

The Federal Reserve and the economy

DATA BRIEF
MARCH 2026

Overview: The Federal Reserve and the economy

Federal Reserve (Fed) chair Jerome Powell's term will end in May 2026. As the Senate considers President Trump's nominee to replace him, questions will arise about the Federal Reserve's role, how it functions, and its impact on the economy, prices, and the workforce.

The Federal Reserve raised interest rates and reduced its balance sheet to slow price increases after the economic disruptions of the COVID-19 pandemic and the subsequent inflation surges. As labor market conditions have recently softened and inflation has slowed (but remains above the Fed's target), the Federal Reserve has begun easing policy. In 2025, the Fed lowered the federal funds target rate three times, bringing it to a range of 3.5% to 3.75%. It also began expanding its balance sheet after a reduction period that lasted from March 2023 through December 2025. The Fed expands its balance sheet by buying securities and reduces its balance sheet by either selling securities or not reinvesting once its securities mature.

This brief summarizes the Federal Reserve's role in the economy, the tools it uses to carry out monetary policy, and recent trends in inflation and employment that shape those policy decisions.

Data summary

- Inflation has slowed but has remained above the Fed's target of 2% since 2021, with the Personal Consumption Expenditures (PCE) price index (the Fed's preferred inflation metric) averaging about 2.9% in 2025. As of January 2026, inflation was 2.8%.
- The unemployment rate rose to an average of 4.3% in 2025, a second consecutive annual increase, though it remained below long-term historical averages. Unemployment was 4.4% in February 2026.
- The employment-to-population ratio for adults ages 25-54 is near historic highs, but has recently declined. It averaged 80.6% in 2025, about one point below its 2000 peak after declining for the first time since 2020.
- The Federal Reserve began easing monetary policy in 2025 due to slowing inflation and a softening labor market. The Fed lowered the federal funds target range three times during the year, bringing it to 3.5%–3.75%. It began expanding its balance sheet in mid-December 2025 after reducing it from March 2023 through early December 2025.

What is the Federal Reserve?

The Federal Reserve (Fed) is the US central bank, created by the Federal Reserve Act of 1913. It was initially created to address banking crises, but now it is charged with several broader responsibilities to promote a healthy economy:

Federal Reserve responsibilities

- 1 Conduct monetary policy (dual mandate)
- 2 Promote stability in financial system
- 3 Supervise and regulate financial institutions
- 4 Foster payment system safety
- 5 Promote consumer protection

Source: Federal Reserve System

How is the Fed structured?

The Federal Reserve System has three parts: the Board of Governors (Board), 12 Federal Reserve Banks, and the Federal Open Market Committee. The Board is an independent federal agency that reports to, and is directly accountable to, Congress. This means the Board must explain, justify, and report its actions to Congress, though it makes policy decisions independently. The Chair of the Board of Governors typically chairs the Federal Open Market Committee, with the President of the New York Federal Reserve Bank serving as Vice Chair.

Federal Reserve structure

Body	Number of members	Term length	Nominated by	Accountable to
Board of Governors (Board)	Seven governors; including a Chair and Vice Chair	14 years for governors; Chair and Vice Chair can serve additional four-year terms	US President	US Congress
12 Federal Reserve Banks	12 presidents	Five years	Board of Governors	Directors of corresponding district bank
Federal Open Market Committee (FOMC)	12 voting members (including Board, President of the New York Fed, and four bank presidents*) Chaired by the Board Chair and the NY Fed president as Vice Chair	Board and New York President are permanent members One-year terms for presidents on rotating basis	US President (Board members) and Board of Governors (bank presidents)	US Congress (through the Board of Governors)

Source: Federal Reserve System

* The remaining seven Reserve Bank presidents attend the FOMC meetings and participate in deliberations but do not vote.

To what extent is the Fed independent?

