



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The Committee reviewed developments in the System Open Market Account. As of the November 29, 2006 release, total SOMA domestic securities holdings stood at \$768.5 billion, composed of \$461.4 billion in Treasury notes and bonds and \$277.0 billion in Treasury bills. This represented an increase of \$0.8 billion from the prior release of November 22, 2006. It was noted that this account covers SOMA securities holdings only — total size, composition, and the week-over-week change — and does not encompass the results of repo and reverse-repo operations, for which no point-in-time-safe data source is currently available; discussion of open market operations was accordingly confined to the outright holdings data on hand.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reviewed incoming data on activity, labor markets, and prices. Core PCE inflation on a year-over-year basis was 2.05%, marginally above the 2.0% reference point. The unemployment rate was 4.4%, well below the estimated natural rate of 5.04%, and initial jobless claims stood at 327,000, a level that did not signal deterioration in the labor market. The Chicago Fed National Activity Index registered 0.77, consistent with activity running somewhat above trend. The Employment Cost Index reading was 103.4, and M2 money supply was \$6,939 billion. The current federal funds rate stood at 5.25%.

The Beige Book, prepared at the Federal Reserve Bank of Atlanta on information collected before November 20, reported that most Districts saw continued moderate growth, with New York and Richmond observing acceleration, Dallas describing a continued deceleration from high levels, and Atlanta characterizing activity as mixed. Consumer spending increased in most Districts during October and early November despite softness in automobile and housing-related sales, and the holiday retail outlook was described as cautiously optimistic. Housing markets continued to show an overall decline in single-family home sales, some reports of lower prices, and continued weakening in single-family construction indicators, though a few specific markets remained strong and nonresidential activity generally improved. Many Districts continued to report tight labor markets, especially for high-skilled occupations, with wage growth generally moderate but stronger for some specialized professions. Several Districts noted slowing mortgage lending and a slight rise in delinquencies, and most reported that prices moderated for construction materials and energy products.

STAFF REVIEW OF THE FINANCIAL SITUATION



Financial conditions were characterized as calm and accommodative. The financial stress index registered 0.3, at the low end of its range, and the VIX stood at 11.27, an unusually subdued level of implied volatility. The Baa corporate spread of 1.65 percentage points indicated no meaningful distress in credit markets. At the same time, the 10-year/2-year Treasury yield curve spread was slightly inverted at -0.07, and the 3-month Treasury bill traded 0.35 percentage point below the current funds rate — signals typically read as flagging recession risk and market expectations of eventual easing rather than tightening. Taken together, the data pointed to markets that priced a lower rate path ahead while showing no acute stress that would force near-term action.

STAFF ECONOMIC OUTLOOK

The staff outlook drew on the forward-looking quantities available. With the estimated neutral real rate (r^*) at 1.015 and core inflation running near 2%, a neutral nominal rate would lie in the neighborhood of 3%; against that benchmark, the prevailing 5.25% funds rate implied a meaningfully restrictive stance. Inflation momentum was estimated at -0.1, suggesting that price pressures were edging down rather than building, consistent with the Beige Book's accounts of moderating construction-materials and energy prices. Unemployment momentum was 0.0, indicating that the labor market, while tight relative to the natural-rate estimate, was not yet deteriorating.

The reference rules were judged reliable and pointed in an easing direction, though with considerable dispersion. The Taylor, Balanced Approach, and ELB-adjusted rules each prescribed -75 bps, driven largely by the wide gap between the 4.4% unemployment rate and the 5.04% natural rate together with inflation near target. The First-Difference rule, which responds to the change in conditions rather than their level, prescribed 0 bps, reflecting flat momentum. Reconciling these signals against the loss function — with fading inflation momentum, an inverted curve, and no financial stress weighed against still-tight labor and a core print still marginally above target — the framework's loss-minimizing recommendation was a modest -25 bps, a step that begins realigning policy toward neutral without matching the aggressiveness of the level-based rules.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their predictive discussion, all five participants independently arrived at a hold at 5.25%. The inflation-focused member emphasized that core PCE at 2.05% remained above the 2.0% target and that unemployment at 4.4% sat well below the 5.04% natural rate, a combination the member read as keeping inflation risk live; the Beige Book's references to tight labor markets and stronger wage pressures for some specialized professions reinforced that caution. This member acknowledged that moderating energy and construction prices, along with softening housing, reduced the urgency of any hike, but judged that cutting while inflation remained above target was unjustified and that holding



preserved flexibility.

