

Peterson Institute for International Economics

Global Economic Prospects: Spring 2025

April 15, 2025, 1:00 PM to 2:15 PM EDT

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[00:00:01.58] - Adam S. Posen

Hello everyone and welcome back to the Peterson Institute for International Economics. I'm Adam Posen, the Institute's President, and it's my pleasure to be hosting and also today contributing to our semiannual Global Economic Prospects meeting. As always, we hold these meetings timed to be roughly a week before the fall and spring IMF World Bank meetings, G20 meetings, and in particular to come out ahead of the IMF's World Economic Outlook. This is a tradition and one of our most popular event series that we have been running for, I think, nearly 20 years now. Fred Bergsten and I came up with the idea, and it was initially hosted—or not hosted, led by Michael Musa and then by David Stockton, and for the last I guess 7 or 8 years, we've been extremely fortunate to have Professor Karen Dynan, who splits her time between the Harvard Kennedy School and Peterson Institute, as the leader of our forecasting effort. As always, we combine Karen giving an overview of the real growth outlook and to some degree inflation for the global economy, meaning the major G20 economies, but also a deeper dive on the US economy where she is one of the world's leading experts, including having been Chief Economist Assistant Secretary for Economic Policy at the US Treasury in the Obama administration and had previously been Vice President and Co-Director of Economic Studies at Brookings.

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As Karen will acknowledge, this is an unusual time to be doing forecasting. Karen and I have been going back and forth about this. You know, I have never had to update my forecast as repeatedly as this week, except literally during September, October 2008 and March of 2020. But what's different, of course, is this is policy-induced. This is not some exogenous shock that we didn't see coming. And it still makes it very hard to forecast, but it's important to understand that. As always, we have additional speakers, not just Karen, um, although that would be enough. Um, today we have, uh, Dr. Chad Bown, uh, who is the Reginald Jones Senior Fellow at the Peterson Institute, one of our four named chairs here. Um, Chad is of course the go-to person both analytically and in terms of data working with the team here at the Peterson

Institute. On the unfolding of tariffs and trade, he has been leading our efforts and again collaborating with the team here in a wonderful way to keep the world updated with the facts about trade. And he continues to co-author frequently and usefully with our distinguished colleague Douglas Irwin on a number of these topics, as well as others in the staff.

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Chad returned to the Institute after leave for public service. He spent a year as the chief economist of the U.S. State Department and has previously served as a senior economist on the U.S. Council of Economic Advisers for the Obama White House. And of course, he is the co-creator and the host of Trade Talks, the world's most popular specialized trade podcast. Which is much more popular than that sounds, as everyone in this room knows. Finally, it's our pleasure to welcome back, not in any institutional sense, but in the physical sense, our colleague Jacob Kierkegaard, Jacob Fung Kierkegaard, who is based in Brussels and splits his time between our cousin institute, Bruegel, and the Peterson Institute. Jacob has been working importantly and well at the last few years at the intersection of national security and economics, particularly with respect to issues arising out of Russia's invasion of Ukraine, Europe's adapting to defense requirements. He has a background before he joined the Peterson Institute in military intelligence, and I would note that that was for the Danish military, so therefore independent and principled. I would also note that Jacob and I co-edited and wrote part of a report for the European Commission some 7 years ago about how a sense of common international threat and need would be the path to fiscal integration in Europe as it was in the US following the Civil War.

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And so he's going to be more current than that, but I think that is an important context. Finally, uh, unusually, I'm going to come back and give my own take on the U.S. outlook, um, trying to complement Karen's, but from a slightly different point of view. So with that, thank you all for joining us. I'm deeply grateful to my colleagues who've put in the work to prepare today's important presentations. And let me turn it over to Karen Dynan.

[00:05:35.46] - Karen Dynan

Thank you very much. It's great to be here. I'll start by saying that in normal times, economic forecasting is about pattern recognition. But these aren't normal times, and I think there are Patterns to be recognized, and Adam will talk more about that in a minute, but they're not the ones that are in the standard economist toolkit. That said, I think it's really clear that the outlook for global growth has weakened markedly in recent months. Here's my global forecast under the

assumption that the tariffs currently announced by the Trump administration are mostly kept in place, maybe with some retaliation, A lot of countries are going to experience significantly slower growth in coming quarters, and we'll see global growth that is about half a percentage point lower than it was last year and only a little stronger next year. I'm not going to offer you specific numbers for other major economies other than the United States because I think that would just give you false confidence in how we think things the way things are playing out. It's too much precision, but I'll give you some broad thoughts. So United States, I'll talk much more about that in a minute, but basically it's a story about a solid foundation giving way to stalled economic growth and higher inflation.

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Our trading partners in North America, they're going to be hit hard by higher US tariffs. I think Mexico is particularly vulnerable between their weaker fundamentals, the worst terms they're likely to see in the USMCA revisions. There might be some upside related to nearshoring, more nearshoring, given the recent escalation and trade tensions with China. Europe and UK, some green shoots there. I think we'll see positive, albeit subdued growth in Europe and the UK. I think Europe, the euro area in particular, is going to benefit from common action on debt issuance and increased defense spending, and Jacob will be talking more about that. As for China, I think growth is likely to fall well short of the 5% target. I think a number more like 4% is more realistic. You know, they're suffering from ongoing structural challenges, incredibly heightened tensions with the United States over trade. And people have made the point that the government can stimulate, but the household response to stimulus just hasn't been very strong. Asia outside of China exposed to risk from potentially large increases in US tariffs. We'll have to see how the negotiations about the so-called reciprocal tariffs play out. Within Asia, I think India remains a bright spot.

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They're continuing to draw in foreign investment even though they'll see higher tariffs. And then for other emerging market economies, it's a grab bag. They're all kind of kind of face their own unique challenges. I will say, I think they're all going to suffer from tariff-related drag. Some might benefit from some more nearshoring, but I think this is all going to be amplified for them by a slower global growth. Okay, so, you know, the main reason for these changes is US economic policy. So I'm going to spend a few slides going through that. Tariffs are, of course, the big story. We've seen a very large increase in tariffs that Chad's going to talk about in a minute, but basically going from a 2.4% average rate to something like 15% or 20%. As PII analysis has emphasized in the last couple of years, the tariffs are going to raise prices. That's going to reduce real incomes. That's going to disrupt supply chains for businesses and cause

businesses to reorganize. That's all going to be bad for economic growth, but I think kind of the a big deal in recent weeks is just the whipsawing of tariff policy has just created this surge in economic policy uncertainty, and that is going to have a meaningful effect by itself on economic growth in this country.

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Changes in immigration policy are also a big deal. Last couple of years, as you can see on the right, we've had the surge in immigration, and that has actually allowed the economy to grow at something that's like 3/4% points above where we thought trend was while still enjoying kind of a decline in inflation. We don't have a lot of hard data to go off of. The numbers around immigration or net immigration are just lacking. But as you can see in the slide on the left here, we know that border crossings have plunged to something like pretty close to zero. We also know that up to a million people are going to lose their temporary protected status. That's going to lead them to drop out of the labor force and maybe self-deport, and then there are going to be the deportations by the government. All told, I have immigration declining to half a million this year. And that, even in the absence of tariffs, that would put a cap on growth just because of its effect on potential labor supply. There's been a lot of discussion about the Department of Government Efficiency, DOJ.

