The Federal Reserve and Interest Rates

Few financial issues receive more attention in the press than the Federal Reserve Board's actions with interest rates. It seems there is always some mention of what the Fed's chairman, Ben Bernanke, is saying or might say about the economy, interest rates or the markets in general.

The Federal Reserve is the independent central bank established by Congress in 1913. One of its primary functions is to help maintain the economic soundness of the US economy by setting the interest rates banks charge each other for overnight loans.

Thousands of banks in the country frequently borrow money or lend money to other banks for short periods, often just overnight. The Fed oversees that activity and sets the interest rates on the borrowing and lending. This type of institutional borrowing helps to keep liquidity in the financial system and the banking system strong.

How it works
The Federal Reserve has a 12 member Federal Open Market Committee that meets 8 times a year to review the economy and make changes to the "overnight loan" rates. For the past few decades, the Fed has tried very hard to keep inflation under control by managing the overnight interest rates.

The members review all types of information and keep their meetings and decision-making process secret. At the end of their meetings, there is an announcement of any changes they make. These announcements are anxiously awaited and studied very carefully by financial professionals to get a glimpse into the thinking of these decision-makers.

Why is this important
The cost of borrowing has direct effects on the costs of businesses and individuals. By raising or lowering this central interest rate, the Fed can influence how fast or how slow the economy will grow or contract. However, it usually takes many months to see the full effect of any changes they make.

How does the Fed affect consumers?
Many consumer interest rates are strongly influenced by changes made by the Fed. Usually when the Fed raises or lowers rates, the prime rate (the rate charged to large corporations by banks) changes almost immediately. Many credit card and consumer loan rates are tied directly to the prime rate. In addition, mortgage rates are also greatly influenced by the Fed rate changes.

Since the stock and bond markets are closely interwoven, changes by the Fed can also affect the stock market. While there is no direct link, the market tends to react positively to rate cuts and negatively to rate increases. Usually, "the markets" are already sensing what actions the Fed may take and prices may rise or fall long before the Fed actually meets and announces any changes.

Fed Actions
In 2008, the Fed reduced rates several times in response to a weakening economy and to provide additional liquidity as financial markets dealt with uncertainties in the sub-prime mortgage and other credit markets. In 2009 and 2010, the Fed has kept rates low.

In the late summer and fall of 2008, Congress granted the Federal Reserve significantly more authority to deal with the turmoil in the financial markets. This includes purchasing illiquid securities from institutions, making loans to troubled firms and making investments in banks and other institutions to provide additional capital for their operations.

In 2010 and 2011, the Fed has been buying U.S. Treasury obligations and other government debt as part of their efforts to keep interest rates low, make credit available and stimulate the economy.

What should you do?
There is probably nothing specific that an individual investor should do about the Federal Reserve Board's actions. However, it makes sense to watch what they say and do and try to put their actions into your overall financial thinking.