KIM: What is the Federal Reserve how does it raise or lower interest rates?

Mickey Kim
October 8, 2016

INVESTING
Mickey Kim

The Federal Reserve ("Fed") has been front page news. Investors are obsessively worrying about when the Fed will next raise interest rates. In addition, the Republican presidential nominee has accused the Fed and its Chair, Janet Yellen, of "playing politics" by not raising rates.

If you're wondering just what is the Fed and how it raises (or lowers) interest rates, you're not alone. See "In Plain English: Making Sense of the Federal Reserve," published by the Federal Reserve Bank of St. Louis. https://www.stlouisfed.org/in-plain-english.

Congress passed the Federal Reserve Act in 1913 in response to a series of panic-induced bank "runs" and failures. Picture the scene outside the Bailey Bros. Building & Loan in "*It's a Wonderful Life*." Often a run on one bank had a domino effect, causing depositors at other banks to withdraw their funds, even if those banks were not in danger of failing.

Banks needed a source of emergency funding to protect them from failure due to a run and depositors needed the comfort of knowing there was a provider of this funding.

The Federal Reserve System was created to address banking panics as the "lender of last resort," but its mandate has expanded to include pursuing ***price stability*** and ***maximum employment***.

While Congress oversees the entire Federal Reserve System, each of the Fed's three parts—the Board of Governors (7), the regional Reserve Banks (12) and the Federal Open Market Committee (FOMC)—operates independently of the federal government.

Banks are required to hold a portion of their customers' deposits in their vaults or with a Reserve Bank. This *"reserve requirement"* cannot be loaned. Banks with excess reserves can loan the surplus to borrowers, including other banks. Banks short on reserves must borrow the shortfall from other banks or the Fed.

The FOMC conducts the Fed's monetary policy by establishing its target for the "federal funds rate," the interest rate banks charge one another for overnight loans.

Historically, if the Fed wanted to "ease credit" or pursue an *expansionary* monetary policy, the FOMC bought Treasury bonds from banks, which increased the amount of reserve funds in the system, putting downward pressure on the federal funds rate.

Conversely, if the Fed wanted to "tighten credit" or implement a *contractionary* policy, the FOMC sold Treasury bonds to banks, reducing the amount of reserves and putting upward pressure on the federal funds rate.

Think of the Fed's monetary policy as operating like an economic accelerator or brake pedal by making credit cheaper or more expensive.

In *normal* times, the Fed can only directly impact very short-term interest rates. However, in response to the financial crisis, the Fed not only slashed its target for federal funds to 0-0.25%, it also pushed longer-term interest rates lower by buying $3.8 ***trillion*** in Treasury bonds in an initiative known as "quantitative easing (QE)."

With the banking system awash in excess reserves, the FOMC's historical tool of selling Treasury bonds to push the federal funds rate higher is no longer effective. Since 2008 the Fed has been paying banks interest on their deposited excess reserves. Thus, when the Fed raises this "IOER" rate, the federal funds rate will also rise because no bank will lend for less than it is receiving from the Fed.
