Fed Announces Gradual Rise in Rates

Unanimous FOMC vote raises Federal Funds Rate

The Fed has kept us wondering when interest rates will begin their upward climb. A December 16th Federal Reserve press release[1] announced that the Federal Open Market Committee (FOMC) has decided to raise the target range for the federal funds rate by ¼ of a percent to the 0.25% to 0.50% range, the first increase in nine years. Since the FOMC met in October, economic activity has been expanding at a moderate pace.

Although inflation is below the Committee's 2% objective for a rise in rates, household spending and business fixed investments have increased in past months and the housing sector and labor market have shown improvement. Considering these factors and the length of time it takes for policy changes to affect future economic outcomes, the Committee voted unanimously in favor of a gradual increase in rates.

In a conference following the press release on December 16th, Federal Reserve Chair, Janet Yellen noted "This action marks the end of an extraordinary seven-year period during which the federal funds rate was held near zero to support the recovery of the economy from the worst financial crisis and recession since the Great Depression. It also recognizes the considerable progress that has been made toward restoring jobs, raising incomes, and easing the economic hardship of millions of Americans. And it reflects the Committee's confidence that the economy will continue to strengthen."[2]

Chair Yellen later posed a question that was likely weighing on the minds of industry professionals. "With inflation currently still low, why is the Committee raising the federal funds rate target?" She cited "transitory factors", namely the sharp decline in energy prices, of which the effects should dissipate with time allowing inflation to increase to the 2% threshold. Additionally, Chair Yellen noted the time it takes for monetary policy action to affect the economy. Further delay in policy normalization could lead to abrupt tightening in monetary policy and push the economy into recession.

Contrary to the amount of attention this increase has and will receive by media outlets, for investors, this particular increase is relatively insignificant as it was both small and expected. Since the move was anticipated for most of 2015, it did not initiate volatility in the already adjusted markets.

This rise in the federal funds rate is not a one-time event but signals that the rate will continue to slowly increase. Future rate increases may cause further market adjustments, the severity of which largely depends on the speed and magnitude of such increases. Despite the struggling global economy, this action by the FOMC is a sign of confidence in the strength of the U.S. economy.

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[1] Press Release. Board of Governors of the Federal Reserve System. 16 December 2015.
[2] Transcript of Chair Yellen's Press Conference. Board of Governors of the Federal Reserve System. 16 December 2015.

For more information on the impact of rising rates, read our August 2015 article, The Buzz on Interest Rates.

For the full text of the Federal Reserve press release, please visit their website.