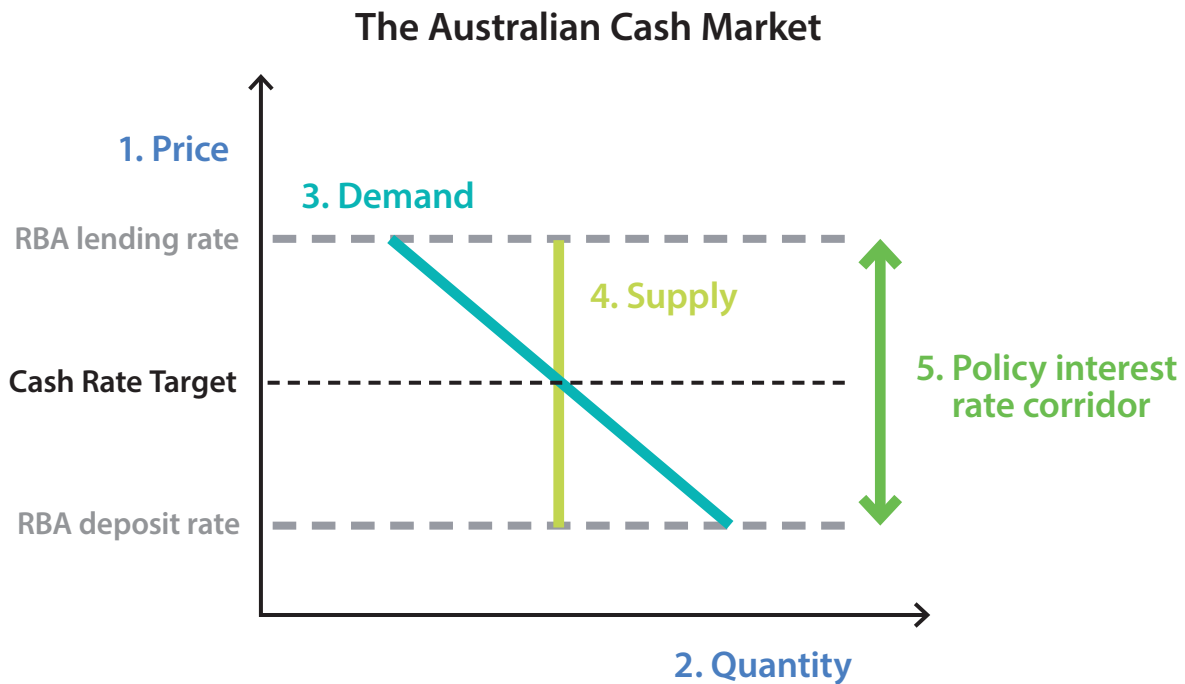




How the Reserve Bank Implements Monetary Policy

The Reserve Bank of Australia implements monetary policy by undertaking transactions in domestic money markets. These transactions are mainly conducted in an auction following a public announcement to all commercial banks that the central bank intends to buy or sell cash. The price a commercial bank is willing to pay determines who is, and who is not, successful in obtaining cash. This auction approach is referred to as 'Open Market Operations'.

How monetary policy is implemented can be explained by stepping through five aspects of the cash market: the **price**, **quantity**, **demand**, **supply** and the **policy interest rate corridor**.



1. Price

The cash market is where banks lend and borrow funds from each other overnight. The price in this market is the interest rate on these loans. In Australia, this interest rate is called the cash rate. As the Reserve Bank sets a target for the cash rate, it is often referred to as the 'instrument' of monetary policy.

2. Quantity

The quantity traded in this market is called Exchange Settlement (ES) balances, which are used to settle interbank transactions. Banks have deposit accounts at the Reserve Bank to record the value of their ES balances. Because the Reserve Bank is Australia's central bank and controls banknotes available to the public, ES balances are considered to be the equivalent of cash.

3. Demand

Banks use ES balances as a store of value and to make payments between each other. Some of these payments are on behalf of their customers and some are related to their own business. The Reserve Bank estimates the demand for ES balances each day. Demand may vary for a number of reasons, including changing financial market conditions.

4. Supply

The Reserve Bank manages the supply of ES balances. Supply is set so that it meets demand and the cash rate is as close as possible to its target.

A number of factors can change the supply of ES balances. For example, any payments made by the Australian Government or received into its accounts at the Reserve Bank will affect ES balances.

The Reserve Bank responds to changes in the demand and supply of ES balances to maintain the cash rate target. This is mainly achieved with open market operations. There are three types of transactions which the Reserve Bank typically conducts:

1. Bond purchases or sales

The Reserve Bank purchases or sells bonds in exchange for ES balances. Transactions using bonds therefore change the ES balances of banks.

2. Repurchase agreements (Repos)

Repos are used frequently. A repo is a transaction with two parts. In the first part the Reserve Bank could lend ES balances to a bank and receive a bond in exchange. This increases the supply of ES balances available to banks. In the pre-arranged second part, the transaction is reversed.

The Reserve Bank returns the bond and receives back the ES balances. As a result, the supply of ES balances decreases.

The two parts of repos make them very flexible, which is one reason they tend to be used more frequently than direct bond purchases or sales. Repos are used every day in open market operations.

3. Foreign exchange swaps

A foreign exchange swap is very similar to a repo. The main difference is that, instead of bonds, foreign currency (e.g. US dollars or Japanese yen) is used in the transaction.



5. Policy interest rate corridor

The Reserve Bank pays an interest rate on ES balances that is 0.1 percentage points below the cash rate target. Banks have an incentive to deposit as little as possible at this rate, and instead prefer to earn the higher cash rate by lending out their balances.

The Reserve Bank is also willing to lend ES balances to banks if this is required. The interest rate on these loans is 0.25 percentage points above the cash rate target. Banks have an incentive to borrow as little as possible at this rate, and instead prefer to borrow at the lower cash rate in the market.

The deposit and lending rates form the lower and upper bounds of the policy interest rate corridor. Banks have no incentive to borrow or lend ES balances outside this corridor. If interest rates in the market were lower than the deposit rate paid by the Reserve Bank, banks would choose to hold more ES balances. Similarly, if market interest rates for cash balances were above the top of the corridor, banks would choose to borrow more cheaply from the Reserve Bank. The corridor represents a range within which banks have an incentive to trade ES balances amongst themselves.

The corridor also provides a mechanism for implementing changes to the cash rate target. The bounds of the corridor are set with reference to the target, regardless of the level of the cash rate. The corridor shifts in line with changes in the cash rate target, as do the incentives for trading within that range. On the day that a new cash rate target is announced by the Reserve Bank, it is not necessary to conduct additional market operations to guide the market toward the new interest rate.