



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

No System Open Market Account holdings data was available on or before the point-in-time-safe cutoff for this meeting, and consequently the Committee could not review the total size, composition, or change from the prior release of the portfolio. Members were advised that this discussion covers SOMA holdings only; it does not extend to the results of repurchase or reverse-repurchase operations, for which no point-in-time-safe data source currently exists. In the absence of the underlying holdings series, the staff offered no quantitative characterization of open market operations for the intermeeting period.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff review pointed to broadly weak economic activity in the wake of the September 11 attacks. Reports from all Federal Reserve Districts described soft conditions in September and the first weeks of October, with a short period of sharply reduced activity immediately following the attacks. Retail sales, apart from autos, softened in September and early October in nearly all Districts, though the staff noted that some of this weakness may have already been under way before September 11. Auto sales fell at the outset of the period but rebounded following new zero-financing incentive plans. Both shipments and orders across a broad range of manufactured goods, from steel to semiconductors, were weak in most of the country, and construction generally slowed. The Chicago Fed National Activity Index stood at -0.18, consistent with below-trend growth.

Labor-market indicators showed signs of strain. Initial jobless claims were elevated at 483,000, and the Beige Book reported layoffs and plant closings across many industries and Districts, ranging from financial services on the East Coast to media and advertising on the West Coast to auto parts in the central states. The unemployment rate was 4.9 percent, still modestly below the estimated natural rate of 5.07 percent. On prices, core PCE inflation was running at 1.23 percent on a year-over-year basis, well below the 2.0 percent objective. The Beige Book noted little upward pressure on either wages or prices and, in some cases, outright declines. Insurance premiums had increased and security precautions were disrupting productivity.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions remained fragile and reflected elevated market anxiety following the September shock. The VIX stood at 33.46, signaling heightened volatility and risk aversion, while the financial stress index at 0.1854 pointed to tighter but not extreme overall conditions. The Baa corporate spread of 3.35 indicated meaningful credit-market stress, with borrowing costs elevated for lower-rated corporate issuers. The 10-year/2-year Treasury spread remained positive at 1.96, so the yield curve was



not inverted. At the front end, however, the 3-month Treasury bill traded at a spread of -0.49 relative to the current 2.5 percent funds rate, which the staff characterized as consistent with market expectations of further near-term easing.

STAFF ECONOMIC OUTLOOK

The staff outlook emphasized that most forward-looking quantities pointed toward continued weakening in activity and subdued price pressures. Inflation momentum was negative at -0.125 , indicating that price pressures were not merely low but still receding from an already below-target starting point. Unemployment momentum was positive at 0.25 , implying that the jobless rate was likely to drift upward from 4.9 percent even though it remained below the estimated natural rate; the elevated level of initial claims reinforced the expectation of a near-term rise. Taken together, these momentum readings described an economy absorbing a demand shock rather than one settling back toward trend.

The reference rules spanned a wide range, reflecting the tension between still-favorable level readings and deteriorating momentum. The Taylor rule prescribed 75 basis points and the ELB-adjusted and Balanced Approach rules each pointed to 25 basis points, all anchored in part on an estimated neutral rate of 3.834 percent and on an unemployment rate still below its natural level. By contrast, the First-Difference rule, which responds to the change in conditions rather than the level of the gaps, prescribed -50 basis points. With the reference rules judged reliable, the optimal policy engine's loss-minimizing recommendation settled at -25 basis points, a figure positioned between the level-based rules counseling restraint and the momentum-based rule counseling more aggressive easing.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their predictive discussion, participants converged from a range of analytical perspectives on the view that policy should ease by 50 basis points. The member most attentive to inflation risk observed that core PCE at 1.23 percent was well below the 2.0 percent target and that the Beige Book reported little wage or price pressure, with some prices falling outright. In this reading, the usual caution against cutting while inflation is elevated simply did not bind: the operative concern was disinflation stemming from the post-September 11 demand shock, not any latent inflation danger. With the VIX at 33.46 and the Baa spread at 3.35, this participant judged that the risk of doing too little clearly dominated the risk of reigniting inflation from so soft a base.

