

The Money Market

Past Present and the Future

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*Paper presented at the CDH 10th Anniversary
Symposium*

26 November, 1997

THE MONEY MARKET: PAST, PRESENT AND THE FUTURE

Good evening, ladies and gentlemen. I am honored indeed to have the opportunity to address such a distinguished gathering on a subject which is very close to my heart. Although I wear a professional hat as a financial economist and academic, I am also an interested party because of my affiliation with the CDH Group (Consolidated Discount House and Consodiscount Asset Management) as an advisor. The advantage of wearing the latter hat is that it has given me a first hand opportunity to observe the workings of the money market over the last one year.

The objective of this presentation is to trace the evolution of Ghana's money market. Of particular interest to us is the effect of government policy on the evolution and performance of the money market. In the spirit of a constructive review of policy, we hope to establish some policy proposals which are likely to help achieve the objectives of money market development.

THE NATURE OF MONEY MARKETS

In this paper, we define money markets broadly to include all financial instruments easily converted to means of payment (MI) that are used by governments, financial institutions and non-financial institutions for short-term funding or placements. By convention, we limit our scope to instruments of less than one year maturity.

The most important function of a money market is to provide a means whereby economic units can quickly adjust through cash positions. For all economic units (business, households financial institutions or governments) the timing of cash inflows is rarely perfectly synchronized or predictable in the short run.

However, buffer stocks of cash ties up resources in a relatively unprofitable form. Thus, if a unit has access to facilities for short-term lending and borrowing at low transaction costs, then, given the same general pattern of cash inflows and outflows, it can operate with a lower average stock of cash. Organized money markets provide obvious advantages to many units such as banks and large companies who deal in large sums.

In addition to facilitating the liquidity management of economic actors, money markets fulfil a number of additional economic functions:

1. Interest rates on money market instruments serve as reference rates for pricing all debt instruments;
2. Governments or central banks use money market instruments as tools at monetary policy;
3. Short-term interbank markets, finance longer-term lending when financial intermediaries transform maturities.

Surprisingly, the role of the money market in economic development has not attracted as much attention as say banking and more recently the more "sexy" topic of capital markets. This neglect increasingly becoming untenable as financial markets are liberalized and government shift from direct controls to more market oriented systems.

GHANA'S FINANCIAL SYSTEM DEVELOPMENT AS A DIALECTIC

The Past

Financial markets in Ghana have evolved in fairly identifiable stages as follows:

- 1) The Colonial Era (up to 1960)
- 2) The Centrally Planned and Closed Economy Period (1960-83)
- 3) The Structural Adjustment and Transition Period (1983-present)

Financial sector development is the interactive outcome of a relationship between regulators and the regulated institutions. The exploration of this interaction enables us to put historical developments and potential changes in a proper perspective.

The development of a financial system and its regulatory regime may be viewed as a *dialectic* or change resulting through a process of action and reaction by opposing forces. In his classic presentation, the philosopher Hegel described a dialectical process as:

- 1) An initial set of arguments or rules (the thesis)
- 2) A conflicting set of arguments or responses (the synthesis)
- 3) A change or modification (the synthesis) resulting from an exchange or interaction between opposing forces.

The idea that the regulation of financial institutions is a dialectic – one of a cyclical interaction between opposing political and economic forces was introduced by Professor Kane in the late 1970s.¹ The experience of Ghana is no different.

During the colonial era, the colonial government restricted itself to monetary stability and monetary growth was tied to export performance. Banking was established with the object of providing banking services for the British trading enterprises and the British Colonial Administration. The financial system played a passive and limited role in promoting economic development as its primary function financial system was to provide essential currency infrastructure. We note, parenthetically, that the first Treasury Bill issue was made in July 1954 on the initiative of the then Bank of the Gold Coast, with the bank acting as agents for the flotation. The bank also guaranteed to buy the bill at all times. This was the first attempt to create a securities market. The Treasury Bill issue was for a total of £500,000 of three-month Treasury Bills issued at 3/8 of 1%. Since the government budget was in a substantial surplus, the sole aim was to create a local market for government securities, rather than to finance a government deficit. By 1957, there were three banks: The Colonial Bank (now Barclays Bank), the British Bank of West Africa and the Bank of Gold Coast. The three banking institutions offered traditional banking services which included documentary credit (letters of credit), discounting bills of exchange, collection and remittances.

