Discovering Open Market Operations

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Open market operations, the principal tool of U.S. monetary policy, was discovered accidentally and was the biggest development in terms of the Fed's evolution from a passive to an active institution. (Monetary policy consists of the actions taken by the Fed to influence the availability and cost of money and credit.) That such an important responsibility was stumbled upon during the Fed's early years is another indication of the open-ended nature of the Federal Reserve Act—the idea that the Federal Reserve System would evolve and adapt as needs arose.

Following World War I the country suffered from an economic slowdown that had particular severity in agricultural regions. Because of the slowdown, Federal Reserve district banks were transacting less business with member banks and hence earning so little funds it was feared that some banks would not meet their expenses. So, Fed banks purchased government securities at a great pace through the first half of 1922 to improve their earnings positions. The money paid by the Fed banks for the securities was placed by the sellers in commercial banks, swelling the reserves of banks across the nation.

Soon, Fed officials realized that by purchasing securities on the open market, Federal Reserve Banks could affect general credit conditions across the country. In other words, when the Fed bought securities it increased commercial bank reserves and eased credit; the opposite applied when the Fed sold securities. Open market operations, the Fed's primary tool in implementing monetary policy, was born. By May 1922 a committee was established to coordinate investment policy through a centralized location—the Federal Reserve Bank of New York—and by the following year the Open Market Investment Committee for the Federal Reserve System (OMIC) was formed.

The Banking Acts of 1933 and 1935 established the Federal Open Market Committee (FOMC) to replace the OMIC, and the FOMC came to be the most powerful policymaking body of the Federal Reserve System. Twelve voting members make up the FOMC: five presidents of Federal Reserve Banks (members rotate annually among the Reserve Banks, with the president of the New York Fed retaining a permanent seat) and the seven members of the board of governors, who make up a voting majority.

With the establishment of the FOMC less than 25 years after its own formation, the Federal Reserve System had evolved beyond its founders' furthest expectations: from its beginnings as essentially a "banker's bank" to one of its most important functions—establishing the nation's monetary policy. In 1978 the board of governors was required under the Humphrey-Hawkins Act to report to Congress twice a year on the objectives and plans of the board and the FOMC with respect to monetary policy. Those objectives were addressed in a broad sense, by Paul Volcker, chairman of the Board of Governors, in a speech he gave in 1984:

> Industrial nations, including our own, nowadays rely heavily—sometimes too heavily—on their central banks and on monetary policy to achieve our economic goals: to promote growth and employment, to blunt the forces of inflation, and to maintain financial stability. At times, the pursuit of those objectives requires speed and flexibility in decision-making, and that flexibility is one of the virtues of monetary and credit policy. But through the necessary process of adaptation and change runs another, more constant, threat—the need for a sense of discipline. In the broadest sense, all of economics—I am tempted to say all of life—teaches us that our collective desires always exceed the means to achieve them. And history has taught us, again and again, that the creation of money is no substitute for productivity, for savings, and for investment in enlarging our economic welfare. Yet the temptation is always there to try—with the ultimate result of destructive inflation that, in the end, only undermines those goals.

In addition to open market operations, the Federal Reserve can determine monetary policy in two other ways: by changing reserve requirements and through the discount rate level. Reserve requirements are the percentage of deposits that financial institutions are required to maintain against deposits. Changing reserve requirements is a hard-hitting measure and is seldom used. In the past those reserve requirements only applied to certain accounts in some commercial banks, but the Depository Institutions Deregulation and Monetary Control Act of 1980 extended reserve requirements to all depository institutions.

Finally, the third tool of monetary policy is the discount rate—the rate the Fed charges to lend money to financial institutions. When a Federal Reserve Bank lends money in its region there is an increase in reserves. A change in the discount rate, which is approved by the board of governors following recommendation by the district banks, is sometimes used as an indication of monetary policy.

The Fed's involvement in monetary policy through the years has gradually spawned its role as a center for economic research. Research departments grew over the years at the board of governors and within each district bank as a means to study the Fed's involvement in the economy and thereby improve its performance, and also to examine other economic issues. The research departments of district banks are generally representative, ideologically, of the bank's current president. In other words, given the interest of a particular president, a bank mad be led to research certain theories or investigate certain problems. The notion of the Fed as an active member of the economic research society is a recent development in terms of the central bank's history and is becoming one of the chief ways for district banks to develop their own personality.

The Federal Reserve System earns income, for the most part, from holdings of U.S. government securities acquired through open market operations, with the remainder coming from holdings of foreign currencies, loans to depository institutions and fees charged for services provided to depository financial institutions.

In 1987 the Fed returned $17.7 billion, or 91 percent of its $19.4 billion gross earnings, to the United States government, of which $285 million was contributed by the Minneapolis Fed. The Fed paid $1.1 billion in operating expenses for the 12 Federal Reserve Banks and their branches—$62 million for the Minneapolis Fed—$82 million in expenses for the board of governors and $171 million for the cost of currency.

Also, the Fed paid $117 million in six-percent dividends to its member banks (required by law) and put $174 million in its surplus account.

Minneapolis Fed President Gary Stern wrote in the bank's 1985 annual report of the unique role of the Federal Reserve System as a policymaker.

"The situation of a U.S. policymaker is not easy in any year. The Fed has a somewhat vague general objective of maximizing the current and future welfare of society, which all public policy institutions share. Congress has translated that into a few broad operating goals—stable prices, high employment, and economic growth, for example—but these are not necessarily compatible goals, the Fed has no direct control over them, and they are measured only infrequently...

"What's a policymaker to do? The Fed does what economic theory says is best for a decision-maker in this situation: It uses all the information available at each point in time to move as close as possible to its broad goals. This means not targeting anything except those goals...

"*Targeting* in this context means just what one might guess: aiming to hit particular values..."

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