



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The Committee reviewed the most recent data on the System Open Market Account. As of January 24, 2007, total SOMA domestic securities holdings stood at \$775.5 billion, comprising \$467.9 billion in Treasury notes and bonds and \$277.0 billion in Treasury bills. This represented no change from the prior release of January 17, 2007, a week-over-week movement of \$0.0 billion. It was noted that these figures cover SOMA holdings only — the total size, composition, and week-over-week change — and do not encompass repo or reverse-repo operation results, for which no point-in-time-safe data source currently exists.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reported that core PCE inflation on a year-over-year basis stood at 1.91 percent, fractionally below the 2.0 percent objective. The unemployment rate was 4.5 percent, below the estimated natural rate of 5.04 percent, indicating a labor market that remained tight. Initial jobless claims were 335,000, a level consistent with continued moderate hiring and no evident deterioration. The Chicago Fed National Activity Index registered -0.48, pointing to growth somewhat below trend. The Employment Cost Index reading was 104.2, and M2 money supply stood at \$7,020.8 billion.

The most recent Beige Book, prepared before the reference cutoff, characterized economic activity as expanding at a modest pace across most Districts. Growth was described as moderate in the New York and San Francisco Districts, while Dallas reported further deceleration from a high level and Minneapolis saw only slight growth; Boston characterized activity as mixed and Cleveland saw softening. Retail sales rose modestly, though vehicle sales were sluggish in several Districts and tourism spending was up in a number of them. Service-sector reports were generally positive, and manufacturing continued to expand in most Districts, with weakness concentrated in products tied to residential construction. Nearly all Districts reported continued softening in housing markets, with high inventories of new homes slowing residential building, while commercial real estate remained strong. Lending was mixed — commercial and industrial lending generally up, residential mortgage origination and refinancing continuing to weaken. Labor markets were described as tightening, with some firms reporting difficulty finding qualified workers, though wage gains were characterized as relatively moderate even as some Districts expressed concern about the benefit portion of compensation. Price increases were described as moderate.

STAFF REVIEW OF THE FINANCIAL SITUATION

The staff reported that financial conditions were notably calm. The financial stress index stood at 0.099, a very low reading, and the VIX was 9.89, reflecting an unusually quiet volatility environment.



The Baa corporate spread of 1.57 percentage points indicated tight, healthy corporate borrowing conditions with no evident credit strain. The yield curve was mildly inverted, with the 10-year/2-year spread at -0.12, a configuration that has historically been associated with elevated recession risk. The 3-month Treasury bill yield sat 0.25 percentage point below the current 5.25 percent funds rate, a spread consistent with market expectations of no further tightening and possibly future easing.

STAFF ECONOMIC OUTLOOK

Taking the forward-looking quantities together, the staff projection pointed toward a mildly decelerating path for activity against a backdrop of inflation that had returned to roughly its objective. With the estimated neutral real rate (r^*) near 1.075 percent and core inflation close to 1.9 percent, an approximately neutral nominal rate would be in the vicinity of 3 percent, well below the prevailing 5.25 percent funds rate — implying that the current stance was meaningfully restrictive. Inflation momentum was only slightly positive at 0.025, suggesting little upward drift, while unemployment momentum was negative at -0.15, consistent with a labor market not yet loosening.

The reference rules underscored the tension in these signals. The Taylor rule, Balanced Approach rule, and ELB-adjusted rule each pointed to -75 basis points, reflecting the gap between the actual rate and neutral given near-target inflation and unemployment below the natural rate. The First-Difference rule, which responds to changes rather than levels, returned 0 basis points, reflecting the small momentum readings and the absence of fresh deterioration. The deterministic policy engine, treating the reference rules as reliable, reconciled these into a recommendation of -25 basis points — a measured step toward neutral rather than the fuller adjustment the level-based rules implied. The projection thus implied that, absent renewed inflation pressure, conditions would likely support a gradual dialing back of restraint rather than continued holding or tightening.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their opening assessments, all five participants independently arrived at a hold at 5.25 percent for the upcoming meeting. The reasoning converged on a shared reading: core PCE at 1.91 percent was essentially at target, removing urgency for a hike, while a labor market with unemployment at 4.5 percent — below the 5.04 percent natural rate — and Beige Book reports of firms struggling to find qualified workers left no employment case for a cut. Participants generally judged that inflation had moderated substantially without being decisively contained, and that below-trend growth signals, including the inverted yield curve and the -0.48 Chicago Fed reading, warranted watchfulness but not yet action.



