



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The Committee reviewed the most recent data on the System Open Market Account. As of January 18, 2006, total SOMA domestic securities holdings stood at \$742.4 billion, comprising \$449.1 billion in Treasury notes and bonds and \$272.8 billion in Treasury bills. This represented an increase of \$1.3 billion from the prior release of January 11, 2006. It was noted that these figures cover SOMA holdings only — total size, composition, and the week-over-week change — and do not reflect the results of repo or reverse-repo operations, for which no point-in-time-safe data source is currently available. The composition remained tilted toward notes and bonds, with bills making up somewhat more than a third of the portfolio.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reported that economic expansion continued across all twelve Federal Reserve Districts through the last several weeks of 2005. Six Districts — New York, Philadelphia, Chicago, St. Louis, Minneapolis, and Kansas City — characterized their economies as expanding moderately or modestly, while activity accelerated or increased at a solid pace in San Francisco, Richmond, Atlanta, and Dallas. Boston described activity as continuing to expand, and Cleveland reported conditions as remaining reasonably strong. Most Districts noted moderate increases in employment, with labor markets tightening in some areas and for some occupations; on the whole, however, wage increases were characterized as moderate. This picture was consistent with the national data: the unemployment rate stood at 4.9 percent, slightly below the estimated natural rate of 5.04 percent, and initial jobless claims were low at 290,000. The Chicago Fed National Activity Index registered 0.48, indicating growth somewhat above trend. The Employment Cost Index reading of 100.7 did not point to any marked acceleration in labor compensation.

On prices, core PCE inflation was running at 1.42 percent on a year-over-year basis, below the 2 percent objective. The Beige Book indicated that input-price pressures continued for many items, particularly early in the supply chain, but were less intense at year-end than earlier. Several Districts — San Francisco, Kansas City, Chicago, Richmond, Cleveland, Philadelphia, and Boston — reported that increases in energy prices had moderated or actually fallen, albeit from high levels, and in San Francisco, Cleveland, and Richmond these developments were associated with a wider easing in overall price pressures. Retail and more-finished producer prices were widely reported as rising only moderately or remaining stable. Retail sales rose in most Districts and travel and tourism spending was generally strong. Most Districts noted some cooling in residential real estate activity, while commercial real estate generally continued to improve. Consumer borrowing was flat or fell in most Districts, and commercial borrowing was more mixed.



STAFF REVIEW OF THE FINANCIAL SITUATION

The staff characterized financial conditions as broadly easy and free of evident stress. The financial stress index stood at a low 0.123, and the VIX at 13.31 pointed to subdued market volatility, if anything suggesting complacency rather than concern. Credit conditions appeared healthy: the Baa corporate spread was tight at 1.81 percentage points, giving no indication of borrowing-cost strain. The most notable feature of the term structure was its flatness — the 10-year/2-year Treasury spread was just 0.03 percentage point, close to inversion. The 3-month Treasury bill spread relative to the current funds rate was 0.0, indicating that short-term rates had fully caught up to the policy setting of 4.25 percent. M2 stood at \$6,691.6 billion.

STAFF ECONOMIC OUTLOOK

The staff's forward-looking assessment drew on the estimated neutral real rate and the momentum in the underlying data. With r^* estimated near 1.04 percent and core inflation running at 1.42 percent, the implied nominal neutral rate lies well below the current funds rate of 4.25 percent, suggesting the present stance is modestly restrictive relative to fundamentals. Inflation momentum was negative at -0.035, consistent with the Beige Book's reports of easing input-price pressures and moderating energy costs, and pointed toward continued softness in price data rather than renewed acceleration. Unemployment momentum was mildly positive at 0.05, a signal that some slack could begin to accumulate even though the level of unemployment remains near the natural rate.

