



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, and so the Committee had no current figures on the total size, composition, or period-over-period change in SOMA holdings before it. This limitation pertains to the SOMA portfolio itself; it should be noted separately that no point-in-time-safe data source currently exists for the results of repurchase and reverse repurchase operations, so those operations are likewise not summarized here. The staff accordingly confined its account of open market operations to the observation that the underlying holdings data could not be reported on a basis consistent with the Committee's documentation standards.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reported that economic activity had continued to expand at a solid pace. The most recent Beige Book, prepared on information collected before early August, described continued strength across the twelve Districts, with retail sales robust in the second quarter before decelerating somewhat in July, in some cases owing to low inventories of clearance merchandise. Manufacturing continued to expand in most parts of the country, though performance varied sharply by industry: electronics, heavy trucks, and construction materials remained strong, while textiles and metals stayed weak. Residential construction and housing markets were strong in most Districts, and commercial real estate markets remained tight. Loan demand was steady or rising, with brisk growth in commercial and industrial and consumer lending even as residential mortgage and refinancing activity eased. The Chicago Fed National Activity Index stood at -0.19, indicating growth running slightly below its historical trend.

On the labor side, the unemployment rate was 4.2%, well below the estimated natural rate of 5.13%, and initial jobless claims were low at 281,000, together pointing to a very tight labor market. The Beige Book confirmed widespread labor shortages in virtually every District, but noted only scattered reports of an actual acceleration in wages. On prices, core PCE inflation was 1.43% on a twelve-month basis, below the 2% objective. The Beige Book described final prices of goods and services as relatively stable for the most part, with some accelerating prices tied largely to home construction and with climbing oil prices, but with 'no evidence of any broad-based pickup in consumer price inflation.' Grain prices were depressed by expectations of large Midwest harvests, while drought hurt crops in the eastern part of the country. M2 stood at \$4,542.3 billion.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions were characterized as moderate and generally orderly. The financial stress index registered 0.2625, a moderate reading that did not signal acute systemic strain, and the Baa corporate



spread over Treasuries was 2.25, indicating that credit costs remained contained. The VIX stood at 23.77, somewhat elevated and suggestive of a degree of market nervousness, though below levels associated with acute distress. The Treasury yield curve remained slightly positive, with the 10-year/2-year spread at 0.25, providing no recession signal from that channel. Notably, the 3-month Treasury bill traded 56 basis points below the current 5.25% federal funds rate, a spread the staff flagged as consistent with market expectations of easier short-term conditions ahead rather than further tightening.

STAFF ECONOMIC OUTLOOK

The staff's forward-looking assessment drew on the estimated neutral rate and on the momentum in the mandate variables. With the estimated real neutral rate (r^*) at 3.624 and core inflation near 1.4%, the implied neutral nominal rate lay somewhat above the current 5.25% funds rate, suggesting that policy was not, on this metric, meaningfully restrictive. Inflation momentum was slightly negative at -0.035 and unemployment momentum was flat at 0.0, indicating little near-term impetus for either price acceleration or labor-market deterioration and pointing toward broadly stable conditions absent a shock.

The reference rules spanned a wide range and did not speak with one voice. The Taylor rule prescribed 50 basis points of firming and both the Balanced Approach and ELB-adjusted rules prescribed 75 basis points, each driven largely by the wide gap between the 4.2% unemployment rate and the 5.13% natural rate. The First-Difference rule, which responds to the direction of the data rather than to static level gaps, prescribed -25 basis points, consistent with the negative inflation momentum and flat unemployment momentum. The reference rules were assessed as reliable under current conditions, and the deterministic optimal-policy engine, weighing below-target inflation against flat momentum, produced a loss-minimizing recommendation of -25 basis points.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their predictive discussion, participants agreed on the essential features of the data picture but weighed them differently. All noted that core PCE inflation at 1.43% was below the 2% objective and that the labor market, with unemployment at 4.2% against a 5.13% natural rate and widespread labor shortages reported in the Beige Book, was very tight. The disagreement turned on how heavily to weight the prospect of future inflation arising from that tightness against the absence of any realized broad-based pickup in prices.

Three participants initially favored a 25 basis point increase. One, focused on inflation risk, argued that a labor market running this hot was precisely the condition under which future wage and price pressures



build, and that waiting for broad-based wage acceleration would mean acting late; this participant read the elevated home-construction and oil prices as early evidence of building pressure and judged that low financial stress left room for a precautionary move. A second participant, attentive to financial stability, favored a measured 25 basis point step as preemptive but non-destabilizing, noting that the VIX at 23.77 and Baa spreads at 2.25 argued against aggressive action while still permitting a modest firming before any window for a measured step closed. A third participant, taking the data at face value, initially read the combination of tight labor and robust demand as favoring gradual preemptive tightening.

Two participants favored holding. One, weighting employment risk, observed that there was no labor-market deterioration to counter — jobless claims were low and shortages widespread — so no case for easing existed, but that preemptively tightening into a strong-but-not-inflationary economy risked harming employment against a threat that had not materialized. Another, focused on market pricing, emphasized that the 3-month bill trading 56 basis points below the funds rate indicated markets did not expect near-term hikes and might view current policy as already somewhat restrictive; in this participant's view, market pricing already aggregated the overheating concern and was not demanding a move. Over the rebuttal round, the data-focused participant was persuaded by these points and revised toward a hold, judging that realized inflation 0.57 percentage point below target, together with market signals leaning against tightening, did not directly support a move now.

When the discussion turned to the framework's loss-minimizing recommendation of -25 basis points, participants split along familiar lines but with notable nuance. The market-focused participant endorsed the recommendation outright, finding it aligned cleanly with the negative front-end spread and with the First-Difference rule's momentum logic. The inflation-focused participant declined, arguing that the -25 output rested on a single momentum rule and on a backward-looking inflation reading, while three of the four reference rules — Taylor at 50, Balanced Approach and ELB-adjusted at 75 — pointed upward; with r^* at 3.624 implying a neutral nominal rate above 5%, this participant judged that easing into evident supply-side tightness was unwarranted.

The remaining three participants agreed with the easing direction but not its full magnitude. The employment-focused participant supported the direction only as modest insurance, noting that flat unemployment momentum made a full 25 basis point cut into a hot labor market feel premature. The financial-stability participant judged that orderly credit conditions and only moderate stress made a cut defensible but not compelling, favoring a smaller measured step if any. The data-focused participant characterized the gap between a hold and the -25 recommendation as modest rather than a compelling easing case, concluding that soft inflation and flat momentum supported the direction



toward easing while firm activity and labor shortages argued against committing to a cut right now.

COMMITTEE POLICY ACTIONS

In the predictive vote, the Committee's five members split three to two in favor of holding the federal funds rate at 5.25%, with two members favoring a 25 basis point increase and three favoring no change. On the deterministic framework's -25 basis point recommendation, the Committee did not reach full agreement: one member endorsed the recommendation as-is, one member declined to support it, and three members agreed with the easing direction but not its magnitude or timing. The member weighting inflation risk declined; the member focused on market signals endorsed; and the members focused on employment, financial stability, and the literal data reading each registered partial agreement.