



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The Committee reviewed the most recent System Open Market Account data, reported as of April 21, 2004. Total SOMA domestic securities holdings stood at \$673.2 billion, comprising \$411.4 billion in Treasury notes and bonds and \$247.3 billion in Treasury bills. The change from the prior release, dated April 14, was a modest increase of \$0.2 billion, indicating essentially stable holdings over the week. It should be noted that this figure covers SOMA holdings only — total size, composition, and the week-over-week change. It does not encompass the results of repo or reverse-repo operations, for which no point-in-time-safe data source is currently available; the discussion here should therefore not be read as a complete account of open market activity.

STAFF REVIEW OF THE ECONOMIC SITUATION

Incoming data pointed to a broad-based expansion. The Beige Book described economic activity as having increased across the nation from mid-February through early April, with growth widespread: retail sales moved up noticeably, and manufacturing, mining, energy, tourism, and services all grew. New home construction was reported as strong in a number of districts, though commercial real estate markets remained soft. Consumer spending was characterized in varying terms across districts — improving and strengthening in some, moderately above year-ago levels in others, and as brisk, solid, or surprisingly strong in several. Vehicle sales were mixed, with strength in light trucks and SUVs contrasted against softer car demand in some districts, and a number of auto dealers reported inventories higher than desired. Lending activity increased and credit quality remained solid.

On the labor and price side, the Beige Book reported that labor markets tightened somewhat with modest wage increases. Initial jobless claims stood at 339,000, a moderate level not indicative of deterioration. The unemployment rate was 5.7 percent, above the estimated natural rate of 5.04 percent, leaving some measured slack in the labor market. Core PCE inflation on a year-over-year basis was 1.08 percent, well below the 2 percent objective. Many districts reported only modest increases in overall consumer prices, but most districts noted significant increases in numerous commodities and input products. The Chicago Fed National Activity Index registered 0.08, and the Employment Cost Index was reported at 95.5. The fed funds rate stood at 1.0 percent.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions were calm and orderly across the measures reviewed. The financial stress index was low at 0.0735, and the VIX stood at a subdued 15.07, indicating little market anxiety. Credit conditions appeared healthy: the Baa corporate spread was 2.08, consistent with the Beige Book's report of solid credit quality and increased lending. The Treasury yield curve was steeply positive, with



the 10-year/2-year spread at 2.22, showing no inversion or recession signal. The 3-month T-bill spread relative to the current funds rate was essentially flat at -0.03, indicating that markets were pricing little in the way of a near-term policy move. Taken together, the signals suggested stable, accommodative conditions with no evident credit fragility and no market pressure demanding an immediate policy shift.

STAFF ECONOMIC OUTLOOK

The forward-looking quantities available to the staff pointed to a stance that is presently quite accommodative relative to estimated neutral. With the estimated neutral rate (r^*) at 2.102 percent and the funds rate at 1.0 percent, the real policy stance was materially below neutral. The level-based reference rules reflected this gap directly: the Taylor rule, the Balanced Approach rule, and the ELB-adjusted rule each pointed to roughly 75 basis points above the current rate, consistent with a view that policy would need to firm over time as the expansion matured and slack narrowed.

Momentum measures, however, cut in the other direction. Inflation momentum was slightly negative at -0.08 and unemployment momentum was -0.2, the latter indicating that the unemployment gap was closing even as a level of slack remained. The First-Difference rule, which responds to change rather than level, recommended -50 basis points on the strength of soft, still-easing inflation below target. The deterministic loss-minimizing output resolved these competing signals at -25 basis points, treating the disinflation momentum as warranting modest insurance against a persistent below-target inflation outcome rather than as a case for tightening now. On balance, the projection implied a stance close to appropriate but perhaps marginally too tight on a momentum-weighted reading, with the level rules signaling that the eventual risk to the policy path lies in the direction of firming rather than further ease.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their predictive discussion, all five participants independently arrived at no change in the funds rate for this meeting, and the subsequent rebuttal round did not dislodge that view. The common ground was clear: core PCE at 1.08 percent is barely half the 2 percent objective, so realized inflation posed no urgency to tighten, while unemployment at 5.7 percent above the 5.04 percent natural rate left measured slack that argued against any move to restrain the recovery. Several participants also emphasized that market pricing corroborated a hold — the near-flat 3-month T-bill spread and the steep yield curve indicated that no near-term move was priced into the front end, so an unexpected step would surprise orderly markets to no clear benefit.

