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CRS Report for Congress

Federal Reserve Interest Rate Changes: 2001-2008

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Summary

The Federal Open Market Committee (FOMC) decided at its scheduled meeting held on October 29 to lower the target rate for federal funds to 1% from 1½% set at its unscheduled meeting of October 8, 2008. In making its decision to reduce the target, the FOMC stressed the following factors: (1) the pace of economic growth appears to have slowed markedly owing importantly to a softening of consumer spending; (2) business equipment spending and industrial production have weakened; (3) economic slowdowns abroad have dampened the prospects for U.S. exports; (4) intensified strains in financial markets are also likely to further reduce spending; and (5) inflation prospects have improved due to declines in energy and other commodity prices. Because of the international scope of the financial turmoil, the downside risks to growth remain. Nevertheless, the FOMC believes that the substantial easing of monetary policy to date, combined with other measures to provide liquidity to the financial system, should help to promote moderate growth over time. The Board of Governors also reduced the discount rate for primary credit to 1¼% from 1¾%. The next scheduled meeting of the FOMC is set for December 11, 2008. This report will be updated as events warrant.

Rates Changes

The Fed directly changes two interest rates. The first, called the *discount rate*, is an administered rate explicitly set by the Fed. It is the rate at which the Fed lends short-term funds to banks, pursuant to P.L. 96-221, the Monetary Control Act of 1980. It is determined by the seven-person Board of Governors of the Federal Reserve System. The second, known as the *federal funds rate*, is a market rate at which banks lend to each other overnight to meet their "reserve requirements" and other liquidity needs. The Fed sets a target for this rate and buys and sells U.S. Treasury securities with an aim to achieving the target, which speedily becomes known to market participants. It is decided by a 12-person Federal Open Market Committee, which includes each member of the board plus a varying five-person roster selected from among the 12 regional Federal Reserve Bank presidents (among the 12, the New York bank is always represented on the FOMC).

On January 6, 2003, the Board of Governors announced a fundamental change to the setting of the discount rate. Henceforth, it was to be made a penalty rate for those banks who chose to borrow from the Federal Reserve to meet temporary reserve deficiencies as opposed to borrowing in the federal funds market. A primary discount rate of 2¼% was set for banks judged to be in a sound financial condition, whereas banks whose financial condition was judged to be riskier would be required to pay a higher secondary rate of 2¾%. This change in operating procedure is shown in **Table 1.**

Understanding the Announcements

Because the discount rate is administered, changes in it are stated explicitly. Hence, the changes shown in **Table 1** are exact. Because the federal funds rate varies somewhat in response to market conditions, when the Fed changes only the federal funds rate, it may specify the target rate, or it may only announce that it is "increasing [or decreasing] slightly the degree in pressure on reserve positions" and that the action is "expected to be associated with a small increase [or decrease] in short-term money market interest rates." In the latter case, the size of the rate change must be inferred. Hence, some of the federal funds rates in the table are approximate, based on observation instead of announcements.

Rationale for Changes

The Fed tries to keep the economy operating at an output level consistent with a low rate of inflation and low unemployment. It therefore seeks a level of interest rates at which the economy will grow at its potential to produce. The interest rate levels that produce this growth rate vary with the course of the business cycle. Different rates are judged appropriate at different times. Changes in interest rates are the most visible signs of the Fed's monetary policy, immediately affecting financial institutions and markets of all kinds here and abroad. Unusual financial market conditions such as those related to the Asian financial crisis of 1997-1998, the Russian debt crisis of 1998 and the terrorist attacks of September 2001 also influence Fed decisions on rate changes. The Fed reports to Congress twice yearly on its monetary policy including rate changes, in oversight hearings in February and July as originally required by P.L. 95-188, the Federal Reserve Reform Act.

Monetary policy has varied considerably over the current economic expansion that began early in 2001. Initially, it was aimed at setting the expansion in motion. To do this, the federal funds target was reduced from 5½% in March 2001 to 1% in June 2003. It remained at 1% for a year. As the expansion gathered momentum, the target was raised in 17 equal increments spread over two years to 5¼%. Even as the FOMC drew attention to upward movements in the core rate of inflation at various meeting during 2006 and 2007, it continued to express the view that it would moderate over time as would the rate of growth of GDP. These reasons appear to be important for leaving the rate unchanged at 5¼% for more than a year. However, during the late summer of 2007, the fall in housing prices and conditions in financial markets related to the difficulty in refinancing sub-prime mortgages became a matter of concern. To ease these conditions, the Board of Governors on August 17, 2007, reduced the discount rate for primary credit to 5¾%. This was followed on September 18 with another reduction of ½% and a reduction in the federal funds target to 4¾%. Additional cuts of ¼% in both rates were

approved on October 31 and December 11, 2007. On January 22 the target was reduced by ¾% and on January 30 by a further ½%.