Although Congress oversees the Federal Reserve, it is designed to operate with policy independence from day-to-day political direction. The Fed was established with structural characteristics that contribute to its independence:

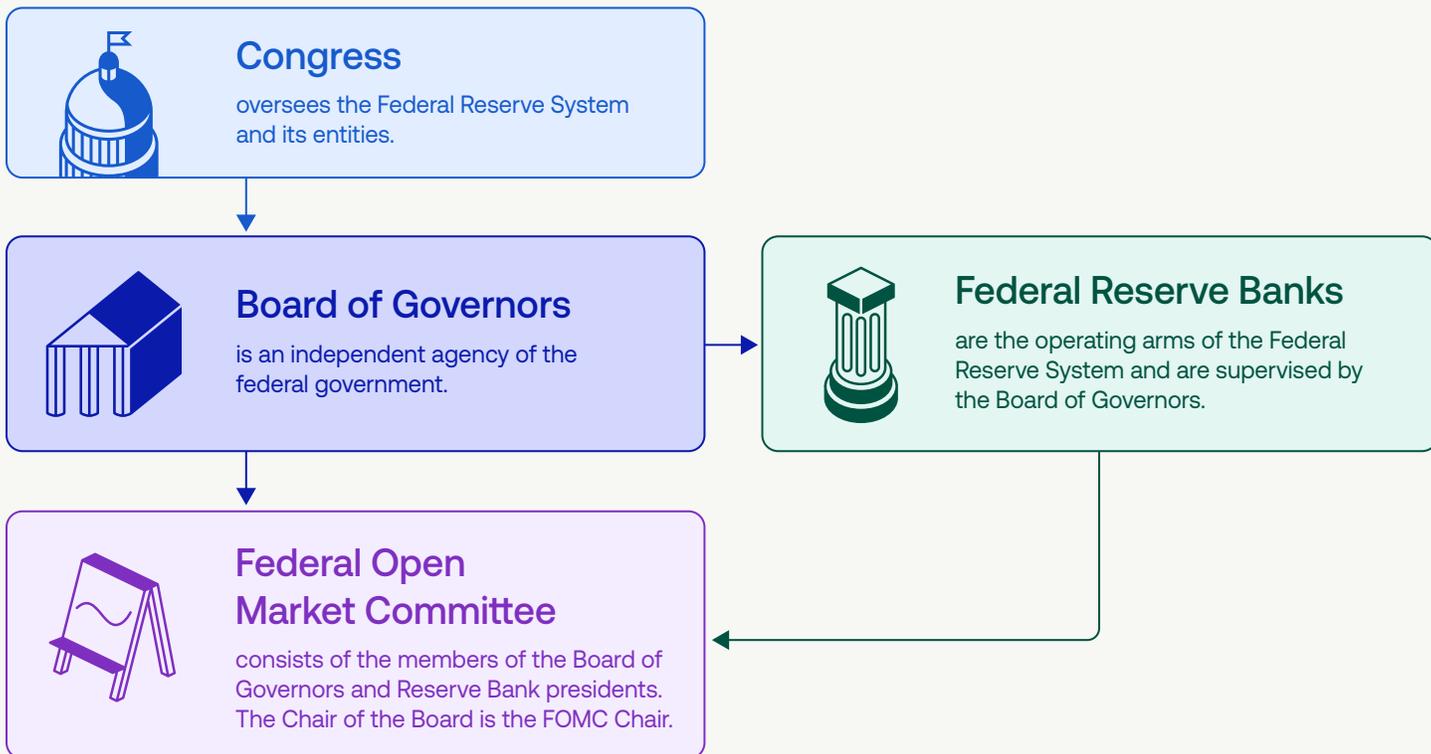
- The Fed is self-funded and not subject to appropriations. It funds its operations primarily through interest earned on its securities holdings.
- The governors who lead the Board serve long, fixed terms and may be removed only “for cause.”
- The Fed’s regional bank presidents are not appointed by the President, and the Fed’s policies are not subject to Office of Management and Budget (OMB) review.

Independence is supported by longstanding institutional practices that emphasize nonpartisan, consensus-based decision-making.

What are the responsibilities of the Board of Governors?

