An Analysis of the Impact of U.S. Tariffs on Growth, Inflation, and Monetary Policy

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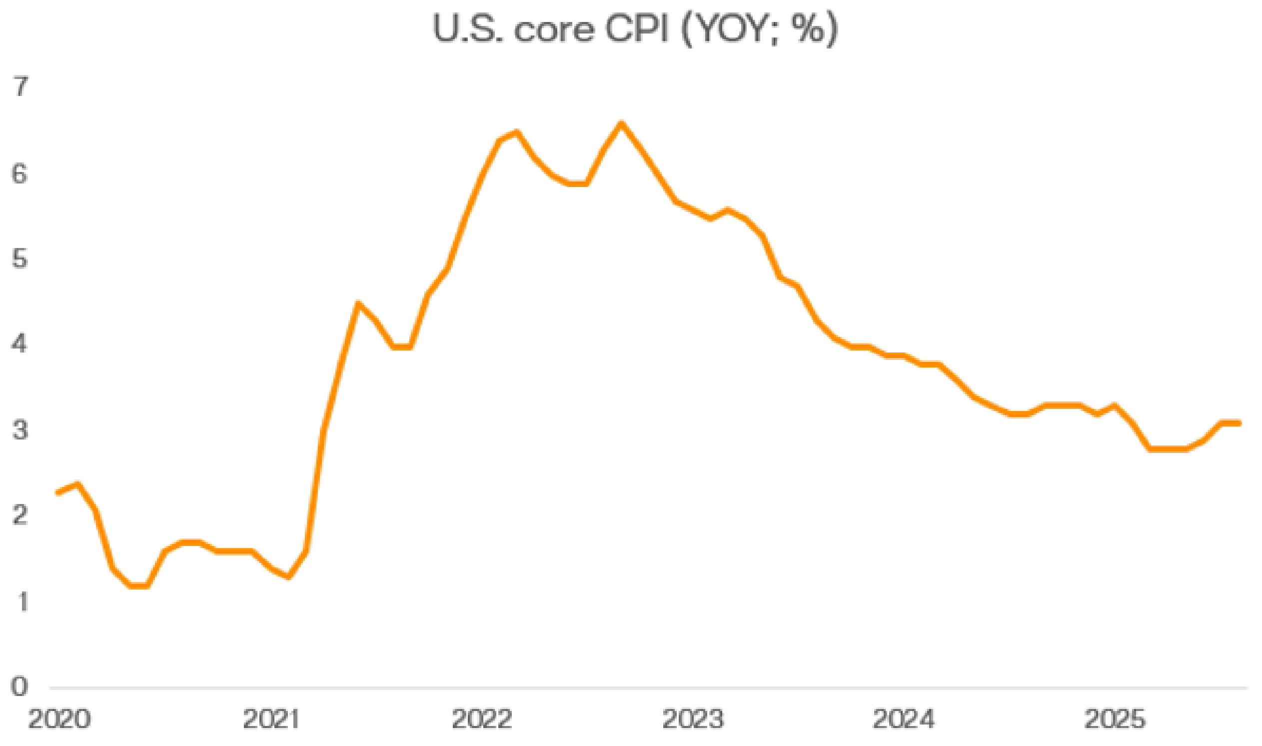
Key points

- While the potential negative impacts of tariffs are well documented, the White House's other major policies including tax cuts and deregulation are largely pro-growth.
- Tariffs have not led to runaway inflation in the U.S. for two main reasons. On a micro level, cost pass-through is difficult given stable household income. On a macro level, the monetary environment has been somewhat restrictive, with real interest rates being positive and money supply no longer growing rapidly.
- Should inflation remain largely stable, the Fed's rate-cutting cycle may extend into 2027. Given the Fed's dual mandate, signs of weakness in the labour market will also support further monetary accommodation. The terminal Fed funds rate may be closer to 2% than the FOMC's median guidance of 3%.
- The U.S. is the single largest export destination for many economies and also happens to be the least reliant on international trade among major economies. This explains why trade issues have featured so prominently as a negotiation tactic to further various U.S. interests. While bilateral agreements have appeared to stem tit-for-tat retaliations, tariffs and trade barriers are likely here to stay.