The economy began to soften in the third quarter of 2007 (GDP growth was negative, falling at an annual rate of -0.2%). In the first quarter of 2008 it was positive again, and rose at an annual rate of 0.9%. During the second quarter, the growth was also positive and at an annualized rate of 2.8%. The unemployment rate began to rise on a sustained basis in February and in August it reached 6.1% (it remained at this rate in September). Job losses since December 2007 are in excess of 700,000. As conditions in financial markets worsened and the economy softened, the FOMC and the Board approved further reduction in the federal funds target and discount rate. Both rates were lowered on March 18, April 30, October 8, and October 29 and the discount rate was reduced itself on March 16. They now stand at 1% and 1¼%, respectively. As these developments were taking place, the world price of energy began to rise at a brisk rate. Rising energy prices threatened to boost the overall rate of inflation posing a challenge to the Fed's mandated commitment to stable prices. Initially, the Fed reacted by holding the federal funds target steady. However, as the magnitude and international scope of the credit crisis became apparent and energy and other commodity prices began to fall, the target was lowered and the Fed undertook a number of new and innovative measures to shore up the financial system. These measures were also undertaken to shore up the economy in general as growth slowed and job losses mounted.

For further discussion, see CRS Report RL30354, *Monetary Policy and the Federal Reserve: Current Policy and Conditions*, by Marc Labonte and Gail Makinen.

Table 1. Recent Interest Rate Changes

Date	Federal Funds Rate Target			Discount Rate		
	Before	Change	After	Before	Change	After
Apr. 18, 2001	5	-½	4½	4½	-½	4
May 15, 2001	4½	-½	4	4	-½	3½
June 27, 2001	4	-¼	3¾	3½	-¼	3¼
Aug. 21, 2001	3¾	-¼	3½	3¼	-¼	3
Sept. 17, 2001	3½	-½	3	3	-½	2½
Oct. 2, 2001	3	-½	2½	2½	-½	2
Nov. 6, 2001	2½	-½	2	2	-½	1½
Dec. 11, 2001	2	-¼	1¾	1½	-¼	1¼
Nov. 6, 2002	1¾	-½	1¼	1¼	-½	¾
Jan. 6, 2003	—	—	—	2¼[a]	—	—
June 25, 2003	1¼	-¼	1	2¼	-¼	2
June 30, 2004	1	+¼	1 ¼	2	+¼	2¼
Aug. 10, 2004	1¼	+¼	1 ½	2¼	+¼	2½
Sept. 21, 2004	1½	+¼	1 ¾	2½	+¼	2¾
Nov. 10, 2004	1¾	+¼	2	2¾	+¼	3
Dec. 14, 2004	2	+¼	2¼	3	+¼	3¼
Feb. 2, 2005	2¼	+¼	2½	3¼	+¼	3½
Mar. 22, 2005	2½	+¼	2¾	3½	+¼	3¾
May 3, 2005	2¾	+¼	3	3¾	+¼	4
June 30, 2005	3	+¼	3¼	4	+¼	4
Aug. 9, 2005	3¼	+¼	3½	4¼	+¼	4½
Sept. 20, 2005	3½	+¼	3¾	4½	+¼	4¾
Nov. 1, 2005	3¾	+¼	4	4¾	+¼	5
Dec. 11, 2005	4	+¼	4¼	5	+¼	5¼
Jan. 31, 2006	4¼	+¼	4½	5¼	+¼	5½
Mar. 28, 2006	4½	+¼	4¾	5½	+¼	5¾
May 10, 2006	4¾	+¼	5	5¾	+¼	6
June 29, 2006	5	+¼	5¼	6	+¼	6¼
Aug. 17,2007	—	—	—	6¼	-½	5¾
Sept. 18, 2007	5¼	-½	4¾	5¾	-½	5¼
Oct. 31, 2007	4¾	-¼	4½	5¼	-¼	5
Dec. 11, 2007	4½	-¼	4¼	5	-¼	4¾
Jan. 22, 2008	4¼	-¾	3½	4¾	-¾	4
Jan. 30, 2008	3½	-½	3	4	-½	3½
Mar. 18, 2008	3	-¾	2¼	3¼[b]	-¾	2½
Apr. 30, 2008	2¼	-¼	2	2½	-¼	2¼
Oct. 8, 2008	2	-½	1 ½	2¼	-½	1¾
Oct. 29, 2008	1 ½	-½	1	1¾	-½	1¼

Source: Federal Reserve System.

a. As of January 6, 2003, 2¼% was the new primary rate and 2¾% was the secondary rate.
b. On March 16, 2008, the Board reduced the rate by ¼% to 3¼%.