



Implementing Monetary Policy—II

Primary Dealers

The Federal Reserve implements monetary policy through the purchases and sales of U.S. Government securities in the secondary market, in which previously issued securities are traded. Its private sector business counterparties, known as primary dealers, are able to handle large orders efficiently, quickly, and safely. In recent years, the number of primary dealers has ranged between 37 and 46.

To minimize the credit, delivery and settlement risks associated with its transactions, the Federal Reserve has developed criteria for selecting trading counterparties for its open market operations. Primary dealers must be either commercial banking organizations subject to official supervision by U.S. federal bank supervisors or brokers/dealers registered with the Securities and Exchange Commission. They must meet the minimum capital standards of their primary regulators, and also must have certain minimum amounts of capital.

All primary dealers are expected to engage in

substantial trading with the Desk, provide the Desk with market information and analysis that may be useful for formulation and implementation of monetary policy and participate meaningfully in Treasury auctions. If a dealer fails to meet these standards, the Desk has the authority to discontinue its trading relationship with that dealer.

The Desk arranges its open market transactions—RPs, MSPs, and outright purchases and sales—with primary dealers through an automated processing system. For RPs and MSPs, an electronic announcement is sent to primary dealers and, typically, they are asked to respond within 10 to 15 minutes. The Desk notifies all dealers of the propositions accepted and rejected, usually within about 5 minutes of the closing time for the response, again using its automated processing system.

The Desk does not have a fixed time for its outright purchase and sale operations. It times its outright transactions during the day when market participants are not preoccupied with other developments, because these transactions can be somewhat more time con-

suming than RPs and MSPs. But recent changes in the method of outright coupon operations involving a series of smaller transactions, as described earlier, have significantly reduced the turnaround time on operations.

As part of its business relationship, the Desk maintains extensive contacts with all primary dealers. Over the course of each day, traders at the Desk talk to most dealers, using direct telephone lines, about the activity in the securities markets and the financing of their securities positions. Each afternoon, one or more members of the Desk staff hold brief meetings, usually arranged over the telephone, with representatives of two primary dealers. Over a four-week period, the Desk staff has the opportunity to talk to representatives of all primary dealers. Discussions at these meetings cover a broad array of topics; many topics are common to all dealers, while others vary depending on the dealers' business interests.

Ongoing contacts with primary dealers inform the Desk staff about the wide-ranging forces at work in financial markets: changing demands of the dealers' customers in the securities markets and their interest in particular types of securities; the economic and interest rate outlook that various dealers are presenting to their clients; financing of the dealers' securities positions; special developments influencing reserve conditions; the dealers' expectations about Treasury financing in the period ahead, and potential customer interest in coming financ-

ing; the strength of business loan demand at banks associated with primary dealers, and any issuance of wholesale market instruments to fund lending at those banks.

Informing the FOMC

The Manager and the Desk staff keep the FOMC fully informed about evolving reserve market conditions and their daily plans for open market operations, as well as about the feedback on policy from financial markets. The Desk's main channels for communicating with the FOMC are (1) a daily conference call, (2) two daily reports, (3) a weekly report on financial market developments and a biweekly report on open market operations for each maintenance period, (4) an intermeeting period report on operations and financial market developments prepared for each FOMC meeting, (5) the Manager's reports at the regular FOMC meetings, and (6) an annual report on monetary policy operations; some consideration is now being given to replacing this annual report with quarterly or semi-annual reports. In addition, the Manager and the Director of the Division of Monetary Affairs at the Board make sure that the Chairman is fully informed at all times about significant developments relating to open market operations and financial markets. When appropriate, the Manager, the Director and the Chairman discuss unfolding events that may have important implications for the Committee's directive or its implementation.

The Conference Call

Each business day, at present about 10:20 a.m., the Manager and several other Desk staff members gather in an office near the trading room at the Federal Reserve Bank of New York to participate in a telephone conference call. The call links the Manager and other New York staff with the Director of the Division of Monetary Affairs and other staff members at the Board, and with one of the four Reserve Bank Presidents outside of New York currently voting on the FOMC. The call, which usually lasts about 15 minutes, offers the Desk's review of reserve conditions and financial market developments, and the Manager's plan for open market operations. It also enables the Desk to consult, on a daily basis, with one of the Committee members concerning the implementation of the directive. Desk staff members report on financial market developments and the reserve outlook. At times, other participants may make brief comments on special aspects of economic and financial market developments that may be of interest on a particular day. The financial market review includes price and rate movements in the U.S. Government securities markets and the main influences on market movements. Mention is made of the effects of any data releases and other events on activity in the securities markets. Desk staff members describe

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the situation in the federal funds market, providing the latest information on rates and on the reserve needs and the funding activity of major banks. They also note key developments in the foreign exchange markets.

