



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The System Open Market Account domestic securities portfolio stood at \$2,082.5 billion as of December 1, 2010, the most recent release available on or before the point-in-time-safe cutoff. Composition was concentrated in longer-dated Treasury securities and agency mortgage-backed securities: Treasury notes and bonds accounted for \$848.3 billion, Treasury bills for \$18.4 billion, and agency MBS for \$1,022.7 billion. Relative to the prior release of November 24, 2010, total holdings rose by \$1.1 billion, a modest week-over-week increase consistent with the ongoing purchase operations already underway. It should be noted that this review covers SOMA holdings only — total size, composition, and the change from the prior release. It does not cover repo or reverse-repo operation results, for which no point-in-time-safe data source currently exists; those operations are therefore outside the scope of what can be reported here.

STAFF REVIEW OF THE ECONOMIC SITUATION

Incoming data described an economy expanding at a slow but positive pace. The Chicago Fed National Activity Index registered 0.09, near its trend level, while the labor market remained deeply underutilized: the unemployment rate held at 9.8%, far above the estimated natural rate of 5.02%, and initial jobless claims stood at 436,000, still elevated relative to levels consistent with strong hiring. On the price side, core PCE inflation was running at 0.71% year-over-year, well short of levels generally regarded as consistent with the price-stability mandate. The Employment Cost Index reading of 113.3 pointed to subdued wage dynamics, and M2 stood at \$8,767.1 billion.

The most recent Beige Book reinforced this picture of uneven, generally modest improvement. Activity was reported to have increased at a slight to modest pace in the Boston, Cleveland, Atlanta, Dallas, and San Francisco Districts, with a somewhat stronger pace in New York, Richmond, Chicago, Minneapolis, and Kansas City, while Philadelphia and St. Louis characterized conditions as mixed. Manufacturing continued to expand in almost all Districts, with relatively strong growth in metal fabrication and the automotive industries; New York was the lone District reporting a weakening in manufacturing. Consumer spending reports tended to be positive, though several Districts noted that households remained price sensitive and focused on necessities, and holiday-season expectations were generally favorable. Housing markets remained depressed, with further weakening reported in several Districts, and commercial real estate activity stayed at low levels. Hiring showed some improvement across most Districts while wage pressures were described as contained. Prices for final goods and services were fairly stable despite rising input costs, particularly for agricultural commodities, metals, and fuel — firms were, for the most part, not passing those costs through.

STAFF REVIEW OF THE FINANCIAL SITUATION



Financial conditions were broadly calm. The financial stress index stood at 0.1647, a low reading indicative of well-functioning markets rather than strain, and the VIX at 17.99 pointed to contained equity-market volatility. Credit conditions appeared steady: the Baa corporate spread of 2.99 was moderate rather than distressed, consistent with Beige Book reports of stable lending activity and credit quality that was steady to improving across most Districts. The 10-year/2-year Treasury yield curve spread of 2.61 was steeply positive, showing no inversion and no recession signal from the term structure. At the front end, the 3-month T-bill spread relative to the current target rate was 0.015 — essentially flat — indicating that market pricing embedded no expectation of a change in the target range.

STAFF ECONOMIC OUTLOOK

The staff projection pointed to a continuation of the slow recovery rather than either a sharp acceleration or renewed deterioration. Inflation momentum was estimated at -0.11, implying that underlying prices were still drifting modestly lower rather than firming, so that core inflation was likely to remain well below levels consistent with the mandate for some time absent a change in the accommodation stance. Unemployment momentum of 0.05 was essentially flat, suggesting that the large gap between the 9.8% unemployment rate and the 5.02% estimated natural rate would close only gradually. Taken together, these readings implied persistent slack and a durable disinflationary backdrop over the projection horizon.

