What is the Federal Funds Rate?

When banks do not have enough reserves to meet the required reserve ratio (the ratio of reserves to deposits established by the FED), they can obtain overnight loans from two sources: (1) from the Discount Window (see below) and (2) by borrowing from other banks.

The Federal Funds rate is the rate that banks charge one another for overnight loans. The FED acts as broker for bank to bank overnight loans and sets a target for the Federal Funds rate. Depository institutions are required to keep a specified percentage of deposits as cash on hand or reserves with the FED branches. The federal funds rate is targeted at a specific level each month by the FED, through its Federal Open Market Committee.

The federal funds rate is one of the monetary policy tools used by the FED to directly influence the money supply. If the federal funds rate is high, commercial banks for example will be less willing to borrow money from the FED to keep their reserves at the required level, which means the banks will loan less money to the public. If the commercial banks do make loans, the loans will have a higher interest rate, as the banks are paying a higher interest rate to borrow. Because loans are harder to get and more expensive, businesses and consumers will be less likely to borrow.

When the federal funds rate is low, the scenario is vice versa. Banks will be more willing to make loans because it is cheaper to borrow from the FED. Businesses and consumers will also be more willing to borrow at cheaper interest rates.

What is the Discount Rate?

The discount rate is the interest rate charged to depository institutions on loans they receive from their regional FED branch.

According to the FED website there are three different discount window programs it offers to depository institutions. The three discount t windows are: primary credit, secondary credit, and seasonal credit. Each discount window has its own interest rate.

The primary credit is the FED's main discount window program. Under this program the FED lends to depository institutions which generally have a strong financial position. The discount rate charged for primary credit (or the primary credit rate) is set above the usual level of short-term market interest rates. The loans are issued for short periods, typically overnight.

The secondary credit program is for depository institutions which do not qualify for the primary credit program. The depository institutions who borrow under this program usually are under financial stress and are in need of the loan to financial problems. The discount rate on secondary credit is higher than the primary credit rate.

The seasonal credit program is provided to banks in agricultural or seasonal resort communities as they experience high degree of variability. The discount rate for seasonal credit is an average of selected market rates according to the FED website.

A map of the twelve FED districts is available online from www.federalreserve.gov.

Last Updated: March 22, 2010
