



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

No System Open Market Account holdings data was available on or before the point-in-time-safe cutoff for this meeting. As a result, this section cannot report a total portfolio size, its composition across security types, or any change from a prior release, as it ordinarily would. Members were advised that the data underlying this section is limited to SOMA holdings and does not extend to the results of repurchase or reverse repurchase operations, for which no point-in-time-safe data source currently exists. The desk's operational activity over the intermeeting period therefore could not be characterized quantitatively in this document.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff review characterized the economy as expanding at a pace modestly above trend while both mandate variables sat close to their reference points. Core PCE inflation on a twelve-month basis stood at 1.86 percent, just below the 2.0 percent target. The unemployment rate was 5.4 percent, only a tenth of a percentage point above the estimated natural rate of 5.3 percent, indicating a labor market at or very near balance. Initial jobless claims of 352,000 were moderately elevated, a figure the staff flagged as worth monitoring but not as evidence of a sharp deterioration in hiring. The Chicago Fed National Activity Index at 0.39 pointed to growth running somewhat faster than the economy's longer-run trend. M2 stood at 3,724.8 billion dollars.

The most recent Beige Book, released May 8 and summarizing commentary through April 1996, provided District-by-District reporting from all twelve Reserve Banks. The summary offered no indications of distress or unusual strain across the Districts, consistent with the picture drawn from the national data of steady activity and contained price pressures. Taken together, the incoming information described an economy neither overheating nor slowing appreciably, with inflation slightly under target and employment near full.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions were calm and accommodative across the indicators reviewed. The financial stress index registered 0.09, a very low reading signaling an absence of systemic tension, and the VIX at 14.9 pointed to subdued equity-market volatility. Corporate credit conditions appeared healthy, with the Baa spread over Treasuries at 1.58, a moderate level showing no evident borrowing-cost strain. The term structure carried no recession signal: the 10-year/2-year spread was positively sloped at 0.65. Of particular note, the 3-month Treasury bill traded 0.24 percentage point below the current 5.25 percent funds rate, a configuration the staff read as the front end pricing in no near-term tightening and possibly a modest easing bias over some horizon.



STAFF ECONOMIC OUTLOOK

The forward-looking quantities available pointed to a modestly restrictive current stance. With the estimated neutral rate (r^*) at 2.782 percent and twelve-month core inflation near 1.86 percent, the implied neutral nominal rate lay well below the prevailing 5.25 percent funds rate; measured against inflation, the real funds rate of roughly 3.39 percent exceeded neutral. This gap suggested that policy, left unchanged, would continue to exert mild downward pressure on activity and prices over time rather than adding stimulus.

Momentum readings were slightly negative on both sides of the mandate: inflation momentum at -0.09 and unemployment momentum at -0.05, each indicating gentle softening rather than acceleration in either direction. The reference rules diverged in a manner that framed the projection well. The Taylor, Balanced Approach, and ELB-adjusted rules each called for -75 basis points, driven principally by inflation running below target. The First-Difference rule, which responds to the change in conditions rather than their level, returned 0 basis points, reflecting the near-flat momentum. With the reference rules judged reliable, the deterministic engine reconciled these signals to a recommended -25 basis points — a projection that soft, sub-target inflation warranted some easing while stable momentum and above-trend growth argued against a large adjustment.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their independent predictive assessments, all five participants arrived at a hold at 5.25 percent, though they reached that conclusion by different routes. The inflation hawk emphasized that core PCE at 1.86 percent, while below target, gave no case for a cut, and that above-trend growth paired with a tight labor market created genuine upside inflation risk to guard against; the appropriate posture, in this view, was to hold while remaining prepared to tighten should price pressures materialize. The labor market dove noted that unemployment at 5.4 percent sat essentially at the natural rate and found no evidence of rising unemployment or slowing job growth that would justify preemptive easing, though the participant flagged the 352,000 claims figure as worth watching. The financial stability voice stressed the calm backdrop — stress at 0.09, VIX at 14.9, contained credit spreads — and saw no reason to disrupt benign conditions. The data-dependent centrist read the economy as near both mandate targets with stable markets and no clear case for change, while the market signal realist leaned on the negative T-bill spread as evidence that markets expected no hike and would be surprised by tightening.

The rebuttal round reinforced rather than reshaped this convergence. Participants generally agreed that no argument had been offered for a cut and that an immediate hike was not justified by the inflation data. The hawk restated firm opposition to easing given tight labor and above-trend growth, while acknowledging that market pricing argued against a surprise hike. The dove reiterated that the



precondition for easing — weakening employment — was simply not present in the data, and found the centrist's framing of an economy near both targets persuasive. A couple of participants observed that the -0.24 T-bill spread, though notable, did not itself constitute a mandate for action.

The optimal-framework rounds introduced real tension by placing the deterministic engine's -25 basis point recommendation before the committee. Several participants observed that the framework's inputs genuinely undercut a strict hold: core inflation below target, negative inflation momentum, and a real funds rate meaningfully above the 2.782 percent neutral estimate all indicated that current policy was mildly restrictive rather than neutral. The labor market dove moved most decisively, pointing to negative unemployment momentum and elevated claims as early signals of softening and arguing that restrictive policy risked falling hardest on jobs; this participant found the Balanced Approach logic most compelling and judged -25 basis points a sound insurance step. The financial stability voice concluded that a modest cut would validate the market's priced-in easing without shocking credit conditions, while warning that the full -75 basis points implied by the level rules could risk overheating asset valuations given how calm markets were.

The data-dependent centrist and market signal realist both endorsed -25 basis points as the literal, loss-minimizing compromise — blending the aggressive level-rule signals against the steadying First-Difference reading of near-flat momentum. The realist added a note of caution that the bill spread might reflect a longer horizon rather than this specific meeting, which was consistent with markets pricing gradual future easing rather than immediate action, but concluded that -25 basis points honored that forward pricing without the level rules' excess.

The inflation hawk alone resisted acting at the full magnitude now. This participant accepted that the data lacked an inflation threat and that the easing direction was not wrong, but weighted inflation-reignition risk asymmetrically and preferred, given above-trend growth, a smaller or delayed step — holding at this meeting and reassessing as data confirmed. The hawk found the First-Difference rule's 0 basis points and the realist's longer-horizon reading of the bill spread most supportive of that patience.

COMMITTEE POLICY ACTIONS

In the predictive vote on the policy decision for this meeting, all five participants supported holding the federal funds rate unchanged at 5.25 percent, a unanimous $5-0$ outcome. On the separate question of the deterministic framework's -25 basis point recommendation, the committee recorded four endorsements and one partial. The labor market dove, the financial stability voice, the data-dependent centrist, and the market signal realist each endorsed the recommendation as-is, agreeing that soft,



below-target inflation and a modestly restrictive stance warranted a small, market-consistent easing. The inflation hawk registered a partial position, agreeing with the easing direction but not with acting at the full magnitude at this meeting, preferring a smaller or delayed step given above-trend growth. No participant declined the recommendation outright.