

KPMG Economics

Breaking up is hard to do Tariffs & trade wars

Diane C. Swonk, Chief Economist

KPMG US

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In a month when couples are known to come together to engage in lavish displays of affection, the new president decided to do the opposite. On February 2nd, he signed an executive order levying steep tariffs on Mexico, Canada and China. It was the economic equivalent of a "Dear John" letter.

The announcement sent shock waves around the world, roiled financial markets and made for strange bedfellows. Businesses and unions banded together to protest the move.

Then, almost as quickly as the crisis emerged, it began to recede. The president agreed to delay the decision on tariffs for Mexico and Canada for a month. It is unclear that was a full reprieve.

It takes at least that long for US Customs and Border Protection, the agency tasked with collecting tariffs, to implement them. Markets breathed a sigh of relief the tariffs were not higher, then the news cycle moved on.

Tariffs on China will move forward. Anything already en route to the US prior to the tariffs taking effect will be exempt. That leaves a narrow window to get things into the US, which will further increase shipping rates, particularly from Shanghai.

Proposals from the campaign trail that sound like a silver bullet for all that ails us often fail to deliver in terms of economic outcomes. The desire to pull back and protect an economy that has left so many behind is a natural, almost primordial desire.

The problem is that the economic research on protectionism, of which tariffs are a key aspect, reveals that the costs outweigh the benefits. This report is written through an economist's lens.

Growth is front-loaded in 2025

The economy ended 2024 on solid footing with annual growth hitting 2.8% for the year, only one tenth of a percent behind the 2.9% annual pace of 2023. Consumer spending accelerated, aided by replacement demand due to Hurricanes Helene and Milton. Consumers went all in on travel, especially at year-end. Housing activity rebounded slightly. Business investment slowed, while inventories remained unusually low. Government spending moderated but posted solid gains. The trade deficit hit a new record as the US continued to outperform all its major trading partners.

Real GDP growth is forecast to rise 2.4% in the first quarter of 2025, close to the 2.3% pace of the fourth quarter. Consumer spending is expected to drive overall gains, buoyed by the push to front-run tariffs and the replacement demand due to fires in California. Housing is expected to contract in response to higher mortgage rates. Business investment is poised to rebound in the wake of the strike in the aerospace industry. Inventories are expected to be replenished. Government spending is expected to slow. The trade deficit is expected to continue to widen as importers scramble to get shipments in ahead of tariffs.

Growth is poised to slow to a 1.5% pace in the second quarter. Consumer spending hits a speed bump as tariffs start to bite and earlier efforts to front-run tariffs borrow from spending later in the year. Business investment is expected to weaken, while inventories rebuild. A new budget provides little boost to government spending, as that is an area the administration has targeted for cuts. The trade deficit widens only slightly, as exports weaken more rapidly than imports.

Fed stands pat. The Fed is expected to remain on the sidelines as it weighs the effects of tariffs and how they interact with other policies that the administration is offering up. Higher inflation due to tariffs and curbs on immigration are expected to keep the Fed on hold for the remainder of 2025.

Brace yourself. We are not done with tariffs; the next round could be significantly higher. The last executive order signed on Inauguration Day greased the wheels for the most sweeping tariff hikes since the 1930s.

It ordered economists across federal agencies to assess the threat of unfair trade policies across countries and products to come up with a list of tariff recommendations by April 1; recommendations regarding national security are due by April 30.

Investigations that typically take a year or more will be compressed into a few months. A potential glitch is that those tasked to complete that work will not know whether their jobs will be cut once they are done.

Tariffs are seen as a means to several ends:

- A negotiating tool to gain concessions from our trading partners.
- A source of tax revenues to balance other tax cuts in the budget process.
- A way to protect favored industries and increase manufacturing jobs.
- A mechanism to narrow or eliminate trade deficits.

Tariffs are designed to raise the cost of imports, curb demand and reduce competition for protected industries. Economists dislike them because they are a regressive tax that hits those who can afford it the least, while failing to deliver the promised returns.

