OpenFed

POLICY STATEMENT | August 3, 2004

PREDICTED FED DECISION +25 bps

1.50%

OPENFED OPTIMAL RATE −25 bps

1.00%

KEY TAKEAWAY

The Committee unanimously expects a 25 bps hike, even as its own policy framework judges optimal policy to be a 25 bps cut, driven by flat momentum against a below-neutral funds rate.

STATEMENT

The most striking feature of this meeting is the gap between what the Committee expects and what its framework recommends. All five members independently arrived at the same predictive conclusion: a measured 25 bps increase, lifting the funds rate from its current 1.25%. Yet the Committee's deterministic policy engine, minimizing loss over the state of the economy, points the other way, to a 25 bps cut. The Committee reports both as its own considered conclusions.

The predictive case rested on the same reading across the members. With the funds rate at 1.25% and the estimated neutral rate near 1.888%, real policy remains deeply accommodative on level terms, a judgment reinforced by the Taylor rule, the balanced-approach rule, and the ELB-adjusted rule, each of which pointed to 75 bps. Core PCE at 1.42% sits below the 2% objective, so no member saw a case for moving faster than a quarter point, but the Beige Book's widespread producer-level price increases in energy, steel, and cement, together with rising benefits costs, weighed on the members most attentive to pipeline inflation risk. Financial conditions offered no barrier: the stress index at 0.0915, the VIX at 16.03, a Baa spread of 2.14, and a steeply positive yield curve at 1.79 all indicated markets could absorb a hike smoothly. The 3-month T-bill spread of 0.21 over the current rate was read as pricing a near-certain quarter-point move, so delivering it posed little risk of disruption. Set against this were mild cautionary signals several members acknowledged: moderating growth in several districts, slowing retail and auto sales, and generally flat wage gains. Those signals argued against aggressive tightening but not, in the members' judgment, against a single measured step.

The optimal conclusion turns on a different reading of the same data. The framework's -25 bps recommendation is driven by the first-difference rule, which reacts to momentum rather than levels, and here the momentum is faint: inflation momentum of only 0.125 and unemployment momentum of 0.0. With core inflation well below target, unemployment at 5.6% still above the 5.04% natural rate, and demand softening at the margin, the loss-minimizing calculation sees no reason to tighten and, at the margin, a case to ease. This is where the level-based rules and the change-based rule diverge sharply, 75 against -25, and members read that dispersion in opposite ways. The lone member who endorsed the framework's call emphasized the persistent labor-market slack and the moderating growth the level rules underweight, judging easing the employment-protective choice given subdued inflation. The four who declined it argued that four of five reference rules point up, that the Beige Book describes an economy that 'continued to expand' rather than one contracting, and that cutting into calm markets already pricing a hike would be a move in the wrong direction with no financial-stability rationale behind it.

Reconciling the two, the Committee reads the divergence as quantifying how accommodative current policy is in level terms while momentum stays flat enough that inflation risk is not yet urgent. The predictive expectation reflects a committee inclined to begin normalizing off an emergency-low floor; the framework's optimal -25 bps reflects a pure state-contingent reading in which soft inflation and remaining slack dominate. Both are stated here as the Committee's own conclusions, arrived at through the same deliberation.

COMMITTEE VOTE	The predictive vote was unanimous, 5-0, for a 25 bps increase. On the framework's -25 bps recommendation, the Committee split 4-1, with one member endorsing the cut and four declining it.
NOTES	*The single optimal-side endorsement came from the member weighting employment most heavily, who argued that unemployment at 5.6% remains well above the 5.04% natural rate with flat wage gains and moderating demand, so that with core PCE at 1.42% inflation imposes no constraint; on this view the first-difference rule's -25 bps minimizes loss by prioritizing a labor gap the level-based rules underweight, and tightening risks choking recovery before that gap closes.*