



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

No point-in-time-safe data on System Open Market Account holdings was available on or before the cutoff for this meeting, and the Committee accordingly had no current figures on the total size, composition, or period-over-period change in SOMA holdings before it. The staff noted that this gap pertains to the SOMA securities portfolio only; results of repurchase and reverse-repurchase operations are a separate matter, and no point-in-time-safe source for those operation results currently exists either. Discussion of open market operations was therefore confined to the general observation that market conditions had been orderly, with no reference to specific portfolio balances.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reported that the economy remained strong through the intermeeting period, with the most recent District survey describing gains in activity as widespread. Retail activity showed little sign of slowing in April and May, with home furnishings and motor vehicles selling particularly well, and consumers were characterized as upbeat. Manufacturing continued to improve from the sluggish conditions of the prior year and a half, led by electronics, machinery, heavy trucks, and construction equipment, though steel and apparel still faced stiff foreign competition. Construction was growing briskly, spurred by strong home sales, and in some Districts shortages of labor and materials had pushed up building costs. Lending remained strong overall, with a slowdown in refinancing attributed to slightly higher mortgage rates. Conditions in the farm economy were mixed, with little optimism about 1999 incomes given low commodity prices, while energy activity had been slow to respond to recent oil price increases despite high expectations of recovery.

Labor markets were described as very tight in almost all Districts, with increased reports of upward pressure on wages and some indication that labor supply constraints were impeding employment growth. The civilian unemployment rate stood at 4.2 percent, well below the estimated natural rate of 5.14 percent, and initial jobless claims were low at 292,000. Despite this tightness, prices were reported as generally well behaved apart from several construction materials. Core PCE inflation was running at 1.4 percent on a year-over-year basis, below the 2.0 percent objective, and the Chicago Fed National Activity Index at -0.08 indicated growth close to trend rather than sharp acceleration or deceleration.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions were generally stable and supportive of continued expansion. The financial stress index at 0.1947 was moderate and not at levels associated with dislocation. The VIX at 21.7 was somewhat elevated but did not point to acute market fear, and the Baa corporate spread of 2.12 percentage points over Treasuries indicated contained credit conditions with no sign of a broad credit



dislocation. The Treasury yield curve remained positive but flat, with the 10-year/2-year spread at 0.29 percentage point, offering no recession signal from the curve. The 3-month Treasury bill yielded 0.15 percentage point below the current federal funds rate of 4.75 percent, suggesting that markets were not pricing an aggressive near-term tightening and, on some readings, that front-end conditions were already modestly firm relative to the funds rate.

STAFF ECONOMIC OUTLOOK

The staff's forward-looking assessment drew on the estimated neutral real rate, the momentum in the two mandate variables, and the reference-rule outputs. With the neutral real rate estimated at 3.547 percent, the level-based reference rules — the Taylor rule, the Balanced Approach rule, and the ELB-adjusted rule — each pointed to a funds rate of roughly 75 basis points above the current 4.75 percent setting, reflecting the wide gap between the 4.2 percent unemployment rate and the 5.14 percent natural rate. These rules effectively treat the labor market gap as the dominant force, implying that the prevailing stance is accommodative relative to activity-based neutral and that conditions would tend toward firmer policy if that gap were the governing consideration.

A different picture emerged from the change-based reading. Inflation momentum was slightly negative at -0.06 and unemployment momentum was flat at 0.0, so the First-Difference rule, which responds to the direction of change rather than to the level of any gap, recommended -25 basis points. The deterministic loss-minimizing output followed that rule, yielding a recommendation of -25 basis points with the reference rules judged reliable. Taken together, these figures imply a genuinely two-sided path: level-based logic anchored on a high neutral rate and a tight labor market argues that conditions warrant firmer policy, while the absence of upward inflation momentum and the below-target core reading suggest that price pressures are, if anything, easing and leave room on the downside. The projection is therefore best read as one in which realized inflation stays soft in the near term even as the labor market remains tight, leaving the appropriate direction sensitive to which of these signals is weighted more heavily.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their opening assessments, all five participants independently arrived at a preference for a 25 basis point increase in the target rate. The reasoning, however, came from distinct vantage points. The member most focused on inflation risk acknowledged that core PCE at 1.4 percent was below target and thus posed no realized inflation problem, but emphasized that forward risk was tilted upward given unemployment far below the natural rate, widespread strength in the District survey, and building wage and building-cost pressures; on this view a modest hike was prudent insurance against overheating. The labor-focused member reached the same conclusion by a different route, observing that there was



