Monthly Economic Monitor - World

Economics and Strategy

NATIONAL BANK OF CANADA FINANCIAL MARKETS

December 2024 - January 2025

U.S. elections add layer of uncertainty to global outlook

By Jocelyn Paquet

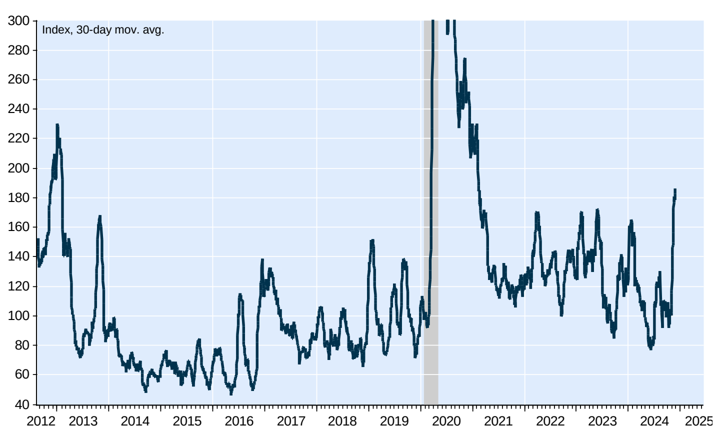
Summary

- Of all the events of the past month, the U.S. election is undoubtedly one that will continue to impact the global outlook for the foreseeable future. This is not only due to the protectionist policies advocated by the President-elect during his campaign, but also to the fact that the implementation of these policies has been made more likely by the Republican Party's takeover of both houses of Congress.
- Taking several factors into account, and bearing in mind that any projection made at this stage is highly uncertain, our base scenario incorporates only a modest intensification of Washington's protectionist measures in 2025. We expect China and Mexico to be the main targets of new tariffs, with the latter country bearing the brunt of collateral economic damage due to its greater exposure to U.S. demand. Canada, Vietnam, Germany and Japan could also be affected, but to a lesser extent.
- The shock of new tariffs should be manageable, but that doesn't mean that global growth will be solid in 2025. This is because the escalation of trade tensions will occur at a time when many parts of the world are already showing signs of weakness.
- Our global growth forecast for 2025 remains unchanged at 2.9%, with downward revisions in China and Mexico largely offset by a significantly more robust trajectory in the U.S. Looking further ahead, we expect global growth to accelerate slightly to 3.1% in 2026.

Of all the events of the past month, the U.S. election is undoubtedly one that will continue to impact the global outlook for the foreseeable future. This is not only due to the protectionist policies advocated by the president-elect during his campaign, but also to the fact that the implementation of these policies has been made more likely by the Republican Party's takeover of both houses of Congress. We say “more likely” because, to a large extent, the program that will be put forward on Day 1 of the new administration remains a mystery. And it is precisely this uncertainty that is helping to raise anxiety levels in many of the world's capitals.

U.S.: Republican sweep casts doubt about Washington’s future policies

Economic policy uncertainty index for the U.S.

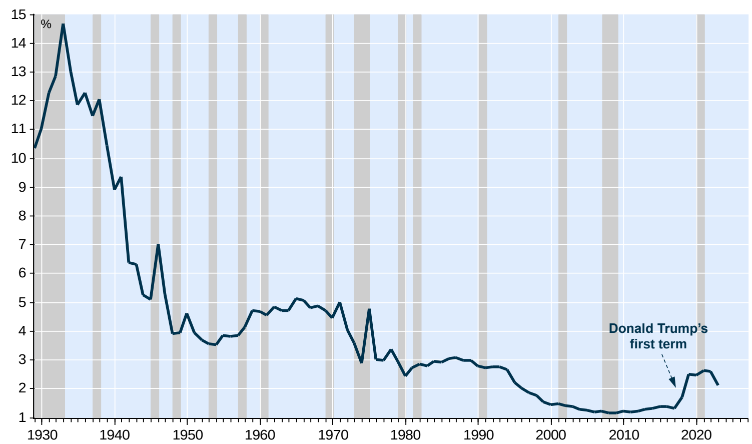


NBC Economics and Strategy (data via Refinitiv)

It is, of course, the threat of tariffs that is generating the most stress. And with good reason. President Trump's first term in office had already seen a reversal of the secular trend towards lower tariffs, and given the growing support for such measures both within Republican ranks and in public opinion, it is logical to expect them to be used more widely in the future.

