretion on individual transactions. It should also make minimum intrusion into commercial arrangements.

8.39 The principal consultants to the Committee in this area[10] have expressed doubt that such an approach would present additional problems of definition and identification. They contend that the problem of definition and identification is 'symmetrical'. Indeed, in their view, the definitional problems would be less formidable under the proposed approach than under the present approach. Under both approaches it should not be difficult to keep definitions in line with emerging commercial practices.

8.40 The Committee recognises the importance of maintaining a data base for a monitoring system. Collection of data is not, however, synonymous with a system of approval and the Committee feels that data collection could be maintained by having a system of notification for all — or all specified — foreign exchange transactions, with approval, if necessary, being required only for certain specified transactions. The extent of statistical demands must, of course, be balanced against the costs involved.

8.41 Therefore the Committee ***recommends*** that:

(a) At an early date, the administration of exchange controls should be changed to permit all foreign exchange transactions freely, except those specifically designated.

(b) An appropriate ongoing monitoring and reporting system should be developed immediately, based on notification of transactions as they occur.

(b) Proceeds of Trade Transactions and Other Current Payments

8.42 Current transactions and trade credit are subject to timing requirements and special scrutiny to ensure they are not in fact capital transactions that are subject to firmer control. The broad range of controls which at present limit the timing of transactions and the handling of foreign exchange (e.g. on pre- and post-payments for exports and imports) would hinder the development of a market-oriented foreign exchange system and would leave closed avenues for private forward cover arrangements. The Committee feels that, having regard to their limited effectiveness and their effects on efficiency, restrictions on the timing of trade transactions (or 'leads and lags' as they are sometimes called) should be abandoned at an early stage of a program of deregulation. In the view of the Committee, such controls would not be needed in the foreign exchange environment suggested in Chapter 7.

8.43 Therefore the Committee ***recommends*** that **the controls on the timing of payments for trade and services should be abolished at an early date.**

(c) Overseas Borrowings by Residents

8.44 Controls (other than VDR — which is discussed later) that apply or have applied to non-resident loans to Australia borrowers include[11]:

- embargo on short-term borrowings (not in force at present); and
- scrutiny of borrowing contracts.

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10 Syntec Report, op. cit.

11 The restrictions on interest-bearing investments by non-resident banks and governments and the conduct of $A accounts by non-residents are discussed separately later. There are, in addition, some restrictions on equity investments imposed by the Foreign Investment Review Board. These are not strictly part of the exchange control mechanism and it is assumed that the same objectives could be achieved through separate legislation.

8.45 Two observations might be made about these controls:

- The short-term borrowing embargo would be largely, but not totally, redundant if a VDR were in force, as it would be possible to substantially control such flows without resort to an embargo; for reasons discussed later the Committee prefers an instrument which impacts on price to a system of quantitative controls.
- The process of scrutinising details of borrowing contracts, to close potential loopholes in inflow controls, is a time-consuming and costly process for transactors and officials.

8.46 The Committee ***recommends*** that:

(a) Embargoes on short-term borrowings should not be used as an instrument of exchange control.

(b) The scrutiny of borrowing contracts should cease.

(d) Resident Equity Portfolio Investments Overseas

8.47 Until recently, the controls applying to resident portfolio investments overseas (including those which indirectly have that effect) were:

- a virtual ban on fixed-interest investments;
- limits on investment in shares; and
- restrictions on the establishment of Australian share registers and on the listing of securities on Australian stock exchanges by companies incorporated overseas.

8.48 Restrictions on investment overseas in shares were lifted in July 1981. The restrictions applying to investment in fixed-interest securities remain unchanged and are discussed in Section (f) below.

8.49 A foreign corporation must obtain the Reserve Bank's approval to establish an Australian register of its shares or other securities, or to list any of its securities on an Australian stock exchange. Authority is not often given.

8.50 Retaining this restriction on listing after the recent liberalisation of controls on share purchases overseas would appear to do no more than exclude Australian sharebrokers from one area of share trading (i.e. many Australian investors would simply go through overseas brokers and purchase the stock overseas).

8.51 Transactions costs might be lower if stocks could be purchased domestically rather than overseas. Small investors, whose orders may be too small to justify an overseas purchase, would be offered a wider spectrum of stocks.

8.52 It is assumed that problems concerning stock exchange listing and disclosure requirements can be overcome. No company need be accepted for listing which is not already listed overseas and which does not agree to Australian disclosure requirements.

8.53 It is worth noting that a number of countries, including the United States, Singapore and the United Kingdom, allow foreign corporations to list their securities domestically.

8.54 The Committee therefore ***recommends*** that **the restriction on listing of foreign corporations on Australian stock exchanges should be lifted.**

(e) Non-resident Holdings of $A Balances and Interest-bearing Investments

8.55 At present, non-resident banks and governments are permitted to hold $A balances only to cover minimum working balances plus any firm commitments falling due immediately (normally interpreted as within one month). Such balances may not be invested, nor may the Australian banks with which they are held pay interest on them. Other non-residents may deposit funds at interest and make other interest-bearing investments in Australia (subject to any borrowing controls current at the time).

8.56 The restrictions on interest-bearing investments by overseas banks are designed to close a potential channel for speculation and arbitrage between domestic and overseas capital markets.

8.57 In terms of its impact on short-term capital flows, the effectiveness of such a measure is open to question because of its fairly narrow coverage. A study prepared for the Committee[12] demonstrates a very close link between capital movements and interest rate differentials. One reason is that foreign corporations with domestic subsidiaries are able to respond flexibly to interest differentials.

8.58 Nonetheless, the Committee is conscious that holdings of $A balances and interest-bearing investments by non-resident banks etc. may significantly increase the potential volume of short-term capital flows. This raises similar issues to the holdings of foreign currency and short-term investments overseas by residents which are discussed in the section below.

8.59 The restriction on $A holdings, especially by official agencies, is intended to discourage the development of a reserve currency role for the Australian dollar. The Committee is not in a position to make judgments on all these issues but their resolution does not depend on the existence of comprehensive exchange control machinery.

(f) Foreign Currency Accounts and Interest-bearing Investments Overseas by Australian Residents

8.60 Australian residents are permitted to retain foreign currency balances accruing from export proceeds etc. only to meet foreign currency obligations falling due within one month. Banks are permitted to hold only minimum foreign currency working balances.

8.61 Similarly, there is a virtual ban on overseas investment in loans or other fixed-interest securities by Australian residents.[13] This ban has been described by the Committee's main consultants as 'the linchpin in the set of controls which are designed to govern short-term outward movements of capital'.[14]

8.62 The Committee is of the view that these arrangements are inappropriate for the more liberal foreign exchange environment that has been recommended. Their removal would also facilitate the development of forward cover facilities and in some respects complement these facilities.

8.63 The Committee is conscious of the concern of the authorities that these types of accounts could accumulate over time and become a source of potential

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12 Curland and Valentine, op. cit. See also Figure 8.6 of the Interim Report.

13 There is one minor exception; this is referred to in the Interim Report, paragraph 14.19.

14 Syntec report, op. cit.

speculative 'overhang'. It notes, however, that privately held foreign exchange balances can at times act as a stabilising force in the market (see paragraph 8.25). Moreover, there is already a large volume of ongoing and accumulated overseas equity and interest bearing investments in Australia. There can also be substantial 'leads and lags'. These funds can be extremely mobile and can also be viewed as a potential overhang. Finally, it should again be pointed out that under a more market-oriented exchange rate system, the potential capital flows would generally impact on the exchange rate rather than on domestic monetary conditions. There may be some increased economic risk in moving towards a more liberal approach on both resident and non-resident balances — but the risk must be kept in perspective and must be set against the potential advantages. Nonetheless, it would be prudent to maintain (at least initially) the capacity for some containment of such funds flows.

8.64 The Committee therefore ***recommends*** that:

- **Controls on resident foreign currency balances and resident holdings of interest-bearing investments overseas should be progressively dismantled.**
  - **In the transitional period, however, some degree of control and surveillance might be retained.**
  - **The controls could take the form of threshold limits.**

8.65 It has been argued that liberalisation of exchange controls may allow banks to partially neutralise the effects of an increase in the variable reserve requirement on their $A deposit liabilities (see Chapter 4). For example, overseas branches of Australian banks (and parent offices of foreign banks in Australia) could make foreign currency denominated loans to their Australian offices for on-lending to resident customers, or banks could offer resident customers 'Eurodollar-type' deposit facilities.

8.66 However, the Committee would point out that:

- in a more market-based financial system, there would be greater reliance on open market operations and only limited resort to reserve requirements as an instrument of monetary policy;
- by paying a 'commercial' rate of interest on reserve requirement deposits, as the Committee proposes, the incentive to circumvent reserve requirements would be reduced;
- a flexible, market-oriented exchange rate would help to restrict the magnitude of the potential problem for monetary policy; and
- reserve requirements could include, if necessary, a provision for the extension of such requirements (when required) to include foreign currency deposit liabilities.

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15 The VDR which operated in the 1970s had the following principal features:
- Borrowers were obliged to lodge with the Reserve Bank an interest-free, non-assignable deposit in Australian currency representing a certain proportion of the amount drawn.
- Deposits were held for the period of the borrowing and were refunded proportionately as loan repayments were made.
- The deposits were required to be lodged through the borrower's bank concurrently with receipt of loan proceeds.
- The deposits percentage applicable to new borrowings were varied by the Government from time to time.

(g) Variable Deposit Requirement (VDR)

8.67 The VDR[15] has, along with the embargo on short-term borrowing, been the principal means of regulating short-run capital flows into Australia during the 1970s. It acted by increasing the effective cost of overseas borrowings. As implemented, the measure has generally only applied to new borrowings (including drawings under established arrangements); it has not applied to existing portfolio positions. The VDR has been varied in intensity on a number of occasions. However, the record appears to suggest that the VDR has generally been levied or increased only **after** an increase in inflows has occurred, thus creating an incentive for transactors to borrow in anticipation of its introduction.[16]

8.68 Notwithstanding these limitations and its partial coverage, the VDR has been viewed, especially by the authorities, as a useful short-term measure to combat external instability. Most evidence suggests that the VDR reduced those types of funds flows on which it was levied, at least over the short term. Moreover:

- it is more market-oriented than other controls; it does not totally prohibit market transactions as capital is free to move if transactors meet the 'tax' levied;
- it can be applied flexibly, both as to the required deposit and the length of time for which this is held by the authorities; and
- it is easily understood by transactors.

8.69 The Committee accepts that such an instrument may have a role to play in certain circumstances. In general, control instruments like the VDR which regulate capital inflows by impacting on price are to be preferred to quantitative controls. However, the Committee agrees with its consultants[17] that if this instrument is to have maximum impact, consideration should be given to extending the coverage to both debt **and** equity portfolio investments.

8.70 One special feature of the VDR is that it requires a deposit to be made with the Reserve Bank, i.e. it compels companies to borrow larger amounts of foreign exchange to obtain access to a given desired amount of $A; companies thus face a larger foreign exchange exposure and, perhaps more importantly, some of them may run into gearing problems when they attempt to do this. With the VDR having been set as high as 33.3%, these effects could be significant.

8.71 Another difficulty with the VDR is that it impacts solely on capital inflows. While the Committee expects that in the 1980s, governments will more often be concerned with the pattern of capital **in**flows than capital **out**flows, an instrument that can impact quickly on either side of the balance sheet would be more useful to the authorities (during the transitional period) than one that impacts only on inflows.

8.72 The authorities might therefore give some thought to a capital inflow/outflow tax — a variant on a dual exchange rate system.

8.73 If a control instrument like VDR (or an inflow/outflow tax) is to be effectively activated at times when it is needed, a continual information collection would need to be maintained.[18] This is consistent with the earlier recommendation on this question.

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16 Sieper and Fane, op.cit., Chapter 1; see also Syntec, op. cit., Part III).
17 Syntec report, ibid.
18 In addition of course appropriate regulations would have to be in place.

8.74 It is important to emphasise the limited situations in which the Committee sees such an instrument being used:

- it is intended that it be only available during the difficult period of transition to a more market-oriented foreign exchange system;
- it should be regarded **as a last-resort measure,** providing a buffer against external fluctuations which cannot be handled satisfactorily with the available policy tools; it cannot serve as a substitute for prompt and appropriate domestic policies. Nor can it serve as a substitute for a realistic market-determined exchange rate.

8.75 There is no case, in the view of the Committee, for frequent or sustained use of an instrument like the VDR (or inflow/outflow tax). Indeed, the Committee is bound to point out that the active use of such an instrument is likely to create some lingering market uncertainty. For that reason alone it would need to be used very sparingly. In addition, it is not likely to be effective if it is used too often or for long periods.

8.76 Subject to that proviso, the Committee ***recommends*** that, **during the transitional period, while the foreign exchange market is developing, the authorities should retain a reserve power to apply (as a last resort measure) a VDR or like instrument. Preferably the instrument would have the capacity to cover flows of both debt *and* equity portfolio investment.**

F. TIMING

8.77 The Committee is recommending three major changes in external policy:

- an early shift from the present 'flexible peg' system (fixing a rate at the start of each day, with the Reserve Bank operating as a residual supplier/purchaser at that rate) to a system of 'managed floating' (under which the exchange rate is determined in the market and the authorities deal in the market if they wish to promote a particular rate);
- a progressive reduction in the level of official intervention in foreign exchange markets; and
- a progressive dismantling of exchange controls.

8.78 These three policy changes would represent, in the aggregate, a major structural transformation of the foreign exchange system. It is important that they be synchronised, as they are highly interdependent.

8.79 It may take a little time before the foreign exchange market develops sufficient depth and range for it to function effectively without requiring a significant degree of official intervention (see Chapter 7). In addition, the Committee notes that there may be a period of less certainty for domestic economic policy following the move to more flexible interest rates and monetary policies. The entry of foreign banks may also have the effect of adding further linkages between Australian financial markets and world markets (although the Committee has argued elsewhere in this Report that there is already a high degree of integration).

8.80 All these factors, taken together, may require that the proposed external policy changes be made progressively and with care. They do not, however, preclude an early start to the process of liberalisation of exchange controls; **and**

indeed such liberalisation will assist the development of the foreign exchange market.

8.81 Coincident with a progressive reduction in the level of official exchange rate intervention, there should be a progressive dismantling of exchange controls.

8.82 The Committee is not in a position to offer a detailed timetable for the relaxation and ultimate removal of exchange controls. It believes that some changes will make a particular contribution to the development of the foreign exchange market. Others will need to await further development of that market.

8.83 The Committee suggests that the early steps would need to include:

- Discontinuation of present institutional arrangements for intervention by the authorities on the exchange rate and a shift to the more market-oriented arrangements discussed in Chapter 7. (This would include removal of present limits on the rates that banks can set on transactions with their customers.)
- An early relaxation in the capacity of those operating in the market (e.g. banks) to hold larger balances of foreign exchange.
- A switch from the present approach of prohibiting all transactions except those specifically approved to one in which all foreign exchange transactions would be permitted except those specifically designated.
- The development of an information system to replace, as necessary, the one presently provided by the administration of exchange control regulations.
- A move away from the use of exchange controls for ancillary purposes. In many cases, exchange controls have been used as the convenient administrative arrangement. That is not a valid justification for retaining such controls.
- More generally, a review by the authorities of the various remaining controls. In many cases, early removal or raising of thresholds might well be possible. It would appear to the Committee that the removal of those relating to short-term funds flows might need to await substantial development of the foreign exchange market.

8.84 The Committee recommends the retention of powers to impose a VDR or similar instrument throughout the transition period, in case pressures develop that cannot, in the situation of the time, be handled by official intervention in the market.

G. ROLE OF OFFSHORE BANKS

8.85 The Committee commissioned a comprehensive study on the scope for establishing an offshore banking market in Australia.[19]

8.86 In its simplest sense, offshore banking refers to banking business conducted from a host country and transacted purely in foreign currencies. In a fully deregulated financial system, where all restrictions are lifted on non-resident holdings of domestic currency and on resident holdings of foreign currencies, the distinction between offshore banking (conducted in foreign currencies) and onshore banking (conducted in domestic currencies) would disappear.

