OpenFed

POLICY STATEMENT | August 5, 2003

PREDICTED FED DECISION **HOLD**

1.00%

OPENFED OPTIMAL RATE **−50 bps**

0.50%

KEY TAKEAWAY

The Committee expects the real Federal Reserve to hold at 1.0%, but its own framework judges the loss-minimizing policy to be a 50 basis point cut, a divergence rooted in disinflation and widening labor slack.

STATEMENT

Information reviewed for this meeting described an economy that was firming but far from fully recovered. Core PCE inflation stood at 0.96%, barely half the 2.0% objective, and the Beige Book characterized prices as 'generally little changed.' The unemployment rate, at 6.2%, remained well above the 5.05% natural rate, with initial jobless claims near 401,000 and the Chicago Fed National Activity Index at -0.15 both pointing to below-trend growth. At the same time, several participants noted genuine signs of stabilization: activity was reported to have 'increased a notch,' manufacturing was edging higher, two districts cited an end to production declines, and housing was strong. Financial conditions were calm across the board, with a financial stress index of 0.09, a moderate Baa spread of 2.62, a steeply positive yield curve at 2.59, and a VIX of 22.68 that was elevated but well short of crisis territory.

On what the real Federal Reserve is likely to do, the Committee arrived at a hold, with the current 1.0% funds rate left unchanged. The reasoning that carried the majority ran along several lines that reinforced one another. With core inflation this low there was no overheating to resist, so no case for a hike; but with the funds rate already at 1.0%, near the effective lower bound, conventional easing room was limited and, in the view of most participants, better preserved for genuine deterioration than spent while the data were mixed-to-firming. The financial-stability reasoning weighed heavily here — cutting further toward zero risks distorting short-term funding markets for limited benefit, and there was no credit-market stress compelling a defensive move. Participants attentive to market pricing observed that the 3-month T-bill spread of -0.06 implied at most a faint easing tilt rather than a demand for an actual cut; had markets expected a 25 basis point move, the spread would be materially more negative.

The single participant favoring action pressed the case for insurance easing of 25 basis points, citing the wide employment gap and claims sitting right at the recession-signaling threshold, but even that participant acknowledged the firming activity signals and the limited room to ease.

The Committee's own deterministic framework reached a materially different conclusion, identifying -50 basis points as the loss-minimizing policy. The reference rules were split in an instructive way. The Taylor rule prescribed +75 basis points, but participants judged it an outlier here: anchored on an estimated r* of 2.69, it overweights a mechanical inflation gap that sub-1% core PCE plainly contradicts. The rules built to capture the state of labor and prices all pointed the other way — the balanced-approach rule and the ELB-adjusted rule each at -25 basis points, and the first-difference rule at -75 basis points. The first-difference result drew particular attention because it responds to the direction of change: inflation momentum was negative at -0.05 while unemployment momentum was positive at +0.15, meaning prices were still drifting down and the labor market was still deteriorating rather than healing. The framework's -50 recommendation sits between the easing rules, discounting the hawkish Taylor outlier. Several participants added that entrenched disinflation is itself a risk worth pre-empting, since falling prices raise real debt burdens and can stress credit intermediation — a consideration that, from a stability lens, argues for acting while markets are calm rather than being forced into disorderly moves later.

Taken together, the gap between the expected hold and the framework's -50 basis point call quantifies the Committee's judgment that current policy is somewhat tighter than conditions warrant, with both mandate legs — inflation well below target and labor slack still widening — pointing toward more accommodation. The expected hold is defensible as caution about a nascent, uneven recovery and about spending scarce ammunition near the floor; the framework's recommendation reflects the plain reading of two wide gaps and a disinflation trend. The Committee will continue to monitor incoming data, the durability of the activity improvement, and the persistence of labor slack.

COMMITTEE VOTE

The Committee's predictive vote was 4-1 in favor of a hold at 1.0%, with one participant favoring a 25 basis point cut. On the framework's -50 basis point recommendation, the optimal-side deliberation landed 1-4: one participant endorsed the recommendation as-is, and four agreed with the direction of easing but not the -50 magnitude, with none declining outright.

NOTES

The lone predictive dissenter argued for a 25 basis point insurance cut, pointing to unemployment at 6.2% against a 5.05% natural rate, claims of roughly 401,000 near the recession threshold, and a below-trend activity index, while conceding that firming signals and limited room to ease left the majority favoring a hold. On the optimal side, the four partial votes all accepted that easing was directionally right but judged -50 too aggressive given the emerging recovery notch and proximity to the lower bound, several preferring a measured -25 to preserve room.