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A lot of people have noted that the DOJ layoffs, despite all the news they're getting, that they're not large relative to our labor market. Likewise, they're not going to do much for the budget deficit. The shorter bar that you can see in this chart here is my estimate of the compensation savings you'd get from cutting half of the federal civilian labor force. I think that's a vast overstatement relative to what we're actually going to see, maybe 3 times as large. But remember, we'll see a lot of contractors lose their jobs as well. But you can see how short that bar is relative to what I've got on the right, which is the Committee for a Responsible Federal Budget's estimate of the amount of deficit reduction we need on an annual basis to keep debt to GDP at 100%. So it pales in comparison. Doge is also not going to be good for productivity either over the short run or the long run, given the operational disruptions in the near term and then cuts to research and development that are going to impact things over the longer term. And then the last big piece of US policy, of course, is the coming fiscal package.

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This slide here just shows you what I think is going to happen. On the tax side, the likely big change is the extension of most of the expiring 2017 tax cuts. There will also be a few changes

related to campaign promises. In the middle column, likely changes on the spending side. Here, I think the biggest change will be cuts to the Medicaid program. And then the last column, I talk about the effects on aggregate demand. On demand relative to current policy. And here I think it's a small net negative effect because extending those tax cuts just retains the same level of fiscal support. And then you have these spending cuts that are going to slightly outweigh the additional tax cuts. As I note in the banner stretching across, in terms of deficit reduction, of course, tariff revenue is going to help maybe a bit with that, maybe a couple hundred billion dollars. But that, as I've already said, that's going to reinforce the negative demand effects, especially because it shifts, you know, collectively these actions shift the tax burden to people with higher marginal propensities to consume. And that's been emphasized in some work by Kim Clausing and Maury Obstfeld here at Peterson.

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Okay, so given all these changes, here's where I'm landing. You can see my forecast for quarterly GDP growth in the chart in this picture. And what you can see basically is a stalling of economic growth this year. I've got one negative quarter of negative growth, but basically I've got on net output almost unchanged for this year before increasing again next year. On the right, I have a table with some specific numbers. I'm going to talk more about unemployment and inflation in a moment, but I've got inflation peaking at 4% for the year as a whole. On a quarterly basis, the peak is going to be 4.5%, and the unemployment rate rising to 5%. So let me just take a couple of slides now and talk about what we're seeing so far, because I think that's actually really important to thinking about how the Fed's gonna respond to this all. So markets are reading these policy changes as a big negative for the US and global economies. You can see the huge drop in stock prices on Liberation Day, little bit of rebound since then, but stock markets are down on net. On the right, I've got the dollar index, and I think this one's a really interesting one because, you know, we teach our students that if you put down big big tariffs, it's going to raise the value of your currency.

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And instead, we've seen the value of our currency fall a bunch. And I think maybe that's partly related to weaker prospects for the US economy, but it's also related to this loss in appetite for US Treasuries and other US assets. And I think that's potentially a big deal. And I'll come back to that when I talk about downside risks. In terms of hard data, Ah, we really don't have much suggesting a fall-off in demand. I've got nonfarm payrolls up here in the chart. You can see the strong reading we got for March. Really, that report as a whole was a very solid report. And then you've got the spending data. And there, I think it's really clouded because you've got maybe a pullback related to, you know, all the forces I've already talked about, but it's clouded by people

pulling forward their purchases on both the household side and the business side. Ahead of tariff-related price increases. We saw that, for example, with motor vehicle sales in March, which, which, which popped up. Soft data shows more of a weakening. So on the left here, I've got the PMI, the New Orders Index, and you can see, you know, striking declines in the last couple months.

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I think the services component is particularly interesting. These are at the low end of the range. For recent years. Consumer confidence has plunged. I'm sure people know about that. There, I think you should take the surveys with a bit of a grain of salt. I mean, I think some of it is going to be reflected in how people spend money, but I also think there's a strong partisan bias, which you can see in the slide I've got up here. You can just see just this enormous difference between Republicans and Democrats. And so I think it's partly speaking to people's actual planned behavior, but it's also partly speaking to the media that people are consuming. So I'm putting more weight on business surveys these days. And then quickly, the last piece of data I wanted to emphasize was just what we've seen on inflation. You know, the March CPI report was just very benign. You know, the trends are moving in the right direction, But inflation as a whole is still above the Fed's target. And I think that's the main point here, which is particularly for services and for services outside housing, what you can see is that we are actually starting at a point that's above where we were prior to the pandemic.

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So the tariff-related increases are going to build on that. OK, so given all this data, you can see why it is the Fed seems to be leaning on incoming data and how they're describing themselves as kind of feeling themselves forward. I think the Fed's also going to be challenged by inflation expectations. I think they care a lot about whether inflation expectations are going to become unmoored, but we just don't have great measures of inflation expectations. And to make that point, I've actually plotted 4 different measures of median 12-month-ahead inflation. So conceptually very similar, and you can just see this huge range that we're getting from these different household surveys. And you know, this is over the 12-month horizon. So I think the longer-term horizons, it's even worse in terms of measuring inflation. I think the monetary policymakers are also going to be challenged by really not knowing where the neutral policy rate is. FOMC members suggest that the current setting is well above the neutral policy rate, but I think there are a lot of reasons to be skeptical about that. And I think kind of this this loss of appetite for US assets is going to basically reinforce that, implying a higher neutral rate.

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Anyway, where I think the Fed is going to come out is I think they're going to hold steady basically until the end of this year. They're going to be weighing this higher unemployment against higher inflation. But with inflation going up to levels that are going to be well above target and fears of expectations becoming unanchored, I think that's going to discourage cuts. So I think basically what's going to happen is we're going to see the unemployment rate rising, and eventually that's going to induce some easing once the higher frequency, the quarterly inflation readings appear to be subsiding. So here's— I'll just— this just summarizes my inflation and unemployment forecast. As I said before, I've got later this year, I've gotten core inflation peaking around 4.5% before things start to subside because those price increases from tariffs, they will eventually pass through the system. And I've got the unemployment rate rising and then starting to decline again as those price increases subside and stop demand destruction, but also because of the Fed cuts. Last thing I want to do is just talk a little bit about risks. So I think there's a higher— I'm not forecasting a recession, but their odds are higher than they normally are at 40%.

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I think there are lots of channels through which economic weakness could be amplified. A larger stock market decline than what we've already seen. We really don't know whether the degree to which the market was overvalued, you know, in the, in start, you know, as we embarked on this whole episode. So I think there is risk there. Big one, a loss of confidence in US fiscal management due to, you know, large budget deficits. Deficits, general chaos and breakdown of institutional norms could cause, you know, a big spike in our interest rates. And then lastly, a need for the Fed to tighten policy if the high inflation doesn't subside, as I think it will, and looks to become self-sustaining. Now, the last slide I just want to put out there is, is there upside risk? And I would say yes, there is upside risk relative to the forecast I have here. The administration would have to materially really reverse its tariff increases. But if that happens, remember I talk about the solid foundation we're building off of. You've got AI innovations on top of that, deregulation that's coming, investment tax incentives that are coming. Generally, business animal spirits could be restored, and this could sustain strong productivity gains through more investment.

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It could restore solid growth. All that said, I think the immigration policies of this administration are not going to reverse. You're still going to have a cap on growth. Growth is going to be— growth above 2.5% is just highly unlikely at this point. That's everything I have to say. With that, I'm going to close out and turn things over to Chad.