In the immediate post-independence era, the government of Kwame Nkrumah adopted a socialist development strategy under which the state was to be predominant in all aspects of economic

¹ Kane, Edward J. "Good Intentions and Unintended Evil: The Case against Selective Credit Allocation", Journal of Money, Credit and Banking, 9 (February 1977): 55-69. See also Kane, Edward J. "Accelerating Inflation, Technological Innovation and Decreasing Effectiveness of Banking Regulation", Journal of Finance, 36(May 1981): 355-367

policy making and implementation. In addition to import licensing and exchange controls this period was characterized by:

- Quantitative restrictions on interest rates
- Forced lending programs including requirements for banks to lend to sectors of the economy which were considered priority sectors by the government.
- Reserve requirements that made it obligatory for banks to count government securities as reserve assets.

This period also marked the use of state power to create a broad array of financial institutions. In the years following independence, the economic and political environment changed significantly. However, the regulatory structure of the financial system did not change.

The initial era of state banking was supported by an unstable macro-economy. Evidence of financial repression was reflected in the following

- *The high inflation rate had eroded the capital base of most banks*
- *Demand deposits constituted 64% of total deposits, thus constraining long-term lending*
- *Controls on interest rates had resulted in negative real rates of interest. The cost of bank deposits was not based on market signals and there was no incentive to compete for deposits. Indeed banks were known to have driven away depositors from their banking halls.*
- *Large public sector(fiscal) deficits financed by the banking system*
- *Credit allocation and interest rate controls resulted in several banks having surplus funds for extended periods with no means of investing such funds. Banks with deficit positions had no avenues for accommodation except by recourse to the central bank's facilities.*

This repressed financial system syndrome was the antithesis to the period of financial control and led to the regulatory adjustments of the 1980s.

The Structural Adjustment (Transition) Period 1983-95

In 1983, the Government adopted an economic recovery program which had the objective of restoring macroeconomic stability by removing distortions and liberalizing economic activity.

From 1987, there was a gradual liberalization of the financial system:

- *All sectoral credit allocations were phased out, with the last target for agriculture abolished in 1990*
- *Interest rate controls were gradually relaxed and full liberalization was achieved in February 1988*
- *In November 1990, the Bank of Ghana decontrolled all bank interest rates, charges and fees*
- *A foreign exchange auction was introduced in 1986 and the establishment of forex bureaus were permitted in 1988.*

The synthesis which resulted from the weak financial structures of the planned economy period was the Financial Sector Adjustment Program(FINSAP). Launched in 1988, FINSAP provided for a comprehensive restructuring of the financial sector. The objectives of the programme were:

- *To undertake the restructuring of financially distressed banks;*
- *To enhance the soundness of the banking system through an improved regulatory and supervisory framework;*
- *To improve the mobilization and allocation of financial resources – including the development of money and capital markets*

Discount Houses

As part of the process of financial restructuring, the central banks entered into discussions, initially with the Merchant Bank and later with the major commercial banks in August 1986 to find solutions to the liquidity problem of the banks. Initially, the discussion focused on the introduction of acceptance credits for export and import by banks which would be acceptable for rediscounting by the central bank. The best answer to why the discount house was chosen as the key intermediary in Ghana's money market is "tradition".

The U.K. Experience

Uniquely British institutions called discount houses began in the early 19th century. The discount houses were experts in the assessment and fine-grading of credit risks and they selected and insured by means of accepting bills suitable to be held in their and other portfolios. It was not until 1890 that discount houses became the main route through which bills came for rediscount at the Bank of England. As part of this arrangement, the ultimate lenders to discount houses were clearing banks and the ultimate borrowers commercial firms and later the government. Clearing banks lent money at very short-term (on call or on an overnight basis) to the discount houses who then used these funds together with a certain volume of funds raised from non-bank sources, to discount longer maturity treasury bills or commercial bills, that had been accepted by an established accepting house. The discount houses acted as bankers to the banks and stood as an intermediary between the banks and the ultimate lenders.

Discount houses enabled the banks to economize on their cash reserves by providing them with interest bearing assets which were almost as liquid as cash – the default risks and interest rate risks involved being borne by the accepting and discount houses. The funds the discount houses obtained from the banks were secured – the discount houses pledged assets against their borrowing with a margin of security in excess of the actual amount borrowed. As far as the banks were concerned, the liquidity of the call loans to the discount houses were underpinned by the fact that the Bank of England assumed the role of lender of last resort to the discount houses; the discount houses could if necessary, obtain cash to repay the banks if loans were called, by rediscounting bills or borrowing on the security of bills from the bank. The discount houses held bills to maturity but also made a secondary market in bills, the banks acquired bills nearing maturity from the discount houses for holding in their own portfolios.

