



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

No point-in-time-safe data on System Open Market Account holdings was available for this meeting, and the Committee therefore had no current figures on the total size, composition, or period-over-period change in SOMA holdings before it. This absence pertains specifically to the SOMA portfolio; it should be noted separately that no point-in-time-safe data source currently exists for the results of temporary open market operations, including repurchase and reverse repurchase transactions, so no summary of those operations is presented here either. The discussion that follows accordingly draws on the economic and financial indicators available rather than on portfolio detail.

STAFF REVIEW OF THE ECONOMIC SITUATION

The real economy entered the intermeeting period on firm footing. Core PCE inflation stood at 1.34 percent on a year-over-year basis, well below the 2.0 percent objective, and the Beige Book prepared at the Federal Reserve Bank of Boston reported that most districts saw generally stable or declining prices for both producers and consumers. Exceptions were scattered rather than broad: home prices were rising in some districts, service fees were said to be up in Dallas, and Boston noted price increases by selected manufacturers, while energy and most agricultural prices remained low by historical standards. Labor markets were tight. The unemployment rate was 4.3 percent, well below the 5.15 percent estimate of the natural rate, and initial jobless claims came in at 311,000. All twelve districts mentioned labor market tightness, with Atlanta, Chicago, and Richmond recording heightened wage pressures in some sectors and St. Louis citing increased worker 'poaching,' though Kansas City, Boston, and San Francisco reported that some extreme shortages had eased.

Aggregate activity looked solid but uneven across regions. The Chicago Fed National Activity Index registered 0.11, consistent with growth near trend. The Beige Book characterized most regions as showing solid growth overall despite mixed or weak results in individual sectors, with New York, Philadelphia, and Richmond reporting a recent pickup while Boston, Atlanta, Cleveland, Kansas City, and San Francisco indicated that the pace of growth had slowed for at least some sectors. Holiday retail sales generally grew at a moderate pace, with brisk growth reported in Kansas City, Philadelphia, and Minneapolis and weak results only in Atlanta; retail discounting around Christmas and the turn of the year was described as more extensive than usual in some areas. Looking ahead, contacts in most districts remained optimistic about 1999, especially the first half, though respondents in most districts expected somewhat slower growth than in 1998.

STAFF REVIEW OF THE FINANCIAL SITUATION



Financial conditions carried a note of lingering nervousness even as the real economy held up. The VIX stood at 29.23, an elevated reading indicative of meaningful market volatility, while the broader financial stress index registered 0.2238, a moderate level rather than one signaling acute dislocation. The Baa corporate spread was 2.57, pointing to some credit-cost stress without extreme widening. The term structure was notably compressed: the 10-year/2-year spread was just 0.06, close to flat, and the 3-month Treasury bill traded roughly 40 basis points below the current 4.75 percent funds rate, a configuration consistent with market expectations of easier policy ahead. Taken together, these readings suggested markets were pricing some prospect of accommodation while stopping short of signaling crisis.

STAFF ECONOMIC OUTLOOK

The forward-looking indicators available to the staff pointed toward a policy setting that was modestly restrictive relative to a loss-minimizing benchmark. The estimated neutral real rate (r^*) was 3.318, which against core inflation of 1.34 percent implies a fairly demanding nominal neutral rate; with the funds rate at 4.75 percent, the real stance sits somewhat below r^* but remains tight given how soft realized inflation is. Momentum measures were muted in both directions: inflation momentum was barely positive at 0.05 and unemployment momentum was slightly negative at -0.1, indicating no accelerating price pressure and a labor market still edging tighter rather than loosening.

