



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The Committee reviewed the composition and size of the System Open Market Account. As of the most recent release on July 27, 2005, total SOMA domestic securities holdings stood at \$721.9 billion, comprising \$437.4 billion in Treasury notes and bonds and \$265.0 billion in Treasury bills. The change from the prior release of July 20, 2005 was essentially flat, at zero on a rounded basis, indicating no net addition or runoff over the intervening week. It should be noted that this review covers SOMA holdings only — total size, composition, and week-over-week change — and does not encompass the results of repurchase or reverse-repurchase operations, for which no point-in-time-safe data source is currently available; accordingly, no characterization of those operations is offered here.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reported that economic activity continued to expand at a solid pace. Core PCE inflation stood at 1.75% on a twelve-month basis, modestly below the 2% objective. The unemployment rate was 5.0%, essentially even with the estimated natural rate of 5.04%, and initial jobless claims were low and stable at 316,000. The Chicago Fed National Activity Index registered a positive 0.21, consistent with above-trend growth, and the Employment Cost Index reading of 99.3 pointed to no notable acceleration in labor compensation. The current federal funds rate was 3.25%, and M2 stood at \$6,502.7 billion.

The most recent Beige Book, prepared at the Federal Reserve Bank of Kansas City and based on information collected on or before July 18, reported that all twelve Districts indicated continued expansion in June and early July. Several Districts characterized the pace as solid, one described it as moderate, and only one District reported a slowing in the rate of growth. Most Districts reported increases in retail sales, with vehicle sales boosted by renewed price discounting; demand for services and tourism continued to rise, and manufacturing activity expanded moderately to solidly in most Districts. Residential real estate remained strong overall, though a few Districts noted signs of cooling, and commercial real estate improved in most Districts. Labor markets generally continued to improve, with skilled worker shortages reported in several Districts, though hiring was mixed in some. Nearly all Districts described wage pressures as moderate. Overall price pressures were reported to have eased slightly or remained unchanged in most Districts, despite substantial increases in energy costs.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions were characterized as calm and accommodative. The financial stress index was low at 0.1161, and the VIX stood at 11.75, a subdued level suggesting abundant risk appetite. Credit conditions appeared healthy, with the Baa corporate spread tight at 1.68 percentage points and no



evident borrowing-cost strain. The 10-year/2-year Treasury yield curve spread was positive but narrow at 0.28, indicating a flattening that had not progressed to inversion. At the front end, the 3-month Treasury bill yielded 9 basis points above the current 3.25% funds rate, a configuration consistent with market expectations of further near-term policy firming.

STAFF ECONOMIC OUTLOOK

The staff outlook drew on the estimated neutral rate and the momentum readings underlying the reference rules. With r^* estimated at 1.246% and inflation running near 1.75%, a neutral nominal rate would lie in the vicinity of 3.0%, close to the prevailing 3.25% funds rate; this implies that policy was only mildly restrictive and near neutral rather than substantially tight. Inflation momentum was modestly positive at 0.11, suggesting prices were firming rather than fading, while unemployment momentum was slightly negative at -0.15, indicating a labor market continuing to firm rather than loosen. Taken together, these figures point to conditions drifting gently in a direction that offers no clear evidence of emerging slack or of accelerating price pressure.

The reference rules diverged in their implications. The Taylor rule, the Balanced Approach rule, and the ELB-adjusted rule each pointed to roughly -75 basis points, reflecting inflation modestly below target and unemployment essentially at the natural rate — level-based signals that read 3.25% as already somewhat restrictive relative to the implied neutral level. The First-Difference rule, which responds to changes rather than levels, indicated 0 basis points, consistent with the benign momentum readings. The deterministic policy engine judged the reference rules reliable and, weighing the aggressive level-based cut signals against stable momentum and calm financial conditions, arrived at a loss-minimizing recommendation of 0 basis points. On balance, the projection is for an economy remaining near equilibrium, with policy positioned close to neutral and no shock present that would compel a sharp move in either direction.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In the predictive round, all five participants independently arrived at the same near-term expectation: a further 25 basis point increase in the federal funds rate. The reasoning converged from distinct vantage points. The participant most focused on inflation emphasized that although core PCE at 1.75% sat below the 2% objective, the Beige Book flagged substantial energy cost increases and skilled worker shortages against a backdrop of solid, broad-based expansion, and that a funds rate of 3.25% remained accommodative — grounds, in that participant's view, for continued preemptive removal of accommodation. The participant attentive to labor conditions observed that unemployment at 5.0% was essentially at the natural rate, claims were low and stable, and the Beige Book described improving labor markets with only moderate wage pressures; with no rising joblessness or slowing hiring, the usual



