



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The Committee reviewed the composition of the System Open Market Account as of June 21, 2006. Total SOMA domestic securities holdings stood at \$762.6 billion, comprising \$464.6 billion in Treasury notes and bonds and \$275.4 billion in Treasury bills. Holdings were unchanged from the prior release of June 14, 2006, a week-over-week change of \$0.0 billion. It was noted for the record that this review covers SOMA holdings only — total size, composition, and week-over-week change — and does not encompass repo or reverse-repo operation results, for which no point-in-time-safe data source is currently available.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reported that core PCE inflation stood at 1.85 percent on a year-over-year basis, modestly below the 2.0 percent reference figure. The unemployment rate was 4.6 percent, below the estimated natural rate of 5.04 percent, indicating a tight labor market. Initial jobless claims were 308,000, a low and stable reading. The Employment Cost Index was recorded at 101.6, and the Chicago Fed National Activity Index at 0.03, consistent with growth near its trend pace. M2 money supply stood at \$6,797.1 billion. The current federal funds rate was 5.0 percent.

The most recent Beige Book, prepared on information collected on or before June 5, indicated that economic activity continued to expand from mid-April to early June, though with some signs of deceleration. Activity moderated in four Districts — Atlanta, Kansas City, Richmond, and San Francisco — and the New York District noted increased concern about the outlook for the second half. Seven Districts reported growth similar to the prior report, while Philadelphia reported improvement. Consumer spending continued to increase but at a slower rate, and residential real estate markets continued to cool across the country. Manufacturing still expanded strongly but showed more areas of weakness than earlier in the spring, while commercial real estate and service-producing industries were generally strong. Labor markets continued to tighten, with more Districts reporting difficulty finding skilled workers; wage pressures were described as moderate overall, the exception being workers with hotly demanded skills. High energy costs were fueling price increases in manufacturing and, to a much lesser extent, retail, with reports of costs being passed forward varying considerably.

STAFF REVIEW OF THE FINANCIAL SITUATION

The staff characterized financial conditions as broadly calm. The financial stress index registered 0.1377, a low reading, and the VIX stood at 15.88, indicating subdued equity-market volatility. The Baa corporate spread was 1.69, a contained level consistent with the good credit quality reported in the Beige Book. More cautionary were the term-structure signals: the 10-year/2-year Treasury spread was



essentially flat at -0.03 , and the 3-month Treasury bill yield sat 20 basis points below the current funds rate. Together these suggested that market participants viewed the policy rate as at or near the peak of the tightening path and did not anticipate aggressive further firming.

STAFF ECONOMIC OUTLOOK

The staff outlook drew on the forward-looking quantities available. The estimated neutral real rate (r^*) was 0.927 percent. With core inflation near 1.85 percent, this implies a neutral nominal rate in the neighborhood of 2.8 percent, well below the current 5.0 percent funds rate — a configuration indicating that the prevailing stance is meaningfully restrictive relative to neutral. Momentum readings were soft in both directions: inflation momentum was only 0.11, giving little indication of accelerating price pressure, and unemployment momentum was -0.1 , consistent with a labor market that is cooling gradually rather than overheating.

The reference rules, judged reliable by the framework, pointed predominantly toward easing. The Taylor rule, Balanced Approach rule, and ELB-adjusted rule each prescribed -75 basis points, reflecting sub-target core inflation and a policy rate far above the levels those rules imply. The First-Difference rule, which adjusts from the current stance and reacts to changes rather than to a single level estimate of r^* , prescribed no change. Reconciling the aggressive level-rule prescriptions against the gradualism of the First-Difference rule, the framework's loss-minimizing recommendation settled on a measured -25 basis point step — a calibration back toward neutral that acknowledges restrictiveness without lurching, consistent with the inverted curve and negative bill spread but not with any crisis dynamic given the low stress readings.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their predictive discussion, participants converged on the view that the most likely near-term policy action was a further 25 basis point firming, and all five arrived at that assessment despite differing weights on the underlying risks. The member most focused on inflation risk emphasized that core PCE at 1.85 percent, while below target, was accompanied by upside risks: energy and commodity costs fueling price increases in manufacturing, a labor market tight at 4.6 percent against a 5.04 percent natural rate, and Beige Book reports of employers struggling to find skilled workers. This participant read the prior guidance that 'some further firming may yet be needed' as still operative and data-dependent, and judged one more measured step warranted to secure price stability.

