Global Macro Research

5 March 2025

8:25 minute read

#US / #Globalisation / #Inflation

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Are tariffs a growth or inflation shock for the US?

If sustained, we think tariff increases on China, Mexico and Canada will raise US inflation and dent growth, but there is uncertainty around the relative size of these impacts. Amid this uncertainty we think the Fed will proceed cautiously in additional easing. However, it will need to clarify its reaction function before long.

Key Takeaways

- President Trump's decision to raise tariffs on the US economy's three largest trade partners represents a huge shock to the trade sector at home and abroad.
- We continue to suspect tariffs on Canada and Mexico will be at least partially rolled back in coming days and weeks, although China looks unlikely to get a reprieve.
- Either way, uncertainty is weighing on sentiment. With some nowcasts showing a big fall in Q1 GDP, markets are pricing three Fed rate cuts this year.
- Forecasting the impact of tariffs is complicated. The shock to growth and inflation is sensitive to the structure of the affected market, behavioural changes, and currency adjustments, among other things.
- If sustained permanently, we think the latest tariff announcements would take between 0.3-1% off US GDP, while adding 0.5-1% to the price level.
- But it is possible the shock generates a larger hit to activity, and smaller price level effect, if firms absorb tariffs into margins or there are large FX adjustments.
- The Fed will be sensitive to relative changes in growth and inflation, and in the near term it might prefer to stay on hold amid uncertainty. We are currently forecasting that the Fed cuts once this year, in September.
- More easing is certainly possible should risks to the expansion emerge, with labour market data key to this assessment. Of course, if the economy holds up then higher inflation could make it hard for the Fed to ease at all. What is clear is that the central bank needs to clarify its reaction function.

Profound uncertainty about the eventual tariff mix

Following the imposition of 25% tariffs on imports from Mexico and Canada (with a lower 10% rate on energy from Canada), and an additional 10% tariff on China, we estimate that the US average weighted tariff rate has risen from 3.3% at the start of President Donald Trump's term to about 12% based on current trading patterns. This is a level last reached in the 1930s.

But there is substantial uncertainty about both the outlook for these latest tariffs, and the broader US tariff mix.

In a speech to Congress on 4 March, Trump seemingly brushed off economic and market concerns about tariffs, saying there may be "a little bit of an adjustment period".

On the other hand, some members of the administration sound more uncomfortable with the rapid rate of tariff increases on large trading partners. For example, Commerce Secretary Howard Lutnick has suggested that the Canada and Mexico tariffs may be reduced in exchange for concessions.

For now, it's still (uncomfortably!) our baseline expectation that the Mexico and Canada tariffs are at least partially rolled back in coming days and weeks – although we don't expect any reversal of the Chinese tariffs. But it's clearly possible these latest tariffs stick for much longer, perhaps until the renegotiation of USMCA in mid-2026 (there have been calls to bring this forward).

Stepping aside from the latest spat, more tariffs are almost certainly coming, including reciprocal tariffs and additional product-specific tariffs on sectors such as steel and aluminium, autos, pharmaceuticals, and semiconductors.

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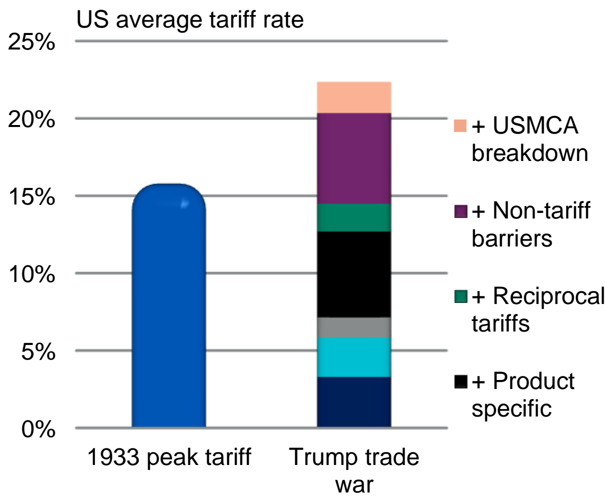
Indeed, putting together the full mix of Trump's latest tariffs threats, we estimate that they could push the US average weighted tariff rate substantially higher still (see Figure 1).

Figure 1: Adding together all of Trump's tariffs threats would take the US average weighted tariff rate well above 1930s peaks

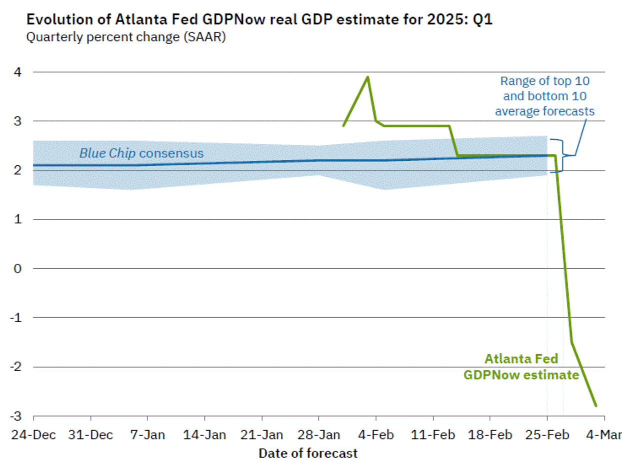


Source: Aberdeen, Haver, March 2025. Note: increase in effective tariff rate estimated pre-carve outs and pre-substitution effects

