Intervention techniques under a deregulated financial environment

An address by Peter Nicholl, Deputy Governor Reserve Bank of New Zealand, to Annual SEACEN Meeting Directors of Research and Training Suva, Fiji Tuesday, 30 November 1993

Introduction

I would like to thank the South East Asian Central Banks Research and Training Centre for inviting me to address this meeting of the directors of research and training from member central banks.

In New Zealand we have spent a lot of time and effort over the last nine years developing a set of monetary policy techniques that will work in a deregulated financial environment. But we are by no means the only central bank that has been going through that process. Most central banks have done so or are currently doing so. In my address today, I want to try and draw on some general lessons that I think come out of changes that are occurring in the operation of monetary policy around the world. I will not discuss here issues of prudential regulation and supervision, though issues certainly arise in this area as financial markets are liberalised.

To do this I would like to start by reviewing the trends of deregulation and internationalisation of financial markets and describing the features of generic monetary policy architecture. I would then like to share with you the conclusions we have reached in New Zealand on the appropriate monetary policy regime in a deregulated financial environment. From this I will try and draw what I think are the general lessons about the operation of monetary policy.

Deregulation and Internationalisation

There is little doubt that deregulation and internationalisation have been key features of many financial markets over the last two decades. The processes have started at different times and proceeded at different paces and to different degrees in various countries. They have also come about for different reasons: attracting foreign investments; meeting the domestic demand for legitimate overseas investment opportunities; acceptance of international obligations; or simply a wish to increase the efficiency of financial markets in allocating financial resources according to relative risks and returns. In any event there would have been few, if any, financial markets that have escaped the impacts altogether.

The main changes impacting on financial markets over the last 20 years or so have been:

1. a progressive dismantling of exchange controls;
liberalisation and reform of domestic financial sectors in many countries, including removal or reduction of interest rate controls and restrictions on various activities. The regulations that compartmentalised financial markets are generally being removed or scaled down;

3. dramatic decreases in the costs of telecommunications and information gathering and processing;

4. an increasing need and increasing opportunity to hedge against the high variability of asset prices and inflation rates that were features of the world economy in the 1970s and 1980s; and

5. increasing ‘securitisation’ and ‘institutionalisation’ of savings and investment which has reduced the relative role of “banks”.

However, even though the internationalisation of financial markets has expanded rapidly, the degree of integration is frequently overstated. A few examples taken from a recent Goldstein/Mussa paper\(^1\) illustrate the point.

1. less than one-fifth of the IMF’s members have no restrictions on external payments;

2. the lion’s share of investment in all countries is still financed by domestic savings;

3. portfolios of individuals and even of institutions in most countries, including the major industrial countries, continue to have a strong “home” country bias; and

4. there has not been as much convergence of nominal and real interest rates across even the large industrial countries as one would have anticipated if the markets were well integrated.

The deregulation and integration of financial markets has undoubtedly changed the operation of domestic monetary policy for most countries. Old style regulations and rules of thumb are unlikely to work in the same way and may not work at all. But domestic monetary policy can still have an impact in most countries - indeed, in important respects, monetary policy has been made more effective in many countries in the wake of financial markets liberalisation. This, in fact, was probably the single most important reason for the main liberalisation measures in New Zealand.

So the first lesson is that as central bankers we are not yet an endangered species. But like most species we have to be prepared to adapt, in our case, to the impacts on our role of deregulation of financial markets. Specifically, we have to be prepared to grasp the opportunities which these developments offer for strengthening and modernising monetary policy.

Monetary Policy Architecture

In all countries, whether deregulated or not, the monetary policy architecture has much the same general elements. It has:

1. An ultimate target or targets: these may be fixed or variable, single or multiple, made public or kept within the policy making cadre. But however it is determined and specified at any point in time, there is some target(s) that the authorities are trying to achieve.

2. Financial variables: monetary or credit aggregates, interest rates, exchange rates etc that act either as intermediate targets or information variables that influence the stance of policy.

3. Monetary policy instruments: the monetary authorities need to have some instrument(s) that they control and which have some reasonable relationship to the ultimate target(s) if monetary policy is to exert any predictable impact.

4. Transmission channels: there will be a number of possible channels by which changes in the instruments will change the intermediate financial variables and eventually impact on the ultimate target.

Deregulation does not change the basic monetary policy architecture as sketched out above. But it does have an impact, sometimes a significant one, on the design of an efficient monetary policy framework as it does influence the effectiveness of alternative instruments and transmission channels and even which targets are sensible and achievable.

