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FOMC Policy Preview

For the meeting of October 28-29, 2025

Federal Reserve Monetary Policy Working Group

FIU Economics Undergraduates

Issue date: October 28, 2025

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Sheng Guo and Riley Miret prepared the document. This document draws on the presentation material prepared by Francisco Fernandez, Samuel Perez, Juan Pernas, Katheleen Socorro, Aleksandre Subeliani and Sofia Teixeira. We acknowledge various inputs to this project by Elias Alvarez-Sosa, Ahmer Ansari, Diego Fiorito, Conor Moore, Favio Arista Nicho, Juliana Pena, and Damian Pinnock. All the aforementioned individuals are current FIU economics undergraduates, except Sheng Guo, who is an Associate Teaching Professor of Economics and the faculty advisor of the Working Group. We thank Glory Adebayo, Mihaela Pintea, and the Department of Economics for their support.

The Working Group will continue to publish monetary policy preview briefs in the future. For the latest release updates and presentation arrangements, please contact Sheng Guo, sguo@fiu.edu, 305-348-2316.

Executive Summary

Since the start of the Federal Reserve's monetary tightening cycle, inflation has fallen meaningfully from its highs. It is now trending closer to the 2 percent target but still elevated. At the same time, the labor market—though resilient—has cooled, with slower job creation, a higher unemployment rate, and wage growth moderating. Economic growth remains positive but uneven. Consumer spending continues to drive activity. Trade policy remains a key source of uncertainty, clouding the economic outlook. Conflicting indicators raise the risk of undermining Fed's progress on the balance between the desirable inflation target and maximum employment.

We expect the Federal Open Market Committee (FOMC) to reduce the federal funds rate by 25 basis points, to a range of 3.75–4.00%, in an effort to ease pressure on a softening labor market without significantly compromising the ongoing disinflation process. The rate cut represents a risk-management decision — a prudent adjustment intended to safeguard economic stability and sustain labor market health. A precautionous move like this at this stage is preferable to risking a deeper, avoidable downturn in the future.

Introduction

Since the start of the Federal Reserve's monetary tightening cycle, inflation has fallen meaningfully from its highs and is now trending closer to the 2 percent target but still elevated. At the same time, the labor market—though resilient—has cooled, with slower job creation, a higher unemployment rate, and wage growth moderating. Economic growth remains positive but uneven, with elevated uncertainty surrounding its outlook. Conflicting indicators increase the risk of undermining the Fed's efforts to balance its dual mandate of price stability and maximum employment.

This paper begins with an overview of the macroeconomy, followed by analyses of the labor market, inflation developments, and financial market conditions. After discussing the economic outlook and assessing key risks, we conclude with the likely FOMC policy decision and forward guidance.

Economic Overview

The Bureau of Economic Analysis (BEA) reports that real GDP contracted at a 0.6 percent annualized rate during the first quarter of 2025, before rebounding to a strong 3.8 percent growth rate in the second quarter, primarily driven by a decline in imports and an increase in consumer spending. On a year-over-year basis, GDP has increased by 2.1 percent. Figure 1 shows that although growth momentum has eased in recent quarters, it remains in positive territory. Blue Chip Economic Indicators data hints at slower growth in the future, with average growth levels moderating to 1.6 percent.

Figure 1



On the income side, BEA data show a 0.4 percent rise in personal income in August, but the annual growth rate of real disposable personal income has continued to edge down since the pandemic. On the spending side, personal consumption expenditures contributed 1.68 percentage points to the 3.8 percent real GDP growth in the second quarter of 2025, accounting for roughly 44 percent of total growth. A key indicator of consumer spending, monthly retail sales, rose 0.6 percent in August from July, reflecting continued strength across both goods and services.

However, monthly retail sales are expected to decline by 0.4 percent before returning to growth next year.

Figure 2

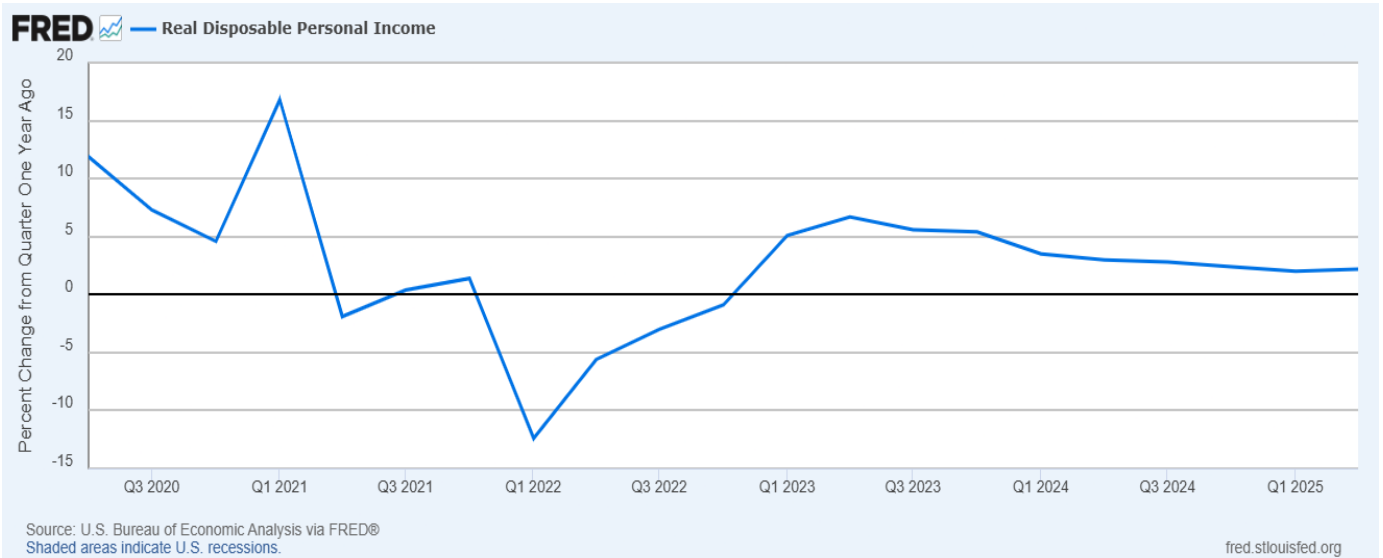
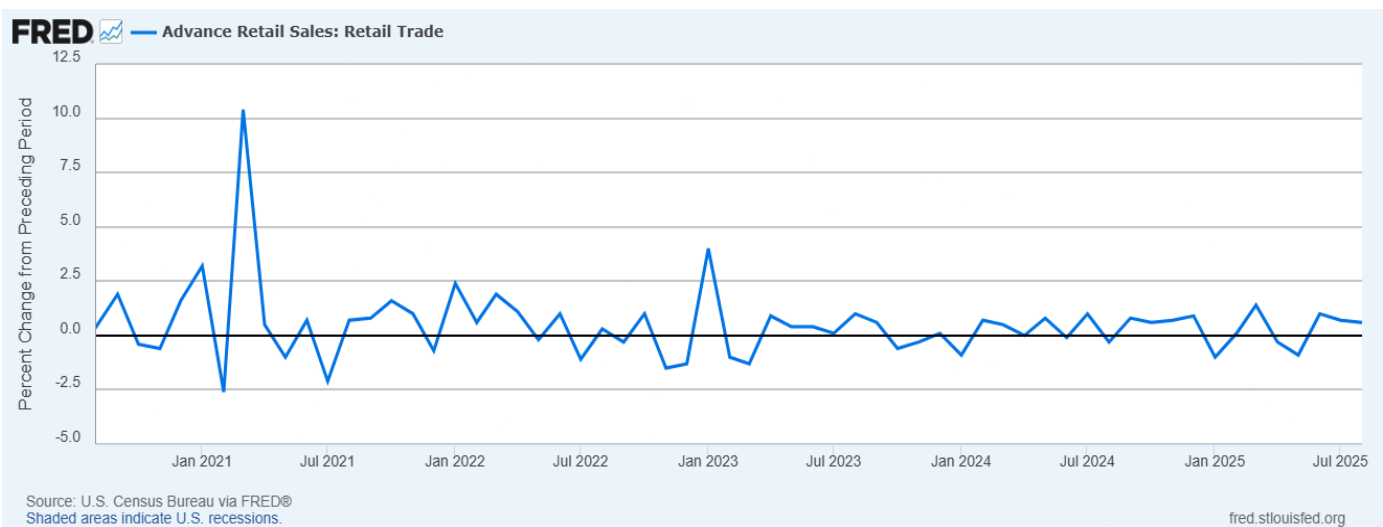


