OpenFed

POLICY STATEMENT | July 31, 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%, but its own framework judges the loss-minimizing policy to be a 25 bps cut — a one-increment gap between caution and optimality.

STATEMENT

The defining feature of this meeting is not disagreement about the data but a clean divergence between what the Committee expects to happen and what its own framework judges best. On the predictive side, four of five members concluded that policy will most likely be held at 5.25%. Core PCE at 1.8% sits just below the 2.0% objective, and while that is reassuring, participants favoring a hold did not read it as inflation defeated. The Beige Book continued to flag input cost pressures, especially petroleum-related, with retail prices rising at a moderate rate, and the labor market remains tight: unemployment at 4.5% is well below the 5.05% natural-rate estimate, jobless claims are low at 305,000, and employment increased further in most Districts. Wage gains were described as moderate, with no wage-price spiral evident. Against that backdrop, participants generally judged that cutting now would risk front-running easing that the fundamentals do not yet demand.

One member dissented from the hold, weighting market-implied pricing above the current-state readings. On that view, the 3-month T-bill trading 0.53 below the funds rate is the single most informative signal — markets are already discounting easing rather than a hold — and the near-flat 10-year/2-year spread at +0.22, an elevated VIX of 23.52, and a Baa spread creeping to 1.85 all point toward tightening financial conditions. The hold camp acknowledged these as watch items warranting vigilance, but not as evidence of acute distress: the financial stress index at 0.213 is elevated, not extreme, and 'could spill' into the labor market is not 'has spilled.' The debate turned on the same distinction throughout — a forward-looking market read against a state-based reading of realized conditions — and neither side moved the other on the predictive question.

The Committee's own deterministic framework reaches a different destination: the loss-minimizing recommendation is a 25 bps cut. That figure reconciles a real internal tension among the reference rules. The Taylor rule, the balanced-approach rule, and the ELB-adjusted rule each call for -75 bps, driven by inflation below target and unemployment well under the natural rate; with r* estimated at 1.36, a neutral nominal rate near 3.2% leaves the current 5.25% clearly restrictive, which is why those rules push aggressively. The first-difference rule, by contrast, recommends only -25 bps, responding to momentum rather than level gaps — inflation momentum at -0.11 and unemployment momentum flat at 0.0. With the reference rules flagged reliable, the framework lands at -25 bps, and in deliberation the members coalesced around the first-difference logic: a measured, gradual adjustment that corrects a genuinely tight stance without the destabilizing signal of a 75 bps lurch, which several judged would validate market anxiety and overshoot given that growth is still expanding and no labor deterioration has appeared.

The gap between the expected hold and the optimal cut is therefore one 25 bps increment, and members were candid about what it reflects. From the labor and financial-stability perspectives, holding at 5.25% with inflation below target and CFNAI at -0.4 signaling below-trend growth leaves policy needlessly restrictive; a preemptive quarter-point cut would insure a still-healthy labor market and address widening spreads before deterioration shows in the hard data. The framework's -25 bps is the Committee's considered judgment of optimal policy for this meeting, even as it expects the real Federal Reserve to wait for clearer confirmation before easing.

COMMITTEE VOTE

The predictive vote was 4-1 in favor of holding at 5.25%, with one member preferring a 25 bps cut. On the framework's -25 bps recommendation, the optimal-side deliberation landed 4-1 in the same direction: four members endorsed the cut as-is and one endorsed its direction while remaining a shade more cautious on acting now.

NOTES

On the predictive question, the market-focused member dissented from the hold, arguing that the 3-month T-bill trading 0.53 below the funds rate already prices a first cut and that holding at 5.25% leaves policy behind the curve; the inflation-focused member, while endorsing the framework's easing direction, entered a partial reservation on the optimal side, judging that persistent petroleum cost pressures and a below-natural-rate labor market warrant waiting for confirmation before cutting — one increment more cautious than the framework's -25 bps.