# Policy Implementation

# A Morning at the New York Fed

- The manager of the Fed's System Open Market Account (SOMA) interprets and executes the policy directives of the Federal Open Market Committee (FOMC)
  - government securities are bought and sold from the SOMA to affect intermediate monetary targets
  - the buy or sell orders are issued to securities traders who work for the New York Fed

# A Morning at the New York Fed

- The Fed traders call primary dealers
  - 23 large banks and securities dealers with whom the Fed deals directly
- The traders then meet to announce their buy or sell offer prices
- The manager tells the traders to discharge the most profitable transactions up to the amounts that the Fed wishes to buy or sell

# Who Are the Primary Dealers? Primary Dealers as of July 1, 2004

Following is a list of the 22 primary dealers that buy and sell securities directly with the Fed in the execution of monetary policy. In recent years, the number of primary dealers has fallen due to mergers among large financial institutions.

ABN AMRO Bank, N.V., New York Branch
BNP Paribas Securities Corp.
Banc of America Securities LLC
Barclays Capital Inc.
Bear, Stearns & Co., Inc.
CIBC World Markets Corp.
Citigroup Global Markets Inc.
Countrywide Securities Corporation
Credit Suisse First Boston LLC
Daiwa Securities America Inc.
Deutsche Bank Securities Inc.
Dresdner Kleinwort Wasserstein Securities LLC.
Goldman, Sachs & Co.
Greenwich Capital Markets, Inc.
HSBC Securities (USA) Inc.
J. P. Morgan Securities, Inc.
Lehman Brothers Inc.
Merrill Lynch Government Securities Inc.
Mizuho Securities USA Inc.
Morgan Stanley & Co. Incorporated
Nomura Securities International, Inc.
UBS Securities LLC.

SOURCE: Federal Reserve Bank of New York, **http://www.newyorkfed.org/newsevents/markets/prldealers_current.html.**

# A Morning at the New York Fed

- As the deals are consummated, reserves are either supplied or withdrawn from the banking system
- The manager of SOMA then examines the effects of these changes on intermediate targets and decides if additional purchases or sales are needed

# The FOMC Policy Directive

- Once the long-term policy stance is set, the focus of the FOMC shifts to the immediate period
  - indicators of underlying economic and financial conditions are examined
  - the FOMC then devises short-term strategies that are consistent with its longer-range projections

# The FOMC Policy Directive

- The FOMC issues a policy directive that guides the conduct of open market operations until the next FOMC meeting
  - the link between the decisions formulating policy and the actions implementing policy

# The FOMC Policy Directive

- The policy directive is released along with a statement that communicates the Fed's evaluation of the risks associated with regards to sustainable economic growth and price stability
- Beginning in 1994, these policy directives are announced immediately following the FOMC meetings
  - eliminates questions and doubts

# The Reserves Market and Open Market Operations

- To implement the policy directive, the Trading Desk of the New York Fed tries to manage reserve levels in the banking system so that the federal funds rate is equal to the targeted rate
  - to do this the Trading Desk develops estimates of the supply and demand for total reserves

# The Reserves Market and Open Market Operations

- The demand for reserves consists of
  - the demand for required reserves
  - the demand for excess reserves
- The supply of reserves consists of
  - borrowed reserves
    - borrowed from the Fed's discount facility
  - non-borrowed reserves
    - available in the open market

# Total Reserves

| Total Reserves Demanded | = | Total Reserves Supplied | = | Total Reserve Components |
|---|---|---|---|---|
| Excess Reserves | | Borrowed Reserves (discount window) | | Deposits at the Fed |
| | = | | = | |
| Required Reserves | | Nonborrowed Reserves | | Vault Cash |

Buffer against check-clearing needs and other uncertainties → Excess Reserves

$\left[\text{Transaction's Deposits}\right] \times \left[\text{Reserve Ratio}\right]$ → Required Reserves

# The Reserves Market and Open Market Operations

- In recent years, the Fed has implemented policy by focusing its open market operations with an eye toward achieving the targeted federal funds rate
- To follow the directive, the Trading Desk determines the reserve need
  - the difference between actual reserves and those projected to be needed to keep the federal funds rate at the desired level

# The Reserves Market and Open Market Operations

- Each day, the Fed updates its estimates of the supply of reserves and new information on the other factors affecting reserves
  - using this information, the manager revises his estimates of the reserve need

# The Reserves Market and Open Market Operations

- In recent years, required reserves have declined substantially and are continuing to decline
  - this is due to the widespread growth of retail sweep accounts
    - "sweep" balances out of transactions accounts that are subject to reserve requirements and into other deposit accounts that are not
    - first appeared in 1994

# The Reserves Market and Open Market Operations

- The significant decline in required reserves in recent years due to sweep accounts has raised concern that the fed funds rate may become more volatile
  - may affect the implementation of monetary policy

# The Reserves Market and Open Market Operations

- In recent years, Congress has considered authorizing the Fed to pay interest on reserves
  - the Fed has advocated that this would make the banking system more efficient
  - the incentive to use sweep accounts would be minimized

# How the Demand and Supply of Reserves Are Calculated

- Banks are required to hold reserve assets for a two-week maintenance period
  - the actual amount of required reserve assets that must be held is determined during the computation period
  - the average daily amount of required reserve assets that must be held is equal to the required reserve ratio times the average daily amount of deposits subject to reserve requirements

# How the Demand and Supply of Reserves Are Calculated

- Currently, only checkable deposits are subject to reserve requirements
  - 0% on transaction deposits up to $6.6 million
  - 3% on transaction deposits between $6.6 million and $45.4 million
  - 10% on transaction deposits over $45.4 million

# How the Demand and Supply of Reserves Are Calculated

- Between 1984 and the end of July 1998, contemporaneous reserve accounting was used
  - the computation period begins two days before the maintenance period begins
  - when one computation period ends, another immediately begins

# How the Demand and Supply of Reserves Are Calculated

- Beginning in July 1998, the system was changed to lagged reserve accounting
  - the maintenance period begins 30 days after the beginning of the computation period
  - when one computation period ends, another immediately begins
  - the change makes it easier for depository institutions to calculate their required reserve balances for the current maintenance period

# How the Demand and Supply of Reserves Are Calculated

- In addition, with lagged reserve accounting, the Trading Desk at the New York Fed can obtain more accurate information about required reserves
  - helpful in determining the overall demand for reserves by the banking system