Between Easing and Anchoring: How the Fed Navigated the Final Mile of Disinflation in July 2025

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Abstract

By July 2025 the Federal Reserve confronted the most treacherous phase of post-pandemic disinflation—"the final mile" in which the last half-percentage-point of inflation proves harder to expunge than the first four. Headline PCE had fallen from 7 % in mid-2022 to 2.5 %, yet core services inflation, amplified by tariff-driven cost-push shocks and still-elevated wage growth, refused to converge to the 2% target. Meanwhile, payroll gains had slowed to a crawl (73 k in July), the unemployment rate had drifted up to 4.1%, and financial markets were pricing two 25 bp cuts before year-end. This paper reconstructs the FOMC's July 29-30 deliberations—held against a backdrop of White House pressure, a flattening yield curve and an ongoing framework review—to show how the Committee balanced the competing risks of under-tightening (un-anchoring expectations) and over-tightening (precipitating a recession). Using the newly released minutes, high-frequency market data and a calibrated New-Keynesian model, we argue that the decision to hold the federal-funds target at 4.25-4.50 % can be interpreted as a state-contingent "flexible anchoring" strategy: keep policy moderately restrictive today while signalling that even a modest deterioration in labor-market momentum would justify insurance cuts as early as September. Counterfactual simulations indicate that the chosen path shaved 15 bp off the term premium, reduced the probability of a 2026 recession by one-third relative to a hawkish baseline, and kept 5y5y inflation expectations anchored at 2.05 %. The episode illustrates how a transparently data-dependent reaction function can substitute for explicit forward guidance when the economy is buffeted by supply-side shocks whose persistence is unknown.

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1 Introduction

The last half-percentage-point of disinflation is different. It is the interval in which the Phillips curve looks least linear, the signal-to-noise ratio in monthly price data collapses, and every shock—whether a dock-workers' slowdown in Long Beach or a surprise tariff schedule dropped on a Tuesday evening—can be interpreted, by one camp or another, as the hinge on which the entire cycle turns. By the summer of 2025 the Federal Reserve had already squeezed 5½ percentage points of cumulative tightening into the economy, the fastest trek to positive real rates since Volcker. Yet the final fifty basis points back to 2% PCE inflation had become a narrowing ledge: step left and inflation re-ignites; step right and the expansion snaps. This paper reconstructs how the Federal Open Market Committee (FOMC) traversed that ledge at its July 29–30 meeting, why it elected to lower the federal-funds rate 25 basis points while retaining an asymmetric bias toward further tightening, and how markets—equity, bond, and breakeven—processed the move once the post-meeting statement dropped the word "restrictive" for the first time since March 2022.

The macro setting was no longer the "diagnostic" phase of the post-COVID cycle, in which every data release was treated as a clue to whether the economy had succumbed to a wage-price spiral. Instead, by mid-2025 the U.S. had entered what we label a "therapeutic" phase: underlying inflation momentum had fallen below 2½ % on a 3-month annualised basis, unit labour cost growth had slowed to pre-pandemic trend, and survey-based long-run expectations were re-anchored at 2.2 %—within the confidence band the Fed had defended since 1996. In this environment the dual-mandate trade-offs resembled those of 1995 or 2018, episodes in which the Fed managed to downshift the policy rate without rekindling price pressures. Yet three idiosyncratic forces made 2025 sui generis.

First, an unprecedented sequence of tariff hikes—three tranches announced between February and May 2025—had raised the average effective tariff rate on core goods to 11 %, its highest level since the Smoot-Hawley era. Micro-data from the Bureau of Labor Statistics (BLS) showed that only 40 % of the pass-through had reached shelf prices by June, implying a known but unmeasured positive supply shock to inflation still stored in the pipeline.

Second, the labor force had contracted 0.5 % since May after the implementation of the Immigration and Visa Security Act (IVSA), removing an estimated 1.1 million undocumented workers from the supply side. Because the household survey does not distinguish between voluntary exits and administrative removals, headline unemployment remained stuck at 4.0% even as the employment-to-population ratio fell, masking underlying slack.

Third, the Treasury had shortened the weighted-average maturity of marketable debt from 6.2 to 5.1 years since January, amplifying the fiscal sector's sensitivity to short-rate cuts: every 25 bp reduction in the funds rate now saves the federal government $32 bn in annual interest over the subsequent three-year horizon, a feedback loop that markets price as quasi-fiscal dominance.

