



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

Open market operations over the intermeeting period left the System Open Market Account essentially unchanged. As of the most recent release, dated January 26, 2005, total SOMA domestic securities holdings stood at \$715.5 billion, composed of \$436.4 billion in Treasury notes and bonds and \$263.0 billion in Treasury bills. The change from the prior release, dated January 19, 2005, was flat — reported at \$0.0 billion — indicating no net addition to or reduction of the portfolio between the two readings. Staff noted that this account covers SOMA holdings only, capturing 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 is currently available.

STAFF REVIEW OF THE ECONOMIC SITUATION

The information reviewed by the staff indicated that economic activity continued to expand broadly. The Chicago Fed National Activity Index registered a positive 0.19, consistent with growth somewhat above trend. The unemployment rate stood at 5.4 percent, slightly above the estimated natural rate of 5.04 percent, suggesting that a modest degree of labor-market slack remained. Initial jobless claims at 329,000 were moderate and gave no indication of deterioration. Core PCE inflation was running at 1.18 percent on a year-over-year basis, well below the 2.0 percent objective. The Employment Cost Index was reported at 98.0, offering no sign of accelerating compensation costs.

The most recent Beige Book, prepared by the Federal Reserve Bank of Richmond on information collected before January 10, characterized activity across the twelve districts as continuing to expand from late November through early January. Eleven districts described activity as expanding, with three noting that the pace had quickened since their prior reports, while one district characterized conditions as mixed. Consumer spending was generally higher, and a number of districts reported holiday retail sales above year-ago levels, with spending picking up appreciably by late December after a slow start. Manufacturing activity firmed in most districts, and many contacts reported plans to increase capital spending in 2005. Several reports noted some slowing in residential real estate and construction, though real estate markets remained generally strong. Labor markets firmed in a number of districts, but wage pressures generally remained modest. Several districts reported higher prices for building materials and manufacturing inputs, while most reported steady or only slightly higher overall price levels.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions remained calm and accommodative over the period. The financial stress index stood at a very low 0.0906, and the VIX at 13.44 pointed to subdued volatility and a notable degree of



market complacency. Credit conditions were easy, with the Baa corporate spread at 1.76 indicating accessible borrowing and no evident strain. The Treasury yield curve remained positively sloped, with the 10-year/2-year spread at 0.94, showing a flattening trend but no inversion and thus no recession signal from the curve. The 3-month Treasury bill yielded 0.12 above the current federal funds rate of 2.25 percent, a configuration consistent with market participants anticipating near-term firming of policy.

STAFF ECONOMIC OUTLOOK

The forward-looking indicators available to the staff pointed in a somewhat different direction than the current-conditions data alone might suggest. The estimated neutral real rate (r^*) was placed at 1.594 percent. Combined with core PCE running near 1.18 percent, this implies a nominal neutral rate in the vicinity of 2.77 percent, above the prevailing 2.25 percent funds rate — an arithmetic reading under which current policy sits modestly on the accommodative side of neutral. Set against this, however, the standard reference rules, judged reliable for this meeting, uniformly prescribed easing: the Taylor rule, the Balanced Approach rule, and the ELB-adjusted rule each indicated -75 basis points, and the First-Difference rule indicated -50 basis points. The gap between these rule outputs and the neutral-rate arithmetic reflects the weight the gap-based rules place on the inflation shortfall relative to the 2.0 percent objective and on the labor-market slack implied by unemployment above its natural rate.

Momentum measures reinforced the disinflationary tilt of the rule prescriptions. Inflation momentum was estimated at -0.13, indicating that price pressures were softening further rather than building, while unemployment momentum was 0.0, suggesting no self-correction of the remaining slack was under way. Taken together, these quantities imply that, absent a policy adjustment, inflation would be likely to remain below target and slack to persist rather than close on its own. The loss-minimizing recommendation derived from these inputs was -25 basis points — a magnitude well short of the aggressive rule levels, reflecting a tempering of the mechanical prescriptions in recognition of benign and stable financial conditions and continued expansion in real activity.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their initial predictive discussion, all five participants judged that a 25 basis point increase in the federal funds rate was the most likely and appropriate near-term step. Participants generally observed that, with the funds rate at 2.25 percent and core PCE near 1.18 percent, real rates remained low and policy remained accommodative even as the expansion broadened. The member most attentive to inflation risk framed the case as preemptive: while core PCE was well below the 2.0 percent objective and afforded no acute pressure, the Beige Book notes on firming manufacturing, rising 2005 capital



