June 2025

Fed Thoughts: Heavy Lift on Trade and Monetary Policy

Vincent Reinhart | Chief Economist & Macro Strategist

BNY | INVESTMENTS

MELLON

Federal Reserve (Fed) officials have repeatedly relayed they are in no hurry to adjust the stance of monetary policy. Our readers are probably not as patient, so we will first cut to the chase to summarize our expectation for the upcoming meeting of the Federal Open Market Committee (FOMC) on June 17 to 18 and offer a few observations on the ongoing confrontation between the Fed and the White House. The remainder of the note is a heavy lift on trade policy for the patient.

We think that patience will be rewarded. In our view, the Fed's description of tariffs as posing a supply shock increasing inflation and damping aggregate demand is partly wrong, reflecting the limitations of a macro shop trying to incorporate micro interventions on trade. We do not buy the White House's assertion that the US has so much market power that foreign producers will pay a considerable portion of tariff duties by compressing their profit margins. But plausible estimates, such as one recently done by the Congressional Budget Office, suggest that they will pay some to provide a stimulative budgetary offset to the drag on aggregate demand of the tariff duties paid by domestic purchasers.[1] We incorporate uncertainty about key behavioral parameters and take a detailed look at bilateral trade data at the six-digit end-use level to map risks for the Fed. The threat map puts plausible probabilities on a supply shock (positive on prices and negative on aggregate demand) and an expansionary shock (positive on prices and aggregate demand). That is, Fed officials have ample reasons for going slow on cutting the policy rate, perhaps more than they have incorporated with one-sided worries about aggregate demand.

Need to know

First, what you should know immediately.

- The policy rate will remain on hold at 4.25% to 4.50%.
- The only alteration of the FOMC statement will probably be the date at the top.
- In the Summary of Economic Projections, FOMC participants will nudge their forecast of real GDP growth lower and admit more material risk to inflation in 2025. The median dot may align with only one quarter-point cut this year, and the downward path thereafter may be slightly flatter than in the March round.

In truth, this is a meeting they would probably rather not have. We expect neither drama nor market consequences from them proceeding despite their better instincts. The Fed has essentially hunkered down and is awaiting a decisive move on tariff policy from the Trump Administration.

What may seem especially puzzling is that the Fed usually prides itself on being forward looking. The institutional trope is that, because monetary policy influences the economy with a lag, policy setting must be preemptive. For instance, compare Alan Greenspan's firming in response to incipient inflation pressures in 1994 to Fed Chair Jerome Powell's passive response to the Pandemic shock in 2022. But this time seems different.

About Policy Coordination

The best description of the Fed's response to policy set by political actors in Washington, DC, comes from the circus (whether it's the stance on the federal budget, regulation or trade policy). A trapeze artist is well advised not to swing out from the platform until confident that the other performer is in motion. Otherwise, there is a risk of being left alone in midair. From Election Day to Liberation Day to now, the White House has been on and off again about the size and scope of tariffs. The court has interceded, more judgments are pending and some in Congress have been restive about the exercise of its Constitutional authority on trade that it has delegated to the Executive branch. The Fed cannot act in advance of policy changes that it cannot be sure if, how and when the policy changes will be put into place. Instead, it waits, unhurried, for the actual application of tariffs on a sustained basis. Given the traffic on social media, Fed officials also probably fear that early action would appear politically motivated.

A reactive Fed planning on limited policy accommodation raises the odds that a bad outcome on trade becomes worse, adding to recession risks. The Fed may be forced into motion sooner by financial markets, either by an even sharper decline in capital values that tightens financial conditions significantly or a disruption in functioning that brings the Fed's responsibility for financial stability into play.

A slow response to market jitters and faltering economic indicators will likely draw the ire of the White House during the process of finding Chair Powell's replacement as his term draws to a close. The latest development was the meeting of Fed Chair Powell and President Trump on May 29. One got the impression that neither wanted to be there, but they both felt a need to keep up appearances.

At his most recent press conference, Chair Powell was asked whether he had met with the president. He answered no and explained that the process was nonpartisan across occupants of the White House: He would go if asked but would never ask.

We believe both sides will keep on as before. The president will likely complain about the Fed to deflect attention on the economy, and Powell will likely respectfully ignore the complaints and proceed unhurriedly. Both are also aware of the calendar. President Trump can reset the Fed table starting next year, and Chair Powell most likely increasingly considers his legacy. As for the former, the less we hear from the White House, the more likely it is they have already decided on the replacement.

About Trade and Monetary Policy

The imposition of a tariff likely imposes a supply shock driving inflation away from the goal of price stability and aggregate demand away from the goal of maximum employment. But that may not be a good guide for the risks that the Fed faces in current circumstances.

