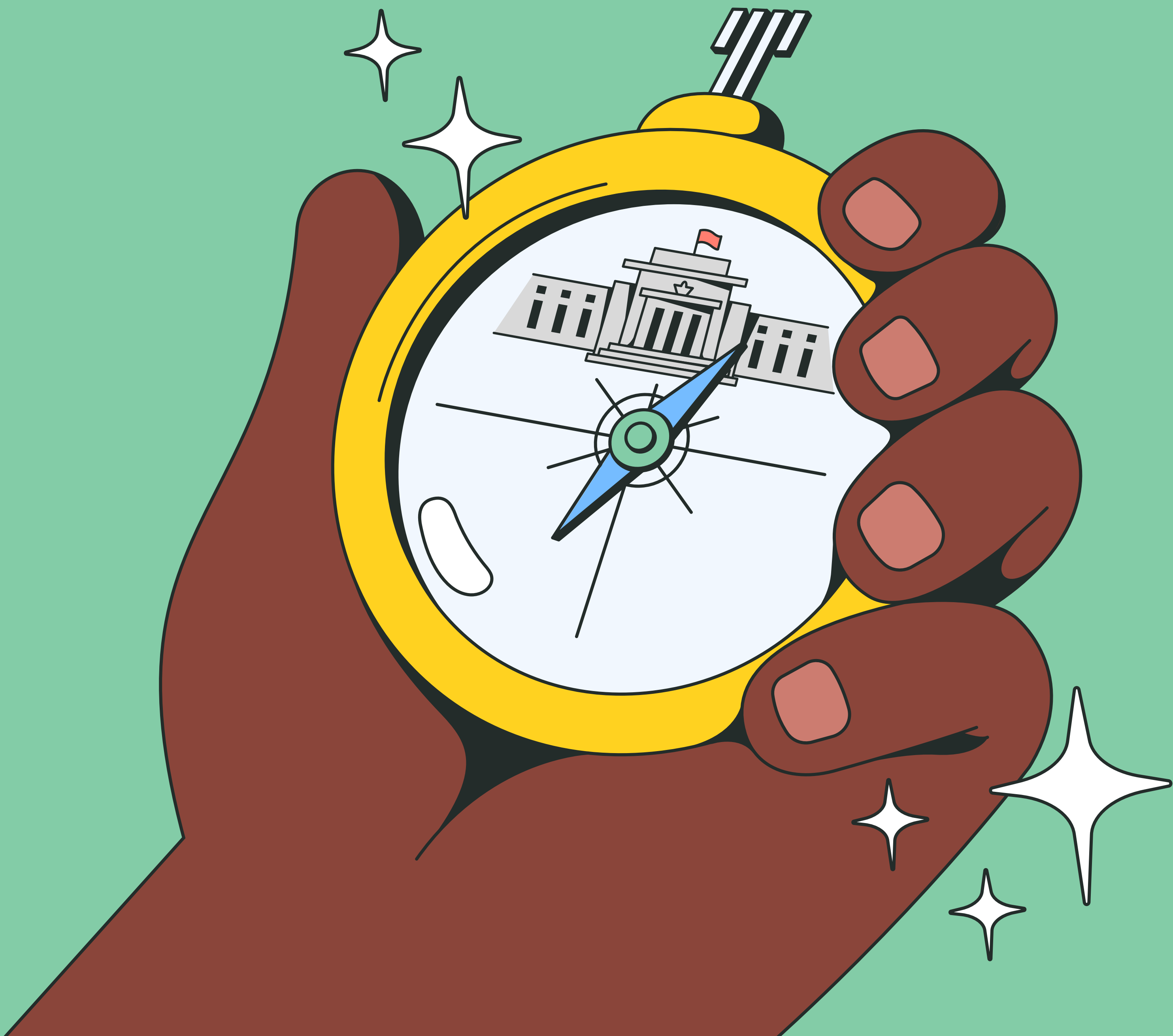
Fed Fundamentals



Fed Fundamentals

The Federal Reserve: Simplified. Here are key terms for understanding the Fed's moves and our current rate environment.

The Federal Reserve is the central bank of the United States, and it's responsible for adjusting interest rates, setting monetary policy and more. Sound simple enough?

When you start to dig in, the Federal Reserve can be confusing. But it's foundational to understanding your money, interest rates and the economy at large. These terms are fundamental to figuring out the Fed — and may come in handy as you navigate your personal finance journey.

The Fed: In Three Acts

The Federal Reserve consists of three key entities that operate separately, but cooperate together. The overall goal of these entities is to promote the health of the US economy, while ensuring the stability of the US financial system.

The three key system entities are:

- The Federal Reserve Board of Governors (headed by the Chair of the Federal Reserve)
- The Federal Reserve Banks
- The Federal Open Market Committee (FOMC)

Federal Reserve Board of Governors

The Board of Governors is the governing body of the Federal Reserve. It is based in Washington, D.C.

The board consists of seven members, known as “Governors.” These members are nominated by the U.S. president and must be confirmed by members of the United States Senate.

The Board guides the overall policy and operations of the Federal Reserve system.

The Board is headed by the Chair of the Federal Reserve. The Chairman or Chairwoman of the Federal Reserve presides over Board meetings and is the active executive officer of the entire Reserve system.

