



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The desk reported that total System Open Market Account domestic securities holdings stood at \$4,205.0 billion as of December 7, 2016, essentially unchanged from the prior release. Holdings were composed of \$2,332.0 billion in Treasury notes and bonds and \$1,740.7 billion in agency mortgage-backed securities. The week-over-week change from the November 30 release was a decline of \$0.4 billion, a negligible movement consistent with a portfolio being maintained at a broadly stable size. It was noted that this account covers SOMA securities holdings only — total size, composition, and the change from the prior release — and does not encompass repo or reverse-repo operation results, for which no point-in-time-safe data source is currently available.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reported that labor market conditions remained tight. The unemployment rate stood at 4.6 percent, below the estimated natural rate of 4.8 percent, and initial jobless claims were low at 268,000, giving no indication of rising layoffs. Core PCE inflation on a year-over-year basis was 1.54 percent, still below the Committee's 2 percent objective. The Chicago Fed National Activity Index registered -0.08, consistent with growth running close to its historical trend, and the Employment Cost Index was reported at 127.4.

Information from the District survey described economic activity as having remained flat since the prior report, with labor markets remaining tight. Contacts reported little change in selling prices and in price and wage pressures overall, though a rising number of service-sector contacts anticipated wage increases in the months ahead. Manufacturers noted a modest pickup in activity while service firms reported steady to softer conditions. Both consumer spending and tourism were characterized as sluggish, with retail sales soft in October before showing some signs of improvement in early November. Prices were reported to be steady to up slightly. Residential and commercial real estate markets were mixed but steady overall, with residential construction holding steady and office construction picking up. Banks reported strengthening loan demand, continued improvement in delinquency rates, and somewhat tighter credit standards on commercial borrowers.

STAFF REVIEW OF THE FINANCIAL SITUATION

The staff characterized financial conditions as calm and broadly accommodative. The financial stress index was very low at 0.075, and equity market volatility as measured by the VIX stood at 12.22, a subdued reading. The Baa corporate spread over Treasuries was 2.61, a moderate level with no sign of widening or credit-market distress. The 10-year/2-year Treasury yield curve spread was positive at 1.24, giving no signal of recession risk from term spreads. The 3-month Treasury bill spread relative to



the current target rate was 0.115, indicating that markets were pricing in roughly a full 25 basis point move above the current range midpoint. Taken together, these readings pointed to easy financial conditions with no evident funding stress or fragility.

STAFF ECONOMIC OUTLOOK

The staff's outlook was framed around the forward-looking quantities available. The estimated neutral real rate (r^*) was -0.5, a low reading implying that the current target range of 1/4 to 1/2 percent is closer to a neutral stance than its nominal level alone would suggest, and thus less restrictive than a higher neutral estimate would imply. Both inflation momentum and unemployment momentum were modestly positive at 0.05, suggesting that inflation was firming gradually rather than receding, and that the labor market was not deteriorating.

The reference rules — the Taylor rule, the Balanced Approach rule, the First-Difference rule, and the ELB-adjusted rule — each pointed to -25 basis points, reflecting the shortfall of core PCE inflation below the 2 percent objective. The deterministic policy engine, however, judged these rules reliable this period yet did not adopt their mechanical signal, instead recommending 0 basis points. This gap reflected the low neutral-rate estimate and the modestly positive momentum on both mandate sides: with the current stance already near neutral and conditions firming rather than weakening, the projection did not support easing, even as subdued inflation offered no case for tightening. The implied path is one of near-neutral policy, with conditions expected to firm gradually rather than either overheat or falter.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their initial predictive assessments, participants converged on a single 25 basis point increase to a target range of 1/2 to 3/4 percent. The member most attentive to inflation risk emphasized that although core PCE at 1.54 percent remained below target, the labor market showed slack largely exhausted, with unemployment at 4.6 percent below the 4.8 percent natural rate and District contacts in the service sector increasingly anticipating wage increases. This member read the anticipated wage pressure as the leading edge of building inflation and argued that preemptive, gradual action was the prudent response, with waiting risking falling behind as slack disappeared.

The participant focused on employment risk reasoned that a cut would be warranted only if unemployment were rising or job growth slowing, and neither condition was present: claims were low at 268,000 and the labor market was described as tight. With the employment mandate essentially satisfied, this member saw no case for accommodation and judged a well-telegraphed gradual step non-threatening to jobs. The financial-stability member observed that a very low stress index of 0.075,



a subdued VIX of 12.22, moderate Baa spreads, and a positively sloped curve left ample room to absorb a hike; strengthening loan demand and improving delinquencies described a healthy credit backdrop, and delivering an anticipated move was seen as less destabilizing than a surprise in either direction. The data-dependent centrist read the balance of indicators literally as supporting a single step, and the market-signal member placed greatest weight on the 3-month bill spread of 0.115, which was taken to show markets already pricing roughly a full move. Across two predictive rounds, no participant offered a case for holding or cutting, and all five reaffirmed +25 basis points.

When the discussion turned to the framework's loss-minimizing recommendation of 0 basis points, participants engaged with the tension between that output and their predictive votes. All agreed that the reference rules' uniform -25 basis point signal should be rejected. The inflation-focused member stressed that cutting into sub-natural unemployment with firming wage expectations would court an overshoot, and found the First-Difference logic most congenial given modestly rising momentum on both fronts; this member characterized the divergence as agreement on direction — no easing — with a preference to go one step further to a hike. The employment-focused participant reached the hold from a different route, noting that with unemployment momentum flat at 0.05 the easing urgency he would normally press was simply absent, while soft inflation made a hike premature; holding preserved accommodation without risking overheating.

The financial-stability voice emphasized that with no stress signal present, the usual caution against destabilizing tightening carried less weight, but that a low neutral rate and calm markets argued against feeding financial excess through a cut; the hold preserved optionality without adding stability risk from either direction. The centrist read the two mandate sides — below-target inflation against modestly sub-natural unemployment — as roughly offsetting, with a low r^* placing the current stance near neutral and a steady, unremarkable Beige Book picture supporting patience rather than action either way. The market-signal member accepted that the framework correctly rejected the mechanical cut but maintained that markets had already discounted a hike and that easy conditions could comfortably absorb one, leaving the hold mildly behind market-priced fundamentals.

The recurring theme was that the 25 basis point gap between the predictive votes and the framework's recommendation illuminated a stance close to appropriate — neither clearly restrictive nor clearly accommodative. Participants generally judged that benign financial conditions and a low neutral-rate estimate neutralized the rules' easing bias, while below-target inflation removed any urgency to tighten. A couple of participants continued to see a modest step as the better-calibrated response given tight labor markets and market pricing, while the remainder judged inaction the loss-minimizing choice at face value.

**COMMITTEE POLICY ACTIONS**

In the predictive vote, all five members supported a 25 basis point increase in the target range to 1/2 to 3/4 percent, a unanimous 5-0 tally. On the framework's loss-minimizing recommendation of 0 basis points, the Committee did not fully align: three members endorsed the recommendation as-is — the participant focused on the labor market, the financial-stability voice, and the data-dependent centrist — while two members registered partial agreement, concurring with the direction of not easing but preferring a 25 basis point step rather than a hold. Those two were the inflation-focused member and the market-signal member. No member declined the recommendation.