



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 or before the point-in-time-safe cutoff, dated January 20, 2010, total SOMA domestic securities holdings stood at \$1,904.2 billion. Agency mortgage-backed securities made up the largest share at \$970.9 billion, followed by Treasury notes and bonds at \$708.9 billion and Treasury bills at \$18.4 billion. Holdings rose by \$4.1 billion from the prior release of January 13, 2010. Staff noted that this review covers SOMA securities holdings only — total size, composition, and week-over-week change — and does not encompass repo or reverse-repo operation results, for which no point-in-time-safe data source currently exists.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reported that inflation remained subdued. Core PCE inflation stood at 1.22 percent on a year-over-year basis, well below the 2.0 percent objective. Labor market conditions remained weak: the unemployment rate was 10.0 percent, far above the estimated natural rate of 5.04 percent, and initial jobless claims were still elevated at 444,000. The Chicago Fed National Activity Index registered 0.16, consistent with growth near trend rather than a vigorous rebound. The Employment Cost Index reading was 111.8, and M2 stood at \$8,410.3 billion.

The most recent Beige Book, prepared by the Federal Reserve Bank of Philadelphia and based on information collected on or before January 4, 2010, indicated that while economic activity 'remains at a low level,' conditions had improved modestly further, with those improvements broader geographically than in the prior report. Ten Districts reported some increased activity or improvement, while Philadelphia and Richmond reported mixed conditions. Most Districts reported holiday-season consumer spending slightly greater than in 2008 but still far below 2007 levels, with retail inventories very lean. Manufacturing activity increased or held steady in most Districts, and the near-term manufacturing outlook was described as optimistic, though spending plans remained cautious. Home sales rose in most Districts toward the end of 2009, especially for lower-priced homes, while commercial real estate was still weak nearly everywhere, with rising vacancy rates and falling rents. Loan demand continued to decline or remain weak in most Districts, and credit quality continued to deteriorate.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions were characterized as calm but not fully complacent. The financial stress index stood at 0.24, a moderate and relatively low level, and the VIX at 18.68 signaled no acute market panic. The Baa corporate spread was contained at 2.48, suggesting that credit-cost stress had eased



considerably from crisis levels. The 10-year/2-year yield curve spread was steeply positive at 2.76, with no inversion and thus no near-term recession signal from that measure. The 3-month T-bill spread versus the current rate was slightly negative at -0.065, consistent with policy resting at its effective floor and with markets pricing no imminent change. Staff observed that these market-based readings coexisted with the credit-side softness noted in the Beige Book — weak loan demand, deteriorating credit quality, and persistent weakness in commercial real estate.

STAFF ECONOMIC OUTLOOK

Looking ahead, the staff projection drew on the real forward-looking quantities available. The estimated neutral real rate (r^*) used in the framework was 1.476, and with inflation running well below target, this implied that a meaningfully accommodative stance remained warranted. Inflation momentum was modestly positive at 0.17 and unemployment momentum was 0.15 — both small, pointing to only gradual firming rather than either an inflation acceleration or a renewed deterioration. On these readings, conditions were projected to continue improving slowly from a low base, with substantial resource slack persisting and cost pressures remaining contained for some time.

The reference-rule outputs framed the projection's central tension. The Taylor rule, the Balanced Approach rule, and the ELB-adjusted rule each pointed to 75 basis points, reflecting the positive r^* against the backdrop of the large gap between the 10.0 percent unemployment rate and the 5.04 percent natural rate. The First-Difference rule, which responds to the change in conditions rather than the level gap, indicated 0 basis points, and the framework's loss-minimizing recommendation was likewise 0 basis points. The staff noted that the gap between the level-based rules and the loss-minimizing outcome reflected the binding effect of the effective lower bound together with subdued inflation, so that the loss function judged the cost of premature tightening to dominate the mechanical, gap-driven prescriptions.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their discussion of current conditions, participants generally agreed that inflation posed no near-term threat and that the labor market remained the more pressing concern. With core PCE inflation at 1.22 percent, well below the 2.0 percent objective, and unemployment at 10.0 percent against a natural rate near 5.04 percent, participants judged that both legs of the mandate pointed in the same direction — toward maintaining accommodation. The member most attentive to inflation risk observed that even weighting price stability heavily, there was simply no inflation to lean against; the Employment Cost Index and the Beige Book's reports of cautious spending plans and persistent hiring reluctance showed no sign of wage-price acceleration. That member emphasized that vigilance argued against easing rather than for tightening in the absence of price pressure.



