The Fed’s inflation dilemma just got more challenging as Trump's new tariffs loom

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The Federal Reserve’s preferred inflation gauge showed prices in February rose more than expected, re-intensifying the central bank’s inflation battle at a time when it expects new tariffs from the Trump administration to push prices higher.

The new reading makes it more likely that officials hold rates at current levels for longer as policymakers look for signs of how President Trump's policies will affect the US economy in the months ahead.

"It looks like a 'wait-and-see' Fed still has more waiting to do," said Ellen Zentner, chief economic strategist for Morgan Stanley Wealth Management.

"Today’s higher-than-expected inflation reading wasn’t exceptionally hot, but it isn’t going to speed up the Fed’s timeline for cutting interest rates, especially given the uncertainty surrounding tariffs."

Fed Chair Jerome Powell has said that his "base case" is that any extra inflation from Trump's slate of tariffs will be "transitory." But some of his colleagues worry the effects could be more persistent, adding to the uncertainties ahead for the central bank.

Federal Reserve Chair Jerome Powell at a March 19 press conference in Washington, D.C. REUTERS/Nathan Howard TPX IMAGES OF THE DAY · REUTERS / Reuters

The Fed's goal is to get inflation down to its 2% target, but the key measure released Friday remains well above that marker. The "core" Personal Consumption Expenditures (PCE) Index, which excludes volatile food and energy prices, rose 2.8% year-over-year.

That reading was higher than economists' estimate of 2.7%, jumping from 2.6% in January. The month-over-month reading was also hotter, clocking in at 0.4%. That was higher than the 0.3% expected and up from that same level in the previous month.

Inflation now stands at the level the Fed predicted it would be at year's end — and that's before some of Trump's most aggressive tariff plans kick in. The president plans to announce a sweeping set of "reciprocal" country-by-country duties next week.

Fed officials raised their 2025 inflation forecast at a meeting last week, to 2.8% from 2.5% previously, due in large part to uncertainty surrounding the new tariffs. They also lowered their economic growth forecasts for the year.

But February’s inflation report now shows that even the Fed’s revised inflation forecast may prove to be too conservative.

'Transitory' — or not?

Traders are still pricing in an interest rate cut in June with the potential for another cut in the fall. And the two-cut prediction from Wall Street still matches what Fed officials estimated at their meeting last week where they held rates unchanged.

Some Fed watchers, however, argue that these rate cut predictions could be challenged, too.

The new PCE reading "reinforces our view that the Fed is unlikely to cut interest rates this year," said Stephen Brown, deputy chief North America economist for Capital Economics.

The critical question ahead for Fed policymakers is how much of any additional inflation they expect to see is a one-off effect that will prove to be temporary.

While Powell has argued in favor of a potential "transitory" effect, some of his colleagues have offered more caution.

Boston Fed president Susan Collins said Thursday while speaking in Boston that she believes it’s “inevitable that tariffs are going to increase inflation in the near term” and she expects the uptick in inflation could be short-lived.

But she added, “there are risks around that and depending on how that unfolds, it could be more persistent.”


Susan Collins, the president of the Federal Reserve Bank of Boston. (Photo by David L. Ryan/The Boston Globe via Getty Images) · Boston Globe via Getty Images

Collins stressed that if there are additional rounds of tariffs, they are more broad-based, or if there are different levels of retaliation, then inflation could be more persistent than just a relatively fast adjustment to a higher level of prices.

In that context she said she would be looking more closely at inflation expectations because anchoring expectations is important for the Fed's credibility to bring inflation back down.

St. Louis Fed president Alberto Musalem also said this week that he could be "wary of assuming that the impact of tariff increases on inflation will be entirely temporary, or that a full 'look-through' strategy will necessarily be appropriate."

He noted that tariffs could create a one-time increase in price-levels, but that so-called "indirect effects" where domestic producers raise prices as importers raise prices could cause inflation to be more long lasting.

Musalem offered the example of beer from Canada. If it is subject to a 25% tariff, US consumers could shift from Canadian beer to American-made Budweiser, and then Budweiser could increase its prices as people look for locally produced goods.

"Distinguishing, especially in real-time, between direct, indirect, and second-round effects entails considerable uncertainty," he added.