

THE BOTTOM LINE

Tariff turmoil and the Fed: A stagflation minefield

By **Ramkishen S Rajan**

AFTER a prolonged period of interest rate hikes to curb inflation, the Federal Reserve held the federal funds rate at a two-decade high of 5.5 per cent from July 2023 to August 2024. As inflation began to ease, the Fed shifted course, cutting rates three times between August and December 2024, bringing the target range down to 4.25 to 4.5 per cent to support growth and employment.

Just as monetary policy was turning more accommodative, fresh risks emerged. The reintroduction of tariffs under US President Donald Trump's trade policies has considerably complicated the inflation and growth outlook. Following the 100-basis-point reduction, the Federal Open Market Committee (FOMC) chose to pause further rate cuts in January 2025, signalling a shift in strategy.

Typically, central banks do not react to one-off tariff increases since their impact on prices is usually temporary. The US, as a large market and price setter, tends to experience milder effects from such policy

changes compared to economies that are price takers.

However, in the current post-Covid inflation environment, there is growing concern that a series of tariff hikes – rather than a single adjustment – could unsettle inflation expectations. Recent surveys from the New York Fed (on regional firms) and the University of Michigan (on consumers) indicate early signs of this unease.

Tariffs on steel and aluminium are particularly worrying for industries such as construction, automotive and machinery manufacturing. Disruptions in these sectors are already straining supply chains, especially with key trade partners like Canada and Mexico. The unpredictability of tariff policies – dubbed Trump's "Tariff Roller Coaster" by *The Wall Street Journal* on Mar 5, 2025 – adds to business uncertainty. Potential retaliation from trade partners could further complicate the picture.

At the same time, Trump's crackdown on illegal immigration – an issue within any nation's sovereign rights – could tighten labour markets, pushing wages higher

and fuelling inflation. With fewer blue-collar workers, particularly in industries reliant on immigrant labour, rising wages could contribute to broader price pressures.

Combined with structural challenges, such as housing shortages and an ageing workforce due to baby boomer retirements, the risk of stagflation – slower growth, rising inflation and increasing unemployment – is becoming more pronounced.

Despite stagflationary risks, certain factors could exert disinflationary pressure. Amid global economic uncertainty, weakening import demand from the US, and recent rate cuts by the European Central Bank and Bank of England, the US dollar is likely to strengthen. A stronger greenback should help temper import prices, partially offsetting the impact of tariffs and easing inflationary pressures. Additionally, heightened demand for US Treasuries as a safe haven could push long-term rates lower.

Trump's economic priorities – his vision of DEI (deregulation, energy and

investment) – could introduce another layer of potential disinflation. The Trump administration's focus on curbing fiscal spending could slow economic growth in the near term.

Deregulation, particularly in environmental policies, might alleviate concerns about "greenflation" linked to the clean energy transition, offering short-term stimulus and incentivising investment. However, this could also expose the economy to medium and long-term climate risks, leading to "climateflation" – inflationary pressures driven by disruptions to supply chains caused by climate-related events.

The outlook for interest rates in the near term is uncertain, influenced by shifting trade and economic regulations along with tighter fiscal policies. Although data remains noisy, both economic indicators and financial markets suggest an increasing risk of recession.

With seven FOMC meetings left in 2025, the Mar 19 and May 7 decisions will be closely watched. The Fed must balance the risk of cutting rates too soon, which could

reignite inflation, against keeping them too high, which may weaken growth.

With inflation hovering around 2.5 to 3 per cent, real rates currently stand at about 1.5 to 2 per cent, slightly above the estimated neutral rate of 0.5 to 1.5 per cent, according to well-regarded models such as Laubach-Williams and Holston-Laubach-Williams. This suggests monetary policy remains mildly restrictive, leaving some room for gradual rate cuts to maintain neutrality.

However, in the near term, the Fed may opt to wait for clearer signals from economic data and the Trump-induced policy disruptions. Fed chair Jerome Powell seemed to suggest just that in prepared remarks in New York at the University of Chicago Booth School of Business "2025 US Monetary Policy Forum" last Friday (Mar 7). In the meantime, financial markets are likely in for a turbulent ride, with bouts of volatility ahead.

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