[Research](#) by economists at the Federal Reserve revealed that the 2018-2019 trade war backfired and reduced employment. The few jobs gained in the steel sector due to higher steel tariffs were more than offset by the losses incurred by higher manufacturing costs.

Fears of recession picked up as losses in manufacturing mounted. The result was a decline in manufacturing employment, which was so severe that it forced the Fed to do a U-turn and cut rates.

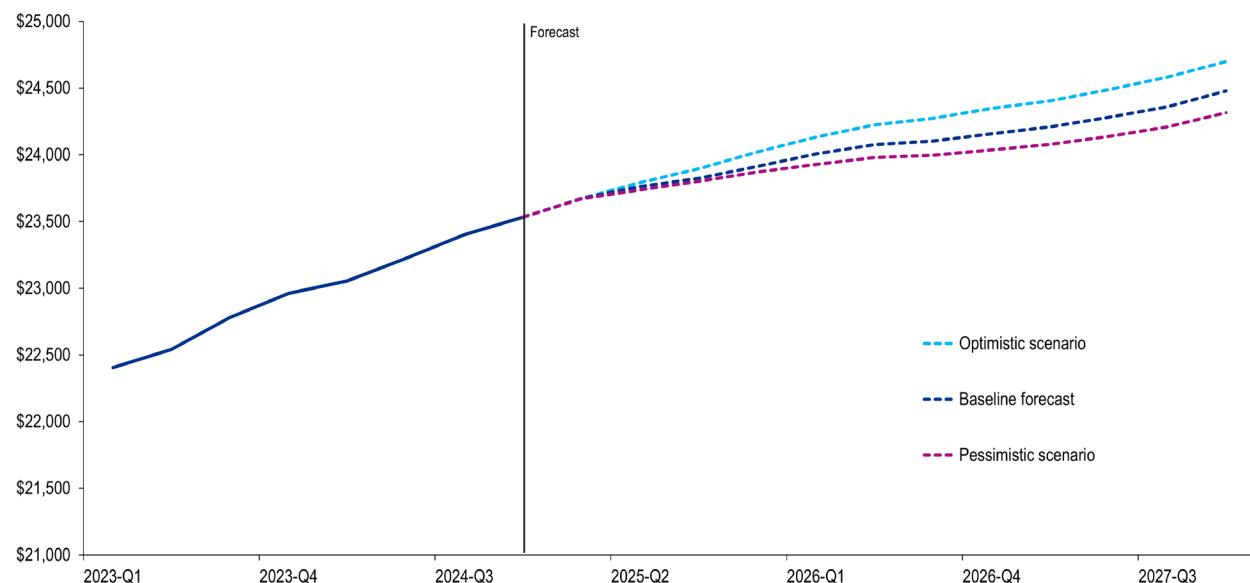
This edition of *Economic Compass* takes a closer look at which countries and products are most likely to be tariff targets. Special attention will be paid to why this time is different. The size and scope of tariffs are greater, while the battle against inflation continues.

Fears that the last mile on inflation could be the longest and littered with potholes have prompted the Fed to pause rate cuts. We have now no rate cuts until mid-2026, barring a prolonged spike in unemployment.

Chart 1

Policy impacts hit later in 2026/7

Real GDP, 2017\$, billions



Source: KPMG Economics, Bureau of Economic Analysis

The outlook

Updating scenarios

Last month we presented three scenarios assessing the impact of policy proposals—base case, optimistic case and pessimistic case. Chart 1 provides an updated analysis of these scenarios.

Initial US Immigration and Customs Enforcement raids have had a chilling effect on undocumented workers. That has left firms reliant on immigrants who fill jobs US-born workers will not, unable to function.

Our internal tax experts tell us that a deal on tax cuts is not likely until year-end. Republicans are debating a mix of sweeteners for individuals and a step up in the depreciation schedule for investments and R&D expenditures. The debate has pivoted from permanent cuts to temporary cuts, to avoid having to fully offset the blow to revenues from another round of large tax cuts.

Budget cuts are accelerating, even as discretionary funding for deportations and border protection has increased. It is unclear the net effect on spending in the near term, but it is now assumed to be more of a drag on growth than a month ago.