From about the mid-1950s, the scope of financial claims traded in the London money market broadened significantly. When organized trading in other short-term claims began to develop, such markets were often referred to as parallel markets – essentially unsecured instruments. Newer markets included:

1. The Inter-bank market
2. Certificate of Deposit Market
3. Commercial Paper

In 1997, The Bank of England implemented dramatic changes to its liquidity management regime, replacing the discount house role with an active REPO market along American lines. By February

1997, most discount houses in the U.K. had either wound up or transformed themselves into financial boutiques offering an assortment of financial services including merchant banking and brokerage.

The Ghana Experience

The first discount house in Ghana, Consolidated Discount House, was established in 1987; a second discount house, Securities Discount Company was incorporated in 1990 and started operations in 1991.

The prerequisites for successfully operating a discount house system is that there should be adequate supply of liquid funds, sufficient and continuous flow of suitable short-dated bills and government support. In Ghana, this was made possible by the fact that banks do come by large volumes of liquid funds everyday. In addition, there are bills which are fully negotiable and of the highest quality such as Treasury Bills, negotiable certificates of deposit and bankers acceptances.

At inception, the discount houses in Ghana were expected to fulfil the following functions:

- 1)** Taking very short-term deposits from banks and thereby supplying them with highly liquid assets;
- 2)** Discounting commercial bills of exchange and thereby supplying industry and commerce with short-dated funds;
- 3)** Underwriting the weekly tender for Treasury Bills;
- 4)** Making a market for short-dated bills of the financial system.

In return for performing the above functions, call money placed by banks with discount houses qualify as first-line liquid assets for satisfying the secondary reserve requirement This privilege enables discount houses to mobilize funds at low cost.

The impact of the establishment of Consolidated Discount House was immediate. Excess cash reserves which constituted 18.8% of deposits in 1986 dropped to 2.9% by march 1989. Currently, not all the functions of a discount house are developed. For example, some functions such as the underwriting of the weekly tender for Treasury Bills and the rediscounting of bills are shared with the Bank of Ghana.

The history of discount houses also indicates that over time, the intermediary function of discount houses is slowly replaced by direct dealings between the central bank and the banks. In some cases such as Singapore and the U.K., the discount house intermediary function no longer exists. Discount houses in Ghana face several challenges. Several new developments have taken place since the inception of discount houses in Ghana, which have had the net effect of weakening the market position of the discount houses.

Over the past few years, Bank of Ghana policy and operational procedures have drifted in the direction of relying on the money markets to conduct their monetary policy without recourse to discount houses as intermediaries.

This is reflected in:

- 1.** The emergence of a primary dealership system for Treasury Bills, with the discount house being only one of several primary dealers.
- 2.** The Bank of Ghana's efforts toward the establishment of an active REPO market in Ghana. It is envisaged that BOG will engage in REPO activity directly with the banks.

3. Overdrawn operational balances of the Bank of Ghana are charged rates which are more favourable relative to rates charged to discount houses, undercutting the ability of discount houses to pass on their high costs of borrowing at the Bank of Ghana to banks who call on the discount houses for funds.

In addition, the emergence of an interbank market, which actively competes with discount houses for overnight funds has strengthened the ability of the banks to manage their liquidity without recourse to the discount houses. The interbank market has had an important effect on how the money market works. Since banks have the lowest cost of funds, the interbank borrowing is much cheaper than funds obtained by selling NCDs to a discount house or by rediscounting bills.

The Future

A Rationalization Of Rates

The interest rates on money market instruments serve as reference rates for pricing other forms of debt financing. Usually, longer term and riskier instruments are priced as increments over a basic reference rate. If the loanable funds are to be allocated efficiently, the reference rate must be a market rate – else the pricing of debt instruments will not be optimized. To achieve this goal, the following steps must be undertaken:

Further Liberalization of Rates

The Bank of Ghana should allow supply and demand to determine the treasury bill rate. By observation, it is easy to establish that the Bank of Ghana has established an unofficial ceiling on the bid rate for the weekly treasury bill auction. Otherwise, there is no reason why the rate should be the same week after week, even when total sales are consistently below the amount offered. Under a market based rate primary dealers would tender based on their alternative opportunities for the use of funds. The Bank of Ghana must avoid the temptation to manipulate money market rates.

