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2025 Global Economic Outlook

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OVERVIEW

- The US economy retains significant momentum and, in our view, the new administration's policies on trade, regulation and taxes may drive continued US economic outperformance at the expense of increasing vulnerabilities abroad. Some of that US fiscal support further frays the longer-term fiscal position.
- The Federal Reserve (Fed) is in a bind. Inflation will likely edge lower, but that progress is vulnerable to potential government policies. The Fed will likely dial back future easing more than other central banks. Quantitative tightening will likely be wound down.
- China's domestic challenges appear more pressing. Policymakers will likely strive to stabilize the real estate sector, but domestic demand is likely to remain subdued given longstanding structural issues and a weak consumer.
- Europe's recovery faces headwinds. The European Central Bank (ECB) will likely ease monetary policy amid fiscal tightening and tariffs that threaten growth. Lower domestic price and wage pressures should clear the way.
- Japan's reflation should continue, in our view, with the Bank of Japan (BOJ) steering its policy rate toward 1% by the end of 2025. We expect strong spring wage negotiations to fuel further domestic price pressures.
- Geopolitical risks remain. Hot wars in Ukraine and the Middle East remain key risks to the global outlook and can rapidly be transmitted into markets via prices for energy and commodities. Several consequential elections mark the calendar in the year ahead, beginning with Germany in February.

Shifting Sands from Elections

2024 was a busy year for elections, with over 75 countries and nearly half of the world's population involved in national votes. Many voters turned against incumbents in countries like the United States, United Kingdom, Japan, France and India. While almost all incumbent parties lost support compared to previous elections, not all lost power. That said, a number of new governments are in the driver's seat and will look to steer policy in different directions.

The most important election last year took place in the US, which will undergo major policy shifts. President Trump begins his second term with a strong US economy, the best performing among major developed markets. The second Trump administration sees itself as having a clear mandate and plans to take a bold approach, proposing new policies likely to fuel higher growth and inflation. Tariffs, viewed as an important tool by the administration, represent a significant source of uncertainty. An aggressive approach to raising tariffs could deeply disrupt growth in foreign economies, while a more targeted approach would be less damaging.

Political uncertainty could increase abroad, with many government coalitions in fragile shape. Divided governments are finding it harder to enforce fiscal discipline, worsening budget trajectories and putting upward pressure on long-term interest rates. In Europe, the policy outlook is uncertain until the outcome of Germany's February vote, while France's fragile coalition could fail and require fresh elections. Other important votes are scheduled in Australia (May), the Philippines (May), Argentina (October), and Canada (before October). Newly elected leaders will strive to work with a US that has a more bilateral and transactional approach to international matters.

United States

The US economy grew more than its global peers in 2024, despite the shadows cast by the end of a significant tightening spell by the Fed and the uncertainties surrounding a contentious national election. The 2.75% expansion of real gross domestic product (GDP) was supported by sectoral balance sheets, which remained strong; financial markets, where investors appeared to be receptive to risk; and fiscal policy, which did not dial back stimulus.

Election outcomes may widen the range of economic possibilities in 2025, as a president returns to office after an interregnum for the second time in US history. We think the president will move quickly to further his unfinished agenda. Tariffs will likely be hiked in the early part of the year, possibly to 10% across the board and an increase up to 60% punitively against China. Border restrictions will likely be toughened. Regulation will likely loosen, especially in energy and finance, due to changes at the top of agencies and as new rules replace old ones over time. Given that the Tax Cuts and Jobs Act of 2017 is set to expire at the end of 2025, Congress will address tax policy, likely adding to overall fiscal stimulus.

The Fed turned toward easing in September 2024 to bring the nominal federal funds rate into better alignment with the lower trend rate of inflation. The cuts in the policy rate are intended to support economic expansion but were limited to keep the real rate restrictive. The Fed apparently believes that the economy can withstand an above-neutral real policy rate because of ongoing impetus from easy financial market conditions and fiscal policy. From the Fed's perspective, we think job creation settled to trend and the labor market moved roughly to balance at a 4.25% unemployment rate. With consumer price inflation still running near 3%, some restraint is viewed as necessary for the final push to price stability.

