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BOARD OF GOVERNORS
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To Dr. Goldenweiser

Subject: The principles of open-market policy reconsidered

From Emile Despres

The principles governing open-market operations were developed at a time when the short-term money market occupied a strategic place in our banking framework. Federal Reserve policies operated in the first instance upon the short-term money market, and the broader effects of these policies upon the economy were communicated through that channel. In other words, that market was the principal point of contact between the Federal Reserve System, on the one hand, and the banks and the whole economy, on the other. Through its operations in short-term Treasury securities, the System was able to increase or decrease the volume of member bank rediscounts, and the banks responded to the variations in their indebtedness by altering the terms upon which they placed funds in the money market.

Now, however, member banks, instead of having to borrow from time to time in order to keep their reserves at the required level, have excess reserves in an amount which is more than double the System's security portfolio; meanwhile, the supply of most kinds of short-term paper has been reduced to a mere fraction of its volume in the Twenties. There is little likelihood that it will be possible to restore the mechanism of the Twenties, even if such a development were desirable.

It is clear that open-market operations no longer possess the sort of significance which they had in the past. Since the principles which were developed under the conditions of the Twenties do not furnish satisfactory guidance today, there is need for a new appraisal of the functions of open-market operations in the light of today's conditions.

It is generally acknowledged that the final objective of central bank policy in its relation to economic activity is to influence the volume of expenditure in the markets for goods and services. The influence of the central bank upon expenditure is only indirect, however, and operates through the market for loanable funds. By influencing the cost and avail-

ability of funds to those who wish to borrow and spend, the central bank can exert a retarding or stimulating effect on the volume of such expenditure. The central bank's influence is confined to the supply side of the loan market, and the actual amount of borrowing is dependent, of course, on a variety of other factors as well. Nevertheless, the volume of expenditure is never wholly independent of the cost and availability of loanable funds, and the central bank's influence over the flow of expenditure and income derives from this fact.

The focal point of Reserve System control during the Twenties was, as noted earlier, the short-term money market. This control could be exercised because the Reserve System was able to influence the volume of member bank indebtedness through open-market operations and to determine the cost of this borrowing through rediscount rates. With these instruments at its disposal the System had power to produce rapid and substantial changes in the level of open-market short-term rates, and these rate movements led to much smaller movements in the yields of long-term securities and in money rates outside the principal financial centers.

The System sometimes regarded its function as one of influencing the money and capital markets, and sometimes as one of influencing the volume of bank deposits. Under the circumstances then prevailing, it made little difference, in practice, which interpretation was adopted. Today, however, the distinction is an important one, and it is therefore worth pointing out that it is through the money and capital markets that central bank policies, and changes in the money supply, exert an influence on economic activity. Apart from its effects on the interest rate structure, a change in money supply has little economic significance. In principle any volume of expenditure in the markets for goods and services can be financed from any quantity of money. All that is necessary is that the volume of turnover be sufficiently rapid or slow. Of course, this principle can be pushed to absurd lengths, but, within the limits of practicality, all degrees of prosperity or depression can exist whatever the quantity of money may be.

Open-market operations during the Twenties operated through their effects on the lending or investment policies of banks. For example, by selling securities in sufficient

volume, the System was able to check an expansion of bank loans and investments, and bank deposits, or could even produce a contraction in bank assets and deposits.1/ The rise in money rates tended to draw domestic nonbanking funds, as well as foreign funds, into the money market. Thus, as banks withdrew from the loan market, bank depositors exchanged their deposits for the short-term assets previously held by banks. The decline in deposits was accompanied by a transfer of earning assets from banks to their depositors. Clearly, a shift in asset holdings from cash to nearby substitutes for cash need not have any effect on the volume of expenditures for goods and services. The statement frequently made that the Reserve System can influence the volume of deposits but not their rate of turnover is, therefore, not quite accurate. Any central bank action which tends to expand or contract the volume of deposits ~~has~~ an opposite effect on their rate of turnover. It is only in so far as ~~the effect on the volume of deposits outweighs its offsetting effect on the rate of turnover~~ that central bank policy can influence the flow of expenditure and income.

In practice, of course, central bank policies influence not only the volume of deposits but also, to a much smaller extent, the flow of expenditure and income. In other words, their effect on the volume of deposits is not completely nullified by their effect on the rate of turnover. But it is because money and interest rates are raised by restrictive policies, and lowered by expansive policies, that the volume of spending for goods and services is influenced by central bank action.

