Order Code 98-856 E
Updated May 12, 2006

CRS Report for Congress
Received through the CRS Web

Federal Reserve Interest Rate Changes: 2000-2006

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Summary

The Federal Open Market Committee (FOMC) decided on May 10, at its third scheduled meeting in 2006, to raise the target rate for federal funds to 5% from 4¾%, the 16th increase since the current round of rate hikes began on June 30, 2004. In a public statement issued at the conclusion of its meeting, the FOMC made several notable comments that describe its current thinking: (1) economic growth has been quite strong this year with some moderation to a more sustainable pace likely, (2) core inflation has only been modestly influenced by higher energy and other commodity prices, (3) ongoing productivity gains are holding down the growth in per unit labor costs, (4) inflation expectations remained contained, and (5) higher energy prices and possible increases in resource utilization have the potential to add to inflationary pressure. Thus, the FOMC judges that further measured policy firming may yet be needed to address inflation risks. The FOMC concluded its statement with a reminder that it will respond to changes in economic prospects as needed to support the attainment of its objectives. In a companion move, the Board of Governors raised the discount rate to 6% from 5¾% for primary credit. The next meeting of the FOMC is set for June 28/29, 2006. 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).

The period between January 3, 2001, and June 25, 2003, was one of monetary easing. In 13 moves, the FOMC voted to lower the target for the federal funds rate to 1% from 6½%. The target rate was then held at this level for one year. On June 30, 2004, the FOMC began to tighten policy by increasing the target to 1¼%. This stance was continued with the target raised by ¼% at meetings held on August 10, September 21, November 10, and December 14, 2004; February 2, March 22, May 3, June 30, August 9, September 20, November 1, and December 13, 2005; and January 31, March 28, and May 10, 2006. The target rate now stands at 5%, a rate last seen early in 2001. In a companion move over the period of FOMC easing, the Board of Governors also lowered the discount rate until it stood at ¾%. On January 6, 2003, the board announced a fundamental change in the discount rate procedure. From that date, the discount rate was made to be 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, while 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, 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%. The board raised both rates by ¼% on June 30, August 10, September 21, November 10, and December 14, 2004; February 2, March 22, May 3, June 30, August 9, September 20, November 1, and December 13, 2005; and January 31, March 28, and May 10, 2006. The primary rate now stands at 6%, a rate last seen in May 2000.

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
May 16, 2000	6%	+½	6½%	5½%	+½	6%
Jan. 3, 2001	6½	-½	6	6	-½	5½
Jan. 31, 2001	6	-½	5½	5½	-½	5
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	2 ¼	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

Source: Federal Reserve System.

a. 2¼% was the new primary rate and 2¾% was the secondary rate, as of January 6, 2003.

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 more than 12%), the economy is considered to be in an expansionary rather than simply a recovery phase. The growth in demand that has been achieved has been strong enough, in the face of a higher rate of productivity growth, to bring about a gradual reduction in the unemployment rate. The rate now (April 2006) stands at 4.7%, an expansion low first reached in January 2006. Job creation has been noticeably strong since August 2003. While continuing to express the view that the economy is improving and moving toward full employment, the FOMC adopted additional "insurance" at its 15 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 16 meetings (including June 30, 2004), it raised the target federal funds rate by a quarter of a percentage point. The target rate now stands at 5%. The FOMC concluded its public statement with the opinion that some additional policy firming may yet be needed to contain the risk of inflation. Any moves in this direction will depend on the evolution of the economy as described by incoming data. The next scheduled meeting of the Federal Open Market Committee is set for June 28/29, 2006.

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

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