THE GLOBAL ECONOMY AT MID-YEAR: SO FAR, SO GOOD. BUT WATCH OUT FOR THESE THREE DERAILERS IN THE 2ND HALF.

Outside the US, GDP growth in the first quarter generally exceeded expectations in the European Union, the UK, and emerging economies, including China. After the surge in imports that preceded the US tariff hike, the backlash in the second quarter will be more limited than expected in most cases. However, it would be premature to sound the all-clear, as three dangers loom: tariffs, inflation, and public debt.

THE PATIENT IS HOLDING UP BETTER THAN EXPECTED SO FAR

Outside of the US, where it contracted, Q1 GDP growth generally exceeded expectations — in the EU's case by a wide margin, with a quarter-on quarter pace of 0.6% vs 0.2% forecast by the ECB in March. UK growth surprised on the upside as well. Emerging markets proved surprisingly resilient too: China's growth beat expectations at 5.4% year-over-year and growth surprises were generally positive across the board. Following the Q1 surge in exports to the US to front-run tariffs, a large payback in Q2 has been expected, but the data available so far — notably PMI surveys, exports and industrial production — suggest it will be limited in most cases. (The UK stands out with a contraction in activity recorded in both May and June, and France indicators have been lagging behind the rest of the Eurozone). Even China, epicenter of the trade war, saw its exports continue to grow strongly, allowing Q2 GDP to decelerate only slightly to 5.2% yoy. In line with activity, labour markets have remained strong, with unemployment rates at or near historical lows in most regions[1].

RECOVERY OF THE CONSENSUS AND STOCK MARKETS

Accordingly, consensus GDP growth forecasts and stock markets have recovered from their spring trough. Most regions should record either a mild deceleration or, in the case of the Eurozone, an acceleration[2]. The US growth outlook has been downgraded the most compared to the start of the year; but recession fears, which loomed large back in April, have evaporated (*chart 1*). And its main stock indexes, while still lagging global peers — particularly in US dollar terms (*see chart 2*) — were near record highs at the time of writing.

What accounts for this surprising resilience? Trade war restraint, falling inflation, fiscal policy support and supportive financial conditions.

Following the April 2 "Liberation Day" tariff salvo, US trade policy retreated to a less aggressive posture, both *de jure*, but even more *de facto*. After reaching nearly 30% at the peak of trade hostilities between the US and China, the US average external tariff quickly retreated below 15% in statutory terms; but the rate effectively collected stayed below 10% through May. Apart from Canada and China (who later relented), no trading partners retaliated. Instead, all except the US have been redoubling efforts to boost trade links with other counterparts.

REAL GDP CONSENSUS FORECAST, Y/Y, %

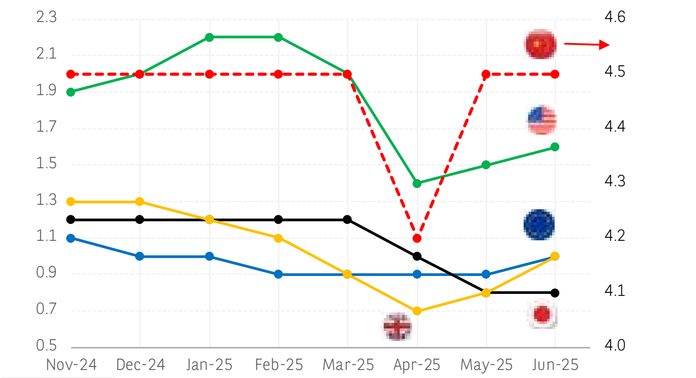

CHART 1 SOURCE: CONSENSUS ECONOMICS INC, BLOOMBERG, BNP PARIBAS

MSCI EQUITY INDEXES IN USD, 01/01/2025 =100 2025

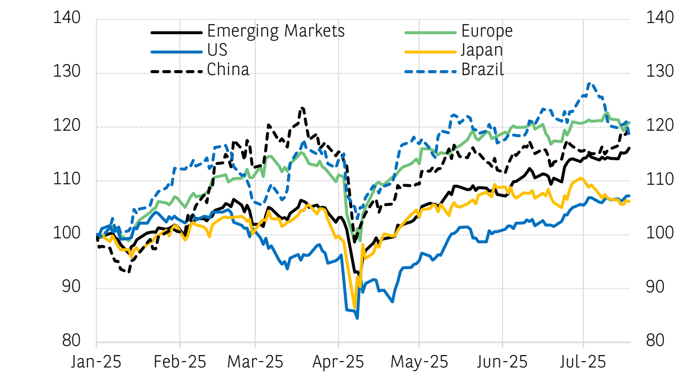

CHART 2 SOURCE: LSEG, BNP PARIBAS

As a result, global trade has held up well, even accounting for the front-running-then-payback dynamics created by the staggered timeline announced by the US for higher tariffs to come into force. Even as exports to the US fell, overall exports did not[3].

1 For more details, see our July EcoPulse.
2 Our own forecast expects a better outturn than the consensus, with +1.2% GDP growth in 2025, but either way it would be one of the few regions in the world with accelerating growth in 2025.
3 See our recent Chart of the Week on this topic: The first effects of the Trump tariffs are measurable, and they are massive.

