



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The Committee reviewed the most recent data on the System Open Market Account. As of March 14, 2007, total SOMA domestic securities holdings stood at \$777.3 billion, comprising \$468.6 billion in Treasury notes and bonds and \$277.0 billion in Treasury bills. This represented no change from the prior release of March 7, 2007, a flat reading of essentially \$0.0 billion week over week. The staff noted that these figures cover SOMA holdings only—total size, composition, and the change from the prior release—and do not encompass repo or reverse-repo operation results, for which no point-in-time-safe data source is currently available. Accordingly, no discussion of temporary open market operations was included in this review.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reported that core PCE inflation stood at 1.81 percent on a twelve-month basis, modestly below the 2.0 percent reference. The unemployment rate was 4.5 percent, well below the estimated natural rate of 5.04 percent, and initial jobless claims registered 308,000, a level consistent with a still-firm labor market showing no upward drift. The Chicago Fed National Activity Index came in at 0.24, indicating activity somewhat above its historical trend. The Employment Cost Index reading was 104.2, and M2 money supply totaled \$7,081.1 billion. The current federal funds rate was 5.25 percent.

The March 7 Beige Book, prepared on information collected on or before February 26, characterized most Districts as reporting modest expansion, though several noted some slowing. New York described growth as well-maintained but with a few signs of deceleration, while St. Louis reported slower activity than the prior period, Boston noted some softening, and Dallas said activity continued to decelerate; Philadelphia, by contrast, reported conditions improved slightly. Retail sales grew steadily in most Districts, though vehicle sales remained sluggish, and demand for services continued to expand, with strong gains in health care, accounting, legal, and technology services. Manufacturing was steady or expanding despite continued weakness tied to construction and autos. Almost all Districts reported housing markets remaining weak, though signs of stabilization were noted in several, while commercial real estate continued to firm. Most Districts reported further expansion in labor markets and continued tight supply of skilled and professional workers, with wage pressures increasing slightly in several Districts even as pay increases remained moderate overall. Most Districts characterized price pressures as little changed; energy and construction-related materials prices fell, while food input costs rose in several Districts.

STAFF REVIEW OF THE FINANCIAL SITUATION



The staff reported that financial conditions remained broadly benign. The financial stress index stood at 0.1104, a low reading, and the VIX at 17.27 indicated moderate expected volatility with no sign of acute market disruption. Credit markets appeared contained, with the Baa corporate spread at 1.72. The yield curve, however, carried a cautionary signal: the 10-year/2-year spread was essentially flat-to-inverted at -0.01, and the 3-month Treasury bill spread stood at -0.29 relative to the current funds rate, indicating that money-market pricing sat below the prevailing policy rate. Taken together, the data pointed to calm current conditions coexisting with market-implied expectations that the next policy move was more likely to be an easing than a firming.

STAFF ECONOMIC OUTLOOK

Looking ahead, the staff framed its projection around the real forward-looking quantities available. The estimated neutral real rate (r^*) used in the analysis was 1.143 percent; with core PCE near 1.8 percent and the nominal funds rate at 5.25 percent, the implied real policy rate stands well above this neutral estimate, consistent with a policy stance that is currently restrictive. Inflation momentum was slightly negative at -0.015 and unemployment momentum was likewise small and negative at -0.05, together suggesting that underlying conditions are drifting gradually rather than shifting sharply in either direction—easing inflation pressure alongside a labor market not yet deteriorating.

The reference rules were judged reliable under current conditions. The Taylor rule, Balanced Approach rule, and ELB-adjusted rule each pointed to a substantial reduction of 75 basis points, reflecting the below-target core reading and the wide unemployment gap relative to the natural rate. The First-Difference rule, which responds to the change in conditions rather than the full level of the gaps, indicated a more restrained 25 basis point reduction. Reconciling these against the small momentum readings, the framework's loss-minimizing recommendation was a modest 25 basis point cut—an outcome that leans toward gradual adjustment from the current stance rather than a full recalibration to the level implied by the gap-driven rules. The projection implied that, absent a fresh inflation impulse or a growth shock, conditions were likely to justify a measured removal of restriction over time rather than either aggressive easing or renewed firming.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In the predictive phase of the deliberation, all five participants independently favored holding the federal funds rate at 5.25 percent. Participants generally judged that core PCE at 1.81 percent, just below the 2.0 percent reference, removed the urgency to firm further, while a labor market with unemployment at 4.5 percent—well beneath the 5.04 percent natural rate—and jobless claims at 308,000 offered no trigger for easing. One participant, weighting inflation risk most heavily, emphasized that high resource utilization retains the potential to sustain inflation pressures, pointing to



