



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The Committee reviewed the most recent System Open Market Account holdings data, released as of September 13, 2006. Total SOMA domestic securities holdings stood at \$764.8 billion, comprising \$461.8 billion in Treasury notes and bonds and \$277.0 billion in Treasury bills. This represented an increase of \$2.1 billion from the prior release of September 6. Staff noted that the composition remained weighted toward longer-dated notes and bonds, with bills making up somewhat over a third of the portfolio. It was emphasized that this review covers SOMA securities holdings only — total size, composition, and the week-over-week change — and does not extend to repo or reverse-repo operation results, for which no point-in-time-safe data source is currently available.

STAFF REVIEW OF THE ECONOMIC SITUATION

Staff reported that core PCE inflation on a twelve-month basis stood at 2.0 percent, precisely at the level the Committee regards as consistent with its objective. The unemployment rate was 4.7 percent, below the estimated natural rate of 5.04 percent, indicating that resource utilization in the labor market remained relatively tight. Initial jobless claims came in at 314,000, a level staff characterized as low and stable, with no sign of emerging labor market stress. The Chicago Fed National Activity Index registered 0.0, consistent with growth at roughly its trend pace, and the Employment Cost Index reading was 102.6. M2 stood at \$6,852.3 billion.

The most recent Beige Book, prepared on information collected on or before August 28, indicated that economic activity continued to expand, though five Districts reported some deceleration while the remaining seven saw little change in the pace of growth. Slowing was noted in the Boston, New York, Philadelphia, Kansas City, and Dallas Districts, though Dallas still described growth as strong; Atlanta characterized activity as 'mixed', Richmond called growth 'slow', and San Francisco noted a 'solid' pace. Consumer spending increased slowly in most Districts, held down by sluggish sales of vehicles and housing-related goods. Manufacturing continued to expand in all Districts despite pockets of weakness tied to autos and residential construction. Reports on residential real estate were uniformly weak, while the commercial sector showed fairly widespread strength. Financial institutions reported some softening in loan demand, especially for home mortgages, but credit quality was still described as favorable. Labor markets were mostly steady, with scattered labor shortages and associated upward wage pressures noted in a number of Districts, particularly for workers with specialized skills.

STAFF REVIEW OF THE FINANCIAL SITUATION

Staff reported that financial conditions were broadly calm but carried some signals of expected restraint ahead. The financial stress index stood at 0.1182, a benign reading, and the VIX at 11.18 was



extremely low, indicating little market anxiety. The Baa corporate spread over Treasuries was 1.7 percentage points, a moderate level consistent with the favorable credit quality noted in the Beige Book. More notable were the yield curve signals: the 10-year/2-year spread was essentially inverted at -0.03, and the 3-month Treasury bill yielded 0.44 percentage point below the current federal funds rate of 5.25 percent. Staff observed that this configuration was consistent with market participants pricing no further tightening and, if anything, anticipating eventual easing.

STAFF ECONOMIC OUTLOOK

The staff outlook drew on the forward-looking quantities embedded in the policy framework. With the estimated neutral real rate (r^*) at 0.95 percent and core inflation at 2.0 percent, a nominal neutral rate near 2.95 percent was implied, leaving the current 5.25 percent funds rate meaningfully above neutral — that is, in genuinely restrictive territory. Inflation momentum was modestly positive at 0.25, indicating that prices were not yet demonstrably declining below target, while unemployment momentum was barely negative at -0.05, signaling that the labor market had not begun to weaken. Taken together, these readings suggested an economy slowing toward trend under existing restraint rather than one either overheating or contracting.

