



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The Committee reviewed the most recent data on the System Open Market Account, reported as of April 20, 2005. Total domestic securities holdings stood at \$715.0 billion, comprising \$432.9 billion in Treasury notes and bonds and \$263.0 billion in Treasury bills. The account was unchanged from the prior release of April 13, 2005, a change of \$0.0 billion week over 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; the review of open market operations was therefore confined to the holdings data available.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reported that the expansion remained broad-based. The Chicago Fed National Activity Index stood at 0.57, consistent with growth above its trend rate, and initial jobless claims of 317,000 pointed to a labor market without evident signs of stress. The unemployment rate was 5.2 percent, only modestly above the estimated natural rate of 5.04 percent, indicating a labor market close to balance. Core PCE inflation on a year-over-year basis was 1.28 percent, running below the 2 percent objective. The Employment Cost Index reading was 98.6, and M2 stood at \$6,475.2 billion.

The Beige Book, prepared on the basis of information collected on or before April 11, corroborated this picture of continued expansion. All twelve Districts reported that business activity continued to grow from late February through early April, with Atlanta describing a robust pace, Kansas City and San Francisco noting solid growth, and Chicago and Dallas characterizing growth as moderate; New York, Cleveland, and Richmond described more uneven or restrained conditions. More than half of the Districts reported improving retail sales, though Chicago, Dallas, New York, and Cleveland cited subdued or disappointing results. Manufacturing was described as ahead of prior levels, and residential real estate remained strong across most of the country. Of particular note, the report stated that price pressures have intensified in a number of Districts, with high or rising energy prices cited as a concern across sectors.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions were described as calm and accommodative. The financial stress index registered 0.1149, a low reading indicating an absence of systemic strain, and the VIX at 14.91 pointed to subdued expectations of market volatility. The Baa corporate spread of 1.7 percentage points was moderate, suggesting no widening of credit costs or borrowing stress. The 10-year/2-year Treasury yield curve spread was positive at 0.61 percentage point, with no inversion and thus no market signal of imminent



recession. The 3-month Treasury bill traded 0.11 percentage point above the current 2.75 percent federal funds rate, a configuration consistent with market participants anticipating a modest near-term firming of policy.

STAFF ECONOMIC OUTLOOK

The staff outlook drew on the forward-looking quantities available. With the estimated neutral real rate (r^*) at 1.396 percent and core inflation near 1.3 percent, the implied neutral nominal rate is roughly 2.7 percent — close to the current 2.75 percent funds rate — which suggests that policy is presently near neutral rather than materially restrictive. Inflation momentum was estimated at a small positive value of 0.025, and unemployment momentum at 0.0, indicating that neither price pressures nor labor conditions were shifting sharply in the near term.

The reference rules diverged in magnitude while agreeing in direction. The Taylor, Balanced Approach, and ELB-adjusted rules each pointed to a reduction of 75 basis points, driven mechanically by core inflation running about 0.72 percentage point below the 2 percent objective together with unemployment near its natural rate. The First-Difference rule, which adjusts incrementally from the prevailing rate and gives weight to momentum, pointed to a smaller move of 25 basis points. The framework judged the reference rules reliable for this meeting, and its loss-minimizing recommendation settled at a reduction of 25 basis points — closer to the gradualist First-Difference reading than to the deeper level-based cuts, reflecting the proximity of the current rate to estimated neutral and the near-flat momentum readings.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their predictive discussion, all five participants independently arrived at the view that a 25 basis point increase in the federal funds rate was the most likely near-term outcome, and the subsequent rebuttal round did not move any participant from that position. Participants generally judged that the current 2.75 percent rate remained accommodative relative to an expanding economy, and that the data offered no basis for either a pause or a larger step. The participant most focused on inflation risk emphasized the Beige Book's explicit language that price pressures had intensified across a number of Districts, with energy costs a broad concern, and treated leaning against building price pressures as the dominant task even though core PCE at 1.28 percent remained below target. The participant most attentive to employment observed that a dovish response was not warranted, since unemployment near the natural rate, contained claims, and above-trend activity revealed no labor-market deterioration to defend against. The participant weighing financial stability noted that low stress readings, a subdued VIX, and contained credit spreads meant calm conditions could readily absorb a measured move, and that surprising markets would itself be the destabilizing choice. The centrist read



