Could Trump's universal tariff revive inflation?

US special

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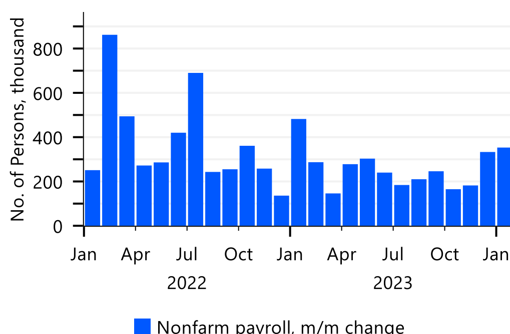
Summary

- Based on current opinion polls and our expectation of a deterioration of economic data in 2024, we have decided to assume a Trump victory in our current forecasting round for the global economy.
- Given Trump's first term in office and his recent remarks on trade policy, we should expect a broad rise in import tariffs under a Trump presidency.
- This could lead to a rebound in inflation, especially in 2025, complicating the Fed's mission to get inflation back to its 2% target in a sustainable manner.
- Ceteris paribus, this could reduce the amount of rate cuts that the Fed has in mind for 2025.

Introduction

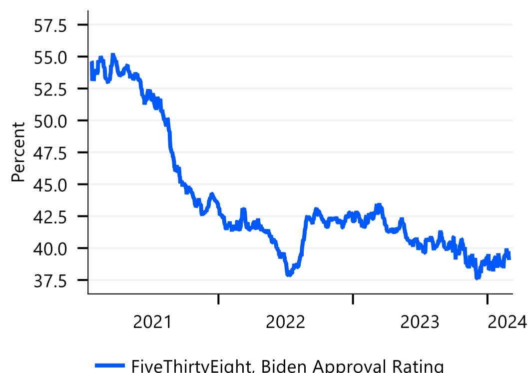
While the White House is celebrating the strong economic data of recent months, Biden's approval rating remains in the doldrums. From this point it is hard to imagine even stronger economic data, which implies that from here the risk is mostly to the downside. Nonfarm payroll growth figures exceeding 300K per month, which we saw in December and January, are not likely to be sustained. So this is as good as it gets for Biden. We also expect the unemployment rate, which stood at 3.7% in January, to rise during the course of 2024, as the lagged effects of the Fed's hiking cycle are working their way through the economy. The deterioration in economic data that we expect to see during the course of the year is likely to further damage voter confidence in Biden's economic policies.

Figure 1: Jobs are plenty...



Source: Macrobond

Figure 2: ... but Biden's approval is in the doldrums



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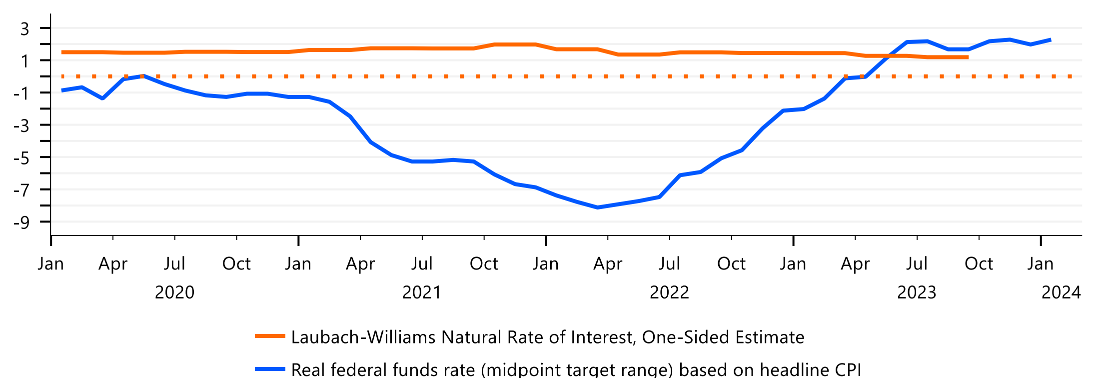
Although many expect a soft landing from the recent years of high inflation in the US, we still think that a mild recession is more likely to occur this year. This would further undermine Biden's chances in the November elections. If the Sahm rule applies, a rise in the unemployment rate of less than 0.5 ppt would still qualify as a soft landing, but a larger rise would indicate the start of a recession[1]. The current market exuberance is based on the assumption of a soft landing, which means that a hard landing (i.e. a recession) would be a major disappointment and lead to a further loss in Biden's popularity. Recession or not, at this point in time, a second term looks more likely for Trump than for Biden. While there are many uncertainties about the impact of a second Trump presidency on economic policy, a raise in import tariffs is highly likely. This will affect the trajectory of inflation and consequently the Fed's rate path.

