Using shares rather than bonds in open market operations

Leslie Terebessy

Stabilization policies
Monetary policy is exercised by central banks to achieve price stability. If there is a looming recession, the central bank will expand the money supply. This will encourage expenditure and production. If there is a threat of inflation, on the other hand, the central bank will aim to reduce the money supply. This will reduce expenditure and growth.

Monetary policy is applied primarily by buying and selling government bonds. This is known as “open market operations.” If the central bank buys or sells bonds entirely new money enters or leaves the financial system, respectively. The purchase of bonds by the central bank injects new money into the system. The sale of bonds reduces it. The former is known as “quantitative easing,” or “printing money.”

If it wishes to spur economic activity, the central bank will purchase government bonds in the bond market. Purchasing government bonds will inject new money into the economy, reduce interest rates, stimulate expenditure, and spur employment.

If the central bank wishes to reduce inflation, on the other hand, it will sell government bonds. This will increase interest rates, reduce expenditure, and reduce pressure on prices to rise. The former is known as an “easy monetary policy.” The latter is known as a “tight monetary policy.”

According to Keynesian economic theory, if a nation is facing inflation (rising prices), it should implement a “tight” monetary policy. If the nation is facing a recession, it should adopt an “easy” monetary policy. Whether the central bank will apply one or the other policy depends on prevailing economic circumstances and government priorities.

Equity-based open market operations
However, better results may be achieved by trading in shares rather than bonds. Shares represent possession of productive assets. They are traded privately as well as in share markets.

If the central bank intends to spur economic activity, it can buy shares, including new shares. This will inject money into the economy, and encourage spending, production as well as employment.

Similarly, if the central bank intends to rein in inflation, it can sell shares. This will drain money from the economy, reduce expenditure and dampen inflationary pressures. Ownership of shares by the central bank should be temporary.
Advantages

When the central bank buys the shares of companies, money enters the real economy faster than when it buys bonds. The reason is that the entry of funds into the economic system via the banking sector takes longer than would be the case if the funds entered the real sector directly.

Conversely, when central banks sell bonds to banks, the money paid for the bonds is taken from the reserves of the banks rather than the real sector. Thus, the impact of selling bonds to banks on economic activity is limited. The effect on aggregate demand would be greater if the central bank sold shares to the real sector rather than bonds to banks. For in this case, payments for the shares would come from the real rather than the banking sector.

Moreover, increasing the reserves of banks does not guarantee that the funds received by the financial institutions will find their way into the real sector. The funds may remain in the banking sector indefinitely. As the saying goes, “one can take a horse to the water, but one cannot force it to drink.” If the funds enter the real sector directly, however, they will be available for use immediately. This provides a compelling reason for considering using shares rather than bonds in the conduct of open market operations by central banks.

To make the transition process smooth, central banks could begin by using the methods in tandem. They should afterwards expand the trading in equities and reduce trading in bonds. As far as the Islamic countries are concerned, this would enhance compliance with the sharia, as trading in debt is forbidden in Islam.