



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The System Open Market Account held \$484.1 billion in domestic securities as of October 22, 2008, essentially unchanged from the prior release on October 15, with a recorded week-over-week change of \$0.0 billion. The portfolio was concentrated in Treasury coupon securities, with \$410.8 billion in notes and bonds and \$18.4 billion in Treasury bills, the remainder falling outside those two categories. Members were reminded that these figures capture SOMA outright holdings only — total size, composition, and the change from the preceding release — and that they do not encompass the results of repurchase or reverse-repurchase operations, for which no point-in-time-safe data source is currently available. Accordingly, this review makes no representation about the scale or direction of temporary open market operations over the intermeeting period.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reported that economic activity had weakened markedly and on a broad basis. The Chicago Fed National Activity Index stood at -1.13, consistent with growth running well below trend. Labor market indicators pointed in the same direction: the unemployment rate was 6.1 percent, roughly a full percentage point above the 5.05 percent estimate of its natural rate, and initial claims for unemployment insurance had climbed to 478,000, a level suggestive of continuing deterioration ahead. The Employment Cost Index reading of 109.6 showed no evidence of wage-driven cost acceleration. On the price side, core PCE inflation was running at 2.05 percent on a year-over-year basis, only marginally above the 2 percent objective.

The most recent Beige Book, prepared on the basis of information collected on or before October 6, reinforced the picture of a broad-based softening. Economic activity was reported to have weakened in September across all twelve Federal Reserve Districts, and several Districts noted that contacts had grown more pessimistic about the outlook. Consumer spending decreased in most Districts, with declines in retailing, auto sales, and tourism and a reported pullback in discretionary and big-ticket purchases. Manufacturing slowed in most Districts, residential real estate remained weak, and commercial real estate activity slowed in many Districts. Credit conditions were characterized as tight across all twelve Districts, with several reporting reduced credit availability for both financial and nonfinancial institutions. Inflationary pressures were said to have moderated a bit in September; while some pass-through of earlier increases in metals, food, and energy prices continued, most Districts indicated that cost pressures had eased and that wage pressures remained limited.

STAFF REVIEW OF THE FINANCIAL SITUATION



Financial conditions were described as extraordinarily strained. The financial stress index registered 1.0, the maximum on its scale, and the VIX stood at 69.65, a level indicative of severe market dislocation and elevated fear. The Baa corporate spread had widened to 5.6 percentage points, signaling that borrowing costs facing firms remained punishingly high despite the low policy rate, consistent with the tight credit availability reported across all twelve Districts. The 3-month Treasury bill was trading 0.26 percentage point below the current 1.5 percent funds rate, a negative spread the staff read as reflecting both a flight to safety and market expectations that the policy rate would move lower. By contrast, the 10-year/2-year Treasury spread of 2.12 percentage points remained steeply positive rather than inverted, a shape more consistent with expected easing working through the curve than with a market pricing of imminent contraction on its own terms.

STAFF ECONOMIC OUTLOOK

Looking ahead, the staff assessment drew on the small set of forward-looking quantities available this round. With the neutral real rate estimated near 1.74 percent and the nominal funds rate at 1.5 percent, real policy was judged to be close to neutral rather than clearly restrictive, which tempered the case for reading current conditions as an argument for open-ended additional accommodation. Inflation momentum was measured at only 0.075, near flat, suggesting that the slightly above-target core PCE reading was not accelerating and might drift back toward the objective over time. Unemployment momentum of 0.3, by contrast, indicated that labor market slack was still widening rather than stabilizing, pointing to further softening in employment before conditions turn.

The reference rules did not speak with one voice, and the staff flagged them as not reliable under present conditions. The Taylor rule prescribed a 75 basis point increase, reflecting the still slightly above-target inflation reading and disregarding the collapse in financial conditions; the Balanced Approach and ELB-adjusted rules each pointed to a 50 basis point cut, weighting the widening unemployment gap; and the First-Difference rule, responding to the modest measured momentum in inflation and unemployment, indicated a 25 basis point cut. Netting these against the loss function, the framework's recommendation came out at a 25 basis point reduction — an easing that acknowledges the deterioration in activity and the acute financial strain while stopping short of the larger move implied by the level-based rules, in recognition of the near-neutral real stance and the finite policy room remaining above the effective lower bound.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their initial predictive assessments, all five participants judged that a policy easing was warranted, and each independently arrived at a 50 basis point cut. The reasoning converged from different starting points. The participant most attentive to inflation risk observed that core PCE at 2.05 percent



