US Economy Risk Assessment

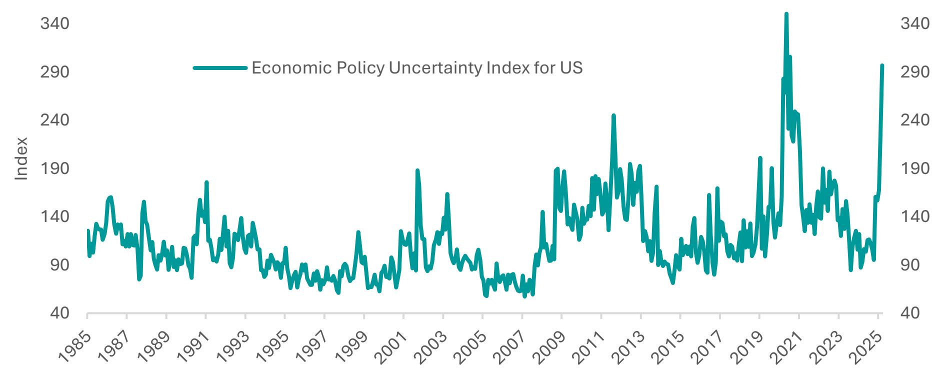
Not the Fed Tealbook, May 2025

Prepared by: Meri Yeghoyan, Diana Nazaryan, Asya Kostanyan and Jared Laxton

Grand Narrative: The US government seems poised to execute a policy agenda that will apply a similar mix of shock types that the economy faced during the pandemic. These include extreme levels of uncertainty, global trade and supply-chain disruptions due to an aggressive tariff policy, effective shut down of the southern border and big fiscal policy being proposed by the Congress. The roadmap for analysis in the next year will be about gauging the magnitude of these forces and whether they will lead to another major inflationary wave or not. Our current risk assessment suggests that near-term factors related to tariffs and restrictive immigration will put supply-side pressures on higher inflation and lower output however, it is not until October 2025 if the Congress moves forward with an expansionary fiscal policy that a major inflationary wave could occur, not as large as during the pandemic but significant enough that would require tighter monetary policy.

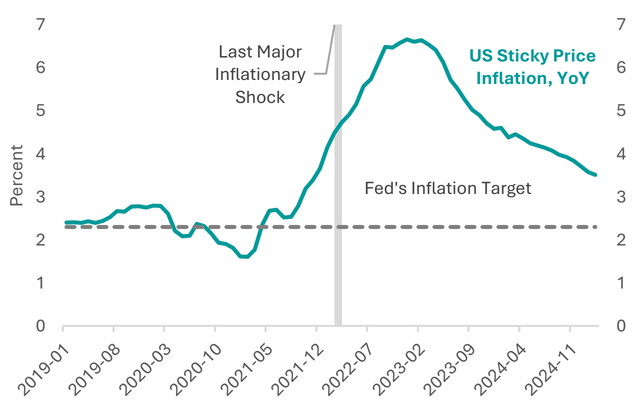
Important Features of Current Conditions: The real economy is around its potential, but inflation is settling above the target. This contrasts with the conditions in 2021 when the real economy was weak from very high levels of unemployment and inflation was below the target.

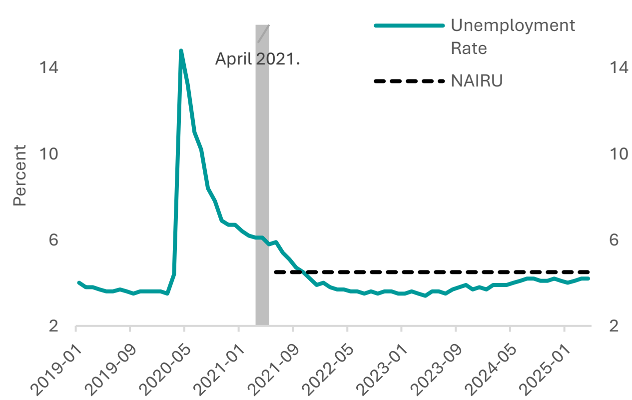
Economic Policy Uncertainty Index for United States is at COVID levels. Uncertainty remains a key macroeconomic variable in this economy that could justify why interest rates need to decline if it leads to a crisis in confidence, say in equity prices, and or a material decline in consumption and investment.



