



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

No point-in-time-safe data on System Open Market Account holdings was available on or before the cutoff for this meeting. As a result, the Committee is unable to report the total size, composition, or change from the prior release of SOMA holdings for this period. This gap pertains to SOMA securities holdings only; it should be noted separately that no point-in-time-safe data source currently exists for repurchase and reverse repurchase operation results, so those operations are likewise not summarized here. Members were advised that this section reflects the absence of source data rather than an absence of activity, and that the review of open market operations was necessarily limited on this occasion.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reported that economic activity continued to expand at a moderate pace as 1997 drew to a close. Core PCE inflation stood at 1.5 percent on a year-over-year basis, below the 2.0 percent objective. The unemployment rate was 4.7 percent, well below the 5.2 percent estimate of the natural rate, and initial jobless claims were low at roughly 307,000. The Chicago Fed National Activity Index at 0.31 pointed to growth somewhat above trend. The most recent Beige Book, prepared before mid-January, characterized the pace of growth as moderate, with retail sales for the holiday season mainly at or slightly above expectations after a slow start in early December, and with motor vehicle sales picking up at yearend on strength in sport utility vehicles, minivans, and light trucks. Manufacturing activity remained fairly strong, though a few Districts noted signs of easing, and construction and real estate markets were strong, with tight office and industrial space in several regions and some evidence of more speculative building in response to rising rents.

Labor markets were described as tight or very tight in all Districts, with more frequent reports of firms scaling back production or expansion plans because of labor shortages, and some Districts noting increased wage pressures for retail workers and certain skilled occupations. Even so, business contacts reported that prices were generally flat, attributing the restraint to intense competition and lower import prices. The staff highlighted that the impact of the Asian financial turmoil was felt in most Districts, chiefly through weaker exports and increased competition from Asian products in U.S. markets, and that despite lower prices, oil and natural gas drilling activity remained strong. Lending activity was brisk nationwide despite softer demand for consumer loans.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions were generally stable but carried some signs of external unease. The financial stress index was low at 0.1254, and the Baa corporate bond spread at 1.62 percentage points was



moderate, consistent with contained credit conditions rather than distress. The VIX at 22.27 was elevated but short of panic levels, in keeping with the Asia-related caution reflected in the Beige Book. The 10-year/2-year Treasury spread at positive 0.24 percentage point was flat but not inverted, indicating no acute recession pricing. The staff drew particular attention to the 3-month Treasury bill, which traded about 40 basis points below the current 5.5 percent federal funds rate, a negative spread suggesting that market participants anticipated some easing of policy over time.

STAFF ECONOMIC OUTLOOK

The staff outlook drew on the forward-looking quantities available for this meeting. The neutral real rate (r^*) used in the analysis was 3.115 percent; with the funds rate at 5.5 percent and core PCE inflation at 1.5 percent, the current stance appeared modestly restrictive relative to that neutral benchmark, and would become more so in real terms were inflation to continue drifting lower. Inflation momentum was negative at -0.085, indicating that price pressures were decelerating rather than building, consistent with the flat prices and disinflationary import influences noted in the Beige Book. Unemployment momentum was -0.15, implying that joblessness was still edging lower even as the labor market remained tight.

The reference rules were judged reliable and pointed, on balance, toward modest accommodation. The Taylor rule prescribed -75 basis points, reflecting the wide gap between actual conditions and the neutral benchmark and the below-target inflation reading; the Balanced Approach and ELB-adjusted rules each prescribed -25 basis points; and the First-Difference rule prescribed no change. Taken together, these outputs suggested that a measured easing rather than either an aggressive cut or an unchanged stance would best align policy with disinflation and the still-firm employment backdrop, and the loss-minimizing recommendation settled at -25 basis points. The staff cautioned that the projection remained contingent on how the Asian financial turmoil transmitted to domestic exports, employment, and credit conditions in the months ahead.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their independent opening assessments, all five participants arrived at the same predictive judgment of no change to the funds rate. The reasoning behind that convergence varied by perspective but rested on a common reading of the data: inflation was contained below target while the real economy remained solid, leaving no strong case to move in either direction. The participant most attentive to inflation risk emphasized that although core PCE at 1.5 percent was not running hot, labor markets were tight or very tight in all Districts and wage pressures were emerging for retail and skilled workers. That participant read the current price softness as largely import-driven, attributable to intense competition and lower import prices rather than domestic slack, and therefore potentially reversible, and warned



