International Scene | 12 March 2025

Policy uncertainty in the US is taking a toll on the global growth outlook

The global economy is at a cross-roads given heightened policy uncertainty while monetary easing, though ongoing, has limited room to run further given already material cuts to policy rates while inflation continues to be above target. In the US, amid tariff flip-flops and wider policy uncertainty, the economy is showing signs of weakness with bond yields down sharply recently and expectations for Fed rate cuts rising again. In the Eurozone, the tariff threat is a major headwind, but the expected increase in defense spending should boost growth. The UK economy lost the early-2024 momentum while fiscal and monetary policies have little room to support growth. In Japan, policy rates are set to rise further in 2025 while 10-year bond yields have surged to multi-year highs. Finally, China has set an ambitious 5% growth target for 2025, signaled an appetite to increase fiscal spending, and sticked, so far, to a limited tariff-retaliation strategy.

Amid tariff flip-flops and wider policy uncertainty, the US economy is showing signs of weakness

In the US, post-election buoyancy has faded, with January's retail sales and personal spending falling, and some sentiment indicators weakening. In fact, the treasury secretary recently warned of a "detox period" for the economy, attributing that to a needed shift from public spending to private-sector spending. Some forecasts are now indicating negative GDP growth in Q1, though that could be partially skewed by soaring imports given tariff front-running as seen in the January trade data. The markets are echoing this weaker outlook with the UST 10-year yield falling by around 50 bps since mid-January, the S&P 500 dropping 9% since 19 February, and the futures market currently implying two-to-three 25-bps Fed rate cuts up from zero-to-one few weeks ago. Meanwhile, the labor market continues to soften gradually with moderating monthly job gains, but a still-low unemployment rate (4.1%) and ongoing-robust wage growth (4% y/y). A more pronounced weakening in the job market will not be surprising amid the increased policy uncertainty, impacting confidence and investment levels, especially given the ongoing federal job cuts. Meanwhile, January's PCE inflation helped calm some worries about renewed price pressures with the core rate moderating to 2.6% y/y, nearly a four-year low.

The weaker outlook is mainly being driven by the tariff-related flip-flops and wider uncertainty about the administration's overall policies. In terms of tariffs, what went into effect already is only a 20% duty on Chinese goods, while several other sectoral and country-specific (mainly Canada, Mexico, EU) levies have been imposed then postponed, threatened, or still due to go into effect. A key date will be April 2nd, when details of "reciprocal" duties will start to be announced on different countries. On the other hand, Trump's pledges, such as lowering taxes and increasing oil output are yet to materialize, while not much has been seen in terms of deregulation, delaying the expected support to the economy. Meanwhile, Republicans in Congress are trying to find a way to pass/implement Trump's plans as well as deal with the debt ceiling issue, big challenges to surmount given their razor-thin majority, often wide differences among them, and no support from Democrats.

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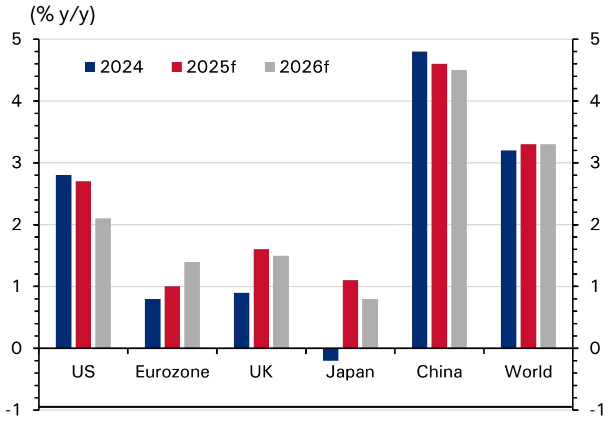
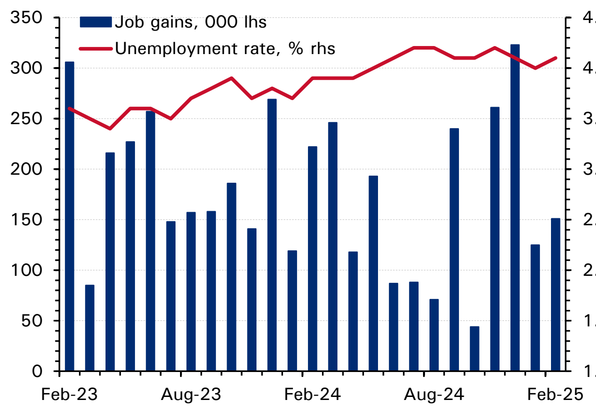
Chart 1: GDP growth as per the IMF



Source: IMF January 2025 WEO

Chart 2: US labor market



Source: Haver

Higher defense spending in the Eurozone to boost growth while the tariff threat is a major headwind

The Eurozone economy grew by 0.2% q/q in Q4, higher than-initially-estimated putting full-year growth at 0.9%, up from 0.4% in 2023. Meanwhile, CPI inflation remains above the 2% target, with the headline rate at 2.4% y/y and core at 2.6% in February, driven by still-elevated though softening services inflation. PMI surveys for January-February indicate generally steady growth in terms of services and a softer contraction in manufacturing. In a major development, the EU, led by Germany is pushing for massive fiscal reform to allow increased government spending on defense. Germany's chancellor-in-waiting, Friedrich Merz, is planning to amend the country's constitution to exempt defense and security expenditures from limits on public spending. The expected major increase in government spending (over several years) across the EU will push up GDP growth and likely inflation as well, with the bond yields of the bloc's four largest economies soaring by more than 40 bps in one week's trading in early March while the euro rallied by more than 4% against the US dollar over the same period.