The worst fears about the damage of tariffs have not materialised

- Consensus projections of the impact of U.S. tariff policies have turned out to be rather different from reality.
- In spite of elevated trade policy uncertainties, the U.S. economy overall has been holding up fairly well, and major stock indices have continued to reach new heights.
- The biggest fear was undoubtedly soaring inflation, which has not materialised. Inflation expectation remains largely stable, while tariff-induced price increases have yet to become commonplace.



Source: Bloomberg, BEA Economic Research

Trade policy uncertainty has subsided following a historic surge

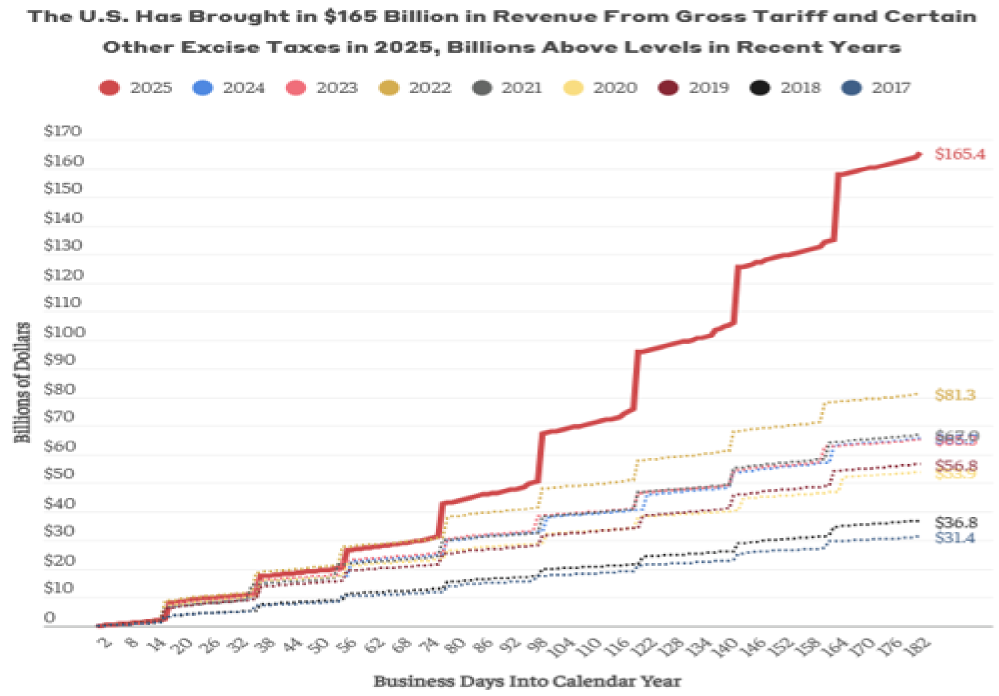
- "Liberation Day" propelled trade uncertainty to levels never seen before, disrupting business decision-making, logistics, and consumer behaviour.
- As the U.S. negotiated deals with its trading partners, the worst-case scenario of tit-for-tat measures and countermeasures was averted. Sentiment then gradually improved, even though tariffs are now still substantially higher than those before the trade war.
- To ease trade tensions, bilateral agreements have proliferated. The WTO's multilateral system is becoming increasingly ineffective in solving trade disputes.

Source: "Measuring Economic Policy Uncertainty" by Scott Baker, Nicholas Bloom and Steven J. Davis at www.PolicyUncertainty.com

Tariffs are only one part of the White House's economic agenda

- While the potential negative impacts of tariffs are well documented, the White House's other major policies including tax cuts and deregulation are largely pro-growth. Even tariffs themselves are often negotiating tactics to serve other goals.
- The One Big Beautiful Bill Act (OBBBA), passed into law in July 2025, includes the largest set of tax cuts for individuals and businesses since the 2017 Tax Cuts and Jobs Act (TCJA), providing a boost for corporate earnings and household income.
- While the situation of U.S. public finances remains dire and intractable as deficits and total debts continue to surge, tariffs are bringing in record revenue.