The new administration's policies may put that plan at risk. Tariffs directly raise the prices of imported goods in the consumption basket. More aggressive policing of the border cuts the flow of new workers and deportation would reduce the stock of existing ones, putting upward pressure on labor costs. Extending the existing tax structure prolongs fiscal support of aggregate demand and more aggressive changes, a distinct possibility, would impart more stimulus. Potential looser regulation, likely welcomed by capital markets, can spur capital spending. On balance, we think economic growth will slow to 2%, around trend, with more upside than downside risks. This should keep the labor market roughly balanced, but supply considerations put more pressure on costs and prices than in our prior forecasts.

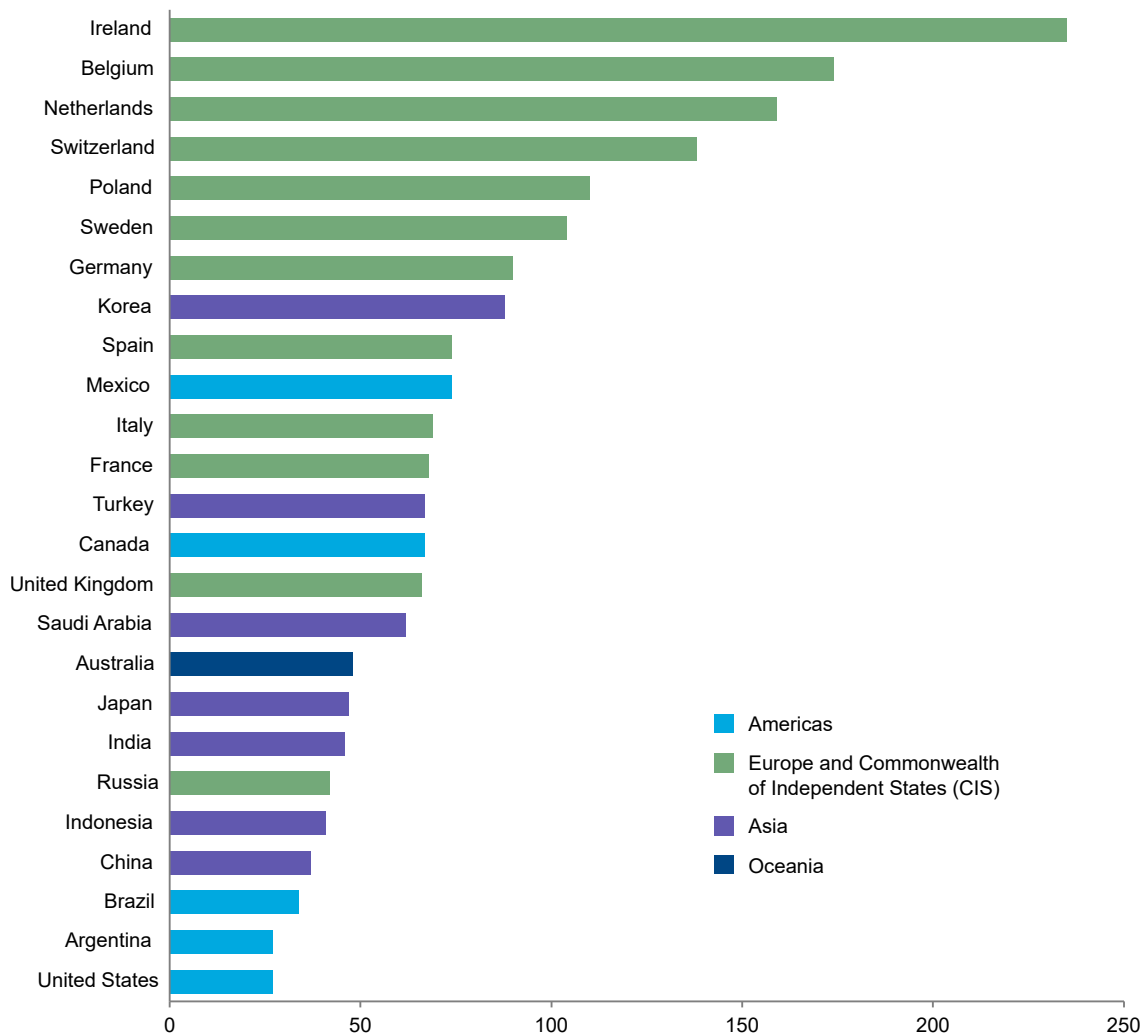
The Fed will let the data guide them in the near term, but the assessment of the political economy may increasingly factor into their thinking. Fed officials cannot presume policy action by the next administration without appearing judgmental. We expect the Fed to raise its forecasts on inflation and the appropriate policy rate over 2025 but not to fully incorporate their assessment of the possible policies until those policies are put in place. The policy rate will likely be cut about 0.5% by the middle of the year, less than previously expected and with more upside than downside to the outlook.