The Desk staff review of the reserve outlook presents the estimated reserve needs, and explains revisions to the outlook from the previous day. Finally, the proposed "program" for open market operations is read and the Reserve Bank President is asked for comments. Normally the president will concur with the Manager's plan, but occasionally may ask questions about the plan or other possible options. Formal presentations are concise and leave room for conference participants to ask questions and make other brief comments. Also, the Director of the Division of Monetary Affairs at the Board may occasionally use the call to provide the latest information on developments in monetary aggregates.

Daily Reports

A summary of the conference call, put together by the Board staff, is delivered to each Board member shortly after the call and immediately transmitted to each Reserve Bank president. After the securities markets are effectively closed around 5:00 p.m., the Desk staff

sends, electronically, a summary of the day's developments in the financial markets to Reserve Bank presidents and Monetary Affairs staff at the Board in Washington, D.C.

Weekly and Biweekly Reports

Every Friday, the Desk staff sends a weekly report to the FOMC on developments in the domestic securities and foreign exchange markets. Every other Friday, the weekly report contains a comprehensive review of open market operations for the maintenance period ended on the preceding Wednesday. The biweekly portion of the report describes the conduct of operations and the reserve market conditions over the maintenance period, and includes the latest information on monetary aggregates.

Prior to each FOMC meeting, the Desk staff submits a background report to the FOMC on open market operations and financial market developments in the latest intermeeting period. A brief description of reserve operations also appears in the Blue Book, prepared by the Board staff, in advance of the FOMC meeting. At the regular FOMC meetings, the Manager's presentation also covers operations and market developments during the intermeeting period. Finally, in the first quarter of the year, the Desk staff prepares an

annual report on monetary policy implementation and financial market developments for the preceding year. A modified version of this report is published in the annual report of the Federal Reserve Bank of New York.

A Day at the Open Market Desk

The working day at the Desk begins soon after 8:00 a.m., although one person is usually in the trading room about an hour earlier to contact people from overseas

markets where U.S. Government securities are traded. The early part of the day is occupied with information-gathering activities and meetings that help the Manager and other Desk staff prepare the daily plan for open market operations. Traders track early trading and related developments in U.S. financial markets. They talk to dealers about their expectations for business activity in the securities markets

and to the large money center banks about their funding plans in the federal funds market. Other staff members collect information on economic and financial developments by looking at headlines from news services and reading information screens. Such information includes, among other things, economic data releases, comments of various analysts on recent economic and monetary developments, trading of U.S. Government securities in

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Asia and Europe, and reports of any event that might influence early trading in U.S. financial and foreign exchange markets.

The Treasury Call

Each weekday morning, at present about 10:00 a.m., several Desk staff members, including staff from the Desk's reserve projections unit, gather in an office near the trading room for a telephone conference with representatives of the Treasury. Before the call, the assembled group quickly looks at preliminary estimates of nonborrowed reserves and its components over the maintenance period and in the days immediately ahead. When the estimates of the New York Fed and Treasury staffs suggest that the Treasury balance is likely to move away from the desired levels on the current and upcoming days, the Treasury staff will, if possible, take action to bring it back into line by transferring funds to or from depository institutions.

After the Treasury call, which usually lasts only a few minutes, the senior Desk staff begin a discussion of the plan of action for the day. The starting point of the discussion is the estimated need to add or drain reserves for the maintenance period, but as described in Chapter 5, the range of issues involved is quite broad; some of the subjects are similar from one day to the next, while others differ with circumstances. As they move toward a decision on the plan for the day, the Manager and Desk

staff call the Director of the Division of Monetary Affairs to get a reading of the Board staff's assessment of the reserve situation and to provide a preliminary indication of what sort of operation is being contemplated.

While work on the day's action plan is still in progress, the reserve forecasters deliver tables containing the revised estimates of the New York Fed staff as well as those of the Federal Reserve Board staff. If these estimates are significantly different from the preliminary estimates, the action plan may need to be modified. As the discussion reaches a conclusion, one of the participants writes a program of action for the day. The program reviews the reserve situation, the trading in the federal funds market that morning and other factors that have influenced the proposed action.

As described earlier, the proposed program for open market operations is read during the daily three-way conference call that links the Desk staff, the Board staff and a Reserve Bank president. If the action plan of the day involves temporary transactions, RPs or MSPs, they are carried out immediately after the conference call. The Desk staff normally completes its operations within a few minutes. Once the transactions are executed, including receipt of collateral, the reserve accounts of the dealers' banks are credited or debited accordingly, altering the supply of nonborrowed reserves in the monetary system.

Over the remainder of the day, the trading room

continues to monitor rates and prices in the securities markets, trading in the federal funds market, and other financial market developments. In addition, each afternoon, the Desk staff holds brief telephone conferences with representatives of two primary dealers as part of its ongoing efforts to gather information on the wide-ranging forces at work in financial markets. On a regular basis, Desk staff members visit with market participants

and dealers at their offices in New York City to learn about markets and dealer operations; these visits frequently take place in the afternoons. Toward the end of the day, as mentioned earlier, the Desk staff sends, electronically, a summary of the day's financial market developments to the Board staff and Reserve Bank presidents.