In our new base case:

- Real GDP rises 2.1% in 2025 with gains front-loaded as consumers and firms scramble to order and buy ahead of tariffs.
- Unemployment rises modestly in 2025, but more rapidly in 2026 and 2027.
- Inflation accelerates and peaks in early 2026.
- A strong dollar mitigates some of the upward pressure on import prices due to tariffs, but it curbs exports.
- The Fed pauses on rate cuts until mid-2026 when inflation begins to cool.

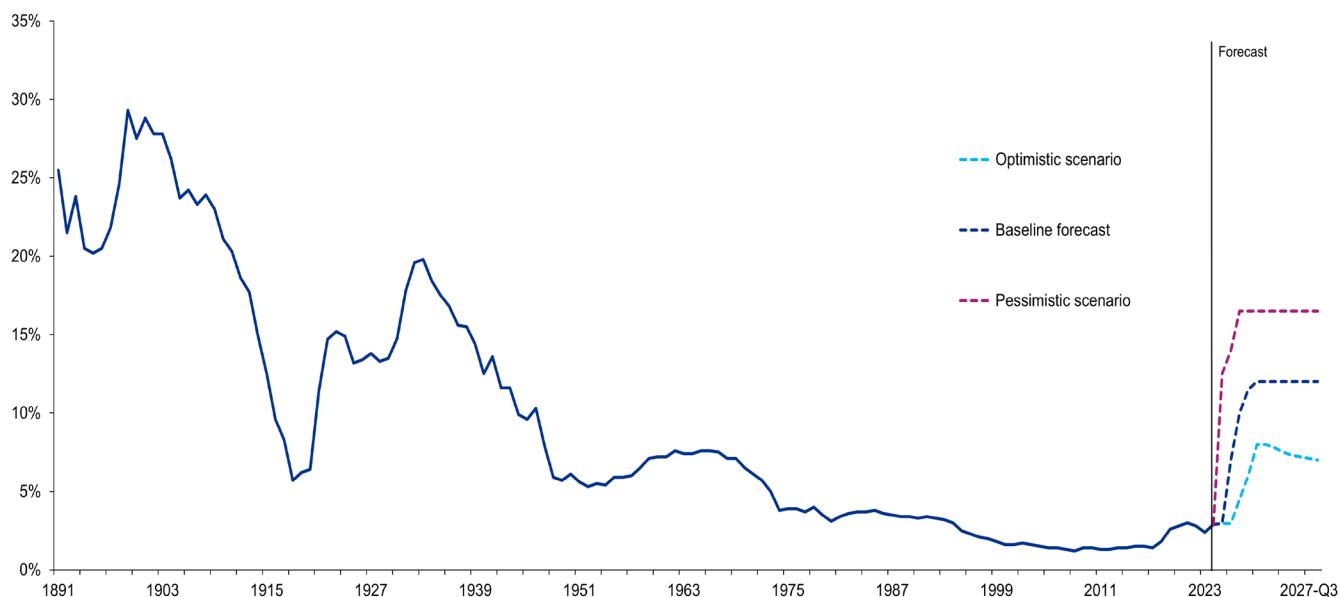
Chart 2 lays out three tariff scenarios. In all three scenarios, the effective tariff rate reaches the highest level since the 1960s - another inflationary period. The most pessimistic scenario has the highest effective tariff rate since the 1930s. It includes the full tariffs on Canada and Mexico along with the added tariffs due to be announced in April.

It seems reasonable to expect the hardest hit industries to get waivers. Lawsuits regarding tariff actions are another possibility. Those moves cannot protect firms from retaliatory measures.

Chart 2

Effective tariff rate set to rise in all three scenarios

Effective tariff rate, percent



Source: KPMG Economics, United States Census Bureau

Heightened uncertainty clouds outlook

Chart 3 shows the index for global trade policy uncertainty. It jumped to a record high post-election, but receded a bit when none were announced on Inauguration Day. It likely spiked again in February.

Policy uncertainty tends to delay major spending decisions by households and firms. Anecdotes of firms scaling back expansion plans due to their dependence on imports peppered the news in the wake of the announcement.

