Investment Fundamentals

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Federal Funds Rate

- The federal funds rate is an interest rate set by the Federal Reserve for borrowing and lending between major banks.
- The FOMC's strategy around setting the target federal funds rate requires a delicate balancing act.
- Changes made to the federal funds rate have implications for the broader economy.

It's no mystery that global markets are sensitive to the federal funds rate, an interest rate set by the U.S. Federal Reserve (Fed) for borrowing and lending between major banks. An adjustment to the rate only needs to be anticipated — not actually made — for the markets to react. And sometimes it's a lack of change that drives market volatility. Recently, for example, investors have been bracing themselves for rates to increase for the first time since 2006, fearing that the stock market will drop as a result. All of this has been covered exhaustively by financial news media.

But what remains a mystery to many is what exactly the federal funds rate is, how it's set and *why* its movements (or lack thereof) can have such a profound effect on market activity.

Putting the "Fed" in federal funds rate

In order to understand the federal funds *rate*, you must first understand federal funds. And before understanding federal funds, you must first understand the Fed.

The Fed is the U.S. central banking system where the country's currency, money supply and interest rates are managed. Among other functions, it provides financial services to commercial banks, allowing them to keep reserve balances at one of the 12 regional Fed Banks. These balances are called *federal funds*. Commercial banks are able to loan each other federal funds, usually overnight. And, like any loan, federal loans come with an interest rate — called the *federal funds rate*.

Targeting the federal funds rate

The actual federal funds rate used overnight among banks fluctuates (depending on the supply of funds and the demand of loans), but is generally within the range of a *target* federal funds rate. This target rate is set by the Federal Open Market Committee (FOMC), which typically meets eight times a year to review economic and financial conditions.

The FOMC's strategy around setting the target federal funds rate requires a delicate balancing act — typically based on the conditions of two factors: achieving maximum employment and price stability. If employment is weak, for example, the rate might be lowered to spur economic growth, as inexpensive borrowing costs would make job-creating activities more feasible for established companies and entrepreneurs. However, in weighing whether or not to lower the rate, the FOMC must consider that doing so might fuel inflation (or rising prices), since the supply of borrowed money available for spending would expand.

On the other hand, if the primary concern of the FOMC is inflation, it might increase the target federal funds rate in order to slow prices (by reducing demand for borrowed money). But a consequence of this is that job creation may suffer.

FOMC: A bigtime trendsetter

The FOMC's need to execute such a delicate balancing act shows that the federal funds rate effects more than overnight borrowing at the Fed — it also has implications for the broader economy. In fact, the federal funds rate serves as a reference point for most other short-term financing activity in the U.S.

In the words of the Fed itself, "changes in the federal funds rate trigger a chain of events that affect other short-term interest rates, foreign exchange rates, long-term interest rates, the amount of money and credit, and, ultimately, a range of economic variables, including employment, output, and prices of goods and services[1]." Essentially, the federal funds rate is a bigtime trendsetter.

What it means for you

What should you do in the face of potential market volatility around interest-rate activity? First, know that a shock to the financial system is sometimes just what the market needs in order to avoid a recession. (See our paper on Stock Market Corrections.) Second, as always, stay focused on your long-term investment objectives. While stocks historically feel pressure when the Fed raises interest rates, they tend to make up for this in the long term. Overreacting by selling investments could result in missing out on gains when the market bounces back.

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[1] http://www.federalreserve.gov/monetarypolicy/fomc.htm

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