



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The System Open Market Account's domestic securities holdings totaled \$2,569.8 billion as of September 5, 2012, according to the most recent release available on or before the point-in-time-safe cutoff. Of this, Treasury notes and bonds accounted for \$1,568.5 billion and agency mortgage-backed securities for \$843.7 billion. The portfolio grew by \$9.5 billion from the prior release of August 29. The Manager noted that these figures describe SOMA securities holdings only — total size, composition, and the week-over-week change — and do not encompass the results of repo and reverse-repo operations, for which no point-in-time-safe data source currently exists and which are therefore not reflected in this review.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reported that inflation remained subdued. Core PCE inflation was running at 1.45 percent on a year-over-year basis, well below the Committee's 2.0 percent objective. Labor market slack remained pronounced, with the unemployment rate at 8.3 percent against an estimated natural rate of 5.36 percent, and initial jobless claims elevated at 365,000. The Chicago Fed National Activity Index stood at -0.13, consistent with growth somewhat below trend. The Employment Cost Index registered 117.3, and M2 stood at \$10,021 billion.

Regional information from the most recent Beige Book described activity in the Seventh District as expanding at a moderate pace in July and early August, with growth once again slowing from the prior period. Contacts reported heightened concern about the outlook, citing the U.S. fiscal situation and weaker growth in Europe and Asia. Consumer spending picked up somewhat, aided in large part by heavy retail discounting to clear inventory ahead of the back-to-school season, though contacts noted that higher gasoline prices were curbing discretionary purchases. Business spending grew more slowly, with capital projects proceeding but new commitments approached with greater restraint. Manufacturing production moderated further while construction continued a slow, steady increase. Labor market conditions were described as 'little changed on balance,' with hiring remaining selective and demand comparatively stronger for skilled manufacturing and construction workers, IT specialists, and engineers. Credit conditions were again reported as 'slightly improved.' The staff flagged the ongoing drought as a supply-side risk: smaller anticipated corn and soybean harvests pushed crop prices higher and raised feed costs, with 'some pass-through to wholesale prices already taking place.'

STAFF REVIEW OF THE FINANCIAL SITUATION

The staff characterized financial conditions as calm and non-crisis. The financial stress index stood at a low 0.111, and the VIX was subdued at 15.6, signaling little systemic fear. The Baa corporate spread of



3.19 was moderate, indicating that borrowing-cost pressures were contained rather than acutely distressed. The 10-year to 2-year Treasury spread was positively sloped at 1.41, showing no inversion and no imminent recession signal from the yield curve. The 3-month T-bill spread relative to the current target rate was essentially flat at -0.015, consistent with market pricing of no near-term change in the target range. Taken together, these readings pointed to stable financial conditions with no dislocation in money or credit markets, even as regional contacts voiced heightened outlook concerns.

STAFF ECONOMIC OUTLOOK

The staff outlook pointed to continued accommodation being appropriate over the projection horizon, with the current stance already constrained by the effective lower bound. The estimated neutral real rate (r^*) was negative at -0.367, implying that a target range of 0.0 to 0.25 percent leaves policy accommodative — and arguably still somewhat tight — relative to neutral, and that conventional easing through the rate range is effectively exhausted. Inflation momentum was slightly negative at -0.06, suggesting price pressures were drifting lower rather than building, while unemployment momentum was flat at 0.0, indicating a labor market that was neither healing nor deteriorating materially.

Consistent with these readings, all four reference rules — 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 for this meeting. The unconstrained rule prescriptions, given the inflation shortfall and substantial labor slack, would point below zero, but the lower bound floors them at the current range. The staff projection therefore implied that conditions were likely to evolve slowly: below-target inflation and elevated unemployment persisting absent a shift in the underlying momentum, with downside risks tied to the fiscal situation and weaker growth abroad, and a narrower supply-side upside inflation risk from the drought-driven rise in crop and feed prices.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

Participants generally agreed that no change in the target range was warranted at this meeting, though they reached that conclusion from distinct vantage points. A recurring theme was that the funds rate was already pinned at the 0.0 to 0.25 percent floor, so the range decision was in large measure a corner solution: conventional cuts were effectively exhausted regardless of how one weighed the underlying data. Several participants observed that this arithmetic constraint, rather than conviction that current conditions were satisfactory, was the binding fact for the range itself.

The participant most attentive to inflation risk emphasized that core PCE at 1.45 percent was well below the 2.0 percent objective and that inflation momentum was negative, so there was no active price threat demanding a hike. This participant flagged the Beige Book's note of drought-driven crop-price



increases with 'some pass-through to wholesale prices already taking place' as a supply-side signal worth monitoring, but judged it narrow and localized rather than a broad, demand-driven breakout. On that reasoning, the pass-through argued against adding accommodation but did not justify tightening; holding was described as the disciplined choice consistent with inflation vigilance while acknowledging genuine slack and a low neutral rate.

The participant focused on the labor market stressed the size of the employment gap — unemployment at 8.3 percent against a 5.36 percent natural rate — together with elevated jobless claims at 365,000 and a below-trend Chicago Fed activity reading of -0.13. This participant read the Beige Book's 'selective' hiring and 'little changed' labor conditions as evidence of a labor market that was not accelerating, and would have preferred more accommodation were it available. With inflation below target posing no barrier and the neutral rate deeply negative, the participant argued that holding at the floor represented maximal available accommodation rather than a comfortable stance, and that tightening into a weak labor market would be reckless.

The participant most concerned with financial stability reviewed the stress indicators and found no basis for either an emergency move or a destabilizing one. The stress index at 0.111, VIX at 15.6, a moderate Baa spread of 3.19, a positively sloped yield curve at 1.41, and a flat T-bill spread all pointed to calm, contained conditions, reinforced by Beige Book credit conditions described as 'slightly improved.' The market-oriented participant similarly noted that the essentially flat T-bill spread implied markets expected no near-term change, and that accommodation appeared adequately priced. The data-dependent participant took the indicators at face value and characterized the reading as an unusually clean convergence: both mandate gaps pointed away from tightening, while the lower bound removed room for conventional easing.

In the optimal-framework discussion, participants noted with some emphasis that all four reference rules returned 0 basis points and were judged reliable, which they regarded as strong grounding for the hold. Views converged on the ELB-adjusted and Taylor logic — that unconstrained rules would prescribe rates below zero given the inflation shortfall and slack, but that the floor binds. Rebuttal exchanges did not move any participant off this reading: the inflation-focused participant reaffirmed that slack was not license to relax price vigilance, the labor-focused participant reaffirmed a preference for more support constrained only by the floor, and the financial-stability and market participants confirmed that no stress or pricing signal argued for a change in either direction. Participants generally concluded that policy was appropriately calibrated at the constraint, with the negative r^* underscoring that the stance remained accommodative and that vigilance to fiscal and global downside risks was warranted going forward.

**COMMITTEE POLICY ACTIONS**

In the predictive phase, all five members forecast no change to the target range, a unanimous tally of 0 basis points (5 members at +0 bps). 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 partial support. The Committee accordingly decided to maintain the target range for the federal funds rate at 0.0 to 0.25 percent.