19 J. R. Hewson, 'Offshore Banking in Australia', AFSI *Commissioned Studies and Selected Papers*, Part 2.

8.87 Three broad categories of offshore banking can be identified:

- **a pure offshore market** where the authorised 'offshore bank' intermediates foreign currency transactions between non-resident borrowers and lenders only;
- **an offshore market with resident loan access** — in addition to foreign currency dealings with non-resident borrowers and lenders, the authorised 'offshore bank' can also lend foreign currencies to residents, but it is not allowed to accept deposits from residents;
- **an offshore market with resident loan and deposit access** — this is the most wide-ranging category, with the authorised 'offshore bank' accepting foreign currency deposits from and on-lending to both residents and non-residents.

8.88 Authorised 'offshore banking' units can comprise domestic banking institutions as well as 'local units' of foreign banks.

8.89 Currently all major Australian banks have branches overseas through which they undertake international intermediation activities. These branches provide a wide range of banking services, a growing percentage of which is unrelated to the transactions of their Australian customers.

8.90 At present the major restriction on banks undertaking these activities is the foreign exchange risk that they can carry. However, this might be satisfied by the bank hedging its position.

8.91 The regulations basically prevent Australian banks (operating through their resident base) from accepting foreign currency deposits. This is also the case with the representative offices of foreign banks. The representative offices arrange foreign currency loans for residents but the formal position is that the loans must be organised by their offices overseas in order to remain strictly within the boundaries of current official guidelines.

8.92 The Committee addresses these issues more fully in Chapter 25, where it indicates a preference for agency rather than representative office status for foreign banks not admitted to the domestic banking system. This would formalise the representative offices' foreign loan business and simply allow documentation to be signed in Australia rather than overseas. No major freeing up of exchange controls would be implied. This move could be made early in the deregulation process outlined above.

8.93 The establishment of a formal 'offshore market' would be facilitated by some relaxation of the regulations concerning resident holdings of foreign currency deposits and possibly non-resident holdings of domestic currency deposits. These matters are taken up in some detail in the consultancy report and the Committee refers this report to the authorities for study. If the Government believes there is a place for an offshore market during the transitional period of deregulation, a program of staged development could be devised, consistent with the gradual phasing out of exchange controls.

8.94 At the embryonic stage both foreign banks and domestic banks might be permitted to accept **non-resident** foreign currency deposits (within limits) and to on-lend to non-residents.

8.95 The nature of the regulatory and prudential requirements that might be imposed on this new offshore market are considered fully in the consultancy report.

8.96 Once exchange controls have been sufficiently liberalised to permit all residents to hold foreign currency balances, a natural development would be to permit offshore banks and domestic banks to accept **foreign currency** deposits from, and on-lend to, **residents.**

8.97 Allowing offshore banks and domestic banks to take the further step of accepting **$A deposits** from **non-residents** would substantially broaden the potential for setting up a Euro or Asian $A market. This move would have to await the final step in exchange control liberalisation.

8.98 Some foreign banks operating as offshore banks might advance a further stage by obtaining access to **resident Australian dollar deposits** and loans. This would make them indistinguishable from domestic banks. In Chapter 25, the Committee recommends that the Government should offer, as soon as practicable, domestic banking licences to a number of foreign banks. It is envisaged that, progressively thereafter, further licences would be granted. While some of these additional domestic bank licences could be granted to offshore banks, an offshore bank licence would in no sense represent an automatic delayed entry into the domestic banking system. A situation may arise, therefore, where foreign banks may have a dual presence, with many foreign banks operating in the offshore market and a limited number with full domestic bank licences.

APPENDIX 8.1

MAJOR CHANGES TO EXCHANGE CONTROLS

1939–1972	Australia had almost an 'open door' policy to capital inflows.
Sept. 1972	Embargo placed on borrowings repayable in two years or less.
Dec. 1972	VDRintroduced, and set at 25%.
Feb. 1973	Borrowing controls extended to include non-resident deposits and fixed-interest investments. Surveillance measures applied to large intercompany accounts. Timing limits applied to payments for goods and services, and dividends.
Oct. 1973	VDR increased from 25% to 33.3%.
June 1974	VDR reduced from 33.3% to 25%.
Aug. 1974	VDR reduced from 25% to 5%.
Nov. 1974	Borrowing embargo modified to apply to borrowings of six months or less; VDR suspended.
Jan. 1977	Embargo increased to two years and VDR reactivated at 25%. Restrictions on the leading and lagging of trade payments were tightened.
July 1977	Embargo reduced to six months; VDR suspended.
Jan. 1978	Embargo suspended.
Jan. 1979	Some relaxation of the controls applying to earnings from direct investment overseas.
April 1980	Adjustment to ceiling limits on resident portfolio investments overseas.
July 1980	Modification of capital inflow surveillance.
July 1981	Restrictions on resident investments overseas in shares and real estate lifted. Approval is still required.

PUBLIC SECTOR FINANCING

CHAPTER 9: THE MARKETING OF GOVERNMENT SECURITIES AND THE ROLE OF AUTHORISED DEALERS

A. INTRODUCTION

9.1 Since the Committee began its deliberations there have been some significant changes in arrangements for the marketing of Commonwealth securities. In particular:

- the tap issue of Treasury notes has been replaced by a tender system;
- the periodic cash-and-conversion bond issues have been replaced by tap issues; and
- Australian Savings Bonds are now being sold additionally through post offices.

Some details are shown in Appendix 9.1.

9.2 Success in marketing securities depends upon:

- the characteristics (e.g. return, maturity including any early redemption rights) of the instrument;
- the appropriateness of marketing arrangements; and
- the existence of a secondary market.

9.3 Adoption of some of the Committee's recommendations, together with certain ongoing developments, will reinforce both the need for, and the benefits flowing from, an active and efficient market in government paper. In particular they include:

- increased emphasis on open market operations as an instrument of monetary control;
- the elimination of captive markets; government securities will need to be sold on their merits; and
- the direction of sectoral assistance through the Budget.

9.4 This chapter deals with marketing arrangements and secondary market support for Commonwealth Government securities (although many of the points are equally relevant to the marketing of local and semi-government securities). It is concerned both with the issue of 'new' securities to the market at large and with the role of the Reserve Bank and authorised dealers in the secondary market for government securities. Of particular concern are the special facilities provided by the Reserve Bank exclusively or on a preferred basis to authorised dealers. The range of securities that might be offered is discussed in Chapter 11.

B. NEW ISSUE MARKET

9.5 The broad objectives of official monetary management are to ensure that:

- monetary 'targets' are met; and
- the liquidity of the financial system is managed in a way that maintains overall financial stability.

9.6 The objectives of debt management[1] are to:

- cover the Government's financing requirement;
- borrow at the lowest possible long-term cost;
- maintain an appropriate spread of maturities; and
- promote stability and confidence in the bond market.

9.7 There is some potential for conflict between the demands of economic stabilisation policy and effective debt management. For example, an attempt to keep down the cost of government debt by 'supporting' bond prices can seriously undermine monetary and other economic policies. More generally, while the Committee does not seek to detract from the prime authority of government, it is nonetheless a theme of the Committee's approach that the demands of government on financial markets arising from the Budget should be consistent with the preferred monetary policy. Potential conflicts between fiscal policy (and its associated debt management) and monetary policy should be resolved by consultative processes (see Chapter 2).[2]

9.8 It is clear that the achievement of the objectives of both debt management and monetary policy hinges significantly on the effectiveness of the arrangements for marketing government paper, as well as on the attractions of the paper itself.

9.9 Arrangements for the funding of government by the private sector can in principle be based on two systems:

- government can offer securities at **fixed yields**, accept the quantity of funds proffered, and vary, if necessary, either rates in subsequent issues or its fiscal and/or monetary program; or
- government may independently determine how much it wants to borrow; it would then sell (by tender or otherwise) the **quantity** so determined at whatever prices and yields are necessary to achieve this result.

9.10 Broadly speaking, Australia has, at least until recently, adopted the first system.

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1 The Loan Council has a co-ordinating role in relation to the borrowing programs of the Commonwealth and State Governments, their authorities and local governments. This is described in Chapter 12 of the Interim Report. In brief the Loan Council's functions include:

- determination of the aggregate annual borrowing programs of the Commonwealth and State Governments and their authorities;
- distribution of the programs between the Commonwealth and the States;
- allocation of the proceeds of Commonwealth borrowings;
- prescription of maximum terms and conditions for various categories of borrowings;
- regulation of the timing of domestic public borrowings; and
- approval of the terms and conditions of overseas borrowings.

2 A fundamental aspect of this issue is determination of the volume of government securities to be marketed to the private sector. In some countries the fiscal authorities tend to follow the discipline of funding the budget deficit from the market. In Australia, the Reserve Bank 'finances' that part of the government deficit which the private sector fails to do. It must be recognised that funding by the Reserve Bank is not a substantive response to the problem of reconciling fiscal, monetary and debt management policy.

9.11 This approach may work reasonably well in a situation where:

- the securities are appropriately priced;
- competition from private sector securities is not particularly strong;
- there are significant captive investors;
- borrowing requirements are relatively modest;
- the Government is seeking to influence interest rates rather than monetary aggregates.

9.12 To an extent, these conditions applied throughout most of the 1950s and 1960s. However, this subsequently ceased to be the case.

- There is now a much wider range of commercial securities available, some of which have risk properties (in part supported explicitly or implicitly by governments) near that of government securities but which generally offer a higher yield for comparable terms; bank paper is a prime example.
- The relative importance of captive investors in the financial system has been eroded over time (see Chapter 10); and the most rapidly growing financial intermediaries have not been substantial investors in government securities.
- The overall public sector deficit has been much larger (see Table 9.1).
- Greater emphasis has come to be placed on the control of monetary aggregates and direct controls on private sector interest rates, particularly those of banks, have been reduced.

9.13 As indicated in paragraph 9.1, sales of government securities in Australia are currently a hybrid of both tap and tender approaches (bonds through the tap and Treasury notes through the tender). Developments over recent years have tended to change the focus a little towards the second alternative, but the fixing of yields by the authorities still ranks importantly in the issue of securities.[3]

9.14 The tender system adopted for the issue of Treasury notes has no underwriting agreement. Bids are accepted from registered tenderers, who may make a range of bids at different prices. The total of bids may fall short of the total on offer, or the authorities may find some bids unacceptable and choose not to allocate the full amount. In the experience of the system so far, neither of these events has occurred often.

9.15 There appears to have been some reluctance on the part of the Australian authorities (as well as authorities in several parts of the world) to adopt a tender system for the issue of medium and long-term government bonds.

9.16 It has been argued that in a relatively under-developed market for government securities, the tender yield may not be a good guide to the 'true' yield and investors generally look to the authorities for some sort of lead on interest rates. The adoption of a tender system could therefore lead to greater volatility in interest rates.[4] In particular, there is concern that at times when the market is unsettled it will be necessary to issue bonds at relatively high yields.

9.17 While there might be greater **short-run** volatility in interest rates, it is not clear to the Committee that there would be **greater long-run instability** in the

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3 Appendix 9.1 discusses the methods used to sell government securities in Australia.

4 This kind of argument is similar to the argument put forward for maintaining the present administered exchange rate regime. See Chapter 7.

TABLE 9.1: THE PUBLIC SECTOR DEFICIT ($m)[a][b]

	Commonwealth authorities[c]			*State and local authorities*[c]							
Year	*Cwlth budget sub-sector*	*Cwlth non-budget sub-sector*	*All Cwlth authorities*	*State budget sub-sector*	*State non-budget sub-sector*	*All state authorities*	*Local authorities*	*All state and local authorities*	*All public authorities*	*Total deficit as % GDP*	*Total deficit as % of change in financial institutions' assets*
1958–59	271	71	261	410	190	439	41	n.a.	372	3.0	35.9
1959–60	218	77	229	428	194	430	49	n.a.	324	2.4	20.0
1960–61	17	−2	−5	458	193	474	78	n.a.	152	1.0	17.1
1961–62	318	44	312	492	235	550	83	n.a.	517	3.5	41.2
1962–63	415	121	397	478	230	528	86	n.a.	532	3.3	34.4
1963–64	419	112	372	516	247	560	103	n.a.	544	3.0	21.7
1964–65	183	179	170	553	296	705	90	792	432	2.2	24.7
1965–66	255	201	248	591	337	780	119	897	576	2.8	37.3
1966–67	552	235	537	563	368	778	112	889	835	3.7	35.0
1967–68	642	232	578	610	362	810	112	921	862	3.5	33.8
1968–69	385	160	309	619	401	840	126	964	633	2.3	16.6
1969–70	191	286	200	676	430	917	153	1 062	582	1.9	13.8
1970–71	10	381	70	539	490	849	150	994	541	1.6	13.0
1971–72	134	346	109	642	551	952	165	1 113	640	1.7	8.6
1972–73	709	286	663	606	490	852	157	1 002	990	2.3	9.0
1973–74	293	523	365	687	628	986	217	1 207	823	1.6	10.0
1974–75	2 567	1 052	2 531	1 334	1 045	1 860	303	2 145	3 454	5.6	42.2
1975–76[d]	3 585	620	3 545	1 012	1 112	1 514	331	1 827	4 000	5.5	32.3
1976–77[d]	2 740	614	3 046	1 331	1 239	2 045	261	2 290	4 025	4.8	29.6
1977–78	3 333	642	3 882	1 500	1 469	2 547	338	2 874	5 450	6.0	48.5
1978–79	3 478	237	3 646	1 325	1 599	2 649	403[e]	3 038	5 537	5.4	32.4
1979–80	2 034	527	2 450	1 216[e]	2 033[e]	2 990[e]	449[e]	3 428[e]	4 558	4.0	n.a.
1980–81	1 127[e]	523[e]	1 471[e]	1 074[f]	2 530[f]	3 286[f]	n.a.	3 705[f]	4 179[e]	3.2[e]	n.a.

(a) Excludes public financial enterprises.
(b) There are significant advances between sub-sectors. These are netted out at higher levels of aggregation.
(c) Northern Territory included in Commonwealth budget sub-sector prior to 1 July 1978, thence in State budget sub-sector.
(d) The deficits for 1975–76 and 1976–77 are affected by the payment by the Commonwealth to the States in 1975–76 of $216 million relating to hospitals, which otherwise would have been paid in 1976–77.
(e) Preliminary.
(f) Budget estimate.

Sources:
The Treasury, *Treasury Information Bulletin, Supplements and Budget Papers*; Australian Bureau of Statistics, *Government Financial Estimates*, Catalogue No. 5501.0.

market place than under the present tap system. An 'administered' tap system creates more uncertainty about the actions and intentions of the authorities and over a period it can lead to sharper interest rate changes.

9.18 It may be asked why the benefits of a tender system cannot be achieved with a more flexible tap system. While this is conceptually possible, it would require an ability by the authorities to determine and a willingness to match market rates which may be difficult to achieve in practice.

9.19 It is for these reasons that the Committee prefers a system where the Government determines how much it wants to borrow and the interest rate is clearly determined by the market[5] — the tender system is obviously such a system.

9.20 The Committee accordingly ***recommends*** that **the authorities should follow a market-oriented approach in the sale of government securities: pursuant to this policy they should adopt a tender system as the preferred system for the issue of securities (other than savings bonds).**

9.21 To the extent that the authorities wished to ensure that, under such a system, offered amounts were always bid for in full, some form of underwriting commitment might need to be arranged.

9.22 In recommending adoption of a tender system for new issues of government securities the Committee does not seek to **preclude** the authorities from issuing bonds through tap systems or any other technique appropriate to the conditions prevailing from time to time. If a tender system were the only method used to sell bonds there might be difficulties in arranging for continued direct subscriptions by non-tenderers. The Committee would expect non-tenderers to meet their requirements from the authorised dealers, stockbrokers or other participants in the market. Even so, a tap system may help to achieve a wider spread of sales among investors than a tender system. For that reason, the authorities may not wish to shift exclusively to a tender system from the start.

9.23 If both tap and tender methods were used, it would be important to a well-functioning, well-informed tender system that the relevant authorities publish regularly meaningful detail on new issues outside of the tender.

