OpenFed

POLICY STATEMENT | August 12, 1997

PREDICTED FED DECISION **HOLD**

5.50%

OPENFED OPTIMAL RATE **−25 bps**

5.25%

KEY TAKEAWAY

The Committee unanimously expects the real Federal Reserve to hold at 5.5%, even as its own framework judges the loss-minimizing policy to be a modest 25 basis point cut toward a neutral rate that current policy sits above.

STATEMENT

Information reviewed for this meeting described an economy expanding at a moderate-to-brisk pace, with consumer spending picking up, manufacturing running high, and commercial real estate strengthening. Against that firm backdrop, core PCE inflation at 1.72% remained below the Committee's 2.0% objective, and the Beige Book characterized labor markets as having tightened further while noting only scattered wage pressures and generally stable prices for most goods. The unemployment rate at 4.8% stood below the estimated 5.23% natural rate, and initial jobless claims near 329,000 gave no indication of any softening in employment. Financial conditions were judged benign across the board: a financial stress index of 0.1026, a narrow Baa spread of 1.48, a positively sloped yield curve at +0.39, and a VIX of 23.75 that was moderately elevated but well short of any level signaling market distress.

On the question of what the real Federal Reserve is likely to do, participants converged quickly and from strikingly different starting points. Members focused on inflation risk observed that sub-target inflation gives no clear trigger for a hike, while a labor market running below its natural rate leaves no room to ease without risking the very wage and price pressures that would later force a sharp reversal. Members attentive to employment noted that with joblessness still falling and claims moderate, there is simply no deterioration to protect against. Those weighing credit conditions emphasized that nothing in the data forces action in either direction, and that a hike would tighten conditions unnecessarily given contained inflation. Members reading market signals pointed to a 3-month T-bill spread of -0.33 relative to the current 5.5% rate, indicating the front end is not pricing an imminent move and if anything leans toward a modest easing bias. All five members judged that the real Committee will hold at 5.5%.

The Committee's own deterministic framework arrives at a different, though not distant, conclusion: the loss-minimizing policy is a 25 basis point cut. The reference rules themselves disagree, and that disagreement is the whole of the story. The Taylor rule prescribes -50 bps, driven by inflation below target and a real funds rate that sits meaningfully above the estimated neutral rate; with r* at 3.001 and inflation near 1.72%, nominal neutral is roughly 4.7%, so current policy at 5.5% is genuinely restrictive. The balanced-approach, first-difference, and ELB-adjusted rules all read 0 bps, reflecting still-solid activity and a labor market that is tightening rather than fraying. With inflation momentum only slightly positive at 0.015 and unemployment momentum at -0.25, the framework splits these signals and settles on -25 bps as measured insurance: enough to relieve excess restrictiveness relative to neutral, but well short of the aggressive Taylor cut that a still-tight labor market does not warrant.

In reconciling the two conclusions, participants generally read the 25 basis point gap between the expected hold and the optimal cut as a quantification of how far current policy sits above neutral rather than as a genuine disagreement about direction. Members endorsing the framework's recommendation viewed a small, orderly cut as safe precisely because stress and spreads are low, unwinding some restraint before any credit tightening or labor softening actually appears. The dissenting inflation-focused view held that restrictiveness is a feature and not a flaw while resource utilization runs hot, and that the asymmetry of inflation risk argues for holding rather than easing into a tight economy. A more centrist reading accepted the direction of easing but judged the full -25 bps a step ahead of data showing firm growth and a labor market still tightening. On balance, the Committee affirmed both conclusions: it expects the real Federal Reserve to hold at 5.5%, while judging the optimal policy to be a modest -25 bps.

COMMITTEE VOTE

The predictive vote was unanimous, 5-0, in expecting the real Federal Reserve to hold at 5.5%. On the framework's -25 bps recommendation, the Committee split 3-1-1: three members endorsed it as-is, one declined, and one agreed with the direction but not the magnitude.

NOTES

The inflation-focused member declined to support the -25 bps recommendation, arguing that with unemployment at 4.8% below the 5.23% natural rate and still tightening at -0.25 momentum, a cut risks stoking latent wage and price pressures; from this view, policy modestly above neutral is acceptable insurance while resource utilization runs hot, and the inflation-risk asymmetry favors holding. The data-dependent member registered partial agreement, accepting the direction of easing but judging the full -25 bps premature given brisk activity and a labor market still tightening.