

# Was the Fed's December Rate Cut Premature?

December 16th, 2025

## The Fed Cut Interest Rates By 25 bps to 3.50% - 3.75%

As markets had anticipated, the Federal Open Market Committee (FOMC) cut its federal funds rate by 25 basis points to a range of **3.50-3.75%** last Wednesday. This is the third time that the Fed has cut rates in 2025, and it came amid mixed economic signals. Even though the Fed appears to be moving toward a more accommodative monetary policy regime, there was notable dissent within the FOMC regarding the appropriate trajectory of policy. Austan D. Goolsbee, President of the Chicago Fed, and Jeffrey R. Schmid, President of the Kansas City Fed, both favored keeping interest rates unchanged. In contrast, Stephen I. Miran dissented in the opposite direction, preferring a larger 50 basis point cut. This divergence highlights the underlying tension within the Committee. The key question going into early 2026 is whether the Fed will continue cutting rates in an environment where inflation risks remain skewed to the upside, while the labor market outlook remains highly uncertain.

## Setting the Scene with the Current Economic Environment

The labor market, which has appeared to take on greater priority in recent Fed communications, has shown meaningful cooling since the beginning of the year, strengthening the case for a rate cut. Overall, unemployment has gradually increased over the months to **4.6% in November**, while job openings have declined meaningfully from their peak. Additionally, the private sector has shown weakness, with November highlighting employers shedding 32,000 jobs, led by smaller businesses due to cautious consumers and an uncertain macroeconomic environment. Chair Powell notes that a part of the labor market cooling reflects a decline in the labor force, due to **lower net immigration and labor force participation**. Hence, this shows a slowing labor supply

alongside softening labor demand. Despite the labor market still being relatively in balance, any further cooling of labor demand will have negative implications for the economy.

On the other side of the dual mandate, a pressing concern is still getting inflation back to the Fed's 2% target. For September, the Fed's preferred gauge, headline and core PCE, were reported to be around **2.8% with core easing slightly from earlier months**. Similarly, both headline and core CPI sit around 3.0% YoY, with **service inflation being particularly sticky**. Inflation seems to be drifting lower, albeit persistently elevated. However, the inflation fight is not over, especially as we head towards a neutral-accommodative policy stance. Near-term inflation expectations, which have been somewhat anchored, haven't shown signs of declining, as they are reported to be **3.2% by the New York Fed**. The economy has shown resilience, with the Fed projecting real GDP growth in 2026 was raised to about 2.3% in the December Summary of Economic Projections (SEP), an increase from the 1.8% in the September projection. Uncertainty is widespread, and caution should be warranted, but easing while the economy seems to be holding up can lead to a new norm of a higher inflation steady state.

## **More Than Rate Cuts: Fiscal Constraints and the Limits of Monetary Easing**

Generally, rate cuts are intended to stimulate economic activity by lowering borrowing costs and easing overall financial conditions. Rate cuts can improve affordability, particularly in housing, by indirectly lowering long-term borrowing costs, including mortgage rates. However, this transmission has not materialized in the current environment. The 30-year fixed mortgage rate remains elevated at approximately 6.22% as of December 11, while the 10-year Treasury yield has risen following the Fed's rate cut, despite modest declines in recent days, standing at around 4.15% at the close on December 16. This divergence underscores the limited effectiveness of policy easing in lowering long-term rates when inflation expectations and term premia remain elevated.

In recent months, the Fed has been providing liquidity through a combination of declining ON RRP balances, increased use of repo facilities, and targeted Treasury bill purchases.

While understood as technical operations aimed at maintaining market functioning and easing financial conditions, including lowering long-term yields and improving affordability, these actions also help absorb elevated Treasury supply, **raising concerns that monetary and fiscal dynamics are becoming increasingly intertwined**. Ultimately, this can undermine monetary policy effectiveness by constraining central bank independence and weakening traditional transmission channels.

The December rate cut and liquidity provision are not inflation-neutral. Even if it can be “framed” as hawkish through forward guidance, the easing of policy loosens financial conditions at the margin. Since monetary policy operates with a lag, these actions influence expectations today even if their full macroeconomic effects materialize later. In an economic environment where inflation risks are already skewed to the upside, this policy mix risks undermining the Fed’s inflation-fighting credibility by signaling a premature pivot toward accommodation. If inflation pressures reignite while the labor market continues to soften, the Fed could enter 2026 facing tensions to its dual mandate due to elevated inflation and rising unemployment, with less room to cut rates further and greater difficulty re-anchoring inflation expectations than if policy had remained restrictive for longer.

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