Global Economic Viewpoint

Some unpleasant tariff arithmetic: beware stagflation risks

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Economics
Global

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Upside risks to our tariff base case

The latest tariffs announcements could raise the effective rate by around 5pp. Based on the composition of imports over the last 12 months, we estimate that the effective rate would rise to nearly 16% (Exhibit 1). While our structural views remain unchanged, the latest developments pose upside risks to our base case that effective tariffs will settle at around 10%. Especially since more sector-specific tariffs could be announced. The uncertainty and tariff shocks are extending in time. Even with a Trump put, tariffs may not get back all the way to the US-China deal lows from May.

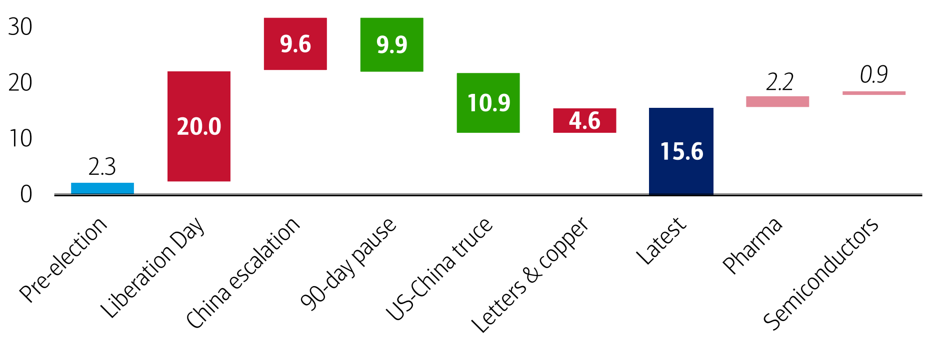
Higher conviction in our Fed call

A roughly 5pp increase in the effective tariff rate would lower the fiscal deficit by about 50bp, not much for a deficit that remains above 6% of GDP, and pose about 30bp of upside risk to inflation and downside risk to growth. But the latest tariff announcements are far from a done deal. Rather, the extension of the deadline from July 9 to August 1 suggests there is room for negotiation. Still, with the stagflationary shock possibly extending into 2026, it becomes more likely that the Fed will be frozen in place, consistent with our out-of-consensus call of no Fed cuts this year.

Our estimates are closely tracking collected tariffs

As of May, our estimates of effective tariffs are very close to actual collected duties, showing an aggregate effective tariff rate of 9.6%. Still, we find a few discrepancies. Tariff collection for May outpaced our estimates for China, with actual calculated duties close to 46% vs our 38% calculation, while tariff collection fell short of our estimates for Canada and Mexico, even though our own estimates are at the lower end.

Exhibit 1: US effective tariffs could climb to 16% or more if further sector-specific tariffs emerge
After a trough of 11% with the US-China truce, President Trump's tariff threats are heating up again (pp)



Source: BofA Global Research, Haver. Note: 90-day pause includes the electronics exemption. US-China truce includes UK deal. Letters & copper includes Vietnam and Indonesia deals. Pharma and semis show the estimated impact of hypothetical 25% sector-specific tariffs.
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Upside risks to our tariff base case

Right as the expiration of the 90-day pause was approaching, President Trump launched another round of escalation in the trade war. President Trump targeted 25 trading partners announcing higher tariffs effective August 1, raising concerns about higher inflationary risks and downside risks to growth. These letters included the EU, Japan, Korea, Canada, and Mexico, all major exporters to the US, as well as 20 other countries.

The administration also announced a 50% tariff on copper imports, and later announced a deal with Indonesia. Together, the latest tariff announcements would raise the US effective tariff rate by nearly 5pp to around 16% (Exhibit 2). In addition, President Trump has hinted at imposing a 15-20% blanket tariff and sectoral tariffs on pharmaceuticals and semiconductors, posing further upside risks to our estimates.

