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How Will the Trade-off Between Employment and Inflation Risks Shape the Fed's Policy Outlook?

Zhiteng Zeng, Economist

In 2025, the Trump 2.0 economic policies have intensified stagflation risks in the U.S. economy, challenging the dual mandate of the Federal Reserve (the Fed hereafter) regarding maximum employment and price stability. Amid heightened uncertainty over the economic outlook, the Fed paused its rate-cutting cycle. As downside risks to the labor market gradually came to outweigh upside risks to inflation, the Fed shifted its policy focus from inflation towards employment, resuming monetary easing in September. It subsequently delivered rate cuts at three consecutive policy meetings, totaling 75 basis points over the year. Looking ahead to 2026, the balance of risks between employment and inflation will remain the key driver of Fed's policy direction. This article assesses the potential risks facing the U.S. labor market and inflation, and analyzes their implications for the Fed's policy trajectory in 2026.

I. Labor Market: Demand May Cool Further with Rising Unemployment and Layoff Risks

Data from the first three quarters of 2025 indicate that the U.S. labor market has broadly settled into what Chair Powell described as a "curious balance resulting from a marked slowdown in both the supply of and demand for workers." In other words, the negative impact of weakening labor demand on the unemployment rate has largely been offset by a contraction in labor supply. Nevertheless, as labor demand has cooled faster than supply, an upward trend in unemployment has gradually emerged. At the same time, amid rising economic uncertainty but only manageable recession risks, the labor market has displayed a "low hiring, low layoffs" pattern. Looking ahead to 2026, the risk of a sharp deterioration in employment conditions

remains relatively low; however, the cooling trend is unlikely to reverse and may continue to be reflected in unemployment and layoff indicators.

The simultaneous decline in labor supply and demand is expected to persist, with the contraction in labor demand likely outpacing that of labor supply. In 2025, labor demand gradually cooled under persistent pressure due to the high interest rate environment and the "wait-and-see" sentiment induced by policy uncertainty under the Trump administration; immigration restrictions and low labor force participation rates have constrained employment growth from the supply side. The simultaneous contraction on both sides has significantly lowered the "breakeven" employment growth (the monthly payroll increases needed to keep the unemployment rate stable). According to the St. Louis Fed's estimates, following Trump's implementation of immigration restrictions, "breakeven" employment growth has fallen sharply from approximately 150,000 to a range of 32,000 and 82,000. Consequently, nonfarm payroll increase declined notably in the first three quarters (Figure 1). At the December FOMC press conference, Powell further noted that official employment data, which were already relatively weak, may systematically overestimate actual employment growth, which could even have turned negative. While the dual contraction in supply and demand has helped keep the unemployment rate relatively stable, since August 2025 the unemployment rate has risen above the median of the Fed's longer run estimate (Figure 2) for the first time since 2022. The Summary of Economic Projections (SEP) released at the December meeting also shows that the Fed's median forecast for the unemployment rate at end 2025 reaches 4.5%, above the longer-run median estimate of 4.2%. Given that the simultaneous decline in labor supply and demand is less likely to reverse in the near term, the slowdown in employment growth is expected to extend into 2026, with labor demand potentially continuing to weaken faster than supply.

Figure 1: U.S. Monthly Non-farm Payroll Gains (Thousand Person)

