



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The Manager reported on developments in the System Open Market Account. As of the most recent release dated July 28, 2004, total SOMA domestic securities holdings stood at \$691.7 billion, comprising \$421.5 billion in Treasury notes and bonds and \$255.2 billion in Treasury bills. This represented an increase of \$1.4 billion from the prior release of July 21, 2004. Participants were reminded that these figures cover SOMA securities holdings only — total size, composition, and the week-over-week change — and do not encompass repo or reverse-repo operation results, for which no point-in-time-safe data source currently exists; accordingly, the discussion of open market operations was confined to the outright holdings data available.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reviewed incoming data indicating that the economic expansion continued, though at a pace that appeared to have moderated somewhat in several areas. The Chicago Fed National Activity Index registered 0.3, consistent with growth running somewhat above trend. Initial jobless claims stood at 341,000, a level the staff characterized as moderate and not deteriorating. The unemployment rate was 5.6 percent, above the estimated natural rate of 5.04 percent, implying that some slack remained in the labor market. Core PCE inflation on a twelve-month basis was 1.42 percent, below the 2 percent benchmark. The Employment Cost Index reading was 96.4, and M2 stood at \$6,293 billion.

The most recent Beige Book, prepared before July 19, reported that economic activity continued to expand in June and early July, though several districts noted that the rate of growth had moderated. Roughly half the districts described growth as ranging from modest to solid, while others reported that growth had slowed somewhat. Reports of rising prices at the producer level remained common — energy, steel, and cement were widely cited as high and moving higher, and some agricultural products including beef, chicken, and milk were also noted as adding to pricing pressures — but increases in retail prices were only infrequently reported. Wage gains were described as generally flat while benefits costs continued to rise. Retail sales were widely reported to have slowed, with auto sales flat to down in most districts. Manufacturing activity rose across the country, albeit with pockets of weakness and gains more measured than in the early spring. Residential construction remained strong while nonresidential building stayed generally weak, and commercial borrowing rose moderately with mortgage originations robust even as refinancings fell further.

STAFF REVIEW OF THE FINANCIAL SITUATION

The staff characterized financial conditions as calm and broadly accommodative. The financial stress index stood at 0.0915, a low reading indicating little tightness in financial markets. The VIX was 16.03, a



subdued level suggesting limited market anxiety. The Baa corporate spread over Treasuries was 2.14, a moderate reading with no sign of credit-market distress or widening. The 10-year/2-year Treasury yield curve spread was positive at 1.79, steeply upward-sloping with no inversion and no recession signal from the curve. The 3-month T-bill spread relative to the current 1.25 percent funds rate was 0.21, a configuration the staff read as consistent with market expectations of a modest near-term firming in the policy rate.

STAFF ECONOMIC OUTLOOK

The staff outlook drew on the forward-looking quantities available. With the estimated neutral rate (r^*) near 1.888 percent and the current funds rate at 1.25 percent, the real policy stance remained accommodative on a level basis, implying room for conditions to remain supportive of continued expansion in the near term absent a change in policy. The level-based reference rules — the Taylor rule, the Balanced Approach rule, and the ELB-adjusted rule — each pointed to roughly 75 basis points, reflecting the gap between the prevailing rate and neutral. The First-Difference rule, which responds to changes rather than levels, pointed instead to -25 basis points.

The divergence among the rules traced largely to the momentum readings. Inflation momentum was low at 0.125 and unemployment momentum was 0.0, indicating little acceleration on either side of the mandate. On these subdued dynamics, the loss-minimizing output of the framework was -25 basis points, driven by the First-Difference rule, with the reference rules judged reliable. Taken together, the projection implied an economy expanding at close to trend with inflation contained below benchmark and no near-term acceleration signal — a configuration in which the level gap and the momentum reading pulled in opposite directions, leaving the appropriate path sensitive to how much weight was placed on closing the distance to neutral versus responding to a flat-to-softening trajectory.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their initial predictive discussion, all participants judged that a measured 25 basis point increase in the target rate was the likely appropriate step. Participants generally observed that a funds rate of 1.25 percent left policy deeply accommodative relative to an expanding economy, with real rates negative given a neutral rate near 1.89 percent. One participant emphasizing inflation risk pointed to the widespread producer-level price increases documented in the Beige Book — energy, steel, and cement moving higher, alongside rising benefits costs — as evidence of building pipeline pressure that warranted beginning to withdraw accommodation, while acknowledging that core PCE at 1.42 percent, still below the 2 percent benchmark, argued against a larger move. A participant focused on the labor market noted that unemployment at 5.6 percent remained above the natural rate but that jobless claims and above-trend activity gave no indication the current rate was harming employment, so that a



