OpenFed

POLICY STATEMENT | October 18, 2006

PREDICTED FED DECISION **HOLD**

5.25%

OPENFED OPTIMAL RATE **−25 bps**

5.00%

KEY TAKEAWAY

The Committee unanimously expects the Federal Reserve to hold at 5.25%, even as its own policy framework judges the optimal move to be a modest 25 basis point cut toward a less restrictive stance.

STATEMENT

Information reviewed at this meeting pointed to an economy in which the case for further tightening had largely dissolved while the case for easing had not yet forced itself. Core PCE inflation stood at 1.94%, essentially at the 2.0% objective, softening the 'elevated' characterization carried over from the prior meeting. The labor market remained tight, with unemployment at 4.6%, below the 5.04% estimated natural rate, and Beige Book reports of skilled-worker shortages and scattered wage pass-throughs. Against that, growth signals were turning: the Chicago Fed National Activity Index at -0.27 indicated below-trend activity, housing was cooling widely, and the 2s10s curve was mildly inverted at -0.08. Financial conditions were placid throughout, with the stress index at 0.1155, the VIX at 11.34, and the Baa spread contained at 1.7 — no market strain arguing for action in either direction.

On the question of what the Federal Reserve is likely to do, all five members converged quickly and from different vantage points. Members focused on inflation risk judged that a single reading just under target does not defeat inflation, that tight labor markets keep upside risk live, and that cutting now could reignite pressure; but they also conceded the mild curve inversion and below-trend growth argue against a hike, so cumulative restraint should be left to work. Members attentive to employment saw no current job weakness to guard against, with jobless claims low and stable, and thus no basis for a preemptive cut, while equally rejecting a hike that could crack the labor market later. Those weighing credit and market signals emphasized that the inverted curve and a 3-month bill sitting 0.29 below the funds rate mark policy as already sufficiently restrictive, with markets pricing no hike and a mild easing tilt. The predictive conclusion was a hold at 5.25%, with residual firming bias.

The Committee's own deterministic framework told a different and more pointed story about the optimal stance. With an estimated r* of 0.973 and inflation at target, three reference rules — the Taylor rule, the balanced-approach rule, and the ELB-adjusted rule — each pointed to -75 basis points, reflecting a current 5.25% rate that sits well above a neutral level near 3%. The first-difference rule, by contrast, returned 0 basis points, reacting to momentum rather than level, and both momentum terms were small: inflation momentum of 0.075 and unemployment momentum of 0.05. Reconciling the aggressive level-rules against the inertial momentum reading, the framework's loss-minimizing recommendation landed at -25 basis points — a modest, single step toward neutral rather than an abrupt correction. Members endorsing this read it as honest recognition that policy is modestly overtight: the balanced-approach logic weighs employment and near-target inflation symmetrically, the credit channel is contracting as housing cools, and market pricing already embeds roughly this quarter-point move. The gap between the hold and the -25 quantifies how much the predictive vote reflects institutional caution and lingering inflation vigilance rather than the framework's assessment of underlying conditions.

Taken together, the Committee's two conclusions are that the Federal Reserve will most likely hold at 5.25% this meeting, while the framework's optimal call is a -25 basis point cut. The direction of that divergence — an optimum below the expected outcome — reflects a shared judgment that current policy leans restrictive, tempered by genuine disagreement over whether positive inflation momentum warrants waiting for confirmation before beginning to unwind restraint.

COMMITTEE VOTE

The predictive vote was unanimous, 5-0, to hold at 5.25%. On the framework's -25 basis point optimal recommendation, the Committee split 4-1 in favor of endorsement.

NOTES

The sole objection on the optimal side came from the inflation-focused member, who declined to endorse the -25 basis point cut. Weighting the first-difference rule's 0 basis point signal and positive inflation momentum of 0.075 most heavily, this member argued that easing before inflation is convincingly contained risks undoing hard-won discipline, conceding only that policy is marginally too tight given r near 0.97 while preferring to hold and confirm the moderation in the data.*