



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The System Open Market Account held \$756.3 billion in domestic securities as of May 3, 2006, essentially unchanged from the prior release on April 26. The composition was weighted toward Treasury notes and bonds, which stood at \$458.3 billion, with the remaining \$275.4 billion held in Treasury bills. The week-over-week change was zero, indicating no net addition or runoff over the interval. It should be emphasized that these figures cover SOMA securities holdings only — total size, composition, and week-over-week change — and do not encompass the results of repo or reverse-repo operations, for which no point-in-time-safe data source currently exists; nothing in this section should be read as characterizing short-term operating activity.

STAFF REVIEW OF THE ECONOMIC SITUATION

Economic activity continued to expand through March and the first half of April. Core PCE inflation stood at 1.64 percent on a twelve-month basis, below the 2.0 percent objective. The unemployment rate was 4.7 percent, beneath the estimated natural rate of 5.04 percent, and initial jobless claims came in at 321,000, a level consistent with steady labor conditions rather than any fraying. The Chicago Fed National Activity Index registered 0.02, pointing to growth at roughly its trend pace. The Employment Cost Index reading was 101.6, and M2 stood at \$6,776.9 billion.

The Beige Book, prepared at the Federal Reserve Bank of Boston on information collected on or before April 17, reported that all twelve Districts described continued expansion. Three Districts characterized growth as 'solid,' while several others used terms such as 'modest,' 'moderate,' or 'steady'; Richmond noted a quicker pace and Dallas indicated continued strengthening, whereas New York suggested the rate of growth may have 'slipped a bit' since the prior report. Most Districts reported manufacturing orders or revenues running ahead of year-earlier levels, though comparisons were complicated by the shift of Easter from March in 2005 to April in 2006. Housing market activity was said to be moderating in many Districts while commercial activity was firming. A majority of Districts noted that labor markets, at least for skilled workers, were tight or tightening. Energy costs remained high and selected other input costs were rising, but businesses continued to report 'limited ability to raise their selling prices.'

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions were notably calm and accommodative. The financial stress index was low at 0.1143, and the VIX stood at 11.99, an unusually subdued level suggestive of market complacency. The Baa corporate spread was tight at 1.61, giving no indication of credit-market strain. The yield curve was flat but not inverted: the 10-year/2-year spread was 0.21, barely positive, while the 3-month T-bill sat 5 basis points below the current 4.75 percent funds rate. Taken together, these readings pointed to loose



financial conditions with no signs of fragility, alongside a term structure signaling that markets viewed policy as approaching restrictive territory.

STAFF ECONOMIC OUTLOOK

The forward-looking indicators available to the staff pointed toward an economy near trend with policy sitting above neutral. The estimated neutral rate (r^*) was 0.872; combined with core inflation near 1.64 percent, this implied a nominal neutral rate in the vicinity of 2.5 percent, well below the current 4.75 percent funds rate — a stance that on its face is meaningfully restrictive in real terms. Inflation momentum was negative at -0.045, consistent with price pressures easing rather than building, and unemployment momentum was -0.1. These directional signals, together with the flat yield curve, suggested that the current setting was more likely to slow activity than to accommodate an overheating.

The reference rules underscored this reading, though they differed on magnitude. The Taylor rule, the Balanced Approach rule, and the ELB-adjusted rule each pointed to -75 basis points, reflecting the sub-target inflation level and the below-natural unemployment rate as filtered through the low r^* estimate. The First-Difference rule, which adjusts incrementally from the current stance based on changes in inflation and unemployment rather than on level gaps, indicated -25 basis points. The loss-minimizing recommendation landed at -25 basis points, with the reference rules judged reliable. The projection embedded in these figures is one in which, absent a change in stance, an above-neutral rate would continue to bear down on activity that is already at roughly trend, with disinflationary momentum reinforcing the case that restraint exceeds what fundamentals warrant.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their initial predictive round, all five participants independently arrived at a 25 basis point increase, and the discussion that followed largely served to test that convergence rather than to unsettle it. Participants generally acknowledged that core PCE at 1.64 percent sat below the 2.0 percent objective, so that realized inflation was not itself alarming. The case for continued firming rested instead on forward pressures: the inflation hawk emphasized that unemployment at 4.7 percent below the 5.04 percent natural rate signaled resource-utilization pressure, that the Beige Book confirmed tight or tightening skilled-labor markets across most Districts, and that energy and other input costs remained elevated even where pass-through was limited. Prior guidance that 'some further policy firming may be needed' was cited by several participants as consistent with one more measured step.

The labor-market-focused participant, whose mandate leans toward guarding against employment weakness, observed that the data showed no such weakness to protect against — jobless claims were



low and stable and the labor market was genuinely tight — and therefore saw no basis to resist a modest hike, while noting that a tight market below the natural rate could eventually feed wage pressure. The financial-stability participant highlighted the calm across stress signals, with the low stress index, subdued VIX, and tight Baa spread indicating no fragility that would argue against a quarter-point move, but flagged the near-flat curve as a caution against anything larger. The market-signal participant read the sub-rate T-bill and barely positive 10-2 spread as markets pricing one further standard step with the path near its end, and the centrist framed the 25 basis point move as the most literal, consensus-consistent reading of contained-but-upward-tilted risks. In rebuttal, no participant was moved from +25; the flat curve and low stress were seen as ruling out a 50 basis point move, while broad growth and firm labor were seen as ruling out a pause.

When the discussion turned to the optimal-policy framework, which recommended -25 basis points, participants confronted a direct divergence from their predictive vote and engaged it seriously rather than defending their forecasts. Several observed that their +25 call had leaned on the prior 'further firming' guidance, and that the framework's math told a different story: with r^* near 0.872 and core inflation near 1.64 percent, a nominal neutral around 2.5 percent left 4.75 percent looking clearly restrictive. The inflation hawk, while reiterating residual concern about tight skilled-labor markets and high energy costs, accepted that negative inflation momentum and firms' 'limited ability to raise selling prices' undercut the classic case for holding, and endorsed a cautious single step that would unwind excess restriction without abandoning vigilance.

The labor-market participant read the moderating housing activity, New York's slipping growth, and the Chicago Fed index at 0.02 as early signs that demand might be cooling, and favored easing modestly before labor weakened materially. The financial-stability participant returned to the yield curve, warning that further hikes risked pushing a near-flat structure into inversion — a destructive tightening of conditions — while insisting that benign, even complacent, credit markets gave no cause for a large lurch. Across the group there was broad agreement that the three level rules at -75 basis points overweighted the inflation shortfall given firm labor and trend growth, and that the First-Difference rule's -25 basis points, gradual and momentum-based, was the more persuasive logic. The final rebuttal round produced no reversals: participants converged on the view that policy stood at or above neutral, that downward momentum in both inflation and unemployment argued for relieving rather than adding restraint, and that a measured quarter-point reduction reconciled the aggressive gap rules with the gradualist adjustment without shocking calm markets.

COMMITTEE POLICY ACTIONS



In the predictive vote, all five participants supported a 25 basis point increase in the target rate, a unanimous 5-0 tally reflecting the prior guidance and the forward inflation and labor-market considerations discussed above. On the separate question of the optimal-policy framework's recommendation of a 25 basis point reduction, the Committee's recorded stance was full agreement: all five participants — the inflation hawk, the labor-market dove, the financial-stability voice, the data-dependent centrist, and the market-signal realist — endorsed the recommendation as-is, with none declining and none registering only partial agreement, for a tally of 5 endorse, 0 decline, 0 partial.