[00:21:29.17] - Chad P. Bown

Thank you, Karen.

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Thank you, Adam, um, for the opportunity to be a part of this. And a huge thanks, as Adam mentioned, to the entire Peterson team. I'm going to show you a lot of charts, um, and other visuals, and it is largely because of them. So, um, Alex, Sam, Jing, Christine, Melina— I could list hundreds of people. US trade policy update, and please don't anybody check their phones for the next 10 minutes, and this will be accurate. After that, we'll have to update again, of course. OK, so this is what we've basically done so far, or what we've seen so far. And I'm not going to go through it. You can click on our website, which provides an up-to-the-minute tracker. But initially, things started off very early. February 4th, 10% tariffs on China. March 4th, another 10% tariffs on China. The story back then was all about what was going on with Canada and Mexico, and those ultimately got kind of pulled back for the most part. But the tariffs on China remained. Then we saw tariffs on steel and aluminum going back on, a surprise announcement on autos that went on April 3rd. And then, of course, the actions, the reciprocal tariff, whatever we're going to call them, that was announced on April 2nd.

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10% baseline on the world writ large. And then depending on who you were, and if you run a trade and goods surplus with the United States, you were going to get something on top of that. Ranging from what would ultimately be 1% to 125% as it would play out over the next few days. But then, of course, those were pulled back on April 9th. So a day or so into them actually being in place, President Trump said he was going to put them on pause for 90 days, with the exceptions of the ones that had been put on China and that had subsequently increased from there. And then over the weekend, we saw, oh, except there's going to be some carve-outs for certain products that contain semiconductors, so smartphones, laptops, things of that nature. OK, so that's where we are as of today. And then we have more tariffs or implementation issues that are still coming. We've got the end of the de minimis program with respect to China that they said will go into effect on May 2nd. And then on May 3rd, we've got another round of 25% tariffs on auto parts. Going into effect.

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And then they've also signaled more tariffs are likely forthcoming. We've got national security Section 232 investigations on lumber and copper. You can tell that I made my chart last night before I saw that they have actually put forward the Section 232 investigations on

pharmaceuticals and semiconductors. So we may see something there. We've got the secondary tariffs for Venezuelan oil. Et cetera, et cetera, et cetera. OK, so what does this mean?

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Well, a lot.

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So this is the— Karen already indicated Doug and I, Doug Irwin and I, are putting together some estimates of the current tariffs in a longer-term historical context. So if we think of what we know at the moment, the tariffs this year might end up somewhere in the range of 15% to 20%. That's actually a really, really big number in historical context. Ones that we haven't seen here in the United States since the 1930s. And these are numbers, average tariffs, import trade weighted average tariffs. So it's a really, really big number. The increase, the starting point being so extraordinarily low. As of January 20th, the tariffs were about 2.4%. So this is a really big increase in a very short period of time. There's a lot of new tariffs that are getting put on Goods for which we've had zero tariffs for a very, very long time, typically because we don't make the stuff here, suddenly those are going on as well. And then finally, we have a lot of cross-country differences. And the high end of those differences is this chart, which we do have a lot of different information or a lot of additional information on, which is the US-China relationship.

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So here, let me just— tell you what the current tariffs are, and then I'll tell you how we got there and why this is important. So as of right now, the US average tariff on imports from China is about 124%, and the Chinese average tariff on stuff coming in from the United States is about 148%. OK, now how did we get there? So first Trump administration, we started off US tariffs for China were only about 3%. Tariffs China's toward the US were only about 8%. The course of the first— set of— the first trade war, the set of tariff actions between the two in 2018, 2019 raised those to about 20%. So for the United States, maybe a 16%age point increase that was implemented over 16 or 18 months. So yes, it covered a lot of trade. At the time, it was hugely consequential. But in the end, it was only increasing the average tariff by 16%age points. Here, we've gone from 20% to 124% in less than 3 months. And now we're essentially covering everything that the United States imports from China. And back then, there were a lot of products that weren't covered, a lot of consumer-facing products.

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The weekend stories was all about smartphones, and laptops, and all the things containing semiconductors that they dialed back the tariffs on. True. But the 20% tariffs that the administration imposed, the 10% of February 4th, March 4th, those are all still on. And tariffs did not go on those goods at all in the first administration. So there's a lot of consumer-facing goods imported from China that have never yet been hit with tariffs that we're going to see being hit this time around. And so this could lead to very, very different kinds of price outcomes and feeding into the sorts of economic indicators and performance that Karen already went through. The trading partner response thus far has been varied. Obviously, we've seen China announce tariff— and I just showed you the numbers— tariff retaliation of their own. Probably in terms of China's response, that's the least meaningful of what it is that they're doing. If you look at the data on what China imports from the United States, what the US exports to China, it hasn't really moved all that much. Much since 2021, 2022, when China started resuming farm products, agricultural products, soybeans, and things like that.

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They'd essentially stopped buying American automobiles. Airplane orders never really recovered. The things that— the manufactured goods the United States used to ship a lot to China never really came back. So additional tariffs aren't really going to be that meaningful, with the exception of the farm sector in the United States, which is still hugely dependent on China. Now, will they actually go through with it or not? How dependent is China on American soybeans, or can they get it from Brazil in an alternative source? We'll have to wait probably until later in the year. October, November, December is when those goods are harvested, brought to market, shipped overseas. And so we have time. Maybe they'll come to some resolution before then. I'm not optimistic. But in any case, farming, farm products is where the action is there. The bigger items are— and Adam mentioned this in a piece that he wrote either last week or the week before. In foreign affairs, China's continuing on with its pattern of export restrictions in a lot of places where the United States is incredibly vulnerable. So you're thinking about things like critical minerals, raw materials, rare earths, where the United States is highly dependent on China.

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And it's been an area where, for years now, the United States has been doing creative policies to try to adjust those dependencies and move some of those supply chains. Hadn't happened yet. And so China's announced the export restrictions. We'll see if they tighten those things up. And then they've done a number of other things to companies, new antitrust actions, sanctions, et cetera. For other countries, we're really waiting to see how it is that they're going to respond. The Canadians have announced, of all the other countries out there, tariffs in response to steel

and aluminum and some of the other actions. But otherwise, countries that have traditionally responded with tariffs against the United States in these sorts of episodes, so the EU in particular, made an announcement of tariffs, but then put it on pause when President Trump said that he was going to pause his tariffs at the end of the week. So we're kind of in a wait-and-see mode with a lot of these other countries. Mexico has been very quiet in what their response is going to be as well. In terms of the economics, I'll be very quick here, and then we'll get back to the good stuff.

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What's going to be the impact here? We'll see. I want to give you a little bit of what we learned from the last time around and what we're expecting to look for in the data here. So if we remember, as Karen already indicated, there was a lot of front running of trade in anticipation of these tariffs after the election. And so we are going to see— you would expect to see a drop off in trade flows in the March and April data, in all likelihood, even without the tariffs actually going on. So if you see a drop, which we will, we shouldn't overinterpret that as being entirely due to the tariffs, because it was expected to fall for other reasons. And then, And of course, we could see trade volumes decline if the economy slows in the ways that Karen has indicated. Incidence of the tariffs— what's the tax burden expected to be? Well, the first time around with the Trump administration, most of the burden, the incidence of the tariffs, fell on Americans, the American taxes. It was either the importers or retailers. Some were eventually passed along to the consumers. But there was very little evidence that these were passed through to foreign sellers, to say Chinese exporters.

