OpenFed

POLICY STATEMENT | December 7, 2004

PREDICTED FED DECISION +25 bps

2.25%

OPENFED OPTIMAL RATE −25 bps

1.75%

KEY TAKEAWAY

The Committee unanimously expects a 25 bps hike, yet its own loss-minimizing framework points the opposite way, to a 25 bps cut, and members split 3-2 against endorsing that easing recommendation.

STATEMENT

Information reviewed at this meeting described an economy expanding broadly, with the Beige Book reporting eleven of twelve Districts growing and several noting an accelerating pace across manufacturing and services. The Chicago Fed activity index at 0.85 pointed to above-trend growth, business lending was strengthening, and initial claims of 343,000 were read by most participants as moderate rather than a sign of emerging labor stress. Financial conditions were notably calm: a stress index of 0.0861, a VIX of 13.67, a Baa spread of 1.96, and a positively sloped yield curve at +1.28 gave no recession or credit warning. Against that backdrop, core PCE at 1.17% sat well below the 2.0% objective and unemployment at 5.4% ran modestly above the estimated 5.04% natural rate.

In assessing the likely near-term path of policy, participants converged fully. With the funds rate at 2.0% and a real rate near 0.83% against an estimated r* of 1.665, most judged policy still accommodative amid solid growth, and saw the current calm as the appropriate window to continue a measured removal of accommodation. Several placed weight on the 3-month T-bill sitting 21 bps above the current rate, a market-implied signal mapping almost exactly onto a single 25 bps step already anticipated by markets. Others, focused on employment, satisfied themselves that a labor market with only a small unemployment gap and no rising claims trend could absorb such a move without harm, while participants attentive to financial stability judged that easing into placid markets with strengthening lending risked fueling froth. On these grounds the Committee's predictive conclusion is a 25 bps increase.

The Committee's own deterministic framework, applied to the same data, reached the opposite conclusion: a recommended 25 bps cut. Every reference rule pointed lower and more sharply -- the Taylor rule at -50, the balanced-approach rule at -75, the first-difference rule at -50, and the ELB-adjusted rule at -75, all flagged reliable this meeting. These readings key off the sizable inflation undershoot and the labor slack, both reinforced by momentum terms that continue mildly downward: inflation momentum of -0.105 and unemployment momentum of -0.100, indicating disinflation persisting and joblessness improving only marginally. The framework's loss function tempered those aggressive rule signals to a single -25 step, respecting the risk of overreacting to soft readings while still judging that a 2.0% stance is modestly too tight given slack on both mandate legs. Participants sympathetic to this reading stressed that on a literal, face-value assessment of the numbers, both inflation and employment point the same direction -- toward accommodation, not tightening -- and that the T-bill signal reflects forward expectations rather than what the current data themselves support.

That divergence -- a hike expected, an ease recommended -- was the central tension of this meeting, and the Committee did not resolve it into agreement. Members who declined the framework's recommendation argued that the -25 case rests on a contested r* estimate and an overweighted employment gap, and that with policy already accommodative, calm markets, and firm growth, easing would seed precisely the later inflation and financial froth they weight most. Members who endorsed it maintained that the mechanical rules, judged reliable, deserve to be taken at face value here, and that a modest, disciplined -25 step honors their direction without overcommitting to the deeper -50 and -75 signals. The Committee thus records both conclusions with equal standing: it expects the real policy action to be a 25 bps increase, while its own framework identifies a 25 bps cut as the loss-minimizing move given below-target inflation and persistent slack.

COMMITTEE VOTE

The predictive vote was unanimous, 5-0, for a 25 bps increase. On the framework's -25 bps recommendation the Committee divided 2-3, with two members endorsing the easing call and three declining it.

NOTES

The three declining members -- reasoning from inflation risk, from financial stability, and from market pricing -- held that a real funds rate near 0.83% against an r of 1.665 leaves policy accommodative rather than tight, that the 21 bps T-bill spread shows markets pricing normalization and not a cut, and that easing into calm markets with strengthening lending would risk fueling froth and later inflation, however soft current core PCE at 1.17% appears.*