simply no employment weakness to defend against — claims were low, job growth was constrained by scarce labor rather than weak demand — so the usual case for easing did not apply, and a modest move to lean against wage pressure would not harm a robust labor market.

The participant most attentive to financial stability judged that conditions were stable enough to absorb a measured move without dislocation, citing the moderate stress index, contained Baa spread, and a positive if flat curve, and stressed that preemptive action now would avoid the greater destabilization of sharper tightening later. The data-dependent member read the indicators at face value and saw an economy neither overheating sharply nor cooling, with risks tilted up, supporting a single modest step. The market-focused member noted that the mildly negative T-bill spread and flat curve were consistent with expectations of stable-to-slightly-tighter policy and gave room for a single insurance hike without pricing anything more aggressive. In the rebuttal round no participant was moved off this position; the unanimity itself was cited as reinforcing rather than altering individual convictions, and several participants explicitly resisted any move larger than 25 basis points, pointing to below-target inflation as capping the appropriate size.

A sharp divergence emerged when participants turned to the deterministic framework, whose loss-minimizing recommendation was -25 basis points, driven by the First-Difference rule. Here the group split. The market-signal member found the easing case genuinely persuasive on its own terms, arguing that the T-bill spread, the flat curve, and the below-target core reading with negative momentum all pointed down, and that markets appeared to doubt the high neutral rate embedded in the level rules. The centrist and the labor-focused member both accepted, in their optimal-framework reasoning, that the current 4.75 percent stance might already be modestly restrictive relative to realized inflation, and that the First-Difference logic — changing policy only when conditions change — had force when inflation was undershooting and unemployment momentum was flat.

The inflation-focused member, by contrast, could not endorse easing into a tight, wage-pressured economy. That member emphasized that three of the four reference rules recommended 75 basis points, capturing the overheating gap, and that the First-Difference rule was backward-looking on momentum; forward inflation risk from tight labor, rising oil prices, and higher building costs outweighed soft current readings. In the final rebuttal the disagreement on magnitude came into sharper relief. The labor-focused member, while accepting the easing direction as insurance for employment against a possible future slowing signaled by the flat curve, judged a full 25 basis point cut too aggressive given no actual employment deterioration. The financial-stability member similarly supported the direction — front-end pressure and a near-inverted curve argued for relief rather than a hike — but worried that a full cut into widespread economic strength, upbeat consumers, and brisk



construction and lending might overshoot and fuel asset excess.

The centrist, applying the most literal reading, ultimately resisted the framework's direction, holding that soft inflation favored patience but that active easing into demonstrable strength, tight labor, and rising oil prices was not the consensus literal read; that member judged the -25 recommendation to over-weight momentum against the level rules and strong activity data. The result was a discussion in which the group agreed almost entirely on the near-term policy call yet fractured on the framework's optimal recommendation, with the fault lines running between those who weighted realized, decelerating inflation and market pricing and those who weighted the labor gap and forward inflation risk.

COMMITTEE POLICY ACTIONS

On the predictive question of the appropriate policy action, the Committee voted unanimously for a 25 basis point increase in the target federal funds rate, with all five members in agreement (5 of 5 for +25 basis points). On the separate question of whether to support the deterministic framework's loss-minimizing recommendation of -25 basis points, the Committee was divided: one member endorsed the recommendation as-is (the market-signal member), two members declined it (the inflation-focused member and the data-dependent centrist), and two members gave partial support, agreeing with the easing direction but not the full magnitude (the labor-focused member and the financial-stability member). The optimal-side outcome was thus a genuine split of 1 endorse, 2 decline, and 2 partial, standing in contrast to the unanimous predictive vote.