United States: The end of a century-old trend?

Custom duties as a percentage of total imports



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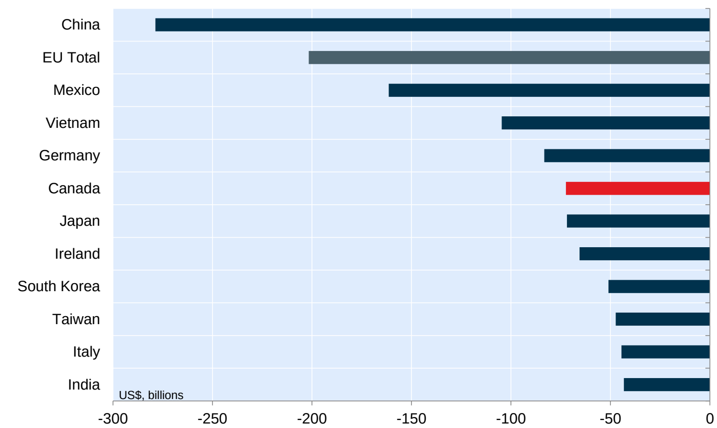
It goes without saying that the imposition of additional tariffs by Washington would weigh on global economic growth, but it is almost impossible at this stage to know to what extent. There are simply too many unknowns. Would affected countries retaliate? Would tariffs be challenged in court? Would these legal actions be successful? And if so, how long would it take to enforce court decisions? But before we can even address these questions, we need to know which countries will be affected, and to what extent. And on these points, we may not get much reliable information before the handover of power on January 20. The President-elect has put forward a few figures in recent weeks (25% tariffs on all imports from Mexico and Canada, an additional 10% on China and 100% on the BRICS countries), but these are more likely to serve as starting points for negotiations than as final offers.

Not knowing the exact details of the U.S. administration's future policy does not, however, prevent us from providing our readers with an analytical framework for judging the degree of exposure of different countries to protectionist measures. Rightly or wrongly, President Trump and his entourage believe that the United States is being “cheated” by countries with which it has a significant trade deficit. According to this parameter, China, Mexico, Vietnam, Germany, Canada and Japan seem particularly exposed to an intensification of the trade war.

World: The trade deficit likely to be the main contention point
Merchandise trade deficit with the United States in 2023, balance of payment basis



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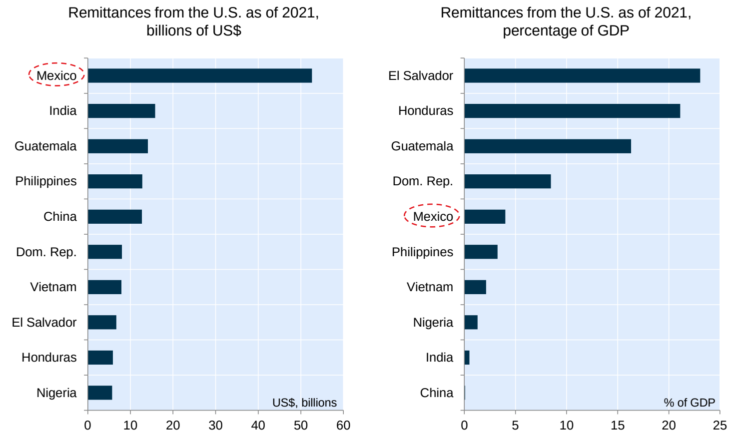
Central America highly exposed to a drop in migration flows to the U.S.

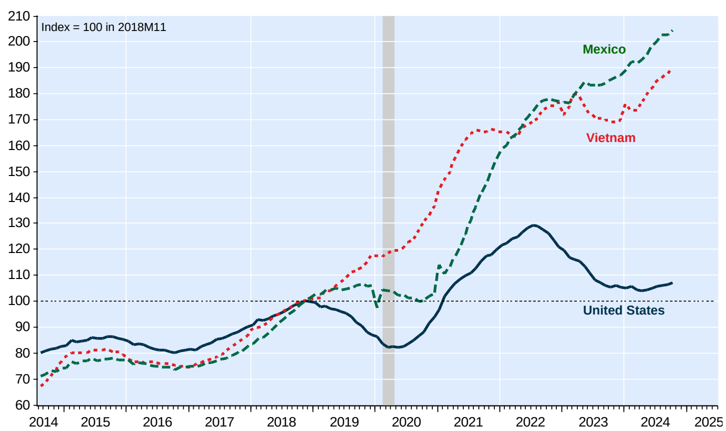


NBC Economics and Strategy (data via the Migration Policy Institute and the IMF)