Protectionism Appears to be on the Rise

Tariffs are a key pillar of the new US administration's economic policy and are a potential shock to many trade-centric economies. The US has persistently run a large deficit in its international trade balance, implying that exports are much lower than imports. As a result, tariffs by the US are placed on a larger portion of activity (imports) than retaliatory tariffs (exports) and implies that the US could weather the impact of tariffs better than countries where trade is a larger contributor to jobs and growth. The US is predominantly a service economy, with goods employment making up only 14% of the total workforce.¹ We think the new administration views this as leverage because trading partners rely relatively more on goods-producing industries. This may leave some countries highly exposed to goods exports and trade. In the chart below, we identify which economies are currently most reliant on foreign trade, ranking them by exports plus imports as a share of overall economic output.

Importance of Trade for the 25 Largest Economies

Sum of Exports and Imports Relative to GDP in 2023 (Percent)



Source: World Bank, Open Data. The dataset excludes Taiwan. Latest year is 2023 except for Japan and the US which is 2022. Economies are ranked by their US dollar nominal GDP in 2024, according to the IMF World Economic Outlook (October 2024).

Which Countries are Most Exposed?

- Tech-heavy economies like Ireland, South Korea and Taiwan are significantly dependent on trade and exports to the US.
- Manufacturing hubs such as Germany, Sweden, Japan and Switzerland also face substantial exposure.
- Canada and Mexico are highly exposed due to tightly integrated supply chains within the United States-Mexico-Canada Agreement (USMCA) trading bloc. Trade is concentrated, with over 75% of exports from Canada and Mexico going to the US.²
- China is expected to face the harshest tariffs, with rates potentially rising from 20% to 60% across all goods.

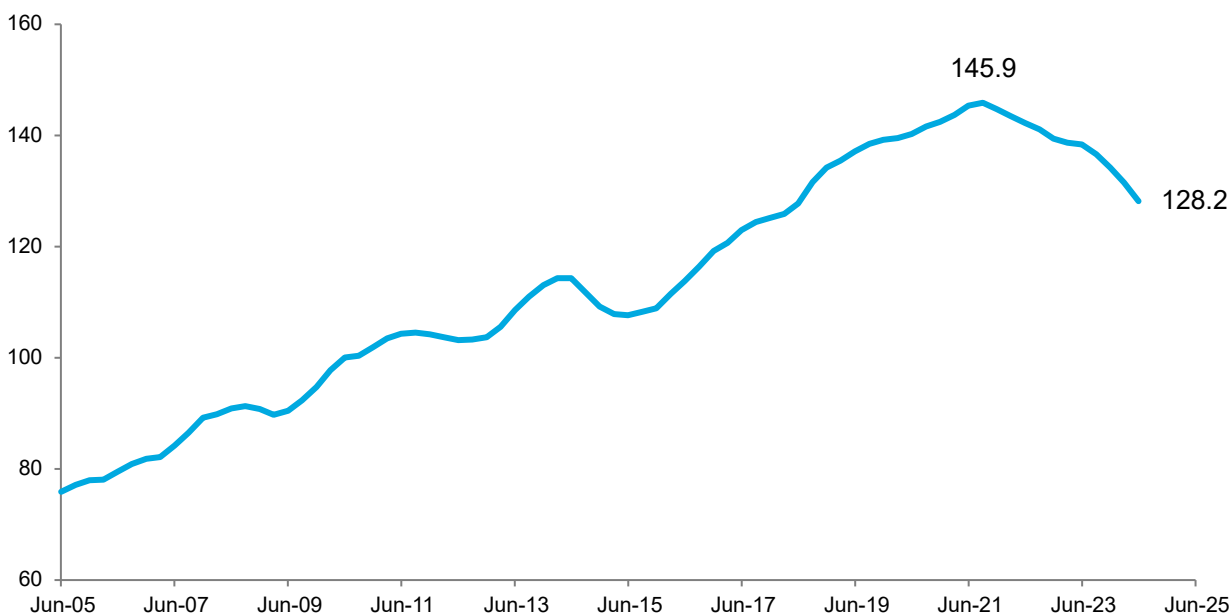
Retaliatory trade measures, ranging from tariffs to export restrictions, are likely from many countries, which may intensify trade wars and deepen impacts on the global macroeconomy. This could further drag on growth through reduced trade volume and a poor investment climate, while pushing up costs.

