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A slightly different point arises in the context of testing the effects of federal funds futures on other market rates. It makes sense that short rates move most closely with the federal funds rate. However, the theoretical link with long rates is rather more ambiguous. In what way should long rates react to changes (and expected changes) in short-term policy rates? This could go either way, and indeed there could be no link at all. Suppose the Fed is tightening rates in order to bring down inflation in the future. This will raise implied forward rates up to some term, but it may lower interest rate expectations further out, that is, tip the yield curve. In such cases, forward rates further out will change but the change could quite logically be in the opposite direction. Tighter policy now could lower inflation expectations further out and, hence, create expectations of lower interest rates in the future. Hence, it might be interesting to test the reaction of long forward rates, in addition to yields to maturity, as the former will strip out the impact at the short end of the yield curve. What actually happens in each case will be dependent on the complexity of the environment, and the reaction might be asymmetric—rises may have a different impact than falls.

Why and to whom is all this likely to be interesting? Potentially there are three groups who may be able to learn something from the relationships that emerge from this and similar studies: first, the monetary authorities themselves; second, market participants who trade in these and related markets; and third, those in the economics profession who want to understand how monetary policy works, that is, those with an interest in the transmission mechanism.

The monetary authorities may be interested in all this for two possible reasons. First, by monitoring the federal fund futures they can see what the markets expect policy to be and can factor that into their decisions. Second, they could understand what impact an unexpected rate change has on the markets. (I will return later to the issue of whether these results mean that only unexpected rate changes matter.) I do not know for sure, but my guess is that Federal Open Market Committee members have reliable ways of backing out market expectations and of estimating the impact of their policy rate changes without having to rely on this evidence from the federal funds futures market. Hence, I suspect that the contribution of these results to policymakers’ decisionmaking is quite small.

Market participants have little to learn from these results because the federal funds futures prices reflect their behavior in the first place, so they are not going to learn about their own expectations from a price that their behavior has created. There may be something that these players could learn from federal funds futures prices, but only if the data were much more finely sampled. Tick-by-tick data for this and other closely linked money markets might help to identify exactly where changes in sentiment first appear. Market traders probably know this already, but it is also possible that the news for some episodes appears to some segments of the market first. However, it is more likely that market participants get new information more or less simultaneously and the timing of market movements is purely a product of how we measure the “market price.” That is, all prices respond as quickly as is technically possible to the same information.

So what can we as economists learn from all this about the transmission mechanism of monetary policy? I suggest that this evidence does nothing but confirm what we already knew: Markets anticipate what policymakers are going to do, and markets move most when the policy change is most unexpected. However, I should emphasize that this evidence neither supports nor confounds the old notion of the Lucas aggregate supply curve, by which only unexpected policy changes have real effects.

To see this, I hypothesize that monetary policy works through a number of channels to influence aggregate demand in the economy. Only one of these channels is the direct effects on other market interest rates. Other channels include asset prices (and thus wealth effects), expectations and confidence, and international financial markets (and thus the exchange rate). The fact that market rates anticipate policy rate changes does not mean that the changes have no effect: it just means that the effects happen sooner. Market rate changes will still affect saving and investment decisions and
thus also aggregate demand. They will also affect asset valuations and thus create wealth effects.

Unexpected policy rate changes may well have a bigger measurable impact on market rates of all maturities, but this does not prove either that only unexpected rate changes have real effects or that unexpected rate changes have bigger real effects. It remains possible that unexpected policy changes have a bigger impact on aggregate demand, but the evidence adduced here does not address this issue.

In short, this paper contains some outstanding innovative econometric work that throws much light on the links between federal funds futures prices, the policy rate, and other market rates. However, the results have no apparent implications that should cause us to revise our view of how monetary policy works.

REFERENCES

