Australia's Approach to Monetary Policy

Jane Sneddon Little

Vice President and Economist, Federal Reserve Bank of Boston. *The author is grateful to Frank Campbell, head of the RBA's domestic markets department, for his very helpful comments. Oksana Nagayets provided excellent research assistance.*
jane.little@bos.frb.org

According to Australia's Reserve Bank Act, the central bank's broad policy objectives include maintaining the stability of the currency, full employment, and the economic prosperity and welfare of the people of Australia. In 1993 the Reserve Bank of Australia adopted a specific, and thus transparent, inflation target as its operating objective; it aims to keep overall inflation[1] between 2 percent and 3 percent on average over the business cycle.

The Reserve Bank of Australia (RBA) is accountable directly to the Parliament and, through Parliament, to the general public. The Reserve Bank Act (1959) requires the Bank's Board to provide an annual report on its operations and finances to the Treasurer and to Parliament. A 1996 "Statement on the Conduct of Monetary Policy," issued jointly by the Governor of the Bank and the Treasurer, clarifies the respective roles of the Bank and the government in regard to monetary policy and provides formal government endorsement of the Bank's inflation objective. It also outlines a procedure for the Governor to appear before the House of Representatives Standing Committee on Economics, Financial Institutions, and Public Administration twice a year to report on its conduct of monetary policy. In the event of a disagreement between the Government and the Bank's Board on policy issues, the Reserve Bank Act lays out the procedures to be followed. They have never been used, and formal and informal contacts between the Bank, the Treasury, and other government departments are frequent.

Central Bank Assets

At the end of June 2001, the Reserve Bank of Australia held assets equaling $A58 billion, of which 62 percent were in foreign exchange and 2 percent in gold. Government securities (of which the majority were securities sold under repurchase agreements) comprised 8 percent, while loans, advances and bills held (including securities bought under repurchase agreements), and clearing items made up 26 percent.

Since the Bank began announcing its policy changes in 1990, the desired stance of monetary policy has been expressed in terms of the operating target for the cash rate, the money market rate on overnight interbank funds. Because the Australian system operates without reserve requirements, the banks' demand for overnight funds stems from their need for settlement balances, which are held as exchange settlement (ES) accounts at the Reserve Bank. Each bank is required to have a positive balance in its ES account at all times. Through its daily open market operations, the Reserve Bank adjusts the supply of funds to keep the cash rate close to its target.

Open Market Operations

Although, with minor exceptions, only banks have ES accounts, the Reserve Bank of Australia is now willing to deal with all major financial institutions, both bank and nonbank, that are members of the Reserve Bank Information and Transfer System (RITS), an electronic system for the settlement of large-value cash and Commonwealth Government Securities (CGS) transactions.[2] Currently, RITS has 137 members—54 banks, 3 special service providers, and 80 nonbanks—but in practice the Bank deals regularly with around a dozen institutions. The Bank conducts two types of transactions. It may buy (sell) outright CGSs of less than about eighteen months to maturity. It also accepts CGS, state and territory Commonwealth government, and certain supranational securities in repurchase agreements. In fact, 80 percent of open market transactions take the form of repos. The average maturity of the repo book has lengthened in recent years from two days in the mid-1990s to 12 days in 2000–01. In addition—and to an increasing extent—the Reserve Bank may choose to do a foreign exchange swap (basically a repo, with both a spot delivery and an agreement for future reversal, based on foreign exchange rather than securities) for purposes relating to liquidity management rather than to exchange rate stabilization.

When Australia moved from a deferred, net settlement system to real time gross settlement (RTGS) in June 1998, the schedule for open market operations changed slightly. The Reserve Bank still announces its estimate of the banking system's cash position for the day and its dealing intentions at 9:30 a.m. Bids / offers are then tendered and accepted in order of attractiveness, based on term and yield, up to the volume needed to keep the cash rate at the target level. The process is usually complete by 10:15 a.m. Since the switch to RTGS, the Bank also stands ready to conduct open market operations at a second time later in the day if needed. In practice, the Bank has conducted a second round of open market operations very infrequently, just a few times per year.

Standing Facilities

Under real time gross settlement, the banks face a continuous flow of payments and receipts through their exchange settlement accounts all day. To reduce the risk of an unexpected loss of liquidity or an episode of gridlock if a bank is unable to make a payment, the Reserve Bank of Australia has established two facilities to be activated at the discretion of the banks.[3] The first is an intraday, collateralized repo facility that allows banks to raise interest-free cash from the Reserve Bank at any time during the day as long as the transaction is reversed before the close of business. The second facility is an end-of-day standby. This facility allows a bank that is unable to borrow from the money market late in the day to do an overnight repo with the Reserve Bank, exchanging securities acceptable for open market operations for cash at an interest rate 25 basis points above the target

[1] Originally, the target referred to underlying inflation, but after the Australian Bureau of Statistics removed distortions related to mortgage and consumer interest rates from its measure of inflation, the RBA switched to the overall index.