The Board guides the Federal Reserve System’s operations to fulfill its goals and responsibilities. It oversees the operations of the 12 Federal Reserve Banks, with whom it shares responsibility for supervising and regulating financial institutions and activities. The governors are also automatic members of the Federal Open Market Committee.

Federal Reserve entities

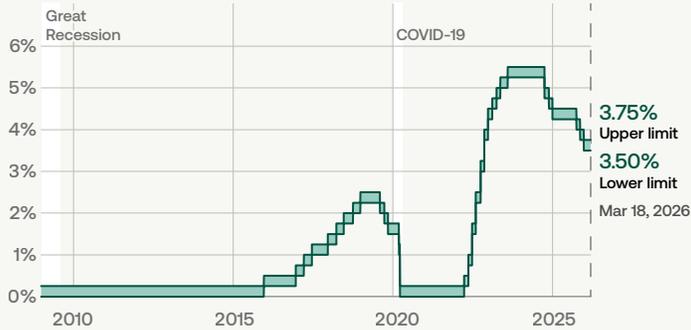


Source: Adapted from Federal Reserve System

How does the Fed change interest rates?

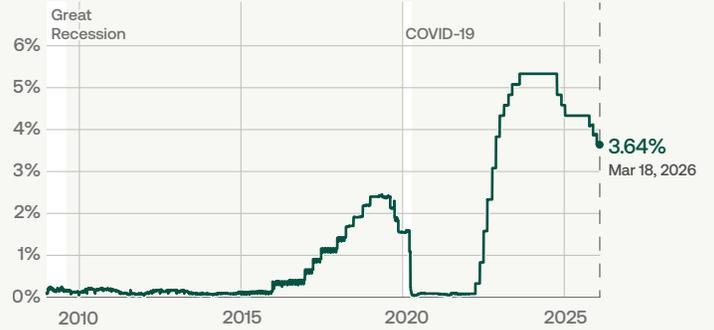
When necessary, the Fed adjusts monetary policy. It does this primarily by raising or lowering its target range for the federal funds rate, which is an interest rate for overnight borrowing between banks. Transactions in this market typically occur within the target range, and the average rate across all overnight transactions is known as the “effective federal funds rate.”

Target federal funds range



Source: Federal Reserve Bank of St. Louis

Effective federal funds rate



Source: Federal Reserve Bank of St. Louis

Short-term interest rates

When the Fed lowers the federal funds rate target range, short-term borrowing becomes cheaper for banks, which can make it easier for them to extend credit to households and businesses. Lower borrowing costs can increase demand for loans, which supports spending, investment, and employment. The Fed typically uses this approach during periods of economic weakness. For example, during the COVID-19 pandemic, the target range was reduced to near zero.

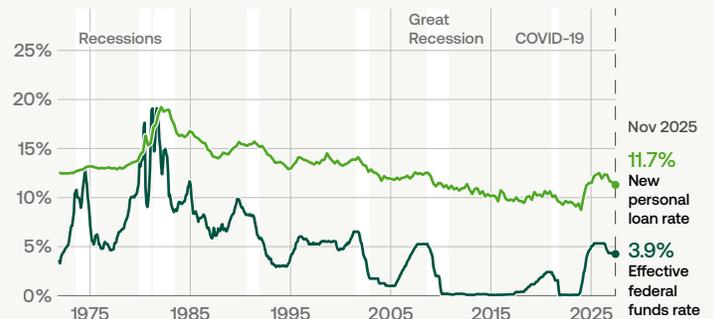
When the Fed raises the target range, borrowing becomes more expensive. Higher interest rates tend to reduce loan demand, slow spending and investment, and help limit price increases. The Fed may raise rates when inflation is elevated, as it did in 2022. Interest rates on consumer loans, such as auto loans and personal loans, often rise and fall alongside changes in the federal funds rate, reflecting shifts in borrowing costs.

