KPMG Economics

New year, new agenda
Beware of unintended consequences

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In 1776, Adam Smith published the foundation for modern economics, “The Wealth of Nations.” Smith’s key insight for the purpose of this analysis was that there were both intended and unintended consequences to the self-serving actions of individuals.

A baker doesn’t bake bread to provide food for the hungry, but to earn a living. Through that self-interest, bakers end up feeding their community.

Smith focused mainly, but not solely, on the positive aspects of what he termed the “invisible hand” of market forces. On the downside, when merchants from the same trade gathered, “[T]he conversation ends in conspiracy against the public, or in some contrivance to raise prices.”

Hence, the role that governments play in preventing price collusion. I have been in meetings where economists from the same industry have had to literally remove themselves from a room when a competitor speaks, to prevent even the appearance of collusion.

That seems an apt place to start when trying to assess the new administration’s agenda and what it means for the economy. Global economic integration and offshoring reduced prices but displaced workers. Inequality worsened and spurred political instability the world over. The pandemic and inflation amplified those tendencies.

The challenge is to heal the wounds inflicted by those problems without inadvertently making them worse. What sounds good on the campaign trail may not work in practice. Changes to tariffs and immigration policy are complex and can have unintended consequences for inflation.

Consumers bring holiday cheer

Real GDP growth is forecast to rise 2.2% in the fourth quarter, after surging 3.1% in the third quarter. Consumer spending remained a driver of overall gains, with much of the strength coming at year-end. A late Thanksgiving and repairs due to hurricanes boosted spending in December. The housing market rebounded after contracting much of the year. Government spending slowed from the torrid pace of the third quarter but continued to move up on the heels of efforts to get Inflation Reduction Act (IRA) funding out the door. The drag on growth came from a strike in the aerospace industry, which dealt a blow to business investment and inventories. The trade deficit was essentially unchanged.

Prospects for the first quarter of 2025 remain solid if not spectacular, with real GDP forecast to rise 2.1%. Anecdotal reports suggest the consumer remained strong at the start of the new year, with some of the trading down we saw in 2024 abating. Mortgage rates have moved up along with long-term bond yields, but a rise in remodeling and repairs due to disasters should blunt the blow of higher rates. Business investment and inventories are forecast to rebound. Government spending is expected to slow on the heels of the continuing resolution, which caps spending at existing levels; there are exceptions for mandated spending, such as Social Security. The trade deficit is poised to widen slightly. Firms are expected to stockpile ahead of tariffs.

The Fed pauses. The Fed has signaled that it will pause in January. The Fed will not front-run policy shifts by the administration, but wait-and-see how policy shifts actually play out. We expect only two quarter point rate cuts in 2025. Much depends on the trajectory on inflation and whether it loses some of the ground made in terms of cooling in response to policy changes. Repairs and replacement demand triggered by disasters is another major variable.

This edition of *Economic Compass* lays out three scenarios that capture the possible impact of the president's key agenda items. Special attention is paid to how those shifts could alter the trajectory for inflation and rate cuts by the Federal Reserve.

The remarkable resilience of the economy and concerns that inflation may cool more slowly have scaled back the forecast for rate cuts. The risk is that they could be scaled back further, given the rise in prices triggered by the gut-wrenching devastation of epic storms and fires.

Three scenarios

Chart 1 shows the results of three scenarios in the outlook for the economy:

- **Scenario 1** is our most optimistic. It shows the consequences of a full extension of personal tax cuts, an escalation in tariffs on goods from China, some retaliation, curbs on government spending and a slowdown in immigration.
- **Scenario 2** is our base case. It includes a full extension of personal tax cuts, a larger hike in tariffs, retaliation, weaker government spending and a drop in immigration.
- **Scenario 3** is our most pessimistic. It includes a full extension of personal tax cuts, a broader-based hike in tariffs and a full-blown trade war, more curbs to federal spending and a larger drop in immigration.