THE VAST MAJORITY OF ECONOMIES HAVE SEEN INFLATION MAKE FURTHER PROGRESS TOWARD THEIR CENTRAL BANK'S TARGET

In the Eurozone, inflation has actually been back at target for the last two months. This has allowed most central banks across developed and emerging economies to reduce the restrictiveness of their monetary policy stance[4]. This was facilitated by two unexpected developments: instead of the textbook prescription that the USD dollar should appreciate in response to tariffs, in fact the opposite happened. Since the start of the year, the US dollar has weakened against most DM and EM currencies, thereby cheapening the cost of all imported goods priced in US dollars. On top of this effect, energy prices have been pushed down by unfavourable supply-demand conditions created by OPEC countries to regain market share. Lower inflation has helped support growth by restoring purchasing power for households and by allowing central banks to ease monetary policy.

FISCAL POLICY SUPPORT HAS BEEN A POWERFUL WILD CARD

Nowhere more than in Europe has fiscal policy support been a powerful wild card. In particular, Germany's decision in April to reform its constitutional debt brake to allow at least EUR 1 trillion of public investment in infrastructure and defence has been a game-changer. The European Commission's decision to give member states flexibility from the bloc's fiscal rules in order to meet their new and higher defence spending commitments has provided additional space. In all, from a restrictive stance in 2024, fiscal policy should turn neutral or even mildly stimulative in 2025 and especially 2026. These steps, alongside targeted incentives to private investment in Germany, and a comprehensive agenda of supply-side structural reforms across the EU, have boosted sentiment indicators all around the Eurozone. On a smaller scale, China too has deployed fiscal policy to support domestic consumption, with expectations that more is to come.

As global investors have been reconsidering their expectations of US outperformance, many developed and emerging markets have seen strong capital inflows that tended to compress bond spreads and fuel the performance of their stock markets. Meanwhile, US investors have remained bullish about their own markets and allocated accordingly, with the same impact. All told, financial conditions have been supportive of activity almost everywhere.

IT WOULD BE PREMATURE TO SOUND THE ALL-CLEAR

Three dangers lurk: tariffs; inflation; public debt. Days from the expiration of the latest deadline set by President Trump to reach "deals", there is a very real prospect that baseline tariffs for most countries, including the EU, will be significantly higher than the currently prevailing 10%. Moreover, additional sectoral tariffs have yet to be announced, which will further raise the effective rate. While the eventual reduction in tariff uncertainty will help, higher tariffs, applied asymmetrically across countries, will create multiple frictions and headwinds to growth that in some cases may be too large to offset with domestic policy support. Moreover, higher tariffs are more likely to elicit retaliation, which could then lead to escalation and further damage to growth. Stock markets being priced for steady earnings growth could reprice violently.

Inflation is primarily a concern for the US economy. But one with global implications. The US June inflation showed modest but unmistakable signs of the first passthrough of tariffs into domestic prices. Core goods excluding used vehicles have seen prices rise at their fastest monthly pace since Spring 2022, when inflation surged. We expect the impact of tariffs to become far more visible over the coming few months. That's not controversial. What is, is how large the passthrough will be, and how long the price shock will persist. Some, like Fed Governor Waller, believe that the passthrough will be limited and short-lived. He therefore favours a rate cut as early as next week[5]. A majority of FOMC members, as of the last meeting, were concerned the opposite may happen and therefore favour keeping the Fed policy modestly restrictive. As long as the Fed is seen as retaining the independence to act in line with what it believes to be the right policy to meet its dual mandate of stable inflation and maximum employment, there is no reason for the tariff increase to create persistent inflation, or markets fear thereof. But should recent relentless political attacks on the Fed by the Trump Administration evolve in such a way that investors no longer trusted the independence of the Fed, sharp adverse market reactions would be likely, especially in bond and FX markets. Such shocks would then be likely to reverberate across global markets.

Last, but not least, bond markets have been so far relatively forgiving of ever larger public borrowing requirements from the largest economies in the world: the US, Germany, Japan, the UK and France, albeit all have seen the cost of their long term debt rise meaningfully over the last year — by 20 to 50 bps at the 10-year maturity point. 30-year yields have been even more under pressure. In recent months, the US 10Y yield has actually fallen, reflecting in part a deliberate strategy to borrow more at the short end of the curve. This saves on the interest bill[6] but creates higher refinancing risks. As long as fiscal policies are perceived to be broadly sustainable, markets will remain well-behaved, and yield increases will remain orderly. However, with the exception of Germany, whose debt to GDP ratio and debt trajectory raise no concerns whatever, there is no room for complacency. Policymakers should remember from the turmoil generated by then UK's Prime Minister Liz Truss's mini-budget in September 2022 just how quickly bond markets can turn punishing.

The year has worked out better than expected so far, and this positive momentum has strong potential to carry on through year-end. Let's hope politics do not interfere. Happy Summer.

Isabelle Mateos y Lago

4 The US Federal Reserve and, among EM, the central banks of Brazil and Türkiye. are notable exceptions.
5 See "The Case for Cutting Now", speech by Governor Christopher Waller, July 17, 2025.
6 See our Chart of the Week on this topic: Rising long-term interest rates: a relatively good point for the Eurozone.