FEDERAL RESERVE BANK OF DALLAS
Station K, Dallas, Texas 75222

Circular No. 84-10
January 23, 1984

TO: All depository institutions in the Eleventh Federal Reserve District

ATTENTION: Chief Executive Officer

SUBJECT: **Open market operations**

SUMMARY: The Board of Governors of the Federal Reserve System has issued a statement discussing the relationship of contemporaneous reserve requirements to open market operating procedures.

ATTACHMENTS: Text of Board's statement

ADDITIONAL COPIES: Public Affairs Department, Extension 6289

Beginning Thursday, February 2, the new contemporaneous reserve requirement (CRR) system will become effective. In that connection, questions have been raised about the implications of this change for the Federal Reserve's open market operating procedures. This issue has been considered by the Federal Open Market Committee. Taking account of technical transitional uncertainties as well as policy judgments about the role of M1 and other monetary aggregates under current circumstances, the Committee agreed to make no substantial change in current operating procedures at this time.

Background

The new CRR system differs from the present lagged reserve requirement structure in two principal ways. First, required reserves against transactions deposits will have to be held on an essentially contemporaneous basis, instead of being lagged by two weeks. Second, the reserve holding period has been lengthened from one week to two weeks (with the relevant period for deposits also lengthened to roughly the same two weeks--the 2-week deposit period running from Tuesday to the second Monday, and the reserve period running from Thursday to the second Wednesday).

This structural change in the reserve accounting system has tightened the linkage between reserves and the current behavior of transactions deposits--demand deposits and interest-bearing accounts with full checking privileges (NOW and similar accounts). These deposits, along with currency, held by the public, comprise M1, the measure of money most nearly related to the transactions needs of the economy. But because of NOW and similar accounts, which have grown substantially in volume over the past few years, M1 is also affected by saving propensities and patterns. The Committee has been placing less weight than formerly on M1 because of the institutional changes that have altered its composition, affected its behavior, and increased uncertainties about its relationship to the economy.

Other, broader aggregates--M2 and M3--encompass M1 plus other highly liquid assets and forms of saving, such as money market funds accounts and time and savings deposits held at banks and thrift institutions. Some of these other assets also, in one degree or another, serve transactions purposes, though they are not, by law, subject to transactions reserve requirements. In general, the bulk of the assets in the broad aggregates are not subject to reserve requirements, although nonpersonal time deposits bear a relatively small lagged requirement.

Open market operations and CRR

Adaptations in open market operating procedures to CRR must take account of certain technical and transitional issues as well as the policy issue about the weight to be given M1 and other monetary aggregates in operations. The more technical and transitional issues involve how the depository system as a whole adjusts to the new reserve requirement system--which may influence demands for excess reserves, attitudes toward the discount window, and the speed of asset and liability adjustments generally. It can be expected that some time will elapse before banks and other depository institutions have fully adjusted their reserve management, as well as portfolio and liability management, to the new system. Money managers have to become accustomed to operating without certain knowledge of their required reserves for a full reserve averaging period during most of that period. In addition, usual start-up problems with new data systems will probably add to uncertainties at least for a while. Such data problems would also affect the timing and reliability of figures available to the Federal Reserve.

These technical issues aside, the new reserve requirement structure would potentially permit somewhat closer short-term control of M1 in particular. With CRR, if open market operations were geared primarily to M1, an "automatic" tightening or easing of reserve positions that worked to bring M1 under control would tend to occur somewhat more promptly than with lagged reserve accounting.

Whether operating procedures should be adapted for this purpose does not depend on the technical characteristics of the reserve requirement system in place but rather on broader policy judgments about the relative weight to be given to M1 as a target and the desirability of seeking close short-run control of that aggregate. To the extent less weight continues to be placed on M1, and relatively more on broader aggregates less closely related to reserves,"automatic" changes in reserve pressures in response to short-run movements in M1 alone may not be appropriate.

In light of these various considerations, the Committee agreed that no substantial change would be made in open market operating procedures at this time. These operating procedures will be reviewed after a transitional period in the context of the role played by the monetary aggregates, particularly M1, in policy implementation and the potential implicit in CRR for achieving closer short-run control of M1.

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