



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The System Open Market Account held \$715.2 billion in domestic securities as of the March 9, 2005 release, the most recent available on or before the point-in-time-safe cutoff. Of this total, Treasury notes and bonds accounted for \$433.1 billion and Treasury bills for \$263.0 billion. The account was unchanged from the prior release of March 2, 2005, showing no net change over the week. It should be noted that these figures cover SOMA securities holdings only — total size, composition, and 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.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reviewed incoming data indicating that the expansion continued at a moderate pace. Core PCE inflation stood at 1.22 percent on a year-over-year basis, below the 2 percent objective. The unemployment rate was 5.4 percent, somewhat above the estimated natural rate of 5.04 percent, leaving a modest degree of labor-market slack. Initial jobless claims at 324,000 were moderate and did not point to any deterioration in labor conditions. The Chicago Fed National Activity Index at -0.28 indicated growth running slightly below trend. The Employment Cost Index reading was 98.0, and M2 money supply stood at \$6,443.3 billion. The current federal funds rate was 2.5 percent.

The Beige Book, prepared on information collected on or before February 28, 2005, reported that all twelve Districts saw increased activity, with Richmond noting some deceleration and Dallas some acceleration; New York and San Francisco reported relatively brisk growth. Consumer spending was steady to up moderately, though several Districts cited sluggish auto sales, and retailers were generally satisfied with inventories and optimistic on the outlook. Manufacturing expanded in nearly all Districts, and housing markets and residential construction were described as robust in most areas, while commercial real estate was mixed. Labor markets strengthened in almost all Districts; wages rose at a moderate pace, but many Districts reported ongoing pressures from higher benefit costs and increased difficulty locating skilled workers. A number of Districts reported higher prices for manufactures and materials, others noted some easing of input costs, and prices of consumer goods and services were mixed but relatively flat on balance.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions were broadly calm. The financial stress index at 0.0924 was very low, and the VIX at 13.15 signaled subdued volatility. The Baa corporate spread of 1.51 was tight, consistent with orderly credit conditions and little borrowing-cost strain. The 10-year/2-year Treasury yield curve spread was positive at 0.79 — flatter than earlier in the cycle but not inverted, and therefore not carrying a



near-term recession signal. The 3-month T-bill spread of 0.25 relative to the current 2.5 percent funds rate was consistent with market expectations of a policy move at this meeting.

STAFF ECONOMIC OUTLOOK

The forward-looking indicators available to the staff pointed in a somewhat mixed direction relative to the current stance. With the estimated neutral real rate (r^*) at 1.521 and core inflation running near 1.22 percent, the reference rules judged reliable this meeting all pointed toward a lower funds rate: the Taylor rule and the Balanced Approach rule each at -75 basis points, the ELB-adjusted rule at -75 basis points, and the First-Difference rule at the least aggressive -50 basis points. These readings reflected the combination of an inflation shortfall against the 2 percent objective and a residual unemployment gap of roughly 0.36 percentage point above the natural rate.

Momentum measures suggested those gaps were not widening or narrowing quickly. Inflation momentum was slightly negative at -0.015, indicating no building upward price pressure in the current data, while unemployment momentum was flat at 0.0, implying a labor market neither deteriorating nor tightening decisively toward full employment. Taken together, the reference rules and momentum readings implied that policy at 2.5 percent sat above the level a mechanical loss-minimizing reading would prescribe, though the loss function itself tempered the rules' deep-easing signals to a modest -25 basis point recommendation — a reflection that the level gaps, rather than any deterioration in trajectory, drove the rule outputs.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their initial predictive assessments, all five participants judged that a 25 basis point increase in the federal funds rate was the most likely outcome at the upcoming meeting. The common thread was that policy at 2.5 percent remained accommodative relative to a moderately expanding economy operating near its natural rate of unemployment, and that gradual removal of accommodation was warranted. Participants noted the calm financial backdrop — a low stress index, a subdued VIX, and tight Baa spreads — as leaving ample room to continue normalization without disrupting orderly conditions.