The New Zealand Monetary Model

The design of an appropriate monetary policy regime in any particular country is largely an empirical issue and there will be no universal answer that is applicable in all respects to all countries. I will outline the conclusions we have reached in New Zealand and the reasons for them.

1. The ultimate target
The ultimate target for monetary policy in New Zealand is very clear. It is the achievement of price stability. That in itself is not so unusual, as price stability is the stated objective of the monetary policy of many countries around the world. The uniqueness of our model lies in the specification of the target - both in the processes that are used to specify the target and the clarity of the definition of the target.

The legislation under which we operate, The Reserve Bank of New Zealand Act 1989, says: “The primary function of the Bank is to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices.”

The equivalent clause in our previous legislation set out multiple objectives - price stability, economic growth, full employment and balance of payments equilibrium.

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The 1989 Act also requires that the Minister of Finance shall fix, in agreement with the Governor, policy targets for the carrying out of the Bank’s primary function and that these policy targets must be published.

A copy of our present “Policy Targets Agreement (PTA)” is attached as Appendix 1 to this paper. It says in essence that, subject only to certain specified shocks (significant terms of trade changes, changes in indirect taxes or government charges, interest rate movements), we are required to keep 12-monthly increases in the Consumers Price Index at between 0 and 2 percent.

As an aside, I will just mention that after having inflation persistently above 10 percent for almost all of the 1970s and 1980s, inflation has been within our 0-2 percent targets range for the last 2½ years. The first part of our statutory task to “achieve” price stability has been achieved. We now have the task of maintaining price stability.

The key general features of the way we have specified our monetary policy target are therefore:

(a) There must always be a clearly specified target for monetary policy that is known to the public - and therefore known to the financial markets. The financial markets, and other economic agents, don’t have to spend time pouring over Reserve Bank and Ministerial statements and actions, trying to work out what we are aiming to achieve. The target is clear and unambiguous.

(b) The target is set by the Government, not the Reserve Bank. We advise them, of course, but it is their decision. There are mechanisms in the Act by which the Government can alter the target, but it is an open and transparent process. We in the Reserve Bank, on the other hand, can’t decide that we will change the target and aim at something else. The framework is consistent with the Westminster approach to democracy we have in New Zealand.

(c) There is a single target - price stability. The adoption of a single target, and the choice of price stability as that target was the result of:

(i) Our history.
Some of the rationale came from having had around twenty years of inflation well in excess of our main trading partners (about 2½ times on average). Between 1967, when New Zealand set off on an inflation devaluation roller-coaster, and 1989, prices increased by around 1000 percent.

(ii) Our views of monetary theory.
Our reading of monetary theory is that the most that can reasonably be expected of monetary policy is medium-term control over inflation. We believe the output and employment effects of monetary policy are neither predictable nor permanent enough for output and employment to be realistic or sensible objectives of monetary policy. Our history suggests that the end result of trying to achieve these objectives with monetary policy is likely to be more inflation but little or no sustained growth.
(iii) A desire for transparency and accountability. The changes made to the monetary policy framework in New Zealand were also consistent with the process of reform in the most of the New Zealand public sector which aimed to specify clear objectives for government agencies and hold them accountable for achieving the objectives. The Governor is accountable for achieving price stability. His job is at stake.

The scope, if it ever existed, to try and achieve multiple objectives or frequently changing objectives with monetary policy has, I believe, disappeared. The general consensus gaining ground internationally is that domestic monetary policy should be aimed at price stability. We in New Zealand certainly believe that to be the case. Our monetary policy framework is based on that belief.

If central banks try to fool deregulated financial markets, and the general public, by switching the balance among multiple targets or being deliberately vague about their target, the financial markets will immediately price that uncertainty into interest rates and exchange rates. The speed with which problems will come back to haunt policymakers has been increased by deregulation. It is therefore important that you don’t lose credibility. As has been often said, credibility is hard to gain but easy to lose.

2. Intermediate targets or information variables
While there continues to be a considerable amount of academic discussion about rules versus discretion in the implementation of monetary policy, most central bankers have, I believe, reached the conclusion based on empirical research and experience, that no intermediate target has a sufficiently strong and consistent relationship to the ultimate target of policy to allow a Central Bank to steer monetary policy through a fully binding operational rule.

Central Bankers will to continue to conduct research, and keep an eye on academic research and debate in case someone can find a stable relationship that would allow a rule-based approach to policy interventions. We certainly do that.

