



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The Committee reviewed the most recent data on the System Open Market Account. As of December 3, 2008, total SOMA domestic securities holdings stood at \$481.6 billion, composed primarily of \$410.5 billion in Treasury notes and bonds and \$18.4 billion in Treasury bills. This represented a modest decline of \$0.6 billion from the prior release of November 26. It was noted that these figures cover SOMA holdings only — their total size, composition, and week-over-week change — and do not encompass the results of repo or reverse-repo operations, for which no point-in-time-safe data source is currently available.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reported that economic activity had weakened across all Federal Reserve Districts since the previous Beige Book. Districts generally reported decreases in retail sales, with vehicle sales down significantly in most Districts and particularly weak for more expensive and less fuel-efficient models. Service-sector reports were generally negative, manufacturing activity declined in most Districts amid soft new orders, and nearly all Districts described weak housing markets with reduced selling prices alongside low but stable sales activity. Commercial real estate declined in most Districts, and lending contracted broadly, with many Districts reporting reductions in residential, commercial, and industrial lending together with tightening standards. Labor market conditions were characterized as weakening, wage pressures were largely subdued, and price pressures were easing in light of declines in energy, fuel, raw materials, and food prices.

The incoming quantitative data reinforced this picture of rapid deterioration. The unemployment rate stood at 6.7 percent, well above the estimated natural rate of 5.05 percent, and initial jobless claims had reached 570,000. The Chicago Fed National Activity Index registered -2.68, consistent with activity running deeply below trend. On the price side, core PCE inflation was 1.75 percent on a year-over-year basis, below the 2 percent objective, with the Employment Cost Index reading of 109.6 and subdued wage pressures offering no indication of wage-driven inflation. M2 stood at \$7,879 billion. The fed funds rate was at 1.0 percent entering the meeting.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions reflected acute and broad-based stress. The financial stress index registered its maximum reading of 1.0, and the VIX stood at 58.91, indicating extreme volatility and risk aversion. The Baa corporate spread had widened to 6.06, signaling severe strain in credit markets and elevated borrowing costs for firms even as the policy rate remained low. The 3-month Treasury bill spread was -0.98 relative to the current 1.0 percent funds rate, indicating that bills were trading well below the



policy rate and that markets had effectively priced a policy rate near zero. The 10-year/2-year yield curve spread stood at 1.83. Taken together with the Beige Book's account of contracting lending and tightening standards across nearly all Districts, these readings pointed to a substantially impaired credit channel.

STAFF ECONOMIC OUTLOOK

The staff's forward-looking assessment drew on the available projection inputs, which uniformly pointed toward continued weakness with little offsetting inflation risk. The estimated neutral rate was 1.769 percent, above the prevailing 1.0 percent funds rate, but the reliability of standard reference rules was judged to be low under current conditions. Inflation momentum was estimated at only 0.11 and unemployment momentum at 0.3, indicating that price pressures were likely to remain contained while labor-market slack continued to build in the near term.

The reference-rule outputs illustrated the unusual dispersion produced by the crisis environment. The Taylor rule prescribed a 75 basis point increase, a result the staff treated as spurious given that it leaned on the neutral-rate estimate while inflation sat below target and activity was contracting sharply. The Balanced Approach and ELB-adjusted rules each pointed to a 50 basis point cut, and the First-Difference rule to a 25 basis point cut, the latter aligning with the loss-minimizing recommendation of a 25 basis point reduction. On balance, the projection inputs implied that conditions were likely to remain weak, that inflation posed no near-term upside constraint, and that the proximity of the funds rate to its effective lower bound would increasingly shape the feasible policy path.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

Participants agreed that the incoming data described a deep and rapidly worsening downturn, and their discussion in the predictive rounds centered less on direction than on magnitude. All members judged that inflation posed no constraint on easing: with core PCE at 1.75 percent, below the 2 percent objective and easing broadly per the Beige Book, and with wage pressures subdued, the usual case for caution against cutting did not apply. The member most attentive to inflation risk was explicit on this point, observing that vigilance found little to fear this meeting — if anything, the risk had shifted toward disinflation given the collapse in activity — and revised an initial inclination to hold toward a substantial cut.

In the opening round, several participants converged on a 75 basis point reduction, emphasizing the labor-market deterioration — unemployment at 6.7 percent against a 5.05 percent natural rate, claims at 570,000, and a Chicago Fed index of -2.68 — while acknowledging that at a 1.0 percent funds rate



only limited conventional room remained. Two participants argued instead for the full remaining 100 basis points to the effective lower bound. The member most focused on financial stability stressed that the maxed stress index, a VIX near 59, and a Baa spread of 6.06 reflected a systemic credit seizure demanding the most aggressive relief, and warned that failing to deliver what markets already expected would itself create a destabilizing gap. The member weighting market signals most heavily made the parallel point that the 3-month bill spread of -0.98 showed markets had already priced a policy rate near zero, so that a full cut would not surprise them and incrementalism would leave conventional tools unused.

This market-pricing argument proved decisive in the rebuttal round. The member most attentive to labor conditions moved from 75 to 100 basis points, reasoning that with no inflation constraint and jobs collapsing, holding a marginal 25 basis points in reserve served no purpose that would help employment. The centrist member likewise revised to 100 basis points, treating the negative bill spread as a literal, data-supported observation rather than speculation and concluding that half-measures leave conventional tools idle during a systemic crisis. The inflation-focused member remained at 75 basis points, persuaded off a hold but retaining a preference for a small margin above zero given the limited remaining room.

When the discussion turned to the framework's loss-minimizing recommendation of a 25 basis point cut, participants broadly accepted its direction while questioning its size. All noted that the reference rules had been judged unreliable and that the Taylor rule's prescribed increase was an outlier that ignored collapsing activity and credit. Several found the ELB-adjusted and Balanced Approach rules, both at 50 basis points, closer to the appropriate response, and the market-focused member observed that even a 50 basis point step lagged the -0.98 spread markets were pricing. The inflation-focused member offered the most sympathetic reading of the 25 basis point step, noting that near the effective lower bound each cut spends scarce conventional ammunition, an argument for restraint — while still judging that systemic stress warranted front-loading beyond incremental rules.

The recurring theme across the optimal-framework rounds was that the deterministic recommendation anchored on the proximity of rates to zero and on mild inflation and unemployment momentum, whereas participants weighed the acute crisis readings more heavily. Members repeatedly warned that incrementalism risked reinforcing a credit-contraction spiral, and none were moved toward greater caution by the discussion. Participants agreed the direction of policy was not in question; their reservations concerned magnitude and the case for decisive action while conventional room remained.

COMMITTEE POLICY ACTIONS



In the predictive vote, the Committee's five members recorded a decision of -100 basis points, with four members supporting the 100 basis point reduction and one member preferring 75 basis points. On the framework's loss-minimizing recommendation of a 25 basis point cut, all five members took a partial stance: none endorsed the recommendation as-is and none declined it outright. Each agreed with the direction of easing but judged the recommended magnitude too timid given the severity of the activity, labor-market, and credit-stress readings, favoring a larger move toward the effective lower bound.