

# I, Rate

By *Bill Dickneider*

**M**y name is Feddy and I can shake the stock market and change how much you pay for credit or earn on a savings account. You might know me by my formal name, Federal Funds Rate.

My home is the Fed, which also has a formal name, the Federal Reserve. The Federal Reserve is our nation's central bank. It's headed by Janet Yellen, who talks about me a lot. Last December she announced that I would be getting a little taller: "...the Federal Open Market Committee decided to raise the target range for the federal funds rate by ¼ percentage point, bringing it to ¼ to ½ percent."<sup>1</sup>

The Federal Open Market Committee sets the Fed's monetary policy. It consists of the 7 members of the Fed's Board of Governors and 5 presidents from the 12 regional Federal Reserve Banks.<sup>2</sup> Where do I fit in? I'm the key to the committee's task of raising or lowering interest rates.

Banks keep money on reserve at the Fed. I'm the rate that banks pay when they borrow these reserves from one another. Reserves are called federal funds, so you can see how I got my name. The Fed first sets a target rate for me and then nudges me up or down to its target.

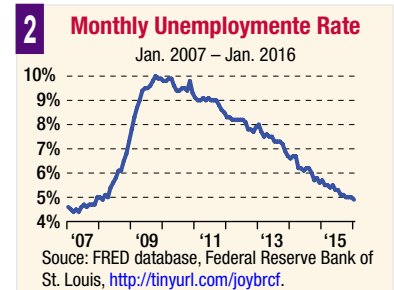
Chart 1 shows how the Open Market Committee pushed me down near zero when the economy sank into a deep recession in 2008. How did it do

this? By increasing the supply of money in banks' reserves, which enabled banks to lend more money to one another. The larger supply of these loans decreased me, just as a larger supply of strawberries reduces their price during harvest time. How did the Fed increase banks' reserves? The last question in *To Think About* on page 2 has a video that explains this.

**We gratefully acknowledge the support of our SMG newsletter editorial committee:**

Anthony Lamport <i>The Lambda Funds</i>	Herb Lash <i>Thomson Reuters</i>
Alair Townsend	Sam Stovall <i>S&amp;P Capital IQ</i>

With more money available, other interest rates followed my lead. These include rates on savings accounts, certificates of deposit, car loans, Treasury bills, credit cards, and other deposits and loans. In 2008 the Fed wanted lower interest rates to encourage more borrowing and spending in hopes of stimulating a recovery from the economy's downturn.

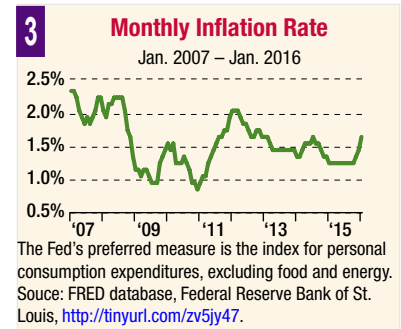


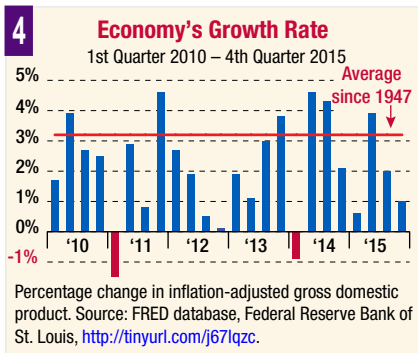
Later, whenever the economy had recovered sufficiently, the Fed would raise me back to normal. Otherwise, its policy of continually adding more money and credit to the economy and keeping interest rates abnormally low might fuel higher inflation – a more rapid increase in the prices of goods and services.

The recession did end in 2009, but our economy's recovery since then hasn't been as strong as in the past. However, signs of improving economic health last December encouraged the Fed to begin raising me and other interest rates. In her announcement Chair Yellen put it this way:

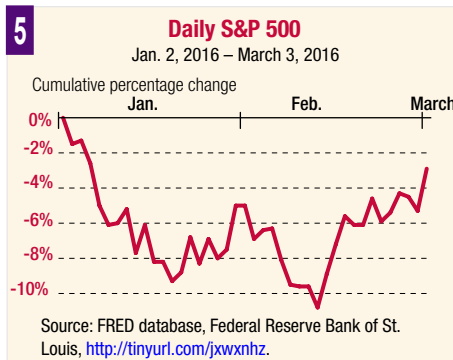
**This action marks the end of an extraordinary seven-year period during which the federal funds rate was held near zero to support the recovery of the economy from the worst financial crisis and recession since the Great Depression... Since March, the [Open Market] Committee has stated that it would raise the target range for the federal funds rate when it had seen further improvement in the labor market and was reasonably confident that inflation would move back to its 2 percent objective over the medium term. In our judgment, these two criteria have now been satisfied.**<sup>3</sup>

When setting my target, the Open Market Committee has two main goals required by Congress: *maximum employment and price stability*. It defines price stability as a yearly inflation rate of 2 percent and maximum employment as an unemployment rate between 4.7 and 5.8 percent of the labor force.<sup>4</sup> Charts 2 and 3 show unemployment and inflation since 2007. Chart 4 shows our economy's growth rate, which is another indicator the Fed uses to determine my height.





As the Fed took its first step toward higher interest rates last December, it pushed me and other rates up. The Fed also announced plans to gradually raise me in a number of future steps so that by 2018 I'd reach 3.25 percent.



In her December announcement, Janet Yellen cautioned that my future increases would depend on indicators, such as those in Charts 2-4 above, signaling our economy's better health. As 2016 began, however, the stock market tumbled, as Chart 5 shows. Did the decline mean that the economy was weaker than it had appeared the month before, when the Fed announced its plans? Investors wondered if the stock market's decline would convince the Federal Reserve to postpone plans to raise me in the coming months.

Raising me would impact the stock market because higher interest rates might prevent the stock market from

rising — or push it even lower. Why? Because higher rates increase the return on bonds and other IOUs issued when businesses and the government borrow money. The higher returns encourage people to buy more of these interest-paying investments and fewer stocks, so stock prices might remain low.

The decline in stock prices and mixed signals about the economy's health challenged the Fed's policy makers. They wanted to raise me and other interest rates, but they didn't want to cut back on money and credit if the economy wasn't strong enough. Nor did they want higher interest rates that might keep a lid on stock prices.

Conditions in the stock market can change rapidly, however, and reports about the economy can suddenly turn more positive — or negative. A key report closely watched by the Fed is the monthly jobs report from the US Department of Labor. The latest one, issued on March 4, reported an unchanged unemployment rate of 4.9 percent and a surprisingly strong jump in the number of new jobs. But it also reported a decrease in hourly earnings.

I'm closely watching reports about jobs, the economy and the stock market.

They shape the Fed's decisions about me, and I'm eager to get back to my normal height.

1. Transcript of Chair Yellen's Press Conference December 16, 2015, Board of Governors, Federal Reserve, <http://tinyurl.com/zpwwszk>. You can also watch the first few minutes of her press conference at: <http://tinyurl.com/7en9b3n>. or on CSPAN at <http://tinyurl.com/zpbalz6>.
2. You can learn more about the Open Market Committee at: <http://tinyurl.com/23prt6>.
3. See footnote 1.
4. "What Are the Federal Reserve's Objectives in Conducting Monetary Policy," Board of Governors of the Federal Reserve, <http://tinyurl.com/hgo84rd>. Maximum employment doesn't mean a zero unemployment rate because workers normally move in and out of jobs and the labor force and spend time searching for the best job. During these searches, they are counted as unemployed.

### To Think About

- ✓ The following article describes some of the economic statistics (data) the Federal Reserve weighs when making decisions about monetary policy. Do you think some of these statistics are likely to be more important than others when the Fed makes a decision about the federal funds rate? Explain. <http://tinyurl.com/ogz5nns>.
- ✓ Read this article about the March 4, 2016 jobs report. Does it suggest the current labor market and stock market are giving the Fed conflicting advice about raising the federal funds rate? Explain. <http://tinyurl.com/za9kpf6>.
- ✓ Want to learn more about monetary policy and the Fed? Watch the following Crash-Course video: "What's all the Yellen About? Monetary Policy and the Federal Reserve," <http://tinyurl.com/nen485c>. At 4.5 minutes, the video begins focusing on how the Fed uses a tool, open market operations, to change the amount of money banks have on reserve at the Fed. How was the Fed able to use this tool to increase bank reserves when the recession began in 2008. How can the Fed use this tool to raise the federal funds rate in the future? Explain.