Don’t sweat the small stuff...By the time you read this, the August 8 FOMC meeting will be history, but as I write, the event looms ahead. Today, after the July employment report was released, financial market participants laid 80 percent odds that there would be no change in the FOMC’s funds rate target at the August meeting. Before the report, which indicated that employment expanded somewhat less than the markets had anticipated, the odds were much closer to a 50-50 split between no change and a hike of 25 basis points.

Financial market participants’ views about the August meeting have been unsettled for some time. The odds of no change have been both above and below the odds for an increase over the past several months, wavering with data releases, comments by various Federal Reserve officials, and world events. And the August meeting is by no means unique: Expectations about likely FOMC actions at several meetings this year have been subject to shifting odds, driven by the uncertainties prevailing at the time.

Considering all the energy that goes into speculating about the FOMC’s next action, one might wonder just how important 25 basis points really are, in the grand scheme of things, to the success or failure of monetary policy. Given all the uncertainties involved in the policy process, it would seem nearly impossible to determine that 25 or even 50 basis points one way or another in the setting of the funds rate target makes a crucial difference. For example, after the FOMC’s 1994 decision to increase the funds rate from 3 percent to 6 percent, inflation stayed on an even keel. Although the pace of economic activity slowed in 1995, growth was fairly strong for the balance of the decade. Clearly, the FOMC’s strategy to prevent inflationary pressures from building early in the decade was successful, but can anyone say with authority that a rate of 5 1/2 percent would have failed to arrest inflation’s momentum, or that 6 1/2 percent would have tipped the economy into a recession? It seems unlikely.

The fact is, despite the optimal policy paths cranked out by economic models, there is little reason to think that the funds rate must attain some magical value at particular points in time, including peaks and troughs. That is why the more useful policy models provide confidence intervals that run above and below the optimal policy path.

Some financial market participants might be interested in forecasting the funds rate because they enjoy the sport of speculation. Others might be holding positions in related markets and use option contracts on fed funds futures to hedge those positions. A third group of participants might have their own views on what the FOMC should do in order to achieve its inflation and economic growth objectives, and they compare their own projections against the FOMC’s actual decisions. These forecasters care less about the funds rate as such than about the outlook for economic activity and inflation.

For this group, small deviations in the funds rate from their calculated paths are not likely to be distressing, but large cumulative deviations could signal trouble. At times when the FOMC puts the funds rate at a greater distance above or below where a forecaster thinks it ought to be, that forecaster is going to reexamine his model closely. He will conclude either that his model is wrong (and revise his view of the future) or that the FOMC will produce an outcome that drifts away from what the forecaster understood the FOMC’s objectives to be. In this latter case, the forecaster would like to know whether it has misunderstood the FOMC’s objectives, or whether the Committee itself will be surprised by its forecasting error.

When financial market traders bet among themselves on the funds rate decision at an upcoming FOMC meeting, we might regard the process as neutral from society’s perspective: for every loser there is a winner. The existence of relatively large discrepancies between private forecasts of the funds rate path and its actual trajectory would be a matter for monetary policy makers to think about.

At the moment, most private forecasters appear to think that the pace of economic activity and the rate of inflation will continue to develop in a way that is consistent with maximum sustainable growth and price stability. If there are voices decrying a monetary policy that is already too restrictive, or demonstrably lax, they are muted. Perhaps that is why the voices we do hear belong to those who are, indeed, sweating the small stuff. Compared with the big stuff, perhaps that’s not so bad.