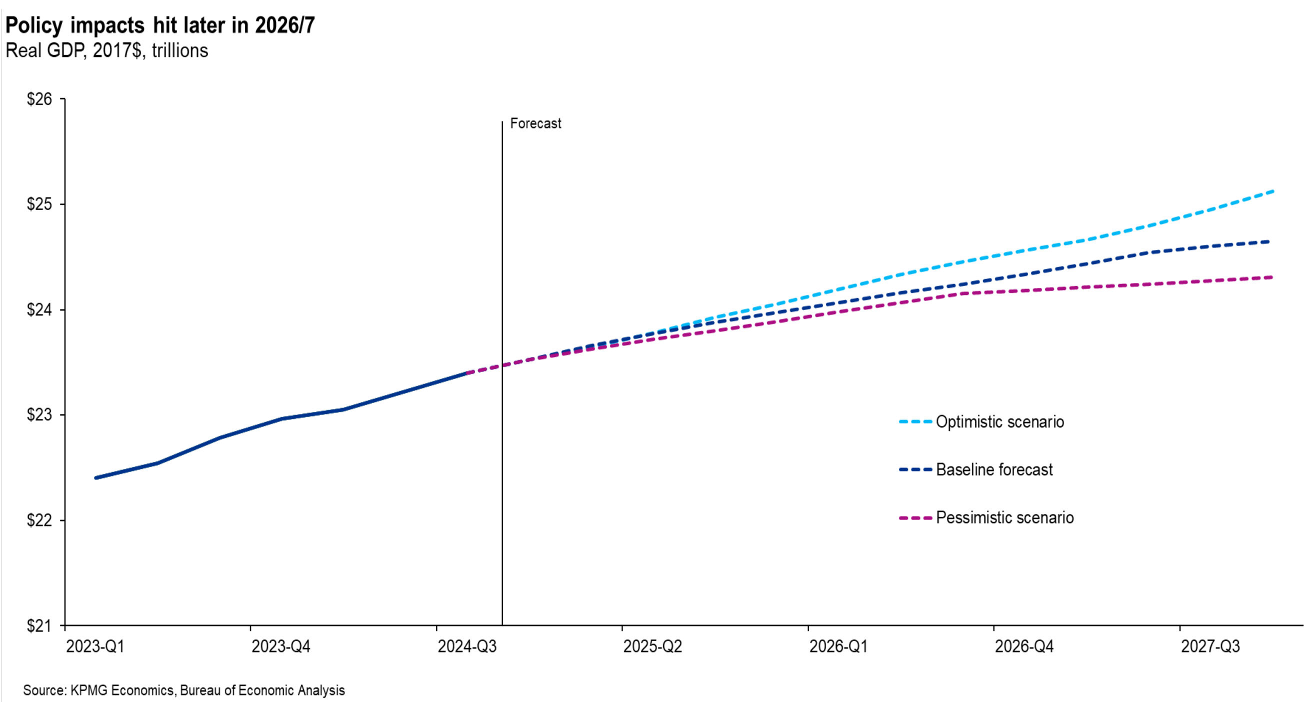
The boost to growth associated with deregulation is front-loaded; tariffs and curbs on immigration take time to be fully implemented.

Moreover, the negative effects of tariffs more than outweigh the subsidies provided to domestic industries. Research on tariffs suggests that the blow to consumer spending is greater via higher prices than the boost to investment in protected sectors of the economy.

Across-the-board tariffs on Mexico and Canada would be a violation of the United States-Mexico-Canada Agreement (USMCA) trade deal, which is up for renegotiation in 2026. A failure to ratify the deal would trigger the sunset clause, which would bring the agreement to an end by 2036.

Similarly, research on deportations in the 2010s reveals that counties that suffered the most deportations also suffered the largest permanent jobs losses for native-born workers. Foreign-born workers often fill jobs that native-born workers will not. They add to the entire ecosystem of a community; once they are gone, the community suffers.