9.24 More generally, the market's confidence in and ability to price government securities would be facilitated by the provision of a greater degree of information by government authorities. The Committee considers that the market in government securities would be assisted if all public bodies provided meaningful information in respect of their total activities in the securities markets.[6]

C. SECONDARY MARKET

9.25 The operations of long-term investors in the secondary market for government securities are mainly affected by the shape of the yield curve,

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5 The authorities can of course respond to market pressures in other ways than through the interest rate, e.g. they can shorten the maturity structure, or issue variable rate securities. The important point to be stressed is that it would be inappropriate to abandon the essential discipline of funding the borrowing requirement from the market; recourse to Reserve Bank finance should be avoided, other than for a temporary period.

6 The general issue of information gaps is taken up in a broader context in Chapter 44.

expectations about changes in that yield curve, and the availability of new issue stock relative to the desired size of their portfolio of government securities.

9.26 The Reserve Bank operates in the secondary market largely through stockbrokers and the authorised dealers. Brokers and dealers operate in the secondary market, partly as intermediaries between buyers and sellers and partly as principals. When selling from their portfolio they meet the net demands of investors for additional securities not available through either the tap or the tender — this is particularly the case with investors looking for short securities, such as Treasury notes with less than three months to maturity.

9.27 The depth of the secondary market in government securities is not uniform across the maturity spectrum. The market in shorter dated securities is the stronger for several reasons:

- The risk of capital losses on longer dated securities may be unacceptably high in an unsettled interest rate environment. The authorities have responded to this by issuing, in recent years, a relatively large volume of short-dated securities.
- Institutions which hold a significant volume of government securities for liquidity purposes naturally prefer short-dated securities.
- The authorised dealers are restricted to holding the bulk of their assets in the form of government securities with less than five years to maturity.
- Many life offices and superannuation funds value their securities at cost for purposes of the 30/20 rule. A loss in value upon sale for this purpose inhibits trading in securities.

9.28 There are many benefits to be gained from having an active secondary market:

- investors can meet demands for cash by selling their holdings to other investors with cash in excess of immediate needs; this enhances the overall financial stability of the system;
- the increased liquidity of the securities adds to their attractiveness and this may permit lower yields and longer maturities to be issued;
- a sound secondary market facilitates open market operations by the monetary authorities;
- information on the current state of the market is passed back to the issuing body.

9.29 Market making is an integral part of an active secondary market. This role could be filled by the Reserve Bank or by private sector intermediaries such as the authorised dealers, which may or may not have special support from the Reserve Bank.

9.30 For reasons discussed elsewhere,[7] the Committee believes it would be inappropriate for the Reserve Bank to stand directly in the market across the maturity spectrum at all times. The Committee sees it as appropriate for the Reserve Bank to be generally more willing to buy short-dated government bonds (albeit at times at a discount on market) than it has been in the past, but this is in its role of providing adequate liquidity rather than in a role of market making.

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7 See Chapter 5.

9.31 In the Australian context, the authorised dealers represent the major participants in the secondary market in government securities. To fulfill their market-making role requires them to hold stocks of government securities and they therefore constitute a significant market for securities in their own right. At mid 1980 they held around $1300 million in Commonwealth securities, accounting for around 7% of the private sector's total holdings.

9.32 The Committee's reasons for preferring a market-making function through private sector institutions rather than through the Reserve Bank can be summarised as follows:

- The continuous presence in the market of the Reserve Bank as a market maker would inhibit the proper and healthy development of that market.
- It is sensible commercial practice to interpose a wholesaling intermediary group between the Reserve Bank and essentially retail financial institutions; the alternative would be a duplication within the Bank of a retail trading and market-making function which already exists in private financial institutions.
- The existing authorised dealers, in addition to being market makers, also have an ancillary role in providing a safe avenue for the investment of substantial overnight and short-term funds; although this would no longer necessarily be a unique facility if the Committee's proposals for deregulation of the banks (specifically the removal of all controls on bank deposits, including the thirty-day limitation) were adopted, advantages would flow from the existence of a healthy and vigorous competitor for the banks in this area.
- The expertise and commercial viability of those financial institutions making the market in government securities is developed and enhanced by specialisation.

9.33 The Committee considers that there should be a role in the future for specialist market makers in government securities, i.e. intermediaries generally willing to make competitive bids for parcels of government securities, acting as principals at risk.

9.34 The authorised dealers were originally accorded a special relationship with the Reserve Bank as part of a deliberate policy to foster the development of a market in government securities. To ensure further development of that market, the Committee accepts that for the time being at least, specialised government security dealers should continue to be accorded some special privileges and that the benefits flowing therefrom outweigh any disadvantages arising from such factors as competitive neutrality.

9.35 However, in the opinion of the Committee, the need for the Reserve Bank to provide such privileges in perpetuity is far from clear. Furthermore, their existence may inhibit the development of more efficient alternatives. Hence it is important for the authorities to keep the general need and the specialised form of the privileges under close review. The long-term aim should be to make access to any continuing official facilities available to all intermediaries providing an active and substantial wholesale dealing function.[8]

8 The market in government securities could be further strengthened by allowing dealers to short-sell securities. This is a common practice overseas and is particularly significant in the USA and UK. The general question of short-selling is dealt with in Chapter 21. It is noted that the government securities market is particularly suited to short-selling because of its relative depth. The Committee recognises, however, that some technical problems would need to be overcome first, e.g. the dealers might need a facility for stock substitution to ensure delivery can be made. Prudential aspects are discussed in Chapter 19.

9.36 The Committee ***recommends*** that:

(a) Specialist market-making intermediaries in government securities should, for the time being, continue to be recognised and 'encouraged' by the Reserve Bank.

(b) The Reserve Bank should keep this policy under close review.

9.37 If it appears that the market-making function is not being performed satisfactorily, by either the authorised dealers or another private sector group, the Reserve Bank in its review will need to consider the costs and benefits of any additional privileges or concessions required to ensure that the private sector performs the market-making role. If necessary as a last resort, the Bank will need to assume this essential function itself.

D. AUTHORISED DEALERS

(a) Role

9.38 Given the Committee's desire to see a continuing role for private sector market makers in the marketing of government securities, it is important to examine the extent of official 'support' that might continue to be provided to those fulfilling this role. It is also necessary to consider the likely impact of changes recommended elsewhere in this Report.

9.39 The authorised dealers are currently officially 'encouraged' and advantaged by:

- preferential rights of direct dealing in government securities with the Reserve Bank;
- access to a line of credit from the central bank to enable the holding of government securities temporarily in excess of their capital and deposit liabilities;
- provision of daylight overdrafts and some other facilities (see paragraph 9.55);
- a prohibition against banks paying interest generally on deposits made for less than thirty days; and
- apparent restrictions on new entry.

9.40 The relative size of authorised dealers in the financial system has been reduced in recent years by a number of factors including:

- the unattractiveness, at times, of government security yields relative to private sector rates;
- an expansion in the range of short-term private sector securities — particularly bank bills — which are close substitutes in many respects for government securities;
- a diversification of the institutional base offering short-term money market facilities; competitors now include subsidiaries and affiliates of foreign banks, domestic banks and companies associated with the authorised dealers themselves.

9.41 The market-oriented approach to the government securities markets recommended by the Committee should strengthen the position of market makers: it should reflect directly in an increased attractiveness of government debt and indirectly it should work to broaden the range of intermediaries and direct lenders prepared to hold and trade in government securities.

9.42 At the same time the Committee is also recommending certain changes which would significantly weaken the relative position of authorised dealers — principally its proposals to remove the restriction on the minimum term of banks' interest bearing deposits and to remove all controls on bank interest rates. The entry of further banks could reinforce these factors.

9.43 Whether specialist market makers in government securities would be able to survive in the proposed environment without at least some preferential rights of access to the Reserve Bank is an issue on which the Committee is unable at present to make a confident judgment. The ability of the dealers to attract deposits, make a margin thereon, and a profit from trading will critically depend on the structure of interest rates which might emerge, and in particular on the differential between official and private sector rates, including interest on bank call deposits. Their specialised nature could give dealers a base from which to offer a package of interest returns, high liquidity and security which others may find difficult to match.

(b) Privileges for Authorised Dealers

9.44 The suggested changes to the structure of the official market require the Committee to consider whether, given their marketing responsibilites, the Reserve Bank should make available to authorised dealers:

- preferential access to direct dealing arrangements;
- line-of-credit arrangements; and
- other facilities supporting the market.

(i) Preferential Access

9.45 There is an advantage to the Reserve Bank in having a small number of specialist dealers in government securities which it can contact when it wishes to deal quickly in the market. Furthermore, if the authorities were taking steps to foster a strong secondary market in government securities it would not make sense to by-pass those dealers who are seeking actively to make markets.[9]

9.46 For these reasons, the Committee ***recommends*** that **the Reserve Bank should continue to deal primarily through the authorised dealers when dealing in the secondary market, subject to such authorised dealers as a group continuing to perform the principal role of market makers.**

9.47 In the environment envisaged by the Committee, dealers will probably find that active trading in securities is the only way to operate profitably. In any event such active trading is a necessary prerequisite if dealers are to perform their market-making role. It will therefore be necessary for the Reserve Bank to supervise this aspect of dealers' operations.

9.48 The Committee ***recommends*** that **the authorities should undertake regular reviews to ensure that individual authorised dealers are fulfilling their market-making function.**

9.49 The current exceptions to 'exclusive' dealing by the Reserve Bank with authorised dealers in the secondary market are transactions carried out through

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9 In this context it should be noted that the dealers, in turn, provide the Reserve Bank with statistical returns which provide detailed information about the composition of each dealer's assets and liabilities, transactions in securities, interest rates currently ruling and related details.

stockbrokers, and purchases of very short-dated bonds from banks. The latter exception does not have substantial implications for overall market making — but it does have implications for liquidity. The Committee does not propose any changes to present arrangements with banks (in respect of very short-dated bonds).

9.50 The Committee understands that only a relatively small number of brokers is active in the government securities market. It seems anomalous to allow all stockbrokers, some of whom rarely deal in the market, the same rights of dealing with the Reserve Bank as institutions which conform to strict regulations. The emphasis should be placed on demonstrated capacity to make markets in government securities.

9.51 The Committee therefore ***recommends*** that **stockbrokers who wish to retain their right to deal direct with the Reserve Bank should be subjected to a turnover review and an accreditation (for this purpose) similar to that recommended for the authorised dealers (see above).**

(ii) Lines of Credit

9.52 For an authorised dealer, acting as principal, to deal effectively in government securities he must be able to firmly quote for securities at all times. This will often require him to borrow the required funds in the market place later in the day. If he finds these funds are unavailable he will be faced with selling securities or borrowing from the Reserve Bank before the close of business.

9.53 A scheme under which the Reserve Bank would be generally a relatively more willing buyer of certain short-dated bonds is outlined in Chapter 5. Such an arrangement should increase the attractiveness of these securities for liquidity purposes.

9.54 This arrangement may not, however, be sufficient for dealers in government securities. They could well require a more flexible arrangement since their cash flows are relatively unpredictable and their deposit base volatile. On this basis, the authorised dealers may require — especially in the initial period after deregulation — an arrangement whereby funds can be obtained for short periods at times when the system as a whole is short of cash. An injection of cash into the system as a whole can only come from the Reserve Bank.

9.55 The Reserve Bank at present almost invariably imposes a minimum term of seven days on loans to authorised dealers.[10] Minimum-term requirements can add volatility to market rates. In the more market-attuned environment envisaged by the Committee, it is important that the dealers have a large measure of flexibility, so that interest rate volatility is not accentuated. The Committee, therefore, believes that the provision of overnight loans to authorised dealers should be more common. However, it recognises that there may be a continued need for some use of a mixed penalty of term and rate.

9.56 The Committee therefore ***recommends*** that:

(a) The Reserve Bank should continue to provide a line-of-credit facility to authorised dealers and should be more willing to depart from the application of the seven-day loan rule in appropriate circumstances — e.g. by the

10 This is the current situation, with only 'technical' exceptions such as when one of the major financial centres is closed due to a local holiday.

provision, at times, of an overnight facility. The interest rate should be at the discretion of the Bank.

(b) The facility should come under official review periodically and should be maintained only to the extent necessary to ensure a stable, competitive and efficient market in government securities.

9.57 The Committee favours a line-of-credit arrangement in preference to a system of repurchase or purchase agreements because:

- a minimum of documentation is involved and the transaction can be processed quickly;
- securities lodged can be 'switched' during the currency of the loan and hence are available for trading, thus enabling the dealer to perform his expected role.

9.58 It is stressed that a line of credit is envisaged as being available only against government securities.

(iii) Other Facilities

9.59 Apart from the provision of last resort loan facilities, the Reserve Bank also provides certain other facilities to the authorised dealers such as special clearing accounts (by means of which funds can be quickly transferred from one point in Australia to another), a safe custody system for dealers' holdings of Commonwealth Government securities (and the issue of certificates against securities so held), and daylight overdrafts in both money and securities. These facilities generally promote the operation of the market in Commonwealth Government securities although the need for such facilities and in particular the provision of daylight overdrafts should be kept under review. The Committee questions whether the facilities should continue to be provided free of charge. It believes costs should be recouped.

(c) Gearing Limits

9.60 The Committee accepts that it will continue to be appropriate to impose maximum gearing ratios on the portfolio of the authorised dealers. This aspect is discussed in Chapter 19.

(d) Asset Structure

9.61 The Committee has considered the possibility of allowing the authorised dealers to invest a still greater proportion of their assets in private sector paper. It has also considered whether fixed portfolio constraints are the most appropriate form of control, or whether a different approach, such as a required level of turnover, is to be preferred.

9.62 The Committee considers that any significant reduction in the required holdings of government securities would detract from the authorised dealers' primary role as specialists in the marketing of government securities; this function provides the basic justification for the special arrangements with the Reserve Bank. It is, of course, open to any dealer to operate with a smaller holding of government securities without the benefit of special association with the Reserve Bank.

9.63 Accordingly, the Committee ***recommends*** that **authorised dealers should be required to invest at least 70% of their portfolios in Commonwealth securities with terms to maturity of up to five years.**

9.64 However, the Committee considers that a greater degree of flexibility in determining the composition of the remaining 30% would allow the dealers to

meet more effectively the increased competition from a deregulated banking system. The Committee does not propose any basic change in the class of assets which are eligible for inclusion in the remaining 30% of the portfolio. It does, however, suggest that the dealers be free to determine the mix between public authority and bank paper within the 30%.[11] The present 'other' assets tranche of 2.5% is envisaged as still being within the 30%.[12]

9.65 The Committee ***recommends*** that **authorised dealers should be permitted to hold up to 30% of their portfolios in securities of approved major public authorities, bank certificates of deposit and bank bills (all with maturities of up to five years)[13] but the relative proportions held within the 30% tranche should be left to their discretion.**

(e) Admission to Authorised Dealer Status

9.66 The number of authorised dealers has remained at nine since 1960. It is worth recording that larger overseas markets do not have a proportionately greater number of active dealers in government securities. It is noted that the Australian market also supports several brokers and a portion of the business of some unofficial dealers.

9.67 The Committee is not aware of any approaches to the Reserve Bank, in the period since 1960, by organisations wishing to become authorised dealers. Profits and/or losses have reflected the volatility of interest rates, especially during the last seven years. As with banking status, the Committee suspects that the balance of burdens and benefits has been viewed by outside bodies as being relatively unattractive. Nevertheless, the Committee suggests that (subject to paragraph 9.75 below) it would be appropriate for the Reserve Bank to recognise for dealership any organisation with the capacity to appropriately undertake substantial dealings in government securities.

9.68 There are currently limitations on the ownership of authorised dealers by Australian banks and non-residents. In no case does a local bank have a direct equity interest and indirect interests may not exceed 12.5% of the shareholding of an authorised dealer. The maximum non-resident equity interest is 45%. The Reserve Bank scrutinises proposed changes in ownership, and looks for dispersion.

9.69 The present policy of restricting bank ownership of licensed dealers raises important issues of principle for the Committee. In so far as it represents a functional restriction on banks — but not on other financial intermediaries — it may not be consistent with competitive neutrality. Moreover, the banks are collectively the major holders of readily tradeable government securities and there is a case for the authorities to encourage them to participate actively in the making of the secondary market.

9.70 Against this background, the Committee has looked very critically at justifications for the present policy.

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11 Obligations of AIDC (with maturity up to five years) are presently permitted within the 30% of gearing limit constraint to a maximum of 5% of gearing limit. In Chapter 29 the Committee recommends the abolition of this privilege of the AIDC.

