



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The System Open Market Account held \$783.4 billion in domestic securities as of the release dated May 2, 2007. Of this total, Treasury notes and bonds accounted for \$471.9 billion and Treasury bills for \$277.0 billion. The portfolio was unchanged from the prior release of April 25, 2007, a week-over-week change of \$0.0 billion. It should be noted that this review covers SOMA holdings only—total size, composition, and the change from the prior release. It does not encompass repo or reverse-repo operation results, for which no point-in-time-safe data source currently exists; accordingly, no discussion of those operations is included here.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reviewed incoming data indicating that overall activity was expanding at a pace near trend. The Chicago Fed National Activity Index stood at 0.05, consistent with growth close to its historical average. Core PCE inflation was running at 1.69 percent on a twelve-month basis, below the 2.0 percent level the Committee has treated as its reference. Labor market indicators pointed to continued tightness: the unemployment rate was 4.4 percent, well below the estimated natural rate of 5.05 percent, and initial jobless claims were low at 301,000. The Employment Cost Index registered 105.1, and M2 stood at \$7,170.1 billion.

The Beige Book material described services activity continuing to increase across most Districts, particularly among firms serving business customers, with generally positive tourism. Residential real estate remained the principal soft spot, with sales declining in many Districts and flat in others, and several Districts reporting reduced homebuilding; Boston was an exception, noting some improvement in sales volume. Commercial real estate was described as active, with reports of robust commercial construction. Lending activity was mixed, with weakening residential mortgage activity offset by increases in commercial and industrial lending, though several Districts noted little or no overall loan growth. Most Districts reported tight labor markets, especially for skilled occupations, with several noting faster wage growth for skilled workers but only modest overall wage increases. Consumer prices were characterized as generally stable, even as most Districts reported rising input and energy costs. Retail sales reports were generally positive, with several Districts attributing some strength to the early Easter; apparel and spring merchandise sold well while demand for home goods was soft in some areas.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions were broadly calm. The financial stress index stood at 0.1239, a low reading indicating no aggregate tightening or dislocation, and the VIX at 13.08 pointed to subdued expected volatility. The Baa corporate spread of 1.66 percentage points was contained, showing no sign of credit



distress or widening. The 10-year/2-year Treasury spread was flat at 0.0, a muted rather than deeply inverted recession signal. The 3-month Treasury bill traded 46 basis points below the current federal funds rate of 5.25 percent, a spread the staff read as consistent with market expectations of some eventual easing rather than any current stress demanding immediate action.

STAFF ECONOMIC OUTLOOK

Taking the available forward-looking quantities together, the staff outlook pointed to conditions that were mildly restrictive relative to a lower estimated neutral setting. The estimated neutral real rate (r^*) used in the analysis was 1.208 percent; with core inflation near 1.7 percent, this implied a neutral nominal rate on the order of 2.9 to 3.0 percent, well below the prevailing 5.25 percent funds rate. Inflation momentum was slightly negative at -0.12 , suggesting no near-term acceleration and, if anything, continued gradual softening. Unemployment momentum was essentially flat at 0.05 , implying no imminent labor-market deterioration on the current trajectory.

The reference rules were judged reliable and clustered toward easing, though they differed in magnitude. The Taylor rule, the Balanced Approach rule, and the ELB-adjusted rule each indicated -75 basis points, reflecting sub-target inflation combined with a sizable negative unemployment gap. The First-Difference rule, which adjusts incrementally from the current stance using momentum rather than resetting to an estimated level, indicated -25 basis points. The framework's loss-minimizing recommendation was -25 basis points, favoring a measured single step over the larger level-based moves. On this projection, the likely path of conditions was one in which policy remained above neutral while realized inflation stayed contained, leaving room for gradual movement toward a less restrictive setting absent a shock.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their initial predictive discussion, participants converged on maintaining the target rate at 5.25 percent. Several observed that core PCE inflation at 1.69 percent was below the 2.0 percent reference, but recalled that the prior statement had named inflation the predominant policy concern and had warned it might fail to moderate. One participant weighting inflation risk most heavily argued that this vigilance remained warranted despite the softer core reading, pointing to unemployment at 4.4 percent against a 5.05 percent natural rate, low claims at 301,000, and Beige Book reports of faster skilled-wage growth and rising input and energy prices—upside pressures that high resource utilization could sustain. A participant focused on employment reached the same conclusion from the opposite direction: with no rising unemployment or slowing job growth, the trigger that would prompt easing to protect jobs was simply not present. A participant attentive to financial stability noted that the stress index at 0.1239, the VIX at 13.08, and the Baa spread at 1.66 all pointed to calm markets with no