Figure 3



The ISM indices in Figure 4 lend support to the outlook for a near-term slowdown. The Services PMI has trended downward yet stayed above the neutral threshold of 50 through September, reflecting a deceleration but continued expansion in the service sector. Meanwhile, the Manufacturing PMI registered 49.1 in September, marking the sixth consecutive month of contraction. This divergence underscores a bifurcated growth pattern, with services maintaining modest resilience while manufacturing remains subdued.

Figure 4

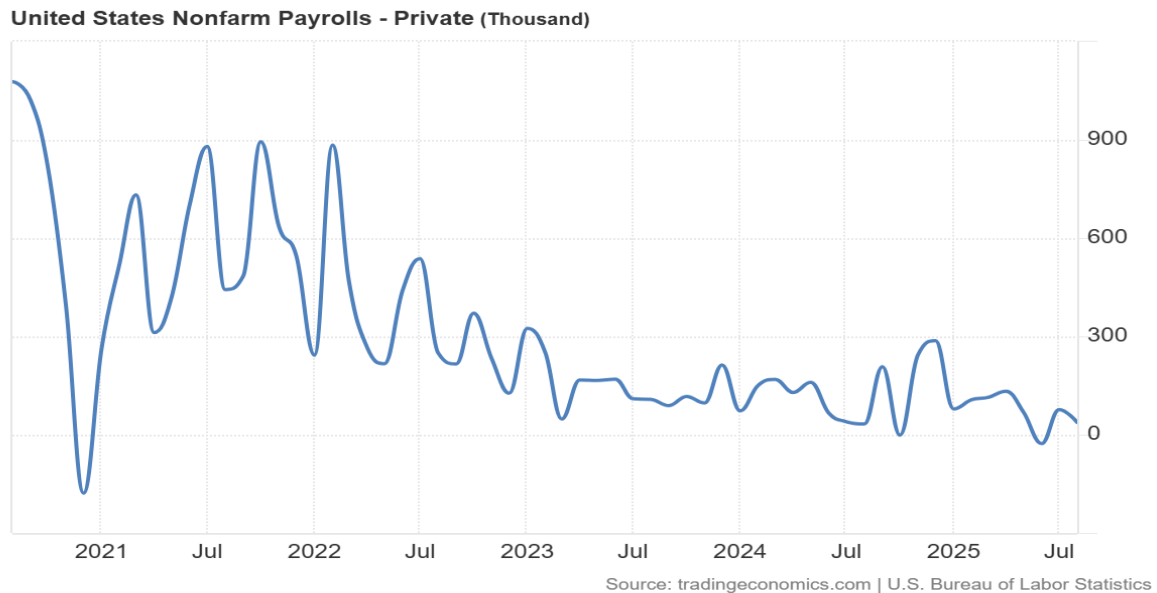


Given the signs of a weakening economy, how is the labor market holding up? We turn to this question in the following section.

Labor Market

Figure 5 shows the monthly changes in private nonfarm payrolls reported by the Bureau of Labor Statistics (BLS). Aside from a strong rebound of 287,000 in December 2024, job gains have generally trended downward since 2023, with the latest increase at 38,000 in August 2025.

Figure 5



However, initial jobless claims have remained mostly within the range of 200,000 to 250,000 over the past two years (Figure 6). For the week ending September 20, 2025, initial jobless claims declined to 218,000, down from 232,000 the previous week and well below market expectations. The four-week moving average also eased, signaling continued stability in employment. This decline indicates that layoffs remain contained, and the labor market is consolidating rather than weakening. Job losses have been concentrated in federal government employment and in mining, quarrying, and oil and gas extraction, the industries more sensitive to higher interest rates and tighter financial conditions.

At the same time, job creation has slowed and hiring demand has eased, as shown by the JOLTS data from the BLS (Figure 7), reflecting firms' adjustments to tighter financial conditions and heightened uncertainty. Job openings have continued to decline, signaling that labor demand is gradually cooling. Total job openings stood at 7.23 million in August 2025, down by more than

half a million from 7.76 million in January. Taken together, these pieces of evidence point to a “low-firing, low-hiring” labor market environment.

