A Day at the Trading Desk*

By ALAN R. HOLMES
Senior Vice President, Federal Reserve Bank of New York and Manager of the System Open Market Account

What I would like to do is try to convey to you some of the flavor of the fascinating job that we at the Trading Desk of the New York Federal Reserve Bank have in translating the policy decisions of the Federal Open Market Committee into concrete dollars and cents operations in the open market. I think it is a good general rule for the Manager of the System Open Market Account to keep his mouth shut and work quietly behind the impersonal screen of the money market. But there seems to be enough lack of understanding about Federal Reserve operations in the press, in the academic world, and even in financial circles to warrant an attempt to set out for you just what it is that we do at the Desk and how we go about it. So this is a "how to do it" talk, not a discussion of Federal Reserve policy or current monetary problems.

Perhaps the best way to start is to take a quick look at the institutional framework within which open market operations are conducted and at the tools of open market operations. Then I would like to turn to the instructions we receive from the Open Market Committee and go on to a description of how and why we operate in the markets.

As you know, open market policy is determined by the Federal Open Market Committee, composed of the seven members of the Board of Governors and five Reserve Bank presidents. Actual operations for the entire System are conducted by the Federal Reserve Bank of New York which has been designated by the Committee as its operating arm. Each Reserve Bank, however, participates in System holdings with a daily sharing out of all purchases and sales among the twelve Reserve Banks. The Federal Reserve is not—of course—a profit-oriented institution. But with a portfolio approaching $60 billion in Government securities and no problem with financing costs, it is hard not to make money. Last year earnings from the System portfolio amounted to over $3 billion, distributed among the Reserve Banks, but with the lion's share subsequently being paid by the Reserve Banks into the United States Treasury.

I should note in passing that, in addition to System open market operations, the Trading Desk also acts as agent for the Treasury in its market and financing operations and on behalf of foreign central banks. In this respect it is rather interesting that for the past several years the volume of outright purchases and sales for foreign central banks has exceeded the volume undertaken for the System Account. This is a constant reminder of the linkages between our own money and securities markets and the international money market.

I am sure that there is no need to say much to this audience about the tools that the Federal Reserve uses to carry out open market operations. The chief instrument, of course, is the outright purchase or sale of Government securities. A purchase of Government securities by the Federal Reserve adds reserves to the banking system—other things being equal—as payment is made to the reserve account of a member bank somewhere in the United States. And if our operations do in fact add to reserves, banks can expand their lending and investment activities. Similarly, a sale of securities by the Federal Reserve takes reserves away from the banking system and restricts the ability of the banks to make loans and investments.

Besides outright operations in Government securities, we also acquire Government securities and Government agency securities under repurchase agreement; that is, we buy securities—injecting reserves into the market—and at the same time execute a contract to resell them on a fixed

* An address delivered before the twenty-first annual investment seminar of the New York State Bankers Association, New York City, September 18, 1970.

date, thereby withdrawing reserves at that future time. Since 1966, we also have used the matched sale-purchase agreement, under which we sell securities to the market and agree to buy them back at a specified future date, usually in a day or so. The repurchase agreement and the matched sale-purchase agreement add to our flexibility in handling temporary reserve needs or excesses with a minimum disturbance to the securities market.

In addition to operations in Governments, we do a similar but far more modest business in prime bankers' acceptances for the account of the New York Bank under the direction of the Open Market Committee.

These, then, are the tools we use to affect the reserve position of the banking system.

The Federal Reserve, however, is not the only—or even the major—influence on bank reserve positions and on the money and credit markets. Each and every day there are millions of private decisions to spend, to save, and to invest that result in some net change in the demand for money, liquidity, and credit. The net impact of this myriad of individual decisions and transactions—and they may involve foreign as well as domestic transactions—tends to be transmitted through the banking and credit system. Starting with individual banks, the impact works through regional money centers and finally converges on the New York money market. An increase in the demand for money or credit, of course, tends to be reflected in firmer conditions in the money market, a faster growth rate in the money or credit aggregates, and a greater demand for bank reserves; at least it would do so in the absence of offsetting System open market operations.

In addition, there are a number of technical factors, with which you as bankers are all familiar, that may—and do—absorb or supply reserves to the banking system in large amounts. I refer to such things as Federal Reserve float, the level of Treasury balances held at the Reserve Banks, the flow of currency into or out of circulation, changes in the United States gold stock and other international reserve assets, or activity under the Federal Reserve foreign currency swap network. All these factors are obviously outside the control of the Trading Desk, but we have to be prepared to deal with changes in them. And change they do, with fluctuations supplying or absorbing reserves in amounts running up into the hundreds of millions—or even more—from day to day or week to week. On many occasions, large open market operations are required just to prevent these "natural" flows from disrupting the reserve position of the banking system and the money market.