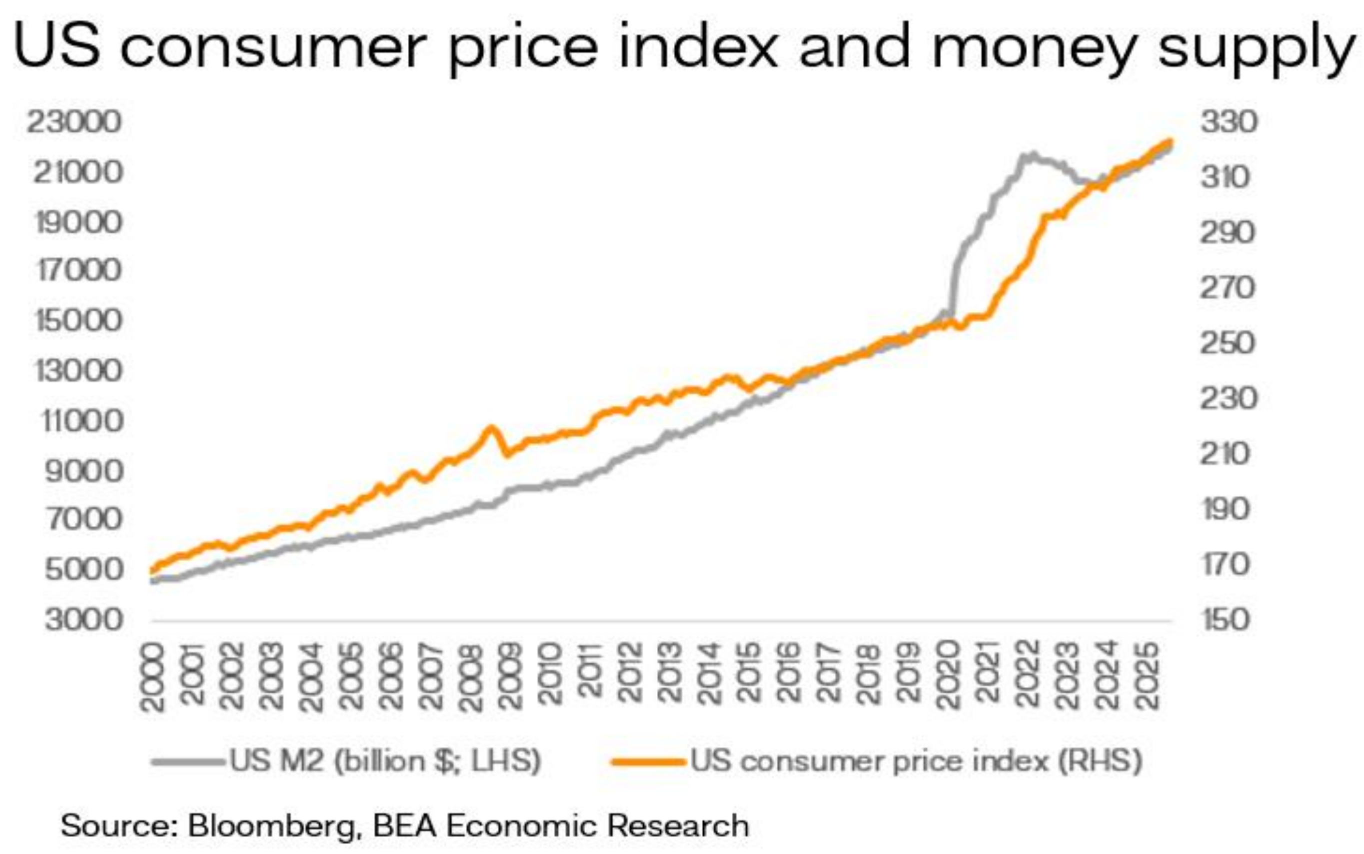
U.S. Tariff and Excise Tax Revenue: 2017-2025



