SPEECH

Kos: The Interplay of Markets and the Fed's Open Market Operations

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Remarks by Executive Vice President Dino Kos before the Money Marketeers of New York University Thank you Chris, it's a pleasure for me to be here. Good evening, ladies and gentlemen. The importance of financial markets to our country's economic well-being is certainly known to this audience, and it is no surprise that a central banker would take a keen interest in their robustness. Normally, the perspective that central bankers take is understandably at a macro level - particularly given the role that financial markets have in the allocation of resources in our economy.

But we are also interested in markets at the micro level. At the New York Fed, one of our roles is to implement the monetary policy decisions of the Federal Open Market Committee (FOMC). This role brings us into the marketplace as participants every day. We execute trades with many of your firms to add or drain reserves; we periodically execute transactions in other markets for our central bank and other customers. We therefore have an interest in how markets work if we are to effectively achieve our mandate to implement the monetary policy decisions of the FOMC.

Along those lines, I'll be talking about three interrelated issues this evening. First, I'll offer some personal views about the conditions in which markets operate most efficiently and some thoughts on the role of regulation and, perhaps more importantly, the role of financial firms and their management in assuring a fair and robust marketplace. Indeed, I believe there exists an important self-regulatory responsibility for market participants. I'll next turn to some developments in the Federal Reserve Bank Desk's open market operations, particularly in response to the changing expectations for the supply of Treasury securities. Lastly, the Desk's securities lending program has undergone significant change in recent years and I'll bring you up to date on our activities and motivations in that area.

What links these three topics is that - first - the wholesale fixed income markets are vibrant, dynamic, and constantly evolving. Second, since these are also the markets we operate in, the Desk needs to adapt to changes in those markets. Third, as we change how we operate, we need to work closely with the marketplace to explain our thinking and assure that our operations complement, or at least do not hinder, the robust and dynamic marketplace we have.

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I. Market Efficiency

The wholesale money and capital markets are a critically important component of a well functioning market economy. The efficient allocation of credit hinges on robust financial markets. Since central banks rely on these markets to implement policy, the ability of central banks to effectively carry out their policy objectives may be adversely affected to the extent that these markets do not function efficiently, with the potential for negative effects on the broader economy. We have seen in recent years countries where dysfunctional banking and financial systems hindered the effectiveness of central banks to execute policy. So, what are the conditions that lead to robust and efficient financial markets? What role does regulation play? And, what can market participants do to foster that outcome?

These clearly are very broad questions about which financial observers can actively debate. You should take my views not as answering those questions definitively, but as adding a set of views and perspectives that you can compare with others. I want to stress that my comments reflect my own views and not necessarily the views of the Federal Reserve System more broadly. My starting point is that financial markets, like the environment in the broader economy, are ever changing. The demands of customers evolve. Competition fosters new products and innovations. Technology provides the means to create new products on an ever-faster cycle.

In that setting, financial markets and institutions need to respond quickly to changes in the environment. Trading practices evolve. Settlement conventions change to reflect new trading practices and new technology. Risk management systems that did not exist 15 or 20 years ago need to be tweaked to take account of exposures created by the latest bit of financial innovation. This constant evolution forces providers to gravitate toward cheaper and more efficient platforms, thus creating value for the users of financial services. Witness the growth of electronic trading platforms in the bond market or of electronic broking services in the foreign exchange market.

One key reason that wholesale bond and foreign exchange markets, for example, have been able to adapt the means through which they transact so efficiently is because of the regulatory regime under which they operate. In general, the wholesale markets operate with a less onerous regulatory regime, given that this market segment is comprised of professional dealers and large investors. Markets with more active retail participation - appropriately in my view given the diverse investors that transact business there - operate with a heavier dose of regulation. Of course, most market intermediaries, such as banks and broker dealers are regulated, but the marketplaces are not.

