

Why interest rates matter

by Sophia Yudkowsky, CFP®

If you have ever applied for a mortgage or financed a car, you may have noticed that sometimes the interest rate being charged for the loan is relatively low, and sometimes it is much higher. Why?

Interest Rates

An interest rate is defined as the cost of borrowing. In the simplest form, an interest rate will be quoted as a percentage of the value of a loan. For example, a \$100,000 loan with an annual interest rate of 5% will cost the borrower \$5,000 annually. Interest rates play a part in almost all areas of our daily financial lives; whether it is borrowing money to purchase a home in the form of a mortgage or lending money to the bank in the form of deposits. In the former, the consumer is the borrower and is liable for interest rates whereas in the latter the bank is the borrower and pays interest to the consumer.

Interest rates are impacted by several economic factors as well as government policy. One of the key drivers is something known as the Federal Funds Rate.

What is the Federal Funds Rate?

In the United States, the Central Bank is known as the Federal Reserve (the "Fed"). The Fed is an autonomous and independent institution separate from the executive and judicial branches of government. For this article, it is important to make the distinction between Congress' power versus that of the Fed. Congress directs Fiscal Policy (i.e. taxes and government spending) whereas the Fed oversees Monetary Policy (i.e., interest rates and money supply).

The Fed has a dual mandate to ensure price stability and sustainable economic growth through full employment. While there are limitations around what the Fed can and can't do, one of the main tools at its disposal is setting something called the target Federal Funds Rate ("Fed funds rate"). The Fed funds rate is the rate that banks charge each other on overnight loans to meet their reserve requirements. This rate is revised eight times per year by the Federal Open Market Committee ("FOMC"), a committee within the Fed. While the Fed can't mandate what interest rates the banks charge each other on this overnight lending, they have several ways that they can try to influence the rate to get to their target. One of the most common ways is by increasing or decreasing the money supply.

Let's use the analogy of a gas and brake pedal to illustrate how the Fed uses the Fed funds rate and the money supply to influence the economy.

- If the Fed is trying to slow down the economy, it will "step on the brake" by increasing the Fed funds rate. By making the cost of borrowing more expensive, there will be less economic activity.
- On the other hand, if the Fed sees a need to stimulate the economy (think of Coronavirus stimulus), it will "step on the gas" and increase the money supply, thereby decreasing the cost of borrowing and leading to more economic activity.

The Fed funds rate is one of the most important interest rates in the US economy. It sets the standard for almost every other interest rate we see as consumers. The Fed funds rate also has an impact on the market, which is why many investors like to pay close attention when the Fed meets. Investors often see lower interest rates as a signal that the economy will be picking up and people and businesses will be increasing their spending. With a lower-rate environment, businesses are more likely to borrow money and spend. This stimulates the economy in a variety of ways, since businesses will not only be producing more goods, but will also be able to hire more people and boost the economy even further. This can often lead to positive moves in the market as people expect the businesses to be impacted favorably. Additionally, with bonds offering lower interest rates, investors may prefer investing in the stock market rather than the bond market.

Reach out to your wealth advisor to see how changes in interest rates may impact your personal financial situation.

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