Economic Update

PNC

April 8, 2025

Trump Announces Larger-Than-Expected Tariff Increases, Likely to Lead to Higher Inflation and Weaker Growth; Impact Will Depend on How Long They Last; Market Reaction Is Very Negative

- **The tariff increases announced by President Trump on April 2 were larger than expected. They include a minimum 10% tariff on all imports, with higher tariffs on countries that have significant trade surpluses with the US.**
- **Many of the tariffs have already taken effect, and others will take place shortly.**
- **China has already retaliated, and other trading partners will also respond.**
- **The tariffs will increase inflation and weigh on economic growth in the near term. The longer the tariffs remain in effect, the greater the impact.**
- **The tariffs will do little to reduce the trade deficit.**
- **The higher tariffs increase the likelihood of near-term recession.**
- **Market reaction has been very negative, with equities down sharply and long-term Treasury yields lower.**
- **The tariffs will make the Federal Reserve's job of slowing inflation and supporting the labor market more difficult. Fed funds rate cuts are on hold for now.**
- **PNC will incorporate the tariff impact into its economic forecast.**

In a speech on the afternoon of Wednesday, April 2, President Trump announced sweeping increases in tariffs on imports. The tariffs include a minimum 10% tariff on all imports that start on April 9. They also include "reciprocal" tariffs that started on April 5. He also announced a 25% tariff on foreign-made autos that started on April 3. The president is imposing these tariffs without Congressional approval, using his authority to declare a national emergency.

The administration said that the so-called reciprocal tariffs were intended to equal one-half of a country's equivalent tariff rate on US imports, including non-trade barriers and currency manipulation. However, when the administration released details, the reciprocal tariffs were determined by a formula based on the size of a country's trade deficit with the US, which may or may not have anything to do with tariffs or other trade barriers. In addition, the 10% across-the-board tariff applies to all countries, even those with which the US has a trade surplus. The reciprocal tariffs are based only on goods; the US exports and imports services as well, such as US movies viewed overseas (a services export) or travel by US citizens abroad (a services import).

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Among the reciprocal tariffs the president announced were 34% on China, on top of 20% tariffs already announced; 24% on Japan; and 20% on the European Union. There are no new tariffs on imports from Canada and Mexico, although previously implemented tariffs of 25% on Canada and Mexico will remain in place, with exceptions for goods compliant with the United States-Mexico-Canada agreement. In addition tariffs on specific goods already previously implemented, such as steel and aluminum, will not be subject to the additional tariffs, although the current tariffs will remain in effect.

The immediate impact of the tariffs will be to increase goods prices throughout the US economy. Importers will charge higher prices to compensate for the tariffs, although final prices to US purchasers will likely increase by somewhat less than the full amount of the tariff. The extent of the passthrough will vary, depending on demand for the product and the availability of US-made substitutes. The tariffs will not raise just import prices; US manufacturers will also increase prices to take advantage of higher prices for competing goods. These higher prices will start to show up in the economy almost immediately.

The tariffs will also boost consumer inflation indirectly, by raising prices for US businesses that use imported goods. Many U.S. manufacturers include imported components in their products, while others buy imported goods to use, such as services firms that use computers and telecommunications equipment. These companies are likely to raise their prices to consumers in response to higher input costs from tariffs.

The tariffs will weigh on near-term economic growth. Tariffs are a tax; as with any tax consumers and businesses will have less total money to spend on goods and services in the economy. According to the Budget Lab at Yale, the average effective tax rate on tariffs across the economy, including all tariffs under the Trump administration (including ones announced earlier) will go up more than tenfold, from 2% to 22%. This is equivalent to a tax increase of $650 billion based on 2024 import levels, about 2% of GDP, although the actual size would be smaller because the tax would reduce the level of imports. Even so, this tax increase will be a drag on the economy.

Higher prices from the tariffs will also weigh on the economy. If the prices that Americans pay for goods, both imported and domestic, go up, they have less money to spend on other goods and services. This would reduce real (inflation-adjusted) GDP relative to tariffs remaining at their previous, lower levels. In addition, US trading partners are starting to retaliate, increasing tariffs on US exports. On April 4 China announced a 34% tariff on US imports, in response to the administration's 34% reciprocal tariff. Even if some domestic industries benefit from tariffs, the overall impact will be negative. In 2024 goods imports accounted for 11% of U.S. GDP, while goods exports accounted for 7%.