was only barely above target and that the Beige Book explicitly described moderating cost pressures and limited wage pressures, with the Employment Cost Index showing no wage-driven acceleration; on that basis the upside inflation case, which had constrained policy previously, had softened materially, while the dominant near-term risk had shifted toward growth and a disinflationary credit seizure. The participant focused on employment emphasized the full point of slack between the 6.1 percent unemployment rate and the 5.05 percent natural rate, elevated claims at 478,000, and a Chicago Fed index of -1.13, arguing that the credit contraction was itself a threat to hiring. The participant most concerned with financial stability pointed to the stress index at its maximum, the VIX near 70, and the Baa spread at 5.6 as evidence of systemic strain demanding decisive action, while the participant attentive to market signals stressed that the negative Treasury bill spread showed an easing was already priced in.

A recurring theme in the first two rounds was the tension between the severity of the stress and the limited room remaining with the funds rate at 1.5 percent. Several participants noted that they had considered a larger, 75 basis point move but concluded that preserving some capacity to respond to further deterioration argued against it; the financial stability participant framed conserving ammunition as itself a stability consideration. The inflation-focused participant, having been inclined toward holding, described being persuaded to join the easing by the combination of essentially at-target core inflation, the qualitative evidence of moderating price pressures, and crisis-level financial stress, while stressing a preference to resist any push beyond 50 basis points and a desire for the statement to preserve concern about the still above-target inflation reading. The predictive discussion thus settled on a genuine consensus at a 50 basis point cut rather than a negotiated compromise.

When the discussion turned to the framework's loss-minimizing recommendation of a 25 basis point cut, the participants engaged seriously with the divergence from their predictive vote. Two found the smaller move to be the better call on its own terms. The inflation-focused participant read the 25 basis point recommendation as aligning with the First-Difference rule and with his own disposition — easing in response to deteriorating conditions without over-committing while inflation remained nominally above target and while policy approached the effective lower bound. The participant oriented toward literal reading of the data likewise endorsed the smaller cut, noting that with the neutral real rate near 1.74 percent and the funds rate at 1.5 percent, policy was already close to neutral in real terms, and that the reference rules being flagged unreliable counseled against leaning on the level-based prescriptions; a 25 basis point move eased into the weakening activity without overshooting under high uncertainty.



The remaining three participants agreed with the direction of the recommendation but judged its magnitude insufficient. The employment-focused participant argued that unemployment momentum of 0.3 showed the labor market still buckling and that a 25 basis point move, while defensible and directionally correct, was weaker than the urgency of the deterioration warranted. The financial stability participant acknowledged a real tension: with rate transmission impaired by the credit blockage, the marginal calming effect of an additional 25 basis points was small, and preserving room mattered — yet from a stability lens he continued to lean toward the larger cut as a means of shocking markets calm amid maximal stress. The market-signal participant read the negative Treasury bill spread and panic-level VIX as pricing more than a 25 basis point move, though he conceded the spread was modest enough that it did not unambiguously demand a full 50 and that core inflation at target and near-neutral real policy tempered the case for the larger step.

Across both the predictive and framework discussions, participants agreed that inflation was no longer a binding constraint on easing and that the direction of policy should be lower. The genuine, unresolved question was one of magnitude: whether to deliver the decisive 50 basis point move that the priced-in market path and crisis-level stress seemed to call for, or the more measured 25 basis point step that respected finite policy room, near-neutral real conditions, and the unreliability of the reference rules this meeting.

COMMITTEE POLICY ACTIONS

In the predictive vote, all five participants supported a 50 basis point reduction in the target federal funds rate, a unanimous 5-to-0 outcome. On the framework's alternative recommendation of a 25 basis point cut, the Committee did not divide on direction — no participant declined the recommendation — but it split on magnitude. Two participants, the one most focused on inflation and the one favoring a literal reading of the data, endorsed the 25 basis point recommendation as-is. The other three — the participants focused on the labor market, on financial stability, and on market signals — agreed with the easing direction but regarded 25 basis points as too small, preferring the larger move, yielding a final optimal-side tally of two endorse, zero decline, and three partial.