



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The System Open Market Account's domestic securities holdings totaled \$4,203.2 billion as of January 24, 2018, essentially unchanged from the prior week's release, having risen by \$0.7 billion since January 17. The composition remained split between \$2,305.2 billion in Treasury notes and bonds and \$1,771.1 billion in agency mortgage-backed securities. The staff noted that these figures capture SOMA holdings only — their total size, composition, and week-over-week change — and do not encompass the results of repurchase or reverse repurchase operations, for which no point-in-time-safe data source is currently available.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reviewed a set of readings that, taken together, described an economy growing at a moderate clip with a labor market that had continued to tighten. The unemployment rate stood at 4.1 percent, well below the estimated natural rate of 4.73 percent, and initial jobless claims were low at 220,000. The Chicago Fed National Activity Index, at 0.27, was consistent with above-trend growth. Against this backdrop, core PCE inflation on a year-over-year basis was 1.05 percent, still running close to a full percentage point beneath the Committee's 2 percent objective. The Employment Cost Index registered 130.6, and M2 stood at \$13,845.0 billion.

The most recent Beige Book characterized economic activity as expanding at a modest pace as 2017 closed, with a majority of contacts across manufacturing, retail, and software and information technology reporting revenue gains, though some saw flat or declining revenue. Employers across districts cited tight labor markets as a constraint on expansion, and outlooks remained positive. Several districts described tightening labor markets and wage pressures that were broadening — Richmond noted wage pressures had 'broadened,' Cleveland pointed to pressure concentrated among low- and middle-skills workers, and Chicago described wages rising 'modestly.' Even so, price growth was generally reported as modest to moderate, with selling prices continuing to rise only modestly in several districts. Retailers in a number of districts reported better-than-expected holiday sales, while real estate and construction activity was mixed but generally steady.

STAFF REVIEW OF THE FINANCIAL SITUATION

The staff reported that financial conditions remained calm and accommodative. The financial stress index was extraordinarily low at 0.018, and the VIX stood at 11.47, signaling minimal market volatility. Credit markets showed no sign of borrowing-cost stress: the Baa corporate spread was tight at 1.64 percentage points. The Treasury yield curve remained positively sloped, with the 10-year/2-year spread at 0.57, giving no inversion signal. The 3-month T-bill spread relative to the current policy rate



was only about 4.5 basis points, suggesting that markets were pricing gradual firming ahead rather than an urgent near-term move. Several district reports, including those from Chicago, indicated that financial conditions had improved somewhat.

STAFF ECONOMIC OUTLOOK

Looking ahead, the staff projection drew on several forward-looking quantities. The estimated neutral real rate (r^*) was judged to be about -0.5 percent, implying that the current target range of 1.25 to 1.50 percent sits closer to neutral than its nominal level alone would suggest, and by some measures modestly on the restrictive side. Inflation momentum was weakly positive at 0.09, pointing to continued subdued price pressures rather than a building acceleration, notwithstanding the tightness evident in labor markets. Unemployment momentum was -0.15, indicating that the labor market was still tightening rather than turning, so no near-term deterioration in employment appeared in prospect.

The staff's reference rules, judged reliable this meeting, clustered toward a materially easier stance than current policy: the Taylor rule, Balanced Approach rule, and ELB-adjusted rule each pointed to -75 basis points, while the First-Difference rule, which responds to momentum rather than level gaps, indicated -50 basis points. The loss-minimizing framework, weighing the sizable inflation shortfall against genuine labor-market strength and the two momentum readings, tempered these outputs to a recommended -25 basis points. The implication of these figures, taken as a projection, is that conditions would be consistent with a stance somewhat more accommodative than the prevailing one, with the persistent gap between realized inflation and the 2 percent objective the dominant driver, and only mildly offset by the still-falling unemployment rate.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

Participants began by considering the appropriate stance for the current meeting. All five saw the labor market as tight and strengthening: unemployment at 4.1 percent was well below the 4.73 percent natural rate, jobless claims were low, and the Beige Book repeatedly cited tight labor markets with broadening wage pressures. At the same time, participants agreed that core PCE inflation at 1.05 percent remained well below the 2 percent target and showed no urgency. Two participants — one weighting employment risk and one weighting financial stability — initially favored a 25 basis point increase, reasoning that a well-telegraphed, gradual move would carry no systemic risk given calm markets and would keep policy on its normalization path while conditions were strong. The remaining three, including the member most attentive to inflation risk, the data-dependent centrist, and the member anchored on market signals, favored holding, emphasizing that a hike had just been delivered at the prior meeting, that the 3-month T-bill spread of roughly 4.5 basis points signaled markets embedded the next step later rather than now, and that soft inflation counseled patience.