That's a statement about aggregating the outcomes in myriad individual goods markets. In any one of them, imposing a tariff raises the price of the import, depending on the market power of consumers.[2] When consumers have none, as in a small, open economy, the duty passes through completely. Consumers ration back demand at the cost of some welfare lost from not buying as many goods as cheaply. The government garners revenue, the tariff rate applied to the new, lower level of imports.

Herein lies economists' hostility toward trade interventions. In a small, open economy, a tariff makes everyone worse off because domestic residents pay it entirely and their welfare is set back by the price-induced reduction in demand.

In a larger economy that has some market power, foreign sellers absorb some of the tariffs in their profit margins (essentially paying part of the duty burden for their customers). Import prices go up less than with full passthrough (a business changing its output price to reflect a change in its input price), so domestic buyers cut back demand less. There is less welfare loss, and some, all or more of that could be offset by remitting the foreign tariff proceeds to domestic residents.

When the passthrough is incomplete, imposition of a tariff may raise welfare. Indeed, the academic trade literature is full of research on the "optimal tariff" that is only assuredly zero only for an economy with no market power.

Here's the logical conundrum. Fed officials are uncertain about the extent to which tariffs will be reflected in import prices, as reflected in this discussion in their latest minutes: "Participants noted that the recent imposition of tariffs on a range of imported goods had introduced additional uncertainty into the inflation outlook. Several participants remarked that the extent and timing of the passthrough of these tariffs to import and consumer prices remained unclear, with some emphasizing that firms' pricing power and supply chain adjustments could influence the degree of passthrough."[3] They should correspondingly be uncertain whether consumers are hurt by, indifferent to, or helped by tariffs. After all, if consumer surplus goes up because foreign suppliers are paying a considerable portion of the duty, why would aggregate demand go down as the result of a tariff? Theory suggests that there's a sliding empirical scale in which the correlation of the effects of a tariff on inflation and aggregate demand goes from negative to positive as the passthrough goes from one to zero.

This is exclusively about the direct effects of a tariff on aggregate demand, which is central to the assertion that it is a supply shock. We have many other reservations about trade policy. The White House's execution of trade policy has elevated uncertainty to the detriment of investment. Foreign competitors are sure to retaliate, restricting US exports officially through tariffs and unofficially by darkening their view of the US as a partner. Supply chains will become more expensive as they are rerouted to minimize taxes as well as maximizing productive efficiency.[4] And the private sector will waste resources lobbying the government for protection on trade.

Our immediate concern is about the Fed's near-term outlook, which leads to our empirical strategy.

1. Calibrate a simple model of import demand that fixes both the price elasticity of demand and the passthrough of tariffs to import prices to the Census Department's data for 2024 on bilateral trade by end-use categories (as explained in the appendix).

2. Make some sense of the Administration's pronouncements about trade to build an approximate tariff schedule. Tariffs are applied differentially to our main competitor (China), seven others with large bilateral deficits and the remaining 45 regions. There is also a "Venezuela stack," or a surcharge added to countries with high imports from that country. At the goods level, additional duties are added on some categories (such as aluminum, steel and autos) and some categories are exempt (such as oil). This is approximate, as of June 1, and could easily be put out of date with a few social-media postings, but we're reassured that the Congressional Budget Office arrived at the same place in its recent effort.[5]

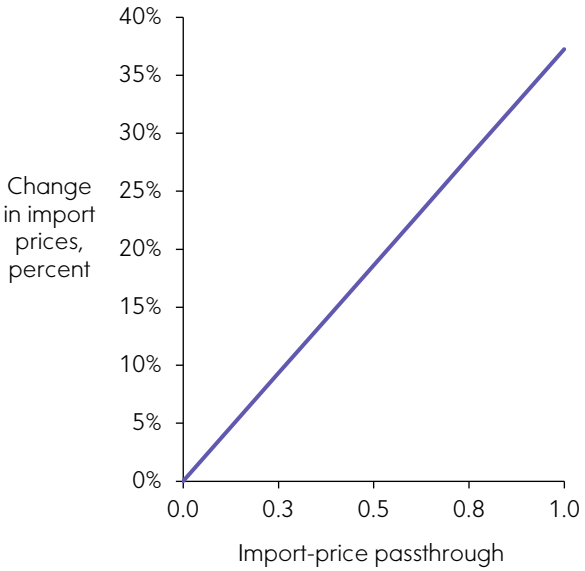
3. Use the calibrated model to generate the effects of tariffs given estimates for specific parameter assumptions on trade volumes, the loss in consumer surplus from demand restriction and the net after tariff proceeds are remitted to residents.[6]

