

Insights

The Federal Reserve & Interest Rates

While most investors enjoy speculating about potential interest rate changes, many do not understand the Fed's role, including how it forecasts the state of the U.S. economy and makes decisions about rate changes or the tools it uses to conduct monetary policy.

Forecasting the State of the Economy

The Fed is charged with maintaining price stability and promoting economic growth. If the Fed overstimulates the economy, inflation will rise. If the Fed fights inflation too aggressively, growth will suffer. The Fed tries to maintain the middle course. To gauge the health of the economy and make decisions about rate changes, the Fed relies on hundreds of economic indicators. Some are considered "leading indicators," since they vary in advance of the overall economy, while others are termed "coincident indicators" since they change at about the same time as the overall economy. Keep in mind that the Fed tends to look at several indicators in conjunction, in order to get meaningful insight into growth trends. For example, if consumer confidence is high and real earnings are increasing while employment is strong, retail sales would be expected to be strong as well. Some of the most important indicators are shown below.

Housing (Leading) — Construction Spending

- Existing Home Sales
- Housing Market Index — Housing Starts
- New Home Sales

Consumer Confidence/Other (Leading) — Consumer Confidence Index

- Redbook Retail Averages (same store sales of a group of companies)
- Retail Sales — Leading Economic Indicators (composite index of 10 indicators leading economic activity)

Employment/Other (Coincident) — Initial Jobless Claims

- Employment Report (Lagging)
- Purchasing Managers Index (PMI) — Personal Income and Consumption
- Beige Book (survey of key businessmen, economists, market experts, etc., on economy)

Inflation (Coincident) — Consumer Price Index

- Employment Cost Index (ECI)
- Producer Price Index — Productivity & Unit Labor Cost

Industrial Production (Coincident) — Business Inventories

- Durable Goods Orders
- Factory Orders — Gross Domestic Product (GDP)
- Industrial Production and Capacity Utilisation

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HZ-2004

SCPB-103-0608-F-E

Tools the Federal Reserve Uses to Conduct Monetary Policy

Using the tools described below — Open Market Operations, Discount Rate and Reserve Requirements — the Fed influences the demand for, and supply of, monetary balances that depository institutions hold at Federal Reserve Banks and, in this way, alters the Federal Funds rate. The Fed Funds rate is the interest rate at which banks lend to each other overnight and this benchmark rate influences market rates throughout the world. Changes in the Fed Funds rate triggers 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 the prices of goods and services.

Open Market Operations — This is the Fed's principal tool for implementing monetary policy and involves purchasing and selling US Treasury and federal agency securities.

Discount Rate — This is a secondary policy tool. The discount rate is the interest rate charged to commercial banks and other depository institutions on loans they receive from their regional Fed lending facility. When the Fed charges a high interest rate, banks borrow less than when the Fed charges a low interest rate.

Reserve Requirements — Banks and other depository institutions are legally required to hold a specific amount of funds in reserve. These funds, which can be used to meet unexpected outflows, are called reserves and banks keep them as cash in their vaults, or as deposits with the Fed. Currently, banks must hold between 3% and 10% of the funds they have in interest-bearing and non-interest-bearing checking accounts as reserves. Banks also may hold additional reserves needed for clearing overnight checks and other payments. The higher the reserve requirements, the less banks are able to lend out money, which limits credit growth, a necessary fuel for economic growth.