But in the meantime most, if not all of us, have to exercise discretion. This means exercising judgment. The issue that is of primary interest to Central Bankers is to find and use means by which discretion can be guided and constrained in sensible ways.

Two areas that seem to be gaining most attention are:

(a) Specify the ultimate target fairly precisely - preferably by some price stability target. I have already talked about this. But its relevance to the implementation of monetary policy is that a clearly specified target does direct and constrain a Central Bank’s behaviour when it implements policy.

The hallmark of completely discretionary policy has often been actions which are too little and too late because there is generally a bias against raising interest rates. Having a clear objective based on price stability should add an element of discipline that helps reduce the bias and the too little/too late characteristics of discretion.
This is certainly how it has worked out so far in New Zealand. The publicly announced target has led to important behavioural changes within the Reserve Bank. The target provides a clear structure for internal discussions about the appropriate stance of policy. Once we had been operating under this framework for a while we realised how many of our past internal debates and arguments arose not because we had major differences about current and future financial or economic conditions, but because most of us had different weights on the various elements of the multiple objective function.

(b) Where central banks are using a number of information variables or a checklist approach to guide their judgements, they should specify the empirical relationships between these variables and the ultimate targets as precisely as possible. Research on these information variables is therefore very important.

We publish a considerable amount of material explaining our analytical framework. The main source is a formal “Monetary Policy Statement” that our Act requires us to publish at least every six months.

The first point we always make, and which is now widely understood, is that because our target is inflation, the main thing we focus on (and therefore others should focus on also) is the expected inflation track.

Our key internal process is to compare forecast inflation with the 0-2 percent target. If forecast inflation in the next 6-24 months falls outside the target range (and both top and bottom of the range are equally important), then some change of policy setting is indicated. We focus on the 6-24 months period as we believe the lags between taking action and having an impact on inflation fall within that period.

The main information variables we focus on internally, and discuss in our published Monetary Policy Statements are:

- the exchange rate;
- the level of interest rates and the shape of the yield curve;
- monetary and credit aggregates.

Of course, in preparing forecasts for the inflation outlook we also take into account what is happening in the real economy, and what is happening to inflation expectations.

Of the financial variables we look at, the exchange rate is the most important. But we use it as a control variable, not as a target, though there is frequently argument about this in New Zealand. But we only have one target—price stability.

The choice of the exchange rate rather than interest rates or monetary or credit aggregates as the control variable is the result of empirical work. Neither interest rates nor aggregates have been found econometrically to have sufficiently stable relationships with inflation to be possible control variables for us in New Zealand. Interest rates influence the exchange rate and provide information about inflation expectations. They are considered as part of the forecasting process which underlies the determination of
policy settings. Monetary aggregates in New Zealand have not had a leading-indicator or causal relationship with the proximate causes of inflation. They are monitored regularly by the Bank, but are likely to affect policy settings only when their growth rates depart significantly from what can be considered judgementally to be consistent with actual and forecast paths of nominal activity.

We produce regular forecasts for inflation (generally quarterly) which incorporate our view on all the other variables that have an impact except the exchange rate i.e. in the first round of forecasting we assume an exchange rate. Given these forecasts, a range for the exchange rate path can be derived that is consistent with the maintenance of 0-2 percent inflation.

'We refer to this range internally as a ‘comfort zone’. We do not publish this ‘comfort zone’ for the trade-weighted exchange rate index (TWI) as it is a conditional zone. We do not want it to be considered as an exchange rate target in its own right. It can and does change if our forecasts for any of the other inflationary influences vary.

But the financial markets (and others) do know:

- our inflation target is 0-2 percent;
- the starting assumption for the TWI we have used to generate our inflation forecasts;
- The pass-through co-efficient we use to calculate the impact of changes in the TWI on the CPI. This is an empirical issue. We have recently reduced the coefficient from 0.4 to around 0.3 following further research. This has the effect of widening our TWI ‘comfort zone’.

The market can therefore calculate reasonably closely what our ‘comfort zone’ is, and as long as they believe we will hold fast to our inflation target, their approximate knowledge of the zone can and does assist us in the day to day operation of monetary policy.

As I said earlier, the precise operational framework each country chooses will depend on its own circumstances. The general lessons, from our experiences are, I believe, first the more clearly you can specify the framework internally the more consistent and effective your policy performance is likely to be. Your most valuable asset here is good quality empirical research. Second, the more you are prepared to reveal your framework to the markets (provided you are confident you won’t have to change it shortly after revealing it to them), the more the markets are likely to become your ally in transmitting policy changes quickly and effectively. I’ll come back to this point again a little later.