The fear of tariffs is prompting consumers and firms to hunker down and stockpile ahead of tariffs. Hoarding creates its own self-fulfilling prophecy on inflation, as we saw with the price of toilet paper during the pandemic.

Research on the 2018-2019 trade war revealed that banks tightened credit standards in response to tariff uncertainty. The more uncertainty, the less banks lent to firms they feared were vulnerable to tariffs.

That tightening of credit conditions would add to the restrictive stance by the Fed. It increases the costs of financing tariffs, which require producers to write a check or provide a bond ensuring tariffs will be paid.

Tariff targets

The president and his advisors see the trade deficit as a weakness that needs to be eliminated. Trade deficits reflect the size and strength of our economy. Add the reserve currency strength of the dollar and deficits are hard to reverse.

Chart 4 lays out the trade deficit by country. It is ranked by the flow of trade between countries to underscore the back and forth, especially among Mexico, Canada and the US. Vehicle parts cross the borders of all three countries multiple times before they become fully assembled vehicles in the US. That complicates how consumers could escape tariffs and ["Buy American."](#)

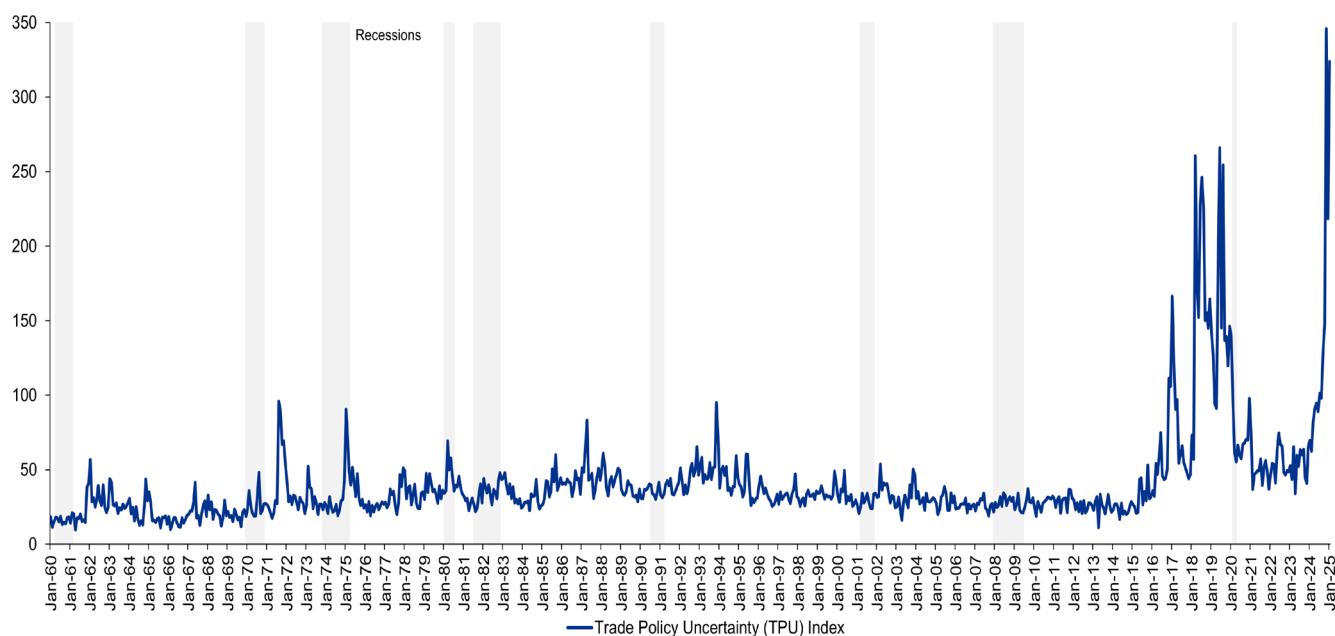
The largest trade deficits for the US in 2024 were with China, Mexico and Vietnam. Much of Europe and Japan are in the cross hairs as well. The only notable countries we run trade surpluses with are Brazil, the Netherlands and the UK.

