



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The System Open Market Account showed no change in domestic securities holdings over the most recent interval. As of June 7, 2017, total SOMA domestic securities holdings stood at \$4,226.1 billion, comprising \$2,326.6 billion in Treasury notes and bonds and \$1,771.0 billion in agency mortgage-backed securities. Relative to the prior release dated May 31, 2017, holdings were unchanged, a flat reading of \$0.0 billion. The Committee notes that this account covers SOMA holdings only — total size, composition, and week-over-week change — and does not encompass the results of repurchase or reverse repurchase operations, for which no point-in-time-safe data source currently exists; accordingly, no characterization of those operations is offered here.

STAFF REVIEW OF THE ECONOMIC SITUATION

Incoming data described an economy expanding at a modest pace with a notably tight labor market. The unemployment rate stood at 4.3 percent, below the estimated natural rate of 4.74 percent, and initial jobless claims at 248,000 remained low. The Chicago Fed National Activity Index at 0.49 was consistent with growth somewhat above trend. Against this backdrop, core PCE inflation on a twelve-month basis registered 1.28 percent, well short of the Committee's 2 percent objective and softer than the characterization prevailing at the time of the prior meeting. The Employment Cost Index reading was 129.0, and M2 stood at \$13,431.3 billion.

The Beige Book portrayed activity that had 'flattened out in recent weeks' even as labor markets remained tight and wages for skilled workers continued to grow moderately. Reports across districts pointed to persistent labor shortages and wage pressures concentrated in high-demand occupations, with some firms substituting capital for labor or enhancing benefits packages to retain workers. Input cost pressures were described as 'fairly widespread,' while selling prices rose only modestly. District detail was mixed: Chicago noted that growth 'slowed to a modest pace' with consumer spending decreasing slightly, several districts reported softening auto sales, and housing markets were characterized as steady on balance while commercial real estate was mixed. Manufacturing new orders and production picked up in some districts.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions remained accommodative and markets notably calm. The financial stress index at 0.054 was extraordinarily low, and the VIX at 10.39 signaled unusually subdued expected volatility. Credit markets showed no evident distress: the Baa corporate spread stood at 2.25, a level consistent with easy borrowing conditions. The yield curve remained positively sloped, with the 10-year/2-year spread at 0.86 and no sign of inversion. Money market pricing pointed toward a near-term policy move,



with the 3-month Treasury bill trading roughly 0.085 percentage point above the current target rate. Taken together, the data described abundant liquidity and comfortable credit conditions rather than any near-term signal of stress or recession.

STAFF ECONOMIC OUTLOOK

The forward-looking quantities available to the staff pointed in a more cautious direction than the level of current activity might suggest. The estimated neutral real rate (r^*) of -0.5 implies that the current target range of 0.75 to 1.00 percent may be closer to neutral, or even mildly restrictive in real terms, than its nominal level would indicate given inflation running well below target. Inflation momentum was only weakly positive at 0.09, offering little indication that core prices were poised to accelerate toward objective in the near term, while unemployment momentum at -0.1 was consistent with continued, if marginal, tightening in labor market slack.

The reference rules, judged reliable under current conditions, generally implied that policy was tighter than the inflation shortfall would warrant. The Taylor rule, Balanced Approach rule, and an ELB-adjusted variant each pointed to roughly -75 basis points, reflecting the sizable gap between core inflation and the 2 percent objective against a low estimated neutral rate. The First-Difference rule, which anchors on momentum in inflation and unemployment rather than on a level estimate of neutral, implied a smaller adjustment of -25 basis points. The loss-minimizing synthesis of these inputs settled on a -25 basis point recommendation, favoring a measured step consistent with the momentum-based rule over the larger corrections implied by the level-based rules, whose magnitude leans heavily on an uncertain neutral-rate estimate.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their predictive discussion of the likely near-term policy path, participants converged on the view that a 25 basis point increase, moving the target range to 1.00 to 1.25 percent, was the most probable outcome. The reasoning ran along several complementary lines. Participants emphasizing labor conditions observed that unemployment at 4.3 percent sat below the estimated natural rate, that jobless claims were low, and that the Beige Book documented tight labor markets and wage pressures across districts — a picture offering no employment weakness to protect against and thus no case for easing. Those attentive to financial stability stressed the extraordinary calm in markets, with the stress index at 0.054 and the VIX near 10, arguing that continued gradual normalization while conditions were placid would reduce the risk of more abrupt moves later. Participants weighting market signals pointed to the 3-month bill trading above the current rate and to the Committee's own last projected median of 1.4 percent as evidence that a quarter-point move was already anticipated and would be readily absorbed.



