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MACROCOSM

Will the Trump Tariffs Be Inflationary?

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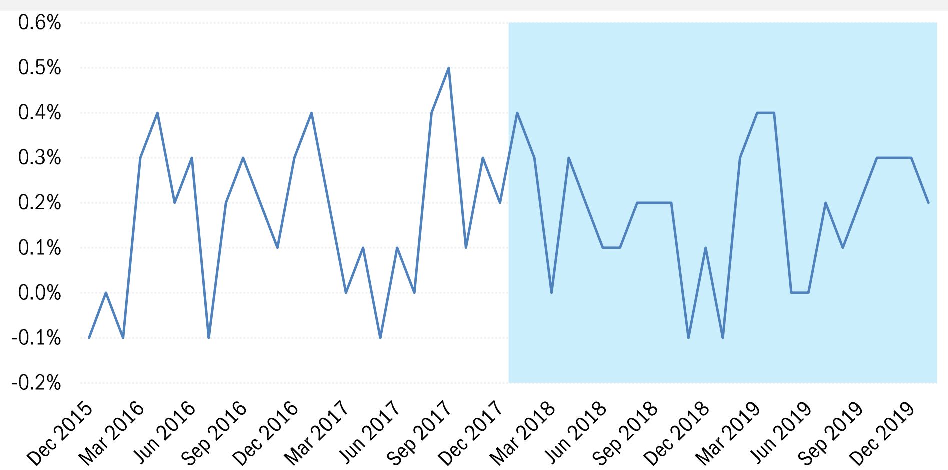
It's tricky. They will feel inflationary, and CPI will confirm it. But the Fed's PCE won't.

Aside from the anti-growth effects of what is effectively a large tax hike in the form of massive new US tariffs (see "Video: What you're not hearing about how tariffs are taxes -- and big new tariffs are big tax hikes" April 8, 2025), *we are asked in every client conversation whether the tariffs will be inflationary*.

- The quick answer is, "how could they not be?"
- A quick and dirty calculation would be that imports of $4.1 trillion per year are 13.9% of $29.7 trillion GDP, and the average tariff rate has risen 14% (from 2.5% last year to 16.5% now). 14% of 13.9% is 1.9%. So *CPI, now at 2.8%, should rise to 4.7%* in the year of the onset of tariffs, and fall back to 2.8% the year after, all else equal.
- But the slow answer is more nuanced. It *depends on the reaction-functions of economic actors* here and abroad, and in the private and public sectors.
- And *it depends critically on which measure of inflation you use* – the Consumer Price Index, or the Personal Consumption Expenditures Price Index that the Fed prefers.
- From an empirical perspective, the onset of *tariffs in 2018 and 2019 did not increase inflation*. It's not that increased inflation was "transitory." It's that no increase happened at all (please see the

CPI month-over-month Before and after Trump tariffs in first term



Source: BLS, TrendMacro calculations

Update to strategic view

US MACRO: Tariffs appear to be inflationary on the face of it. A rough estimate is that CPI would rise from 2.8% to 4.7% over the coming year. But tariffs were not inflationary at all in the 2018-2019 episode. That might be because the currency of China – the focus of most of those tariffs – weakened significantly. This time, without such a safety valve, it is not clear from first principles that the tariffs will be inflationary overall, even if they raise the prices of certain individual goods and services. Where a good has a domestic substitute, it's not clear in a competitive equilibrium that domestic producers have scope to raise their prices to the tariffed level. Where there is no domestic substitute, as with, say, cell phones, the substitute is to buy fewer cell phones. But to the extent that certain prices rise, budget-constrained consumers have to buy less of other items, and their prices will fall. That is recessionary, not inflationary. Credit utilization or stimulus payments could offset that, but then it would be money-growth, not tariffs…

