JANUARY 1995

Monetary Trends

THE FEDERAL RESERVE BANK of ST. LOUIS

Does The Fed Influence Interest Rates?

The conventional wisdom is that the Fed largely controls short-term interest rates by controlling the overnight federal funds rate. Some analysts, however, believe that short-term interest rates are determined largely by factors that are independent of current Federal Reserve actions and that the Fed merely adjusts its federal funds rate objective in response to movements in short-term interest rates.

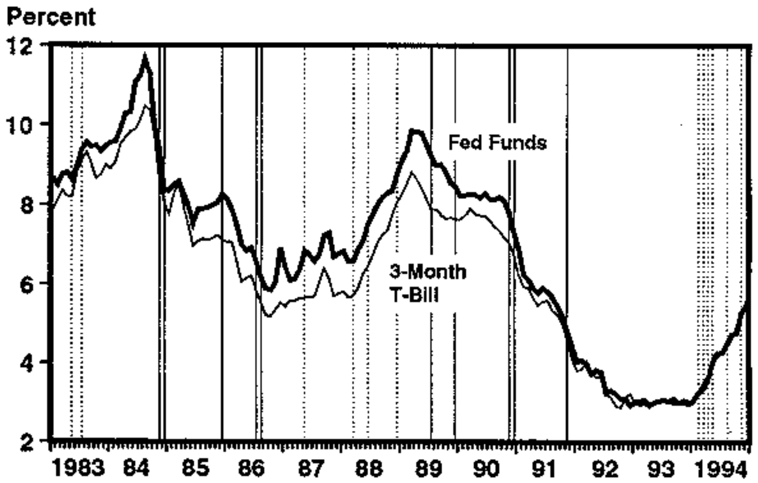
At each meeting since 1983, the Federal Open Market Committee (FOMC) has voted to increase, decrease or maintain the *degree of pressure on reserve positions* (DPRP). A decision to tighten policy (increase the DPRP) should result in slower reserve growth and a rising federal funds rate; a decision to ease policy (reduce the DPRP) should lead to faster reserve growth and a falling federal funds rate. In the August 1994 *Monetary Trends*, I showed that FOMC decisions to tighten or ease policy prompted Fed actions as reflected in statistically significant changes in reserve growth in the expected direction.

The federal funds and 3-month T-bill rates since January 1983 and dates on which the FOMC voted to ease (solid lines) or tighten (dashed lines) policy are presented in the accompanying figure. This figure illustrates why it is difficult to determine whether the Fed moves the market or the market moves the Fed. First, movements in the funds rate sometimes precede movements in the T-bill rate; other times, the T-bill rate moves before the funds rate. Second, in virtually every case, FOMÇ decisions to ease or tighten policy are preceded by falling or rising interest rates, respectively. Proponents of the conventional view, however, point out that the market may be anticipating changes in the funds rate.

If current monetary policy actions are the driving force behind the behavior of short-term interest rates, FOMC decisions to tighten or ease policy should result in pronounced changes in interest rates in the direction consistent with the action. An analysis of the figure shows that there are some instances in which FOMC decisions to tighten (ease) policy are followed by a decline (rise) or leveling off of interest rates. Consequently, unlike reserve growth, there are no sharp, consistent and statistically significant changes in the rate at which interest rates are rising or falling in response to FOMC's decisions to tighten or ease policy. This simple analysis cannot refute the conventional wisdom but it does not support it either.

— Daniel L. Thornton

Federal Funds Rate and 3-Month T-Bill



Note: Vertical lines represent approximations of policy change dates; solid lines are ease and dashed are restraint.