Figure 6

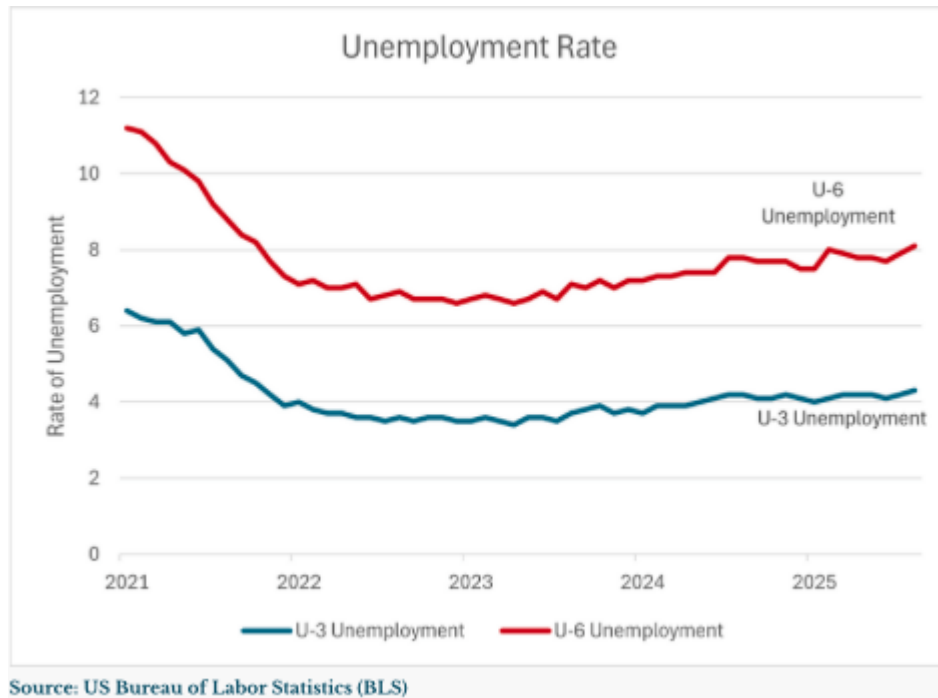


Figure 7



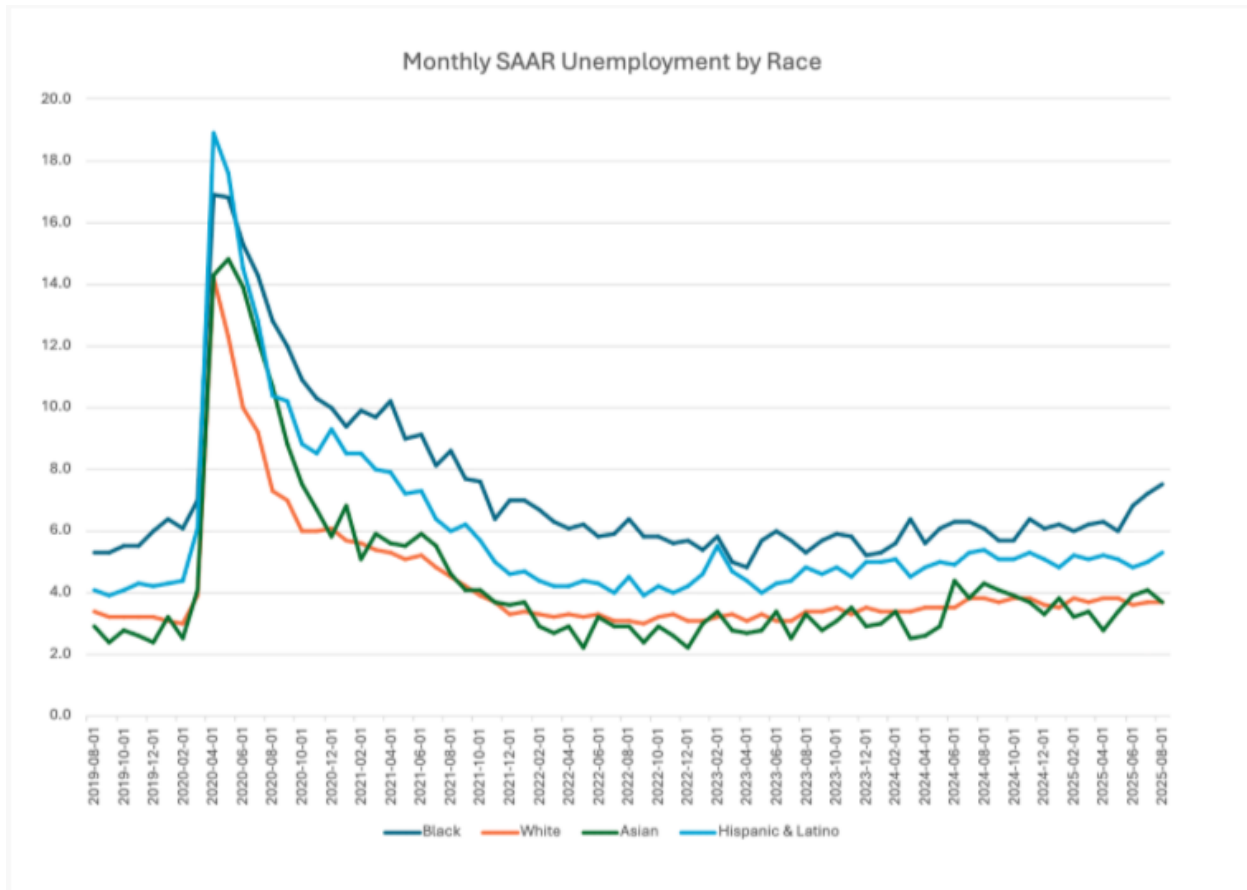
Consequently, the corresponding movement of headline unemployment rates over the past four years is a slow and gradual trend-up (Figure 8). In late 2023, unemployment stood at one of the lowest levels in recent decades before turning into a gradual upward trend that continued through 2025. The total unemployment rate reached 4.3% in August.

Figure 8



The headline unemployment rate conceals persistent disparities across demographic and racial groups (Figure 9). As of August 2025, the unemployment rate for African American workers was 7.5 percent, and for Hispanic workers, about 5.3 percent, compared with 3.7 percent for White and Asian workers. These differences highlight that African American and Hispanic workers remain more vulnerable to the current “low-firing, low-hiring” environment.