Chart 1



Agriculture, leisure and hospitality and construction are among the most immigrant-dependent sectors. Farmers have already asked for waivers to keep their foreign-born workers. Many workers will leave anyway to avoid family separations and the threat of deportation. Anti-immigrant rhetoric has a chilling effect.

We saw legal as well as illegal immigration slow precipitously during the president-elect's first term for that very reason. Obstacles to attaining legal status and the general backlash toward immigration more broadly prompted many to opt out entirely.

Universities have already advised foreign students to return prior to January 20, given the travel bans that are expected to accompany a record number of new executive orders that day. Foreign students tend to pay full tuition, which effectively subsidizes native-born students; those subsidies will diminish with fewer students from abroad. (Understatement.)

Unemployment peaks at 5.5% under the pessimistic scenario, nearly one full percentage point above that of the optimistic scenario. Inflation and unemployment both rise at the same time, which is stagflation. The economy essentially stalls out in 2026 and 2027.

Financial markets react much harder to the base case and pessimistic scenarios than the optimistic scenario. A trade war with China is all but a foregone conclusion. We may be understating the financial market reaction to a larger trade war with China.

The federal deficit balloons from $1.8 trillion to $2.3 trillion in the base case, despite efforts to cut spending. Tariff revenues tend to come in much less than initially estimated, given the distortions they have on demand and supply. (See below.)

Promises vs policies

Mind the gap

The president-elect promised tax cuts and spending that could add nearly [$8 trillion] to the deficit over the next decade. If one takes all comments on the campaign trail at face value, that figure tops $15 trillion.

Our current forecast has only incorporated the personal tax cuts slated to lapse at the end of the year. Those alone add about $4 trillion to the deficit over a decade according to the nonpartisan Congressional Budget Office (CBO). More fiscal stimulus could trigger more growth, but at a price: even higher inflation.

"The blow to consumer spending [of tariffs] is greater via higher prices than the boost to investment in protected sectors of the economy."

There are four avenues the administration can pursue to codify its agenda, given the narrow margins Republicans hold in Congress:

1. **Budget reconciliation**, which only needs a simple majority in the Senate. It enables Republicans to bypass Democrats in their negotiations and enact tax cuts and changes to spending with a simple majority of votes. Legislation in the Senate requires a super majority of sixty votes, which Republicans lack.
2. **Use grant programs and federal funding** to incentivize state and local governments to adopt preferred policies. Attach policy requirements to federal funding disbursements where legal.
3. **Work with supportive state governors** to implement policies at the state level. Provide federal support and resources to states advancing aligned policy goals.
4. **Name and direct cabinet secretaries** to use existing statutory authority to advance policy goals. Reinterpret regulations to align with administration priorities within legal bounds.

Republicans are already working on an aggressive schedule to get many of their fiscal priorities completed using reconciliation. The clock is ticking as the current continuing resolution expires in mid-March. We expect that it will take two rounds of reconciliation, one for fiscal 2025 and another for fiscal 2026, to get the tax cuts over the finish line.

The Treasury estimates that it must begin using "extraordinary measures" to continue to meet US debt obligations in mid-to-late January. Those measures should carry us until mid-August, when a showdown over the debt ceiling could erupt. The fiscal year 2026 budget, which needs to include an extension of lapsing personal tax cuts to avoid falling off a fiscal cliff in January, is due by October 1.

Reconciliation

It's complicated

Reconciliation comes with its own set of hurdles. Any additions to the deficit over a ten-year period require offsetting tax revenues and spending cuts. That complicates the math on getting priorities enacted, which was already difficult. Nearly two-thirds of the $6.75 trillion spent in fiscal 2024 was mandatory and dominated by Social Security and Medicare. The remaining third is discretionary, mostly defense.

The new Senate majority leader has drawn a line in the sand on using reconciliation to fund mass deportations; the increase in government spending needed is large and requires changes that he prefers to put through the regular legislative process.