In the course of the exchange, the two participants who had proposed a hike revised their positions toward a hold. The member focused on employment observed that the case for easing rested on labor-market weakness that was simply not present, while the case for a further consecutive hike was undercut by soft inflation and the recency of the prior move; a hold best fit both considerations. The financial-stability member reasoned similarly, distinguishing feasibility from necessity — that calm markets could absorb a hike was not the same as a hike being warranted, and no credit or systemic signal demanded action in either direction. The inflation-focused member reiterated that latent wage-driven risk warranted vigilance rather than acceleration, and the market-signal and centrist participants held that modest embedded firming and below-target inflation favored patience within the gradual path. The predictive discussion thus converged on holding the target range at 1.25 to 1.50 percent.

Participants then turned to the staff's optimal-policy framework, which recommended a 25 basis point cut. Here the discussion opened up genuine differences. Several participants found the framework's logic compelling as a matter of calibration: with r^* estimated at -0.5 percent and core PCE nearly a full point below target, current policy leaned modestly tight, and the reference rules — clustering at -75 basis points before the loss function tempered them to -25 — captured a real inflation shortfall. The centrist member found the Balanced Approach logic most persuasive, viewing the -25 basis point figure as a reasonable synthesis of a large inflation gap against mild labor-market offset. The employment-focused member endorsed the direction as insurance, noting that sub-target inflation created room to protect job gains even absent rising unemployment, while cautioning that unemployment momentum at -0.15 showed the labor market still strengthening.

Other participants agreed the framework's math was defensible while declining to support an actual cut. The inflation-focused member noted that his usual resistance to easing was weaker given inflation running low, but judged that cutting into extremely loose financial conditions — a stress index of 0.018, a VIX of 11.47, and above-trend activity — risked overheating and sacrificing optionality against future inflation once slack disappeared. The financial-stability member pressed this point most firmly, arguing that the framework rested entirely on the inflation shortfall and lacked a stability guardrail; cutting into calm, arguably frothy markets and a tight labor market courted the very excess he most feared, and easy conditions already made the nominal stance effectively neutral. The market-signal member took an intermediate view, agreeing that below-target inflation and a low r^* pointed to genuine but mild policy tightness, yet holding that his heaviest weight — market pricing, including the flat T-bill spread and positive curve — showed no dislocation to justify the full magnitude of a move.



Across the two strands of discussion, a common thread emerged: participants generally read the current stance as only modestly tight, not urgently so, with the divergence between a hold and a 25 basis point cut reflecting a real but small gap. The disagreement centered on whether that gap warranted action now — with those favoring the framework's call emphasizing the persistent, consensus-supported inflation shortfall, and those declining emphasizing loose financial conditions, the absence of any stress signal, and the risk of adding accommodation where none appeared needed.

COMMITTEE POLICY ACTIONS

On the question of the appropriate policy action at this meeting, the Committee voted unanimously to maintain the target range for the federal funds rate at 1.25 to 1.50 percent; the predictive tally was 5 to 0 in favor of holding. On the staff framework's recommendation of a 25 basis point cut, the Committee did not reach consensus. Two members — the participant focused on labor-market risk and the data-dependent centrist — endorsed the recommendation as calibrated. Two members — the participant focused on inflation risk and the financial-stability member — declined to support it, citing extremely loose financial conditions and the risk of encouraging market excess. One member, anchored on market signals, offered partial support, agreeing with the easing direction implied by the below-target inflation and low neutral rate but not with the full magnitude of the move given the absence of any market dislocation.