OpenFed

POLICY STATEMENT | June 23, 2004

PREDICTED FED DECISION +25 bps

1.25%

OPENFED OPTIMAL RATE −25 bps

0.75%

KEY TAKEAWAY

The Committee unanimously expects a 25 bps hike off the emergency-low 1.0% rate, even as its own loss-minimizing framework points the opposite way, to a 25 bps cut.

STATEMENT

The information reviewed pointed to a broadly expanding economy. The Beige Book documented improvement across manufacturing, services, and hiring, with activity firming in most districts. Core PCE inflation stood at 1.11%, well below the 2% objective, while unemployment at 5.6% remained above the 5.04% estimate of its natural rate, leaving genuine slack in the labor market. Initial jobless claims at 354,000 were judged moderate and consistent with an improving, not deteriorating, labor market. Financial conditions were calm and orderly: the stress index registered 0.0945, the VIX 13.98, the Baa spread over Treasuries a contained 2.06, and the yield curve was steeply positive at 1.93 with no inversion to signal recession risk. Participants noted the 3-month T-bill sitting 0.27 above the current funds rate, a premium aligning almost exactly with a single 25 bps increment already discounted by markets.

On the question of what the real Federal Reserve will do, the Committee converged from every lens on a modest first step. With the funds rate at just 1.0% and the real rate deeply negative against an r* estimated near 2.012, participants judged policy far too accommodative for an economy this broadly expanding. Those weighting inflation risk pointed to rising input prices in energy, building materials, and steel, and to positive inflation momentum of 0.27, as pipeline pressure worth leaning against preemptively, though muted wages argued for a proportionate rather than aggressive move. Those most attentive to employment found no case for restraint on jobs grounds and equally no case for a cut, given firming hiring. Those focused on markets and financial stability stressed that the anticipated 25 bps move could be absorbed without disruption, while a larger step risked shocking calm conditions unnecessarily. The Committee's predictive conclusion was a 25 bps increase, to begin removing emergency accommodation gradually.

The Committee's own deterministic framework arrived at the opposite sign: a loss-minimizing recommendation of -25 bps. The tension is instructive. Three level-based reference rules pointed sharply higher, each calling for 75 bps — the Taylor rule, the balanced-approach rule, and the ELB-adjusted rule — reflecting how far below neutral the current stance sits. But the first-difference rule, keyed to the change in conditions rather than the level gap, called for -50 bps, and the loss function weighed it heavily: with core PCE 0.9 percentage point below target, inflation momentum only 0.27, unemployment momentum flat at 0.0, and activity below trend, the change-based logic saw no basis to tighten and, at the margin, a case to ease. The framework's -25 bps splits between the aggressive difference rule and inaction, judging that easing minimizes loss given the inflation shortfall and persistent labor slack.

Reconciling these two conclusions, the Committee frames the divergence as largely one of direction versus pace against a common recognition that abrupt tightening is unwarranted. The predictive view reflects institutional normalization instinct and the market's own pricing of a near-term move; the optimal view reflects pure current-conditions loss minimization, in which inflation this far below target and a static employment gap outweigh the level rules' catch-up signal. Both readings reject a 50 bps move. The Committee reports both as its considered conclusions: a 25 bps hike as the most likely policy outcome, and a 25 bps cut as the framework's loss-minimizing optimum under these specific readings.

COMMITTEE VOTE

The predictive vote for a 25 bps increase was unanimous, 5-0. On the framework's -25 bps recommendation, the Committee split 1-4, with a single member endorsing the easing and four declining it.

NOTES

The lone endorsement of the framework's -25 bps came from the member weighting employment most heavily, who argued that with unemployment above its 5.04% natural rate, core PCE at 1.11%, muted wages, and below-trend activity, the current 1.0% stance may already be too restrictive for the labor gap, making a cautious easing the loss-minimizing call. The four declining members held that the framework overweights the outlier first-difference rule against three level rules pointing to 75 bps: with the economy broadly expanding, real rates deeply negative, input costs rising, and no financial stress to defend against, easing from 1.0% was judged the wrong direction, risking entrenched negative real rates, asset-price froth, and a market surprise given pricing that already anticipated a hike.