

## EDITORIAL

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## US TARIFFS: THE BIG SHAKE-UP

One direct and immediate consequence of Donald Trump's announcements on 2 April on tariffs, which are reciprocal and reduced in name only, was to accentuate the downside risks to the US economy and to seriously shake up the financial markets. According to our forecasts, the US economy will slow sharply but avoid recession, on the optimistic assumption of a de-escalation in the trade war and an easing of uncertainty. Our US scenario looks like stagflation, as we expect inflation to rise sharply at the same time. Between two evils, the Fed should opt for the monetary *status quo*, extending it until the end of this year. The outlook for growth in Europe, which had received a boost from planned rearmament efforts and the German investment plan, is also down by a few tenths of a percentage point. However, in the Eurozone, growth in 2026 (1.3% as an annual average) should remain higher than in 2025 (1%) and higher than US growth (1.1% in 2026 after 1.3% in 2025). While growth rates are expected to converge on both sides of the Atlantic, inflation and monetary policy trajectories are forecast to diverge: inflation in the Eurozone is likely to remain contained at around 2%, leaving the way clear for the ECB to make two other rate cuts in June and July after the one in April.

## BEFORE AND AFTER

There could clearly be a before and an after to 2 April and the shock caused by Donald Trump's announcements, featuring a massive and widespread increase (albeit differentiated by country) in US tariffs, far greater than anyone could have imagined. Since then, there have been numerous retractions and reversals, except in relation to China, with which the escalation has continued (see our [Tariff tracker](#) for a summary). This US neo-protectionist shock is a major turning point, although it remains difficult at this stage to imagine all the consequences, both in the short and long term. There is no doubt that they will be negative, primarily for the United States<sup>1</sup>; the uncertainty concerns the extent of the repercussions and the reconfiguration of world trade and the international financial system. And even if time is given for negotiations and they lead to agreements and the lifting or lowering of tariffs, the context remains extremely uncertain, with major and lasting negative effects on economic activity.

## BEFORE 2 APRIL, AN INITIAL CHANGE OF PERSPECTIVE, FAVOURABLE TO EUROPE

Let's rewind a bit. Prior to the announcements on 2 April, we revised our growth forecasts in March. For the United States, we lowered them for 2025 by 0.5 percentage points (from 2.3% to 1.8% as an annual average) and left the 2026 forecast unchanged (1.3%). For the Eurozone, we raised our growth forecast by 0.4 pp for 2025 (from 0.9% to 1.3%) and by 0.5 pp for 2026 (from 1% to 1.5%). Indeed, the economic horizon had somewhat brightened, in both senses of the word:

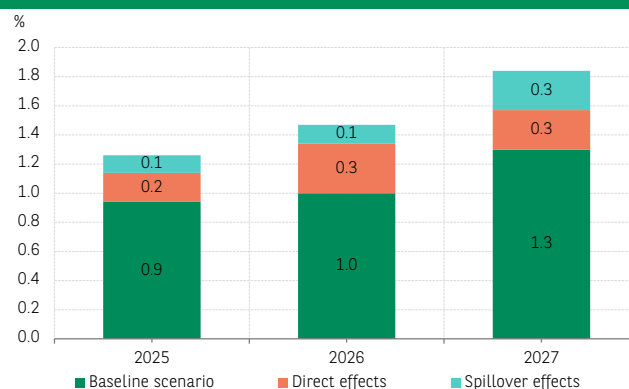
- On the one hand, despite everything, there was a little more clarity about the nature, scale and timing of the new US administration's tariff measures, but the economic outlook for the United States was clouded at the same time.
- On the other hand, the economic horizon was looking a little brighter for Europe, thanks to a series of announcements from Germany and the European Commission marking a major change in terms of (a larger) support for the economy and fuelling hopes of a tangible revival of the EU (see chart 1 and, for more details, the articles on Germany and the Eurozone in this issue, as well as the various sections on the budgetary challenge of rearmament in each country's fact sheet).

<sup>1</sup> See EcoWeek editorial by Isabelle Mateos y Lago, «Reciprocal» tariffs are bad for world growth and worse for the US, 7 April 2025.

<sup>2</sup> See EcoWeek editorial by Isabelle Mateos y Lago, How the 2025 Davos consensus was upended in two months, and what comes next, 17 March 2025.

