US TARIFFS: POTENTIAL IMPLICATIONS FOR THE US ECONOMY

INVESTMENT VIEWS
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February 2025

Tariffs have dominated headlines and are top-of-mind for many investors. While the situation remains fluid, we analyze the significance of tariffs through three key lenses.

1. Their effective rate
2. Their economic impact
3. How these dynamics might influence the Federal Reserve (the Fed)

How large are the tariffs?

Effective rates

At the start of 2025, the effective tariff rate on US imports stood at ~2.7%.[1] The 10% tariff on all imports from China, which took effect at the start of February, raised the effective tariff rate by 1.3 percentage points (pp) to 4%. To put this into context, the increase in tariffs implemented between the inauguration in January and early February of this year was roughly the same amount implemented during the first Trump administration over the entire 2018–2019 period.

The proposed 25% tariffs on imports from Canada and Mexico, if implemented, would raise the effective tariff rate by an additional 6.8pp raising the overall rate closer to 11%.

Potential impact on the US economy

Inflation and GDP

The impact of tariffs on inflation depends on the timing and pace of their implementation. If all tariffs were introduced within a few months of one another, we believe that a 1pp increase in the effective tariff rate could raise the core Personal Consumption Expenditures Index (PCE) inflation by 0.1%.[2]

In terms of gross domestic product (GDP), we believe that for every 1pp increase in the effective tariff rate, US GDP could decline around 0.2–0.3pp.

Recession risk

Our view is that recession risks are relatively low, putting the probability at around 20%. However, a strong rise in the effective tariff rate, such in the case of a 10% tariff on China paired with a 25% tariff on Mexico and Canada, particularly if paired with retaliation from other countries, would see this risk rising meaningfully.

Taking into account the size of this shock, as well as the current state of the US economy and the likely Fed reaction, we think the probability of a US recession within 12 months would rise to 40–50%.

[1] The effective tariff rate is tariff revenue divided by total imports.

[2] The Personal Consumption Expenditures Index (PCE) measures the price that US consumers pay for goods and services. The Core PCE Price Index measures inflation excluding the prices of food and energy.

Potential Fed moves

Rate cut, rate hike scenarios

In our view, if inflation expectations were to remain stable and not influenced by short-term fluctuations, and the Fed were to have absolute confidence in that anchoring, the appropriate response of monetary policy should be to *cut* interest rates.[3] Since tariffs are seen as a tax hike, this response would cushion the impact of the shock on GDP and unemployment, while accepting a temporary period of higher inflation.

There is large uncertainty around these estimates. For instance, the Fed might be quicker to cut rates if countries were to retaliate against US tariffs.

Retaliatory tariffs would increase the negative shock to US GDP, while leaving the impact on US inflation broadly unchanged.

However, a strong rise in inflation expectations, or evidence of a wage-price spiral (e.g., wage growth reaccelerating in the face of a weaker labor market) would likely lead the Fed to deliver some rate hikes.

We see the rate hike scenario as unlikely, but not impossible, particularly if tariffs are accompanied by fiscal stimulus.

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[3] The anchoring of inflation expectations is a necessary condition for central banks to maintain price stability, as it prevents temporary shocks to inflation from feeding into the mechanisms of wage and price formation.

MARK-689051-2025-02-13

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