While the trade deficit is likely to be one of the main criteria used in Washington to determine *which* country will be hit by tariffs, other factors could also come into play to determine the *scale* of these duties. Generally speaking, we believe that countries geopolitically aligned with the U.S. (Canada and Japan, for example) are likely to be treated more leniently than so-called “rival” countries (China). Mexico could be an exception here. Although an ally of the United States, it could be treated relatively more harshly in terms of trade relations, as it is largely responsible for two problems that the new administration seems particularly determined to eradicate: illegal immigration and opioid smuggling.

Washington is also unlikely to take kindly to the fact that Mexico is one of the main beneficiaries of China's re-export strategy, in which goods destined for the U.S. market are channeled through third countries. Other countries are also at risk of being reprimanded for the same reason, notably Vietnam.

Beneficiaries of re-export schemes could be targeted by Washington
China's merchandise exports, selected countries



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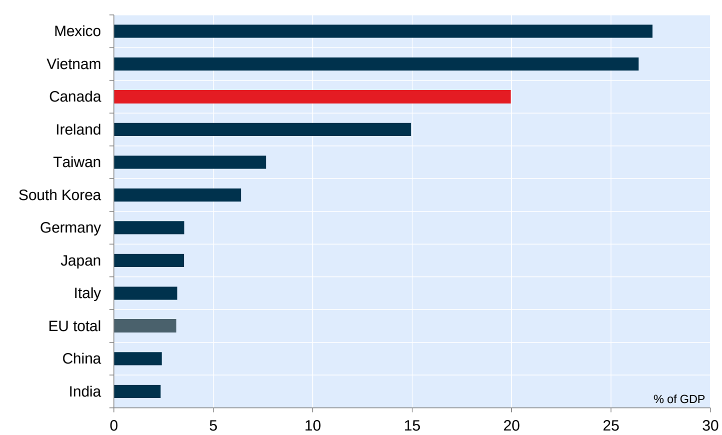
Mexico's vulnerability to a significant reduction in the flow of migrants to the United States should also be highlighted, whether through a reduction in Washington's immigration targets, tighter border surveillance or, less likely, the deportation of illegal immigrants already on U.S. soil. Whatever the method used, if Washington were to succeed in reducing the number of Mexicans taking up residence in the U.S., the result would most likely be a decrease in the remittances they make to their country of origin. And since these account for around 4% of Mexican GDP, this would certainly have a negative impact on growth. The same applies to several other Central American countries.

Returning to our risk analysis framework, and taking into account the factors listed above, we would say that the countries most likely to be affected by tariffs are China and Mexico, closely followed by Vietnam, Canada and Germany. But even in these cases, we doubt that Washington will opt for blanket tariffs, as such an approach would risk reigniting inflationary pressures in the U.S. and sowing chaos in supply chains. It could also fuel anger in the many states where a disproportionate share of employment depends on the free flow of goods from one country to another. In our view, these considerations will lead Washington to adopt a more restrained “industry-by-industry” strategy, with fewer risks for its domestic economy.

As for what this will mean for the growth of countries that will nonetheless be targeted, this will depend on their exposure to U.S. demand. A good way to assess this is to measure the importance of their exports to the United States in their overall economy. And according to this metric, China appears less vulnerable than Mexico, Vietnam or Canada.

China less dependent on U.S. demand
Merchandise exports to the U.S. as a percentage of 2023 GDP



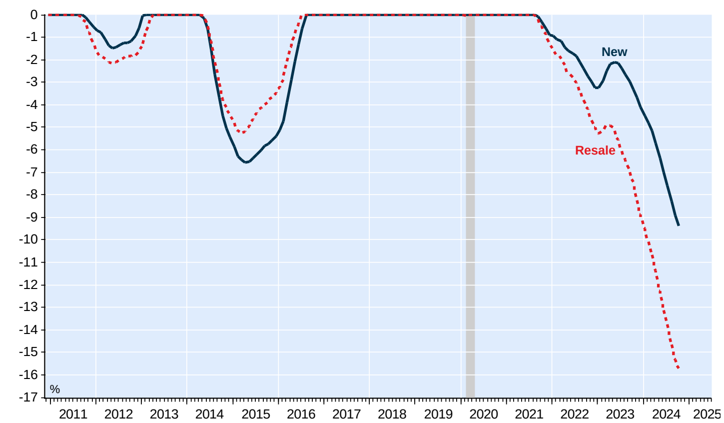
NBC Economics and Strategy (data via the Census Bureau and the IMF)