Commercial bank rate on new 48-month auto loans vs. monthly effective federal funds rate



Source: Federal Reserve Bank of St. Louis

Commercial bank rate on new 24-month personal loans vs. monthly effective federal funds rate



Source: Federal Reserve Bank of St. Louis

Long-term interest rates

Expectations about future Fed policy affect longer-term borrowing costs. Those expectations are reflected in yields on longer-term Treasury securities. As expectations about future interest rates, inflation, or economic conditions change, the 10-year yield moves as well. Many long-term borrowing rates — such as the 30-year fixed mortgage — tend to move in the same direction.

Yield on 10-year Treasury securities vs. 30-year mortgage rate

Monthly average



Source: Federal Reserve Bank of St. Louis

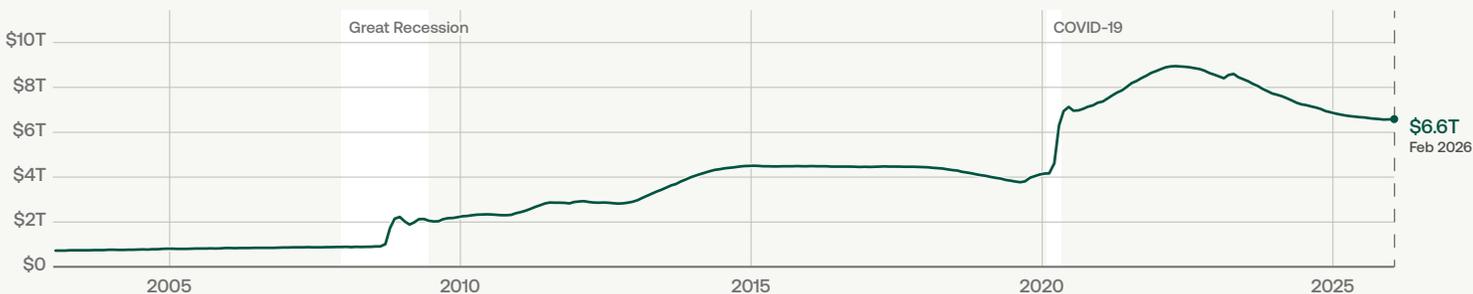
What does the Fed do when changing interest rates is not enough?

When interest rates are already very low, or when financial markets are under stress, rate changes alone may not be enough to influence broader financial conditions. In these instances, the Fed can buy and sell securities, called “open market operations.” When the Fed buys government securities, also known as “expanding its balance sheet”, it increases demand for those bonds, which raises their prices and lowers their yields, helping reduce long-term interest rates across the economy. This can make borrowing cheaper for households and businesses even when short-term rates are near zero. The Fed used this approach during the COVID-19 pandemic, rapidly expanding its balance sheet to support financial markets and help keep borrowing costs low.

When inflation rose post-COVID-19, the Fed reduced its balance sheet to help take money out of the banking system, raise long-term interest rates, and make borrowing more expensive for households and businesses. The amount of securities the Fed holds remains elevated above pre-pandemic levels, however.

Federal Reserve total net assets

Monthly average



Source: Federal Reserve Bank of St. Louis

What other tools does the Fed use to change monetary policy?

The Fed also influences economic conditions by communicating future policy paths. Because many financial decisions in the private sector depend on expectations of future interest rates, signals from the Fed about how it may respond to economic conditions can affect financial markets even before any policy changes. This approach, known as “forward guidance,” shapes expectations about future borrowing costs, inflation, and economic growth. Forward guidance appears in FOMC statements, economic projections, and press conferences.

For example, during the pandemic, the Fed stated its intention to keep interest rates near zero until economic conditions improved. This helped shape expectations about future policy and reduced uncertainty during this severe economic disruption. As inflation rose after the pandemic, the Fed also used forward guidance to signal that it would begin raising interest rates, preparing the markets for a gradual tightening of policy to help limit price increases.

Evaluating the dual mandate: price stability

Personal Consumption Expenditures (PCE) price index

To assess price stability, the Fed has stated a longer-run inflation objective of 2% as measured by the Personal Consumption Expenditures (PCE) price index; however, this is not set in law. Although inflation can be measured in different ways, like the commonly used Consumer Price Index (CPI), the Fed prefers the PCE index because it better reflects changes in consumer spending patterns.

