THE ORETICAL FOUNDATIONS OF OPEN MARKET INSTRUMENTS OF MONETARY POLICY

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Abstract: *This research paper is devoted to the consideration of the reasons for the occurrence of open market operations of monetary policy and its theoretical foundations. In addition, it examines foreign experience in the development of open market policy. According to the research findings, it has been concluded that not only government debt obligations, but also other liquid securities are widely used by Central banks as an object of the open market instruments.*

Key words: *monetary policy, open market policy, government debt obligations, bonds.*

The open market policy is used as the primary instrument in the monetary policy of the central banks in developed countries. This has happened due to the increase in government expenditures incurred because of various wars, which took place at the beginning of XX century and the consequent issuance of the government treasury bills. In particular, J. Keynes made a great contribution for studying the reasons of the great depression of 1929-1936 and developing the proposal to raise public expenditures to overcome this economic crisis. Currently the majority of developed countries are expanding their economies in reliance upon the model by J. Keynes. One peculiarity of this model is that it requires government expenditures to be higher than its revenues, while at the same time raising aggregate demand in the economy. The compliance of this model with our analysis is that the state budget deficit is covered by securities issuance, and these securities are considered the most liquid securities in the financial market, and central banks serve as the primary object of open market policy.

The peculiarity of open market operations is that the central bank can exert market influence on the amount of excess resources at the disposal of commercial banks. This fact promotes reduction or expansion of loan investments directed to the economy, while at the same time having an impact by reducing or raising the liquidity of banks. This impact is attained by the central bank by setting the price of securities purchased or sold from commercial banks on the open market.

With a strict restrictive policy aimed at the withdrawal of loan resources from the lending market, the central bank reduces the selling price or raises the purchase price and, accordingly, increases or decreases its deviation from the market rate. If the central bank's aim is to reduce the reserves of the banking system, it will pursue a contractual policy and act on the supply side in the open market. In this case, it has two chances to achieve its aim:

1. Announces the rate of securities. In this case, the central bank offers any number of securities to reach this rate;
2. Offers a certain amount of additional securities.

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If the central bank's aim is to enhance the banking system's reserves, it will act on the demand side in the open market. In this case, the central bank selects one of two options to achieve its aim:

1. Fixes the rate of securities. In this case, the central bank buys any number of securities to achieve this aim;
2. Regardless of the value of the offerit acquires a certain amount of liquid securities.

If the central bank buys securities from commercial banks, it transfers funds to their correspondent accounts with the central bank, thereby enhancing creditworthiness of banks. They commence to extend loans in non-cash in the form of real money, calculated on the money supply, and converted into cash when needed. If the central bank sells securities, commercial banks will cover such purchases from their correspondent accounts, thereby reducing the issuance of money, which, in turn, will reduce the banks' ability to lend to the economy.

The basic securities traded in the open market are the most liquid securities that are actively traded in the secondary market and the risk is very low. Such securities represent various obligations imposed by monetary policy makers. In particular:

- certificates of indebtedness (Bank of the Netherlands, National Bank of Denmark, Bank of Spain, European Central Bank);
- financial bills of exchange (Bank of England, Rixsbank of Sweden, Bundesbank of Germany, Bank of Japan);
- bonds (Bank of Korea, Central Bank of Chile, Bank of Russia).

Selection of securities depends on the level of development of the financial market and independence of the Central Bank, i.e. its ability to implement transactions not only with government securities, but also with securities of other issuers.The openness of the economy and its dependence on the national currency dynamics raises transactions with external debt obligations (Norway, Austria, Denmark).

The central bank's impact on the money market and capital market is that by changing interest rates in the open market, the bank creates favorable conditions for the purchase or sale of government securities to enhance liquidity of lending institutions. Open market operations are normally implemented by the central bank in cooperation with a group of major banks and other financial institutions. Open market operations are more adaptable to short-term market changes than accounting policies.

