iPartners
inFocus with Michael Blythe August 25

Tariffs, Policy & the Consumer

- US trade policy is the central economic focus and key driver of uncertainty.
- The consensus is that the impact of higher tariffs on the Australian economy will be limited.
- Key drivers are a relative tariff advantage, China trade diversion and stimulus, and the flexible AUD.
- Australia has scope to ease policy settings – but there are signs that policy stimulus is losing traction.
- A positive productivity outcome from the upcoming Economic Reform Roundtable is essential.

Policy makers, forecasters, economists and pretty much everyone else have much to worry about.

We can categorise these worries in the framework popularised by former US Defence Secretary, Donald Rumsfeld. He argued that there are:

- Known knowns - the things we know we know.
- Known unknowns - we know there are some things we do not know.
- Unknown unknowns – the things we don't know we don't know.

Policy makers and forecasters are skilled at incorporating the first two points into their proposals and projections. But they struggle with the third.

The struggle follows from such events being sudden, potentially devastating, shocks that could not have been predicted. Although, after the fact, people often claim that the event was obvious.

A "known known" is global monetary policy. Policy interest rates have been cut pretty much everywhere. And there are more cuts to come.

A "known unknown" is geopolitics. Russia-Ukraine conflict. Middle East conflict. US-China rivalry. Climate change and food security. Take your pick.

Strictly speaking, "unknown unknows" are just that – unknown. But I think we can put tariffs and trade wars under that banner. We know that increases in US tariffs are unavoidable. But changes to tariff proposals are an almost daily event and we don't know where rates will settle. Nor do we know where any tariff retaliation will lead.

Chart 1

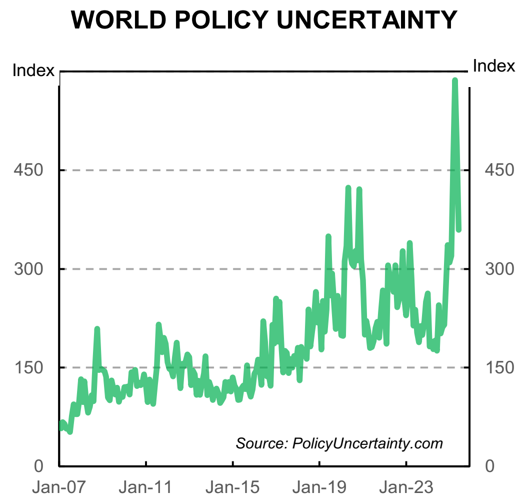
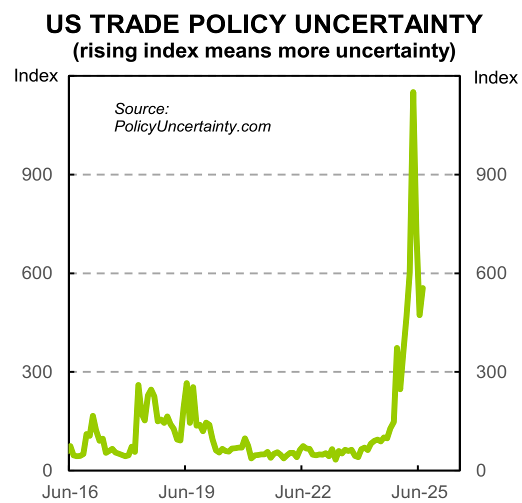


Chart 2



The evidence is there in elevated levels of global policy uncertainty (Chart 1). And the enormous spike in trade policy uncertainty (Chart 2).

Tariffs and unknown unknowns

Tariffs were part of the first Trump Presidency policy package in 2016-20. And they were always going to be part of the second Trump Presidency. The President famously proclaimed: “the most beautiful word in the dictionary is tariff”.

That said, the tariff package announced on 2 April 2025, or Liberation Day, shocked pretty much everyone. Not only was there a 10% *baseline tariff* imposed on all imports. But *reciprocal tariffs* were added for most countries based on their trading position with the US. Australia escaped with a 0% reciprocal tariff. Other countries were hit with tariff rates up to 50%.

Global financial markets tanked. “Uncertain” became the most used word in the forecaster’s toolbox.

The coverage was comprehensive, to say the least. The Heard & McDonald Islands, an Australian external territory populated by birds, seals and penguins, was included in the 10% baseline tariff regime!

There are also a range of other tariffs based on products rather than country. These products include automobiles, steel, aluminium and copper.

Tariffs also became a tool to drive the Trump policy agenda. Additional tariffs were announced for countries seen as sources of illegal migrants and fentanyl. Other tariffs were designed to discourage oil purchases from “rogue” countries like Venezuela (and maybe countries that import oil from Russia to encourage peace negotiations with Ukraine). China at one point was looking at a tariff rate of 145% as the US muscled up.

Financial market volatility “encouraged” the US to place a 90-day pause on implementing the reciprocal tariffs on 9 April 2025. The period since then saw some countries negotiate trade deals with the US that typically resulted in lower tariff rates.

The pause ended on 31 July. New tariff rates were announced, taking effect from 1 August.

But the uncertainty is not over. A range of products may have tariffs applied. These include timber, semiconductors, pharmaceuticals and aircraft. President Trump has also floated the idea that he might change the baseline tariff to 15-20%.

Small wonder that measures of uncertainty remain at elevated levels.

