OpenFed

POLICY STATEMENT | April 26, 2005

PREDICTED FED DECISION +25 bps

3.00%

OPENFED OPTIMAL RATE −25 bps

2.50%

KEY TAKEAWAY

The Committee unanimously expects the real Federal Reserve to raise rates 25 bps, even as its own framework judges the optimal move to be a 25 bps cut toward neutral, and members split sharply on whether to endorse that easing.

STATEMENT

Information reviewed by the Committee described an economy expanding broadly, with little in the way of stress to lean against. The Beige Book reported activity growing across all twelve Districts, robust in some and solid in others, alongside intensifying price pressures and high or rising energy costs cited as a broad concern across sectors. Core PCE inflation at 1.28% remained below the 2% objective, but unemployment at 5.2% stood near the estimated natural rate of 5.04%, initial claims of 317,000 showed no deterioration, and the Chicago Fed activity index at 0.57 pointed to above-trend growth. Financial conditions were calm rather than fragile: the stress index at 0.11, the VIX at 14.91, a modest Baa spread of 1.7, and a positively sloped yield curve at 0.61 together indicated no crisis constraint on policy and ample room to absorb a move in either direction.

On the question of what the real Federal Reserve would do, participants converged quickly and without exception. Members reasoned that with the fed funds rate at 2.75% still accommodative relative to an expanding economy, with price pressures firming in the Beige Book and no labor slack demanding forbearance, the appropriate reading was a continuation of measured normalization. Several emphasized that a 3-month T-bill spread of 0.11 above the current rate implied markets had already priced a near-term 25 bps step, so that such a move was the least destabilizing choice — the one already absorbed. On that basis the Committee's predictive conclusion was a 25 bps hike. A larger move was weighed and set aside, on the grounds that core inflation remained below target and that a well-signaled single step better preserved the calm conditions.

The Committee's own deterministic framework pointed the other way. Its loss-minimizing recommendation was a 25 bps cut, arrived at with an estimated r* of 1.396, positive but slight inflation momentum of 0.025, and unemployment momentum of zero, with the reference rules judged reliable. The Taylor rule, the balanced-approach rule, and the ELB-adjusted rule each prescribed -75 bps, mechanically responding to inflation running well under target and unemployment slightly above its natural rate. The first-difference rule, by contrast, prescribed only -25 bps, and it was this gradualist logic that the framework's final call tracked. Members endorsing the framework observed that with r* near 1.4 and inflation around 1.3%, the neutral nominal rate sits close to 2.7% — barely below the current 2.75% — so that policy is only marginally tight and near-zero momentum argues against the deep cuts the level-based rules imply. Read on the data alone, the below-target inflation undershoot points toward easing, while the flat momentum keeps the warranted adjustment small; the Committee's optimal conclusion is therefore a 25 bps cut.

The divergence between the predicted +25 bps and the optimal -25 bps is the substance of this meeting, and it quantifies the gap between the more hawkish path expected of the real Federal Reserve and what the framework judges fundamentals justify. Support for the framework's easing was genuinely divided. Those endorsing it argued that tightening into above-natural unemployment and sub-target inflation is the wrong direction, and that a gradual step toward neutral insures the labor market while inflation stays contained. Those declining pushed back that every clean market signal — the positive bill spread, the steep curve, the low stress readings — points toward tightening, not easing, and that cutting into calm, expansionary conditions and strong residential real estate risks fueling froth. The intensifying, energy-driven price pressures in the Beige Book weighed on both objectors, one from a financial-stability lens and one from a market-pricing lens, as reasons any cut would be premature.

COMMITTEE VOTE

The predictive vote for a 25 bps hike was unanimous, 5 to 0. On the framework's -25 bps recommendation, the Committee split: two members endorsed it as-is, two declined, and one agreed with the easing direction but not with cutting at this time.

NOTES

The two members declining the optimal easing argued from a financial-stability read and a market-pricing read respectively that forward-looking signals and the Beige Book's broadening energy-cost pressures pointed toward tightening, not a cut; the partial member accepted -25 bps as milder than the -75 bps rule outputs but held that rising price pressures made any cut premature from an inflation-risk standpoint.