



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The System Open Market Account held a total of \$2,585.9 billion in domestic securities as of July 25, 2012. The composition consisted of \$1,566.5 billion in Treasury notes and bonds, \$5.9 billion in Treasury bills, and \$853.4 billion in agency mortgage-backed securities. Total holdings declined by \$6.9 billion from the prior release of July 18. It should be noted that these figures cover SOMA securities holdings only — total size, composition, and the week-over-week change — and do not encompass repo or reverse-repo operation results, for which no point-in-time-safe data source currently exists; the staff therefore confined this review to the confirmed holdings data.

STAFF REVIEW OF THE ECONOMIC SITUATION

The information reviewed by the staff indicated that economic activity continued to expand at a moderate pace while labor market conditions remained soft. The unemployment rate stood at 8.2 percent, well above the estimated natural rate of 5.5 percent, and initial claims for unemployment insurance were elevated at 386,000. The Chicago Fed National Activity Index registered -0.15, consistent with growth running somewhat below its trend. Core PCE inflation was 1.46 percent on a year-over-year basis, below the Committee's 2 percent objective. The Employment Cost Index was reported at 117.3, and M2 stood at \$9,943.9 billion.

The Beige Book material characterized activity in the reporting district as continuing to expand at a moderate pace, with residential real estate sales up relative to a year earlier and commercial construction gaining momentum, while retail sales were roughly flat and manufacturing and business services grew slowly. Contacts reported that costs and prices were increasing 'very moderately, if at all,' and generally did not anticipate much inflation or price volatility in the near term. Firms were largely not laying off workers but most were also not engaged in substantial hiring. A recurring theme was uncertainty about future macroeconomic conditions, which several contacts cited as a reason for postponing investment or other decisions, and many expected aggregate growth to remain sluggish through the remainder of 2012 and into early 2013.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions were broadly calm and showed no signs of acute stress. The financial stress index was low at 0.126, and the VIX, at 19.34, was moderate rather than elevated. The Baa corporate spread over Treasuries stood at 3.3, indicating some credit caution but no destabilizing widening, and credit markets appeared to be functioning normally. The 10-year/2-year Treasury yield curve spread was positively sloped at 1.21, carrying no near-term recession signal, while the 3-month T-bill spread relative to the current policy rate was slightly negative at -0.025, a reading consistent with expectations



of continued accommodation rather than stress. On balance, the staff judged that money and credit markets were operating in an orderly fashion at the effective lower bound.

STAFF ECONOMIC OUTLOOK

The staff's forward-looking assessment pointed to conditions consistent with a continuation of the current stance. The estimated neutral real rate (r^*) was negative at -0.245 , implying that the neutral setting for policy itself lay below zero and that the current target range, at the effective lower bound, was already delivering accommodation rather than restraint. Inflation momentum was slightly negative at -0.07 and unemployment momentum was likewise negative at -0.05 , indicating that neither price pressures nor labor-market gaps were on a trajectory that would call for a change in the policy rate in the near term. With inflation running below target and a substantial unemployment gap, the projected path suggested that slack would be slow to close and that price pressures would remain subdued.

All four reference rules considered by the staff — the Taylor rule, the Balanced Approach rule, the First-Difference rule, and the ELB-adjusted rule — returned outputs of 0 basis points, and the framework judged these rules reliable under present conditions. The convergence reflected the combination of below-target inflation, wide slack, and a negative neutral real rate: standard prescriptions did not call for a positive rate, and the effective lower bound bound the outcome from below. The staff's projection therefore implied that the likely path of conditions was one in which the target range would remain at its current setting, with accommodation sustained rather than augmented or withdrawn.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their discussion of current conditions, participants generally agreed that the incoming data described an economy expanding moderately but with a labor market that was healing only slowly. All noted that the unemployment rate, at 8.2 percent, remained far above the 5.5 percent natural rate, and several pointed to elevated jobless claims of 386,000 and the negative Chicago Fed index reading of -0.15 as evidence of below-trend growth. The participant most focused on employment emphasized that the recovery in the labor market appeared to be stalling rather than accelerating, drawing on the Beige Book observation that firms were 'not engaged in substantial hiring' and were postponing investment amid pervasive macroeconomic uncertainty. Other participants shared the view that labor slack was substantial, even as they weighed it against other considerations.

On the price side, participants uniformly saw little near-term inflation risk. The participant who weighs inflation risk most heavily observed that core PCE at 1.46 percent was well below the 2 percent objective and, with negative inflation momentum, showed no sign of accelerating; he characterized the



usual hawkish trigger — inflation above target — as simply absent, and concluded that there was no honest basis to press for tightening. This concession was noted by the employment-focused participant as reinforcing that a move up was off the table. Participants drew on the Beige Book reports of prices rising 'very moderately, if at all' and contacts anticipating little inflation or volatility to corroborate the soft-inflation reading.

A recurring theme was the constraint imposed by the effective lower bound. Participants observed that the target range was already 0.0 to 0.25 percent and that a conventional rate cut was therefore not practically feasible. The employment-focused participant was candid that his instinct favored more accommodation and that, in his judgment, policy might be insufficiently accommodative given the size of the employment gap; he framed his support for holding as reflecting the binding floor rather than satisfaction with the pace of recovery, and indicated he would back other supportive tools. Several participants noted that the estimated neutral real rate was negative at -0.245 , which implied that holding at the floor was appropriately accommodative rather than restrictive.

The participant attentive to financial stability reported that stress indicators showed no acute strain: the financial stress index at 0.126 was low, the VIX at 19.34 moderate, the Baa spread at 3.3 contained, and the yield curve positively sloped at 1.21 with no inversion. He cautioned that forcing additional easing into calm markets would risk distorting credit conditions with little offsetting benefit, and characterized the Beige Book's pervasive uncertainty as soft caution rather than a credit-market breakdown warranting emergency action. The participant weighing market signals most heavily concurred, noting that the slightly negative T-bill spread of -0.025 and the shape of the curve indicated markets expected no imminent move and had already digested an extended path of accommodation. The data-dependent participant, weighing both sides of the mandate at face value, found that below-target inflation, wide slack, a negative neutral rate, and a binding lower bound all pointed the same direction and made holding uniquely appropriate.

In turning to the framework's loss-minimizing recommendation, participants found that their reasoning and the reference-rule outputs converged. Several singled out the ELB-adjusted rule as speaking most directly to their situation, since it acknowledged that rates were pinned at the floor, while others pointed to the Taylor and Balanced Approach rules returning 0 basis points as confirmation that even standard prescriptions did not call for a positive rate. Participants generally concluded that the agreement between their own views and the framework revealed a stance that was appropriately calibrated — accommodative, constrained by the lower bound, and with no inflation or financial-stability trigger justifying deviation in either direction. Those most concerned with employment noted that this agreement should not be read as complacency about the pace of the labor



recovery, but as recognition that the rate lever itself was exhausted.

COMMITTEE POLICY ACTIONS

In the predictive round, all five members voted for no change to the federal funds target range, leaving it at 0.0 to 0.25 percent (a tally of 5 to 0 for a hold, +0 basis points). On the deterministic optimal policy engine's recommendation of 0 basis points, the Committee was likewise in full agreement: all five members endorsed the recommendation as-is, with none declining and none registering only partial support (5 endorse, 0 decline, 0 partial). 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 the predictive vote and the optimal-side outcome were fully consistent.