



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The System Open Market Account held \$786.1 billion in domestic securities as of the July 25, 2007 release, the most recent point-in-time-safe data available to the Committee. Of that total, Treasury notes and bonds accounted for \$474.7 billion and Treasury bills for \$277.0 billion. The portfolio was unchanged from the prior release of July 18, 2007, 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 preceding release — and does not extend to repo or reverse-repo operation results, for which no confirmed point-in-time-safe data source currently exists.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reported that core PCE inflation stood at 1.8 percent on a year-over-year basis, modestly below the 2.0 percent objective. Labor market indicators remained firm: the unemployment rate was 4.5 percent, well below the estimated natural rate of 5.05 percent, and initial jobless claims were low at 305,000. The Employment Cost Index read 105.9, consistent with the moderate wage gains described across the Districts. The Chicago Fed National Activity Index registered -0.4, pointing to growth slightly below trend. M2 money supply stood at \$7,243.7 billion. Taken together, the data described an economy expanding but with some evidence of deceleration beneath the surface.

The July 25 Beige Book, prepared by the Federal Reserve Bank of Chicago on information collected before July 16, indicated that economic activity continued to expand in June and early July. Several Districts characterized growth as 'moderate' and others as 'modest,' with one noting improved conditions, one describing growth as moderating, and another as strong but decelerating; two more described contacts' reports as 'varied' or 'mixed.' Consumer spending rose at a modest pace, though a number of Districts reported sales that were mixed or below expectations. Capital spending and most business services expenditures continued to rise, manufacturing activity expanded, and employment increased further in most regions and sectors. Most Districts reported that residential construction and real estate activity continued to decline, while commercial construction and real estate were generally more active. Household lending declined in most regions, whereas commercial and industrial lending expanded at a modest pace. Contacts generally reported ongoing input cost pressures, particularly for petroleum-related inputs, while retail prices continued to increase at a moderate rate. Wage gains were widely described as moderate and similar to the prior period.

STAFF REVIEW OF THE FINANCIAL SITUATION

The staff characterized financial conditions as showing elevated but not acute stress. The financial stress index stood at 0.213, and the VIX at 23.52, both above levels associated with calm markets but



well short of crisis readings. The Baa corporate spread was 1.85, indicating some firming in credit costs without the sharp widening that would signal distress. The 10-year/2-year Treasury spread was only modestly positive at 0.22, close to flat. Most notably, the 3-month Treasury bill traded 0.53 percentage point below the current federal funds rate of 5.25 percent, a negative spread consistent with market participants anticipating near-term easing and some flight toward short-dated safe assets. The declining household lending noted in the Beige Book was consistent with this broader picture of gradually tightening credit alongside continued expansion in commercial and industrial lending.

STAFF ECONOMIC OUTLOOK

The staff outlook emphasized that the current stance of policy appeared restrictive relative to estimates of neutral. With r^* estimated at 1.36 and core inflation near 1.8 percent, an approximately neutral nominal rate would lie well below the prevailing 5.25 percent funds rate. This gap was the principal driver behind the aggressive readings of several reference rules: the Taylor rule, the Balanced Approach rule, and the ELB-adjusted rule each pointed to -75 basis points, reflecting inflation below target combined with an unemployment rate well beneath the natural rate. The First-Difference rule, which responds to changes rather than to level estimates of the output gap or r^* , indicated a more modest -25 basis points.

Momentum measures suggested that deterioration was neither sharp nor accelerating. Inflation momentum was mildly negative at -0.11, consistent with price pressures easing rather than building, while unemployment momentum was flat at 0.0, indicating no near-term labor-market softening in the hard data. The loss-minimizing framework, with reference rules judged reliable, reconciled the aggressive level-based rules against the gentler momentum-based rule and settled on a recommendation of -25 basis points. On balance, the staff projection implied that policy could be eased modestly to correct a genuinely restrictive stance, but that the incremental signal from momentum did not support a larger move absent clearer confirmation of weakening in activity or employment.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their predictive discussion, four of the five participants judged that holding the federal funds rate steady at 5.25 percent was the appropriate action at this meeting, while one favored a 25 basis point cut. The participant most focused on inflation risk observed that core PCE at 1.8 percent, though below target, was not yet comfortably contained, and pointed to the Beige Book's flagging of ongoing input cost pressures, especially petroleum-related, and retail prices still rising at a moderate rate. Combined with an unemployment rate well below the estimated natural rate and low jobless claims, this participant saw latent wage-price risk that argued against easing, even as softening growth ruled out any case for a hike.