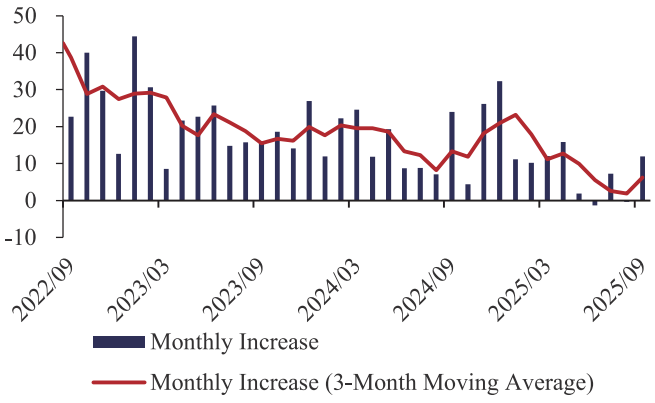
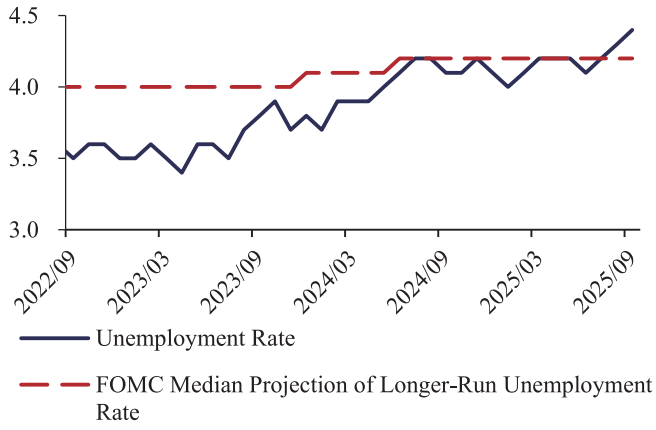


Figure 2: U.S. Unemployment Rate (%)

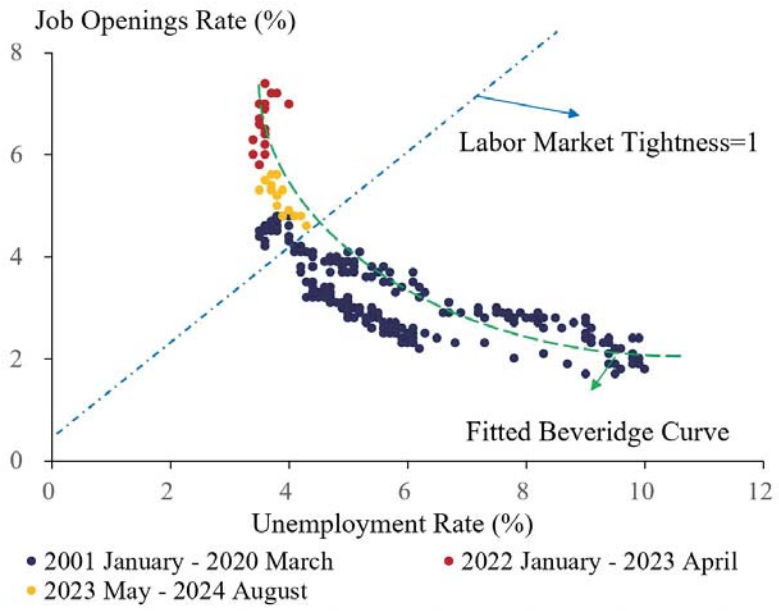


Source: Macrobond, Hong Kong Financial Research Institute of Bank of China

Downside risks in the labor market remain manageable for now, but the risk of a pronounced rise in unemployment and layoffs is accumulating. Since the beginning of the year, coporate appetite for hiring has weakened significantly amid growing economic uncertainty. The hiring rate in the Job Openings and Labor Turnover Survey (JOLTS) fell to 3.2% in October—the lowest level in over five years. In contrast, the layoff rate has remained relatively low at around 1.2%, indicating that businesses prefer to retain human capital rather than undertake large-scale layoffs, which suggests that near-term downside risk to employment remains contained. Nevertheless, from the perspective of the Beveridge curve—which illustrates

the empirical relationship between job openings rates and unemployment rates (Figure 3) — when the key indicator of labor market tightness, the ratio of job openings rate to unemployment rate, approaches 1, the curve tends to flatten. This implies that a contraction in job openings could lead to a more notable increase in unemployment. This indicator has fallen drastically over the past year, reaching the critical threshold of 1 in August 2025. Based on the December SEP and Powell's statements at the FOMC press conference, the Fed judges the risk of a sustained rise in unemployment in 2026 to be limited. That said, if labor demand weakens further and the transmission of recent monetary easing to the real economy falls short of expectations, the pace of unemployment growth could accelerate, potentially triggering a cycle of "rising layoffs and unemployment→reduced aggregate demand→further increases in layoffs and unemployment." Notably, leading indicators such as the Cleveland Fed's advance layoff notices and announced job cuts published by Challenger, Gray & Christmas have already shown signs of pickup in corporate layoffs, which is likely to be gradually reflected in official labor statistics.

