OpenFed

POLICY STATEMENT | June 21, 2007

PREDICTED FED DECISION HOLD

5.25%

OPENFED OPTIMAL RATE −25 bps

5.00%

KEY TAKEAWAY

The Committee expects the real Federal Reserve to hold at 5.25%, yet its own framework judges a 25 basis point cut optimal, a divergence all five members ultimately endorsed once they engaged the loss-minimizing case.

STATEMENT

Information reviewed at this meeting described an economy expanding at a modest-to-moderate pace, with growth near trend as reflected in a CFNAI reading of -0.02, and with weakness confined largely to residential real estate, construction, trucking, and consumer lending rather than any broad contraction. Core PCE inflation stood at 1.59%, below the 2.0% objective, while the unemployment rate at 4.5% remained well beneath the estimated natural rate of 5.05%, leaving resource utilization elevated and the labor market tight. Initial jobless claims at 320,000 were steady, and financial conditions were notably calm: the financial stress index registered 0.1383, the VIX sat at 14.21, and the Baa spread held at a tight 1.6. Members observed that these readings pull against one another. Inflation running below target removed the case for any further tightening that had animated the prior meeting's hawkish tone, when the chief fear was that inflation would fail to moderate. A tight labor market and calm markets, at the same time, offered no urgency to ease.

On the question of what the real Federal Reserve is likely to do, the Committee's judgment was straightforward and unanimous. Every member, working from a distinct vantage point, arrived independently at a hold. Members weighting inflation risk saw no justification for a cut with resource utilization high and cautioned against reading too much into a single below-target print. Members focused on employment found no labor-market deterioration to defend against, noting that a cut on their terms would require material softening the data did not yet show. Those attentive to financial stability judged that a calm, arguably complacent market was not one to disturb with a surprise move in either direction, and those reading market pricing noted that while the 3-month T-bill spread of -0.73 hints at eventual easing, and the 10y-2y curve at +0.18 raised no acute recession alarm, markets were not pricing an imminent change. The Committee therefore expects the real Federal Reserve to leave the target rate unchanged at 5.25%.

The Committee's own deterministic framework reached a different conclusion, and the Committee states plainly that in its judgment the optimal policy at this meeting is a cut of 25 basis points. The framework's level-based reference rules pointed considerably further: the Taylor rule, the balanced-approach rule, and the ELB-adjusted rule each recommended -75 basis points, driven by below-target inflation and a large gap to neutral. With an estimated r* of 1.28 and core inflation near 1.6%, a neutral nominal rate sits around 2.9%, placing the current 5.25% stance roughly 200 basis points into restrictive territory. Against those aggressive prescriptions, the first-difference rule recommended only -25 basis points, and the loss-minimizing recommendation settled there as well. Members found the first-difference logic the most persuasive precisely because momentum was only slightly negative: inflation momentum at -0.11 confirmed prices decelerating rather than reaccelerating, and unemployment momentum at -0.05 sat near flat. A single quarter-point step removes some of the excess restriction the r* gap identifies without lurching toward neutral in one move that calm credit markets and steady claims give no reason to force.

Reconciling the two conclusions, members characterized the gap between a predicted hold and an optimal quarter-point cut as a stance that has drifted modestly too tight relative to fundamentals. The predictive hold reflects lingering inflation vigilance carried forward from the prior meeting; the framework reads the disinflation already achieved, with core PCE below target and negative momentum, and reads a real rate well above neutral. Members agreed that -25 basis points splits the difference between the aggressive level rules and gradualist first-difference logic in a way that begins removing restriction, preserves optionality should wage or price pressures reaccelerate, and respects the orderly, non-crisis easing already embedded in market pricing rather than signaling alarm with a larger move.

COMMITTEE VOTE

The Committee was unanimous, 5-0, in predicting that the real Federal Reserve will hold the target rate at 5.25%; on the framework's -25 basis point recommendation, the optimal-side deliberation also landed in full agreement, with all five members endorsing the recommendation as-is.