The estimated neutral rate (r^*) of 1.036 indicated that a neutral setting lay above the current real policy rate, so that policy remained accommodative as configured. All four reference rules considered — the Taylor rule, the Balanced Approach rule, the First-Difference rule, and the ELB-adjusted rule — returned a prescription of 0 basis points and were judged reliable this meeting. With inflation below target and a wide unemployment gap, the unconstrained prescriptions of the standard rules would sit below zero; the effective lower bound therefore pinned the constrained-optimal nominal rate at the current floor. The projection thus implied that the marginal accommodation over the horizon would have to run through the balance sheet rather than the funds rate, with the recovery expected to proceed slowly and inflation expected to remain subdued.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their initial predictive assessments, all five participants independently arrived at the view that no change to the target range was warranted, though they reached that conclusion from distinct vantage points. The participant most focused on inflation risk observed that the data presented the opposite of the problem he would ordinarily guard against: core PCE at 0.71% was far below the 2.0% target, wage pressures were contained, the Employment Cost Index was subdued, and final goods prices were fairly



stable despite rising input costs in commodities, metals, and fuel. He judged this to be disinflation, not inflation risk, leaving no case to tighten — and with the rate already at the 0.0% to 0.25% floor, no feasible room to cut. He flagged as a residual concern the possibility that rising input costs, combined with sustained easing, could eventually feed through, but saw no current evidence of such pass-through.

The participant weighting labor-market outcomes most heavily emphasized that unemployment at 9.8% against a 5.02% natural rate reflected severe distress, and that initial claims of 436,000 signaled still-weak hiring momentum despite the Beige Book's note of some improvement. She stressed that conventional easing was exhausted at the lower bound and that the active accommodation was being carried by the ongoing Treasury purchase program already underway, which she regarded as the tool doing her preferred work of supporting demand and jobs. The participant attentive to financial stability reported that his scan of stress indicators — the stress index at 0.1647, the VIX at 17.99, the Baa spread at 2.99, and a steeply positive term structure — revealed calm, well-functioning markets with no systemic strain, and cautioned that abruptly altering the in-progress purchase program would risk disrupting those conditions. The data-dependent participant read both mandate gaps as pointing the same direction — inflation too low, employment too weak — and concluded that neither a hike nor emergency action was indicated. The participant anchored on market signals noted that the near-flat front-end T-bill spread of 0.015 showed markets pricing no change, corroborating a hold.

In rebuttal, no participant was moved off the hold, and several noted that the convergence was genuine rather than contrived — the five had reached the same practical conclusion for different reasons. The inflation-focused participant reiterated that even a member disposed to lean against price pressure could not justify tightening with inflation far under target, and that the lower bound foreclosed a cut in any case. The labor-focused participant considered whether deteriorating conditions might warrant some new signal but concluded that improving hiring, contained wages, and the absence of acute stress argued against it. The financial-stability participant reaffirmed that continuity in the purchase program was itself the stabilizing choice.

Turning to the framework's loss-minimizing recommendation of 0 basis points, participants examined the underlying quantities and again converged. Several found the ELB-adjusted rule most persuasive: with r^* at 1.036 and the rate pinned near zero, the unconstrained rules would prescribe a deeply negative rate, so the constrained optimum sat at the floor. The inflation-focused participant stressed that inflation momentum of -0.11 confirmed prices were still drifting down, so that a hike would risk deepening disinflation — an unusual case in which his mandate priority found no fuel. The labor-focused participant characterized the 0 basis point outcome as reflecting the binding lower



bound rather than complacency about the 9.8% unemployment rate, noting that unemployment momentum of 0.05 showed slack barely resolving and that any additional employment support would have to flow through balance-sheet policy. Participants generally agreed that the agreement between the predictive vote and the framework recommendation revealed a coherent stance: rates parked at the floor while the ongoing purchase program carried the marginal accommodation.

A couple of participants recorded prospective cautions that did not bear on the current decision. The inflation-focused participant remained watchful that sustained asset purchases could eventually destabilize inflation expectations, and the financial-stability participant noted that prolonged easing could foster financial imbalances if spreads were to compress too far. Both emphasized that these risks were prospective, not present in the current data — the stress metrics, credit spreads, and term structure all pointing to calm conditions — and therefore did not override the case for holding. Taking the indicators at face value, participants judged the literal reading unambiguous.

COMMITTEE POLICY ACTIONS

In the predictive vote on the appropriate policy action, all five members supported maintaining the target range for the federal funds rate at 0.0% to 0.25%, a unanimous 5-to-0 outcome with no member favoring a change in either direction. On the deterministic optimal policy engine's recommendation of 0 basis points, the Committee likewise reached full agreement: all five members endorsed the recommendation as-is, with none declining and none registering only partial agreement. The predictive and optimal-side outcomes were therefore fully consistent, reflecting a genuine convergence across the differing analytical lenses represented on the Committee.