Figure 9

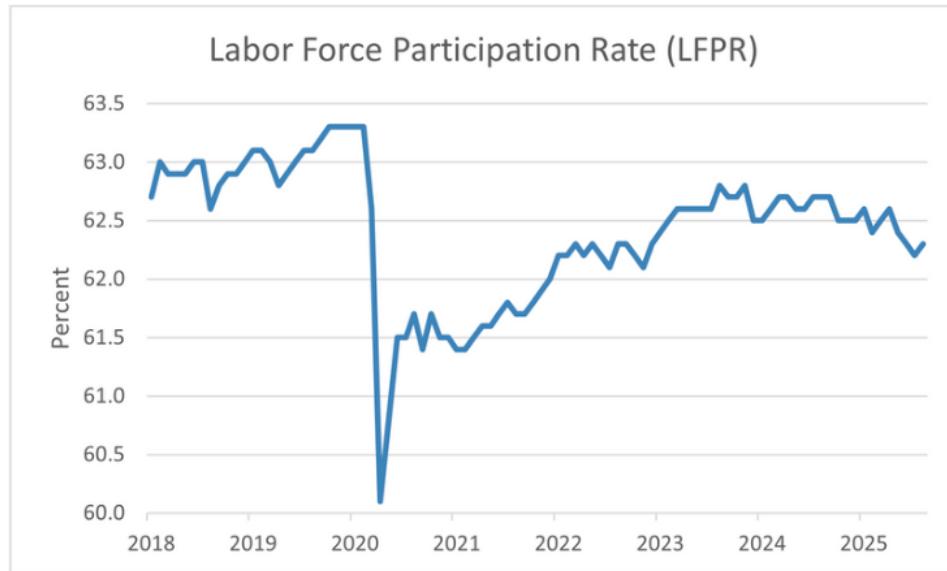


Source: U.S. Bureau of Labor Statistics via FRED®

The labor force participation rate stood at 62.3 percent in August 2025. While this reflects a significant recovery from pandemic-era lows, it remains below the pre-2020 level of about 63.3 percent, showing a general, gradual downward trend since the mid-2023 (Figure 10).

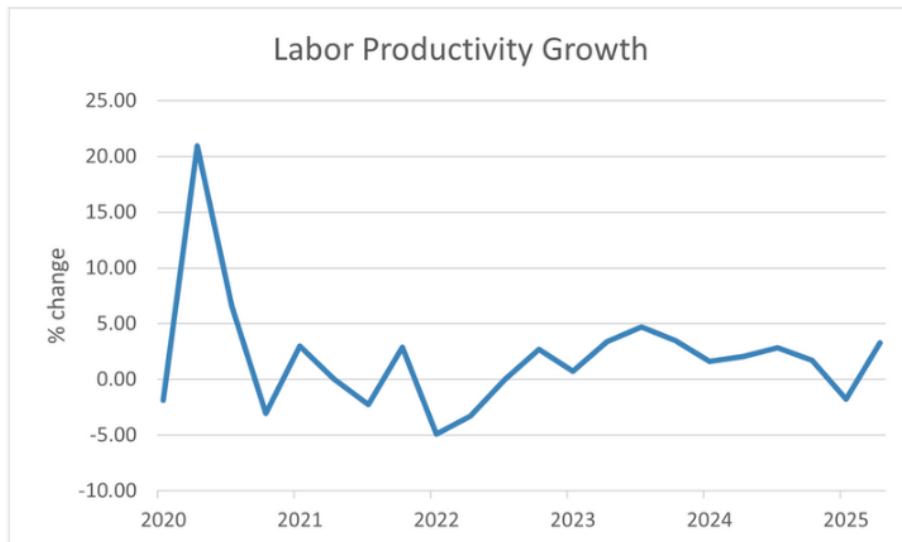
Labor productivity in the nonfarm business sector rose at an annualized rate of 3.3 percent in the second quarter of 2025 (Figure 11), reversing the previous downward trend as output increased 4.4 percent while hours worked grew only 1.1 percent. These gains suggest that efficiency improvements are helping contain inflationary pressures even as labor supply growth has slowed.

Figure 10



Source: U.S. Bureau of Labor Statistics via FRED®

Figure 11



Source: U.S. Bureau of Labor Statistics (BLS)

Currently, the unemployment rate is roughly 4.3% while the vacancy rate is also near 4.3, indicating the Beveridge Curve is at near perfect equilibrium (Figure 12), further confirming the “low-firing, low-hiring” environment currently observed. Consequently, the nonlinear Phillips Curve (Figure 13) shows that the increase in the vacancy rate may lead to higher headline inflation as there’s little slack in the labor market. We turn to inflation in the next section.