One other lesson I think is that for any small, open economy (of which we clearly are one), the exchange rate will play a key role in your monetary policy regime. The choice seems basically to be either peg your exchange rate to someone else’s currency (or a basket of currencies), use your monetary policy to defend that exchange rate and take the inflation rate of the country(s) you have pegged to; or allow your currency to be flexible and have a degree of choice over your own inflation rate. As I’m sure you are aware, there are a range of issues—which I won’t go into here—relevant to the choice of exchange rate regime. The only point I will note here is that in the context of financial
liberalisation there may well be large international capital flows, either inwards or outwards, and maintaining a peg in these circumstances can be difficult for a small, open economy.

3. Instruments

The more financial markets become deregulated and integrated the less is the scope to adopt policies that ‘throw sand in the wheels’ of markets by regulation or quantitative limits. They impose efficiency costs but in the past many countries have felt that the benefits of altering the allocation or cost of a credit etc offset the efficiency costs. The problem is that, virtually by definition, this type of regulation works against what market incentives are encouraging financial markets to do—if they were not, there would be little point in having such regulation. This in turn creates incentives for financial markets to avoid or evade the restrictions. Money, of course, is very “fungible”, and it is relatively easy to devise new instruments, institutions or techniques to skirt controls, so that they tend to become less effective over time. As these ‘sand in the wheels’ policies become less and less effective, the benefits evaporate but efficiency costs remain in one form or another.

In New Zealand we do not use any direct controls on interest rates or credit. Nor do we impose any reserve requirements on financial institutions. We have used all these instruments in the past but we do not believe they are necessary or effective for implementing an anti-inflationary policy in a deregulated market and all were abolished in 1984 and 1985.

While many theorists (and central bankers) seem to believe that some form of reserve requirements are necessary in order to have a monetary policy impact, that belief is beginning to be challenged. As I have said, we do not have any reserve requirements on banks in New Zealand and the Canadians are phasing theirs out. What is necessary, I believe, is a requirement for banks to settle on the books of the central bank and for the central bank to be able to control the terms on which banks can get and use their settlement balances.

The techniques we use for implementing monetary policy are set out in Appendix 2.

We operate solely through the markets. We carry out market operations every trading day but most of our operations are ‘neutral’. That is, they aim to maintain current monetary conditions rather than alter them.

One characteristic in which we are unusual is that we do not specify an interest rate. Our discount rate is set as a margin (currently 90 basis points) above the short-term inter-bank rate. This feature of our operating techniques is extremely useful as it contributes to the automatic market responses that have developed. It also helps to depoliticise monetary policy.

In practice, we have had to adjust our policy settings for the settlement cash target or the discount margin only very infrequently. We eased the settings in September 1991, when we were looked like we would under-shoot our inflation target, and we tightened in January 1993 when downward exchange rate pressure threatened the top end of our target. On this latter occasion we were able to subsequently return to the initial settings over the following month as the pressures abated. These are the only two explicit
monetary policy changes we have had to implement in the last three years. The financial markets know clearly that the Reserve Bank's monetary policy target is 0-2 percent CPI inflation. They also know how the Bank analyses conditions and would react. At most times therefore, financial markets alter monetary conditions in a way that is consistent with the price stability target without the Reserve Bank having to take action. That is, the financial markets anticipate the Bank's potential action and react first. This behaviour generally leads to a smoother adjustment to changes in the inflation outlook. This is the point I referred to earlier—the transparency and clarity of our framework means that financial markets generally do a lot of our job for us.

I also want to comment briefly on one thing we don't do. Though we have the power and means to do so, we do not intervene directly in the foreign exchange markets. We have not done so since we floated our currency in March 1985. Despite this (or possibly in part because of it) our currency has been one of the more stable ones over the last 3-4 years.

One lesson from the recent experiences of many central banks operating in deregulated markets is that it is important that markets are not offered a one-way bet by the authorities. This 'rule' implies:

(a) it is better to make adjustments early before markets become nervous or uncertain; and
(b) orderly and continuous adjustments are better than large, irregular adjustments.

Direct foreign exchange market intervention, particularly when the authorities try to use it as a substitute for interest rate increases, infringes this rule. It tries to prevent adjustment through one transmission channel and allows the pressure to build up as market players bet against the authorities. It frequently ends up as a one-way bet for the market—heads the market wins, tails it gets its money back.

