

Monetary Trends



Are the Fed and Financial Markets in Sync?

The Federal Reserve has taken a number of steps in recent years to make monetary policy more transparent. For example, since 1994, the Federal Open Market Committee (FOMC) has announced its policy decisions, expressed as changes in the target federal funds rate, immediately upon making them. More recently, these announcements have included the Committee's current assessment of the risks of heightened inflation pressures or economic weakness over the foreseeable future. Also, since 1994, the FOMC has changed its funds rate target only twice between scheduled meetings, and the Committee has made it clear that changes between meetings will occur only in extraordinary circumstances. These disclosure and procedural changes suggest that the size and timing of Fed actions have probably become more predictable.

Evidence on the predictability of Fed actions can be gleaned from trading in the futures market for federal funds on FOMC meeting dates (or on the dates of any target changes between meetings). Large movements in the implied yields on federal funds contracts for the current or one month following an FOMC meeting would indicate that the FOMC's decision at that meeting had not been anticipated by market participants. Between January 1994 and June 2000, the average change in the market implied yield on one-month-ahead futures contracts on dates of FOMC meetings or actions was only 4 basis points (6 basis points on dates of target changes). The largest one-day change on such dates was just 13 basis points (on September 24, 1996). By contrast, the average target change during this period was 32.5 basis points in absolute value (ranging from 25 to 75 basis points). Thus, markets have anticipated FOMC target changes with a high degree of accuracy.

The absence of large changes in the implied funds rate in futures market trading on FOMC meeting dates has

been mirrored by a similar absence of large changes in the yields on Treasury securities on these dates. For example, the average absolute change in the yields of 3-month Treasury securities on dates of FOMC target changes between February 1994 and May 2000 (including the dates of the two target changes made between meetings) was just 7 basis points. Average changes in the yields of longer-term securities were similar.

Some researchers claim that the limited response of market interest rates to FOMC target changes indicates that the Fed merely adjusts its target to prior movements in market rates. William Poole and Robert Rasche, however, contend that the response is small because financial market participants correctly anticipate how the FOMC will react at its next meeting to information about the economy revealed before the meeting. Accordingly, markets adjust to new information about inflation, employment, and other factors that market participants believe will affect FOMC decisions. Poole and Rasche present regression evidence showing that market yields respond only to unanticipated movements in the FOMC target, as measured by FOMC meeting-day changes in the implied yields on one-month-ahead federal funds futures contracts.¹ In addition, for all FOMC meeting dates since 1994, including those at which the FOMC did not change its target, changes in the implied federal funds rate from the futures market and changes in the yields on Treasury securities are highly correlated (e.g., correlation coefficient of 0.66 for the three-month Treasury security). This indicates that market yield changes are larger, the less accurately market participants anticipate FOMC policy. Still, since 1994, FOMC actions generally have not taken markets by surprise—the Fed and financial markets apparently are in sync.

¹Poole, William and Robert H. Rasche. "Perfecting the Market's Knowledge of Monetary Policy," Federal Reserve Bank of St. Louis working paper 2000-010A, April 2000.

—David C. Wheelock

