

“No Risk-Free Path”

COMMENTARY
September 2025

Responding to a reporter’s question regarding the Federal Reserve’s going-forward efforts to balance the risk of weaker employment against that of growing inflation, Chairman Powell stated, “We have a situation where we have two-sided risk, and that means there’s no risk-free path.” That two-sided risk scenario always exists, of course, but managing against both of the Fed’s “dual mandates” seems more challenging at present:

- Neither the rate of unemployment nor the rate of inflation is immediately worrisome, though we’d agree with many that view the persistence of the latter well above the Fed’s 2% target as the greater threat
- The directions of change are rather more concerning. Even so, the presumed drivers of upticks on both fronts include factors both abnormal and potentially ephemeral so the Fed’s caution—both in executing a quarter-point cut and in not making a larger cut—seems warranted
- The Fed has said it will remain vigilant to incoming data, the bias of which prompted an “insurance cut” against an even weaker job market, a cut that otherwise may be too small to stoke inflation further

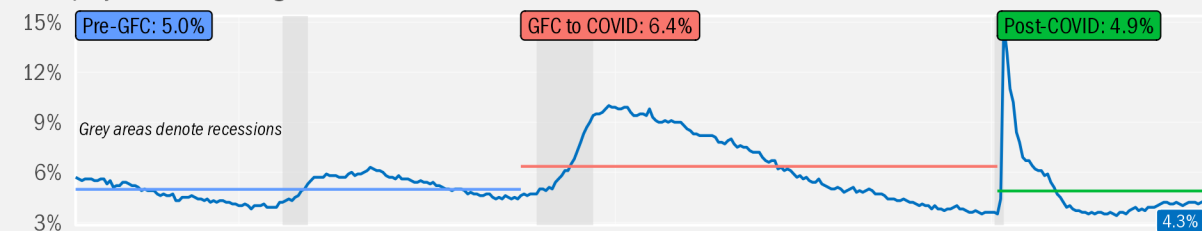
Tight Ropes

Operating under a mandate to achieve “full employment” and to maintain “price stability”, the U.S. Federal Reserve is tasked with fostering a steady environment for macroeconomic growth. Critically, for neither of those quoted items is there a law-bound reference. Maximum employment, for the Fed, is that level of employment/unemployment, “that the economy can sustain while maintaining a stable inflation rate.” Leaving aside the reference to inflation, a wide range of factors variously over time will influence domestic employment. That leaves the “maximum” bit a TBD “we’ll know it when we see it” objective through time. The theory is that tighter labor markets are reflective of a robust economy, one that might be prone to experience heightened inflation pressures. One such pressure may stem from the theory that increased demand for workers relative to the labor force may spark greater demand for higher wages. As that

Figure 1: Federal Reserve Dual Mandate Metrics

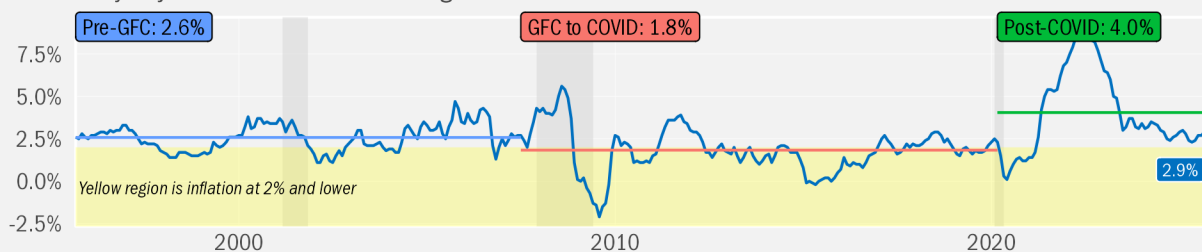
U.S. Civilian Unemployment Rate

Unemployed as Percentage of the Labor Force



Inflation: U.S. Consumer Price Index (CPI)

Seasonally Adjusted Year-over-Year Change



From 08.31.95 to 08.31.25. Inflation = year-over-year change in seasonally adjusted Consumer prices (CPI) as measured by prices paid by urban consumers for a market basket of consumer goods and services. SOURCE: U.S. Bureau of Labor Statistics (unemployment rate) and U.S. Bureau of Economic Analysis (inflation) via Bloomberg

incremental compensation chases an unchanged supply of goods, higher prices (inflation) may result. The reverse is thought to be true as well: an oversupply of potential workers leads to static or even falling compensation, dollars for which retailers must concede pricing in order to capture. The specific levels at which a theoretical equilibrium of just-enough labor supply/ demand are thought to change through time as due to shifts in demographics, required skills, the pace at which jobs become available and are found, regional availability of jobs, regulation and otherwise.

