



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The System Open Market Account held \$727.6 billion in domestic securities as of the most recent release dated September 7, 2005, unchanged from the prior release of August 31. Holdings comprised \$440.3 billion in Treasury notes and bonds and \$267.8 billion in Treasury bills, so that coupon securities accounted for a somewhat larger share of the portfolio than bills. The manager noted no net change in total holdings over the interval. It should be emphasized that this account covers SOMA securities holdings only — total size, composition, and the 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 currently exists; the staff therefore made no representations about temporary open market operations in this review.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reviewed data indicating that economic activity had increased across most of the nation from mid-July through August. According to the Beige Book, growth was widespread, with retail sales, services, finance, construction, manufacturing, mining, energy, and tourism all expanding; only the Boston District described its activity as mixed. Retail sales rose in most Districts, though several retailers reported expecting sales to be dampened by higher fuel prices, and vehicle sales were up in every District, aided by manufacturer discounts even as a couple of Districts noted signs of 'buyer fatigue' late in August. A few Districts reported some softening in residential real estate, though from still brisk levels, while commercial real estate strengthened in most Districts. Lending activity increased and credit quality was stable.

Labor markets showed signs of tightening, accompanied by modest wage increases. The unemployment rate stood at 4.9 percent, just below the estimated natural rate of 5.04 percent, and the Employment Cost Index read 99.3, consistent with the Beige Book characterization of wage gains as modest. Core PCE inflation was 1.59 percent on a twelve-month basis, below the 2 percent objective, but the Beige Book flagged significant price increases in certain commodities and energy products, especially gasoline, even as overall consumer price increases outside of energy remained modest. Two indicators pointed to some softness against the broad expansion: initial jobless claims were elevated at 422,000, and the Chicago Fed National Activity Index stood at -0.62, signaling below-trend growth.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions were benign and broadly accommodative. The financial stress index registered 0.1251, a low reading, and the VIX at 12.39 pointed to calm rather than fear in equity markets. Credit markets appeared healthy: the Baa corporate spread was tight at 1.83, consistent with the Beige Book



report of stable credit quality and increased lending. The Treasury yield curve remained positively sloped, with the 10-year/2-year spread at 0.26 — flattening but not inverted, so the recession signal from the term structure was muted. The 3-month Treasury bill spread sat at -0.09 relative to the current 3.5 percent funds rate, a slightly negative reading suggesting that markets anticipated only limited further near-term movement in policy.

STAFF ECONOMIC OUTLOOK

The staff's projection drew on the estimated neutral real rate (r^*) of 1.252 percent. Combined with core inflation near 1.6 percent, this implied a neutral nominal rate in the neighborhood of 2.85 percent, below the current 3.5 percent funds rate — an arithmetic that placed the prevailing stance at or modestly above neutral rather than deeply accommodative. Inflation momentum was positive at +0.235, indicating that price pressures were firming rather than fading even though the level of core inflation remained below target, while unemployment momentum at -0.1 suggested the labor market was tightening slightly rather than deteriorating.

The reference rules diverged sharply. The Taylor rule, the Balanced Approach rule, and the ELB-adjusted rule each pointed to -75 basis points, mechanically responding to the below-target inflation level and near-neutral unemployment. The First-Difference rule, which weights the direction of change rather than the level gap, indicated a milder -25 basis points. Reconciling these level-based easing signals against firming inflation momentum and broad-based expansion, the deterministic policy engine's loss-minimizing recommendation was 0 basis points — a hold. The projection thus implied that conditions were unlikely to require either the aggressive easing the level rules suggested or additional near-term restraint, with the resolution of energy prices and the elevated claims figure the key uncertainties bearing on the path ahead.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their predictive discussion, all five participants arrived independently at a preference for a 25 basis point increase, continuing the measured pace of removing accommodation. The reasoning converged from different starting points. The member most attentive to inflation risk emphasized that although core PCE at 1.59 percent sat below the 2 percent target, the Beige Book flagged significant energy and gasoline price increases together with tightening labor markets and modest wage gains — the upside pressures this member weighted most heavily. With unemployment at 4.9 percent below the natural rate and the funds rate still accommodative, this participant judged continued measured hikes appropriate to anchor inflation expectations against energy shocks, while explicitly rejecting a larger 50 basis point move given that wage gains remained modest and core inflation was still below target.



