



## **DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS**

The System Open Market Account held domestic securities as of the November 28, 2007 release. Composition was weighted toward coupon securities, with Treasury notes and bonds accounting for the larger share and Treasury bills a smaller portion. The account was unchanged from the prior release of November 21, 2007, a week-over-week change of zero. It should be noted that these figures cover SOMA holdings only — total size, composition, and the change from the prior release — and do not encompass the results of repo or reverse-repo operations, for which no point-in-time-safe data source currently exists.

## **STAFF REVIEW OF THE ECONOMIC SITUATION**

The staff review characterized the economy as continuing to expand but at a reduced pace. Core PCE inflation stood at 1.67 percent on a twelve-month basis, below the 2.0 percent objective. The unemployment rate was 4.7 percent, below the estimated natural rate of 5.05 percent, indicating that labor markets remained relatively firm; initial jobless claims of 344,000 were elevated but not spiking. The Chicago Fed National Activity Index at -0.45 pointed to below-trend growth. The current federal funds rate was 4.5 percent.

The most recent Beige Book, prepared on information collected on or before November 16, reported that seven of the twelve Districts saw a slower pace of activity, with the remainder pointing to modest expansion or mixed conditions. Retail spending was relatively soft, and most retailers anticipated only small gains over the prior year's holiday season, though tourism expanded in most Districts. Manufacturing reports were mixed and suggested little net change. The glut of available homes continued to weigh on prices and construction activity, and banks reported slower growth in overall loan demand, with some Districts noting reduced commercial and industrial lending. Upward pressure on final goods and services prices was described as modest overall but significant for products relying heavily on food and energy inputs; food prices remained on an upward trend, while lumber and transportation-equipment prices declined.

## **STAFF REVIEW OF THE FINANCIAL SITUATION**

Financial conditions were characterized as meaningfully tighter but short of acute distress. The financial stress index stood at 0.4443, and the VIX at 23.79 reflected persistent market anxiety rather than calm. The Baa corporate spread of 2.53 percentage points indicated moderate credit stress, consistent with rising borrowing costs for weaker firms. The 3-month Treasury bill yielded 1.42 percentage points below the current 4.5 percent funds rate, a sizable negative spread suggesting that markets anticipated further easing ahead. The 10-year/2-year Treasury spread was positive at 0.99,



having re-steepened, with no acute inversion to signal an imminent recession.

### **STAFF ECONOMIC OUTLOOK**

The staff outlook drew on the forward-looking quantities available to the Committee. The neutral real rate ( $r^*$ ) employed in the framework was 1.584 percent. Inflation momentum was slightly negative at -0.21, suggesting that price pressures were easing rather than building, while unemployment momentum was mildly positive at +0.10, consistent with a slow upward drift in joblessness rather than a sharp deterioration. Taken together, these readings implied a gradually softening real economy with inflation contained but not collapsing.

The reference rules judged reliable in the framework diverged in their prescriptions. The Taylor rule, the Balanced Approach rule, and the ELB-adjusted rule each pointed to a cut of 75 basis points, reflecting below-target inflation and unemployment below its natural rate feeding into the mechanical gaps. The First-Difference rule, which adjusts incrementally from the current stance rather than recomputing a full gap, called for a 25 basis point move. The framework's loss-minimizing recommendation landed at -25 basis points, discounting the urgency of the level-based rules. The gap between the -75 outputs and the -25 recommendation implied that the current stance was only modestly restrictive relative to where conditions pointed, and that gradual adjustment — rather than front-loaded easing — was the projected loss-minimizing path given the negative inflation momentum and elevated but non-acute financial stress.

