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Fed Warns of Rising Economic Risks as It Leaves Rates Steady

Officials are puzzling over whether to focus on the risks of higher prices or weaker hiring

By Nick Timiraos

Despite President Trump's calls for lower interest rates, the Federal Reserve left its benchmark rate unchanged, warning of higher unemployment and higher inflation because of tariffs. Photo: Andrew Harnik/Getty Images

The Federal Reserve held interest rates steady, citing concerns that tariffs could lead to higher unemployment and inflation.

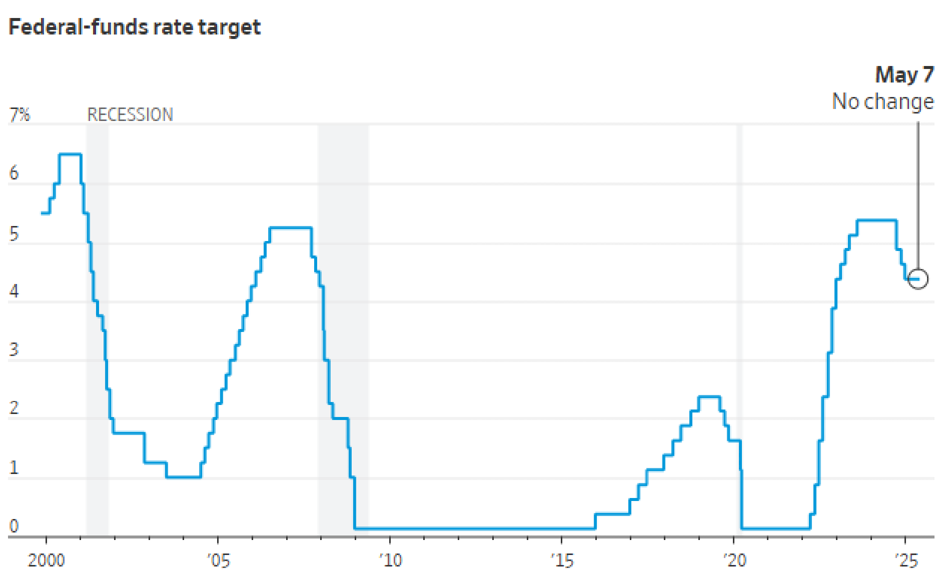
Jerome Powell stated the Fed is in a 'wait and see' mode, as the economic impact of tariffs remains uncertain.

Analysts are divided, some fearing rate cuts could worsen inflation, while others worry about the Fed risking a sharper economic downturn.

The Federal Reserve warned that tariffs were raising risks of higher unemployment and higher inflation when officials unanimously agreed to hold interest rates steady on Wednesday.

"If the large increases in tariffs that have been announced are sustained, they're likely to generate a rise in inflation, a slowdown in economic growth, and an increase in unemployment," Fed Chair Jerome Powell said at a news conference.

Tariffs represent a shock that can decrease an economy's ability to supply goods or services while sending up prices. The unpredictable rollout of increased duties on imported goods threatens to sap profits and chill new investment until businesses have more clarity on their underlying cost structure.



Note: Chart shows midpoint of target range since 2008.
Source: Federal Reserve

The policy changes pose a dilemma for the Fed, which has to decide whether to focus more on the potential for inflation to go up or more on the risk of rising unemployment.

“They’re in a bad situation,” said William English, a former senior Fed adviser. “If I were there, I would be suggesting that they stay put for now.”

Expectations of a rate cut at the Fed’s next meeting in mid-June declined Wednesday. Powell said officials felt like the costs of waiting to learn more about the economy were “fairly low.” He used the term “wait and see” 11 times on Wednesday.

“We don’t feel like we need to be in a hurry. We feel like it’s appropriate to be patient,” he said. “And when things develop, of course, we have a record of—we can move quickly when that’s appropriate.”

Investors broadly expect the Fed to cut interest rates by the second half of the year.

The Fed lowered its benchmark rate by a percentage point last year, to around 4.3%, after inflation declined and the unemployment rate crept up. The central bank had raised rates to a two-decade high in 2022 and 2023 to combat inflation.

President Trump backed off an implied threat to sack Powell last month, but he has continued hectoring the central bank leader to reduce rates. “We have a stubborn Fed,” Trump said in a television interview that aired Sunday. “He should lower them. And at some point, he will.”

The Fed cut rates in 2019 to cushion the fallout from Trump’s first trade war with China, but inflation was much less of a worry back then. Powell said the current predicament is different. “It’s not a situation where we can be pre-emptive because we actually don’t know what the right response to the data will be until we see more data,” he said.

Some economists worry that rate cuts could worsen inflation. If rate cuts cushion the economy and support steady income growth, they could lead businesses and consumers to accept paying higher prices.

Fed officials believe those expectations are self-fulfilling. The thinking goes like this: If consumers and businesses believe inflation will be low and stable over time, these “well-anchored” expectations can play a critical role to ensure that a run-up in prices doesn’t repeat.

Because the economy has just been through a period of high inflation, assuming that consumers and businesses will expect inflation to decline after an initial increase “is a bad risk for the central bank to take,” said Adam Posen, president of the Peterson Institute for International Economics.

Moving faster to cut rates now raises the risk that the Fed will have to reverse course months later by increasing rates, Posen said. Several Trump allies said last year the Fed was stoking risks of more persistent inflation by moving rates down too fast.

“It is very ironic and, frankly, self-contradictory for people in or close to the administration who were critical about the Fed being too inflationary to also argue that the tariff shock is not going to have any effect on inflation,” Posen said. “It’s one or the other.”

Powell repeatedly described the economy as solid. But he also offered a candid assessment when he said last year’s rate cuts were “a little late.”

Other analysts fear that by holding rates steady as the economy slows, the Fed is setting up to keep rates unnecessarily high, risking a sharper downturn.

“The longer they’re on hold, the more they’re passively tightening,” said George Goncalves, head of U.S. macro strategy at MUFG, Japan’s largest bank. Waiting until July or September to cut rates raises the prospect the Fed will have to make larger, half-percentage-point cuts. “That’s just too long of a wait. You might lose that chance of really catching the economy,” he said.

Tariff rates on China have been raised to 145%, a level that Trump and his advisers concede can’t be sustained because they amount to a trade embargo. Cargo volumes from China are down about 35% in recent weeks, and many small businesses are in limbo.

U.S. economic output contracted in the first quarter as importers and businesses raced to order equipment and materials ahead of tariffs. Concrete signals of actual weakness, however, have been sparse.

“We’re all kind of waiting around expecting a slowdown in the economy that the hard data aren’t showing yet,” said English, a professor at the Yale School of Management.

Some economists have argued the situation today is fundamentally different from the 2021 inflation shock that humbled the Fed and other central banks. Back then, the Fed was adding stimulus to an economy buffeted by broad imbalances in goods, housing and labor markets.

Today, labor markets are cooling, and slowing wage growth could provide less fuel to sustain inflation after an initial tariff-driven boost to prices. Market-based expectations of inflation over the next five to 10 years, as derived from Treasury inflation-protected securities, have been at the low end of the range seen over the past year.

“I know why the Fed is leaning towards focusing on inflation expectations, but look at the bond market. The ‘inflation vigilantes’ are nonexistent,” Goncalves said.