



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The System Open Market Account held a total of \$4,206.2 billion in domestic securities as of December 6, 2017, comprising \$2,309.5 billion in Treasury notes and bonds and \$1,767.1 billion in agency mortgage-backed securities. This represented a decline of \$2.5 billion from the prior release of November 29, 2017. The manager noted that this account covers SOMA holdings only — total size, composition, and the 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; accordingly, no discussion of such operations is included here.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reviewed incoming data indicating a labor market operating at or beyond full employment. The unemployment rate stood at 4.1 percent, below the estimated natural rate of 4.74 percent, and initial jobless claims were low and stable at 238,000. The Beige Book characterized economic activity as continuing to increase at a modest to moderate pace through October and mid-November, with a slight improvement in the outlook among reporting contacts. Employment growth had increased since the prior report, and reports of labor-market tightness were widespread: most Districts noted difficulty finding qualified workers across various skill levels, and several indicated that an inability to find suitably skilled workers was restraining hiring plans. Wage growth was described as modest or moderate in most Districts, most notably for professional, technical, and production positions that remain difficult to fill, with many Districts reporting increased use of signing bonuses and other nonwage benefits. The Chicago Fed National Activity Index at 0.65 was consistent with above-trend growth, and the Employment Cost Index registered 130.6.

On inflation, core PCE stood at 1.26 percent on a twelve-month basis, well below the Committee's 2 percent objective. Against that soft realized reading, the Beige Book reported that price pressures had strengthened since the last report, with most Districts noting modest to moderate growth in selling prices and moderate increases in non-labor input costs; construction-material costs rose in most regions, with many Districts citing higher lumber costs and increased demand for materials tied to hurricane rebuilding. Residential real estate prices generally increased as well, though residential activity remained constrained with little growth in sales or construction. Manufacturing expanded in all Districts, described as moderate in most, though the Philadelphia and St. Louis Districts noted signs of a slowdown. Pre-holiday consumer spending on retail and autos was mixed but largely flat, while the holiday-sales outlook was generally optimistic. M2 money supply was reported at \$13,747.0 billion.

STAFF REVIEW OF THE FINANCIAL SITUATION



Financial conditions were exceptionally accommodative. The financial stress index registered 0.03, an extremely low reading, and the VIX stood at 11.02, indicative of unusual market calm. Credit markets showed no sign of borrowing-cost stress, with the Baa corporate spread tight at 1.84. The 10-year/2-year Treasury spread was positive at 0.55, with no inversion, though it bore watching for further compression. The 3-month T-bill spread relative to the current rate stood at 0.155, sitting above the current target midpoint and consistent with markets pricing near-term firming. The current target range for the federal funds rate was 1.0 to 1.25 percent, with the Committee's own last median projected rate of 1.4 percent lying above the range midpoint of 1.125 percent.

STAFF ECONOMIC OUTLOOK

The staff projection drew on several forward-looking quantities. The estimated neutral rate (r^*) of -0.5 percent implied that the current target range of 1.0 to 1.25 percent stood some distance above neutral, suggesting that the prevailing policy stance may be less accommodative than the low nominal level would indicate. Momentum measures were both modestly negative: inflation momentum at -0.045 and unemployment momentum at -0.1. The latter implied that joblessness was still drifting lower rather than rising, consistent with a labor market continuing to firm, while the former implied core inflation drifting somewhat further from, rather than toward, the 2 percent objective over the near term.

The reference-rule set was clustered on the easing side. The Taylor rule, Balanced Approach rule, and ELB-adjusted rule each pointed to -75 basis points, outputs driven largely by the soft realized inflation reading and the low estimated neutral rate. The First-Difference rule, which adjusts from current settings in response to momentum rather than to level gaps, pointed to -25 basis points. The loss-minimizing recommendation of the policy engine landed on -25 basis points, aligning with the First-Difference logic rather than the more aggressive levels-based rules, and the reference rules were flagged as reliable. Taken together, these figures projected an environment in which realized inflation remained below target with soft momentum, even as the labor market continued to tighten — a configuration the framework read as favoring a small easing step rather than either a large levels correction or continued firming.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their predictive discussion of the likely near-term policy path, all participants converged on a 25 basis point increase, moving the target range to 1.25 to 1.5 percent, though they arrived there from distinct vantage points. Participants generally judged the labor market to be tight and strengthening: unemployment at 4.1 percent sat well below the 4.74 percent estimated natural rate, jobless claims were low and stable, and the Beige Book documented widespread hiring difficulty, rising wages, and signing bonuses. Several observed that core PCE at 1.26 percent remained well below the 2 percent



objective, a factor most read as arguing for gradualism rather than for pausing. A number of participants pointed to the Committee's prior guidance of gradual increases as conditions warrant, and to the last median projected rate of 1.4 percent sitting above the current range midpoint, as implying that a move was due.

