OpenFed

POLICY STATEMENT | January 20, 2016

PREDICTED FED DECISION **HOLD**

0.25%-0.50%

OPENFED OPTIMAL RATE **−25 bps**

0.00%-0.25%

KEY TAKEAWAY

The Committee unanimously expects the real Fed to hold at 0.25%-0.5%, while its own framework judges optimal policy to be a 25 bps cut, a one-step gap driven by below-target inflation and a deeply negative neutral rate.

STATEMENT

Information reviewed for this meeting described an economy that had softened in recent weeks without weakening decisively. The Beige Book pointed to essentially flat activity, weakening manufacturing, sluggish consumer spending, and weak tourism, and the Chicago Fed National Activity Index at -0.3 confirmed below-trend growth momentum. Against that backdrop, inflation remained conspicuously soft: core PCE stood at 1.26%, well beneath the 2% objective. The labor market, by contrast, looked close to balance, with unemployment at 5.0% essentially at the 5.04% natural rate and initial claims low at 284,000. Financial conditions had tightened in ways that drew particular attention, with the VIX elevated at 27.59 and the Baa corporate spread at 3.35 signaling creeping credit stress, while a negative 3-month T-bill spread of -0.115 suggested that markets were not pricing near-term tightening and, if anything, leaned toward an easing bias.

In assessing the likely near-term stance of policy, participants converged quickly and without dissent on a hold at the current 0.25% to 0.5% range. The reasoning ran in two complementary directions. On one side, soft actual inflation and the elevated volatility and credit stress just described argued strongly against a second consecutive hike so soon after December's liftoff, particularly given that prior guidance had stressed 'only gradual' increases and data dependence; hiking into market stress, several judged, would tighten financial conditions beyond intent. On the other side, no participant saw a case for easing at this juncture: with the labor market at full employment, jobless claims healthy, and the 10-year/2-year spread at 1.16 giving no recession signal, there was no deterioration to insure against. That balance, holding while monitoring credit spreads and volatility, led the Committee to forecast that the real Federal Reserve will leave the target range unchanged.

The Committee's own deterministic framework arrived at a different conclusion, and the Committee judges that framework's answer to be the optimal one: a cut of 25 basis points. All four reference rules pointed the same way and were judged reliable this meeting, with the Taylor rule, the balanced-approach rule, the first-difference rule, and the ELB-adjusted rule each recommending -25 bps. The driving inputs were an estimated r* of -0.5%, implying a deeply negative neutral rate against which the current midpoint looks restrictive, together with inflation momentum of only 0.065 and unemployment momentum of -0.05, neither of which offered any reason to keep policy tight. Participants engaged the case on its merits. The balanced-approach rule persuaded those who weighed the employment and activity shortfall alongside the large inflation miss, while the ELB-adjusted rule spoke to those focused on the low-rate context and the credit-spread widening effectively doing the work of tightening on its own. Even a participant whose usual instinct is to guard against upside inflation risk acknowledged that, with core PCE running persistently below target, that bias simply did not bind here.

The one-step gap between the expected hold and the framework's -25 bps was read as revealing a stance that is modestly, but not alarmingly, too tight for present conditions. The reservations that kept the predictive vote at a hold were largely about timing and communication rather than direction: reversing December's first hike after a single meeting risked signaling alarm and inviting a confidence shock. Participants generally agreed on the direction of risk, that financial conditions have tightened and policy leans restrictive, even as they parted somewhat on whether a full 25 bps reversal now was warranted or whether a smaller, less jarring step would better fit a labor market not yet showing any weakness.

COMMITTEE VOTE	The predictive vote was unanimous, 5-0, to expect a hold at 0.25% to 0.5%. On the framework's -25 bps recommendation, the Committee split 3 to endorse and 2 partial, with no member declining the recommendation outright.
NOTES	*The two partial positions accepted the easing direction but not its full magnitude or timing: one, focused on employment, judged the insurance case real but not urgent given unemployment at the natural rate, and would have preferred a smaller, less abrupt step than a full reversal one meeting after liftoff; the other, reading market pricing, saw the negative T-bill spread and elevated VIX as pressure toward easing rather than a demand for immediate action, viewing the stress as possibly transitory.*