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It could be different this time around. We'll have to wait and see. It is a different environment, but there was very little evidence of that the first time. And again, as I already mentioned, there's a lot of differences in terms of what the products are that are being impacted this time, a lot of first-time products that weren't hit last time, a lot of new countries. Obviously, the 10% tariff applies to everyone. There's a lot of new products that have never been hit before with these kinds of tariffs. And in some sense, supply can't respond everything everywhere all at once, despite what you see in the movies. Supply chains movements, well, after the first Trump trade war, 2018, 2019, eventually we did see some supply chains begin to move, the sort of China plus one. Depending on the product, maybe the final point of assembly would have moved out of China into a Vietnam or into a Taiwan or into a Mexico. Could this time be different for supply chains? Perhaps. It depends in part on what the administration's policy is going to be toward those other countries, and if it's also not going to be attractive to set up facilities there.

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So we're going to have to wait and see what the eventual— what they settle down with in terms of their tariff policy toward them. Obviously, there's really worrisome things happening in North America at the moment with the USMCA and what a USMCA compliant, non-compliant good is there, what the tariffs are ultimately going to be on Canada and Mexico, and especially for the just-in-time sort of supply chains in the automobile sector, especially. And so that's something to keep an eye on. And then as a final point here, the question of, is the purpose of the policy to really try to target countries that run large bilateral surpluses with the United States? Well, if so, those surpluses are there partly for economic efficiency reasons. We know that overall deficits are a macroeconomic phenomenon. And so in the absence of radical other sort of changes in the policy, those are likely to continue. And so it could just mean a reshuffling of who we have bilateral trade deficits with, depending on how it is that they impose these tariffs, which could lead to a lot of efficiency implications for the US economy as well. With that, I'll stop.

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Thank you.

[00:33:25.53] - Jacob Funk Kirkegaard

Well, thank you, Chad. It's also a particular pleasure for me to go after Chad because I don't have to worry about remembering to, uh, raising the microphone. Uh, but it's also, uh, it's great to be back, uh, at the Peterson Institute. And, and actually, even though the topic today is rearmament and at least war-related issues, Actually broadly good news from, if you like, boring old predictable Europe. So I want to talk a little bit about the reasons for why Europe is suddenly rearming, what is the feasibility and what are the challenges, and then finally, as also Adam alluded to in the beginning, a little bit about the implications. You know, and I'm here, you know, what is it that we need to achieve in Europe? And again, I want to emphasize that you need to make an important distinction between the EU and Europe as a whole. Because one of the things I'm going to argue here is actually that this rearmament drive is going to be extraordinarily good for broader EU, uh, uh, collaboration, not just a broader European, uh, collaboration between EU members and other, uh, European countries. Then I want to talk a little bit about what has been done, uh, and then in good Leninist fashion ask what is to be done still and the implications of that for the rest of Europe.

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So, why now? Right? And there, I really think it's important to recognize that from a European point of view sitting in Brussels, this is a two-front confrontation. Obviously, we've had a war in

Ukraine going on for now over 3 years, but also, and the more recent issue is, of course, a very palpable sense of loss of trust in the traditional US security guarantee provided through NATO. In that sense, as I said here, all— not maybe not all of Europe, but certainly most of Europe are all Gaullists now. And that's a pretty big shift. And it's also important, I think, to recognize that going forward, as Europeans are planning their defense expenditures, they actually are planning today on a potential Russian testing of Article 5 over the next not that many years. So, it really is a combination of Trump and Putin that has prompted this fairly historical shift. So, you know, then the question is, what is it Europe needs to do? Well, Europe needs to be able, in principle, to deter Russia without the assistance of the United States. Is that possible? I would certainly argue absolutely yes. And I think the key thing, the starting point here is to understand, and that is what this chart does.

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It has defense spending as a share of GDP and gross government debt on the x-axis. And the size of the bubbles are the size of the economies. Russia is not the Soviet Union, right? Russia is an economy the size of Spain and Italy together with a population roughly, the combined of Germany and France put together. So it's absolutely doable. Meanwhile, on the European side this time around, if you might say, unlike obviously during the Cold War, we have a very large currently fielded Ukrainian army that's actually, we can talk about that during the Q&A, but actually is doing not too badly against Russian assaults over the last 3 years. I would go from a military point of view, the old Red Army, this large, large arsenal of tens of thousands of tanks and other stuff has been annihilated. It doesn't exist anymore. It has been destroyed. So what it means is that in economic and also military terms, even what I would argue a coalition of the willing, and that's what I tried to allude to here in the chart with the so-called Northern Alliance, which is basically the Nordics, the Baltics, the Poles, the Germans, and the Dutch put together, would be able to deter Russia going forward, provided that Ukraine prevails or actually continues to exist as an independent state.

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So what is Europe's problem, if you like, or challenge from a military production point of view here? Well, that is the the bang for the buck, if you can use that expression here, it's really about getting the military purchasing power parity, if you like, up. And the chart here on the left is really an attempt done by a number of academics trying to sort of PPP adjust the regular defense budgets relative to the United States. And what you can see is that Russia and Ukraine at the top are really the ones that have far, far higher PPPs. You get a lot more for your money there. This is what you can also see on the chart on your right, which is a plot of the per unit price and the annual production numbers of self-propelled howitzers, sort of M— the type of

artillery guns that you use in Ukraine. And the bottom line here is that In the bottom right corner is the Ukrainian Bohdana, which is far cheaper to produce and is being produced in far larger numbers than any other howitzer. So the challenge to do this, if you want to increase your military purchasing power, is you need to obviously research and development.

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Well, if you've got an ongoing war, that's a pretty good laboratory because you can test your products right away. You obviously need low cost. Well, Ukraine has that. And then you need production numbers. So Europe's challenge here really continues to be this sort of military version of the collective action problem that it needs to get to a common EU defense procurement process. We can't have 7 different tanks and 10 different armored personnel carriers, etc. But the good news here again is I would argue that Ukraine will be very useful for the EU here as well, because Ukraine will offer both a low-cost production location, and it will certainly offer a scale more broadly. And it is not just in the current drone production that this will play a role. So again, when it comes to scaling up military production in Europe, I would argue that Ukraine is the key to success. So what has, what has Europe done to date? Well, the first one I think is Europe continues, has supported and will continue to support Ukraine militarily, financially, and diplomatically. And I think it's important here to recognize that from a European point of view, the reason this will continue irrespective of what the Trump administration does is that no deal, aka continued war, is far better than a bad deal.

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From a European point of view. And this is also true for Ukraine to date. Then Europe continues on a bilateral basis, individual member states— this, by the way, the Biden administration did it too, the Trump guys don't do it— but directly support military production in Ukraine, basically paying Ukrainian military manufacturers to produce weapons for the battlefield. This is very possible to scale that up. So actually, even today, Ukraine is already, as I write, I just checked the numbers after this, that Ukraine is already today the largest military producer in Europe. And upon full EU membership, it will probably be among the largest military producers in the world. Then clearly, a number of member states have announced already significant increases in defense expenditures. You know, most of Northern Europe, 3, 3.5% on average, including, you know, this very large recent one in Germany, or I would call it epoch-defining. And then we have an announcement by the European Commission, this €800 billion headline. I wouldn't put too much emphasis on that. It's not the final product, really. It's basically an assumption of agglomerating additional national defense expenditure. So, I wouldn't put too much in that. The real question is what is still to be done.