modest step reduced stimulus without making policy restrictive.

Several participants stressed the benign financial backdrop as removing any barrier to a measured move. The low stress index, subdued VIX, contained Baa spread, and steeply positive yield curve were cited as conditions markets could absorb smoothly. One participant attending closely to market pricing observed that the 3-month T-bill spread of 0.21 implied markets had largely priced a quarter-point move, so that delivering the anticipated step posed far less risk to conditions than either under- or over-shooting expectations. In the rebuttal round, no participant was moved from a measured hike: the softening demand signals — slowing retail and auto sales, moderating growth in several districts — were read as arguments against aggressive tightening rather than as grounds for pausing or cutting, and the predictive discussion closed with unanimous support for 25 basis points.

The subsequent discussion turned to the framework's loss-minimizing recommendation of -25 basis points, and here genuine disagreement emerged over how to weigh level against momentum. Participants generally recognized the tension: three level-based rules pointed to roughly 75 basis points, reflecting how far below neutral the current rate sat, while the First-Difference rule and the framework output pointed to easing on the basis of flat inflation momentum, zero unemployment momentum, and sub-target core inflation. The participant weighting employment most heavily found the framework call persuasive, reasoning that with meaningful labor-market slack still present, softening demand, and inflation imposing no constraint, easing better served the employment mandate than a hike that risked choking recovery before the jobs gap closed. This participant judged that the level-based rules underweighted the deceleration the Beige Book documented.

Other participants, while engaging seriously with the momentum-based logic, declined to endorse easing. The participant focused on inflation risk held that cutting from an already-accommodative floor while producer prices climbed risked letting pipeline pressure feed through, and that limited retail pass-through was a lagging comfort rather than a forward safeguard. The participant attentive to financial stability found no stability rationale for a cut: with credit markets calm and pricing tilted toward a hike, an easing move risked disorderly repricing and ran counter to orderly normalization. The market-signals participant argued that easing into markets pricing a firming, with no financial stress and rates deeply below neutral, contradicted efficient-pricing logic and was wrong on both the level gap and the market-implied path. The centrist participant took the data literally — an economy that 'continued to expand,' manufacturing rising nationwide, rates far below neutral, and inflation contained — and judged that the momentum-only case underweighted both the level gap and the expanding-activity signal, so that gradual normalization fit better than a cut.



In reconciling the two frames, participants who favored a hike characterized the divergence between the predictive +25 and the framework's -25 as revealing how accommodative the current stance remained in level terms even as flat momentum counseled patience. The dissenting participant who endorsed the framework read the same gap as evidence that the expected hike was premature relative to what employment conditions and softening demand justified. The wide dispersion among the reference rules was itself noted as a reason for caution in interpretation, though most participants concluded that the weight of the level rules, the expanding activity in the Beige Book, and market pricing pointed toward gradual normalization rather than easing.

COMMITTEE POLICY ACTIONS

In the predictive vote on the likely policy action, all five members supported a 25 basis point increase in the target rate (5 of 5 for +25 bps). On the separate question of the framework's loss-minimizing recommendation of -25 basis points, the Committee did not reach agreement: one member — the participant weighting the employment mandate most heavily — endorsed the recommendation as-is, while the remaining four members declined to support it, with no member taking a partial position. The four declining members comprised the participants focused on inflation risk, financial stability, market signals, and the data-dependent centrist, each judging that easing ran counter to a below-neutral policy stance, an expanding economy, and market pricing tilted toward firming.