

**Open Market Committee of the  
Federal Reserve System**

**Allan H. Meltzer**

**History**

Section 14 of the Federal Reserve Act of 1913 authorizes open market operations in any of the assets acceptable as collateral for rediscounts and permits purchases and sales of gold and government bonds. Legislative hearings prior to adoption of the act note that the purpose of open market operations is to enable the "Federal Reserve banks to make their rate of discount effective in the general market at those times and under those conditions when rediscounts were slack and when there might have been accumulation of funds in the reserve banks without any motive on the part of member banks to apply for rediscounts or perhaps with a strong motive on their part not to do so." (House of Representatives, 1913, pp. 2317-18).

Initially, operations were conducted by each reserve bank to earn income and increase the bank's earned surplus. Purchases and sales were at the discretion of the individual banks and were not coordinated.

At a meeting of reserve bank Governors in the fall of 1921, some Governors expressed concern about the ability of the reserve banks to

pay dividends to stockholders and the franchise tax to the Treasury during recessions when revenues from member bank discounts were low. The Governors agreed that it was appropriate for reserve banks to invest in government securities to increase revenue. The reserve banks responded at once. Revenue from government securities nearly tripled (to approximately \$17 million) in the following year and provided one third of the banks' much reduced revenues in 1922.

The uncoordinated nature of the operations led to complaints by the Treasury that the banks' actions affected market rates during periods of Treasury debt management operations. In May 1922, a committee of five reserve bank governors began to coordinate purchases and sales. A year later this committee was authorized by the Federal Reserve Board and named the Open Market Investment Committee. (Friedman and Schwartz, 1963, p. 251, n. 15) In May 1928, membership was expanded to include the Governors of all 12 reserve banks. Individual reserve banks retained the right to engage in open market operations and could decide not to participate in the system's purchases or sales.

The Banking Act of 1935 changed the name of the committee to the Federal Open Market Committee (FOMC) and changed the committee's membership. Seven of the twelve votes were assigned to the members of the Board of Governors of the Federal Reserve System. The Chairman of the Board of Governors became Chairman of the FOMC, and the President of the New York Federal Reserve Bank

became Vice-Chairman and a permanent member of the committee. Three of the remaining four seats were assigned to the presidents of specific reserve banks on a rotating three year cycle with the remaining seat on a two year cycle. This structure has remained. All presidents (or their alternates) attend the meetings, but only five vote at any meeting. Thus, power over open market operations shifted from the reserve banks to the Board in Washington.

### **Organization and Operations**

Open market operations are carried out by the trading desk of the New York Federal Reserve Bank subject to the instructions of the FOMC. Since 1955, instructions are written as a "directive" to the Manager of the System Open Market Account. Originally, the directives were kept secret, but they are now made available to the press and the public 45 days after the meeting. In the past, the FOMC met as frequently as every three weeks, but currently about 9 meetings a year are held.

Until about 1970, directives usually were qualitative statements about the desired degree of "ease" or "restraint". These statements were open to different interpretations that encouraged disputes about whether the FOMC's instructions had been followed. (Brunner and Meltzer [1974] 1989). Subsequently, quantitative targets were introduced. Usually the target is specified as a narrow range for the interest rate on overnight loans in the interbank market. This rate is known as the Federal funds

rate.

Every morning the Manager briefs members of the Board's staff and designated members of the FOMC on purchases or sales planned for the day. Most of these operations are unrelated to the conduct of monetary policy; they are "defensive" operations to offset short-term changes in the banks' reserve positions induced by seasonal or temporary changes in the speed of check collection, in float, Treasury balances at commercial banks, and in the public's currency holdings. (Roosa, 1951). Open market operations are not identified as policy or defensive operations in published data, but differences in the ways in which operations are conducted help dealers in government securities (and other market participants) to distinguish defensive from policy operations when they occur..

Defensive operations dominate Federal Reserve operations. For example in 1989 when policy operations increased the monetary base -- bank reserves and currency -- by \$11 billion, total Federal Reserve purchases and sales of securities each amounted to \$1.5 trillion, more than 130 times the change in monetary base. (Board of Governors, 1989, Tables 2 and 3).

Critics of Federal Reserve policy argue that too much attention is given to defensive operations and short-term market movements. They claim that the short-term focus interferes with longer-term objectives such as price stability. The critics use the 1970's inflation and the 1930's

depression as evidence of the problems arising under the FOMC's traditional policy. By holding short-term interest rates fixed, the FOMC finances expansions of aggregate demand and reinforces contractions in demand arising from other shocks. A main consequence of the policy is that money growth typically has increased relative to trend in periods of economic expansion and declined relative to trend in recessions, thereby increasing the amplitude of fluctuations in the economy. To maintain stable prices, the critics recommend that the FOMC control a monetary aggregate such as the monetary base.

