OpenFed

POLICY STATEMENT | January 24, 2007

PREDICTED FED DECISION **HOLD**

5.25%

OPENFED OPTIMAL RATE **−25 bps**

5.00%

KEY TAKEAWAY

The Committee unanimously expects the real FOMC to hold at 5.25%, yet its own framework judges optimal policy to be a 25 bps cut, a divergence the Committee endorsed 4-1.

STATEMENT

Information reviewed at this meeting showed inflation essentially at goal, with core PCE at 1.91%, just below the 2.0% target, and a labor market that remains genuinely tight, with unemployment at 4.5% against an estimated natural rate of 5.04%. The Beige Book described a modest pace of expansion, softening housing, and firms still struggling to find qualified workers, though wage gains were characterized as only 'moderate' and there was no evidence of a wage-price spiral. Financial conditions were notably calm: the financial stress index stood at 0.099, the VIX at 9.89, and the Baa spread at a contained 1.57. At the same time, the 10y-2y curve was inverted at -0.12 and the 3-month T-bill sat 0.25 below the funds rate, signals the Committee weighed as reflecting both recession risk and a market expectation that the tightening cycle has peaked.

On the question of what the real Federal Reserve is likely to do at its upcoming meeting, participants converged without exception on a hold at 5.25%. The reasoning ran in two directions that offset one another around no change. With core inflation near target and only slight upward momentum, there was no urgency to hike; the tight labor market and moderate wage gains gave no fresh cause for restraint. At the same time, with no employment deterioration yet in the data and financial stress absent, participants judged there was no present case forcing a cut. Several members emphasized that market pricing itself, via the sub-rate T-bill and inverted curve, already anticipated a continued data-dependent hold rather than action in either direction. The predicted outcome, then, is 0 bps.

The Committee's own deterministic framework arrived at a different answer: optimal policy at this meeting is a 25 bps cut. The level-based reference rules pointed considerably further, with the Taylor rule, the balanced-approach rule, and the ELB-adjusted rule each returning -75 bps, reflecting the wide gap between the current 5.25% stance and a neutral rate implied by an r* of roughly 1.075 with inflation near 1.9%. Against those, the first-difference rule returned 0 bps, reacting to change rather than level and finding no fresh deterioration to act on, consistent with inflation momentum of only +0.025 and unemployment momentum of -0.15. The framework's -25 bps recommendation splits precisely between these: it recognizes that policy is meaningfully restrictive relative to near-target inflation and below-trend growth (the CFNAI at -0.48, housing and mortgage activity softening across Districts), while honoring the first-difference rule's caution against an abrupt move into placid markets. Members supporting the recommendation noted that a quarter-point matches almost exactly the -25 bps the T-bill spread already prices, addresses the credit-channel signal the curve inversion is flagging, and begins insuring against employment risk before it materializes, all without the destabilizing lurch a -75 bps step would represent.

The gap between the expected hold and the optimal cut is, in the Committee's reading, a measure of how far the current stance lags what the data alone would justify. Participants attributed the likely hold to residual inflation vigilance and the prior meeting's 'elevated' inflation framing, even as the fresh print no longer clearly supports that characterization. The Committee's judgment is that the real FOMC will hold at 5.25% while optimal policy has already tipped toward modest easing.

COMMITTEE VOTE

The predictive vote was unanimous at 0 bps (5-0). On the framework's -25 bps recommendation, the Committee's optimal-side deliberation landed 4-1 in favor of endorsement.

NOTES

The single vote against the framework's recommendation came from the inflation-focused member, who argued that a core PCE reading only 0.09 below target is essentially at goal rather than a signal of deflation risk, that inflation momentum remains positive at +0.025, and that with the labor market still tight and no fresh deterioration in the first-difference rule's logic, committing to a cut this meeting is premature; while not opposed to eventual easing and accepting that -25 bps respects gradualism over the level rules' -75 bps, this member judged the timing too soon while any inflation risk lingers.