The reference rules split sharply, and the divergence is itself informative for the projected path. The Taylor rule, the Balanced Approach rule, and the ELB-adjusted rule each pointed to roughly +75 basis points, driven mechanically by the wide gap between 4.3 percent unemployment and the 5.15 percent natural-rate estimate. The First-Difference rule, which responds to changes rather than levels, pointed to -25 basis points, reflecting below-target inflation and flat-to-soft momentum. With the reference rules judged reliable, the deterministic policy engine resolved this tension in favor of the momentum-based reading, recommending -25 basis points. The projection this implies is one in which the level-based hike signal is discounted because tight labor has not, in the price data, translated into broad inflation, leaving room for a modest easing as the loss-minimizing direction.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their initial predictive round, all five participants independently arrived at a preference for holding the funds rate at 4.75 percent, and the reasoning converged on a common core even as the emphasis differed by mandate. Participants generally judged that core PCE at 1.34 percent, below the 2.0 percent objective, removed any urgency to tighten, while the tight labor market — 4.3 percent unemployment against a 5.15 percent natural rate, low jobless claims, and Beige Book reports of wage pressure and 'poaching' in several districts — removed any employment case for easing. A couple of participants



stressed that elevated volatility, with the VIX at 29.23 and a moderate stress index, argued against tightening into fragile markets, while others noted that solid growth and near-trend activity argued equally against a preemptive cut. The result was a balanced standstill: no compelling case to move in either direction.

The member most attentive to market signals observed that the 3-month bill trading 40 basis points below the funds rate and the near-flat yield curve leaned toward easing, but concluded the signal was too mild to override the solid growth backdrop and that a hold both matched the direction of market pricing and preserved optionality. In the rebuttal round this member held that view, noting markets were pricing expected future easing that need not be delivered immediately. The participant weighting financial stability made a parallel point in the opposite spirit: elevated volatility and a Baa spread of 2.57 counseled against tightening, but easing without a genuine credit event risked adding froth rather than calm. None of the participants was moved from a hold, and the predictive round closed unanimously.

When the discussion turned to the framework's loss-minimizing recommendation of -25 basis points, participants engaged seriously with why a small easing might be optimal even though they had each voted to hold. Several found the First-Difference rule the most persuasive of the four references, precisely because the three level-based rules — reading the wide unemployment gap — generated a +75 basis point hike signal that the actual price data contradicted. As the inflation-focused member put it, tight labor was not translating into broad inflation, so the level rules overstated the Phillips-curve pass-through; the below-target reading and financial fragility instead pointed the other way. The employment-focused participant developed a related argument, questioning whether the natural-rate estimate was stale if unemployment could sit at 4.3 percent without igniting inflation, and framing a cut as forward-looking insurance against the risk that a flat curve and elevated VIX might choke off hiring before weakness showed in the claims data.

Real disagreement remained over magnitude and timing rather than direction. The financial-stability member and the market-signal member came to endorse the -25 basis point recommendation outright, the former because a modest cut would cushion credit markets at essentially no inflation cost, the latter because the inverted short-end and low inflation, in that member's view, justified the full move rather than a smaller step. The labor-market and centrist participants agreed the easing direction was defensible but preferred to wait, judging that strong labor data, solid Beige Book growth, and optimism for the first half of 1999 did not yet compel immediate action. The inflation-focused member went furthest in resistance, conceding that below-target inflation lowered the cost of a cut and softened opposition to the direction, but declining the -25 basis points as premature so long as labor tightness could still feed future wage and price pressure.



The thread running through all four rounds was that participants read current policy as mildly restrictive relative to soft inflation — the real rate near 3 percent sitting below the 3.318 estimate of r^* yet still tight given inflation this quiet — but differed on whether that gap warranted acting now or watching for confirmation. Those who would wait pointed to the absence of any deterioration signal in the labor and growth data; those who would ease pointed to the near-flat curve, the sub-funds-rate bill, and stalled inflation momentum as reasons to move before conditions bit.

COMMITTEE POLICY ACTIONS

In the predictive vote on the policy decision for this meeting, all five participants supported holding the target federal funds rate at 4.75 percent, a unanimous 5-to-0 outcome. On the separate question of the framework's loss-minimizing recommendation of -25 basis points, the Committee was genuinely divided: two members endorsed the recommendation as-is (the financial-stability voice and the market-signal realist), one member declined it (the inflation hawk), and two members took a partial position, agreeing with the easing direction but not with the magnitude or immediate timing (the labor-market dove and the data-dependent centrist).