



How Effective Is Monetary Policy?

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The sluggish recoveries from the past two recessions suggest that monetary policy might have limited impact on economic activity. The figure below shows that the Fed reduced its policy instrument—the effective federal funds rate—by 525 basis points during each recession. During the most recent recession, the Fed was preemptive, reducing the effective funds rate in advance of the business cycle peak. Moreover, the Fed was aggressive, reducing the effective funds rate 475 basis points in the span of a year. Uncertainty about the strength of the expansion caused the Fed to reduce the rate an additional 50 basis points in November 2002—bringing the federal funds rate to its lowest level since the mid to late 1950s.

In both recession episodes the economy's response to the Fed's aggressive policy actions appears to have been anemic. Economic activity coming out of the 1990-91 recession was weak relative to previous post-WWII recessions. The same is true of economic activity after the recent recession—which, indeed, may be somewhat weaker.

Why is it that monetary policy appears to have produced such modest results? One possibility is that the Fed's actions have had only a limited effect on long-term interest rates. According to the standard view of the monetary transmission process, monetary policy affects real economic activity by changing interest rates; but it is long-term rates that are important for spending decisions (especially investment) and not short-term rates, which are more directly affected by policy actions.

While there are several reasons why the Fed's ability to influence spending through the interest rate channel may be limited, recent experience suggests that the Fed's inability to directly affect long-term rates may be important. The figure shows that despite the Fed's aggressive policy actions during the two recent recessions, long-term rates, illustrated by Moody's Aaa bond yield, declined only modestly. Bond yields declined much less than the funds rate during both recessions and during the specific months over which the

effective funds rate was cut. The decline in bond yields was smaller during the recent recession, suggesting that the more aggressive policy actions this time around had a smaller impact on long-term yields.¹

Why long-term rates responded only modestly to these policy actions is unclear. The conventional wisdom is that monetary policy affects long-term rates by changing the market's expectation for future short-term rates. Hence, it could be that market participants expected the reduction in the funds rate to be relatively short-lived. However, the effective funds rate remained more than 200 basis points below its pre-recession peak for nearly a decade after the 1991 trough. Of course, long-term rates may be determined by factors other than simply the market's expectation for short-term rates. Whatever the explanation, recent policy actions appear to have had only a limited impact on long-term yields, which affect spending decisions and thus economic activity. ■

¹ For the purpose of this discussion, I assumed that the recent recession ended in February 2002.