Throughout the predictive rounds, the soft inflation reading was acknowledged as a genuine caution rather than dismissed. Core PCE at 1.28 percent was noted to have softened relative to the prior meeting's characterization, and several participants agreed this argued against any move larger than 25 basis points and against undue urgency. A participant focused on labor conditions flagged that activity had 'flattened out' and that consumer spending had decreased slightly in some districts, but concluded that soft inflation paired with a strong labor market did not amount to an employment threat justifying a cut. The inflation-focused participant framed the case as one of latent, pipeline pressure — widespread input costs and tight labor — that could feed through later even as the current print stayed subdued. On this reasoning the group arrived, unanimously, at a predicted quarter-point hike.

The optimal-framework discussion exposed a sharp divergence from that predicted path. The loss-minimizing engine recommended a 25 basis point cut, driven by the substantial inflation shortfall, weakly positive inflation momentum, and a negative estimated neutral rate; the level-based rules pointed to -75 basis points, while the First-Difference rule and the final synthesis landed at -25. Participants engaged this recommendation seriously and split over it. The participant weighting employment risk found the framework persuasive, reasoning that with r^* near or below the current stance, flattening activity, and inflation stuck well below target, hiking into these conditions risked the labor market unnecessarily; a measured single cut, consistent with the gradualism of the First-Difference rule, addressed excessive restrictiveness without the shock of a larger correction. The participant favoring a literal reading of the data reached a similar conclusion, judging the sub-target inflation reading the single strongest and most direct signal and declining to speculate about latent pressures beyond what the text supported.

Three participants declined the framework's recommendation, though on distinct grounds. The inflation-focused participant maintained that policy should lean against where inflation is heading rather than the current print, and held that easing into a tight labor market with widespread input costs and loose financial conditions would be procyclical and would fuel the very pressures of concern; the reliance of the deep cuts on a poorly measured negative r^* reinforced this reluctance. The financial-stability participant framed the tension differently, observing that the combination of a warm real economy and unusually loose conditions was precisely the setting in which added accommodation could breed future imbalances — and while flattening activity and negative unemployment momentum tempered the overheating worry, easing when spreads were this tight and volatility this low carried a stability cost weighted heavily from that seat. The market-signals participant objected on directional grounds, noting that the bill premium and the positively sloped curve priced a hike, not a cut, and that cutting against efficient market aggregation pointing firmly the other way was the wrong direction regardless of the rule chosen.



In reconciling the two exercises, participants generally recognized that the gap between the predicted quarter-point hike and the framework's quarter-point cut reflected a real tension in the stance rather than an error in either analysis. Several observed that with the current range already plausibly near neutral given a negative r^* , neither a hike nor a cut was strongly compelled by the data on a face-value reading, and a couple suggested the appropriate posture sat between holding and a small move. The mechanical framework responded to the inflation gap against a low neutral rate; the participants emphasizing labor tightness, market pricing, and financial froth weighted latent inflation risk and the loose-conditions setting more heavily. The discussion closed without the divergence being resolved into a single view — a genuine disagreement the Committee judged worth recording.

COMMITTEE POLICY ACTIONS

On the predictive question of the likely near-term policy path, all five participants supported a 25 basis point increase in the target range to 1.00 to 1.25 percent; the recorded tally was 5 to 0 in favor of a quarter-point hike. On the separate question of the deterministic framework's -25 basis point recommendation, the Committee was genuinely divided. Two participants — the one weighting employment and labor conditions and the one favoring a literal, consensus reading of the data — endorsed the recommendation as-is. Three participants declined it: the inflation-focused participant, the financial-stability participant, and the market-signals participant, each on the grounds set out above. No participant took a partial position. The optimal-side outcome was thus 2 endorse, 3 decline, 0 partial.