Figure 3: U.S. Beveridge Curve



Notes: Due to factors such as a significant rise in the temporary unemployment rate, the U.S. Beveridge curve shifted outward after the pandemic. To simplify analysis, data from April 2020 to December 2021 is omitted from Figure 3.
Source: Wind, Hong Kong Financial Research Institute of Bank of China

AI may exert structural impacts on the labor market, but its overall negative effects are likely to remain limited in the near term. While the implications of AI for employment have attracted growing attention, there is insufficient evidence showing it is the primary driver of the recent slowdown in U.S. employment growth. The San Francisco Fed notes that AI technologies are mainly applicable to entry-level office tasks, theoretically posing a higher substitution risk for recent college graduates. However, existing data do not establish a clear causal relationship. Chairman Powell also remarked at the December press conference that some large firms have indeed slowed hiring or increased layoffs due to AI adoption, but this trend has not yet shown up in broader employment statistics. In addition, recent studies—including RAND's Macroeconomic Implications of Artificial Intelligence and an NBER latest working paper titled Artificial

Intelligence and the Labor Market—highlight that the AI's overall effect on employment is currently more complementary than substitutive. On the one hand, task-level substitution effects can be partially offset as workers shift to unaffected or emerging tasks. On the other hand, widespread AI adoption boosts productivity and may even expand overall labor demand. Taken together, while rising AI penetration may generate structural disruptions for certain industries (e.g., information technology and professional services) and specific groups (e.g., new graduates), its negative impact on the overall labor market is expected to remain limited in the near term.

II. Inflation: Tariffs Pass-Through to Persist, with Overall Inflation Remaining Sticky

So far in 2025, despite the substantial increase in tariffs rates under the Trump administration, the pass-through from tariffs to inflation has been weaker than expected, with the headline inflation showing no significant rebound (Figure 4). However, tariffs shocks still exert a tangible impact on the inflation outlook. The goods disinflation, which progressed smoothly in 2024, stalled in 2025, and headline inflation, as measured by year-on-year growth in the PCE price index, remains well above the Fed's 2% target (Figure 5). According to Fed estimates, tariffs account for roughly 40–50bps of the current core PCE inflation of around 2.8%. Looking ahead to 2026, while the risk of a sharp rebound in inflation appears limited, the lagged effects of tariffs pass-through, combined with sticky services inflation, will continue to create uncertainty for the disinflation process. Tariffs pass-through to goods inflation is expected to be largely complete in the 1st half of the year, but from a full-year perspective, bringing inflation back to the Fed's target level will remain challenging.

Figure 4: U.S. CPI Growth and Breakdown (SA, M-o-M, %)