12 See Interim Report, paragraph 12.23.

13 Within that limit of 30%, they should be permitted to hold up to 2.5% of gearing limits in public sector and other securities with more than five years to maturity and 'other' money market assets such as non-bank commercial bills.

9.71 The rationale for restricting bank ownership seems partly related to general concerns about the concentration of economic power. However, as explained in Chapter 32, the Committee does not consider it useful to view issues of concentration in terms of the dominance of particular **nominal groups** (such as banks). While it accepts that it would be undesirable for **individual** financial corporations (banks or non-banks) to become excessively dominant in the financial system, such market power (measured simply in terms of relative balance sheet size) is not likely to be significantly affected by the separation in ownership between banks and authorised dealers: the dealers are a relatively small group, particularly if their liabilities to banks are excluded. Moreover, it may be possible for concerns about concentration of power to be resolved in ways other than outright prohibitions on ownership.

9.72 The argument has also been put that, if banks were closely linked to authorised dealers, they might thereby obtain more direct access to liquidity support from the central bank. These concerns are given greater point by the fact that banks are unique (among private intermediaries) in that they can create paper (bank bills) eligible for authorised dealers to hold (within the 30% tranche). However, it must be remembered that central bank liquidity support facilities are (and should continue to be) available only on the security of government paper and on terms generally discouraging to their abuse. Moreover, given competition between dealers, any enhanced access by an owning or associated bank would be of marginal significance. In any event, it is difficult to see why any advantages (e.g. in improved liquidity management) from an association with an authorised dealer should not be available equally to a bank as to any other intermediary.

9.73 A more substantive justification for excluding banks from ownership of dealers is that banks are both major customers and major competitors of the dealers and also issue paper that is in direct and close competition with short-dated government paper. A policy of keeping the banks and the dealers at 'arms length' from each other may promote a more vigorous and durable competitive environment (e.g. in the wholesale market for safe deposits) and minimise the scope for conflicts of interest. The Committee recommends in Chapters 4 and 19 that the balance sheets of banks and their subsidiaries (or major affiliates) be consolidated for purposes of meeting both prudential and monetary policy obligations. Applied rigorously, this may impose a marked constraint on the incentive for substantial ownership linkages between banks and authorised dealer companies.

9.74 On balance, there are strong arguments **in principle** for allowing banks maximum functional freedom, and in the longer run, the Committee would not favour any restrictions. However, it is inclined to accept a continuation of present policy restricting bank ownership of dealers, **during the initial stages of deregulation**, when major structural changes may be under way.

9.75 The Committee therefore ***recommends*** that **the policy of discouraging banks from holding, directly or indirectly, ownership interests in authorised dealer companies should be kept under close review to ensure it remains appropriate in a changing financial environment. Ultimately there may be no need for a formal restriction but initially the Committee believes that a restriction can be justified.**

9.76 Any limit placed on foreign ownership should, of course, reflect government policy on foreign investment.

9.77 The Committee stresses the need for a flexible approach to the ownership of authorised dealers. In the period ahead some additional organisations may seek authorisation as dealers, while in the case of existing dealers there may be a desire for corporate reconstruction, with shareholdings perhaps being consolidated. A flexible approach to ownership on the part of the authorities would assist such changes although it would, of course, be important at the same time to preserve a competitive market.

E. PAYMENT OF BROKERAGE

9.78 The Reserve Bank currently pays brokerage on transactions conducted on the Stock Exchange and when brokers are buying through the tap on behalf of clients. No brokerage is paid on transactions off the Exchange. Nor is brokerage paid to authorised dealers.

9.79 The Committee does not object to the payment of brokerage by the Reserve Bank on transactions conducted by it through a broker on the Exchange, but considers that purchasers from the tap, be they dealers, brokers or others, should be treated equally. The Committee leaves it to the authorities to devise appropriate arrangements which, while facilitating the sale of securities, would be consistent with neutrality and equity.

APPENDIX 9.1

MARKETING OF COMMONWEALTH SECURITIES IN AUSTRALIA

1 This Appendix briefly surveys the systems used to sell government securities in Australia.

The Issue of Treasury Notes by Tender

2 The Treasurer announced details of the tender system of issuing Treasury notes on 9 December 1979. This system replaced the previous tap system of issuing notes at predetermined yields. Advantages of the new system were said by the Treasurer to be:

- the authorities would be able to influence more directly the amount of Treasury notes sold, and at the same time ensure that the price of the instrument was in tune with the market;
- the greater flexibility in the issue price would assist the process of smoothing out shorter term, including seasonal, liquidity swings.

3 The main features of the arrangements are:

- tenders are usually held on a weekly basis;
- announcement of the amount to be offered has been made on Fridays with bids to close on the following Wednesday at noon;
- take-up of settlement may be effected on any day over the following Thursday to Wednesday;
- allotment of tender bids is made in ascending order of yields; pro rata distribution is made at the highest yield necessary to issue the amount on offer. The amount offered may not be allotted if, for instance, yields are considered unacceptable;
- tenderers must be registered in advance with the Reserve Bank (to enable the Reserve Bank to verify their credentials);
- the minimum bid is $100 000 face value, and above that, bids are in multiples of $5000 face value;
- the Treasurer has retained the right to reject any bid;
- so far, only 91 and 182-day notes have been offered, and 182-day notes have not been offered at all tenders;
- settlement by authorised dealers and banks must be in same day funds; other bidders must pay by bank cheque;
- no brokerage or commission is paid in connection with the issue of Treasury notes;
- there is no underwriting of tenders by either private sector institutions or the Reserve Bank;
- if the Reserve Bank wishes to acquire new notes, the amount is announced at the time of the public announcement calling for tenders; this amount is additional to the amount offered publicly; the Reserve Bank acquires its notes at the weighted average yield of notes allotted; and
- following allotment, details (amount allotted, weighted average yield, range of yields accepted and proportion of bids accepted at highest successful yield bid) are published for each maturity.

TABLE 9A.1: TAP STOCKS AND AMOUNTS SOLD

Tap issue no.	*Date introduced*	*Date withdrawn*	*Maturity*	*Initial yield (approx.)*	*Indicated amount $m*	*Sales[a] $m*	*Reserve Bank and LCIR[b] subscriptions*
1	30.4.80	27.6.80	April 82	11.50	500	237	275
2	30.4.80	9.5.80	April 85	11.84	250	263	—
3	2.6.80	6.8.80	May 86	11.79	400	281	125
4	7.7.80	5.8.80	Nov. 82	11.57	500	293	218
5	7.7.80	10.12.80	June 90	11.80	250	59	125
6	21.8.80	6.2.81	Feb. 83	11.54	500	145	362
7	21.8.80	7.11.80	Nov. 84	11.71	500	12	140
8	14.11.80	21.11.80	May 82	12.45	300	224	81
9	26.11.80	6.3.81	Sept. 82	12.44	300	20	139
10	18.12.80	9.6.81	Dec. 87	12.64	150	77	10
11	9.2.81	8.5.81	May 83	13.10	400	253	20
12	9.3.81	9.7.81	July 84	13.10	400	47	80
13	11.5.81	25.9.81	April 83	13.10	500	383	120
14	10.6.81	(c)	May 88	13.10	150	53	10
15	10.7.81	(c)	June 84	13.60	500	75	120
16	29.9.81	(c)	June 83	14.50	300	—	—

(a) Excludes subscriptions by Reserve Bank of Australia and Loan Consolidation and Investment Reserve.
(b) Loan Consolidation and Investment Reserve.
(c) Still on offer at 30 Sept. 1981. Sales in period to 30 Sept. 1981.

The Tap Issue of Bonds

4 Details of the tap system of selling bonds were announced by the Treasurer on 13 April 1980. The system replaced periodic cash loans at predetermined yields held usually three or four times a year.

5 Under the tap arrangements, Commonwealth bonds are available in one or more maturities on a more or less continuous basis throughout the year. In his statement on 13 April 1980 the Treasurer outlined the following advantages that were expected to flow from the tap system:

- greater flexibility and scope for greater precision in the quantity of securities issued and the maturity spread;
- minimising the disadvantages, associated with the previous system of periodic cash loans, of speculation associated with 'good' and 'poor' loan results;
- avoiding the instability which has sometimes been generated in the past as a result of unusually large and very concentrated cash loan raisings;
- availability of new securities on a more or less continuous basis should be more satisfactory from the point of view of investors.

6 The major features of the arrangements are:

- details of each new stock are announced at the time of its introduction and normally include the amount of each stock to be issued, the coupon interest rate, its maturity, and the initial price and yield at which each stock will be offered. These details are determined by the Loan Council. Subsequently, prices and yields are made available by the Reserve Bank who manages the issue subject to certain consultative arrangements;
- subscriptions are subject to a minimum of $5000 and may be made in multiples of $1000 above that figure;
- settlement may be made in full on the day of application or on the following banking day;
- interest accrues from the date of settlement;

- the Reserve Bank continues to conduct open market operations including the offering of parcels of bonds from its own portfolio;
- the Treasurer reserves the right to close an issue at any time;
- the securities are listed on Australian stock exchanges;
- brokerage is paid on applications lodged at a Registry by a stockbroker and bearing his stamp; and
- details on the sales of individual tap stocks are made available on a regular basis, usually monthly.

7 Table 9A.1 presents details of tap stock sales, including amounts raised compared with 'targets' announced at the introduction of each stock.

The Issue of Australian Savings Bonds (ASBs)

8 Australian Savings Bonds are available through the Reserve Bank, banks, stockbrokers and official post offices. Applications must be made in amounts of $20 or multiples thereof, and there is a maximum holding of $150 000. ASBs are not listed on Australian stock exchanges. Some further details are set out in the Interim Report.

CHAPTER 10: CAPTIVE MARKET ARRANGEMENTS APPLYING TO GOVERNMENT AND SEMI-GOVERNMENT SECURITIES

A. INTRODUCTION

10.1 In the context of this chapter, the term 'captive market' is used to describe official regulations which require or induce private sector institutions to hold in their portfolio public securities in amounts larger than might ordinarily be the case. In some cases this is not the primary purpose of the regulation.

10.2 Areas of the Australian financial system which are often thought to be subject to captive market arrangements include:

- life insurance offices: 30/20 requirement
- superannuation funds: 30/20 requirement
- authorised dealers: 80/70 requirements
- trading banks: LGS requirement
- savings banks: 40/7.5 requirements
- designation of trustee securities status

10.3 The Committee needs to consider whether the basic objective of these various arrangements is being achieved and, if so, whether it is in the most effective manner. As will become clear, the Committee does not accept as a general principle that greater holdings of government securities should be a quid pro quo for 'benefits'.

10.4 Each so-called captivity provision may form only part of a broader set of policies or arrangements affecting the relevant group of institutions. The major types of captive measure are considered separately in this chapter. Some general considerations relating to captive markets are discussed in Chapter 4.

B. LIFE OFFICES AND SUPERANNUATION FUNDS: THE 30/20 RULE

(a) Background

10.5 The 30/20 rule provides for higher taxation of life offices and superannuation funds if they do not hold at least 30% of their assets (or increase in assets above a base) in the form of public securities, of which at least 20% must be in Commonwealth securities. The arrangement was introduced in 1961 with two stated aims:

- to arrest the decline in the take-up of government securities by life offices and superannuation funds; and
- to balance, to some extent, the then favourable tax treatment of life insurance/superannuation.

10.6 The decline in the take-up of government securities by life offices was quite marked in the late 1940s and during the 1950s.[1] Undoubtedly this represented a reaction to the large volume of Commonwealth paper issued during World War II. A less transitory influence, however, was the development of financial markets in Australia, including the introduction of new private sector financial instruments. Having available an expanding range of increasingly more attractive financial assets, life offices and superannuation funds diversified their portfolios away from government securities. The trend was encouraged by the failure of official interest rates to respond fully to changes in private sector rates, which resulted in the gap between them widening considerably during the 1950s.[2] With some increase in the flexibility in official interest rates, and a subsequent narrowing of the differential between private and public sector yields in recent years, public securities have become, to a degree, more competitive; notwithstanding this, support of the market for government securities has remained the primary reason put forward for the retention of the 30/20 rule.

10.7 While important at the time, the second original aim of the 30/20 rule — to offset tax bias — has also become much less relevant over the years, at least in respect of life offices. Changes made in the 1973–74 and 1974–75 Budgets have altered the taxation treatment of life offices in several respects:

- Following the 1973–74 Budget, life offices were made subject to tax at the full company rate rather than at the lower rates which had previously applied. This increased the rate on mutual income from 37.5% to the general company tax rate, then 47.5% (now 46%), in respect of the first $10 000 of taxable income, and from 42.5% to the general rate in respect of the remainder.
- The special deduction under section 115 was reduced from 3% of 'calculated liabilities' to 1% (a reduction of 1% was made in each of the 1973–74 and 1974–75 Budgets).
- The amount of dividends in respect of which a life office is entitled to a rebate under s.46 was reduced in the 1973–74 Budget by a portion of the deductions allowed for 'calculated liabilities' and expenses of general management.

10.8 Nevertheless, investors in 30/20 institutions continue to benefit from some tax concessions[3] and the 30/20 rule is still justified by some as a 'quid pro quo' for favourable tax treatment. As noted in Chapter 1, the Committee does not favour such 'balancing acts' because they tend to give rise to inefficiencies in financial markets and cloud a proper evaluation. It therefore considers that the 30/20 rule and the taxation levied on the institutions subject to it should be treated as separate questions. The taxation question is taken up in Chapter 15. This chapter looks at the issues relating to the 30/20 balance sheet requirement in isolation.

(b) Advantages Claimed for the 30/20 Rule

10.9 The main advantages claimed for the 30/20 rule are that it:

- reduces the cost of government borrowing;
- has important advantages for macroeconomic policy;

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1 In 1953, some 52% of life offices' assets were held in Commonwealth, local and semi-government securities; by 1960 the figure had fallen to 35%; in 1980 it was 30%.

2 The margin between the long-term Commonwealth bond rate and the weighted average rate on first mortgages in NSW widened from 1.21% in 1950 to 3.29% in 1960 — see Table 9.1 of the Interim Report for further details.

3 See discussion in Chapter 15.

- is the only way of ensuring a market for the securities of the smaller local and semi-government authorities; and
- serves a prudential function.

10.10 In this section an examination is made of each of these claims.

(i) Cost of Government Borrowing

10.11 It has been said that the 30/20 rule permits governments to pay lower interest rates and that this is economically justified because many government activities generate benefits which cannot be charged directly to, or which extend well beyond, the immediate consumers. The 30/20 rule is thus sometimes seen as a way of delivering a desirable subsidy to the consumers of public services.

10.12 Underlying this view is an assumption (among others) that if the 30/20 arrangements were dismantled, the Government would be forced to accept a **substantial and sustained** increase in official interest rates. This assumption relies in turn on statistical studies which suggest that a large increase in interest rates would be needed to achieve even a small increase in the demand for government bonds. The results of these studies undoubtedly, however, reflect the influence that present 30/20 arrangements have on the underlying demand for official paper. Captive requirements, in effect, segment the market for government paper, with the demand of the captive segment of the market being determined by the size of the captive institutions and the value of the designated ratio. In such a constrained environment, the captive institutions are not likely to increase their take-up of government securities significantly in response to an increase in interest rates. However, in a **free market** environment the same increase in the interest rate would almost certainly lead to a significantly larger take-up of government securities.[4]

10.13 There are other reasons for doubting whether the 30/20 rule is as effective in reducing government's cost of borrowing as is often claimed:

- It can be argued that the all-up cost of government borrowing is understated when only the interest cost is considered. To this must be added the benefit of tax concessions which certain captive institutions enjoy.
- While initially the 30/20 rule reduced the cost of government borrowing, there is doubt about its continuing effectiveness. Thus, in the Interim Report (paragraph 9.6) it was shown that the **differential** between public and private sector rates, although wider in Australia than some other countries free of captive arrangements, had narrowed somewhat since 1970. This could have arisen from a greater willingness to offer near to market rates on government securities, having regard for the large increase in the public sector borrowing requirement. In part, it may also have reflected certain tax changes since 1961 which have reduced the incentive to hold government securities in excess of the amount required under 30/20 rule.[5] Undoubtedly, however, important factors have been: the relative contraction in the size of the institutions to

4 Evidence in support of this view can be adduced from several places. In 1976 there was a very strong demand response to the introduction of a competitively priced Australian Savings Bond. Semi-government authorities have recently attracted large subscriptions to those debt issues bearing near to market rates of interest.

