



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The Committee reviewed the composition and size of the System Open Market Account. As of the most recent release on August 5, 2009, total SOMA domestic securities holdings stood at \$1,350.9 billion, up \$11.7 billion from the prior release on July 29. The portfolio comprised \$636.9 billion in Treasury notes and bonds, \$18.4 billion in Treasury bills, and \$542.9 billion in agency mortgage-backed securities, the last of which represented the largest single component. It was noted that these figures cover SOMA holdings only — total size, composition, and week-over-week change — and do not encompass the results of repo or reverse-repo operations, for which no point-in-time-safe data source is currently available. The staff accordingly confined its report on open market operations to the securities holdings data described above.

STAFF REVIEW OF THE ECONOMIC SITUATION

Economic activity remained weak going into the summer, though the pace of decline appeared to be moderating. Core PCE inflation stood at 1.11 percent on a twelve-month basis, well below the 2 percent objective, while the unemployment rate was 9.5 percent, far above the estimated natural rate of 5.04 percent. Initial jobless claims were reported at 584,000, a level consistent with continued job losses. The Chicago Fed National Activity Index at -0.01 was essentially at its trend level, and the Employment Cost Index registered 110.7. M2 money supply stood at \$8,370.1 billion.

The most recent Beige Book, prepared at the Federal Reserve Bank of Boston on information collected on or before July 20, characterized activity across the twelve Districts as weak but with the pace of decline moderating in most Districts or activity beginning to stabilize at a low level. Five Districts described activity as 'slow', 'subdued', or 'weak'; Chicago and St. Louis reported that the decline was moderating; and New York, Cleveland, Kansas City, and San Francisco pointed to signs of stabilization, while Minneapolis said its economy had contracted further. Retail activity was generally sluggish, with mixed results across Districts. Manufacturing showed some improvement in Richmond, Chicago, and Kansas City. Residential real estate stayed soft though many Districts noted signs of improvement, whereas commercial real estate weakened further in two-thirds of Districts. Price changes were described as varied but generally modest, with competitive pressures damping increases, though several Districts noted some recent gains in metals prices. Banking contacts in six Districts reported weaker demand for some categories of loans.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions showed continued signs of stabilization while remaining fragile. The financial stress index stood at 0.426, elevated relative to more tranquil periods but well off crisis peaks. The VIX was



24.9, above calm levels but far below the readings seen earlier in the episode. The Baa corporate spread over Treasuries was 2.95 percentage points — still wide, indicating that borrowing costs for weaker credits remained strained even as credit stress normalized somewhat. The 10-year/2-year Treasury yield curve spread was steeply positive at 2.57, consistent with anchored front-end policy rates and expectations of eventual recovery rather than fresh recession. The 3-month T-bill spread relative to the current target rate was only 0.065, indicating no near-term change in the policy rate was priced by markets and no acute funding stress.

STAFF ECONOMIC OUTLOOK

The staff projection took as reference the estimated neutral rate of 1.571 percent and the observed momentum in the key mandate variables. Inflation momentum was slight, at 0.075, suggesting little near-term upward pressure on prices, while unemployment momentum was 0.65, consistent with joblessness remaining stubbornly high or edging higher from an already elevated level. Together these implied that resource slack would continue to weigh on cost pressures over the projection period, with core inflation likely to remain below the 2 percent objective for some time absent a broadening of the isolated commodity-price gains noted in a few Districts.