4. Calculate the effect on import prices in individual bilateral markets and aggregate.

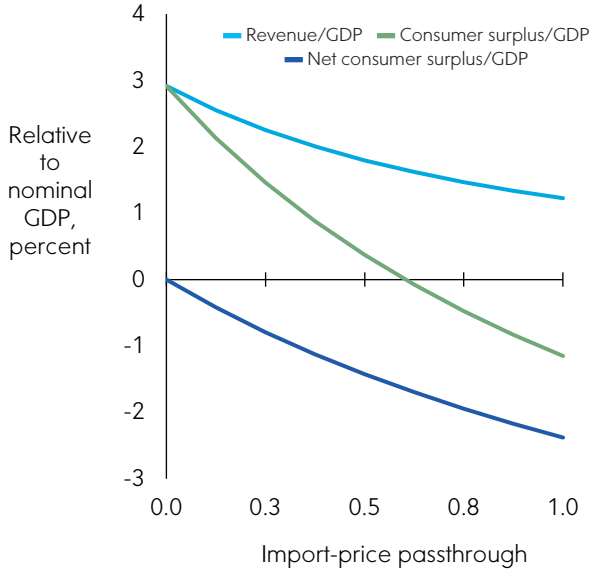
The last point doesn't depend on behavioral assumptions and demonstrates the wedge between economic incidence and measurement. The Bureau of Labor Statistics weights import prices by volumes two years earlier. This implies the demand-constraining effects of the tariff (which determines the effect on total import costs) do not enter the published figures. The more sensitive import demand is to price, the more published data will overstate the actual rise.

First, we report some aggregate results to capture these various concepts, as in the chart below.

Prices, Revenue and Welfare as the Import-Price Passthrough Varies
Change in Import Prices, percent



Revenue and Consumer Surplus
Relative to nominal GDP, percent



Source: Initial conditions match bilateral trade for 53 economies at the six-digit end-use categories from the Census data in "US International Trade in Goods and Services" (FT900) for 2024, including an aggregate of the European Union and the Rest of the World. Thus, it covers all US trade in goods. Tariff rates are assigned by country (general) and certain goods (specific) by our reading of the policy of the Administration as of June 1. This tariff schedule is consistent with that used by the Congressional Budget Office in its recent assessment of trade policy. The price elasticity of import demand is assumed to be -2.5. That, and the various passthrough coefficient, are used to make predictions from the trade model in the text and box for the prices and volumes of trade, government tariff revenue and the consumer surplus of the purchasers of imports, reported relative to the nominal GDP in 2024 from the Bureau of Economic Analysis. Firm analysis, June 8, 2025.

The left panel plots observed increases in import prices (along the vertical axis) as the import price passthrough increases along the horizontal axis. Obviously, the less foreign providers absorb the tariff (the higher is the passthrough), the more import prices go up. Given the high tariff rates applied to many economies and the stacking on top of specific duties, the impetus to inflation can be large. (Not considered here, import-price increases pass through to consumer prices by about one-fifth.)

The teal line in the right panel shows that revenue falls as the import base contracts because of an increased price response. The White House's dream of imposing the tax entirely on foreigners (the far left of the chart) is associated with tariff revenue amounting to 3% of nominal GDP. As the tax burden is levied more on residents moving to the right, that share falls to about 1.25% of GDP.

The dark blue line shows that residents are increasingly worse off as they ration demand in response to higher prices. The green line gives the net effect, which assumes revenue (both paid abroad and at home) is remitted to residents to lessen the demand-restricting incidence of the tariff. If the passthrough is less than about 0.6, a tariff improves social welfare because foreigners pay at least four-tenths of the levy and demand falls less. Our presumption is that an improvement in social welfare because foreigners are shouldering more of the tax burden increases aggregate demand. That is, when the passthrough is below 0.6, the Fed faces an excess demand shock when tariffs rise—one that raises inflation and employment. Above a passthrough of 0.6, tariffs pose a supply shock that raises inflation and lowers employment.

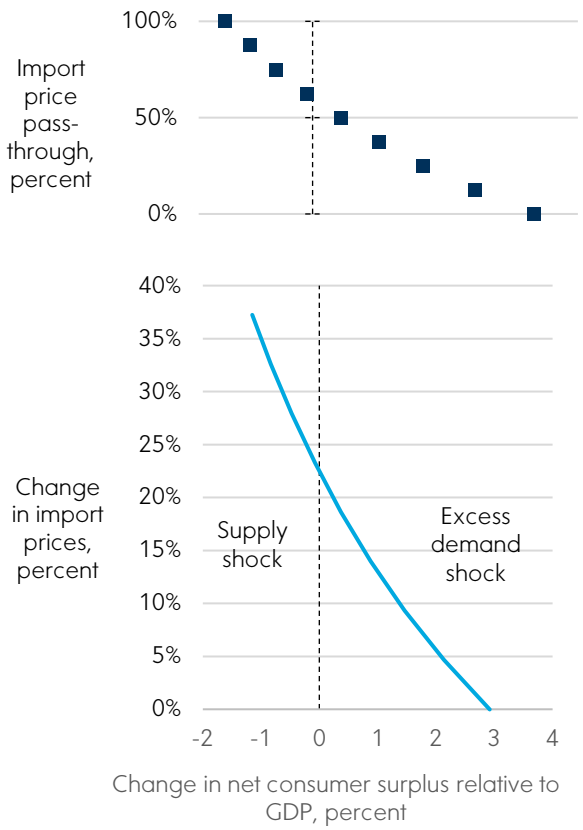
This is summed up at the right, with the lower part of the chart pairing the responses of import prices and net consumer surplus as the passthrough varies in the upper portion of the chart. This illustrates that the correlation of risks flips sign depending on the passthrough. If the passthrough is high, then Fed officials need, as they seem currently preoccupied with, to be concerned about weaker demand as they consider a policy to fight higher inflation. If the passthrough is low; however, aggregate demand has its own support from tariff revenue from abroad.