[2] For over 30 years, until 1996, the Reserve Bank carried out open market operations through authorized money market dealers. Banks held their settlement balances as interest-paying loans to the dealers, and ES balances at the Reserve Bank, which paid no interest, were very low. In 1996, the Bank began dealing with all major financial institutions. It also began paying interest on ES balances. At first, it paid 10 basis points below the target cash rate, an excessively attractive rate that caused ES accounts to rise sharply. Since October 1997, ES balances have earned a rate 25 basis points below the target cash rate, and these balances have fallen to more desirable levels.

[3] Use of these facilities has no quantitative limit beyond the need for adequate collateral.

cash rate—again at the discretion of the bank.[4] Fearing that such recourse would be seen as a sign of weakness, the banks originally proved reluctant to use it. However, once the Reserve Bank clarified its view that occasional use should be considered a normal part of the RTGS framework, drawings picked up a bit. Nonetheless, in 2000–01 only 18 draws were made on this facility.

Possible Future Changes in the Settlements Systems

The transition to RTGS was very smooth. Although the demand for ES balances rose with the introduction of RTGS, once the participants got used to the new system, they found it allowed them to economize on such balances. Throughout the transition, the cash rate remained stable, with little change in its daily volatility from the average of recent years. Looking ahead, the Reserve Bank of Australia is exploring ways to assess the safety and efficiency of its payments system and to establish criteria for approving netting systems, which would likely reduce liquidity costs even further. In addition, because Australia has five separate clearing and settlement systems—one each for Commonwealth government debt, other debt, equities, options, and futures—the possibilities of consolidating positions versus a single central counterparty for certain debt securities or of allowing some rationalization of the systems is also under discussion. Such moves, which are under way in parts of Europe and Canada, might possibly further reduce the demand for ES balances. On the other hand, these balances are already so low (on average less than $A1 billion) that banks may not be willing to reduce them any further.[5]

Changes in Eligible Collateral as a Response to the Diminished Supply of Commonwealth Government Securities

According to OECD data, after the general government financial deficit peaked at 6 percent of nominal GDP in 1992, Australia achieved a surplus of 0.5 percent in 1998. This surplus is likely to reach about 1 percent of GDP in 2005, according to OECD projections. Australia's gross financial liabilities are expected to fall to 27 percent of GDP by 2001, down from 42 percent in 1995, while net financial liabilities are projected to dwindle to 7 percent of GDP from 27 percent in 1995. Recently, the Australian Treasury announced a Commonwealth government surplus of $A2.3 billion in 2000–01. As the Commonwealth's budget has moved into surplus, the net stock of CGS on issue has fallen from $A107 billion in 1997 to $A66 billion in 2001 (10 percent of GDP).[6] With large negative funding requirements in recent years, the Commonwealth's modest new issuance programs were undertaken primarily to maintain the liquidity and efficiency of CGS markets. In particular, the Treasury has sought to build liquidity in its key benchmark instrument, the Fixed Coupon Bond, over a yield curve extending to 12 to 13 years.

In anticipation of these trends, in June 1997 the Reserve Bank expanded the list of securities that it could accept as collateral for repos to include Australian dollar securities issued by the central borrowing authorities of the state and territory governments (semi-government securities), as long as they were lodged in the main trading system for these securities, Austraclear. Expectation and the announcement that the Bank would expand its list of eligible collateral to include semi-government debt coincided with a sharp fall in the spread between rates on semi-government securities and CGSs. Since then, spreads have returned to their average of the early 1990s. In 1997–98, about 30 percent of the Bank's repos were based on securities issued by state and territory governments. In June 2001, state government securities represented 42 percent of the collateral used in Reserve Bank operations. This ratio is broadly in line with the share of these securities in total government securities outstanding. At other times, however, the semi-governments have represented a disproportionately large share of the repo book, in part because the opportunity cost of using state government securities is less than that for CGSs. In addition, in June 1997, the Prime Assets Requirement (PAR) was reduced from 6 percent of banks' liabilities to 3 percent, and state government securities became eligible as PAR assets. These changes allowed the banks to reduce their holdings of CGSs, increasing the supply of securities for open market transactions. In April 1998, the Reserve Bank also announced that the PAR

[4] The Reserve Bank applies a haircut to the collateral accepted at its end-of-day facility but not at its intraday facility. It also makes a haircut of 2 percent of cash value for repos used in open market operations. It marks all assets to market daily and makes margin calls if its exposure exceeds 1 percent of the funds extended.

[5] The Reserve Bank suggests that an enduring shortage of CGS may also encourage the banks to hold more ES balances for liquidity reasons.

[6] Net of holdings of the Loan Consolidation and Investment Reserve as of June 30, 2001.

would be abolished once the banks have persuaded the Australian Prudential Regulation Authority of the adequacy of their liquidity management policies.[7] Most recently, in October 2000 and June 2001, the Bank further widened its range of eligible securities to include certain highly rated supranational paper and Australian dollar-denominated securities issued by state and territory governments in euro markets and lodged in Austraclear as "euroentitlements."

