OpenFed

POLICY STATEMENT | September 17, 2002

PREDICTED FED DECISION **HOLD**

1.75%

OPENFED OPTIMAL RATE **HOLD**

1.75%

KEY TAKEAWAY

The Committee expects the Federal Reserve to hold at 1.75% and independently judges that hold optimal, with its own framework recommending 0 bps despite three level-based reference rules calling for 75 bps of firming.

STATEMENT

Information reviewed for this meeting described an economy losing momentum without tipping into contraction. Core PCE inflation stood at 2.18%, modestly above the 2.0% objective, but Beige Book reports indicated that input and final goods prices were flat or up only slightly and that wage pressures remained minimal, with the principal cost concern confined to health care. Against that, the labor picture had clearly softened: the unemployment rate at 5.7% sat above the 5.06% natural rate, initial claims were elevated at 412,000, and most Districts reported little or no employment gain in July and August. The Chicago Fed National Activity Index at -0.34 pointed to below-trend growth, while a VIX of 38.01 and a Baa spread of 3.51 signaled elevated financial stress and strained credit conditions. The 3-month T-bill spread of -0.08 relative to the current 1.75% rate suggested markets leaned toward easing rather than tightening, though the 10-year/2-year spread at 1.81 remained steeply positive, with no inversion to warn of imminent recession.

In assessing the most likely near-term policy outcome, participants divided but converged on a hold. A majority judged that with inflation above target and no acceleration in prices, easing could not be justified, and that the mildness of the market's easing signal, together with a positively sloped curve and a merely moderate financial stress index of 0.1896, argued against reading current volatility as a credit crisis demanding insurance action. A minority placed more weight on labor slack and on the severity of market stress reflected in the VIX and Baa spread, judging that a modest 25-basis-point cut would offer prudent insurance for employment and fragile credit conditions without appearing to panic. On balance, the Committee's predictive assessment was that the Federal Reserve would leave the target range unchanged at 1.75%.

The Committee's independent policy framework arrived at the same destination by a distinct route, and the tension within that framework is worth stating plainly. Three level-based reference rules — the Taylor rule, the balanced-approach rule, and the ELB-adjusted rule — each prescribed 75 basis points of firming above the current rate, reading the above-target inflation and small unemployment gap through an estimated r* of 3.371. The first-difference rule, by contrast, prescribed 0 bps, and it was this rule that participants found most persuasive given where the economy actually stands. What tipped the balance was momentum: inflation momentum registered only 0.095 and unemployment momentum only 0.1, both tepid and stable, so the change signals that drive the first-difference rule counseled patience rather than motion in either direction. Several participants noted that the level rules' implied vigor was contradicted by the incoming activity data, and that the r* figure of 3.371 likely overstated the true neutral rate given decelerating growth. Firming 75 basis points into a VIX of 38 and a wide credit spread was widely judged to risk amplifying financial fragility for little inflation benefit, while cutting would spend limited room with inflation still above target. The framework's loss-minimizing recommendation was therefore 0 bps, and the Committee determined that holding at 1.75% is the optimal policy this meeting.

Both conclusions rest on the same reading: a modest inflation overshoot that is not building, set against softening labor markets and elevated but not dysfunctional financial stress, with a policy rate that is already accommodative rather than restrictive. Participants generally emphasized preserving optionality, flagging rising jobless claims, weak hiring, and any upturn in inflation momentum or the ECI as the developments that would move them off a hold in one direction or the other.

COMMITTEE VOTE

The Committee's predictive vote was 3-2 in favor of a hold at 1.75%, with two members favoring a 25-basis-point cut; on the framework's 0 bps recommendation, the Committee's optimal-side deliberation ended in full 5-0 agreement to endorse.

NOTES

The two members who dissented from the predictive hold argued for a 25-basis-point cut as insurance easing: one gave priority to labor-market slack — unemployment above the natural rate, elevated claims at 412,000, and flat District employment — while the other stressed that a VIX of 38 and a Baa spread of 3.51 warranted a modest move to steady fragile credit and volatile markets, both judging the mild inflation overshoot no barrier to easing.