OpenFed

POLICY STATEMENT | December 15, 1998

PREDICTED FED DECISION **HOLD**

# 4.75%

OPENFED OPTIMAL RATE **−25 bps**

# 4.50%

KEY TAKEAWAY

**The Committee expects the real Federal Reserve to hold at 4.75%, but its own framework judges a 25 basis point cut optimal, a modest divergence reflecting policy that sits slightly restrictive against subdued inflation.**

## STATEMENT

Information reviewed this meeting described an economy still expanding but showing scattered soft spots. All twelve districts reported continued growth in November, with above-trend activity confirmed by a Chicago Fed reading of 0.25 and initial jobless claims low at 305,000. The labor market remained tight, unemployment at 4.4% well below the 5.16% natural rate, though participants noted that wage pressures had subsided and that expansion was slowing in several districts, with export industries contracting and manufacturers anticipating further output cuts. Inflation was plainly not the concern: core PCE at 1.35% sat well below the 2.0% target, and goods prices were reported steady or falling across nearly all districts. Set against this were clear signs of financial stress, with the VIX at 29.42, the Baa spread at 2.6, and bankers tightening lending standards despite strong loan demand.

In predicting what the real Federal Reserve will do, most participants converged on holding the rate at 4.75%. Their reasoning ran along parallel lines. With inflation subdued, there was no case for tightening; but with the labor market still firm, jobless claims low, and growth continuing across all districts, there was likewise no employment or price deterioration compelling a preemptive cut. Several emphasized that policy had already eased earlier in the fall and that this accommodation was still working through construction and refinancing, so the appropriate posture was to let it transmit rather than add stimulus into a still-expanding economy. Financial stress, while elevated, was judged to be lingering rather than acutely worsening, with spreads partially normalized. One participant dissented from this reading, weighting market-implied pricing above other signals: the 3-month T-bill trading 0.37 below the funds rate aligns almost exactly with one further 25 basis point cut, and with core PCE so far below target there is no inflation cost to validating that expectation.

The Committee's own deterministic framework, applied independently, recommended a 25 basis point cut. The tension here is instructive. The level-based reference rules pointed the other way, with the Taylor rule, the balanced-approach rule, and the ELB-adjusted rule each returning +75 bps, driven mechanically by unemployment sitting far below the natural rate. What tips the framework toward easing is the first-difference rule at -25 bps, which responds to momentum and changing conditions rather than static level gaps. With inflation momentum essentially flat at 0.015 and unemployment momentum at just 0.05, the overheating that the level rules assume simply is not present in the dynamics; the strength in the unemployment level is being offset by falling goods prices and softening activity abroad. Against an estimated r* of 3.316, a real rate near 3.3% leaves policy modestly restrictive with subdued inflation, room the framework judges best used for a small insurance cut that addresses genuine credit-market stress at essentially no inflation cost.

The distance between the two conclusions is real but narrow. The predictive hold reflects a cautious, face-value reading of an economy that is still growing and a stress picture that is elevated yet stable; the framework's -25 bps reflects the same data read through momentum and market pricing, which quantifies current policy as slightly tight relative to optimal. Participants engaging the framework broadly accepted its direction — none argued for the hawkish level-rule outcome under this financial stress — differing mainly on whether the full step was warranted now or whether confirmation should be awaited first.

**COMMITTEE VOTE**

The predictive vote to hold at 4.75% carried 4 to 1, with one member favoring a 25 basis point cut. On the framework's -25 bps recommendation, the optimal-side deliberation landed 3 endorse, 0 decline, and 2 partial.

**NOTES**

*On the predictive side, one member dissented in favor of a 25 basis point cut, arguing that the 3-month T-bill spread of -0.37 and elevated VIX priced in further easing and that, with inflation well below target, following the market's implied path carried no inflation cost; the hold camp's worry about appearing reactive was, in this view, a communications point rather than a data one. On the optimal side, two members endorsed only the direction and not the full magnitude, preferring to await confirmation before committing to a complete 25 basis point step given the still-tight labor market and above-trend growth.*