Title: Derivatives and Monetary Policy

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ABSTRACT

This paper discusses the role of derivatives – mainly interest rate futures and options contracts – on the determination of short-term and long-term interest rate in a post Keynesian perspective. According to Keynes and post Keynesians (e.g. Davidson, Khan, Kregel) changes in short-term interest rates initiated by the central bank are transmitted to other interest rates through substitution and expectations effects. Agents's analysis of the interest rate behaviour is confronted to their liquidity preference in order to determine their willingness to buy more or less long-term bonds. Their liquidity preference is determined according to the degree of income risk and capital risk aversion and the time period till realisation as well. Another important aspect concerning agents's decision is the degree of interest rate increase that leads to a net loss to the bond holder, given the time period till realisation. As a consequence, the longer the term of the bond the more risky they are. The paper, thus, discusses the impacts of the introduction of derivatives in the interest rate determination. Firstly, it is discussed whether derivatives are a efficient way of hedge against the impacts of interest rate variations, mainly capital risk. Secondly, it is discussed whether derivatives may modify the income and wealth effect resulting from a monetary policy action and, as a consequence, decrease the degree of efficiency of monetary policy. The paper, thus, argues whether derivatives may increase asset substitutability, affecting the speed and extent with which short-term interest rate variations are transmitted along the maturity spectrum.

JEL classification: E43, E52.