The response to this criticism is that Germany and Japan have controlled inflation and avoided large swings in aggregate demand while using a short-term interest rate target. The Swiss National Bank effectively controlled inflation using a monetary base target, however. The operating characteristics and efficiency of the alternative methods remains an open issue.

### **Theory**

In its early years, the Federal Reserve tried to rely mainly on changes in discount rates. Late in the 1919--20 expansion, the Federal Reserve raised discount rates and imposed a penalty rate on some types of member bank borrowing. They also used preferential rates and non-uniform rates across districts. But, member bank borrowing and market interest rates continued to rise during the early months of the recession.

The Governors interpreted the rise in market rates as a consequence of the increased member bank borrowing and concluded that, particularly in rural areas, higher discount rates or even penalty rates did not reduce borrowing or did so only after a long lag.

To many in the Federal Reserve, the 1920-21 experience showed the difficulties of controlling the volume of reserves, bank earning assets and member bank borrowing by discount rate changes. The reason they gave was that member banks did not borrow to profit from relending. They borrowed reluctantly to meet needs for required reserves.

Empirical observation opened the way to a new explanation and a new procedure based on the "reluctance theory" of member bank borrowing. Observations suggested that open market operations and member bank borrowing were inversely related. The new interpretation made open market operations the driving force behind member bank borrowing. When open market purchases increased bank reserves, banks repaid borrowing from the Federal Reserve. Open market sales induced banks to borrow. Thus, open market committee could control member bank borrowing more effectively by open market purchases and sales than by changing the discount rate. And by controlling member bank borrowing, the committee could influence open market interest rates and other variables. (Riefler, 1930; Federal Reserve Board, 1924). In the 1930's a low level of borrowing and relatively high level of reserves in excess of requirements introduced modifications to the

theory. Free reserves, defined as excess reserves minus member bank borrowing, replaced borrowing as the key variable affected by open market operations.

The introduction of demands for reserves and borrowing that depend on the discount rate and the federal funds rate again modified the theory late in the 1960's and produced a change in operating procedures. The federal funds rate became the target of open market operations.

A broader set of theoretical issues concerns the way in which open market operations affect interest rates, other relative prices, the absolute price level, and the pace of economic activity. A central issue in much of this literature is the distinguishing characteristic that makes money differ from bonds or real assets. Work by Cagan (1958), Brunner and Meltzer (1971), Laidler (1982), and McCallum (1983) find this difference in the role of money as a medium of exchange and in the relative fixity (or high cost of privately producing units) of the monetary base.

Open market operations change relative prices on a variety of assets and change asset prices relative to the prices of new production and the service yield of money. These changes in relative prices and real wealth are not confined to the short-term money market. They affect the relative demands for assets and spill over to the market for current output. Thus, the effect of open market operations spread through the

markets for assets, output and labor.



## References

- Brunner, K. and Meltzer, A.H., (1989). The Federal Reserve's attachment to the free reserve concept. In *Monetary Economics*, ed. K. Brunner and A.H. Meltzer, Oxford: Basil Blackwell, 1989, pp. 21-96.
- Brunner, K. and Meltzer A.H., (1971). The uses of money: money in the theory of an exchange economy. *American Economic Review*, 61, (December), pp. 784-805.
- Cagan, P., (1958). Why do we use money in open market operations? *Journal of Political Economy*, 66, (February), pp. 34-46.
- Federal Reserve Board, (1924). *Tenth Annual Report of the Federal Reserve Board (for the year 1924)*. Washington: Federal Reserve Board.
- Friedman, M. and Schwartz, A.J., (1963). *A Monetary History of the United States, 1867-1960*. Princeton: Princeton University Press for the National Bureau of Economic Research.
- House of Representatives, (1913). House Report 69, 63rd Congress, 1st Session, (September 9, 1913). Reprinted in H. Krooss, ed. *Documentary History of Banking and Currency in the United States*. New York: Chelsea House Publishers (in association with McGraw Hill, 1969), vol. 3, pp. 2275-2342.
- Laidler, D., (1982). *Monetarist Perspectives*. Oxford: Philip Allan.

McCallum, B.T., (1983). The role of overlapping generations models in monetary economics. *Carnegie-Rochester Conference Series on Public Policy*, 18, pp. 9-44.

Riefler, W.W., (1930). *Money Rates and Money Markets in the United States*. New York: Harper and Bros.

Roosa, R.V., (1951). Interest rates and the central bank. In *Money, Trade and Economic Growth, Essays in Honor of John H. Williams*. New York: Macmillan, pp. 270-95.