OpenFed

POLICY STATEMENT | September 13, 2005

PREDICTED FED DECISION **+25 bps**

3.75%

OPENFED OPTIMAL RATE **HOLD**

3.50%

KEY TAKEAWAY

The Committee expects the real Fed to raise rates 25 bps, but its own framework judges the optimal move to be a hold at 0 bps, with all five members endorsing the hold as the more defensible call.

STATEMENT

Information reviewed at this meeting pointed to broad-based expansion. The Beige Book described widespread growth across nearly all Districts and sectors, with labor markets showing signs of tightening and modest wage increases; lending had increased and credit quality was stable. Unemployment, at 4.9%, was running just below the estimated natural rate of 5.04%, and financial conditions were notably benign, with the financial stress index low at 0.1251, the VIX calm at 12.39, and the Baa spread tight at 1.83. Against this, members flagged genuine soft spots: initial jobless claims were elevated at 422,000, and the Chicago Fed National Activity Index at -0.62 signaled below-trend growth. Core PCE, at 1.59%, remained below the 2% objective, though members repeatedly noted the significant energy and gasoline price increases running through the Beige Book as a live upside risk.

In assessing the likely path of policy, participants converged quickly. With the current fed funds rate at 3.5% judged historically accommodative given the strength of activity, and with no credit-market stress to counsel a pause, members generally viewed continued measured normalization as the natural course. Those weighting inflation risk most heavily argued that accommodation could not be tolerated while energy-driven price pressures built and unemployment ran below the natural rate; those attentive to the labor market judged that, absent clear employment deterioration, an abrupt pause would surprise markets already positioned for a gradual path. Market-implied signals were read as fully consistent with continuation: the 3-month T-bill spread at -0.09 sat just below the current rate, indicating an expected near-term move but nothing dramatic, and the yield curve, though flattening, remained positive at 0.26 and gave no recession signal. On that basis the Committee's predictive judgment was for a 25 bps increase.

The Committee's own deterministic framework, however, arrived at a materially different optimal conclusion: a hold at 0 bps. The reference rules pulled sharply toward easing, with the Taylor rule, the balanced-approach rule, and the ELB-adjusted rule each pointing to -75 bps, and the first-difference rule to -25 bps, driven mechanically by core inflation's undershoot of target against an estimated r* of 1.252. Members did not accept those cut signals. The decisive offset was inflation momentum of +0.235, indicating prices firming rather than fading, reinforced by the Beige Book's picture of expansion and energy pressure; unemployment momentum, at -0.1, showed no acute deterioration to defend against. Members judged that cutting 75 bps into a tightening labor market, rising energy prices, and calm, arguably complacent markets would risk unanchoring inflation expectations and feeding stretched risk-taking, while the below-target inflation reading and near-neutral unemployment gave no strong tightening mandate either. The loss function nets these opposing forces, and the framework's 0 bps recommendation was read as the coherent middle: neither easing prematurely into building inflation risk nor over-tightening against soft claims.

Both conclusions reflect the same reading of an economy already near neutral. With r* at 1.252 and core inflation near 1.6%, members repeatedly observed that 3.5% sits only modestly above a neutral nominal rate, which explains why the framework's optimal hold and the members' individual +25 leans differ by only a single notch. The predictive 25 bps reflects an expectation that policy will continue to lean tighter than pure loss-minimization requires; the optimal 0 bps reflects the Committee's own judgment that, given firming momentum, benign financial conditions, and mixed activity signals, patience is the more defensible stance while energy prices and elevated claims resolve.

COMMITTEE VOTE

The predictive vote was unanimous at 5-0 for a 25 bps increase. On the framework's own recommendation, the optimal-side deliberation was likewise unanimous, with all five members endorsing the 0 bps hold as-is (5 endorse, 0 decline, 0 partial).

NOTES

There was no dissent on either side. The notable tension was not among members but between the two conclusions themselves: every member's predictive +25 bps lean diverged by one notch from the 0 bps hold each also endorsed as optimal, a gap all five attributed to policy sitting close to neutral, with the reference rules' -75 bps cut signals unanimously rejected as overreacting to the inflation level while ignoring positive momentum.