OpenFed

POLICY STATEMENT | January 21, 2004

PREDICTED FED DECISION **HOLD**

1.00%

OPENFED OPTIMAL RATE **−50 bps**

0.50%

KEY TAKEAWAY

The Committee unanimously expects the real Federal Reserve to hold at 1.0%, even as its own framework judges the loss-minimizing policy to be a 50 basis point cut, given core inflation running far below target.

STATEMENT

Information reviewed at this meeting described an economy that continued to improve but unevenly across districts, with the Beige Book reporting only slow or modest growth in several regions, strong housing, and rising manufacturing activity. Core PCE inflation stood at 0.54 percent, far below the 2 percent objective, and the unemployment rate at 5.7 percent remained above the estimated natural rate of 5.04 percent, with initial claims of 362,000 still elevated and hiring characterized as minimal. Beige Book reports of 'subdued' wage pressures, workers easy to recruit, and only modestly reduced layoffs reinforced the reading that meaningful labor market slack persists. Financial conditions were notably calm: the financial stress index at 0.0723, the VIX at 14.34, a contained Baa spread of 2.33, and a steeply positive 10-year to 2-year curve at 2.36, with no inversion to signal recession.

Against this backdrop, participants were unanimous in expecting the real Federal Reserve to leave the target rate unchanged at 1.0 percent. The reasoning converged from distinct angles. Members focused on inflation judged that, with core PCE at roughly a quarter of target, there was no overheating to lean against and hence no case for a hike, while cutting from an already accommodative 1.0 percent could plant future inflation risk once slack closes and recovery firms. Members attentive to the labor market noted that although slack is real, the trend is one of tentative healing rather than deterioration, so the trigger for further easing was not being met, and with policy room scarce a cut would spend limited ammunition for little gain. Those weighing financial stability and market signals observed that a cut into visibly calm markets risked being misread as an alarm, and that the 3-month T-bill sitting 13 basis points below the funds rate priced a hold with, at most, a slight easing lean. The predicted outcome is therefore to hold at 1.0 percent.

The Committee's own deterministic policy framework reached a different conclusion, identifying a 50 basis point cut as the loss-minimizing policy. The reference rules were sharply split. The Taylor rule, the balanced-approach rule, and the ELB-adjusted rule each printed +75 basis points, driven by an estimated r* of 2.254 and the unemployment gap, but these level-based prescriptions assume inflation near target, an assumption plainly at odds with core PCE at 0.54 percent. The first-difference rule, which responds to the direction of change rather than an assumed neutral level, printed -75 basis points, consistent with inflation momentum of just 0.04 and unemployment momentum of -0.05, dynamics that show disinflation not yet decisively reversing. The framework's -50 recommendation blends these signals, rejecting the level rules' implied hike and leaning on the momentum-based easing case that the severe inflation undershoot demands. Members broadly agreed the direction was right: with both mandate legs pointing toward accommodation and calm markets imposing no fragility constraint, easing carries little instability cost.

The divergence between the unanimous hold and the framework's -50 bps recommendation is the central story of this meeting, and it measures how much caution about acting into an improving, non-crisis recovery restrains the willingness to ease that the raw inflation gap would otherwise justify. Where the framework optimizes directly against the inflation shortfall, participants weighed the forward risk of over-easing from a low floor, the sufficiency of current accommodation, and market pricing that supports a bias toward easing but not a move of this size. Most members accepted the easing direction while declining the full magnitude; on the framework's own terms, the loss-minimizing policy remains a 50 basis point cut.

COMMITTEE VOTE

The predictive vote to hold at 1.0 percent was unanimous, 5-0. On the framework's -50 bps recommendation the Committee split 1 endorse, 3 partial, and 1 decline, with the three partial votes agreeing on the easing direction but not the full magnitude.

NOTES

The labor-focused member endorsed the -50 bps cut outright, arguing that with unemployment above the natural rate, elevated claims, and inflation catastrophically below target, both mandate legs pointed the same way and the predictive hold underinsures employment. The inflation-focused member alone declined the recommendation, respecting the -50 math but weighting more heavily the forward risk that cutting from 1.0 percent could reignite inflation once slack closes and the broadly improving recovery firms.