BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

STRICTLY CONFIDENTIAL (FR)
CLASS I - FOMC

Office Correspondence

Date December 11, 1987

To Federal Open Market Committee

Subject Strategies for Open Market Operations

From Donald L. Kohn & Peter D. Sternlight

This memorandum is intended to provide background for a Committee discussion of the approach to the implementation of policy through open market operations It compares the approach followed before the stock market collapse of concentrating on achieving objectives for adjustment and seasonal borrowing at the discount window with that followed since October 19 of placing greater emphasis on the level of the federal funds rate.[1] It also includes several alternative approaches for Committee consideration in the current circumstances

Prior to October 19

The focus of implementation on borrowed reserve objectives evolved from the nonborrowed reserves operating strategy. Under that strategy, objectives for borrowed reserves were derived from a nonborrowed reserve path keyed to desired money growth and the actual level of demand for required reserves Borrowing and associated federal funds rates could vary over a wide range over an intermeeting period in reaction to deviations of money growth from Committee objectives When money seemed to become less closely associated with the ultimate objectives of policy, its movements were no longer allowed automatically to affect the level of borrowing and hence reserve market conditions Over the last few years borrowing has been set on a more discretionary basis,

1. The memorandum of July 1, 1987 from Mr Kohn along with that from Messrs Lindsey and Glassman gives general background on the relationship of borrowing objectives to the federal funds rate under the previous procedure The memorandum of October 29, 1987 from Mr Kohn as well as Messrs Lindsey and Gillum deals with the issue of how to treat seasonal and special adjustment credit in a borrowing objective.

modified from time to time in response to a variety of incoming information about the economy and financial markets and flows The new system retained some element of flexibility with respect to the federal funds rate, in that this rate was allowed to fluctuate for a given level of borrowing--more so than before October 1979, when a fairly narrow range for the funds rate was the proximate target of daily open market operations.

As noted in the previous memo to the Committee, the relationship of borrowing objectives and the federal funds rate has not been very precise or stable. Moreover, for a variety of reasons, borrowing objectives cannot be achieved with great precision in a given two-week maintenance period. Even if achieved, the objective may be associated with a range of federal funds rates, depending, among other things, on market expectations about the course of monetary policy, and shifts in the willingness of depository institutions to use the discount window. In the course of implementing policy the Desk tends to take some of these factors into account and compensates for them to an extent in implementing policy Even so, the federal funds rate can vary as much as a half percentage point for a given borrowing objective.

The advantage of this operating strategy lies in the scope it gives for market forces to work The movements of the federal funds rate can convey information about underlying forces in the market, and those forces frequently move interest rates in a stabilizing direction--that is, one that correctly anticipates the next policy action For example, strength in demands for money and credit may push up the federal funds rate, especially when incoming data on required reserves, and Desk response to those data, lag the actual strength. Or markets may anticipate a policy response to information about the economy, prices, or international developments. In short, this approach can provide useful scope for the market to firm or ease "on its own "

The disadvantage of this system is that it can lead at times to unintended results in the money markets, and to a misreading of the Federal Reserve's intentions. Difficulties in achieving borrowing levels may delay the effectiveness of a policy action to ease or tighten through open market operations, and movements in federal funds rates for a given borrowing level can lead observers to conclude that a change in policy has occurred when none was intended. Sophisticated market participants, aware of the operating strategy, learned not to overreact to short-run fluctuations in money market conditions, especially when unaccompanied by changes in reserve pressures. Over time, borrowing objectives should be achieved, and with most factors affecting the relationship balancing out, federal funds rates should line up as anticipated with those objectives But the problems have been more acute and longer-lasting when inaccurate market expectations persist or when a shift in the underlying relationship has been recognized only with a lag. Generally, though, it has been possible with flexible open market operations to head off or mute most possible misinterpretations.

After October 19

The initial response of open market operations to the stock market collapse was the massive provision of liquidity to reassure the markets, calm fears, and assure that any unusual demands for money or reserves were accommodated This provision was undertaken with little regard for reserve paths or even the level of the federal funds rate on a given day. Once past the initial liquidity providing stage, this strategy has evolved into a form of federal funds rate targeting--albeit less narrow and precise than before October 1979. At its last meeting the consensus of the Committee was that federal funds should generally trade in a range of 6-3/4 to 6-7/8 percent; it was understood that the level of borrowing was a secondary consideration. While an initial borrowing objective was specified, the implication was that it should be recalibrated if it seemed inconsistent with federal funds trading in the desired range.