Taking all these factors into account, and bearing in mind that any projection made at this stage is highly uncertain, our baseline scenario incorporates only a modest intensification of Washington's protectionist measures in 2025. We expect China and Mexico to be the main targets of new tariffs, with Mexico bearing the brunt of collateral economic damage due to its exposure to U.S. demand. Canada, Vietnam, Germany and Japan could also be affected, but to a lesser extent.

However limited, the imposition of tariffs should still result in lower growth in the targeted countries, mainly through reduced exports and business investment. However, this decline should be partly offset internationally by a more robust expansion in the United States.

The shock of new tariffs should therefore be manageable, but this does not mean that global growth will be solid in 2025. This is because the escalation of trade tensions will unfortunately occur at a time when many parts of the world are already showing signs of weakness. China, for example, continues to suffer from a painful process of deleveraging in the housing sector, which has resulted in a sharp fall in house prices, an undesirable scenario in a country where real estate represents a disproportionate share of household wealth.

China: Home prices continue to decline
70-city residential building price index, drawdown since previous peak



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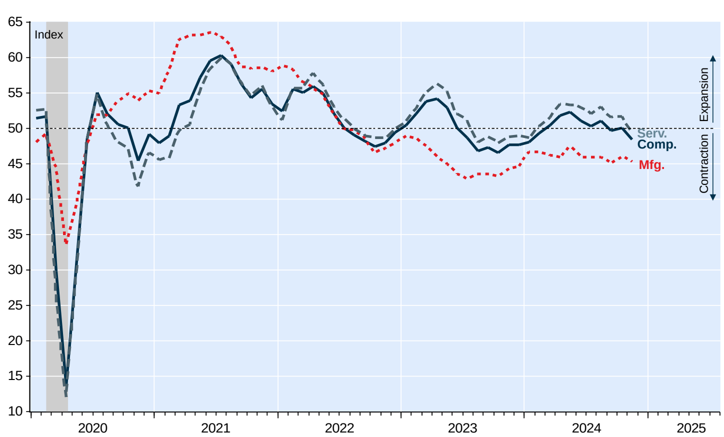
Not to mention the authorities' apparent aversion to more aggressive fiscal stimulus measures. While Beijing has announced an increase in the debt ceiling for local governments and authorized the refinancing of their shadow debt at lower cost, this may not be enough to fully offset the loss of revenue caused by the collapse in sales of land owned by these entities to property developers. As for possible direct transfers to households – the solution put forward by most economists – these do not appear to be on the cards for the time being.

More than China, however, it is the eurozone that is likely to continue to weigh on the global economy in the future. After a relatively encouraging Q3, growth seems to have slowed again in the single currency zone, judging by the most recent PMI report published by the HCOB.

Eurozone: The private sector back in contraction in November
HCOB Flash PMI. Last observation: November 2024



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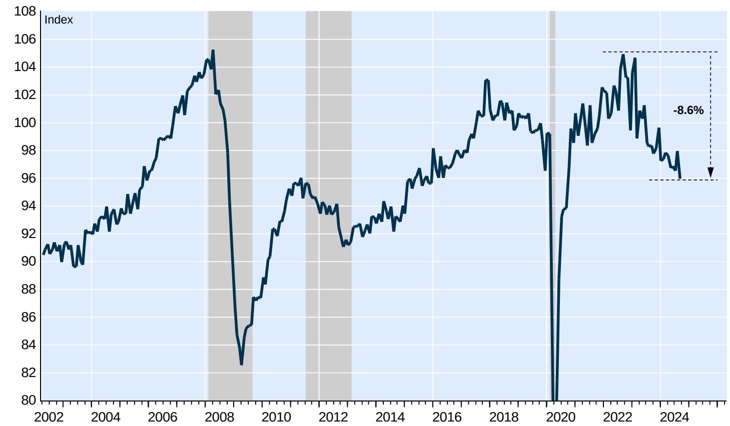
Industrial production, meanwhile, has continued to fall, with a disproportionate effect in Germany, which has been flirting with recession for several quarters now.