<sup>3</sup> See EcoWeek editorial by Jean-Luc Proutat, Europe's major investment projects: an increasingly complex financial equation, 31 March 2025.

EUROZONE GROWTH FORECASTS: IMPACT OF DEFENCE SPENDING INCREASES AND GERMANY'S INFRASTRUCTURE PLAN



SOURCE: BNP PARIBAS CALCULATIONS

CHART 1

The emergence of more negative economic signals in the United States and more positive ones in the Eurozone supported this change in outlook, which was also reflected in a remarkable turnaround in the financial markets.<sup>2</sup>

## EUROPEAN RESPONSIVENESS IS A POSITIVE THING, BUT ALSO A SOURCE OF COMPLICATIONS

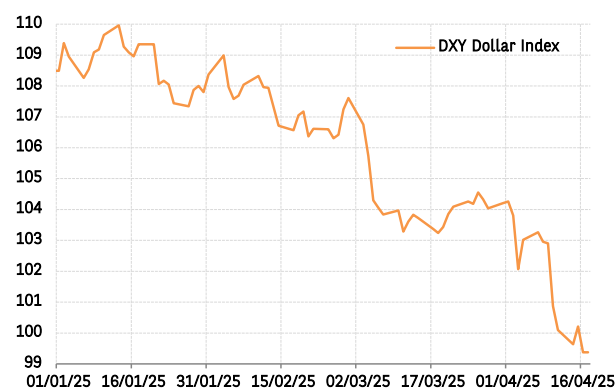
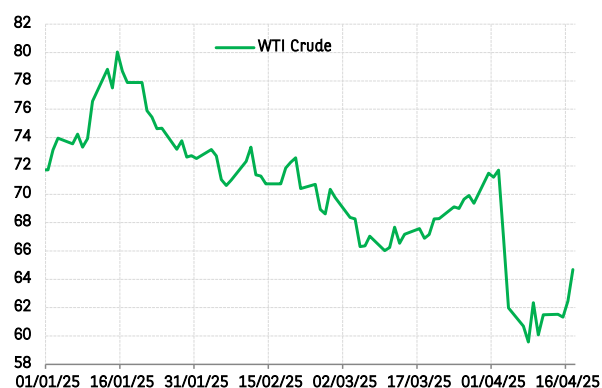
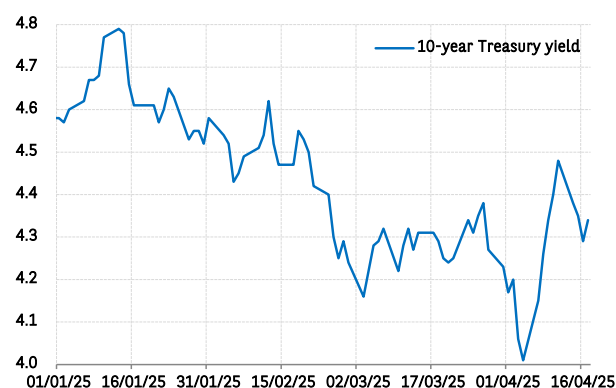
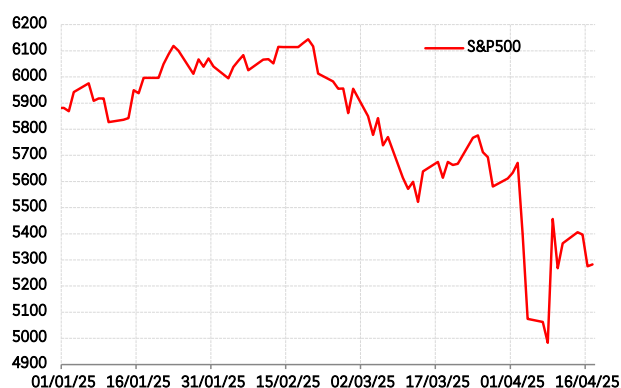
The German budgetary turnaround and the European rearmament effort, while welcome, also raise new questions and complications<sup>3</sup>. Managing to reconcile the various imperatives of the moment (discretionary increases in public spending on defence and energy transition, and mechanical increases in spending on an ageing population), in an environment of higher interest rates, with very high public debt-to-GDP ratios in many countries and limited growth potential in most of the same countries and in many others, is like squaring a circle.