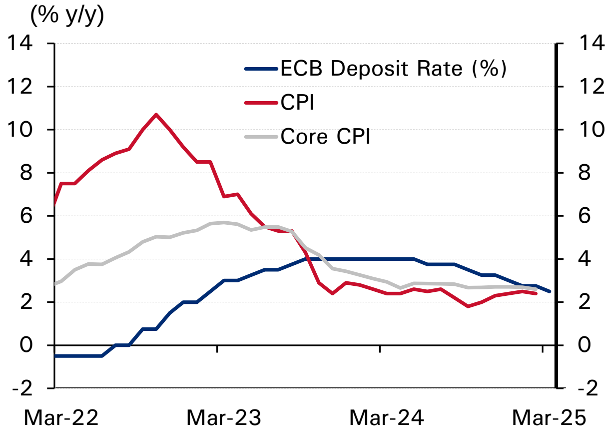
On the other hand, the threat of tariffs is a major headwind, with president Trump on several occasions vowing to impose a 25% duty on imports from the EU. We note that the latter is the US's largest trading partner and had a merchandise trade surplus with the US of around $240 billion in 2024, indicating that it will likely be targeted in a meaningful way by Trump's "reciprocal" tariffs, starting early April. Given statements by EU officials, the bloc will undoubtedly retaliate to any US-imposed tariffs. Finally, at its March meeting, the ECB cut rates by another 25 bps (to 2.5%), bringing total cuts to a steep 1.5% since June 2024, and lowered 2025-2026 GDP growth by 0.2 percentage points (to 0.9% and 1.2%, respectively), on weaker projected exports and investment.

UK economy has lost H1 2024 momentum while fiscal/monetary policy have little room to support growth

The UK economy has lost the momentum seen earlier in 2024 partly due to the budgetary hike in employment taxes and a re-acceleration in inflation. Although Q4 GDP growth came in at a higher-than-expected 0.1% q/q, improving from no growth in Q3, that was mainly driven by higher government expenditures and an increase in inventories, while household spending was flat, and business investment fell. The recent PMIs continue to indicate sustained headwinds, with manufacturing (46.9 in February) at the lowest since December 2023 and services still subdued at around 51 since November 2024.

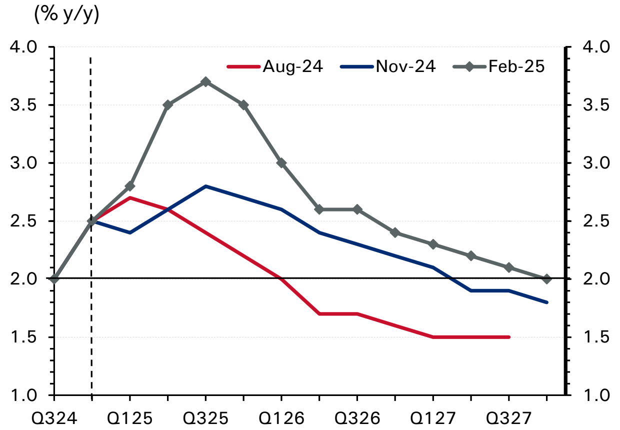
Given the weakening economic landscape and the likelihood of an official downgrade to the GDP growth forecast later this month, the government finances will likely come under further pressure. The government may have to raise taxes again (still seemingly unlikely at this point), and/or rationalize spending, pressuring growth prospects. Regarding trade and possible tariff implications, the US has a goods trade surplus with the UK, and hence, imposing tariffs on the latter may not be a priority for the US administration. At its February meeting, the Bank of England (BoE) cut the bank rate by 25 bps to 4.5%, and sharply downgraded its 2025 GDP growth forecast to 0.75% from 1.5%. Moreover, price pressures resurfaced with CPI inflation in January at a 10-month high of 3% y/y, and the BoE projecting a rise further to 3.7% by Q3, then softening to hit 2% only by end-2027. Amid higher inflation and accelerating wage gains, the bank may struggle to cut interest rates aggressively to support growth. The futures market is currently expecting around two more 25 bps rate cuts by end-2025, with a hold at the bank's meeting later this month.