The participant focused on inflation risk emphasized that a tight labor market sustains upside inflation risk and that market pricing 'is not a mandate to ease,' concluding that cutting with core near target would be premature. The participant attentive to employment stressed the discipline that a cut requires actual labor-market weakness rather than leading-indicator worry alone; with claims contained at 335,000 and hiring described as expanding, that member saw no present deterioration to act on, while flagging the curve inversion and soft activity index as genuine forward risks. The participant weighing financial stability observed that the very low stress index, calm VIX, and tight Baa spread showed no acute distress demanding easing, but cautioned that hiking into an already-inverted curve could deepen the inversion and destabilize credit conditions. The market-signal participant noted that the 3-month bill sitting 25 basis points below the funds rate and the inverted 2s10s curve suggested the tightening cycle had likely peaked, while the data-dependent participant read the literal figures as a balanced case in which residual inflation risk and recession-risk signals offset one another around a hold.

When the discussion turned to the deterministic framework's -25 basis point recommendation, the emphasis shifted. Several participants observed that with core inflation now fractionally below 2.0 percent, the prior characterization of inflation as 'elevated' no longer clearly held, and that the current 5.25 percent rate implied a real rate far above the estimated r^* of roughly 1.075 percent — a meaningfully restrictive stance. The participant focused on employment found the Balanced Approach logic persuasive, arguing that keeping policy restrictive into a fragile-growth environment — housing softening, sluggish vehicle sales, decelerating activity in some Districts — threatened the labor market before deterioration set in, and endorsed a modest first easing step as insurance. The financial-stability participant weighted the credit-channel signal heavily, pointing to weakening residential mortgage origination and refinancing in the Beige Book as the transmission point where excessive restraint could become systemic risk, while cautioning that an abrupt -75 basis point move into placid markets could itself signal hidden distress; a -25 basis point step was seen as threading that needle.

The data-dependent participant reasoned that the -75 basis point level rules were too aggressive given benign financial conditions, while the First-Difference rule's 0 basis points ignored that policy was meaningfully restrictive; a -25 basis point move split these cleanly and matched the -25 basis point signal embedded in the T-bill spread. The market-signal participant reinforced this, noting the near-exact correspondence between the bill spread and the framework's recommendation and characterizing the move as orderly repricing rather than crisis-driven easing. The dissenting voice came from the participant focused on inflation, who acknowledged that -25 over -75 respected gradualism and that the direction might eventually prove right, but insisted that inflation momentum remained positive at 0.025, that unemployment well below the natural rate could reignite wage



pressure, and that Beige Book concern over benefit costs pointed to latent, not extinguished, inflation risk. That member concluded that committing to a cut at this meeting, before confirming inflation stayed contained, was premature and forfeited the hawkish discipline for uncertain growth insurance.

Across the rounds, participants generally agreed that no fresh inflation deterioration and no acute financial stress were present, and that the calm in markets argued against any destabilizing lurch. The remaining difference was one of timing and emphasis: whether the recession-risk signals and the gap between the funds rate and neutral justified beginning to relieve restraint now, or whether positive inflation momentum and a still-tight labor market counseled continued patience.

COMMITTEE POLICY ACTIONS

In the predictive vote on the policy decision expected at the upcoming meeting, all five participants supported maintaining the target federal funds rate at 5.25 percent, a unanimous 5-0 outcome. On the separate question of the deterministic framework's optimal recommendation of -25 basis points, four participants endorsed the recommendation as-is — the participant focused on employment, the participant weighing financial stability, the data-dependent participant, and the market-signal participant — while the participant focused on inflation risk declined to support it, judging a cut premature while inflation momentum remained positive and the labor market tight. The optimal-side tally was thus four to endorse and one to decline, with no partial positions recorded.