



Introduction

As the nation's central bank, the Federal Reserve System is responsible for formulating and implementing monetary policy. The formulation of monetary policy involves developing a plan aimed at pursuing the goals of stable prices, full employment and, more generally, a stable financial environment for the economy. In implementing that plan, the Federal Reserve uses the tools of monetary policy to induce changes in interest rates, and the amount of money and credit in the economy. Through these financial variables, monetary policy actions influence, albeit with considerable time lags, the levels of spending, output, employment and prices.

The formulation of monetary policy has undergone significant shifts over the years. In the early 1980s, for example, the Federal Reserve placed special emphasis on objectives for the monetary aggregates as policy guides for indicating the state of the economy and for stabilizing the price level. Since that time, however, ongoing and far-reaching changes in the financial system have reduced the usefulness of the monetary aggregates as policy guides. As a consequence, monetary policy

plans must be based on a much broader array of indicators. Today, the monetary aggregates still play a useful role in judging the appropriateness of financial conditions and in making monetary policy plans, but their role is quite similar to that of many other financial and nonfinancial indicators of the economy.

To a considerable extent, changes in policy formulation have been accompanied by corresponding changes in the implementation approach. In the early 1980s, monetary policy was implemented by targeting a quantity of bank reserves that was based on numerical objectives for the monetary aggregates. As the Federal Reserve reduced its reliance on the monetary aggregates and conditioned its policy decisions on a wide range of indicators, the implementation strategy shifted toward a focus on reserve and money market conditions consistent with broader policy goals, rather than on achieving a particular quantity of reserves.

No one approach to implementing monetary policy can be expected to prove satisfactory under all economic and financial circumstances. The actual

approach has been adapted from time to time in light of different considerations, such as the need to combat inflation and the desire to deal with uncertainties stemming from structural changes in the financial system. Thus, it is fair to say that the current implementation approach is likely to continue to evolve in response to changing circumstances.

Regardless of the particular approach, implementing monetary policy involves adjustments in the supply of bank reserves, relative to the reserve demand, in order to achieve and maintain desired money and financial market conditions. Among the policy instruments used by the Federal Reserve, none is more important for adjusting bank reserves than open market oper-

ations, which add or drain reserves through purchases or sales of securities in the open market. Indeed, open market operations are, by far, the most powerful and flexible tool of monetary policy.

Focusing on open market operations, this book offers a detailed description of how monetary policy is implemented. By tracing the economic and financial conditions that influence the actual decision-making process, it attempts to provide a sense of the uncertainties and challenges involved in conducting day-to-day operations. The book also reviews the monetary policy formulation process, and offers a broad perspective on the linkages between monetary policy and the economy.