The member most focused on employment stressed the nearly five-point gap between unemployment and its natural rate, together with initial claims still at 444,000, as the dominant fact. That member's instinct was to provide further support for employment but acknowledged that the target range of 0.0 to 0.25 percent was already at its effective floor, leaving no room to cut through conventional means. Several participants weighed whether the fragile labor market and lingering credit weakness might warrant reopening emergency facilities, but concluded that the calm in market-based stress measures — a stress index of 0.24, a VIX of 18.68, and a steeply positive yield curve at 2.76 — indicated no acute crisis demanding extraordinary action in either direction.

The participant most attentive to financial stability read the stress indicators first and found conditions relatively calm but not complacent. That member drew particular attention to the Beige Book's flags on declining loan demand, deteriorating credit quality, and commercial real estate weakness across nearly all Districts, describing these as latent vulnerabilities in still-healing credit transmission. On that view, premature tightening could destabilize credit markets that were only beginning to mend, especially as emergency liquidity facilities were already being wound down. Preserving accommodation, that member argued, functioned as an insurance premium against destabilizing fragile credit conditions. The participant anchored on market signals similarly noted the slightly negative T-bill spread of -0.065 and the contained Baa spread of 2.48 as evidence that markets had internalized an extended period of low rates and were pricing no change, so that a hold was the efficient expectation.

When the discussion turned to the framework's loss-minimizing recommendation, participants confronted the sharp divergence between the level-based reference rules — Taylor, Balanced Approach, and ELB-adjusted, all at 75 basis points — and the First-Difference rule and loss-minimizing output, both at 0 basis points. Participants across perspectives found the First-Difference logic most persuasive: with the rate already pinned near zero, the relevant question was the change in stance, and with inflation momentum at 0.17 and unemployment momentum at 0.15 both very small, there was no impetus to move. The inflation-focused member framed this as accommodation deliberately set below rule-implied levels precisely because the lower bound constrains and slack suppresses the inflation risk that member normally guards against, adding that if inflation momentum were to accelerate, the 75 basis point signals would be where policy first moved. The employment-focused member read the same gap as confirming that policy was not restrictive but maximally accommodative given the bound, reinforcing the case to keep the rate pinned to protect the labor recovery.

Participants converged on the view that the divergence of the 75 basis point rules reflected their inattention to the effective lower bound and to the fragile state of credit transmission, rather than any genuine case for tightening. The centrist member characterized the outcome as a literal reading of the



data on which both mandate legs and the momentum figures agreed, while the financial stability and market-signal members emphasized that their agreement rested on distinct reasoning — credit fragility and market pricing, respectively — even as it pointed to the same conclusion. No participant advanced an argument that shifted the group toward action in either direction, and the CFNAI reading of 0.16 was cited as consistent with a tepid, near-trend recovery rather than any risk of overheating.

COMMITTEE POLICY ACTIONS

In the predictive phase of the deliberation, all five members independently arrived at a stance of no change, maintaining the federal funds target range at 0.0 to 0.25 percent; the recorded predictive tally was unanimous at 5 to 0 for holding. On the framework's loss-minimizing recommendation of 0 basis points, the Committee was likewise in full agreement: all five members — the inflation hawk, the labor market dove, the financial stability voice, the data-dependent centrist, and the market-signal realist — endorsed the recommendation as-is, with none declining and none registering partial agreement. The Committee accordingly agreed to maintain the target range for the federal funds rate at 0.0 to 0.25 percent.