



## **DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS**

The System Open Market Account held \$665.2 billion in domestic securities as of January 21, 2004, the most recent release available. Of this total, Treasury notes and bonds accounted for \$406.2 billion and Treasury bills for \$245.0 billion. Holdings were unchanged from the prior release of January 14, 2004, showing no net change over the intervening week. The manager noted that this account covers SOMA holdings only — total size, composition, and week-over-week change — and does not encompass repo or reverse-repo operation results, for which no point-in-time-safe data source currently exists.

## **STAFF REVIEW OF THE ECONOMIC SITUATION**

The staff reported that economic activity had continued to improve since the prior survey. The Beige Book, prepared before January 6, characterized most Districts as growing at a moderate pace or strengthening further, with the strongest report coming from the San Francisco District. Several Districts, however — Cleveland, Chicago, and Dallas — described only slow or modest growth, and St. Louis reported mixed conditions. Manufacturing activity rose in nearly all Districts, and holiday retail sales were generally positive, with less discounting reported in some areas than in prior years. Housing remained strong, particularly in Boston and San Francisco, while commercial real estate was still weak despite a few signs of firming. The Chicago Fed National Activity Index stood at 0.05, roughly at trend.

Labor markets remained slack. The unemployment rate was 5.7 percent, above the estimated natural rate of 5.04 percent, and initial jobless claims stood at 362,000. The Beige Book reported modest improvements in labor markets across many Districts, taking the form of reduced layoffs or modestly increased hiring, though new hiring was still minimal in several Districts and most types of workers remained easy to recruit. Consistent with this slack, wage pressures were described as generally subdued, even as health care and other benefit costs continued to rise. On the price side, core PCE inflation was 0.54 percent on a year-over-year basis, well below the 2 percent objective; retailers and manufacturers reported that prices were generally steady despite increases in some raw materials costs. The appearance of mad cow disease was noted as a source of considerable uncertainty in the cattle industry.

## **STAFF REVIEW OF THE FINANCIAL SITUATION**

Financial conditions were calm and accommodative. The financial stress index stood at 0.0723, a very low reading, and the VIX was 14.34, indicating subdued volatility. Credit markets showed no signs of strain: the Baa corporate spread was 2.33, and the Beige Book reported bank loan demand flat or slightly lower with credit quality generally unchanged. The Treasury yield curve was steeply positive, with a 10-year/2-year spread of 2.36 and no inversion. The 3-month Treasury bill traded 13 basis points



below the current 1.0 percent funds rate, a slightly negative spread consistent with market expectations of no near-term tightening and, if anything, a mild easing bias.

### **STAFF ECONOMIC OUTLOOK**

The staff projection drew on the forward-looking quantities available. With the estimated neutral rate ( $r^*$ ) at 2.254 percent and the current funds rate at 1.0 percent, the level-based reference rules — the Taylor rule, the Balanced Approach rule, and the ELB-adjusted rule — each pointed to a funds rate on the order of 75 basis points above the current setting, reflecting the mechanics of a positive neutral rate and the unemployment gap. Those level rules, however, embed an assumption of inflation near target, which does not describe the current environment: with core PCE at 0.54 percent, actual price pressure is far weaker than a positive- $r^*$  prescription would suggest.

Momentum measures pointed in the opposite direction from the level rules. Inflation momentum was essentially flat at 0.04, giving no indication that inflation was accelerating back toward target on its own, while unemployment momentum was slightly negative at -0.05, consistent with a labor market healing only gradually. The First-Difference rule, which responds to the direction of change rather than to an assumed neutral level, prescribed -75 basis points, and the loss-minimizing engine landed at -50 basis points, treating the persistent inflation shortfall as the binding consideration. Taken together, these figures imply an environment in which real rates are comparatively restrictive relative to a sub-1-percent inflation reading, with the disinflation gap — rather than the estimated output or unemployment gap — the dominant risk to the projected path.

