



Do Changes in Reserve Balances Still Influence the Federal Funds Rate?

by: A. Lee Smith

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Declining reserves have placed upward pressure on the federal funds rate in recent years despite the payment of interest on reserve balances.

Over the past decade, the implementation of U.S. monetary policy has changed significantly. Rather than adjusting the quantity of reserves in the banking system, policymakers now primarily use the interest rate paid on reserve balances, the IOR rate, to bring the federal funds rate within the target range. However, the recent rise in the federal funds rate relative to the IOR rate has raised questions about the primary drivers of the spread between the federal funds rate and the IOR rate in the Federal Reserve's new operating framework.

A. Lee Smith examines the role declining reserve balances have played in influencing the federal funds-IOR spread. He finds that declining reserve balances have placed upward pressure on the federal funds rate in recent years despite the payment of interest on reserve balances. His findings suggest that the funds rate may continue to move higher relative to the IOR rate as reserve balances decline, potentially motivating further adjustments to the implementation of U.S. monetary policy.

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