The participant weighing employment risk most heavily arrived at the same conclusion by a different route. In this member's view, the labor data showed no deterioration — unemployment at 4.5 percent, claims at 305,000, and employment increasing across most Districts — so the acute conditions that would justify aggressive easing were absent. This participant took the below-trend Chicago Fed reading and mixed consumer spending seriously as forward indicators, and flagged an easing bias in tone, noting a readiness to support a prompt cut should financial stress begin to hit hiring, but concluded that market pricing was a financial-conditions signal rather than a labor signal and did not yet warrant action.

The participant attentive to financial stability agreed that current stress was elevated but not acute, citing the stress index at 0.213, VIX at 23.52, and the Baa spread at 1.85 as within manageable ranges rather than signaling systemic distress. This member acknowledged that the negative bill-funds spread could reflect flight to safety and anticipation of stress, but cautioned that front-running the full market discount risked validating anxiety the data did not yet support. The data-focused centrist likewise read the indicators at face value, stressing that market anticipation of a cut is not itself a mandate condition, and that the broad-based fundamental picture pointed to no urgency in either direction. The dissenting member, weighting market-implied pricing most heavily, held that the 3-month bill trading 53 basis points below funds already discounted an easing path and that a hold left policy behind the curve; this participant read the majority's state-based reasoning as failing to engage with the forward-looking signal, while agreeing that the modest scale of the discount implied a single 25 basis point move rather than anything larger.

When the discussion turned to the framework's loss-minimizing recommendation of -25 basis points, the participants engaged closely with the gap between that call and the level-based rules pointing to -75 basis points. There was broad agreement that the three deeper rules overstated the case: they leaned on inflation and unemployment gaps while a labor market running below the natural rate, with flat unemployment momentum, did not support emergency-scale easing. Several members found the First-Difference logic most persuasive precisely because it adjusts incrementally from the current stance using momentum rather than resetting to a level estimate. The centrist noted that with r^* near 1.36, a neutral nominal rate of roughly 3.2 percent lay far below 5.25 percent, confirming that policy was genuinely restrictive and that a modest correction was warranted. The financial-stability member added that a -75 basis point lurch could itself signal alarm and destabilize the credit markets it was meant to protect, so gradualism served stability directly.

Reflecting on the divergence between their predictive hold and the framework's -25 basis point call, most participants concluded that the current stance was modestly tighter than optimal. The



employment-focused member characterized a 25 basis point cut as insurance for a still-healthy labor market against softening signals before deterioration showed in the unemployment rate. The inflation-focused member came closest to resisting, noting that inflation momentum at -0.11 weakened the case for holding out of price fear, yet remaining one increment more cautious than optimal on account of lingering petroleum cost pressures and labor tightness. The member weighting market signals viewed the framework's conclusion as aligned with what pricing already implied — a measured first step consistent with the size of the bill-funds discount, without overreaching.

COMMITTEE POLICY ACTIONS

In the predictive vote on the policy action for this meeting, four participants supported holding the federal funds rate steady at 5.25 percent and one favored a reduction of 25 basis points, for a recorded tally of 4 to 1 in favor of no change. On the framework's loss-minimizing recommendation of a 25 basis point cut, the Committee's recorded stances were four endorsements and one partial endorsement, with no member declining. The participant weighting inflation risk most heavily registered the partial position — agreeing with the direction of a modest easing but remaining one increment more cautious than the recommended magnitude — while the members focused on labor markets, financial stability, data-dependence, and market signals each endorsed the -25 basis point recommendation as-is.