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One, clearly, we're going to have continued— most defense expenditures in Europe will remain national, but there will be, and this is the design discussions right now, about a new institutional mechanism to be designed. And as I said earlier, this will be a coalition of the willing. This won't be the EU, It may not even be all of the EU because maybe Hungary decide not to join, but it will certainly also have to include the UK, Norway, possibly others. You could imagine even, you know, the Canadians or others wanting to join. So, the specifics, institutional design, as I said, remains to be seen. But the key point is you need to identify specific military needs that can be solved together and then you fund them, not the other way around, not euro bonds first, but military needs and then funding. Very, very high levels of uncertainty. We don't know what the dominant technologies coming out of Ukraine will be. And we don't know the full extent of current US military capabilities that Europe may want to fully replicate. And that is particularly relevant with sort of intelligence gathering satellites, etc. But the bottom, the end product of this, whether it's a bank or if it's a special purpose vehicle of another type of institution is, I believe, that you will have a grant-based multi-year vehicle big enough to incentivise private sector investment over a decade.

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And that means we're talking about a 10-year, over a 10-year horizon, somewhere between €200 and €250 billion over the next 10 years. That is what— what would this mean fiscally, the broader rearmament issue? Well, it will, as this chart shows, This chart is basically just the current primary balances from last year, and then added to them the gap so that each member state can reach this sort of informal target that Mark Rutte, the Secretary General of NATO, put out of 3.7% defense expenditure. Where would that have put these countries? And what you can see is that it would put nearly everybody into significant deficits. But it's also clear that most of Northern Europe would absolutely be able to do that, including, of course, Germany. And they have announced that they will do it, and they will go ahead and do it and simply increase debt as a result of that. I think we should also expect, because of the uncertainty that I mentioned earlier, a lot of this defense expenditure will be backloaded. We simply don't know yet precisely what to invest in. But nonetheless, because the emphasis in Europe, where traditionally at least 50% of equipment has been purchased in the United States, that will drop very significantly, maybe not to zero, but certainly a lot.

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So the overall fiscal multiplier over the years from this, I think, should be expected to be in the higher range, maybe even as high as 1, maybe even higher than that for some countries. On the other hand, I would argue that this rearmament is not going to have particularly big

monetary and inflationary expectations. So it will not be offset by the ECB. And then finally, what will it mean? As I said, two-front challenge will really facilitate collaboration between EU and non-EU members, although recent events in Turkey means that we don't quite know where Turkey fits in. I think it will mean that Ukraine is more likely to get into the EU as a full member by 2030 than much later. And it's also worth noting that if that happens, by the time Ukraine becomes a member of the EU, it will be among the largest arms producers in the world. It will have a very, very capable, very, very large army. So in that— at that point in time, the EU— I know it sounds crazy today, but the EU will actually be a material, meaningful military force put together with Ukraine. Clearly, these ongoing defense needs as well as funding needs for Ukraine will mean that euro bond issuance will continue.

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There won't be any early repayment of Next Generation EU and these types of things. And then, you know, finally, as Adam mentioned, the fact that the EU itself is now beginning to take on more and more defence-related capabilities or tasks will mean that the state formation process of the EU will accelerate further going forward. So with that, if we can debate whether that's good news or bad news, but anyway, those are the news. So thank you very much.

[00:46:53.43] - Adam S. Posen

Thank you. As I said, I'm going to try to give a complementary perspective on the U.S. outlook to that of Karen's. I do need shorter microphones. Um, the reason for this is because there is a logic here. As Karen mentioned, forecasting, macro forecasting, is really about pattern recognition. And what I want to say is that there was a pattern already evident in the fall to what the Trump administration's economic policy approach would be. This had very clear implications, and this is That's what's turning out so far to be the case. And when you look at it from that perspective, you get a different macroeconomic forecast, one that is essentially much more inflationary, much worse for growth in the— both short and medium term, and one which is not going to go away anytime soon. And the point, part of the point of this is there is so much chatter, not among the wise people here, let alone my colleagues, but so much chatter in the markets and the press about who's up, who's down in this administration, which side of the bed the president got up on this day, what does Vietnam or Mexico or Canada bring to the table, all of which is important, but is ultimately secondary.

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What we are undergoing is a fundamental shift in the regime of US economic policy. And by regime, I mean it in the political economy sense, the ongoing set of norms, institutions, practices

that define a situation. And so the bottom line is we may get recession, we may not, but you're going to get inflation either way. And that it can happen here. The US economic governance can go fundamentally wrong. So, um, I put up a clip from an article I published in Foreign Affairs in October in which I talked about the true dangers of Trump's economic plans. And what I argued in that article was that there were two major commitments of the Trump administration incoming. If they came in, that would be destructive. First, the efforts to close off the US economy, and second, the deliberate choice to weaponize uncertainty in its relations with other countries. And my point was, not only would these reduce real income, but that these should be seen as creating negative supply shocks. And I bring up what I said not to say I told you so, because frankly, while the world's going to heck, I told you so is very small comfort.

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I bring it up to make the point most of this was predictable. There is a logic here. This is not just the accumulation of temporary chaos. This was by bad design. And so, in theory, in such a situation, and this is something officials in the Trump administration have said, in theory, this doesn't have to result in inflation. You're having a reallocation effect. You have a cutback in real incomes, and if the central bank holds the line and everyone believes the central bank holds the line, you have a real adjustment. And economic historians or people familiar with economic history will remember that this was essentially what Britain did during the Great Slump in the 1920s or what Andrew Mellon and Herbert Hoover wanted in the '30s, which is to say, suck it up, adjust, get over it. And if that were to happen, it's true, that would not be inflationary. That's how you end up with things like the Great Slump, the Great Depression. But in practice, that's not how things usually go because you don't usually have a government or even a central bank that can ignore that going on in a democracy. And particularly when you have an unstable regime.

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And so what happens is things that used to be true in the US are now reversed. One could say it looks more like an emerging market. I don't like saying that because it's lazy and makes things too simple. What's happening is the quality of economic policy regime is shifting to one where the relationships are reversed. So one example, reversal, of course, would be what we saw in the Treasury markets last week. It's as Karen indicated, it's not self-evident what happened, but it is at least consistent that if you were looking for a shift in how people think about the US economic regime, a period of stress when the currency goes down at the same time interest rates go up would be a reversal of normal patterns. We have a situation where there are, as I will discuss, going to be shortages of various goods and services. and these will feed, rather than market adjustments, these will feed protectionism, which will feed subsidies, which will feed

further shortages. It's a situation where the allies, and this goes to some of the work Jacob has been doing, instead of insuring themselves by putting more money in the US, will insure themselves by self-insuring and relying less on the US.

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And it is a situation critically for the short-term forecast where attempts to do macro stabilization will result in more inflation rather than less. This is forecastable and this is where we are. So, oops, thank you. So this is my chart as opposed to say Karen's or our colleague Ward McKibbin's much more sophisticated charts. This is a histogram of the likely outcomes of growth in my forecast for the US economy. So the Y-axis is the risk of a particular growth rate, and then you have the growth rate by quarters, points. This is meant to be essentially the average over the next 2 years. First point is if we define a recession as averaging for an extended period negative growth, recession risk is 65%. That's a very high number. Second point is there's a fat tail to the right, to the positive side, and the reason there's a fat tail is because we don't know what fiscal policy is going to be. If they really do just pass the 2017 tax cut extensions with very little else and they cut back Medicaid, and they get a lot of revenues from tariffs, which is essentially the baseline you have to look at.