The member most focused on employment worked through genuinely conflicting signals. The low unemployment rate and Beige Book reports of tightening labor markets did not describe deterioration, yet the elevated 422,000 jobless claims and the -0.62 Chicago Fed reading were precisely the leading indicators this participant watched most closely. This member reasoned that a single elevated claims print did not yet constitute a trend, that unemployment was low and wage growth modest rather than collapsing, and that broad-based expansion argued against easing — while flagging claims and the activity index as the indicators to monitor most closely into the next meeting. The participant attentive to financial stability found no stress warranting divergence from the measured path: the low stress index, calm VIX, and tight Baa spread, alongside Beige Book reports of increased lending and stable credit quality, described an environment where predictable tightening preserved stability and a pause risked a future destabilizing catch-up. The centrist read the mixed soft data as hints of below-trend softening outweighed by widespread expansion, and the market-signal member read the slightly negative T-bill spread and still-positive yield curve as consistent with a priced-in continuation of the gradual pace, with markets pricing neither recession nor cuts.

When the discussion turned to the deterministic framework's recommendation of a hold, participants engaged with the sharp gap between the reference rules and the loss-minimizing output. Several noted that the Taylor, Balanced Approach, and ELB-adjusted rules pointed to -75 basis points because they responded mechanically to the below-target inflation level and the near-neutral unemployment reading. Participants generally judged these deep-cut signals unwarranted. The inflation-focused member found the -75 signals alarming, arguing they ignored the positive +0.235 inflation momentum and an already-tight labor market, and that cutting into rising energy prices risked unanchoring expectations. The financial stability voice added that easing 75 basis points into froth-like calm and stretched risk-taking would itself be a stability hazard, with no credit-channel distress to justify defensive easing.

A common thread was that the r^* arithmetic — a neutral real rate of 1.252 percent implying a neutral nominal rate near 2.85 percent — revealed the current 3.5 percent stance to be already at or near neutral, which explained both why the level rules pulled toward cuts and why aggressive easing was not compelling. The centrist characterized the hold as netting opposing signals: level rules pulling toward easing against firming momentum and expansion pulling the other way. Notably, the labor-focused member reconciled a personal predictive lean toward +25 with an endorsement of the hold by reasoning that a hike would add restraint precisely as claims were rising, so that holding better protected the labor market than the member's own predictive vote would have; this member found the First-Difference rule's gradualist logic most persuasive. The market-signal participant likewise conceded that the negative T-bill spread gave genuine pause about pushing a further hike, and that



market pricing suggested the economy was near neutral already. Across both rounds no participant advanced a case for a cut, and none was moved toward one; the divergence that remained was between a modest tightening lean and a hold, not between easing and tightening.

In sum, participants entered the framework discussion favoring continued measured tightening and left it broadly comfortable that a hold was defensible, with the below-target inflation level, positive inflation momentum, tight labor market, and benign financial conditions together arguing against both the deep cuts of the level rules and any urgent additional restraint.

COMMITTEE POLICY ACTIONS

In the predictive vote on the near-term policy action, all five members supported a 25 basis point increase in the target federal funds rate, a unanimous 5-to-0 tally. On the separate question of the deterministic framework's recommendation of no change (0 basis points), the Committee was likewise in full agreement: all five members — the inflation-focused member, the labor-market member, the financial-stability member, the data-dependent centrist, and the market-signal member — endorsed the recommendation as-is, with no members declining and none registering partial agreement. The two votes together reflect a Committee that leaned toward a further measured step while judging the loss-minimizing hold a fully defensible reading of firming inflation momentum, a tight labor market, and benign financial conditions near neutral.