Reference-rule outputs illustrated the gap between the level of policy the rules would prescribe absent constraints and the level actually available. The Taylor rule, the Balanced Approach rule, and the ELB-adjusted rule each pointed to 75 basis points, reflecting the large unemployment gap and the inflation shortfall. Because the target range was already at 0.0 to 0.25 percent, those level prescriptions could not be met by cutting and were best read as aspirational once slack begins to close. The First-Difference rule, which prescribes changes relative to the current stance rather than a level implied by an estimated neutral rate, returned 0 basis points, and the framework's loss-minimizing recommendation was likewise 0 basis points. With the reference rules judged reliable, the projection implied that the current stance was appropriately accommodative and that any firming of policy would await a diminution of slack rather than a reversal of the still-subdued inflation picture.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their discussion, participants converged on the view that the funds rate should be held in its current range, but they arrived there from distinct starting points, and their exchange drew out both the constraints binding on policy and the risks that a rate move would carry in either direction. The member most attentive to inflation risk began by testing whether an inflation case for tightening existed and found none: core PCE at 1.11 percent sat well below the 2 percent objective, the unemployment gap between 9.5 percent and the 5.04 percent natural rate pointed to enormous slack, and the Beige Book showed modest, competition-damped price changes with only isolated metals gains. This member



emphasized that holding imposed no near-term inflation risk given the shortfall below target, while preserving the option to firm promptly should inflation momentum reverse upward.

The participant focused on employment underscored that the labor market remained deeply distressed — unemployment at 9.5 percent, initial claims at 584,000, and unemployment momentum of 0.65 all signaling continued weakness. This member would have preferred to add accommodation but recognized that the funds rate was already at its effective lower bound, and that pushing into negative territory risked money market disruption. The point was made repeatedly that the constraint was the lower bound itself, not any committee reluctance, and that additional easing had to come through the ongoing asset purchase program rather than the funds rate. The member accordingly framed holding as the maximally accommodative rate action available.

The participant most concerned with financial stability read the conditions data as healing but not healed: the stress index at 0.426 and VIX at 24.9 signaled fragile stabilization, and the Baa spread at 2.95 showed borrowing costs for weaker credits still strained. This member drew particular attention to the Beige Book reports of weakening loan demand across six Districts and commercial real estate deterioration in two-thirds of Districts, characterizing the latter as a concentrated systemic risk that a funds-rate move could not address and that argued for continued asset purchases instead. Tightening into wide spreads and weak loan demand, this member cautioned, would risk re-widening credit spreads and destabilizing a recovery only beginning to take hold. The member attentive to market signals reinforced this read, noting that the 3-month T-bill spread of 0.065 showed markets expected the range to hold, that the steep 2.57 curve reflected anchored front-end rates rather than recession fear, and that honoring the prior commitment to exceptionally low rates for an extended period — already priced by markets — maintained credibility.

The data-dependent centrist tied these strands together in a more literal reading of the numbers: with the range at the lower bound, deep slack, and inflation well contained, no data supported either a cut, which was infeasible, or a hike, which would be premature. When the discussion turned to the optimal-policy framework, participants dwelt on the divergence between the level rules, all pointing to 75 basis points, and the First-Difference rule and loss-minimizing output, both at 0 basis points. There was broad agreement that the First-Difference logic was the more persuasive guide in present circumstances, because it adjusts from the current stance rather than chasing a level that the effective lower bound makes unattainable by cutting. Several participants observed that the 75-basis-point readings were best understood as aspirational — describing where rates would belong once slack closed — and as confirmation that policy should remain maximally easy, with the asset purchase program substituting for the further conventional easing the rules would otherwise call for. Across all



four rounds no participant was moved to favor action in either direction, and each judged that the current stance was correctly calibrated to the fragile, subdued environment the data described.

COMMITTEE POLICY ACTIONS

In the predictive phase of the deliberation, all five members supported maintaining the target range for the federal funds rate at 0.0 to 0.25 percent, a unanimous 5-to-0 outcome (5 votes for no change). On the optimal-policy side, the framework's recommendation of 0 basis points drew full agreement: all five members endorsed the recommendation as-is, with none declining and none registering partial agreement. The inflation hawk, the labor market dove, the financial stability voice, the data-dependent centrist, and the market signal realist each recorded an endorsement, so that the predictive vote and the optimal-side outcome coincided completely in supporting an unchanged stance alongside continued asset purchases.