Some in the Senate have suggested they should ignore the rules again to get extensions to those tax cuts. Budget hardliners are not having it. That is probably why many of the president-elect's closest allies refused to lift or suspend the debt ceiling before it lapsed; it leaves them with leverage to extract concessions.

Chart 2 shows the areas Republicans have identified for offsetting tax revenues and spending cuts. Tariffs top the list, with an estimated $2.7 trillion in additional revenues coming from those alone over ten years.

There are several problems with those calculations. The first is that official estimates of revenues from tariffs are static. They do not allow for the drop in demand for imports due to higher prices or the curbs to exports triggered by weaker global growth and retaliatory measures. Those reactions dramatically reduce the revenues generated by tariffs.

The other concern is that tariffs levied via executive order do not technically qualify for the reconciliation process because they could be revoked. That has prompted some in Congress to suggest they levy their own tariffs. The last time that occurred was in 1930, when the Smoot-Hawley Tariff Act passed.

The result was a trade war that plunged the global economy deeper into the depths of the Great Depression. Many believe that those shifts helped sow the seeds of WWII. That is one of many reasons economists oppose tariffs; they are a regressive tax that hurts those who can least afford it, while they escalate already-elevated geopolitical tensions.

Second is the repeal of the IRA. The challenge there is that most of the subsidies and investments triggered by the IRA went to Republican districts. More than 80% of all electric battery plants alone are in Republican districts; they don't want to lose those jobs. Some 18 Republicans have already let the Speaker of the House know that repealing the IRA in full is a nonstarter.

Third is unauthorized spending. That totals about $500 billion. The largest program is health benefits for veterans, at $119 billion. The next largest is addiction treatment, including opioids; that is $48 billion. Those cuts would create very bad optics.

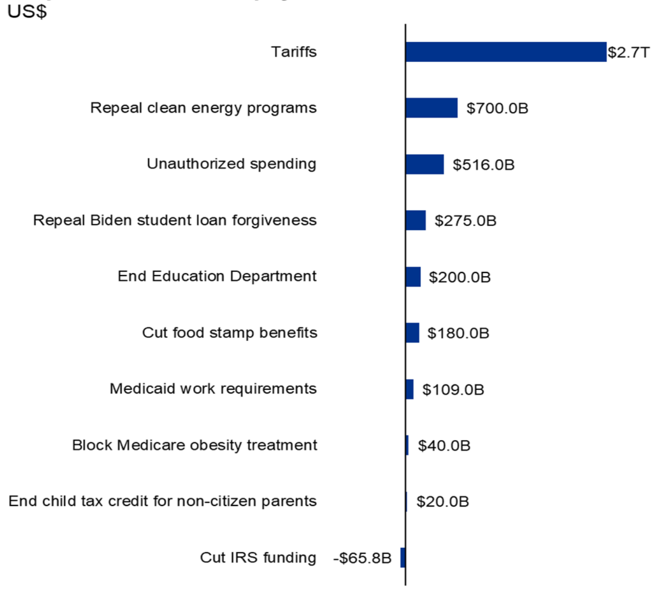
The easier area for both sides of the aisle to agree upon is government waste. Democrats have already reached out to the president-elect's advisors on that front.

Studies on government waste have found defense contracts, healthcare spending, infrastructure projects and tax evasion as the largest drivers of cost overruns and waste. Antiquated technology exacerbates those problems; major investments are required for upgrades.

Tax evasion is not likely to get a quick fix. Spending on upgrades to technology and staffing at the IRS, which were a part of the IRA, are slated to be cut. That is despite the scoring of those expenditures, which the CBO estimated more than paid for themselves via increased tax revenues. (Yes, you read that correctly.)

Chart 2

Proposed revenue to pay for tax cuts
US$



Source: KPMG Economics; Congressional Budget Office; The Washington Post

Risks of larger deficits

Neither party has had much success in reducing the deficit. If I had to place a bet, I would say that deficits will end up much larger. The rising ranks of retiring baby boomers make the math much harder on Social Security and other mandatory spending. The net effect is more economic growth with higher rates of inflation.