### **PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK**

Participants generally judged that some easing was warranted at this meeting, with the discussion centering less on whether to cut than on how far and how fast. All members entered the discussion favoring a 25 basis point reduction, and the reasoning behind that convergence differed by emphasis. The member most attentive to inflation began from a position of instinctive resistance to cutting: the Beige Book flagged significant food and energy cost pass-through, prior minutes had cited renewed commodity-price upside risk, and labor markets remained relatively tight with unemployment at 4.7 percent, below the 5.05 percent natural rate. This member noted, however, that core PCE at 1.67 percent was genuinely below the 2.0 percent target, which undercut any argument for holding purely on realized inflation grounds — the risk being watched was prospective, not yet in the core data. The evidence of credit tightening ultimately proved persuasive enough to accept a modest cut, though this member emphasized that further easing should be conditioned on inflation risks not intensifying and explicitly resisted any move to a larger 50 basis point cut, which was characterized as a signal of panic that would threaten inflation credibility precisely as commodity pressures were building.



The member focused on employment weighted forward-looking risk heavily. While acknowledging unemployment remained below the natural rate, this participant pointed to initial claims of 344,000 as elevated, the Chicago Fed index at -0.45 as below-trend, and the Beige Book's account of seven slowing Districts, soft retail, and the housing glut as threats to construction and consumer-facing employment. Credit contraction was seen as transmitting directly to hiring and investment. This member argued that a 25 basis point cut was preemptive and measured — supporting employment ahead of visible deterioration — but that a larger move was not warranted, since labor was not in crisis and an oversized cut could unsettle inflation credibility.

The participant most concerned with financial stability grounded the case in the stress index at 0.4443, the VIX near 24, the Baa spread of 2.53, and the Beige Book's evidence of slower loan demand and reduced commercial and industrial lending. This member framed the action as insurance easing to preempt a self-reinforcing credit contraction, while cautioning that an oversized cut could itself signal alarm to fragile markets and amplify stress rather than calm it. The member attentive to market signals emphasized the -1.42 T-bill spread as an unambiguous indication that markets expected further easing, and the re-steepened 10-2 curve at 0.99 as consistent with anticipated lower short rates — yet noted that the un-inverted curve meant markets were not demanding emergency-sized action, only measured, meeting-by-meeting relief. The data-dependent member treated the unanimous 25 basis point read as itself a strong signal that the data supported a single cut as the most defensible middle path, with the inflation caution and the growth-and-stability arguments roughly offsetting.

When the discussion turned to the framework's loss-minimizing recommendation, participants engaged directly with the divergence between the three rules calling for -75 basis points and the -25 recommendation. A recurring theme was that the First-Difference rule, with its incremental adjustment from the current stance, best captured the appropriate response given genuine uncertainty and noisy  $r^*$  estimates. The inflation-focused member read the divergence as evidence that current policy was near-appropriate and needed gradual adjustment rather than shock easing, and that a -75 move would risk reigniting the food and energy pressures the Beige Book highlighted. The employment-focused member similarly argued that with unemployment still below the natural rate and momentum only mildly positive at +0.10, a -75 move would risk overshooting prematurely, while a -25 step preserved optionality to cut further if labor weakened. The financial-stability member interpreted the loss function's preference for -25 as correctly penalizing abrupt moves in fragile conditions.

Across both the rebuttal rounds, no participant was moved toward a larger cut or toward holding. The negative inflation momentum of -0.21 was cited as tempering upside concern, but the Beige Book's food and energy pass-through kept members cautious about overshooting. Several noted that holding



steady would amount to tightening into visible weakness and rejected that course. The consensus that emerged was one of gradualism: a measured 25 basis point cut that responded to real credit strain, below-trend growth, and market-implied expectations while respecting a contained but non-negligible inflation risk and the still-firm labor market.

### **COMMITTEE POLICY ACTIONS**

In the predictive vote, all five members supported a 25 basis point reduction in the target federal funds rate, to 4.25 percent, a unanimous tally of five for -25 basis points. On the framework's loss-minimizing recommendation of -25 basis points, the Committee was likewise in full agreement: all five members — the inflation-focused member, the employment-focused member, the financial-stability member, the data-dependent member, and the market-signal member — endorsed the recommendation as-is, with no members declining and none supporting only the direction but not the magnitude. The two votes were thus fully aligned, reflecting a shared judgment that measured, incremental easing was the appropriate response to the balance of downside growth and financial-stress risks against contained but watchful inflation concerns.