Signing these effects is one matter, but is the reversal of correlation empirically plausible? We think, "yes," because no one can be certain about the behavioral response as the Administration moves policy well outside the range of experience. To consider this, we took our calibrated model for a test drive in a Monte Carlo simulation, which estimates the probability of various outcomes by accounting for the presence of random variables. We generated 500 sets of observations on:

- The passthrough of general tariffs (at the country level) and specific ones (for those goods subject to an additional stacked tariff). Those draws were from a uniform distribution from 0.5 to 1.0 for the tariffed countries and 0.25 to 1.0 for the goods subject to an extra tariff. The two were assumed to be correlated, and the wider range for the latter was posited because they apply mostly to the output of large firms where there are more opportunities for persuasion from the Chief Executive.

Import Price Inflation and the Change in Net Consumer Surplus as the Passthrough to Import Prices Varies

Change and relative to nominal GDP, percent



Source: Change in net consumer surplus and import prices as the import-price passthrough varies in the calibrated trade model explained in the text and previous chart. Firm analysis, June 8, 2025.

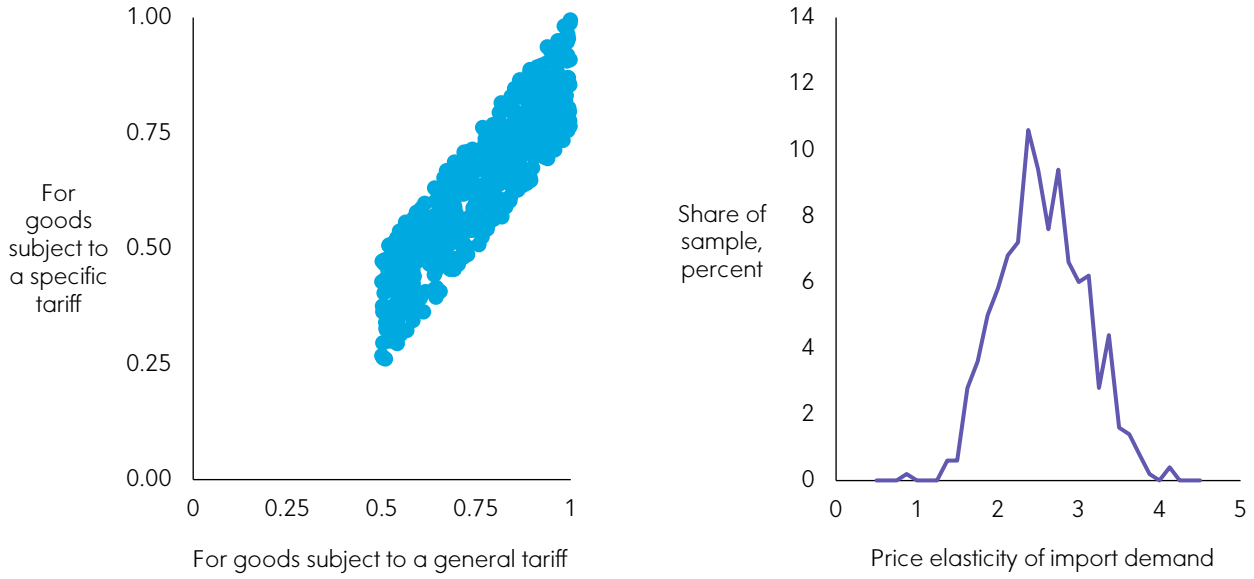
- The price elasticity of demand was drawn from a normal distribution centered on 2.5, our reading of the central tendency of the academic literature, with a standard deviation of 0.5, because we just can't be sure.

The two upper panels in the simulation summarize the draws for these behavioral parameters. Of note on the passthrough, we lean more toward the empirical literature than the Administration's aspiration. The lower panels give the distributions of model's predictions for revenue and welfare given these behavioral parameters. Most of the variation, especially the range around the central tendencies, owes to the variation in the passthrough. The lower right panel gives the randomization of our policy bottom line, which is notable for the number of observations on both sides of zero for net consumer welfare. The Fed should be prepared as much to lean into its inflation fight, because tariffs may not be the adverse hit to aggregate demand that it fears.

