



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The Committee reviewed developments in the System Open Market Account. As of the November 3, 2004 release, total SOMA domestic securities holdings stood at \$706.0 billion, comprising \$431.3 billion in Treasury notes and bonds and \$259.4 billion in Treasury bills. This represented an increase of \$1.4 billion from the prior release of October 27, 2004. It should be noted that these figures cover SOMA securities holdings only — total size, composition, and week-over-week change — and do not encompass the results of repo or reverse-repo operations, for which no point-in-time-safe data source is currently available.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reported that economic activity continued to expand through September and early October. Core PCE inflation stood at 1.21 percent on a year-over-year basis, below the 2.0 percent objective. The unemployment rate was 5.4 percent, modestly above the estimated natural rate of 5.04 percent, and initial jobless claims registered 332,000, a level consistent with steady but unremarkable labor conditions. The Chicago Fed National Activity Index at 0.04 pointed to growth roughly in line with trend rather than an accelerating or overheating economy. The current federal funds rate was 1.75 percent.

The Beige Book, prepared on the basis of information collected before October 18, indicated that activity continued to expand across most Districts, with several reporting continued expansion, a couple noting a quickened pace, and others suggesting growth had moderated somewhat; one District cited widespread hurricane-related disruptions. Business outlays appeared to pick up in most regions, with modest increases in both capital spending and hiring, while consumer spending was mixed by District and category. Residential real estate activity remained robust in most Districts, whereas nonresidential activity was still relatively weak. Manufacturing increased further. Many reports indicated that higher energy costs were constraining consumer and business spending, and businesses continued to express concern over rising input costs. Notably, more manufacturers and business service providers were reportedly able to pass part — if not all — of these cost increases along to customers, though increases in wages and retail prices were generally described as subdued. Household loan demand softened somewhat while business loan demand picked up.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions were broadly calm and accommodative. The financial stress index registered 0.0885, a low reading, and the VIX stood at 14.04, indicating subdued market volatility. Credit conditions appeared orderly, with the Baa corporate spread contained at 2.08 percentage points over Treasuries. The Treasury yield curve remained positively sloped, with the 10-year/2-year spread at 1.49



percentage points, giving no signal of imminent recession from the term structure. At the front end, the 3-month Treasury bill yield sat 0.17 percentage point above the current federal funds rate, a spread roughly consistent with market participants pricing in a near-term policy move. Taken together, these indicators suggested no financial-market strain that would constrain a change in policy.

STAFF ECONOMIC OUTLOOK

The staff outlook drew on the forward-looking quantities available. With the estimated neutral real rate (r^*) near 1.745 percent and core inflation running near 1.2 percent, the current nominal funds rate of 1.75 percent implied a real policy rate well below neutral, characterizing the stance as still accommodative. Inflation momentum was modestly positive at 0.16, and unemployment momentum was negative at -0.1, suggesting that price pressures were firming only mildly while the labor market was improving gradually. Neither momentum reading pointed to an accelerating imbalance in either direction.

The reference rules, judged reliable this meeting, spanned a range: the Taylor rule indicated no change, the First-Difference rule indicated -25 basis points, and both the Balanced Approach and ELB-adjusted rules indicated -75 basis points. The dispersion reflected the tension between an inflation shortfall relative to target and above-natural unemployment on the one hand, and a policy rate already deeply accommodative in real terms on the other. The more aggressive rules weighted the inflation and employment gaps heavily; the First-Difference rule, which relies on momentum rather than a precise r^* estimate, produced the more modest adjustment. The loss-minimizing recommendation aggregating these inputs was -25 basis points, implying that on a purely gap-based reading, conditions left room for modest easing rather than for tightening.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In the predictive phase of the deliberation, participants converged on a measured 25 basis point increase in the federal funds rate. Members generally judged that policy at 1.75 percent remained accommodative relative to an economy the Beige Book described as broadly expanding, with business outlays and hiring picking up. The participant weighting inflation risk most heavily emphasized emerging cost-push signals: rising energy costs and the observation that more firms were now able to pass input cost increases along to customers, characterizing this as a genuine pass-through risk even though core PCE at 1.21 percent remained below target. That member argued for continuing to remove accommodation while conditions permitted, but noted that subdued wage and retail price increases did not yet warrant an aggressive move.

