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Macroeconomic and geopolitical outlook

The financial markets have recently undergone a significant shift in their outlook for the United States and the rest of the world following the election of Donald Trump in November. This article delves into the underlying reasons for this change, the potential impacts on the global economy, and the strategies that Europe and other economies might adopt in response to these challenges.

Markets have completely changed their outlook since the election of Donald Trump

There has been a notable change in sentiment, and as always, the question is what was initially priced in. For the US, the expectation was an immediate implementation of pro-growth policies. Instead, we have witnessed the rollout of the least growth-friendly parts of Trump's agenda, namely tariffs, which are essentially taxes. This process is ongoing, with more measures expected. Additionally, we have seen federal spending cuts and reductions in the federal workforce, which, in fairness, might have been anticipated from the start. However, many did not foresee this. The rollout of these policies has also led to a spike in uncertainty, which is highly detrimental to economic activity. We have observed signs of a pronounced slowdown in retail sales and manufacturing production, along with a marked deterioration in several confidence indicators. Despite this, the US economy remains robust. It started from a strong position, allowing it to decelerate while still maintaining strength. The labour market remains very robust, with the unemployment rate at a record low, just above 4%. The direction of travel is concerning, and it could deteriorate further, depending on the evolution of the trade war in the coming weeks.

Can Europe become autonomous in terms of defence?

The question of whether Europe can achieve autonomy in defence over the medium term is crucial. Currently, Europe does not have the means to do so. However, it is not the case that Donald Trump has declared an immediate withdrawal from NATO. The issue is more about the direction of travel. Realistically, Europe is giving itself around five years to reach a greater level of autonomy. This requires immediate spending, which is why the recent German decision is so encouraging. At the European level, and in conjunction with the UK, which is vital for the continent's defence, decisions are being made to free up fiscal space and increase defence spending. There are technological and production capacity aspects to consider, in addition to financial ones. Europe has relied on the US security umbrella since the Second World War, and this cannot be undone in a matter of weeks. However, we believe it is going to happen. Europe perceives an existential threat and is determined to do whatever it takes to achieve this level of autonomy.

ECONOMIC RESEARCH by BNP PARIBAS

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What strategy should Europe adopt in response to Donald Trump's tariffs?

It is essential to distinguish between negotiation tactics and the optimal steady state. As economists, we know that lower tariffs are better. Therefore, we should strive to avoid any escalatory spiral. However, negotiating with Donald Trump requires a different approach. He responds better to strength than to weakness. In this context, the stance taken by the EU so far is appropriate. The EU has stated that it does not want tariffs, considering them a tax on consumers and businesses. However, if the US imposes tariffs, the EU will retaliate. This approach is risky but necessary. The European Commission is fully aware of the need to minimize self-harm. Importantly, trade with the US is not the main engine of growth for Europe, accounting for less than 10% of its total trade. The EU's main trading partner is itself. Therefore, increasing intra-single market trade can easily offset a decline in trade with the US. Europe has had a significant current account surplus for decades, driven by an export-oriented growth model. As Europe ramps up investment in infrastructure and defence, we expect this surplus to shrink, shifting towards a more domestically-driven growth model. China has similar ambitions, although there are reasons to be sceptical about the speed of this transition. If the US succeeds in reducing its trade deficit and remains the consumer of last resort, it will force the rest of the world to adopt a more domestically-driven growth model. This scenario is not necessarily bearish for Europe, given its high savings rate, which provides room for increased consumer spending if confidence returns.

What will central banks do in the face of these uncertainties?

The European Central Bank (ECB) and the Federal Reserve (Fed) are in very different positions. The ECB is dealing with an economy operating below full potential and a downward trend in inflation across all components, including services. Recent data have been encouraging, positioning the ECB to continue cutting rates towards neutrality, estimated at around 2%. The ECB has room to cut rates further, with additional cuts expected in the next quarter. The ECB must navigate the negative shock from US trade policy and potential retaliation, balanced by the positive impact of the German fiscal boost and increased defence spending. Overall, the ECB can be confident in bringing inflation back to 2% while easing monetary policy further. The Fed, on the other hand, faces higher inflation and de-anchoring inflation expectations among households. Market measures of inflation expectations remain stable, but the Fed must consider the potential price impact of high tariffs. The economic environment has changed significantly since the first Trump administration, making it unlikely for the Fed to cut rates this year unless the economic damage from policy rollout leads to a recession and labour market deterioration. Currently, the US is experiencing stagflationary dynamics, limiting the Fed's ability to cut rates in this environment.

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