A Monte-Carlo Simulation of US Goods Trade

Randomized Inputs:

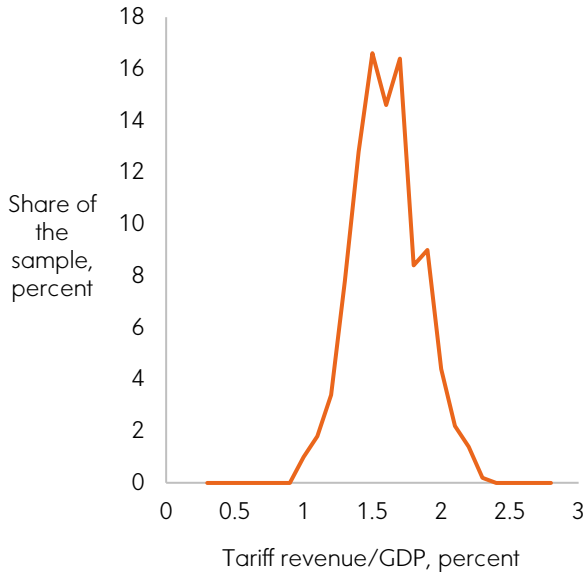
The passthrough of tariffs to goods under a general and specific tariff and the price-elasticity of demand



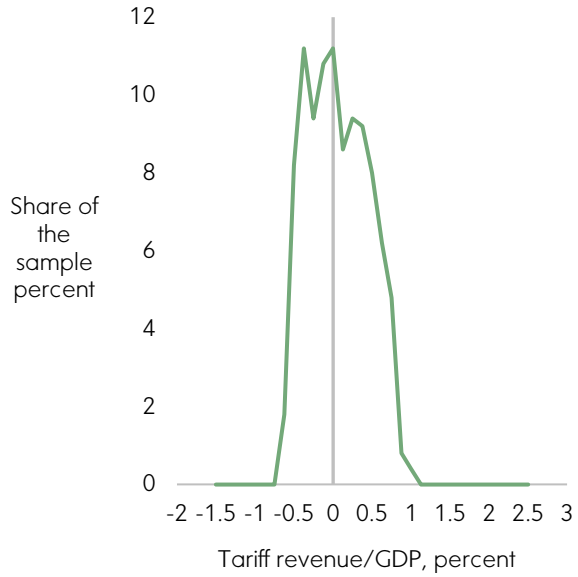
Source: Monte Carlo simulation drawing 500 random values for the passthrough of tariffs to the prices of goods subject to a general and specific tariff and the price-elasticity of demand. Initial conditions match bilateral trade for 53 economies at the six-digit end-use categories from the Census data in "US International Trade in Goods and Services" (FT900) for 2024, including an aggregate for the European Union and the Rest of the World by our reading of the policy of the Administration as of June 1. This tariff schedule is consistent with that used by the Congressional Budget Office in its recent assessment of trade policy. The randomized parameters are used to make predictions from the trade model in the text and box for the prices and volumes of trade, government tariff revenue and the consumer surplus of the purchasers of imports, reported relative to nominal GDP in 2024 from the Bureau of Economic Analysis. Firm analysis, June 8, 2025.

Model Outputs:

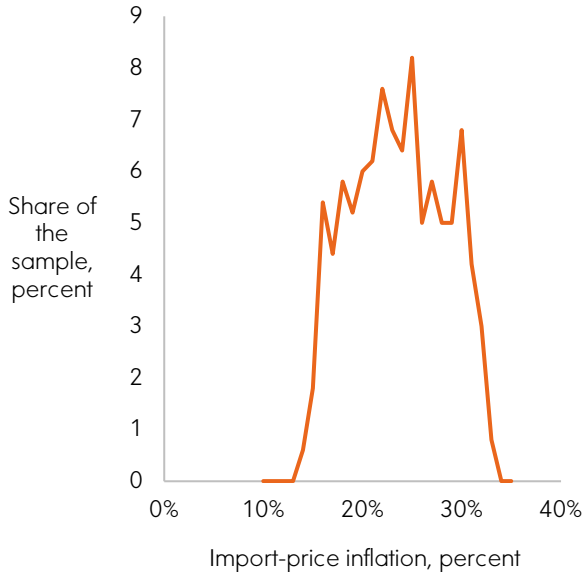
Tariff Revenue Relative to Nominal GDP
Rate and share of sample, percent