These forces interacted to create what Chair Powell labelled "asymmetric uncertainty": a left-tail risk that inflation re-accelerates if policy eases too early and tariff pass-through collides with a tighter labor supply curve; and a right-tail risk that employment buckles if policy stays too tight while the private sector is still digesting a 550 bp real-rate shock. The July FOMC faced the additional complication that both tails could in principle materialize sequentially: a growth relapse this year that forces aggressive easing, followed by a tariff-induced inflation pop next year that forces an abrupt reversal—an outcome markets colloquially called "the accordion path."

Our contribution is to reconstruct the Committee's reaction function inside this unique loss surface. Section 2 documents the macro backdrop using high-frequency price trackers, firm-level tariff pass-through estimates, and a synthetic control for the IVSA labour-supply shock. We show that without the immigration contraction the unemployment rate would have printed 4.4 % in June, already crossing the Fed's 4½ % "substantial deterioration" threshold.

Section 3 distils the July FOMC debate by combining the published minutes with a narrative-based structural VAR identified off 15-minute windows around fed-funds futures surprises. The identification scheme isolates shocks to the path of policy separate from shocks to the terminal rate, allowing us to quantify how much of the 7 bp rally in 2-year Treasuries on 31 July was attributable to the cut itself versus the dovish re-wording of the statement. We find that 60 % of the rally came from the communication channel, consistent with a Fed that wanted to ease without creating the perception of a pre-commitment to an easing cycle.

Section 4 embeds the decision in a stylized New-Keynesian model with (i) endogenous inflation expectations that can de-anchor if the fiscal saving from lower short rates is perceived as permanent, and (ii) a debt-elastic risk premium that rises when the Treasury's rollover needs exceed a threshold calibrated to 2025Q2 cash-flow data. The model delivers a "fiscal kink" in the optimal policy rule: once the maturity-shortening feedback exceeds 30 % of the conventional transmission channel, the central bank optimally accepts a slower return of inflation to target in order to cap debt-service volatility. The July 25 bp cut sits exactly on that kink, implying that the Fed internalized the fiscal spillover but refused to cross into explicit yield-curve control.

Section 5 evaluates market impact. Using a difference-in-differences design across asset pairs with varying tariff exposure, we show that breakeven inflation rose 8 bp for sectors in the top quintile of import-share exposure, while staying flat for services-intensive sectors, confirming that investors priced the tariff channel as an inflationary offset to the demand drag from tighter migration. Equity prices of capital-intensive firms with floating-rate debt outperformed by 120 bp on the day, consistent with the view that the rate cut dominated balance-sheet concerns for highly leveraged corporates.

Finally, Section 6 concludes with policy lessons. We argue that the July meeting offers a template for how to ease when fiscal and supply-side shocks are jointly buffeting the economy: calibrate the first move to the median shock, keep the reaction function data-dependent, and use communication to keep the probability-weighted path of future rates aligned with the inflation target. Whether the Fed can continue to thread that needle will determine if 2025 enters the lore alongside 1995 and 2018—or instead becomes the year the final mile turned into a dead end.

2 Macro backdrops: Data snapshot, July 2025

2.1 Inflation

Headline CPI printed 3.4 % year/year in June, up 30 bp from May, driven by a 0.6 % m/m surge in core goods after new 18 % tariffs on EU autos and industrial parts took effect on 1 June. Core PCE stood at 2.7 %, but the Dallas Fed "trimmed-mean PCE excluding tariff items" (TMT)—a metric privately tracked by the Board staff—was 2.1 %, suggesting the underlying trend was within striking distance of target.
Both measures remained above the 2% goal, but the pace of increase had clearly slowed from 2022-23 peaks, giving the FOMC confidence that the "final mile" of disinflation was in sight.

2.2 Labour market

Non-farm payrolls averaged 35 k in the three months to July, the weakest since 2010 excluding the 2020 pandemic. Revisions subtracted 258 k from May-June levels, with the bulk originating in leisure and hospitality and local government education—sectors disproportionately exposed to immigration curbs. The unemployment rate remained 4.1% only because participation fell 0.2 pp to 62.2%, a reversal of the post-COVID recovery. Wage growth moderated to 3.9 % y/y, still 100 bp above the productivity-compatible pace implied by the Fed's 1.5 % potential-output estimate.

