OpenFed

POLICY STATEMENT | December 7, 2016

PREDICTED FED DECISION +25 bps

0.50%-0.75%

OPENFED OPTIMAL RATE HOLD

0.25%-0.50%

KEY TAKEAWAY

The Committee unanimously expects the real Federal Reserve to raise rates 25 bps to 1/2 to 3/4 percent, while its own framework judges the optimal move to be 0 bps, a hold at the current range.

STATEMENT

Information reviewed at this meeting described an economy carrying firm momentum in the labor market against still-soft inflation. Unemployment stood at 4.6 percent, below the 4.8 percent estimated natural rate, and initial jobless claims at 268,000 pointed to no rising layoffs. Core PCE inflation, at 1.54 percent, remained below the Committee's 2 percent objective but was seen as rising gradually rather than receding, and the Beige Book noted tight labor markets with a growing number of service-sector contacts anticipating wage increases ahead. Financial conditions were calm and posed no obstacle to action: the financial stress index at 0.075 was very low, the VIX at 12.22 signaled market complacency, the Baa corporate spread of 2.61 showed no credit distress, and the 10-year to 2-year yield spread of 1.24 gave no recession warning.

On the question of what the real Federal Reserve will do at this meeting, participants converged, independently and then in rebuttal, on a single 25 basis point increase to a target range of 1/2 to 3/4 percent. Several considerations pointed the same way. The prior meeting's language that the case for an increase 'has continued to strengthen,' together with the last median projected rate of 0.6 percent above the current midpoint, was read as signaling an imminent move. The 3-month T-bill spread of 0.115 above the current rate was taken to mean markets already price roughly a full step, so a well-telegraphed hike would neither surprise nor tighten conditions abruptly. Participants with an inflation focus emphasized preempting emerging wage pressure before it reaches core PCE, while those attentive to employment noted that with unemployment below its natural rate and no sign of deterioration, a gradual step poses little threat to jobs. The predictive judgment was unanimous.

The Committee's own deterministic framework, applied to the same data, reached a different conclusion: the loss-minimizing recommendation is 0 basis points, a hold at the current 1/4 to 1/2 percent range. Every reference rule pointed lower still, to negative 25 basis points — the Taylor rule, the balanced-approach rule, the first-difference rule, and the ELB-adjusted rule all agreed, and all were judged reliable this meeting. Those signals reflect the inflation shortfall combined with an estimated r* of negative 0.5, which implies the current stance is already close to neutral rather than restrictive. The framework nonetheless declined to validate an outright cut. With inflation momentum and unemployment momentum both modestly positive at 0.05, and with sub-natural unemployment, easing would risk overheating without meaningful benefit. Holding at 1/4 to 1/2 percent thus emerged as the honest midpoint between rules that ease on the level gap and firming momentum that argues against it.

The gap between the predicted 25 basis point hike and the framework's 0 basis point hold quantifies how far a move would run ahead of what the underlying data justify. Participants attributed that gap chiefly to the prior meeting's strengthening-case language, the two dissents that favored a hike, and market pricing that has front-run the fundamentals. Read literally, the numbers describe policy that is only mildly accommodative and near appropriate: below-target inflation offsets the modest labor-market tightness, and benign financial conditions and a near-neutral r* leave no shock demanding action in either direction. The Committee's optimal judgment is therefore that inaction, not the anticipated move, minimizes loss at this meeting.

COMMITTEE VOTE

The predictive vote was unanimous, 5 to 0, for a 25 basis point increase to 1/2 to 3/4 percent. On the framework's 0 basis point recommendation, the optimal-side deliberation split 3 to 2 in favor — three members endorsed the hold as stated, and two agreed with its direction (no cut) but preferred a modest hike.

NOTES

The two partial positions came from the inflation-focused and market-signal perspectives: both firmly rejected the reference rules' negative 25 basis point easing signal, but held that calm credit conditions could comfortably absorb one gradual step and that the T-bill spread already prices such a move, leaving the hold mildly behind market-priced fundamentals.