



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

No point-in-time-safe data on System Open Market Account holdings was available on or before the cutoff for this meeting. As a result, the Committee is unable to report the total size of SOMA holdings, their composition across security types, or any change from a prior release. Members should note that this gap pertains specifically to the SOMA portfolio; it is separate from repurchase and reverse repurchase operation results, for which no point-in-time-safe data source currently exists either. In the absence of these figures, this section is confined to acknowledging the unavailability rather than characterizing balance-sheet developments.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff review pointed to an economy operating at a high level of activity. The Chicago Fed National Activity Index stood at 1.06, consistent with growth running above trend. The unemployment rate was 4.5%, well below the estimated natural rate of 5.17%, and initial jobless claims at 316,000 gave no indication of labor-market deterioration. Core PCE inflation on a year-over-year basis was 1.43%, below the 2.0% objective. M2 stood at \$4,193 billion. Taken together, the incoming data described a strong real economy paired with muted current inflation.

The most recent Beige Book, prepared before July 27, generally reported a high level of economic activity and further expansion, though with some moderation in growth across certain regions and sectors. Retail sales rose in most Districts and were broadly in line with retailers' expectations, with inventories characterized as balanced; strength was noted in seasonal apparel and big-ticket items such as motor vehicles, home furnishings, and major appliances, which contacts attributed to strong consumer confidence, robust home sales, and favorable financing terms. Manufacturing remained at a high level, but the GM strike, weakening export demand, and a general slowing in the high-tech sector damped expansion. Residential and commercial real estate activity continued to fuel construction in most of the nation. Financial institutions reported healthy loan demand and generally accommodative credit conditions. At the same time, many Districts flagged labor shortages, shipping bottlenecks, and continued weakness in East Asia as factors beginning to temper growth.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions presented a mixed picture. The VIX stood at 31.91, an elevated reading indicative of significant market volatility and risk aversion. Broader measures were more contained: the financial stress index was 0.1572, in moderate territory, and the Baa corporate spread was 1.74, showing no sign of acute credit distress. The term structure was notably flat, with the 10-year/2-year spread at just 0.06. The 3-month Treasury bill traded 0.6 percentage point below the current 5.5% funds rate, a



configuration the staff read as consistent with market expectations of lower short-term rates ahead. Alongside the Beige Book's reports of healthy loan demand and accommodative credit conditions, these readings suggested equity-market anxiety and an expectation of future easing coexisting with credit markets that had not yet seized up.

STAFF ECONOMIC OUTLOOK

The forward-looking quantities available to the staff pointed toward a modestly restrictive current stance. With the estimated neutral rate (r^*) at 3.239 and core inflation at 1.43%, the prevailing nominal funds rate of 5.5% implied a real rate above 4%, appreciably higher than r^* . On that basis alone, current policy sits above neutral. The reference rules, however, diverged sharply. Level-based rules keyed off the wide gap between the 4.5% unemployment rate and the 5.17% natural rate: the Taylor rule prescribed +50 basis points, and both the Balanced Approach and ELB-adjusted rules prescribed +75. The First-Difference rule, which responds to changes rather than levels, prescribed -25 basis points.

The momentum figures help reconcile that divergence and shape the projected path. Inflation momentum was -0.13 and unemployment momentum -0.15, both small and both pointing lower. With inflation already below target and drifting further down, and with the flat curve and elevated VIX signaling caution about the growth outlook, the loss-minimizing calculation favored the First-Difference prescription of a modest -25 basis point move, with reference rules judged reliable. The projection that emerges is one in which softening inflation momentum and an above-neutral real rate gradually erode the case for the firm stance the level rules describe, even as current activity remains strong. External weakness from East Asia is a channel that could reinforce the disinflationary drift over the projection horizon.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their initial predictive assessments, all five participants independently arrived at a hold at 5.5%. The starting point for each was the same tension: core PCE at 1.43% removed any current inflation urgency to tighten, while above-trend growth, a tight labor market, and robust Beige Book reports removed any real-economy case to cut. From that shared read, participants weighted the mandates differently. The member most focused on inflation risk emphasized that unemployment at 4.5% relative to a 5.17% natural rate, together with the Beige Book's account of labor shortages, shipping bottlenecks, and robust spending, represented the classic precursors to wage and price pressures; yet with inflation below target and volatility elevated, this participant judged that hiking into market stress offered little immediate benefit and preferred to hold and watch. The member attentive to employment looked hard for signs of labor-market deterioration and found none, citing moderate jobless claims and reports of shortages rather than layoffs, and concluded there was no distress warranting a preemptive cut,