Source: Baker, Scott R.; Bloom, Nick; Davis, Stephen J. via FRED

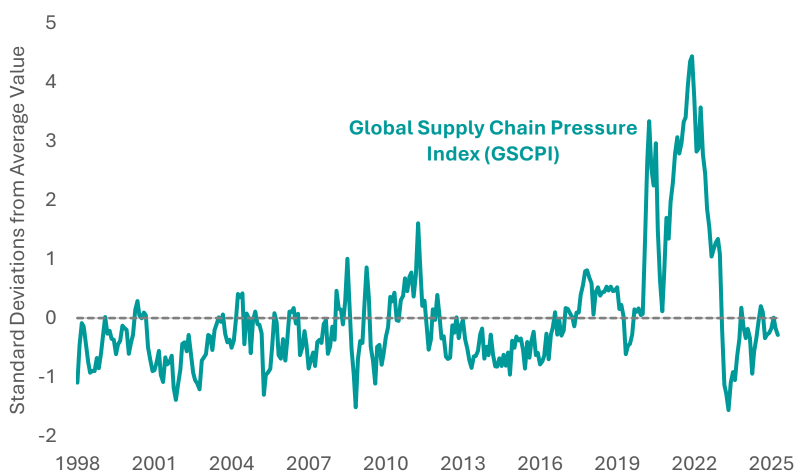
Before the introduction of the latest US economic agenda, there was a much stronger argument for a soft landing from a sticky inflation and unemployment rate perspective. This is now in serious doubt.





Putting Some Numbers to the Narrative: Trade and Supply-chains

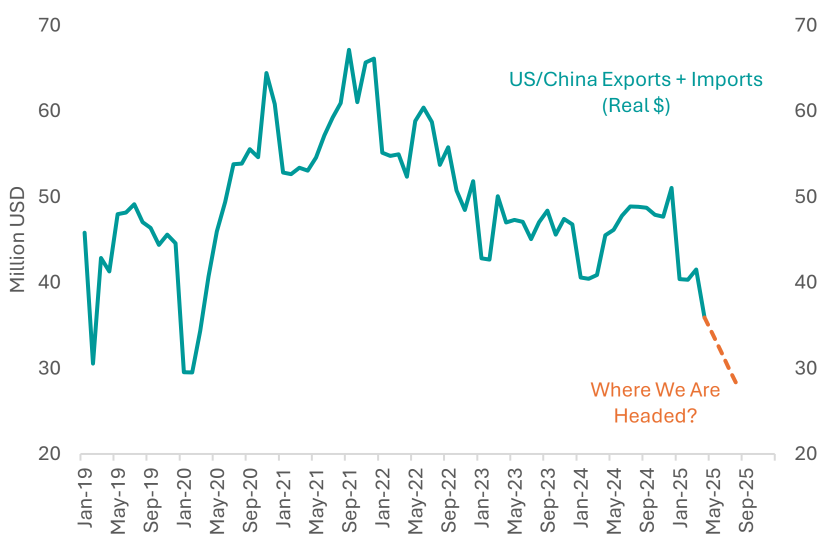
In our previous report on the US, we developed multiple inflation scenarios based on the direct impact of tariffs alone. In this edition, we add some numbers to other issues facing the US that could turn a traditional transitory tariff inflation shock into a more persistent inflation scenario. We learned during the pandemic how lockdowns and re-opening of the economy could wreak havoc on supply chains and was a clear contributing factor to the rise in inflation in 2021 and 2022. This supply-chain factor is meant to be captured by the NY Fed's Global Supply-chain Pressure Gauge. So far, the gauge has not responded negatively to US tariff policy.



However, we are in the early days and supply chains typically come under pressure later once the initial stop in trade occurs and then is restarted. Therefore, if the tariffs are lowered, as the pandemic showed, this would be akin to turning the trade switch back on leading to a rush to buy, for instance, Chinese products again but because they cannot produce them fast enough leads to supply-chain related inflation that would make inflation more persistent than the direct effects of the on/off tariff policy.