Chart 3

EVOLUTION OF 2026 FORECASTS
(annual % change)

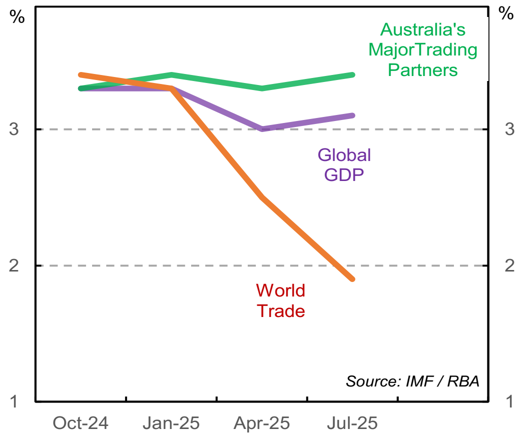


Chart 4

TRADE & POLICY UNCERTAINTY

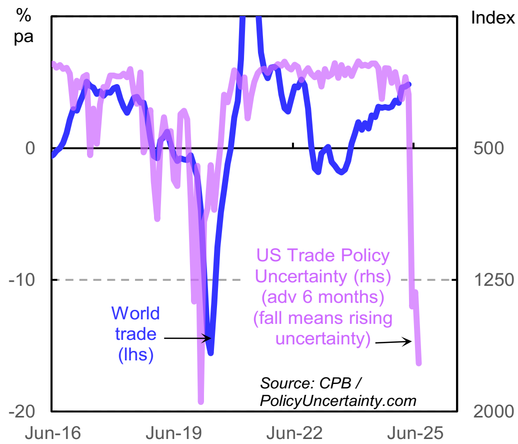
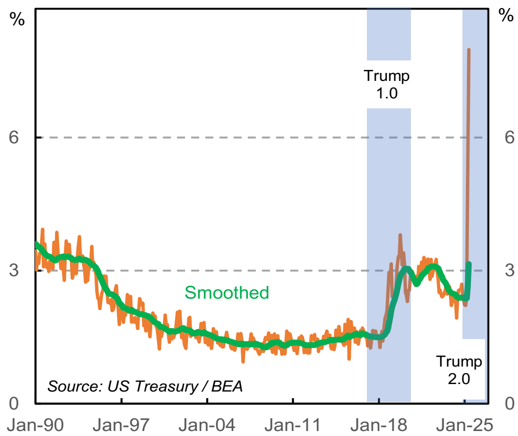


Chart 5

US TARIFF REVENUE
(% of total imports)



Tariffs: just the facts

Pull out an economic textbook and it will lay out how tariffs work and the negatives that follow:

i. Tariffs are a negative for global trade and global growth.

Tariffs, especially when imposed by large economies like the US, reduce the demand for imports as prices rise. Global trade slows as a result. Relative price shifts may encourage a move towards domestic production.

Supply chain interruption and lower productivity can weigh on the domestic economy. Higher prices mean the real purchasing power of households and business declines.

These considerations have seen organisations like the IMF lower their projections for global GDP growth and world trade (Chart 3).

ii. Tariffs increase uncertainty.

The everchanging tariff story has lifted many measures of uncertainty (Chart 4). The IMF have headlined their latest Word Economic Outlook as “Tenuous Resilience amid Persistent Uncertainty”. Uncertain households and businesses are likely to cut spending.

Uncertainty can lift risk premiums, with a flow on to borrowing costs. A negative for spending again.

iii. Tariffs generate government revenue.

Tariffs are a tax levied on imports. The tax flows into revenues.

The impact on US government revenues is already evident, with a sharp spike in tariff revenue as a share of imports (Chart 5).

iv. Consumers and businesses pay the tariff tax.

Tariffs are applied when the imports land on the docks and move to the warehouse. US importers, wholesalers and retailers may absorb some of the price impact. But much of the impact will flow through to the price on the shelves.

Further inflation impacts can flow through from supply chain disruptions and higher inflation expectations.

Estimates from PinPoint Macro, based on the top-20 US import sources and proposed tariff rates, put the cost for the average US consumer at US$1,613 per year (Chart 6).

v. Tariffs push up inflation rates.

A tariff-driven increase in the price *level* means a lift in the inflation *rate* (Chart 7).