The reference rules, judged reliable this meeting, reinforced this reading. The Taylor rule, the Balanced Approach rule, and the ELB-adjusted rule each pointed to easing of 75 basis points, reflecting the sub-target inflation gap and an essentially closed output gap. The First-Difference rule, which adjusts gradually from the current setting and weights momentum rather than level gaps, indicated a smaller 25-basis-point move. The framework's loss-minimizing recommendation aligned with the First-Difference output at -25 basis points, tempering the more aggressive level-based prescriptions. Taken together, these quantities imply conditions in which policy has room to move gradually toward neutral without risking a reacceleration of inflation, with the flat yield curve corroborating that the case for further tightening has largely run its course.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In the initial round of discussion, all five participants independently arrived at the view that the most likely near-term action was a further 25-basis-point increase in the funds rate, continuing the well-established gradual normalization from 4.25 percent. The participant most attentive to inflation risk emphasized that although core PCE at 1.42 percent sits below target, that member weights



inflation risk asymmetrically, and pointed to unemployment below the natural rate and continued expansion across all Districts as reasons to keep removing accommodation. The participant most focused on labor conditions concurred, noting that with the jobless rate at 4.9 percent, claims low at 290,000, and the Beige Book reporting moderate employment gains, there was no employment distress that would warrant a pause, let alone a cut — while flagging that further hikes should be resisted if labor indicators softened.

Several participants gave particular weight to the near-flat yield curve. The member focused on financial stability observed that with the 10-year/2-year spread at just 0.03 and the 3-month bill spread at zero, short rates had fully caught up to policy, and that further tightening risked inverting the curve — the recession signal that member watches most closely. The member attentive to market pricing read the same signals as indicating that policy was approaching restrictive territory and that markets were positioned for a nearly complete cycle. Both nonetheless concluded that with credit conditions benign — a tight Baa spread, low VIX, and a low stress index — a measured 25-basis-point step was consistent with calm markets rather than a source of instability. The data-focused centrist summarized the convergence: solid growth, a tight labor market, and contained inflation supported one more incremental move, with the flat curve arguing against anything larger. No participant was moved off this reading in the rebuttal round; the predictive vote was unanimous for a 25-basis-point increase.

When the discussion turned to the framework's loss-minimizing recommendation of a 25-basis-point cut, participants engaged carefully with the divergence between that call and their own predictive votes. The member most concerned with inflation acknowledged that the usual hawkish trigger was simply absent this meeting: core inflation was running cool, inflation momentum was negative at -0.035, and the Beige Book confirmed easing input-price and energy pressures. That member distrusted the 75-basis-point signal from the level-based rules as risking a reignition of inflation, but found the First-Difference logic — gradual, incremental, wary of large swings — congenial to a cautious temperament, and accepted a modest easing as defensible given the contained inflation and flattening curve, if with residual reluctance.

The labor-focused member endorsed the cut more readily, pointing to positive unemployment momentum of 0.05 as an early sign of slack forming and to the Beige Book's notes of cooling residential real estate and flat consumer borrowing as demand softening that could reach the labor market later. With a real rate estimated near 2.8 percent against an r^* of roughly 1.04 percent, that member judged policy genuinely restrictive and a step toward neutral appropriate. The financial-stability member agreed that the flat curve suggested policy near or past neutral, but cautioned against the aggressive 75-basis-point rules — easing that large into already-easy conditions could inflate asset prices and



credit excess — and favored the First-Difference gradualism as stability-preserving. The market-focused member similarly read the zero bill spread and flat curve as markets pricing policy near its destination, concluding the case for further tightening had essentially run out and that a small reversal toward neutral was defensible.

Across both rounds of the optimal-framework discussion, participants generally characterized their predictive lean toward a hike as reflecting institutional caution and policy inertia rather than what the current numbers strictly supported. The common thread was gradualism: a rejection of the large level-based prescriptions in favor of the First-Difference rule's smaller adjustment, matched to the flat-curve message and the cooling momentum in both inflation and, to a lesser extent, employment. A couple of participants underscored that direction was genuinely contested — the stance sits at or near an inflection point — but that a modest quarter-point move was the smallest and most prudent step available in either direction.

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 target federal funds rate, a unanimous 5-0 tally. On the framework's loss-minimizing recommendation of a 25-basis-point reduction, the Committee's recorded stance was full agreement: all five members endorsed the recommendation as-is, with none declining and none registering only partial agreement. The divergence between the unanimous predictive lean toward a hike and the unanimous endorsement of the framework's easing recommendation was itself noted in the discussion as evidence that the policy stance sits close to neutral, with the case for continued tightening having largely run its course.