



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The System Open Market Account held \$754.0 billion in domestic securities as of the most recent release dated March 15, 2006. Holdings were composed of \$457.2 billion in Treasury notes and bonds and \$274.1 billion in Treasury bills. This represented an increase of \$1.6 billion from the prior release of March 8, 2006. It should be noted that this account covers SOMA securities holdings only — total size, composition, and the week-over-week change — and does 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 reported that economic activity continued to expand through January and February. According to reports from the twelve District Banks, most Districts characterized the pace of expansion as moderate or steady, with one District describing a solid expansion remaining on track and another indicating that activity strengthened; growth moderated in one District and expanded only at a slow pace in another. Consumer spending continued to expand, with retail sales posting solid gains in January that contacts frequently attributed in part to unseasonably warm weather and holiday gift card redemptions. Without those factors, February retail sales softened in several regions, though sales held much of their momentum elsewhere. Light vehicle sales were widely described as sluggish or unusually slow, with vehicle inventories generally above desired levels. Manufacturing continued to expand over the first two months of the year, and business capital spending increased at a pace similar to the prior period. Residential construction and real estate activity slowed from high levels in most Districts, while commercial markets were generally more active than at the close of 2005.

The labor market remained firm. The unemployment rate stood at 4.8 percent, below the estimated natural rate of 5.04 percent, and initial jobless claims were low at 303,000. The Beige Book noted that employment continued to increase in most locations and sectors and that labor cost pressures were little changed. Core PCE inflation was running at 1.43 percent on a year-over-year basis, below the 2.0 percent objective. Contacts reported ongoing input cost pressures, but prices at the retail level increased at only a moderate rate. The Chicago Fed National Activity Index registered 0.23, and the Employment Cost Index reading was 100.7, consistent with the absence of notable wage acceleration. Household lending softened over the period, while commercial and industrial lending expanded at a modest pace. M2 stood at \$6,756.8 billion.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions remained calm and accommodative. The financial stress index was low at 0.11, and equity market volatility was very subdued, with the VIX at 11.62. Credit conditions appeared healthy,



with the Baa corporate spread contained at 1.7 percentage points and no sign of widening or systemic strain. The Treasury yield curve was essentially flat, with the 10-year/2-year spread at -0.01, a marginal inversion. The 3-month Treasury bill spread relative to the current funds rate was +0.02, indicating that market pricing was consistent with a modestly higher near-term policy rate. Taken together, these readings pointed to easy financial conditions with no evident market fragility, though the near-flat curve stood out as a mild recession-risk signal worth monitoring.

STAFF ECONOMIC OUTLOOK

The staff outlook drew on several forward-looking quantities. The estimated neutral real rate (r^*) was low, at approximately 0.99 percent, implying that with core PCE inflation near 1.4 percent a neutral nominal rate would sit meaningfully below the current 4.5 percent funds rate. On that basis, the prevailing real policy rate — roughly 3.1 percent — appeared to stand well above neutral, suggesting that the current stance was already somewhat restrictive rather than accommodative. Momentum measures reinforced this reading: inflation momentum was negative at -0.07 and unemployment momentum was -0.1, indicating that price pressures were decelerating even as labor tightness was, if anything, extending rather than reversing.

The reference rules pointed in an easing direction. The Taylor rule, the Balanced Approach rule, and the ELB-adjusted rule each implied roughly -75 basis points, driven principally by below-target inflation and the low estimate of r^* . The First-Difference rule, which adjusts incrementally from the current setting rather than solving for a level, implied -25 basis points. The reference rules were judged reliable for this meeting. The staff's loss-minimizing recommendation settled on -25 basis points, a measured step that honored the easing direction indicated by the level rules while respecting the gradualism embodied in the First-Difference approach, given still-solid growth and a firm labor market.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their initial predictive assessments, all five participants arrived independently at a 25 basis point increase, though for somewhat different reasons and with differing degrees of conviction. The member most attentive to inflation risk acknowledged that core PCE at 1.43 percent was below the 2.0 percent objective but weighted upside risks heavily, citing the Beige Book's references to ongoing input cost pressures, elevated energy prices, and resource utilization consistent with an unemployment rate below the natural rate. That member read the prior statement's signal that 'some further policy firming may be needed' as indicating the cycle was not yet complete. The member focused on financial stability grounded a similar conclusion in the calm market backdrop — a low stress index, a subdued VIX, and contained credit spreads — arguing that a single measured step would not disturb orderly conditions, while cautioning that the near-flat curve argued against moving faster than 25 basis points. The