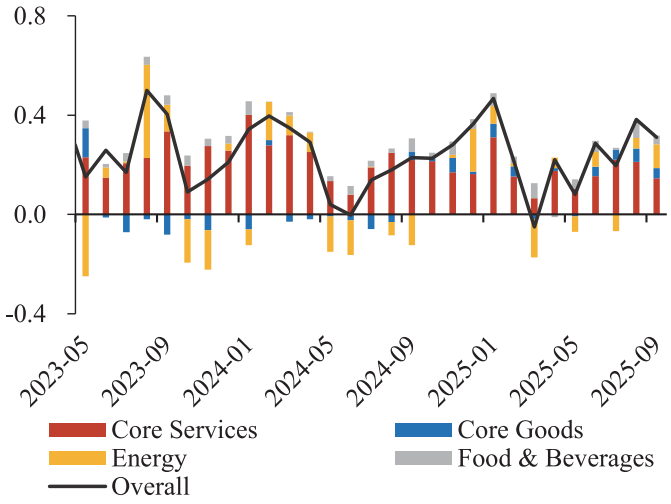
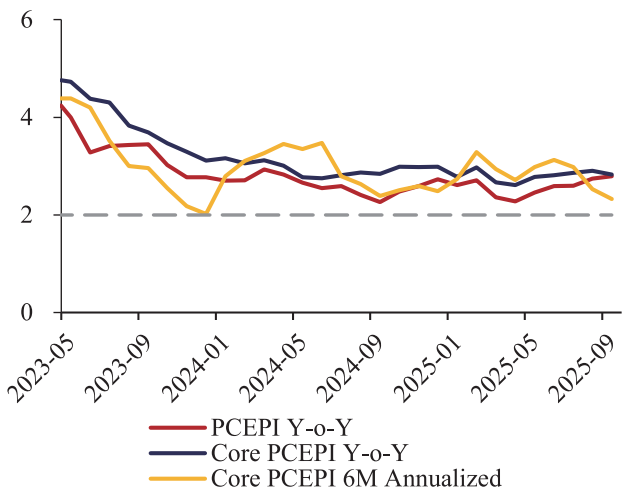


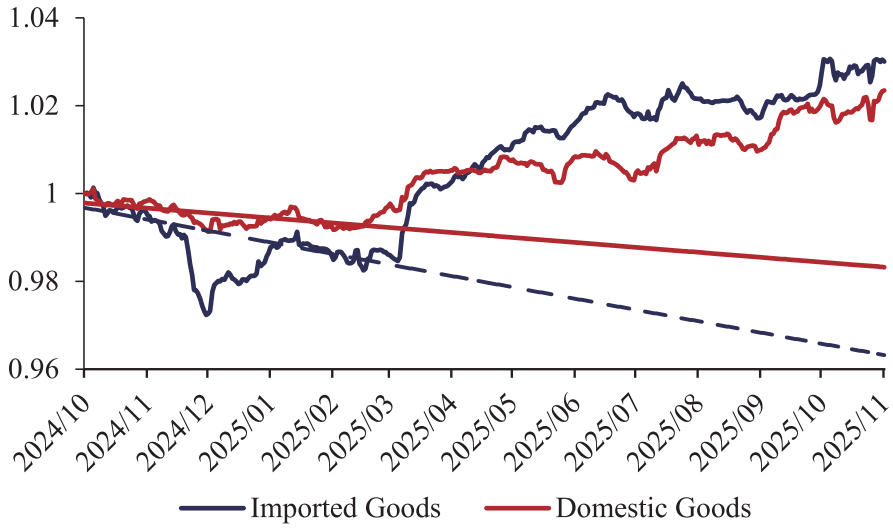
Figure 5: U.S.PCE Inflation (%)



Source: Macrobond, Hong Kong Financial Research Institute of Bank of China

Regarding goods inflation, tariffs pass through is likely to extend into 2026 and peak in the 1st half of the year, with a relatively low probability of translating into persistently high inflation. In 2025, the transmission of tariffs to goods inflation has been cushioned by several factors: U.S. importers front loaded inventories in anticipation of tariffs shocks; frequent adjustments to tariffs policies, coupled with heightened demand uncertainty, have made retailers cautious about raising prices; and firms have tended to absorb some tariffs burdens by compressing profit margins. While these factors have dampened the near-term inflationary impact, they have also prolonged the pass-through process. As inventories are gradually depleted, firms' profit buffers shrink, and tariffs schedules become clearer, tariffs pass through to goods inflation is expected to continue. The National CFO Survey conducted by the Atlanta Fed, the Richmond Fed, and Duke University shows that firms are planning to gradually pass tariffs costs onto consumers, a trend already evidenced in the high-frequency retail price index of Harvard Business School's "Tariff Tracker" (Figure 6). Chairman Powell estimated at the December press conference that tariffs pass-through effects may be largely complete by the 1st half of 2026. Noteworthy, after a sharp rise in mid year, U.S. consumers' inflation expectations have since eased and remain well anchored. This suggests that, absent another round of large scale tariffs increases, the risk of second round effects through self-fulfilling expectations or a wage price spiral is relatively low. Under the baseline scenario, we estimate that tariffs will add around 30–40bps to year on year PCE inflation in 2026, with the impact concentrated in the 1st half of the year and the risk of persistently high inflation temporarily contained.

