



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The Committee reviewed developments in the System Open Market Account. As of the most recent release on or before the point-in-time-safe cutoff, dated July 26, 2006, total SOMA domestic securities holdings stood at \$760.9 billion. The composition was split between \$459.1 billion in Treasury notes and bonds and \$277.0 billion in Treasury bills. Relative to the prior release of July 19, 2006, holdings were essentially unchanged, showing a week-over-week change of \$0.0 billion. It should be noted that this review covers SOMA holdings only — total size, composition, and the change from the prior release — and does not encompass repo or reverse-repo operation results, for which no point-in-time-safe data source is currently available.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reviewed the incoming data on activity, labor markets, and prices. Core PCE inflation on a year-over-year basis registered 2.14 percent, modestly above the 2.0 percent objective. The unemployment rate stood at 4.6 percent, below the estimated natural rate of 5.04 percent, indicating labor markets that remained relatively tight. Initial jobless claims came in at 311,000, a level consistent with no meaningful pickup in layoffs. The Chicago Fed National Activity Index at 0.18 pointed to growth near its trend pace rather than a sharp acceleration or contraction. The Employment Cost Index reading was 102.6, and M2 stood at \$6,829.9 billion.

The Beige Book prepared for this meeting, based on information collected on or before July 17, 2006, indicated that all twelve Districts generally reported continued economic growth during June through mid-July, though numerous individual reports pointed to a slower pace of expansion. Several Districts characterized overall growth as 'moderate' or 'modest'; San Francisco described its expansion as 'solid,' while Atlanta and St. Louis called conditions 'mixed.' Six Districts — Philadelphia, Cleveland, Richmond, Chicago, Dallas, and San Francisco — highlighted an outright decline in the pace of growth. Most retail reports pointed to slightly weaker conditions on balance than earlier in the year, while manufacturing was described as strong, with significant gains in output and sales, especially for durable goods. Residential real estate cooled in most of the country, and residential mortgage lending declined in most Districts, even as commercial and industrial lending expanded and demand for commercial space picked up. Increases in wages and in final goods prices remained 'modest on net,' with persistent upward pressure from elevated energy and other input costs but a few Districts noting moderation in some items.

STAFF REVIEW OF THE FINANCIAL SITUATION



The staff characterized financial conditions as broadly calm and free of systemic strain. The financial stress index stood at 0.1326, a low reading, and the VIX at 15.05 was consistent with subdued expected volatility. The Baa corporate spread of 1.69 percentage points was contained, indicating no material borrowing-cost stress in credit markets. The 10-year/2-year Treasury yield curve spread was essentially flat at 0.02, near inversion, and the 3-month Treasury bill traded 0.31 percentage point below the current 5.25 percent federal funds rate. Taken together, these rate-market signals suggested that market participants judged the current policy stance to be already restrictive and did not anticipate further firming at this horizon.

STAFF ECONOMIC OUTLOOK

Looking ahead, the staff projection drew on the forward-looking quantities available. The estimated neutral real rate embedded in the framework was low, at roughly 0.896 percent; combined with core PCE near 2.14 percent, this implies a neutral nominal rate well below the prevailing 5.25 percent funds rate, so that the current stance is meaningfully restrictive. That reading is reflected in the reference-rule outputs: the Taylor rule, the Balanced Approach rule, and the ELB-adjusted rule each pointed to -75 basis points, reflecting negative slack and a low neutral rate. The First-Difference rule, which responds to changes in conditions rather than the level of any output gap, pointed to 0 basis points.

Momentum measures suggested the economy was near a balance point rather than moving sharply in either direction. Inflation momentum was positive but small at 0.21, indicating that price pressures were still drifting up rather than decaying, while unemployment momentum was slightly negative at -0.10, consistent with a labor market not yet loosening. On balance, the staff projection was that already-tight financial conditions and cooling housing would continue to work through the economy with a lag, limiting inflation over time without requiring additional firming, while the modest positive inflation momentum argued against the large easing implied by the level-based rules. The framework's loss-minimizing recommendation was 0 basis points, aligning with the First-Difference rule's prescription.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their discussion of current conditions and the outlook, participants converged early on the view that the appropriate action at this meeting was to hold the federal funds rate at 5.25 percent, though they arrived there from distinct starting points. The member most focused on inflation emphasized that core PCE at 2.14 percent remained above the 2.0 percent objective and that the tight labor market — unemployment at 4.6 percent against a 5.04 percent natural rate — together with persistent energy and commodity pressures noted in the Beige Book, kept some inflation risk alive. That member stated



