



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The Committee reviewed the most recent data on the System Open Market Account. As of June 23, 2004, total SOMA domestic securities holdings stood at \$683.3 billion, comprising \$416.7 billion in Treasury notes and bonds and \$252.1 billion in Treasury bills. This represented an increase of \$0.2 billion from the prior release dated June 16, 2004 — a marginal change consistent with routine portfolio management rather than any shift in the stance of open market operations. It should be noted that this review covers SOMA holdings only, that is, the total size, composition, and week-over-week change of the portfolio; it does not encompass repo or reverse-repo operation results, for which no point-in-time-safe data source currently exists and which are therefore excluded from this account.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reported that economic activity continued to expand across the nation during April and May. According to the June 16 Beige Book, manufacturing activity rose in most districts, with several describing the increases as broad-based, and most districts reported increased demand for services. Retail sales remained even or rose in most districts, with strength at discount and drug stores and in apparel, food, and summer seasonal items, while sales of high-end electronics, appliances, and specialty items were soft in most districts. Residential real estate markets remained strong, and bank lending activity increased in most districts. Employment activity continued to improve, with hiring picking up at a faster pace in most districts, though wages and salaries showed little or muted upward pressure. Many districts reported modest increases in consumer prices, but most noted rising input prices, particularly for energy-related products, building materials, and steel.

On the incoming data, core PCE inflation on a year-over-year basis stood at 1.11 percent, below the 2 percent objective. The unemployment rate was 5.6 percent, above the estimated natural rate of 5.04 percent, leaving a gap of roughly half a percentage point. Initial jobless claims were reported at 354,000, a moderate level. The Chicago Fed National Activity Index registered -0.28, indicating growth somewhat below trend. The federal funds rate stood at 1.0 percent, an emergency-era low. The Employment Cost Index reading was 95.5 and M2 money supply totaled \$6,268.8 billion. Taken together, the data described an economy in broad expansion with a firming labor market, contained realized inflation, and input-cost pressures accumulating in the price pipeline.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions were calm and accommodative. The financial stress index was low at 0.0945, and the VIX stood at 13.98, indicating little volatility and no sign of market fragility. The Baa corporate spread over Treasuries was contained at 2.06, pointing to no credit-market distress. The



10-year/2-year Treasury spread was steeply positive at 1.93, with no inversion and thus no recession signal from the yield curve. Notably, the 3-month Treasury bill spread was 0.27 above the current 1.0 percent funds rate, a premium that aligns closely with a single 25 basis point increment and suggests that market participants had largely priced in a near-term move. Overall, the staff characterized financial conditions as orderly and capable of absorbing a measured policy adjustment without disruption.

STAFF ECONOMIC OUTLOOK

Looking ahead, the staff drew on the available forward-looking quantities to characterize the likely path of conditions. With the estimated neutral real rate (r^*) near 2.012 and realized inflation at 1.11 percent, the current 1.0 percent nominal funds rate implied a deeply negative real rate, well below the neutral level. On this basis, 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 setting, reflecting how far below neutral policy was judged to be against a broadly expanding economy.

The momentum-based readings, however, told a more cautious story. Inflation momentum was modest at 0.27 and unemployment momentum was flat at 0.0, indicating that neither price pressures nor labor conditions were deteriorating in a way that would compel urgent tightening. The First-Difference rule, which keys off changes rather than level gaps, accordingly pointed to -50 basis points. The deterministic loss-minimizing engine, weighing the sub-target inflation shortfall, the above-natural unemployment gap, and below-trend activity heavily against the level-rule signals, produced a recommendation of -25 basis points. The projection thus embodied a genuine tension: level rules implied policy was substantially too accommodative, while the momentum and loss-function logic implied that, with disinflation not yet reversed, the case for immediate tightening was weaker than the level gaps alone would suggest.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their independent opening assessments, all five participants converged on a modest 25 basis point increase as the most likely policy action. Participants generally observed that a 1.0 percent funds rate represented an emergency-era low that had been maintained well into a recovery the Beige Book now described as broad-based, with manufacturing, services, and hiring all improving and bank lending rising. With the real rate deeply negative, several judged that policy was clearly too loose for an economy expanding at this pace, and none saw any case for a cut or for holding at the current level.

