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INSIGHT

Federal Reserve Cuts Interest Rates in Late 2025

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The Federal Reserve (Fed) targets the federal funds rate (FFR, an overnight interbank lending rate) to achieve its statutory dual mandate of maximum employment and price stability, which it defines as a 2% inflation rate. (For background, see CRS In Focus IF11751, *Introduction to U.S. Economy: Monetary Policy*.) This insight analyses the Fed's recent decision to reduce interest rates in the last quarter of 2025 in terms of its dual mandate.

Monetary policy has whipsawed in response to economic disruptions in recent years, with the Fed first reducing interest rates to zero in 2020 in response to COVID-19, then raising rates from 2022 to 2023 to a peak range of 5%-5.25% in response to high inflation (see **Figure 1**).

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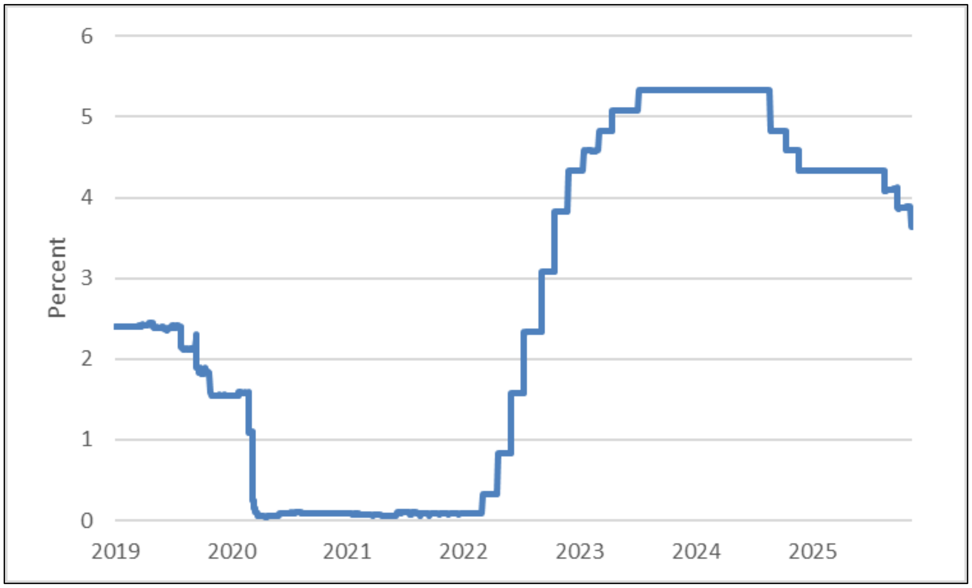
Figure 1. Effective Federal Funds Rate

2019-2025



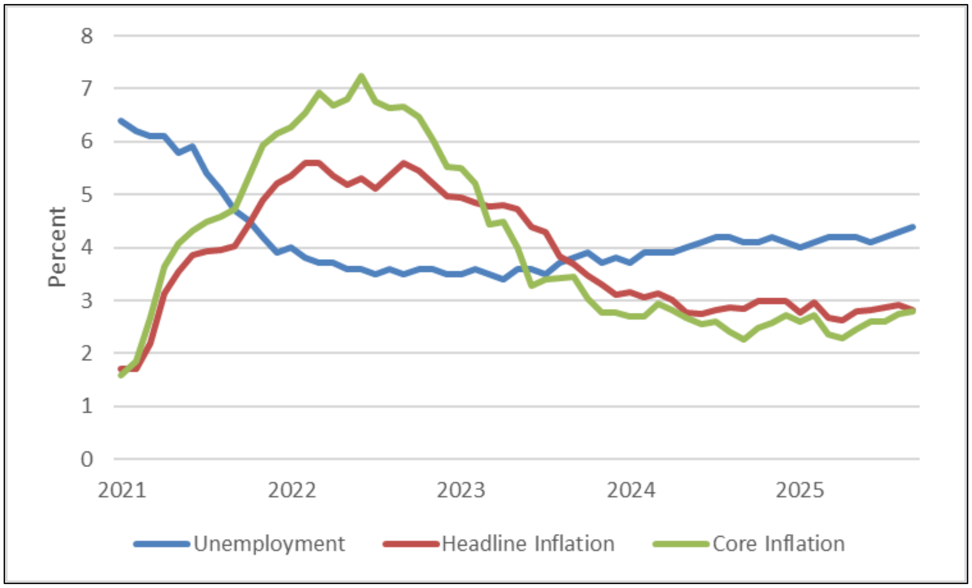
Source: Federal Reserve.