China

A potential hardening of global attitudes toward trade may act as a headwind to Chinese growth, with tariffs likely to be ratcheted up sometime this year. With that said, Chinese exports have become more diversified away from the US since the pandemic, with growing market share throughout emerging markets. In fact, goods exports were actually a bright spot for the Chinese economy in 2024. We think China's more pressing challenges are internal. Domestic demand is subdued and in need of support as the economy navigates longstanding structural issues, including weak demographics, high unemployment, depressed business and household confidence, and a deflating property sector. With annual price growth hovering around zero for the past year, consumer prices are nearly deflating.

China: Residential Property Prices

Index, 2010=100



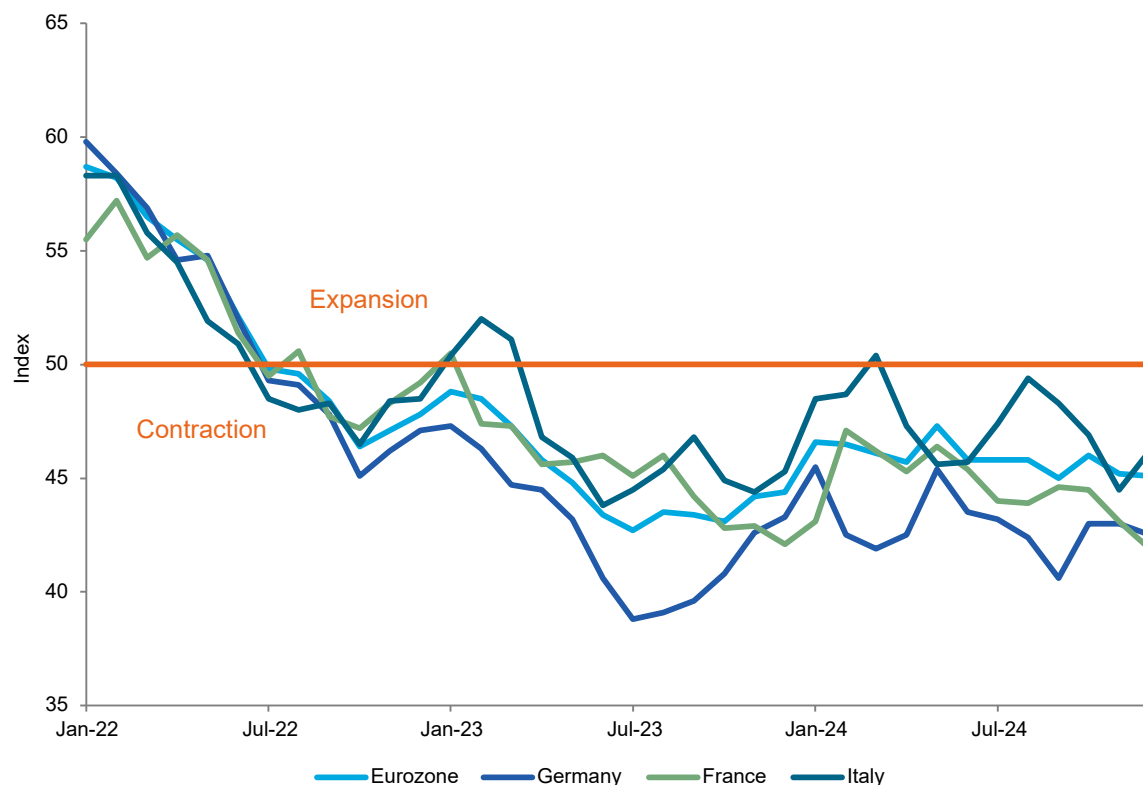
Source: BIS, Residential property prices. Accessed 12/9/2024.

