



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The Committee reviewed the most recent data on the System Open Market Account. As of September 13, 2017, total SOMA domestic securities holdings stood at \$4,235.8 billion, comprising \$2,322.6 billion in Treasury notes and bonds and \$1,782.3 billion in agency mortgage-backed securities. This represented an increase of \$15.0 billion from the prior release of September 6. The staff noted that this review covers SOMA holdings only — the total size, composition, and week-over-week change — 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 economic activity expanded at a modest to moderate pace across all twelve Federal Reserve Districts during July and August. Consumer spending increased in most Districts, with gains in nonauto retail sales and tourism, though vehicle sales were mixed and contacts in many Districts expressed concern about a prolonged slowdown in the auto industry. Capital spending rose in several Districts and manufacturing activity expanded modestly on balance. Both residential and commercial construction increased slightly, with low inventories of homes for sale continuing to weigh on residential real estate activity nationwide. The Chicago Fed National Activity Index stood at -0.01, consistent with growth at roughly its trend pace rather than an acceleration. Activity in the energy and natural resources sector was generally positive prior to shutdowns arising from Hurricane Harvey, which introduced near-term disruption.

Labor markets were widely characterized as tight. The unemployment rate was 4.4 percent, below the estimated natural rate of 4.74 percent, and initial jobless claims stood at 298,000. Reports of worker shortages were widespread, most notably in manufacturing and construction, and firms in several Districts said they had turned down business because they could not find the necessary workers. Even so, employment growth slowed some on balance, ranging from a slight to a modest rate in most Districts, and the majority of Districts reported limited wage pressures alongside modest to moderate wage growth. On prices, core PCE inflation was 1.08 percent on a twelve-month basis, well below the Committee's 2 percent objective. The Beige Book indicated that prices rose modestly overall; input and materials costs generally increased, most notably for freight, lumber, and steel, but a number of Districts reported that pass-through to downstream selling prices was limited, with input price increases exceeding gains in selling prices.

STAFF REVIEW OF THE FINANCIAL SITUATION



Financial conditions were broadly accommodative. The financial stress index registered 0.045, an extraordinarily low reading indicating calm markets with no visible signs of systemic strain, and the VIX stood at 10.5, an unusually subdued level reflecting ample risk appetite. Credit markets showed no distress: the Baa corporate spread was 2.16, a relatively tight level. The 10-year/2-year Treasury yield curve spread was positive at 0.85, providing no inversion signal of near-term recession risk. The 3-month Treasury bill spread relative to the current funds rate was -0.105, indicating that market participants were not pricing an imminent policy firming and, if anything, saw a mild easing bias in the near-term path.

STAFF ECONOMIC OUTLOOK

The staff's forward-looking assessment drew on the estimated neutral real rate and on measures of inflation and unemployment momentum. The estimated r^* of -0.5 implied that the neutral policy stance was very low, so that the current target range of 1.00 to 1.25 percent may be more restrictive relative to neutral than its nominal level suggests. Inflation momentum was negative at -0.16, indicating that the shortfall of core PCE inflation from the 2 percent objective was tending to widen rather than to stabilize and close over the projection horizon. Unemployment momentum was slightly negative at -0.05, consistent with a labor market still firm but with employment growth having slowed to a slight-to-modest pace in most Districts.

Reference-rule outputs pointed in a common direction. The Taylor rule, Balanced Approach rule, and ELB-adjusted rule each prescribed -75 basis points, while the First-Difference rule prescribed -50 basis points; the rules were assessed as reliable under current conditions. Taken together, these figures implied that, absent an offsetting inflation pickup, the projected path of conditions would leave policy modestly tight relative to the level consistent with returning inflation to target. The deterministic policy engine's loss-minimizing recommendation, balancing the more aggressive rules against the First-Difference path, was -50 basis points.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In the predictive phase of the discussion, all five participants independently arrived at a hold of the target range at 1.00 to 1.25 percent. The common thread was that below-target inflation removed any case for firming while the absence of stress or deterioration removed any case for easing. The inflation-focused participant observed that core PCE at 1.08 percent was well below target and, if anything, drifting lower; although the tight labor market would ordinarily activate an inflation-risk concern, the Beige Book's reports of limited wage pressures and limited pass-through of input costs to selling prices meant the transmission from tight labor to prices was not firing. This participant judged that no upside inflation surprise justified a move and that the economy showed no recession signal.



warranting a cut.

