



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The System Open Market Account's domestic securities holdings were reviewed as of the December 1, 2004 release. It should be emphasized that these figures cover SOMA holdings only — their total size, composition, and week-over-week change. They do not encompass repo or reverse-repo operation results, for which no point-in-time-safe data source is presently available; the staff accordingly confined this review to the confirmed holdings data.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff review characterized the economy as expanding broadly. The Chicago Fed National Activity Index stood at 0.85, a reading consistent with growth above its longer-run trend. The Beige Book, prepared on information collected before November 22, reported continued economic growth from mid-October to mid-November, with eleven of twelve Districts noting expansion. New York, Philadelphia, Atlanta, and Dallas each described a pickup in the pace of activity since their prior reports; Minneapolis characterized its expansion as broad-based and San Francisco described regional activity as solid, while Richmond, Chicago, and Kansas City saw moderate gains and St. Louis viewed its gains as modest. Only Cleveland reported little change. Manufacturing and service-sector activity increased across the country, though consumer spending was uneven — a few Districts reported stronger retail sales while many described mixed, flat, or slower conditions, and automobile sales were flat to down across most Districts, with several noting higher-than-desired dealer inventories.

On the labor and price side, the unemployment rate was 5.4 percent, somewhat above the estimated natural rate of 5.04 percent. Initial jobless claims stood at 343,000. Core PCE inflation on a year-over-year basis was 1.17 percent, running below the 2 percent objective. The Employment Cost Index registered 97.1 and M2 stood at \$6,342.7 billion. The Beige Book added that residential real estate activity generally remained at high levels but continued to show signs of cooling in a number of Districts, that nonresidential activity appeared to be turning the corner in several areas, that business lending was strengthening while consumer and mortgage lending was mixed, and that many agricultural producers anticipated large or record crop production, with energy-related activity remaining strong.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions were broadly calm and accommodative. The financial stress index stood at 0.0861, a low reading, and the VIX at 13.67 pointed to subdued volatility. The Baa corporate spread over Treasuries was 1.96, a relatively tight level consistent with well-functioning credit markets, and the 10-year/2-year yield curve spread was positive at 1.28, giving no signal of an impending contraction.



The 3-month Treasury bill rate sat 21 basis points above the current 2.0 percent federal funds rate, a spread pointing toward a near-term firming of policy. Taken together, these readings indicated no distress that would impede an orderly adjustment of the policy stance, and were corroborated by Beige Book contacts reporting strengthening business lending and, in the securities industry, increased inflows into stock mutual funds along with a pickup in issuance and merger-related activity.

STAFF ECONOMIC OUTLOOK

With the federal funds rate at 2.0 percent and core inflation near 1.17 percent, the implied real policy rate stood at roughly 0.83 percent, below the estimated neutral real rate (r^*) of 1.665 percent — an arithmetic that leaves the current stance on the accommodative side of neutral. The momentum figures pointed mildly downward on both mandate legs: inflation momentum was estimated at -0.105 and unemployment momentum at -0.1, suggesting price pressures easing somewhat further and the labor market improving only slightly rather than tightening decisively. On these projections, absent a policy change, conditions would likely evolve with inflation remaining below the 2 percent objective for some time and unemployment closing its modest gap to the natural rate only gradually.

The reference rules, judged reliable at this meeting, uniformly pointed lower: the Taylor rule at -50 basis points, the Balanced Approach rule at -75, the First-Difference rule at -50, and the ELB-adjusted rule at -75. These outputs reflect the sizable inflation shortfall and, in the case of the balanced-approach specification, the added weight placed on the unemployment gap. The loss-minimizing framework tempered these signals to a recommendation of -25 basis points, reflecting a projection that modest accommodation is warranted by below-target inflation and residual slack, but that the aggressive cuts implied by the steepest rules would risk overshooting given genuine ongoing expansion in real activity.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In the predictive rounds, participants converged fully on a 25 basis point increase in the federal funds rate. The unifying assessment was that a 2.0 percent funds rate remained accommodative against a backdrop of solid, broad-based growth, and that continued gradual removal of accommodation was appropriate. Several participants pointed to the Chicago Fed activity index at 0.85 and the Beige Book's eleven expanding Districts as evidence of real momentum, with the participant most attentive to labor conditions observing that unemployment at 5.4 percent, only slightly above the 5.04 percent natural rate, and claims at 343,000 gave no sign of a deteriorating job market that would argue against firming. The participant focused on financial stability noted that low stress, a benign VIX, and tight credit spreads indicated markets could readily absorb a measured hike, while the participant weighting market signals emphasized that the 3-month bill sitting 21 basis points above the funds rate aligned