Source: Bipartisan Policy Center

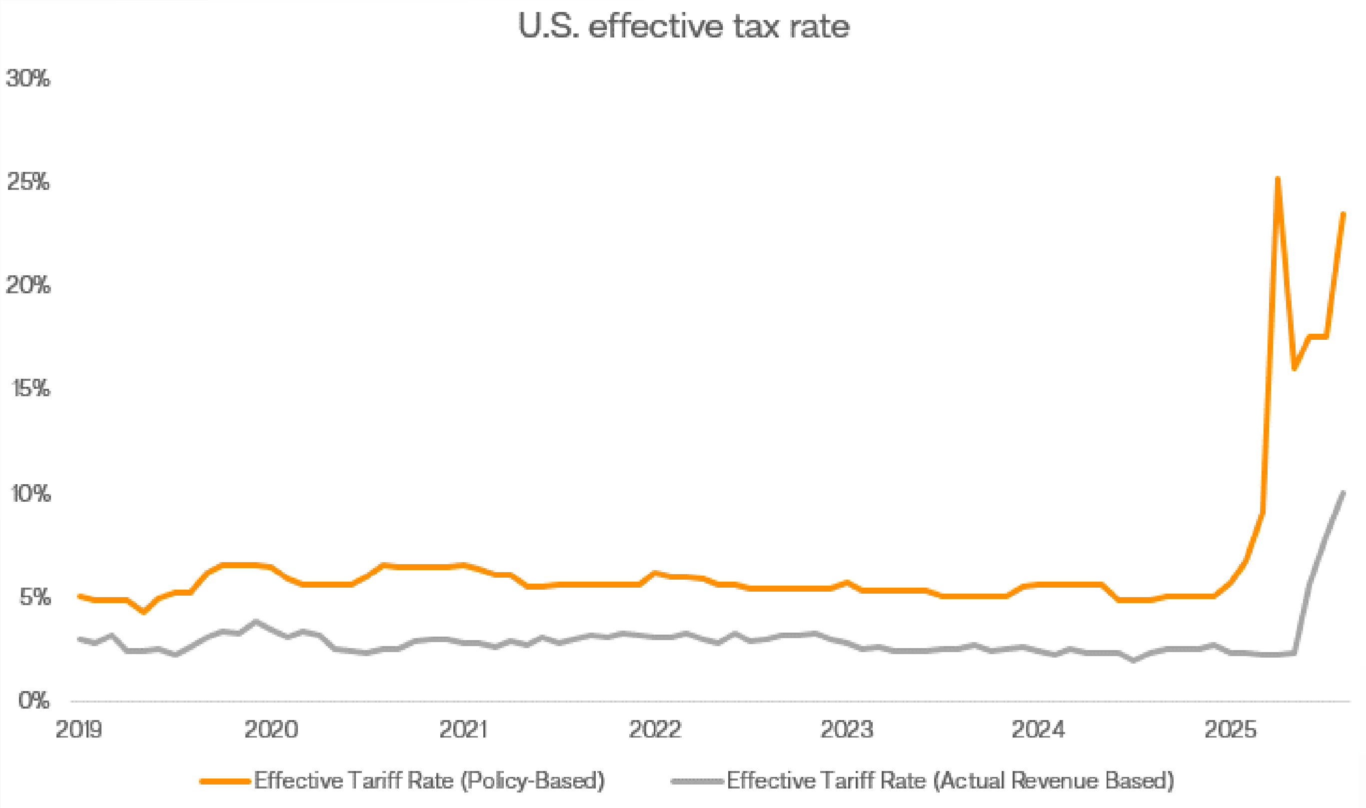
Inflation only occurs when there is excess money supply

- Definitions matter. Inflation measures the increase in prices of goods and services. Inflation occurs due to excess money supply, or too much money chasing too few goods.
- Everyday terms such as food inflation, wage inflation, and energy inflation are inherently misleading, because they mistake price changes for certain goods and services for increases in the general price level.
- From February 2020 to March 2022, U.S. broad money supply (M2) soared by a stunning 43%, the fastest pace on record, which lead to runaway inflation. Pandemic-era welfare spending, fiscal stimulus, zero percent interest rate, and quantitative easing created a textbook case of high inflation caused by excessive money printing and profligate public spending.



