



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The Committee reviewed the most recent System Open Market Account data, reflecting holdings as of January 23, 2008. Total SOMA domestic securities holdings stood at \$718.8 billion, composed of \$471.0 billion in Treasury notes and bonds and \$210.4 billion in Treasury bills. This represented a decline of \$5.0 billion from the prior release of January 16, 2008. It should be noted that these figures cover SOMA domestic securities holdings only—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 is currently available. Any characterization of short-term funding operations was therefore excluded from this review.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff review indicated that core PCE inflation on a year-over-year basis was running at 1.67 percent, below the 2.0 percent objective. The unemployment rate stood at 5.0 percent, essentially at the estimated natural rate of 5.05 percent, suggesting a labor market close to balance. Initial jobless claims of 321,000 were moderate and did not indicate a rapid deterioration. The Chicago Fed National Activity Index at -0.23 pointed to growth somewhat below trend but not to contraction. The current fed funds rate was recorded at 3.5 percent.

The Beige Book, prepared by the Federal Reserve Bank of Atlanta and based on information collected before January 7, 2008, reported that economic activity increased modestly during the survey period but at a slower pace than in the prior period. Seven Districts reported a slight increase in activity, two reported mixed conditions, and three described activity as slowing. Retail reports indicated subdued holiday spending and further weakness in auto sales, though tourism spending was generally positive. Residential real estate conditions remained quite weak across all Districts, and most Districts cited tighter credit standards, with residential lending declining. Demand for construction and housing-related labor continued to fall, while demand for skilled workers in nonfinancial services held steady. Wage increases remained moderate overall. Widespread increases in prices for food, petrochemicals, metals, and energy-related inputs were reported, with production and delivery costs rising on higher fuel prices.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions showed elevated but not extreme strain. The financial stress index registered 0.4221 and the VIX stood at 29.02, both consistent with heightened market anxiety. The Baa corporate spread of 2.95 indicated meaningful credit-cost pressure that borrowers were actually bearing. The 3-month T-bill spread relative to the current funds rate was -0.71, meaning bills were yielding well



below 3.5 percent and pointing to market expectations of substantial further easing. In contrast, the 10-year/2-year yield curve spread was positively sloped at +1.42, so the classic inverted-curve recession signal was absent. Taken together, the short-end pricing suggested markets anticipated a near-term policy move even as the term structure did not price an imminent deep downturn.

STAFF ECONOMIC OUTLOOK

The staff outlook drew on the forward-looking quantities available. The estimated neutral real rate (r^*) was 1.694, which combined with core inflation near 1.67 percent implied a neutral nominal rate of roughly 3.4 percent. Against that benchmark, the current 3.5 percent funds rate was essentially at neutral—only marginally restrictive rather than clearly tight. Inflation momentum was mildly positive at 0.1, suggesting core readings were more likely to firm than to ease going forward, consistent with the breadth of input-cost pressures reported in the Beige Book. Unemployment momentum was a small 0.05, indicating only a gentle upward drift in labor-market slack rather than rapid deterioration.

The reference rules diverged. The Taylor rule, the Balanced Approach rule, and the ELB-adjusted rule each prescribed -75 basis points, reflecting below-target inflation and perceived slack; these level-based rules effectively assumed a rate above neutral. The First-Difference rule, which responds to changes in conditions rather than the absolute level, prescribed a more restrained -25 basis points, in keeping with the small momentum readings and the substantial easing already delivered. Reconciling these against the loss function—with reference rules judged reliable—the deterministic optimal policy engine returned a recommendation of 0 basis points, on the reasoning that policy was already near neutral and neither mandate side was signaling an emergency that further easing would address.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their initial predictive discussion, participants were struck by how much easing had already occurred, with the funds rate at 3.5 percent well below the 4.25 percent of the prior meeting. Four of the five members opened in favor of a further 50 basis point cut. The labor-focused member argued for front-loading support before employment visibly deteriorated, pointing to below-trend growth in the Chicago Fed index, declining housing-related labor demand, and tighter credit standards, while noting that core inflation at 1.67 percent left room to ease. The financial-stability member emphasized that a self-reinforcing credit contraction had to be pre-empted, citing the stress index at 0.42, the VIX at 29, and the Baa spread of 2.95, and warned that delivering only a token move risked a destabilizing repricing given the -0.71 T-bill spread. The market-signal member weighted that same short-end pricing most heavily, reading it as markets expecting cuts well beyond 25 basis points. The data-dependent member, after initially leaning toward restraint, was persuaded that contained inflation and moderate wages removed the constraint and that a modest move would understate the