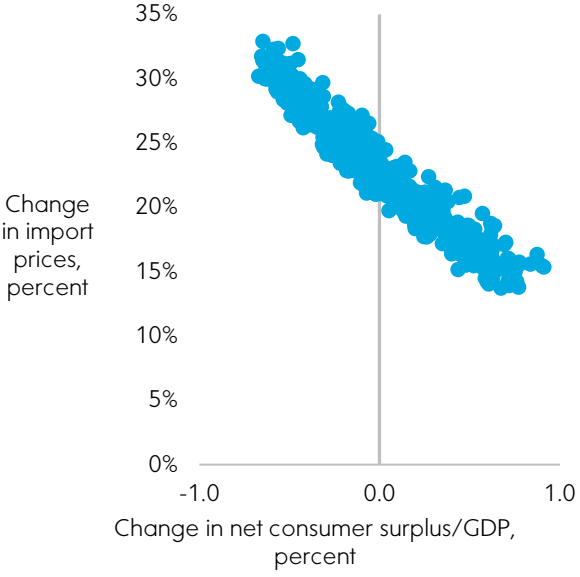
Change in Net Consumer Surplus Relative to Nominal GDP
Rate and share of sample, percent



Import Price Inflation
Rate and share of sample, percent



Import Price Inflation and Net Change in Consumer Surplus
Randomized outcomes



Source: Monte Carlo simulation drawing 500 random values for the passthrough of tariffs to the prices of goods subject to a general and specific tariff and the price-elasticity of demand. Initial conditions match bilateral trade for 53 economies at the six-digit end-use categories from the Census data in "US International Trade in Goods and Services" (FT900) for 2024, including an aggregate for the European Union and the Rest of the World by our reading of the policy of the Administration as of June 1. This tariff schedule is consistent with that used by the Congressional Budget Office in its recent assessment of trade policy. The randomized parameters are used to make predictions from the trade model in the text and box for the prices and volumes of trade, government tariff revenue and the consumer surplus of the purchasers of imports, reported relative to nominal GDP in 2024 from the Bureau of Economic Analysis. Firm analysis, June 8, 2025.

In Closing

We do not believe that tariffs will spark the engine of longer-term economic growth. In fact, we think that trade policy adds grit to the growth machinery as private-sector effort shifts to evading taxes and enshrining protection over time. Moreover, we fear that the Administration's delivery of that policy creates uncertainty, corroding planning and restricting aggregate demand. However, at the same time, we worry that tariffs by themselves may be less of an impediment to near-term aggregate demand than initially feared. On net, we've trimmed back some of the slowing in real GDP growth in our forecast in the near term and now expect only one quarter-point cut from the Fed this year.

Appendix: A Calibrated Model of US Trade

The model is designed to analyze the impact of tariffs on import volume, tariff revenue, consumer surplus and net consumer surplus, with a specification chosen that makes it easy to fit the data and get tractable answers to key questions. In this appendix, we describe the model and derive reduced-form equations for key outcomes.

We chose a specification of import demand function featuring a constant price elasticity and scalar in all other influences demand. The import demand function is given by:

$$M = A(1 + mt)^{-\varepsilon}$$

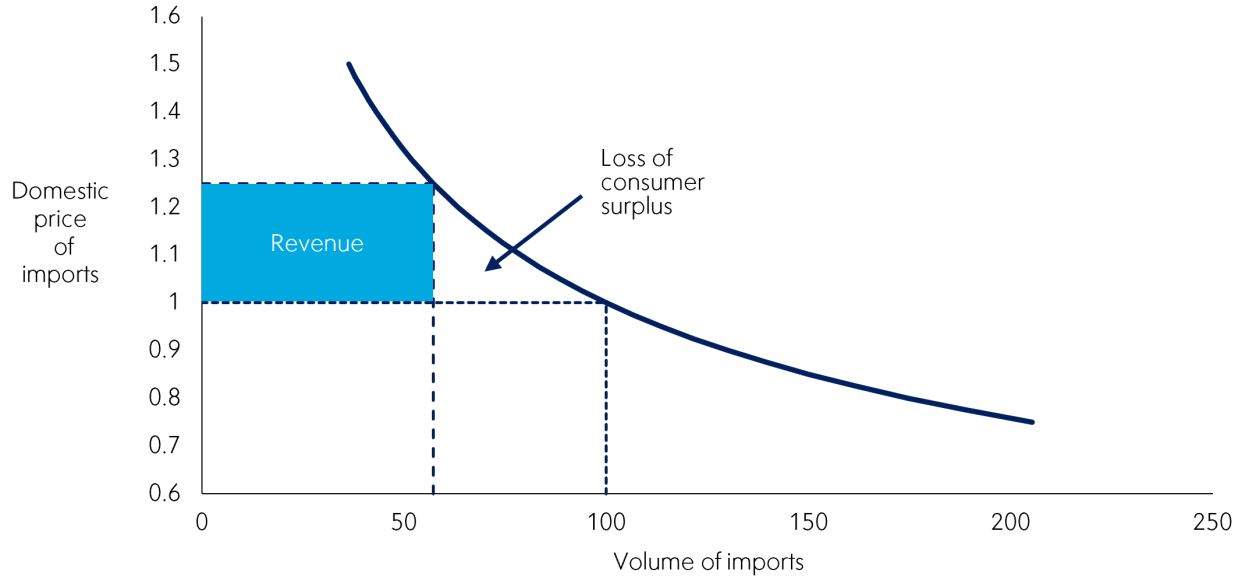
Where:
- M is the import volume;
- A is the scale factor;
- m is the passthrough rate;
- t is the tariff rate;
- the initial price level is set equal to 1; and
- ε is the price elasticity of import demand

This form has the advantage of being easy to take to the data. If the initial price is set to 1, then the scalar, A, equals pre-tariff trade volumes.