Yield Curve

Currently, the longest maturity instrument is the 2-Year Treasury Note, the interest rate on which has been fixed at 33.50% This means that there is no meaningful yield curve which can provide benchmark rates for debt instruments, especially for medium- to long-term instruments. Such a yield curve will be absolutely essential for the development of a long-term debt market as well as their derivatives. The Bank of Ghana should slowly stretch the maturity of treasury issues in order to provide a meaningful yield curve to serve as the basis for the pricing of all fixed income instruments.

The Bank Rate

The bank rate is an indication of the rate at which the central bank lends to the banking system. Theoretically, it should also be the rate at which the central bank discounts first class bills such as Treasury Bills. The bank rate is seen as a penal rate or generally in excess of market rates on treasury bills and other first class bills. The minimum requirement for a bank rate to a lender of

last resort rate is that it should be unprofitable for a financial institution to “round-trip” by borrowing at the bank rate and investing the borrowed funds in treasury bills.

Since the central bank is a lender of last resort, the bank rate indirectly determines many other interest rates. Discount houses, naturally, would relate their market rate of discount very closely to the rate at which they borrow in times of stringency. The banks also adjust the rates the demand for money at call with the discount houses to the yields they see the discount houses earning on bills purchased with such funds.’

Given the above stated role of the bank rate, the current level of the bank rate does not make economic sense. Currently, the bank rate is 45% while the 90-day treasury bill rate is an interest equivalent of 47.93%. This clearly distorts the role of the bank rate as an indicator of the cost of short-term funds. Some would say that raising the bank rate to a rate higher than the 91-day treasury bill rate would shake confidence in the financial system by signaling a rise in interest rates. But we can depoliticise the bank rate by floating it, just as we depoliticised exchange rates by moving from a fixed to a floating rate.

- *The bank rate should be floated at say 1.5% above the weekly treasury bill rate (weighted average). This takes away the political pressure to maintain an economically meaningless bank rate*

Rediscount Rates

Currently, the Bank of Ghana maintains a separate rediscount table in addition to the bank rate. The rediscount table is set at rate which penalize the holding of paper for short periods of time. In addition, the rediscount rates are officially secret which means that the discount houses, banks and other holders of Treasury Bills will only know the rediscounted value of bills on presentation to the Bank of Ghana. This arrangement presents a number of problems:

1. The use of a separate rediscount table usurps the role of the bank rate as the rate at which the central bank provides liquidity to banking system on a last resort basis.
2. The unwillingness of the Bank of Ghana to publish the rediscount table is “anti-market”. Clearly, for economic actors to make rational decisions, they need to have minimum noise in the prices at which they transact. For example, under the current system, a financial institution or commercial enterprises cannot put a liquidation value on the holdings of treasury bills because they cannot establish what the bills will be worth upon rediscounting. Portfolio managers who manage pools of securities also have the problem of not being able to establish the market value of their Treasury Bill holdings.

Liquidity For Non-Government Instruments

The money market can provide liquidity for commercial firms as well as banks. Unfortunately, the current structure of the money market does not serve the liquidity needs of the private sector. In order to achieve this role, private non-bank money market instruments should be encouraged. These include:

- Commercial Paper
- Negotiable Certificate of Deposit(NCD)
- Bankers Acceptances(BA), especially for exports.
- Local government issues

- Mortgage-backed securities

In Malaysia, the development of a secondary market in Bankers' Acceptances were supported with the following policies:

- BAs with a maturity of not more than 21 days may be rediscounted with the central bank.
- Banking institutions were allowed to include BAs (up to a maximum of 5% of the institutions eligible liabilities) as liquid assets (secondary reserves)
- Portfolio regulation governing the discount houses were amended to allow them to hold more BAs and NCDs
- A wider range of institutions which meet specified criteria were allowed to issue NCDs.

The Future Role of Discount Houses

It is clear that the regulatory authorities have not come to term with the fundamental policy question of the long-term role of discount houses in the money market. The policy choices are very clear. Discount houses are intermediaries between the central bank and the banking institutions. The intermediary role is reflected in the fact that the central bank provides liquidity to the financial system by lending to the discount house which in turn lends to the banks. In many countries, central banks have chosen to use a more direct approach by lending directly to the banking system. What is of interest is that countries whose money markets revolved around discount houses have over time transformed into a non-discount house based system. These countries include Singapore and the U.K. A similar process is underway in Malaysia where there are seven discount houses. Undoubtedly, we in Ghana have to come to terms with the same policy decision sooner or later.

