



## **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, and so the Committee's usual review of the total size, composition, and change in SOMA holdings from the prior release could not be conducted from the material at hand. This section is limited by design to SOMA holdings; it does not encompass the results of repurchase or reverse repurchase operations, for which no point-in-time-safe data source currently exists. Members were reminded that, in the absence of these figures, no inference about the level or trajectory of the portfolio should be drawn.

## **STAFF REVIEW OF THE ECONOMIC SITUATION**

The staff reported that economic activity was described as strong in most Federal Reserve Districts, with growth characterized as solid in the Philadelphia and Kansas City Districts and moderate in Atlanta and Chicago. Consumer spending grew rapidly over the holiday shopping period, and many retailers expected the high level of activity to continue into early 2000. Retail sales met or exceeded December expectations in all Districts save St. Louis, where increases of 4 to 5 percent were considered below expectations, and sales were especially high nationwide in electronics, toys, and jewelry. Several Districts reported softer apparel sales owing to unseasonably warm weather. All regions reported large gains in e-commerce, with only St. Louis retailers noting a negative effect on more traditional shopping. Manufacturing continued to expand in nearly every District and was broadly based across industries, with exceptions in food, apparel, agricultural equipment, and some construction-based industries. Residential construction was mixed, and the century rollover caused little or no disruption to commercial or production activity.

The labor market remained very tight. The unemployment rate stood at 4.1 percent, well below the estimated natural rate of 5.12 percent, and initial jobless claims were low at 284,000. Labor markets were described as tight in all Districts, but the Beige Book noted that this tightness 'did not seem to be matched with large wage increases.' On the price side, core PCE inflation was 1.54 percent on a twelve-month basis, below the 2.0 percent objective. Most consumer prices appeared to be holding steady in much of the country, though a few Districts reported moderate increases; producer prices also appeared flat, with the notable exception of rising petroleum prices. The Chicago Fed National Activity Index registered 0.16, consistent with growth somewhat above trend, and M2 stood at \$4,662.6 billion.

## **STAFF REVIEW OF THE FINANCIAL SITUATION**



The staff characterized financial conditions as broadly accommodative but with some caution flags. The financial stress index was moderate at 0.2391, and the Baa corporate spread of 1.59 percentage points indicated contained conditions in corporate credit, with no evident widening. The 10-year/2-year Treasury spread was positive but flat at 0.24 percentage point, showing no inversion and thus no recession signal from the shape of the curve. The 3-month Treasury bill yield sat 0.09 percentage point below the current federal funds rate of 5.5 percent, a small negative spread consistent with market participants discounting a modest firming rather than easing or an aggressive multi-step move. The VIX, at 23.03, was somewhat elevated, suggesting a degree of market nervousness, though it remained well short of crisis levels, and the century rollover had passed without disruption.

### **STAFF ECONOMIC OUTLOOK**

The staff outlook drew on the estimated neutral rate and on the momentum in realized activity. With the neutral real rate ( $r^*$ ) estimated at 3.702 percent, the current nominal funds rate of 5.5 percent less inflation running near 1.5 percent implies a real stance modestly above neutral, suggesting policy is already somewhat restrictive. Inflation momentum was essentially flat at 0.005 and unemployment momentum was slightly negative at -0.05, indicating an economy in which prices are not accelerating and the labor market is still gradually tightening rather than turning. On the balance of these readings, the staff projection is for continued strong activity and a persistently tight labor market in the near term, with realized inflation likely to remain below the 2.0 percent objective absent a new impulse — petroleum prices being the most visible candidate for upward cost pressure.

The reference rules diverged sharply, and this divergence is itself informative for the projected path. The Taylor rule, Balanced Approach rule, and ELB-adjusted rule each pointed to 75 basis points of firming, reflecting the wide unemployment gap; the First-Difference rule, which responds to momentum rather than levels, pointed to -25 basis points. The deterministic loss-minimizing recommendation, with reference rules judged reliable, was -25 basis points, weighting the below-target inflation reading and flat momentum more heavily than the gap-based prescriptions. The projection this implies is one in which, if the momentum readings hold, conditions do not warrant additional restriction and may support a slight reduction; the level rules stand as a reminder that, should wage and price pass-through emerge from the tight labor market, the appropriate path would shift materially higher.

