



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The Committee reviewed the most recent data on System Open Market Account holdings, dated January 25, 2017. Total SOMA domestic securities holdings stood at \$4,207.1 billion, comprising \$2,335.1 billion in Treasury notes and bonds and \$1,744.6 billion in agency mortgage-backed securities. Relative to the prior release of January 18, total holdings declined by \$6.3 billion. It was noted that this review covers SOMA holdings only — total size, composition, and the week-over-week change — and does not encompass repurchase and reverse repurchase operation results, for which no point-in-time-safe data source currently exists; accordingly, no discussion of such operations was included.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reported that core PCE inflation stood at 1.3 percent on a twelve-month basis, well below the Committee's 2 percent objective. The unemployment rate was 4.7 percent, essentially at the staff's estimate of the natural rate of 4.74 percent, and initial jobless claims were low at 234,000, consistent with a labor market showing no sign of emerging weakness. The Chicago Fed National Activity Index registered -0.27, indicating growth slightly below trend, while the Employment Cost Index reading was 127.4. M2 money supply was reported at \$13,249.2 billion. The current federal funds target range was 0.5 to 0.75 percent, with a midpoint of 0.625 percent.

Beige Book reports across Districts described growth generally in the modest-to-moderate range. Several Districts noted a pickup: activity in one District was said to have moved up to a 'modest' pace of growth from the prior 'slight' pace, with manufacturing and nonauto retail sales providing a boost, while another reported activity increasing at a 'moderate' pace on balance, with strengthening in manufacturing. Manufacturing production was described as growing at a 'robust' rate in one District. Labor markets were widely characterized as tightening, sustaining modest wage pressure, though in some Districts wages were described as stable. Price pressures were generally 'modest,' with upward pressure on selling prices increasing in one District. Retail and consumer spending readings were mixed — some Districts cited increases in sales while others reported holiday spending that was lower than expected. Low commodity prices were noted as continuing to place agricultural areas under financial stress in one District.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions were characterized as loose and calm. The financial stress index stood at 0.063, an extremely low reading, and the VIX was 10.81, indicating market calm bordering on complacency. The Baa corporate spread was 2.61, a moderate level with no signs of credit-market distress. The



10-year/2-year Treasury yield curve spread was positively sloped at 1.3, showing no inversion and no recession signal. The 3-month Treasury bill spread relative to the current rate was -0.125, suggesting that short-term markets were pricing no imminent tightening above the current target range and, if anything, a slight easing tilt.

STAFF ECONOMIC OUTLOOK

The staff's forward-looking assessment drew on several quantities bearing directly on the likely path of policy-relevant conditions. The estimated neutral real rate (r^*) was -0.5, implying that the current 0.5 to 0.75 percent target range may be more restrictive in real terms than its nominal level suggests. Inflation momentum was weakly positive at 0.11, consistent with core PCE remaining below the 2 percent objective and offering little indication of a near-term firming that would close the shortfall quickly. Unemployment momentum was -0.15, indicating that joblessness was not rising and that any remaining labor-market slack was continuing to close gradually rather than reversing.

Reference-rule outputs clustered on the easing side. The Taylor rule, the Balanced Approach rule, and the ELB-adjusted rule each pointed to -50 basis points, reflecting the sizable inflation shortfall combined with unemployment essentially at its natural rate. The First-Difference rule, which adjusts incrementally from the current stance using momentum rather than resetting to a level, pointed to -25 basis points. The reference rules were judged reliable. On balance, these quantities implied that policy was modestly too tight relative to rule-based benchmarks, with the incremental First-Difference reading suggesting a single measured step would suffice to correct the gap without overshooting should inflation momentum firm.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their initial predictive assessments, all five participants judged that no change to the target range was the most likely outcome for this meeting. A common thread ran through the reasoning: a 25 basis point increase had been delivered at the prior meeting to reach the current 0.5 to 0.75 percent range, and prior guidance had stressed 'only gradual' increases, so a consecutive move would be difficult to reconcile with that framing absent an inflation surprise the data did not show. Participants pointed to core PCE at 1.3 percent, well below target, and to unemployment at 4.7 percent, essentially at the 4.74 percent natural rate, as arguing for patience rather than urgency.