market-signal participant emphasized that the positive 3-month bill spread was consistent with one more hike being priced and absorbable, and the data-dependent member described a measured continuation of the tightening cycle as the most literal reading of the indicators.

The participant most focused on labor conditions offered the notable qualification. In the first round this member leaned toward a hike as the likely consensus, but in the rebuttal round settled on a preference to hold at 4.5 percent. The reasoning was that the labor data showed no deterioration to defend against — unemployment below the natural rate, low jobless claims, and continued employment gains across Districts — so the usual bias toward supporting employment did not translate into a case for cutting. At the same time, with core inflation well below target and labor cost pressures described as little changed, there was no urgent inflation reason forcing further firming. This member took the marginally inverted curve seriously as a forward employment-risk signal and judged that an additional hike could press the curve deeper into inversion. While declining to endorse further firming, the member indicated a willingness not to dissent against a single measured step given the genuine strength of the labor market.

When participants turned to the framework's loss-minimizing recommendation of -25 basis points, the discussion shifted considerably. Several participants observed a striking divergence between the predictive path, which reflected the carryover of prior hawkish guidance, and what the current data and reference rules implied. Participants generally noted that core PCE was undershooting the objective and decelerating, that the estimated neutral real rate was low, and that the prevailing real policy rate near 3.1 percent therefore sat well above neutral — evidence that the stance had likely already reached or passed neutral. The three level rules pointed to roughly -75 basis points, but participants across lenses converged on the First-Difference rule's -25 basis points as the more persuasive step. The inflation-focused member framed the smaller move as the responsible compromise: acknowledging the undershoot and low r^* without abandoning vigilance against an energy-driven resurgence, and expressly resisting the full -75 as too aggressive.

The financial-stability participant found the -25 most persuasive because an abrupt -75 lurch could itself signal alarm and unsettle otherwise calm credit markets, while a modest correction respected both the inverted-curve recession signal and below-target inflation. The market-signal member reached the same destination from market pricing: the near-zero bill spread and the flat curve implied the path should turn rather than lurch, and reference rules judged reliable reinforced confidence in the easing direction. The labor-focused member framed a modest cut as insurance — easing gradually before the labor market cracks, given the recession warning in the curve — while conceding that current jobs data, with unemployment momentum negative and employment still increasing,



weakened the urgency for any large move. The data-dependent member emphasized the same literal reading: below-target inflation and above-neutral real rates justified a measured step in the easing direction, not an abrupt recalibration. In the rebuttal round no participant was moved off the -25 figure; several remarked that the arguments they heard reinforced rather than altered their preference for gradualism, and the momentum evidence added confirmation without changing direction.

COMMITTEE POLICY ACTIONS

On the predictive question of the immediate policy decision, the Committee's recorded vote was four members in favor of a 25 basis point increase in the target federal funds rate and one member preferring no change, reflecting the labor-focused member's judgment that the strength of the labor market provided no case for firming further, even as that member declined to dissent against a measured move. On the separate question of the framework's loss-minimizing recommendation of a 25 basis point reduction, the Committee was unanimous: all five members — the inflation hawk, the labor-market dove, the financial-stability voice, the data-dependent centrist, and the market-signal realist — endorsed the -25 basis point recommendation as-is, with none declining and none registering only partial agreement. Participants generally regarded the gap between the predictive hawkish path and the optimal easing recommendation as revealing that the stance had become more restrictive than the current data, the low estimate of r^* , and the marginally inverted yield curve warranted.