The participant most focused on inflation risk emphasized that, although core PCE at 1.22 percent was below target and left no case for a larger move, the Beige Book's reports of rising benefit costs, higher prices for manufactures and materials in several Districts, and difficulty finding skilled workers were early wage- and price-pressure signals worth pre-empting. The participant weighting labor conditions most heavily observed that unemployment above the natural rate implied some remaining slack, but stressed that the direction mattered: claims were moderate, labor markets had strengthened across nearly all Districts, and there was no rising-unemployment or job-loss trend that would justify easing.



The participant attentive to financial stability underscored that delivering the move markets were already pricing — implied by the 0.25 T-bill spread — would avoid a disruptive surprise in either direction, while the participant attentive to market signals treated that same spread as the cleanest read that a hike was expected. The data-focused participant found the 25 basis point step the most literal fit to the full body of evidence. In the rebuttal round, no participant was moved from this view; the convergence across distinct vantage points reinforced rather than challenged each member's reasoning.

The optimal-framework discussion introduced a sharper tension, since the loss-minimizing engine recommended -25 basis points — the opposite direction from the predictive vote. Participants engaged this divergence directly rather than dismissing it. Several acknowledged that with core inflation running roughly 0.8 percentage point below target, negative inflation momentum, and residual labor slack, the reference rules' easing signal had genuine substance, and that a 2.5 percent nominal rate against 1.22 percent inflation left a real rate arguably above the estimated neutral level of 1.521. The participant focused on labor conditions found the framework's easing bias intellectually persuasive, judging restrictive policy unwarranted when inflation undershoots with slack present, and endorsed -25 as an orderly step toward closing both gaps. The data-focused participant similarly accepted the tempered -25 as the honest loss-minimizing move on the data, viewing the rules' deeper cuts as overstated in magnitude and correctly discounted against a stable, expanding economy. The financial-stability participant reached endorsement from a different route: uneasy about cutting into calm markets positioned for a hike, but persuaded that if any move were made, the smallest and least disruptive one best respected the preference for gradualism, with the below-target inflation reading giving the direction real content.

Two participants declined to endorse the framework's recommendation. The inflation-focused participant maintained that forward price pressures — benefit costs, input-cost pass-through, and closing slack — argued against easing prematurely, and that 2.5 percent was better read as near-neutral than restrictive given those risks; a cut would move opposite the member's directional judgment. The market-signal participant offered a candid split: the disinflation gave the easing direction genuine substance and could not be dismissed, but market-implied pricing, the primary signal this member trusted, pointed to a hike rather than a cut, and nothing in the discussion suggested markets were distressed or misfiring. That participant characterized the gap between framework and market pricing as one of direction rather than market malfunction, and could not fully endorse an easing call against the signal it weighted most heavily.



Across both strands of deliberation, participants generally agreed that the appropriate policy stance sat close to neutral and that small moves in either direction were defensible on the current data. The disagreement that surfaced was less about magnitude — there was broad discomfort with any abrupt swing — than about which set of signals should govern direction: the level-based inflation and unemployment gaps read by the reference rules, or the forward-looking judgment of an expansion still removing accommodation and the market pricing consistent with it.

COMMITTEE POLICY ACTIONS

On the predictive question of the likely policy action, all five participants supported a 25 basis point increase in the federal funds rate, a unanimous 5-to-0 tally. On the separate question of whether to endorse the optimal-policy framework's recommendation of a 25 basis point cut, the Committee was divided: three participants endorsed the recommendation as-is — the participants emphasizing labor-market conditions, financial stability, and data-dependence — while two declined, namely the inflation-focused participant, who resisted easing while forward price pressures were visible, and the market-signal participant, whose primary indicator pointed toward a hike rather than a cut. No participant took a partial position.