Expectations for Fed rate cuts have been building as market worries about a "Trumpcession"

At the same time, US GDP growth nowcasts have worsened dramatically. The Atlanta Fed GDPNow model is tracking a 2.8% annualised contraction in GDP in Q1 (see Figure 2). This likely overstates the decline in activity early this year given challenges accounting for the swings in trade and inventories. Even so, it has been a soft start to 2025 across a range of survey data and in some hard activity indicators.

Figure 2: A collapse in the Atlanta Fed nowcast

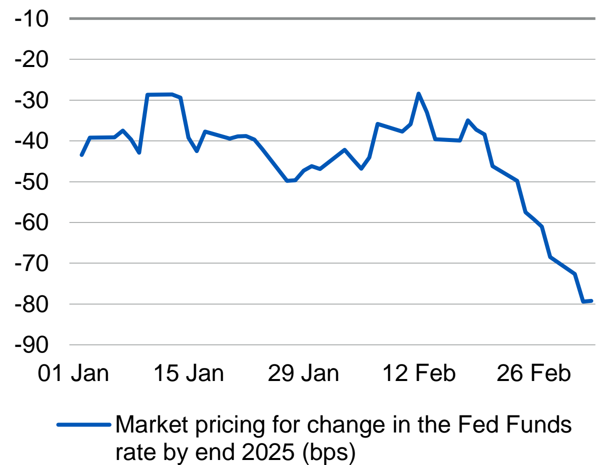


Source: Atlanta Fed, March 2025

This weakness partly reflects problems with seasonal adjustment at the start of the year. Severe weather has also likely temporary weighed on growth. Meanwhile, the weakening in the survey data follows a large surge after Trump's election win, and the soft data has been a less good guide to activity over recent years.

Nevertheless, all this has led to the market reassessing the prospects of Fed easing this year. Around three full 25bps rate cuts are now priced into fed funds futures markets, compared to one less than four weeks ago (see Figure 3).

Figure 3: Markets pricing in more Fed support.



Source: Aberdeen, Bloomberg, March 2025

Much turns on whether tariffs end up being predominately a growth or an inflation shock

We are currently in the process of refreshing our US (and indeed global) economic forecasts for the evolving trade and broader economic and geopolitical environment.

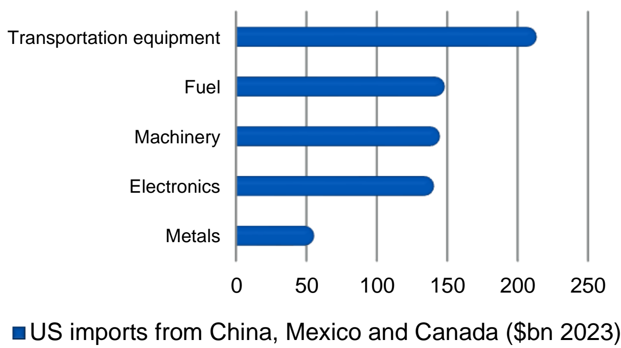
The last time we felt this uncertain about the policy conditioning assumptions that we should be using to underpin our forecasts was in the early days of the pandemic, as lockdowns were being rapidly imposed but it still wasn't clear how widespread or long-lasting they would be.

However, a key uncertainty at play, *beyond* what happens to tariff rates themselves, is how the economic impact of tariffs plays out between US growth and inflation, and therefore how it impacts Fed policy setting.

A very simplistic mechanical model would be that, by raising the price of imported goods into the US, this increases US inflation. Over the past 12 months, the US imported nearly $1.4tn of goods from Canada, Mexico and China, equivalent to 4.8% of GDP. This trade covers a diverse range of sectors with transport equipment (autos), electronics, fuel and machinery standing out as the largest (see Figure 4).

The increase in tariffs on this trade delivered so far averages 19%, implying a "tax" of close to $260bn based on current trading patterns. If passed entirely through to importers, this would equate to an increase in the US GDP deflator (i.e. the price level) of 0.9%.

Figure 4: Important sectors caught up in the trade war



Source: Aberdeen, Haver, March 2025

However, in practice, modelling the impact of tariffs is (much) more complicated, as behavioral changes and currency adjustments can all affect where the incidence of this tax lands and hence the impact on the price level and economic activity.

For example, higher tariffs could push importers to move their supply chains to unaffected trade partners (as occurred in the first US-China trade war) or domestic suppliers, while higher prices and supply-chain disruptions could reduce activity in the sector. The extent of this substitution effect will depend on the structure of the affected market, which differs significantly across product groups.

