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How Federal Interest Rates Work

Story by Dawn Papandrea

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Text Callout : Key Takeaways - How Federal Interest Rates Work

Here is a look at the complex system that dictates federal interest rates and how rates could impact your finances.

How Do Interest Rates Work?

Interest rates can be considered the price of borrowing money.

"Quite simply, it's the amount charged to a borrower by a lender for use of an asset, expressed as a percentage of the principal value," says Peter C. Earle, economist and writer at the American Institute for Economic Research.

Assets borrowed could include a car, home, business property or cash.

Your interest rate will depend on whether you are borrowing money from a credit card issuer, taking out a loan or saving money in a bank account. The annual percentage rate, or APR, is the yearly cost of borrowing and includes fees, unlike the interest rate.

Credit cards: Most credit cards come with an interest rate that is expressed as an APR. A credit card can either have a fixed APR or variable APR for purchases that will be based on your credit score.

Loans: Whenever you take out a loan, the lender will charge you interest as a way to manage risk. A loan that is secured by property may have a lower interest rate than an unsecured loan, such as a personal loan.

Savings accounts: In this case, the bank pays you interest when you open a savings account and keep funds on deposit. It can then use your cash to make loans.

Interest rates for savings accounts, certain types of loans and credit cards are influenced by the federal funds rate. *

Lender Rate Table : Mortgage Purchase Rate table

What Is the Federal Funds Rate?

The federal funds rate is the target interest rate set by the Federal Reserve – the U.S. central bank – that banks use for overnight lending. The Federal Open Market Committee within the Federal Reserve meets eight times yearly, or about every six weeks, to determine a target range. As of January 2024, the target rate is between 4.25% and 4.5%.

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Lower interest rates mean cheaper loans, and cheaper loans should mean more spending to help financial markets recover. More spending also tends to spur inflation, so the Fed closely watches inflation numbers. If inflation gets too high, the Fed may opt to increase interest rates. The Fed maintains an annual inflation target of 2%, meaning goods and services get 2% more expensive each year.

All depository institutions, such as banks or credit unions, are required by the Fed to keep a certain amount of cash on hand each night. If a cash reserve falls under that amount, one bank can borrow funds from another to meet the requirement.

Financial institutions base interest rates for consumers on the Fed's rate and offer their lowest-risk customers what's known as the prime rate. This rate is generally 3 percentage points higher than the federal funds rate and is the best possible interest rate you can get when you borrow money. If your credit isn't ideal, you should expect higher rates.

When the Fed rate rises or falls, it influences consumer interest rates, such as those on home equity lines of credit, credit cards and car loans.

The federal funds rate is also used as a benchmark for setting the interest rates you can earn on deposit accounts. That includes savings and money market accounts and certificates of deposit. Generally, deposit rates increase and decrease along with the Fed's rate.

What Is Today's Federal Interest Rate?

At the Federal Open Market Committee's January meeting, the rate held steady at a target range of 4.25% to 4.5%. The decision follows a quarter-point rate cut in December.

How Do Changing Interest Rates Affect You?

Interest rate changes can have both negative and positive effects, depending on whether you're trying to borrow or save. Changes in interest rates might influence whether you can afford major life purchases, such as a home, a car and even a college education.

Low-interest-rate environments help prospective buyers afford mortgage loans and refinances. A more competitive homebuying market also pushes prices higher, fueling inflation. A rise in rates flips the script, however. Borrowing may be more costly, while opening certificates of deposit or savings accounts could become more lucrative.

"Small changes in a short amount of time usually don't have much of an effect on individual consumers or savers," Earle says. "But the level of interest rates over a longer time period definitely affects the consumer's propensity to (spend) versus to save."

Also worth noting is that, as rates rise, the disposition of lenders changes, Earle says. "Meaning that some lenders will increase or decrease their willingness to loan funds based upon changes in prevailing interest rates."

What Should You Do When Interest Rates Fall?

You can take advantage of low interest rates to improve your financial situation. You might consider making some of these moves:

- Buy a home or car.
- Refinance your mortgage.
- Refinance a student loan or car loan.
- Pay off or transfer high-interest credit card balances.
- Choose investments that help hedge against inflation, such as gold, commodities and Treasury inflation-protected securities, known as TIPS.

What Should You Do When Interest Rates Rise?

Borrowing can become more expensive. On the positive side, savings accounts should begin to earn higher yields as interest rates rise. Here are some tips on how to adjust to higher rates.

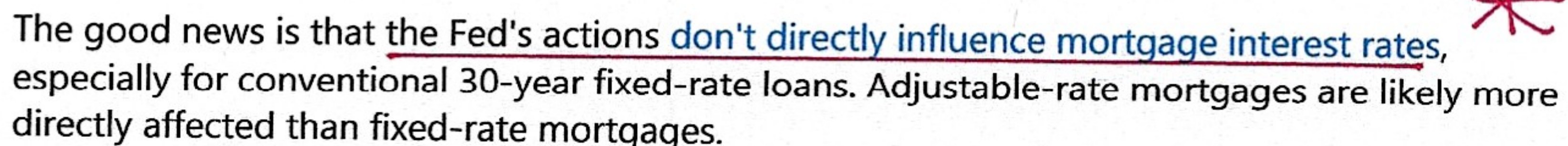
Credit cards: Work to pay off high-interest credit cards if you are carrying balances, which will cost you more when interest rates go up and could cause you to fall into a cycle of debt.

The most affordable method to pay down credit card debt is to target the balance with the highest interest rate first. This is known as the debt avalanche method.

If you need motivation to stay on track, you can use the snowball payoff method instead. Rather than tackling the balance with the highest interest rate first, you focus your efforts on paying off the smallest balance.

The snowball method may cost you more in the long run compared with the avalanche method, but it could pay off if you end up with no credit card debt.

Loans: Even a small increase in the federal funds rate could dramatically affect your ability to make a major purchase, such as a home.



The good news is that the Fed's actions don't directly influence mortgage interest rates, especially for conventional 30-year fixed-rate loans. Adjustable-rate mortgages are likely more directly affected than fixed-rate mortgages.

A few other factors also affect your mortgage rate: credit score, loan size and down payment amount.

Improving your credit score is a wise long-term strategy to blunt the effect of higher interest rates on any type of loan. Generally, the higher your credit score, the lower your interest rate may be.

Savings accounts: Rising interest rates are ideal for your savings account because it should earn more money, Earle says.

"If a bank depositor wants to take advantage of rising interest rates, they might do well to see what savings accounts, CDs and other instruments are paying the highest rates local to them," he says.

Community banks and credit unions tend to offer some of the most competitive rates, as do online banks. Fortunately, plenty of online rate aggregators updated regularly let you search for the best savings rates with just a few clicks.

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