The upside risks to inflation are amplified by the fact that we have failed to fully derail the post-pandemic inflation. Context matters.

Higher inflation

Chart 3 shows the three scenarios for inflation. Earlier rate hikes, coupled with easier year-on-year comparisons drive the core personal consumption expenditures (PCE) index towards the Fed's 2% target in early 2025. The core index strips out the volatile food and energy components.

The Fed officially targets the overall PCE index, but the core is useful as it removes items over which the Fed has little control. Food prices, for instance, have soared on the heels of the bird flu and the largest culling of chickens on record.

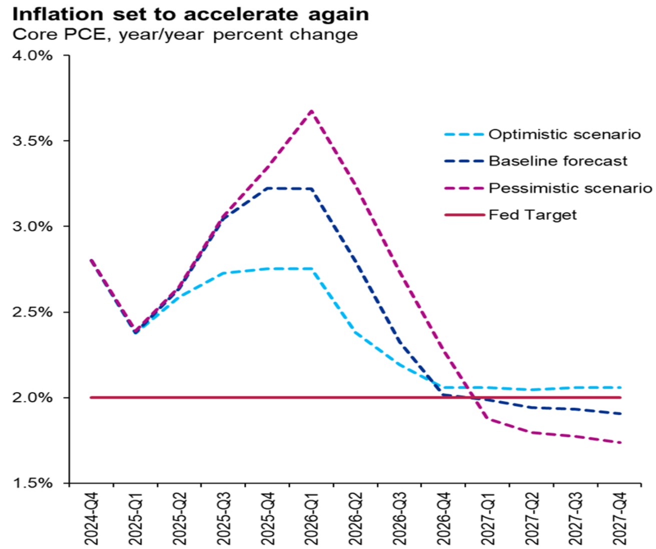
The good news is short-lived, as inflation accelerates on the heels of tariffs in the second half of 2025 and early 2026. Those estimates understate the effects of tariffs on inflation; they cannot fully account for the impact that retaliatory measures have on supply chains.

Inflation expectations for the year ahead spiked in December and early January, according to consumer sentiment. Fears surrounding tariffs are baked into those results; a record number of people intend to buy ahead of price hikes. presumably due to tariffs. That acts as its own self-filling prophecy on inflation, as it prompts consumers to hoard.

Recent disasters are further complicating the outlook. Vehicle sales soared to their highest level since May 2021 in December. That is reversing some of the goods disinflation that we have already seen. The repairs and rebuilding due to the devastation caused by oil well fires in California will only exacerbate those upward pressures.

The deceleration in inflation in 2026 and 2027 is due largely to weaker economic growth and rising unemployment. That helps to lower oil prices, along with deregulation in the energy sector.

Chart 3



Source: KPMG Economics, Bureau of Economic Analysis

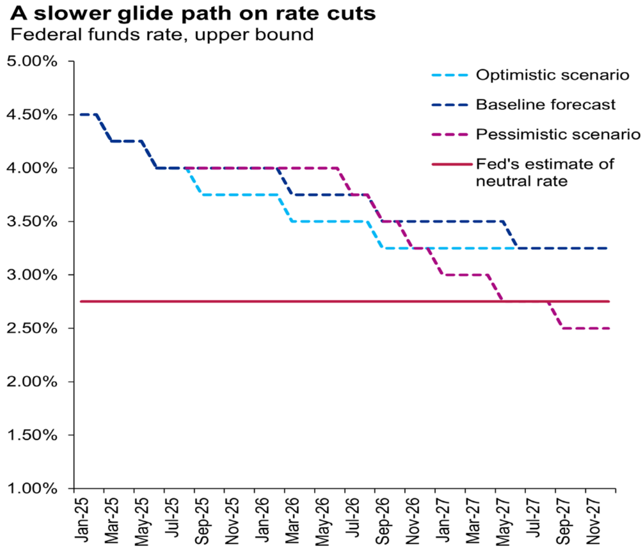
The challenge is that the break-even price on new wells is not much lower than current oil prices. Meanwhile, investors are pushing producers to focus on profits instead of expansions.

