



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The System Open Market Account continued to reflect gradual, passive change over the intermeeting period. As of the release covering data through September 19, 2018, total SOMA domestic securities holdings stood at \$3,988.9 billion. The composition was concentrated in Treasury notes and bonds, at \$2,157.4 billion, and agency mortgage-backed securities, at \$1,695.2 billion, with only a nominal \$0.1 billion in Treasury bills. Total holdings declined by \$1.8 billion relative to the prior release dated September 12, 2018. It should be noted that these figures cover SOMA securities holdings only — total size, composition, and week-over-week change — and do not encompass repo or reverse-repo operation results, for which no point-in-time-safe historically-queryable data source currently exists.

STAFF REVIEW OF THE ECONOMIC SITUATION

The economy continued to expand at a moderate-to-strong pace. The labor market remained notably tight: the unemployment rate stood at 3.9 percent, well below the estimated natural rate of 4.62 percent, and initial jobless claims were very low at 204,000. The Chicago Fed National Activity Index was mildly positive at 0.13, consistent with growth around trend. Core PCE inflation on a twelve-month basis was 1.73 percent, below the 2 percent objective but firming. The Employment Cost Index registered 133.3, and M2 money supply stood at \$14,217 billion.

The Beige Book material corroborated this picture of firm activity accompanied by building cost pressures. Contacts across Districts described activity expanding at a modest-to-moderate pace, with tight labor markets and wage growth characterized as moderate to strong. Several Districts reported difficulty finding qualified workers even as hiring demand remained robust. On prices, contacts continued to observe modest-to-moderate increases but expressed 'growing concern for future inflation'; notably, nearly two-thirds of manufacturers reported rising prices paid, particularly for metals, construction materials, and transportation. Accounts of cost pass-through were mixed — some manufacturers reported passing higher input costs along to customers, while others were unable to do so. Manufacturing growth had slowed to a modest pace in some Districts, and construction activity was uneven, weakening in some areas while residential activity firmed in others.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions remained calm and accommodative over the period. The financial stress index was extremely low at 0.042, and the VIX, at 11.75, indicated subdued market volatility and, by some readings, a degree of investor complacency. Credit markets showed no signs of strain: the Baa corporate spread was tight at 1.88. The 10-year/2-year Treasury yield curve spread was positive but flat at 0.27, not inverted but continuing to flatten. The 3-month T-bill spread relative to the current target



rate stood at 0.255, a level broadly consistent with markets pricing in a near-term 25 basis point move. Taken together, these indicators suggested that financial markets could comfortably absorb a well-telegraphed policy step without destabilization.

STAFF ECONOMIC OUTLOOK

The staff's forward-looking assessment gave particular weight to the estimated neutral rate and to the momentum embedded in the incoming data. The estimated real neutral rate (r^*) was unusually low at -0.5, implying that the current target range of 1.75 to 2.00 percent — against core inflation near 1.73 percent — leaves the real policy rate close to a low neutral level. On this reading, remaining accommodation is limited, and policy is nearer to a neutral stance than the nominal level alone would suggest. Inflation momentum was modestly positive at 0.075, pointing to a gradual upward drift in prices rather than a receding trend, while unemployment momentum was slightly negative at -0.05, consistent with a labor market that remains firm.

