



Economics Group

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Tariffs Bring Upside Risks to Inflation Back Into the Fore

Renewed threats to significantly raise tariffs on Chinese imports have brought back upside risk to the outlook for tepid inflation. While the tariff hikes would boost inflation, the impact is likely to be modest and temporary.

Just When Inflation Fears Were Fading...

After handwringing about below-target inflation last week, upside risks to inflation jumped back into the spotlight this weekend. In tweets yesterday, President Trump threatened to push ahead with raising tariffs on \$200 billion of imports from China to 25% by this Friday. As of last September, these goods were already subject to a 10% tariff, which was initially set to be raised to 25% on January 1. The increase to 25% was subsequently delayed while discussions progressed between the United States and China.

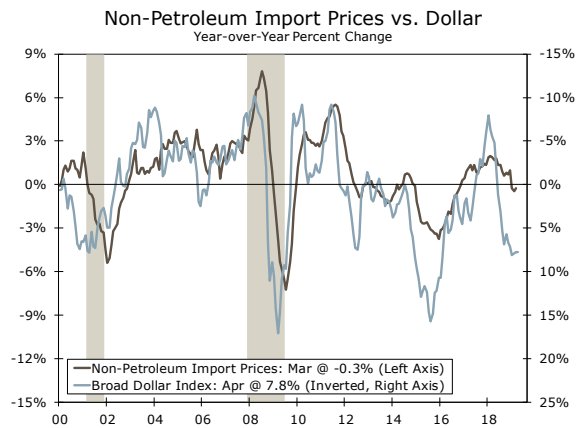
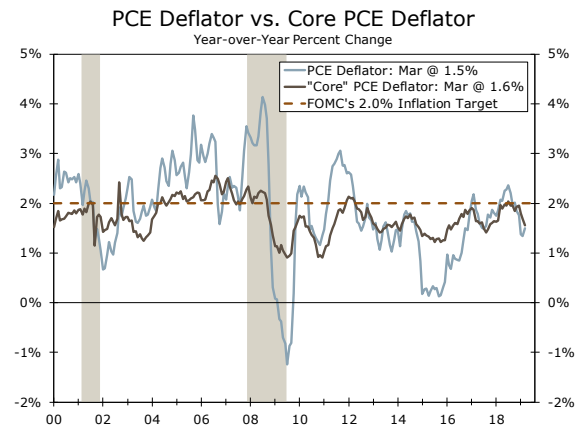
If the tariff rate on the \$200 billion of imports from China currently subject to the 10% rate were to be raised to 25%, it would be the largest effective tariff increase to date, worth about \$30 billion. For comparison, the 25% steel tariffs that came to pass last spring were worth only about \$6 billion, since the United States imports only about \$25 billion of steel. So how much could inflation rise as a result of the latest proposed change?

We estimate that the year-over-year rate of CPI inflation could rise by about 0.15%. However, President Trump also threatened to implement 25% tariffs on remaining imports from China, valued at about \$290 billion. With tariffs on many finished consumer goods unavoidable, the blanket tariffs on the remaining imports could raise CPI inflation by up to 0.4%.

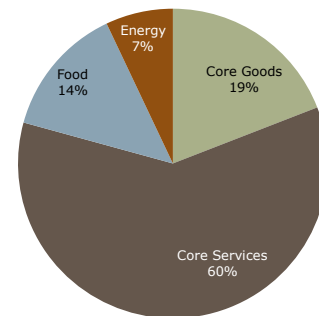
We caution, however, that those estimates are likely to be an upper bound as it relates to inflation. There are a myriad of factors that are likely to prevent import prices (and therefore prices of similar U.S.-produced products) from rising in lockstep with the increased value of tariffs based on recent import levels.

For starters, businesses may choose to absorb the cost of tariffs rather than pass them on to consumers. If businesses view the higher tariff rate as temporary, or fear consumers would scale back purchases significantly if the additional costs were fully passed on, they may absorb some of the tariffs via lower margins. This might not be an option for some businesses that are already locked into price contracts. Companies importing goods from China may also put pressure on their suppliers, reducing the starting value of goods subject to the higher tariff rate. At the same time, a trade war would have negative implications for global growth and therefore support the value of the dollar, reducing import-price inflation (middle chart). Even if the full cost of tariffs were to be passed on and consumer demand was unfazed, the impact to inflation would be fairly minimal given that about two-thirds of consumer spending goes towards services (bottom chart).

Admittedly, the potential for major tariff increases on the bulk of Chinese imports raises the prospects of inflation at a time when the Fed continues to fall short of its inflation goal and needs every tenth it can get. That said, tariffs would represent a one-time shift in the level of prices, making the boost to inflation “transitory”, to borrow a word from Chair Powell.



Share of the Consumer Price Index



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