There is a policy push to address some of this domestic slack, with a concerted effort beginning last September when the People's Bank of China cut lending rates and introduced a variety of measures to alleviate a struggling property sector. This was followed up with a 10 trillion yuan debt package to ease local government balance sheets. We expect the real estate sector to find more stability in 2025. However, weak domestic demand may prove more difficult to fix without a significant boost in fiscal stimulus. In the year ahead, we anticipate a gradual increase in fiscal support. In terms of timing, authorities may be waiting to assess the impact of higher tariffs on the external environment before leaning more heavily into its fiscal resources. We expect the Chinese economy to muddle through 2025 and forecast real GDP to grow at 4.3%, short of the likely 5% annual growth target to be announced in March. This reflects some stability in the property sector but may also include continued headwinds to growth from stubbornly weak consumption and slower global trade.

Europe

In 2024, the euro area avoided recession, with the more service-oriented southern economies, such as Spain and Italy, outperforming the more manufacturing-focused northern economies, including Germany. The European Central Bank (ECB) began lowering interest rates last summer and will likely continue to do so in 2025 amid a cooler inflation backdrop and easing wage pressures. Monetary policy support will likely be welcomed given ongoing fiscal tightening, as increased spending on defense and vulnerabilities to trade crowd out other budget priorities. An election in Germany scheduled for February can raise questions about its government's commitment to the "debt brake," a fiscal rule in the constitution that sets a limit on deficit spending and borrowing.

Euro Area: Manufacturing Purchasing Managers' Index



Source: Bloomberg as of 1/6/2025.

We expect the ECB to bring its policy rate into expansionary territory by the second half of the year. Central banks on the periphery of the euro area, like the Swedish Riksbank and Swiss National Bank, will likely ease further alongside the ECB.

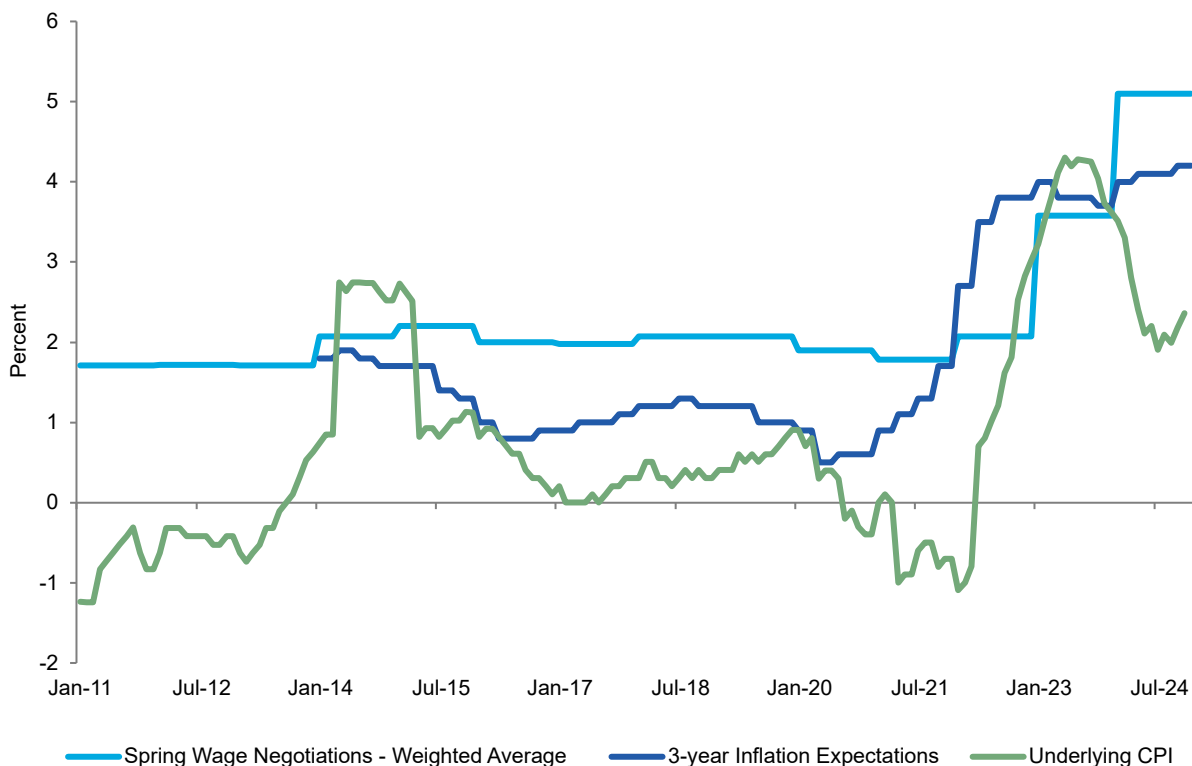
The United Kingdom's latest budget increased the profile for inflation in the outlook which resulted in the Bank of England setting out a slower pace of easing. However, we see fading service cost pressures and a loosening labor market allowing for rate cuts in 2025.