Thus, it is well to bear in mind that a "firmer" Federal Reserve policy cannot always be equated with net sales of Government securities, or an "easier" policy with net purchases. What really matters is the combination of market factors and Federal Reserve operations and the resultant impact of the two on bank reserves and ultimately on the monetary and credit aggregates and on interest rates. In a growing economy, even a policy of restraint is very likely to require substantial net purchases of securities over time—at least in the absence of changes in reserve requirements or discount window use. Last year, which I am sure most of you would not classify as a period of monetary ease, we added over $4 billion to our portfolio of Governments.

With this very sketchy background in mind, let me turn to the process by which the Federal Open Market Committee transmits its instructions to the Federal Reserve Bank of New York.

The Committee's policy decisions are based on a comprehensive consideration of a wide variety of factors that affect the growth and stability of our economy. The Committee's ultimate focus of concern is on the real economy—on gross national product, on prices, on employment, on production, and on the international position of the dollar. But in giving instructions for the conduct of open market operations, the Committee has to translate its policy aims—which are essentially long term in character—into terms of its proximate responsibilities, that is, into terms of money, credit, reserve availability, and the money market conditions that are likely to be associated with desired changes in the monetary and credit aggregates. As you know, the Committee has been putting greater emphasis since early this year on the monetary aggregates in giving instructions to the Trading Desk. But I see no evidence that the Committee feels it has found a magic formula. Rather, there is an evolving effort to sort out the monetary and credit growth and the associated money market conditions that will foster the broad objectives of the Committee's long-range policies. And, while no two members of the Committee think exactly alike, there does emerge from each meeting a consensus about the aggregates and money market conditions that will get the Committee where it wants to go. This consensus is summarized by Chairman Burns at the conclusion of a very frank go-around of Committee members, and a formal vote is taken on a directive to the Federal Reserve Bank of New York, which governs operations until the Committee meets again.

The directive is necessarily couched in relatively broad terms, usually focusing on a desired rate of growth of the monetary aggregates but with ample attention to the general state of the money market. For example, the operating paragraph of the directive adopted at the May 1970 meeting—the last to be published—gave these instructions to the Desk:

> in view of current market uncertainties and liquidity strains, open market operations until the next meeting of the Committee shall be conducted with a view to moderating pressures on financial markets, while, to the extent compatible therewith, maintaining bank reserves and money market conditions consistent with the Committee's longer run objectives of moderate growth in money and bank credit.

The specific language of this directive is typically modified from meeting to meeting—sometimes a little, sometimes a lot—to reflect the shifting emphases of Committee concern.

I should emphasize immediately that the Manager of the System Open Market Account has much more than the directive to serve as a guide in the conduct of operations between Committee meetings. Before each meeting of the Committee, the staff has circulated a detailed analysis of alternative growth paths in the monetary and credit aggregates, their relation to the real economy, and the money market conditions and interest rates likely to be associated with them. As you can imagine, making this set of projections and targets is not precisely an exact science, and the staff analysis is subjected to a critical review by the Committee members. For the Manager, the full discussion of the Committee as it reaches a policy decision adds a great deal of flesh to the bare bones of the directive.

We have now reached the point where the Committee has issued a directive to the Federal Reserve Bank of New York. The task of the Trading Desk then becomes the conversion of that policy decision into concrete decisions to buy or sell a certain amount of securities in the open market. Basically our job at the Desk in carrying out the Committee's directive involves a comprehensive analysis of (1) very detailed statistical reports of bank reserve positions and monetary and credit aggregates, (2) projections of the aggregates and of factors affecting bank reserves, and (3) observations of what is happening from minute to minute and hour to hour in the money and securities markets. A blow-by-blow description of a day at the Trading Desk is not really possible in a talk, but let me try to do the best I can.

Our trading room looks very much like the trading room of any major securities house or large bank. There is the usual quote board reflecting up-to-the-minute price and yield quotations on Government and agency securities. In front of each trader is a telephone console with direct wires to the dealers in Government securities, to the Federal funds brokers, and to the money desks of a number of large banks. But the Fed's Trading Desk differs markedly from the others. Our job is not to trade for a profit, but to control the supply of bank reserves in line with the Open Market Committee's broad policy objectives. In addition, we serve as the eyes and the ears on the market for the whole Federal Reserve System and the Treasury. Both the Fed and the Treasury recognize that the market can tell us a great deal about the current decisions and expectations of borrowers and investors, and this information is a significant supplement to what we can learn from the many statistical series that we receive.