Similarly, “price stability” has proved a moveable target over the years. Left without a specific aim prior to that time, the Fed has maintained a 2%-ish inflation target since January 2012¹. After realizing that target (plus or minus 0.10%) in only 17 of the 103 months thereafter, or about 17% of the time, the Fed in August 2020 shifted its stance toward its inflation target from a constant value to an average value, thereby allowing for excess inflation after periods of less-than-desired increases in prices and vice-versa. That shift came, rather ironically, just prior to the COVID-response and Ukraine war-induced inflation spike in 2021-22. Since then, the 2% goal has remained well elusive, in this post-COVID era on account of annual price increases running far hotter than the Fed would like.

Where We are Now

As it stands, the level of unemployment remains on the tighter side of recent history, while inflation remains on the hotter side of the Fed’s target. By levels alone, one would think that the Federal Reserve should retain a reasonably restrictive stance. However, as we’ve noted so often in the past, in economics as in finance and investment, the direction and rate of change in metrics often matter more to decision makers and investors. And on those counts, the job market seems to be weakening somewhat, but the drivers of that weakening are curious and the pace of unemployment growth has been modest. Questions surround the potential impact of the reduction of the workforce based on falling immigration and the exodus of prior immigrants. Given stable demand for workers, labor markets should tighten. But hiring has slowed, with the younger generation of workers bearing the brunt of the burden. Perhaps the shift in tariff policy has dampened employer demand for labor, offsetting the loss of potential workers. Domestic manufacturers nonetheless continue to rank the building and retention of a reliable workforce among their greater challenges.

So it’s perhaps not surprising that wage growth remains robust (near 4% per year) for the average worker. As we suggested earlier, those extra funds may be putting upward pressure on prices. Changes in supply on account of tariffs could further these forces. And the tariffs themselves likely are showing up across the spectrum of goods and services. Services prices are also rising, perhaps as a result of higher wage demands as well. The upshot is that we no longer are in a state of disinflation. Even so, the change in the upward pace of inflation (the acceleration of inflation) remains tepid.

So, which is the greater concern? Which should be the greater concern? By cutting rates a quarter point earlier this month, the Fed confirmed that trends in employment were top of mind, even as the labor market remains historically tight (in the aggregate). The cut was small, however, qualified by Chairman Powell as “insurance” against greater weakness in the labor market. And by retaining what the Open Market Committee continues to believe is a modestly restrictive stance, the current rate backdrop should help to keep a lid on prices.

The decision continues to leave doors open from the remainder of the Fed meetings this year and into next. And on that front the Committee for good reasons we think can be seen as remaining more vigilant against inflation. The broader economy remains energetic: Gross Domestic Product (GDP) for the second quarter of this year was revised up to an annualized rate of 3.8% from a prior estimate of 3.3%, after a modest decline in Q1 (as suppliers bolstered inventories in advance of the revised tariff regime). Both GDP and employment are “lagging” indicators, in that they describe the past and tell us little of the future. But “coincident” and “leading” measures of the economy remain broadly healthy, if mixed. Retail sales, industrial production and personal income sit well on positive/ growth side of the ledger. Manufacturing continues to struggle, but not greatly. Service providers, on the other hand, are showing broad strength,

even as stubborn (and rising) prices may be crimping margins. Meantime, concerns about inflation are weighing down consumer sentiment, with trends there remaining on the negative side of recent history.

Taken together, the data express an economy that remains well on the growth side of the ledger, and not in any manner excessively so (leaving aside the bonkers growth in spending on generative artificial intelligence infrastructure, which we will address in next month's commentary). But that strength may be based on narrow footing. Barring any dramatic break from present trend, then, we should not be surprised to find the Federal Reserve open to decisions presently divergent from current market expectations.

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ⁱ <https://www.clevelandfed.org/publications/economic-commentary/2021/ec-202109-flexible-average-inflation-targeting-reactions>