



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The System Open Market Account held \$2,199.6 billion in domestic securities as of January 19, 2011, up \$5.3 billion from the prior release on January 12. The composition was concentrated in longer-dated Treasury debt and agency mortgage-backed securities: Treasury notes and bonds accounted for \$1,004.7 billion, agency MBS for \$980.2 billion, and Treasury bills for a comparatively small \$18.4 billion. The modest week-over-week increase is consistent with the ongoing asset purchase program proceeding at its established monthly pace. Members were reminded that this account covers SOMA securities holdings only — total size, composition, and the change from the prior release — and does not encompass the results of repo or reverse-repo operations, for which no point-in-time-safe data source is currently available; nothing in this review should be read as a characterization of temporary open market operations.

STAFF REVIEW OF THE ECONOMIC SITUATION

Incoming data pointed to continued disinflation alongside a labor market that remained deeply underutilized. Core PCE inflation stood at 0.59 percent on a year-over-year basis, far below the 2.0 percent objective. The unemployment rate was 9.4 percent, well above the estimated natural rate of roughly 5.01 percent, and initial jobless claims remained elevated at 445,000. The Chicago Fed National Activity Index at 0.02 indicated growth at only about its historical trend. The Employment Cost Index registered 114.0 and M2 stood at \$8,836.9 billion.

The Beige Book material described genuine improvement in activity over the most recent four-to-six-week window. Manufacturing posted solid December gains, building on a pickup in the two prior months, with contacts citing strength in both orders and shipments; a chemical producer expected to run near 95 percent of capacity over the coming year, and an auto-parts supplier reported demand exceeding forecasts to the point of material shortages and higher supplier costs. Retailers noted a spike in December sales and a marked increase in foot traffic, and the banking sector reported moderate improvement in business loan demand, particularly for industrial equipment. Labor demand, however, lagged: temporary employment agencies described demand as flat to up slightly. On prices, contacts reported that raw materials rose somewhat faster than in the prior report while finished-goods prices were little changed. Residential real estate was mixed and commercial construction remained weak, though several commercial Realtors cited a pickup in sales. Port activity was generally above year-ago levels, with a note that a weak dollar had helped support commodity exports.

STAFF REVIEW OF THE FINANCIAL SITUATION



Financial conditions were calm and broadly accommodative. The financial stress index registered 0.132, a low reading, and the VIX at 17.31 indicated moderate volatility with no sign of systemic anxiety. Credit spreads were contained, with the Baa corporate spread at 2.7. The Treasury yield curve was steeply positive, the 10-year/2-year spread standing at 2.77 with no inversion. In short-term funding markets, the 3-month T-bill spread relative to the current policy rate was essentially flat at 0.025, consistent with the front end anchored at the prevailing target range and with market participants expecting no near-term change in policy.

STAFF ECONOMIC OUTLOOK

The forward-looking quantities available to the staff pointed toward continuity in the policy stance. The estimated neutral rate (r^*) was 0.959, a low figure that implies even a neutral nominal policy setting would be modest; with core inflation near 0.6 percent, real policy at the current range remains supportive rather than restrictive. Inflation momentum was negative at -0.21, indicating that price pressures were still drifting downward rather than building, and unemployment momentum at 0.1 was essentially flat, suggesting that the large labor-market gap was not closing quickly.

Each of the reference rules considered — the Taylor rule, the Balanced Approach rule, the First-Difference rule, and the ELB-adjusted rule — returned 0 basis points, and the reference rules were judged reliable in the current environment. The interpretation is straightforward: with inflation undershooting and substantial slack remaining, unconstrained formulations would call for further easing, but the effective lower bound binds, so the ELB-adjusted framework confirms that holding at the current range is the loss-minimizing outcome. Taken together, these projections describe an environment in which conditions are likely to improve only gradually, with disinflation risk still the dominant near-term concern and no projected impetus toward tightening on the visible horizon.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their discussion, participants were unanimous in judging that the appropriate action was to hold the target range at 0.0 to 0.25 percent, but they arrived at that conclusion through the distinct lenses their mandates emphasize. The participant most focused on inflation risk was explicit that, despite the priority he places on price pressures, the data did not support a tightening case: core PCE at 0.59 percent represents disinflation, materially undershooting the 2.0 percent objective, and a cut was neither feasible at the lower bound nor warranted given that inflation was subdued rather than collapsing. He drew attention to the Beige Book's signals of rising raw-material prices, strong manufacturing orders, inventory restocking, and supplier cost pressure as the potential seeds of future inflation, and he tied that watchfulness to the ongoing asset purchase program. But he stressed that finished-goods prices were described as little changed, so those upstream pressures had not yet



