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Taking the W

In June, we joked with colleagues that listening to commentary on the “disconnect between ‘hard’ and ‘soft’ data” felt a bit like stumbling upon a Reddit forum for tarot. “The cards don’t seem to be working. What am I doing wrong?”

Who could blame consumers for being in a foul mood? They’d been told for months that consumer prices would rise in direct proportion to tariffs. As we noted last November (“[Tarrific Logic](#)”), the incidence of taxation is a complex

subject. About one-third of the corporate income tax is paid by consumers in the form of higher prices, but it's hard to imagine anyone citing inflation as a reason to oppose an increase in its rate. Consumption never pulled back to the extent implied by surveys, and airline CEOs expect it to pick up now that price increases have proved less jarring than advertised.

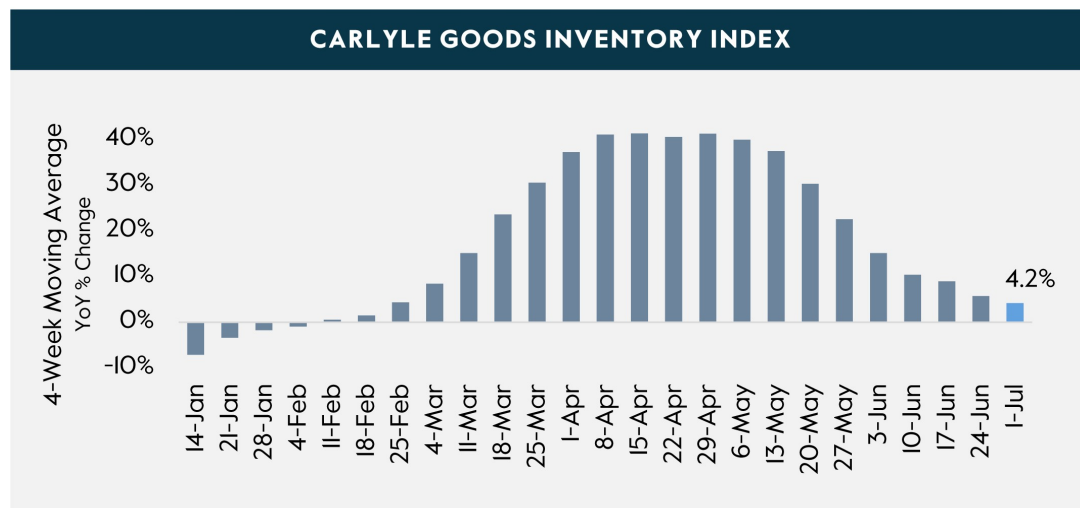
For businesses, the tariffs were a major inconvenience. Productivity contracted in Q1-2025 as management teams devoted countless hours to game planning tariff scenarios. Then the initial tariff schedule proved much harsher and differed materially from what "reciprocal" was thought to mean. Sentiment *was* weak! But rather than panic, CEOs projected a sense of normalcy, drawing down inventories accumulated in advance of tariffs, reassuring customers, and looking for ways to capitalize on competitors' missteps.

Beyond inflation, the main objection to tariffs is that they invite trading partners to respond in kind. But what if...those trading partners *are fine with it*? If Japan and the European Union (EU) are willing to accept a 15% baseline tariff as recompense for their own border-adjusted value-added tax (VAT), perhaps existing arrangements *did* disfavor the U.S.

But let's not presume that all this will be cost-free. A \$300 billion (1% of GDP) "globalization tax" hit the U.S. economy and isn't going away. Recent trade "deals" signal the Administration's willingness to accept lower sector- and-product specific duties to maximize the baseline rate. Implicitly, they define success in terms of revenue, not the bilateral trade balance or scale of onshoring. That makes it more likely the tax sticks, not just for the next year but in perpetuity as the U.S. Treasury comes to depend on the associated revenue and exporters adjust to new realities.

Pre-tariff inventories held down market-clearing prices since March, but they'll reach exhaustion in the coming months (Figure 1). If prices don't rise after that, a larger share of businesses will experience margin pressure, potentially triggering layoffs.

Figure 1: Drawdown in Pre-Tariff Inventories



Source: Carlyle Analysis of Portfolio Company Data, July 2025. There is no guarantee any trends will continue.

Many businesses postponed price increases because of worries about the strength of final demand in their end markets and questions about which tariffs would remain in place. The combination of trade deals, Fed rate cuts, and tax cuts could strengthen demand in ways that open the door to price increases, not just for tariff-affected businesses but also those operating in travel, tourism, and transportation.

Macroeconomic models treat tariffs as a negative supply shock that central banks should ignore. This means that they *shouldn't hike* in response to any measured rise in inflation because it's likely to prove a one-time increase in relative prices that's beyond the scope of monetary policy. But that's different than *easing policy* in response to a supply shock, which could strengthen demand in ways that transform a one-time rise in the price level into something more persistent and self-reinforcing.

When inflation breaks out, it's always the result of an interplay between supply and demand. Blaming the "supply chain crisis" for the 2021–23 inflation ignores the record fiscal and monetary stimulus that arrived at the same time. A spike in the per-barrel oil price from \$60 to \$100 in 2007 didn't result in inflation but a sharp decline in spending on other things, notably mortgage coupon payments. Tariffs can prove a non-inflationary source of revenue as long as policymakers accept the associated decline in the real income of the corporate or household sector.

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