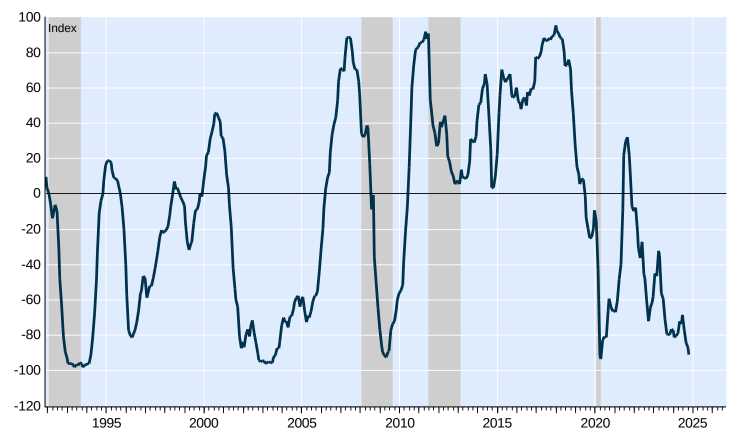
Eurozone: Industrial sector in a funk
Industrial production



NBC Economics and Strategy (data via Bloomberg)

Germans' optimism about their own economy even fell to one of its lowest levels ever following the collapse of the coalition government and the announcement of new elections in February.

Germany: One of the worst economic situation in living memory?
ZEW survey, assessment of current economic conditions



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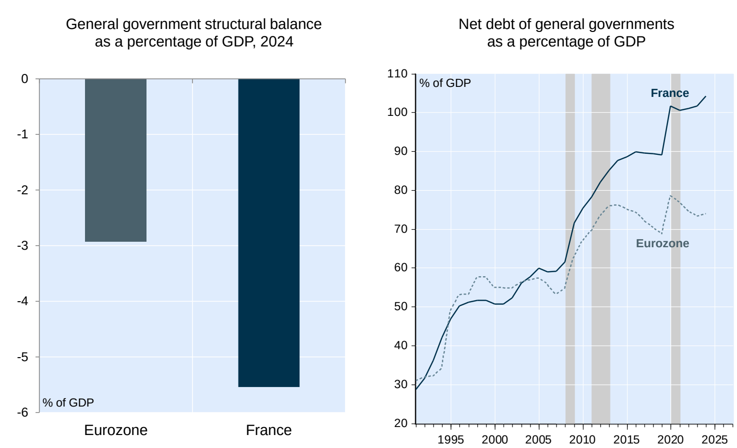
And as misfortune never comes alone, the French government also fell after failing to pass a budget that called for €60 billion in fiscal tightening.

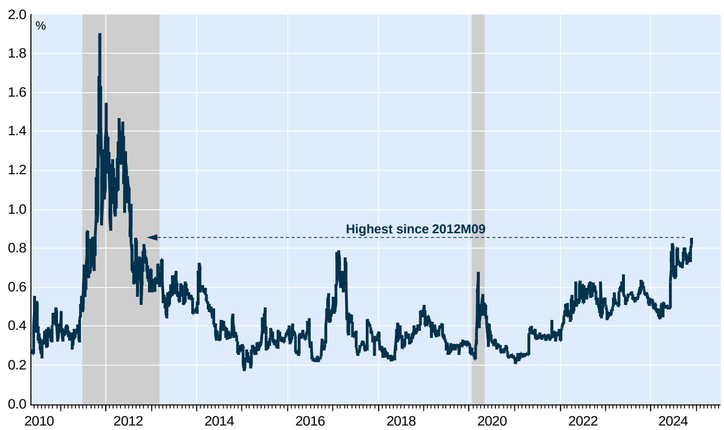
France: Public finances in need of a shake-up



NBC Economics and Strategy (data via the IMF)

This, of course, did nothing to calm markets already concerned about the overall trajectory of French debt and the fragmentation of the electorate. Credit spreads duly widened, even temporarily reaching their highest level since the 2011-2013 debt crisis.