From tariffs to taxes and back again

While we had some optimism based in the developments until then, including the 90-day pause and the US-China deal and the US-Vietnam deal (see Sealing the deal and Vietnam's (not so) good deal), we had also argued that passage of the One Big Beautiful Bill Act by July 4 could open the door for re-escalation on the tariff front going into the July 9 deadline (see: July deadlines = noisy headlines).

Market complacency increases risks

In our view, the passage of the fiscal bill gave the Trump administration some cushion to withstand another round of uncertainty with re-escalation of trade tensions with major trading partners. However, markets are complacent, with both equities and rates barely budging in response to tariff headlines. This might embolden the administration to further escalate the trade war. If that happens, however, some de-escalation should follow again if and when the Trump put is eventually triggered.

Same structural view, different balance of risks

Our overall structural view remains unchanged, but the balance of risks has mildly shifted towards a more hawkish tariff scenario. We continue to think that the Trump administration will negotiate comprehensive country-specific deals involving trade, immigration, defense, and energy, and that the Trump put would be triggered again if the market reaction becomes sufficiently aggressive.

However, we also think the uncertainty shock could be more protracted than initially expected. Even after comprehensive trade deals are reached, the nature of the deals so far (all keeping a 10% or higher baseline tariff) pose upside risks to our base case of US effective tariffs converting to around 10%, which is around the level reached with the US-China deal and the 90-day pause and actual tariff revenue in May (Exhibit 2).

Exhibit 2: The latest tariff escalation is a blow to EU, Japan, Korea, among other trading partners
Timeline of estimated effective tariff rates by region (%)

	Pre-election	Liberation day	China escalation	90-day pause	US-China truce	Latest	Pharma & semis	May actual tariffs
China	11.0	79.9	156.0	128.7	37.9	**38.1**	38.4	**45.6**
EU	1.1	13.4	13.6	7.8	7.8	**19.0**	27.4	**6.7**
Mexico	0.2	6.0	6.2	6.0	6.8	**6.9**	6.9	**4.3**
Canada	0.1	2.9	3.6	3.0	3.5	**4.2**	4.2	**1.9**
Japan	1.5	22.0	22.1	14.2	14.2	**22.6**	24.9	**14.0**
Korea	0.2	20.7	21.1	13.7	13.7	**21.6**	24.7	**12.1**
ASEAN-6	2.2	29.6	29.7	6.5	6.5	**14.1**	17.6	**5.9**
RoW	1.2	16.6	17.2	7.4	7.2	**11.1**	14.7	**5.2**
World	2.3	22.3	31.9	22.0	11.0	**15.6**	18.7	**9.6**

Source: BofA Global Research, Haver. Note: 90-day pause includes the electronics exemption. US-China truce includes UK deal. Letters & copper includes Vietnam and Indonesia deals. Pharma and semis show the estimated impact of hypothetical 25% sector-specific tariffs. "Actual" tariff revenues are based on the by-country calculated duties reported by the Census Bureau. They tend to differ slightly from duties paid, which aren't broken out by country.

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The Trump tariff rollercoaster

With the flurry of tariff headlines since the beginning of the year, it is easy to lose track of the state of play. We start by taking stock of the trade war timeline so far, noting the most relevant events along the way (Exhibit 3). For starters, the US effective tariff rate was just slightly above 2% before Trump was re-elected, with the bulk of those tariffs explained by tariffs on China around 11%.

Effective tariffs peaked above 25% after Liberation Day

After the fentanyl and migration tariffs announced on China, Canada, and Mexico, tariffs on steel and aluminum and on autos and auto parts were imposed. However, goods that comply with the United States-Mexico-Canada agreement (USMCA) are exempt from tariffs (except the non-US content of autos). Liberation Day on April 2 followed as the day of reckoning with announcements taking the US effective tariff rate above 22%.

The days that ensued witnessed an aggressive US equities, dollar and rates selloff and a materially higher perceived recession probability. In addition, the escalation following the retaliation between the US and China delivered a further theoretical increase of US effective tariffs of over 9pp. This would have taken US effective tariffs above 30%, to levels unseen since the 19th century.