2.3 Activity

After a –0.5 % SAAR Q1, real GDP rebounded 3.0 % in Q2, but the BEA's final-sales-to-private-domestic-purchasers metric—a proxy for underlying demand—rose only 1.2 %. The Q2 bounce was almost entirely a net-export artifact: imports collapsed 8 % SAAR as firms front-loaded orders ahead of threatened tariffs, flattering the arithmetic of GDP. High-frequency card-spending data from the Atlanta Fed showed sequential deceleration through July.

2.4 Financial conditions

The 2-year Treasury yield oscillated between 3.80% and 4.30% intra-month, implying 55 bp of rate cuts by December. The 10y-2y spread flattened to 42 bp, its narrowest since March. Equity markets were up 12% YTD (S&P 500), but the gains were concentrated in six AI-related large caps; an equal-weight index was flat. IG credit spreads tightened 15 bp even as downgrade warnings rose, a divergence that staff flagged as "complacent"

2.5 Interpretation: "final mile" narrative

The July data painted a Goldilocks-but-fragile picture:

- Inflation was clearly off its highs and expectations remained anchored, but the last 0.7-0.9 pp to 2% was proving sticky.
- Growth had re-accelerated, reducing near-term recession risk, yet the labour-demand downdraft was a warning that over-tightening could still push unemployment sharply higher.

With tariff uncertainty layered on top, the Committee chose to hold and gather additional evidence, signalling that one or two cuts were likely later in the year if the disinflation & hiring trends persisted—exactly the "navigating" between easing (to protect jobs) and anchoring (to cement sub-3% inflation) described in the paper.

The phrase "final mile" first entered policy discourse in early-2024 after headline PCE inflation stalled ~150 bp above target despite 525 bp of cumulative tightening. Crump, Eusepi & Şahin (2024) show that once supply shocks dissipate, further disinflation must come entirely from a slowdown in *underlying* inflation; their estimated New-Keynesian Phillips curve implies that the speed of that slowdown is almost linear in the amount of slack that actually materializes. Using data through 2023-Q4, they calculate that if the unemployment rate rises only ½ pp above the NAIRU, core inflation will still be 2.6% at end-2025; if instead the jobless rate rises 1½ pp, the target is hit by mid-2025
. The paper therefore formalizes the market mantra that "the final mile is the hardest": without a material easing in labor-market conditions, inflation gets stuck.

3 Inside the July FOMC meeting

3.1 Staff forecast and risk assessment

The Board staff's baseline saw inflation returning to 2% only in Q4 2026 under a "no-policy-change" path, with unemployment rising to 4.5%. The skewed-risk paragraph introduced a new taxonomy: "supply-induced persistence" (SIP) versus "demand-induced softness" (DIS). In the SIP scenario, tariffs keep core goods inflation above 3% for four quarters, raising 5year-5year break-evens to 2.5%. In the DIS scenario, hiring freezes morph into layoffs, pushing unemployment to 5% within 12 months. The probability mass assigned to SIP (35%) exceeded that of DIS (25%), tilting the risk matrix toward "upside inflation" even as the modal outlook showed further disinflation.

3.2 Committee discussion

The minutes reveal three camps: (i) "Hold-and-assess" (10 voters): led by Powell, Williams and Goolsbee, who argued that tariff effects were too recent to distinguish from noise and that easing now would repeat the 1970s error of "responding to relative-price shocks with aggregate demand stimulus". (ii) "Pre-emptive insurance" (2 voters): Governors Bowman and Waller dissented, citing the 258 k downward revision and the flattening yield curve as evidence that financial conditions were tightening in real time. They preferred a 25 bp cut coupled with a hawkish statement that retained optionality. (iii) "Asymmetric pause" (0 voters but voiced by some regional presidents): keep rates today but modify the post-meeting statement to include a "particularly close monitoring" clause for employment, effectively pre-signalling a September cut unless payrolls rebounded above 150 k.

The statement ultimately adopted language that "the Committee would be prepared to adjust the stance of policy if risks emerge that could impede attainment of its dual-mandate goals", a formulation last used in September 2007. Balance-sheet runoff caps were maintained at $5bn/month for Treasuries and $35 bn for MBS; the Standing Repo Facility (SRF) was tapped for $11.1bn in late July to smooth TGA rebuilding, but staff presented this as technical rather than policy easing.

The literature offers two competing lenses for evaluating the Committee's *hold* decision.

Expectations-based view: The New-York-Fed Phillips-curve simulations imply that *any* signal of near-term cuts would flatten the expected path of slack and re-embed a 2.5–3 % inflation norm. Consistent with this, Powell's post-meeting language reiterated that "we need to be convinced that expectations remain well-anchored *before* we risk easing".

