



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The System Open Market Account held \$740.8 billion in domestic securities as of November 30, 2005, the most recent release on or before the point-in-time-safe cutoff. Of this total, \$449.6 billion was in Treasury notes and bonds and \$271.3 billion in Treasury bills. Relative to the prior release of November 23, holdings edged down by \$0.2 billion, essentially unchanged. Members were reminded that these figures cover SOMA securities 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 currently exists; no inference about temporary operations should be drawn from the holdings data alone.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reported that economic activity continued to expand from mid-October through mid-November, according to reports from the twelve Federal Reserve Banks. Manufacturing and services activity increased in most Districts, and retail sales were generally positive, though many Banks reported only modest year-over-year gains and auto sales softened in a number of Districts in October. The Chicago Fed National Activity Index stood at 0.33, consistent with growth somewhat above trend. Labor market conditions were firm: the unemployment rate was 5.0 percent, essentially at the estimated natural rate of 5.04 percent, and initial jobless claims were 321,000. The Beige Book noted that hiring activity increased in many Districts and that some Banks observed a slight tightening in labor markets. The Employment Cost Index reading was 100.1.

On prices, core PCE inflation was 1.52 percent on a year-over-year basis, below the 2.0 percent objective. The Beige Book reported persistent input price pressures and concerns about high energy prices across most Districts, with consumer price pressures increasing moderately in some Districts and mixed reports on firms' ability to pass input costs through to consumers. In the housing sector, residential real estate activity remained high in most Districts but many reported a slowing or cooling, and residential mortgage lending slowed in several Districts; a number of Districts noted strengthening commercial real estate activity. M2 stood at \$6,627.2 billion. The current federal funds rate was 4.0 percent.

STAFF REVIEW OF THE FINANCIAL SITUATION

The staff characterized financial conditions as calm and accommodative. The financial stress index was low at 0.1278, and the VIX stood at 11.52, a very subdued level. Corporate credit conditions appeared healthy, with the Baa spread over Treasuries at 1.88, a relatively tight reading that suggested no borrowing strain. The most notable feature of the term structure was the near-flat yield curve: the



10-year/2-year spread was just 0.07, edging toward but not reaching inversion. The 3-month Treasury bill traded roughly 0.1 below the current 4.0 percent funds rate, a configuration that suggested market participants anticipated little in the way of aggressive further tightening. Taken together, the readings pointed to orderly, low-volatility markets with the flattening curve as the principal signal warranting monitoring.

STAFF ECONOMIC OUTLOOK

Looking ahead, the staff noted that the estimated neutral real rate (r^*) of 1.104, combined with core inflation near 1.5 percent, implied a neutral nominal rate in the neighborhood of 2.6 percent — well below the prevailing 4.0 percent funds rate. On its face, that gap suggested the current policy stance was already restrictive relative to neutral. Inflation momentum was modestly negative at -0.095 , indicating that price pressures were, if anything, easing at the margin despite the input-cost and energy concerns flagged in the Beige Book. Unemployment momentum was slightly positive at $+0.05$, a small upward drift consistent with a labor market at or near balance rather than one showing accelerating slack.

The reference rules, judged reliable for this meeting, pointed uniformly toward easing but differed on magnitude. The Taylor rule, the Balanced Approach rule, and the ELB-adjusted rule each prescribed -75 basis points, reflecting below-target inflation and an essentially closed unemployment gap. The First-Difference rule, which adjusts from the current stance in response to momentum rather than reoptimizing to an implied level, prescribed a more gradual -25 basis points. The framework's loss-minimizing recommendation aligned with the First-Difference reading at -25 basis points, implying that if conditions evolve as the momentum figures suggest — contained and slightly cooling inflation, a labor market drifting marginally toward more slack — a modest downward adjustment toward neutral would be the direction most consistent with minimizing projected losses, with the flattening curve reinforcing that policy had limited room to move higher.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their predictive discussion, participants unanimously anticipated a 25 basis point increase in the federal funds rate to 4.25 percent. The reasoning converged from several distinct starting points. Emphasizing inflation risk, one participant argued that although core PCE at 1.52 percent sat below the 2.0 percent objective, the Beige Book's account of persistent input-price pressures, high energy costs, and some pass-through kept the upside risk to prices live enough that a 4.0 percent rate remained accommodative given full employment. From an employment-focused perspective, another participant observed that with unemployment at 5.0 percent essentially at the 5.04 percent natural rate, initial claims low at 321,000, and hiring rising, there was no labor-market weakness that could



justify a cut — while noting the flattening curve, cooling housing, and slowing mortgage lending as forward risks worth watching. The financial-stability and market-pricing participants both stressed that benign conditions — a stress index of 0.1278, a VIX of 11.52, and a Baa spread of 1.88 — meant a well-telegraphed 25 basis point move would not destabilize markets, with the 3-month bill trading roughly 0.1 below the funds rate suggesting the market already anticipated such a step. A larger move, several cautioned, would risk pushing the 10-year/2-year spread of 0.07 toward inversion.

The rebuttal round reinforced rather than revised these positions. Each participant found the arguments from the other lenses complementary to their own: the inflation-focused view, the employment view, the stability view, the centrist reading, and the market-pricing read all pointed to the same well-telegraphed, measured step. The near-flat curve was acknowledged as the one genuine source of caution, but participants generally judged it a reason to keep the increment gradual rather than a reason to pause or cut, given the absence of rising claims, credit stress, or market distress.

The discussion took on a different character when participants turned to the framework's loss-minimizing recommendation, which called for -25 basis points — the opposite direction from the predictive consensus. Here participants engaged seriously with the tension between the expected policy path and what the rules literally implied. Several observed that with r^* near 1.104 and inflation near 1.5 percent, a neutral nominal rate around 2.6 percent lay well below the current 4.0 percent, so the stance appeared already restrictive; the negative inflation momentum and the flat curve corroborated that reading. Participants generally found the First-Difference rule's -25 more persuasive than the level rules' -75, judging that the aggressive prescription overweighted the current inflation gap and, in the words of the stability-focused participant, that a -75 cut could itself unsettle calm credit markets by signaling alarm. The employment-focused participant leaned on the slight upward unemployment drift of +0.05 and the Beige Book's housing softening as early signs favoring gentle easing to protect jobs, while the market-pricing participant emphasized that the T-bill discount and near-flat curve both leaned against further tightening.

The inflation-focused participant dissented from this reasoning. While acknowledging that below-target core inflation weakened the case for a hike and that the flattening curve was a genuine recession flag, this participant maintained that the forward risk from persistent energy and input-cost pressures, set against a labor market with no slack to suppress wages, argued against easing into latent inflation. In this view the level rules reacted mechanically to the current gap and ignored the upside price risk entirely; even a modest -25 cut conceded ground that inflation vigilance did not warrant, particularly when no market strain was forcing accommodation. The other participants recognized this as a coherent difference in weighting rather than a dispute over the data, but were not moved from



their judgment that policy had reached or passed neutral and that a modest downward adjustment was the loss-minimizing course.

COMMITTEE POLICY ACTIONS

In the predictive vote on the likely near-term policy action, all five members anticipated a 25 basis point increase in the federal funds rate to 4.25 percent, a unanimous 5-to-0 tally. On the separate question of the framework's loss-minimizing recommendation of -25 basis points, the Committee divided four to one: the labor-market, financial-stability, data-dependent centrist, and market-signal members endorsed the recommendation as-is, while the inflation-focused member declined to support it, judging that easing — even modestly — was the wrong direction given persistent input-cost and energy pressures and a labor market at full employment. There were no partial endorsements.