



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

Total System Open Market Account domestic securities holdings stood at \$4,232.2 billion as of September 14, 2016. Of that total, Treasury notes and bonds accounted for \$2,336.3 billion and agency mortgage-backed securities for \$1,763.5 billion, leaving the portfolio roughly split between the two, with a modest tilt toward Treasury holdings. Holdings rose \$19.5 billion from the prior release of September 7, a small increase relative to the size of the portfolio. The staff noted that this account covers SOMA holdings only — the total size, composition, and week-over-week change — and does not encompass repurchase or reverse-repurchase operation results, for which no point-in-time-safe data source currently exists; accordingly, no figures on those operations were presented.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reviewed incoming indicators as describing an economy growing at a solid, roughly above-trend pace with a firm labor market. Core PCE inflation over the prior twelve months was 1.32 percent, remaining below the Committee's 2 percent objective. The unemployment rate was 4.9 percent, essentially at the staff's estimate of the natural rate of 4.8 percent, and initial jobless claims were low at 259,000, consistent with no deterioration in labor conditions. The Chicago Fed National Activity Index registered 0.27, a reading consistent with growth somewhat above trend. The Employment Cost Index stood at 126.7, and M2 money supply was \$12,891.8 billion.

The most recent Beige Book material, drawn from the First District, described economic activity as continuing to increase, though with scattered signs of slowing growth rates. Most responding retailers and manufacturers, along with staffing firms, cited higher sales and revenues than a year earlier. Respondents in several sectors reported tight labor markets, with staffing firms noting short supply and strong demand, but firms reported 'little action on prices,' with prices described as unchanged or only slightly higher. Residential real estate was constrained by limited inventory, and commercial activity was flat to up slightly. A travel-industry contact reported that Boston-area hotels had revised their 2016 expectations modestly lower — room revenue growth trimmed from an original 6.5 percent to 4.0 percent — attributing the revision to softer business-travel spending in recent months. Contacts generally expected more of the same going forward.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions were characterized as calm and accommodative, with no signs of systemic strain. The financial stress index was low at 0.117, and the VIX, at 18.14, was moderate rather than elevated. The Baa corporate bond spread of 2.7 percentage points indicated that credit markets were functioning without distress. The Treasury yield curve remained positively sloped, with the 10-year/2-year spread



at 0.93 percentage point — positive but relatively flat — showing no inversion or recession signal. The 3-month T-bill spread relative to the current policy rate was slightly negative at -0.015, indicating that markets were not pricing an imminent policy tightening. Taken together, these readings pointed to contained volatility and functioning credit channels.

STAFF ECONOMIC OUTLOOK

The staff's forward-looking assessment drew on the estimated neutral rate and on the momentum embedded in the incoming data. The estimated real neutral rate (r^*) used in the analysis was -0.5 percent, a deeply low figure implying that the current 0.25 to 0.5 percent target range may be modestly restrictive relative to neutral. Inflation momentum was faintly positive at 0.035, suggesting no meaningful upward drift in prices, while unemployment momentum was slightly negative at -0.05, pointing to a labor market that continues to firm modestly rather than deteriorate. On these inputs, the projection is for inflation to remain below the 2 percent objective for some time absent a policy adjustment, with the labor market holding near its estimated natural rate.

The reference-rule suite reinforced this reading. The Taylor rule, the Balanced Approach rule, the First-Difference rule, and the ELB-adjusted rule all pointed to -25 basis points, and the rules were judged reliable this meeting. The common thread across the rules is that the roughly 0.68 percentage point inflation shortfall dominates the very small unemployment gap, so that a loss-minimizing prescription tilts toward easing rather than holding. With the neutral rate estimated well below zero, the rule outputs imply that maintaining the current range leaves policy somewhat tighter than the projected path of conditions would warrant, though the momentum figures indicate the gap is a matter of modest restrictiveness rather than acute deterioration.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their initial predictive assessments, all five participants favored holding the target range at 0.25 to 0.5 percent. The through-line across their opening positions was that inflation, at 1.32 percent core PCE, remained well below the 2 percent objective while the labor market showed no deterioration — unemployment near the natural rate, jobless claims low, and Beige Book contacts describing tight labor conditions but 'little action on prices.' The participant most attentive to inflation risk observed that although tight labor markets are the classic precondition for building wage-price pressure, the pass-through was simply not materializing in the data, and prior guidance had emphasized gradual increases. That participant noted an inclination toward eventual tightening but judged the current data not compelling enough to justify moving now.



Other participants approached the same conclusion from their own vantage points. The participant most focused on employment stressed that neither rising unemployment nor slowing job growth was present, so easing was unwarranted, yet cautioned that hiking against soft inflation and signs of soft business investment risked restraining employment gains prematurely. The participant attentive to financial stability found calm conditions — low stress, moderate volatility, contained credit spreads, a positively sloped curve — that removed any constraint in either direction but created no urgency to act. The participant weighting market signals emphasized that the slightly negative 3-month T-bill spread indicated markets were not pricing a near-term move, and the centrist read the balance of data literally as a solid labor market paired with a persistent inflation shortfall that tilted toward patience. In the rebuttal round, no participant was moved off this view; the convergence was mutually reinforcing rather than the product of deference, and the predictive vote remained unanimous for a hold.

The discussion took on a different character when participants turned to the deterministic policy framework, which recommended a 25 basis point cut with all four reference rules in agreement and judged reliable. Here the reasoning diverged more openly from the predictive vote. Several participants acknowledged that with the estimated neutral rate at -0.5 percent, the current range may already be modestly restrictive, and that the roughly 0.68 percentage point inflation shortfall dominated a near-zero unemployment gap in the loss function. The employment-focused participant found the Balanced Approach rule most persuasive, arguing that faint negative unemployment momentum and scattered slowing signals in the Beige Book — softer business travel, downward-revised hotel revenue — supported easing preemptively to cushion labor risk while inflation ran comfortably below target.

The participant attentive to financial stability leaned on the ELB-adjusted rule's logic, reasoning that near the effective lower bound a cut taken while markets are calm is low-cost insurance against future credit tightening, and that acting cheaply now preempts distress later. The inflation-focused participant reached the most candid tension: conceding that sub-target inflation with a negative neutral rate genuinely favors easing on the framework's own terms, yet retaining a risk-management preference for preserving scarce policy space and not reversing course quickly, and thus landing on the direction being right but full immediate action being premature. The centrist similarly accepted the direction while judging that benign conditions — near-target unemployment, above-trend growth, no financial stress — argued for a smaller, more patient step than the full move. The market-signals participant agreed easing was the eventual direction but held that front-end pricing, with the T-bill spread barely negative, did not affirmatively call for acting now.

Across both the predictive and optimal-framework discussions, a consistent picture emerged: participants generally judged that the direction implied by the reference rules — toward easing — was



defensible given persistent below-target inflation and a low neutral rate, but they differed on whether the immediate magnitude and timing were warranted against a backdrop of calm markets, a firm labor market, and only faint momentum in either mandate variable.

COMMITTEE POLICY ACTIONS

On the predictive question of the appropriate policy decision for this meeting, the Committee voted unanimously, 5 to 0, to maintain the target range for the federal funds rate at 0.25 to 0.5 percent. On the separate question of the deterministic framework's recommendation for a 25 basis point cut, the Committee's recorded stance was divided: two members — the participant focused on the labor market and the participant attentive to financial stability — endorsed the recommendation as proposed, while three members — the inflation-focused participant, the data-dependent centrist, and the participant weighting market signals — offered partial agreement, supporting the easing direction but not the immediate magnitude or timing. No member declined the recommendation's direction outright.