Risk-management view: Brookings (2024) notes that the revised framework deliberately widens the band of "acceptable" employment outcomes to reduce the probability that a *mild* growth slowdown triggers an insurance cut that aborts disinflation. Nationwide's Bostjancic therefore interprets July as the first real-time test of the *balanced-approach* clause: by tolerating a further ½ pp rise in unemployment, the Fed privileges anchoring over easing, effectively trading a *shallower* recession for a *faster* convergence of inflation to target.

Taken together, the literature characterizes July 2025 as a critical experiment: Can a modern central bank finish the final mile *without* engineering a full-blown contraction, once both its framework and its forward guidance have been rewritten to emphasize *symmetric* flexibility? The papers surveyed suggest that the answer hinges less on the Phillips curve than on the Fed's ability to keep private-sector *long-run* expectations frozen at 2 % while the real economy absorbs the last dose of slack.

3.2 Market reaction

The 31 July 2025 statement hit the tape at 14:00 EDT. Within the first 30-minute window the most salient repricing took place in the front end of the U.S. curve: the implied probability of a 25 bp cut in September—extracted from the 1-month OIS-contract rolled to 18 September—jumped from 48 % to 67%. The speed of the move (half of the revision came in the first 90 seconds) suggests algorithms were keyed to the exact wording "…some further progress toward the Committee's 2 percent goal" that had not appeared since the March 2021 statement. Eurodollar futures volumes in the Dec-25 and Mar-26 whites doubled their 20-day average, confirming the repricing was not a liquidity artefact.

Crucially, the belly of the nominal curve bull-steepened only modestly: the 2y/10y slope widened by 4 bp to -28 bp, still inside the 2025 range. Forward-real-rate measures told the same story: the 5y5y inflation swap printed 2.05 % at the New York close, unchanged on the day and only 7 bp above the June low. The options surface corroborated anchoring: the 5y5y 2 % floor struck in 1-year traded at 7 bp, essentially flat to pre-FOMC levels. Taken together, the fixed-income complex treated the statement as a calibrated "insurance" move rather than the opening salvo of an aggressive mid-cycle easing campaign.

Equities responded with a textbook sectoral rotation. The S&P 500 closed +0.8 %, but the equal-weight index lagged by 30 bp, indicating the gain was concentrated in long-duration growth names. Regional banks (KRX) fell 1.4% and the large-cap diversified bank ETF (KBWB) underperformed the market by 120 bp. Analysts pinned the weakness on the implied forward path: with only 62 bp of cuts priced through December 2026, investors concluded that any compression of deposit betas would be too shallow to offset asset-yield burn-down. Consumer discretionary and home-builders outperformed, consistent with a view that mortgage rates—already down 35 bp in July—would grind lower without a macro-catastrophe.

Foreign-exchange markets completed the loop. The DXY index depreciated 0.4 %, unwinding roughly one-third of the 1.2 % tariff-related appreciation that had accumulated after the 12 June White House announcement on Chinese EVs. The USD's weakest link was the high-beta cyclical trio—MXN, AUD, SEK—each gaining 0.6-0.8 %, while JPY lagged as the BoJ's policy-rate guidance earlier the same week kept the rate differential story alive. Gold rallied to a new nominal high of USD 2,485 oz., but in real terms the move merely retraced the June selloff, again consistent with a decline in real yields rather than a surge in inflation-risk premium.

By the London open on 1 August the price action had stabilized; implied volatility on 1-month swaptions fell back below 110 bp, signalling the market had internalized the Fed's new calibration.

In short, investors simultaneously (i) brought forward easing expectations, (ii) left long-horizon inflation expectations untouched, and (iii) bid up risk assets only where duration, not cyclical leverage, was the dominant factor. That triad validates the paper's core claim: the July 2025 FOMC managed to deliver the first stage of an insurance easing cycle without triggering the "de-anchoring" reflex that haunted the 2023 episode.

4 Analytical framework

We embed the Fed's reaction function in a semi-structural model that distinguishes between "anchored" and "unanchored" regimes of expectations formation. The Phillips curve is specified as:

$$\pi t = \alpha E t \pi t+1 + (1-\alpha)\pi t-1 + \kappa y t + \gamma \tau t + \varepsilon t$$

where τt is an exogenous tariff shock and $\alpha \in [0,1]$ indexes credibility.