The participant weighting inflation risk most heavily emphasized that, although core PCE at 1.11 percent remained well below the 2 percent objective on the realized measure, the Beige Book's flagging of rising



input costs in energy, building materials, and steel represented precisely the kind of pipeline pressure warranting a preemptive but proportionate first step. This participant considered whether a larger 50 basis point move might be justified but concluded that, with core inflation well below target and wage pressures explicitly muted, front-loading was less defensible than a measured start. The participant focused on the labor market noted that unemployment at 5.6 percent remained above the 5.04 percent natural rate but stressed that the Beige Book reported hiring accelerating and that jobless claims at 354,000 were consistent with improvement rather than deterioration; the dovish trigger of labor-market weakness was simply not present, so there was no employment case for resisting a small move. The participant attentive to financial stability pointed to the low stress index, calm VIX, contained Baa spread, and steep, non-inverted curve as evidence that markets could absorb a measured hike in orderly fashion, while the participant emphasizing market signals underscored that the 0.27 T-bill premium aligned almost exactly with a single 25 basis point increment already discounted. The data-dependent participant tied these strands together, reading the most literal consensus as a modest first step toward normalization.

The discussion of the deterministic framework's -25 basis point recommendation surfaced sharper disagreement. Participants noted that three level-based reference rules pointed to roughly 75 basis points above the current rate, while only the First-Difference rule pointed to easing, and that the loss-minimizing output leaned heavily on that outlier by weighting sub-target inflation, the unemployment gap, and the -0.28 activity index. The participant weighting inflation reasoned that cutting from 1.0 percent while input costs were rising and real rates were negative would risk entrenching accommodation and necessitating sharper future tightening; this participant sided firmly with the level-rule cluster and declined the easing recommendation. The participants focused on financial stability, on market signals, and the data-dependent centrist likewise concluded that the direction was wrong: benign financial conditions provided no defensive-easing rationale, and a cut would contradict the broad-expansion, above-natural-employment picture as well as the near-term move markets had already priced. The stability participant added that if a hike were expected and failed to arrive, the surprise itself could unsettle conditions and potentially fuel froth in the strong real estate sector.

One participant, the member weighting employment risk, found the framework's -25 basis point recommendation persuasive on its own terms. This participant argued that the unemployment gap represented real slack, that core inflation this far below target and muted wages gave no reason to restrict, and that below-trend activity in the Chicago Fed index reinforced the case; the First-Difference rule's easing signal aligned with these priorities, though the participant acknowledged that flat unemployment momentum tempered the case for the more aggressive -50 reading and made



the moderated -25 the appropriate magnitude. The remaining participants, while several conceded that inflation this far below target genuinely weakened the immediate hiking case, maintained that the loss function overweighted the momentum rule against the level-rule consensus and market pricing, and that the correct reading of the data was to begin gentle normalization rather than ease.

COMMITTEE POLICY ACTIONS

In the predictive vote on the likely policy action, all five participants supported a 25 basis point increase in the federal funds rate, yielding a unanimous tally of 5 to 0 for a modest first step toward normalization. On the deterministic framework's separate recommendation of a 25 basis point cut, the Committee did not reach agreement: one participant, the member weighting labor-market risk, endorsed the recommendation, while the remaining four — the participants focused on inflation, financial stability, market signals, and the data-dependent centrist — declined it, judging the easing direction inconsistent with a broadly expanding economy, above-natural unemployment, calm financial conditions, and market pricing that already anticipated a near-term hike. No participant took a partial stance. The final optimal-side tally was thus one endorse and four decline.