Another drag on the economy will come from lower stock prices, which are down sharply since the announcement. Stock-owning households have lost about $6 trillion in wealth, which will weigh on their purchases.

The 25% tariff on auto imports is likely to show up in prices almost immediately, and sales are set to drop sharply as affordability plunges. Auto sales were almost 18 million in March (seasonally-adjusted annualized rate), up 11% from February to their highest level since early 2021, as consumers moved to buy ahead of price increases, but will fall over the next couple of months as higher prices on both foreign and domestic cars and trucks reduce affordability.

It is unclear to what extent the higher tariffs are a negotiation tactic by the Trump administration to reduce other nations' trade barriers, versus a long-lasting attempt to reduce imports. If the higher tariffs persist, the greater the increase in inflation and the greater the drag on the US economy. The uncertainty surrounding the tariffs is itself a weight on economic growth. Many business investment decisions are on hold. Firms don't

want to make a big investment in domestic production until they have more certainty that tariffs will remain in place.

The tariffs will not have an impact on the US trade deficit. By definition, the trade balance is equal to net saving in the economy. Because the US runs large federal government budget deficits the nation is a net dissaver, borrowing from abroad. Tariffs do not change this, and the US will continue to run a large trade deficit no matter what tariffs are imposed. In addition, the tariffs are focused on bilateral trade deficits—the deficit between the US and any given country. But what matters for economic growth is the overall trade balance, the difference between exports and imports to and from all nations.

One major unanswered question is how the Federal Reserve responds to the tariffs. One of the central bank's goals set by Congress is stable prices, which the Fed defines as 2% inflation; inflation has been above this target since 2021. By raising prices to consumers higher tariffs will cause higher inflation. However, the Fed's response will depend on whether this increase in inflation is temporary or permanent. If the tariffs cause a one-time jump in prices, but then inflation (the rate at which prices increase) quickly reverts to its pre-tariff level, the Fed could choose to ignore the temporary pickup in inflation. Alternatively, if tariffs cause inflation to move higher for an extended period of time, perhaps because higher tariffs lead to larger increases in wages that in turn keep inflation elevated, the central bank could decide to keep monetary policy tight.

But the Fed's other goal is full employment. To the extent that higher tariffs weigh on economic growth and slow the labor market, meeting the Fed's two goals could come into conflict. Rate cuts are likely on hold for at least the next few months, until it becomes clearer what the impacts from higher tariffs are on inflation and employment.

As more details on the tariffs become available PNC will incorporate those into its economic forecast. Incorporating the tariffs will require assumptions about how long they remain in place. The US economy is in good shape at the start of the second quarter, with average job growth of around 150,000 through the first three months of 2025 and a low unemployment rate of 4.2%. But despite solid fundamentals the big increase in tariffs has increased the risk of near-term recession dramatically. At the start of 2025 the probability of a near-term US recession was around 15%; now it is more like 35%.

Investors have responded very negatively to the larger-than-expected tariffs. In the first three trading days after President Trump announced the tariffs stock prices (S&P 500) have fallen more than 10%, and they are down 13% since the beginning of 2025 as investors have reduced their expectations for corporate profits. The yield on the 10-year Treasury note, which was 4.18% before the president's announcement, got to as low as 3.89% over the weekend, but is now back to where it was prior to the announcement. The value of the dollar against a basket of foreign currencies has swung dramatically, and is now slightly weaker compared to where it was before the announcement. The price of a barrel of West Texas Intermediate crude oil has fallen sharply from $72 to $61, on expectations for reduced energy demand with much weaker economic growth. In addition, OPEC+ announced a larger-than-expected increase in crude oil production starting in May, adding to global oil supply. A material drop in crude oil prices that pushes down energy prices for consumers and (non-energy) producers could partly offset the inflationary impact of higher tariffs and the associated squeeze in company profit margins.

Investors expect the Federal Open Market Committee to aggressively cut the federal funds rate later this year in response to economic weakness. The fed funds futures market is now pricing in a 95% probability of at least a 25 basis point cut in the fed funds rate by the time of the FOMC's meeting in mid-June (the FOMC's next meeting is on May 6 and 7). Investors expect the rate to be in a range between 3.25% and 3.50% at the end of this year, down a full percentage point from the current range.

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