Thus we keep in close touch with the market through daily meetings with individual Government securities dealers and by constant telephone communication during the day. Our traders spend the lion's share of their time on this activity, putting together and analyzing what they hear from individual dealers, banks, and brokers and developing a feel for current market trends.

While this activity is going on each morning, there has been a steady flow of statistical information coming into the Desk from the New York money market banks, from Government securities dealers, and by wire from the other Reserve Banks. A little after 9:30 every morning we receive a summary report of the reserve position of the banking system as of the close of business the night before. This we check immediately against what our projections had indicated the reserve position to be the day before. A few minutes later our computer has spewed out a detailed breakdown of the money position of the New York money market banks, and by 10:30 we have a similar report from the other Reserve Banks on the position of thirty-eight other major banks scattered throughout the country. These are followed by reports from the dealers in Government securities on their positions and the volume of trading on the previous day. By this time, too, we have checked with our Foreign Department to find out what has been going on in the European foreign exchange markets, and to get a preliminary view of likely buy or sell orders that will be forthcoming from foreign central banks.

At 10:10 a.m. we check with the Treasury our respective estimates of what will happen to the Treasury balances held in the Reserve Banks, and the Treasury decides whether or not to make a call or adjust some previous call on its Tax and Loan Accounts at the major commercial banks. As you know, the flow of funds through the Treasury account is huge, particularly around tax and financing dates, and large shifts in Treasury balances held at the Fed could disrupt the reserve position of commercial

Banks. Thus the Treasury, very properly, tries to keep a roughly constant balance with the Reserve Banks so as not to be a factor affecting bank reserves and the money market.

As the morning progresses—by 10:40 if we're lucky —we get a detailed projection from our Research Department on the reserve outlook. The projection covers daily estimates of float, currency circulation, vault cash held in banks, gold and foreign operations, the Treasury balance, and required reserves, together with weekly reserve averages, for the next four weeks. And by 11 o'clock we should have similar estimates from the Federal Reserve Board staff in Washington. Like all projections, these are subject to a wide margin of errors. But new projections are made every day, permitting constant updating and continual cross-checking of assumptions by our technicians in New York and Washington.

In recent years, considerable effort within the Federal Reserve System has gone into the development of projections of the monetary and credit aggregates that are of particular interest to the Committee. Thus, each week we have new projections—usually reaching out three months ahead—that serve as a supplement to the historical record in judging whether money supply and bank credit are within the target ranges desired by the Committee. These projections are far from perfect, and constant efforts are being made to improve them and, indeed, the statistical series themselves. Our use of the projections and of the money and credit statistics is quite cautious, because experience indicates that both money supply and bank credit can behave very erratically, particularly in the short run. I would warn you, therefore, not to over-interpret week-to-week, or even month-to-month, changes in the money supply. The Committee's attention, after all, is focused on longer run growth rates, not on short-run movements that may turn out to be without real meaning.

By 11 o'clock we are already beginning to develop a pretty good idea of how money market conditions are going to shape up for the day. By this time we have already had several conversations with the Board and Treasury staffs bringing them up to date on early developments and have sent off a brief wire report to the Reserve Banks and Board.

Since the Federal Reserve is a regional central bank, we have had to develop an elaborate network of communications to assure that all the Reserve Banks and the Board of Governors are kept up to date on current open market operations and their background. This involves a number of written reports as well as wire and telephone communication. But perhaps the focal point of that network is the conference call we place each morning at about 11:10 to the Board, where certain staff members and perhaps one or more Governors may be gathered, and to a Reserve Bank where a president currently serving on the Open Market Committee and his staff advisers are gathered. During the course of the call, one of the officers on the Trading Desk gives a fairly detailed rundown of current and prospective developments affecting bank reserves and the money and securities markets. The Reserve Bank president may comment on how the situation may look from his vantage point. The Board staff may comment on their latest information concerning the money supply or bank credit developments or provide other pertinent information, and we have an opportunity to check out the staff projections of bank reserves. We then present our tentative plan of action, if any, for the day and receive any comments that the other call participants may care to make. Immediately following the call, a detailed summary is prepared by the Board staff, placed before each Governor, and dispatched by wire to each Reserve Bank president. Thus each member of the Open Market Committee has before him by about 1 p.m. a review of the current situation and our plan for open market operations for the day.

