XIV. The Sudden Rise in the Federal Reserve's Discount Rate

A. Introduction

On December 16, 2015, the Federal Reserve Bank (the Fed) decided to raise interest rates for the first time in nearly a decade.[1] The Fed claimed that the economy's recent improvement warranted the increase.[2] Federal interest rate increases affect banks, institutional lenders, and businesses alike.[3] Many economists and financial analysts have polarizing opinions on the effect of the 2015 interest rate increase; some believe the rate increase will ultimately be beneficial, while others foresee more deleterious effects.[4] This article will discuss the Fed's authority to implement interest rate hikes, how this increase will affect significant areas of the economy, and how this policy decision might affect the economy moving forward.

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[1] Press Release, Bd. of Governors of the Fed. Reserve Sys., 2015 Monetary Policy Releases (Dec. 16, 2015), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20151216a.htm [https://perma.cc/3KDS-MBYU].

[2] *Id.* ("The Committee judges that there has been considerable improvement in labor market conditions this year, and it is reasonably confident that inflation will rise, over the medium term, to its 2 percent objective.").

[3] *See, e.g.*, Chris Seabury, *How Interest Rates Affect the U.S. Markets*, INVESTOPEDIA (2009), http://www.investopedia.com/articles/stocks/09/how-interest-rates-affect-markets.asp [https://perma.cc/LW28-YB4W].

[4] *Compare* Kate Davidson, *Economists React to the Fed's Interest-Rate Decision: 'When Is the Next Hike?'*, WALL ST. J. (Dec. 16, 2015), http://blogs.wsj.com/economics/2015/12/16/economists-react-to-the-feds-interest-rate-decision-when-is-the-next-hike [https://perma.cc/4RFZ-J57N] ("'In the end, the pace [of future rate increases] will be determined by the data and financial markets developments. We remain skeptical that the pace will be as gradual as is being suggested, mainly because we expect the unemployment rate to keep falling, eventually leading to more upward pressure on inflation. For now, though, it makes sense for officials to be as reassuring for markets as they can without compromising their flexibility later.' *—Jim O'Sullivan, High Frequency Economics."*), *with* Karl Russell & Binyamin Applebaum, *Why the Fed Raised Interest Rates*, N.Y. TIMES (Dec. 16, 2015), http://www.nytimes.com/interactive/2015/09/12/business /economy/fed-rates-explainer.html?_r=0 [https://perma.cc/KCX4-74SU] ("Officials said the economy was strong enough to keep growing with a little less help from the central bank.").

1. Statutory Inception of the Federal Reserve

The Federal Reserve Act of 1913 established the Federal Reserve System.[5] Congress enacted the statute "to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes."[6] The Federal Reserve Act also created the Board of Governors of the Federal Reserve System and gave them specific responsibilities.[7] The Board of Governors' mandate is to assess long-term domestic and international economic conditions and make decisions that will maximize employment, balance prices, and sustain long-term interest rates.[8] Ultimately, the Board of Governors shapes the Fed's monetary policy, which primarily consists of important decisions regarding the US money supply and federal interest rate.[9]

Congress gave the Fed day-to-day responsibilities and functional ability to regulate and moderate the United States economy.[10] One important tool that the Fed uses to accomplish these

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[5] *See generally* Federal Reserve Act, 12 U.S.C. §§ 221-522 (1913).

[6] *Federal Reserve Act*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., http://www.federalreserve.gov/aboutthefed/officialtitle.htm [https://perma.cc/P4JZ-EV5J].

[7] *Federal Reserve Act*, *Section 2A. Monetary Policy Objectives*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., http://www.federalreserve.gov/aboutthefed/section2a.htm [https://perma.cc/LS7U-RA2Y] ("The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.").

[8] *Id.*; *The Structure and Functions of the Federal Reserve System*, FED. RESERVE EDUC., https://www.federalreserveeducation.org/about-the-fed/structure-and-functions [https://perma.cc/37UL-G332] [hereinafter *Structure and Function*].

[9] *See, e.g.*, *Structure and Function, supra* note 8.