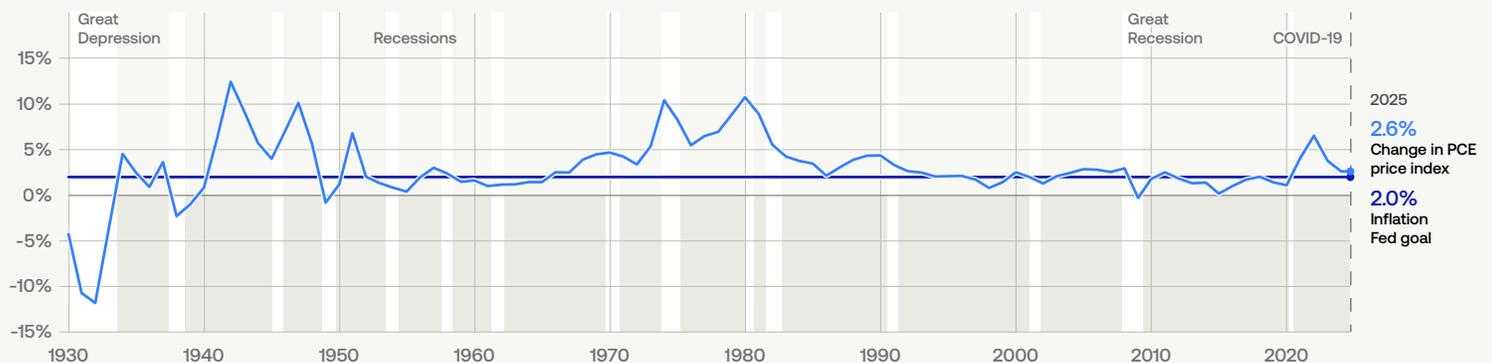
The year-over-year change in the PCE price index has been above the Fed’s 2% goal since February 2021. As of January 2026, the rate was at 2.8%. Shorter-term inflation measures can fluctuate from month to month. However, looking at inflation over a longer period provides additional context: from 2000 to 2025, the average annual PCE price index increase was about 2.2%. Inflation has averaged higher over an even longer period, about 2.9% since 1930, largely driven by high inflation in the late 20th century.

Year-over-year percent change in Personal Consumption Expenditures (PCE) price index



Source: Federal Reserve Bank of St. Louis

Annual percent change in Personal Consumption Expenditures (PCE) price index



Source: Federal Reserve Bank of St. Louis

How have inflation trends evolved over time? Where do they stand today?

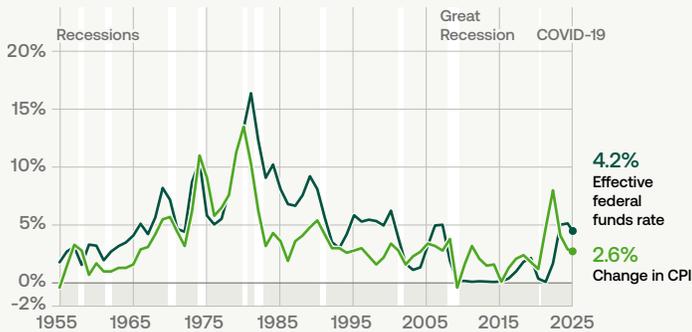
While the Federal Reserve defines its inflation objective using the PCE price index, the Consumer Price Index provides a longer historical view of inflation and is commonly used to describe changes in consumer prices over time.

Historically, inflation has varied in response to economic conditions. During the Great Recession (2007–2009), inflation cooled, and prices briefly declined. Conversely, during the COVID-19 pandemic, inflation reached a 40-year high. Over these periods, inflation and monetary policy moved together. The effective federal funds rate decreased during the Great Recession and was near zero in the years afterward. The Fed increased the rate during the post-pandemic period when inflation spiked.

The average monthly inflation rate in 2025 was 2.6%. It was slightly lower than the 2024 average rate of 2.9%, and lower than the 2019–2024 average rate of 3.8%. In February 2026, year-over-year inflation was 2.4%, unchanged from the month before.