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As Karen says, that is probably net zero or slightly negative fiscal impulse. I do not believe that's going to be the case. I do not believe that they will stop at just the 2017 tax cut extension. I do not believe that the spending cuts are going to materialize except possibly possibly for Medicaid. I do not believe the revenues from tariffs are going to be as high as they say. And I do believe that there is a chance, particularly if we start getting negative growth, that the president and the Republican majority in Congress will say, well, we had a good time mailing out checks in 2000 with a big Donald J. Trump signature on it. Let's send everybody a \$1,000 check. So in my view, I don't know what fiscal policy is going to be. So it could be even as high, say 5% or 10% chance you could get above 1% growth, but only if there is a very large, irresponsibly large fiscal stimulus. And otherwise, I'm very much with Karen for reasons that I'll go into and others are saying, you're not going to get a big consumer bounce. You're not going to get a corporate investment bounce.

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In fact, you're more likely to see a cutback. Back in corporate. So government— and you're not getting net exports. So the only way you get growth is if you get a large government stimulus. Now, the upshot of this, as I said, is that while there's that range of growth outcomes in my

forecast, inflation is actually much more range-bound. That inflation is going to be higher even if we get the recession. In other words, we're going to have stagflation. Why is this? Because ultimately, the Fed is too complacent about the anchoring of inflation expectations. It's not a disaster. It is a bit of a contradiction that many of the people in the Trump administration and/or advising the Trump administration or even potential candidates for the next Fed chair from the Trump administration spent part of the fall talking about how the Fed had been irresponsible and led to inflation, but now say that inflation expectations will be anchored and none of this is going to get passed through. None of the tariffs and other things are going to get passed through. None of the currency weakness is going to get passed through. That is a contradiction.

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And while I think these people who are critical of the Fed exaggerated their case in the fall, they had a point. It is wrong to think that inflation expectations are as anchored now as they were in before 2020. That is simply not credible. If we think about what happened in 1982 versus 1985, when Paul Volcker was doing the disinflation, the same inflation shock in 1985 led to a bigger response because inflation expectations had not been brought down fully. In 1982. Secondly, the Fed is already too loose. Some of you have heard me make arguments about this. Karen mentioned in the jargon, and correctly, that the R-star, meaning the neutral rate for the economy, is probably significantly higher than the Fed thinks it is, meaning the monetary policy right now is looser than the Fed thinks it is. We've had a number of events, and I and others have spoken— Olivier Blanchard, Larry Summers, Maury Obstfeld, Karen— about why R-star may be higher. But anyway, so monetary policy is not as big. But let me just go forward a second. If you look at the left chart, this to me, if I have to pick one variable to define monetary conditions, it's this, which is the spread on corporate yields on B-level corporate bonds to 10-year Treasuries.

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And what you see is even with a slight spike in the last few weeks, the spread is well below levels of most of the last 10 to 15 years. So even though the Fed raised interest rates by 550 basis points, financial conditions have not actually tightened. You could also look at mortgage rates, real mortgage rates. You could also look at credit default rates. You could also look at money supply. There are a whole bunch of things you can look at This is only one of them. But it tells you that people who say, as Fed officials do, that we're already in restrictive territory, I think are overselling it. And so that makes the point even more pertinent that if we get inflation, the Fed will be behind the curve. And then there are political economy reasons why they would be behind the curve. Then, as I mentioned, it is only reasonable to assume that if we get an obvious recession, fiscal policy will loosen. Moreover, there are structural things going on. Chad

and his colleagues and our colleagues have spoken a lot about this. But all the talk from the Trump administration officials and some market observers that pass-through from the tariffs to inflation are going to be low, I think is a bad bet.

[00:59:37.13]

One point is, as Chad already said, all the evidence from last time is maybe it didn't all go through to consumer inflation, but almost none of it, close to zero, was paid by foreigners. It was paid by American companies, the importers. But even more so this time, if we are having deregulation, if we are having mergers and acquisitions and increasing concentration because we don't have the policies of the Biden FTC, if we have discretionary implementation of antitrust and other things that allow for more corporate concentration, if we have exemptions to incumbent companies that get behind tariff walls and get protection. All of those give more pricing power to the companies that are here. You can argue those are good things or necessary things or corrections to Biden excess, but you cannot argue that they do not increase the ability of companies to mark up their prices. So I take the over on what Chad already said. That we are likely to see more rather than less pass-through of the inflation in this period. The most important point is the nature of this new regime. A lot of talk is this is transitional. Okay, they're doing 90 days, companies will reassess, they'll renegotiate with Europe, they'll be peaceful.

[01:00:58.24]

Maybe China won't be done, but they'll do okay with Mexico. All of which does matter, but for macro, it does not. Because this is not a transitional state. The uncertainty, the fundamental shift in uncertainty is there and will remain so. I'm gonna make an analogy to Brexit. During Brexit, I was part of the public debate and various people, including people who were opposed to Brexit as well as those advocating it would say, The problem with Brexit is we're just so uncertain. We don't know whether it's going to be hard or soft Brexit. Jacob did a lot of work on this. This is where there's going to be negotiations with the EU, how it's going to go, how's it going to be implemented. I kept saying the problem with Brexit isn't the transitional uncertainty. The problem with Brexit is Brexit. That you're going to have ongoing uncertainty because it's closing off the economy and changing the relationship with your biggest trading partner. And so fundamentally, you're going to have ongoing uncertainty. And if you look at the chart on the right here, this is a measure of uncertainty for the UK. And what you see is to the right of 2016, you're essentially in a range double the measure of uncertainty that you were before, leaving aside the financial crisis, obviously.

[01:02:20.40]

And this is ongoing. And I could have put up a similar chart showing corporate investment in the UK, that it has been flat since 2016, which is what you would expect if you've had a fundamental degrading of regime and a fundamental reduction of efficiency and a fundamental increase in uncertainty. Will the US suffer like UK did under Brexit? No. Will the US regime change we are undergoing cause similar persistent rises in uncertainty and therefore almost certainly flattening of investment, yes. The other aspect in terms of why inflation and why the short-term outcome is going to be grim is because of macroeconomically relevant shortages. People have begun to speak about this. Karen very importantly highlighted the issue of reduced labor coming in through immigration, both legal and undocumented, and our colleagues Marcus Nolan, Warwick McKibbin, and Megan Hogan have done work on this, modeling this. But I want to just emphasize one fundamental channel of many, which is we already have a problem in housing supply in the US that we don't build enough housing and there's excess demand and prices are going up. Housing supply elasticity is going to decline because we're going to get supply shocks specifically to housing.

[01:03:46.58]

First, we're not gonna get Canadian lumber and other materials, at least not at the same price we've been getting it. Second, Asian, read China, sourced inputs to residential housing, including the 80% of air conditioning units that are built in China, for example, are not going to be cheap. Now again, this isn't quite like rare earths or pharmaceuticals. There are other sources, things can be expanded, less so for Canadian lumber than Chinese air conditioning. Conditioning, but it is an upward price shock. Second, as Karen pointed out, and as our colleagues have worked on, and Michael Clemens has commented on as well, in residential construction in the US, except for large apartment buildings, roughly 50% or more of the workforce is migrant labor, much of it undocumented. You're cutting off the skilled workers. And again, you can say it's worth it, you have to do it, Fine, not really, but okay. But from an economic forecasting point of view, this is a supply shock that you're not going to be able to substitute for in any finite length of time. Even wonderful unemployed, non-existent unemployed manufacturing workers in our full employment economy cannot be converted to construction workers overnight.