Sectors that are most dependent upon imports include: manufacturing (notably vehicle production), construction, energy, agriculture and finance and insurance. The finance and insurance industries rely heavily upon electronics.

Chart 3

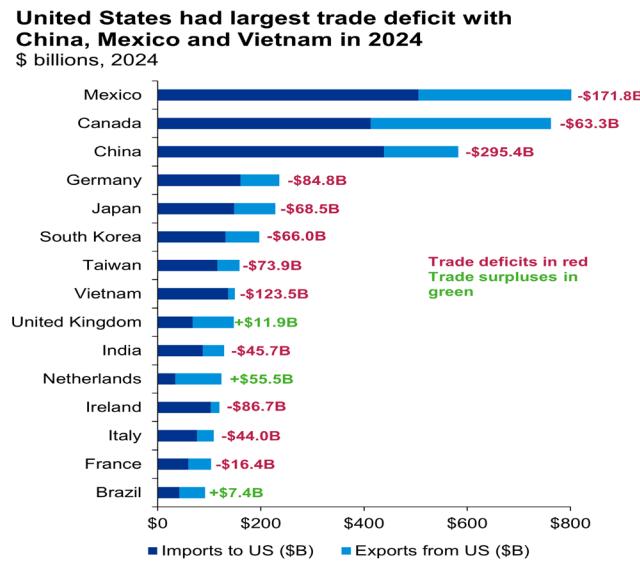
Trade policy uncertainty index surges to record highs

Index, monthly



Source: KPMG Economics; Dario Caldara, Matteo Iacoviello, Patrick Molligo, Andrea Prestipino and Andrea Raffo

Chart 4



Imports considered the highest on the list of national security concerns include high-tech manufacturing, batteries, communications equipment, some data services and pharmaceuticals. Primary metals, vehicles and defense manufacturing, construction and mining are the most dependent on those imports.

Many companies stocked up on imports in December to hedge against the threat of tariffs on Chinese imports. The trade deficit widened by the largest amount on record. The prices of steel, aluminum and construction materials have already moved up in anticipation of tariffs. That underscores how even the threat of tariffs can be inflationary.

Gaming out trade wars

Trade wars trigger a [Prisoner's Dilemma](#) in which countries have a choice of accepting the pain tariffs induce without retaliating or deciding to retaliate and enduring more pain. Countries tend to retaliate to preserve their autonomy and credibility even though they would be better off not retaliating.

The US is the 800-pound gorilla of the global economy; anything that happens here has an even larger impact abroad. That means that our trading partners will need to be strategic about retaliation.

Canada has already threatened to go after exports produced in Republican strongholds, including agriculture and liquor. Another tactic will likely be to disrupt supply chains, which have grown longer and more vulnerable to disruptions post-pandemic.

Supply chains for North America, Latin America and Europe lengthened as firms circumvented and hedge tariffs on China, while supply chains in the Asia Pacific region excluding China have become more regionalized.

Nearly all major industries in the US now require longer travel times between suppliers and producers than they did pre-pandemic. Efforts to hedge tariffs and geopolitical risks prompted a reshuffling of supply chains.

Visibility into where the goods were routed is opaque; many producers did not realize those efforts made supply chains longer and more fragile.

No easy off-ramp

Tariffs are harder to reverse than implement. They tend to take on a life of their own. Retaliatory cycles create escalating tensions.

Breaking that cycle requires one side to back down, which can be politically costly. No leader wants to look weak to their electorate. That creates strong incentives for leaders to maintain an aggressive position even when they recognize the economic costs.

How do we get out of trade wars? Countries tend to move slowly, agreeing to lift tariffs gradually over a specified time, contingent upon reciprocal actions. Sector-by-sector negotiations can be leveraged to break the conflict into smaller, more manageable pieces.

“Brace yourself. We are not done with tariffs; the next round could be significantly higher.”

The key is to create win-win situations, where both sides can save face and claim a victory. That is no easy task, especially given current fissures.

