



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The System Open Market Account's domestic securities holdings totaled \$473.3 billion as of June 18, 2008, down \$3.4 billion from the prior release of June 11. The portfolio remained heavily concentrated in Treasury notes and bonds, which accounted for \$412.4 billion, with Treasury bills making up a further \$21.7 billion of the total. The manager noted that this accounting reflects SOMA holdings only — total size, composition, and the week-over-week change in outright holdings — and does not capture the results of repo or reverse-repo operations, for which no point-in-time-safe data source is currently available; that portion of open market activity is therefore excluded from the figures reported here.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reported that economic activity remained generally weak through late April and May. The most recent Beige Book, prepared on information collected on or before June 2, characterized three Districts as softer, weaker, or lower, four as showing slower, sluggish, or modest growth, and the remaining five — Philadelphia, Cleveland, Atlanta, St. Louis, and San Francisco — as stable or little changed. Consumer spending slowed further, with contacts in several Districts attributing softer sales in other categories to rising energy and food prices that pinched household incomes; higher energy prices also appeared to damp domestic tourism. Manufacturing activity was generally soft, with weak demand for housing-related products partly offset by rising demand for exports. Residential real estate remained weak across most Districts, while commercial real estate and nonresidential construction conditions varied. Lending activity likewise varied across Districts and segments, though tighter credit standards were reported for most loan categories.

On the labor side, the unemployment rate stood at 5.5 percent, above the estimated natural rate of 5.05 percent, and initial jobless claims registered 378,000. The Beige Book described hiring as spotty in most Districts, with wage pressures reported as moderate or limited outside a few skilled-labor positions. The Chicago Fed National Activity Index at -0.72 pointed to below-trend growth. On prices, core PCE inflation ran at 1.82 percent on a year-over-year basis, just under the 2 percent target, but reports of higher input costs were widespread; manufacturing contacts in several Districts noted some ability to pass higher costs to customers, while retailers reported mixed success raising final goods prices. Districts reporting on agriculture and energy noted improved crop conditions and increased drilling and extraction activity. The Employment Cost Index read 108.3 and M2 stood at \$7,684 billion.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions remained stressed but well off the acute levels seen at earlier points in the cycle. The financial stress index stood at 0.4818, elevated and consistent with continued fragility in credit



markets, and the Baa corporate spread of 2.95 percentage points indicated meaningful credit strain for corporate borrowers. The VIX at 22.24 signaled elevated but not panic-level market anxiety. The term structure gave a less alarming read: the 10-year/2-year Treasury spread was comfortably positive at 1.27 percentage points, and the 3-month Treasury bill spread relative to the current funds rate was essentially flat at 0.04 percentage point, indicating that the front end was aligned with the prevailing 2 percent policy rate and that markets were not pricing a near-term move in either direction. Tighter credit standards reported across most loan categories in the Beige Book reinforced the picture of a credit channel that remained impaired even as broad market measures had calmed from their worst readings.

STAFF ECONOMIC OUTLOOK

The staff's forward-looking assessment drew on the estimated neutral rate and the available momentum measures. With the real neutral rate (r^*) estimated at 1.737 percent, the current 2 percent nominal funds rate — set against core inflation near 1.82 percent — implied that the policy stance was already accommodative rather than restrictive. Inflation momentum was positive at 0.055 and unemployment momentum positive at 0.05, suggesting that price pressures were building modestly rather than fading while the labor market continued to loosen at the margin. Taken together, these figures pointed to an environment in which further easing would risk adding to an already-accommodative stance amid firming inflation, while the modest labor gap of roughly 0.45 percentage point did not on its own indicate a sharp deterioration ahead.

The reference rules spanned a wide range and were judged reliable. The Taylor rule prescribed +25 basis points, reflecting inflation near target and an already-accommodative real rate; the First-Difference rule pointed to -25 basis points on the strength of the soft momentum readings; and both the Balanced Approach and ELB-adjusted rules called for -75 basis points, driven by heavier weight on the unemployment gap. This dispersion straddling zero was itself informative: with the rules pulling sharply in opposite directions, the loss-minimizing point settled at no change, and the deterministic policy engine's recommendation came in at 0 basis points. The projection implied by these quantities was thus one of a stance holding near appropriate calibration — prior easing continuing to work through fragile markets, with genuine two-sided risk around the path rather than a clear case for moving in either direction.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