Additionally, currency changes can cushion the shift in relative prices but at the cost of lower economic activity. For example, were the dollar to appreciate on higher tariffs (again as occurred in the first US-China trade war), this could make the price increase of imported goods from the perspective of US consumers smaller, but the competitiveness of US exports lower.

We also need to consider the extent to which importers pass higher tariffs through to the final consumer or absorb them into margins. Finally, how any additional tariff revenues are used – as fiscal stimulus or to reduce the deficit – will also have an impact.

"Model uncertainty" introduces yet more unknowns

We can rely on models to estimate these relationships, but these are of course sensitive to the assumptions underpinning them.

For example, the Yale Budget Lab estimates a post-behavioural-changes impact of between 0.7-0.9% on the US price level from the tariffs measures so far, with the hit to GDP 0.7% at the end of 2026 and 0.3-0.4% into the long-run.

But this contrasts with work by UBS, which argued for a similar growth hit (0.8%) but more marginal inflation uplift (0.1%).

This gap likely reflects differences in model construction, but also more deliberate choices around the passthrough of tariffs to consumers. UBS assumes businesses absorb around half the increases in import costs, while the Budget Lab thinks that most of this increase will be passed through. Empirical work around the 2018-2019 US-China trade war showed that Trump's first-term tariff hikes were almost entirely passed on to end consumers, although this pattern is not guaranteed to be replicated this time.

With this uncertainty in mind, we flagged in early February, when tariffs on Canada and Mexico were first threatened, that the hit to growth from these measures specifically would likely fall between 0.3 to 1% of GDP, while the price level would increase by 0.5 to 1%.

We think that this judgement remains a reasonable starting point given the uncertainties (see Figure 5 for a broader range of estimates). The key point is that the severity of the shock, and that the relative impact across growth and inflation, could plausibly look quite different depending on behavioural responses.

Figure 5: Forecasters are split on the impact of Trump's tariffs

Forecaster	GDP level	Price level
Yale Budget Lab	-0.7%	+0.7% to +0.9%
UBS	-0.8%	+0.1%
Peterson Institute	-0.3%	+0.6%
Oxford economics	-1.3%	+0.6%
GMR working assumption	-0.3% to -0.1%	+0.5% to +1.0%

Source: Aberdeen, Yale Budget Lab, Peterson Institute, UBS, Oxford Economics, March 2025

On balance, we expect the Fed to remain cautious

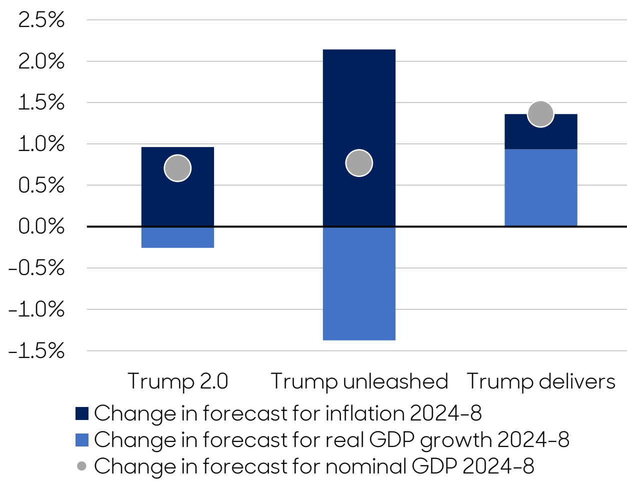
The Fed will be juggling with the same uncertainty and won't just be thinking about the very latest tariff increases in isolation.

The Fed has a set of (somewhat unclear) working assumptions for the full range of Trump policy measures. In our own working assumptions (which are, again, subject to updating), across all of Trump's policy measures, the upward inflation impact is larger than the negative growth impact in both our baseline and 'Trump unleashed' scenarios (see Figure 6).

Our instinct has therefore been that the Fed will react cautiously to tariffs, given concerns that even a one-off price-level shock could risk dislodging inflation expectations following years of above-target inflation.

Indeed, early commentary from the central bank has tended hawkish, with NY Fed President John Williams arguing yesterday that tariffs would raise prices and that he will be watching inflation expectations very closely. Chicago Fed President Austan Goolsbee echoed that prices would rise, and that the Fed should slow the pace of easing.

Figure 6: We have been thinking of Trump's full policy mix as having a bigger upward inflation impact than negative growth impact



Source: Aberdeen, March 2025

Overall, it seems most likely the Fed will be in wait-and-see mode in the short term, and we have been forecasting a single cut this year in September.

Certainly, this inaction could be shaken by the apparent very rapid slowdown in growth, especially if the Fed sees this as more than statistical quirks and a risk to the business cycle expansion. It is also possible that a very sharp sell-off in equities and tightening in financial conditions could add to the need to cut rates more rapidly.

But there are also risks that the Fed does not loosen at all, especially if the inflation impact of tariffs is large and front loaded. However, Chair Jay Powell has put a high bar for the central bank hiking rates again, and this is likely to remain if growth slows while inflation remains hot.

Either way, the Fed probably needs to clarify its reaction function to tariffs and other aspects of the Trump policy agenda further, to help manage market expectations.

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