Chart 6

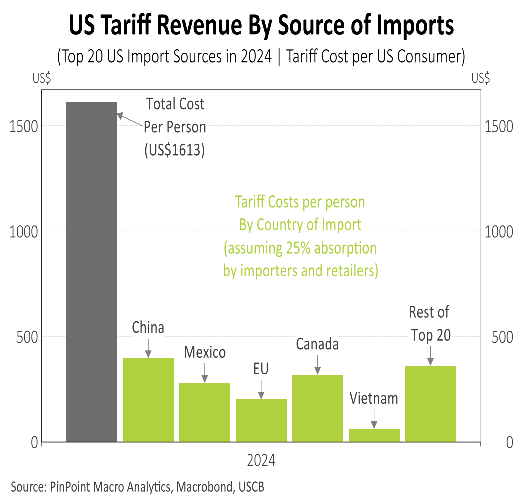


Chart 7

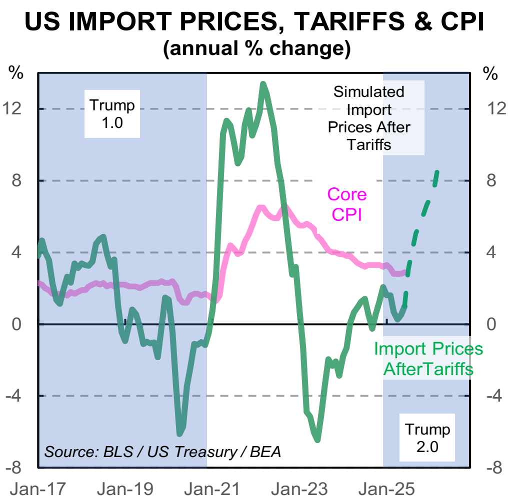
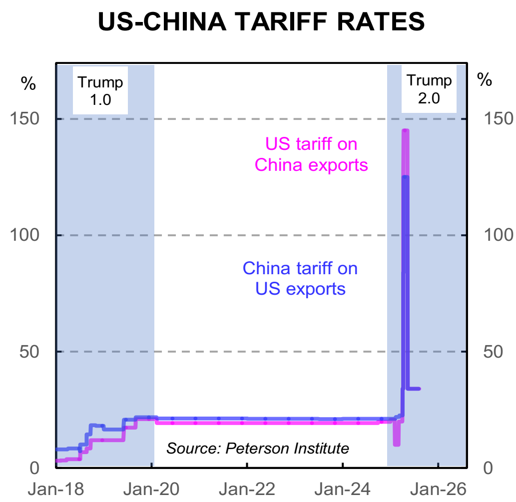


Chart 8



Tariffs & Australia

The consensus is that the impact of higher tariffs on the Australian economy will be limited. The main factors driving this conclusion are:

- The share of Australian exports going to the US is relatively small – at about 6% of the total.
- The US runs a trade *surplus* with Australia so most Australian exports to the US will be taxed at the baseline rate of 10%. Australian exporters have a relative tariff rate advantage over competitors.
- Growth in Australia's major trading partners is holding up (Chart 3).
- Australia is a low-cost producer of many resources and agricultural materials. This relative price advantage should help support demand.
- Slower global growth may put downward pressure on commodity prices. But the AUD should also move lower, supporting export receipts, business profits and government revenues in local currency terms. The Aussie has proved a very effective shock absorber for the Australian economy at times global and financial market stress.
- Slower global growth should also contribute to lower Australian import prices. A slower inflation rate means more scope for RBA policy stimulus than otherwise would be the case.

China is the more important part of the global story when assessing the implications of US tariffs for Australia. China is our biggest trading partner and ultimately determines how much we sell and the price we get for it.

The China – US tariff story remains unclear. US tariffs on Chinese imports have been all over the place in the past few months (Chart 8). At one stage the proposed rate was as high as 146%. China responded in a tit-for-tat fashion.

These obscenely high tariff rates on both sides were wound back. But negotiations on a trade framework continue. Some press reports suggest the final resting place could be a China tariff rate of 80%.

Nevertheless, there are some encouraging signs from an Australian perspective:

- China's exports to the US have weakened. But total exports are continuing to rise (Chart 9). In other words, China is successfully diverting its exports elsewhere. A similar trade diversion was evident during the US-China trade tensions during the first Trump Presidency.

Chart 9

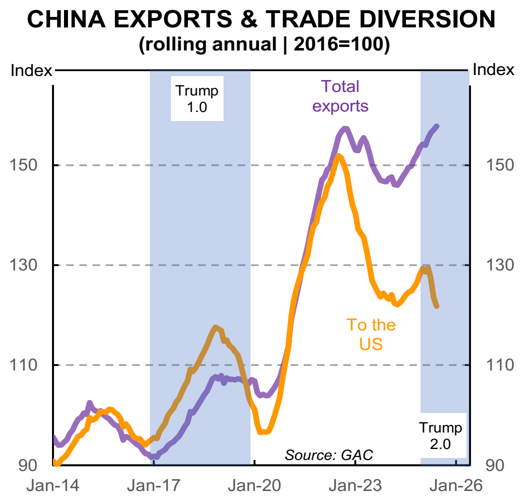


Chart 10

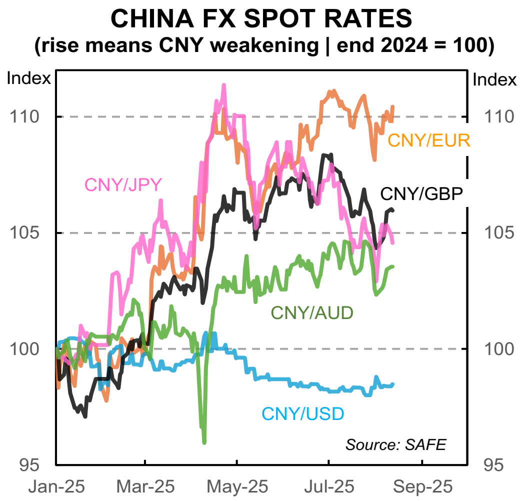
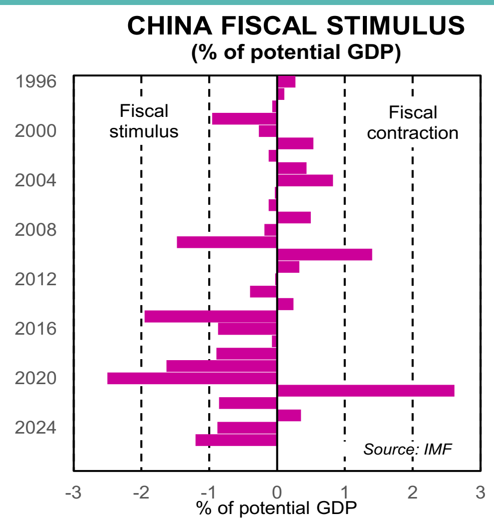


Chart 11



- The CNY has strengthened a little against the USD so far in 2025. But CNY has weakened against other major currencies Chart 10). This relative price shift is favourable for Chinese trade diversion.
- Chinese authorities are willing to ease fiscal policy further to support domestic growth in the face of higher tariffs (Chart 11). The PBoC has also eased monetary policy modestly. Chinese policy often favours infrastructure, a positive for commodity demand and prices.

