OpenFed

POLICY STATEMENT | December 5, 2006

PREDICTED FED DECISION HOLD
5.25%

OPENFED OPTIMAL RATE −25 bps
5.00%

KEY TAKEAWAY

The Committee unanimously expects the real Federal Reserve to hold at 5.25%, yet its own framework judges a 25 bps cut optimal, a divergence four of five members ultimately endorsed.

STATEMENT

Information reviewed at this meeting placed the economy in an unusually quiet posture. Core PCE inflation stood at 2.05%, only marginally above the 2.0% target, while the unemployment rate at 4.4% remained well below the estimated 5.04% natural rate, signaling a labor market that is still tight rather than weakening. The Beige Book reinforced this reading, describing moderate growth, generally moderate wage gains alongside some stronger pressure for specialized professions, moderating construction and energy prices, and continued softening in housing. Financial conditions were notably calm: the VIX at 11.27, a stress index of 0.3, and a Baa spread of 1.65 pointed to no credit distress in either direction. Set against this, the 10y-2y spread was slightly inverted at -0.07 and the 3-month T-bill sat 0.35 below the funds rate, signals participants read as markets pricing eventual easing and a mild recession risk worth monitoring.

On the question of what the real Federal Reserve will do, all five participants arrived independently at the same place and did not move off it through two rounds of exchange: a hold at 5.25%. The reasoning converged from different mandates. Those weighting inflation emphasized that 2.05% remains above target and that a tight labor market can still sustain price pressure, making a cut unjustified while preserving the option to reassess. Those focused on employment saw no rising unemployment or slowing hiring to trigger easing, with jobless claims at 327k giving no sign of deterioration. Participants attentive to financial stability and to market pricing agreed the inverted curve and sub-funds T-bill anticipate easing but carry no imminent trigger, and that cutting now would front-run a shallow inversion while inflation sits marginally above target. Where any tension surfaced, it ran toward tightening rather than easing, but participants judged that moderating prices and cooling housing removed the urgency for a hike and that a hold best balanced these forces. The predictive vote was unanimous.

The Committee's own deterministic framework reached a different conclusion, and the Committee states it with equal weight: the loss-minimizing policy is a 25 bps cut. The reference rules pulled hard in that direction, with the Taylor rule, the balanced-approach rule, and the ELB-adjusted rule each printing -75 bps, driven by unemployment well below the natural rate combined with inflation near target and an estimated r* of 1.015, which places neutral near 3% nominal and current policy meaningfully restrictive. Against those, the first-difference rule returned 0 bps, reflecting flat momentum rather than the level of accumulated restraint. The loss function, with inflation momentum at -0.1 and unemployment momentum at 0.0, tempered the aggressive level rules against the change-based rule and landed on -25 bps. Participants who engaged this framework found the compromise persuasive: fading inflation momentum weakens the case for staying tight, the inverted curve and housing softening argue for pre-emptive relief before weakness spreads, yet a full -75 would risk reigniting demand into a still-tight labor market. A 25 bps step begins realigning policy toward neutral without overreach.

The divergence between the two conclusions is the substance of this meeting. The unanimous hold reflects institutional caution and an anchor on an above-target core print; the framework's -25 bps reflects a reading in which near-target inflation, negative momentum, and a curve-inverted, sub-neutral rate structure make 5.25% mildly too restrictive. Most participants judged that gap to be real and worth naming: the level of restraint, not merely its rate of change, is what the reference rules and market pricing are flagging.

COMMITTEE VOTE	The predictive vote to expect a hold at 5.25% was unanimous, 5-0. On the framework's -25 bps recommendation, the Committee endorsed by a 4-1 margin.
NOTES	*The lone decline on the optimal side came from the inflation-focused position, which held that with core PCE still above the 2.0% target, an insurance cut is premature; this member found the first-difference rule's 0 bps most consistent with waiting until inflation durably clears target and viewed the -75 level rules as over-weighting the labor gap.*