Fewer rate cuts

Chart 4 provides the forecast for rate cuts under each scenario. All are slower than just a month ago. Fed officials already signaled that they are ready to pause, which allows time to assess when and if they cut again:

- **Scenario 1**, which is our most optimistic, has the softest landing. It includes three rate cuts in 2025, two in 2026 and only a modest increase in unemployment in 2027.
- **Scenario 2**, our base case, skirts a recession, but only barely. It includes two rate cuts in 2025, two in 2026 and one in 2027.
- **Scenario 3**, which is our most pessimistic, represents a hard landing. It includes two cuts in 2025, three in the back half of 2026 and two additional cuts to stimulate in 2027.

Chart 4



Source: KPMG Economics, Federal Open Market Committee

A shift in Fed leadership

The composition of the voting members is moving in the wrong direction for the president-elect in 2025. Three of the four regional Fed presidents who are rotating into voting roles on the Federal Open Market Committee (FOMC), the policy setting arm of the Fed, are known inflation hawks. The fourth is a dove, who has changed his tune and scaled back the forecast for cuts in 2025.

Michael Barr stepping down from his role as the Vice Chair of Supervision in February but staying on the Board of Governors. That will enable the president-elect to ease bank regulations by naming one of his previous Board nominees, Miki Bowman or Christopher Waller. Bowman was a regional banker before joining the Fed and is the most logical choice.

Fed Chairman Jay Powell's term expires in May 2026, at which point he intends to retire. Waller is on the list of potential replacements, along with Kevin Hassett who is rejoining the administration as the Chairman of the National Economic Council. Former Fed Governor Kevin Warsh has expressed an interest, although his hawkish stance on interest rates may be a deterrent to the president-elect.

The president-elect has stated his desire for loyalty from whomever succeeds Powell. That is not uncommon. Many a president has attempted to influence the Fed's decisions, dating back to President Harry S. Truman. When they succeeded, the research is unequivocal; we suffered even more inflation or stagflation as a result.

Bottom Line

What sounds good from a candidate on the campaign trail often translates poorly into economic policy. What was hoped to be a fix for high inflation and border security could stoke inflation. That would hurt those who can afford it least. Beware the law of unintended consequences.

The Fed has already signaled that it has entered wait-and-see mode, which has roiled financial markets. The once inevitable soft landing now looks farther away and harder to achieve.

The silver lining is the remarkable resilience of the US economy. We have absorbed just about everything one could imagine, while inflation cooled without a sharp increase in unemployment. It is in that resilience that there is hope. That is as good a place as any to end. Be kind; pay it forward.