There is sufficient uncertainty in the tariff plan that it pays to consider the downside story. The RBA has scoped out a scenario where the current situation deteriorates into a widespread and lengthy “trade war”. The scenario they’ve modelled isn’t pretty (Chart 12).

A tariff shock would hit hard and fast. Confidence collapses. Asset prices tumble. Business and consumer spending dries up. The global economy takes a bigger hit than it did during the GFC. Australia is not spared.

By the end of 2027:

- Global GDP is 3% below the current baseline; China’s down 4%.
- Australia’s GDP is 3% lower, with the unemployment rate pushing towards 6%.
- The inflation rate fades to around 2% as demand weakens and wages growth slows.

Do monetary & fiscal policies still work?

One comforting assumption about Australian economic prospects is that policy makers have scope to move. The RBA can cut rates further. And, while our fiscal position has deteriorated, we are much better placed to pull the fiscal levers than many other countries.

A worrying development, therefore, is some indications that the effectiveness of economic policy is reduced.

i. Monetary policy

The RBA finally joined the global push to lower interest rates in February 2025. The 25bpt cut to the cash rate at that time was the first reduction since late 2020. Two further 25bpt cuts have followed and the cash rate now stands at 3.6%.

A significant slowing in the inflation rate and a growing belief that CPI growth could run “sustainably” at around 2½% underpinned the cuts (Chart 13 - the green lines show the evolution of inflation forecasts, and the red line is the latest projections from August).

Chart 12

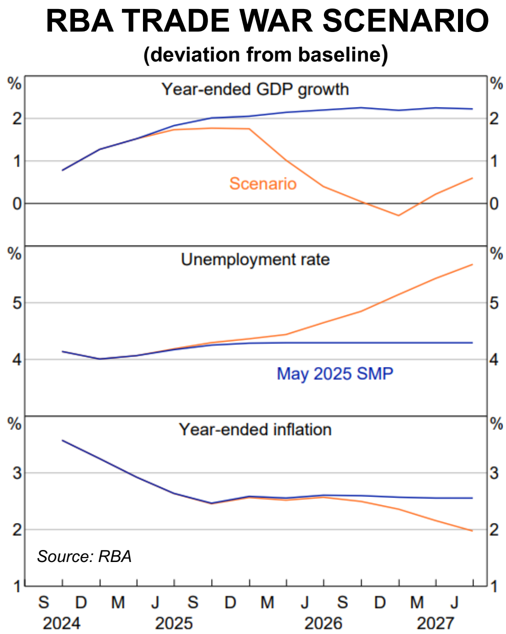


Chart 13

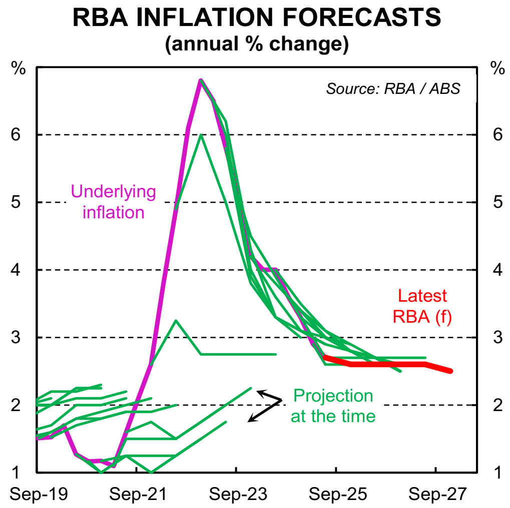


Chart 14

The delay and perceived slow pace of rate cuts resulted in some critical commentary on the RBA decision-making process. But the reality is that the shape of the current cycle is similar to other easing cycles (Chart 14).

And there were some good reasons for the RBA to lag the global easing cycle:

- The RBA was late to join the policy tightening cycle in 2022. So symmetry meant that the switch towards easing was always also going to lag.
- The RBA was less aggressive than other central banks. The cumulative increase in US interest rates exceeded the RBA's efforts by 100bpts. So there was little need to *cut* rates aggressively.
- The labour market remained unambiguously strong. A characteristic of the forecasting backdrop in recent years was the need for the RBA (and others) to *lower* their unemployment rate projections. So rapid policy stimulus was not required.

Where to from here for interest rates?

The one *certainty* in the outlook for interest rates is that the RBA is *uncertain*. A flick through recent RBA *Statements on Monetary Policy* shows a dramatic spike in the use of "uncertain" when discussing the economy (Chart 15).

The RBA will remain "data dependant" in uncertain times. They will respond as they see fit to inflation and labour market trajectories. This response may be appropriate. But it doesn't provide much in the way of guidance.

What we can say is that when the RBA starts the process, standard practice is to get policy rates back to a "neutral" setting. Interest rates are not exerting a positive or negative influence on the economy at that point.

Current RBA estimates of neutral lie in a 1-4% band. A band of that size is big enough to drive a truck through! The consensus among private economists puts the neutral rate at 3¼%.

Financial markets are much more certain. Current market pricing has the cash rate at 3.1% by Q1 2026 (Chart 16).

Neutral rate estimates and market pricing suggest we should expect another 50bpt of rate cuts by early 2026.

