

Peterson Institute for International Economics

Global Economic Prospects: Fall 2025

October 9, 2025

This is an unedited AI-generated transcript that may contain errors. Please confirm quotes in the corresponding event recording. If you find substantive errors, please contact meetings@piie.com.

[00:00:14.01] - Adam S. Posen

Hello, everyone. Premature hello. 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 host today and participate in the latest of our semiannual Global Economic Prospects events, chaired and led substantively by my colleague, Karen Dynan. As many of you know, we've been doing these semiannual forecasts for a long time. And our general approach is that Karen, and before that, David Stockton, before that, Mike Musa, but we're very proud and happy to have Karen now, would give their view on the growth outlook for the next year or two for the major economies in the world and then a focus on the US. And then we would have two speakers talking about either themes or regions other than the US as to give a full perspective. And we do this deliberately a few days before the IMF and OECD release their World Economic Outlook. So we're the official sector. And our belief is that we don't have the huge apparatus that some of the investment banks and certainly the IMF or the OECD or the World Bank do, that drawing on our internal expertise, we can make calls about policies, implications, and some longer-term issues that for political and other reasons some of the official sector cannot.

[00:01:56.28]

And that we have a pretty good record, if you go back, on calls made, um, as well as we hope more importantly understanding created. What we did unusually in April, and we're repeating again today, is devoting 2 of the 3 slots to the U.S. economy. This is because— or in last time, 2 of the 4 slots. This is because right now the US economy, for obvious reasons, is the source of the greatest uncertainty and volatility, the probably biggest change agent in the world. And so what happens in the US in terms of growth, inflation, policy response is probably the biggest driver. And so we're spending more time on the US than we usually do beyond Karen's remarks. So with that, let me just introduce two of my longest time and dearest colleagues, Karen Dynan and Arvind Subramanian. Karen is a nonresident senior fellow with us at the Peterson Institute for now more than 8 years. She's a professor in the practice at the Harvard University Economics Department and at the Harvard Kennedy School. She previously served as

Assistant Secretary for Economic Policy and Chief Economist at the US Treasury from 2014 to 2017. And prior to that was Vice President and Co-Director of Economic Studies at Brookings.

[00:03:19.26]

Karen has a long career in the Federal Reserve System, in other places as a visiting prof at the Council of Economic Advisers at Johns Hopkins, and is one of the leading experts on consumer behavior, savings behavior, fiscal and macro policy, household finances. And we are, again, delighted that for the last 8 years, Karen has been leading our Global Economic Prospects effort. After Karen gives her remarks on the global economic prospects in general and her dive on the US economy, we will welcome back to our stage Arvind Subramanian. Arvind has been associated with the Institute since 2007. He was on leave, extended period of public service, up through August 2023. He's previously been a distinguished non-resident fellow at the Center for Global Development, a professor at Ashoka University in New Delhi, visiting lecturer at the Kennedy School. But most relevantly, although far from most importantly, Arvind served as the Chief Economic Advisor to the Government of India between 2014 and 2018, where he distinguished himself during that time and since for his commitment to honest, good public engagement based on honest, good analysis. And that legacy has served him and the Institute and most importantly, the Indian people well.

[00:04:47.32]

Arvind, with the support of Open Philanthropies, continues to do a large amount of very serious consulting work for 3 Indian state governments. And I am delighted to say that in a month's time or roughly 4 weeks' time, we will be hosting here at Peterson the premiere in the US of his new book with Devesh Kapoor of Johns Hopkins, *A Sixth of Humanity: Independent India's Development Odyssey*. This is a book that will be of lasting value. It's going to be the India economy book for the next 20 years at least. And so I hope you'll join us for that on November 5th. Arvind today, however, is going to speak in a different capacity. His trenchant observations and analyses through the years of the global trading system and of China's rise within it extend to thinking about what's been called China Shock 2.0, and he's going to give his and his co-authors vision of that on based on some recent research. Finally, then I will come back and tell you why inflation is going to be really high in the US. So with that, Karen.

