OpenFed

POLICY STATEMENT | September 11, 2007

PREDICTED FED DECISION −50 bps

4.75%

OPENFED OPTIMAL RATE −25 bps

5.00%

KEY TAKEAWAY

The Committee expects the real Federal Reserve to cut 50 basis points, but its own framework judges the loss-minimizing move to be a smaller 25 basis point cut, a gap driven by market pricing running ahead of fundamentals.

STATEMENT

The defining feature of this meeting was the gap between what the Committee expects the real Federal Reserve to do and what its own framework judges to be optimal. On the incoming data there was broad agreement: core PCE at 1.47 percent sits meaningfully below the 2.0 percent objective, removing the inflation constraint that had dominated prior discussion, while financial conditions had clearly tightened, with the financial stress index at 0.3666 and the VIX at 25.27 pointing to genuine market strain. The Beige Book confirmed tighter residential mortgage lending standards, a contracting mortgage market across most Districts, and deepening housing weakness, and the Baa spread at 2.11 showed borrowing-cost stress building without reaching extreme levels. Against this, participants generally judged that the real economy had softened but not broken: unemployment at 4.6 percent remained below the 5.05 percent estimated natural rate, initial claims at 321,000 were still contained, and the CFNAI at -0.08 read as roughly trend growth rather than contraction.

On the predictive question, a majority of participants concluded the real Federal Reserve would deliver a 50 basis point cut. The single most cited signal was the 3-month T-bill sitting 129 basis points below the current 5.25 percent funds rate, a front-end move that several read as the market's aggregated forecast of roughly 50 basis points of near-term easing already priced in. Participants weighting labor-market risk stressed that credit tightening typically reaches hiring with a lag and favored preemptive insurance before deterioration shows in the data; those focused on financial stability argued that credit contagion can move nonlinearly and that a 25 basis point move risked appearing behind the curve. Two participants dissented from the 50 basis point call, judging that the hard activity data did not yet justify aggressive action and that a larger cut risked over-easing should the credit turmoil prove transitory.

The Committee's own deterministic framework reached a different destination: a 25 basis point cut as the loss-minimizing policy. Here the reference rules pulled in genuinely different directions. The Taylor rule, the balanced-approach rule, and the ELB-adjusted rule all pointed to -75 basis points, reflecting core inflation below target and unemployment beneath its natural rate. The first-difference rule, by contrast, indicated only -25 basis points. Participants engaging the framework found the first-difference logic most persuasive precisely because it responds to changes in conditions rather than levels: with inflation momentum at just 0.055 and unemployment momentum at 0.05, and with the estimated r* at 1.411, the case for a jumbo -75 move looked like an overreaction to still-modest momentum. A measured 25 basis point cut, on this reading, opens the easing cycle to address real credit and housing stress while inflation remains contained, preserves policy space, and avoids overshooting on ambiguous signals.

Both conclusions follow from the same argument. The divergence between the expected 50 basis point outcome and the optimal 25 basis point recommendation reflects, in the Committee's judgment, a market curve pricing more easing than fundamentals strictly demand: the front-end T-bill collapse expresses expectations, while the small momentum terms and a labor market not yet deteriorating support a more incremental first step. The Committee therefore holds that the real Federal Reserve is likely to cut 50 basis points, while identifying a 25 basis point cut as the policy most consistent with its own loss framework.

COMMITTEE VOTE

The predictive vote favored a 50 basis point cut, 3 to 2. On the framework's -25 basis point recommendation, the optimal-side deliberation landed at 3 endorsing as-is, 0 declining, and 2 partial (agreeing with the direction of easing but preferring a larger step).

NOTES

Two participants dissented from the majority 50 basis point predictive call, arguing that unemployment at 4.6 percent below its natural rate, contained claims, and near-trend CFNAI did not justify aggressive action, and that a 50 basis point move risked over-easing if the credit turmoil proved transitory; on the optimal side, the two partial stances came from those weighting market pricing and financial-stability contagion risk, who accepted -25 as directionally correct but judged it too timid given the T-bill signal and the nonlinear nature of credit stress.