The RBA provides a very useful schematic on how these rate cuts should impact on the economy and inflation (Diagram 1).

The schematic does look a little like something only a central banker could love and understand. But it does give us a checklist of transmission channels we can monitor to assess the effectiveness of monetary policy.

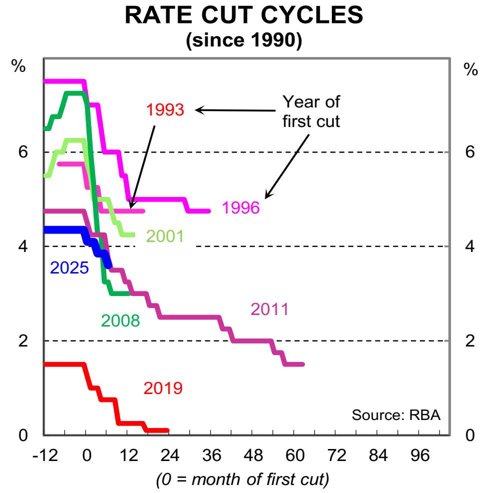


Chart 15

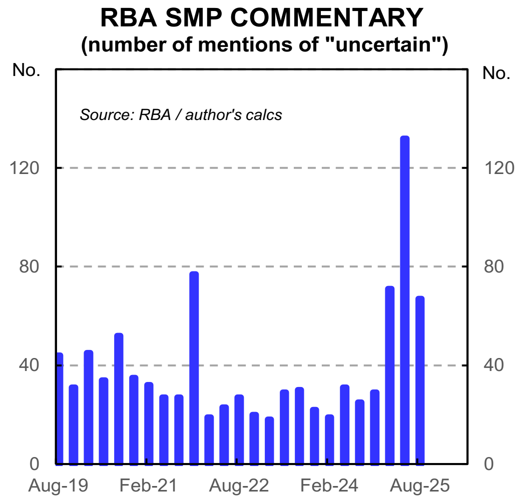


Chart 16

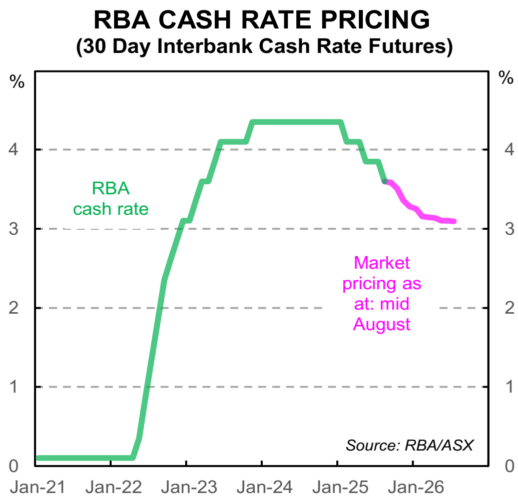
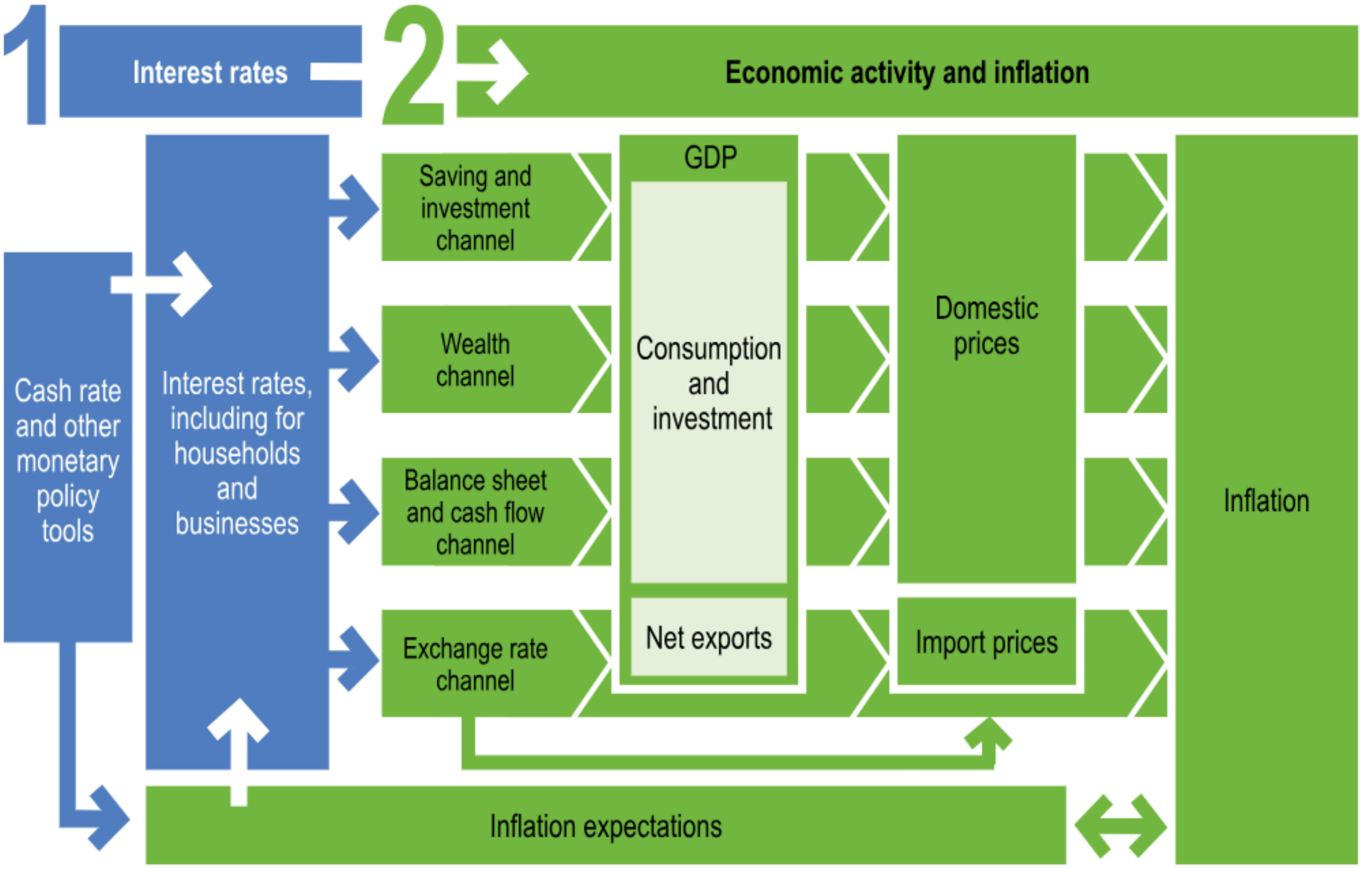