credit stress the data documented.

The inflation-focused member dissented from this consensus in the predictive round, favoring 25 basis points. That member acknowledged the credit-stress evidence as real and declined to hold at zero, but resisted the full 50 basis points on the grounds that the Beige Book flagged live, broad-based upside pressures in food, energy, metals, and petrochemicals, and that chasing a market-implied path risked pro-cyclical over-easing that could unanchor expectations. The member observed that growth, while soft, was not collapsing—unemployment essentially at the natural rate, claims contained, the activity index only slightly below trend—and that the labor case for aggressive front-loading was weakened by the dove's own concession that employment had 'not yet clearly' deteriorated. The predictive vote closed 4-to-1 for -50 basis points.

When the discussion turned to the framework's loss-minimizing recommendation of 0 basis points, the character of the conversation shifted markedly. Several members who had voted for a 50 basis point cut found the neutral-rate arithmetic compelling: with r^* at 1.694 and core inflation near 1.7 percent, neutral nominal was roughly 3.4 percent, so the current 3.5 percent stance was only marginally restrictive. Participants generally judged that the three level-based reference rules pointing to -75 basis points overstated the case by ignoring how close policy already was to neutral, and that the First-Difference rule at -25 basis points better captured the reality that substantial cumulative easing had already been delivered. The positive 10-year/2-year spread of +1.42 was noted repeatedly as undercutting any case for panic cuts, and mild momentum readings—0.1 for inflation, 0.05 for unemployment—were read as little new deterioration to chase.

The data-dependent member concluded that neither mandate side was flashing an emergency and that holding preserved optionality if stress genuinely worsened. The labor-focused member accepted the hold as well, reasoning that with policy near neutral and labor near the natural rate, aggressive cutting risked overshooting for no current employment gain, while ammunition was preserved to act fast if claims turned. The inflation-focused member, unmoved toward easing, found the discussion strengthened the case that holding defended against entrenching commodity-driven price pressures. Two members, however, did not fully embrace a complete stop. The financial-stability member, while conceding that accommodation already in transit made a hold defensible and that overshooting could unanchor expectations, judged from that seat that a modest step down was prudent insurance given elevated, unresolved credit stress. The market-signal member likewise leaned toward the framework but held that the -0.71 T-bill spread genuinely signaled a priced-in move, so that at least a modest cut, rather than a full stop, remained warranted—tempered by the recognition that market pricing reflects expectations rather than a mandate signal.

**COMMITTEE POLICY ACTIONS**

In the predictive vote on the likely policy action, the Committee recorded a tally of 4 members favoring a 50 basis point cut and 1 member favoring a 25 basis point cut, for a final predictive outcome of -50 basis points. On the separate question of the deterministic framework's recommendation to hold at 0 basis points, three members—the inflation-focused member, the labor-focused member, and the data-dependent member—endorsed the recommendation as-is. Two members registered partial agreement: the financial-stability member and the market-signal member agreed that no aggressive easing was compelled by fundamentals but judged that a modest cut, rather than a complete hold, was warranted given credit stress and market-implied pricing. No member declined the recommendation outright, leaving an optimal-side stance of 3 endorse, 2 partial, and 0 decline.