The University of Texas at TYLER Soules College of Business

Hibbs Brief

Hibbs Institute for Business & Economic Research

The Federal Reserve Lowered their Rate… Why do we care?

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Yesterday, September 18, the Federal Reserve (known simply as "the Fed") announced it will decrease the federal funds rate from 2.25% to 2.00%. The federal funds rate is the rate at which banks and other depository institutions lend money to each other, usually on an overnight basis to meet the minimal money reserve requirements.[1] In this issue of the ***Hibbs Brief***, we discuss what a decision by the Fed to change this rate means for the economy and how the changes also impact on our daily lives.

The federal funds rate was lowered a quarter of a point by the Federal Open Market Committee (FOMC)[2] on July 31, 2019. This cut was the first change in direction of their policy[3] since 2015. Over the past four years the federal funds rate was raised nine consecutive times.[4]

- *When the federal funds rates are raised:* The FOMC believes the economy is growing, and such growth may increase inflation beyond the annual target of 2%. They believe and trust that indicators of a growing economy are strong enough that borrowing costs will not reduce wanted growth, but simply dampen speculative growth and possible any unwanted acceleration of inflation.

- *When the federal funds rates are lowered:* The FOMC aims to stimulate the economy by making credit less costly for businesses and individuals. Businesses are incentivized to invest and hire more, while consumers are encouraged to spend more freely, thus stimulating economic growth.

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[1] Fed Funds Rate; Bankrate. https://www.bankrate.com/rates/interest-rates/federal-funds-rate.aspx

[2] The Fed changes rates through the Federal Open Market Committee meetings (FOMC). The FOMC changes the federal funds rate to control inflation and maintain a healthy economic growth.

[3] When the Fed raises rates (contractionary monetary policy), banks lend money at a higher rate because they are borrowing money at a higher Fed funds rate. Since loans are more expensive (and harder to obtain), businesses and individuals will be less likely to borrow, which will slow down the economy. When the Fed lowers the rate (expansionary monetary policy), banks borrow money at lowers rates and are able to lend money also at a lower rates, making credit more accessible. As credit card interest rates drop, consumers buy more. Also, as banks lend cheaper, businesses expand.

[4] The FOMC raised the federal funds rate nine consecutive times to the following levels: 0.5% on Dec. 15, 2015; 0.75% on Dec. 14, 2016; 1.0% on March 5, 2017; 1.25% on June 14, 2017; 1.5% on Dec. 13, 2017; 1.75% on March 21, 2018; 2.0% on June 13, 2018;
2.25% on September 26, 2018; and 2.5% on December 19, 2018.

The federal funds rate is one of the many tools that the Federal Reserve has to control the U.S. economic growth. The federal funds rate is powerful because changes in it directly affects short-term interest rates offered by financial institutions -- including banks' prime rate, savings accounts rates, and interest rates on business loans and credit cards. Nevertheless, changes in the federal funds rate can take weeks, if not months to work their way through the entire economy and either slow or stimulate overall economic growth. This fact, plus trying to figure out from many different and mixed signals whether the economy needs to be stimulated or cooled off, is why the Fed thoroughly evaluates the current economic conditions, considers different perspectives, and analyzes the different possibilities or scenarios at every FOMC meeting (every 5 to 8 weeks to complete 8 meetings in a year) before making a decision to raise, lower, or keep its rate.

Although the nation has experienced its tenth year of consecutive economic expansion and the unemployment rate is fairly low, the Fed is not willing to risk a recession due to a downturn of the global economy and negative impacts from decisions on commercial trade with some countries. This is why the federal funds rate was lowered two consecutive times on July 31 and yesterday, September 18, as they decided to give a boost to the U.S. economy.

The next FOMC meeting session will take place on November 7 and 8. Their evaluation of the economic conditions at that moment will determine what action to take to keep our economy healthy and in good shape.