Why U.S. tariffs have not resulted in soaring inflation

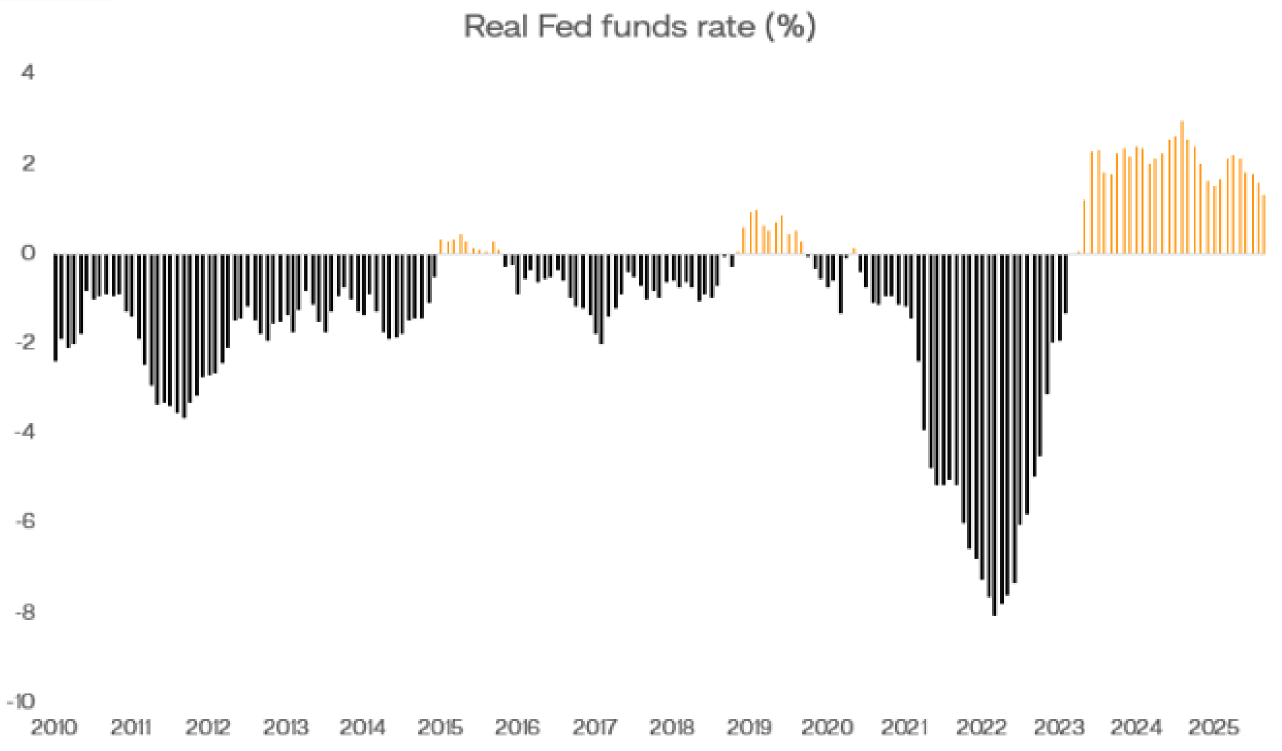
- Many believe the consumer ultimately bears the cost of tariffs. However, tariffs cannot simply be passed on to the consumer, whose income remains unchanged regardless of the importer's costs.
- In reality, tariff costs are shared by exporters, importers, retailers, and consumers. The importer also tends to be reluctant to raise prices so as to avoid losing sales.
- Even if tariffs do lead to higher prices for some goods, the consumer will then have less money to spend on others, mitigating the effect on the overall price level.
- Furthermore, effective tariff rates are much lower than the elevated levels announced by the U.S. government, thanks to exemptions and other offsetting measures.



Source: MacroMicro. The orange line represents the tariff rate calculated based on U.S. government–announced policies. The grey line represents the effective tariff rate calculated from actual tariff revenues.