trigger for supportive easing was simply not activated, and gradual normalization posed no threat to a healthy labor market.

The participant oriented toward financial stability noted that a low stress index, a subdued VIX, and tight Baa spreads together indicated calm-to-complacent markets with no strain that would argue against continued measured tightening; that participant also cautioned that a pause could either signal alarm the data did not support or further feed existing complacency. The participant focused on market signals pointed to the 3-month bill sitting 9 basis points above the funds rate as evidence that markets had largely priced another move, and to the still-positive yield curve as indicating no imminent recession. The centrist read the literal data as showing a solidly expanding economy with rates below neutral, favoring continued gradual firming. In the rebuttal round, no participant was moved from this view; the unanimity across lenses was taken to reinforce rather than challenge the case, and the final predictive vote was recorded as a full complement in favor of 25 basis points.

The optimal-framework rounds shifted the discussion toward the engine's 0 basis point recommendation and the wide split among the reference rules. Participants generally accepted that the three level-based rules calling for roughly -75 basis points were reacting to inflation modestly below target and a near-closed output gap, but they broadly rejected the notion of easing. Several stressed that inflation momentum was positive at 0.11 and that the Beige Book's energy-cost and labor-shortage observations argued against cutting into firming prices. The First-Difference rule's 0 basis point signal, keyed to benign momentum rather than uncertain level estimates, was described by more than one participant as the most persuasive of the four, and the centrist's estimate that a neutral nominal rate lay near 3.0% against the current 3.25% was widely cited as evidence that policy was near neutral — close enough that holding and one further hike were both defensible while a sharp cut was not.

A couple of participants observed that the flattening of the 10s-2s spread to 0.28, though not yet an inversion, tempered any instinct toward pushing tighter, since continued firming could risk inverting the curve. The participant most attentive to stability, who had leaned toward a modest hike as a lean against frothy credit and complacent volatility, cited that curve flatness in accepting the hold as the more prudent course. The labor-focused and centrist participants judged that, with employment near equilibrium and inflation below target, neither stimulus nor further restraint was clearly warranted, making a hold the loss-minimizing choice. The inflation-focused participant and the market-signal participant, while agreeing firmly that easing would be a mistake, retained a preference for one further measured step — the former on inflation-risk grounds, the latter because front-end pricing still pointed to normalization from an accommodative stance. The recurring theme across both the predictive and optimal rounds was that the genuine debate lay only between holding and a single additional hike; the



aggressive easing implied by the level rules found no support.

Throughout, participants characterized financial conditions as loose and undisturbed, with no distress signal that would justify support, and they drew repeatedly on the observation that the real funds rate — roughly 1.5% against an r^* near 1.246% — placed policy only mildly above neutral. That framing, more than any single indicator, anchored the shared conclusion that the appropriate direction was toward restraint or steadiness, not accommodation.

COMMITTEE POLICY ACTIONS

In the predictive vote on the near-term policy decision, all five members supported a 25 basis point increase in the target federal funds rate, a unanimous outcome recorded as 25 basis points ({25: 5}). On the deterministic framework's loss-minimizing recommendation of 0 basis points, the Committee did not divide over direction but did divide over magnitude: three members — the labor-market-focused participant, the financial-stability-focused participant, and the data-dependent centrist — endorsed the 0 basis point recommendation as-is, while two members — the inflation-focused participant and the market-signal-focused participant — registered partial agreement, concurring with the direction (that no cut was warranted) but favoring one further measured step rather than a hold. No member declined to support the framework's direction. The recorded optimal-side tally was three endorse, two partial, and zero decline.