What is in the latest data?

No official data has been released yet for the US, but some anecdotal information exists that points to a significant decline in traffic at ports of Los Angeles and Tacoma. However, now that there is a 90-day reprieve on US/China tariffs will likely lead to a large increase in orders and increase in trade to beat the tariffs leading to port congestion.



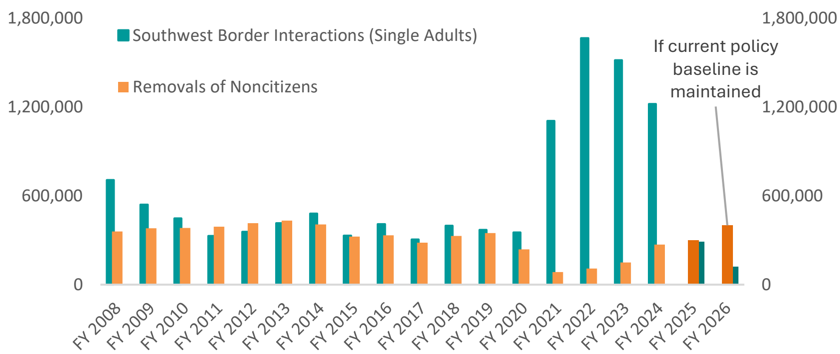
What are reasonable estimates of supply-chain based inflation in the next year?

The SF Fed estimates that supply-chain pressures contributed about 2pp to PCE inflation in 2021 and 2022. The current situation is not nearly as acute, but we consider a plausible contribution of 0.3 pp representing the share of trade between the US and China. While the pandemic affected trade on a global scale, the disruption of trade between the US and China could still be significant as the US and China represent about 1/3 of global GDP.

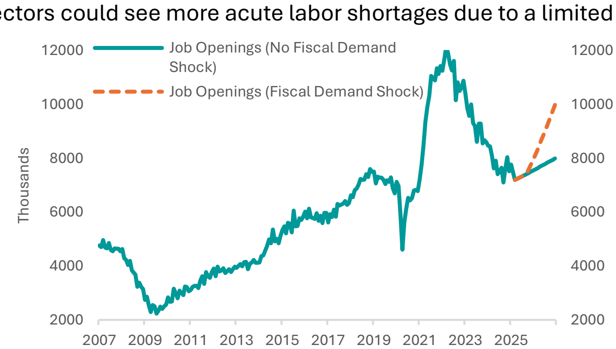
Putting Some Numbers to the Narrative: Restrictive Immigration

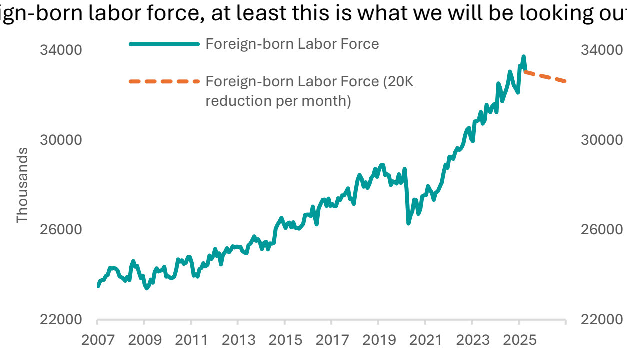
Interactions along the southwest border have collapsed in February and March to around 10,000 single adults. This compares to the monthly average between 2022-24 of 125,000. If this policy remains in place it would represent between a 1-1.5 million difference annually in migrant inflows, effectively bringing growth in the foreign-born labor force to zero. On top of restricting the inflow of immigrants into the country, the Trump administration is determined to increase the number of deportations of illegal immigrants, once stating they intended to deport 1 million illegal immigrants annually or 80,000 per month. So far, the administration has only managed to remove about 10,000 a month. There is historical precedence of much larger removals under the Obama administration when they removed about 400,000 illegal immigrants annually or about 30,000 per month. This is our current baseline view that would result in about a 20,000 reduction in the foreign-born labor force per month.