One of the seven Board members is selected by the U.S. president to be the Chair and will serve a 4-year term. The Chair is selected by the president, but must be confirmed by the Senate.

Federal Reserve Banks

There are 12 Federal Reserve Banks, with a total of 24 branches. They are spread throughout the country, and each is responsible for its own geographical area (known as a district).

A primary function of the Federal Reserve Banks is to gather economic data from specific regions. This data is then compiled with data from other Reserve branches and used to make monetary policy decisions.

The Banks also serve as the backbone of the US financial system.

- They lend to financial institutions to ensure liquidity in the financial system
- They store and distribute physical currency and coins
- They oversee the federal Wire Transfer and Automated Clearing House (ACH) payment system
- They examine certain financial institutions to ensure compliance with federal regulations and fair lending laws

Federal Open Market Committee (FOMC)

The Federal Open Market Committee (FOMC) is composed of Fed officials. The committee is responsible for reviewing economic data and financial conditions to determine the appropriate stance for monetary policy. The FOMC sets the federal funds rate.

Economic Terms

Basis points (BPS)
BPS, or “bips,” measure interest rates and percentages in finance. A basis point is equal to 1/100th of 1%. One basis point = 0.01%, 25 basis points = 0.25% and 100 basis points = 1%.

Consumer price index (CPI)
CPI is a measure of inflation calculated based on the change in prices of commonly purchased goods and services. CPI measures inflation using a combination of many major spending categories (food, energy, rent, services, etc.)

Inflation
Inflation is a natural phenomenon in modern economies that refers to a decrease in the general purchasing power of money, which is fueled by a rise in prices. For example, $5 a few decades ago could’ve bought you a sit-down meal, and the same meal now might cost $15 to $20.

Interest rates
A lender charges a borrower an interest rate to take out a loan, and it’s expressed in a percentage, referring to the interest charged annually. Different interest rates include interest on loans or credit cards, interest earned in savings accounts, the Fed’s interest rate and the Fed Funds interest rate.

The term “rising interest rates” in the news generally refers to a rising federal funds rate.

Target inflation rate

The Fed has a target inflation rate, and the goal is to keep inflation at the set rate. When inflation dips below the target inflation rate, the Fed may print more money, lower interest rates or other tools.

When inflation is higher than the target rate, the Fed may increase interest rates or decrease the money supply.

Variable interest

Variable interest is the rate on a loan that can change, like a credit card, and it's the opposite of a fixed interest rate.

Variable interest rates are usually based on a benchmark rate. It might be Prime Rate + 5%. If the Prime Rate rises, variable interest rates also rise.

Fed-Specific Terms

Federal funds rate

The Federal Open Market Committee sets the federal funds rate, the interest rate at which banks lend each other money overnight. The rate covers deposits held at the Federal Reserve (called "federal funds").

When a bank has extra liquidity (cash), it may lend cash overnight to a bank with a shortfall in liquidity. The lending bank would charge the borrower the current federal funds rate.

Fed minutes

After each meeting, the Fed publicly releases minutes, a record of discussions during the session. Markets closely watch the minutes, as they can reveal plans for interest rate changes and other decisions.

FOMC meetings

The FOMC meets eight times a year to determine the target federal funds rate and discuss other economic factors.

Monetary policy

Monetary policy is the set of actions a country's central bank performs to promote growth, stabilize markets and control the money supply. Monetary policy aims to keep the economy growing steadily while keeping inflation within the target range.

Prime rate
The prime rate is a short-term interest rate for lending in the U.S. It's primarily used as an index rate on which total interest rates are built. The rule-of-thumb for the prime rate is: (Federal funds rate + 3%) = U.S. Prime Rate.

Tightening and Easing
There are two broad directions that the Federal Reserve can move in. Tightening refers to tight monetary policy, which means a rising federal funds interest rate. Easing refers to easy monetary policy, which typically means a decreasing federal funds interest rate.

How would rising interest rates affect me?

Rising interest rates can have broad effects on the overall economy.

When interest rates are high, businesses and consumers often cut back on spending. This can lead to a slowdown of economic growth or even a recession.

On the other hand, rising interest rates may help to tame inflation. With inflation running well above Fed targets, there is hope that the Federal Reserve raising interest rates will help slow the inflation rate, which should benefit the economy.

Rising interest rates from the Fed can also lead to higher interest rates paid by consumers. Increasing rates lead to higher costs for banks, typically passed onto consumers in higher APRs on credit cards and loans.

How would lower interest rates affect me?

When rates are low (or decreasing), businesses and consumers tend to borrow more. Businesses borrow to build new facilities or expand operations, while consumers may borrow to buy a home or other substantial purchase to take advantage of low-interest rates.

If you have credit card debt, paying it off can help save you a lot of money in interest. One of the best ways to pay off credit card debt is to use Tally†. Tally works by helping qualifying applicants consolidate credit card debts and pay them off at a lower interest rate.

†To get the benefits of a Tally line of credit, you must qualify for and accept a Tally line of credit. Based on your credit history, the APR (which is the same as your interest rate) will be between 7.90% - 29.99% per year. The APR will vary with the market based on the Prime Rate. Annual fees range from $0 - $300.