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Unpacking the Fed Rate Decision: What It Means for Inflation and Employment

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September 18, 2025

***farmdoc daily* (15): 171**

Recommended citation format: Mashange, G. "Unpacking the Fed Rate Decision: What It Means for Inflation and Employment." *farmdoc daily* (15): 171, Department of Agricultural and Consumer Economics, University of Illinois at Urbana-Champaign, September 18, 2025.

Permalink: https://farmdocdaily.illinois.edu/2025/09/unpacking-the-fed-rate-decision-what-it-means-for-inflation-and-employment.html

The Federal Reserve resumed its rate-cutting cycle yesterday, lowering the federal funds rate by 25 basis points to a target range of 4.00%-4.25%.[1] Changes in this rate influence both prices and employment: raising the federal funds rate makes borrowing more expensive and tightens financial conditions, which cools demand, helps bring inflation down, but tends to slow hiring over time. On the other hand, lowering the federal funds rate makes borrowing cheaper and eases financial conditions, supports spending and investment, bolsters job growth, but it can also add upward pressure on inflation. This is the balancing act the Fed must navigate in pursuing its dual mandate—guarding price stability while supporting maximum employment.

This is the Fed's first move since January, when it held the target range at 4.25% to 4.50% after three consecutive cuts in late 2024—a 50 basis point cut in September followed by two 25 basis point cuts in November and December. The January pause reflected policymakers' reticence in lowering rates any further while inflation remained well above their 2% target. Throughout the year, policymakers emphasized the need for clearer evidence that inflation was slowing and pointed to a strong labor market as a justification to wait before continuing their rate-cutting cycle.

Yesterday's decision signals a tilt towards supporting economic growth amid a softening labor market, despite inflation remaining above 2%. In this farmdoc daily article, we examine key economic indicators such as labor market trends, inflation measures, and import prices to explain the Fed's recent decision and its broader implications.

[1] The effective federal funds rate (EFFR) is the weighted average interest rate that depository institutions (like banks) charge each other for lending their reserve balances held at the Federal Reserve, typically on an overnight basis. The Federal Reserve's Federal Open Market Committee (FOMC) influences this rate by setting a target range for it as a primary tool of U.S. monetary policy.

U.S. Labor Market Conditions

Wednesday's decision was widely expected, given the mounting signs of labor market weakness. The unemployment rate crept up to 4.3% in August, from 4.1% in June and 4.2% in July (see *BLS Employment Situation Summary*). Payroll growth was weak last month, with just 22,000 jobs added in August. Additionally, revisions to prior months' figures further highlight the slowdown in the labor market: 19,000 jobs were added in May, 13,000 were lost in June, and 79,000 were added in July. Lastly, the labor force participation rate remained the same for the most part at 62.3% (down 0.4 percent over the year).

Inflation Remains Above the Fed's 2% Target

Inflation remains a challenge and has been ticking up in recent months. In August, the core Consumer Price Index (CPI), which excludes food and energy, rose 0.3% in August and was 3.1% higher for the year (see *BLS Consumer Price Index Summary*). Moreover, the year-over-year change in the core CPI fell from 3.3 percent in January to 2.8% in March, where it remained until May. In June, the core CPI rose to 2.9%, then rose again to 3.0% in July. The headline CPI, which includes all items, rose 0.4 percent in August and was 2.9% higher compared to the same time last year. In July, the headline CPI rose by 0.2% over the month and was 2.7% higher on a year-over-year basis.

Food prices continue to exert pressure on households. In August, food prices rose 0.5% and are up 3.2% over the past year. The food index is divided into two main categories: food at home, which covers groceries purchased at supermarkets and other retail food stores, and food away from home, which captures meals and snacks purchased at restaurants, cafeterias, and similar establishments. In August, food at home prices increased 0.6%, while prices for food away from home rose 0.3%. Over the past 12 months, food at home prices are up 2.7%, led by meats, poultry, fish, and eggs (+5.6%), followed by nonalcoholic beverages (+4.6%), and fruits and vegetables (+1.9%). Food away from home is 3.9% higher year-over-year, with prices up 4.6% at full-service restaurants and 3.2% at limited-service outlets.

The Fed's preferred inflation measure, the Personal Consumption Expenditures (PCE) Price Index, typically runs below the CPI due to broader range of good and services covered and methodological differences. In July, the latest available month, the headline PCE price index was unchanged from June at 2.6% year-over-year, while core PCE has been increasing, rising from 2.6% in April to 2.9% in July (see *BEA Personal Income and Outlays, July 2025*) August PCE estimates are not yet available, but July's figures reinforce the view that inflation remains a challenge.

U.S. Import Prices

U.S. import prices in August were unchanged compared to a year ago and rose 0.3% in August (see *BLS U.S. Import and Export Price Indexes Summary*). Nonfuel import prices rose 0.4% month-over-month, and 0.9% compared to a year ago. Notably, import prices for finished goods such as consumer goods went up 0.7%, while capital goods rose by 0.5%, and automotive vehicles rose by 0.2%. Meanwhile, prices for imported foods, feeds, and beverages fell for the sixth consecutive month, declining by 2.1% in August, driven by price declines in fruit, green coffee, and cocoa beans. Lastly, import prices from China rose 0.6% in August—the largest monthly increase since December 2021—even as they remain 3.1% lower year-over-year.

Conclusion

The Fed's decision to cut rates reflects a cautious pivot toward supporting employment amid a softening labor market, even as inflation remains above target. However, the updated "dot plot" (see *Figure 2 on page 4 of the Summary of Economic Projections*) shows that there is a wide range of views on what the appropriate target rate should be in 2026, and in subsequent years. This makes interpreting the future path of monetary policy challenging. Additionally, it is uncertain how inflation will trend for the remainder of the year, and the next, under this lower rate environment. On top of this, the effects of tariffs might also become more evident in prices over time. Looking ahead, how many more cuts should we expect for the remainder of 2025 and how large will each be? According to the CME Group's FedWatch Tool as of September 17, 2025, futures traders are pricing in a 86.6% probability of an additional 25 basis point cut in October, and a 80.6% probability of another 25 basis point cut in December taking the target range down to 3.50% to 3.75% by the end of the year. These odds will update as more economic data is made available.

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