The reference rules diverged sharply, which itself is informative for the projected path. The Taylor rule, the Balanced Approach rule, and the ELB-adjusted rule each pointed to 75 basis points above the current setting, anchoring on the sizable gaps between current conditions and estimated neutral given tight labor and near-target inflation. The First-Difference rule, which responds to the direction of change rather than to level gaps, pointed to -25 basis points, reflecting soft inflation momentum. Reconciling the low r^* against these level-based prescriptions, the loss-minimizing framework output was 0 basis points — a hold — implying that conditions are likely to evolve gradually from a stance already near neutral, with the flat yield curve counseling against pushing rates materially higher in the near term.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their predictive discussion, all five participants independently arrived at an expectation of a 25 basis point increase, moving the target range from 1.75-2.00 percent to 2.00-2.25 percent, though each reached that view through a distinct analytical lens. The participant most attentive to inflation risk emphasized that, while core PCE at 1.73 percent sits below the 2 percent objective, the Beige Book signaled broad and building cost pressures — 'growing concern for future inflation' and nearly two-thirds of manufacturers reporting rising prices paid — against a very tight labor market with unemployment well below the natural rate. From this vantage, a measured hike would preempt upside inflation risk while financial conditions permitted. The participant focused on the labor mandate noted that neither rising unemployment nor slowing job growth was present, so employment considerations posed no barrier to a gradual step. The participant attentive to financial stability judged that benign conditions — a stress index of 0.042, a subdued VIX, and tight credit spreads — could comfortably



absorb a well-telegraphed move, and that holding when markets anticipated a hike could itself introduce volatility. The data-dependent participant read the incoming data as literally supporting continued normalization, while the participant most attentive to market pricing observed that the 3-month T-bill spread of 0.255 mapped closely to one 25 basis point move already priced in. The rebuttal round produced no revisions; each participant reaffirmed the 25 basis point view.

When the discussion turned to the framework's loss-minimizing recommendation of 0 basis points, however, the balance of views shifted meaningfully, and genuine disagreement surfaced. Participants generally observed that the three level-based reference rules — Taylor, Balanced Approach, and ELB-adjusted — all called for 75 basis points, but that these prescriptions rested heavily on the low unemployment gap and near-target inflation while ignoring the unusually low estimated neutral rate. With r^* at -0.5, several participants noted that the current 1.75-2.00 percent range leaves policy close to a low neutral in real terms, so that the level rules overstate the appropriate degree of tightening. The First-Difference rule's -25 basis point reading, reflecting soft inflation momentum, drew sympathy from those weighing below-target inflation, though most declined to endorse an outright cut absent any labor weakness or credit stress.

A recurring theme was the flat yield curve. The 10-year/2-year spread at 0.27, positive but near inversion, was cited by the market-focused and centrist participants as the more forward-looking signal, one that outweighed the modest T-bill spread and cautioned against over-tightening into a low- r^* environment. This argument proved influential. The participant attentive to financial stability, who had leaned toward a 25 basis point step in the predictive rounds partly to lean against market complacency and froth, indicated that the curve warning tempered that impulse decisively, judging over-tightening into a flat curve and complacent credit the greater systemic risk than froth itself. The labor-focused and data-dependent participants likewise concluded that holding protected against premature restriction while respecting soft inflation.

The participant most attentive to inflation risk registered the sharpest reservation. While accepting that a hold was more defensible than a cut, this participant maintained that a gradual hike remained the more appropriate move: inflation momentum was positive rather than receding, prior guidance had pointed to 'further gradual increases,' and loose financial conditions left ample room to act without destabilizing markets. From this view, a 0 basis point recommendation read as direction-neutral rather than as the continued vigilance the inflation outlook warranted, and holding risked letting accommodation persist while inflation risk visibly built. Participants broadly acknowledged the tension between the predictive expectation of continued gradualism and the framework's counsel of patience — several characterizing the one-increment gap between the predicted 25 basis point step and the



optimal 0 as evidence that the stance is already close to neutral, with the expectation of further hikes reflecting momentum and guidance inertia more than a demonstrated need for additional restriction.

COMMITTEE POLICY ACTIONS

In the predictive vote on the likely policy action, all five participants supported a 25 basis point increase in the target range to 2.00–2.25 percent (5 of 5). On the framework's optimal-side recommendation of a 0 basis point hold, the Committee's recorded stance was four members endorsing the recommendation as-is — the labor-market, financial-stability, data-dependent, and market-signal participants — and one member, the inflation-focused participant, in partial agreement, concurring with the direction of holding over easing but preferring a gradual 25 basis point increase on magnitude. No member declined the recommendation outright.