[10] *What is the Purpose of the Federal Reserve System?*, BD. OF GOVERNORS OF THE FED. RESERVE SYS. (Feb. 4, 2014), https://www.federalreserve.gov/faqs/about_12594.htm [https://perma.cc/3GUQ-2JS6] ("The Federal Reserve System, often referred to as the Federal Reserve or simply "the Fed," is the central bank of the United States. It was created by the Congress to provide the nation with a safer, more flexible, and more stable monetary and financial system.").

goals is its ability to change the discount rate.[11] The discount rate is "the interest rate charged to commercial banks and other depository institutions on loans they receive from their regional Federal Reserve Bank's lending facility—the discount window."[12] This rate affects the interest rates banks charge borrowers, and in turn, the amount of money that commercial banks lend out to the public.[13] In this sense, the discount rate is a powerful metric, as it essentially dictates the availability of credit for the entire economy.[14]

2. How Federal Interest Rates Affect the Money Supply

The Fed's interest rate affects everyday financial vehicles such as mortgages, car loans, consumer loans, and the money supply as a whole.[15] The basic premise is that commercial banks borrow money from the Fed, and are required to pay back that money with interest according to the going discount rate.[16] The commercial banks then pass these interest costs along to the consumer, and add a few additional percentage points in order to make a profit.[17] The higher the

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[11] *Id.* ("The discount rate can be altered by the Federal Reserve either to encourage or discourage borrowing from financial institutions.").

[12] *The Discount Rate*, BD. OF GOVERNORS OF THE FED. RESERVE SYS. (Feb. 23, 2016), http://www.federalreserve.gov/monetarypolicy/discountrate.htm [https://perma.cc/KW5F-2JEP].

[13] Sean Ross, *How Does a High Discount Rate Affect the Economy?*, INVESTOPEDIA, http://www.investopedia.com/ask/answers/013015/how-does-high-discount-rate-affect-economy.asp [https://perma.cc/NL43-K4WQ] ("When it is less expensive for banks to borrow money from the Federal Reserve, they can subsequently charge less interest on their own loans. This has a ripple effect on the demand for loanable funds . . . .").

[14] *Id.* (explaining that the discount rate affects the interest rates banks charge consumers on their mortgages, car loans, and other extensions of credit).

[15] *Id.* ("This has a ripple effect on the demand for loanable funds everywhere . . . .").

[16] *The Discount Window*, FED. RESERVE BANK OF N.Y. (July 2015), https://www.newyorkfed.org/aboutthefed/fedpoint/fed18.html [https://perma.cc/P57W-N8RZ].

[17] Taylor Tepper, *Why the Fed Raised Interest Rates – and What it Means for You*, TIME (Dec. 16, 2015), http://time.com/money/4149221/federal-reserve-raised-interest-rates/ [https://perma.cc/WX4P-KJYG] ("Higher interest rates means the cost of financing a loan will increase.").

interest rates are, the lower the demand for loans will be.[18] Consequently, a higher discount rate may deter borrowing by consumers unwilling to shoulder the resulting increase in borrowing costs.

This system, in the aggregate, is the primary mechanism by which the Fed affects the money supply. The U.S. money supply consists of all of the currency that the U.S. Treasury circulates, in addition to deposits held at commercial banks and other depository institutions such as credit unions.[19] The Fed manages the money supply and uses the discount rate to manipulate the money supply to best serve the American economy.[20]

B. Recent Trends in Interest Rate Manipulation

On December 16, 2015, the Fed, in a joint effort with the Federal Open Market Committee (the Committee), raised the discount rate a quarter of a point to a range of 0.25% to 0.5%.[21] Before this increase, the Fed's discount rate was at its lowest ever, between zero and 0.25%.[22] Generally, the Fed sets the discount rate in the 2 to 5% range, which is typical of a healthy American economy.[23] The Committee expects to raise rates to this more average level sometime in 2016, so the discount rate is likely to trend upwards.[24]

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[18] *Definition of Mortgage*, INVESTOPEDIA, http://www.investopedia.com/terms/m/mortgage.asp [https://perma.cc/A8TS-3VDQ] ("If interest rates increase later, the borrower may not be able to afford the higher monthly payments.").

[19] Anna J. Schwartz, *Money Supply*, LIBRARY OF ECON. AND LIBERTY (Apr. 5, 2016), http://www.econlib.org/library/Enc/MoneySupply.html [https://perma.cc/F4BR-9KBM].

