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Two-Headed Monster Stagflation Is Lurking

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Stagflation has entered the chat.

President Trump's decision to dramatically raise tariffs on imports threatens the U.S. with an uncomfortable combination of weaker or even stagnant growth and higher prices—sometimes called "stagflation."

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The U.S. has imposed 25% tariffs on Mexico and Canada, and another 10% hike on China following last month's 10% increase. They "will be wildly disruptive to business investment plans," said Ray Farris, chief economist at Prudential PLC. "They will be inflationary, so they will be a shock to real household income just as household income growth is slowing because of slower employment and wage gains," he said.

It is still unclear how long Trump intends to keep the tariffs in place. Commerce Secretary Howard Lutnick suggested Tuesday afternoon on Fox Business that a rollback could be in the works.

Some economists said if they stay, the odds of recession will meaningfully rise.

"This thing could get off the rails pretty quickly," said Tim Mahedy, chief economist at Access/Macro. "This is not at the level of the 1970s or 1980s. But it does have a whiff of stagflation, or a ministagcession."

Sentiment indicators and business commentary in recent weeks point to slumping confidence over the threat of higher prices.

China and Mexico are the top two sources of consumer electronics sold at the retailer **Best Buy,** Chief Executive Corie Barry told analysts Tuesday. "We expect our vendors across our entire assortment will pass along some level of tariff costs to retailers, making price increases for American consumers highly likely," Barry said. The company's shares plummeted 13% in the midst of a general stock-market retreat.

Brothers International Food, based in Rochester, N.Y., imports mangoes and avocados from Mexico and sells fruit juices, purées and frozenfood concentrates to food and beverage manufacturers. New tariffs are forcing the 95-person company to pass on price increases to its customers or accept lower profit margins.

Many of the company's customers accelerated shipments in January in anticipation of tariffs. "We are bracing for softer sales in the coming months," said Chief Operating Officer Jack Whittier.

Trump and his advisers have said some short-term pain might be warranted to achieve the administration's long-term ambitions of remaking the U.S. economy. They have also said their steps to boost energy production could offset higher goods prices.

Note Fed

Nonetheless, tariffs are a particularly difficult economic threat for the Federal Reserve to address. Its mandate is to keep inflation low and stable while maintaining a healthy labor market. Tariffs represent a "supply shock" that both raises inflation, which calls for higher interest rates, and hurts employment, which calls for lower rates. The Fed would have to choose which threat to emphasize.

Fed officials thought they might have engineered a soft landing over the past 18 months. A few are publicly warning of a stagflationary scenario.

"A deterioration of the labor market alongside higher inflation could present difficult choices," said Alberto Musalem, president of the Federal Reserve Bank of St. Louis, at an economics conference in Washington on Monday.

John Williams, president of the Federal Reserve Bank of New York, said Tuesday at an event hosted by Bloomberg that he expected tariffs would lead to higher inflation this year than he had anticipated. Tariffs on consumer goods, he said, "filter into prices that consumers pay. That happens relatively soon." Tariffs on intermediate goods, meanwhile, take longer to show up but last longer, he said.

Core inflation, which excludes volatile food and energy prices, has been falling steadily from its 2022 peak of 5.6% to 2.6% in January, using the Fed's preferred inflation gauge. That is still above the Fed's 2% target.

Researchers at the Federal Reserve Bank of Boston estimate that lifting tariffs on Canada and Mexico by 25% and on China by 10% could add 0.5 to 0.8 percentage point to core PCE inflation depending on the response of U.S. importers.

They don't account for consumers' substituting cheaper domestic goods, retaliation or fluctuations in exchange rates.

