EDITORIAL

HOW DIFFERENT WILL 2025 BE FROM 2024?

The year 2024 is coming to an end, but political and economic uncertainties persist and are expected to continue into 2025, albeit in new forms. Donald Trump's economic agenda is known. On the other hand, the measures that will actually be implemented, their timing and their economic impact are among the great known unknowns of 2025. In any case, uncertainty itself is expected to be a major drag on growth next year. A convergence of growth rates between the US and the Eurozone is expected in the course of 2025, via a slowdown in US growth. The latter would suffer from the inflationary effects of Trumponomics and the resulting more restrictive monetary policy, with the Fed's expected *status quo* on rates throughout 2025. In the euro area, the expected strengthening of growth would remain limited and constrained, but the return of inflation to the 2% target would be secured, allowing the ECB to continue its rate cuts. 2025 would thus be marked by the beginning of convergence of growth rates between the United States and the euro area, but by divergent inflation trajectories and a decoupling of monetary policies. Next year should also be different from 2024 by a likely rise in unemployment rates. The possibility of a European revival and the potential introduction of bolder measures to address the region's structural challenges are among the upside risks.

2024 is not quite over yet and there is still a lot of uncertainty as the year draws to a close, but the focus is already on 2025. How different or similar will next year be to this year?

The weight of uncertainty. One point that 2024 and 2025 both have in common is the high degree of uncertainty adversely affecting the economic environment. This is certainly not specific to either year, as it has been a recurring feature for several years now. The nature and origins of this uncertainty differ over time, but it is actually persisting and even getting more intense. In 2024, the results of the numerous elections over the year were high among these known unknowns. Now that the results of these elections are known, they do create other uncertainties for 2025, however. First and foremost of these uncertainties, is President-elect Donald Trump's planned economic agenda, relating to which measures he will actually implement and when, and what the economic consequences will be both for the United States and the rest of the world (*see box*). And while some political uncertainties have disappeared, others have taken their place, particularly in France, Germany and Japan. Together, they stand as another impediment to growth[1].

Growth rates would start to converge. Growth prospects on both sides of the Atlantic should somewhat continue their 2024 trajectories, with US growth remaining significantly higher than euro-area growth (with the 2025 annual averages standing at 2.1% and 1%, respectively). However, these figures are expected to mask a convergence starting in the course of 2025, with a fairly significant slowdown in US growth anticipated. Eurozone growth rebound is expected to remain limited, constrained by an ever-increasing number of headwinds[2] that will counteract those factors supporting growth[3]. Nonetheless, 2025 should still be slightly better than 2024 (0.8%). In 2026, we expect the US slowdown to continue (1.3%), which is partly why we do not expect a stronger growth rate in the euro area (1%). This slowdown will contribute to a significant narrowing of the growth gap between the United States and Europe.

The United Kingdom and Japan are expected to see their economies accelerate quite sharply in 2025 (through a combination of monetary and fiscal support in the United Kingdom and a more supportive momentum of household disposable income in Japan) before slowing down again in 2026 (as the effects of US protectionist measures kick in).

Fiscal consolidation and rising unemployment. Unlike 2024, 2025 should see more fiscal consolidation and likely a more marked rise in unemployment rates. Against this backdrop, and despite help from lower interest rates and significantly higher purchasing power gains in 2024, it seems difficult to predict that 2025 will finally see a rebound in consumer spending in Europe and a sharp drop in savings rates. From this point of view, 2025 could look very much like 2024.

Corporate investment is also facing headwinds. On the one hand, there is the easing of financing conditions and the ever more critical need for digitalisation and the greening of production systems, while on the other, there are some signs of deterioration in companies' financial positions, fragile demand and prevailing uncertainty. Over the year as a whole, 2025 could see a deterioration in this growth component compared to 2024. Conversely, residential investment could benefit a bit more from the easing of credit conditions, with a knock-on effect of helping the construction sector to start coming out of the crisis that it has been facing. There are also hopes that the European automotive industry will also start to emerge from its current downturn. However, there is no certainty that the entire industrial sector will see an end to its recession. While the situation could be better in 2025, it should nonetheless be yet another challenging year for industry as a whole (with the aeronautics sector seemingly escaping this trend, with more positive prospects). The dichotomy between the difficulties in industry and the growth engine role of the services sector, one of the characteristics of 2024, is likely to continue into 2025.

1 See, for example, the recent work by the OFCE on quantifying the economic cost of uncertainty (https://www.ofce.sciences-po.fr/blog2024/fr/2024/20241203_RS/, 3 December 2024).
2 Increased uncertainty about trade policy, potentially weaker German growth, French fiscal consolidation and higher customs tariffs.
3 Increased real income, easing of credit conditions, buoyant economies in Southern Europe, continued disbursements of NGEU funds, and the likely increase in specific budgetary items (defence and decarbonisation).

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Inflation and monetary policy on diverging trajectories on both sides of the Atlantic. According to our forecasts, diverging inflation trajectories between the US and the euro area are what will primarily distinguish 2025 from 2024 and, as a result, lead to a decoupling between monetary policies.