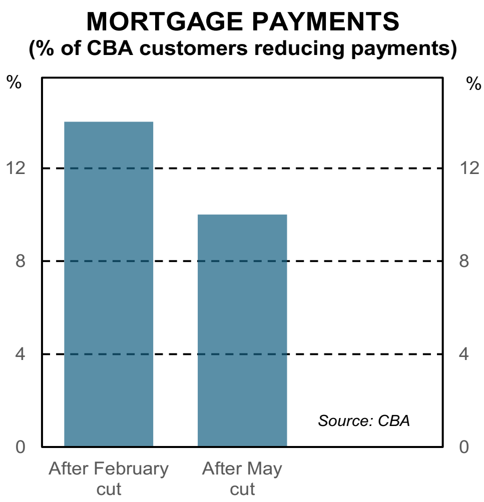
Diagram 1



The key channels identified by the RBA are:

- Cashflows. Rate cuts reduce interest repayments on debt, increasing the amount of cash available for households and businesses to spend on goods and services.
- Exchange Rates. Lower interest rates (relative to the rest of the world) should mean a lower exchange rate. Imports become more expensive compared with domestic goods and services. This relative price shift leads to an increase in exports and domestic activity.
- Saving & investment. Rate cuts should reduce savings incentives for households. And increase the incentive to borrow and invest by businesses. Household and business spending should rise.
- Wealth. Lower interest rates support asset prices (especially housing). An increase in asset prices lifts wealth. This lift can lead to higher consumption and housing investment as households spend some of that rise in wealth.

Chart 17



There are some concerning signs that these transmission channels are not working. Or delivering a negative outcome.

The Commonwealth Bank, for example, notes that only14% of eligible home loan customers reduced their home loan repayments following the February 2025 rate cut. And only 10% chose to reduce repayments after the May rate cut (Chart 17). The cashflow transmission channel appears to be providing meagre support at best.

The Aussie dollar has strengthened rather than weakened so far in 2025. The AUD/USD *fell* by an average of 6½% in the first six months of previous rate cut cycles (since 1990). This time, however, the AUD/USD has *appreciated* by around 5% (Chart 18). The exchange rate transmission channel is delivering a perverse result.

Households are *lifting* savings and businesses are reluctant to invest. Broad Money is essentially an indication of cash savings. The growth rate in Broad Money per person has *increased* since the RBA began cutting interest rates (Chart 19). At the same time, non-mining capex is *declining*. The savings & investment transmission channel is not delivering the expected result.

The historical experience over the past 30-plus years is that dwelling prices rise as the RBA cuts interest rates (Chart 20). The average increase during the first year of previous rate cut cycles is 6%. The current rate cut cycle appears to be on track. Dwelling prices have risen by 4% in the five months since the RBA first cut rates in February.

The consensus among the Big 4 banks is that dwelling prices will rise by 4% in 2025 and a further 5% in 2026.

Households' biggest asset is housing. So wealth should be increasing. The wealth transmission channel is operating as normal.