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## THE BESSENT DASHBOARD



UPDATED ON 18 APRIL 2025

The bond markets are keeping a close eye on things, and their pressure, which for the time being is limited, is a clear incentive not to relax budgetary consolidation efforts in those countries with the biggest imbalances and the least room for manoeuvre (for example, the United Kingdom, where 10-year bond yields rebounded sharply between 4 and 9 April, almost as much as US yields, while German, French and Italian yields showed little change over the same, short, period).

However difficult it may be, not reducing primary deficits (where they are currently the largest) is not a feasible option, as this would require a very negative  $r-g$  differential to stabilise public debt ratios (all the more so as the current primary deficit is far from the stabilising level), far from what can be achieved in the current state of affairs. As for the option of allowing debt ratios to drift further, this can only be envisaged in a contained manner and over a short period of time, given the current nervousness of the markets and the increased risk of tensions on interest rates<sup>4</sup>. As the United States showed in the week of 7 April, it too is not immune to an episode of stress on interest rates, caught up in the scale of its fiscal imbalances at a time when the US protectionist shift, and the chaotic and ineffective conduct of policy are leading to fears of a loss of confidence among foreign investors.

<sup>4</sup> In the European Commission's latest report on debt sustainability ([Debt Sustainability Monitor 2024](#), 17 March 2025), only two countries are identified as facing a high short-term budgetary risk (Romania and Slovakia). Medium-term risk (with unchanged fiscal policy) are considered high for 11 countries (Belgium, Greece, Spain, France, Italy, Hungary, Austria, Poland, Romania, Slovakia and Finland). In terms of long-term risks (again assuming no change in fiscal policy), four countries are exposed to a high risk (Belgium, Luxembourg, Malta and Slovakia).

<sup>5</sup> The WTO's mid-April forecast of a fall (even a slight one of -0.2%) in world trade in 2025 is a clear illustration of these fears ([WTO | 2025 News items - Temporary tariff pause mitigates trade contraction, but strong downside risks persist](#), 16 April 2025).

## AFTER 2 APRIL, A NEW TIPPING POINT AND A LEAP INTO THE UNKNOWN

One direct and immediate consequence of the 2 April announcements was to accentuate the downside risks to the US economy and seriously shake up the financial markets. US Treasury Secretary Scott Bessent, who wants to see lower US long-term interest rates, a lower dollar and lower oil prices, has certainly been granted his wish, but with two notable drawbacks: (much) lower stock market indices too and a sharp rise in US long-term interest rates that followed a few days after "Liberation Day" (see charts 2a-2d). The reversals on 9 April and the days thereafter partially halted the damage. But there is still a great deal of uncertainty about the future course of the trade war, and consequent fears about US and world growth remain high<sup>5</sup>. The risk of a recession in the United States has suddenly reappeared. We give it a probability of 25%.

At this stage, our central scenario is that of a marked slowdown in US growth (to 0.5% y/y in Q4 2025 and 1.3% as an annual average, then to 1.1% in 2026, i.e. respectively 0.5 and 0.2 pp lower than our previous forecast of 19 March; see the article on the United States in this issue for a more detailed presentation of our analysis of the situation and outlook).



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The US economy would avoid recession under the optimistic assumption of a tariff<sup>6</sup> de-escalation and reduced uncertainty. Otherwise, recession would become the most likely scenario. If, on the other hand, the de-escalation were to go faster and further than anticipated, this would obviously be a plus for growth.

Nor does the accentuation of the post-Liberation Day tariff shock leave Europe's growth prospects unscathed (see the articles on the euro zone, Germany, France, Italy, Spain and Belgium in this issue for a more detailed presentation of our analysis of the situation and outlook). It has taken about half of the extra growth in the Eurozone generated by rearmament and investment efforts and the knock-on effects between countries. We are now forecasting annual average growth of 1.1% in 2025 and 1.3% in 2026 (-0.2/-0.3 pp below our previous forecast of 26 March). However, despite the US slowdown, a growth pick-up is still expected in the Eurozone between 2025 and 2026, thanks to the ramp-up of the German infrastructure plan and defence spending across Europe. Our scenario, which was already characterised by a noteworthy convergence in growth rates between the United States and the Eurozone, now also has the distinctive feature of forecasting growth in the Eurozone higher than in the United States in 2026. This is not insignificant and is more the exception than the rule.

