US Economics

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February 5, 2025

Quick Reid: What tariffs could mean for the US economy

The threat of sweeping tariffs on Canada, Mexico, and China would have been (and may still be) the most significant trade shock in the US since the *Smoot-Hawley Tariff Act* of the 1930s. And, while the worst of the shock may be delayed or reduced, we are still firmly focused on a fundamental shift in US trade policy that's persisted for nearly a century. It will likely have implications for growth and inflation—the magnitude of which will depend on the policy path ahead. Importantly, as we await the future of tariffs on Canada and Mexico (delayed until March 1st), the US has implemented an additional 10% tariff on Chinese goods, and China has retaliated with tariffs on US imports in a sign of what's ahead for US trade. US President Donald Trump's first term offers a limited economic playbook for the magnitude of trade policy changes now being discussed. As we highlighted in A US-Canada trade shock: First economic takeaways, **in 2018, we saw the effective US tariff rate double from 1.5% to 3%**. **But at 25% tariff on Canadian and Mexican goods is nearly four times as impactful and would increase to the US average tariff rate to 10.6%**.

President Trump is still engaged in the April 1st America First Trade Act and in the renegotiation of the USMCA trade accord, which is scheduled for July 2026. Effectively, tariff delays or not, trade isn't going away from the US economic agenda anytime soon. And forecasting the impact of trade shocks is a complicated exercise. It requires a long list of assumptions about the duration, potential retaliation, and shocks to demand that will ultimately determine the impact on the US economy. These uncertainties are not one sided on impact either. Some could worsen the severity of the tariff shock on growth, and some could alleviate a portion of it, including the possibility that the policy is reversed in short order (as we saw with Colombia). For now, we continue to lean on RBC Economics A playbook for how to measure a tariff shock as a model to assess the outlook through these uncertainties. Below we identify the most frequent questions we are receiving and how we're thinking about the risks:

Will tariffs contribute to higher inflation?

Yes, tariffs almost always lead to higher prices. In 2018, we saw the cost of core goods (as measured by Personal Consumption Expenditures Price Index) increase by 0.5 percentage point following the announcement of tariffs on China. In that period, stable service and energy prices helped to limit the increase to headline inflation to about 0.3 ppt. But we are currently in a very different price environment and unlikely to see deflationary offsets from other sectors. This means a disruption to the goods deflation we've been seeing could be more impactful without the help of price stability. Ultimately, what matters for consumers and the Federal Reserve is the extent to which higher costs are passed on by businesses. We saw the Producer Price Index (PPI) increase 0.6 ppt in 2018, suggesting some of those price increases were not passed through fully to the consumer. Currently, healthy profit margins in the US could limit the pass through this time around.

However, we would expect a 25% persistent tariff rate on Canada and Mexico to contribute about 0.5-1.0 percentage point increase to the year-over-year pace of PCE in the US. Effectively, that means we could see headline inflation creep back above 3.0% year-over-year by the end of 2025 if the tariffs are enacted on March 1. In particular, the US is exposed to Canadian energy imports (and less likely to see a drop off in US demand), because Americans have no true substitute for Canadian commodity imports. The lack of substitutes implies higher prices for both American producers and consumers. The extent non-energy prices re-accelerate will depend on foreign exchange rates—primarily stemming from the continued appreciation of the US dollar relative to the rest of world.

Will tariffs weigh on growth?

In the near term, the tariffs are more problematic for China compared to the US. Tariffs are hitting the Chinese economy at a period when it is already struggling to maintain its target growth rate. China issues stem from an aging population, falling property values, and a rising youth unemployment rate. As the country continues to operate with excess supply, it increasingly relies on trade (notably with the US) to boost GDP growth.

Conversely, the US economy has seen above-trend growth, unemployment remains historically low, causing the Fed to pause its cutting cycle at the January FOMC meeting. Still, while the US economy is starting from a relative place of strength (and is far less reliant on trade to sustain growth), it could see a stagflationary shock if retaliatory policies from Canada and/or Mexico come into play.

