



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The Manager reported on developments in the System Open Market Account. As of the most recent release dated November 26, 2003, total SOMA domestic securities holdings stood at \$662.9 billion, comprising \$406.2 billion in Treasury notes and bonds and \$243.3 billion in Treasury bills. This represented an increase of \$1.8 billion from the prior release of November 19, 2003. It should be noted that these figures cover SOMA holdings only — total size, composition, and week-over-week change — and do 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 reviewed the incoming economic data. Core PCE inflation was running at 1.02 percent on a year-over-year basis, well below the 2.0 percent objective. The unemployment rate stood at 6.0 percent, roughly a full point above the estimated natural rate of 5.05 percent, indicating meaningful slack remaining in the labor market. Initial jobless claims registered 357,000, still at an elevated level, though the Beige Book prepared at the Federal Reserve Bank of Atlanta characterized labor market conditions as having 'generally stabilized after an extended period of weakness,' with several districts noting a slowing in layoffs and stronger demand for temporary workers. The Chicago Fed National Activity Index at 0.04 placed overall activity near its historical trend.

The Beige Book indicated that the economy 'continued to expand in October and early November,' with improvements described as 'reasonably broadly based' across a number of industries, even as descriptions of the pace of growth varied across districts. Wages and prices of finished goods and services 'remained fairly stable,' although some increases in input prices were reported and virtually all districts continued to flag concerns about rising health care costs. A majority of districts reported year-over-year gains in retail spending and generally positive holiday expectations. Manufacturing activity picked up in most districts, but few reported factory-sector employment gains. Residential real estate was characterized as strong nearly everywhere, while commercial real estate markets remained weak, and banking contacts generally described loan demand as subdued.

STAFF REVIEW OF THE FINANCIAL SITUATION

The staff reviewed financial conditions, which were broadly calm. The financial stress index stood at a low 0.0858, and the VIX at 16.27 pointed to subdued equity-market volatility. The Baa corporate spread of 2.3 percentage points was moderate and showed no signs of widening credit distress. The Treasury yield curve was steeply positive, with the 10-year/2-year spread at 2.31, offering no recession signal. The 3-month T-bill spread relative to the current funds rate was slightly negative at -0.08, consistent



with market participants expecting steady policy or, at most, a faint easing bias in the near term. M2 stood at \$6,089 billion. Taken together, the indicators suggested that markets were functioning normally and were not pricing an imminent policy move in either direction.

STAFF ECONOMIC OUTLOOK

The staff outlook drew on the forward-looking quantities available. The estimated neutral real rate (r^*) of 2.346 percent, set against core inflation running near 1 percent, implied that a neutral nominal policy setting would sit well above the current 1.0 percent funds rate — a configuration that, on a level basis, would ordinarily point toward firmer policy. The reference rules reflected this tension: the Taylor rule prescribed 75 basis points, the Balanced Approach rule 50 basis points, and the ELB-adjusted rule 50 basis points, all above the prevailing rate. The First-Difference rule, by contrast, prescribed -50 basis points.

The divergence among the rules turned on how they treated the persistent inflation shortfall and the momentum in the data. Inflation momentum registered 0.03 and unemployment momentum -0.05 — both weak, indicating only marginal improvement and no self-correcting upward pull toward the target. The level rules key off the output and employment gaps while assuming inflation near target, and thus tend to lag an ongoing disinflation; the First-Difference rule responds to the change in conditions and reads the soft momentum as calling for additional accommodation. Reference rules were assessed as reliable. On balance, the loss-minimizing framework, weighing the below-target inflation gap and the roughly one-point unemployment gap against benign financial conditions, pointed toward a modest easing of 25 basis points as the calibrated response.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their initial round of discussion, all five participants independently favored holding the funds rate at 1.0 percent. Reasoning from an inflation-focused perspective, one participant emphasized that core PCE at 1.02 percent was less than half the 2.0 percent target, so disinflation, not inflation, was the operative reality; input-price increases and health care costs were worth watching as forward signals but did not amount to elevated inflation risk. The participant weighing labor market conditions most heavily stressed that unemployment at 6.0 percent remained nearly a full point above the natural rate and that claims at 357,000 signaled a market that had stabilized but not healed, with factory-sector hiring still lagging the pickup in manufacturing. The participant attentive to financial stability observed that the low stress index, subdued VIX, moderate Baa spread, and steep yield curve all indicated calm, orderly markets, so that an unexpected move in either direction would itself be the destabilizing action. The data-dependent participant read the data literally as supporting a hold — low inflation and persistent slack coexisting with a broadening but modest expansion — while the participant focused on



market signals noted that the slightly negative T-bill spread and the absence of any priced-in move argued for steady policy.

