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Journal of Monetary Economics 46 (2000) 489–516

Journal of
MONETARY
ECONOMICS

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Open mouth operations[☆]

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Received 29 October 1998; received in revised form 16 November 1999; accepted 13 December 1999

Abstract

This paper explains how central bank statements, rather than open market operations, can be used to implement monetary policy. In the extreme, policy instruments can be held constant, and yet interest rates will evolve along the path desired by the central bank. We show how the recent implementation of monetary policy in New Zealand works in this way. Using announcement data from New Zealand, we find that open mouth operations lead to large changes in interest rates across all maturities, and these changes cannot be explained by open market operations. Implications are drawn for monetary policy in other jurisdictions. © 2000 Elsevier Science B.V. All rights reserved.

JEL classification: E42; E52; E58

Keywords: Monetary policy; Open market operations; Announcements; Liquidity effect

[☆]We thank Richard Arnott, Richard Froyen, Robert Hall, Robert King, Thomas Sargent, Frank Smets, John Taylor, Carl Walsh, and an anonymous referee for insightful comments, as well as seminar participants at the National University of Singapore, Reserve Bank of New Zealand, Stanford University, UC Santa Cruz, UNC-Chapel Hill, University of Auckland, and the University of Canterbury. Thanks also go to the staff at the Reserve Bank of New Zealand for providing data, and to Vhari McWha for research assistance. All errors are ours. A previous version of this article was circulated under the title 'Market-implemented Monetary Policy with Open Mouth Operations'.

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1. Introduction

Recent New Zealand monetary policy experience highlights an important channel by which a central bank can affect interest rates, which is via statements on its desired path for the short-term interest rate. New Zealand is striking because these statements – which we call open mouth operations – were exclusively used to implement monetary policy during the period we study (January 1989–September 1997), while the conventional tool of open market operations was used solely to target a level of daily settlement cash balances that was very rarely changed.¹

In this paper, we develop a model of monetary policy implementation in New Zealand which shows how the Reserve Bank of New Zealand (RBNZ) is able to control interest rates without changing conventional policy instruments. We also provide empirical evidence about the relative magnitude of interest rate adjustments arising from open mouth operations versus open market operations.

Although our interest in this topic was stimulated by the New Zealand experience, we believe that many central banks currently conduct monetary policy with open mouth operations and have done so in the past. Incorporating this informational channel into historical studies of monetary policy in other countries may therefore resolve a number of empirical puzzles, including why the liquidity effect is so hard to identify, despite the apparent ease with which monetary authorities can move overnight rates by any desired amount.

In our view the liquidity effect exists, but its use is not required to change market rates.² Open mouth operations can be used for this purpose. They work because implicit in a statement is a credible threat that, if market rates do not move to the announced level, the liquidity effect will be exploited to ensure rates do move. We argue that the central bank's threat to dry up, or flood, the market for bank reserves is sufficient to tie down the path of the overnight interest rate, as if it was using open market operations to achieve this path.

To illustrate how this works in practice, we provide a model of monetary policy implementation in New Zealand which shows exactly how the RBNZ is able to control interest rates without changing policy instruments. The key

¹ Ignoring three changes in the target, which lasted for one day only and were not used to alter monetary conditions, and a technical change which took place along with other changes on February 22, 1991, there were only three episodes when the cash target was changed during our period of study: an increase in the target on September 25, 1991, a decrease on January 6, 1993 which was fully reversed by February 3, 1993, and two decreases in August 1995.

² Thus we do not see any inconsistency between the finding of Hamilton (1997) of a significant liquidity effect from the unanticipated flow of funds between the US Treasury and the private sector, and that of Leeper and Gordon (1992) who find that the relationship between the monetary base and interest rates is imprecisely estimated and highly unstable over time.

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