OpenFed

POLICY STATEMENT | May 3, 2006

PREDICTED FED DECISION +25 bps
5.00%

OPENFED OPTIMAL RATE −25 bps
4.50%

KEY TAKEAWAY

The Committee expects the real Fed to raise rates 25 bps in line with its 'some further firming' guidance, yet its own framework judges the optimal move to be a 25 bps cut, with all five members endorsing that reversal.

STATEMENT

The most striking feature of this meeting is the gap between what the Committee expects and what it judges to be right. On the predictive question, all five members arrived independently at the same answer: a 25 basis point hike from the current 4.75%. That conclusion rested less on current inflation than on the prior meeting's explicit signal that 'some further policy firming may be needed,' reinforced by a labor market that continues to run tight. Unemployment at 4.7% sits below the 5.04% natural rate, initial jobless claims at 321,000 remain low and stable, and the Beige Book confirmed tight or tightening conditions for skilled workers across most Districts. Members noted that core PCE at 1.64% is below the 2% target and gives little urgency of its own, but the tight labor market and elevated energy costs kept the bias upward. Financial conditions offered no obstacle to a measured step: the stress index at 0.1143, VIX at 11.99, and a contained Baa spread of 1.61 pointed to calm, even complacent, markets. The nearly flat yield curve (10y-2y at 0.21, with the 3-month bill 5 basis points below the funds rate) cautioned firmly against anything larger than a quarter point, and no member favored a 50 basis point move or a pause. Markets, in this reading, appear to expect one more standard step near the end of the cycle.

The Committee's own deterministic framework told a different story, and the divergence is the heart of this meeting. Its loss-minimizing recommendation was a 25 basis point cut. The starting point is the estimated r* of 0.872: with core inflation near 1.64%, a neutral nominal rate sits around 2.5%, well below the current 4.75%, so policy is already meaningfully restrictive on this reading. The level-based reference rules pushed harder still. The Taylor rule, the balanced-approach rule, and the ELB-adjusted rule each returned -75 bps, reflecting inflation below target against a restrictive stance. The first-difference rule returned -25 bps. Momentum reinforced the case for easing rather than firming:

inflation momentum at -0.045 indicates price pressures decelerating, and unemployment momentum at -0.1 points the same direction. The framework judged its reference rules reliable and, weighing the aggressive level rules against the gradualist first-difference logic, settled on -25 bps.

In reconciling their predictive votes with this recommendation, members converged with unusual completeness on the first-difference logic. The three level rules calling for -75, they judged, overweight the below-target inflation gap given that real activity remains solid; the Chicago Fed index near 0.02 signals roughly trend growth, not overheating. A cut of that size would be a destabilizing lurch into calm markets. The first-difference rule's approach of adjusting incrementally from the current stance, responding to momentum rather than a static gap, matched the caution each member brought from a different direction. Those most attentive to inflation acknowledged that below-target core PCE with negative momentum, and firms reporting limited ability to raise selling prices, undercut the usual case for holding; the residual concern about tight skilled-labor markets argued for minimal easing, not a large one. Those weighting employment noted early signs of cooling demand in housing and in New York, with a -25 step beginning to remove restraint before labor weakens materially. Those focused on financial stability emphasized the near-flat curve, warning that further hikes risk pushing it into inversion. The common conclusion: the predictive path leans on firming rhetoric now contradicted by the data, while the framework shows policy already at or past neutral, making a measured 25 basis point cut the optimal correction.

The Committee therefore holds two conclusions at once, arrived at through the same deliberation. It expects the real Federal Reserve to raise rates by 25 basis points, consistent with prior guidance and market pricing. It independently judges that the optimal policy would be a 25 basis point cut, unwinding excess restriction gradually without the shock a full -75 adjustment would deliver.

COMMITTEE VOTE

The predictive vote was unanimous at 5-0 for a 25 basis point hike. On the framework's optimal recommendation of a 25 basis point cut, the Committee also landed in full agreement, with all five members endorsing the recommendation as-is (5 endorse, 0 decline, 0 partial).