5 As a result, the premium on private sector securities required by a 30/20 investor to make them competitive with official assets has narrowed (on one estimate from about 2.5% to 0.7%).

which the 30/20 restriction applies,[6] and the large increase in the size of the public sector borrowing requirement. This has forced government to sell an increasing proportion of its paper to non-captive holders at rates closer to market.[7]

- The 30/20 rule has also been a force retarding the development of an active secondary market in some public securities; this reduces their appeal to investors and increases the yield demanded by them. In particular, the 30/20 rule requires that a minimum percentage of the captive institutions' assets must, **at all times**, be held in official securities (rather than, for example, an average calculated over the whole year). Because 30/20 institutions have the option to value their holdings at cost for purposes of the rule, they are discouraged from substantial trading in these securities during periods of rising interest rates.

10.14 In the light of the above discussion, the Committee cautions against assuming that the 30/20 arrangements have **markedly** reduced the overall government borrowing cost over the long term. Nevertheless, the Committee accepts that **some** reduction may have occurred and that it may have permitted governments to provide certain services a little more cheaply than might otherwise have been the case. However, the Committee questions whether this is the most cost-effective way of assisting consumers of public services, should that be the Government's aim. Specifically:

- the extent of the subsidy depends in a completely arbitrary fashion on the gap between the rate paid on government paper and the free market rate;
- the subsidy is not directed only to those projects and services which have relatively high externalities;
- the identities of those who lose (e.g. insurance policyholders) and those who gain (e.g. beneficiaries of government spending or of any reduction in taxation) cannot be precisely determined;
- there appears to be no reason on equity grounds why the cost of the subsidy should be borne specifically by one particular group — those investing in artificially low-yielding government debt; and
- an alternative, more certain and readily assessable method of carrying out the desired redistribution would be to subsidise public services explicitly through the Budget.[8]

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6 This statement ignores any offsetting advantages the captive institutions obtain from taxation concessions. As noted in paragraph 10.8, the Committee wishes to consider these questions separately. Table 3.1 of the Interim Report shows that the share of life offices in the total assets of all financial institutions fell from 13% in 1973 to 10% in 1978, while pension funds retained their share of 8% over the same period.

7 Life office holdings of local and semi-government securities fell from 9.2% of total holdings in 1970 to 8.0% in 1980 (Table 2.33 of the Interim Report updated). However, life office holdings of Commonwealth Government securities were 10.3% of the total in both 1970 and 1980 (Table 2.32 of the Interim Report updated).

8 See P. D. Groenewegen, 'Market Rates or Tax Exempt Rates on Semi-government Securities', paper presented to the Symposium on Interest Rates, Macquarie University, November 1980.

10.15 At times the 30/20 arrangement is seen as a way of keeping private sector interest rates lower than otherwise would be the case. It is difficult to justify the latter proposition because private sector rates will reflect the volume of funds competed away by government from the private sector. In this regard it does not seem all that important if the Government attracts funds by way of interest rates, tax concessions or a required holding.

(ii) Macroeconomic Policy and Stability of Interest Rates

10.16 It has been argued, from the viewpoint of macroeconomic policy, that the 30/20 rule reduces the uncertainties involved in funding the Budget by ensuring a **minimum** take-up of government paper from year to year, even when the climate is unfavourable. It is also claimed that it reduces the variability of official interest rates.

10.17 These claims can be disputed:

- Government would find it easier to place its securities and would have less need for 30/20 measures if, in addition to setting realistic interest rates, it maintained a range of financial instruments tailored to the needs of particular sections of the financial market, or allowed a shortening of the maturity of the debt structure when interest rate expectations were unfavourable. This shortening might not always be the preferred position of the authorities; but even under present arrangements, there is a tendency for the captive institutions to concentrate on paper with a short maturity when an increase in interest rates is expected. This is evident, for example, from the behaviour of life offices in the second half of the 1970s. See Table 10.1.

- Perverse interest rate expectations are likely to be less significant in an environment in which the interest rate is basically market-determined. In the present institutional framework interest rate expectations revolve importantly

TABLE 10.1: LIFE OFFICES – MATURITY STRUCTURE OF HOLDINGS OF GOVERNMENT SECURITIES (%)

Year ended 31 Dec.	*Treasury notes*	*Less than one year*	*One to two years*	*Two to five years*	*Five to ten years*	*Greater than ten years*
1965[a]	—	—	0.3	2.1	6.2	91.4
1966	—	—	0.7	0.9	14.7	83.6
1967	—	0.5	—	0.7	11.3	87.5
1968	—	—	0.6	0.8	7.5	91.0
1969	—	0.6	—	2.2	6.4	90.8
1970	—	—	—	2.7	5.1	92.2
1971[b]	—	—	—	1.3	4.5	93.2
1972[c]	0.2	0.3	0.3	2.4	7.6	89.2
1973	0.9	1.3	—	1.2	8.8	87.9
1974	1.5	0.1	6.8	3.4	11.5	82.9
1975[d]	0.4	1.8	1.7	7.4	22.2	66.4
1976	3.9	0.5	0.4	8.6	25.2	61.5
1977	—	1.5	0.3	6.0	33.5	58.7
1978	0.8	0.1	0.6	5.4	36.5	56.6
1979	3.1	3.1	3.6	7.6	32.1	50.5
1980	3.9	1.4	5.5	20.9	24.7	43.7

(a) Data for five life offices
(b) Data for seven life offices
(c) Data for eight life offices
(d) Data for nine life offices
Source: AFSI Survey

around views about likely future actions of the authorities and such expectations are often more volatile than those generated by a free market system.

10.18 It is agreed that the 30/20 rule may, in the very short run, widen the range of options in debt management; it may, for example, provide the Government with a **degree of** influence for a limited period over **both** the interest rates on government securities and the quantities taken up by the private sector; it might, for example, be able to avoid temporarily the full impact of private sector interest rate movements. The 30/20 rule may therefore contribute, **in the short term**, to the establishment of a smoother (less volatile) pattern of **official** interest rates.

10.19 On the other hand, the following points should be noted:

- Even with the aid of the 30/20 provision, any attempt to hold back official rates when rates elsewhere are rising reduces the possibilities for effective control of monetary aggregates.
- 30/20 type arrangements cannot, in the long run, insulate yields on government securities from influences arising in other financial markets. The 30/20 rule and similar forms of intervention serve at best only to slow the speed of adjustment of official rates to market forces.
- The market has become conditioned to variability in official interest rates and seems capable of adjusting without difficulty and fairly quickly to even greater variability. Indeed, it can be argued that a more market-oriented approach, once established, would result in fewer sharp and abrupt changes than has inevitably been the case in the past.
- To the extent that 30/20 measures temporarily insulate official rates from interest rate movements in the private sector, they can in other ways destabilise official interest rates. In Chapter 4, it is recommended that the authorities rely in the future principally on open market operations to influence monetary aggregates. The 30/20 rule contributes to the thinness of markets for some public securities; the holdings of captive institutions tend to be relatively unresponsive to interest rate changes and a **larger** change in government security yields is needed to achieve a given effect on monetary aggregates. As a result, the operation of monetary policy may induce sharper movements in official interest rates and create greater uncertainty than would be the case in a less constrained market. Abolition of the 30/20 rule would also encourage broader participation in secondary markets, allowing open market operations to impact more evenly across investors and across markets.
- Any greater stability of official rates in the short term, arising out of the 30/20 arrangements, may simply push adjustment processes into other areas, causing additional variability in non-official rates.

(iii) Local and Semi-government Securities

10.20 It has been suggested that the 30/20 rule provides a more certain market for local and semi-government securities, particularly small bodies with lesser borrowing capacity.

10.21 On the other hand, a number of smaller local and semi-government authorities have pointed out to the Committee that the 30/20 rule is not in fact providing their securities with an assured market. With the recent trend towards funding of authorities from the market rather than via the Commonwealth

Budget,[9] the amount of public authority debt of 30/20 status (i.e. eligible for the non-Commonwealth tranche) has greatly increased. In this situation it is generally the securities of larger authorities which are preferred because they are likely to be more vigorously marketed, have trustee status outside their home state and have better secondary markets. Authorities at the low end of the 'quality' spectrum in market terms cannot, under present Loan Council arrangements, offset this by offering higher yields on their securities and hence tend to be competed out of the 30/20 umbrella. It seems that the benefits derived from the 30/20 rule by the smaller local and semi-government authorities are diminishing and may now be rather limited.

10.22 The problems of marketing local and semi-government securities and the Committee's recommendations on this question are discussed in Chapter 12.

(iv) Prudential Function

10.23 It has been suggested that the 30/20 rule serves an important prudential role for life offices and superannuation funds. The Committee is not persuaded that this is so. Some factors relevant here are:

- While government securities are free of the bankruptcy risks commonly associated with private paper, they entail (in common with all fixed-interest securities) a capital value risk which 'crystallises' upon early realisation and which can be quite substantial for long-term assets.
- The 30/20 restriction does nothing to ensure appropriate matching of asset and liability structures; hence, when expectations of interest rate adjustments are strong, shifts into longer or shorter official securities (which may or may not be desirable) will occur regardless of this control.
- The major part of captive institutions' portfolios lies outside the 30/20 ratio thus creating a wide scope for imprudent practices to emerge. Indeed, it is possible that the 30/20 rule may encourage captive institutions to seek 'compensatory' high risk, high return assets (see paragraph 10.26).

10.24 It is not believed, therefore, that the Government's final decision on the 30/20 rule should be significantly influenced by any perceived prudential implications for life insurance and superannuation. The Committee's preferred approach to the prudential regulation of these intermediaries is outlined in Chapter 20.

(c) Efficiency Costs

10.25 In the Committee's view, therefore, the benefits of the 30/20 rule have been greatly overrated. Moreover, substantial costs are involved which must not be overlooked.

10.26 As mentioned above, some of these costs arise at the level of individual institutions; for example, the 30/20 rule prevents captive institutions from adopting the optimum composition of their portfolios. They are forced to hold more government paper at going interest rates than they would if they were free to determine their own investment portfolios. This means that, all other things equal,

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9 Between 1969–70 and 1979–80 the deficit of state and local authorities increased by 223% to $3428m. To meet this financing requirement, net advances from the Commonwealth rose 85% while borrowing by these bodies under the Loan Council rose by 235%. Borrowings by Commonwealth authorities outside the Budget rose by 88% over the same period. Further details are shown in Table 9.1.

they are obtaining a return on their portfolio which is lower than that which they would have obtained in an unconstrained situation — a factor which has further important ramifications. For example, the captive institutions may alter the composition of the remainder of the portfolio by moving into riskier but higher yielding assets in order to compensate for the lower return. Whatever their reaction, it is likely that the resulting portfolio composition will involve a less appropriate risk/return profile than the one which would arise in an unconstrained situation.

10.27 More generally, as already noted, the capacity of 30/20 institutions to offer competitive services to their customers is reduced. Consequently the competitive neutrality and efficiency of the financial system is disturbed. (A parallel can be drawn here between these costs and those generated by lending controls and required liquidity ratios — see Chapter 4.)

10.28 When examining the so-called benefits of the 30/20 rule earlier, the Committee also drew attention to some of its by-product distortions — such as its effects on the development of a secondary market in government paper and the arbitrary distribution of costs and benefits.

10.29 Finally there are the obvious costs of administration and compliance which must be 'weighed-in' to any overall cost benefit evaluation.

10.30 Some, while recognising at least some of the costs mentioned with regard to the present operation of 30/20, suggest the appropriate course is to extend a smaller government security requirement (e.g. 20/10) to a wider range of institutions. They see this as preferable to the abolition of the 30/20 rule.

10.31 In support of this position, it is argued that:

- The implicit cost burden imposed by the 30/20 requirement could be spread more equitably over a wider range of institutions — and to that extent would, at least for a time, reduce its effect on the relative competitive position of different financial institutions.
- Since the requirement for individual captive institutions would be lower under this proposal, it would 'permit' them to hold a quantum of government securities closer to that which they might hold at prevailing yields in an unconstrained situation; this would interfere less with the workings of secondary markets in government paper.
- The arrangements would still provide an assured take-up of government paper, even in periods of great economic uncertainty.

10.32 The Committee points out that, in its view, such a proposal does not overcome all the basic deficiencies of the present system. Rather, it spreads their impact over a wider area of the financial system. Many of the costs referred to earlier — in particular, the effects on the competitive balance between captive and 'non-captive' institutions, on the portfolio investment process and on the incentive to trade in government securities — would inevitably recur at times, although they would differ in form.

10.33 In addition, it should be noted that any extension of captive market arrangements would be arbitrary in a number of important respects — in particular the choice of the institutions to be subject to the control and the magnitude of the ratio. There would also be the usual administrative complexities to overcome.

(d) Conclusions and Recommendations

10.34 The Committee in no way questions the right of any government to appropriately subsidise the cost of public goods and services. However, it seriously doubts the equity, the economic logic and the efficiency of pursuing this objective through the current 30/20 rule or any similar arrangement which, in effect, substitutes forced lending to the Government for more explicit funding by taxes or borrowing at market rates. In particular, with regard to the 30/20 rule in its present form:

- there is uncertainty about its degree of effectiveness;
- it involves a largely arbitrary distribution of costs and benefits; and
- significant damage is caused to the efficiency of the financial system.

10.35 The Committee does not believe that a 30/20 or like arrangement, possibly covering an expanded range of institutions, is necessary or appropriate either for macroeconomic stability or for prudential purposes. In the opinion of the Committee the best way to ensure a continued take-up of government debt is to make the return on, and the range of, government securities more responsive to market preferences. It accepts that a consequence of removal of the rule would be a need to market government securities more vigorously and that this could involve, at least initially, higher yields on government securities, although not to the extent often assumed.

10.36 The Committee would stress that its recommendations in this area — as in so many other areas — presume a strong commitment by government to interest rate flexibility. If the 30/20 requirement were removed without acceptance of a reasonably market-oriented approach to the sale of government securities, there might be a tendency for previously captive institutions to reduce their holdings of government securities.

10.37 Of course, any potential or resultant increase in interest costs needs to be considered in the light of the increased scope for modification to related tax concessions as well as the broader enhancement of the operation of the financial system.

10.38 The Committee therefore ***recommends*** that **the Government should abolish the 30/20 requirement and rely on market-directed initiatives to appropriately fund its borrowing requirements.**

10.39 Recommendations are made elsewhere in the Report which will have the effect of facilitating the sale of various types of government securities (see Chapters 5, 9, 11 and 12). These would tend to cushion some of the effects of removal of the 30/20 requirement on the bond market.

(e) Timing

10.40 As emphasised above, interest rate flexibility (which is not necessarily synonomous with significantly higher interest rates) is a *sine qua non* for the successful abolition of the 30/20 rule and the implementation of many of the Committee's other recommendations. Liberalisation in these areas would enhance the development of the secondary market in government securities; this is an important aspect of the Committee's recommendations. It is desirable therefore that the 30/20 rule be removed at an early stage of the deregulation process.

10.41 There remains the question whether the restrictions should be removed overnight or whether a phasing-in period — in which, for example, the ratio is steadily reduced towards zero — should be allowed. A gradual approach to the removal of the rule tends to be suggested by those who fear that its immediate removal would cause the captive institutions to promptly dispose of their substantial holdings of government securities on the market, thereby creating serious disruption and causing a short-run problem of debt placement for the Government, with potentially adverse consequences for monetary policy.

10.42 Against this, it can be argued that the captive institutions will always desire some government securities in their portfolios in order to properly balance their liquidity and risk characteristics. In addition, official interest rates have been increasing in recent years and may increase a little further after the removal of the restriction; thus many of the institutions may be deterred from selling because of the prospect of capital losses on their holdings. Moreover, the higher interest rates and more active secondary markets are likely to attract additional investors to hold these bonds.

