The Federal Reserve and Rates in 2024

What is happening and why does it matter?

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pfm asset management

Over the last year, amidst steady reporting about — and tracking of — inflation and its effects, you've no doubt seen references to "potential action by the Federal Reserve." These actions center on projections of whether the Federal Reserve (Fed) is inclined to take steps to adjust short-term interest rates to address concerns about an overheating economy.

But even with frequent mentions of the Fed and the attention surrounding its activities, a lot of people still only have a vague idea of what the Fed is and why its actions are so important to the broader economy. By understanding the Fed's role in our economy, investors can better decipher some of those news stories and understand how the Fed influences rates on many instruments available to investors and interest income on short-term investments.

Origins of the Fed

The Federal Reserve was created in 1913 by an act of Congress as an institution that could help prevent the periods of financial panic that regularly rattled the U.S. economy and led to widespread unemployment, bank failures, and volatile prices throughout the 19th and early 20th centuries. Originally designed to smooth the sharp ups and downs of the business cycle, the Fed has added other responsibilities over the years.[1]

Today, the Fed's main responsibilities include:

- Affecting monetary policy with a goal of full employment and stable prices;
- Regulating banks and other financial institutions in an attempt to ensure their safety and soundness and seeking to protect the credit rights of consumers;
- Maintaining the stability of the financial system and containing systemic risk;
- Providing certain financial services to the U.S. government, U.S. financial institutions and foreign official institutions; and
- Playing a role in operating and overseeing the nation's payment systems

The "Federal" in Federal Reserve refers to the system's structure. On the national level, the Fed has a central Board of Governors in Washington, D.C., overseen by a chairman. There also are 12 regional Federal Reserve Banks in major cities, including Atlanta, Chicago, Philadelphia and San Francisco. The regional banks monitor economic activity in their districts and provide key input for the central bank's policies.[2]

A Measure of Independence

History has shown that the Fed typically can only respond to business cycles — without controlling them — while keeping an eye on the long term. The Fed has been designed to resist pressure from politicians to act only for short-term gain.

1 "Federal Reserve Act." Federal Reserve, August 24, 2022. https://www.federalreserve.gov/aboutthefed/fract.htm.
2 "Structure of the Federal Reserve System." Federal Reserve, August 24, 2022. https://www.federalreserve.gov/aboutthefed/structure-federal-reserve-system.htm.

U.S. presidents appoint the seven members of the Board of Governors, subject to Senate approval. But to assure independence, governors' terms are staggered such that no president can appoint a majority of the board until late in their second term.

Congress exercises oversight of the Fed and frequently calls officials to testify on economic conditions. Otherwise, the Fed functions fairly free of external pressure.

Indeed, the Fed is considered independent within the government. Its revenue comes from banks and other financial institutions that are members and use its services, not from Congressional appropriations.

Significant changes in the structure and responsibilities of the Fed occurred following the financial crisis of the late 2000s. In July 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, more commonly known as the Dodd-Frank Act.[3]

Dodd-Frank changed the Fed's governance, increased its transparency, increased consumer protections, expanded its regulatory responsibilities, and transferred most Fed consumer protection responsibilities to a new Consumer Financial Protection Bureau. Throughout its history, the Fed's best-known tool for carrying out one of its primary duties — affecting monetary policy — is its power to influence interest rates. However, the power is indirect and far from immediate in its operation.