### **PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK**

Participants entered the discussion in broad agreement that the appropriate action at this meeting was to hold the funds rate at 1.0 percent, though they reached that conclusion from distinct analytical vantage points. The member most focused on inflation observed that core PCE at 0.54 percent was far below the 2 percent objective, so that the usual caution against easing while inflation runs hot simply did not apply; the data showed disinflation, not overheating. That member nonetheless firmly opposed any cut, reasoning that with rates already well below neutral, further accommodation risked planting future inflation once slack was absorbed. The member attentive to employment noted that unemployment at 5.7 percent remained above the 5.04 percent natural rate and that claims at 362,000 pointed to a still-fragile recovery, but judged that the labor market was healing rather than deteriorating — the condition that would trigger a cut — and that with rates already at 1.0 percent, policy ammunition was scarce enough to counsel against spending it absent a worsening trend.



The member weighing financial stability emphasized that the stress index at 0.0723, the VIX at 14.34, the tight Baa spread at 2.33, and the steep, non-inverted yield curve all described a benign environment with no systemic strain. From that lens, a cut risked being misread as an alarm signal and disturbing the prevailing calm, while a hike would tighten prematurely against low inflation and persistent slack. The data-dependent member read the most literal interpretation of the data as a hold — inflation far below target and labor slack arguing against tightening, calm markets and improving-but-uneven growth arguing against a cut. The member most focused on market signals stressed that the 3-month bill trading 13 basis points below the funds rate and the steep curve indicated that markets expected no move, and that the efficient reading was patience. Across two rounds no participant was persuaded to shift, and the predictive view converged unanimously on holding at 1.0 percent.

The discussion then turned to the optimal-policy framework, which recommended -50 basis points. Here genuine differences emerged. Several participants acknowledged that the framework's logic was coherent: the level rules' prescription of a hike reflected  $r^*$  mechanics rather than actual price pressure, and with core inflation at roughly a quarter of target, the momentum-based and loss-minimizing signals rightly identified the inflation shortfall as the binding problem. The employment-focused member went furthest, endorsing the framework's easing bias outright — with both mandate legs pointing the same way and financial conditions calm enough that easing carried little instability cost, that member judged that a hold underinsured the still-slack labor market and that the First-Difference rule's response to weak momentum was the more persuasive guide than a possibly mismeasured neutral level.

Other participants agreed with the direction but not the magnitude. The financial stability member reasoned that although calm markets imposed no fragility constraint on easing, they also created no crisis demanding it, and that a 50-basis-point cut from a 1.0 percent floor risked signaling alarm to stable credit markets — the direction of ease was defensible given disinflation, but the size exceeded what conditions warranted. The centrist accepted that severe inflation undershoot plus labor slack supported the easing direction while judging that a full 50 basis points from a 1.0 percent floor was large given improving, non-crisis conditions and an uneven recovery, with Cleveland, Chicago, and Dallas still slow and St. Louis mixed. The market-signal member noted that the slightly negative bill spread supported an easing bias but that markets were not pricing a cut of that size, favoring instead a smaller, insurance-sized step. The inflation-focused member alone declined the recommendation, respecting the -50 arithmetic as the pure loss-minimizing answer but weighting more heavily the forward risk that cutting deeply now would reignite inflation once slack closed and the expansion firmed.



Underlying much of the exchange was a shared recognition that the level rules and the momentum rules told opposite stories, and that the resolution turned on how much weight to place on the depressed level of inflation versus the improving trajectory of activity. Participants generally agreed that no case existed for tightening — every member rejected a hike — and that the true debate was between holding and easing, and, among those inclined to ease, over how large a step calm markets and a low rate floor could justify.

### **COMMITTEE POLICY ACTIONS**

On the predictive question of the action to take at this meeting, the Committee voted unanimously to hold the funds rate at 1.0 percent, 5 to 0. On the separate question of the optimal-policy framework's recommendation of -50 basis points, the Committee was divided: one member (the labor-market-focused participant) endorsed the recommendation as-is; one member (the inflation-focused participant) declined it, judging the forward inflation risk of over-easing too great; and three members (the financial-stability, data-dependent, and market-signal participants) gave partial support, agreeing that the direction toward easing was defensible given the deep inflation undershoot but judging the full 50-basis-point magnitude larger than calm markets and the already-low rate floor warranted.