10.43 Perhaps the most substantial argument against making the change gradual concerns the potential impact on the demand for new government debt. Once it became clear, by announcement or otherwise, that the restrictions were to be removed, expectations of increases in official interest rates (relative to other interest rates) would be generated. While these expectations persist, governments could have greater difficulty in selling their paper. One possibility is that current interest rates may react to the expectations and rise quickly to the level they would have reached had the change occurred without a lag. In this case it is not clear what would be gained by a phasing-in of the change. It is even conceivable that in the climate of uncertainty created by drawing out the process of deregulation, interest rates could well overshoot the level ultimately required.

10.44 The Committee therefore ***recommends*** that **the Government should remove the 30/20 rule without a transition period.**

(f) Effect on Resource Allocation

10.45 Abolition of the 30/20 restriction will almost certainly have some implications for resource allocation. The actual outcome (and its duration) will depend on a number of factors — in particular, the impact on the structure of interest rates and its implication for the public sector borrowing requirement.

10.46 It should be made clear that in recommending abolition of the 30/20 requirement, the Committee is not aiming for any particular reallocation of funds. It is not expressing any view about the extent to which public sector services, such as education, health, transport and housing, warrant subsidisation to encourage their consumption; nor is it seeking to favour any particular sector such as natural resources. The Committee leaves it to governments to pursue particular allocational and distributional objectives through direct budgetary measures. The size of their budget outlays and the extent to which they are funded by taxation or borrowing are matters for their judgment. The Committee simply points to the advantages of allowing financial markets to allocate funds **on the basis of price**. This approach, in its view, is to be preferred on the grounds of cost effectiveness.

10.47 It is, however, incumbent on the Committee to indicate what it sees as the likely effect of the abolition of the 30/20 rule on the pattern of funds flows.

10.48 Assuming a market-oriented environment consistent with the

Committee's recommendations, the removal of the 30/20 rule will **of itself** (i.e. ignoring the impact of the Committee's other recommendations) tend to have the following effects:

- It could narrow to some degree the differential between government security yields and private security yields.
- To the extent that public investment levels are at least partly sensitive to interest costs, the overall public sector borrowing requirement would fall and there would be some reallocation of real capital resources from the public to the private sector.
- In the longer term, institutions such as life offices and superannuation funds might gain a larger share of the savings market and this could lead to further changes in funds flows. At present these institutions tend to invest to a greater extent than others in equities and, to a reducing extent, business loans. It is unclear whether they would maintain such concentration in the event of any substantial changes in government bond yields and housing interest rates and how quickly any adjustment would be made. The Committee would expect any redeployment of funds to be gradual.

10.49 It is not, of course, sufficient to look at the resource allocation effects of removal of the 30/20 rule in isolation. In the context of the Committee's Report as a whole, perhaps more relevant is the impact of a number of complementary changes. The general effect of the Committee's recommendations would be to eliminate or reduce official barriers to funds flows and enable markets to respond more effectively to demands for funds from various sectors.

10.50 In indicating the consequences of removing the 30/20 rule for the allocation of resources, the Committee has abstracted from other possible government actions to assist the public sector. If, for example, after considering the Committee's recommendations, the Government considered any of the reallocation effects undesirable (e.g. on grounds that the market did not allow sufficiently for any special externalities associated with 'public' goods), then it would have other means available to it to influence the outcome. For example, the interest cost of projects which are judged to produce relatively large external benefits could be subsidised out of general revenue to an amount roughly proportional to those benefits. If the taxation system were broadly based and fairly neutral, this alternative approach would avoid most of the costs inherent in the captive market arrangements (see Chapter 36).

C. AUTHORISED DEALERS

10.51 Authorised dealers in the short-term money markets are required to hold at least 80% of their portfolio limits in official securities and 70% in Commonwealth securities. Several factors distinguish this 'captive' market from that formed by the 30/20 rule:

- Essentially, it is an agreement between each dealer and the Reserve Bank whereby, as long as he abides by his Memorandum of Agreement and maintains a particular portfolio, the dealer has access to a range of facilities provided by the Reserve Bank, including lender of last resort loans and preferred access to dealing privileges.
- The nature of authorised dealers' business requires them to hold large

amounts of government securities since that enhances their ability to make a market in these securities.

10.52 It is doubtful, therefore, that the portfolio requirements applying to dealers can be properly called a captive arrangement and that the concerns expressed earlier about the 30/20 regulation apply. Requirements for authorised dealers are examined in greater detail in Chapter 9.

D. BANKS

10.53 Savings banks are at present generally[10] subject to three distinct balance sheet ratios:

- the 100% ratio, restricting the investment of savings bank deposits to a limited range of prescribed assets (in practice this has meant principally public sector investments and housing loans);
- the 40% ratio, requiring that 40% be invested in certain liquid and public securities; and
- the 7.5% ratio, specifying that 7.5% of deposits must be held on deposit with the Reserve Bank or in Treasury notes.

10.54 These ratios have been designed for a number of purposes. They initially were imposed on private savings banks to minimise changes in financial flows as they competed with government savings banks. Beyond that, as well as seeking to promote a take-up of government debt, they have been seen as a prudential discipline, as an instrument of housing policy and in part as a fulcrum for monetary policy. The prudential and housing implications are discussed in Chapters 19 and 37. The monetary policy aspect is discussed in Chapter 4.

10.55 Here the Committee focuses on the captive market aspects, i.e. their capacity to provide an assured market for government securities generally and local and semi-government securities in particular.

10.56 The Committee recognises that the smaller local and semi-government authorities have in the past been especially dependent on the savings banks for support. Their dependence on the savings banks has now been reduced to some extent but, in any case, the Committee does not see captive market provisions as an appropriate means of meeting their funding requirement.

10.57 It should be recognised that many local and semi-government bodies have long-standing banking associations with savings banks and that normal commercial considerations could reasonably be expected to result in continued significant borrowing being available to them from such organisations. Indeed, any reluctance in the past to lend to local and semi-government bodies has been importantly associated with official efforts to maintain interest rates below that which commercial considerations would have dictated.

10.58 For reasons similar to those cited in the discussion of the 30/20 ratio, particularly the arbitrary and discriminatory incidence of the subsidy, its longer term relative ineffectiveness, and its impact on the competitive neutrality and

10 The Trustee Savings Banks are not at present fully subject to the 100% and 7.5% requirements. Proposals in Chapters 4 and 19 would have them subject to requirements fully consistent with those applying to other savings banks.

efficiency of financial intermediation, the Committee favours allowing savings banks greater flexibility in their investment policies.

10.59 The trading bank LGS ratio is seen by the authorities as providing a basic fulcrum for monetary policy but it also involves a captive holding of government securities. The Committee feels that bank holdings of government paper should be determined on the basis of interest rate offered rather than any formal requirement (other than prudential). The more substantial consideration — i.e. its role as a fulcrum for monetary policy — is discussed in Chapter 4, where it is concluded that the need to include government securities within the required reserve ratio would disappear if the authorities adopt, as proposed by the Committee, a more market-oriented approach to monetary policy.

10.60 The Committee therefore ***recommends*** that **savings and trading banks should not be subject to any formal portfolio requirements aimed at supporting the market for public securities.**

E. TRUSTEE STATUS

10.61 The captive markets examined so far have all originated from regulations which specify minimum holdings of official assets. The granting of trustee status to a security as a reflection of prudential considerations (which is discussed in more detail in Chapter 21) can have advantages for the financial system, and the Committee sees no objection to the continuation of this practice. However, the granting of such status can create a special preferential market for the security. When the status reflects considerations other than prudential ones, inappropriate distortions of funds flows can result.

10.62 The Committee noted in its Interim Report the uneven approach of different states in according trustee status to marketable securities. (See Interim Report, paragraph 12.28.) Frequently trustee status is granted as a way of promoting the sale of securities of particular local and semi-government authorities rather than as a measure of the security of the asset. One consequence is that securities which may otherwise have very similar risk and return characteristics become very different to investors in different states. This works against the integration of borrowers and lenders in different regions and may produce significant variations in the cost of capital faced by borrowers and distortions in the process of resource allocation.

10.63 The Committee ***recommends*** that **the Commonwealth and States should seek to ensure that arrangements for granting trustee status are on a consistent and uniform basis.**

CHAPTER 11: RANGE OF GOVERNMENT SECURITIES

A. INTRODUCTION

11.1 It was suggested in Chapter 10 that the effects of the implementation of many of the Committee's recommendations, especially those on captive markets, could lead to some increase in the level of official interest rates relative to private sector rates. There could also be greater short-run variability in official rates.

11.2 It was also suggested that these effects would be minimised if the Government were to ensure that the range of financial instruments which it offered were better tailored to meet the needs of the market.

11.3 This chapter looks at a variety of government securities that might be relevant for the Australian environment. It also examines certain specific suggestions put to the Committee.

11.4 Commonwealth Government securities on issue include the following:

- *Treasury bills* — Internal Treasury bills are issued only to Commonwealth trust funds. Public bills are issued to the Reserve Bank as instruments used in residual financing, or for state 'lag-in-revenue' purposes. They carry a 1% p.a. yield and are not available to the public.
- *Treasury notes* — These are issued at a discount with periods to maturity of thirteen weeks and twenty-six weeks, and in the normal course have been rediscountable by the Reserve Bank at the holder's option on terms and conditions the Bank determines from time to time. As from 15 September 1981 they will only be discountable as to within 91 days to maturity. They are sold by tenders, usually held weekly. Treasury notes are not listed on Australian stock exchanges, but there is considerable trading in them in the money markets.
- *Commonwealth bonds* — These securities are generally issued on a more or less continuous basis through the tap system with maturities ranging from about fifteen months to about twenty years, although issues up to thirty-five years have been made. They are the securities most commonly used in open market operations by the Reserve Bank, although Treasury notes may also be used for the same purpose, particularly with regard to short-term liquidity management.
- *Australian Savings Bonds* — These are usually issued with a period to maturity of about seven years and are redeemable at face value at one month's notice (although a reduced interest rate may apply in certain circumstances on early redemption). Individual maximum holdings currently permitted amount to $150 000.

11.5 Table 11.1 shows securities of the Commonwealth and State Governments

TABLE 11.1: GOVERNMENT SECURITIES ON ISSUE 1978 to 1981 ($m)

Year ended 30 June	*1978*	*1979*	*1980*	*1981*
Treasury bills				
Internal	1 856	1 669	1 810	1 156
Public	1 500	2 000	2 500	1 900
Treasury notes	363	1 410	1 615	3 527
Commonwealth bonds	16 135	16 930	17 380	17 568
Australian Savings Bonds/				
Special Bonds	2 879	3 183	3 358	3 037
Other securities	555	639	723	795
Total repayment in Aust. currency	23 288	25 831	27 386	27 983

Source: 'Government Securities on Issue', *1980-81 Budget Paper No. 6.*

on issue at 30 June 1978 to 1981. Further details including statistics on issues by local and semi-government bodies are shown at Table 9.1 and in Chapter 2, Section C of the Interim Report.

11.6 Local and semi-government authorities issue public and private securities with maturities of four years to ten years or more. They are also increasingly borrowing in the money market using instruments such as bills of exchange and promissory notes, generally with a maturity of three or six months. Issues specifically related to these borrowings are discussed in Chapter 12.

B. SOME OPTIONS FOR CONSIDERATION

11.7 It is clear that in order to appropriately market government paper the authorities should not only be willing to offer market-related yields but also to react flexibly to market developments with regard to the range of securities offered. The range must keep pace with that offered by the private sector if government securities are to remain competitive.

(a) Treasury Notes with a Wider Maturity Range

11.8 It is clear to the Committee that a range of relatively short-dated securities should be available to private enterprises to enable them to prudently manage their liquidity.

11.9 New issues of Treasury notes are presently available through the tender with maturities of three months and six months, the three-month notes being in stronger demand. It has been suggested that there would be benefits in issuing notes with a wider range of maturities; suggestions have ranged from seven days to one year.

11.10 Under the present system and that which would eventuate if the recommendations in the Report were implemented, Treasury notes and short-dated bonds are likely to be the primary channel of access to official liquidity. It is important that such access be available on as wide and as convenient a basis as might be practicable. Notes with an initial maturity of **less than three months** — say one month — might assist in meeting this objective.

11.11 Because the volume of notes in the Reserve Bank's portfolio has increased significantly over recent years, the Bank is usually capable of providing the market with notes within the three-month maturity range. However, the Committee understands that it does so only to a limited degree.

11.12 The Committee accepts that substantial and regular sales of notes by the authorities from their portfolio could adversely affect the willingness of the private sector to participate in the Treasury note tender since there would be a greater element of uncertainty as to the total volume of short notes coming onto the market. However, sales of notes by the Reserve Bank from its portfolio could well be advantageous at times when the private sector finds itself with an unsatisfied demand for very short notes, and the Committee believes that such securities should be more readily available than has, at times at least, been the case in the past.

11.13 The Committee has no reasons for recommending against the issue of Treasury notes with maturities **beyond six months**. It believes, however, that there is unlikely to be a great demand for these notes since it is possible to purchase short bonds with more than six months to maturity in the market place. The major difference between these and a longer term Treasury note is the lack of as certain a rediscount facility. The demand for Notes beyond six months would therefore depend importantly on the liquidity of conventional bonds of the same maturity and any policy initiatives in the Treasury note area would need to be considered in conjunction with the recommendation (Chapter 5) for issuing some nominated bonds with a 'discounting facility'.

11.14 There appears to be only a limited role for a Treasury note with a maturity of **twelve months or more**. Notes are, to a large extent, held with a view to providing liquidity in the tax rundown and one-year notes maturing to coincide with tax payments would therefore have to be purchased during the previous year's tax rundown.

(b) Call Deposits with the Reserve Bank

11.15 It has been suggested that banks should be allowed to lodge interest-bearing deposits with the Reserve Bank[1] in addition to those arising from the 'required reserve ratio'. It has also been suggested that such a facility might be extended to other institutions. If one were to assume, as would seem to be realistic, that the rate offered on call deposits were to be below that offered on three-month Treasury notes, the facility could be expected to be used primarily as a depository for surplus overnight or very short-term funds.

11.16 While this possibility might warrant further exploration by the authorities, some reservations are recorded:

- an asset of this type is already available to investors in the form of call deposits with the authorised dealers;
- it could result in the Reserve Bank competing directly with money market dealers and could substantially lessen the ability of the dealers to make a market in government securities;
- the facility would tend to attract 'temporary' funds; to this extent the Reserve Bank would, in effect, be involved in running a money market operation; and
- if the facility were made attractive and yet restricted to particular institutions, its introduction could affect the competitive neutrality of the system.

11.17 A facility of this type is just one way in which the authorities as a whole would be able to borrow on a very short-term basis. Given a relatively active

1 Such a facility is currently available to savings banks but not to trading banks.

market in Treasury notes, including participation by the Reserve Bank, there seems to be little to be gained (from the point of view of the financial system as a whole) by the offer of a call deposit facility by the Reserve Bank.

11.18 In a different context, it has been suggested that the Reserve Bank issue its own short-term security. It is argued that this would help liquidity management and permit a clearer separation of the Government's debt management and monetary policy. As far as the security is concerned, many of the points made above would apply. The interrelationship between debt management and monetary policy is raised in Chapter 9.[2]

(c) Certificates of Tax Deposit

11.19 A certificate of tax deposit (CTD) is an instrument which records the receipt of a deposit which can be tendered to meet a tax liability.

11.20 CTDs were introduced in the United Kingdom in 1975. Initially subscriptions were low. Rates paid were subsequently set at a small margin over money market rates (to compensate for their non-marketability) and subscriptions now run to significant levels.

11.21 At one stage CTDs, in the form of Tax Anticipation Bills, were also available in the United States. They were issued at a discount to mature one week after the due date for payment of corporate tax, but were accepted at par value as of the tax payment date, thus giving the holder one week's 'extra' interest. The price of the instrument was bid up in secondary market transactions for this factor with a corresponding reduction in yields. No Tax Anticipation Bills have been issued since 1975.

11.22 Some have claimed that a similar CTD instrument in this country would encourage taxpayers to make particular provision for their tax payments and thereby contribute to an evening out of seasonal fluctuations in liquidity. The Committee believes that the underlying problems associated with seasonality would be reduced if the measures recommended in Chapter 6 were implemented. The introduction of a CTD is seen by some as a useful adjunct.

11.23 The government security used most frequently at present by the system as a whole to provide for tax payments is the Treasury note. Taxpayers do not necessarily acquire these themselves; most are in the hands of the banks and authorised dealers.