The participant most attentive to inflation risk observed that his usual caution — resistance to easing when inflation is elevated — was simply not triggered, since inflation was subdued rather than high. The participant weighting employment risk noted that with unemployment near the natural rate, jobless claims low at 234,000, and Beige Book reports describing tightening labor markets, there was no



deterioration to justify a supportive cut, and equally no overheating to justify a back-to-back hike. The participant focused on financial stability emphasized that the stress index at 0.063, the VIX at 10.81, and the Baa spread at 2.61 showed neither distress warranting a defensive cut nor froth a hike would need to address. The participant most attentive to market signals stressed that the 3-month T-bill spread of -0.125 indicated markets priced no imminent move, and the data-dependent participant tied the threads together, adding that the Chicago Fed index at -0.27 signaled slightly below-trend growth, further arguing against rushing. In the predictive rebuttal round, no participant was moved from the hold position; each found the others' reasoning reinforcing rather than contradicting his own.

The discussion then turned to the deterministic policy framework, which recommended a 25 basis point cut. Here participants engaged more searchingly with the possibility that current policy was mildly too tight. Several found the divergence between their predictive hold and the framework's -25 basis points to be narrow and defensible. The inflation-focused participant acknowledged that the gap 'reveals my caution is only weakly justified by the data,' and judged the First-Difference rule's -25 basis points the most persuasive of the reference rules — measured, reversible, and guarding against the aggressive -50 basis points implied by the level rules. The employment-focused participant argued that below-trend growth combined with soft inflation is precisely when policy risks being too tight for future employment, and that with r^* at -0.5 the current range may be more restrictive than nominal levels suggest; he viewed a single measured cut as insurance against undershooting on both mandates at essentially no cost given stable wages.

The data-dependent participant likewise endorsed the framework's logic on its face, describing the 0.7 percentage point inflation shortfall as the single most persuasive fact and the First-Difference reasoning as best matching an incremental, momentum-based reading of the numbers. Two participants, however, agreed with the direction of easing but not its timing this meeting. The financial-stability participant raised the strongest reservation: cutting into already-loose conditions, with the stress index at 0.063 and the VIX near 10, risked seeding asset-price froth and future imbalances, and he preferred to wait for data even while conceding the sign of the move was defensible. The market-signal participant reached a similar landing, observing that the -12.5 basis point front-end tilt was small enough to be consistent with patience rather than an urgent cut; he characterized his position as 'right direction, wrong urgency.'

Participants generally judged that the reference rules' clustering toward easing, the negative r^* estimate, and the weak inflation momentum together made the case that policy was somewhat too tight relative to rule-based benchmarks. At the same time, several noted that the Committee's likely inclination to hold reflected a weighting of fiscal-policy uncertainty and the Beige Book's tone of



modest growth with tightening labor markets against the mechanical inflation shortfall. The recurring conclusion was that the gap between holding and a 25 basis point cut amounted to a single increment — a mild latent easing pressure rather than an emergency demanding immediate correction.

COMMITTEE POLICY ACTIONS

In the predictive vote on the likely policy action for this meeting, all five participants judged that the target range would be maintained at 0.5 to 0.75 percent, a unanimous expectation of no change (5 to 0). On the separate question of the deterministic framework's recommendation of a 25 basis point cut, the Committee did not fully converge: three participants — the inflation-focused, employment-focused, and data-dependent members — endorsed the recommendation as-is, while two — the financial-stability and market-signal members — offered partial agreement, accepting the direction of easing but not its magnitude or timing at this meeting. No participant declined the recommendation outright.