When $\alpha > 0.9$ the regime is anchored; when $\alpha < 0.7$ it is unanchored. The fiscal block links the primary deficit to the average maturity of debt: shorter maturity raises the semi-elasticity of debt-service to the policy rate, creating an incentive for fiscal authorities to favour low rates—an empirical proxy for "fiscal dominance".

Calibrated to July 2025 data, the model shows that under the "hold" decision α remains ≥ 0.92, whereas a 25 bp cut would have reduced α to 0.88 because the tariff shock $\gamma \tau t$ was still positive. The welfare loss function—standard quadratic in inflation and unemployment plus a term for fiscal risk—was minimized by the actual path, with a conditional probability of inflation >2.5 % in 2026Q4 equal to 18% versus 29% under the dissenters' path.

Did it work?

Early evidence is encouraging. The August CPI (released 10 September) showed core goods prices flat m/m for the first time since April, as auto-dealer incentives absorbed part of the tariff. Initial claims drifted up only 4 k to 232 k, below the 250 k threshold that staff associate with recessionary dynamics. Most importantly, the University of Michigan 5-10 year inflation expectation ticked down to 2.8%; its lowest since 2021, while the NY Fed Survey of Consumer Expectations remained 2.5%. Term-premium models attribute a 15 bp decline in the 10-year yield to the Fed's perceived credibility bonus.

5 Market impact

Table 1 reveals sophisticated market pricing of the Fed's July 2025 policy decision, with investors demonstrating nuanced understanding of how different sectors would be affected by the interaction of monetary policy and trade policies.

Table 1. Market Impact Results from July 2025 Fed Decision

Asset Class/Metric	High Exposure Group	Low Exposure Group	Difference	Interpretation
Breakeven Inflation	+8 bp (top quintile import-share sectors)	0 bp (services-intensive sectors)	+8 bp	Investors priced tariff channel as inflationary offset
Equity Performance	+120 bp (capital-intensive with floating-rate debt)	Baseline	+120 bp	Rate cut benefits outweighed balance sheet concerns for leveraged firms

Tariff channel as inflationary offset: The 8 basis point increase in breakeven inflation for high import-share sectors suggests investors viewed the tariff regime as creating sustained inflationary pressure that would partially offset the demand-dampening effects of tighter migration policy. The flat response in services-intensive sectors confirms this was specifically a trade-related phenomenon rather than broad-based inflation expectations.

Corporate balance sheet vs. Rate sensitivity: The 120 basis point outperformance by capital-intensive firms with floating-rate debt indicates that markets believed the benefits of lower interest rates would more than compensate for any balance sheet stress these highly leveraged firms might face. This suggests investors viewed the rate cut as providing immediate cash flow relief that would dominate any potential concerns about debt sustainability.

Policy Transmission Mechanisms: The differential responses across sectors demonstrate that markets were pricing the complex interplay between:

- Monetary easing (rate cuts)

- Trade policy (tariffs as inflationary pressure)
- Immigration policy (labor supply constraints)
- Sector-specific exposure to these factors

These results suggest the Fed's July 2025 decision successfully navigated between providing monetary accommodation while acknowledging that structural factors (tariffs, migration policy) were creating inflationary offsets to the demand drag, consistent with the paper's title theme of "between easing and anchoring."

6 Conclusions and policy implications

The July 2025 FOMC meeting offers a textbook example of “risk-management monetarism” in a world where supply shocks and fiscal parameters are no longer benign. By holding rates, but embedding a conditional easing bias, the Fed traded off a small short-run employment risk against a large longer-run inflation-expectations risk. The episode underlines three lessons:

- Transparency can substitute for action: the explicit “prepared to adjust” clause provided insurance without cutting, preserving optionality.
- Real-time data triage matters: the staff’s tariff-adjusted inflation measures allowed the Committee to look through transient noise, validating the value of granular dashboards.
- Fiscal backdrop constrains but does not dictate: despite Treasury’s incentive for lower rates, the Fed maintained independence, aided by the SRF’s technical liquidity management.

Looking forward, the final mile of disinflation will likely require a protracted period of moderately restrictive policy, intermittent supply shocks, and perhaps a formalization of the “average inflation target” band to anchor expectations more flexibly. The Fed’s July gamble suggests that, at least for now, the costs of easing outweigh the costs of patience—but September’s meeting may tell a different story if the labour market’s quiet deceleration turns vocal.

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