Example of open market operations as a monetary tool research paper

Business, Marketing

Introduction

In the United States, the Federal Reserve System is charged with regulating the country’s monetary policy. The system was implemented after leaders noted the deficiencies in the previous national banking system. The previous system had a currency that was inelastic and there were liquidity problems in the economy. There were a lot of financial panics in the economy caused by the inefficiencies in the system.

A republican representative proposed the creation of a centralised banking system that would operate with a minimum level of government involvement. The Federal Reserve System was instituted in 1913. The system was able to solve three problems that the leaders had been grappling with. There were issues with the inflexible currency system, pyramidal reserves and lack of a check collection mechanism. The Federal Reserve System is interested in ensuring that there is sufficient money supply in the economy. The money however should be at a level that does not encourage inflation. The main duty of the Federal Reserve System is to ensure there is stability in the economy. If there is inflation the Fed has three tools that it uses to reduce and control the supply of money in the economy. These tools are the open market operations, the discount rate and the reserve requirements.

The Monetary Policy Tools

These actions taken by the Federal Reserve Bank to influence the availability and the cost of money in the economy is known as the monetary policy. The monetary policy regulates the monetary base in the economy. The monetary

base refers to the money supply in the market or in circulation and the amount of money in the reserve deposits (Athanasios & Wieland, 2000). The three tools of regulating and controlling the monetary policy is implemented through the Federal Open Markets Committee and the Board of Governors. The Board of Governors is in charge of the operations of the discount rate and the Federal Reserve System while the Federal Open Markets Committee is in charge of the open market operations. These bodies are in tasked with ensuring there is maximum employment, stable prices and moderate interest rates in the economy. Federal Banks issue short term credit to financial institutions using a certain discount rate at a particular point in time. The discount rate is adjusted periodically to either increase or reduce the supply of money in the economy. When the Fed decides to increase the discount rate, the banks end up borrowing less from the government. The banks opt to reduce the loans they are issuing out to the public in order to use the money to repay the Fed. The banks also reduce the amount of money for use in the short-term investments category. These actions lead to a reduction in the money supply in the economy.

When the bank decides to lower the discount rate, the banks will desire to take advantage of the lower borrowing rates. They will therefore take cheaper loans in order to give out loans to the public and earn a higher profit leading to an increase in the money supply in the economy. This Federal Reserve Lending Facility is known as the discount window. The loans assist the financial institutions to take care of their short-term liquidity needs.

The reserve requirements refer to the amount of money in the demand deposit accounts in the banks that the government requires the banks to set

aside and reserve.

The mandatory reserve amount depends on the size of the financial institution and the type of deposits that the institution has. The cash is held in the Federal Reserve banks. When the government wants to restrain the money supply in the economy, it raises the reserve requirement causing the banks to have less money to give out as loans. When the Monetary Control Act was passed in 1990, all the deposits of the financial institutions were placed under the Federal Reserve. The board of governors have the authority to impose certain percentages of the reserve requirements in the market. For the transaction accounts, the board can impose a percentage of 8% to 14% however in the non-personal deposits; a percentage of 9% is imposed. An advantage of using the reserve requirement is that the fed can predict the change in the money supply. Banks usually reduce the amount of the excess reserves since they do not receive any interest on these amounts. The banks therefore tend to either issue out more loans or invest in securities (Calvo, 1978).

The disadvantage of using the reserve requirement as a monetary tool is the opportunity cost of the lost interest that banks could have earned had the reserve requirements been lower. The fed is also reluctant to participate in an action that will reduce the interest earned by the banks. The frequent changes to the reserve requirements are also quite disruptive to the banking industry. The use of the reserve requirement is therefore rarely used unless there is a structural problem in the industry. In the open market operations, the government engages in the buying and selling of government securities in order to influence the short-term interests and the money supply in the

market. Each day the members of the Federal Reserve Bank of New York monitor the level of the reserves, the discount rate, the treasury activities and the target money supply in the economy. They engage the primary dealers and banks in order to get to know and understand more the market conditions and the expectations on treasury activities. The Federal Open Markets Committee is also in charge of the reserve system operations in the foreign exchange markets. Any intervention to be carried out in the foreign exchange markets is coordinated by the United States Treasury. The treasury is tasked with monitoring the exchange rate of the dollar in international markets.

The federal bank gets advice and consent from the Monetary Affairs Division of the Board of Governors on the appropriate assets to sell or buy on the Trading Room Automated Processing System (TRAPS). This is a computer system that is connected to all the primary dealers. The fed bank will select the best prices for the assets it wants to buy and sell. The bank can enter into two different kinds of transactions. The bank can enter into repo and reverse repo transactions with the primary dealers. In a repo, the bank purchases the government securities with the guarantee that the dealers will purchase the assets from them within a period of one to fifteen days. In a reverse repo, the dealers purchase the securities with the agreement that the Fed will repurchase the securities from them in the near future. They are also those outright transactions where the bonds enter or exit the fed’s balance sheet.

The liquidity of the government bond market and the availability of repo and reverse repo transactions make the open market operations, a suitable tool

for monetary policy. The disadvantage with of open market operations is that it may not be effective in the money markets that are not fully developed (Meulendyke, 1988). If the commercial banks have excess reserves, the sale of securities by the government may not reduce the money supply. The government may not be able to exert the influence that is required to stabilise the market. The advantages of the open market operations are many. First of all the sale of government securities occurs quickly through electronic systems. If the government wants to reverse the effect, it is also able to do so quickly (Barro & Gordon, 1983).

During the financial crisis in 2008, the credit markets were not able to function appropriately. The federal government therefore introduced additional lending programs by invoking its emergency powers. There was the introduction of a term auction facility. The depository institutions were able for short-term funds at a discount rate decided on through auction. The primary dealers were able to get overnight loans from the fed bank at the prevailing discount rates through the facility known as primary dealer credit facility. The dealers also gained by being able to exchange the treasury assets for riskier collateral through the term securities lending facility. The exchange period was for a period of twenty eight days. The fed also assisted the money market mutual funds to meet their redemptions through the asset-backed commercial paper facility. The mutual funds did not have to sell their securities in the market at that time.

The markets had been very distressed at that time.

The Federal Reserve Bank was also allowed to purchase securities from the non-financial institutions through the commercial paper funding facility. The

bank however prefers to use the open market operations over the discount rate and the reserve requirements. To understand the bank’s preference, it is important to discuss the pros and cons of the discount rate and the reserve requirements. It is hard to predict or analyse the change in the bank borrowings once the bank increases or decreases the discount rate. The effect will only be dependent on the extent banks respond to the discount rate changes. There is usually a lot of speculation by the fed watchers as they try to predict the future direction of the monetary policy. These speculations are bound to have an effect on the banks’ behaviour. There are times when the speculations turn out to be false.

The discount window is quite a short period of time for the fed to gauge the impact of their action. There are certain advantages of the discount rate. Banks are able to get temporary sources of liquidity when there are sudden shortages in the market. These shortages could be caused by internal or external factors. After the September 11 terrorist attacks, there was a sudden increase in the short term borrowing by the banks. The borrowing totalled to $46 Billion. This allowed the banks to serve their customers instead of relying on the payments from other banks.

Conclusion

In light of the various disadvantages of the discount rate and the reserve requirement, it is evident why the government prefers to use the open market operations as its preferable choice when it comes to monetary policy. Whichever tool the government uses it has to ensure there is economic stability in the country.

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