



## **DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS**

The Manager reported that total System Open Market Account domestic securities holdings stood at \$654.9 billion as of October 15, 2003, up \$0.2 billion from the prior release on October 8. The portfolio was composed of \$399.6 billion in Treasury notes and bonds and \$241.9 billion in Treasury bills. The week-over-week change was modest, consistent with routine portfolio management rather than any shift in the stance of open market operations. It should be noted that these figures cover SOMA securities holdings only — total size, composition, and the change from the prior release. They do not encompass repo or reverse-repo operation results, for which no point-in-time-safe data source is currently available; nothing in this report should be read as characterizing that activity.

## **STAFF REVIEW OF THE ECONOMIC SITUATION**

The staff reported that the pace of economic expansion appeared to have picked up. According to the most recent Beige Book, prepared on the basis of information collected before October 7, ten of the twelve Districts indicated that activity was expanding, while Boston and Cleveland reported mixed but steady conditions. Consumer spending generally strengthened, though most Districts noted a recent pullback in auto sales, and retailers anticipated modest year-over-year gains for the holiday season with inventories described as at or near desired levels. Manufacturing activity strengthened in most Districts, and residential real estate and construction showed broad-based strength, though commercial real estate remained sluggish. The Chicago Fed National Activity Index registered 0.14, and the disruptions from Hurricane Isabel in the Richmond District were reported to have been short-lived.

On prices and labor, the staff noted that both wages and prices of finished goods and services remained relatively stable, with only scattered reports of business input cost pressures. Core PCE inflation stood at 1.02 percent on a year-over-year basis, well below the 2 percent objective. The unemployment rate was 6.1 percent, above the estimated natural rate of 5.05 percent, and initial jobless claims were 387,000. Manufacturing employment was described as generally weak despite the broader firming in activity, though a few Districts noted pockets of hiring. Banks in almost all Districts reported a substantial drop-off in refinancing activity since the prior report, with some pickup in business loan demand; credit quality was generally described as good, with only scattered reports of increased delinquencies.

## **STAFF REVIEW OF THE FINANCIAL SITUATION**

The staff characterized financial conditions as calm and broadly accommodative. The financial stress index stood at 0.0888, a low reading, and the VIX at 16.55 indicated subdued expected volatility. The Baa corporate spread of 2.39 percentage points pointed to moderate, benign borrowing costs with no



evident credit-market widening, consistent with the Beige Book's report of generally good credit quality. The Treasury yield curve was steeply positive, with the 10-year/2-year spread at 2.49 percentage points and no sign of inversion. The 3-month Treasury bill spread relative to the current 1.0 percent funds rate was slightly negative at -0.09 percentage point, suggesting that market participants anticipated steady rates with, if anything, a faint residual easing bias, and certainly no near-term tightening.

### STAFF ECONOMIC OUTLOOK

The staff outlook drew on several forward-looking reference points. The estimated neutral real rate ( $r^*$ ) used in the policy analysis was near 2.49 percent, which, against a current nominal funds rate of 1.0 percent and low measured inflation, implied that the real stance of policy remained accommodative but was sensitive to further disinflation. Inflation momentum was estimated to be slightly negative at -0.065, indicating that the shortfall relative to the 2 percent objective was tending to widen rather than close, while unemployment momentum was estimated at 0.0, suggesting that labor-market slack was not yet self-correcting even as activity firmed.

The reference rules spanned a wide range. The Taylor rule prescribed a 50 basis point increase, reflecting its sensitivity to conditions when inflation is treated as near target, while the Balanced Approach rule pointed to a 75 basis point reduction and the ELB-adjusted rule likewise to a 75 basis point reduction, both giving greater weight to the combined inflation and unemployment gaps. The First-Difference rule indicated a 50 basis point reduction. The loss-minimizing synthesis across these rules recommended a 50 basis point reduction. Taken together, the momentum readings and the preponderance of rule outputs implied that, absent a stronger pass-through from firming activity into prices and hiring, the balance of forward risks tilted toward inadequate accommodation rather than overheating, with the proximity of the funds rate to its lower bound adding an asymmetric dimension to that assessment.

### PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their predictive discussion of the likely policy decision, all five participants judged that the Committee would most probably leave the funds rate unchanged at 1.0 percent. The participant most attentive to inflation risk observed that, with core PCE near 1.02 percent, the live danger was disinflation rather than overheating; his usual inclination to guard against price pressure offered no support for a hike, since the premise for tightening — elevated inflation risk — was simply not present in the data. At the same time, he saw no case for easing, reasoning that the current stance was already very accommodative, that expansion was broadening across ten of twelve Districts, and that a premature cut could sow future inflation risk. The participant most focused on the labor market emphasized unemployment at 6.1



percent, elevated claims at 387,000, and the Beige Book's description of manufacturing employment as generally weak, a pattern he characterized as a jobless recovery. Yet with the rate already at 1.0 percent, he judged that a further cut would consume much of the remaining conventional easing capacity for a labor market that, though soft, was not deteriorating sharply.

The participant attentive to financial stability found no stress requiring a response: the stress index, the VIX, and the Baa spread were all subdued, and the yield curve was steeply positive with no inversion. He flagged the sharp drop-off in refinancing activity as worth watching but read it as a normalization from the refi boom rather than a deterioration in credit quality. The data-dependent participant took a similar literal reading of the numbers — soft inflation, persistent slack, calm markets — and concluded that a move in either direction would be unwarranted. The participant who weighs market pricing most heavily noted that the slightly negative 3-month bill spread implied markets expected steady-to-slightly-easier policy, so that a hike would be a genuine shock, while the breadth of the expansion argued against a cut. In the rebuttal round, no participant was moved from a hold, and the predictive view converged unanimously.

The discussion then turned to the framework's loss-minimizing recommendation of a 50 basis point reduction, and here the participants engaged more searchingly with the tension between the incoming activity data and the mandate arithmetic. Several participants observed that the twin gaps pointed in the same direction: core PCE roughly a full point below target, with negative momentum, and unemployment more than a point above its estimated natural rate, with slack not yet improving. The participant focused on financial stability advanced the argument that most tested the others — that holding the rate steady while inflation drifted lower would let real rates creep up, a passive tightening into a fragile recovery, and that near the lower bound the asymmetric risk of a downward drift toward deflation warranted preemptive insurance. The labor-focused participant found this point reinforcing, noting that such passive tightening would bite precisely the employment recovery he cared about most, and he endorsed the 50 basis point reduction as squarely consistent with his employment-first priority. The data-dependent participant likewise endorsed the recommendation, reasoning that with both mandate legs undershooting simultaneously the literal reading of the numbers pointed to accommodation, and that the Beige Book's firming was qualitative and forward-looking while the hard data still showed the gaps.

Other participants accepted the direction of the recommendation but questioned its magnitude. The inflation-focused participant agreed that the deep undershoot and negative momentum justified easing rather than holding, and even acknowledged the risk that below-target inflation could unanchor expectations downward — a genuine inflation-direction concern for him — but worried that a full 50



basis point cut into a strengthening economy could fuel later inflation and spend limited ammunition, favoring a smaller step. The financial-stability participant, having made the case for insurance against deflation, similarly concluded that with activity genuinely reviving and markets calm, a decisive-but-smaller move would better preserve scarce policy room. The market-signal participant made the same reservation from a different angle: the modest negative bill spread corroborated at most a residual easing bias, not an urgent deflation scare, and with expansion picking up across ten Districts he judged that firming activity and calm conditions argued against front-loading the full 50 basis points, even as he accepted that the stance was mildly too tight relative to the mandate optimum. Participants generally reconciled the gap between the unanimous predictive hold and the framework's easing call as evidence that current policy was modestly too tight against a purely mandate-based benchmark, with the improving but backward-lagging activity data explaining the expected caution.

#### **COMMITTEE POLICY ACTIONS**

On the predictive question of the likely policy decision, the Committee's vote was unanimous for no change in the target funds rate, holding at 1.0 percent, with all five participants concurring. On the separate question of the framework's loss-minimizing recommendation of a 50 basis point reduction, the outcome was a genuine split. Two participants — the one focused on the labor market and the data-dependent participant — endorsed the recommendation as-is. The remaining three — the inflation-focused participant, the participant attentive to financial stability, and the participant who weighs market pricing — took a partial view, agreeing with the easing direction but not with the full magnitude of the recommended cut, citing the breadth of the firming activity, calm financial conditions, and the value of preserving limited policy room near the lower bound. No participant declined the recommendation's direction outright.