The participant weighting labor-market risk most heavily framed the case in terms of employment. Initial claims at 483,000 were described as alarmingly elevated, and the Beige Book's account of layoffs



and plant closings across financial services, media, and auto parts was taken as evidence that unemployment would rise sharply notwithstanding its current reading below the natural rate. This member favored forceful easing to get ahead of a deteriorating labor market rather than reacting after the fact. The participant focused on financial stability emphasized the fragility of credit and funding conditions, noting that the 3-month bill spread of -0.49 indicated markets had already priced close to a full 50-basis-point cut; delivering less risked a disorderly repricing and an unwelcome tightening at precisely the wrong moment. The member most attentive to market signals treated that front-end pricing as the single most decisive indicator, and the data-dependent centrist stressed that the data were uniformly weak across activity, labor, and prices, with no inflation constraint to hold policy back. All five participants maintained their -50 positions through the rebuttal round, with several observing that a 25-basis-point move would be inadequate to the severity of the shock while a larger move risked appearing panicked without clear benefit.

When the discussion turned to the framework's loss-minimizing recommendation of -25 basis points, participants engaged directly with the tension between the level-based and momentum-based reference rules. The inflation-focused member found the compromise persuasive, reasoning that with the funds rate already at 2.5 percent and unemployment still below the natural rate, the ELB-adjusted and Balanced Approach rules argued for preserving optionality and avoiding an overreaction to a shock-driven slowdown; this member judged -25 basis points to be the measured, disciplined pace and endorsed it. The data-dependent centrist likewise endorsed the recommendation, characterizing -25 as the literal median of the rules and the loss-minimizing balance, easing meaningfully against disinflation and stress without exhausting limited policy room from an already-low starting point.

The remaining three participants agreed with the direction of easing but regarded the magnitude as insufficient. The labor-market member held that the First-Difference rule's -50 output better captured the deterioration momentum evident in the 483,000 claims figure and the positive unemployment momentum, and worried that a 25-basis-point move risked a hawkish surprise relative to the priced path. The financial-stability member made a parallel argument grounded in credit conditions, contending that under-delivering against a market that had priced close to a full cut risked disappointing fragile markets and tightening conditions; while acknowledging the merit of conserving ammunition, this member judged that 2.5 percent left ample room and that hoarding accommodation now risked a costlier stress spiral. The market-signals member similarly held that the -0.49 bill spread priced a full 50-basis-point cut almost exactly and that surprising markets in fragile post-shock conditions would tighten financial conditions perversely. Each of these three characterized their stance as direction-right but magnitude-too-small.



Across both the predictive and optimal-framework discussions, participants agreed on several points: that inflation posed no constraint on easing given core PCE well below target and negative inflation momentum, that the Taylor rule's 75-basis-point prescription rested on a neutral-rate estimate of 3.834 percent that several judged stale in a shocked economy, and that the appropriate direction for policy was clearly lower. The genuine disagreement centered entirely on magnitude and on how much weight to give the market-implied path and deterioration momentum against the caution urged by the level-based rules and the value of preserving policy room.

COMMITTEE POLICY ACTIONS

In the predictive vote, all five participants supported a 50-basis-point reduction in the target federal funds rate, a unanimous tally of five for -50 basis points. On the framework's loss-minimizing recommendation of -25 basis points, the Committee did not reach full agreement: two members endorsed the recommendation as it stood, and three members registered partial agreement, supporting the direction of easing but preferring a larger cut, while no member declined the recommendation outright. Specifically, the inflation-focused member and the data-dependent centrist endorsed -25 basis points, while the labor-market, financial-stability, and market-signals members took partial positions favoring a deeper reduction.