The employment-focused member noted that with unemployment below the natural rate, jobless claims moderate at 327,000, and no sign of slowing hiring, the conditions that would trigger an easing bias were simply not present. This member took the inverted 10y-2y spread and the negative 3-month T-bill spread seriously as forward-looking recession signals, and flagged housing and mortgage softening as headwinds, but treated these as risks to watch rather than present labor-market deterioration warranting a cut. The financial-stability member similarly read the low stress index of 0.3, the very calm VIX of 11.27, and the tight Baa spread of 1.65 as evidence of no acute distress in either direction, while cautioning that a hike now could accelerate housing and credit deterioration; the slight rise in delinquencies and slowing mortgage lending were early credit-quality signals to monitor closely. The data-dependent centrist and the market-signal member both concluded that conditions had not shifted decisively since the prior pause: inflation near target, growth moderate but positive, and market pricing consistent with eventual — but not imminent — easing. The rebuttal round produced no movement; participants observed that their arguments converged rather than conflicted, and the predictive stance remained a unanimous hold.

When the discussion turned to the framework's loss-minimizing recommendation of -25 bps, participants engaged the divergence between their expected hold and the modest cut candidly. Several found the easing direction persuasive once they weighed the level of accumulated restraint rather than the change in conditions. The employment-focused member argued that the Balanced Approach rule, which weights the employment gap directly, best matched that seat and pointed to substantial restrictiveness relative to a roughly 3% neutral rate; with inflation momentum at -0.1, the main reason to stay tight was seen as dissolving, and a pre-emptive 25 bps step was framed as insurance against labor-market downside before housing weakness could spread into employment. The financial-stability member reached a similar conclusion by a different route, observing that low volatility and tight spreads can mask fragility and that a modest cut would relieve curve-inversion pressure without the destabilizing signal of alarm that a -75 bps move might convey.

The market-signal member emphasized that the T-bill trading 35 bps below the funds rate and the inverted 10y-2y spread confirmed policy was mildly too tight relative to the market-implied path, and that -25 bps matched that path while disciplining the level rules' overshoot to -75 — a 35 bp discount, the member argued, did not justify three cuts at once. The centrist moved from a strict hold toward accepting a modest, insurance-style cut, judging that a -25 bps step sensibly split the aggressive level rules against the First-Difference rule's 0 bps while respecting still-tight labor and a core print above target; a full -75 bps was seen as risking a reignition of demand.



The inflation-focused member remained the dissenting voice on the optimal case. While acknowledging that inflation momentum was fading and that the easing direction had support, this member stayed anchored on the observation that core PCE was still above 2.0% and that unemployment well below the natural rate represented a residual inflation risk, with some Districts still reporting stronger wage pressures for specialized professions. The absence of any financial emergency — stress index 0.3, VIX 11.27, Baa spread 1.65 — was read by this member as supporting patience rather than accommodation, and the First-Difference rule's 0 bps was cited as most consistent with that temperament. The member preferred to wait for confirmation that inflation was durably at or below target before endorsing even an insurance cut.

COMMITTEE POLICY ACTIONS

In the predictive vote on the likely policy decision, all five participants supported maintaining the target federal funds rate at 5.25%, a unanimous 5-0 for no change. On the separate question of the framework's loss-minimizing recommendation of a 25 bps cut, the Committee divided four to one: the employment-focused member, the financial-stability member, the data-dependent centrist, and the market-signal member endorsed the -25 bps recommendation as calibrated and appropriate given fading inflation momentum, an inverted yield curve, and a stance judged restrictive relative to the estimated neutral rate, while the inflation-focused member declined, preferring to hold until inflation cleared target. There were no partial endorsements.