In the rebuttal round, no participant was moved off the hold position. The labor-focused participant weighed whether to press for a cut to support employment, but judged that a cut would look premature against confirmed, broadly based expansion with the funds rate already near its floor, while remaining ready to ease should employment indicators reverse. The inflation-focused participant likewise saw no case to cut, viewing further accommodation amid calm conditions as risking future inflation for little marginal benefit. The convergence was genuine rather than deferential: participants arrived at the same conclusion from inflation, labor, financial-stability, data-dependent, and market-signal starting points. The predictive vote was accordingly unanimous for no change.

The discussion then turned to the framework's loss-minimizing recommendation of -25 basis points, which diverged from the participants' hold. Here the tenor of the deliberation shifted. The inflation-focused participant reconsidered the direction of inflation risk, reasoning that with core PCE barely half of target and inflation momentum essentially flat at 0.03, the genuine threat ran downward — toward further disinflation — and that guarding against below-target inflation was symmetric to guarding against overshooting. On that logic, an anti-cut reflex calibrated to above-target risk was miscalibrated to present conditions, and a modest easing amounted to insurance rather than emergency action. The labor-focused participant found the First-Difference rule most persuasive as a reading of persistent employment weakness, and took the divergence between hold and -25 as evidence that the current stance was already effectively too tight for the labor market by the loss function's measure.

The participant attentive to financial stability framed the question as whether a 25-basis-point cut would threaten stability, and concluded it would not: with stress at 0.0858 and spreads contained, calm conditions could absorb a modest easing without disruption, and the slightly negative T-bill spread suggested such a move would not surprise markets. The data-dependent participant characterized the gap between hold and -25 as small but tipped toward action by the persistent inflation shortfall, noting that the level rules overstated the needed rate given ongoing disinflation while the First-Difference rule captured the soft momentum. The market-signal participant treated the -0.08 T-bill spread as quietly endorsing easing while stress stayed low, reading -25 as the moderated step — consistent with what market pricing already implied — rather than the fuller -50 of the First-Difference rule.

Across the final round of rebuttal, participants generally agreed that the level rules (Taylor at 75, Balanced Approach at 50, ELB-adjusted at 50) assumed inflation near target and lagged the disinflation underway, and that the First-Difference rule at -50 read the disinflationary drift more



accurately. Several observed that the Beige Book's signs of broadening recovery — expansion described as reasonably broadly based, positive holiday expectations, CFNAI near trend — had underpinned their predictive hold, and that the difference between that instinct and the framework's call reflected genuine uncertainty near the low rate floor rather than a sharp disagreement about direction. On balance, participants judged the disinflation gap combined with a roughly one-point unemployment gap to be the dominant, persistent problem, and viewed a measured easing at negligible financial-stability cost as the technically correct loss-minimizing response.

COMMITTEE POLICY ACTIONS

In the predictive vote on the current policy decision, the Committee was unanimous in favoring no change to the funds rate, holding at 1.0 percent, by a vote of 5 to 0. On the separate question of the framework's loss-minimizing recommendation of -25 basis points, all five members endorsed the recommendation as-is, with none declining and none registering partial agreement — a tally of 5 endorse, 0 decline, 0 partial. The inflation-focused, labor-focused, financial-stability, data-dependent, and market-signal participants each endorsed the -25 basis point call, having reconciled their predictive hold with the framework's assessment that the persistent below-target inflation gap and remaining labor slack, set against calm financial conditions, warranted a modest easing as insurance against further disinflation.