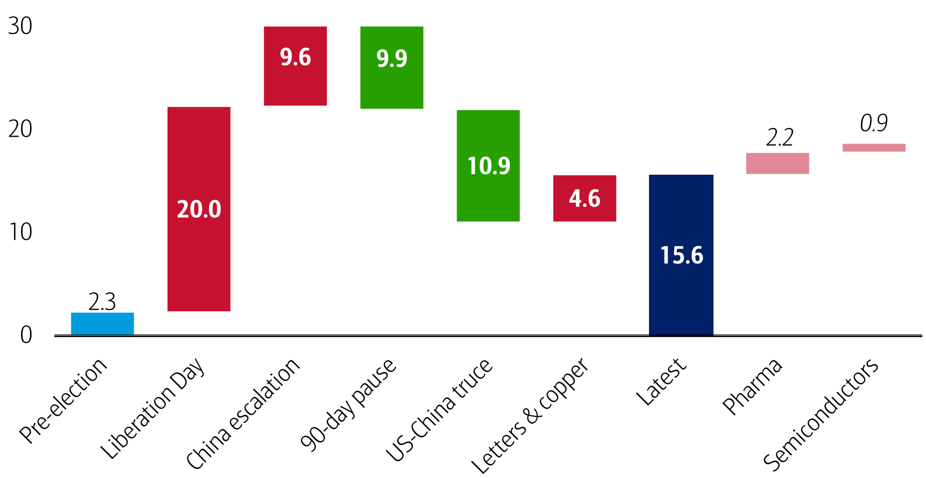
Significant de-escalation reduced tariffs to around 11%

In the days that followed, and at the edge of a broader bear market, it was the persistent selloff in long-end US Treasuries that triggered the "Trump put," in our view (see The bond market triggers the Trump put). The week following Liberation Day, President Trump announced a 90-day pause in reciprocal tariffs, taking tariffs to the lower 10% baseline for countries that had not retaliated (i.e. everyone except China).

This decision, coupled with the exemption of key electronic products, reduced the potential shock to effective tariffs by nearly 10pp. Afterwards, May saw the initial agreement between the China and the US rolling back tariffs for 90 days, which walked back all the retaliation and only left the 20% fentanyl tariffs and the 10% baseline tariffs in place (beyond the pre-existing ones). This agreement came shortly after the US-UK deal and led to a trough in implied effective tariffs, with a reduction of over almost 11pp leaving the estimated US effective tariff rate at 11%.

Exhibit 3: US effective tariffs could climb to 16% or more if further sector-specific tariffs emerge

After a trough of 11% with the US-China truce, President Trump's tariff threats are heating up again



Source: BofA Global Research, Haver. Note: 90-day pause includes the electronics exemption. US-China truce includes UK deal. Letters & copper includes Vietnam and Indonesia deals. Pharma and semis show the estimated impact of hypothetical 25% sector-specific tariffs.

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Renewed escalation before the end of the 90-day pause

Before the 90-day pause was about to expire, the Vietnam deal delivered the first sign of escalation of the tariff front. While the deal cleared some uncertainty, it meant a 20% baseline tariff for Vietnam. In addition, the agreed levy would climb to 40% for goods that are considered transshipment (i.e. rerouting, see: Friendshoring, or rerouting, that is the question). This could be seen as a blueprint for future bilateral trade deals.

Furthermore, after the passage of the One Big Beautiful Bill Act and before the expiration of the 90-day pause, we estimate the latest tariff announcements (letters, 50% tariff on copper imports, and the 19% tariff in the US-Indonesia deal) would increase the US effective tariff rate by 4.6pp. This would raise US effective tariffs to about 15.6%, further increasing upside inflation risks and downside risks to growth.

Where we stand with the latest announcements

The administration has sent letters to 25 trading partners so far, stating that they will face substantially higher tariffs starting August 1 (Exhibit 4). More letters might be in the pipeline, but so far, the most notable escalation has been with the EU (which would face a new tariff rate of 30%), Japan (25%), Korea (25%), Canada (taking 'fentanyl' tariffs from 25% to 35%), and Mexico (taking 'fentanyl' tariffs from 25% to 35%). Several South East Asian counties were also hit with large tariff hikes.

