

RESERVE BANK BILLS

The Reserve Bank bill is to replace government stock and Treasury bills as the major component of primary liquidity. This article, by Ian Harrison, explains the change.

On 7 July 1988 the Governor of the Reserve Bank announced that a new financial instrument, the Reserve Bank bill, was to replace government stock and Treasury bills as the major component of primary liquidity. The first Reserve Bank bill tender took place on 2 September and from 1 December 1988 the Reserve Bank bill will be the only instrument that will be discounted on demand by the Reserve Bank.

This article briefly explains the two main reasons why the decision was made to introduce a Reserve Bank bill. These two reasons were, firstly, that the bill will improve the operation of monetary policy, and secondly, that it will allow the Government's short term funding programme to be conducted more flexibly. The article then outlines some of the bill's more important operational features.

The Monetary Policy Advantages

Before examining the monetary policy advantages of the Reserve Bank bill, it is important to note that its introduction does not represent a major change in either the framework or the conduct of monetary policy. While Reserve Bank bills will replace Treasury bills and Government stock as primary liquidity, the monetary policy role of primary liquidity will be unchanged. The Reserve Bank will continue to place a restraining influence on monetary conditions by controlling the level of primary liquidity available to the financial system. The role of other instruments of policy, including the cash target and the discount margin, will also be unchanged. What the Reserve Bank bill enables the Bank to do is to exert a closer degree of control over both the level and the structure of primary liquidity and so improve the consistency and transparency of the Bank's monetary policy stance.

Under the previous system, Treasury bills and government stock

had dual functions. Their first role was to serve as primary liquidity for the last 30 days to maturity. The second was to smooth net liquidity injections (mostly relating to government income and expenditure flows) into the banking system. Because of the seasonal nature of these flows, a large element of seasonality has also been introduced into the primary liquidity track. The normal pattern of liquidity influences is for a period of net Government expenditure which is followed by a month in which there is a larger than normal tax drain due to provisional or terminal tax payments. Like commercial enterprise, the Government funds its initial cash shortfall by issuing Treasury bills (via liquidity management operations conducted by the Bank) which are dated to mature when the Government is expecting to receive revenue from the tax flow. Because the tax flows and Treasury bill maturities are concentrated on a period of a few days over the middle of the tax months, there will be a corresponding increase in the level of primary liquidity 30 days before the tax flows begin. Figure 1, for example, shows how primary liquidity increased sharply in the middle of January 1988 as Treasury bills maturing in February to fund the February tax flows entered primary liquidity.