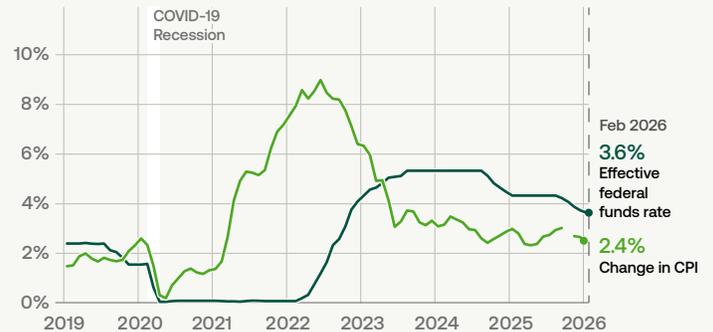
Because monetary policy affects borrowing costs, spending, and investment gradually, changes in economic activity — and ultimately inflation — often appear with a delay after policy adjustments. It is also important to note that many factors beyond interest rates, including supply chains, energy prices, and global economic conditions, also influence prices.

Annual percent change in Consumer Price Index (CPI) vs. annual effective federal funds rate



Source: Bureau of Labor Statistics and Federal Reserve Bank of St. Louis

Year-over-year percent change in Consumer Price Index (CPI) vs. monthly effective federal funds rate



Source: Bureau of Labor Statistics and Federal Reserve Bank of St. Louis
Note: Consumer price index data is seasonally adjusted. Due to the 2025 government shutdown, the BLS did not publish October 2025 data.

Evaluating the dual mandate: Maximum employment

The Fed’s second mandate, maximum employment, does not correspond to a single fixed number. Instead, it evaluates a range of labor market indicators to assess the employment picture. These indicators include unemployment, the employment-to-population ratio, labor force participation, job openings and hiring rates, wages and wage growth, and hours worked. Together, these capture worker supply and employer demand. Monetary policy affects these measures indirectly — and with a lag. Long-term factors such as population aging, educational trends, and caregiving responsibilities can also influence labor market outcomes independently of economic conditions.

Unemployment rate

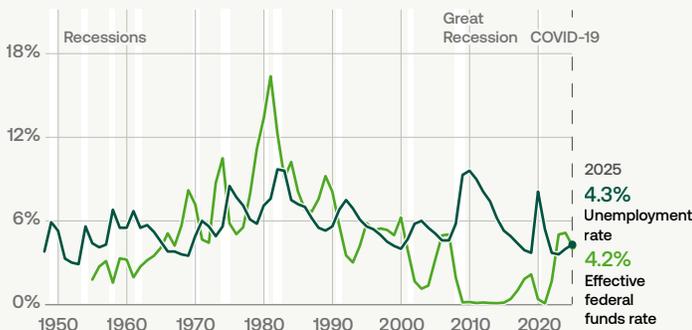
The unemployment rate measures the share of people in the labor force who are actively seeking work but not currently employed. It is one of the most cited labor market indicators. The public understands this well-known metric, making it useful for communicating the state of the economy. It’s measured the same way over time and updated every month, allowing for consistent comparisons. Also, sharp changes in the unemployment rate have historically signaled economic downturns, making it a useful indicator when the economy begins to slow. The unemployment rate increased during each of the last 12 US recessions.

In 2025, the average annual unemployment rate was 4.3%, marking the second consecutive year of rising unemployment. Even so, this level remained below the long-term average (1948–2025) of 5.7%, which is also the 21st-century average.

As of February 2026, the unemployment rate was at 4.4%. This was 0.2 percentage points above February 2025, and 0.9 percentage points above the pre-pandemic level in February 2020.