[01:05:08.20]

Third, Going to the deregulatory side, there are tales that as part of the attempt to privatize Fannie and Freddie as a way station, they are likely to reduce the ceiling of level of mortgages that can be backed by Fannie and Freddie, essentially reducing liquidity and availability of mortgage money for a large segment of the housing market. So in addition to everything at the macro level that Karen was talking about, in addition to the direct tariff effects that Chad was

talking about, you should be looking for a stagflationary shock and shortage in the US housing market. Finally, DOJ. As Karen mentioned, and I want to emphasize, although it's very hard to get numbers on this, DOJ has done crazy things. And again, it has to do with the governance and the process, not necessarily what they were doing. So I think it's terrible they shut down USAID. I think it's a little less terrible, but bad that they shut down the US Department of Education. But we knew they were gonna do that. And if the Republican majority, if the Trump administration had decided through legal measures to say, "Those two departments we don't like, we're putting a bill in Congress that in next year's budget, those will be zeroed out," that would be one thing.

[01:06:26.10]

Might not be good, but it would be of trivial economic significance.

[01:06:31.43]

If DOJ says, "We're going to create a miasma of uncertainty over all US government employees, all hiring, all senior officials, and we're making it so that most American government contractors are not getting paid for last year's contracts and don't know whether they're getting next year's contracts," that has ramifications throughout the whole economy. So it's not about the number, which as Karen pointed out is a very small number. And what happens is we've got some specialized public services like FAA traffic controllers, people who run nuclear plants, um, civil engineers for specialized infrastructure, public health officials who maintain certain kinds of hospitals and medical services who cannot be replaced in any short amount of time. So this is like being in India where there are power cuts. We're essentially going to have less dependable, less available key infrastructure because of Doge, and that is a price shock, a negative supply shock. So bottom line, it can happen here. Self-inflicted policy wounds do create negative feedback loops. The way it's going to show up in the short-term forecast is inflation, whatever the growth outlook is, but likely stagflation. This will lead, as I concluded my Foreign Affairs article in October, to macroeconomic costs of generating uncertainty that outweigh any gains from hardball trade negotiations.

[01:08:10.02]

And this is radically different from any economic program pursued by either major U.S. political party during the past half century. They tried to weaponize uncertainty, They're trying to withdraw the US from the world economy, and the damage to the United States will be difficult to reverse. It was, however, predictable. So see the broad pattern. Don't get caught up in the day-to-day. And realize it's going to be the work of several years to get it back. Thank you very

much. If I could ask my colleagues to join us up here and we'll take questions live from our in-person audience. So we have a standing mic in the middle of the room. Jessica is holding a traveling mic. Please raise your hand if you'd like to ask a question, uh, when you get to the mic. Please identify yourself and say if there's a particular speaker you'd like to address the question to. Barry, do you want to go to the mic over there if possible?

[01:09:29.31] - Audience

Barry Wood, RTHK Radio in Hong Kong. Karen, you don't see any interest rate cuts until the end of the year. Adam, I assume you don't either because you see higher inflation ahead. Um, the Fed has indicated it wanted to cut rates 2 or 3 times this year. If the economy slows, won't they be forced to cut rates?

[01:09:59.47] - Karen Dynan

I think they're going to be pained by the increase in, uh, the unemployment rate. They're going to worry about that side of that mandate, of their mandate. But there's another side of their mandate, which is inflation. And I think the direct effects of the tariffs are going to drive— will be to drive inflation up. And their starting point is already above target. So the combination of those increases and the risk of inflation expectations becoming unmoored, which Adam so characterized so well, I think that's going to be on their minds. And I think that that's going to discourage cuts until they see inflation start to subside. So that's why I'm saying no cuts until the end of this year.

[01:10:53.31] - Adam S. Posen

Basically, I agree with Karen's forecast. I think they're going to be paralyzed and they're going to wait to see what happens with fiscal policy and the effect of the tariffs. And then they're going to be reluctant to move, and they may be divided. Um, and there are a bunch of political economy as well as straight-up economic reasons for that. And to go with what Karen said, I mean, so I'm sure Barry, you and others noted the remarks of Governor Waller yesterday. And Governor Waller has a record since his time, his brief but useful time as governor, he's made a number of very good calls. I think on this one he's wrong because essentially what he said, and I don't mean to pick on him, but just as an example, the kind of arguments that are back and forth at the FOMC is essentially if the tariffs are small, they won't be passed through. If the tariffs are big, the recessionary effects will outweigh the inflationary effects. This is what in the inflation targeting business we call the divine coincidence, the idea that your inflation rate and your Basically, your output gap moved together. That is only true if your inflation expectations are well anchored and if you don't have a major supply shock.

[01:12:15.50]

So if the Fed does end up cutting, they're just going to have to take it back. Please, could you go to the mic? Thank you.

[01:12:33.10] - Audience

Ma Lin Sheng with Xinhua News Agency. Thank you very much for the very informative presentations. I want to ask Adam and Chad, and maybe other panelists can also weigh in about the global trade system. Right now, we've seen some of the tariff policies on and off, and maybe you are talking about uncertainty is not going to stay there forever, but I wonder how do you see the potential long-term impact in the global trade system, especially we've already seen some years of backlash in globalization for different reasons. Do you see this moment as a turning point in terms of global trade system. Thank you.

[01:13:21.14] - Chad P. Bown

Yes. Yeah, I mean, the way that these are being carried out, it's outside of the rules and norms. And in addition to all of the uncertainty that it's created, I think we just— we don't know what the future is going to hold. But the certainty of a rules-based system that was provided over the last 70 years, I think, is largely disappeared. And what comes next, I think, we just don't know.

[01:13:52.05] - Adam S. Posen

Just add two points. One is to reference work that Chad and also our colleagues Kim Clausing, Mary Lovely, and Doug Irwin have done, also Marcus Nolan. In the US system, and I think in most systems, once tariffs go on, they're very hard to go back. Rollback.

[01:14:11.17]

I mean, the incredibly high tariffs US-China may, but as we saw, the Biden administration basically kept on all the tariffs of Trump. And then once you start doing industrial subsidies to protect, make up for the tariffs, those are incredibly hard to pull back. So even if there is a recognition that this is self-harming or in enlightened, not in your enlightened self-interest, even if there's a negotiation, it is going to be very difficult for the US to pull back. The only thing on the horizon that I could see, and again, Kim and Mary in particular are the experts on this, but also our colleagues Alan Wolf and Gary Hufbauer, would be if Congress intervened. Basically, Congress, I'm not a constitutional scholar, but Congress has the legal mandate to set tariff policy, set tax policy, to do all this, and to oversee the president's use of any so-called

emergency powers. If Congress, as was attempted in a small way by the bill by Senators Kaine and Paul with respect to Canada, were to take action on a real level, or if there was a court case brought that forced Congress somehow to take action on a real level, that is the one thing that could make a major difference quickly, but additionally would be credible to people that maybe we wouldn't just go right back on to the tariffs.