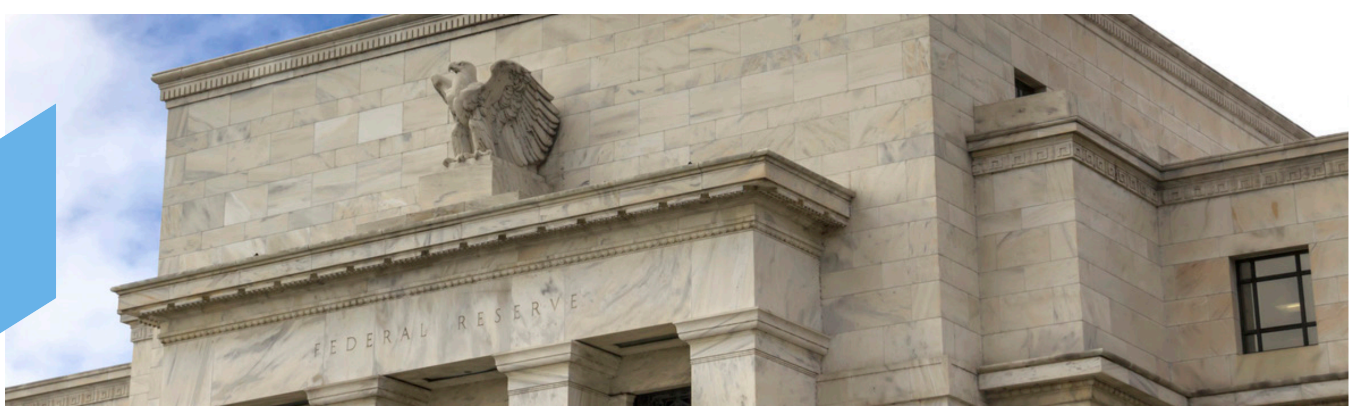
Influencing Rates and the Economy

The Fed influences interest rates by periodically setting a target for a specific rate known as the federal funds rate. This is the rate that banks charge each other for overnight loans between their accounts at the Federal Reserve. The rate is set by the Federal Open Markets Committee (FOMC), a 12-member panel that includes the Fed governors and a portion of the regional Fed presidents, who serve on a rotating basis.

Changes in the federal funds rate ripple through the economy, affecting all other rates and, ultimately, the economy as a whole.

Many banks peg their lending rates for credit cards and auto loans to changes in the target rate, and longer-term loans like mortgage rates can be indirectly affected by changes in the target rate. Bank interest rates for accounts and for certificates of deposit are also mainly correlated to the target rate. Traders in the bond market set prices for actively traded short-term fixed income securities such as U.S. Treasury bills and short-term federal agency obligations based on a variety of factors including the target federal funds rate. Since those short-term investments comprise most of the permitted investments for local government investment pools (LGIPs), net yields offered to investors in those pools are also closely tied to the target rate.

3 U.S. Congress. "H.R.4173 — Dodd-Frank Wall Street Reform and Consumer Protection Act."



HOW DOES THE FED TRY TO REACH ITS TARGET? IT USES THREE TOOLS:

Open market operations are the buying and selling of U.S. Treasury and federal agency securities. When the Fed buys securities from banks, it adds cash to their reserves, easing credit and leading to lower interest rates. When the Fed sells securities, the opposite occurs.

Discount window lending is lending to banks directly from the Fed at rates set by the Board of Governors. The Fed can create demand for borrowing from the discount window, and charge higher rates, by raising banks' reserve requirements, the Fed's third tool.

Reserve requirements dictate the level of cash that banks and other depository institutions must hold in reserve as a percentage of the deposits held by their customers. The Fed can set the requirement to affect demand for cash depending on how it would like to influence interest rates. When banks need cash to meet reserve requirements, rates go up. When banks don't need cash, rates fall. By using these three interrelated tools as levers, the Fed is able to exert influence over the rates of return on many instruments available to public sector investors.

The Fed Today

At its May 1 meeting, the Fed voted to hold rates steady and left the federal funds target rate unchanged at 5.25% to 5.5%. The monetary policymaking body continues to underline the meeting-by-meeting analysis of the data and the need for stronger evidence that inflation is moving sustainably lower. Fed Chair Jerome Powell responded to questions about the risk of re-acceleration in inflation, noting that the Fed monitors the overall picture but similarly would need to see "persuasive evidence" that the policy stance is not sufficiently restrictive. Current market expectations reflect less than two cuts for the remainder of the year.[4]

4 "Federal Open Market Committee Meeting Minutes." Federal Reserve, https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20240501.pdf.

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