Session 5: Changing Interest Rates

When the money supply is changed, interest rates also change. In fact, an increase or decrease in short-term rates is what the Fed is trying to achieve in authorizing its open market operations. This is done through utilizing the market forces of supply and demand.

As reserves increase and the money supply expands, the interest rate known as the federal funds rate drops. That is the rate that banks charge each other for very short-term, overnight loans. A drop in the federal funds rate results in an immediate drop in the prime rate. That rate determines the interest rate banks charge on consumer and business loans. And when the cost of borrowing drops because the supply of money increases, demand for borrowing increases.

The opposite is true when reserves decrease and the federal funds rate increases. In this case, the prime rate increases, the price of borrowing increases, and demand for loans decreases. Reduced borrowing slows spending, which in turn slows economic expansion. While the federal funds rate may change in response to supply and demand without Fed action, it always changes when the Fed buys and sells.

The difference between the federal funds rate and the prime rate is known as the "spread". It is typically three percentage points, although not exactly and not always. For example, if the fed funds rate is 2.25%, the prime rate is 5.25%. If the Fed raises rates to 2.50%, the prime rate will rise in lockstep to 5.50%.