It should be noted, that developed countries mainly focus on the development of an open market instrument of monetary policy of central banks, as this instrument is currently the most flexible way to regulate the liquidity and lending capacity of banks in developed financial markets.

At the early stages of the open market operations development in the United States, the Federal Reserve system purchased federal government securities with the aim of obtaining an additional profit while the interest income from loans and excess liquidity provided to member banks of the Federal Reserve was low. The majority of the Federal Reserve banks identified New York as the most suitable place to implement such operations, and it was here in the 1920s that an informal committee composed of representatives of all twelve independent Federal Reserve banks coordinated their performance on federal government securities. Almost immediately after commencement of its business, the committee began tomake an impact on the development of the economy by covering the gold circulation in the economy through the purchase and sale of

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securities and creating additional liquidity for the commercial banking system. The activities of this committee as the Federal Open Market Committee (FOMC) were officially formalized and legalized only after the adoption of the Banking Law in 1935. The Federal Open Market Committee manages current operations of securities in the open market, that is, the central bank pursues an open market policy. At its meeting, this committee investigates the economic situation and selects the most optimal way for implementing monetary policy.

Herewith the Federal Reserve may not only make amendments in the monetary policy, but also “protect” the open market of securities in response to unfavorable changes in liquidity in the banking system.In particular, until 1971, the Federal Reserve implemented several “protection” operations in the open market to indemnify for the deficit in the US trade balance, which began in 1957 and subsequent outflow of gold. In addition,operation of “protection” through the open market instrument of monetary policy of the Federal Reserve System is made in the event of a change in the volume of deposits of the state treasury of the FRS.If an open market operation is not implemented in due time, this change can make a negative impact on the monetary base.

Between 1953 and 1958, the FOMC limited its activities in the open market only to government treasury bills and other short-term securities with the maturity of up to one year. So-called “promoters”of this type of fiscal policy, called a “promissory note”, have noted that buyers and sellers who are aware of the specific type of federal government securities to which the FRS’s future open market operations are allocated, have some advantage. Being aware of the repurchase periods of these securities by the issuer greatly simplifies the task for dealers and investors to predict the consequences of future open market operations. Currently the majority of open market operations are implemented with short-term securities, although a number of experts believe that this is not always the case and that there are some artificial restrictions.

In the early 1960s, the US Treasury in cooperation with the FRS sought to simultaneously lower interest rates on these securities through the purchase of long-term securities and bonds, as well as to raise interest rates on them by selling short-term securities on the open market. This fiscal policy is called an “operation twist”. Such FRS measures have been aimed at promoting the domestic economy by lowering long-term interest rates, as well as attracting foreign investors to invest in the US economy by raising interest rates on short-term securities. However, actually in economic life, such fiscal policy has demonstrated a slight impact on raising interest rates on short-term securities. Although yields on long-term US government securities and bonds declined in this case, interest rates on corporate bonds and liabilities have not changed significantly.The financial policy of the “operation twist” has not made any significant impact on the economy, because in addition to the targeted purchase and sale of securities on the open market, interest rates also depend on a number of financial and economic factors. Moreover, it should be noted, that once a financial resource is “injected” into the banking system, the central banks cannot control their further use, while central banks cannot control the financial markets when financial resources are removed from the banking system.

In conclusion, an open market policy is essential for the central banks to implement money supply. In addition, it is recommended to use in the open market policy not only government debt obligations, but also other types of highly liquid securities.

We can learn from the experience of developed countries that the use of long-term securities in the open market is more profitable than the use of short-term securities. The Central Bank of

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Uzbekistan does not possess an adequate experience in the open market. In particular, open market operations started in late 2018 and up to present time have been conducted mainly with short-term securities, i.e. with the maturity of up to one year. Indeed, until 2011 there were also operations with public debt in the open market, but the volume of these operations did not make any significant impact on the liquidity of the banking system and the economy as a whole.

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