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Discounting the Discount Rate

During the first eleven months of 2001, the Federal Open Market Committee (FOMC) announced ten reductions in its target for the federal funds rate. Each of the announcements also included a statement about the discount rate. For example, the November 6 announcement that the federal funds rate target was being lowered by 50 basis points to 2 percent also noted that “In a related action, the Board of Governors approved a 50 basis point reduction in the discount rate to 1-1/2 percent.” In fact, changes in the discount rate have been identical in timing and magnitude to changes in the federal funds rate target since mid-1999.

The accompanying figure shows that the perfect one-for-one movement between these two key interest rates is a fairly recent development. During the late 1980s and early 1990s, the federal funds rate target deviated from the discount rate by varying magnitudes, with the discount rate changing less frequently than the intended federal funds rate. Nevertheless, the announcements accompanying discount rate changes often explained that changes were made simply to keep the discount rate aligned with market interest rates.

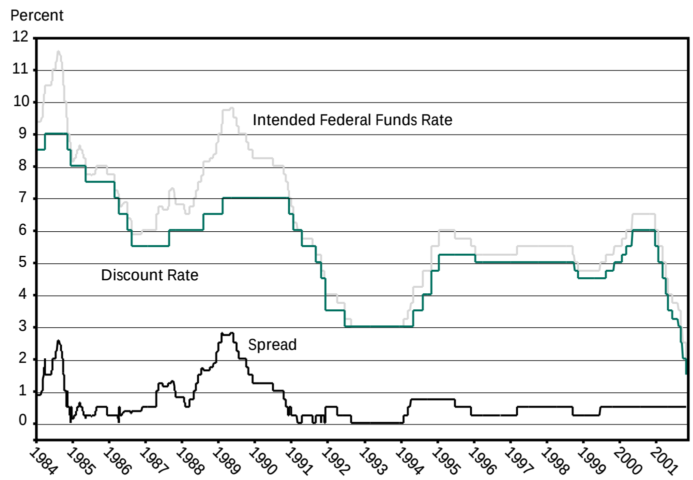
The discount rate has not always had such a passive role in the conduct of monetary policy. During the 1960s and 1970s, for example, the discount rate often served a signaling function: Changes in the FOMC’s objective for the federal funds rate were not publicly announced at the time, and the visibility of discount rate changes made it a useful tool for communicating major changes in policy. During the years when the Fed used a nonborrowed reserve operating target for conducting monetary policy (1979-82), the spread between the federal funds rate and the discount rate was highly variable as changes in reserve demand were accommodated by fluctuations in discount window borrowing. That operating regime was succeeded by one in which the Fed ostensibly targeted the amount of borrowed reserves, amounting to a procedure for manipulating the spread between the funds rate and discount rate. Under the current operating procedure, the federal funds rate is the direct instrument of policy, with the discount rate and the very low average level of discount borrowing having little or no significance in the conduct of monetary policy.

Given the reduced importance of the discount rate in the Fed’s conduct of monetary policy, there have been proposals to dramatically alter the nature of the discount window. Some have suggested that the discount rate be adjusted automatically with changes in the federal funds rate or other market rates. Other proposals have even suggested the elimination of the discount window altogether.

The surge in borrowing following the September 11 terrorist attacks demonstrated, however, that the discount window can perform a crucial stabilizing function, providing temporary liquidity in times of crisis. Moreover, the evolution of the Federal Reserve’s operating procedures has shown that the importance of policy tools can change over time. While the discount rate has little independent significance in the present context, it may again sometime in the future.

—Michael R. Pakko

The Intended Federal Funds Rate and the Discount Rate



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