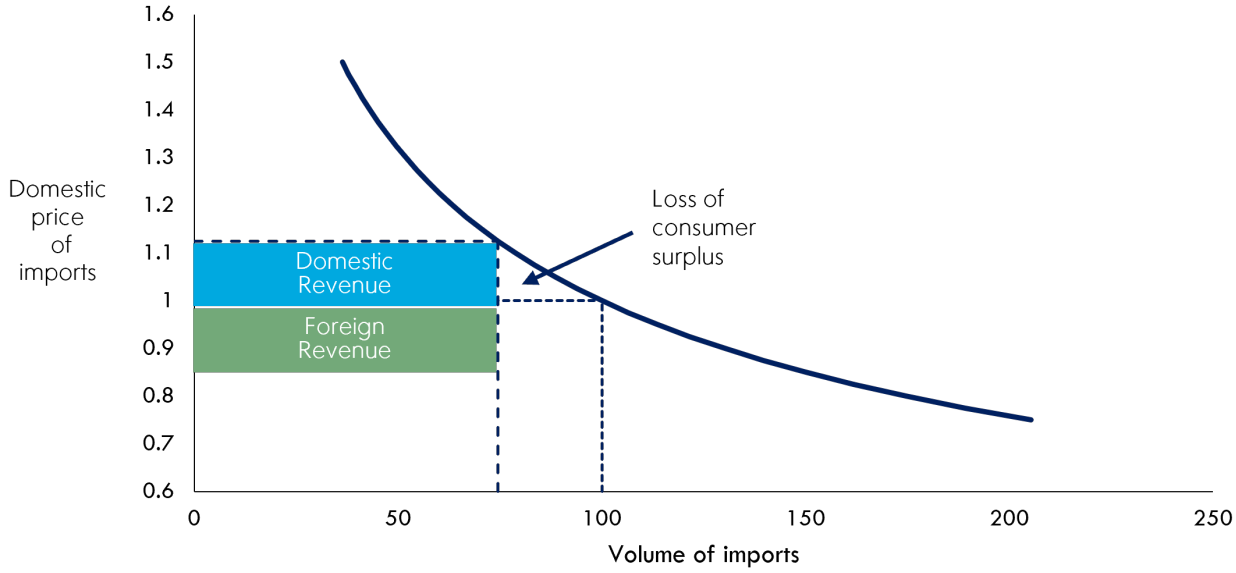
The two figures below show the moving parts of the model, drawn on the assumption that the price elasticity of import demand is -2.5.

Import Demand With the Imposition of a 25% Tariff

When the passthrough to import prices is 100 percent



When the passthrough to import prices is 50 percent



Source: Evaluation of the import demand model when the initial volume of imports equals 100, the price equals 1, and the price-elasticity of demand equals -2.5. Firm analysis. June 7, 2025.

Both consider the imposition of a tariff of 25%, with the left showing complete passthrough and the bottom one a passthrough of 50%. When an economy has no market power as the chart on top, residents pay the duty, the blue rectangle, and restrict demand as the price of the imported good moves up the full 25% of the tariff. The result is an unambiguous loss of consumer surplus, even though the tariff proceeds are remitted to purchasers. At the bottom, the price of the imported good moves up by half the tariff, as half the duty is paid by the foreign supplier. That reimbursed income (the green rectangle) more than offsets the loss in consumer surplus (the triangle under the demand curve). As in the text, given the assumed price elasticity of demand, a passthrough less than 0.6 implies that net consumer surplus rises with a tariff.

More generally, **Tariff Revenue** is the tariff rate times import volume accounting for the passthrough to prices:

$$TR = t\ A(1+mt)^{-\varepsilon}$$

Given this, the revenue-maximizing tariff is:

$$t^* = 1/m(\varepsilon-1)$$

The **Change in Consumer Surplus (ΔCS)** is the area under the demand curve lost as demand is restricted to the new, higher price:

$$\Delta CS = -A/\varepsilon-1\ [1-(1+mt)^{1-\varepsilon}]$$

Correspondingly, the **Change in Net Consumer Surplus (ΔNCS)** reflects the loss surplus from demand restriction offset by the reimbursement of tariff revenue, ΔNCS = ΔCS + TR, or:

$$\Delta NCS = -A/\varepsilon-1\ [1-(1+mt)^{1-\varepsilon}] + t\ A(1+mt)^{-\varepsilon}$$

We applied the model to trade volumes in 2024 across the Census Department's bilateral goods trade data by end-use category (US International Trade in Goods and Services (FT900)). Goods were grouped according to those subject to the country tariff, those subject to an additional tariff and those that are exempt. The country data was summed into 53 groups, mostly by nation, but also including the European Union and the Rest of the World. Coverage matched US total goods trade across the 159 goods/regions cells. The main text then calculates the concepts above for various assumptions about the behavioral parameters.