4. Transmission Channels

Monetary text-books generally talk about three main transmission channels:

(a) interest rate impacts on spending and saving;
(b) exchange rate effects;
(c) credit rationing.

Some also add asset prices and wealth effects as a fourth. As more and more countries adopt inflation targeting, then direct impacts on behaviour by affecting inflation expectations can also become another channel.

Deregulation and internationalisation have undoubtedly affected the monetary policy transmission channels. The main lesson from many countries, including New Zealand, is that increasingly the credit constraint channels are becoming weaker (though they may still be relatively important for smaller borrowers); and the interest rate and exchange rate channels are becoming more dominant.
Romer and Romer in a recent paper concluded that they don’t expect the changes that have occurred, and are continuing in financial markets, to affect interest rate transmission channels too much. As long as there is some role in the economy for currency and demand deposits, there will be an interest rate transmission channel for monetary policy.

Some theorists argue that because of financial innovation, a bigger change in interest rates may now be required to have a given effect on spending. For example, they say the rapid growth of derivatives, such as swaps and options, has allowed firms to insulate themselves more against interest rate swings. That may certainly lengthen the impact lag but I’m not sure that it need weaken the degree of impact.

For an open economy like New Zealand the exchange rate channel is a dominant one. As your economies become more and more open, that trend is also likely to develop in your countries.

Up until now we have not paid a lot of attention to asset prices and wealth effects. But it is something we intend to apply some research effort to. There are some theorists, such as Charles Goodhart, who go so far as to say that the inflation target, which countries like New Zealand focus on, should include asset prices in the target in some way. So far this idea seems to have gained little support.

An important empirical question is whether there is a direct transmission channel (i.e. one that doesn’t operate through financial market effects) which influences inflation expectations. In particular, has there been any evidence in New Zealand that announcing price stability targets, applying policy consistently towards them and achieving them, has changed price-setters actions in a way that has opened up such a channel? There is some evidence of this. Inflation expectations, which we and other agencies in New Zealand survey because of their significance, have trended steadily down. More people are acting on the basis of the expectation that price stability can be maintained.

Having lived with an inflation mentality in New Zealand for around 20 years we are hopefully on the way to establishing a price stability mentality.

The key to this, indeed the key to implementing monetary policy in a deregulated environment, is credibility. If the target, the operating procedures and the resolve of the authorities are perceived as credible then financial markets transmit the impact of any changes in the policy outlook speedily and effectively. Direct transmission channels via inflation expectations may also develop to help you.

Lose credibility about any of the three elements—target, instruments or resolve—and the markets and economic agents will conspire to work against you.

That is as good a point as any to finish my address on as it is by far the most important lesson for any central banker to learn when operating in a deregulated environment.

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Appendix 1
Reserve Bank of New Zealand Policy Targets Agreement

This agreement replaces that signed under section 9(4) of the Reserve Bank of New Zealand Act 1989 (the Act) between the Minister of Finance (the Minister) and the Governor of the Reserve Bank of New Zealand (the Governor) on 19 December 1990.

It is made under section 9(4) of the Act, and also under section 9(1) of the Act, so that it shall also apply during the Governor’s next term of office.

In terms of section 9 of the Act, the Minister and the Governor agree as follows:

1. **Price Stability Target**

   Consistent with section 8 of the Act and with the provisions of this agreement, the Reserve Bank shall formulate and implement monetary policy with the intention of maintaining a stable general level of prices.

2. **Measurement of Price Stability**

   (a) In pursuing the objective of a stable general level of prices, the Bank will monitor prices as measured by a range of price indices. The formal price stability target will be defined in terms of the All Groups Consumers Price Index (CPI), being the measure that is monitored most closely by the public.

   (b) For the purposes of this agreement, 12-monthly increases in the CPI of between 0 and 2 percent will be considered consistent with price stability.

3. **Deviations from the Targets**

   (a) There is a range of possible price shocks arising from external sources, certain government policy changes, or a natural crisis which are quite outside the direct influence of monetary policy. The Bank shall generally react to such shifts in relative prices in a manner which prevents general inflationary pressures emerging.

