OpenFed

POLICY STATEMENT | January 26, 2005

PREDICTED FED DECISION +25 bps

2.50%

OPENFED OPTIMAL RATE −25 bps

2.00%

KEY TAKEAWAY

The Committee unanimously expects a 25 bps hike as the real Fed continues measured normalization, even as its own framework judges the loss-minimizing move to be a 25 bps cut toward neutral.

STATEMENT

Information reviewed at this meeting described an economy expanding broadly, with the Beige Book noting activity firming in eleven of twelve districts, manufacturing strengthening, and capital spending plans rising into 2005. Labor markets had firmed in a number of districts, initial jobless claims at 329,000 were moderate rather than deteriorating, and unemployment stood at 5.4%, modestly above the 5.04% natural-rate estimate. Core PCE inflation was 1.18%, well below the 2.0% objective, and wage pressures were generally described as modest. Financial conditions were notably calm: the stress index was very low at 0.0906, the VIX at 13.44 pointed to complacency more than fragility, the Baa spread of 1.76 indicated accessible credit, and the 10y-2y curve remained positively sloped at 0.94.

In forming its predictive judgment, participants converged quickly and without meaningful dissent. With the funds rate at 2.25% still accommodative and real rates near zero, they judged that easy policy risked allowing pipeline cost pressures to build even as current inflation stayed subdued. The forward evidence weighed heavily: the 3-month T-bill trading 0.12 above the current rate was read as markets already pricing a near-term move, so that a measured quarter-point step would neither surprise nor destabilize calm markets, while a pause or a larger move would. Broad-based expansion, firming labor markets with no rising-unemployment signal, and the absence of any credit or recession alarm all pointed the same way. The Committee therefore expects the real Federal Reserve to raise the target rate by 25 bps, continuing the gradual, well-telegraphed removal of accommodation.

The Committee's own deterministic framework arrived at a different conclusion, and participants engaged with it directly. Every reference rule pointed toward easing, and by a wide margin: the Taylor rule, the balanced-approach rule, and the ELB-adjusted rule each returned -75 bps, with the first-difference rule at -50 bps. The logic turns on the same data read against fundamentals rather than momentum. With core PCE roughly 0.82 percentage point below target, inflation momentum running negative at -0.13, unemployment above its natural rate, and unemployment momentum flat at 0.0, the mandate case for tightening simply does not bind. Against an r* estimate of 1.594, current policy sits close to or slightly above a low-inflation neutral, so the rules judge the stance more restrictive than conditions warrant. The loss function tempered those aggressive rule prescriptions to a modest step, and the framework's loss-minimizing recommendation was -25 bps. Participants read the gap between that figure and their own predictive vote as a measure of how far expected normalization has drifted ahead of what the data alone would justify this meeting.

Weighing both conclusions, the Committee found the -25 bps optimal call defensible on its own terms: below-target and softening inflation removes the case for restriction, persistent labor slack argues for moving toward neutral, and calm markets and a positive curve mean a gradual quarter-point ease carries little risk of disorder or renewed price pressure. At the same time, the tension with market pricing was real and not fully resolved. Those most attentive to forward signals held that a cut would run against a clearly priced hike, and that firming Beige Book activity does not itself call for accommodation. The Committee thus records a genuine divergence: its best prediction of real-world policy is a 25 bps hike, while its independent framework judges the optimal move to be a 25 bps cut.

COMMITTEE VOTE

The predictive vote was unanimous at 5-0 for a 25 bps hike. On the framework's -25 bps recommendation, the Committee split 3-1-1: three members endorsed it as recommended, one endorsed the direction but not the full magnitude, and one declined.

NOTES

The lone decline on the optimal side came from the member weighting market-implied pricing most heavily, who argued that the T-bill spread of 0.12, a positively sloped curve, subdued volatility, and firming activity all pointed to continued removal of accommodation, and that a cut fighting a clearly priced hike could not be endorsed; the partial position agreed easing had support from soft inflation but questioned whether a full quarter-point was warranted against calm, firming conditions.