Vincent Reinhart

Chief Economist & Macro Strategist

Vincent is the firm's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also spent 24 years at the Federal Reserve, holding several roles including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

Endnotes

[1] Congressional Budget Office, "Budgetary and Economic Effects of Increases in Tariffs Implemented Between January 6 and May 13, 2025", June 4, 2025.

[2] A more formal analysis is in the appendix, which starts from one market and aggregates up to many and applies the results to the US data.

[3] Federal Open Market Committee. "Minutes of the Federal Open Market Committee," May 6-7, 2025

[4] Tariff incidence is not just about the rates that the Administration impose. The US tariff code fills a volume as thick as an unabridged dictionary, potentially implying slippage between posted and paid rates. Compliance to the code in terms of the duties paid follows a trust-but-verify scheme through spot checking by customs officials. Exporters may attempt to re-export through low-tariff jurisdictions, and multinationals might adjust transfer pricing along their supply chains to minimize the net duty paid.

[5] "Budgetary and Economic Effects of Increases in Tariffs Implemented Between January 6 and May 14, 2025. The Congressional Budget Office, June 4, 2025.

[6] Remitting revenue to households is the standard assumption in trade theory. It's possible that there are aggregate consequences of differing distributions (such as spreading the revenues generally or applying them to reduce the deficit). We think it is defensible to assume households are similar and see through such processes.

Disclosure

PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

All investments involve risk, including the possible loss of principal. Certain investments have specific or unique risks. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.

This material has been provided for informational purposes only and should not be construed as investment advice or a recommendation of any particular investment product, strategy, investment manager or account arrangement, and should not serve as a primary basis for investment decisions. Prospective investors should consult a legal, tax or financial professional in order to determine whether any investment product, strategy or service is appropriate for their particular circumstances. This document may not be used for the purpose of an offer or solicitation in any jurisdiction or in any circumstances in which such offer or solicitation is unlawful or not authorized. Views expressed are those of the author stated and do not reflect views of other managers or the firm overall. Views are current as of the date of this publication and subject to change. This information may contain projections or other forward-looking statements regarding future events, targets or expectations, and is only current as of the date indicated. There is no assurance that such events or expectations will be achieved, and actual results may be significantly different from that shown here. The information is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. References to specific securities, asset classes and financial markets are for illustrative purposes only and are not intended to be, and should not be, interpreted as recommendations. Charts are provided for illustrative purposes and are not indicative of the past or future performance of any BNY product. Some information contained herein has been obtained from third party sources that are believed to be reliable, but the information has not been independently verified. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission.

Indices referred to herein are used for comparative and informational purposes only and have been selected because they are generally considered to be representative of certain markets. Comparisons to indices as benchmarks have limitations because indices have volatility and other material characteristics that may differ from the portfolio, investment or hedge to which they are compared. The providers of the indices referred to herein are not affiliated with Mellon Investments Corporation (MIC), do not endorse, sponsor, sell or promote the investment strategies or products mentioned herein and they make no representation regarding the advisability of investing in the products and strategies described herein. Investors cannot invest directly in an index.

BNY Investments is one of the world's leading investment management organizations, encompassing BNY's affiliated investment management firms and global distribution companies. BNY is the corporate brand of The Bank of New York Mellon Corporation and may be used to reference the corporation as a whole and/or its various subsidiaries generally.

Mellon Investments Corporation (MIC) is a registered investment adviser and subsidiary of The Bank of New York Mellon Corporation. MIC is composed of two divisions; Mellon, which specializes in index management, and Dreyfus, which specializes in cash management and short duration strategies. Securities are offered through BNY Mellon Securities Corporation (BNYSC), a registered broker-dealer and affiliate of MIC.

Personnel of certain of our BNY affiliates may act as: (i) registered representatives of BNY Mellon Securities Corporation (in its capacity as a registered broker-dealer) to offer securities and certain bank-maintained collective investment funds, (ii) officers of The Bank of New York Mellon (a New York chartered bank) to offer bank-maintained collective investment funds, and (iii) Associated Persons of BNY Mellon Securities Corporation (in its capacity as a registered investment adviser) to offer separately managed accounts managed by BNY firms.

For more market perspectives and insights from our teams, please visit www.mellon.com.

MICA-752950-2025-06-10

BNY | INVESTMENTS

MELLON

www.mellon.com