In 2024, following a few lower monthly inflation readings, the Fed reduced rates three times between September and December 2024 with the goal of bringing interest rates down to a more neutral level (one that would neither stimulate nor contract economic activity). The Fed then left the FFR unchanged until September 2025, largely to wait and see whether the increase in tariffs implemented by President Trump in 2025—which were potentially large as initially announced but have been repeatedly modified—would have a greater effect on inflation or employment. Tariffs feed through to consumer price inflation to the extent that producers pass on the cost of tariffs to consumers by raising retail prices. This effect would potentially call for higher interest rates to curb inflation, but the Fed has assumed that any increase in inflation from tariffs would be temporary, in which case (in its view) interest rates did not need to be increased in response. Tariffs can also potentially disrupt economic activity in the short run, potentially curbing employment growth. This effect would call for lower interest rates.

By September 2025, the Fed deemed that it could start cutting rates again to achieve (in its view) a more neutral policy stance. It made rate cuts at the three final meetings of 2025. The Fed justified cutting rates on the basis that "downside risks to employment rose in recent months." Monthly job growth was below average from May to September 2025, and the unemployment rate has risen by one percentage point since mid-2023 and about half a percentage point since the beginning of 2025 (see **Figure 2**)—although October and November data were not available at the time because of the government shutdown. However, the unemployment rate is still relatively low by historical standards, and the "break even" job growth needed to prevent unemployment from rising is estimated to have declined in 2025 due to the decline in immigration and the aging of the labor force. For example, Dallas Fed research estimates that the break-even rate has fallen from 250,000 jobs per month in mid-2023 to 30,000 in 2025. Thus, the employment slowdown may not be primarily caused by weak hiring demand—raising questions about the primary justification for cutting rates.

Figure 2. **Unemployment and Inflation**

2021-2025



Source: Bureau of Labor Statistics, Bureau of Economic Analysis.

The Fed decided to cut rates even though the 12-month change in (both headline and core) inflation has remained above 2% in each month since 2021, as shown in **Figure 2**. Inflation fell until April 2024, but since then both headline and core inflation have shown no downward trend, remaining above 2% and below 3%—although October and November data were not available at the time because of the shutdown.

Fed Chair Jerome Powell acknowledged that the Fed faced risks to both its full employment mandate and its price stability mandate when it chose to reduce rates in 2025, and holding rates constant in December based on the price stability mandate could also have been justified. In Powell's view, inflation had not returned to 2% in 2025 largely because of the tariffs, but he expected it would once the tariffs' effects on prices fell out of the data in the second half of 2026. Therefore, he argues, "in recent months, the balance of risks has shifted" to employment risks relative to price stability risks. However, the longer that inflation remains above target, the more entrenched higher inflationary expectations could become among the general public. The Fed's decision to cut rates since 2024, while inflation continually exceeded its target since 2021, may decrease the perceived credibility of its target in the public's eyes, thereby increasing inflation expectations. The Fed always has the option to raise rates if inflation does not continue falling, but it might be reluctant to do so, because it tries to avoid frequent and sudden reversals in policy. Therefore, moving to a neutral monetary policy before inflation returns to target runs the risks of inflation remaining above target for a more extended period.

The other main risk in moving monetary policy to what Powell described as "within a range of plausible estimates of neutral" stems from the fact that there is considerable uncertainty surrounding what interest rate is consistent with a neutral policy. The neutral interest rate is not directly observable—it is conceptual and can be estimated only by using an economic model. Thus, the estimate is only as good as the model and its assumptions. Current rates are roughly neutral according to the New York Fed's model, but that model also estimated a large decline in the neutral rate following the 2008 financial crisis compared to the period from 1961 to 2007. A key question moving forward is whether the historically-low-interest-rate environment from the financial crisis through the pandemic has persisted or whether the higher interest rates that have prevailed since inflation rose are indicative of a return to higher neutral rates than the 2008-2020 period. If the neutral rate is higher than estimated and more comparable to the pre-2008 period, then current policy is stimulative rather than neutral, which would be expected to increase inflation further above target and lower unemployment.

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