Positive real interest rates imply further rate cuts

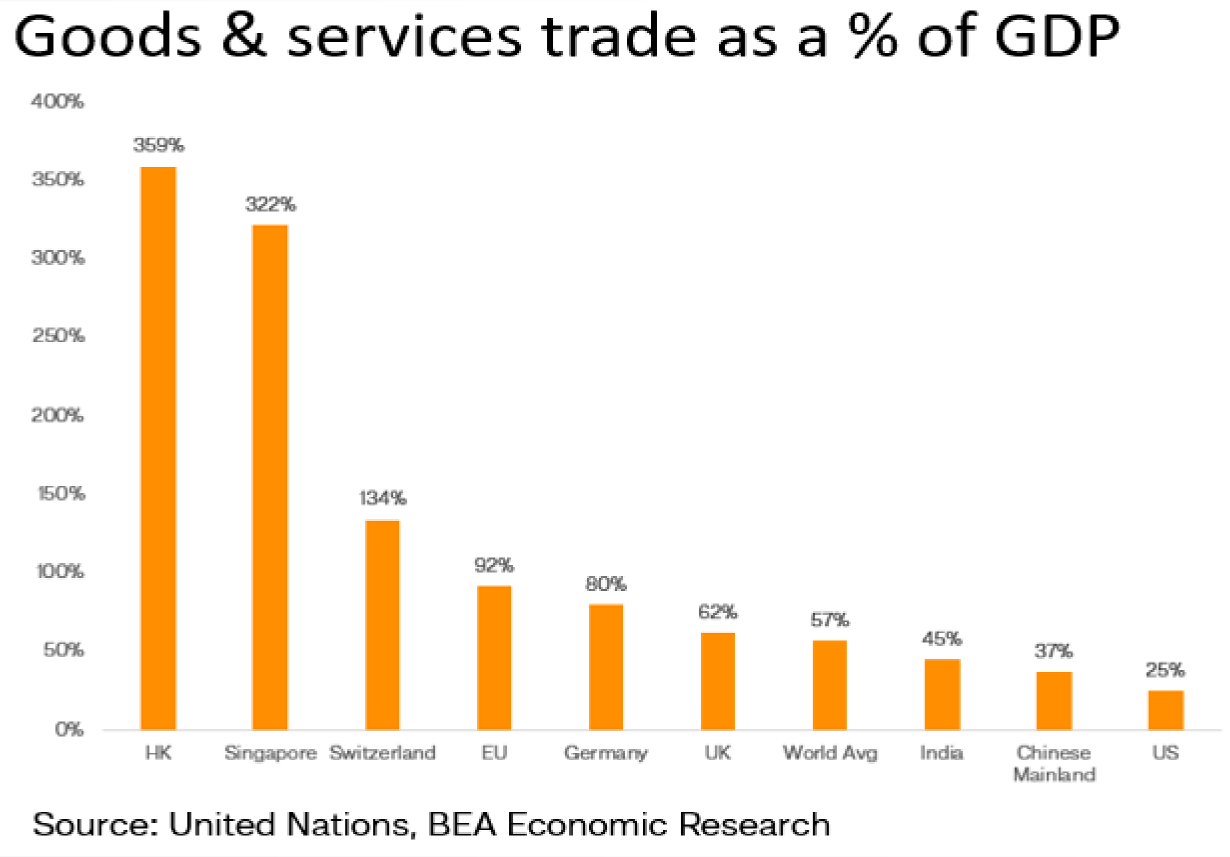
- The latest median FOMC projections pencil in two more rate cuts in 2025 and only one in 2026.
- Since the Great Financial Crisis, the real fed funds rate, as measured by the difference between the Fed funds rate target and the CPI (YOY), has been deeply negative for the majority of time. The current phase of positive real rates starting from March 2023 is a remarkable exception.
- Should inflation remain largely stable, the Fed's rate-cutting cycle may extend into 2027. Given the Fed's dual mandate, signs of weakness in the labor market will also support further monetary accommodation. The terminal Fed funds rate may be closer to 2% than the FOMC's median guidance of 3%.



Source: Bloomberg, BEA Economic Research

Tariffs and trade barriers are likely here to stay

- While the U.S. is the single largest export destination for many economies, it is also the least reliant on international trade among major economies. This combination of features explains why trade issues have featured so prominently as a negotiation tactic to further various U.S. interests.
- Due to the sheer size of its economy, the Chinese Mainland's reliance on trade also appears relatively low at first glace. However, surging trade surplus has become an increasingly important growth driver.
- As a trading, financial, and logistics hub, Hong Kong's trade volume is exceptionally large. International trade creates business opportunities throughout entire services value chains, while diversification efforts have strengthened the resilience of exports.



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