It is clearly the case that countries which have made a successful transitions out of the discount house model are those countries whose discount markets had developed into active secondary markets. Regardless of the future role assigned to discount houses, government policy has to move in the direction of facilitating the development of the discount houses into active dealers in government securities.

In order to improve the operational efficiency and growth of the discount houses into full scale market makers in money market instruments, the following developments should be considered.

Financing of Positions

Discount house positions must be carried i.e. financed. To serve as a market maker, it has to hold inventory positions – long or short. Long positions required the firm to borrow funds and the short positions provide funds that can be lent. It is the difference that must be financed. This can be done through an expanded REPO market, i.e. sell and buy back. Discount houses must fully collateralize loan. The central bank can support this by accepting REPOs entered into with discount houses as secondary reserve items.

The Primary Dealer System

The transfer of the distribution of treasury bills to the primary dealers is a step in the right direction. However, adequate compensation must be paid to the primary dealers to discharge this function. Currently the Bank of Ghana pays commission at the rate of .25% of the treasury bills purchase. On a deal size of ₵20 million, the Bank of Ghana pays a commission of ₵50,000. For a commission of ₵50,000, the customer wants the dealer to provide purchase and redemption services, automatic rollovers and up-to-date statements of account. The services that go with a treasury bill transaction require clerical, accounting and information systems resources which are not covered by the commission paid by the Bank of Ghana.

It seems to me that there are two options open to the Bank of Ghana – either pay an economically sensible commission or convert the treasury bill market into a wholesale market, so that deal sizes can be large enough to cover the cost. In such a case, small investors can invest in treasury bills by buying into money market unit trusts and mutual funds which are operated by non-bank financial institutions such as the HFC Unit Trust and others that are awaiting licensing.

Challenges to Discount Houses

The discount houses themselves need to undertake a strategic appraisal of their current role in the money market. Such a strategic evaluation should consider the obvious reality that they have to adapt to a new environment in which they have to compete with the interbank market for funds from an increasingly disadvantageous position. A second reality is that they have to operate within a regulatory system whose prime objective is to create a secondary market in which the discount houses will not necessarily have a monopoly on intermediation. As in other countries where similar developments have taken place, such a strategic repositioning should as a minimum have the following elements:

1. Development of additional services that build on and complement their current product menus
2. Move from a "buy and hold" to a "buy and trade" posture.

The latter posture would be fully supportive of the central bank's objective of transferring all secondary dealing to the primary dealers.

Let me further suggest that such a strategic repositioning will require a radical revamping of ownership and control of the discount houses. Today, the discount houses stand as victims of the manner of their creation, which simply put, was an imitation to all the banks and other financial institutions to support the creation of discount houses by subscribing to shares. To the banks, being part of the discount house was a call to national duty as well as providing them with an instrument for earning returns on their short-term surplus funds. No one envisaged that a few years down the road, the banks would be locked into a competitive battle for short-term funds with their creation. Control of the discount houses, through the boards of directors, is in the hands of the banks who are competing with them in the interbank market and in some cases in other product areas such as corporate finance and treasury bill sales. The anomalous situation has created a conflict of interest for the bank– shareholders, turning the entire governance process on its head. Clearly, the discount houses cannot develop as market driven institutions with a keen nose for market opportunities and strategic repositioning unless they are owned by investors who are not competitors.

Payments System and Scripless Securities

Last but not the least, the participants in the money market are anxious to see more rapid progress towards an electronic payments system and scripless securities trading.

Distinguished guests, I would not want to leave you with a pessimistic prognosis. Recalling where we came from and where we are today, we have every reason to be proud of our accomplishments and the credit should be shared by all market participants - regulators and the regulated. However, it is also a reality that regulatory systems everywhere operate with lag. Market players, who are usually free of the statutory obligations of regulators are usually far ahead in terms of diagnosing problems and developing solutions of their own, some of which may not please regulators. Regulatory drag can only be shortened through an institutionalized process of dialogue and consultation. Judging from the full participation of market operators and regulators in this symposium, I am confident such a process is already underway.

Thank you very much for your attention.