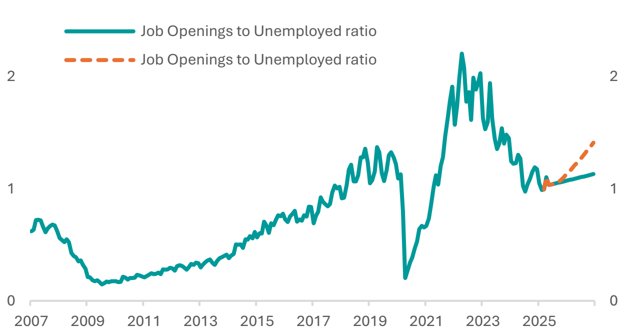
Southwest border interactions have collapsed. If maintained and deportations pick up could result in an outright decline in the foreign-born labor force

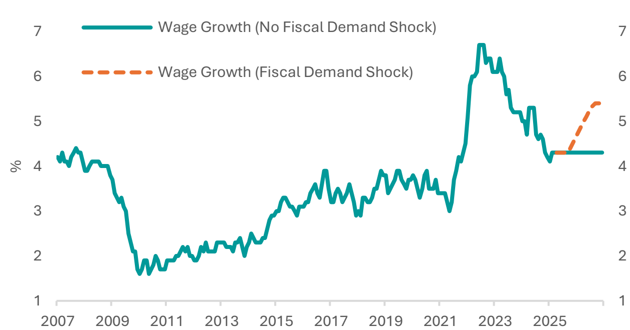


The labor shortages that occurred during the pandemic were special because they were a result of large early retirees, big changes in consumer habits and the stop and restarting of the economy associated with lockdowns. A large influx of immigrants eventually helped alleviate labor market tightness but still resulted in substantial supply-side inflation between 2021 and 2022. The potential of restrictive immigration in 2025 and 2026 is not on this level in terms of magnitude but can still lead to a labor market that was cooling to heating back up again. This is particularly concerning given that wage growth has yet to fall to what would be consistent with the inflation target. Furthermore, while the foreign labor force is a fraction of the total labor force (~25%), foreign labor is more important in certain sectors (construction, freelance services, transportation, etc.). Using the George Evans view of the Phillips curve and sectoral labor market bottlenecks, these sectors could see more acute labor shortages due to a limited foreign-born labor force, at least this is what we will be looking out for.