though noting a clear bias to ease quickly if hiring slowed.

The participant focused on financial stability treated the VIX at 31.91 and the 3-month bill trading 60 basis points below the funds rate as the signals warranting the most weight, but observed that acute credit indicators were not flashing: the Baa spread at 1.74 was contained, the stress index at 0.1572 only moderate, and loan demand healthy. On that reading, market volatility was a watch item rather than a systemic threat, and cutting into strength could itself alarm jittery markets. The market-signal participant likewise read the negative bill spread and near-flat curve as a directional lean toward future easing rather than a mandate for action at this meeting, distinguishing markets pricing easing over a horizon from markets pricing a cut today. The data-dependent member summarized the convergence: the most literal reading of the data justified neither a hike into elevated volatility with inflation below target nor a cut against above-trend growth and a tight labor market. The final predictive vote was unanimous for no change.

When participants turned to the deterministic framework's -25 basis point recommendation, the discussion sharpened. Several noted that the recommendation rested on the First-Difference rule alone among the reference rules, with the level-based Taylor, Balanced Approach, and ELB-adjusted rules all prescribing hikes of 50 to 75 basis points. The centrist member pressed this point most directly, observing that three of four reference rules pointed higher and that this consensus tempered the case for cutting now; at the same time, this member acknowledged that a real rate above 4% against an r^* of 3.24 confirmed the stance was genuinely tight, and that softening inflation momentum favored the direction of trimming restrictiveness even if not the full magnitude.

The employment-focused and financial-stability members found the framework's logic persuasive. The former argued that with both inflation and unemployment momentum negative and inflation running well below target, restrictive policy risked damaging employment before inflation even reached target, and that the flat curve and inverted bill spread indicated easing was, if anything, overdue as insurance. The financial-stability member agreed that the confluence of a flat curve, elevated VIX, and disinflation momentum made a modest cut low-cost insurance, though this member remained slightly more cautious than the framework, preferring to acknowledge the direction while noting the real economy had not yet confirmed the fragility the VIX implied. The market-signal member endorsed the -25 outright, reasoning that markets were pricing roughly 60 basis points of relief through the bill spread and that a 25 basis point step was a modest, defensible move consistent with the forward-looking signals he trusted.

The inflation-focused member was the principal holdout on the optimal side. This participant conceded that below-target inflation softened the usual anti-cut stance and that the momentum figures pointed



down, and allowed that -25 was defensible as reversible insurance. But the member emphasized that the momentum readings were small and measured from an already-hot base, that the VIX largely reflected equity fear rather than a credit crisis, and that easing into tight labor markets and above-trend growth risked reigniting the very wage pressures of greatest concern. On balance this participant did not prefer a cut now, preferring instead to wait for confirmation of softening before easing.

COMMITTEE POLICY ACTIONS

On the predictive question of the appropriate policy action at this meeting, the Committee voted unanimously to maintain the federal funds rate at 5.5%, with all five members supporting no change. On the separate question of the deterministic framework's recommendation of a 25 basis point cut, the Committee did not reach full agreement: three members endorsed the recommendation as-is (the labor-market, financial-stability, and market-signal participants), one member declined it (the inflation-focused participant, preferring to await confirmation of softening before easing), and one member offered partial support (the data-dependent centrist, agreeing with the direction of trimming restrictiveness but not the full magnitude given still-strong current activity).