Chart 3: Eurozone inflation and ECB policy rate



Source: Haver

Chart 4: BoE UK CPI inflation projections



Source: Haver

Policy rates in Japan are set to rise further in 2025 while 10-year bond yields surge to multi-year highs

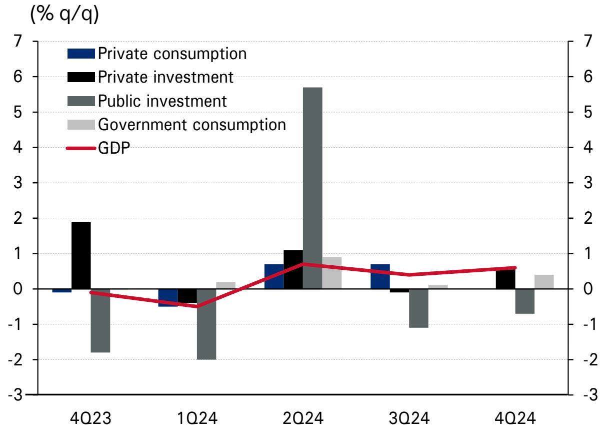
Japan's GDP growth for Q4 2024 improved to 0.6% q/q from 0.4% in Q3 mainly on rebounding business spending and a strong net exports performance. In contrast, growth in private consumption (more than half of GDP) decelerated sharply, likely impacted by the persistent inflation, which has remained on an uptrend, reaching a two-year high of 4% y/y in January, while core inflation (3.2%) rose to its highest level since June 2023. This contributed to the Bank of Japan's (BoJ) decision to hike interest rates to around 0.5% in mid-January, the highest since 2008, while raising its projections for core inflation for FY24 and FY25 to 2.7% and 2.4% respectively, from 2.5% and 1.9% previously, making core inflation above the 2% target for four straight years. This has supported the yen which is currently trading at levels last seen in October 2024 while 10-year government bond yields remain on an uptrend, reaching a multi-year high of more than 1.5% recently. However, the BoJ is expecting cost-push price pressures to dissipate by mid-2025, supporting a positive rise in real wages, especially following the Shunto 2025 negotiation results, which the BoJ considers as key for further rate hikes. Market-implied expectations are currently split regarding another rate hike in the summer, but overall indicate at least one more 25 bps hike before year-end. Related to that, recently, the BoJ Deputy Governor Uchida mentioned that the bank plans to continue raising interest rates in line with market expectations, and remained optimistic about the country's economy. In fact, the services PMI climbed to 53.0-53.7 in January-February, sharply higher than the Q4 average (50.4) and the highest in six months, auguring well for Q1 growth.

China sets an ambitious 5% growth target for 2025; authorities stick to a limited tariff-retaliation strategy

The Chinese government's measured retaliation to the US administration's cumulative 20% tariff hike indicates no willingness to engage in a full-blown trade war that will compound the losses on both parties. However, this is no guarantee that this approach will hold in the face of additional measures taken by the US administration. The economy had rounded off 2024 on a positive note with GDP growing by a stronger-than-expected 5.4% in Q4, helping the country reach its growth target of "around 5%" for the year. However, domestic demand remains muted with headline inflation in negative territory in February (-0.7% y/y) and the core rate in deflation for the first time in around four years while imports tumbled by 8.4% y/y in January-February, much weaker than expected. Moreover, the property market continues to be a drag with new home prices continuing to drop, falling 5.0% y/y in January although by a softer rate for the third straight month. PMI data for January and February indicated a generally stable economic backdrop, though February's expansion has likely been supported by the Lunar New Year festivities.

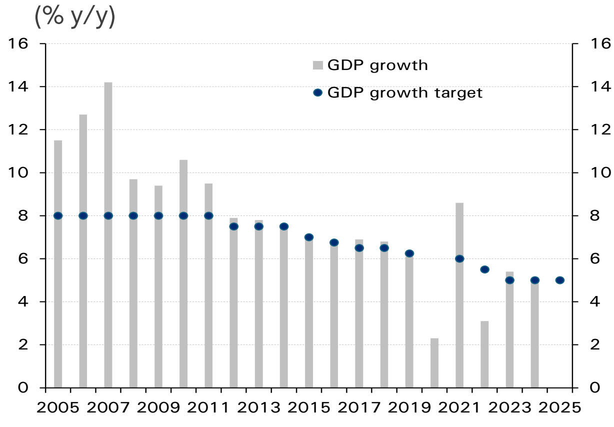
Meanwhile, the People's Bank of China (PBoC) left interest rates unchanged for the fourth month in a row in February after cutting rates sharply in 2024. Looking ahead, the outlook has become more uncertain given the imposition of US tariffs, which may pressure exports, China's key growth driver in 2024. However, in a positive and favorable step for the outlook, the authorities set an ambitious "around 5%" growth target for 2025 during the recent National People's Congress meeting, raised the target budget deficit to a multi-year high of 4% from 3% in 2024, and emphasized that boosting domestic consumption is a top priority.

Chart 5: Japan GDP growth and components



Source: Cabinet Office

Chart 6: China GDP growth



Source: Haver; no target was set for 2020.

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