Open-market purchases

Business, Marketing

Open-market purchases permit reductions in currency revenues and thus a lower inflation rate. The reduction in interest rates engineered through open-market purchases always yield smaller increases in the inflation rate than a reduction brought about by other means, such as a decrease in the required reserve ratio (the ratio of required reserves to the required deposits in given Fed banks). A policy-maker who prefers low inflation and henceforth a reduction in real interest rates should prefer open-market purchases.

It is said that it is best to buy low and sell high in the case of long-term bonds, which are essentially IOUs, promises to repay a given amount of money within a specified time and often, by a specific date. Purchases of Treasury securities supply the necessary reserves to the banking system and consequently, downward pressure on the funds rate. Sales remove the reserves and put upward pressure on said funds rate. There are several advantages to Treasury securities: 1 - The market is large and liquid, since the Fed can conduct large trans- actions giving control over reserve balances and the funds rate

2 - They use open-market transactions to implement monetary policy and avoid directly affecting private capital, an important con- sideration in the conducting of monetary policy 3 - They are free of credit risk Federal Reserve banks are required to maintain a gold reserve against their liabilities, although increases in the Fed system largely offset decreases in gold stock. A two-tiered gold system of both private and official sectors, each with its own price, can determine the growth of the monetary base by both gold stock and Federal Reserve credit.

As for the measurement of the effect of foreign exchange activities on the Fed, four assumptions are made: 1 - U. S. Treasury is usually unaffected to any great extent by foreign money investments, unless the deposits are very large. When the Treasury deposits are increased significantly, the reserve base decreases. 2 - Monetary authorities do not generally take specific action to offset any possible impact 3 - Foreign banks convert their holdings into Treasury securities 4 - Gold reserves not used for intervention

Intervention is also usually made by the following three institutions: foreign banks, the Federal Reserve and the Exchange Stabilization Fund. The Fed's exchange is a component of short-term interest rates by open-market operations with short-term (maturing in less than a year) bonds. Actual transactions are unnecessary; the rates can usually be manipulated by simply announcing the desired target. Also, under a flexible exchange market, the exchange rate is allowed to move with market forces.

This way, prices can adjust to clear the market without the need for official intervention. Finally, if the domestic monetary authority increases its money supply, either by purchasing gold or foreign currency, the immediate result will be an excess domestic supply of money. For the most part, conducting monetary policy through the NYSE is a sound, logical course of action, but there is always the danger of un- scrupulous entrepreneurs attempting to defraud the Stock Exchange by making excess buying and trading.

References: www. stlouisfed. org