Figure 6: Harvard Business School Pricing Lab "Tariff Tracker" Price Index (2024/10/1= 1)



Notes: The price index is constructed using online data from five major U.S. retailers at a daily frequency and is designed to measure the impact of the 2025 tariffs. The data are updated through November 1, 2025. The dashed line represents the pre-tariff trend of the corresponding price index.
Source: Harvard Business School, Hong Kong Financial Research Institute of Bank of China

Regarding services inflation, downside potential for shelter inflation appears limited, while the pace of cooling in "super-core inflation" will be the key determinant of disinflation in 2026. Although indicators such as the Zillow Rent Index suggest that market rent growth remains on a downward trajectory, the stickiness of CPI shelter inflation—along with its average month-over-month increase of 0.28% in the first

nine months of 2025, close to pre-pandemic norms—implies that further disinflation in this component may be constrained. In comparison, "super-core inflation" (core services inflation excluding shelter), which is closely linked to the labor market, is likely to face downward pressure as the labor market continues to soften, making it a central driver of disinflation in 2026. That said, ongoing supply-side constraints such as immigration restrictions, together with relatively contained recession risks, suggest that the deceleration in services inflation may not fully offset the upward pressure from goods inflation and the stickiness of shelter inflation.

Under our baseline scenario, we expect PCE inflation in 2026 to decline by roughly 30-50 bps from its 2025 level, broadly consistent with the Fed's December SEP projection range (2.2%-2.7%, with a median of 2.4%). While inflation expectations remain well anchored and labor market softening can drive "super-core inflation" lower—keeping the risk of a marked inflation rebound generally well-managed—inflation is still expected to remain some distance from the 2% policy target.

III. Monetary Policy: Rate-Cutting Cycle to Continue amid Uncertainty over the Pace of Easing

In 2024, with inflation risks broadly under control and the labor market gradually normalizing from its post-pandemic tightness, the Fed initiated a rate-cutting cycle in September, delivering cumulative cuts of 100bps over the year. However, following the start of his second term in January 2025, Trump introduced a series of policies—particularly tariffs measures—that posed stagflation shocks to the U.S. economy (i.e., upside inflation risks along with downside employment risks), creating two-sided pressures on the Fed's dual mandate. Against this backdrop of heightened uncertainty and an unclear balance of risks between inflation and employment under the dual mandate framework, the Fed adopted a cautious "wait-and-see" stance from January to July 2025, keeping policy rates unchanged. As downside risks to the labor market increasingly outweighed upside risks to inflation, Powell delivered a clear dovish signal at the Jackson Hole Economic Symposium in August, stating that the "baseline outlook and the shifting balance of risks may warrant adjusting our policy stance." This marked a crucial turning point in the Fed's policy trajectory in 2025. Subsequently, the Fed cut rates by 25bps at each of the three FOMC meetings from September to December, bringing total easing for the year to 75bps. Notably, elevated uncertainty surrounding tariffs policy widened differences among Fed officials over the economic outlook and the trade-off between inflation and employment risks, leading to the rare occurrence of dissenting votes at four consecutive meetings from July through December.

Taken together, the above analysis of the labor market and inflation suggests that stagflation risks—defined as the coexistence of weakening employment and rising inflationary pressure—remain present in the U.S. economy. However, the pattern of downside employment risks exceeding upside inflation risks is expected to persist into 2026. Accordingly, under the baseline scenario, the Fed is likely to maintain the policy orientation articulated by Powell at Jackson Hole, placing relatively greater weight on employment stability in balancing its dual mandate. The likelihood of a reversal in the easing cycle therefore appears low. Given the limited probability of a sharp near-term deterioration in employment, the Fed is more likely to continue its "risk-management" approach to rate cuts, addressing downside risks to the labor market in a gradual manner.

