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Interest Rate Products

Interest Payment on Account Balances and the Impact on Monetary Policy

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The Federal Reserve's decision to pay interest on account balances held by depository institutions introduces an important new monetary policy tool – all the more important as the Fed plans to exit from the extraordinary lending and reserve supply policies that it implemented in response to the 2008 financial crisis. This makes an interesting development for financing and money market professionals who use 30-Day Fed Funds futures and options to manage short-term interest rate risk.

In October 2008, the Federal Reserve banks began to pay interest on the reserve balances that depository institutions hold at the Fed. By doing so, the Fed eliminated in theory the opportunity cost of holding reserves, thereby establishing a lower bound on the daily effective fed funds rate. This, in turn, should act as a disincentive for depository institutions to arrange fed funds transactions at interest rates below the rate paid by the Fed. Accordingly, the Fed is considering communicating the stance of monetary policy, during its impending transition to a more normal policy regime, in terms of the floor interest rate it pays on reserve balances, rather than by way of an announced target for the daily effective fed funds rate.

In fact, the daily effective fed funds rate has consistently traded at levels slightly below the Fed's current 25-basis point "floor" rate. The reason most frequently cited for this apparent anomaly is that market participants who are unable to deposit reserves with the Federal Reserve have few alternatives other than to lend excess cash in the fed funds market. Due to the large volume of excess reserves already held by the banking system, rates paid by borrowers in the fed funds market are typically lower than those paid by the Fed.

The target rate still the benchmark . . .

One result is that the level of activity and liquidity in the fed funds market has declined considerably, raising the possibility that the fed funds rate could for a time become a less reliable indicator of conditions in short-term money markets. On the other hand, although the daily effective fed funds rate has tended to run below the floor rate paid by the Fed, the spread between the two has been tight and consistent. Insofar as the Fed open market desk has been able to hold the daily effective fed funds rate in close alignment with the Fed's stated target level, this would appear to reinforce the status of the fed funds target rate as the Fed's principal monetary policy tool when the transition to a more normal policy configuration is completed.

The Fed has not made a decision on this issue but anticipates that it will eventually return to an operating framework with much lower reserve balances than at present, and with the fed funds rate as the operative target for policy.

Fed funds market still crucial to liquidity . . .

Irrespective of any changes in the Fed's monetary policy mechanism, the domestic interbank market for fed funds remains—as it has been for many decades—the largest, deepest, and most efficient means for distributing and allocating liquidity throughout the U.S. banking and financial system.

Unsurprisingly, movements in the overnight fed funds rate correlate highly with many key short-term interest rates, including the prime rate and London interbank offered rates. They also influence the dynamics of interest rates on money market instruments such as commercial paper, bankers' acceptances, commercial time deposits, securities lending and repurchase agreements, and related arbitrage activities.

For these reasons, the fed funds market has always played a crucial role in the transmission of Fed monetary policy actions – *regardless of the channel through which the Fed chooses to communicate its intentions*. The recent global financial crisis has underscored its importance, as financial institutions continue to rely on it to cope with liquidity shocks and to manage reserve positions.

Fed funds—and 30-Day Fed Funds futures and options—still in the spotlight . . .

As a direct reflection of market expectations of the future path of the daily effective fed funds rate, 30-Day Fed Funds futures and options are as important today as ever. The Fed's decision to pay interest on reserve balances not only serves as an important monetary policy tool to assist the Fed in managing the daily effective fed funds rate to the target rate, it also places renewed emphasis upon the role of the domestic market for fed funds in the transmission of monetary policy decisions. This means 30-Day Fed Funds futures and options play a correspondingly more prominent role as a convenient, effective tool for bank treasurers and other money market practitioners to lock in short-term funding costs, manage cash reserve positions, hedge the financing risks of securities lending operations, or to engage in arbitrage activities.

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