plainly that a cut was not warranted with inflation above target. At the same time, the broad-based slowdown in the Beige Book — six Districts reporting a declining pace, cooling housing, softer retail, and falling mortgage lending — plus wage and price gains described as 'modest on net' meant inflation was not accelerating dangerously, and so the case for an additional hike was weak.

The member weighting employment risk most heavily noted that the classic trigger for easing — rising unemployment — was simply absent. With unemployment below the natural rate, jobless claims low at 311,000, and the Chicago Fed index at 0.18 signaling near-trend growth, there was no employment emergency to justify a cut now. This member flagged the near-flat yield curve and negative T-bill spread as forward-looking recession-risk signals warranting vigilance, but read them as arguing against further hiking rather than for immediate easing, and expressed readiness to move quickly to cut should claims spike or job growth stall.

The participant attentive to financial stability observed that stress indicators were benign — a stress index of 0.1326, a VIX of 15.05, and a Baa spread of 1.69 — with no systemic distress requiring accommodation. The key concern raised was the flat 10-year/2-year spread at 0.02 combined with the T-bill trading below the funds rate, which together suggested markets already viewed 5.25 percent as restrictive; hiking into a flat curve risked destabilizing credit conditions and inverting the curve further. The member focused on market signals reinforced this, reading the negative 3-month T-bill spread and near-flat curve as coherent evidence that market pricing pointed to a pause after seventeen consecutive hikes, with no panic demanding action in either direction. The data-dependent member tied the strands together, noting that inflation only marginally above target while growth clearly decelerated supported holding steady under the prior meeting's data-dependent framing, which gave cover to pause and assess without abandoning inflation vigilance.

When the discussion turned to the framework's optimal recommendation, participants engaged directly with the divergence between the reference rules. Several observed that the Taylor, Balanced Approach, and ELB-adjusted rules all pointed to -75 basis points, resting on a low estimated neutral rate near 0.896 percent and on negative slack. Participants generally judged that a cut of that magnitude would be premature: with core PCE above target, positive inflation momentum of 0.21, and unemployment below the natural rate, easing would risk re-accelerating prices and, as the financial-stability member cautioned, an abrupt 75 basis point move would itself be a destabilizing shock to markets and credibility. The First-Difference rule's 0 basis point prescription — adjusting on momentum rather than uncertain level gaps — was described as the most persuasive by members across their differing lenses. The inflation-focused member framed the divergence as revealing that rates were high but that gradualism was warranted; the labor member noted the fragility of the



neutral-rate estimate cautioned against acting on it aggressively; the market-focused member emphasized that markets were not validating a cut mandate. Participants read the agreement between their own predictive judgment and the framework's loss-minimizing answer as a signal that the current stance was near-neutral and appropriately patient, restrictive enough to contain modestly elevated inflation while allowing cooling housing and lagged tightening to do their work.

Across all four rounds, no participant argued for a hike and none for a cut at this meeting. The recurring themes were that inflation, though above target, was not accelerating; that the labor market remained healthy but showed no deterioration demanding easing; that financial conditions were calm with no distress in credit or volatility measures; and that the flat-to-slightly-inverted curve indicated policy was already doing enough. Participants emphasized preserving optionality — to firm again if inflation reaccelerated, or to ease promptly if labor data weakened — while letting the substantial cumulative tightening continue to filter through.

COMMITTEE POLICY ACTIONS

In the predictive round, all five members supported holding the federal funds rate at 5.25 percent, an unchanged stance of 0 basis points, for a unanimous tally of 5 to 0. On the framework's optimal recommendation of 0 basis points, the Committee was likewise in full agreement: all five members — the inflation-focused member, the labor-market-focused member, the financial-stability member, the data-dependent member, and the market-signal member — endorsed the recommendation as-is, with none declining and none registering partial agreement. The predictive judgment and the optimal-side outcome therefore coincided completely.