



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The System Open Market Account held \$1,684.4 billion in domestic securities as of October 28, 2009. Holdings were composed of \$705.7 billion in Treasury notes and bonds, \$18.4 billion in Treasury bills, and \$774.1 billion in agency mortgage-backed securities, the last of which now represented the single largest component of the portfolio. The account was unchanged from the prior release of October 21, with a week-over-week change of \$0.0 billion. The Manager noted that these figures describe SOMA securities 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; accordingly, this review makes no representation about those operations.

STAFF REVIEW OF THE ECONOMIC SITUATION

Economic activity remained weak but showed signs of stabilization. The unemployment rate stood at 9.8 percent, far above the estimated natural rate of 5.04 percent, indicating a very large margin of resource slack. Initial claims for unemployment insurance were reported at 531,000, a still-elevated level consistent with continued softness in labor demand. The Chicago Fed National Activity Index registered -0.29, signaling growth below its historical trend. The Employment Cost Index reading of 111.1 pointed to only minimal advance in labor compensation. On the price side, core PCE inflation was 1.11 percent on a year-over-year basis, well below the 2 percent objective. M2 stood at \$8,333.5 billion.

The Beige Book, prepared before October 13, described either stabilization or modest improvement across many sectors in the twelve Districts, though often from depressed levels and almost always qualified as small or scattered. Residential real estate and manufacturing led the more positive reports, continuing a pattern that had emerged over the summer; several Districts — including New York, Philadelphia, Cleveland, and San Francisco — cited small pickups in manufacturing. Reports on consumer spending and nonfinancial services were mixed. Commercial real estate was the weakest sector, described as weak or deteriorating across all Districts, and banking faltered in several Districts, with continued erosion in credit quality noted in Kansas City and San Francisco and more erosion expected. One bright spot in banking was lending to first-time homebuyers in response to the tax credit. Labor markets were generally characterized as weak or mixed, with only occasional pockets of improvement and little or no increase in wages reported.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions had eased from crisis levels but had not normalized. The financial stress index stood at 0.3099, a moderate reading well off earlier peaks but not benign, and the VIX at 27.91 indicated volatility that remained elevated relative to calmer periods. The Baa corporate spread of 2.85



percentage points showed that credit stress had receded but that borrowing costs remained wider than normal. The yield curve was steeply positive, with the 10-year/2-year spread at 2.49 percentage points and no inversion — a configuration typically read as reassuring on near-term recession risk. The 3-month Treasury bill spread relative to the current policy rate was -0.045, essentially flat, indicating stable short-term funding conditions and no market expectation of an imminent change in the policy rate.

STAFF ECONOMIC OUTLOOK

The staff's forward-looking assessment took as its starting point an estimated neutral real rate (r^*) of roughly 1.57 percent, a level that — combined with the prevailing degree of slack — lay well above the rate implied by the effective lower bound. Standard policy prescriptions reflected this gap: the Taylor rule, the Balanced Approach rule, and the ELB-adjusted rule each pointed to a nominal rate near 75 basis points, driven principally by the large unemployment gap. The First-Difference rule, which responds to the change in conditions rather than to level gaps, pointed instead to no change. The staff judged the reference rules broadly reliable under current conditions, while noting that the level-based prescriptions could not be reconciled straightforwardly with a policy rate already resting at its floor.

Momentum measures suggested no near-term impulse toward tightening. Inflation momentum was negative, at -0.175, implying that core inflation was drifting further below rather than toward the 2 percent objective. Unemployment momentum was slightly positive, at 0.15, consistent with labor-market slack that was, if anything, still widening rather than being absorbed. Taken together, these quantities implied that price pressures were likely to remain subdued and that the absorption of slack had not yet begun in earnest — a projection under which the loss-minimizing policy setting remained at the current range, with the level-based prescriptions best understood as describing an unreachable neutral configuration rather than a feasible near-term target.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their independent opening assessments, all five participants arrived at the same conclusion — that the appropriate action was to maintain the federal funds target range at 0.0 to 0.25 percent — though they reached it from distinct vantage points. The participant most attentive to inflation risk framed the question as whether inflation risk was actually elevated, and found that it plainly was not: core PCE at 1.11 percent sat well below the 2 percent target, the Employment Cost Index showed minimal wage growth, and nearly five percentage points of unemployment slack argued for continued dampening of cost pressures. With the rate already at its floor, this participant saw no room to cut and, given the absence of any inflation trigger, no justification to hike.