The administration also announced a 50% tariff on copper imports. More than half of the US's copper imports are from Chile and Canada, though presumably the latter's copper exports to the US are mostly compliant with USMCA and therefore exempt from the tariffs.

Exhibit 4: The administration has alerted countries of potentially higher tariff rates on August 1
Latest tariff rate vs. the Liberation Day Rate (%)

Country	Latest Rate	Liberation Day Rate	Change
Algeria	30	30	0
Bangladesh	35	37	-2
Bosnia	30	35	-5
Brazil	50	10	40
Brunei	25	24	1
Cambodia	36	49	-13
Canada*	35	25	10
European Union	30	20	10
Indonesia**	32	32	0
Iraq	30	39	-9
Japan	25	24	1
Kazakhstan	25	27	-2
Laos	40	48	-8
Libya	30	31	-1
Malaysia	25	24	1
Mexico*	30	25	5
Moldova	25	31	-6
Myanmar	40	44	-4
Philippines	20	17	3
Serbia	35	37	-2
South Africa	30	30	0
South Korea	25	25	0
Sri Lanka	30	44	-14
Thailand	36	36	0
Tunisia	25	28	-3

Source: White House. Note: *Canada and Mexico quote the "fentanyl and migration" tariff rates. **Indonesia shows tariff rate announced in the initial letter, before 19% tariffs were announced with the US-Indonesia deal was announced.

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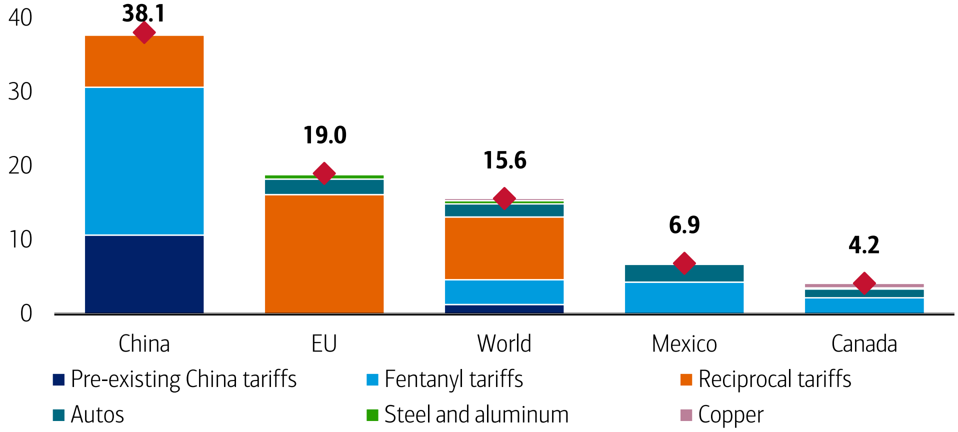
Exhibit 5: The EU would face c. 20% tariffs with the latest escalation, but USMCA is mostly spared
Contributions to US effective tariffs facing major trading partners



Source: BofA Global Research, Haver

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The announced tariffs pose upside risks to our base case

The latest tariffs announcements would raise the effective rate by around 4.6pp. Based on the composition of imports over the last 12 months, we estimate that the effective rate would rise to 15.6% (Exhibit 2 and Exhibit 3). In other words, there are upside risks to our base case that the effective tariffs will settle at around 10%. Especially since we are still waiting on the Section 232 investigations on pharma and semiconductors, which could lead to additional tariffs.

Higher tariffs for the EU, Japan, and Korea, but USMCA still mostly spared

The effective tariff rate on the European Union could reach 19%, while it could become 14% for Japan and 12.1% for Korea. In addition, ASEAN nations would be significantly impacted, with the effective rate for the ASEAN-6 increasing from 8% (or 6.5% before the recent deal with Vietnam) to 14% accounting for the higher tariff rates announced in the letters and the 19% tariffs agreed between Indonesia and the US.

