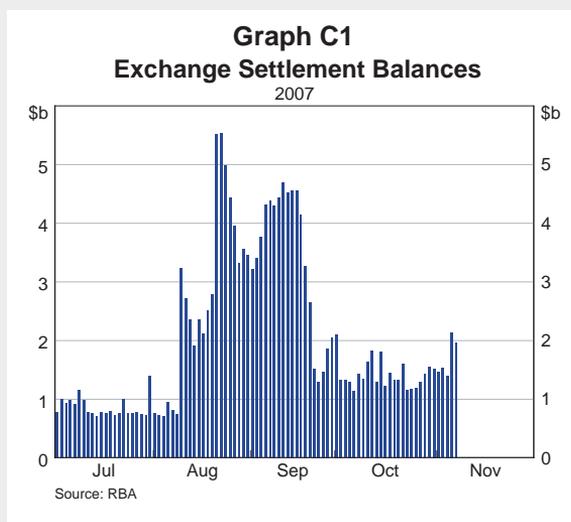


Box C: Reserve Bank Open Market Operations

The Domestic Markets Department of the Reserve Bank conducts open market operations on a daily basis in order to keep the cash rate as close as possible to the target rate established by the Reserve Bank Board. By injecting or withdrawing funds, open market operations affect the aggregate balance of financial institutions' Exchange Settlement (ES) accounts at the Bank – these balances are used for settling transactions with each other and the Commonwealth Government. Typically, these operations are conducted by engaging in repurchase agreements ('repos') with financial market participants for Australian dollar securities, though occasionally large flows to or from the Government need to be accommodated by transactions undertaken by the Bank in the foreign exchange swap market.

The shock to money markets around the world in mid August, described in the main text, saw the demand for settlement funds rise sharply. Pressures in money markets intensified over the following weeks, with 3-month funding rates in Australia peaking at over 7 per cent in mid September, more than 50 basis points above the corresponding rate that measures expectations of the cash rate (the overnight indexed swap rate). In response to these developments, the Reserve Bank injected additional liquidity through its open market operations to help money markets function as smoothly as possible. Other central banks undertook similar operations in their own markets.¹

During this period, market participants' greater demand for liquidity was evident in the Bank's domestic market operations in several ways: there was an increased number of market participants bidding for cash, their bids were larger and they were willing to pay more for that cash. In order to keep the cash rate as close as possible to the target rate, the Bank responded to this increased demand for liquidity by injecting a significant amount of funds into the market, resulting in a rise in ES balances. The aggregate balance of ES accounts rose as high as \$5.5 billion on 23 August, compared with an average balance of around \$750 million over recent years (Graph C1). Because demand was substantially greater, the bids at which the Bank conducted repos were higher than they had been, despite the larger injections of liquidity.

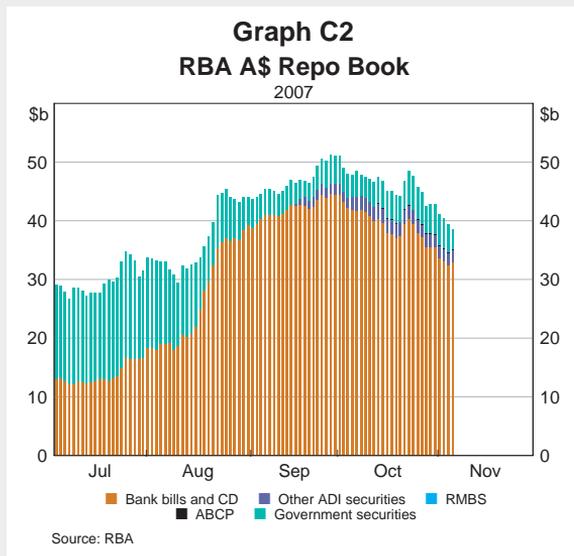


¹ See Battellino R (2007), 'Central Bank Market Operations', RBA Bulletin, September, pp 19–26.

In response to pressures in the bank funding markets – particularly for longer term loans – the Bank altered its market operations in a couple of ways. The Bank conducted a greater share of its operations as repos collateralised by bank bills and certificates of deposit (CDs), with an offsetting decline in the share collateralised by government securities. The Bank also increased the maturities of the repos it conducted in response to the difficulties faced for longer-term funding. As a result, the share of the Bank’s holdings of bank bills and CDs in its domestic

securities increased, from an average of around 40 per cent over the past year to around 80 per cent in early November (Graph C2). The maturity of the Bank’s outstanding repos increased from an average of around 20 days to over 50 days by mid September, with a significant portion of the repos entered into in this period having terms extending beyond three months.

Over this period, the Bank also allowed its foreign exchange swaps to decline, both to facilitate an increase in the holdings of domestic securities and to accommodate changes in the size of the Bank’s balance sheet. The Bank’s foreign exchange swaps



declined from just over \$45 billion in early August to close to zero by early November. Over recent years, foreign exchange swaps had gradually built up to accommodate the increase in the Bank’s balance sheet, without adding to pressures in domestic asset markets.

In early September, the Reserve Bank announced an expansion of the range of securities that could be used for repos in the Bank’s domestic market operations to include other high quality securities.² This represented the latest stage in the progressive broadening of the range of securities accepted for repos that has occurred over the past decade but its timing also provided an avenue for the Bank to assist the functioning of a broader range of markets. The list of authorised deposit-taking institutions (ADIs) whose bank bills and CDs were eligible for Reserve Bank repos was broadened and longer-term securities issued by ADIs (with a high credit rating) were accepted for the first time. The Bank has also begun to accept both short- and long-term securities backed by residential mortgages – asset-backed commercial paper (ABCP) and residential mortgage-backed securities (RMBS) respectively – as collateral. As was previously the case, the Bank will only accept securities from unrelated parties. Overall, these securities now account for about \$3 billion, or around 5 per cent, of the Bank’s domestic portfolio.

2 These changes were announced in the Reserve Bank press release ‘Domestic Market Dealing Arrangements’ on 6 September 2007.

As conditions in the money market have improved, the Bank has withdrawn much of the liquidity it has injected. ES balances have been around \$1.4 billion in recent weeks. This is still higher than the average level before the recent turbulence, reflecting the desire of some financial institutions to operate with a higher level of cash balances than previously. Throughout the whole period, the Bank's actions in the money market have seen the cash rate remain very close to the target, deviating only very occasionally and by no more than two basis points. ↗