11.24 As the yields on Treasury notes have become much more closely attuned to the market since the introduction of the note tender, it is doubtful whether the introduction of a CTD would substantially expand the options open to taxpayers. Nevertheless, the possibilities may be worth exploring, together with other measures to ease seasonal fluctuations in liquidity (see Chapter 6). It is likely that the yield on CTDs would have to be above that on Treasury notes because the latter offer access to liquidity through the rediscount option — a feature which presumably is unlikely to be offered on a CTD.

11.25 The Committee leaves it to the Government to assess whether the benefits that may be obtained from the introduction of a certificate of tax deposit outweigh the higher yield that may be required on such an instrument.

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2 The question of funding the Reserve Bank is discussed in Chapter 2.

(d) Variable Rate Securities

11.26 Over the past two decades, the trend of generally rising interest rates has induced many institutions to lend to the private sector on terms which can be varied during the life of the loan. Some financial institutions have offered similar facilities to investors.

11.27 Governments have, however, tended to offer only fixed interest rate securities.[3] As a result, investors in other government securities have chosen to invest in the shorter maturities.[4] The shortening in maturity pattern may at times present refinancing problems for the Government, but it is generally cheaper and more appropriate, of course, when inflation and nominal interest rates are expected to fall.

11.28 The issue of a variable rate security would be a more direct way of satisfying the demands of those investors seeking some protection from the effects of inflation and rising interest rates.

11.29 A variable rate security would match facilities currently offered by private sector borrowers and offer many of the characteristics of 'inflation-linked' securities. (The issues with regard to the latter are discussed in the next section.)

11.30 To the extent that it filled a market need, a variable rate security would facilitate the funding of government debt, especially at times of adverse interest rate expectations. At the same time, the Government would be protected against a subsequent fall in interest rates.

11.31 An alternative way in which the Government may protect itself from being locked into borrowings at high rates of interest in an environment of falling rates would be by the introduction of a 'call' feature into its bond issues. This could allow the Government to redeem the security prior to maturity, albeit at a penalty. Such a feature is found in some overseas bond markets.

11.32 However, the investor, not having a corresponding call option, is placed at some disadvantage should rates rise. The Committee doubts that the characteristics of this particular security would be conducive to its marketing and it would not therefore facilitate debt management to the same degree as a variable rate security.

(e) Inflation-linked Securities

11.33 A relatively high level of inflation has been a feature of the economy for most of the past decade. While financial markets have adapted to some extent to inflation, it remains a major influence — a point which is discussed more fully in Chapter 43.

11.34 As noted in the previous section, arrangements which involve interest review dates enable loan terms to at least partially reflect inflation. However, variable rate securities fall short of fully protecting lenders (and borrowers) against unexpected changes in the rate of inflation. Many investors therefore see

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3 A partial exception has been the Australian Savings Bond, holders of which have been able to exercise the early redemption option when rates on old issues have become lower than those currently available.

4 The average maturity of non-official holdings of Commonwealth securities quoted on Australian stock exchanges fell from 10.6 years to 7.7 years over the period 1976 to 1980 (see *1980–81 Budget Paper No. 6*; also see Table 2.35 of the Interim Report, which includes Treasury bills and notes).

advantage in having a security the rate of return on which is formally linked to an index of inflation, since it eliminates an element of uncertainty with regard to their returns (in real but before tax terms).[5] By reducing the element of risk to the lender, it is possible that the real cost to the borrower is lowered.

11.35 Inflation-linked securities could take many forms. For instance, there might be a formal undertaking to adjust the capital value of financial assets for inflation on redemption or alternatively at more frequent intervals; the formal adjustment might be full or partial; threshold and/or ceiling levels might apply. The choice of the price index and the real rate of interest will be important.

11.36 An indexed security would in a sense compete with corporate shares and other equities in so far as these are held as a hedge against inflation. However, given the types of indexed securities envisaged by the Committee, equities would continue to offer a distinctive risk/return package. Taxation however, again becomes a major consideration.

11.37 The Committee accepts that in marketing terms there could be some advantage for the Government in offering indexed securities:

- it could assist control of the money supply and inflation by facilitating sales of government securities in periods of uncertainty;
- it could provide risk-averse household savers, unwilling to invest in equities, with some protection from loss of real capital (before tax), and generally increase the range of choice available to such investors and others;
- there would be less scope for arbitrary redistribution of wealth between borrowers and lenders as a consequence of inflation;
- the Government would avoid being seen to be 'predicting' continued high interest rates or inflation whenever it chose to nominate a rate for its long borrowings; and
- it would lessen the risk of the Government being locked into high interest rates and reduce the need to rely extensively on sales of short-dated government stock.

11.38 Conversely, it has been put that formal indexation of financial assets would be inappropriate because:

(i) The issue of indexed government securities would be an acknowledgment that inflation is to continue and might remove an incentive for the Government to control it — especially if there were a general weakening of the anti-inflation lobby in the community at large.

(ii) It would be difficult for private borrowers to compete with the Government's indexed bond, at least without significant increases in the cost of debt: depending on its form it could also have destabilising effects on corporate balance sheets.

(iii) The Government's debt servicing costs would be uncertain and probably higher than for conventional securities.

(iv) The experience of indexed securities in countries which have introduced them has not been impressive.

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5 The taxing of nominal interest returns and its effect on real returns is discussed in Chapters 17 and 43.

11.39 As far as **point (i)** is concerned the Committee points out that the issue of indexed claims could be a logical course for the Government irrespective of its view about inflation; such an asset would reduce uncertainty for both the borrower and the lender as the **real** cost of indexed government debt would be constant; by contrast the real cost of servicing fixed-interest debt declines if inflation rises and increases if it falls. In fact, the issue of long-term securities at high fixed nominal rates of interest may well be more likely to be seen as a government admission that inflation will remain high. Moreover, if the issue of an attractive security assisted in the control of the money supply it could help to 'calm' inflationary expectations. Finally, it should be noted that there is no reason the community as a whole should become more tolerant of inflation. If governments have borrowed on indexed terms, they will have a strong budgetary interest in containing inflation. To the extent that indexation spreads to the private sector and shifts costs from lenders to borrowers there could well be an increase in the strength of the lobbying against inflation; private sector borrowers tend to be more sensitive and vocal about interest costs. Experience over the past decade has shown how mute many individual investors have been even when their real returns (before and after tax) have been negative.

11.40 As to **point (ii)**, the purpose of the introduction of the indexed security is to offer a security which is attractive and fills a need. It is possible that at the time of introduction there might be some temporary disruption in the sources of funds of competing institutions, particularly those dependent upon the household market, but this could be minimised if:

- index linking were confined to long-term securities;
- the initial size were limited, and;
- the issue were put to tender to ensure the real (before tax) returns truly reflected market expectations.

A tender system is less suitable for securities which are sold to households, but it may be possible to issue some securities by tender to institutions and set the rate to be offered to households with regard to that established through the tender.

11.41 Private borrowers should be free to compete with the Government by issuing indexed debt, and it is important that there not be any government-induced barriers reducing the incentive or ability of private enterprises to follow this path.

11.42 There is no regulatory impediment to a private sector borrower issuing securities which carry a variable rate of interest set at a fixed margin, for example over the annual rate of increase in the consumer price index.[6] Such securities have been available in the Australian market in the past.

11.43 Under the present tax system, the full interest income on such securities is taxable in the lender's hands, and the borrower can claim full deductibility of interest payments. If the private sector were to issue securities in which the capital sum was indexed, consistency with present tax arrangements would require that an element of the capital return be subject to tax in the hands of the lender and a deductible expense to the borrower. Such an approach would involve solving some timing and 'lumping' issues. The more general question of whether, in fact, the

6 Commercial prudence may dictate that a ceiling be imposed on rates payable if the borrower (an intermediary) were unable to revise rates charged on the on-lending of funds. One would expect, however, a 'marrying' of the arrangements.

increment is, or should be, nominally a capital sum or not for taxation purposes is discussed in Chapter 17.

11.44 As to **point (iii)**: whether the Government's nominal **interest bill** would turn out to be higher or lower in the long term than on conventional securities is not clear. To the extent that lenders were willing to accept a lower real return because the uncertainty about the effects of unexpected inflation was removed (and the rate of inflation was accurately forecast by the Government when setting the rate on conventional securities), the proposal could result in lower average nominal interest rates on government paper over the long term.

11.45 The Committee accepts that there would be increased budgetary uncertainty with respect to nominal debt servicing obligations. It is not clear that there would be much change with respect to real servicing costs and, furthermore, it should be noted that the nominal cost of servicing government debt in future years has already become less certain due to the shortening in the average maturity. It might be said that implicit in this shortening has been a form of indexation.[7]

11.46 On **point (iv)**, the Committee considers that it is not appropriate to compare Australia with some countries which had an extremely high rate of inflation at the time of the introduction of indexed securities. More recent experience of indexed bonds, albeit on a limited scale, in countries with less extreme rates of inflation — such as in the UK — has shown that there can be considerable demand for indexed bonds.

11.47 On balance, the Committee can see advantages in the issue of indexed government securities. It recognises, however, that wider economic considerations are involved. Certainly the timing of any such issues must depend on economic, monetary and budgetary circumstances. It suggests that such a security be included among the Government's debt management policy instruments for possible use in appropriate circumstances.

11.48 In the light of the above discussion, the Committee ***recommends*** that **both 'variable rate' and 'inflation-linked' government securities should be viewed as ongoing policy options and should be introduced in appropriate market circumstances.**

11.49 As to the choice of an appropriate index, the Committee points to the benefit of a broadly based indicator of the general cost of living. That said, the Committee would leave the choice of an index to the Government in the knowledge that, to be successful, that choice would need to be acceptable to investors.

11.50 The Committee has considered whether index-linked securities should be sold only to particular groups, such as the retired. It sees some merit in these proposals, but believes that a freely available security is preferable. A wide variety of individuals and institutions desire protection from inflation, and a security available only to a limited section of the community is open to abuse since it is unlikely that such a limitation could be effectively enforced. Methods of effectively handling social objectives (which frequently lie behind such suggestions) are discussed in Chapter 36.

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7 It should be pointed out again that indexed securities would add certainty to new loan raisings, and this should be set against any increased uncertainty on debt servicing costs.

(f) Other Household Securities

11.51 It would be possible to introduce a variety of new securities designed for households other than an indexed security — e.g. a contractual savings scheme, or a security where the interest is reinvested.

11.52 The Committee sees the Australian Savings Bond as potentially a flexible instrument which, appropriately packaged and marketed, has the capacity to be attractive to investors. Subscriptions appear to have been sensitive to the rate of interest offered and, except in situations of acute uncertainty, a realistic interest rate policy should generally ensure an adequate level of subscriptions. Therefore the Committee does not see a need to recommend a specific new household security — apart from an indexed or variable rate security in certain circumstances, as mentioned above.

11.53 It should be noted that the issue of attractive household securities will particularly affect the flow of funds to intermediaries such as building societies and savings banks. The Committee accepts the need for the Government to offer securities with a particular appeal to specific groups. However, in Chapter 4 the Committee drew attention to the advantages of government action having as broad as possible an impact across the financial system. Clearly, the authorities will need to balance these two factors.

C. ADMINISTRATIVE ARRANGEMENTS

11.54 The Reserve Bank, acting as agent for the Government, provides a range of debt servicing operations through its inscribed stock registries. Functions currently include the management of new issues, the conduct of accounts for inscribed stock holders and the issuing and redemption of bearer securities. The registries operate under the Commonwealth Inscribed Stock Act and its associated regulations. Some of the options listed for consideration in this chapter could have implications for present administrative arrangements. Although this would not seem to be a crucial issue, it would seem appropriate to keep the arrangements under review to ensure that:

- they do not impede the efficient performance of the service;
- a service is provided which keeps pace with that provided for commercial paper; and
- the marketing of government paper is not disadvantaged.

The Committee suggests that it would be timely to undertake early review of present legislation in this area.

D. OTHER COUNTRIES

11.55 Two papers prepared for the Inquiry provide some considerable detail on the range of government paper issued in selected countries overseas.[8] In making its recommendations, the Committee has had regard for overseas practice.

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8 A. M. Cohen and L. Scott-Kemmis, 'Techniques for the Marketing of Public Sector Debt Instruments'; and Morgan Stanley & Co. Inc., 'Public Sector Borrowing in Canada, The United Kindom and The United States', in AFSI *Commissioned Studies and Selected Papers*, Part 4, AGPS, Canberra, 1981.

CHAPTER 12: LOAN COUNCIL REGULATION OF LOCAL AND SEMI-GOVERNMENT BORROWINGS

12.1 Local and semi-government authority borrowing represents a significant part of the capital market; some indication of this can be seen from Table 9.1. As such, it has major effects on the flow and cost of funds to other sectors of the economy. Arrangements for such borrowings can also impact importantly on the degree of efficiency with which the nation's financial and economic resources are utilised; the detrimental impact of present captive market arrangements and some recommendations in this regard were discussed in Chapter 10.

12.2 Local and semi-government activity has traditionally been considered as occurring at the state level. However, in recent years there has been a substantial increase in the magnitude of borrowings by Commonwealth statutory authorities operating outside the Commonwealth Budget; they are treated as semi-government authorities in this chapter.[1] Much of what is said in Chapters 9 and 11 on the marketing and range of Commonwealth Government securities is of relevance also to local and semi-government securities.

12.3 The major part of local and semi-government authority borrowing is subject to Loan Council regulation, as to aggregate volume, term, rates of interest and other conditions.[2] There is no statutory framework for this regulation; it operates by mutual consent between the Commonwealth, the States and the authorities. Moreover, unlike state government borrowing programs, local and semi-government loans are not underwritten by the Commonwealth; if rates of interest are set at an inappropriate level shortfalls will occur.

12.4 Some financing by local and semi-government authorities may, however, be conducted outside Loan Council supervision, e.g. temporary borrowings (less than one year), supplier credit (i.e. instalment or deferred payments for capital equipment), and leasing (including leveraged leasing). This type of financing has increased in relative importance in recent years. Such a trend obviously has reduced the significance of overall control and oversight of the financing operations of local and semi-government authorities.

A. THE ISSUES

12.5 Loan Council regulation of local and semi-government borrowing is said to be justified because:

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1 Where reference is made to local and semi-government authorities this should be read as including such Commonwealth bodies, and where reference is made to state governments regulating aspects of local and semi-government borrowing, the Commonwealth Government should be read as having similar controls over its authorities.

2 Some mention was made in Chapter 9 and further details are given in the Interim Report at Chapter 12 and the Addendum.

- some control is maintained over the total amount borrowed by the public sector, reducing the possibility that it will 'crowd out' private investment and force up interest rates;
- restrictions on the amounts individual authorities can borrow should be a force directing investment to areas of highest return (including any external benefits they generate);
- a more co-ordinated approach to the market by local and semi-government authorities is facilitated in that, while they may borrow private funds at any time (within their total programs), they must adhere to a schedule for public raisings; also maximum rates (and brokerage and underwriting fees) are set so that the capacity for authorities to bid against one another is reduced;
- the restriction on borrowing overseas gives the authorities a greater capacity to control international capital flows and hence domestic monetary conditions and the exchange rate.

12.6 While the Committee accepts that co-ordination of both the volume and timing of local and semi-government borrowing can be beneficial, it is not convinced that the benefits from the operation of the Loan Council in this area have been as substantial as sometimes suggested. It believes some doubts exist on each of the claims made in the previous paragraph:

- Public sector borrowing certainly has a **potential** to 'crowd out' private investment. Whether it does so in practice, however, will depend on a complex range of factors.[3] The 'crowding out' effect is likely to be most pronounced in the case of public authorities which are not subject to any market disciplines and whose borrowings tend to be insensitive to interest rate changes. It should also be noted that, as mentioned in paragraph 12.4, a number of forms of borrowing are now outside Loan Council supervision. So too is aggregate borrowing by 'smaller' borrowers.[4]
- It is not clear to the Committee that the project vetting processes within the Loan Council mechanism ensure that funds are necessarily allocated to projects giving the highest economic return.
- Although Loan Council arrangements (especially as recently amended) have made a contribution to a more orderly approach to the market, they have not removed altogether the problem of 'bunching'; there is, for example, still a tendency for authorities to borrow early in the financial year rather than later, in order to minimise the risk of shortfalls. If a shortfall occurs there may be little chance for the authority to make it up by receiving a correspondingly larger program in the following year. At the same time, controls on rates can and have compounded the difficulties faced by at least some authorities in funding their requirements.
- The Committee agrees that the Loan Council restriction on overseas borrowing can assist the Commonwealth Government in controlling monetary conditions and influencing exchange rates. The Committee also agrees with the Commonwealth Government view that removal of the restrictions on overseas borrowing would not result in lower domestic interest rates. If the

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3 Such as the size of the public sector debt relative to GDP, the degree of sensitivity of public sector borrowings to interest rate changes, the degree to which public securities are regarded as substitutes for private debt securities, the effect of public sector borrowings on inflationary expectations, the trend in private investment etc.