This lighter regulatory regime allows wholesale firms to respond relatively quickly to changes in the environment by altering their business model to pursue new opportunities or lower costs. Barriers to entry and exit are relatively low, with room to innovate. As a result, older practices need not be locked in. Inefficiencies can be wrung out. To the extent that the marketplace becomes more robust, it is beneficial for the firms and their customers and, in turn, helpful to the economy more broadly.

Regulation in this country is often the outcome of a perceived failure by the marketplace to police itself. The major regulatory efforts in the equity markets followed the reported abuses that led to the 1929 stock market crash. The Government Securities Act of 1986 followed the failures of Drysdale Securities, ESM Securities, and others in the early- to mid-1980s. So, the way to avoid more onerous regulatory regimes is for market participants to take responsibility themselves to assure that markets are fair and open - and that they are seen by both public sector and other private sector participants to be fair and open. There are various ways this can be achieved. Trade groups or self-regulatory associations are two typical examples. Both can be useful sources of ideas that generate best practice recommendations that upgrade market practices as a whole.

Of course, central banks and other regulators also have a role to play in creating an environment for a smooth-functioning marketplace. Regulators, for example, can and should pursue cases where individuals or firms have violated rules or regulations. Such actions may have a helpful deterrent effect. But the defining factor that influences how well markets function lies not with the central bank or other public officials - or for that matter with trade associations - but rather with market participants themselves. Ultimately, the quality of a marketplace will rely very significantly on the skill, the ethics, and the risk management systems of the firms in that marketplace.

And that brings us back to management. It is the management that is the ultimate guardian of a firm's reputation. First and foremost, management has the responsibility to assure a high standard of ethics and fair dealing. How a firm recruits and trains its staff is important, as is structuring incentives that reward desired behaviors and punish undesired ones. If management does not set a strong example, the danger is that lower layers of the organization will get lax, with unwelcome results.

Strong risk management systems are another element that a firm's management should focus on. Management has to remain vigilant and understand on an ongoing basis the risks being undertaken in all business lines. In particular, management has to scrutinize the strategies that its trading desk is using. There are at least three aspects to this point. First, management needs to monitor and measure the market risk taken by its traders. Increasingly sophisticated trading techniques call for increased managerial vigilance. Second, firms should have a strong culture with respect to counterparty credit assessments. In this connection, disclosure is very important. Firms should solicit and carefully analyze financial statements of current and prospective counterparties. But for that process to be useful, the statements need to be comprehensive and give a true picture of the firm's financial status. If there are questions about the quality of financial statements, that can only corrode the credibility of the marketplace. Lastly, operational risks need to be acknowledged and controlled. In this context operational risk was recently defined in a recent report by G10 bank supervisors as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events." Examples of such losses are well known.

Certainly the absence of such scrutiny over market, credit, and operational risks can have sharply adverse effects on the reputation of individual firms. Unfortunately, we have all seen how adverse effects on individual firms' reputations can have a negative impact on the marketplace as a whole, as everyone gets tarred with the same brush.

The view I have sketched out is one where wholesale markets operate best when they are sufficiently regulated to foster a level and well-defined playing field, but not regulated to the point where flexibility to adapt to changing circumstances, changing demands, and changing technology is discouraged. But the corollary of that environment is that it places the onus on market participants to maintain a clean, robust, and transparent marketplace. This strikes something of a balance between flexibility and responsibility. The alternative to this model is a far more regulated marketplace wherein regulators write down detailed rules on trading practices, duties to other participants, and standards of care in handling transactions - and then audit how firms perform. This model has some advantages. But if regulation is overdone and creates inefficiencies, it stimulates smart people within your institutions to devise clever ways to evade those rules. But even if firms are successful in bypassing these regulatory burdens, there is a cost in doing so, since time and money have to be devoted to this effort.

II. Desk Operations

Let me now turn to the management of the Federal Reserve's portfolio of domestic securities, and the conduct of our open market operations. One of the biggest challenges potentially confronting us going forward is managing the domestic securities in the Federal Reserve's portfolio in an environment marked by diminishing supplies of Treasury debt, with the possible need to hold an expanded set of financial assets. Even though immediate budget prospects are quite different from what was contemplated just one year ago, the continued prospects for less Treasury debt cannot be ignored.