The participant most attentive to labor conditions concurred with the 25 basis point step while framing the question in terms of whether current conditions warranted a pause or cut to support employment.



That member concluded they did not: unemployment at 5.4 percent was only modestly above the natural rate estimate, claims were moderate rather than spiking, and the Beige Book reported modest hiring gains. Crucially, this member observed that a 1.75 percent rate was accommodative rather than restrictive given a negative real rate, so a measured step did not threaten the tentative labor recovery. The participant focused on financial stability underscored the benign backdrop — a low stress index, subdued volatility, and contained credit spreads — arguing that markets were calm enough to absorb continued gradual normalization without disruption, and that an abrupt larger move or an unexpected pause would risk introducing volatility. The participant weighting market pricing pointed to the front-end T-bill spread of 0.17 percentage point as roughly consistent with a 25 basis point move already being anticipated, and the data-dependent member read the indicators at face value as pointing to continued measured removal of accommodation.

When the deliberation turned to the framework's loss-minimizing recommendation of -25 basis points, a genuine divergence emerged between the members' predictive stance and the gap-based optimum. All participants acknowledged that the recommendation rested on defensible foundations — core inflation below target, unemployment above the natural rate, and reference rules judged reliable — and several singled out the First-Difference rule as the most persuasive of the four, since it grounds action in observed momentum and avoids overreliance on an uncertain r^* estimate. The participants focused on labor conditions and on data at face value found the case for modest easing compelling. The labor-focused member reasoned that with inflation no obstacle and hiring only tentative, restrictive tightening risked choking off fragile gains, and that the First-Difference rule's -25 basis point path was gradual and appropriate. The data-dependent member noted that both mandate legs read soft, that the rule average skewed easier, and that the -25 basis point figure sat as a measured middle between the neutral Taylor reading and the more aggressive -75 basis point rules.

Other participants declined to endorse the easing direction despite respecting the framework's internal logic. The member weighting inflation risk maintained that cutting from an already deeply accommodative stance risked re-igniting inflation precisely as cost pass-through was building, and judged that current policy was near neutral rather than restrictive. The financial-stability voice reasoned that the recommendation optimized purely on inflation and employment gaps while ignoring that calm credit and equity markets could readily tolerate normalization; with the real rate deeply negative and no stress signals present, that member saw easing as risking future imbalances rather than addressing any current fragility. The market-signals member emphasized that the front-end spread and the steep, positively sloped curve pointed to an efficient forward path of gradual normalization upward, not down, and could not endorse easing when market pricing and conditions pointed the other way. Across both phases, no participant advocated a larger move or a pause in the



predictive vote, and the disagreement in the optimal phase centered on the asymmetry between a gap-based reading that saw room to ease and a conditions-and-pricing reading that saw room to normalize.

The discussion made clear that much of the divergence reflected differing judgments about how to treat an accommodative starting point. Members who declined the easing recommendation stressed that a 1.75 percent rate with a real rate below neutral described a still-stimulative stance from which continued removal of accommodation was warranted; members who endorsed it stressed that the observable data — below-target inflation and above-natural unemployment, with subdued wage and price gains — did not yet justify tightening. Both sides agreed that financial conditions were calm, that the reference rules were reliable, and that momentum readings were mild, and both favored gradual, incremental adjustment over abrupt moves in either direction.

COMMITTEE POLICY ACTIONS

In the predictive vote, all five participants supported a 25 basis point increase in the federal funds rate, a unanimous 5-0 outcome. On the framework's loss-minimizing recommendation of -25 basis points, the Committee was divided: two participants — the member focused on labor market conditions and the data-dependent member — endorsed the recommendation as consistent with below-target inflation and remaining labor slack, while three participants — the member weighting inflation risk, the financial-stability voice, and the market-signals member — declined to support it, judging that an already accommodative stance, building cost pass-through, calm markets, and market pricing of gradual normalization argued against easing. There were no partial endorsements. The recorded optimal-side tally was thus two to endorse and three to decline.