In contrast, Canada and Mexico would remain mostly spared, as the large majority of their exports to the US is USMCA-compliant and therefore exempt from tariffs (see Global Watch: USMCA: Can't see the forest for the trees). Exhibit 5 shows a decomposition of the global US effective tariff rate as well as those on China, the EU, Canada, and Mexico, assuming tariffs become effective.

Actual revenues are close to our estimate

The daily customs and excise tax revenue data from the Treasury Department point to an effective tariff rate of about 9.6% for goods imported in May (for which tariff would have been paid in June, Exhibit 6). May was the first month for which tariff revenues would fully reflect the Liberation Day tariffs. And in fact, our average theoretical tariff rate based on May imports and the various measures announced is also 9.6%. Therefore, our own estimates of tariff revenue appear to be broadly on track.

Looking at the sectors driving tariff revenue, it becomes clear that the recent increase has been driven by the manufacturing and agricultural sectors, in that order. Manufacturing has seen the largest increase in collected tariffs, followed by agricultural imports, while commodities and other categories still face average effective tariffs below 1% (Exhibit 7).

Exhibit 6: US effective tariffs for goods imported in May was c. 9.6%
Effective tariff rate (%)

Source: BofA Global Research, Treasury Department, Census Bureau

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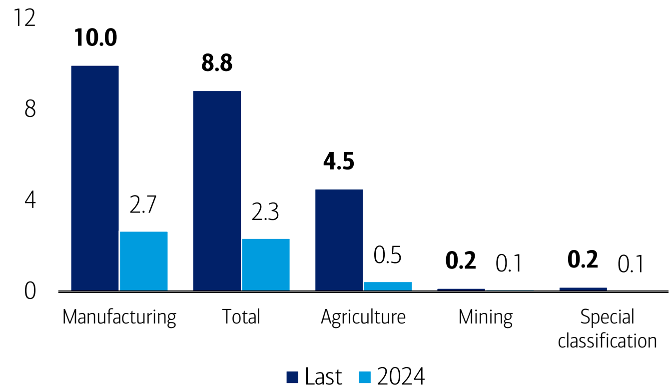
Exhibit 7: Manufacturing and Agricultural show the largest tariff hikes
Evolution of effective tariff rates by broad sectors (%)



Source: BofA Global Research, Haver. Note: "Actual" tariff revenues are based on the by-sector calculated duties reported by the Census Bureau. They tend to differ slightly from duties paid, which aren't broken out by sector.

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Our estimates are close to actual at the country level

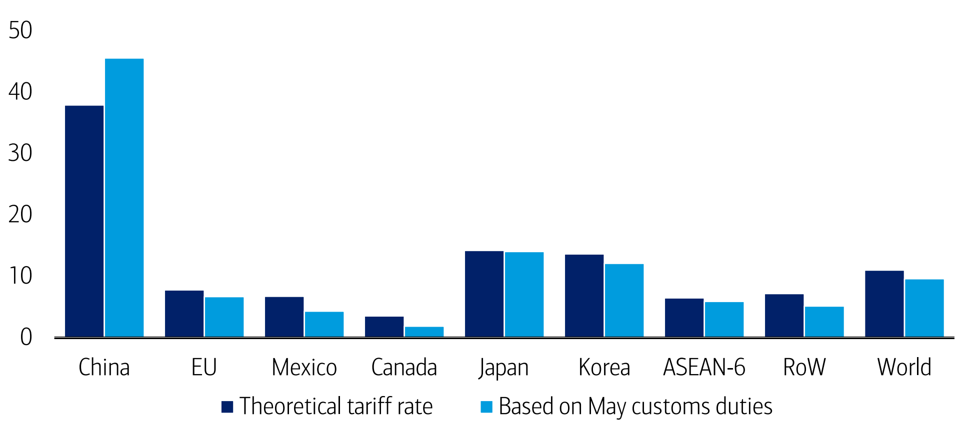
Looking at calculated duties in the US Census data, we can approximately track effective tariff collection by country. At the country and regional levels, our own estimates of effective tariff rates as of May (US-China truce column in Exhibit 2) are generally very close to actual calculated duties (Exhibit 8).