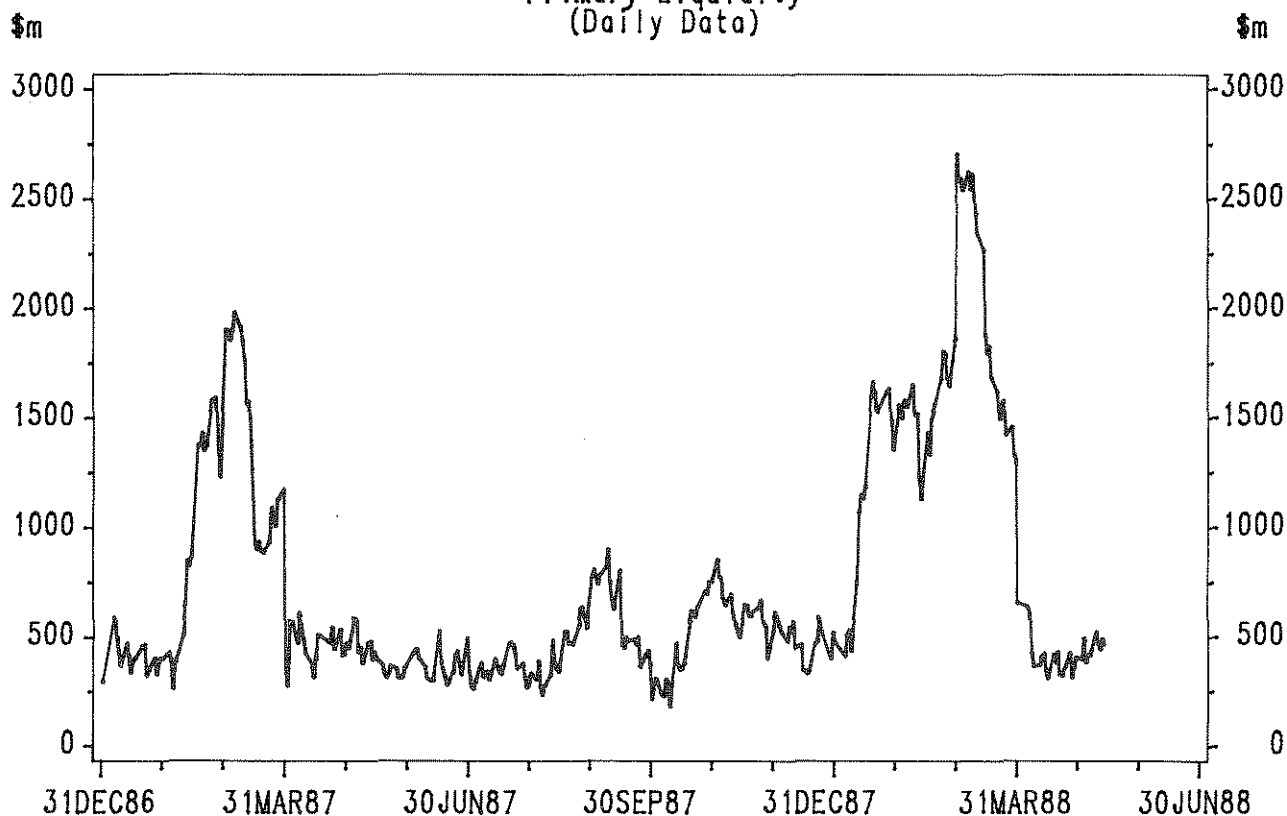
The rise in primary liquidity before and during the tax flow does not, however, undermine the central thrust of monetary policy. What basically matters is the trend in the level of primary liquidity and the Reserve Bank has made it clear that this will be controlled so as to maintain an appropriate degree of pressure on monetary conditions. The significant participants in the financial market understand this fact and their lending behaviour is unlikely to be materially affected by seasonal increases in the level of primary liquidity. Furthermore the increase in the level of primary liquidity overstates the increase in effective liquidity available to the system. The lumpiness of Treasury bill maturities means that most of the increase in

primary liquidity initially consists of longer dated bills. These bills are relatively illiquid because the cost of discounting increases with the number of days the bill has to maturity. In addition, banks will wish to hold on to Treasury bills to balance the outward flows to Government during the actual tax payment period. The bills tend to be 'tied to' or dedicated to those flows rather than representing a general increase in the liquidity available to the system.

Another factor that tends to help keep monetary conditions firm during the tax flow periods is that these periods are normally associated with some upward pressure on interest rates. There is always some risk that the forecasts of tax flows could have been under-estimated, and that financial institutions will be left holding insufficient Treasury bills to finance the flows to Government. This possibility exposes the settlement institutions to the risk of having to borrow from the Reserve Bank by way of sellback at unknown interest rates, which tends to increase the demand for primary liquidity.

The main problem with the seasonal swings in primary liquidity is that they interfere with the signalling properties of primary liquidity and can obscure the Reserve Bank's policy intent. While there is a stated objective of controlling the trend level of primary liquidity, in practice it is difficult to draw any ready conclusion as to whether the Reserve Bank is actually adhering to its policy when the track is heavily distorted by seasonal influences. When there were only two provisional and terminal tax flow periods in a year the problem was more manageable as primary liquidity would be at its base level for much of the year. However, the increase in the number of tax flow periods from two to four in 1988/89 increased to seven the number of months in which average primary liquidity levels were affected by tax flows and it became more difficult to clearly discern the underlying trend level in

Figure 1
Primary Liquidity
(Daily Data)



PL. Under the previous arrangements the quantity of primary liquidity would have lost its role of providing a clear signal of the Reserve Bank's monetary policy stance for approximately half the year.

The second problem with the dual role of Government debt is that it can affect the maturity structure of primary liquidity which in turn, particularly in months when PL is at its baseload level, can affect liquidity conditions through the month.