almost exactly with a single 25 basis point step already being priced. Even the participant most concerned with inflation, while acknowledging that core PCE at 1.17 percent was below target and therefore posed no immediate price threat, judged that a negative-to-near-zero real rate amid a tightening labor market warranted preemptive, gradual normalization.

The optimal-framework deliberation introduced a genuine tension, because the loss-minimizing engine recommended a 25 basis point cut rather than a hike, with the reference rules pointing further down still. Participants engaged this divergence seriously rather than dismissing it. Those who came to endorse the framework's recommendation grounded their reasoning in the literal data. The labor-focused participant emphasized that unemployment above the natural rate constituted real slack, that unemployment momentum of -0.1 showed the job market not tightening decisively, and that inflation momentum of -0.105 left ample room to prioritize employment support; on this view, hiking into slack while inflation cooled risked stalling the recovery, and a modest ease was the disciplined step, with some sympathy expressed for the deeper balanced-approach cut. The data-dependent participant reached the same conclusion by a face-value reading: both mandate legs showed slack, all four rules were flagged reliable and pointed negative, and the most literal, consensus interpretation of the provided numbers favored accommodation, not tightening — with the anticipatory hike case resting on forward expectations that exceeded what the data directly supported.

The three participants who declined the framework's recommendation did not deny the arithmetic so much as weigh other considerations more heavily. The participant attentive to inflation risk reframed his mandate as caution about easing as much as about hiking: with the economy expanding, lending strengthening, and no disinflationary spiral in evidence, adding stimulus now would in his judgment plant the seed of future inflation, and he distrusted the steep -75 rule readings as overweighting the employment gap and leaning on a contested r^* estimate. The financial-stability participant argued that none of the easing case rested on a stability signal — stress at 0.0861 , the VIX at 13.67 , and the Baa spread at 1.96 all pointed to calm, healthy credit markets — and that easing into placid conditions with strengthening lending risked fueling froth; he read the framework's own rejection of the -75 cuts as consistent with his anti-overreaction instinct, even as its -25 direction contradicted his conditions-based view. The market-signal participant held that efficient pricing embodied in the 21 basis point bill spread already digested the below-target inflation and labor slack and still pointed toward a hike, so that the framework's cut contradicted what markets actually expected.

Reconciling these strands, participants generally acknowledged that the current 2.0 percent stance sits near a boundary. With the real funds rate around 0.83 percent against an r^* of 1.665 percent, several read policy as still accommodative and therefore appropriately due for further gradual firming; the



rules, keying off the inflation shortfall and slack, instead read policy as modestly too tight relative to neutral. A couple of participants observed that both camps in fact rejected the aggressive rule cuts, differing chiefly on the direction of the small, incremental adjustment the First-Difference logic and mild downward momentum would support. The discussion left the divergence between the anticipated policy path and the loss-minimizing recommendation clearly on the record, with participants divided on whether the soft inflation reading or the accommodative real rate and calm conditions should govern the next step.

COMMITTEE POLICY ACTIONS

On the predictive question of the policy action, the Committee voted unanimously, 5 to 0, in favor of a 25 basis point increase in the target federal funds rate. On the separate question of the framework's loss-minimizing recommendation of a 25 basis point cut, the Committee was divided: two members endorsed the recommendation as-is — the participant focused on labor-market conditions and the data-dependent participant — while three members declined it, namely the participant weighting inflation risk, the participant focused on financial stability, and the participant weighting market signals. No member took a partial position. The optimal-side tally was thus 2 to endorse and 3 to decline, reflecting the genuine tension between a below-target inflation reading that argued for accommodation and an accommodative real rate amid calm markets and solid growth that argued for continued firming.