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February 17, 1928

Mr. Hamlin

Open Market Operation

Mr. Goldenweiser

Some time ago, you asked me what would have happened if there had been no open-market operations by the Federal reserve banks. I think in discussing this subject we might as well eliminate the entire period prior to 1922, when there was no open-market policy and when discounts were very much more important than open-market purchases. The following is for your own personal use. It is more informal than any statement that I should care to make to the Board.

In 1922 the reserve banks bought large amounts of securities, because they were alarmed by the decrease in their earnings. They soon learned that this resulted in a decrease in their discounts and that their earnings were not benefitted by the change. It was only in 1923 that the open-market policy with reference to credit conditions was formulated and came to be understood. I think that the course of events in 1923 would have been essentially the same if the securities in the Federal reserve banks' portfolio had not been permitted to run off. The liquidation of these securities did, however, result in increasing indebtedness of the member banks and in some tightening in the money market. Perhaps the boom which appeared to be under way early in 1923 would have lasted a little longer if it had not been for Federal reserve action. In 1924 large-scale purchases of securities contributed to the plethora of funds and put the member banks in the financial centers practically out of debt to the reserve banks. In that year the Federal reserve system was probably responsible for a certain part of the extreme monetary ease and the consequent growth in the investments and security loans of member banks.

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I think that in 1925 and 1926 open-market operations merely had the effect of smoothing the machinery at the turning points without playing a large part in credit policy. In the early part of 1927 open-market policy resulted in encouraging easy money and thus facilitating gold withdrawals, and later in the year up to the middle of November in offsetting the effects of these exports. After that time open-market purchases were in small volume and gold exports had their full effect on the money market.

On the basis of these facts, it is my general impression that: (1) The effects of the open-market policy on the general credit situation are not as great as is generally believed. (2) Open-market operations, except for some errors in judgment, particularly in regard to the timing of operations, have been conducted with wisdom and have supported changes in discount rates. (3) It is often overlooked that one important reason for open-market operations in a volume larger than what may come to be considered normal has been the unusually large gold movements of recent years. With the re-establishment of the gold standard and the diminution of the volume of international gold movements, it may be expected that open-market operations will be on a smaller scale. (4) It would at times be very difficult to operate the Federal reserve banks without recourse to open-market operations and to limit the banks' authority in this respect would be unfortunate. No central bank in the world operates without this power.