In the United Kingdom, average annual growth is expected to change little (-0.1 pp, to 1% in 2025 and 0.8% in 2026), with the country being less penalised than its European neighbours (see the article on the United Kingdom in this issue for a more detailed presentation of our analysis of the situation and outlook). In Japan, the expected rebound in growth in 2025, which is already modest and comes between two years of barely positive growth (0.1% in 2024, 0.2% in 2026), has also been revised downwards (to 0.7% from 1% previously) in view of the country's high exposure to the United States (see the article on Japan in this issue for a more detailed presentation of our analysis of the situation and outlook).

## INFLATION AND MONETARY POLICY: DIVERGING TRAJECTORIES CONFIRMED

The current outlook for inflation and monetary policy on both sides of the Atlantic reinforces the anticipated divergence in trajectories outlined in our previous issue of Eco Perspectives<sup>7</sup>. Admittedly, the latest data available, for March, shows that disinflation is continuing in the Eurozone, the United Kingdom and the United States. But the risk of higher inflation on the other side of the Atlantic, caused by the substantial increase in US tariffs, remains very real.

According to our forecasts, US inflation will visibly start to pick up from Q3 2025 onwards, rising slightly above 3% y/y and peaking at 4% in Q2 2026. Average annual inflation is expected to be 3.1% in 2025 and 3.7% in 2026. This increase is not the result of a self-sustaining inflationary loop, as in 2021-2023. From this point of view, it is of a transitory nature (assuming the Fed does not prematurely cut rates, see below). An even sharper slowdown in the US economy, or even a recession, could moderate this inflation bump. Could it even disappear? It's hard to say, and no more acceptable as the price to be paid for the trade war (inflation or recession? bearing in mind that stagflation, a combination of the two, remains a possible scenario). On the other hand, there is one favourable development at the moment, which will drive down US inflation, but not only: the fall in oil prices.

Given the risk of inflation expectations in the United States becoming unanchored, we are maintaining our central scenario of a prolonged monetary status quo by the Fed in 2025. We continue to believe that, given this de-anchoring risk and based on our inflation and growth forecasts, the Fed cannot ignore the rise in the former and cut rates in response to the slowdown in the latter. We see the upside risks to inflation and the downside risks to growth as cancelling each other out (and not the latter as more important than the former, as suggested by the rate cuts priced by the markets). In 2026, on the other hand, the Fed should be in a position to resume rate cuts (-100bp), as the inflation/growth trade-off shifts in favour of the latter.

In the Eurozone, we see the balance continuing to tip towards further disinflation and a safe return to the target. In terms of domestic components, the momentum is disinflationary, while in terms of non-domestic components, inflation imported from the United States and the additional costs arising from friction and the reorganisation of production chains should be offset by the strengthening of the EUR/USD, the absence of any major retaliatory measures and disinflation, or even deflation, imported from China. In 2026, inflation is even expected to (slightly) fall below the 2% target. Core inflation, however, would remain above this mark, with a slight upward trend in the second half of the year, fuelled by the German fiscal stimulus and European rearmament efforts.

For the ECB, the conditions remain ripe for further rate cuts in the short term. We continue to expect another 25 bp cut in June, following the one in April, and followed by another one in July given the downside risks to growth. In 2026, on the other hand, in the second half of the year, the slightly more favourable growth picture combined with the inflationary nature of the rearmament effort is likely to lead the ECB to raise its rates (+50 bp according to our forecasts), further accentuating the decoupling with the Fed. The BoE has less leeway than the ECB on the inflation front (higher and more persistent in the United Kingdom than in the Eurozone) while facing a difficult economic situation. According to our forecasts, this would lead the BoE to continue its easing at the slow pace of one cut per quarter, spreading it out until Q1 2026. The BoJ, which has stood out by cautiously raising its key rates, is set to move closer to its peers by putting this adjustment on hold for the rest of the year. A status quo like the Fed, but for different reasons: in Japan, concerns about growth are predominant. Once these concerns have passed, the BoJ is likely to resume its cautious rate hikes in 2026 (+25 bp in Q1 and +25 bp in Q3).

Article completed on 17 April 2025

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<sup>6</sup> Average effective tariff on US imports lowered to 16% from 27.3% based on announcements on 10 April.

<sup>7</sup> Eco Perspectives - Advanced Economies | 1st Quarter 2025 - Economic Studies - BNP Paribas, 17 December 2024



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