



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

No point-in-time-safe data on the System Open Market Account was available for this meeting, and accordingly the Committee's review of SOMA holdings could not address total portfolio size, security composition, or the change from the prior release. The desk's summary was therefore limited in scope. It should be noted that this section concerns SOMA holdings only; it does not cover the results of repurchase or reverse repurchase operations, for which no point-in-time-safe data source is currently available. Members were advised that reporting on open market operations would resume as reliable holdings data became available.

STAFF REVIEW OF THE ECONOMIC SITUATION

Core PCE inflation was running at 1.25 percent on a year-over-year basis, roughly three-quarters of a percentage point below the 2 percent objective. The labor market remained tight: the unemployment rate stood at 4.6 percent, below the estimated natural rate of 5.16 percent, and initial jobless claims were a manageable 302,000. Broad measures of activity pointed to continued near-trend expansion, with the Chicago Fed National Activity Index at 0.28 and M2 money supply at roughly 4,242 billion dollars. The fed funds rate was 5.25 percent going into the meeting.

The most recent Beige Book characterized the economy 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. Weakness in the Asian economies was cited as a source of continuing and in some cases increasing softness in certain industries, alongside falling import prices that had helped push industrial commodity prices lower. Retail prices were generally steady or declining slightly across most Districts, while a large number of Districts continued to report labor market tightness that appeared to be pushing wages up at a faster pace. Construction activity was described as very strong nationally. Notably, several Districts reported a sharp deterioration in both business and household expectations for the fourth quarter and 1999, with the report from one District describing the number of contacts expressing concern about the near future as 'striking.'

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions had tightened materially and showed clear signs of stress. The VIX stood at 45.74, an extraordinarily elevated level indicating acute market volatility and fear. The financial stress index registered 0.2919, and the Baa corporate spread had widened to 2.65 percentage points, both consistent with rising borrowing costs and credit-market strain. The 3-month Treasury bill was trading 1.45 percentage points below the current funds rate, a sizable gap suggesting that markets were



already pricing in substantial near-term easing. The 10-year/2-year Treasury spread was relatively flat at 0.46, consistent with expectations of slower growth ahead. Taken together, these indicators pointed to a de facto tightening of financial conditions being imposed by markets independent of any change in the nominal policy rate.

STAFF ECONOMIC OUTLOOK

The staff's forward-looking assessment drew on the estimated neutral rate and on measures of momentum in the underlying data. The neutral real rate used in the framework was 3.287 percent. With inflation momentum estimated at 0.115 and unemployment momentum at 0.10, both readings were small, implying that neither prices nor labor conditions were shifting rapidly at present. This combination suggested that the level-based case for a restrictive stance rested largely on the still-tight labor market rather than on any accelerating price dynamic.

The reference rules diverged sharply, and this divergence was itself informative about the range of plausible paths. The Taylor rule pointed to a 25 basis point increase and both the Balanced Approach and ELB-adjusted rules to increases of 75 basis points, each reflecting the tight labor market and the gap between unemployment and its natural rate. In contrast, the First-Difference rule, which responds to the change in conditions rather than to gaps in levels, called for a 50 basis point cut, capturing the deterioration in the outlook and the buildup of financial stress. The loss-minimizing recommendation, with reference rules judged reliable, was a 25 basis point reduction — a value that tempered the easing implied by the First-Difference rule against the tightening implied by the level-based rules. The implication was that the current stance was modestly too restrictive relative to conditions, with the balance of risks tilted toward the downside signaled by financial markets and by deteriorating expectations, even as realized activity had not yet weakened.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

Participants began from a common observation: with core PCE at 1.25 percent, well below the 2 percent objective, inflation posed no obstacle to easing. The member most attentive to inflation risk was explicit that this fact, more than any other, shaped the discussion. Retail prices were steady or declining, import prices were falling under the weight of Asian weakness, and commodity prices had moved lower — a disinflationary rather than inflationary picture. This member noted that the one genuine inflation concern, wage pressure arising from a labor market with unemployment at 4.6 percent against a 5.16 percent natural rate, had not fed through into consumer prices, and that inflation momentum of 0.115 confirmed the absence of an accelerating price dynamic. The usual hawkish caution against easing, this member concluded, simply did not bind when inflation was already contained.



A second strand of the discussion centered on financial stress. The member most focused on stability described the VIX at 45.74 as extraordinary — genuine market fear rather than routine volatility — and pointed to the stress index at 0.29 and the Baa spread at 2.65 as evidence of building credit-market strain. The concern most emphasized was that market stress could transmit into the real economy through credit channels, potentially in a nonlinear fashion, before it showed up in inflation or employment. Waiting for stress to fully arrive in the hard data, on this view, risked acting too late. The member attentive to labor markets echoed this from the employment side, treating the sharp deterioration in Beige Book expectations for the fourth quarter and 1999 as a leading signal that typically precedes actual job losses, and framing a cut as prudent insurance to protect employment ahead of any rise in claims. The member weighting market pricing most heavily read the 3-month bill sitting 1.45 percentage points below the funds rate as the market's explicit demand for accommodation, reinforced by the flat 10-year/2-year curve.

Against these forward-looking concerns, participants repeatedly returned to the still-solid state of realized activity. Jobless claims at 302,000, the CFNAI at 0.28 near trend, unemployment below the natural rate, and strong construction were cited as evidence that the real economy had not yet cracked. This was the main reason no participant advocated a larger, 50 basis point move. Several acknowledged that the size of the bill-rate gap arguably priced in more than a single cut, and that the First-Difference rule's call for 50 basis points captured the deteriorating momentum well. But most judged that a deeper cut would risk overreacting to sentiment and volatility ahead of confirmed weakness, and the stability-focused member added that a 50 basis point move could itself signal panic and destabilize confidence. The deterioration, as one participant put it, was in expectations, not yet in the realized data.

In the optimal-framework rounds, participants tested their predictive positions against the reference rules and the loss-minimizing recommendation. Several were struck by the divergence in the rules — three of the four level-based rules pointing to tightening while only the First-Difference rule eased — and read the framework's landing on a 25 basis point cut as evidence that stress and momentum factors dominated the still-tight labor level. The centrist member characterized the recommendation as tempering the First-Difference signal against the hawkish level rules, converging on a measured middle path. Members generally found that the framework agreed with their own predictive vote, and treated that convergence as reassuring rather than as introducing new information. The inflation-focused member reiterated that a 25 basis point cut sacrificed no price stability and remained small enough to reverse should wage pressure ever transmit into prices, while holding would amplify a stress-driven slowdown for no inflation-fighting benefit — in that member's words, the wrong trade.



In the concluding rebuttal, no participant was moved toward either holding or a full 50 basis point cut. Those who leaned toward the First-Difference logic — chiefly the labor, stability, and market-signal members — accepted 25 basis points as the prudent first move that preserved optionality if fourth-quarter conditions weakened further. Those emphasizing contained inflation and firm activity likewise saw 25 basis points as the calibrated response. Participants generally judged that a modest insurance cut fit the combination of contained inflation and elevated financial stress, acknowledging the clear stress signals without abandoning a fundamentally healthy real economy.

COMMITTEE POLICY ACTIONS

In the predictive round, all five members supported a 25 basis point reduction in the target federal funds rate, a unanimous outcome (five of five at -25 basis points). On the framework's loss-minimizing recommendation of -25 basis points, the Committee's recorded stance was full agreement: all five members endorsed the recommendation as-is, with none declining and none registering partial support on magnitude or timing. The inflation hawk, labor market dove, financial stability voice, data-dependent centrist, and market signal realist each endorsed the 25 basis point cut.