



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The Committee reviewed the most recent System Open Market Account holdings data, as of October 18, 2006. Total SOMA domestic securities holdings stood at \$762.5 billion, comprising \$458.1 billion in Treasury notes and bonds and \$277.0 billion in Treasury bills. This represented a decline of \$2.3 billion from the prior release of October 11. It was noted that this review covers SOMA holdings only — total size, composition, and the week-over-week change — and does 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

Core PCE inflation registered 1.94 percent on a twelve-month basis, sitting just below the 2.0 percent reference level. The unemployment rate stood at 4.6 percent, below the estimated natural rate of 5.04 percent, indicating a still-tight labor market. Initial jobless claims were low and stable at 305,000. The Chicago Fed National Activity Index came in at -0.27, consistent with growth running somewhat below trend. The Employment Cost Index was reported at 103.4, and M2 money supply stood at \$6,878 billion.

The most recent Beige Book, prepared at the Federal Reserve Bank of Richmond and based on information collected before October 2, indicated that economic activity continued to expand across the twelve Districts. Four Districts reported that growth firmed while a couple noted that growth cooled, with other reports characterizing conditions as moderate or mixed. Consumer spending increased more quickly in a number of Districts, though several reports continued to note sluggish automobile and home-related sales. Manufacturing conditions generally held up well, and commercial construction gained strength in most of the country. Reports on residential real estate indicated widespread cooling, with the majority of Districts citing lower asking prices, rising inventories, and softening sales; financial institutions reported that residential mortgage lending had tapered off while commercial lending picked up in several Districts. A number of Districts described labor markets as tight, with some noting shortages of skilled workers. Wage pressures were associated with tightening conditions in a few Districts, though other reports noted wage pressures were in check. While most Districts characterized price pressures as 'contained,' input prices rose in several Districts and a few reports mentioned increased pass-throughs by businesses.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions were broadly calm. The financial stress index stood at a low 0.1155, and the VIX was subdued at 11.34, indicating little market anxiety. The Baa corporate spread was contained at 1.7 percentage points, showing no evident credit distress. The Treasury yield curve was mildly inverted, with the 10-year/2-year spread at -0.08. The 3-month Treasury bill traded 0.29 percentage point



below the current federal funds rate of 5.25 percent, a configuration consistent with market expectations of no further tightening and some prospect of eventual easing. Taken together, these readings pointed to benign credit conditions alongside curve-based signals of a policy stance markets read as restrictive relative to the anticipated forward path.

STAFF ECONOMIC OUTLOOK

Staff analysis emphasized several forward-looking quantities. The estimated neutral real rate (r^*) was low, at 0.973 percent; combined with inflation near 2 percent, this implied a neutral nominal rate in the neighborhood of 3 percent, well below the current 5.25 percent funds rate. On that basis, the prevailing stance appeared meaningfully restrictive in real terms, suggesting that cumulative restraint would continue to bear down on rate-sensitive activity — most visibly in the residential real estate and mortgage-lending channels already showing widespread cooling.

Momentum indicators were modest in both directions: inflation momentum was mildly positive at 0.075 and unemployment momentum was small at 0.05, implying no abrupt turn in either price pressures or labor slack in the near term. The reference rules diverged along a familiar seam. The Taylor rule, Balanced Approach rule, and ELB-adjusted rule each pointed to -75 basis points, reflecting the wide gap between the current rate and estimated neutral together with inflation essentially at target. The First-Difference rule, which reacts to momentum rather than the level gap, indicated no change. Reconciling these, and treating the reference rules as reliable, the deterministic policy engine recommended a modest -25 basis point step — a partial removal of restraint that respected the level signal without overreacting to still-soft momentum. The projection implied by these figures was of an economy decelerating gradually beneath calm markets rather than one at risk of an abrupt downturn.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In the predictive round, all five participants independently arrived at a hold at 5.25 percent, though they reached that judgment from distinct vantage points. The inflation-focused participant stressed that core PCE at 1.94 percent, while just under target, did not defeat inflation on the strength of a single reading, and that a tight labor market — unemployment at 4.6 percent against a 5.04 percent natural rate — together with skilled-worker shortages and reported price pass-throughs in the Beige Book kept upside inflation risk live. This participant judged that cutting would be clearly inappropriate with inflation essentially at target and labor tight, preferring to hold with a continued firming bias while cumulative restraint worked.

The employment-focused participant looked first for signs of labor-market softening and found none: claims low and stable, unemployment well below the natural rate, and the Beige Book confirming tight



conditions. Absent current job weakness, this participant saw no basis for a preemptive cut, but likewise no case for a hike that might risk future job losses given below-trend growth. The financial-stability participant read the low stress index, subdued VIX, and tight Baa spread as evidence of no acute distress, while treating the inverted 2s10s curve and the sub-rate T-bill as signals that policy was already sufficiently restrictive; on that reading, an additional hike risked pushing an inverted curve and softening economy toward instability. The market-signal participant emphasized that market pricing collectively pointed to hold with a mild easing tilt, and the data-dependent centrist judged that the incoming data literally supported neither a hike nor a cut. In the rebuttal round, none of the participants was moved off the hold; the convergence from five different frameworks reinforced each member's confidence in patience.

The discussion then turned to the deterministic framework's recommendation of a -25 basis point cut, and here a genuine reappraisal took place. Several participants came to view the current stance as modestly too tight once the level gap between 5.25 percent and an estimated neutral near 3 percent was taken seriously. The employment-focused participant found the Balanced Approach logic most persuasive — with inflation at target and activity below trend, that rule tilted toward easing to protect jobs — and read the inverted curve, negative CFNAI, and sub-rate bill as evidence of building labor-market risk that outweighed a core PCE already at goal. The financial-stability participant argued that a real-estate-led credit slowdown, with mortgage lending already tapering off, warranted a measured preemptive easing to relieve pressure on the inverted curve and rate-sensitive credit without shocking calm markets. The centrist and the market-signal participant reached the same destination, the latter noting that the sub-rate T-bill essentially priced in exactly a quarter-point cut and that a full -75 would overreact.

The inflation-focused participant, by contrast, remained unpersuaded on the direction. This participant weighted the First-Difference rule most heavily, reading its zero-change signal as capturing the caution that positive inflation momentum of 0.075 demanded. While conceding that policy was modestly restrictive given the low r^* , this participant maintained that even a -25 step would ease before inflation was convincingly contained, that low VIX and tight spreads showed no crisis forcing a cut, and that setting policy to validate market pricing on inflation was not appropriate. The prior committee framing of inflation risks as elevated was shared, and the preference was to hold and confirm moderation in the data before moving.

Across both strands of the discussion, participants generally agreed that momentum figures were small in both directions, that financial conditions were calm enough that no aggressive move was warranted in either direction, and that the -75 level-rule signals overstated the case for rapid easing. The dividing



line was how much weight to place on positive inflation momentum and residual wage risk against the accumulating evidence — the inverted curve, below-trend activity, and widespread housing cooling — that the level of the funds rate had drifted well above neutral.

COMMITTEE POLICY ACTIONS

In the predictive vote, all five participants supported maintaining the target federal funds rate at 5.25 percent, a unanimous 5-0 hold. On the deterministic framework's recommendation of a -25 basis point reduction, the Committee did not reach full agreement: four participants — the labor-market dove, the financial-stability voice, the data-dependent centrist, and the market-signal realist — endorsed the recommendation as-is, while the inflation hawk declined it, judging that positive inflation momentum and residual price risk argued against easing before moderation was confirmed. There were no partial positions. The optimal-side outcome was therefore 4 to 1 in favor of the -25 basis point recommendation.