The reason for this outcome is that the lumpiness of the normal flows to and from Government over the course of a month means that Treasury bill maturities are similarly bunched. In turn this bunching can mean that there are gaps in which there is no PL maturing and that substantial variations in the liquidity of

PL outstanding at any point in time can occur. When outstanding primary liquidity is weighted to longer dated instruments, the effective level of liquidity is reduced and upward pressure on interest rates can be experienced. The Reserve Bank can fill these gaps by selling bills to mature within the month and can increase PL from its low points, but there are limits to the extent to which this smoothing can be done without raising the average level of PL above the target level.

The introduction of Reserve Bank bills will cut neatly through these problems. The amount of discountables outstanding will no longer depend on the seasonal nature of the flows to and from Government and the pattern of flows within each month. Bill levels and maturities will

be determined directly by the Reserve Bank and it will be possible to obtain very precise control over both the level and the maturity structure of primary liquidity.

Debt Management Advantages

Ordinarily there is no significant conflict between the use of Treasury bills as a monetary policy instrument and as a seasonal funding tool. Abstracting from Government transactions, the amount of Treasury bills issued is basically determined by the requirement to maintain the settlement banks' cash balances at the Reserve Bank at a targeted level. In commercial terms this requirement is equivalent to preventing the Crown from making

planned use of settlement account balances to fund its expenditure. In other words seasonal patterns in net Government expenditure must be financed by issuing Treasury bills rather than by running up an overdraft with the Reserve Bank (which in turn funds from the settlement banks' settlement accounts).

Normally Treasury bill maturities are those which would be chosen if the Government debt management was based on purely commercial grounds. In order to smooth out the liquidity impact of Government flows, maturities are normally set so that bills mature when taxes are being received. This strategy is in line with the normal commercial practice of matching borrowings against expected future cash receipts.

There are, however, two reasons why the monetary policy role of short-term debt can be a problem from a debt management perspective. The first is that it may sometimes prove cheaper to obtain seasonal funding by rolling over a short-term instrument than to borrow for the full term that the funds are required. For example, if a commercial borrower who needs funds for 6 months thought that borrowing for 90 days and then refinancing that borrowing for a further 90 days as it matured would be cheaper than borrowing for 180 days at the outset, he would borrow funds for the two terms of 90 days. In the Government's case, however, if sufficient Treasury bills had already been sold into a particular month to fund flows to Government and to reach the targeted level of primary liquidity, then any further bills would have to be sold to longer maturities. If the market was not focussing on the longer term flows and wished to purchase shorter term bills, then a higher than normal rate would have to be accepted to sell the longer dated bills. Ordinarily this mismatch between the market's demand for Treasury bills and the Government supply is not a major problem because of a natural demand for bills to fund tax flows, but there

have been occasions when small premiums have been paid to sell longer dated bills.

A potentially more important gain is that the Reserve Bank bill will make it easier to sell large liquid maturities of Treasury bills for base-load funding purposes as part of the Government's debt programme. Technically it would have been possible to issue regular maturity Treasury bills under the old regime, but this was not an attractive option because of problems when the bills entered primary liquidity. Either the level of primary liquidity would have risen, which could have undermined monetary policy, or the bills would have had to have been bought back before they entered into primary liquidity. The latter operation would have been complicated and potentially costly to the Crown.

Overall then, introduction of the Reserve Bank bill is expected to result in a worthwhile enhancement of the present system for the operation of monetary policy and debt management. The existing system was working reasonably well in the operation of monetary policy, but there would have been more problems with it due to the introduction in the operation of four payment periods for provisional and terminal tax. The operation of monetary policy should be less complex and more transparent and the Government's debt program should be slightly less costly. There will be significantly more flexibility in the use of short-term debt instruments for both the debt programme and for liquidity management purposes.

The Main Features of the Reserve Bank Bill

The Instrument

The Reserve Bank bill is a similar instrument to Treasury bills and bank bills. It is issued at a discount, which reflects the yield on the bill, and will be freely traded in the market place. The significant difference of course is that only the Re-

serve Bank bill can be automatically discounted at the Reserve Bank.

Normally Reserve Bank bills will have a maturity of 91 days and will be defined as primary liquidity for the 28 days before their maturity. A 91 day maturity was chosen because it provides plenty of time for financial institutions to obtain an adequate portfolio of Reserve Bank bills (either by direct purchase though tenders or through purchases on the secondary market) making it less likely that interest rate pressures will be generated by an uneven distribution of primary liquidity. The reason why Reserve Bank bills have a maturity of 91 days rather than an even 90 days is that 91 days is a whole number of weeks. Consequently, bills will mature on the same day of the week as bills from the latest tender are settled so that, once the initial placement of bills has taken place, the normal rollover of bills will have no liquidity impact.