However, we find a few discrepancies. Most notably, tariff collection for May outpaced our estimates for China, with actual calculated duties close to 46% vs our 38% estimate. In addition, tariff collection fell short of our calculations for Canada and Mexico, even though our own estimates of effective tariffs for USMCA are by far at the lower end.

Stagflation risks: larger, more protracted

A roughly 5pp increase in the effective tariff rate would lower the fiscal deficit by around 50bp, not much for a deficit that remains above 6% of GDP, and pose about 30bp of upside risk to inflation and downside risk to growth on our estimate. However, we would also caution that the latest round of tariff announcements is far from a done deal. Rather, the extension of the deadline from July 9 to August 1 suggests there is still room for negotiation.

Exhibit 8: Our tariff calculations are closely tracking observed data so far, with a few discrepancies
Theoretical vs. "actual" effective tariff rates revenues by country/region (%)



Source: BofA Global Research, Haver, Census Bureau. Note: "Actual" tariff revenues are based on the by-country calculated duties reported by the Census Bureau. They tend to differ slightly from duties paid, which aren't broken out by country.

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Higher tariffs are not a done deal…

We remain optimistic that at least some of the countries that received letters will be able to negotiate comprehensive agreements around trade, defense, energy, immigration, etc. with the US, which should result in lower tariffs. However, it now seems more likely that we may converge to a midpoint between our base case assumptions and the most recent announcements.

…and would not be fully reflected in the data until October

If the announced tariffs are implemented on August 1, they would not be applied to goods that had already left foreign ports as of August 1 (this is the "on the water" rule). Since it takes two-to-three weeks for goods to travel from Asia to the US West Coast, this means the August 1 tariffs will only be fully paid for September imports. And recall that those payments will happen in October.

The bulk of tariff payments for September should be reflected in the Daily Treasury Statement for October 23, which will be released on October 24. And even so, nothing guarantees that August 1 will be the real deadline, in our view. If August 1 were to become the new July 9, the uncertainty and tariff shocks would become even more protracted, making it harder to judge the inflation trajectory.

If implemented, the tariffs would amplify stagflation risks

Any pass-through to inflation will most likely take even longer to play out. Retailers are unlikely to raise prices on goods that were imported before the tariffs were implemented (that is probably also why we have not yet seen the full impact of the April tariffs). They usually take a few months to turn their inventories over.

We think that the August 1 tariffs, if implemented, would increase the risk of a larger and more persistent inflation shock, lasting into 2026 with core PCE peaking around 3.5%. However, we would be more concerned about the risk of non-linear effects under such a hawkish tariff scenario.

Not only tariffs, but uncertainty itself, pose downside risks to growth

In terms of GDP growth, the latest tariff announcements increase the risks of a sustained uncertainty shock, which could dampen the stimulative effect of the OBBBA on capex. This could be true even if the tariffs are not implemented, as corporates might find it difficult to commit to projects when trade policy is in a constant state of flux.

Non-linearities could start to matter

With inflation expectations that have already deteriorated under some measures including the Michigan survey, big cost push shocks could also induce more firms to deliver price increases. Under the logic of menu costs, many more firms could find it optimal to pay the fixed cost of adjusting prices. At the same time, the impact of the shock on economic activity would magnify, potentially leading to proper stagflation.

Fed: more reason to be cautious on cuts

In our view, the latest round of tariff uncertainty, with the stagflationary shock possibly extending into 2026, increases the risk that the Fed will be frozen in place. This is consistent with our out-of-consensus call of no Fed cuts this year. In fact, Chair Powell has repeatedly argued that the Fed wants greater clarity on the impact of policy changes before making its next move.

Such clarity might not be forthcoming if there are risks of additional meaningful changes to the tariff regime. Of course, the Fed's hand could be forced if the labor market rolls over. But with unemployment rate falling to 4.1% in June and initial claims normalizing after what looks like a seasonal increase in June, we also do not see clear signs of labor market slack. We think the muddle-through scenario remains the most likely for the US. Therefore, extending the "escalate to de-escalate" strategy just increases the option value of waiting for the Fed.

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