We expect US inflation to rise again from Q2 2025 under the effect of Trumponomics 2.0 and this would prevent the Fed from continuing its cycle of rate cuts initiated in September 2024. The Fed will not be able to look through this new pickup in inflation given the still relatively favourable economic and financial backdrop. After an expected final cut of 25 basis points at the December FOMC meeting, we believe that it will opt for a prolonged monetary status quo on Fed Funds, whose target range would be kept unchanged at 4.25-4.50% until mid-2026. It is then expected to resume its rate cuts (we anticipate two of 25 bps each), once inflation reaches its peak according to our forecasts. Even if inflation remains high, US growth falling below its potential pace could enable the Fed to be more forward-looking.

In the euro area, disinflationary pressures should prevail, and the return to the 2% inflation target should be secured in 2025, enabling the ECB to continue the gradual easing of its monetary policy until it reaches the neutral level in the middle of next year. Specifically, after four rate cuts of 25 bps in 2024, the ECB is expected to continue at this pace at each of the upcoming meetings and should therefore make four further rate cuts in 2025, taking the deposit rate down to 2% in June, which corresponds to the midpoint of our neutral rate range. However, it is likely that the ECB will cut rates below this neutral rate and begin to adopt an accommodative policy if the economy weakens more than we expect.

Overall, there are more downside risks than upside risks in this new baseline economic scenario. However, we will conclude by highlighting an upside one: Europe may bounce back with bolder measures being implemented to address the region's structural challenges[4].

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4 For more information, read Isabelle Mateos y Lago's editorial, European Silver Linings, 12 November 2024.

Trump 2.0: differenciated direct negative effects, widespread indirect negative effects

For the United States, our baseline scenario is based on an almost full implementation of Trump's economic platform, based on the following assumptions:

• A 25 percentage-point (pp) increase in tariffs on Chinese goods (up to an effective rate of around 40%): +10 pp in Q1 2025 and the remaining 30 pp being implemented from Q3 2025 and phased in over four quarters.

• An average increase of 3 pp in tariffs on other countries (with an overall effective rate of around 5%), starting in Q4 2025 and phased in over four quarters.

• In the short term, some countries, such as Canada and Mexico, should escape tariff increases. These would also not apply to goods with highly visible prices, such as oil or unprocessed food.

• TCJA tax cuts are extended and combined with government spending cuts, mainly in social welfare, including some in 2025-2026. The fiscal impulse should be slightly negative compared to 2024.

• On the immigration side, net new irregular arrivals are forecasted to fall to around 300,000 in 2025 (compared to 1 million in 2024 YTD and compared to a negative net rate of 129,000 in 2019). No large-scale involuntary departures are expected.

• Deregulation should take the form of a broad pause in new rulemaking, a streamlining of administrative processes, and targeted deregulation measures to support investment, especially in the energy sector.

The net impact (positive minus negative effects) on US growth of this programme is initially expected to be positive over approximately the first six months of 2025. The American economy should continue to show signs of resilience, supported by post-election optimism, before starting to suffer more noticeably because of the new Trump administration's economic policy, in particular its inflationary effects and an ensuing more restrictive monetary policy.

In a qualitative way, among Europe's major developed economies reviewed in our publication, we expect Germany and Italy to be the most vulnerable to increases in tariffs, given their close trade links with the United States, their high bilateral trade surpluses and their sectoral specialisation. The Netherlands is stuck in the middle: the United States is just the fifth largest destination for Dutch exports and the United States has a significant trade surplus with that country, but the Netherlands is also a hub for European trade.

France, on the other hand, appears to be relatively unexposed directly, with bilateral Franco-American trade being rather balanced. The mutual dependence of both countries on the aeronautics industry should also protect this sector. For Belgium and Spain, the direct consequences should also be limited, as both countries export relatively little to the United States. The weight of services in the Spanish economy is another protective factor, as this sector should not be affected by the higher tariffs. The United Kingdom also does not appear very vulnerable, as while there is a trade surplus with the United States, it is very small. Furthermore, the United Kingdom, like Spain and France, is a services-oriented country.

Outside Europe, Japan appears to be doubly exposed, as the United States is Japan's largest export market and China is the second largest. While the direct effects will be more limited for some countries than others, all will be negatively impacted by the all-pervasive uncertainty, but also by knock-on effects (through inputs and lower growth among European partners) and any trade war escalation or retaliatory measures. The net impact in terms of inflation is currently unclear, between the inflationary factors (due to higher tariffs and the depreciation of currencies against the US dollar), disinflationary ones (weaker demand, disinflationary pressures or even deflationary Chinese pressures) and the behaviour of corporates regarding their margins (to what extent they have pricing power and are able or not to protect their margins). The ECB and the BoE are expected to be able to continue their monetary easing by focusing on the downside risks to growth, while the BoJ is set to continue its very gradual tightening.