Figure 12

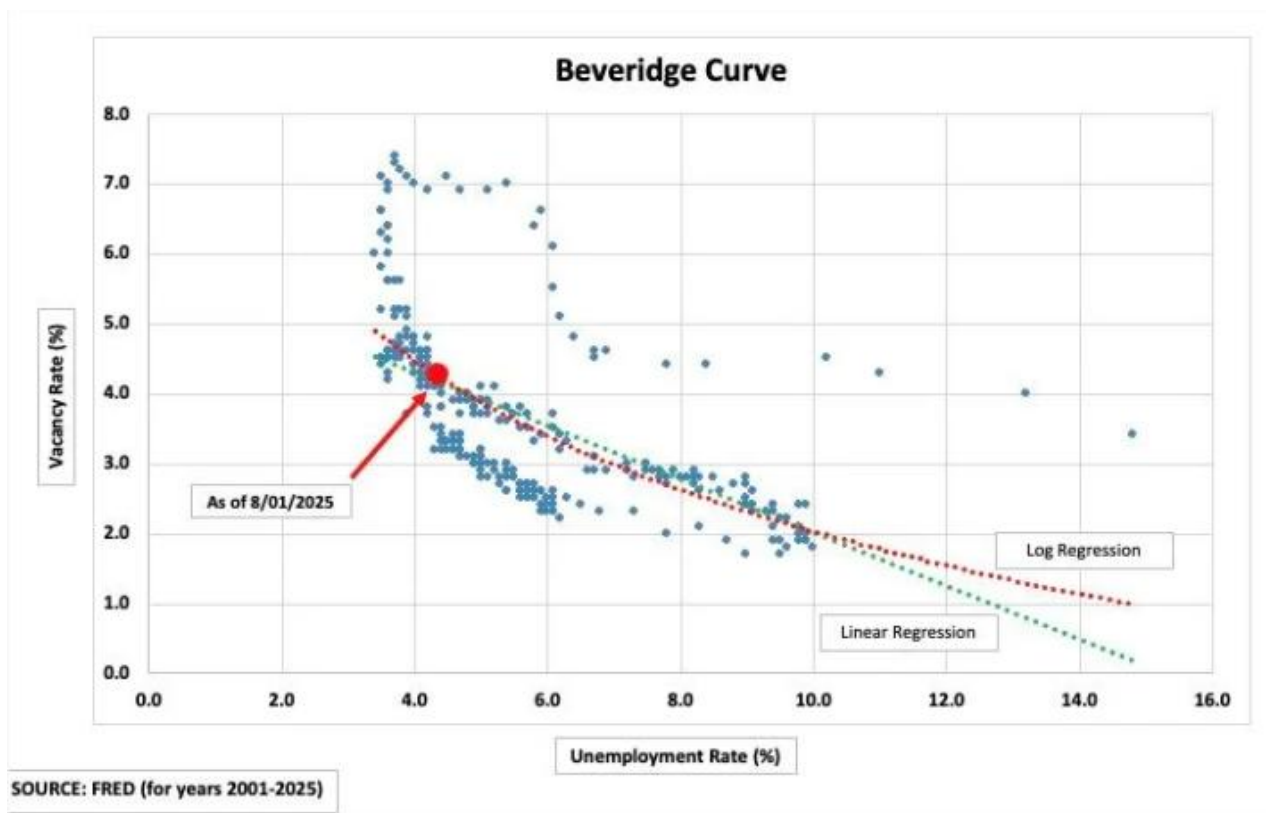
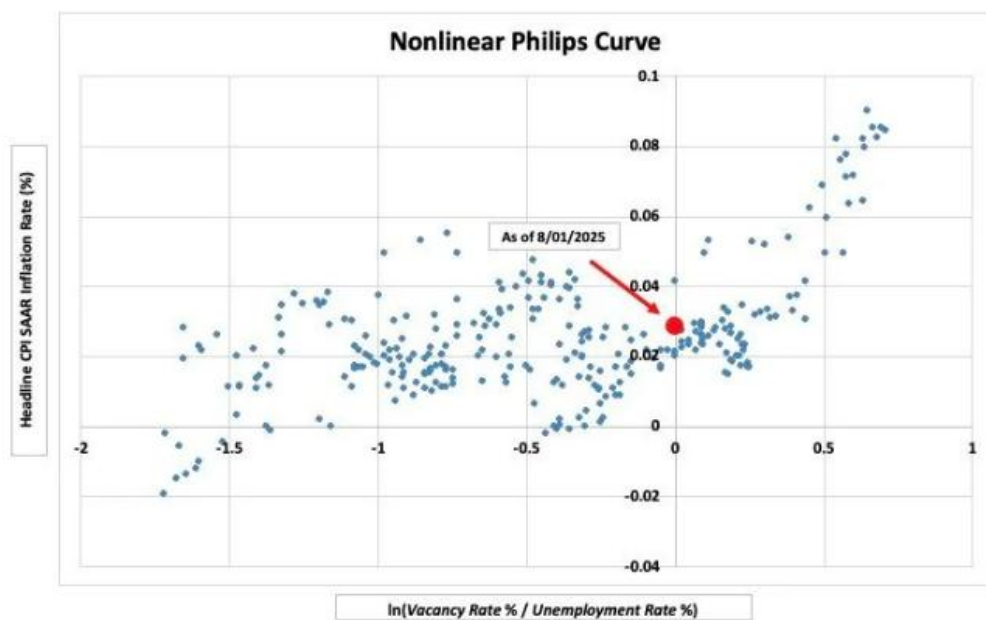


Figure 13

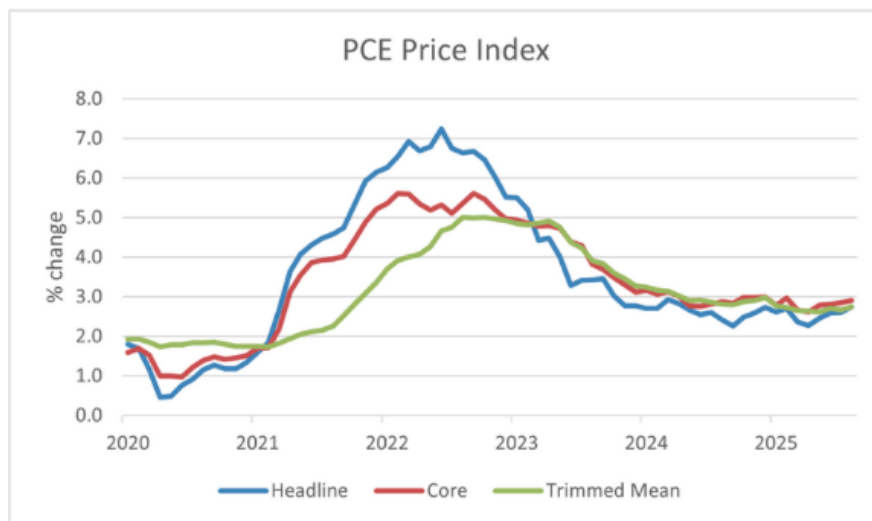


SOURCE: FRED (for years 2002-2025)

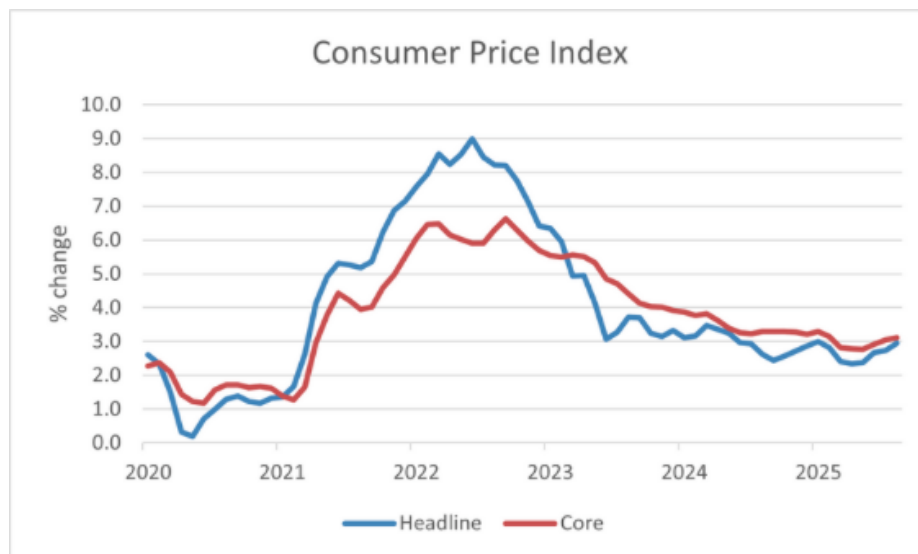
Inflation

Inflation has come down noticeably since its 2022 peak but still remains above the Fed's 2% target (Figure 13). Headline PCE and core PCE in August were 2.7% and 2.9% respectively, signaling a broad cooling in inflation. However, PCE inflation is likely to edge up to around 3.1% in the near term. The CPI data show a similar pattern, with both the headline and core CPI increasing by 3.0% year over year in September.