The participant weighting employment most heavily reasoned that unemployment at 4.4 percent, below the 4.74 percent natural rate, did not describe a deteriorating labor market, and that claims at 298,000 gave no acute distress signal. Slowing job growth from a strong pace within a still-tight market, together with auto-sector and Hurricane Harvey downside risks, was not the rising-unemployment scenario that would trigger support for easing. The participant attentive to financial stability emphasized that every relevant metric — the stress index at 0.045, the VIX at 10.5, the Baa spread at 2.16, and the positive 10y-2y spread — pointed to benign, accommodative conditions, leaving no distress demanding accommodation and no urgency demanding firming. The market-focused participant treated the -0.105 3-month bill spread as decisive evidence that markets were not pricing an imminent hike, and the data-dependent participant read the literal consensus as a hold given soft inflation and near-mandate unemployment. Several participants also observed that balance sheet normalization had been signaled as beginning 'relatively soon,' and that pairing a rate move with that action risked overtightening into calm conditions.

The tenor of the discussion shifted markedly when participants turned to the deterministic framework's -50 basis point recommendation and the reference-rule outputs underlying it. Here participants confronted the tension between their cautious predictive holds and the loss-minimizing case for easing. The inflation-focused participant acknowledged that the risk in the current environment was undershooting rather than overshooting: with core PCE 0.92 percentage point below target and negative inflation momentum, persistent undershooting risked unanchoring expectations downward, and the estimated r^* of -0.5 meant the current range might be more restrictive than it appeared. This participant found the Balanced Approach rule, which weights the inflation gap heavily, the most persuasive of the reference rules and conceded that the framework correctly prioritized the very gap the participant claimed to weight.

The employment-focused participant went furthest in embracing the easing case, judging that slowing job growth combined with stuck-low inflation was precisely the setting for preemptive easing to protect employment, and that holding risked letting labor momentum fade — the worse error for that mandate. The data-dependent participant likewise read the data at face value as supporting easing, noting that the tight labor market was generating no inflation pressure and that no indicator argued for hiking or holding. Others, while accepting the direction, resisted the magnitude. The financial-stability participant warned that a full 50 basis point cut into complacent, potentially frothy markets — with VIX at 10.5 and spreads tight — risked amplifying risk-taking, and preferred a more measured step. The market-focused participant argued that the -0.105 bill spread implied a mild easing bias, not a large



front-loaded cut, and that a full -50 overshoot what market pricing implied for a single meeting. Both, along with the inflation-focused participant, favored the more gradual First-Difference calibration over the aggressive rule outputs, agreeing on the direction of easing while diverging on how large a first step to take.

In reconciling the two phases, participants generally characterized their predictive holds as reflecting institutional caution and gradualism anchored to prior guidance, while recognizing that the framework, the reference rules, and market pricing all pointed away from any case for tightening. The disagreement that remained was not about direction but about pace: whether below-target inflation warranted a substantial one-step move now or a more incremental adjustment given still-firm labor and complacent markets.

COMMITTEE POLICY ACTIONS

In the predictive phase, the Committee voted unanimously to hold the target range for the federal funds rate at 1.00 to 1.25 percent, with all five members concurring — a tally of 5 to 0 in favor of no change. On the framework's -50 basis point recommendation, the Committee did not divide on direction but did divide on magnitude and timing. Two members — the labor-market-focused participant and the data-dependent participant — endorsed the recommendation as-is. The remaining three — the inflation-focused participant, the financial-stability participant, and the market-focused participant — registered partial agreement, supporting the direction of easing but preferring a smaller or more gradually calibrated step than the full -50 basis points. No member declined the recommendation outright.