that easing into so tight a labor market risked fueling wage-push inflation.

The participant most focused on employment noted that neither of the conditions that would normally trigger a bias to ease was present: unemployment at 4.7 percent sat well below the 5.2 percent natural rate, claims were low, and the Beige Book confirmed tight-to-very-tight labor markets everywhere. This participant framed the Asian turmoil as a forward risk to future hiring rather than present weakness. The participant attentive to financial stability observed that the stress index was low, the Baa spread moderate, and the yield curve flat but not inverted, concluding there was neither acute credit stress justifying a cut nor overheating requiring a hike. The participant weighing market signals gave the most weight to the 3-month bill trading 40 basis points below the funds rate, reading it as evidence that markets anticipated easing eventually but not necessarily at this meeting. The data-dependent participant summed up the cross-currents plainly: tight labor arguing against a cut, soft inflation and Asian drag arguing against a hike, netting out to no change. In the rebuttal round, no participant was moved from a hold, and the predictive vote remained unanimous at no change.

When the discussion turned to the framework's loss-minimizing recommendation of -25 basis points, participants engaged with the divergence between that recommendation and their own predictive holds. Several described the gap as revealing that current policy was mildly restrictive relative to below-target, softening inflation, rather than badly misaligned. The inflation-focused participant acknowledged that with core PCE below target and negative inflation momentum, the usual caution against cutting simply did not apply, and characterized the Taylor rule's -75 basis points as reckless given tight labor markets; a single 25 basis point step, by contrast, was measured enough to preserve restraint against wage-push risk. The employment-focused participant endorsed the cut as cheap insurance against Asian spillover before it showed up in rising unemployment, noting that holding would let the real rate drift higher as inflation eased, amounting to passive tightening.

The financial-stability participant framed a modest cut as a contagion-prevention move, easing preemptively before spreads widened destructively, and pointed again to the negative bill spread as evidence that markets judged 5.5 percent tighter than warranted. The market-signals participant found the -25 basis point recommendation aligned almost exactly with front-end pricing, while judging the Taylor rule's larger cut unsupported by anything in the curve or credit spreads. The data-dependent participant read the split among the reference rules — Taylor at -75, two at -25, the First-Difference rule at 0 — as making -25 the sensible central reading, with below-target inflation outweighing a still-tight but easing labor market. Across the rebuttal round, participants generally reinforced rather than revised these views; a couple observed that the dove's point about muted wage pass-through, with prices flat despite tight labor, slightly eased concerns about inflation from a small



cut. Throughout, participants distinguished between their institutional caution in the predictive vote — a preference to await clearer data — and their assessment of where policy ought to head under the loss-minimizing framework.

COMMITTEE POLICY ACTIONS

On the predictive question of the appropriate policy action at this meeting, the Committee's vote was unanimous for no change to the federal funds target, recorded as 5 members for 0 basis points. On the separate question of the framework's loss-minimizing recommendation of a 25 basis point reduction, all five members endorsed the recommendation as-is, with none declining and none registering only partial agreement. The record thus reflects a genuine and consistently noted divergence: a unanimous predictive hold rooted in institutional caution, tight labor markets, and the absence of acute financial stress, alongside unanimous endorsement of the framework's view that below-target inflation, negative inflation momentum, a modestly restrictive stance relative to the neutral rate, and market pricing embedded in the negative bill spread together justified a single, measured easing step.