



Can the federal funds rate affect the economy?

The Federal Open Market Committee (FOMC) is the policymaking branch of the Federal Reserve. One of its primary responsibilities is setting the federal funds target rate. The FOMC meets eight times per year, after which it announces any changes to the target rate. The Federal Reserve (the Fed), through the FOMC, uses the federal funds rate as a means to influence economic growth.

If interest rates are low, the presumption is that consumers can borrow more and, consequently, spend more. For instance, lower interest rates on car loans, home mortgages, and credit cards make them more accessible to consumers. Lower interest rates often weaken the value of the dollar compared to other currencies. A weaker dollar means some foreign goods are costlier, so consumers will tend to buy American-made goods. An increased demand for goods and services often increases employment and wages. All of which should stimulate the economy. This is essentially the course the FOMC took following the 2008 financial crisis in an attempt to spur the economy.

However, if money is too plentiful, demand for goods may exceed supply, which can lead to increasing prices. As prices increase (inflation), demand for goods decreases, slowing overall economic growth. When the economy recedes, the need for labor decreases, unemployment grows, and wage growth slows. To counteract rising inflation, the Fed raises the target rate. When interest rates on loans and mortgages move higher, money becomes more costly to borrow. Since loans are harder to get and more expensive, consumers and businesses are less likely to borrow, which slows economic growth and reels in inflation.

The Fed monitors many economic reports that track inflationary trends and economic growth. The Fed's preferred measure of inflation is the Price Index for Personal Consumption Expenditures produced by the Department of Commerce. To forecast economic growth, the Fed looks at changes in gross domestic product and the unemployment rate, along with several other economic indicators, such as durable goods orders, housing sales, and business fixed investment.

Source: Federal Reserve, 2018

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