Russia's invasion of Ukraine remains a source of major regional uncertainty. We believe a peace agreement could provide a big lift to confidence, whereas a forced deal that ceded power and territory to Russia would set off alarm bells for regional security.

Japan

After decades of deflation, Japan's economy appears to have undergone a structural reflation, with consumer price growth averaging above 2% since 2022. Strong wage growth should allow the Bank of Japan to further normalize its policy rate this year, bringing the policy rate to 1% by year-end and continuing to taper Japanese government bond purchases through April 2026, gradually reducing holdings on the central bank's balance sheets. We think the yen will likely remain weak versus the US dollar in the year ahead, helping offset some external headwinds.

Japan: Wages and Inflation



Source: Bank of Japan, Japanese Statistics Bureau and Japanese Trade Union Confederation (RENGO) as of 1/6/2025.

Emerging Markets

Turkey and Argentina have brought down inflation from very high levels but are not out of the woods yet.³ Recent data shows inflation running at a monthly rate around 2% after peaking at an annual rate of 72% (Turkey) and 230% (Argentina). Other emerging markets have better-contained inflation, with many Latin American economies in 2024 easing policy after succeeding at returning inflation to targets.

A recent exception is Brazil, where a hawkish central bank began raising its policy rate again, with scope to bring real rates above 10% given a recent upturn in inflation. The high level of real rates has put pressure on government finances, with the deficit approaching 10% and markets looking for a more sustainable path by fiscal authorities.

Currently, India remains in a strong position, driven by solid domestic demand and relatively insulated from goods trade with the US. Southeast Asian economies like Thailand and Vietnam have a bias to cut, with Vietnam highly exposed to trade with the US. Indonesia relies more heavily on oil exports and the direction of oil prices.

Oil prices traded in a stable range of \$70 to \$80 per barrel since early 2023, with temporary spells above \$80 during spikes in Middle East tensions and fears of a broadening conflict within the region. We expect oil prices to ease in the year ahead toward \$60 per barrel, owing potentially to less global demand and rising supply from North America.

The Stage is Set

This year may have twists and turns in store. The range of potential outcomes is wide, given policy uncertainty combined with geopolitical risks. The stage is set with macro divergence appearing likely to continue, as strong US fundamentals drive higher growth compared to peers whose economic activity is more at risk. Inflation will likely edge lower, but that progress is vulnerable to potential government policies. This may cause the Fed to trim its future easing plans more so than other central banks and supports a stronger US dollar environment. High deficits and a rising national debt load will likely persist and represent a growing concern for investors. In the background, an intensification of tariffs could redraw the map of global trade, shifting supply chains and damaging growth in vulnerable trade-reliant economies.



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.



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VP, Global Economist

Nick is a global economist who helps develop the firm's views on global macroeconomics. Previously, Nick contributed to global fixed income investment strategy at Standish Mellon Asset Management, a BNY company.

Nick holds a BA in Economics from Hamilton College and has been in the investment industry since 2013.

Endnotes

¹ Bureau of Labor Statistics.

² Centre d'Etudes Prospectives et d'Informations Internationales (CEPII).

³ International Monetary Fund World Economic Outlook Database.

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