



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The Manager reported on holdings in the System Open Market Account. This review covers SOMA securities holdings only — their total size, composition, and week-over-week change — and does not encompass the results of repo or reverse-repo operations, for which no point-in-time-safe data source currently exists.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reviewed incoming indicators, which on balance described an economy still expanding but with clear soft spots concentrated in housing and credit. Core PCE inflation stood at 1.47 percent on a year-over-year basis, below the 2.0 percent objective and consistent with a genuine moderation in price pressures. The unemployment rate was 4.6 percent, below the estimated natural rate of 5.05 percent, indicating that the labor market remained near full employment; initial jobless claims of 321,000 were still contained though drifting somewhat higher. The Chicago Fed National Activity Index at -0.08 pointed to growth marginally below trend rather than to contraction. The Employment Cost Index reading was 105.9, and M2 stood at \$7,269.2 billion.

The Beige Book, prepared at the Federal Reserve Bank of Cleveland on information collected before August 27, characterized economic activity as continuing to expand, though at varied paces across Districts — described as moderate in some, modest in others, and mixed or slowing in several. The most prominent theme was that recent financial market developments had led most Districts to report tighter lending standards for residential mortgages, with a noticeable effect on housing activity; several noted that reduced credit availability added to uncertainty about when the housing market might turn around. Housing weakness deepened across most Districts, with sales weak or declining and prices flat or falling, and most Districts reported a continuing contraction in the residential mortgage market. Outside real estate, reports that the turmoil had affected activity were limited, and a number of Districts commented that credit availability and quality remained good for most consumer and business borrowers. Retail sales were generally positive, though motor vehicle and furniture sales were described as slow, and manufacturing expanded across most Districts amid softening demand for building materials and autos.

STAFF REVIEW OF THE FINANCIAL SITUATION

The staff's review of financial conditions pointed to meaningful strain relative to earlier in the year. The financial stress index registered 0.3666, and the VIX stood at 25.27, both consistent with the elevated market volatility associated with the summer's credit disruption. The Baa corporate bond spread of 2.11 indicated rising borrowing-cost pressure. Most striking in the money markets was the 3-month



Treasury bill yield sitting 1.29 percentage points below the current 5.25 percent federal funds rate, a front-end configuration signaling that markets were already pricing in substantial near-term easing. By contrast, the 10-year/2-year Treasury spread remained positive at 0.42, so the classic term-structure recession signal was absent even as the front end pointed clearly toward accommodation.

STAFF ECONOMIC OUTLOOK

The staff outlook drew on the forward-looking quantities embedded in the policy framework. With the estimated neutral real rate at 1.411 percent and inflation running below target, the level-based reference rules — the Taylor rule, the Balanced Approach rule, and the ELB-adjusted rule — each pointed to a reduction of roughly 75 basis points, reflecting the combination of sub-target inflation and an unemployment rate below its estimated natural rate. The First-Difference rule, which responds to changes in conditions rather than to their levels, pointed to a smaller move of 25 basis points. The framework's loss-minimizing recommendation was a reduction of 25 basis points, and the reference rules were judged reliable in the current configuration.

The gradualist reading was supported by the momentum measures, both of which were small: inflation momentum of 0.055 and unemployment momentum of 0.05. These figures implied that neither prices nor the labor market were deteriorating sharply, arguing against the larger adjustment the level rules would otherwise call for. On this reading, the likely path of conditions was one of gradual softening — credit tightening and housing weakness weighing on activity at the margin — rather than an abrupt turn, so that an incremental easing step would address emerging downside risk while preserving room to respond further should the housing and credit spillover intensify.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

Participants agreed that the incoming data warranted an easing of policy, though they differed on the appropriate magnitude. There was broad recognition that core PCE inflation at 1.47 percent, comfortably below the 2.0 percent target, had substantially relieved the concern voiced at the prior meeting that moderation had yet to be convincingly demonstrated. One participant who ordinarily weights inflation risk most heavily observed that this progress removed much of the usual case for holding policy tight, and that the tightening of credit standards documented in the Beige Book was itself doing some of the inflation-fighting work, reducing the need for policy to remain restrictive.

A majority favored a more forceful response in the predictive discussion. Participants emphasizing labor market risk argued that credit tightening typically reaches employment with a lag, and that acting preemptively — before deterioration showed up in the jobless data — was the prudent course; jobless claims creeping toward 321,000 and the Chicago Fed index at -0.08 were cited as early signs of



below-trend momentum. Those focused on financial stability made a parallel case, stressing that the risk they weighted most heavily was precisely that credit tightening could spill into the real economy before appearing in lagging indicators, and that a quarter-point move risked appearing behind the curve and failing to relieve funding stress. A participant attentive to market signals underscored that the 3-month bill sitting 1.29 percentage points below the funds rate implied markets expected roughly 50 basis points of easing, and that delivering only 25 would leave that front-end signal unfulfilled.

A dissenting strand of the discussion counseled a smaller, measured step. Here participants pointed to the resilience still evident in the hard activity data: unemployment at 4.6 percent below the 5.05 percent natural rate, activity continuing to expand across Districts, a positive 10-year/2-year spread of 0.42, and the Beige Book's own observation that credit quality remained good for most consumer and business borrowers outside real estate. On this view the turmoil was still largely confined to credit and housing, and a 50 basis point move risked appearing to panic relative to what the activity data showed. The market-pricing argument, one participant noted, reflected expectations rather than fundamentals that demanded the larger cut.

When the discussion turned to the framework's loss-minimizing recommendation of 25 basis points, participants engaged directly with the divergence between the reference rules. Several found the First-Difference rule most persuasive, noting that with inflation momentum at 0.055 and unemployment momentum at 0.05, the small pace of change argued for an incremental adjustment rather than the 75 basis point move implied by the level-based Taylor, Balanced Approach, and ELB-adjusted rules. A gradual first step, they judged, would open the easing cycle while preserving optionality and avoiding overreaction to volatile readings. Participants who had favored 50 basis points in the predictive round accepted the direction of the framework's recommendation but continued to weight downside risk more heavily; one reiterated that financial contagion is nonlinear and that gradualism assumes a linearity the credit dynamics might not respect, while another maintained that the front-end bill spread indicated policy was still too restrictive relative to conditions. The shared conclusion across the discussion was that the direction of policy was clearly toward easing, with genuine disagreement confined to how far to move at this meeting.

COMMITTEE POLICY ACTIONS

In the predictive vote, the Committee's five members split three to two in favor of a 50 basis point reduction, with two members preferring a 25 basis point cut. On the framework's loss-minimizing recommendation of a 25 basis point reduction, three members endorsed the recommendation as-is, and two members registered a partial view — agreeing with the direction of easing but preferring a larger move; no member declined the recommendation. The two partial stances came from the



members weighting financial-stability contagion risk and market-implied pricing most heavily, both of whom judged the direction correct but the magnitude too timid.