The intent was to provide a stable underpinning to the credit markets, reducing risks that Federal Reserve intentions as to money market conditions would be subject to misinterpretation This was considered especially important in the context of a still-fragile market environment. Moreover, with demands for borrowed, excess, and required reserves subject to considerable uncertainty, this approach also helped to assure that unexpected shifts in these demands would be fairly automatically accommodated by the Desk.

In carrying out its instructions, the Desk has been more sensitive to the federal funds rate than to borrowing objectives Federal funds averaged around 6-3/4 percent in the first full maintenance period after the meeting and in the middle of the Committee's range most recently. Borrowing has averaged around $220 million in the two full maintenance periods since the meeting, well below the notional level of $400 million written into the path following the Committee meeting. And, in light of recent experience, the notional borrowing objective in the path has been adjusted down to $300 million to be more consistent with the desired level of federal funds trading.

While this approach has seemed entirely appropriate in the current circumstances, it may have some disadvantages over the longer run It reduces the scope for the interplay of market forces and the possible stabilizing effects these can have, both in moving interest rates and in imparting information to policy makers about underlying forces at work. Focus on the federal funds rate and close identification of Federal Reserve policy with this highly visible rate can impart an undesirable degree of inertia to the policy process Small changes in the rate can come to be seen as signifying major shifts in Federal Reserve policy, and hence can become more difficult to make. With rates moving slowly, shifting economic and financial forces could be reflected more in changes in quantities, such as reserves or the money supply. But with these difficult to interpret, a policy response to emerging forces of inflation or deflation may tend to be too little and too late, as was the case under the federal funds operating objective in the late 1970s.[2]

---

2. In any case, there may be circumstances under which implementing tight control over the federal funds rate could encounter difficulty. This might occur if, for example, market expectations did not line up precisely with System objectives and considerably more or less reserves than seemed appropriate were provided early in the maintenance period, necessitating massive offsetting operations close to the end of the period.

As detailed in the Greenbook and the Bluebook, market conditions have returned to close to normal in some respects, but not in others. Bid-ask spreads have narrowed and dealer financing seems to be available through the usual channels in normal amounts. However, spreads between yields on Treasury and private obligations remain fairly wide in shorter maturities, and in an environment of great uncertainty about the outlook and policy, market confidence still seems fragile. Sharp price moves have occurred in recent weeks, including a renewed flight to quality and liquidity when the stock market and dollar were under some pressure. Markets also have reacted to perceptions of possible changes in System intentions where federal funds rates have deviated from past patterns. In addition, particular concern seems to be centered on possible market tightening around year-end

In these circumstances, several choices for implementing policy over the coming period might be considered.

1. <u>Retain the current emphasis, at least until markets calm further and borrowing behavior returns more to normal</u> The FOMC could continue to indicate a fairly narrow range for the federal funds rate, with the understanding that the Desk normally would react to trading outside that range. This would not preclude federal funds trading outside its range on particular days, but the Desk would be expected to become more aggressive if the rate was far from its range or it persisted outside it. Borrowing targets could be specified, but they would remain secondary, and could be adjusted in keeping with the desired range of federal funds rates. The Committee could instruct the Desk to be alert to signs that markets had quieted sufficiently further to permit placing more weight on borrowing objectives, especially once

year-end distortions had passed. Any such move would require appropriate consultation with Committee members.

2 Place even more emphasis on achieving a predetermined federal funds rate or a narrow range. This might be considered appropriate if the risk of interest rate instability and adverse market reactions to deviations of the federal funds rate from a narrow range were considered high and potentially damaging to the economy or financial markets. Such an approach might involve frequent open market operations that did not seem called for by the nominal reserve path, and even possibly operating more often at different times of the day or more than once each day, as in the 1970s.

3 Shift back toward more emphasis on achieving borrowing objectives, but with greater flexibility and attention to federal funds rates than before October 19 For example, the Manager could be instructed to adjust borrowing objectives more promptly if they clearly were seen as implying an average level of the federal funds rate outside the range established by the Committee But the Manager would attempt to achieve the adjusted borrowing level, which could imply a greater incidence of federal funds trading outside a narrow range, and a less forceful resistance to such occurrences than has been the practice since the stock market crash.

Any such shift in strategy would give somewhat greater scope for the federal funds rate to be shaped by market forces, including expectations. It could give rise to longer episodes of uncertainty about the System's intentions. If the Committee chose to move in this direction, it might want to delay the shift until the Manager judges that it was unlikely to have a significantly adverse effect on financial markets.

4. Finally, the Committee could return to the previous emphasis on borrowing and reserve pressure objectives. Under this approach open market operations would be adjusted no more than previously in response to potential shifts in demands for free reserves. The transition back to this approach could be gradual, involving the Manager's judgement about borrowing behavior as well as the market circumstances, and Committee consultation.