Chart 18

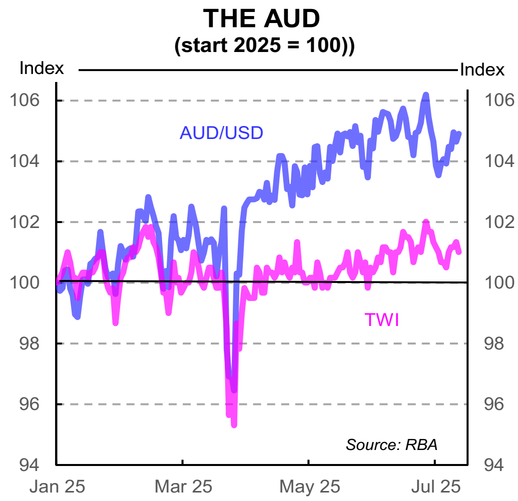


Chart 19

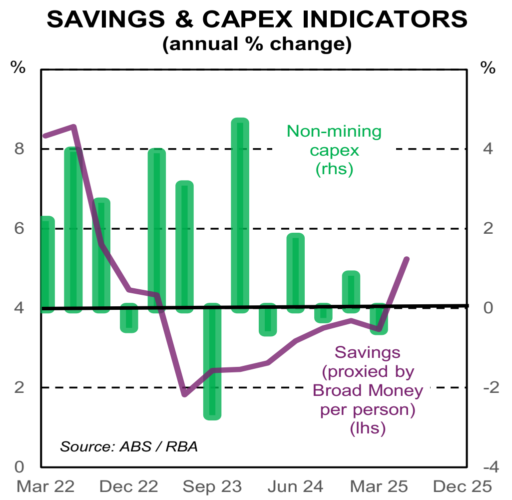


Chart 20

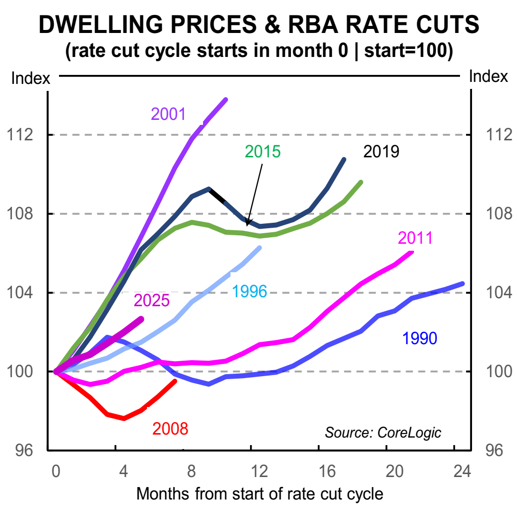
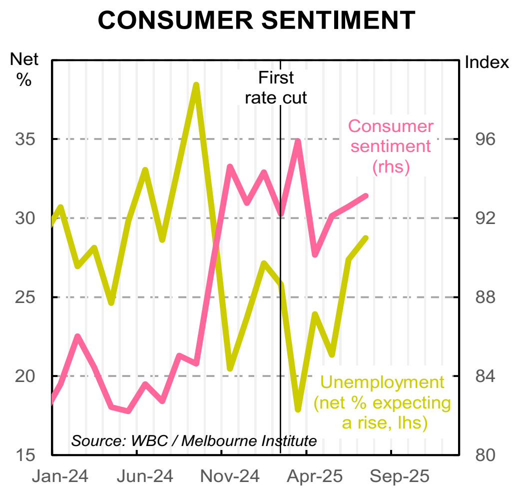


Chart 21



The transmission channels identified by the RBA influence household *ability* to spend. But the *appetite* to spend is also important. This appetite is proxied by measures of household sentiment:

- consumer confidence has not improved since the first RBA rate cut (Chart 21); and
- job security fears have lifted.

The RBA is not the only policy maker struggling to achieve the desired response. The fiscal authorities also face some challenges

ii. Fiscal policy

The Commonwealth government has thrown cash at households to ease the cost-of-living squeeze. Most of these measures, quite rightly, involve *temporary* relief. The Energy Bill Relief Fund is one example.

But there are some *permanent* measures as well. Tax cuts are the key example. The rejigged Stage 3 tax cuts are currently working through the system. The March 2025 Budget surprised by announcing two further rate cuts from 1 July 2026 and 1 July 2027.

The usual economist's rule is that tax cuts are spent three times: once when announced, once when received and then a third time to make sure! But, like interest rate cuts, households are not taking advantage of the tax cuts.

Westpac note that the marginal propensity to consume the income boost from Stage 3 tax cuts is very low. Their Consumer Panel shows households are spending only 16-25 cents of each $1 of tax cuts (Chart 22).

Yet another bank survey by NAB on consumer spending intentions suggests that households are also cutting spending to boost savings further (Chart 23). Non-essential spending is bearing the brunt of the cutbacks. Cuts include travel & holidays, eating out, entertainment, home improvements, major household items, personal goods, and charitable donations.

The flip side is that those unspent tax cut dollars and spending cutbacks are boosting savings, including in mortgage offset accounts. Households are repairing their balance sheets.

As with monetary policy, fiscal policy has boosted household ability to spend. But the appetite to spend remains contained by weak consumer confidence and rising job security fears (Chart 21 again).

There are more tax cuts coming. But Australian households are an ungrateful lot. They soon forget. The tendency to announce tax cuts well in advance of their actual delivery is blunting the stimulus impact. The first