The participant most focused on inflation risk emphasized that while realized core inflation did not itself demand tightening, the Beige Book's report that price pressures had strengthened — rising input, construction-material, and lumber costs, and modest-to-moderate growth in selling prices — constituted forward-looking pipeline evidence not yet visible in core PCE. Combined with a labor market at or beyond full employment, this member argued, the configuration was one in which wage-driven inflation risk builds ahead of the realized data, warranting a pre-emptive step. The participant weighing employment risk most heavily noted that a dovish tilt is triggered by rising unemployment or slowing job growth, and that the data showed neither; with employment healthy, this member saw no case for easing and no employment-based reason to resist a modest hike. The participant attentive to financial stability stressed that the stress index at 0.03, the VIX at 11.02, and the tight Baa spread signaled no distress, and that the more relevant risk was that ultra-loose conditions and low volatility could feed excessive risk-taking; a widely anticipated 25 basis point move, already reflected in the T-bill spread, would carry minimal destabilization risk. The participant most attuned to market signals read the 3-month T-bill spread of 0.155 as consistent with markets pricing roughly one hike, with calm volatility and tight credit posing no obstacle.

When the discussion turned to the framework's loss-minimizing recommendation of -25 basis points, a sharper divergence emerged. Two participants came to endorse the easing step. The employment-focused member reasoned that with the estimated neutral rate at -0.5 percent, the current range might be quietly restrictive, and that hiking into soft inflation and negative inflation momentum risked needlessly restraining future job growth; a First-Difference-style -25 basis point adjustment was preferable to the jarring -75 of the levels rules and insured against employment downside without ignoring healthy labor conditions. The data-focused member weighed the confirmed hard undershoot in core PCE and the negative inflation momentum as the dominant facts, judging that numbers should dominate anecdote where they conflict, and that the First-Difference rule's measured -25 was the literal, defensible reading — with the levels rules at -75 overstating the case by anchoring to a full inflation gap while ignoring how far policy had already moved relative to a low neutral rate.

Three participants declined to support the easing recommendation. The inflation-risk member acknowledged that the negative neutral-rate estimate was the strongest challenge to a tightening bias but distrusted anchoring easing on that estimate while the labor market was so tight, warning that



cutting into loose financial conditions risked unanchoring inflation expectations toward overshoot. The financial-stability member found that no stress reading justified a cut, and that easing into evident complacency and reach-for-yield would amplify asset-overheating risk — a stability negative rather than neutral — concluding that holding at 1.0 to 1.25 percent was the disciplined choice. The market-signals member emphasized that r^* is an unobservable estimate, whereas the T-bill spread, calm volatility, and tight credit were observable and pointed to firming, not easing; a cut would contradict what markets had already priced and confuse the signal. Across both strands of the deliberation, participants generally recognized a genuine tension between a persistent below-target inflation shortfall and a labor market operating beyond full employment, with several noting that the gap between the predicted hike and the framework's recommended cut suggested the current stance was near neutral, such that small moves in either direction were defensible.

A couple of participants returned to the Beige Book's price and wage signals as corroborating a firming real economy that the levels-based rules understated, while others countered that hard inflation data had not yet confirmed those anecdotal pressures. No participant advanced a case for a move larger than 25 basis points in either direction; those favoring firming cited the prior gradual-increase guidance against front-loading, while those endorsing the framework's easing preferred the First-Difference rule's gradualism over the aggressive levels correction.

COMMITTEE POLICY ACTIONS

In the predictive vote on the likely near-term action, all five participants supported a 25 basis point increase in the target range for the federal funds rate to 1.25 to 1.5 percent, a unanimous 5-to-0 outcome. On the separate question of the policy engine's loss-minimizing recommendation of -25 basis points, the Committee was divided: two participants — the labor-market-focused member and the data-dependent member — endorsed the recommendation as-is, while three — the inflation-risk member, the financial-stability member, and the market-signals member — declined to support it. No participant took a partial position. The recorded optimal-side tally was thus two endorse and three decline.