Let me first review the determinants of the basic structure of the Federal Reserve's portfolio, and some general principles that are applied to its management, which would guide the selection of any alternative assets that might ever be held.

The size and structure of the portfolio of domestic assets is driven largely by two domestic policy considerations.

The first of these stems from the policy enshrined in the Federal Reserve Act to provide an elastic currency, which has been translated into a policy of satisfying all demand for Federal Reserve note liabilities or paper currency. Satisfying this demand has required the Trading Desk to accumulate a huge portfolio of domestic securities through its open market operations, rising by $40 billion or so over the past year alone to nearly $600 billion, including both our outright holdings and outstanding repo agreements. In short, this policy ensures that the total size of our domestic financial assets will be very large.

Second, the directives issued by the FOMC call on the Desk to control conditions in reserve markets - that is, to target the federal funds rate. Doing so in the face of sometimes rapidly changing levels of other assets and liabilities on our balance sheet and in response to shifting demands for reserves requires that we be able to operate in asset markets that allow us to make large adjustments in the size of the domestic portfolio in both directions and at times on very short notice. Average daily swings are on the order of $4 billion. But as we saw around the century date change and most recently in the days following September 11, the size of our portfolio may need to swing by tens of billions of dollars in a matter of days. In short, domestic policy implementation objectives require an ability to vary our asset holdings in large amounts quickly in response to forces outside our control.

We apply several guidelines to the selection of the specific kinds of assets that we will hold to serve these policy purposes. First is that the Federal Reserve structures its portfolio and undertakes its operations in such a way as to minimize the impact of its holdings on relative asset values, and to avoid distorting the allocation of credit in the private sector. The monetary policy mission of the Federal Reserve is stated in terms of macroeconomic outcomes and not of outcomes for specific sectors or for relative prices. The Federal Reserve also seeks to tightly control any risks associated with the assets it holds, as ultimately we are dealing with the public's money.

There is also a need for clarity in the conduct of our operations. We place a high priority on transparency and accountability in monetary policy operations that adjust our balance sheet. Central bank transparency and accountability can contribute to the goal of price stability by helping to reduce market uncertainty about both the operational objectives and the ultimate goals of monetary policy. In this regard, I would direct your attention to the information on the Desk's operations and securities holdings available on the Federal Reserve Bank of New York's website.

Finally, we also strive to operate in an efficient manner for the clear objective of lower cost.

For many years, we have been able to meet our policy objectives, our portfolio preferences, and our operating requirements by holding almost exclusively government securities, and by operating just in secondary government securities markets. For the most part, we hold Treasury securities outright, supplemented by repurchase agreements backed by government and agency collateral.

For years, the supply of these securities was seemingly inexhaustible, measured against the size of our portfolio needs, and the government securities markets was among the most efficient in the world. The rise of Federal budget surpluses brought change. You will no doubt recall that at about this time last year the Congressional Budget Office projected an aggregate surplus in the Federal budget over a ten-year period (through 2011) of $5.6 trillion, a view shared by most forecasters.

In July 2000, the Desk took note of the cutbacks in Treasury issuance then occurring and altered its procedures for managing the domestic portfolio, but without changing the types of assets we hold. The changes instituted at that time were intended to help the Desk achieve its objectives for a relatively short and liquid portfolio without distorting the yield curve. This resulted in specific numerical guidelines to limit our holdings of individual Treasury issues. For example, holdings of Treasury bills were capped (and still are) at 35% of outstanding amounts. Holdings of Treasury coupon securities were similarly limited on a graduated scale from 25% for two-year notes down to 15% for issues with maturities of ten years or more. These changes had significant implications for the structure of monetary operations, as they led to large redemptions of T-bills, which had to be replaced over time through a mix of outright and temporary open market operations.