[20] *See id.*

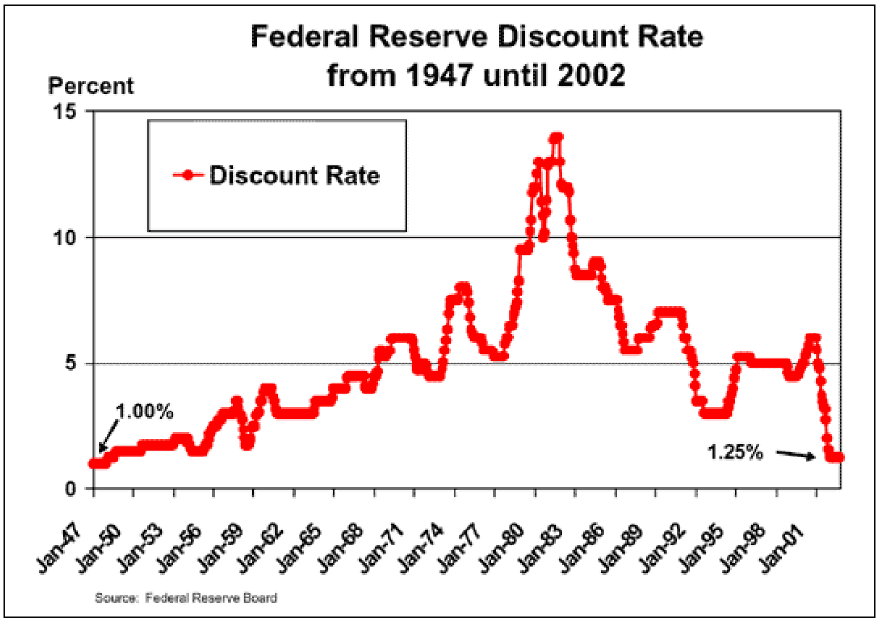
[21] Kimberly Amadeo, *FOMC Meetings: Schedule and Statement Summaries*, ABOUT.COM (JAN. 28, 2016), http://useconomy.about.com/od/governmentagencies/fl/FOMC-Meetings.htm [https://perma.cc/WLW6-M5XR].

[22] Kimberly Amadeo, *Fed Funds Rate History: Highs, Lows, and Chart with Major Events*, ABOUT.COM (DEC. 16, 2015), http://useconomy.about.com/od/monetarypolicy/p/Past_Fed_Funds.htm [https://perma.cc/ZG7E-XBTM].

[23] *Id.* ("Throughout recent history, the Fed funds rate usually hovers between 2-5%.").

[24] *See* Amadeo, *supra* note 22 ("January 26-27, 2016: The Committee kept rates at 0.5%. It expects to raise rates to a more normal level (around 2.0%)

As per the chart below, the Fed's discount rate never fell below 1% between 1947 and 2002.[25] During that time period, the Fed tried to maintain the 2% interest rate threshold characteristic of a healthy economy.[26]



[27]

this year. That assumes unemployment remains low and inflation approaches its 2.0% goal.").

[25] *How Low has the Federal Reserve's Discount Rate Fallen in the Past? Has it Ever Fallen to Zero?*, FED. RESERVE BANK OF S.F. (Aug. 2002), http://www.frbsf.org/education/publications/doctor-econ/2002/august/discount-rate-zero [https://perma.cc/4C9R-87C7] [hereinafter *Past Discount Rates*] ("The Board of Directors of the 12 Federal Reserve Banks lowered the discount rate from 1.50 percent to 1.25 percent between December 11 and December 13, 2001. The last time the discount rate was lower than 1.25 percent was in January of 1948, when it was raised from 1.00 percent to 1.25 percent.").

[26] *See* Amadeo, *supra* note 22.

[27] *See Past Discount Rates*, *supra* note 25.

