DETERIORATING GROWTH PROSPECTS DUE TO THE US TARIFF SHOCK: AN UPDATE

The announcements on April 2, featuring a massive and widespread (albeit differentiated by country) increase in US tariffs, constitute a historic shock. The final extent of the damage and the aftershocks remain to be seen, but there is no doubt that the economic consequences will be negative, starting with the United States. They are already evident in the turbulence on US financial markets. Even if there is a de-escalation in the trade war, which is our base case scenario, uncertainty remains extremely high, and activity will be penalized for a long time. According to our forecasts, the US economy would slow down significantly but avoid recession. The expected rise in US inflation would prevent the Fed from easing its monetary policy in 2025. The anticipated strengthening of growth in the Eurozone, driven by rearmament and investment efforts, would be dampened by the US tariff shock but would not prevent Eurozone growth from outpacing US growth in 2026. In 2025, the ECB would continue to have an easy task: the safe return of inflation to target and downside risks to growth point to further rate cuts (two of 25bps in our scenario, in June and July). The inflation/growth tradeoff facing the BoE is similar to that of the Fed, but not to the point of preventing it from further easing (one cut per quarter until early 2026). The BoJ, meanwhile, would pause its cautious rate hikes due to growth concerns.

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 (albeit differentiated by country) increase 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 US; 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[1].

LESS GROWTH EVERYWHERE, FIRST AND FOREMOST IN THE US

Prior to the announcements on 2 April, we revised our growth forecasts in March, downwardly for the US (because of a more rapid and significant increase in tariffs than initially embedded) and upwardly for the Eurozone (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)[2]. 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. The risk of a recession in the US 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). The US economy would avoid recession under the optimistic assumption of a tariff de-escalation[3] 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. 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 1.0% in 2025 and 1.3% in 2026. 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 US and the Eurozone, now also has the distinctive feature of forecasting growth in the Eurozone higher than in the US 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. 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 US.

ABOVE-TARGET INFLATION EVERYWHERE, BUT IN THE EUROZONE

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 and/or Fed's independence is not called into question). 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.

1 See our latest issue of EcoPerspectives for our full analysis on the current economic situation and outlook in the main advanced economies we cover.
2 For the US, we lowered our growth forecast 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%).
3 Average effective tariff on US imports lowered to 16% from 27.3% based on announcements on 10 April.

EDITORIAL

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 US 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, headline inflation is 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.

In the United Kingdom, the inflation target appears out of reach in both 2025 and 2026, mainly for domestic reasons (food inflation, wage and rent inflation) unrelated to the US tariff shock. In Japan, inflation remaining above target is, on the contrary, in line with the desired outcome in order to break the spiral of creeping deflation.

HARDEST INFLATION/GROWTH TRADEOFF FOR THE FED, THE ECB HAS THE EASIEST TASK

We continue to believe that, given the risk of a de-anchoring of inflation expectations and based on our forecasts, the Fed cannot ignore the rise in inflation and cut rates in response to the economic slowdown. 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). The absence of rate cuts makes monetary policy restrictive in nominal terms but not in real terms, given the rise in inflation. In 2026, on the other hand, the Fed should be in a position to resume rate cuts (-100 bps), as the inflation/growth trade-off shifts in favour of the latter.

For the ECB, the conditions remain ripe for further rate cuts in the short term. We continue to expect another 25-bps cut in June, following the one in April, and followed by another one in July given the downside risks to growth. At 1.75%, the deposit rate would stand in the lower part of the neutral rate estimate range (1.5-2.5%). 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 bps according to our forecasts), further accentuating the decoupling with the Fed.

The BoE has less leeway than the ECB on the inflation front 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).

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> The anticipated strengthening of growth in the Eurozone, driven by rearmament and investment efforts, would be dampened by the US tariff shock but would not prevent Eurozone growth from outpacing US growth in 2026.