Also in 2000, the Fed began to reexamine the types of assets held on our balance sheet, with a view toward expanding this list in the event that Treasury debt became increasingly scarce. At the risk of disappointing tonight's audience, I must say that I have no final announcements on what alternative assets the Fed is prepared to buy and hold, which would meet our needs. However, I will note that repos in municipal securities do not appear to be a viable alternative, while repos in foreign sovereign debt and outright purchases of GNMAs show somewhat more promise. Indeed, analysis of this issue is ongoing. And we continue to explore the feasibility of using our discount window in new ways to extend credit.

More recently, a weaker economy and changing budget priorities have generated a very different Federal budget picture, such that the CBO now projects a return to modest deficits and a ten-year cumulative surplus of "only" $1.6 trillion. The changed outlook for budget surpluses and the associated pickup in Treasury auction sizes during the latter half of 2001 has alleviated some of the Desk's operational tasks coming from redemptions, and may also have affected the timing of the need to determine what alternative assets the Desk might consider. Nonetheless, the principles enumerated here will certainly pertain well beyond any near-term shift in the underlying economic setting for monetary policy.

III. Securities Lending
I want to turn now to another area that I believe will be of interest to this audience, the Federal Reserve Bank of NY's securities lending program.

Revised in April 1999, this program can lend on an overnight basis up to 45 percent of our holdings of individual Treasury securities. The primary goal of the Desk's securities lending activities is to provide a secondary and temporary source of liquidity to the financing market, at least to the extent that we own the securities in demand. I would emphasize that the Desk is not trying to compete with traditional securities lenders. We want to be viewed as a backstop.

From humble beginnings, the program has steadily grown, such that during the last quarter of 2001 we lent an average of $3.7 billion in securities per day. The program was particularly important, as you might expect, during the days following the September 11 attacks. At that time we found ourselves becoming a primary and ongoing source for many dealers to cover short positions. Given the extraordinary circumstances, we were comfortable in this role, and on the peak day extended loans of $13.4 billion. By taking this activist approach, we hoped to provide confidence in the financing market, and encourage some traditional lenders to return. Despite the Desk's operations, the volume of securities fails continued to rise until the reopening of the 10-year note. But, I suspect the situation might have been worse without our presence.

By mid- to late-October, we quickly returned the program to its original objectives. I would also emphasize that, while promoting liquidity and market functioning is important, the Desk's primary responsibility is to implement monetary policy. So, while we share with you a broad interest in operating an effective securities lending program, we are limited by the size and composition of our securities holdings, which itself is determined by our primary monetary responsibilities. Indeed, this is one area in which we look to private sector market makers to take the lead.

In general, I believe that the securities lending program has been successful at meeting its objective of being a secondary and temporary source of securities in the financing market. It has operated at times of relative tranquility and at times of severe stress. Average daily volume has varied with the ebb and flow of the specials market. Securities traders continue to satisfy the vast majority of their needs from traditional lenders in the morning, and then turn to the Fed for those they are unable to obtain in the financing market by noon.

Additionally, we are encouraged by the fact that we have not significantly altered how the specials market functions. Issues continue to trade on special and profit opportunities for matched-book trading remain. Nevertheless, this is an appropriate time to take stock of the program's overall effectiveness and evaluate what enhancements can be added to make the program even better, especially given recent experiences. Thus, we are currently conducting a survey of our counterparties for input as to how the program can be improved to better meet our stated objectives, and we will be meeting with their representatives one week from now to hear their views in person.

IV. Conclusion
This evening I've attempted to draw a parallel between the need for market participants to adapt to changing conditions in the economy and financial markets, and the Federal Reserve's need to respond by adjusting its market operations. Freely functioning markets, with appropriate levels of regulation, can provide firms with the opportunity to make such changes over time. The Desk can contribute to this environment through the neutrality of its open market operations, through transparency, and through programs such as securities lending. We at the New York Fed firmly believe that through open communication and cooperation, the marketplace will continuously improve and thus create benefits for our community and our nation.
Thank you for your attention. I look forward to your questions.