November 25, 2008

How should we think about the monetary transmission mechanism?

That's always a relevant question, but it takes on some added importance in times like these when the federal funds rate—the standard policy target for the Federal Open Market Committee—approaches its lower bound of zero. The recent introduction of a policy to pay banks interest on the reserves they hold on account with the Federal Reserve—which presumably (though puzzlingly not yet operationally) puts a floor on the federal funds rate independent of how much liquidity the central banks pumps into the economy— raises the question afresh.

A week or so back, Glenn Rudebusch, associate research director at the San Francisco Fed, offered his view on this topic:

> "Although the funds rate target cannot be lowered much further—and certainly not below zero—it is *not* the case that the Federal Reserve is necessarily 'on hold.' Indeed, the Fed has already started to employ alternative means for conducting monetary policy in order to stimulate the economy.
>
> "There are three key strategies for a central bank to stimulate the economy when short-term interest rates are fixed at zero or near zero. The first is to attempt to lower longer-term interest rates and boost other asset prices by managing market expectations of future policy actions. Specifically, a credible public commitment to keep the funds rates low for a sustained period of time can push down expectations of future short-term interest rates and lower long-term interest rates and boost other asset prices. Such a public commitment could be unconditional, such as 'maintained for a considerable period' or it could be conditional, such as 'until financial conditions stabilize.' The FOMC made such a commitment in 2003 after the funds rate was lowered to 1 percent and the economy remained weak. With the funds rate currently quite low, the Fed may revisit this strategy. If so, there would appear to be considerable scope for such a strategy to work, as the 10-year U.S. Treasury bond yield remains around 4 percent. When the Bank of Japan promised in 2001 to keep its policy rate near zero as long as consumer prices fell, it was able to help push the rate on 10-year government securities down below 1 percent."

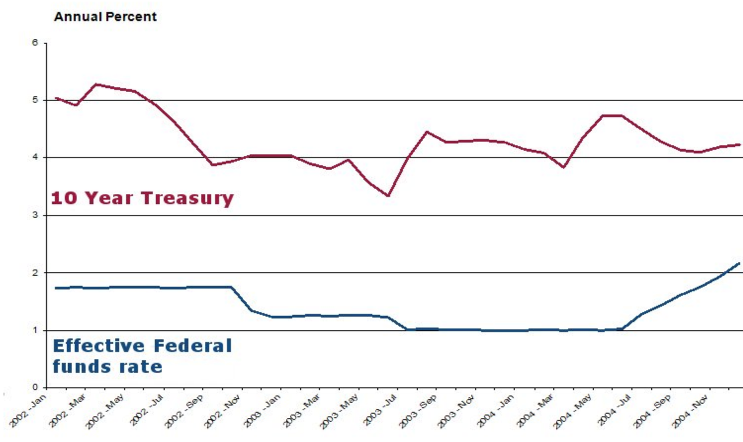
Rudebusch goes on to discuss the other two strategies—worth reading and examining here at a later time—but I think it is interesting to contrast this first statement of strategy with the following, from Tobias Adrian and Hyun Song Shin (of the Federal Reserve Bank of New York and Princeton University, respectively):

> "We find that the level of the Fed funds target is key. The Fed funds target determines other relevant short term interest rates, such as repo rates and interbank lending rates through arbitrage in the money market. As such, we may expect the Fed funds rate to be pivotal in setting short-term interest rates more generally. We find that low short-term rates are conducive to expanding balance sheets. In addition, a steeper yield curve, larger credit spreads, and lower measures of financial market volatility are conducive to expanding balance sheets. In particular, an inverted yield curve is a harbinger of a slowdown in balance sheet growth, shedding light on the empirical feature that an inverted yield curve forecasts recessions."

That empirical feature is in fact documented by Rudebusch and John Williams. Adrian and Shin continue:

> "These findings reflect the economics of financial intermediation, since the business of banking is to borrow short and lend long…
>
> "… our results suggest that the target rate itself matters for the real economy through its role in the supply of credit and funding conditions in the capital market. As such, the target rate may have a role in the transmission of monetary policy in its own right, independent of changes in long rates."

Interestingly, the "considerable period of time" episode referred to in the Rudebusch excerpt above coincided with an *increase* in long-term interest rates and a steepening of the yield curve:



So, if stimulative monetary policy is what we are after, should we be looking for lower long-term rates or higher long-term rates? Discuss.

By David Altig, senior vice president and director of research at the Atlanta Fed

Because of the Thanksgiving holiday, today's posting will be the only macroblog posting for this week.

November 25, 2008 in Federal Reserve and Monetary Policy, Interest Rates | Permalink