Open market operations during the recent financial crisis

[Business](), [Marketing]()

Monetary Policy

Introduction

The Federal Reserve (the Fed) sets monetary policy time -to-time influencing the availability of money and credit. The Fed is an ultimate lender to the nation's financial system ensuring the smooth functioning of financial markets and maintaining adequate liquidity. This was what observed during the recent financial crisis observed in 2008 and onwards.

The paper is an attempt to see how the open market operations during the recent financial crisis were carried out to provide much needed liquidity in the financial market.

The Federal Reserve has three means at its disposal to achieve its goals.

1. The Discount Rate charged to banks and other depository institutions when they borrow from the Fed. The Fed offers three kinds of credit facilities-- primary, secondary and seasonal credit with different interest rates. Primary credit is given to depository institutions for a very short term (overnight). The primary credit is available to institutions with sound financials. The institutions not eligible for primary credit may go for secondary credit to meet their short-term liquidity requirements. The smaller depository institutions go for seasonal credit to meet their funding needs during their lean periods. The examples are agricultural banks. The discount rate for primary credit is set above short-term interest rates. The rate on secondary credit is set above the primary credit rate.

2. Open Market Operations called so because the Fed intervenes by purchasing and selling of US Treasury securities from the open markets. The objective is to set the federal funds rate. When the Fed buys the securities, it

issues currency expanding money in the market and credit. Stability and sustainable economic growth were two objectives that were set out in its policy. When it sells securities, it contracts the money supply and credit in the market.

3. Altering Reserve Requirement is the third tool in the arsenal of the Fed. The bank must hold reserve amount in the form of deposits with Federal Reserve or in the form of cash.

Effects of Monetary Policy

Monetary policy affects economy in the short as well as long run. In expansionary policy, interest rates set reducing and this enhances interest-sensitive spending such as capital equipments, housing construction, consumer-durable spending including automobiles and other households. Thus, expansionary monetary policy brings economy out of recession. When economy is overheated and inflationary, the Fed raises interest rates and reduces money supply and credit availability and thereby managing the inflation rate.

Open Market Operations during Financial Crisis

Looking retrospectively, when the US economy was in grip of recession during 2001 through 2003, the Fed kept funds rate low that reached at 1% by mid 2003. As the monetary expansion took place and price began to rise, the Fed gradually increased interest rates slowly to reach at 5. 25% in mid-2006. When the financial crisis began in 2008 and the economy started experiencing recessionary pressures, the Fed started reducing interest rates to provide impetus to the market. Finally, in December 2008, the interest rates reached at its lowest at 0-0. 25 percent. The Fed aimed at averting the

economy going into great depression and causing high unemployment rate. The low funds rate has still continued as economy has not yet bounced back significantly. This is how the Fed intervenes through its monetary policy as per the set objectives.

Reference

Open Market Operations (2011), online March 31, 2012 from http://www. federalreserve. gov/monetarypolicy/openmarket. htm