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INSIGHT

Why Is the Federal Reserve Reducing Interest Rates?

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On September 18, 2024, the Federal Reserve (Fed) reduced interest rates to a target range of 4.75%-5%. This was the first rate cut since March 2020, and the Fed expects to continue cutting rates this year and beyond.

Why is the Fed cutting interest rates? And why did it decide to reduce rates by 0.5 percentage points (50 basis points), instead of the more standard 0.25 percentage points?

Background

The Fed has a "dual mandate" to promote price stability and maximum employment. The Fed targets the federal funds rate—a short-term interest rate in the interbank lending market—to balance those goals. It reduces rates when employment or inflation is too low and raises rates when either is too high. For an explanation of how changing interest rates affects the economy, see CRS In Focus IF11751, *Introduction to U.S. Economy: Monetary Policy*.

Recent Policy Changes

In March 2020, the Fed reduced interest rates to a range of 0%-0.25% (as well as taking other extraordinary measures) in anticipation that economic disruptions from the pandemic would reduce employment and inflation (see **Figure 1**). Initially, this proved correct—in April 2020, the unemployment rate peaked at 14.8%, and the Fed's preferred measure of inflation (the personal consumption expenditures price index) fell below the Fed's target of 2%. Concerned about the strength of the subsequent recovery, the Fed kept interest rates at that level until March 2022, even though by then unemployment had fallen to 3.6%—unusually low by historical standards—and inflation had risen to 6.9%. It then initiated a series of rate increases through July 2023, eventually raising rates to a range of 5.25%-5.5%—the highest since 2001. For the next year, the Fed kept rates constant, although inflation was still above the Fed's target. In the Fed's judgment, inflation would continue to fall without any additional rate increases. Inflation has continued to fall, although it has taken longer than the Fed expected.

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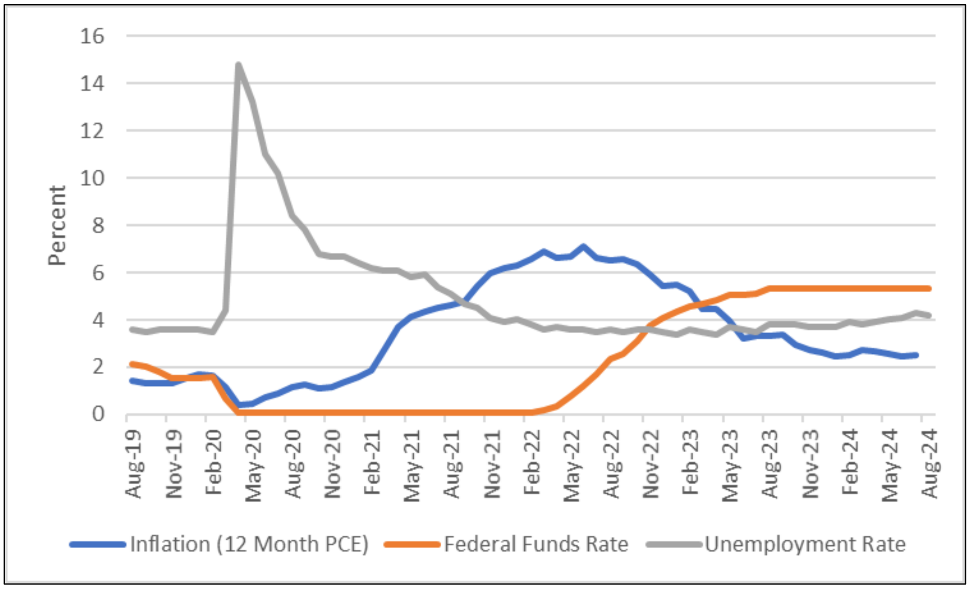
Figure 1. Monetary Policy and the Economy

August 2019 to August 2024



Source: Federal Reserve, Bureau of Labor Statistics, Bureau of Economic Analysis.

Although the Fed initially expected to cut rates in the first half of 2024, inflation in the first three months of the year unexpectedly rose to 3.4% on annual basis—and was even higher if food and energy prices were removed. As a result, the Fed held off on any rate cuts until September after a few low monthly inflation readings gave it more confidence that inflation was heading back to 2%. Nevertheless, the Fed chose to reduce rates before inflation reached 2%—inflation was 2.5% over the past 12 months, although it was lower in the past three months. At the same time, the Fed is concerned that the rising unemployment rate poses a risk to maximum employment.

Analysis

The Fed's statement accompanying its decision said that "the risks to achieving its employment and inflation goals are roughly in balance." One might assume that balanced risks would call for keeping interest rates unchanged. But economists view the monetary policy stance in relation to the natural rate of interest—the interest rate that in theory would neither stimulate nor slow economic activity. Although the natural rate is unobservable and subject to uncertainty, most economists believe that rates are still above the natural rate—in other words, they are contractionary—even after the recent rate cut. For example, at the current inflation rate, the New York Fed estimates the natural rate to be about 3.75%. The Fed aims to have actual interest rates close to the natural rate when the risks are roughly in balance. At the same time, the Fed does not want to change rates too suddenly or unexpectedly, generally preferring to change rates by 0.25 percentage points at a time. But in the current context, it judged that reducing rates by 0.25 percentage points every six weeks would have moved rates toward the natural rate too slowly to keep unemployment low and inflation near its target, so it chose to reduce the target by 0.5 percentage points instead.

This larger reduction also poses risks. Given how high inflation was from 2021 to 2023, there is a risk that reducing rates before inflation has fallen all the way to 2% will work against restoring price stability. Because the Fed tries to avoid frequent and sudden reversals in policy, a more gradual approach would have given the Fed more time to see how these risks evolved. The potential for financial market euphoria in response to a large rate cut also poses a risk to inflation.

However, there is also a growing risk to the employment part of the Fed's mandate that calls for lower rates. Although unemployment is still relatively low, it has risen steadily over the past year—to 4.2% in August 2024—and job growth has slowed in the past five months. According to one popular recession predictor, when unemployment has risen this much in the past, a recession has resulted. Although the current labor market is unique and most economists do not currently predict a recession, this points to the risk of keeping rates high.

Some observers have argued that the Fed should not cut rates this close to the election. A look at the Fed's reasoning underpinning the September rate cut supports Chair Powell's claim that the Fed's decision was not influenced by the election cycle. Before September, the Fed felt too uncertain about the inflation outlook to reduce rates. With the recent slowdown in the job market, the Fed worried that waiting longer to cut rates would pose a risk to maintaining maximum employment. The Fed often describes its policymaking as data driven—given the recent movement in inflation and unemployment data, a decision to not cut rates could have been viewed as a departure from a data-driven approach. Thus, choosing not to cut rates could have also been viewed as being influenced by the election cycle regardless of whether the Fed's decision to cut rates ultimately proves correct.

Author Information

Marc Labonte
Specialist in Macroeconomic Policy

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