This time is different

The lessons of the 2018-2019 trade war reveal that it boosted prices on specific goods and curbed investment. The repercussions this time around are expected to be more consequential.

Higher inflation

1. The scope and breadth of tariffs being discussed is much larger.
2. The embers of inflation are still smoldering and at risk of reigniting.
3. Supply chains have become more susceptible to disruptions.
4. Firms are already front-running tariffs and raising prices.
5. Consumers are buying ahead of tariffs, which is further pushing up prices.

The University of Michigan Consumer Sentiment Index collapsed again in early February due to tariff fears and the inflation they would trigger; expectations for inflation picked up one and five years out. The losses were broad-based and across all political affiliations.

We could be underestimating the speed and velocity of inflation we will see given that shift in behavior.

Both the baseline and most pessimistic scenarios now include a short-lived period of stagflation: a period of rising inflation and unemployment.

When are tariffs deflationary? The Smoot-Hawley Tariff Act of 1930 was enacted to raise tax revenues after the onset of the Great Depression. It tipped off a 25 country trade war, prompted a 67% drop in trade and plunged the global economy deeper into the depths of the Great Depression.

Weaker growth

Tariffs are expected to take a toll on demand and investment. Tax cuts designed to accelerate investment could limit those losses, but there is little that one could pull apart and declare 100% "American Made." Even farmers rely heavily on imported fertilizers, feed and machinery. The biggest drag due to tariffs hit hardest in 2026 and 2027.

Add budget cuts, including efforts to eliminate entire agencies, and growth could be weaker. Furloughs have begun and will have spillover effects from the size of the federal workforce to funding for healthcare, research and nonprofits.

This is in addition to threats of targeting the funding of state and local governments that the administration sees as hostile to its objectives. Hiring by state and local governments was one of the largest single drivers of employment since mid-2023.

Policy purgatory for the Fed

That has left the Fed on hold, with rates still above its estimate of neutral. That is curbing lending. It would prefer to stop short on rate cuts than risk a more disruptive U-turn on cuts.

In the interim, it is expected to remain on the sidelines until mid-2026, when Chairman Jay Powell retires. The president has made clear that he will be looking for a loyalist to replace Powell. Kevin Hassett, who is the National Economic Council chair, will be a top contender.

Hassett is likely to push for rate cuts before some of his colleagues would like. Inflation doesn't return to the Fed's 2% target until the end of 2027, two years later than the Fed forecasted in September 2024.

What would cause the Fed to cut sooner? An abrupt spike in unemployment. The prospects for a "soft landing" are fading.

Bottom Line

"For never was a story of more woe, Than this of Juliet and her Romeo."

In this month dedicated to love, the last lines of Shakespeare's epic tragedy seemed a good place to end. They provide a cautionary tale of the collateral damage from warring factions.

That is how economists see tariffs and trade wars. They sound better in theory than they work in practice, are hard to stop once they start and too often hurt those they are supposed to help.

It is not too soon to de-escalate. The world is already divided enough. Find someone to hug this Valentine's Day. Be kind; pay it forward.