Once the 2008 recession began, this unprecedented economic crisis pushed interest rates below the 1% threshold, a rate that had not existed since before 1947.[28]

On December 16, 2008, the Fed issued a press release relaying its decision to lower interest rates, explaining that key sectors of the economy, including consumer spending, business investment, and industrial production had deteriorated.[29] It noted that the financial markets were "strained," credit lending was "tight," and the general economic outlook was bleak.[30] Further, the press release stated that because prices for energy and other commodities had declined, the Committee expected inflation to "moderate further in coming quarters."[31] The countervailing desires to improve business investment and job growth while also maintaining a low level of inflation and price increases create a challenging economic environment that the Fed must navigate in determining whether to raise or lower interest rates.[32] The Fed felt that the decline in consumer spending and business investment was severe enough to warrant immediate action, so it decided to lower interest rates.[33]

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[28] Press Release, Bd. of Governors of the Fed. Reserve Sys., 2008 Monetary Policy Releases (December 16, 2008), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20081216b.htm [https://perma.cc/D7WK-HVGH] [hereinafter *Monetary Policy*] ("The Federal Open Market Committee decided today to establish a target range for the federal funds rate of 0 to ¼ percent.").

[29] *Id.*

[30] *Id.*

[31] *Id.*

[32] *How does Monetary Policy Influence Inflation and Employment?*, BD. OF GOVERNORS OF THE FED. RESERVE SYS. (Dec. 16, 2015), http://www.federalreserve.gov/faqs/money_12856.htm [https://perma.cc/9PUS-GVCG] [hereinafter *Monetary Policy*] ("[M]onetary policy influences inflation and the economy-wide demand for goods and services--and, therefore, the demand for the employees who produce those goods and services--primarily through its influence on the financial conditions facing households and firms.").

[33] *See id.*

C. Lowering Inflation and Reducing Unemployment: Two, Sometimes Countervailing, Goals of the Fed

Economists generally agree that interest rate fluctuations correlate with changes in both unemployment and inflation.[34] Accordingly, the Fed's monetary policy influences both of these critical economic indicators.[35]

1. Unemployment

The Fed has stated that with respect to unemployment, monetary policy affects demand for goods and services, which in turn influences the demand for the employees responsible for providing those goods and services.[36] When interest rates are lower, both people and corporations are able to borrow money more cheaply.[37] In turn, consumers will buy more goods and corporations will spend more capital on business expansion, including increased employee hiring.[38] This creates a positive loop in which more and more spending occurs.[39] In summation, the lower the interest rates, the more businesses are willing to borrow money, and the more those borrowers are willing to hire employees, thereby creating jobs and lowering unemployment. The Fed does note, however, that there are considerable external forces that also influence unemployment, so the degree of causation between monetary policy and unemployment is still subject to debate.[40]

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[34] *See, e.g.*, *id.* ("Monetary policy also has an important influence on inflation. When the federal funds rate is reduced, the resulting stronger demand for goods and services tends to push wages and other costs higher, reflecting the greater demand . . . .").

[35] *Id.* ("[T]he Federal Reserve has primarily influenced overall financial conditions by adjusting the federal funds rate . . . . Movements in the federal funds rate are passed on to other short-term interest rates . . . . Movements in short-term interest rates also influence long-term interest rates . . . . In turn, these changes in financial conditions affect economic activity.").

[36] *Id.*

[37] *Id.*

[38] *Id.*

[39] *Id.*

[40] *See id.*

2. Inflation

Monetary policy also has a direct impact on inflation.[41] Inflation is defined as "the rate at which the general level of prices for goods and services is rising and, consequently, the purchasing power of currency is falling."[42] For example, if inflation increases, the value of each dollar has less purchasing power.[43] Monetary policy affects inflation because the Fed has the ability to control the amount of money released into the economy, thereby directly influencing the value of the dollar.[44] As the economy improves, demand increases for both the production and consumption of goods and services.[45] Due to this increased demand, employers pay employees higher salaries while also raising prices on their goods and services.[46] Further, when the economy shows signs of improvement, economists begin to speculate about these increases in both costs and salaries, which can fuel inflation further.[47]

While the Fed wants to increase employment, inflation is also an important consideration.[48] In 2008, the Fed explained that it was going to lower interest rates, and specifically indicated that it was not very concerned with the inflation rate at that time.[49] The Fed's

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41 *See, e.g.*, Sean Ross, *How does Monetary Policy Influence Inflation?*, INVESTOPEDIA, http://www.investopedia.com/ask/answers/122214/how-does-monetary-policy-influence-inflation.asp [https://perma.cc/LL54-4NPA].

