

Monetary Trends



The Long and the Short of the Federal Funds Target Cuts

In an attempt to jump-start a lagging economy, the Federal Reserve lowered its federal funds rate target six times between January and June 2001—a cumulative 275 basis point decrease—to an annualized rate of 3.75 percent. The federal funds rate is the interest rate paid by banks for overnight loans from other banks. Therefore, lowering the target reduces the cost of acquiring funds to make up for reserve shortfalls, which in turn makes banks more willing to lend. Conventional wisdom suggests that such periods of policy easing would aid interest-sensitive sectors of the economy such as housing. However, the accompanying chart shows that yields on long-term securities such as 10-year Treasury securities were actually higher in June 2001 than in December 2000, before the Fed began lowering the target. Although long-term rates generally declined with the Fed's target cuts from January to March, long-term rates increased even as the Fed continued to ease in the following months.

Changes in expected inflation can explain why long-term interest rates sometimes rise when the Fed cuts its federal funds target. Although the Fed can exert considerable influence on short-term interest rates, changes in inflation expectations can confound the effect of the federal funds target changes on longer-term interest rates. Easier monetary policy lowers short-term rates now, often at the expense of higher prices in the future. If the market-expected rate of future inflation rises—perhaps because of easing monetary policy—long rates will rise as purchasers of long-term securities demand compensation for rising prices.

Further complicating the analysis of the effects of Fed policy changes on long-term interest rates is the

fact that markets often anticipate forthcoming actions by the Fed. For example, prior to the June 2001 FOMC meeting, the market assigned roughly equal probability to a rate cut of either 25 or 50 basis points, and long-term interest rates reflected this expectation. Hence, the FOMC's cut in the funds rate target of only 25 basis points was lower than the average of the possible expected cuts. Moreover, the 25-point reduction was interpreted widely as signaling the end of the Fed's period of expansionary monetary policy. Fears that the Fed would ease too much and induce inflation subsided and long rates fell.

One additional consideration is the slope of the yield curve. Typically, there is a premium on longer-term securities and the yield curve slopes up. Before April, however, the yield on 3-month T-bills exceeded that of longer-term securities. Long rates may have risen because the market could not sustain an inverted yield curve.

The moral of the story is that the Fed has no direct control over long rates. Therefore, waiting for the Fed to cut interest rates before buying or refinancing a home or engaging in any other long-term debt contract might be misguided, since financing for long-term investments can suffer the whims of inflationary expectations.

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