   (b) This approach means that the CPI inflation rate can be expected to move outside the 0-2 percent range in response to particular shocks. The principal shocks are considered to be:

   - significant changes in the terms of trade arising from an increase or decrease in either import or export prices;
   - an increase or decrease in the rate of GST, or a significant change in other indirect tax rates;
- a crisis such as a natural disaster or a major disease-induced fall in livestock numbers which is expected to have a significant impact on the price level;

- a significant price level impact arising from changes to government or local authority levies; and

- a movement in interest rates that causes a significant divergence between the change in the CPI and the change in the CPI excluding the interest costs component.

(c) In the event of such shocks, the Reserve Bank shall be fully accountable for its handling of the price effects, and, in particular, for any movements outside the 0-2 percent band. In each Policy Statement made under section 15 of the Act, the Bank shall detail fully its estimate of the direct price impact of any such shock and the impact on the Bank’s achievement of the price stability target. The Bank shall also detail what measures it has taken, or proposes to take, to ensure that the effects of such shocks on the inflation rate are transitory.

4. Renegotiation of the Targets

The policy targets are established on the understanding that the monetary policy instruments available to the Bank are adequate to achieve the objective. The Governor shall inform the Minister if he considers that any changes in the availability or effectiveness of these policy instruments impair the conduct of monetary policy. The Minister and the Governor may then set new policy targets.

5. Implementation

(a) The Bank shall implement monetary policy in a sustainable, consistent and transparent manner.

(b) Each Policy Statement released by the Bank under section 15 of the Act shall contain a statement of how the Bank proposes to formulate and implement monetary policy to ensure that price stability is maintained over the succeeding five years.

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16 December 1992

Ruth Richardson  
Minister of Finance

Donald T. Brash  
Governor  
Reserve Bank of New Zealand

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Appendix 2: New Zealand monetary policy tools

The Reserve Bank implements monetary policy through the financial markets. Its ability to do so is derived from three characteristics of the structure of our financial system:

- The Reserve Bank is the banker to the other banks. These banks have accounts at the Reserve Bank and every day they settle the transactions among themselves through these accounts.

- The commercial banks cannot go into overdraft in their Reserve Bank settlement accounts. So all of them have to get their accounts back to a positive balance every day.

- The Government holds the central Public Account at the Reserve Bank and the public gets the notes and coins they want from the Reserve Bank, via the banks. These features mean there are quite large financial flows most days between the private sector and the Reserve Bank.

The Reserve Bank can use these features to implement monetary policy because it has control over three crucial momentary policy tools. These are settlement cash, Reserve Bank Bills and the discount rate.

Settlement Cash
Settlement Cash is the name given to the cash balances held by other banks at the Reserve Bank.

Reserve Bank Bills
These securities are purchased from the Reserve Bank by other banks. These securities, when issued, have a three month maturity. However, the Reserve Bank is willing to purchase for cash, at any time, those Reserve Bank Bills that have less than one month to run before maturing. These are the only securities the Reserve Bank is willing to purchase on demand.

Discount Rate
The discount rate is the price the Reserve Bank charges for purchasing Reserve Bank Bills from a bank before the scheduled maturity date.

We do not set the discount rate as a level, but as a margin (currently 90 basis points) over the short-term interbank market interest rate. Our discount rate therefore moves up or down as market conditions change without us having to take a discretionary policy decision. This has also become an important element of the automatic market responses we are now seeing.

The Reserve Bank operates in the financial markets every day. Most of the transactions are “neutral”. That is, they are aimed at maintaining rather than altering monetary conditions. But the Banks can use them to take a monetary policy action when it believes that is necessary.
The operations the Bank conducts are daily float tenders, open market operations (OMOs) on most days, and twice-weekly bill tenders. Through these operations the Bank aims to keep the supply and price of banking system liquidity at levels consistent with the stance of monetary policy.

The trading banks must compete daily for settlement cash because the Reserve Bank does not permit them to go into overdraft. The Reserve Bank injects or withdraws settlement cash from the financial system by engaging in OMOs. The average supply of settlement cash is determined by the settlement cash ‘target’ on most days.

This arrangement ensures that, by adjusting the settlement cash target up or down, the Reserve Bank is able to ease or tighten short-term monetary conditions. A lowering of the cash target for example, by compelling banks to compete more aggressively for what settlement cash is available and putting upward pressure on interest rates in the wholesale money markets, constitutes a tightening of conditions, and vice versa in the case of raising the target.

These short-term rates are, in reality, the only ones over which the Reserve Bank has any direct influence. But by signalling a change in its policy stance via a change in the settlement cash ‘target’, and thereby altering short-term interest rates, the policy impact is passed down to the economy’s ‘real’ sectors through a number of transmission channels.

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