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Federal Reserve Interest Rate Changes: 2000-2008

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Summary

The Federal Open Market Committee (FOMC) decided on March 18, 2008, to lower the target rate for federal funds to 2¼% from 3½%, its third reduction in less than a month. This is the sixth consecutive reduction since September 18, 2007. In a public statement issued at the conclusion of its meeting, the FOMC made several observations that describe its current thinking: (1) the economic outlook has weakened further with a slowing of growth in consumer spending and a softening of labor markets; (2) financial markets remain under considerable stress with the tightening of credit conditions and a faltering housing market weighing on economic growth in coming quarters; and (3) while inflation has been elevated and some indicators of inflationary expectations have risen, inflation is expected to moderate over coming quarters. The FOMC concluded with the opinion that future policy adjustments will depend on the evolution of the outlook for both inflation and economic growth. The Board of Governors also reduced the discount rate for primary credit to 2½% from 3¼% (on March 16, the Board had approved a cut in the discount rate to 3¼% from 3½%). The next meeting of the FOMC is set for April 29-30, 2008. This report will be updated as events warrant.

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 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).

As the current economic expansion gathered momentum and the unemployment rate began to fall, the FOMC began to raise the federal funds target. Between June 25, 2003, and June 29, 2006, the target was increased 17 times to 5¼% from 1%. These increases were designed to keep economic growth on a sustainable path. Similar changes were made to the discount rate. Over this same three-year period it was increased to 6¼% from 2%. This followed an announcement of a fundamental change in the discount rate procedure made public on January 6, 2003. On that date, the Board announced that the discount rate 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. A *primary* discount rate of 2¼% was 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%. At its meeting on June 24-25, 2003, the Board lowered the primary discount rate by 25 basis points (100 basis points equals 1%) to 2%. The secondary rate was lowered immediately by most regional Federal Reserve Banks to 2½%.

By the summer of 2007, the prices of residential housing began to decline noticeably in a number of markets prompting some to suggest that the "housing bubble" had burst. Falling housing prices and related problems in the home mortgage market compounded to cause grave difficulties for a number of financial institutions. The financial markets began to freeze up and a number of businesses and households began to experience difficulties in getting loans renewed. The FOMC and the Board expressed concern about the adequacy of liquidity in the financial markets and the need to provide lending institutions with assurances about the cost and availability of funding. On August 17, September 18, October 31, and December 11, 2007, and January 22 and 30, and March 16 and 18, 2008, the Board lowered the discount rate for primary credit to 5¾%, 5¼%, 5%,4¾%,4%, 3½%, 3¼%, and 2½%. Similarly, between September 18, 2007, and March 18, 2008, the FOMC reduced the federal funds target to 2¼%from 5¼%. Other market interest rates, especially short-term rates, are influenced by changes in the federal funds target and the discount rate, but they do not change one-for-one with the changes in these rates.

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.

Table 1. Recent Interest Rate Changes

Date	Federal Funds Rate Target			Discount Rate		
	Before	Change	After	Before	Change	After
Jan. 3, 2001	6½	-½	6	6	-½	5½
Mar. 20, 2001	5½	-½	5	5	-½	4½
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

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%.

Rationale for Changes

The Fed tries to keep the economy operating at an output level consistent with a low rate of inflation. 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 interest rates are the most visible signs of the Fed's monetary policy, immediately affecting 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 and the terrorist attacks of September 2001 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.

Inflation-adjusted growth has been positive since the end of the recession in November 2001. Because real GDP has now surpassed its previous high point at the end of the 1991-2001 business cycle (by nearly 20%), the economy is considered to be in an expansionary rather than simply a recovery phase. The achieved growth in demand has been strong enough that in the Fed's opinion the economy has now achieved a high level of resource utilization. This is reflected in the unemployment rate, which has been at or near 4.5% for nearly two years. Job creation has been noticeably strong since August 2003. The data for December 2007 revealed a softening of labor market conditions.

While continuing to express the view that the economy is improving and moving toward full employment, the FOMC adopted additional "insurance" at its 16 meetings subsequent to June 30, 2004, in order to contain any tendency for the underlying or core rate of inflation and inflation expectations to rise. At each of the 17 meetings (including June 30, 2004), it raised the target federal funds rate by a quarter of a percentage point until it reached 5¼%. Even though upward movements in the core inflation rate drew the attention of the FOMC at its August 8, September 20, October 25, December 12, 2006, and January 31, March 21, May 9, June 28, and August 7, 2007 meetings, the view was expressed that it should be expected to moderate over time as is the rate of growth of income. These appear to be important reasons for leaving the target rate unchanged.

However, during the late summer of 2007, the fall in housing prices and conditions in financial markets related to the difficulty in refinancing sub-prime mortgages became a matter of 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%, the first such reduction since June 25, 2003. Additional cuts of ¼% in both rates were approved on October 31 and December 11, 2007, and ¾% on January 22 and ½% on January 30, 2008. As conditions in financial markets worsened, the FOMC and the Board approved a further reduction in the federal funds target on March 18 and two reductions in the discount rate on March 16 and 18. They now stand at 2¼% and 2½% respectively.

For further discussion, see CRS Report RL30354, *Monetary Policy and the Federal Reserve: Current Policy and Conditions*, by Marc Labonte and Gail Makinen.