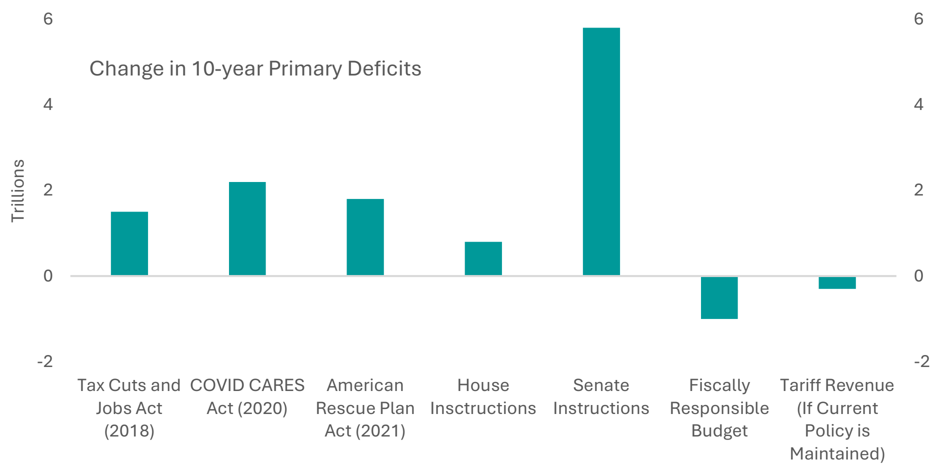






Putting Some Numbers to the Narrative: Fiscal Policy

Fiscal policy in the US is a mess at the moment. The US exits the pandemic era with a persistent deficit to GDP ratio of 6%. There are calls by people like Ray Dalio among others that the deficit needs to be reduced to 3% to put the US on a path towards fiscal sustainability. Why 3%? The assumption would be that the US economy grows in real terms at about 2% while the Fed targets inflation at 2% meaning nominal growth of about 4%. This level of nominal growth would then be sufficient to reduce the debt to GDP ratio over time under a 3% deficit policy. Bringing the deficit to GDP ratio from 6% to 3% requires about $1 trillion in net savings by the government in 2025. However, current budget instructions by the House and Senate are pushing the deficit in the opposite direction. The Senate instructions to increase the deficit by $5.8 trillion would raise the deficit by more than the 2018 tax cuts, 2020 and 2021 pandemic era spending bills combined. After it was announced, markets reacted appropriately that sent the US 10-year bond rate higher and the US dollar crashed, essentially a country risk premium shock that typically occurs in emerging markets and not advanced economies and even more surprising for a reserve currency country.



As it stands, the most optimistic view of fiscal policy are the House instructions which sees $2.8 trillion in new spending with $2 trillion in cuts resulting in $800 billion of new deficit spending. Furthermore, the current tariff policy is on pace to hit $300 billion annually which could also put a significant dent into the new deficit plans. However, if this is the final budget that is approved, and tariff policy continues then it would still mean a substantial expansionary fiscal impulse coming late 2025 at a time when other policies are constricting aggregate supply. The combination of these factors is setting up a scenario in 2026 that sees another major wave of inflation that goes beyond the direct impact of higher tariffs. We provide a breakdown below but it's difficult to decompose inflation in this way with any certainty. The general idea is that we are looking at similar forces that occurred during the pandemic but around a third of the magnitude. In the end we get a similar mix of demand and supply side inflation in 2026 that mirrors the mix estimated in 2022 (Shapiro 2024)

Topic	Defensible inflation impact (alternative view/considerations)
Tariffs	1 pp (on/off again policy mutes the impact, full on policy is larger)
Trade and supply-chain disruptions (supply-side)	0.3 pp (a proportion of the pandemic supply-chain disruption based on the proportion of trade between US/China trade. Effect during the pandemic could have been substantially non-linear)
Restrictive immigration policy (supply-side)	0.2 pp (depends on the ongoing cooling effect in labor demand in areas such as construction)
Expansionary fiscal policy (demand-side)	0.3 pp (this could be much higher but the range of possible outcomes at this stage in the budget process is too large but an increase in the deficit looks certain)
Total	1.8 pp (a modest estimate but the point is that the mix of shocks matter. A 2pp increase in inflation that is a combination of demand and supply, would require a much tighter monetary policy. If the shocks end up being just supply-driven then the extent to which tighter monetary policy is necessary will depend on the credibility of the Fed and whether inflation is well anchored.)

Case Scenarios:

Putting together the above suggests that

Case B: The Case for Lower Interest Rates in the US

If the Fed was in a stronger position in terms of anchoring the economy to the 2% inflation target and there were no other government policies to consider like immigration restrictions and expansionary fiscal policy than the case for lower interest rates in response to a tariff shock is clear. The economy is anchored, wage and price setters understand the tariff will result in a temporary increase in the price level while it will feed into lower activity in the real economy. Therefore, after the initial spike in the price level the real concern becomes recessionary conditions that ultimately pull-down prices for all goods and services once the impact of the tariff goes away. Once the Fed gets a sense of recession, lower interest rates are required despite elevated levels of inflation. The Fed pre-emptively moving in this direction would make sense if the bond market, inflation expectations, and oil prices are all telling this negative demand story and helping reduce the inflationary impact from the tariffs.

Case A: The Case for Higher Interest Rates in the US

It's hard to analyze the tariffs in a vacuum when you have restrictive immigration and expansionary fiscal policy on the table not to mention underlying inflation being above the target for quite some time where wage and price setters have become accustomed to raising prices within a stagflationary environment. Therefore, we need at least two scenarios to describe the case for higher interest rates: the first where the only concern is underlying inflation is above the Fed's target and would worsen under another stagflationary shock so soon after the last one. In this scenario, goods and services not affected by the tariffs also begin to rise because they question whether the Fed is committed to bringing inflation back to target. The second scenario would be a more severe scenario that includes both a delay in the Fed's policy response with added labor shortages from restrictive immigration that leads to upward wage pressure and more persistent inflationary pressure.

Figure 4: Scenario Projections for Unemployment and Monetary Policy