Economic Forecast — January 2025	2024	2025	2026	2024:3(A)	2024:4	2025:1	2025:2	2025:3	2025:4	2026:1	2026:2	2026:3
National Outlook												
Chain Weight GDP[1]	2.8	2.2	1.6	3.1	2.2	2.1	1.9	1.7	1.6	1.8	1.6	1.5
Personal Consumption	2.7	2.5	1.9	3.7	3.1	2.4	1.8	1.5	1.7	2.0	2.2	2.1
Business Fixed Investment	3.7	1.9	1.6	4.0	-1.1	2.1	2.8	2.1	1.6	1.7	1.2	1.0
Residential Investment	4.3	-1.2	-0.6	-4.3	6.3	-2.0	-4.2	-3.0	0.0	-1.8	-0.8	2.4
Inventory Investment (bil $ '17)	44	75	95	58	27	40	72	93	97	99	94	94
Net Exports (bil $ '17)	-1038	-1115	-1130	-1069	-1072	-1100	-1118	-1124	-1119	-1113	-1120	-1134
Exports	3.3	3.0	0.9	9.6	-0.1	5.2	1.9	0.9	0.6	0.5	1.1	1.3
Imports	5.5	4.3	1.0	10.8	0.3	6.8	3.3	1.3	-0.1	-0.4	1.6	2.4
Government Expenditures	3.5	2.3	0.6	5.1	3.6	2.1	0.9	1.0	0.4	0.7	0.6	0.5
Federal	2.7	3.7	1.3	8.9	6.0	2.6	1.7	2.1	0.3	2.0	1.0	0.9
State and Local	3.9	1.5	0.2	2.9	2.2	1.9	0.5	0.3	0.4	0.0	0.3	0.3
Final Sales	2.7	2.0	1.6	3.3	2.8	1.9	1.4	1.3	1.5	1.7	1.6	1.5
Inflation												
GDP Deflator	2.4	3.0	2.9	1.9	2.6	2.3	4.2	4.2	3.7	2.9	1.6	2.1
CPI	3.0	2.8	2.9	1.2	3.1	2.0	4.3	3.5	2.8	2.7	2.7	2.7
Core CPI	3.4	3.2	2.8	2.2	3.6	2.3	4.1	4.1	3.4	2.3	2.4	2.2
Special Indicators												
Corporate Profits[2]	6.6	-0.2	-2.1	6.0	1.9	4.1	-0.2	-1.3	-3.3	-4.0	-3.9	-1.3
Disposable Personal Income	2.9	3.1	3.4	1.1	3.7	3.6	2.0	6.4	2.7	4.3	2.6	1.9
Housing Starts (mil)	1.35	1.30	1.31	1.33	1.32	1.33	1.30	1.29	1.27	1.27	1.29	1.32
Civilian Unemployment Rate	4.0	4.3	4.5	4.2	4.2	4.3	4.3	4.3	4.4	4.4	4.5	4.5
Total Nonfarm Payrolls (thous)[3]	2531	1671	-94	432	510	537	428	146	-12	-103	-115	-100
Vehicle Sales												
Automobile Sales (mil)	2.9	2.9	2.5	3.0	3.0	3.3	3.1	2.7	2.6	2.6	2.5	2.4
Domestic	2.0	1.9	1.7	2.0	1.9	2.1	2.0	1.8	1.8	1.8	1.7	1.7
Imports	0.9	1.0	0.8	0.9	1.1	1.2	1.1	0.9	0.8	0.8	0.8	0.7
LtTrucks (mil)	12.8	12.8	11.5	12.6	13.5	13.8	13.0	12.2	12.0	11.7	11.6	11.5
Domestic	10.1	10.4	9.8	9.9	10.7	10.9	10.5	10.1	10.0	9.9	9.9	9.8
Imports	2.7	2.4	1.7	2.7	2.8	2.9	2.5	2.1	2.0	1.8	1.7	1.7
Combined Auto/Lt Truck	15.8	15.7	14.0	15.6	16.5	17.1	16.1	14.9	14.6	14.3	14.1	13.9
Heavy Truck Sales	0.5	0.4	0.4	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Total Vehicles (mil)	16.3	16.1	14.4	16.1	17.0	17.5	16.5	15.3	15.0	14.7	14.5	14.3
Interest Rate/Yields												
Federal Funds	5.2	4.1	3.5	5.3	4.7	4.4	4.2	3.9	4.0	3.7	3.6	3.4
10 Year Treasury Note	4.2	4.3	3.9	4.0	4.3	4.4	4.3	4.3	4.3	4.1	4.0	3.8
Corporate Bond BAA	5.8	6.2	6.1	5.7	5.8	6.1	6.2	6.3	6.3	6.2	6.1	6.0
Exchange Rates												
Dollar/Euro	1.08	1.10	1.10	1.10	1.07	1.08	1.10	1.10	1.10	1.10	1.10	1.10
Yen/Dollar	151.5	149.0	141.0	148.9	152.5	152.0	150.0	148.0	146.0	144.0	142.0	140.0

[1] in 2024, GDP was $23.3 trillion in chain-weighted 2017 dollars.

[2] Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.

[3] Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.