systemic trigger for a cut. The data-dependent participant read the indicators literally as showing contained-but-not-yet-moderated inflation alongside a firm labor market, and the market-signal participant emphasized that the 46-basis-point negative T-bill spread implied eventual easing but nothing imminent at this meeting.

The rebuttal round produced no change in the predictive stance; each participant reported that the others' arguments reinforced rather than altered the case for holding. The employment-focused participant reiterated that housing weakness had not yet spread into broad labor deterioration, while flagging the flat yield curve as a mild caution worth monitoring. The stability-focused participant stressed that mixed lending—weakening residential mortgages offset by commercial and industrial growth—showed no contagion. Participants noted the negative T-bill spread as a signal of anticipated easing but agreed that market pricing of future cuts was not a mandate for immediate action.

The discussion took on a different character once participants turned to the framework's loss-minimizing recommendation of -25 basis points and the reference-rule outputs behind it. Several acknowledged a genuine tension: with the estimated neutral real rate at 1.208 percent and inflation near target, the current 5.25 percent setting was meaningfully restrictive, and the Taylor, Balanced Approach, and ELB-adjusted rules all called for -75 basis points. Most participants found the First-Difference rule's -25 basis points more persuasive than the larger level-based moves, judging that near-zero momentum readings counseled a small incremental step rather than a full reset toward neutral. The employment-focused participant was notably candid, concluding that a +0 vote had been anchored to stale hawkish framing and that negative inflation momentum of -0.12 suggested the predominant-concern worry had quietly softened; a modest cut, in this view, would serve as preemptive insurance against housing spillover before employment cracked. The stability-focused participant, initially inclined to hold, was persuaded that policy was mildly tight and that a measured -25 would validate the easing markets already anticipated without shocking spreads or re-igniting credit exuberance—an outcome a -75 move risked.

The centrist and market-signal participants reached the same measured conclusion by their own routes. The centrist read the -25 recommendation as the literal middle ground: sub-target inflation and a restrictive stance supported easing, while tight labor and calm markets cautioned against an outsized single-meeting move. The market-signal participant judged that the -0.46 T-bill spread and flat curve pointed to modest easing rather than the -75 the output-gap rules demanded, and concluded that the prior hold had lagged the market signal.

The inflation-focused participant dissented from this reconciliation. While acknowledging that policy was restrictive and that restriction was the chosen tool against inflation, this participant maintained



that -0.12 inflation momentum was too slight to retire an inflation-risk regime, that the sub-target core reading reflected past moderation rather than immunity, and that latent wage and input-cost pressures from a tight labor market still warranted caution. With growth near trend, no financial stress, and no urgency to ease, this participant preferred to preserve optionality and tolerate more restrictiveness, declining to endorse even the modest step.

COMMITTEE POLICY ACTIONS

On the predictive question of the appropriate policy for this meeting, the Committee's vote was unanimous to maintain the target federal funds rate at 5.25 percent, with all five members holding (5-0). On the separate question of the framework's loss-minimizing recommendation of -25 basis points, the Committee did not reach full agreement: four members endorsed the recommendation as-is—the labor-market, financial-stability, data-dependent, and market-signal participants—while one member, the inflation-focused participant, declined to support it, judging that lingering inflation risk argued for preserving the current restrictive stance. There were no partial endorsements.