the Beige Book observations that wage pressures had increased slightly, skilled-worker supply remained tight, and food input costs had risen in several Districts even as energy and construction materials fell. This participant characterized price pressures as 'little changed' rather than clearly abating, and argued that holding preserved optionality to firm should inflation reaccelerate.

A participant focused on labor market conditions concurred with holding but framed the stance as conditional vigilance, noting that the participant's own mandate would justify easing only on evidence of rising unemployment or slowing job growth—neither of which was present. The same participant flagged the inverted 10-year/2-year spread and the negative T-bill spread as forward-looking recession signals warranting close attention. A participant attentive to financial stability likewise supported patience, observing that a stress index of 0.1104, a VIX of 17.27, and a contained Baa spread of 1.72 revealed no acute strain, while cautioning that a firming into softening housing and decelerating Districts would be counterproductive. Participants weighting market pricing most heavily read the -0.29 T-bill spread as evidence that markets already anticipated eventual easing rather than immediate action, reinforcing the case for no change this meeting.

When the deliberation turned to the framework's loss-minimizing recommendation of a 25 basis point reduction, participants engaged directly with the divergence between that recommendation and their predictive holds. Several observed that the Taylor, Balanced Approach, and ELB-adjusted rules each called for a 75 basis point cut driven by the below-target core reading and the wide unemployment gap, but judged those level-based rules to overshoot because the current 5.25 percent stance sits far above their implied optimum and because no actual labor deterioration had yet appeared. There was broad agreement that the First-Difference rule, at 25 basis points, offered the most persuasive logic: it adjusts from the current stance in proportion to the small momentum readings (inflation at -0.015, unemployment at -0.05) rather than resetting to a gap-anchored level.

Participants advancing the optimal case emphasized different rationales for the same modest step. The labor-focused participant argued that a 25 basis point cut represented preemptive insurance for employment, removing restriction before the deceleration described in the Beige Book—New York, St. Louis, Boston, and Dallas all slowing, with construction and auto weakness bleeding into labor-intensive manufacturing—could show up in the aggregate unemployment rate; the participant reasoned that waiting for unemployment to rise before acting risked acting too late. The participant weighting financial stability held that gradualism at 25 basis points would relieve curve-inversion pressure without the disorderly repricing a 75 basis point cut might signal, contending that so large a move could imply a degree of alarm the calm stress data did not support. The market-signal participant noted that the -0.29 bill spread implied roughly one cut being priced, precisely matching a 25 basis point step, and



that the level rules over-eased given a labor market still firm. The data-dependent participant found that the 25 basis point synthesis matched a face-value reading of the indicators—below-target inflation plus a genuine inversion signal, without crisis urgency.

The participant weighting inflation risk most heavily remained the most reserved. This participant reiterated that the buffer below target was thin, that unemployment far below the natural rate signaled utilization capable of sustaining price pressure, and that with the CFNAI at 0.24 above trend and claims stable at 308,000, no growth collapse compelled aggressive easing. While rejecting the 75 basis point rules outright and acknowledging the 25 basis point step as a defensible, marginal move that would preserve optionality, the participant stated a continued unease about cutting at all while resource use is high, and could not fully endorse the recommendation—accepting its direction as insurance while preferring a hold or a smaller step.

COMMITTEE POLICY ACTIONS

In the predictive vote, all five participants supported maintaining the target federal funds rate at 5.25 percent, a unanimous 5-to-0 outcome. On the framework's loss-minimizing recommendation of a 25 basis point reduction, the Committee's recorded stances were four endorsements and one partial: the participants focused on labor market conditions, financial stability, data-dependence, and market signals each endorsed the 25 basis point cut as recommended, while the participant weighting inflation risk most heavily returned a partial position—agreeing with the direction of a modest easing as insurance but not fully endorsing its magnitude or timing, given continued concern about inflation persistence amid high resource utilization. No participant declined the recommendation outright.