Chart 22

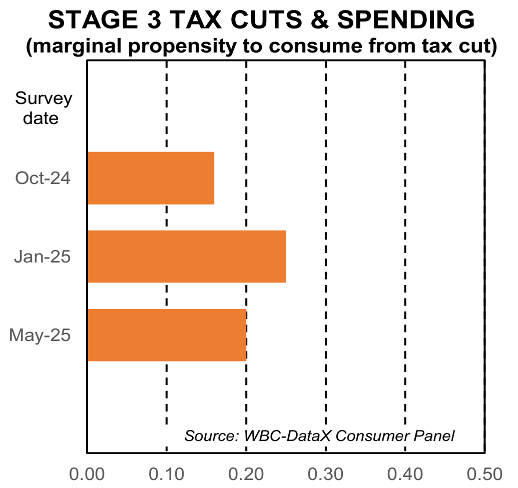


Chart 23

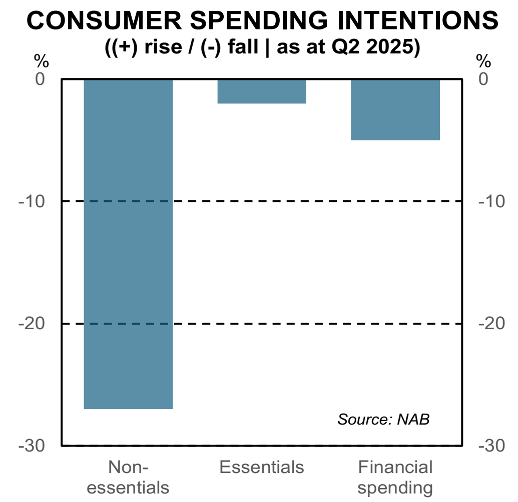
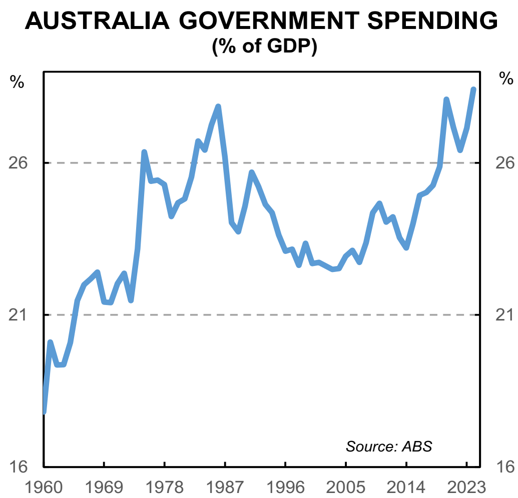


Chart 24



round of top-up tax cuts announced in the March 2025 Budget won't be delivered for 15 months!

The broader problem is that our fiscal cannon has not been reloaded. Government spending now accounts for 28% of GDP, the highest share since at least 1960 (Chart 24).

Yes, we are better placed than many other countries. But from a purely domestic perspective, our ability to deal with future shocks is much reduced.

All these considerations sit as negatives in the outlook for consumer spending. But there are some positives. Real wages are rising again, wealth is lifting, unemployment remains low and cooling inflation rates mean the cost-of-living squeeze is ending. There is also a magic elixir out their waiting for us to grasp. And that is *productivity*.

Productivity: the magic elixir

The story is well known. Productivity growth collapsed in 2022. Despite a persistent belief that a recovery is at hand, it has failed to eventuate. RBA projections nicely summarise the consensus view over the past few years (Chart 25). Every year they expect a productivityt recovery. And every year they are disappointed.

The research and evidence is clear. Better productivity outcomes are associated with:

- rising real wages and more consumer spending;
- faster growth in potential GDP;
- lower prices and improved competitiveness;
- higher profits;
- more government revenues.

It looks an attractive package. And the Government deserves credit for elevating productivity to the top of the policy agenda for its second term.

The Economic Reform Roundtable later in August is the first test of this newfound government resolve.

Let's wait and see what emerges. Is it elixir? Or cool aid?

There are some worrying trends. The Roundtable risks being overburdened by a widening agenda that now covers international opportunities & trade, skills, regulation, competition, AI & innovation and a better tax system.

The risk is that governments cherry-pick the proposals to meet other ends (eg more revenue) rather than pursuing a co-ordinated package. The Henry tax reform agenda is a case in point.

Meanwhile, I'm off to spend my (future) tax cut!

Chart 25

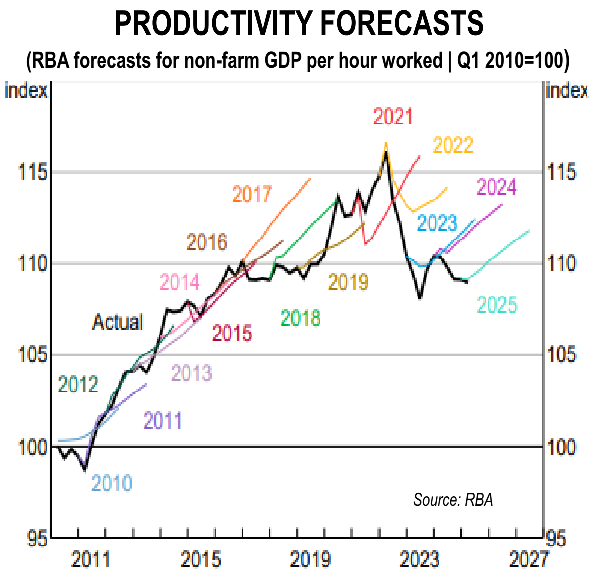
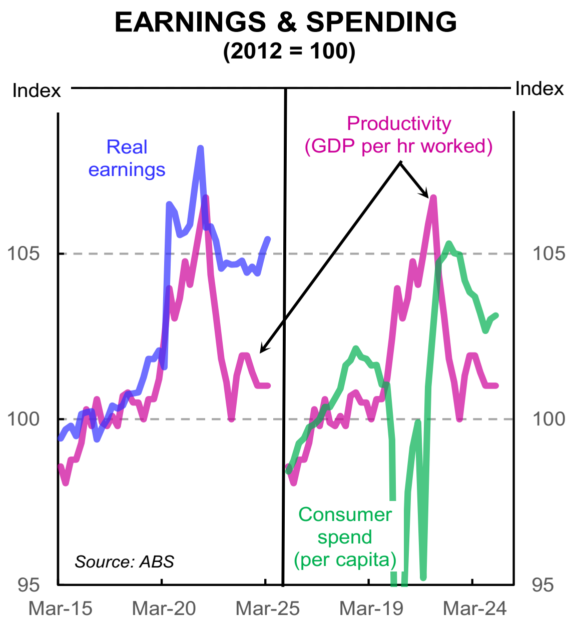


Chart 26



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