42 *Definition of Inflation*, INVESTOPEDIA, http://www.investopedia.com/terms/i/inflation..asp [https://perma.cc/4ZBF-W88A].

43 *See Inflation: What is Inflation?*, INVESTOPEDIA, http://www.investopedia.com/university/inflation/inflation1.asp [https://perma.cc/AX3R-CCQV].

44 *See Monetary Policy*, *supra* note 32.

45 *Id.*

46 *Id.*

47 *Id.*

48 Jason Lange & Howard Schneider, *Fed Raises Interest Rates, Citing Ongoing U.S. Recovery*, REUTERS (Dec. 17, 2015), http://www.reuters.com/article/us-usa-fed-idUSKBN0TY2EX20151218 [https://perma.cc/8KYB-8SNW] ("The Fed's policy statement noted the 'considerable improvement' in the U.S. labor market, where the unemployment rate has fallen to 5 percent, and said policymakers are 'reasonably confident' inflation will rise over the medium term to the Fed's 2 percent objective.").

49 *See* Monetary Policy, *supra* note 32 ("Meanwhile, inflationary pressures have diminished appreciably. In light of the declines in the prices of energy

discount rate is inversely related to both inflation and employment, which creates a fundamental economic concern: increasing employment is generally a good thing, but the perception is not the same for increasing inflation.[50] As of 2015, the Fed felt that the need to stimulate the economy was a lower priority concern than the potential risk of inflation, which helps explain why they decided to raise the interest rates.[51] Notably, this type of monetary policy runs divergent to an inflation-targeting approach, whereby the centralized banking system would use inflation as a benchmark for a healthy economy.[52]

D. Conclusion: What Does the US Economy Look Like Moving Forward?

Many financial experts have divergent opinions on how the interest rate hike will affect the American economy.[53] Some experts feel that this hike will bring America's near seven-year expansion to an abrupt end.[54] They note that historically, it has taken at least a year to see the effects of such rate increases and as such, the negative impact will not be palpable until at least 2017.[55] To other economists, it seems that the risk of rising inflation is less detrimental than the

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and other commodities and the weaker prospects for economic activity, the Committee expects inflation to moderate further in coming quarters.").

[50] Greg DePersio, *What Happens When Inflation and Unemployment are Positively Correlated?*, INVESTOPEDIA, http://www.investopedia.com /ask/answers/040715/what-happens-when-inflation-and-unemployment-are-positively-correlated.asp [https://perma.cc/5WR6-T27N].

[51] *See* Lange & Schneider, *supra* note 48.

[52] *See Inflation Targeting*, INVESTOPEDIA, http://www.investopedia.com /terms/i/inflation_targeting.asp [https://perma.cc/T5AF-V76B].

[53] *See* Davidson, *supra* note 4 ("'In the end, the pace [of future rate increases] will be determined by the data and financial markets developments. We remain skeptical that the pace will be as gradual as is being suggested, mainly because we expect the unemployment rate to keep falling, eventually leading to more upward pressure on inflation. For now, though, it makes sense for officials to be as reassuring for markets as they can without compromising their flexibility later.' *—Jim O'Sullivan*, *High Frequency Economics."*). *But see* Russell & Applebaum, *supra* note 4 ("Officials said the economy was strong enough to keep growing with a little less help from the central bank.").

[54] Nelson D. Schwartz, *Rates Are Going Up. What Could Go Wrong?*, N.Y. TIMES, Dec. 20, 2015, at B1.

[55] *Id.*

danger to American growth, caused by too little inflation.[56] The chief US economist at Barclays noted the "risk is skewed toward moving too fast . . . . That's especially true as the strong dollar and lower-priced imports keep inflationary pressures at bay in the United States."[57] In light of the above, it seems that some predominant expert opinions agree with the Fed; inflation is not the main concern and the focus needs to remain on continued economic growth. Only with time will the truth become clear, as the US nears the end of the eighth year since the Great Recession. Perhaps the economists working for the big banks do not want to see growth stymied because of its effect on their margins; but perhaps they are correct, and we will see a significant stagnation in employment growth and output growth in the near future.

Harrison Freeman[58]

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[56] *Id.*
[57] *Id.*
[58] Student, Boston University School of Law (J.D. 2017).