the consensus of the data literally as favoring continued gradual removal of accommodation, and the participant weighting market signals pointed to the 0.11 percentage point bill spread and the positively sloped curve as a clean market expectation of a 25 basis point step. A couple of participants explicitly considered whether the intensifying price pressures argued for a larger move but concluded that the below-target inflation reading counseled a single measured step.

The character of the discussion shifted when participants turned to the framework's loss-minimizing recommendation of a 25 basis point reduction, which ran directly counter to their predictive votes. Participants engaged seriously with the divergence rather than dismissing it. There was broad agreement that the deep cuts of 75 basis points implied by the Taylor, Balanced Approach, and ELB-adjusted rules overstated the case: those rules responded mechanically to core inflation running below target and unemployment near its natural rate, while the estimated neutral nominal rate of roughly 2.7 percent placed current policy close to neutral rather than deeply restrictive. Several participants found the First-Difference rule, at 25 basis points, the most persuasive of the rule outputs precisely because it respected the near-zero momentum readings and adjusted gradually rather than lurching toward a computed level.

Where participants parted ways was on direction and on whether any easing was warranted at all. The participant most focused on employment endorsed the recommendation, reasoning that unemployment sitting above the natural rate signaled persistent slack and that tightening into sub-target inflation was the wrong direction; a modest easing toward neutral would insure the labor market while inflation remained contained. This participant characterized the Beige Book price pressures as energy-driven rather than broad wage pressures, noting that the Employment Cost Index appeared contained. The centrist likewise endorsed the recommendation, judging that the inflation undershoot dominated the level rules while near-zero momentum justified restraint on magnitude — a small, measured move that both direction and magnitude in the data supported.

Two participants declined the recommendation. The participant weighting financial stability argued that low stress, a subdued VIX, contained spreads, and a positive curve gave no stability-based case for easing, and that cutting into calm, expansionary conditions with strong residential real estate risked fueling froth; with policy already near neutral, this participant's genuine preference remained a 25 basis point increase. The participant weighting market signals similarly could not reconcile easing with the forward-looking evidence, emphasizing that the bill spread above the funds rate and the steep, non-inverted curve pointed to expected tightening, not cuts, and declined the recommendation while acknowledging 25 basis points as the minimal move if any easing were made. The inflation-focused participant took a partial stance: while accepting that the framework's choice of 25 rather than 75 basis



points reflected the same momentum caution it shared, and that this was the least objectionable of the easing options, it held that any cut was premature given broadening, energy-driven price pressures, and so could not fully endorse easing.

Across both strands of deliberation, participants converged on a shared reading of the underlying conditions — an economy expanding broadly, a labor market near balance, calm financial markets, and inflation below target but with price pressures reportedly intensifying — even as they drew different policy conclusions from those same facts. The tension between a predictive expectation of firming and a framework recommendation to ease was understood by participants as reflecting the proximity of the current rate to estimated neutral, so that the practical disagreement was one of direction near equilibrium rather than of urgency.

COMMITTEE POLICY ACTIONS

In the predictive vote on the most likely near-term policy outcome, all five participants supported a 25 basis point increase in the federal funds rate, a unanimous tally of 5 for a 25 basis point hike. On the framework's loss-minimizing recommendation of a 25 basis point reduction, the Committee was genuinely divided: two participants endorsed the recommendation as-is (the participant focused on the labor market and the data-dependent centrist), two declined it (the financial-stability participant and the market-signal participant, both preferring firming over easing), and one participant took a partial stance (the inflation-focused participant, agreeing that the direction, if easing were undertaken, should be gradual at 25 rather than 75 basis points, but not fully endorsing any cut given intensifying price pressures).