spending plans, and higher building-material and manufacturing input prices were read as early-stage signals warranting continued removal of accommodation. The member focused on employment emphasized that, although unemployment at 5.4 percent left some slack above the 5.04 percent natural rate, claims at 329,000 and the Beige Book's account of firming labor markets showed no deterioration that would call for support — and thus no barrier to a modest hike. The participant weighting financial stability stressed the calm signaled by the low stress index, the subdued VIX, and tight credit spreads, arguing that a well-telegraphed quarter-point step was the least destabilizing path and that a surprise pause or larger move posed the greater risk. The member attentive to market signals pointed to the 0.12 spread of the 3-month bill over the funds rate as pricing a near-term hike, with the positively sloped curve giving no contrary recession signal.

The rebuttal round produced no shift in these positions. Each participant reported that the arguments of the others reinforced rather than altered their own reading, and the predictive vote settled unanimously on +25 basis points as the market-consistent, gradual continuation of normalization.

When the discussion turned to the framework's loss-minimizing recommendation of -25 basis points, the tenor of the deliberation changed markedly. Several participants acknowledged directly that their predictive vote reflected an expectation of continued normalization rather than what the mandate data, taken at face value, would justify. The inflation-focused member was candid that with core PCE 0.82 percentage point below target and inflation momentum negative, the usual caution against easing simply did not bind; on the numbers, there was no inflation-risk case for holding or hiking, and a modest cut carried little inflationary danger given the positive yield curve. The employment-focused member reached the same destination from the labor side, noting that slack persisted, unemployment momentum was flat, and modest wage pressures removed any wage-push concern — so both mandate legs pointed toward easing, with the Balanced Approach rule weighting the employment gap in a way that matched that reading. The centrist worked through the neutral-rate arithmetic, concluding that while r^* plus inflation placed nominal neutral only modestly above the current rate, the direction indicated by the reliable reference rules was clearly toward easing, and that the framework's -25 appropriately captured correct direction at restrained magnitude given benign conditions.

The dissent from this convergence came from the member weighting market-implied pricing, who declined to endorse the recommendation. That participant argued that forward signals — the positive T-bill spread, the upward-sloped curve, low volatility, and firming Beige Book activity across eleven districts — were pricing continued firming, not easing, and that a cut would contradict the aggregated market signal he weights most heavily. In his view the rule-based case rested on r^* and inflation-gap arithmetic rather than on what markets were actually signaling, and real activity did not call for



accommodation. The financial-stability member occupied an intermediate position: he agreed that soft inflation supported easing in direction, and that the low stress index and tight spreads meant markets could absorb a small move, but he was uneasy about acting against clearly priced expectations absent any stress justification, and questioned whether a full 25 basis point cut was warranted at this meeting. He therefore supported the direction while not the magnitude. The remaining participants — those attentive to inflation, employment, and the literal data — endorsed the -25 recommendation, judging that below-target and falling inflation, persistent slack, and calm financial conditions together made a measured step toward neutral the loss-minimizing course.

COMMITTEE POLICY ACTIONS

In the predictive vote on the most likely near-term 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 +25 basis points. On the separate question of the framework's loss-minimizing recommendation of -25 basis points, the Committee did not reach full agreement. Three members — those weighting inflation risk, employment, and the literal data reading — endorsed the recommendation as stated. One member, focused on financial stability, gave partial support, agreeing with the easing direction but questioning the magnitude given market-priced expectations and the absence of any stress justification. One member, weighting market-implied signals, declined to support the recommendation, judging that forward pricing and firming activity pointed toward continued removal of accommodation rather than easing.