Biden's hard landing

Although we think that any deterioration of economic data in 2024 is likely to hurt Biden's chances in the November election, there is a good (>50%) chance that a recession occurs this year. This would certainly be difficult for Biden to overcome. We were early to start forecasting a US recession, based on the Fed's fight against inflation. In our view, the only way to squeeze inflation out of the economy, was by engineering a recession. What's more, the inversion of the US treasury yield curve served as an important early warning signal supporting our recession forecast. Later, the weakening in the PMIs underlined the recession risks.

However, contrary to our expectations – and those of many other forecasters – the US economy was very strong in the second half of 2023. Excess pandemic savings have lasted longer than we anticipated. Many have drawn the conclusion that the Fed has successfully engineered a soft landing, which means that inflation will return sustainably to its 2% target (in terms of PCE inflation) without a recession. However, we think it is too early to declare victory. We have three reasons why we still expect a recession. In the first place, although we have seen a steep hiking cycle by the Fed, *in real terms* policy rates have not been positive and restrictive for very long. Therefore, we still expect the long and variable lags of monetary policy to assert themselves in 2025.

Figure 3: The real federal funds rate



Source: Macrobond

Secondly, based on the data, we think that consumers are reaching the end of their remarkable resilience. Excess pandemic savings are getting depleted, while credit card balances and credit card delinquencies are rising. We think that they could reach critical levels during the second half

[1] The Sahm rule is specified in terms of the three month moving averages of the unemployment rate. A rise of 0.5 ppt or more within one year is indicative of a recession.

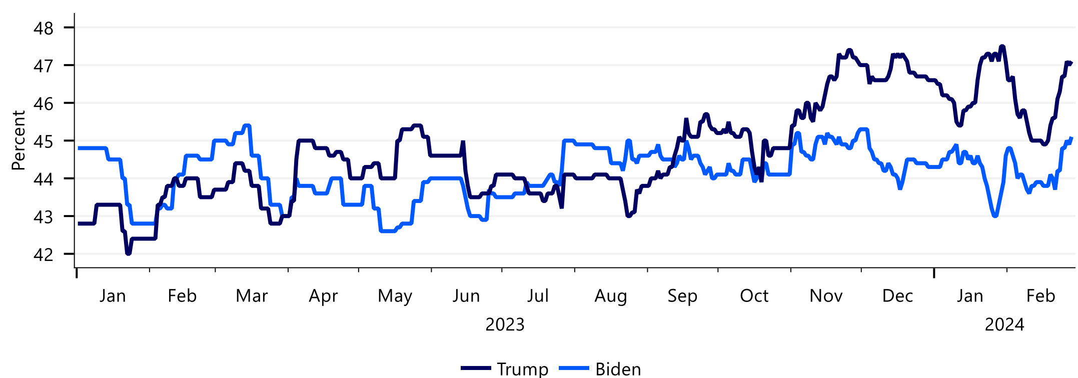
of this year. A slowdown in consumer spending is likely to dampen employment growth and business investment. In turn, this will lead to higher unemployment, further undermining consumer spending. Finally, we remain concerned about the commercial real estate-small bank nexus, which is a peat fire that has been smoldering since last year. We expect this to become a drag on the economy and contribute to a recession. In fact, if the recession turns out more severe than we currently anticipate, we think the feedback between CRE and small banks will be a major cause. Therefore, we still expect that a recession is more likely than a soft landing. However, based on the strong second half of 2023, we have shifted our forecast for a recession to the second half of 2024, from the first half.

Elections and economic forecasts

In our quarterly forecasting round for the global economy we have to make assumptions about the policies that will be in place in 2025. Forecasting the economy is conditional on the election outcome. This means that we cannot escape deciding whether we expect Biden or Trump to win the presidential election on November 5, 2024. Based on current opinion polls and our expectation of a deterioration of economic data in 2024, we have decided to assume a Trump victory in this forecasting round. If our forecast of a recession in 2024 comes true, this becomes even more likely.

This has important implications for our forecasts for 2025. While the impact on fiscal policy remains unclear, because this will also depend on the composition of the new Congress, a US President has much more leeway when it comes to trade and foreign policy. Based on Trump's first term in office and his recent remarks on trade policy, we should expect a broad rise in import tariffs under a Trump presidency. For our forecasts for the US economy, this means an additional rise in consumer prices in 2025 caused by higher tariffs. We also assume that the volumes of exports and imports will slow down in 2025 as a result of the Trump tariffs and retaliatory tariffs of US trading partners.

