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Federal Reserve Interest Rate Changes: 2000-2008

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December 30, 2008

Abstract. The Federal Open Market Committee (FOMC) decided at its scheduled meeting held on December 16 to lower the target rate for federal funds to a range from 0% to % from 1% set at its meeting of October 24, 2008. In making its decision to reduce the target, the FOMC stressed the following factors: (1) the pace of economic growth and industrial production slowed markedly due to a decline in both consumer and business investment spending, (2) labor market conditions show further deterioration, (3) financial markets remain quite strained and credit conditions tight, and (4) inflation prospects have improved due to declines in energy and other commodity prices and the general weakening of economic conditions. The FOMC pledged to employ all available tools to promote the resumption of sustainable economic growth in a stable price environment. It expects that this will require an exceptionally low federal funds target for some time. The Board of Governors on December 16 also reduced the discount rate for primary credit to % from 1% and fixed the interest rate on required and excess reserve balances at %. The next scheduled meeting of the FOMC is set for January 27-28, 2009.

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Summary

The Federal Open Market Committee (FOMC) decided at its scheduled meeting held on December 16 to lower the target rate for federal funds to a range from 0% to ¼% from 1% set at its meeting of October 24, 2008. In making its decision to reduce the target, the FOMC stressed the following factors: (1) the pace of economic growth and industrial production slowed markedly due to a decline in both consumer and business investment spending, (2) labor market conditions show further deterioration, (3) financial markets remain quite strained and credit conditions tight, and (4) inflation prospects have improved due to declines in energy and other commodity prices and the general weakening of economic conditions. The FOMC pledged to employ all available tools to promote the resumption of sustainable economic growth in a stable price environment. It expects that this will require an exceptionally low federal funds target for some time. The Board of Governors on December 16 also reduced the discount rate for primary credit to ½% from 1¼% and fixed the interest rate on required and excess reserve balances at ¼%. The next scheduled meeting of the FOMC is set for January 27-28, 2009. This report will be updated as events warrant.

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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 primarily 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 (the "penalty" aspect of the discount rate comes from the fact that it is set above the target for federal funds). A primary discount rate of 2¼% was initially 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**. Since the onset of the financial crisis in the summer of 2007, the Fed has not made an issue of whether banks borrow at the discount window or in the federal funds market even though the discount rate remains slightly higher than the target rate for federal funds.

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. At its December 16 meeting, the FOMC, for the first time, set a range for the federal funds target. This is because it was having difficulty holding the actual federal funds rate at the 1% target rate set on October 29. For much of the period between that date and December 16, the actual federal funds rate was substantially below the 1% target.

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 the federal funds target are the most visible signs of shifts in Fed monetary policy and they immediately affect 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, the terrorist attacks of September 2001, and the financial crisis that began in the summer of 2007 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 period beginning in 2001. Initially, it was aimed at setting an 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 meetings during 2006 and 2007, it continued to express the view that inflation 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 subprime mortgages and extending credit in general became a matter of great 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%. Unhappily, GDP contracted again in the third quarter. The unemployment rate began to rise on a sustained basis in February and in October it reached 6.7%. Job losses since December 2007 are in excess of 1.2 million. 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, October 29, and December 16, and the discount rate was reduced itself on March 16. They now stand at a range of 0% to ¼% and ½%, 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.

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

Date	Federal Funds Rate Target			Discount Rate		
	Before	Change	After	Before	Change	After
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
Dec. 16, 2008	1	-½ to -1	0 to½	1¼	-¾	½

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%.

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Acknowledgments

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