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In Which Direction Is There a Momentum Effect in the Changes in the Spread Between the Repo Rate and Federal Funds Rate?

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Abstract

Evidence in this chapter shows that there are varying degrees of synchronisation between the repo rate and the Federal Funds Rate (FFR) adjustments. We establish a cointegration relationship between the repo rate and the FFR, and the estimated the long-term repo rate is close to 7 per cent. The results indicate asymmetry in the repo rate adjustments to increases versus decreases in the repo rate-FFR spread. There is evidence of higher momentum in the adjustment of the repo rate when the repo rate-FFR spread is narrowing. The results show that the increases in the repo rate-FFR spread are very aggressive from a very low

point. The repo rate response to inflation is the main driver of the repo rate-FFR spread than movements in the FFR. The policy implication is that low and stable inflation has benefits for the level of the repo rate-FFR spread. Hence, the argument for the lowering of the inflation targeting band is further strengthened by these findings.

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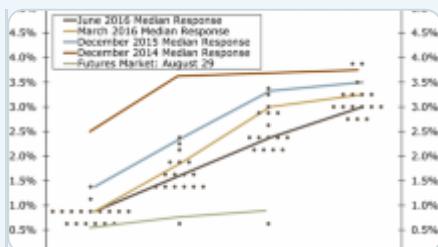
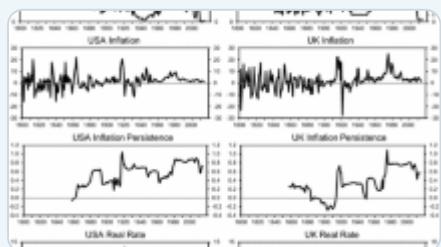
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Notes

1. This aspect is a simplified model and does not take into account the multilateral relationships and the potential effects of the divergence in global policy rates at a time when central banks also use un-conventional monetary policy tools.
2. Partly responding to the scepticism in Hamilton et al. ([2015](#)), Laubach and Williams ([2015](#)) fail to establish evidence that the natural rate has adjusted and increased in line with the recovery of the US economy from the Great Recession. Similarly, Rachel and Smith ([2015](#)) establish that the global neutral real rate may have fallen. Lower expectations for trend growth, shifts in desired savings and investment preferences appear to be important in explaining the long-term decline. Fischer ([2015](#)) is of the view that the equilibrium real interest rate will probably remain low for the policy relevant horizon.
3. In addition, the Fed Chair Yellen clarified that “gradual” does not mean mechanical, evenly timed and equally sized interest rate changes.
4. Since the T-max exceeds the statistics given by Enders and Granger ([1998](#)). In addition, based on Phi-value, we reject the null hypothesis of no cointegration.
5. However, they show that the emerging market real interest rate has increased sharply and diverged from the advanced economies and world real interest rate since the beginning of 2015. This may largely reflect cyclical and structural country-specific factors that could result in temporary or persistent equilibrium rates higher than the global level.

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