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Why Fed's Rate Changes Are Always Measured in Quarters

How using a "blunt instrument" can help it achieve its goal of a "soft landing."

What the Federal Reserve ends up doing with its benchmark interest rates at any of its eight annual meetings is often unpredictable.

But what can be predicted, it seems, is that any rate hike or cut will come in quarter-point increments: 25bps, 50bps, 75bps.

In a financial world driven so precisely by numbers that extend many places to the right of the decimal point, perhaps the Fed could be more precise with its policy announcements.

As it works to navigate to the so-called difficult "soft landing" for the economy, some would think it might have a better chance of getting there with more exact rate adjustments.

Not since 2008 has the Fed deviated from quarter-point basis moves.

Federal Funds Rate is a 'Blunt Instrument'

Joe Brusuelas, chief economist with RSM US, tells GlobeSt.com, that precision and monetary policy rarely should be used in the same sentence.

"The federal funds rate is a blunt policy instrument that can cause significant collateral damage across multiple asset classes," Brusuelas said.

"Using the policy rate to implement a precise financial operation is a little like trying to kill a fly with an anvil. One may kill the fly, but in the process damage the table and the floor where the instrument is dropped.

"Therefore, simple and well understood .25, .50 or .75 percent changes in the policy rate are for now the preferred method of the US central bank."

Fed Aims to Be Transparent, Easily Understood

Brusuelas said that while the Fed "does not necessarily dismiss moving its policy rate by an eighth or a tenth of a percent – like we have observed by other central banks – due to the globally systemic importance of the American fixed income market, the Fed prefers changes in the federal

funds rate to be transparent, easily understood and of an actionable manner for market participants.

“It’s critical that Fed actions whenever and wherever possible avoid market upsets in pursuit of shaping well anchored interest rate and inflation expectations. Moreover, central banks should always strive to avoid market upsets when making policy announcements.”

Setting Rates is Not a ‘Science’

Paula Munger, assistant vice president, industry research and analysis, National Apartment Association, tells GlobeSt.com, “I don’t think [a greater level] of precision on the federal funds rate will make much of a difference regarding the soft landing. It took a pretty steep rise in mortgage rates to really cool down the housing market.”

Munger said the Fed is acutely aware of the damage it can cause, as Fed Chair Jerome Powell stated during the FOMC’s 50bps hike press conference on Dec. 14.

There, it raised its “overnight borrowing rate” to the highest level in 15 years taking it to a targeted range between 4.25% and 4.5%. The Fed also indicated that officials expect to keep rates higher through next year, with no reductions until 2024.

The increase broke a string of four straight three-quarter point hikes, the most aggressive policy moves since the early 1980s.

“Because we talk about the Fed’s actions in numbers and with financial data, I think it might give some a sense that it is a science,” Munger said. “But it is not. There are too many gray areas, and too many unknowns.

“Even the best data in the world is basically based on what has happened in the past; and you just can’t compare what is happening now with cycles of the past. Too many variables have changed and the pandemic and its shocks – and the aftermath that we’re still in – is like nothing we have experienced in modern history.

“So, policy tools that worked in the past might be completely useless now, at best, or harmful, at worst. I do think the Fed has done a pretty good job in evolving its tools, though.”

‘Unfortunately,’ It Wouldn’t Move the Needle

Timothy Savage, Ph.D., professor and director of the CREFC Center for Real Estate Finance at NYU Schack, New York University, tells GlobeSt.com that “under law, the Fed has a dual mandate of maximal employment and price stability.

“To achieve this challenge, it has two policies: acting as the lender of last resort and setting overnight interest rates.

“There is no specific reason it changes overnight interest rates by quarters other than tradition stemming back to the mid-1990′s and its standard meeting schedule.

“The Fed’s real focus is on the correlation between short- and long-term interest rates because long-term interest rates affect the real economy largely through real estate. Unfortunately, that correlation is not stable, so small changes in overnight lending rates, in either direction, would not move the needle.”

Not So Impactful on Investor Psychology
John Silvia, Founder of Dynamic Economic Strategy, and former Chief Economist at Wells Fargo, tells GlobeSt.com that there is a part of the quarter percent usage that is steeped in tradition.

"The quarter percent number is also likely influenced by the impact of interest rate changes," Silvia said. "Given that the impact of rate changes is very imprecise, a change of one-eighth of a percent may not have a perceptible impact on market prices or investor psychology."

'**Tempering' Inflation Levels at Historic Highs**
Pierre Debbas, Managing Partner of Romer Debbas, tells GlobeSt.com, "The increments for interest rate increases are based on the levels the fed believes are necessary to temper inflation.

"Given the fact that the Fed printed trillions of dollars in 2020 and 2021 and distributed them throughout the country, the level of inflation we have is at a historic high and thus the reason for quarter-point increments versus small fractions which would likely not negate the inflation rates we have encountered."

Fed Sticking to Its Strategy
Kurt Carlton, president and co-founder at New Western, tells GlobeSt.com that it's not a matter of if they have access to the data, the Fed has its strategy, and it appears to be sticking to it – only raising rates by multiples of quarter percentages.

"And a half percentage point used to look aggressive before 2022, now it appears soft," Carlton said. "If the Fed is looking to aggressively halt inflation, any fractional percentages might not show enough impact, and smaller percentage hikes will create a need for more economic monitoring and announcements and less time to see the effects on the economy."

Carlton said that less targeted increases might create an environment for fewer hikes or no hikes in 2023.

https://www.globest.com/2022/12/21/why-feds-rate-changes-are-always-measured-in-quarters/