Other participants placed greater weight on signs of moderation and on the term structure. The member attentive to labor conditions observed that the current data showed no employment deterioration — jobless claims low and stable, labor markets still tightening — so no case for easing was



triggered; but this participant's caution ran toward reluctance to keep tightening into a flat-to-inverted curve that could threaten jobs six to twelve months out. The financial-stability member and the market-signal member both flagged the 10-year/2-year spread at -0.03 and the 3-month bill 20 basis points below the funds rate as warnings that policy was already near restrictive territory, cautioning strongly against a 50 basis point move even as they judged a single measured hike defensible and most probable. The centrist member, reading the data literally, noted that tight labor and energy-driven price pressure supported continued measured tightening against a backdrop of contained inflation and calm markets. The predictive discussion thus produced a unanimous lean toward +25 basis points, with several participants stressing a strong preference that any such step be the last.

When participants turned to the framework's loss-minimizing recommendation of -25 basis points, the discussion sharpened around the gap between institutional momentum and the rules' read of restrictiveness. Several participants observed that with r^* estimated near 0.93 percent and a real funds rate around 3.15 percent, policy was well above neutral — a gap corroborated by the inverted curve and the negative bill spread. The Taylor, Balanced Approach, and ELB-adjusted rules all prescribing -75 basis points reinforced the view that the level of rates had overshot, while the First-Difference rule's prescription of no change tempered the case for moving quickly. Momentum readings — inflation at 0.11, unemployment at -0.1 — were cited repeatedly as evidence that no accelerating pressure justified holding a restrictive stance.

A majority of participants concluded that a measured -25 basis point easing was the appropriate calibration toward neutral. The labor-focused member found the Balanced Approach logic most persuasive, viewing a small cut as employment insurance against the curve-signaled downturn without abandoning inflation vigilance given core inflation only just below target. The financial-stability member judged that a single step would remove marginal restriction and slightly steepen the curve, protecting credit conditions without spooking inflation expectations, and stressed that low stress readings argued against the aggressive -75 the level rules implied. The centrist read -25 as the literal compromise between the level rules and the First-Difference rule, and the market-signal member noted that the negative bill spread and inverted curve validated policy as at or past neutral. The inflation-focused member dissented from the easing direction: while acknowledging that the case for further hiking had weakened, this participant found the First-Difference prescription of holding most persuasive, arguing that energy pass-through and a below-natural-rate unemployment level cautioned against relaxing vigilance prematurely, and that a hold better balanced restrictiveness against unresolved price risk.



Across both strands of the discussion, participants generally agreed that the economy was decelerating gradually rather than sharply, that financial conditions remained calm with no forcing event, and that the flat-to-inverted curve was a genuine caution against additional firming. The principal divergence lay in whether the appropriate response to demonstrated restrictiveness was a measured step back toward neutral or a hold pending clearer resolution of the energy-driven inflation risk.

COMMITTEE POLICY ACTIONS

In the predictive vote on the likely near-term policy action, all five members supported a 25 basis point increase, a tally of 5 to 0. On the framework's loss-minimizing recommendation of a 25 basis point reduction, four members endorsed the recommendation as-is — the labor-market member, the financial-stability member, the data-dependent centrist, and the market-signal member — while the inflation-focused member declined, preferring to hold the current stance given unresolved upside price risk. The recorded optimal-side outcome was thus 4 to 1 in favor of the -25 basis point recommendation, with no partial positions.