



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The Committee reviewed data on the System Open Market Account. As of the most recent release dated September 3, 2003, total SOMA domestic securities holdings stood at \$652.5 billion, comprising \$398.9 billion in Treasury notes and bonds and \$240.8 billion in Treasury bills. This represented an increase of \$0.3 billion from the prior release of August 27, 2003 — a modest, essentially technical change in the portfolio's overall size. Staff noted that this review covers SOMA holdings only, meaning total size, composition, and week-over-week change; it does not extend to repo or reverse-repo operation results, for which no point-in-time-safe data source currently exists.

STAFF REVIEW OF THE ECONOMIC SITUATION

Staff reported that the economy continued to display signs of a modest firming. The Beige Book, prepared at the Federal Reserve Bank of Richmond and based on information collected before July 21, characterized the pace of activity as having increased 'a notch' during June and the first half of July. Only the Chicago, St. Louis, and San Francisco districts described activity as sluggish, while Atlanta reported mixed conditions; the remaining districts pointed to somewhat stronger growth, and several noted increased optimism about prospects in coming months. Manufacturing edged higher in most districts, with Philadelphia and Richmond citing an end to recent production declines, and activity in services and energy grew somewhat faster. Against these more positive readings, consumer spending remained lackluster, with only New York reporting a noticeable improvement in retail sales. Housing sales and starts stayed strong across districts, spurred by low mortgage rates, while commercial real estate remained sluggish. Prices were generally little changed, though some districts noted higher health insurance costs continuing to be passed on to employees.

On the labor side, the unemployment rate stood at 6.1 percent, above the estimated natural rate of 5.05 percent, indicating persistent slack. Initial jobless claims were elevated at 422,000. Core PCE inflation on a year-over-year basis was 0.94 percent, well below the 2.0 percent objective. The Chicago Fed National Activity Index registered 0.35, and the Employment Cost Index reading was 92.9. M2 money supply stood at \$6,092.1 billion. Taken together, the data described an economy in which activity was picking up gradually while both inflation and labor-market conditions remained soft.

STAFF REVIEW OF THE FINANCIAL SITUATION

Staff characterized financial conditions as calm. The financial stress index was low at 0.10, and the VIX stood at a moderate 18.85, with no acute spike in volatility. The Baa corporate spread of 2.53 was contained and showed no alarming widening, indicating that credit markets were not signaling funding distress. The Treasury yield curve was steeply positive, with a 10-year/2-year spread of 2.66 and no



inversion, consistent with an absence of near-term recession signals from the curve. At the front end, the 3-month T-bill spread was slightly negative at -0.06 relative to the current 1.0 percent funds rate, a small gap suggesting that markets leaned modestly toward easing or softness rather than pricing in any near-term tightening. Overall, staff noted that financial conditions posed no obstacle to policy action in either direction.

STAFF ECONOMIC OUTLOOK

Staff projections drew on the forward-looking quantities embedded in the reference-rule framework. The neutral real rate (r^*) used in the analysis was estimated at 2.583 percent. Inflation momentum was negative at -0.135, indicating that price pressures were still decelerating rather than stabilizing near target — a signal that, absent a change in the policy stance, the shortfall relative to the 2.0 percent objective could widen further and drift toward deflation. Unemployment momentum was positive at 0.2, implying that labor-market slack was likely to widen rather than narrow in the near term, consistent with the elevated level of jobless claims.

The reference rules were judged reliable this meeting. Three of the four — the Balanced Approach rule, the First-Difference rule, and the ELB-adjusted rule — pointed to -50 basis points, while the Taylor rule was an outlier at +75 basis points, a divergence staff attributed to that rule's implicit assumption that inflation sits near target rather than at the sub-1 percent level actually observed. The framework's loss-minimizing recommendation was -50 basis points. Read together, these quantities implied that policy at the current 1.0 percent setting was modestly tighter than the balance of mandate gaps and adverse momentum would warrant, and that, with the funds rate near the effective lower bound, the projected path of conditions favored additional accommodation to guard against entrenched disinflation.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their initial predictive round, all five participants independently anticipated that the Committee would hold the funds rate at 1.0 percent. The reasoning converged from different starting points. The member most attentive to inflation risk observed that, unusually, the salient danger was disinflation rather than overheating: core PCE at 0.94 percent was well below target, and there was no upside inflation pressure to lean against. With unemployment at 6.1 percent above the 5.05 percent natural rate and claims elevated, this participant saw no basis to hike and, given already-low rates and improving activity signals, judged that holding steady let existing accommodation work through the economy. The member focused on the labor market emphasized the same slack — unemployment above the natural rate, elevated claims, a fragile recovery — and noted that below-target inflation removed any constraint on accommodation. Yet with the funds rate already at 1.0 percent, this



participant found a further cut hard to justify absent sharp deterioration, favoring a hold that preserved scarce room to act later.