The participant focused on the labor market emphasized the depth of distress — unemployment at 9.8 percent against a 5.04 percent natural rate, claims still elevated at 531,000, and a Chicago Fed index at -0.29 signaling below-trend growth. This participant's instinct toward maximal accommodation ran squarely into the lower-bound constraint: with no conventional room to cut, holding the current range was judged the most accommodative feasible rate stance, and the subdued inflation picture provided every reason to keep supporting employment. The participant attentive to financial stability read the stress index at 0.3099, the VIX near 28, and the Baa spread of 2.85 as evidence of a system that was fragile but not acutely stressed, and pointed to commercial real estate weakness across all Districts and continued banking credit erosion as reasons that removing accommodation could destabilize vulnerable segments. This participant took some comfort from the steep, non-inverted yield curve and the stable short-funding conditions implied by the flat T-bill spread.

The data-dependent participant read the indicators literally and found them uniformly against tightening and offering neither room nor need to cut, while the market-oriented participant stressed that pricing itself discounted no move — the flat 3-month T-bill spread and the steep 10-year/2-year curve together pointing to continuity rather than an anticipated shift. In the rebuttal round no participant was moved from the hold position; several observed that the others' arguments reinforced rather than altered their own. The inflation-focused participant noted that ample M2 and prolonged near-zero rates warranted watching for future inflation risk, but judged the transmission to actual price pressure blocked by weak credit conditions.

Turning to the optimal-policy framework, participants engaged directly with the divergence between the level-based rules and the loss-minimizing recommendation. Several found the First-Difference rule's logic most persuasive: because it responds to momentum rather than to the level of the rate gap, it accommodated both a policy rate already at the floor and the reality that a 75 basis point prescription would require conditions the economy had not reached. With inflation momentum negative at -0.175 and unemployment momentum still positive at 0.15, participants generally judged that no tightening impulse was present. The inflation-focused participant put the point sharply: even weighting inflation heavily, one cannot justify hiking into 9.8 percent unemployment with inflation falling below target. The financial-stability participant added that the level rules simply ignored the fragility visible in credit and commercial real estate markets, and that an abrupt divergence from prior extended-period guidance would itself be a destabilizing event.

A recurring theme was that the agreement between each participant's own predictive vote and the framework's +0 basis point recommendation revealed the current stance to be appropriately calibrated. Participants read the gap between the 75 basis point rule outputs and the actual



recommendation not as a sign that policy was too easy, but as a reflection of the effective lower bound and of a neutral rate near 1.57 percent that remained unreachable given the prevailing slack. Consistent with their mandates, the labor-focused participant characterized the current range as the most accommodative feasible setting, while the inflation-focused participant reiterated a readiness to shift toward tightening at a future meeting should positive inflation momentum emerge — a signal all agreed was absent today.

COMMITTEE POLICY ACTIONS

In the predictive vote, all five participants supported maintaining the federal funds target range at 0.0 to 0.25 percent, a unanimous outcome recorded as 0 basis points, 5 to 0. On the optimal-policy framework's recommendation of +0 basis points, the Committee likewise reached full agreement: all five members — the inflation-focused participant, the labor-market-focused participant, the financial-stability participant, the data-dependent participant, and the market-signal participant — endorsed the recommendation as-is, with no members declining and none registering partial support. The two lines of deliberation thus converged on the same conclusion, that the current accommodative stance remained appropriate.