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Could higher tariffs reverse the Fed's easing course?

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While it may be premature for the Fed to incorporate tariff implications into monetary policy decisions, current data on resilient growth, healthy labor markets and other factors suggest that the Fed's path will be gradual, possibly settling at a higher level than their latest projections indicate.

Just when inflation was starting to get (dare I say) boring again, the potential for higher tariffs, a central element of the incoming Trump administration’s agenda, has reignited concerns about inflation. With the much-anticipated Federal Reserve easing cycle just underway, markets must now consider the potential consequences for monetary policy if disinflationary trends were to reverse.

We can look to Trump’s previous term for insight into the Fed’s approach to inflationary pressures from tariffs. In September 2018, the Fed modeled a scenario involving a 15% tariff on all non-oil imports with foreign economies responding in-kind. If the Fed reacted to the resulting inflation spike by raising rates, they projected a mild recession. Conversely, if the Fed looked through the rise in import prices, growth slowed to a mere 0.5% but a recession could be avoided. The Fed concluded that this “see through” response would be most appropriate. However, if inflation expectations rose, which would be more likely in a very tight labor market, then the preferred response could be to hike interest rates.¹

More recently, Minneapolis Federal Reserve Bank President Neel Kashkari shared a similar perspective, describing tariffs as a one-time increase in prices that is not inherently inflationary in the long term. However, he warned that a “tit-for-tat” trade war could exacerbate inflationary pressures, sending prices higher.

Today’s economic environment also differs meaningfully from 2018—while the inflation heatwave is mostly past us, its embers are still alive.

- Recent events have reminded companies of their pricing power, and workers are now more attuned to cost-of-living increases in wage negotiations.
- Although market-based long-term inflation expectations are anchored around 2.0%, consumer expectations have hovered around 3% since May 2021, half a %-point higher than their range in 2018-19.²
- The recent experience of being slow to respond to “transitory” pandemic-related inflation may prompt FOMC members to adopt a more cautious approach to rate cuts next year, especially in the context of resilient economic growth.

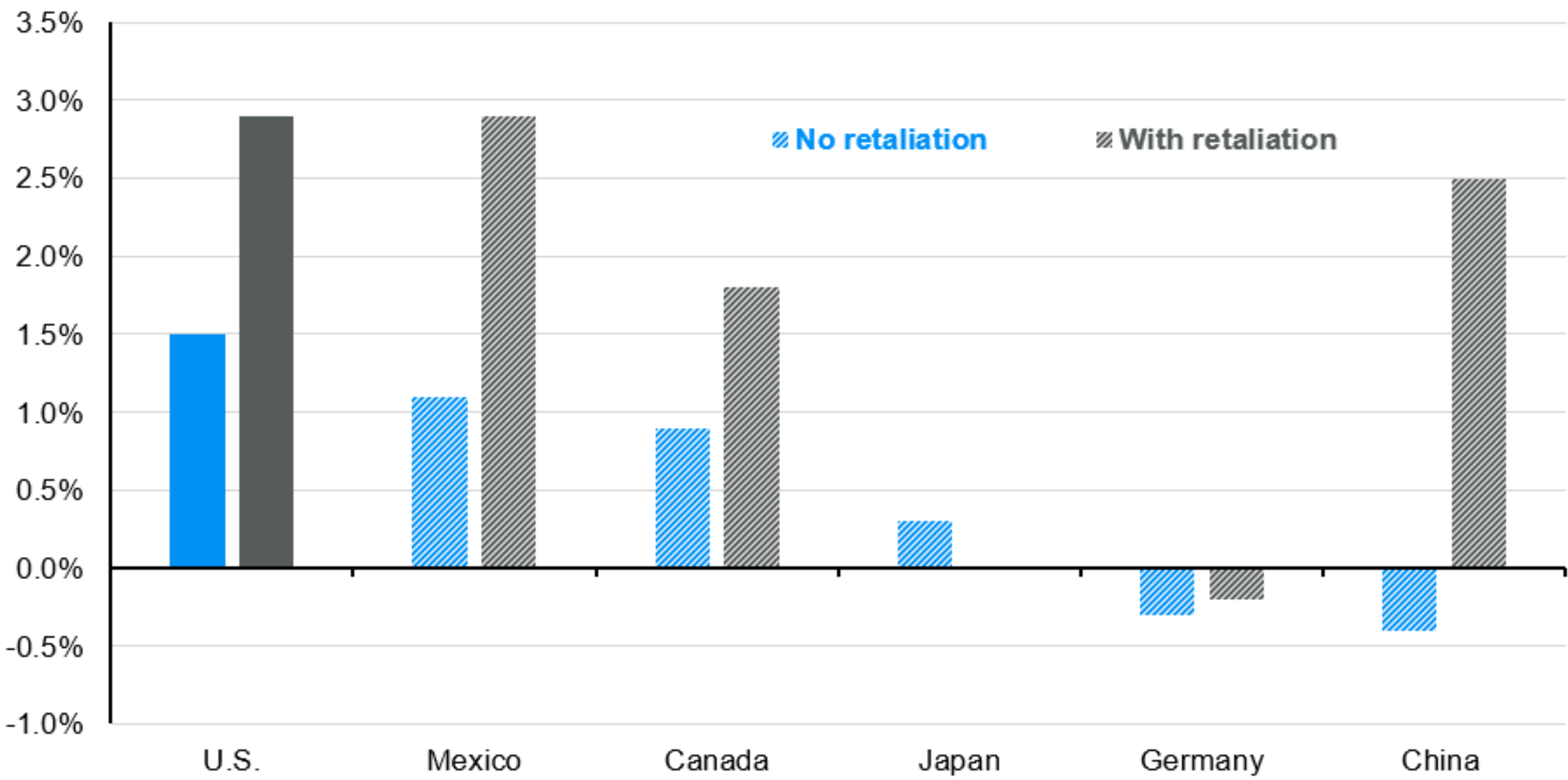
Additionally, several other trade war effects could influence the economy, such as slowing global growth, declining productivity and policy uncertainty weighing on business investment, all of which add complexity to any tariff projections. Investors should also be wary of placing too much emphasis on any specific cabinet appointments. Regardless of whether the incoming administration is staffed with tariff “hawks”, the former President has a track record of initiating trade negotiations with large, ambitious demands that are ultimately whittled down, and look significantly different, to the final agreements.

While it may be premature for the Fed to incorporate tariff implications into monetary policy decisions, current data on resilient growth, healthy labor markets and other factors suggest that the Fed's path will be gradual, possibly settling at a higher level than their latest projections indicate. For bond markets, this, along with the impact of higher deficits, could keep long-term yields elevated in the year ahead.

A tariff inflation spike will depend on the degree of retaliation.

Potential change in inflation from an additional 10% universal tariff and 60% tariff on Chinese imports

Cumulative change on CPI, 2025-28, percentage points



Source: McKibbin, Warwick, Megan Hogan, and Marcus Noland. "The International Economic Implications of a Second Trump Presidency." Peterson Institute for International Economics, September 2024. Please note that while this visual helps illustrate the potential effects of retaliation in accentuating first-round inflationary effect of U.S. tariffs, it should not be interpreted as a comprehensive projection of inflation pathways. Please see the source paper for full details on model projections. Given the inherent uncertainties and risks associated with forecasts, projections or other forward-looking statements, actual events, results or performance may differ materially from those reflected or contemplated. Data are as of November 19, 2024.

¹See “Report to the FOMC on Economic Conditions and Monetary Policy,” Federal Reserve, September 14, 2018, pages 90-92.

²See Guide to the Markets – On the Bench, page 27 “Inflation expectations.”

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