The reference rules diverged sharply. The Taylor rule, the Balanced Approach rule, and the ELB-adjusted rule each recommended -75 basis points, reflecting inflation at target combined with unemployment below the natural rate — configurations these output-gap-sensitive rules read as room to ease. The First-Difference rule, which responds to momentum rather than the level of the gap, called for no change. The framework's loss-minimizing recommendation aligned with the First-Difference rule at 0 basis points, with reference rules judged reliable. The implication of these figures is a path in which lagged effects of prior tightening continue to bring inflation lower over time without an abrupt policy adjustment, provided incoming data confirm the moderation now visible in the activity indicators.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their predictive discussion, participants converged on holding the federal funds rate at 5.25 percent, though they arrived there from distinct vantage points and with genuine differences in emphasis about the balance of risks. The member most attentive to inflation risk stressed that core PCE at 2.0 percent should be read as a ceiling rather than as comfortable margin, pointing to unemployment below the natural rate, the scattered labor shortages and specialized-skill wage pressures in the Beige Book, and still-high energy production as sources of upside risk. This member nonetheless judged that a further hike was hard to justify against a clearly decelerating economy — five Districts slowing, uniformly weak housing, sluggish consumer spending — and that a cut was unacceptable while inflation risk lingered.



The preferred posture was to hold, let prior restraint work, and retain data-dependent, tightening-bias language preserving the option to move if inflation risks re-intensified.

The member focused on employment approached the question through the labor data and reached the same conclusion by a different route. Unemployment below the natural rate and jobless claims at 314,000 indicated a still-tight labor market with no realized deterioration, so no case for easing had yet been met. At the same time, this member took the inverted yield curve and the negative 3-month bill spread seriously as prospective recession signals, arguing they counseled against any further hike. The judgment was to pause while standing ready to ease quickly should employment data genuinely turn. The financial-stability member emphasized the tension between benign current conditions — a low stress index, a very calm VIX, moderate Baa spreads, favorable credit quality — and the forward fragility implied by the near-inverted curve and softening mortgage demand. This member argued that adding tightening into a fragile housing and credit backdrop risked destabilization, while cutting in the absence of any acute stress event would be premature.

The data-dependent member read the constellation of on-target inflation, sub-natural unemployment, trend-level activity, and low financial stress as a literal consensus for holding, with no upside surprise demanding a hike and no confirmed slack justifying a cut. The market-signal member emphasized that pricing across instruments — the 3-month bill 44 basis points below the funds rate, the inverted 10-year/2-year spread, a subdued VIX, and tight credit spreads — collectively indicated the market viewed the tightening cycle as complete while pricing no imminent easing. In the rebuttal round, no participant was moved from the hold position; each found that the others' arguments reinforced rather than challenged the shared conclusion.

Turning to the framework's optimal recommendation, participants engaged directly with the striking divergence between the three reference rules calling for -75 basis points and the loss-minimizing output of 0 basis points. Several members explained that they discounted the Taylor-family cut signals precisely because those rules read on-target inflation as room to ease, weighting the output gap in a way they found too dovish given positive inflation momentum and a labor market not yet weakening. The First-Difference rule's counsel of no change was widely judged the more persuasive logic — respecting momentum and gradualism over a large level-based move on ambiguous signals. The inflation-focused member noted that with the funds rate well above the implied neutral near 2.95 percent, existing policy was already doing restrictive work, so no cut was needed to relieve conditions the data did not show as strained.

A recurring theme in the optimal-side discussion was that a 75-basis-point cut into calm markets and an inverted curve could itself signal alarm the data did not warrant, potentially amplifying recession



expectations rather than stabilizing conditions. The employment-focused member reiterated that unemployment momentum at -0.05 meant the main trigger for easing was absent, and that holding preserved the ability to cut decisively once labor data actually deteriorated. The financial-stability and market-signal members agreed that market pricing anticipated eventual cuts but demanded no immediate lurch. Across both the fourth-round rebuttal and the earlier rounds, participants generally judged that holding at 5.25 percent balanced an on-target inflation print against still-firm labor conditions and lingering price risks, while preserving optionality until incoming data confirmed the slowing already evident in the activity reports.

COMMITTEE POLICY ACTIONS

In the predictive vote on the appropriate policy action, the Committee was unanimous, with all five members supporting no change in the target federal funds rate, leaving it at 5.25 percent (5-0). On the framework's optimal-side recommendation of 0 basis points, the Committee likewise reached full agreement: all five members — the inflation-focused member, the employment-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. Members generally favored retaining data-dependent guidance that preserved the option to adjust policy should inflation risks re-intensify or labor market conditions deteriorate.