We expect to see a much larger drag on US growth if the tariff rates of 25% are applied to Canada and Mexico. The largest drag will likely come from persistent tariffs (i.e., lasting longer than six months) and could reduce GDP growth by more than of 1 ppt. That would not necessarily push the US into a recession (relative to our baseline forecast, that means we would expect no growth in the US economy for 2025). But any additional retaliation or expanded scope of tariffs on other countries or groups (e.g., the European Union has been mentioned as a potential next target) could push the US into recession.

Disproportionately, the tariffs are likely to impact low-income consumers, who are already falling behind. Consumption growth has been robust, but we've been highlighting the fact that the top 20% of income earners account for over 40% of consumption in the US. As further price increases weigh on all consumers, we are likely to see the stress contribute to a re-acceleration in credit card and auto loan delinquencies, revolving credit utilization, and a pullback on consumption by lower-income consumers.

Which sectors are expected to be most impacted?

With the added tariffs on China, the sectors most likely to be impacted are in the consumer goods space (e.g., weighing on margins in wholesale and retail trade), as well as manufacturing supply chains, notably for computer and electronics components. This is also likely to weigh on demand for transportation and warehousing.

With the tariffs on Canda and Mexico paused for the time being, it's still worth mentioning the sectors exposed if the tariffs are enacted on March 1. From a US perspective, the sectors most at risk include energy, auto and parts manufacturing, aerospace manufacturing, metals, and agriculture commodities.

As described in our tariff playbook, we are also mindful that secondary industries in the services sector, for example, are likely to feel knock-on effects. Consider an auto plant that sees reduced demand and then, has to lay off workers. Those laid off workers are less likely to go to restaurants, movie theatres or engage in other "discretionary" spending, which can lead to a further decline in demand, a squeeze on companies' profit margins, and ultimately, layoffs.

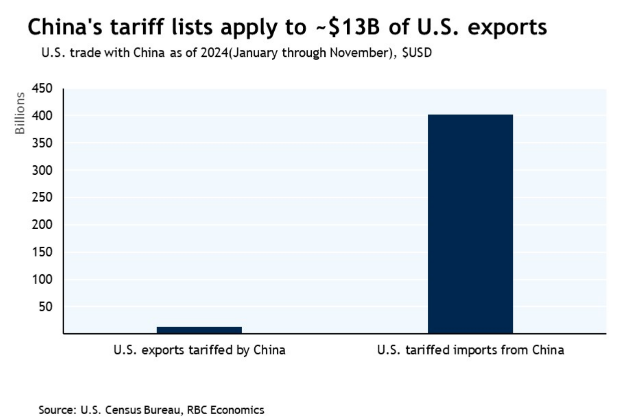
What this means for the Fed

Tariffs are a complicated shock for the Fed. They weigh on growth but increase inflation as they pull on both sides of the dual-mandate in the opposite direction. It's fair to say these tariffs will work against the Fed in terms of getting inflation back to target. That said, our US rates strategists expect the Fed will continue to be data dependent and not react to immediately to the tariff announcements. As Blake Gwinn, Head of US Rates Strategy wrote:

"*We think the Fed is going to respond to the data, not expectations. Yes, policy (theoretically) works on a lag, and the Fed typically wants to skate to where the puck is headed, not where it's been. But the path is too uncertain right now to try to preempt any particular view on where tariffs are going to be 9-12 months out and what that is going to mean for each side of the dual mandate.*"

While the Fed will remain keenly attuned to underlying inflationary trends (i.e., within core services), the short-term shock will likely be most noticeable in the core goods space. This will almost certainly disrupt the deflationary forces we've seen of late and can cause core inflation to get stuck closer to 3.0% y/y. But the greater risks also include potential spillover to other sectors, namely higher construction and housing costs risk a re-acceleration. And if costs for housing, food, and other essentials continue to rise persistently, consumers will likely be quick to demand higher wages, setting off a potential wage price spiral.

Tariffs disproportionately impact China imports



Source: Haver, US Census, RBCCM US Economics.

Tariffs on China exports are unlikely to slow GDP in '25

Source: Haver, US Census, RBCCM US Economics.

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