The member most concerned with financial stability stressed that every relevant stress signal was benign: a low stress index, moderate VIX, contained Baa spreads, and a steeply positive, non-inverted curve. In that member's view there was neither a credit shock demanding emergency easing nor an inflation threat justifying tightening, and cutting near the lower bound risked fueling instability rather than calming it. The data-dependent member read the numbers at face value — disinflation arguing against a hike, improving Beige Book activity and a steep curve arguing against a cut — and concluded that nothing in the data forced a move. The member weighting market signals anchored on the near-flat front-end pricing (a -0.06 T-bill spread) and calm broader conditions, taking the efficient read to be that markets expected no change. In the rebuttal round, no participant's direction shifted; each found the others' arguments reinforcing rather than contradicting. The predictive vote was unanimous for holding.

The discussion then turned to the deterministic optimal-policy framework, which recommended -50 basis points. Here the tenor of the conversation changed markedly. The inflation-focused member, examining the negative inflation momentum of -0.135 alongside a Beige Book that reported prices 'generally little changed' and no wage-price spiral, concluded that the usual objection to easing was simply absent — the genuine tail risk was disinflation hardening into deflation. This member found the Taylor rule's $+75$ basis points unpersuasive because it rested on a misread of sub-1 percent inflation, and endorsed the Balanced Approach logic that weighs both mandate gaps honestly. The labor-focused member reached the same conclusion by a more direct route: a wide and widening employment gap, positive unemployment momentum, and ample inflation room together made a full 50 basis points warranted, and the convergence of the inflation member toward easing strengthened that confidence.

The financial-stability member reframed the case in credit-conditions terms. Acute stress that would force emergency easing was absent today, but disinflation drifting toward deflation was itself a stability threat — raising real debt burdens and widening spreads later — and low current stress was precisely the cheap window in which to take out insurance before a shock forced disorderly, reactive moves. This member found the ELB-adjusted rule most persuasive given how little conventional room remained at 1.0 percent, and endorsed -50 basis points as loss-minimizing from a stability view. The data-dependent member noted that both mandate legs pointed the same way, that three of four reliable rules converged on -50 while the Taylor rule stood alone, and that the front-end market lean of -0.06 meant a cut would not be fighting markets; on a literal reading, the magnitude of -50 matched



the convergent rules with no basis to prefer something smaller.

The one point of genuine daylight came from the market-signals member. That participant accepted the direction — the front-end tilt and the disinflation-near-the-lower-bound case both argued for accommodation — but questioned the magnitude. A 6-basis-point spread, this member argued, hinted at softness rather than demanding a full 50-basis-point cut, and the steeply positive broader curve, contained spreads, and a Beige Book showing activity up 'a notch' with rising optimism suggested calm conditions in which a large, shock-like cut risked overshooting a nascent recovery. Precautionary insurance against deflation was warranted, in this view, but a smaller step matched what markets were actually pricing. Other participants who reached for the ELB-adjusted logic were, in this member's assessment, confirming the direction while overstating the urgency.

COMMITTEE POLICY ACTIONS

On the predictive question of what policy action the Committee would take, all five participants anticipated no change in the target rate, leaving it at 1.0 percent; the predictive vote was unanimous, 5 to 0, for a hold. On the separate question of the deterministic framework's recommendation to ease by 50 basis points, four of the five members endorsed the recommendation as-is — the inflation-focused, labor-focused, financial-stability, and data-dependent members — while the member weighting market signals recorded a partial position, agreeing with the direction of easing but not with the full magnitude, judging that the modest front-end market signal and calm broader conditions favored a smaller step. No member declined the recommendation outright, so the optimal-side outcome was four endorsements, one partial, and none declining.