France: Political brinkmanship eroding markets' confidence
Spread between a French 10-year bond and a German 10-year bond



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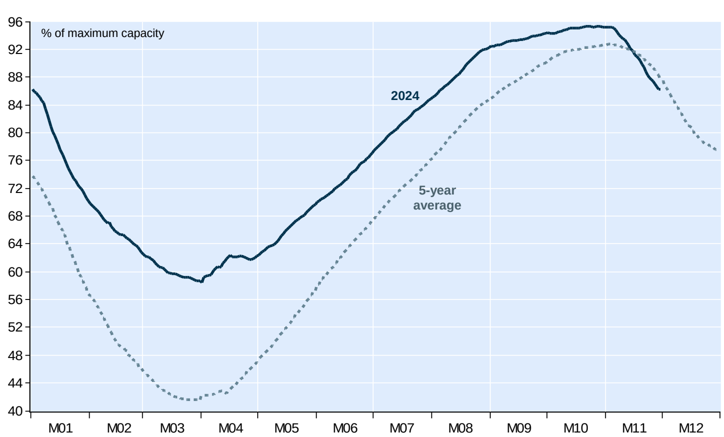
As if that weren't enough, another threat is looming on the horizon in Europe: that of a major disruption to gas supplies. Although reserves remain high by historical standards, they quickly fell below their five-year average this autumn, which was marked by the early arrival of cold temperatures. This was all it took for the price of natural gas for delivery on the European continent to jump; it has now doubled since the start of the year.

Eurozone: Early winter revives old fears about energy security
Reserves of natural gas



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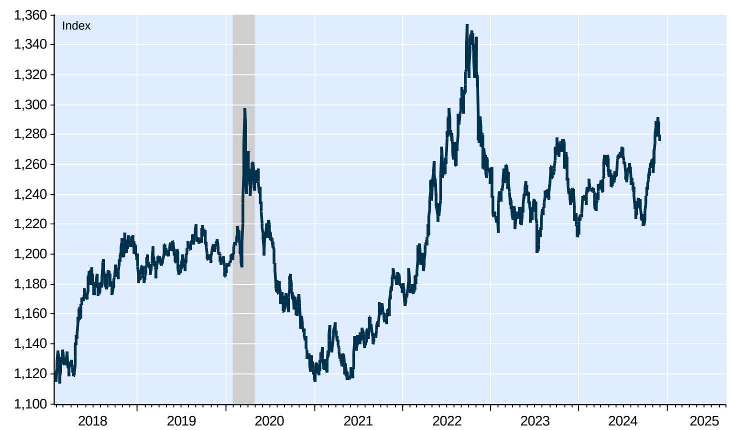
The fact that Gazprombank has been placed under sanction by the U.S. Treasury also partly explains this price movement. Remember that this bank was the last intermediary through which European countries could still pay for Russian gas deliveries to their territory. And although the volume of these deliveries has fallen considerably in recent years, they still account for a significant proportion of supplies to Austria, Hungary and Slovakia (65% on average). Even if an alternative method of payment could be found, there is still a risk that deliveries will cease on January 1, 2025, when the contract governing the transit of Russian gas via Ukraine comes to an end.

It's worth pointing out that, even if the worst-case scenario were to materialize, Europe would not be in danger of running out of natural gas any time soon. On the other hand, it would probably have to pay more for its supplies. This would not only act as a tax on businesses and consumers, but it would also reduce the European Central Bank's flexibility at a time when it is looking to stimulate growth.

In view of recent developments and future risks, we are maintaining our cautious forecast for eurozone growth in 2025. For the reasons mentioned above, we have also downgraded our growth scenario for China and Mexico. Growth in other emerging economies has also been revised downwards to take account not only of the risk emanating from Washington, but also of the continuing appreciation of the U.S. dollar, which is likely to make debt servicing more difficult in some countries and force certain central banks to give priority to defending their currencies to the detriment of growth.

World: Stronger USD a risk for emerging markets
Bloomberg USD Spot Index



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Despite these changes, our global growth forecast for 2025 remains unchanged at 2.9%, thanks to a significant upward revision of the U.S. growth trajectory. Looking further ahead, we expect global growth to accelerate slightly in 2026, to 3.1%.

World Economic Outlook

	2024	2025	2026
Advanced Economies	**1.7**	**1.6**	**1.5**
United States	2.8	2.2	1.7
Eurozone	0.7	0.8	1.2
Japan	0.0	0.8	1.0
UK	0.9	1.3	1.5
Canada	1.3	1.5	1.6
Australia	1.2	2.2	2.3
Korea	2.2	1.8	2.1
Emerging Economies	**4.2**	**3.8**	**4.1**
China	4.7	4.4	4.4
India	7.0	6.2	6.4
Mexico	1.5	0.8	1.7
Brazil	3.1	1.7	2.4
Russia	3.5	1.3	1.9
World	**3.2**	**2.9**	**3.1**

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