Figure 13



Source: U.S. Bureau of Economic Analysis via FRED®



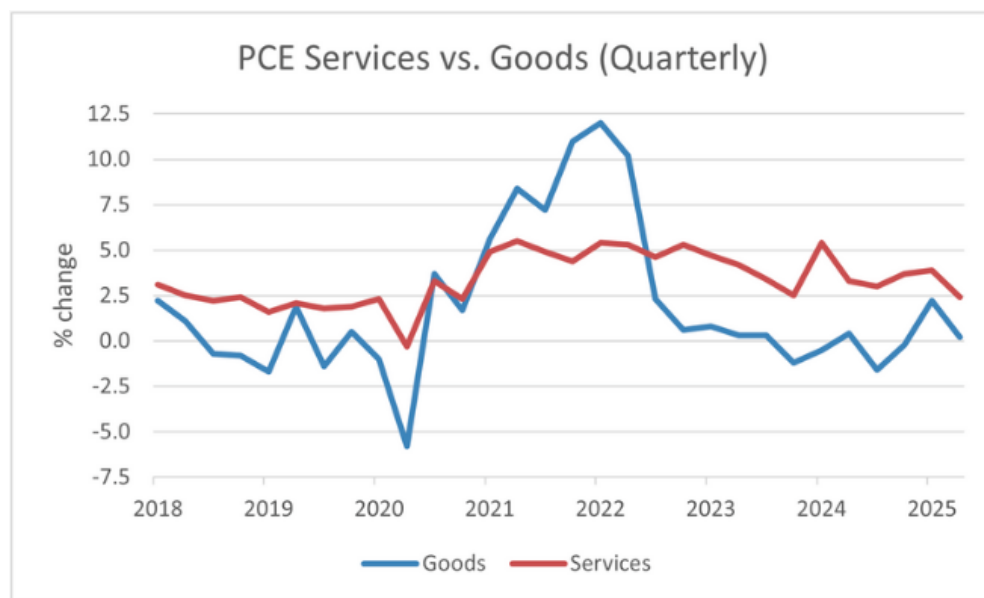
Source: U.S. Bureau of Labor Statistics via FRED®

Among the components of inflation (Figure 14), services inflation remained sticky in the two years following its 2022 peak but has begun to gradually ease this year, moving below the range observed in previous years. Goods inflation spiked sharply during 2020–2022 amid supply disruptions caused by the COVID-19 pandemic. It then largely normalized to around zero before beginning to edge up again since January, reflecting tariff-related concerns and uncertainty.

The pass-through of tariffs to consumers has so far been smaller and slower than expected, as most firms have absorbed much of the cost increase. Nonetheless, some effects have begun to appear in higher prices for certain categories of goods that are predominantly imported. For example, the index for meats, poultry, fish, and eggs has risen by 5.6% over the past 12 months, while the furniture index has increased by about 9.5%. Compounding this issue, the dollar has gradually weakened since 2024 (Figure 15). A weaker dollar tends to amplify the inflationary impact of tariffs by further raising the prices of imported goods.

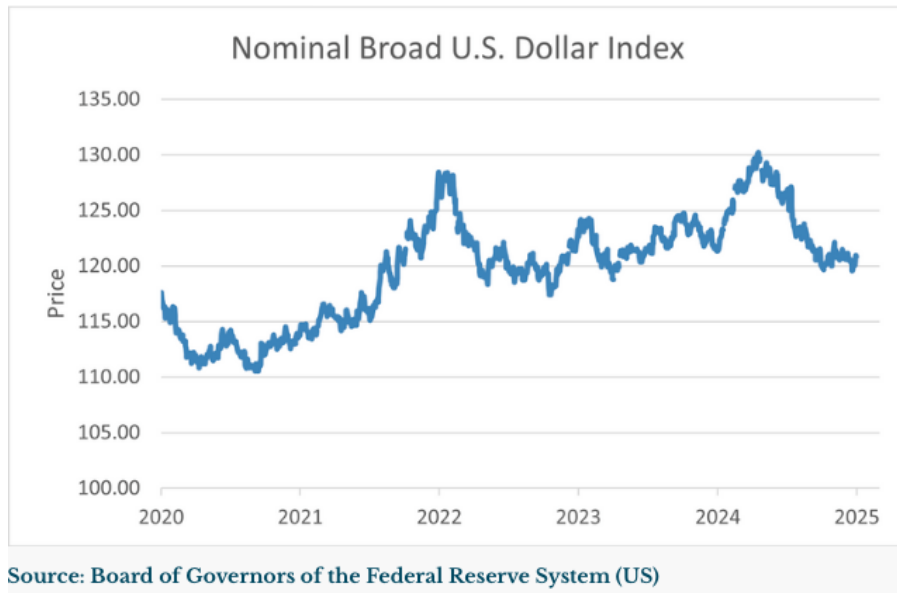
The Federal Reserve expects the tariff impact on consumer prices to be a one-time, temporary price level adjustment, though this remains to be seen in the data over the coming months.

Figure 14



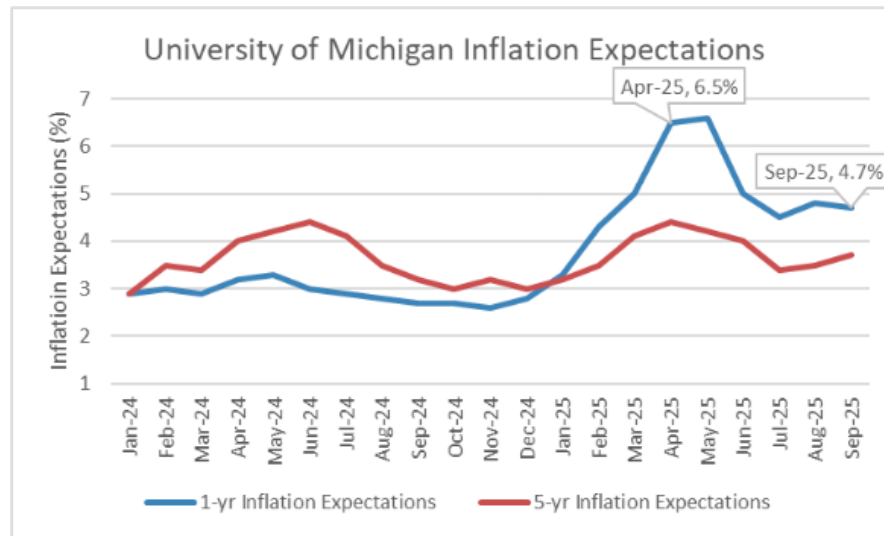
Source: Bureau of Economic Analysis (BEA)

Figure 15



The persistence in inflation could de-anchor consumers' expectations on inflation. Since the announcement of tariffs in April, short-term consumer inflation expectations rose sharply. Although they have since declined from their peaks, they remain elevated. In contrast, longer-term consumer expectations appear more anchored, broadly consistent with pre-tariff levels (Figure 16). Meanwhile, market-based inflation expectations have stayed considerably more stable, with five- and ten-year measures hovering around 2.25%, close to the target.

