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# The Funds Rate Target and Interest Rates

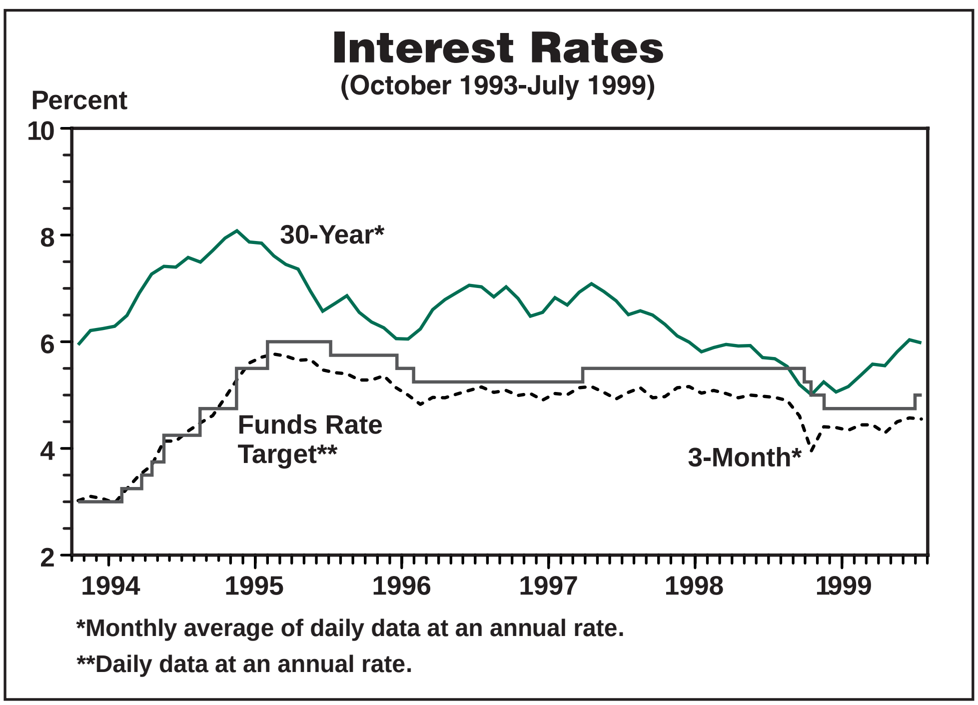
A conventional view holds that the Federal Reserve controls interest rates by setting a target for the federal funds rate and using open market operations to keep the funds rate close to the target level. The *expectations theory of the term structure*, which hypothesizes that longer-term yields are determined by the market's expectation for shorter-term rates, is presumed to account for the close relationship between the funds rate and other short-term interest rates, such as the 3-month T-bill rate.

Despite the fact that empirical tests of the expectations theory nearly always reject it, the close relationship between short-term rates and the Federal Reserve's target for the funds rate has led many observers to conclude that the Federal Reserve has considerable ability to influence short-term rates. The close relationship is apparent in the accompanying figure, which shows the Fed's funds rate target, the 3-month T-bill rate and the 30-year Treasury bond yield from October 1993 through July 1999—the period over which the Fed has announced target changes. The average absolute difference between the federal funds rate target and the T-bill rate was just 34 basis points over this period.

Whatever the Federal Reserve's ability to influence short-term rates, its influence on long-term rates (other than through its effect on expectations for inflation) is questionable. Large changes in the long-term rate have often occurred when the funds rate target was unchanged. For example, the mid-August 1998 announcement that Russia would default on its sovereign debt sent yields on default-risk-free securities dramatically lower. The 30-year bond yield fell by about 190 basis points from April 1997 to September 1998. More recently, the 30-year yield rose nearly 100 basis points prior to the 25 basis-point increase in the funds rate target on June 30, 1999.

In accordance with the expectations theory, some analysts have suggested that changes in long-term yields move in anticipation of future changes in the funds rate target. This seems unlikely, however. For one thing, short-term rates, which should reflect changing expectations for the funds rate target more strongly, do not appear to move in anticipation of policy actions. Moreover, changes in long-term yields are frequently large relative to subsequent movements in the funds rate. It is more likely that long-term yields reflect changing expectation for inflation than expectations of future funds rate target changes.

—Daniel L. Thornton




*Monthly average of daily data at an annual rate.

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