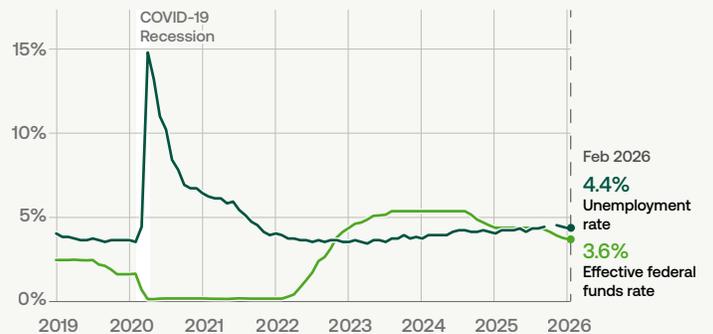
Unemployment rate vs. effective federal funds rate

Annual average



Source: Bureau of Labor Statistics
 Note: Annual data for the effective federal funds rate begins in 1955 because the Federal Reserve did not consistently publish the rate earlier.

Unemployment rate vs. monthly effective federal funds rate



Source: Bureau of Labor Statistics
 Note: Unemployment rate data is seasonally adjusted. Due to the 2025 government shutdown, the BLS did not publish October 2025 data.

Employment-to-population ratio

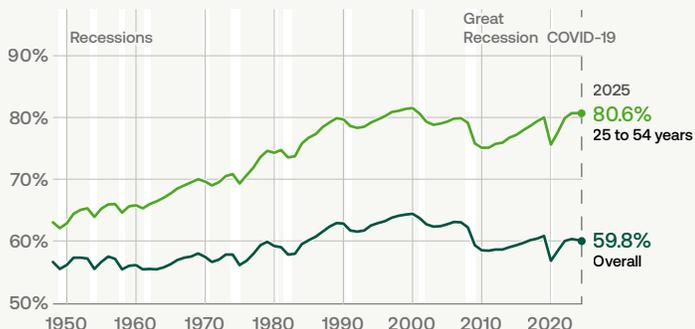
To better understand how the labor market is evolving, the Fed also considers the employment-to-population ratio. It is one of the broadest employment measures available. It shows the share of people who are employed, offering a direct view of how fully the economy is putting people to work. The prime-age version of this measure looks only at adults ages 25–54, making it less affected by the aging population and retirement trends and more reflective of current labor market conditions. Looking at both together helps distinguish between shifts driven by economic conditions and those driven by changes in the workforce’s size and composition.

Both the overall employment-to-population ratio and the prime-age measure peaked in 2000, at 64.4% and 81.5%, respectively. In 2025, the prime-age ratio stood at 80.6%, about 1 percentage point below its historical peak. However, this marked the first decline in prime-age ratio since 2020, while the overall employment-to-population ratio decreased for a second consecutive year. Historically, labor market conditions have weakened during economic downturns and strengthened during recoveries. Unemployment rose sharply during the Great Recession and again during the COVID-19 pandemic, followed by periods of sustained improvement.

In February 2026, the overall rate was 59.3% and the prime-age rate was 80.7%, both down from the month before. While the overall rate decreased compared to February 2025 (0.6 percentage points) and February 2020 (1.8 percentage points), the prime-age rate increased slightly by 0.2 and 0.3 percentage points, respectively.

Annual employment-to-population ratio

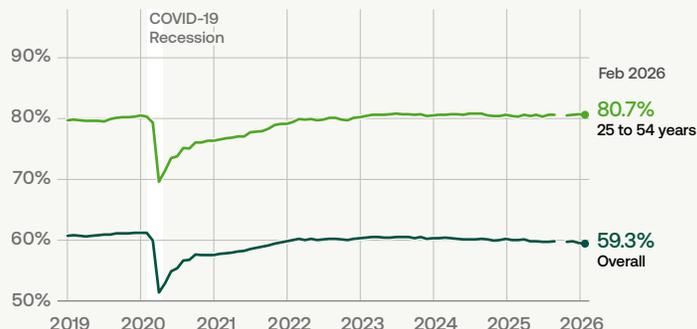
Overall and among 25–54 year olds



Source: Bureau of Labor Statistics and Federal Reserve Bank of St. Louis

Monthly employment-to-population ratio

Overall and among 25–54 year olds



Source: Federal Reserve Bank of St. Louis
 Note: Data is seasonally adjusted. Due to the 2025 government shutdown, the BLS did not publish October 2025 data.

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