Figure 16



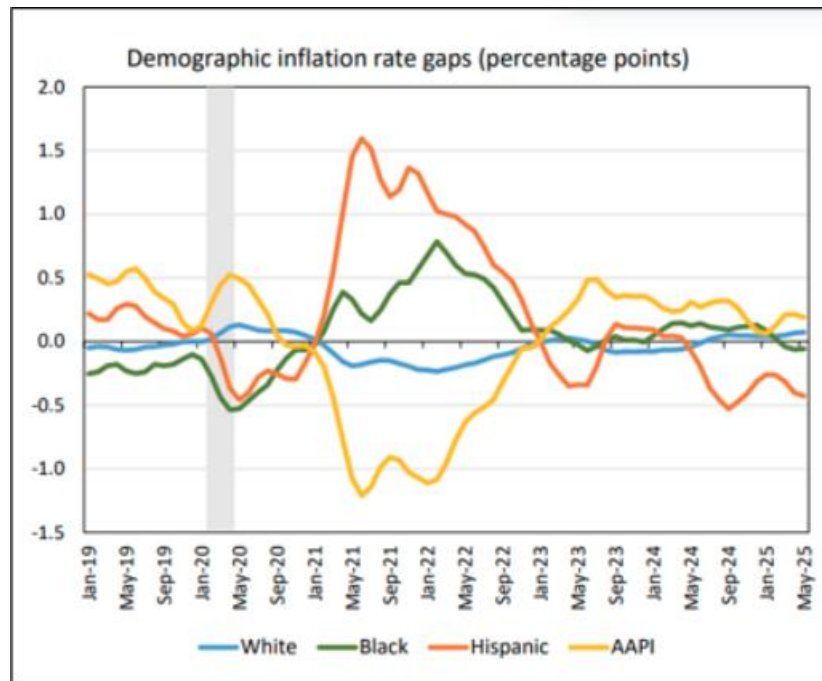
Source: University of Michigan (Surveys of Consumers)



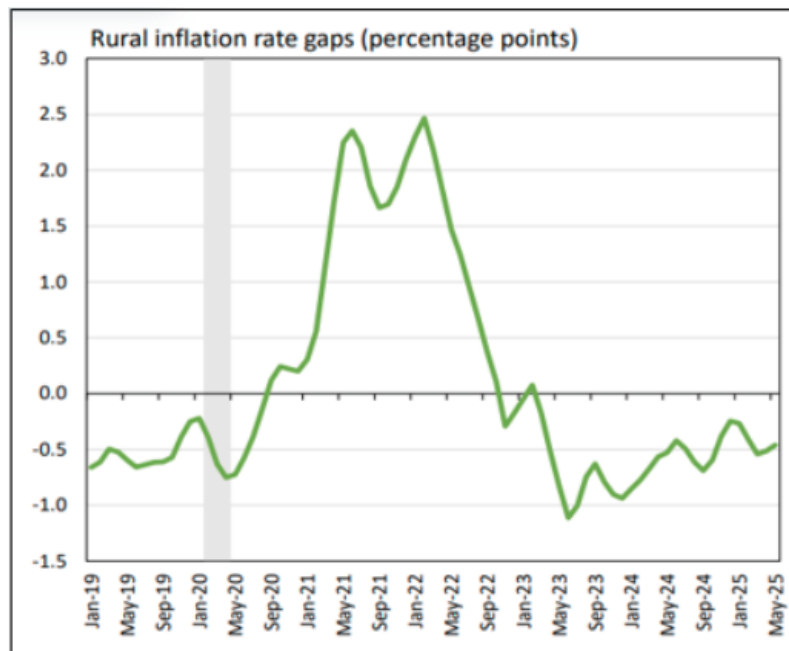
Source: Federal Reserve Bank of Cleveland

One silver lining amid persistent inflation is that the inflation gaps across demographic groups have narrowed since 2022. For instance, Hispanic households have faced lower inflation relative to other ethnic groups, and the inflation gap for African American households has turned slightly negative (Figure 16). Rural households have also experienced less inflation compared with 2022. This convergence suggests a reduction in inflation inequality, which could allow for a less restrictive stance in monetary policy.

Figure 16



Source: Federal Reserve Bank of New York



Source: Federal Reserve Bank of New York

Financial Markets

Following the April tariff pause, equity markets have rebounded, with both the S&P 500 and the U.S. Tech Composite Index surpassing their pre-shock levels by more than 10% (Figure 17). Valuations remain somewhat elevated, reflecting resilient corporate earnings and sustained investor optimism. This rebound has strengthened household balance sheets, particularly among those with significant equity exposure. The resulting wealth effect may continue to support consumer spending in the near term, partially offset the drag from tighter financial conditions and credit standards.

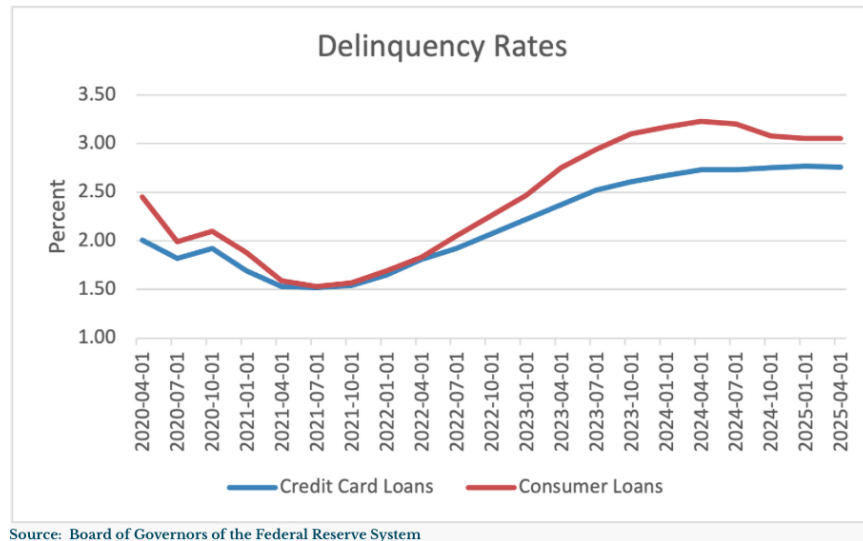
Figure 17



source: tradingeconomics.com

On the borrowing side, consumer delinquency rates remain elevated following their recent rise (Figure 18). As of Q2 2025, the delinquency rate on credit card loans stood at 3.05%, while that for other consumer loans was 2.76%. This persistent trend suggests that at least some households are feeling the strain of higher borrowing costs.