[01:15:48.47]

I still don't think that gets us all the way back to the world before the Chad mentioned. And frankly speaking, Yaleng, the odds are it would roll back things that have nothing to do with US-China that would probably survive Congress. But it's the one thing from here that I could see make a quick difference. What, Jacob?

[01:16:17.13] - Jacob Funk Kirkegaard

No, I mean, I just wanted to highlight that if you abstract from obviously the sort of prospects for tariff rollbacks in the United States. If you look at it from a sort of more global perspective, I mean, the rest of the world now faces obviously the problems associated with potentially global US tariffs. They also face the, if you like, overflow or spillover or outcome of trade diversion from bilateral US-Chinese trade on top of ongoing overcapacity across many Chinese sectors. So, if you're the rest of the world, you've got a trade problem basically with both the US and with China. And for all the difficulties of how you address the situation with the US trade problem, I think that one of the equally to me in some ways open question is how will the rest of the world address its issue that it has with China related to trade, diverted trade and ongoing overcapacity? And how will the rest of the world, meaning not China, not the US, will they pursue, which I think they should, will they pursue ongoing trade integration among themselves? So it's not only, I think, a matter of what happens in the US to decide what happens with the global trading system going forward, but actually both China and third countries have a fairly high degree of agency as well.

[01:17:52.52] - Adam S. Posen

Thank you. We have time for one more question if someone would like to raise their hand or go to the mic. How about right here?

[01:18:01.16] - Audience

Hi, Mike Fratantoni, Mortgage Bankers Association. So, something that both Karen and Adam mentioned, the fiscal policy uncertainty. So, Karen, you seem to have sort of as your base case that all the individual provisions get extended, but But following some of the political analysts,

you know, with the narrow majorities in both houses, that might not happen. And instead, you'd get a bipartisan bill, which would be much, much smaller on the tax side and potentially much smaller on the spending side. So, interesting your thoughts on that. And then, Adam, you really emphasized the policy uncertainty leading to some of your range of outcomes. Isn't this just an accelerant from the deficit and debt picture we were already seeing, and how much is that weighing into the current volatility as well?

[01:18:54.10] - Karen Dynan

Put it on. Yeah, thanks for that question. I'm glad you raised this issue. Yes, the margins are narrow, and yes, if there were a more bipartisan bill, I think you could see more deficit reduction than what I think is likely to happen. In this case, I know the margins are small, and I know that there's been some grumbling about this in Congress, but I just don't think you want to be the one member of the House of Representatives that basically is standing against the President's plans for the economy. And so I just think it's incredibly highly likely that they are going to go through with something that looks like the current reconciliation instructions. And I think in that regard, I think, you know, the House had a bunch of Medicaid cuts in it. I still think there will be cuts to Medicaid, but I think the Senate was far more realistic in assuming that the Medicaid cuts are going to be pretty limited. So I just don't see a lot of deficit reduction relative to current policies, I think we're still looking at 6% unless there's a major recession.

[01:20:11.01] - Adam S. Posen

Thanks for coming in for the question. I actually don't see this as just the culmination of fiscal policy because while I do feel that the continued large deficits of the Biden administration in the second half of their term were truly irresponsible, it was still being done through a congressional process and was not in the context of breaking alliances, breaking trade deals, disentangling the US from the world economy to quite the same degree and attacking government institutions. And specifically with regard to fiscal policy, the point is, The numbers matter, the debt matters, the deficits matter, but ultimately what matters is the governance. And the governance matters in that markets ask themselves, if push came to shove, do I believe this legislature, wherever it is, could raise taxes enough to make things work? And the point was that in the US, despite the very legitimate concerns about the long-term trends in the US budget position, like in Japan, like in even Italy, there were recognitions that every 10 years or so, plus minus, the Congress would get its act together and actually make some cuts and raise some taxes and get us on a more sustainable path.

[01:21:39.55]

And when people used to ask me starting in the mid-'90s, isn't Japan going to blow up, I would say no. Similar to the US, they're starting from a low tax share as a base. As a base for the low tax share of GDP as a base, and the legislature functions at that level. Now people have reason to believe that's not going to be the case. Because yes, the numbers matter, we've let things get worse unnecessarily, so you'd have to do more taxes, but more importantly, given the polarization, but also given the Trump administration approach to economic governance, it's less credible that we will get that reconciliation. And I'll just give one key thing I'm watching. So there's a lot of back and forth in Washington, understandably, with the vestiges of the old rules, which is we go through the reconciliation process and the Joint Commission on Taxation scoring at a 10-year window. And that's where Karen and I and you and everybody sort of talks is these 10-year projections. Because officially, that's what we're supposed to use. But it's been mooted and doesn't seem to be opposed, the idea that not only is there going to be the usual lying, exaggerating, whatever, and magic asterisks, but that the administration wants to use and has at least support in the Senate executive orders as part of the budget projection.

[01:23:08.09]

This is actually really important because it was always, in this period, that the only things that counted for budget reconciliation projections were actual legislation, because legislation you could count on being there until it either sunset or somebody withdrew it. If you let it go to executive orders instead, that means you're projecting, say, revenues from tariffs, which at any point the Trump administration could renegotiate, negotiate away, lift, suspend, postpone. The revenue isn't for real, and you're eroding Congress's role because you're saying it's up to the president to decide on a case-by-case basis what the revenue posture is. It's not legislated. Now, is that going to happen? I think in a sense, a blessing of having Republican control in both houses, even as narrow as it is, is that they didn't initially, the administration didn't initially start to do things to end run around the normal Congress process, which if— budgetary process, which if the Democrats had had the majority in the House, I think they would have done. There was a bunch of legal briefs being prepared about how the president could impound or not spend various bits of money and things like that. I think we're going to get there anyway.

[01:24:30.04]

If it turns out what you raised, which I think a lot of serious people raise and Karen is discussing, that we're looking at a bill that's going to come out of Congress that actually is up for fiscal tightening, I think this administration is going to resort to— I don't know what the right word is. Let's call it unusual means. Now, we have colleagues— I'm not going to cite who because I don't want to put words in their mouth, but we have colleagues, including two people who've been very senior in government, who— US government, who are much more faith in the ability

of Congress stand up to this than I do and believe that there are countable votes in both the Senate and more so in the House that will prevent things, in which case we're in the scenario you and Karen were talking about. But I at least want to raise the warning that I don't think that's going to be allowed to happen. Is there one more question or shall we call it quits? Well, thank you all for your attention, and please join me in thanking Jacob von Kierkegaard, Chad Bowne, and especially Karen Dynan.

[01:25:41.46]

As usual, all the presentations and the videos are about to be available on the PIE website, but also we have our very full set of meetings coming up. Please look for the list. This includes tomorrow the launch of the book *The New Economic Nationalism* by Monika de Bol, Jeremy Cohen Setton and Mahdi Sassepayev and a number of distinguished discussants. We also have on Thursday a moderated online conversation I'll be doing with Olivier Blanchard and Larry Summers about how the trade changes may be impacting the macroeconomic outlook. And then next week we have a number of important central bank speakers, but also next Thursday, the 24th, an event with Morris Obstfeld, Warwick McKibbin talking about does the trade regime change the dollar regime. And then finally picking up on what Jacob so elegantly let down, left put down, a week from Friday, April 25th, we'll be talking in a different way about Europe's future in 3D fiscal trade and defense with Olivier Blanchard, Cecilia Malmström, and our neighbor Constantine of Stelzenmüller. Thank you very much.