### **PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK**

In the predictive discussion, all five participants independently arrived at the same conclusion: a 25 basis point increase in the funds rate. The reasoning, however, came from distinctly different lenses.



The participant most focused on inflation risk emphasized that although core PCE at 1.54 percent was below target, unemployment at 4.1 percent far below the 5.12 percent natural rate signaled significant labor-market overheating, with the Beige Book confirming strong activity and rapid consumer spending across Districts. Rising petroleum prices were flagged as a possible source of future price pressure, and the restraint of tight labor not yet producing large wage gains was judged fragile. From this view a measured preemptive hike guarded against overheating before wage pressures materialized, while the below-target reading argued against anything larger.

The participant attentive to employment risk noted that the usual trigger for easing — rising unemployment or slowing hiring — was simply absent; with claims low at 284,000 and unemployment still falling, there was no job weakness to protect and thus no case for a cut. The financial stability voice found the credit picture reassuring, with contained Baa spreads and no inversion, but singled out the elevated VIX as a caution against any large or abrupt move; a measured step was seen as consistent with what money and credit markets appeared to expect. The market-signal participant read the 9 basis point negative T-bill spread and the flat-but-positive curve as markets already discounting a modest hike rather than a cut or a shock. The data-dependent centrist tied these strands together: strong growth and a very tight labor market argued for continued gradual tightening, while below-target inflation removed any urgency for a larger move. In the rebuttal round, no participant was moved off the +25 position.

The optimal-framework discussion, conducted after the predictive vote was final, confronted the tension between that consensus and the deterministic recommendation of -25 basis points. Participants observed that three of the four reference rules called for 75 basis points, driven overwhelmingly by the unemployment gap, while the First-Difference rule and the loss-minimizing output both pointed to a slight easing, driven by flat inflation momentum (0.005) and a near-flat unemployment momentum (-0.05). Several participants found the First-Difference logic genuinely persuasive on its own terms: with realized inflation below target, wages contained, and prices 'holding steady,' the case for further tightening rested on gaps rather than on realized data. The observation that the real rate stood near or modestly above the 3.702 percent estimate of neutral reinforced the sense that policy might already be adequately restrictive.

Yet the framework's direction met genuine resistance in the rebuttal round. The inflation-focused participant declined the recommendation outright, arguing that cutting into a labor market at 4.1 percent and demand plainly strong in the Beige Book would stimulate the very overheating most feared; realized inflation below target argued against a hike, but latent risk argued equally against an ease, making a hold the defensible middle. The remaining participants agreed with the direction — that



the level rules overstated the tightening case and that not adding restriction was appropriate — but balked at the full magnitude. The employment-focused participant noted that a preemptive cut is warranted only when downside labor risk is visible, and it was not; the stability voice worried that an outright cut into a tight labor market with a jittery VIX could itself signal alarm and unsettle markets. The centrist judged that a 50 basis point swing from the consensus +25 to -25 overread a modest 0.46 percentage point undershoot, and the market-signal participant stressed that a T-bill only 9 basis points under the funds rate implied policy was modestly, not sharply, tight — justifying a pause or a trim, not necessarily a full quarter point.

The discussion thus surfaced a real and instructive gap: the committee's predictive lean was cautiously restrictive, guarding against gap-based overheating fears, while the loss-minimizing math weighted subdued realized inflation and quiet momentum toward slight easing. Participants generally judged that this divergence flagged the current stance as tighter than the realized inflation and market-pricing data alone would justify, even as none but one embraced an active cut.

### COMMITTEE POLICY ACTIONS

In the predictive vote, all five participants supported a 25 basis point increase in the federal funds rate, a unanimous tally of five for +25 basis points. On the separate question of the deterministic framework's recommendation of a 25 basis point cut, the committee did not endorse the recommendation as-is: no participant endorsed it in full, one participant — the member weighting inflation risk most heavily — declined it outright on the grounds that easing into a hot labor market was premature, and the remaining four participants registered partial agreement, accepting the direction away from further tightening but judging a full quarter-point cut to exceed what the stable, contained data supported. The recorded optimal-side outcome was therefore zero endorse, one decline, and four partial.