Reserve Bank bills will be defined as primary liquidity for 28 days rather than the 30 days, as was the case with government securities, because with a 28 days maturity, bills from an equal number of tenders will enter into primary liquidity. With a 30 day primary liquidity definition the number of maturities entering into primary liquidity would vary from week to week and the level of primary liquidity would have a saw-tooth profile.

Tenders

Normally Reserve Bank bills will be sold by telephone tenders which will take place twice a week on Mondays and Thursdays with settlement occurring on the following day. There are two reasons for holding two tenders rather than a single tender each week. The first is that if there had been only one maturity a week the average maturity of primary liquidity and the level of effective liquidity in the system would have systematically varied over each week as the bills got closer to maturity, possibly causing a

weekly interest rate cycle. Probably these cycles would not have been very large or frequent, but as it was a simple matter from an administrative point of view to hold two tenders a week, this option was chosen. The second reason for holding two tenders relates to the distribution of PL. If only one weekly tender was held a single market participant could uplift the whole tender amount, placing other participants in the position of potentially not having any primary liquidity with less than 14 days to maturity. Again, the chances of this happening are probably not great. It is also possible to monopolise primary liquidity maturities under the existing system and this behaviour has not been observed to take place to any material extent. However, with the Reserve Bank bill, primary liquidity for particular maturities will normally be available only at a single auction, and the possibility of 'taking out' an entire week's Reserve Bank bills might have been perceived as being more obvious and attractive.

The amount of Reserve Bank bills offered at each regular tender is a straightforward function of the desired level of primary liquidity. For example, with a primary liquidity target of \$430 million, a settlement cash component of \$30 million, and with eight bill maturities entering into primary liquidity, the amount of bills sold at each tender will be \$50 million.

Amount of Bills on Issue

The aggregate level of bills on issue will depend, as was the case with the old system, on the degree of

pressure on liquidity conditions that is required given the Reserve Bank's monetary policy objectives. However, as bills are issued to meet only the precautionary demand for primary liquidity, the level outstanding over the year will be very much more stable than the old primary liquidity track. There may still be elements of seasonality in the demand for primary liquidity (for example, because of the general uncertainty about flows around tax time) but it is expected that if any seasonal adjustments in primary liquidity are necessary, they will be relatively small.

Other Means of Placement and Shorter Maturity Bills

While most Reserve Bank bills will be sold through the regular Monday and Thursday tenders, there will be occasions on which the Reserve Bank will sell bills through its daily open market operations and/or sell bills with a shorter maturity than 91 days. For example, if the Bank wishes to increase the level of primary liquidity quickly for policy purposes then shorter dated bills would be sold at tenders in addition to the regular 91 day bills or in open market operations. On other occasions when the amount of outstanding primary liquidity had been reduced by heavy discounting then it might be necessary to restore the level of primary liquidity to the targeted level by selling short dated bills. Similarly, there will be occasions when the Bank will buy Reserve Bank bills from the market because supply is seen to be ex-

cessive in relation to monetary policy objectives.

Bidders and Holders

In keeping with the Reserve Bank's general policy of making as few distinctions between institutions and classes of institutions as possible, there are no general restrictions on who may bid for and hold Reserve Bank bills. In order to bid in tenders, however, bidders must be registered and the Reserve Bank applies normal commercial criteria to ensure that the bidding parties are good settlement risks.

While there are no formal restrictions on holding Reserve Bank bills in practice it is expected that most bills will be held by the settlement institutions which have a natural need to hold primary liquidity. Because of the liquidity characteristics of Reserve Bank bills it is expected that their yield will be lower than that on Treasury bills and that investors wanting to hold short-term official debt for investment purposes will normally purchase Treasury bills.

Footnote

Results for the three tenders held up to 8 September, when this issue of the Bulletin went to print showed, as expected, a strong demand for Reserve Bank bills. Total bids received were approximately twice the volume on offer. Nearly all of the successful bids were from settlement banks. The average yield for successful bids was in the range of 30 to 40 points below bank bills of the same maturity.