4 Currently defined as borrowers whose total annual borrowings are less than $1.2 million.

authorities were to borrow overseas at times when the Government was implementing a relatively tight monetary policy then unless the authorities decided simultaneously to change the monetary target, the Commonwealth would have to sell more government securities at home in order to maintain the desired growth in the money supply. This would have much the same consequences for interest rates as if the public authorities had themselves borrowed at home. That said, the Committee would nonetheless point out that many corporations in this country already source their borrowing either overseas or in Australia depending on judgments about rates of interest and the exchange rate, and their number is increasing. In the Committee's view the situation would not be altered materially by giving at least some commercially oriented public authorities this same right.[5] Furthermore, the Committee envisages much more flexibility in exchange rates in the future, with much less risk of domestic monetary instability arising out of overseas capital movements.

12.7 The Committee is also of the view that:

- Despite recent moves towards increased flexibility in government interest rates, there are aspects of the present rate-setting procedures which remain relatively inflexible. It is noted elsewhere that yields on Commonwealth bonds at times have not fully reflected market forces. In addition it is not clear that the margin between Commonwealth rates and those on local and semi-government borrowings have fully reflected changes in the relative volume of funds sought in the two areas. The Committee believes that many of the so-called difficulties associated with borrowings by local and semi-government bodies have arisen because yields set have not appropriately reflected market influences.
- In addition problems for individual authorities arise from the fact that at present interest rate ceilings are uniform across all authorities regardless of the marketability of the particular securities; this operates to the disadvantage of the smaller authorities.
- The secondary market in most local and semi-government securities is weak or non-existent. There are several reasons for this, including the captive market and interest rate constraints. Also important is the large number of borrowing authorities, most of which have many different maturities on issue. The market is therefore highly fragmented, a situation compounded by the lack of information provided to investors on the volume and range of securities on issue.

12.8 Whatever the past experience with the Gentlemen's Agreement, the Committee believes that the coming decade will require, at a minimum, greater flexibility in Loan Council arrangements on local and semi-government borrowing. For example:

- The scale of new borrowing by local and semi-government authorities has expanded significantly and is likely to expand still further. There are unprecedentedly high infrastructure programs already in the pipeline, particularly in the semi-government area; these relate in large part to

5 It is recognised that local and semi-government authorities generally do not have built-in cover against exchange rate risks and would need to take out appropriate cover through market facilities — subject of course to whatever exchange controls may be in force.

electricity generation and the provision of service facilities for natural resource undertakings.

- Local and semi-government authorities are also faced with a major refinancing task in the next few years, because recent borrowings have tended to be at the shorter end, particularly at the four-year minimum.
- If the Committee's recommendations in Chapter 10 are adopted, local and semi-government authorities will have to adapt to the loss of captive markets for their securities; it might be noted that a number of authorities, particularly the smaller authorities, have suggested that the support they receive from captive market requirements is now relatively quite small. At the other end of the spectrum the marketing success of some of the larger authorities does not seem to have been dependent on the existence of 30/20. Interest relativities have become increasingly more critical in marketing debt in recent years and this trend seems likely to continue, irrespective of the response to the Committee's recommendations.
- The Commonwealth appears to be following a policy of decentralising finance functions. It is therefore likely that its major public authorities will increasingly borrow in the market in their own name, rather than rely on government loans or grants.

B. THE OPTIONS

12.9 In examining what form the changes to Loan Council arrangements should take, the Committee has been guided by the following principles:

- The discipline of the market, where it can be made to work, is to be preferred to bureaucratic controls; where the market is judged not to take externalities adequately into account there still are advantages in harnessing market disciplines to the maximum extent possible.
- Marketing arrangements must be flexible. In particular, interest rates must be able to respond fully and promptly to changing market conditions. There is also advantage in permitting scope for innovation in other aspects of financing by authorities.

12.10 The following sections look at:

- possible changes to the extent and nature of Loan Council control;
- the possible extension of Commonwealth borrowing to include local and semi-government requirements; and
- the case for establishing State Central Borrowing Authorities as loan-raising vehicles.

(a) Loan Council Control and Oversight

12.11 Some submissions have advocated an easing in the present Loan Council constraints; they have argued that commercial disciplines and the limited availability of funds (as well as the constraints imposed by their charter) would be sufficient to discourage local and semi-government borrowers from making excessive loan raisings. Authorities would compete freely against one another and against the private sector; ideally funds would flow to those projects yielding the highest return.

12.12 The Committee accepts that substantial relaxation of present arrangements would be beneficial to the financial system and facilitate the funding of local and semi-government bodies. However, it believes that the Loan Council or an alternative body would need to retain at least some general oversight over the total size and direction of borrowing programs where markets clearly cannot exercise an effective discipline.

12.13 Accountability and market disciplines may be inappropriate or impracticable when there is a strong social or community element in the service being provided or where the authority has a monopoly or near monopoly position. Furthermore, as explained in Chapter 26, local and semi-government authorities, by reason of their government ownership, will always have an advantage in competing for funds against the private sector.

12.14 In brief, the Committee has reservations about the extent to which some authorities could be made appropriately accountable to the community by effective market disciplines. **The Committee does not therefore favour complete borrowing freedom for the general run of local and semi-government authorities.**

12.15 Conceptually, the Committee saw merit in attempting to draw a distinction between 'commercial' and 'non-commercial' authorities. It envisaged that 'commercial' authorities would continue to borrow in their own name but, contrary to present practice, without any form of government guarantee. They would be free of Loan Council regulation as to amounts, terms and conditions. 'Commercial' authorities would be those which met the stringent criteria similar to those imposed on government financial institutions (Chapter 26). If they met those criteria their operations would in effect be subject to most normal market disciplines and they could not be said to be 'crowding out' private investment.[6] Non-commercial authorities would tend to be those with a strong 'social' element.

12.16 The dichotomy between the two classes of authorities may present some practical difficulties. In particular:

- even in the cases where no explicit government guarantee is given, the market may well impute a guarantee;
- 'commercial' authorities frequently do not have a totally free hand in their pricing policies but must accommodate decisions taken at the political level;
- the capital structure and profit requirements of 'commercial' authorities cannot be regarded as strictly 'commercial' as that term is understood in the private sector.

12.17 The guidelines proposed for government financial institutions in Chapter 26 are designed to deal, at least in part, with such problems. Notwithstanding, therefore, some of the reservations and practical problems outlined in the preceding paragraph, the Committee considers that the benefits to be derived from a market allocation of funds are sufficient to warrant at least, for those who clearly operate on a commercial basis, a limited move in the direction of borrowing freedom. The Committee would stress, however, the need to apply the tests of commerciality rigorously. These tests might include adequate capital base, clear current and future cash flow to service debt, competitive pricing disciplines and so on. Few might qualify.

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6 It may also be desirable not to classify an authority as a 'commercial' authority unless it had a minimum borrowing requirement sufficient to ensure that there was an adequate secondary market in its paper to give clear signals of market interest rates.

12.18 The Committee therefore ***recommends*** that:

(a) Where it can be clearly demonstrated that a public authority is basically subject to market disciplines, it could be viewed as a 'commercial' authority.

(b) The volume of borrowing by 'commercial' local and semi-government authorities, and the terms and conditions of such borrowing, should be free from Loan Council control; borrowings by these authorities should not be government guaranteed.

12.19 In respect of 'non-commercial' authorities — and these will be much greater in number — the Committee recognises the need for general oversight of total borrowings by the Loan Council. However, the advantages of the Loan Council specifying maximum interest rates and placement fees and imposing restrictions on loan maturities are less clear. The need for flexibility in terms and conditions attached to paper being marketed has already been emphasised and this is difficult to achieve under the present Loan Council system.

12.20 At the same time it should be noted that it is envisaged that such borrowings of 'non-commercial' authorities would commonly continue to be government guaranteed; that means the particular government involved would, as would any guarantor, have to retain the right to approve not only the **volume** but also the **terms and conditions** of all loans raised by a particular authority. Thus, while the **terms and conditions** of borrowings would not require Loan Council approval, they would still be subject to the control of the guaranteeing government.

12.21 In regard to the present controls on the maturities of borrowings, the Loan Council's view is that it is imprudent to finance what is essentially long-term capital expenditure out of borrowings of less than four years. In the recent period of rising interest rates, however, lenders have shown a preference for shorter maturities, a preference which local and semi-government borrowers have been unable to fully adjust to. It can be questioned whether a firm minimum borrowing period should be specified irrespective of changes in market conditions, rates of inflation, yield structure etc. The Committee believes that restrictions on borrowings with a maturity of one to four years could appropriately be removed.

12.22 The Committee therefore ***recommends*** that **'non-commercial' authorities should continue to enjoy a government guarantee and remain under Loan Council oversight in respect of the overall volume of borrowings; however, terms and conditions (including maturities) of borrowings should not be subject to Loan Council control but be negotiable between the government guarantor, the borrower and the lender.**

(b) Extension of Commonwealth Borrowing Responsibility

12.23 It has been suggested that the Commonwealth could extend the borrowing responsibility it undertakes for states to include the needs of local and semi-government authorities.

12.24 The Committee can see a number of advantages flowing from such an approach (particularly for the smaller non-commercial authorities):

- the Commonwealth has long-standing experience as a borrower, both in Australia and overseas;
- the Commonwealth generally is able to borrow at the lowest rates, again both in Australia and overseas;
- provided appropriate arrangements were in place for the issue of

Commonwealth securities (see Chapter 9), there could be a simplification and rationalisation of public sector borrowing — e.g. there would not be as many approaches to the market as at present;

- a consolidation in the range and maturity of public sector borrowings would reduce the degree of fragmentation in the secondary market for public securities; the secondary market in Commonwealth securities is the best developed fixed-interest market in the country and it would be further deepened by the inclusion of additional securities;
- bringing local and semi-government borrowings within the full scope of the Financial Agreement would co-ordinate to a greater degree than at present total public sector borrowing requirements, including overseas borrowing;
- there might be a saving in the direct costs of borrowing (apart from interest costs);
- competition between authorities in terms of rate and timing would be avoided.

12.25 However, extension of the Comonwealth's borrowing responsibility to local and semi-government authorities would be open to some objections:

- at government level, it would add a further element of complexity to the system of distribution of funds as between the various authorities and almost certainly require an undesirable increase in bureaucratic procedures;
- it would reduce the degree of financial autonomy enjoyed by individual public authorities; and
- it would further distance state authorities and officials from the market — including the overseas market — and further separate expenditure decisions from funding arrangements.

12.26 Many of these objections could perhaps be overcome through appropriate Commonwealth–State consultative machinery. The option thus has some appeal. However, there remains the important practical consideration that the proposal would require either a constitutional change or a voluntary transfer of powers from the States to the Commonwealth. On past experience, neither course may be feasible.[7]

12.27 An alternative approach would be to set up State-based Central Borrowing Authorities (SCBAs), as a means of consolidating individual borrowings to the greatest practical extent.

(c) Borrowing through State Central Borrowing Authorities

12.28 There are many possible variants of an SCBA. One possible arrangement would be:

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7 In 1973 the Commonwealth Government proposed changes which, had they been accepted, would have given the Commonwealth Government the power to borrow on behalf of local and semi-government authorities, as well as giving those bodies representation on the Loan Council. The State Governments were not in favour of the proposed changes. A referendum held in 1974 proposed constitutional amendments to give the Commonwealth power to make laws with respect to the borrowing of money by the Commonwealth for local government bodies and grant local government financial assistance; the proposed amendements were rejected. On the other hand, on 10 December 1980 the Victorian Minister for Local Government announced inter alia that the Victorian Government 'supports in principle the concept of the establishment of a central loan funding agency for local government, provided that such an agency is established on a national basis'.

- an Authority might be established in each state; alternatively it would be open to various states to run a joint operation;
- each Authority might raise funds on its own account and distribute the proceeds to local and semi-government authorities according to some agreed system of priorities;
- existing securities would be redeemed and reissued in a consolidated series;
- funds raised would be included in the States' borrowing programs, which would continue to be subject to Loan Council approval and regulation as to volume;[8]
- the Authority would have responsibility for promoting secondary market turnover, including the provision of buy-back facilities for small parcels;
- individual (non-commercial) local and semi-government authorities might be required to raise their finance through the relevant Authority except that they could well retain control over their own short-term borrowings such as bank overdrafts;[9]
- local and semi-government authorities would be on-charged interest and appropriate arrangements made for loan redemption.

12.29 This option has many of the advantages of a centralised Commonwealth borrowing arrangement; in particular:

- there would be substantial rationalisation of approaches to the market (although less than if undertaken by the Commonwealth) in that competition between local and semi-government authorities on the open market would be eliminated; there would be competition between SCBAs;
- smaller authorities would no longer be at a disadvantage in the open market;
- the number of loan raisings would be reduced with benefits for debt management and secondary market turnover;
- the increased marketability of the securities should make them more attractive to investors and possibly enable some reduction in yields, with consequent savings to the borrowing authorities;
- partly arising out of the above, the introduction of new borrowing instruments such as an SCBA security designed specifically for household investors would be facilitated;
- the more integrated borrowing arrangements might help improve the quality of information given to investors, particularly in regard to the volume and maturities of existing securities; and
- SCBAs would develop specialist financial skills which are unlikely to be fully developed in individual authorities.

12.30 Against these potential gains:

- new bureaucracies would be created; care would need to be taken to ensure that the arrangements were such as to not involve an increase in overall administrative costs. In particular, arrangements for the allocation of funds to individual authorities would bear careful consideration;

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8 SCBAs could bring all non-commercial local and semi-government borrowing within Loan Council oversight — at present, the volume of borrowings by those authorities under the $1.2 million annual limit does not form part of a state's total program.

9 Alternatively, use of the SCBA could be at the option of the authority.

- individual authorities would lose a measure of marketing autonomy and experience; and
- authorities might lose their 'local' investors.

12.31 In the Committee's view the advantages of this option outweigh its disadvantages. Of course, there might be even greater efficiency gains if a single **national** borrowing authority were to be set up, but such an approach would be open to the same problems as the extension of Commonwealth borrowing responsibility. On this basis, the Committee suggests the establishment of SCBAs generally along the lines discussed in paragraph 12.28.[10]

12.32 The Committee ***recommends*** that **consideration should be given to the establishment of State Central Borrowing Authorities to borrow on behalf of individual 'non-commercial' local and semi-government authorities.**[11]

C. INFORMATION

12.33 The volume of local and semi-government authority borrowing is large enough to have significant implications for resource allocation on a national scale. To a large extent, prospective lenders, and indeed taxpayers generally, are unaware of the expected rate of return from projects to be undertaken by the local and semi-government authorities, or the assumptions on which calculations have been made. With the prospect of 'commercial' authorities borrowing without a government guarantee, the Committee considers that these authorities will need to provide lenders with a greater amount of information regarding projects to be undertaken. The market for all local and semi-government authority securities would also be assisted if more information were provided on the volume and maturity of securities already outstanding.

10 Some very early steps towards a 'central borrowing' approach have already been taken by some state governments. For example, in Queensland, some local and semi-government borrowers have been grouped together in a 'Joint Government Authority Loan' prospectus in which the actual borrowers have been separately identified. Lenders state the order in which they wish to have their funds allocated. In the case of NSW authorities, there has been one instance where, for administrative convenience, authorities have jointly approached overseas lenders, although subsequent loan documentation was kept separate.

11 Perhaps 'commercial' authorities could be given the option to arrange their finances through SCBAs if they found that preferable to taking an independent stance in the market.

TAXATION POLICY