That said, if labor demand continues to weaken and employment risks intensify materially—such as through an accelerating wave of layoffs or a sustained rise in the unemployment rate above 4.5%—the Fed may adopt a faster pace of policy easing to hedge against recession risks.

At the same time, uncertainty surrounding the inflationary impact of tariffs may constrain the Fed's easing pace. As Powell noted at the December FOMC meeting, the Fed is "well positioned to wait to see how the economy evolves." Accordingly, with tariffs pass-through effects not yet fully realized and the inflation outlook still subject to uncertainty, the Fed is likely to maintain a "wait-and-see" policy stance and remain cautious in its rate-cutting decisions. As the inflationary effects of tariffs are gradually absorbed, inflation is expected to pose less of a constraint on policy easing. This will create more favorable conditions for rate cuts, allowing the Fed to conduct further policy accommodation to mitigate downside labor market pressures. A risk scenario warranting close attention would arise if tariffs pass-through to inflation proves stronger than expected while employment pressures ease markedly at the same time. In such scenario, the role of "super-core inflation" in dampening inflation would weaken, and the Fed could tilt the balance of risks somewhat towards inflation, and slow the pace of rate cuts to prevent inflation expectations from becoming unanchored and triggering a significant inflation rebound.

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主要經濟指標 (Key Economic Indicators)

一、本地生產總值 GDP	2023	2024	2025/Q2	2025/Q3
總量 (億港元) GDP(HKD 100million)	29,010	29,729	7,852	8,537
同比增長率 (%) YoY change(%)	3.3	2.5	3.1	3.8
二、對外商品貿易 External merchandize trade			**2025/10**	**2025/1-10**
外貿總值 (億港元) Total trade(HKD 100million)				
總出口 Total exports	45,317	41,774	4,618	42,602
總進口 Total imports	49,275	46,450	5,017	45,942
貿易差額 Trade balance	-3,958	-4,676	-399	-3,340
年增長率 (%) YoY Growth(%)				
總出口 Total exports	-8.6	-7.8	17.5	13.8
總進口 Total imports	-7.2	-5.7	18.3	13.6
三、消費物價 Consumer Price				
綜合消費物價升幅 (%) Change in Composite CPI(%)	1.9	2.1	1.2	1.5
四、零售市場 Retail market				
零售額同比升幅 (%) Change in value of total sales YoY(%)	-0.9	16.2	6.9	0.0
五、訪港遊客 Visitors				
總人數 (萬人次) Total arrivals(10 thousands)	60.5	3,400.0	458.9	4,106.0
年升幅 (%) YoY change(%)	561.5	5,523.8	12.2	11.9
六、勞動就業 Employment			**2025/8-2025/10**	**2025/9-2025/11**
失業人數 (萬人) No. of unemployed(10 thousands)	16.3	11.3	15.0	14.4
失業率 (%) Unemployment rate(%)	4.3	2.9	3.8	3.8
就業不足率 (%) Underemployment rate(%)	2.3	1.1	1.6	1.6
七、住宅買賣 Domestic property sales and price index			**2025/9**	**2025/10**
合約宗數 (宗) No. of agreements	45,050	43,002	5,643	5,714
住宅售價指數 (1999=100) Domestic price index	369.7	337.4	293.1	288.5
八、金融市場 Financial market			**2025/10**	**2025/11**
港幣匯價 (US$100=HK$) 期末值	780.8	781.1	777.1	778.7
HKD exchange rate (US$100 = HK$), end of period				
銀行體系收市總結餘 (億港元) 期末值	962.5	449.5	540.5	540.7
Closing aggregate balance(HKD 100million), end of period				
銀行總存款升幅 (%)	1.7	5.1	9.7	-
Change in total deposits(%)				
銀行總貸款升幅 (%)	-3.0	-3.6	0.9	-
Change in total loans & advances(%)				
最優惠貸款利率 (%) 期末值	5.6250	5.8750	5.0000	5.0000
Best lending rate (%), end of period				
恒生指數 Hang Seng Index	19,781	17,047	25,907	25,859