

## Box C: Bank Liquidity in the Aftermath of 11 September

Central banks around the world sharply increased the supply of liquidity to their financial institutions in the aftermath of 11 September, to ensure that financial systems continued to operate without disruption. This box explains what that meant in the Australian context.

Broadly speaking, the 'liquidity' of an institution refers to its capacity to meet short-term financial obligations. In the case of banks, the core part of their liquidity is the current balances held with the central bank. Banks can draw on these at any time and receive instant value. In Australia, banks' funds at the RBA are held in Exchange Settlement (ES) accounts.

The supply of ES funds is controlled by the RBA through daily operations in the money market. The RBA varies the supply of ES funds so as to influence the interest rate at which banks borrow and lend funds to each other. This interest rate, known as the cash rate, is the rate in terms of which monetary policy changes are announced. When the RBA wishes to add funds to the banking system, it purchases securities, giving the seller funds in exchange. Sales of securities by the RBA reduce the supply of ES funds.

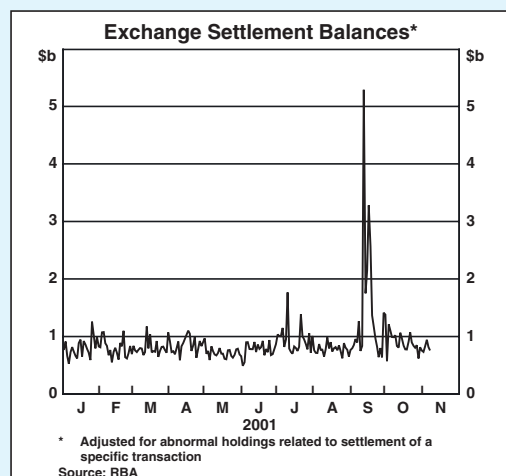
Banks' demand for ES funds is normally fairly stable, being based on their expected payment flows. Demand for ES funds can increase substantially, however, in times of uncertainty as banks are less confident about their payment flows and, as a precaution, seek to increase their holdings of liquid balances. Hence, one of the RBA's priorities on the morning of 12 September was to ensure that there were sufficient funds to meet banks' demand, in order to avoid disruption to markets and increases in interest rates. When markets opened in Australia on the morning of 12 September, the RBA issued a statement that payments

and settlement systems were operating normally and that it would provide the financial system with liquidity as needed.

Early indications pointed to a sharp increase in the demand for liquidity on the day. Banks expecting to receive payments arising from international transactions were uncertain whether those payments would be received. As a result, they became less willing to lend funds themselves.

The RBA injected significant additional ES funds through its market operations on 12 September. In its normal dealing round (which takes place between 10 and 10.15 am) the RBA boosted the supply of funds to about \$2.5 billion, or around three times the amount banks typically hold. The RBA normally only deals once a day but, on this occasion, it undertook a second round of market operations to add further funds later in the day when it was possible to form a clearer view on the demand for funds. This boosted the amount of funds that banks held in their ES accounts at the end of the day to over \$5 billion (Graph C1).

Graph C1



The demand for ES funds remained unusually high for a few days subsequently, with balances averaging about \$3 billion over the week. By late September, normal conditions had returned to the market.

The increased supply of liquidity allowed the money market to continue to operate smoothly throughout the period, with the cash rate remaining very close to the target (Graph C2). ▽

**Graph C2**