passed through, and that acting to hike now would be premature. His watchpoint, as he framed it, argues against further easing rather than for tightening.

The participant weighting the employment mandate most heavily emphasized the severity of the labor-market gap: unemployment at 9.4 percent stands more than four points above the estimated 5.01 percent natural rate, jobless claims at 445,000 remain elevated, and temporary-help demand described as only flat to up slightly offered little comfort about hiring momentum. With inflation soft and its momentum negative, she saw no reason to withdraw support and would have preferred additional easing were it available; because the range is already at the effective lower bound, holding at 0 basis points represents the effective easing floor, with the asset purchase program supplying continued accommodation. She indicated she would firmly resist any pullback in accommodation while slack remained this wide.

The participant attentive to financial stability read the stress indicators first and found them uniformly calm — a stress index of 0.132, a VIX of 17.31, a contained Baa spread of 2.7, and a steeply positive curve with no inversion — and concluded that no acute distress justified a defensive move in either direction. From that seat, continuity was itself a stability virtue: the purchase program is mid-stream, and abruptly altering the rate stance risked unsettling credit conditions unnecessarily. He acknowledged the concern, echoed from a prior dissent, that sustained accommodation could breed future imbalances, and he flagged rising raw-material costs as a possible source of later credit-market repricing, but judged that no imbalance was yet visible in the current readings and that premature tightening into a fragile recovery — widening spreads and tightening conditions — was the outcome he most wanted to avoid. The participant most oriented to market pricing reinforced this, noting that the 3-month T-bill spread just 2.5 basis points above the current rate implied markets expected no move, that the steep curve priced growth ahead without imminent tightening pressure, and that no corner of the market was demanding a policy shift.

The participant favoring a literal, consensus reading of the data observed that both mandate legs pointed the same direction — too much slack, too little inflation — leaving accommodation clearly warranted, while the lower bound removed conventional cutting as an option. He noted that inflation momentum at -0.21 and roughly flat unemployment momentum at 0.1 confirmed that neither overheating nor rapid healing was underway, and that the Chicago Fed index near zero was consistent with only trend-level growth.

When the discussion turned to the optimal-policy framework, participants found that its 0-basis-point recommendation and the agreement of all four reference rules aligned closely with their own reasoning. Several were most persuaded by the ELB-adjusted rule, which they read as recognizing that



unconstrained formulations would want rates below zero but that the binding floor makes an unchanged range plus continued asset purchases the appropriate response. The inflation-focused participant found the Taylor rule most compelling for the way it balances the inflation and unemployment gaps directly, and concluded that from his own seat the honest read was that inflation risk currently lies to the downside, so patience rather than tightening was correct. Across the fourth round, no participant's view was materially changed by the others; the exchanges served to reinforce a shared reading that the current stance is accommodative but not producing measurable financial stress, and that the estimated r^* near 0.96 leaves policy supportive even as it sits at its effective limit.

COMMITTEE POLICY ACTIONS

In the predictive vote, all five members supported maintaining the target range for the federal funds rate at 0.0 to 0.25 percent, a unanimous +0 basis points (5 to 0). On the deterministic optimal policy engine's recommendation of 0 basis points, the Committee likewise reached full agreement: all five members endorsed the recommendation as-is, with none declining and none registering only partial support. The inflation-focused member, the labor-market-focused member, the financial-stability member, the data-dependent centrist, and the market-signal member each endorsed holding the range, and members agreed to continue the ongoing asset purchase program while remaining watchful for the emerging cost pressures noted in the Beige Book.