Modelling Federal Reserve Discount Policy

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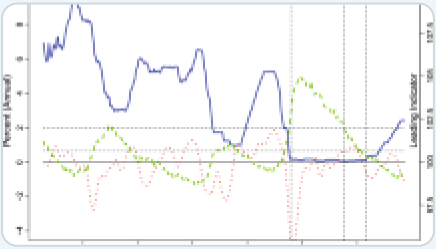
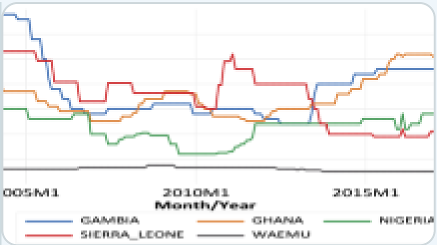
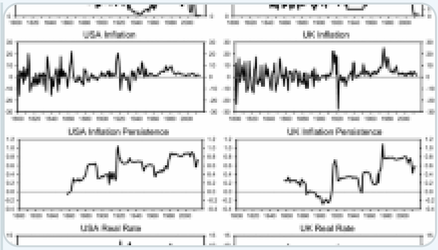
Abstract

We employ threshold cointegration methodology to model the policy problem solved by the Federal Reserve System in their manipulation of the discount rate under a reserves target operating procedure utilized since October 1979. The infrequent and discrete adjustments that characterize movements in the discount rate instrument vis-a-vis the Federal Funds rate do not lend themselves to a linear cointegration framework. The inherently nonlinear relationship arising from the Fed's self-imposed constraints on discontinuously changing the discount rate is satisfactorily modelled as an instance of threshold cointegration between the discount rate and the Federal Funds rate.







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