How the Fed Raises and Lowers Rates

The Federal Reserve (the "Fed") doesn't directly increase or decrease interest rates. In fact, interest rates are set by market participants. What the Fed does is increase or decrease the money supply, which in turn makes borrowing more or less expensive.

Commercial banks are one of the most important market participants that influence the level of short-term interest rates when they borrow and lend money to each other. This is called interbank lending, and it occurs so banks can meet their reserve requirements.

- Reserve requirements are balances banks are required to keep on deposit with the Fed in order to ensure that they can meet their obligations to their depositors.

Fed Funds Rate

In the US, the interbank rate is called the Fed Funds rate. This is the rate that the Fed targets when it acts to raise and lower interest rates.

- The Federal Open Market Committee (FOMC) sets a target rate, which is communicated to the banking system both directly and indirectly.
  - Directly: The FOMC has regular meetings every six weeks to decide policy, and after which they make an announcement as to their intentions for interest rates.
  - Indirectly: Based on the level of reserves the Fed creates, market participants can determine the level of rates the Fed is targeting.
- Only the largest and most credit-worthy institutions can borrow at the Fed Funds rate. Other market participants need to borrow funds at a margin over the Fed Funds rate.

Federal Open Market Operations

When the Fed wants to raise interest rates, they will sell some of the Treasury bonds they own to a designated government securities dealer. The dealer will pay for those bonds by transferring funds from their bank to the Federal Reserve, thus reducing liquidity in the banking system and causing interest rates to rise.

When the Fed wants to lower interest rates, they will buy Treasury bonds from a government securities dealer. The Fed will pay for those bonds by transferring funds to the dealer's bank account, thus increasing liquidity in the banking system and causing interest rates to fall.

These transactions are called Federal Open Market Operations. The dealers that participate in the Open Market Operations are major financial institutions designated ahead of time who get certain privileges in exchange for their willingness to conduct operations with the Fed.