Nevertheless, on occasion, the Reserve Bank has also felt the need to supplement its open market transactions in domestic securities with foreign exchange swaps (or repos). So far, these transactions have been small relative to those in government securities (turnover of $A90 billion in foreign exchange swaps versus $A393 billion in government securities in 2000–01). However, despite the government's pledge to sustain a degree of liquidity in the Commonwealth bond market, the Bank has suggested that use of foreign exchange swaps may become a more routine part of its open market operations as the supply of government securities shrinks. Its motivation would be to leave CGSs in private hands to promote market liquidity.

The need to maintain the value of the Reserve Bank of Australia's capital is a critical element in determining its choice of assets to be used in open market operations and accepted as collateral at its standing facilities.[8] The absolute creditworthiness of the Commonwealth and accepted supranationals and the high credit standing of the states explain the use of their debt. Because the Bank conducts whatever transactions are necessary to implement monetary policy, it accepts the consequent domestic market risk as a residual. However, the Bank is comfortable that the duration of the domestic portfolio has tended to decline with increased use of repos. The concern about maintaining the value of the Bank's capital also explains why the Bank prefers to use foreign exchange swaps (in effect, investing in absolutely creditworthy and highly liquid U.S. Treasuries) when the scope for using very creditworthy domestic securities is constrained. The Bank sees the market for U.S. Treasury securities as underpinning the global credit curve, but if U.S. Treasury securities were to become much less widely available in future, the Bank would have to find an alternative. Any difficulty in trading U.S. Treasury paper would raise concerns about credit risk.

All in all, declining CGS issuance is a serious matter for the Reserve Bank of Australia. While the current level of issuance is not generally an impediment to normal market operations, from time to time problems become evident. Moreover, in the face of current government surpluses, the Bank's repo book has on occasion expanded to the point where the Bank faces *potential* constraints in conducting normal open market operations because it cannot find counterparties with enough securities to offer. From time to time, the spread between unsecured and secured lending has widened as stock becomes scarcer. Accordingly, an Australian consensus is emerging that preserving the transparency and liquidity of the CGS market has merit. The Australian Office of Financial Management has indicated that it intends to maintain the liquidity of the CGS market. It is currently formulating a longer-term strategy that will broadly entail maintaining Australia's current gross level of debt, while acquiring still-to-be-specified "assets."

Loans of Bonds

The Reserve Bank of Australia serves as agent for the Commonwealth in certain debt management activities, for example, conducting tenders, secondary market purchases, and the like.[9] The Bank also undertakes transactions on its own account to enhance the liquidity of the bond market. To this end, the Bank stands ready to lend from its own portfolio of domestic bonds (at a penalty rate).[10] These transactions, which involved bonds valued at around $A1 billion in 2000–01, do not affect the liquidity of the banking system, because one type of security is swapped for another, and no cash changes hands. The Bank believes that were the supply of CGSs on issue to decline significantly, stock shortages might become more frequent, and the Bank's stock lending facility could become more important.

Exchange Rate and Foreign Exchange Reserve Management

Although Australia allows its dollar to float to cushion the impact of external shocks, from time to time the Reserve Bank intervenes in the foreign

[7] The banks will still be required to hold liquid assets, as negotiated with the Australian Prudential Regulation Authority.

[8] Accordingly, the Bank requires that all of its assets, including its repos, be marked to market daily, and any changes in the value of its assets are recorded in a valuation account. If necessary, margins will be adjusted if the RBA's net exposure exceeds 1 percent of the unwind value.

[9] Debt management policy resides with the Australian Office of Financial Management.

[10] The Bank prices its stock at a penalty to the market rate to encourage the view that it is the "lender of last resort."

exchange markets on its own behalf to moderate movements that seem excessive relative to economic fundamentals. Although most of its intervention occurs in spot markets, the Bank makes occasional use of options on the Australian dollar. This allows the Bank to use a limited outlay to create a significant demand for Australian dollars on the part of dealers who had sold the options and need to hedge. The Bank manages its foreign exchange reserves with an eye to liquidity, risk, and return. The Bank holds the bulk of its foreign exchange reserves in securities issued by the national governments of the United States, Germany, and Japan and in deposits with highly rated banks. The benchmark duration of assets in these portfolios is 30 months. In recent years, with yields on Japanese bonds unusually low and the risk of capital losses unusually high, the Bank reduced the maturity of its Japanese assets and the share of these assets in its foreign currency portfolio. This underweight position was unwound last year so that the portfolio is now close to its benchmark target. More generally, the Reserve Bank now adopts a more passive approach to the management of its foreign exchange reserves than was the case until a year or two ago.

So far, the decline in issuance of U.S. Treasuries has had a negligible impact on the way the Reserve Bank of Australia manages its reserves, but any serious diminution of the market for U.S. Treasuries would likely force the Bank to hold a much smaller share of its official reserve assets in the United States. In any event, with the entry of 11 European governments into the European Monetary Union, the Bank is considering expanding its holdings into other highly rated, liquid bonds.

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