Participants converged early and consistently on holding the funds rate at 2 percent, and the discussion across the four rounds developed the reasoning behind that convergence rather than contesting it. The inflation-focused member framed the central tension: core PCE at 1.82 percent might superficially look



benign, but the Beige Book's documentation of widespread higher input costs, sharply rising energy and food prices, and some pass-through to customers pointed to broadening pressure, reinforced by positive inflation momentum of 0.055 and the rising inflation expectations flagged at the prior meeting. In this member's view the funds rate at 2 percent was deeply accommodative relative to these risks, and further cuts would risk unanchoring expectations amid a commodity surge. This member weighed and then set aside the case for an outright hike — real rates near zero on a headline basis and broadening cost pressures could be read as arguing for tightening — concluding that with wage pressures reported as moderate or limited, core inflation still below target, and growth genuinely soft, a hike into this softness would be premature and lacked committee support.

The member most attentive to labor conditions gave voice to the strongest countervailing pull. Unemployment at 5.5 percent stood above the 5.05 percent natural rate, unemployment momentum was positive, jobless claims at 378,000 were elevated, and the Beige Book described hiring as spotty and consumer spending as slowing — a picture this member's instinct read as arguing for a cut, in line with the Balanced Approach and First-Difference rule signals. Yet the member came to see the case for further easing as genuinely weakened. An unanchoring of inflation expectations would eventually force a sharper, more damaging tightening that would hurt employment more, and the moderate-to-limited wage pressures reported in the Beige Book offered comfort against a wage-price spiral. This member emphasized that the labor market looked soft but not collapsing — a deterioration, not a crisis — and that holding at an already-accommodative 2 percent preserved the ability to cut more forcefully should claims and unemployment actually deteriorate further. Cutting now, while inflation momentum was rising, could force a costlier reversal later. The member remained candid that the instinct leaned dovish but judged holding the least-regret choice under uncertainty, and pushed back against any suggestion of a hike.

The member weighing financial stability most heavily read the elevated stress index of 0.4818 and the wide Baa spread of 2.95 as evidence that the credit channel remained impaired, with tighter lending standards reported across most loan categories. But the VIX at 22.24 and the positively sloped yield curve indicated the acute crisis phase had passed, and the flat T-bill spread signaled that markets expected no near-term move. A central point for this member was that another cut would not fix credit-specific stress — spreads were being driven by counterparty and housing risk, not by the policy rate at this level — and that easing further would spend flexibility without a systemic trigger while risking a weaker dollar that would amplify the very commodity pressures pinching consumers. A hike, by contrast, would destabilize already-stressed credit markets. Holding thus preserved what this member valued most: room to act aggressively if credit markets genuinely seized again.



The data-dependent and market-focused members grounded the same conclusion in, respectively, the balance of the data and market pricing. The centrist noted that core PCE below target gave no urgency to hike while the labor slack and below-trend Chicago Fed reading argued against tightening, and that the sharp divergence of the reference rules — Taylor at +25, First-Difference at -25, Balanced Approach and ELB at -75 — straddling zero signaled genuine two-sided risk, with the small positive momentum figures on both mandates arguing against cutting further from 2 percent. The market-signal member read the flat 3-month T-bill spread of 0.04 and the positive 10-year/2-year curve as the strongest available evidence that markets priced neither a cut nor a hike, treating that flat path as the efficient consensus and observing that r^* of 1.737 implied 2 percent was already accommodative. Across the optimal-framework rounds, participants generally accepted that the framework's 0 basis point recommendation split the divergent rules sensibly and matched their own read; the wide rule dispersion was taken not as a defect but as confirmation that no clear directional case existed. Several participants indicated they would want the statement to continue emphasizing downside labor risks and a willingness to act, so that a future cut would remain credible if the labor market weakened materially.

COMMITTEE POLICY ACTIONS

In the predictive vote, all five members supported no change in the target federal funds rate, leaving it at 2 percent; the tally was unanimous at 0 basis points, with no member preferring a cut or a hike. On the deterministic policy engine's recommendation of 0 basis points, the Committee's recorded stance was likewise unanimous: all five members — the inflation-focused member, the labor-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 only partial agreement. The two votes were therefore in full accord, reflecting a shared judgment that a stance already accommodative relative to the estimated neutral rate, set against building inflation momentum and still-fragile but not deteriorating credit conditions, was appropriately calibrated at present.