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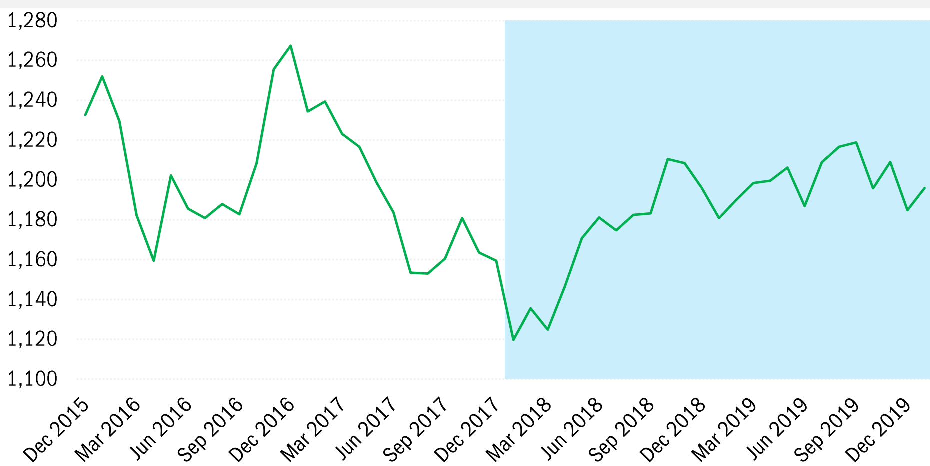
chart on the previous page, and see [“How Much Do Tariffs Matter?”] January 28, 2025).

- But today’s tariffs are far larger and broader. So while the one historical precedent we have in modern times creates reasonable doubt, it is far from dispositive. We have to build our forecasts from first principles.

New US tariffs would not increase US inflation at all if…

- …foreign exporters lower their prices so that US importers are indifferent after paying the tariff.
- …foreign governments intervene to weaken their currencies with respect to the US dollar so that, in dollar terms, US importers are indifferent after paying the tariff.
- It’s not hard to imagine either or both of these things happening, as firms seek to preserve their volumes and market shares and governments seek to preserve their employment and growth strategies.
- These are the arguments used by the Trump administration to support their claim that other nations will “pay for the tariffs.” We have no doubt that these arguments at least correctly adduce possibilities and create reasonable doubt. Dispositive? No.
- At least as far as the currency element is concerned, there is some evidence it helped keep US inflation stable during the 2018-2019 tariffs. The trade-weighted dollar appreciated about 7% over the period (please see the chart below) while the Chinese RMB weakened by about 10%.

Bloomberg Trade-Weighted USD Index Before and after Trump tariffs in first term



Source: Bloomberg, TrendMacro calculations

Another possible firewall against consumer inflation effects of tariffs would be the *absorption of the tariff by the US importer*. Instead of Walmart passing the cost of the tariff on to its customers in the form of higher prices, it could accept lower profit margins. There’s nothing good for US growth about Walmart’s margins contracting, but the question today is inflation. There is no evidence from the 2018-2019 tariffs to suggest that this is the explanation for the absence of consumer inflation then.

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… that would have caused any inflation. CPI does not capture substitution or go-without effects, so any tariff-driven inflation at all will show up most intensely in that flawed index. Thankfully, PCE, the Fed’s preferred index, fully accounts for such effects.

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Let's ignore those safety valves and *think through the effects of tariffs on consumer goods for which there is a domestic substitute* – say, automobiles.

- Let's say a 100% US tariff is applied to imported cars. The price rises from $30,000 to $60,000 for consumers.
- *We could just stop right here and say that tariffs are self-evidently inflationary because they made this price go up. Fair enough. But if we are thinking about inflation as an overall rise in the general price level in the economy, it's not that simple.*
- All else equal, surely people who had intended to buy a foreign car would now buy a domestic one.
- Potentially domestic car producers would raise their prices – arguably to as close to the after-tariff price of the foreign car as possible. But would they really? Likely not all the way. Unless we believe that un-tariffed foreign cars were being dumped on the US market and lowered the entire industry's competitive price structure, the pre-tariff price of domestic cars was in equilibrium with consumer preferences all along. How much would domestic manufacturers want to risk unit-volumes with their existing customers in order to get volumes from new customers whose revealed preference is for something else?