Figure 4: Trump leads Biden in the opinion polls



Source: Macrobond, RealClearPolitics

Trump's universal tariffs

Although we have learned not to take every threat made by Trump literally, his preference for tariffs was very clear during his first term in office. Therefore, we take his threat of a universal tariff seriously. In fact, we expect it to be one of his main campaign promises. The level of the universal tariff remains uncertain, but in August 2023, Trump talked about a 10% universal baseline tariff. In February 2024, he confirmed that he would impose a tariff of 60% or higher on all imports from China were he to win a second term in office. Not only do we expect the universal tariff to be a

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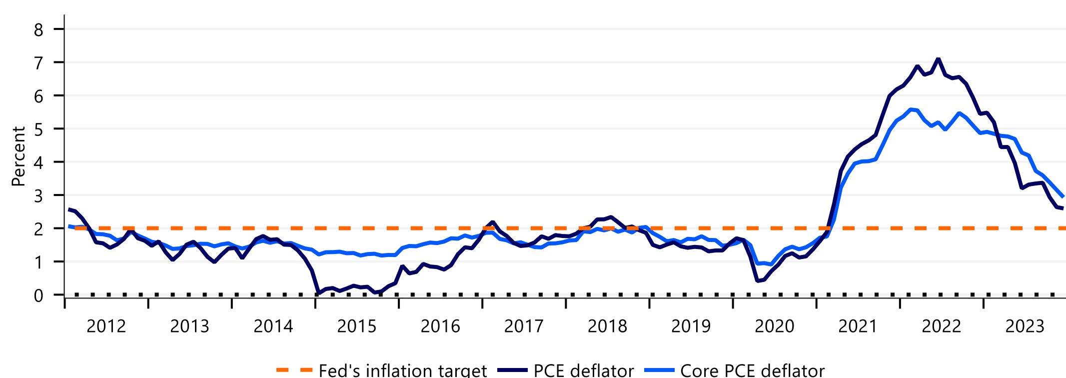
key campaign topic, but we also expect him to implement it soon after inauguration. After all, tariffs are a US President's prerogative. Due to several laws that have delegated certain Congressional powers on trade policy to the President, Trump would not need support from Congress to apply his tariffs. Therefore, we think Trump's threat of a universal tariff is credible and consequently it is a key assumption in our baseline forecasts for 2025 and beyond.

Empirical studies of Trump's 2018 tariffs have shown that most of the cost of US import tariffs has been borne by US consumers and US producers (importers), rather than foreign producers (exporters). Tariffs lead to higher costs for importing producers and higher prices for consumers. In other words, import tariffs are essentially taxes for US consumers and producers. The specific import tariffs of 2018 were visible in the prices of the protected categories of the PPI, but the impact on the CPI remained limited. However, universal tariffs are more likely to show up in the overall PPI and CPI than the specific tariffs of 2018, which were applied only to about one tenth of all imports.

Reviving inflation?

Universal tariffs are likely to have an upward impact on inflation, especially in 2025. Other things being equal, this would complicate the Fed's mission to get the inflation genie back into the bottle. Due to a decline in inflation in 2023, the FOMC has moved closer to achieving sufficient confidence of inflation returning back to the 2% target and is anticipating the first rate cut in 2024. The December dot plot implied a reduction in the federal funds rate of 75 bps in 2024 and another 100 bps in 2025. However, these projections are conditional on PCE inflation falling to 2.4% in 2024 and 2.1% in 2025. Note that in December 2023, PCE inflation was 2.6%. We think that a rise in unemployment would help reduce inflation in 2024, especially in case of a recession, but an inflation revival could soon follow.

Figure 5: Could universal tariffs reverse the Fed's progress on inflation?



Source: Macrobond

The imposition of a universal tariff on US imports may not only have an upward impact on PCE inflation in 2025, it would also hurt US firms that use foreign inputs in their production process. This could negatively affect domestic employment growth, as those firms try to get their costs under control. Retaliatory tariffs by foreign governments on US exporters could have a similar impact on domestic employment. The combination of higher inflation and slower employment growth would force the FOMC to make another trade-off between the two legs of its dual mandate of price stability and full employment. Given the Fed's ongoing battle against inflation, we think that price stability will again be prioritized above full employment, with the now familiar argument that sustainable employment growth requires price stability. From this perspective, an import tariff could be seen as another negative supply shock. Ceteris paribus, this could reduce the amount of rate cuts that the Fed has in mind for 2025.

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The story is not likely to end with Trump's universal tariff. Retaliation could lead to Trump raising universal tariffs to higher levels and we could end up in a global trade war. This would lead to further upward price shocks beyond 2025.

Conclusion

At this point in time, assuming a Trump victory in November seems the most plausible assumption for our global economic forecasts. Consequently, we forecast a rebound in inflation in 2025. Going forward, if we think that a Biden victory is becoming more likely than a Trump victory, we will adapt our baseline forecasts for 2025 and beyond to reflect this. Since the economic data can hardly get better, it would probably be non-economic developments that could change our assumption about the outcome of the US presidential election in November in one of the next forecasting rounds. However for now, thinking about the possible economic impact of a second term for Trump seems a sensible exercise.

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