The member most attentive to inflation risk initially leaned toward a small preemptive step, citing the Beige Book's reports of widespread growth, tightening labor markets, and significant increases in



numerous commodities and input products as early signs of building pipeline pressure, together with the fact that a 1.0 percent funds rate is extraordinarily accommodative in a broad-based expansion. On reflection, this participant judged that with realized core inflation very low, some slack remaining, and no move telegraphed in market pricing, patience was defensible for this meeting — while stressing a clear bias toward removing accommodation should pipeline pressures persist. The participant weighting employment most heavily saw no case for either direction: with the labor market improving rather than deteriorating and wage gains described as modest, there was no basis for a cut, and with inflation subdued there was no need to tighten aggressively into an incomplete recovery. The participant focused on financial stability and the one focused on market signals both emphasized the calm across every measure they watched — low stress, benign volatility, tight credit spreads, no inversion — and concluded that an unpriced move risked an avoidable jolt with no offsetting stability or pricing rationale. The data-dependent participant read the face value of the data the same way: below-target inflation and residual slack, with commodity and input pressures still described as pipeline risks not yet passing through to core consumer prices.

When the discussion turned to the deterministic framework's -25 basis point recommendation, participants engaged directly with the tension between the level-based rules and the momentum-based rule. Several observed that the recommendation depends on treating the soft realized inflation as durable and weighting the negative inflation and unemployment momentum over the level rules that clustered near 75 basis points above the current rate. The employment-focused participant found the First-Difference logic most persuasive and endorsed the cut, arguing that with the unemployment gap still open, inflation below target and softening, and no wage spiral evident in the ECI, holding at 1.0 percent was effectively too restrictive for the labor market — and that the risk of easing too little outweighed easing too much.

The inflation-focused participant reached the opposite conclusion, declining the cut. This participant accepted that momentum matters and that immediate inflation danger is limited, but judged that adding stimulus while commodity and input prices are rising and real policy is already deeply negative would risk seeding the very inflation the mandate guards against; the clustering of the reliable reference rules near 75 basis points reinforced the view that the real risk ahead is tightening, not further ease. The financial-stability participant also declined, noting that calm markets and tight spreads provided neither a stress-driven case for easing nor a tightening urgency, and that easing into broad-based growth and healthy credit risked future imbalances — the -25 was defensible as inflation insurance but not compelled by financial conditions. The market-signals participant likewise declined, giving primacy to the front end's clear read that markets expected a hold and judging the insurance rationale weaker than that signal. The data-dependent participant took a partial position: agreeing that



the direction of the framework's call was defensible given sub-target, falling inflation and residual slack, but judging that widespread strengthening and calm markets argued against a full quarter-point move now. A recurring theme across the exchange was that, whatever the disagreement over magnitude and direction of any marginal adjustment, participants broadly viewed the current stance as close to appropriate and saw no case for tightening at this meeting.

COMMITTEE POLICY ACTIONS

On the question presented for this meeting, all five participants supported no change in the target federal funds rate, leaving it at 1.0 percent; the predictive vote was unanimous, 5 to 0. On the separate matter of the deterministic framework's -25 basis point recommendation, the Committee did not reach agreement: one member (the labor-market-focused participant) endorsed the recommendation as-is, three members (the inflation-focused, financial-stability, and market-signals participants) declined it, and one member (the data-dependent participant) took a partial position, agreeing with the easing direction but not with the full magnitude at this meeting.