Obviously, before we go into the call we have had to make up our minds whether System operations are called for to implement open market policy. Are we going to buy or sell and how much?

Let me summarize briefly the elements that go into that decision:

(1) We have a directive from the Committee setting forth policy objectives and the benefit of the Committee's discussion as it reached its decision.

(2) We have staff estimates and projections of money supply and bank credit measured against the background of seasonal patterns and earlier projections. These we can check against the longer range growth rates desired by the Committee.

(3) We have knowledge of what has happened in the recent past insofar as the various elements of money market conditions are concerned. I can't stress enough that daily operations are not conducted in a vacuum but are part of a continuing process. Each day we build on past experience.

(4) We have projections from the staff about the behavior of market factors (float and foreign operations) —whether they are likely to be neutral, or to supply or absorb reserves.

(5) We have taken careful readings of the market as it has developed and by 11 a.m. have begun to develop a feel of what it is saying about the availability of money and about interest rates.

Suppose our staff estimates indicate that market factors —perhaps a sharp rise in float and a decline in currency circulation—are going to supply $300 million in reserves in the current statement week. Suppose further that the estimates of money supply and bank credit appear about in line with the Committee's desires. In addition, as we check the market, we learn from the Federal funds brokers that there is a large supply of Federal funds from New York and from the West Coast and only a small demand from other banks, and that the Federal funds rate is tending to move lower. This reserve excess appeared to be confirmed by the wire reports giving bank positions for the night before. Moreover, Government securities dealers are having no difficulty in finding funds from corporations and banks throughout the country to finance their positions, and this situation is tending to push Treasury bill rates lower.

Such a situation would clearly be inconsistent with a Committee directive for no change in policy, assuming that was what we had, and our course of action would be clear. The decision would be to sell Treasury bills in the market to absorb reserves or perhaps, if projections indicated that the reserve excess would be only short-lived, to make matched sale-purchase agreements.

I should pause to say that the situation, unfortunately, is not always quite so clear as the one outlined. Expectations are of great importance in shaping market decisions, and we always have to take them into account. At times, too, the projections indicate that there should be an ample availability of reserves, while the market is giving off signals of acute distress. In such cases the projections often have to be set aside, while the tone and feel of the market take predominance. The market, in fact, often enables us to correct erroneous reserve projections, but it too is not infallible. Sometimes banks are very conservative in managing their reserve positions and tend early in the statement week to bid for more Federal funds than they really need to balance out their reserve positions. This, of course, makes for a tighter Federal funds market than the underlying reserve positions would really warrant. On some occasions, too, the reserve and monetary aggregate projections in New York and Washington are far apart. And, on occasion, computers will break down and deprive us of vitally needed information. But the market always functions, and we can get guidance there.

In any case a decision has to be made, and a decision to do nothing is as important and difficult as a decision to buy or sell. But the point I want to emphasize is that any decision is always based on a combination of past experience, statistical reports and projections, and current market developments (which may at times be more affected by expectations than statistics), together with the directive that the Committee has set out.

The actual purchase of securities is far less difficult than reaching a decision as to what to do, but it requires a fair amount of skill in timing and technique. In the situation outlined above our decision might well have been to sell about $300 million of Treasury bills. Our procedure would be to instruct our traders to ask the twenty-odd Government securities dealers with whom we do business to bid us for Treasury bills of any maturity. Each trader would immediately get on the phone and call two or three dealers, as simultaneously as possible, and in a matter of minutes would get back firm bids for stated amounts and at stated prices. Perhaps from all the dealers we might get bids for $600 million or more of Treasury bills. Our job would then be to select those that were bid us at the best price relative to the whole market and those that fit in best with our existing bill portfolio. The whole operation would take us no more than about one-half hour—a very interesting commentary on the ability of our Government securities market to handle large transactions with great facility.

We are, of course, fortunate to have a vigorous market in Government securities that is able to handle large transactions efficiently. The existence of such a market affords the Federal Reserve great flexibility in the conduct of open market operations to influence bank reserves, money, and credit. The System—and the Treasury as a major issuer of debt—both have a vital interest in the maintenance of a strong, competitive free market, and I would like to pay tribute to all those who help keep the market that way.

As we at the Desk operate in the market day by day, we can never be sure at any given moment whether our operations have been in the precisely right amount or whether we are only, hopefully, moving in the right direction. All we can be sure of is that tomorrow will be another day, with a new set of data and projections and new decisions to be made. But we hope that by plugging away we can, through successive approximations, achieve the goals that the Federal Reserve has set for itself.