Now let's think through the effects of tariffs on consumer goods for which there is no domestic substitute – say, cell phones.

- Let's say a 100% US tariff is applied to cell phones, all of which are imported. The price rises from $1,000 to $2,000 for consumers. *Again, that's ipso facto inflation.*
- *In terms of the overall price level, though, the safety valve of an un-tariffed domestic producer doesn't exist. If you want a cell phone, you are paying double the price.*
- *But there is nevertheless an alternative to a foreign-made cell phone. The alternative is nothing.*
- In other words, people will simply buy fewer cell phones when the price doubles. They will be less likely to upgrade just for a sexy new feature, more likely to only buy when they really need a new one.
- Those who still buy a cell phone will have $1000 less to buy anything else. So the demand for everything else should decline, which should lead to a drop in the price of everything else. You want a cell phone? Then get haircuts less frequently. The price of haircuts will fall.
- As a first approximation, across the entire consumption economy, the general price level would not rise on average. *This dynamic may indeed be a formula for recession as such choices get forced on people – but it cuts against simplistic arguments that tariffs are automatically inflationary.*
- For this to work, it assumes people are on a strict budget. Most people are. But many people use credit when they are at the edge of their budget. Sometimes the Fed makes credit utilization easier

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by lowering interest rates, especially when consumers are in distress. Sometimes the government engages in stimulus programs. Either of those amounts to money creation – and they allow consumers to buy the more expensive cell phone and no less of anything else. So inflation rises. That's why "inflation is everywhere and always a monetary phenomenon."

- *In this thought experiment, it's the money creation that creates the inflation, not the tariff.*

An interesting subtlety arises when we consider how the potential inflationary effects of tariffs will be measured in the published statistics.

- We think any effects will show up more in the Consumer Price Index than in the Personal Consumption Expenditures Price Index, even though both look at exactly the same statistical universe of prices in the economy.
- Items in CPI are weighted once a year in January, based on surveys from one year prior of the quantities of various goods and services that people buy. That laggy process is how owners' equivalent rent of primary residences gets more importance in the overall index than pork chops.
- *Under this flawed process, if a $2000 cell phone means that only one person in America buys just one cell phone, the price doubled by tariffs will show up in CPI with the same weight as though people were buying as many cell phones as they were a year ago at half the price.* No, actually, it's worse than that – the weighting of cell phones in the index would actually go up – a lot, in this case -- because every month it is price-adjusted (but not quantity-adjusted).
- The Personal Consumption Expenditures Price Index does not have this fatal flaw. Quantities are adjusted every month, separate from price.
- In PCE, if only one person buys only one cell phone, even though the price of that phone has doubled, it would be so insignificantly weighted as to have no effect on the index.
- *Fortunately, the better-constructed PCE index of inflation is the one the Fed follows. Unfortunately, it is the poorly-constructed CPI that the public follows.*

Bottom line

Tariffs appear to be inflationary on the face of it. A rough estimate is that CPI would rise from 2.8% to 4.7% over the coming year. But tariffs were not inflationary at all in the 2018-2019 episode. That might be because the currency of China – the focus of most of those tariffs – weakened significantly. This time, without such a safety valve, it is not clear from first principles that the tariffs will be inflationary overall, even if they raise the prices of certain individual goods and services. Where a good has a domestic substitute, it's not clear in a competitive equilibrium that domestic producers have scope to raise their prices to the tariffed level. Where there is no domestic substitute, as with, say, cell phones, the substitute is to buy fewer cell phones. But to the extent that certain prices rise, budget-constrained consumers have to buy less of other items, and their prices will fall. That is recessionary, not inflationary. Credit utilization or stimulus payments could offset that, but then it would be money-growth, not tariffs, that would have caused any inflation. CPI does not capture substitution or go-without effects, so any tariff-driven inflation at all will show up most intensely in that flawed index. Thankfully, PCE, the Fed's preferred index, fully accounts for such effects.