Let us assume, for example, that as the result of open-market sales by the Reserve System, commercial banks bid somewhat less actively for short-term paper. Treasury bill rates rise from 3 to 4 per cent, call money advances from 4 to 6 per cent, and similar, though generally smaller, movements occur elsewhere in the interest rate structure. As a result of the rise in rates corporations and institutional investors decide to exchange a part of their bank deposits for earning assets previously held by banks. Thus, a particular industrial corporation which formerly held $10,000,000 in bank deposits may now hold only $3,000,000 on deposit, with, say, $4,000,000 in call loans and $3,000,000 in Treasury bills. The fact that the corporation is

1/ The relationship of Federal Reserve policies to movements of foreign funds, and the resulting limitations on System action, will be left out of account in this analysis.

now earning a higher rate of return on its financial assets may lead it to postpone certain types of optional expenditure, such as for inventory or plant and equipment. More important, the increased costliness of borrowing may lead to some reduction in the amount currently borrowed and, therefore, in the stream of expenditure for goods and services. Thus, the influence which central bank policies exert on the volume of expenditure for goods and services is exerted through their effect on money and interest rates; changes in the volume of bank deposits affect spending and economic activity only indirectly, through the market for loanable funds.

This point has been so fully developed because it is not generally understood and because it is of particular significance under present conditions.

The present large supply of cash is accompanied by an extremely small supply of short-term assets which represent nearby substitutes for cash. The change in the composition of assets other than cash has operated to increase greatly the demand for cash. Prior to 1933, banks were customarily "loaned up" to the limit of their available reserves and they frequently went into debt to the Reserve banks for shorter or longer periods. They held, however, large secondary reserves in the form of open-market paper, and of their remaining assets a considerable portion consisted of customers' loans, secured or unsecured, which were at least nominally short term. Today the secondary reserve of open-market short-term assets has declined, customers' loans are greatly diminished, and holdings of longer-term assets, largely Government securities, have increased. Excess reserves are truly "excess" only in the legal sense. In an economic sense, they meet the banking system's demand for liquidity which was formerly met by its holdings of short-term assets. The willingness of banks to hold their present portfolios of Government securities at existing yields is dependent on the present supply of excess reserves.

For bank depositors the story is virtually the same. The bulk of the growth in deposits relative to predepression levels has been in the deposits of financial institutions, trust funds, and well-to-do individuals. For them cash has taken the place of earning assets and the demand for cash has been heightened by the dearth of nearby alternatives in the form of short-term paper. The popularity of savings bonds

among institutional investors and wealthy individuals is illustrative in this connection.

The demand for cash, besides being larger, is much more volatile than in the Twenties. Large investors, instead of being offered a wide range of assets of varying degrees of liquidity, are virtually confronted with the choice of holding cash or long-term securities. Uncertainty regarding the future price of such securities, i.e., the future level of interest rates, provides the principal motive for holding cash. Anyone would much rather hold an asset yielding, say, 2 1/4 per cent than hold cash, provided he were certain that the asset might be exchanged for cash at any time in the future for at least its original cost. But this certainty does not exist and speculative anticipations have free play in their influence on interest rates.

Several points emerge from this analysis. In the first place, open-market operations have significance not only because of their effect on excess reserves but also because of their effect on the bearish or bullish expectations of holders of high-grade securities. If the market believes that the System is prepared to furnish vigorous support to the Government security market, holders of high-grade securities will be less disposed to press their holdings on the market.

Second, it is just as truly deflationary for the System to refrain from buying Government securities when, owing to some unforeseen event, there is suddenly increased demand for cash on the part of holders of such securities, as it would be for the System to press its holdings on a previously stable market. Since the supply of funds is significant only because of its relation to the interest rate structure, the System is retreating from its essential task if it regards its job as that of determining the supply and allowing the level of rates to respond to the market's changing anticipations. The Reserve System should not try to avoid "taking a view" regarding interest rates.

Third, since the Reserve System was created to provide elasticity to the banking system, it has never had much power to check inflation. Its power today is greater than in the past, however, because it can exercise more direct control over long-term interest rates. It can influence not only the supply of money but also the ~~demand for cash in relation to~~ long-term assets. Merely by indicating that it regards interest rates

as too low and is prepared to press its securities on the market, the System could produce a sharp marking up of bond yields. Conversely, by indicating that it is prepared to keep interest rates from rising otherwise than with extreme gradualness, the System could greatly increase the demand for securities at present yields.

Finally, a coordinated interest rate policy among Government agencies is greatly needed today. System open-market operations, Treasury debt operations, and the activities of Government lending agencies should all be brought within the scope of a unified policy. The Government as a whole has far more power to influence the cost and availability of funds to borrowers than in the past. This power should be effectively coordinated to promote expansion now and stability later.