Economic Forecast — February 2025												
	2024	2025	2026	2024:4(A)	2025:1	2025:2	2025:3	2025:4	2026:1	2026:2	2026:3	2026:4
National Outlook												
Chain Weight GDP ¹	2.8	2.1	1.2	2.3	2.4	1.5	1.0	1.5	1.6	1.1	0.5	0.9
Personal Consumption	2.8	3.0	1.8	4.2	3.2	2.1	1.8	2.1	2.1	1.6	1.1	1.3
Business Fixed Investment	3.7	1.1	0.1	-2.2	1.8	1.5	0.0	0.4	0.6	-0.1	-1.1	-0.6
Residential Investment	4.2	-1.9	-2.8	5.3	-3.1	-4.8	-2.9	-1.6	-2.9	-3.4	-3.6	-0.4
Inventory Investment (bil \$'17)	38	46	80	4	38	46	46	53	62	79	85	96
Net Exports (bil \$'17)	-1037	-1119	-1130	-1067	-1104	-1120	-1126	-1127	-1122	-1128	-1134	-1136
Exports	3.2	2.4	0.6	-0.8	3.3	3.0	0.0	-0.2	0.3	0.6	1.0	2.2
Imports	5.4	4.0	0.7	-0.8	6.5	3.9	0.6	-0.1	-0.3	1.1	1.4	1.8
Government Expenditures	3.4	1.6	0.0	2.5	0.6	0.9	-0.1	-0.1	0.0	0.0	0.0	-0.3
Federal	2.5	1.9	0.2	3.2	-0.4	0.5	0.0	0.2	0.3	0.3	0.2	-0.4
State and Local	3.9	1.3	-0.1	2.0	1.2	1.1	-0.2	-0.2	-0.2	-0.2	-0.2	-0.1
Final Sales	2.7	2.1	1.1	3.2	1.8	1.4	1.0	1.4	1.4	0.8	0.4	0.7
Inflation												
GDP Deflator	2.4	3.0	3.5	2.2	2.6	4.2	4.5	3.7	3.6	2.8	3.1	2.7
CPI	3.0	2.9	3.3	3.1	3.5	2.9	3.4	2.9	3.3	3.7	3.6	3.3
Core CPI	3.4	3.2	3.3	3.5	2.9	3.3	4.4	3.5	2.9	3.5	3.1	2.6
Special Indicators												
Corporate Profits ²	6.2	0.7	-1.7	0.5	5.4	0.1	-1.4	-1.3	-4.4	-2.8	-0.4	1.0
Disposable Personal Income	2.9	2.6	3.0	2.8	2.8	1.2	6.5	2.3	3.6	2.2	1.6	2.2
Housing Starts (mil)	1.36	1.30	1.23	1.38	1.32	1.31	1.29	1.27	1.26	1.23	1.21	1.23
Civilian Unemployment Rate	4.0	4.4	5.0	4.2	4.2	4.3	4.4	4.5	4.7	4.9	5.1	5.3
Total Nonfarm Payrolls (thous) ³	2520	1637	-238	466	557	393	146	13	-47	-171	-298	-375
Vehicle Sales												
Automobile Sales (mil)	2.9	2.9	2.5	3.0	3.3	3.1	2.7	2.6	2.6	2.5	2.4	2.4
Domestic	2.0	1.9	1.7	1.9	2.1	2.0	1.8	1.8	1.8	1.7	1.7	1.7
Imports	0.9	1.0	0.8	1.1	1.2	1.1	0.9	0.8	0.8	0.8	0.7	0.7
LtTrucks (mil)	12.8	12.8	11.5	13.5	13.8	13.0	12.2	12.0	11.7	11.6	11.5	11.3
Domestic	10.1	10.4	9.8	10.7	10.9	10.5	10.1	10.0	9.9	9.9	9.8	9.7
Imports	2.7	2.4	1.7	2.8	2.9	2.5	2.1	2.0	1.8	1.7	1.7	1.6
Combined Auto/Lt Truck	15.8	15.7	14.0	16.5	17.1	16.1	14.9	14.6	14.3	14.1	13.9	13.7
Heavy Truck Sales	0.5	0.4	0.4	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Total Vehicles (mil)	16.3	16.1	14.4	17.0	17.5	16.5	15.3	15.0	14.7	14.5	14.3	14.1
Interest Rate/Yields												
Federal Funds	5.1	4.4	4.0	4.7	4.4	4.4	4.4	4.4	4.4	4.3	3.9	3.4
10 Year Treasury Note	4.2	4.5	4.5	4.3	4.6	4.5	4.5	4.5	4.5	4.5	4.5	4.4
Corporate Bond BAA	5.8	6.4	6.6	5.8	6.1	6.3	6.6	6.5	6.6	6.7	6.6	6.5
Exchange Rates												
Dollar/Euro	1.08	1.06	1.09	1.07	1.05	1.05	1.06	1.07	1.08	1.09	1.10	1.10
Yen/Dollar	151.5	153.5	147.0	152.5	155.0	155.0	153.0	151.0	150.0	148.0	145.0	145.0

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.

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