



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

No System Open Market Account holdings data was available on or before the point-in-time-safe cutoff for this meeting, so the Committee was unable to review the total size, composition, or change from the prior release of the SOMA portfolio. This section is limited to SOMA holdings only; it does not cover the results of repurchase or reverse-repurchase operations, for which no point-in-time-safe data source currently exists. The desk's operational activity is therefore not summarized here, and any characterization of portfolio changes has been omitted rather than estimated.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reported that the economy continued to expand at a moderate pace. Core PCE inflation stood at 1.21 percent on a year-over-year basis, well below the 2 percent objective, and the labor market remained tight, with the unemployment rate at 4.5 percent against an estimated natural rate of 5.17 percent. Initial jobless claims of 305,000 were still contained, and the Chicago Fed National Activity Index at -0.01 indicated growth running roughly at trend. M2 stood at \$4,239 billion. Taken together, the current activity readings pointed to an economy neither collapsing nor overheating.

The most recent Beige Book, prepared before September 8, characterized overall activity as continuing to expand at a moderate pace, though several Districts reported slowing in some sectors. The New York District described significant segments of its economy as slowing, and the Dallas District noted that activity decelerated in August as manufacturing declined. Construction was described as very strong nationally, with high home sales and low unsold inventories noted in some regions. At the same time, several Districts reported a sharp deterioration in both business and household expectations for the fourth quarter and for 1999; the Philadelphia, Atlanta, St. Louis, and San Francisco Districts all reported a less buoyant outlook, and in the Minneapolis District the number of sources expressing concern about the near future was described as striking. Many Districts continued to report labor market tightness pushing wages up at a faster pace, while retail prices were generally steady or declining slightly and falling import prices helped push industrial commodity prices lower.

STAFF REVIEW OF THE FINANCIAL SITUATION

The staff noted that financial conditions had tightened and that market stress was pronounced. The VIX stood at 36.62, an extremely elevated level signaling acute volatility and risk aversion, and the financial stress index at 0.2628 confirmed a broad tightening. The Baa corporate spread of 2.35 pointed to meaningful pressure on borrowing costs, and the 10-year/2-year yield curve spread was nearly flat at 0.07, a configuration associated with rising downside growth risk. The 3-month Treasury bill was 0.81 below the current 5.5 percent funds rate, indicating that short-term markets were already pricing in



easing relative to the prevailing policy stance.

STAFF ECONOMIC OUTLOOK

The staff outlook drew on the forward-looking quantities available. The estimated neutral rate (r^*) of 3.261 implied that a funds rate at 5.5 percent stood well above neutral, consistent with a policy stance that was restrictive relative to underlying conditions. Inflation momentum of 0.085 was only marginally positive, offering no evidence of an accelerating price trend, and unemployment momentum of 0.1 pointed to a labor market whose direction was beginning to turn upward even as the current level remained below the natural rate. These momentum readings, though modest, suggested that the risks to activity were tilting toward softening rather than overheating over the projection horizon.

The reference rules spanned a wide range. The Taylor rule prescribed no change, while the Balanced Approach and ELB-adjusted rules each indicated a substantial tightening of 75 basis points, reflecting the sizable labor-market slack gap. The First-Difference rule, which responds to the change in conditions rather than the level of gaps, indicated a 50 basis point cut. The staff observed that the level-based rules keyed heavily on the still-tight labor market and thus leaned toward tightening, a signal in tension with observed prices, which were flat to falling. The framework judged the reference rules reliable and, weighing the low inflation momentum against the modest but firming unemployment momentum and the elevated stress readings, arrived at a loss-minimizing recommendation of a 25 basis point reduction — less than the First-Difference easing signal but decisively away from the level rules' tightening.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their opening assessments, all five participants independently favored a 25 basis point reduction in the funds rate, and the discussion across rounds elaborated on why a modest cut, rather than a hold or a larger move, best fit the data. Participants generally agreed that core PCE inflation at 1.21 percent, well below the 2 percent objective, together with steady-to-declining retail prices and falling import and commodity prices, removed any inflation constraint on easing. Several observed that the current activity data — the Chicago Fed index near zero, claims at 305,000, and moderate expansion in the Beige Book — argued against aggressive action, while the sharp deterioration in fourth-quarter and 1999 expectations flagged across multiple Districts argued against standing pat.

The participant most attentive to inflation risk acknowledged a genuine reframing of the usual hawkish posture. That participant noted that the one clear inflation signal, Beige Book labor tightness pushing wages up, was a latent concern rather than a present threat, and that with core inflation running a full 80 basis points below target there was no defensible basis to block easing on price-stability grounds.



This member emphasized, however, that residual wage pressure from a labor market with unemployment at 4.5 percent, below the 5.17 percent natural rate, argued against a large, front-loaded cut that could prove hard to reverse — a case for a measured single step rather than for the 50 basis point move implied by the First-Difference rule.

The participant weighting employment risk framed the decision as pre-emptive insurance. This member stressed that current joblessness was still low and claims contained, but that unemployment momentum of 0.1 and the souring Q4/1999 expectations — with New York and Dallas decelerating and Minneapolis concern described as striking — were the leading signals worth getting ahead of. The participant focused on financial stability emphasized the VIX at 36.62, the Baa spread at 2.35, and the near-flat 2s10s curve as evidence of acute strain and tightening credit, arguing that a 25 basis point cut would cushion conditions without appearing to panic markets, whereas an oversized move could itself unsettle markets by suggesting the Committee saw something worse than it was communicating. The data-dependent participant read the indicators at face value and characterized 25 basis points as the literal middle ground between the stable Taylor rule and the easing signals from momentum and stress.

The participant weighting market pricing pointed to the 3-month bill sitting 0.81 below the funds rate as a clear forward signal, consistent on his reading with roughly three cuts relative to the current rate. This member acknowledged a reservation that a single quarter-point move might undershoot the forward signal, but concluded that with current activity still solid a measured first step was defensible and represented the minimum credible response. In the framework discussion, participants converged on the view that the level rules were backward-looking on slack and overweighted the labor gap relative to actual, falling prices, while the First-Difference rule better captured the momentum shift; the framework's 25 basis point recommendation was seen as splitting that difference sensibly. Across the rebuttal rounds, no participant was moved toward a hold or toward a larger cut, and each concluded that current policy at 5.5 percent was modestly restrictive relative to r^* of 3.261 and to where forward conditions pointed.

COMMITTEE POLICY ACTIONS

In the predictive vote, all five participants supported a 25 basis point reduction in the target federal funds rate, from 5.5 percent to 5.25 percent, a unanimous 5-to-0 outcome. The deterministic optimal policy engine likewise recommended a 25 basis point cut, and on the optimal-side vote taken at the close of deliberation all five members endorsed that recommendation as-is, with none declining and none registering partial agreement on magnitude or timing. The predictive and framework-based outcomes were thus in full agreement.