Figure 18



In the bond market, the yield curve has recently returned to a positive slope after nearly two years of inversion (Figure 19). The spread between the 10-year and 2-year Treasury yields has moved above zero, indicating that long-term rates once again exceed short-term rates. Historically, such a shift suggests that markets expect lower short-term interest rates ahead, reflecting anticipated monetary easing as inflation moderates and growth slows.

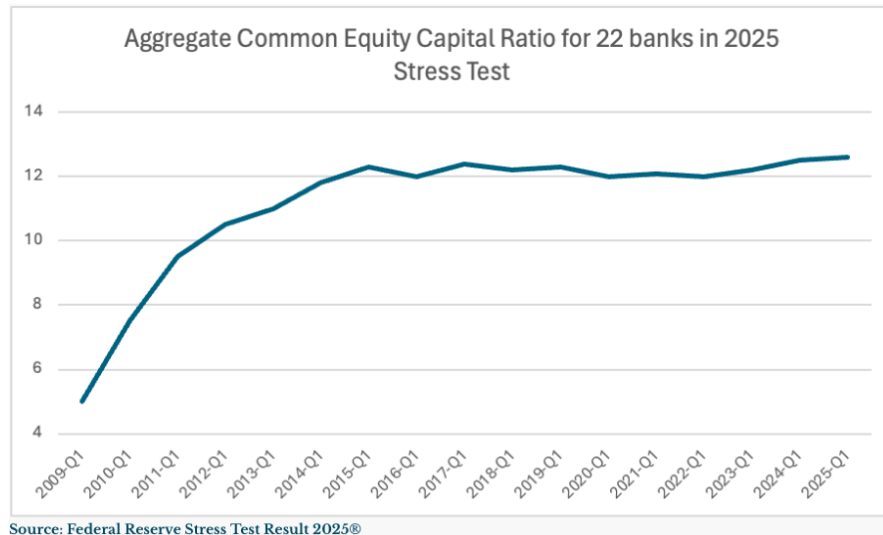
Figure 19



Nonetheless, banks continue to maintain strong capital buffers. The aggregate common equity Tier 1 ratio for the twenty-two largest institutions remains around 12.5%, well above pre-

crisis levels and comfortably above regulatory minimums (Figure 20). This stability underscores the overall health of the banking system and its capacity to absorb potential shocks. Despite tighter financial conditions and lingering credit stress in certain regional segments, large banks remain well-capitalized, supporting overall financial stability.

Figure 20

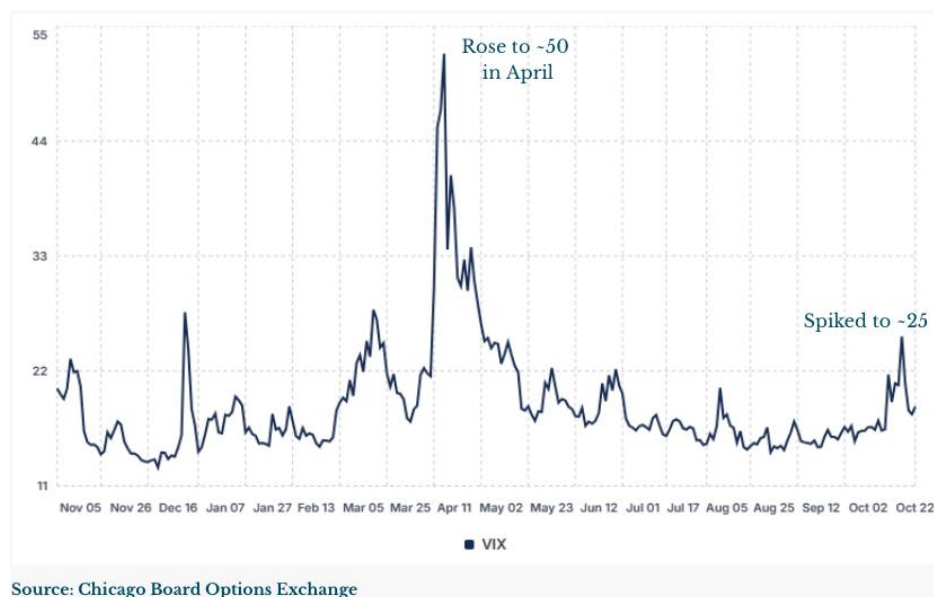


Risk Assessment

The current economic environment underscores a critical trade-off between continued progress on inflation and uneven impacts on employment across sectors. Moreover, the recent government shutdown has added an unusual layer of uncertainty, disrupting data collection, delaying federal reports, and clouding the near-term outlook for both fiscal policy and business sentiment.

In addition, renewed geopolitical uncertainty weighing on market sentiment. Ongoing trade disputes have added volatility to global supply chains and investor expectations. This is reflected in the VIX Index, whose reading in April showed a sharp rise following tariff announcements and heightened geopolitical tensions, before easing as conditions stabilized. While volatility has since normalized, these risks remain a key source of potential financial tightening if uncertainty persists or re-escalates.

Figure 28



Policy Recommendation and Forward Guidance

With inflation trending toward the target and long-term expectations by and large anchored, alongside a gradually weakening labor market and tight financial conditions, the balance of risks remains tilted to the downside. Furthermore, amid conflicting indicators, persistent geopolitical uncertainty, and the lack of timely economic data due to the ongoing government shutdown, we believe the Federal Reserve must act preemptively and decisively to prevent a further deterioration in economic conditions.

We expect the Fed to cut the federal funds rate to a range of 3.75-4.00%. The cut serves as a prudent risk-management move, a measured step to safeguard economic stability and labor market health before a deeper, avoidable slowdown takes hold. Acting conservatively now is preferable to risking a more pronounced downturn later. Our expectations for the key elements of the forthcoming FOMC policy statement are summarized in the following table.

Table 1

Monetary Policy Tool	Recommendation
Federal Funds Rate	Lower the federal funds rate target range by 25 basis points to 3.75% - 4.00%
Forward Guidance	Maintain commitment to data dependence and prioritize the 2% target rate while remaining mindful of further cooling in the labor market
Balance Sheet	Continue decreasing total assets outstanding to drain excess liquidity in short-term assets.