[00:06:08.17] - Karen Dynan

Thank you, Adam. It is always great to be here and talk about my views about the global outlook. I guess I'll just start by saying global growth continues despite headwinds and risks. So incoming data has been stronger than we expected last spring. All of the major economies have

outperformed at least what my expectations were. And I would say the performance of the United States and China to some extent really kind of stands out in terms of surprises to me. This resilience has been welcome. I don't think it's sustainable. So I think we're going to see a slowing of the global economy for reasons I'll explain as I go through my presentation. But if you look at my forecast here, you can see that I have in fact marked up GDP growth to 3.1% this year. That's up by 0.4 percentage point from last year. And I'm expecting a bit of a slowing next year to 2.9%. So turning to the large advanced economies, most of them will downshift in 2025. Sorry, they will downshift in 2026. In the United States, I think I'll do a deeper dive in a minute, but I think that optimism around AI, it's supported US GDP growth so far this year, but the tariff drag is intensifying.

[00:07:43.26]

And turning to Europe, it's really a study in contrast. The countries in the south have held up quite well on tourism and other services still going strong. But there are countries in the north, particularly Germany and France, that are facing substantial headwinds. Germany in the manufacturing sector and France around political uncertainty and fiscal challenges. In Japan, we think the new leadership is going to result in a fiscal policy boost as well as easier monetary policy than otherwise would be expected, and that this will lift Japan's growth in 2026, but it will also lift Japan's inflation. And so we will eventually see a policy retrenchment. And if I were showing 2027 on this graph, I, I would show a decline in growth in 2027. And the UK continues to struggle with fiscal restraint, a strong pound. Amid weak productivity growth. These are all weighing on growth in the UK. Among the large emerging market economies, India and China continue to lead. That's been the case for a while now, and even with tariff pressures. So Chinese exports have held up surprisingly well despite intensification of tariff pressures, but the property downturn there is still a significant drag.

[00:09:09.09]

Sean Lee gave a great presentation at PIE yesterday explaining the details around that. I recommend that you watch it. But anyway, that's going to lead to some slowing for China next year. In India, they are facing tariff pressures as well, but we've got domestic demand sustaining growth there, maybe a bit of a fiscal boost. Russia continues to— or Russia is— the economy there is being weighed down by a weak oil market and lingering sanctions. And in Brazil, we've got growth slowing next year. Monetary policy is still quite high given inflation there, or quite tight given inflation there, and there's a drag from tariffs. Okay, so with that said, let me drill down more deeply into the United States. And I wanna start with our labor market since there's been so much news around it. And really a lot of the news is concerned Payroll growth. So payroll growth, as you can see on the chart on the left here, it's really stalled in the United

States. It's come down quite a bit. We don't have the latest data because the government shutdown has meant that we don't see September yet. But this is— it's very striking, but it's a complicated story in terms of interpretation.

[00:10:30.57]

As you can see on the right, tighter immigration policy has led to a much, a very large reduction in immigration. CBO estimates net immigration has fallen by something like 2 million from last year to this year. And we think that's dragging down the neutral rate of payroll growth. Our colleague Jed Kolko here at PIE has done some great work around that. I think payroll growth has probably come down more than the neutral rate. I mean, you can see it's a very broad-based slowing across categories, but it's complicated to interpret. And for that reason, I think you need to really look across the broad spectrum of labor market indicators for the United States. And that's an interesting story. I'm showing here the unemployment rate on the left, job openings in the middle, and then initial claims for unemployment insurance on the right. That's probably the most timely indicator that we have at this point. And the story there, particularly when you look at the first two indicators, you can see there was a—, you know, a softening of the labor market in 2023 and 2024. But interestingly, there has not as yet been that much of a deterioration in 2025.

[00:11:46.54]

And same story that you see over in initial claims on the right there. And so, you know, the data suggests that there has not been a significant movement in slack either way this year. And I think this goes back. You know, to the immigration story, it is a drag on labor supply, but I think immigration, of course, lower immigration, of course, reduces the demand side. And I think maybe what we're seeing here is that on balance, the labor market is not that much affected, again, as yet. Okay, so, you know, in terms of other important policy developments, tariffs are the highest in 90 years. You can see the considerable increase in the effective tariff rate on the left in this graph. That would be expected to raise inflation. I'll come back to that in a moment. And also, as higher prices weaken the purchasing power of consumers, it should weaken demand. There have been a range of other policy changes this year, of course. And on the right, you can see that this has led to a very high rate of uncertainty around economic policy. That too, we would expect to be weighing on— demand.

[00:13:02.22]

So in terms of thinking about tariffs and their effect on the economy, I think the first place we want to look at is inflation. And so I'm showing components of core PCE inflation on this chart.

I've got goods on the left, housing in the middle, and then what we sometimes call super core, services excluding housing, on the right here. And before I talk about tariffs, I should just say that the starting level of core PCE inflation, which I'm not showing overall here, but it's at least 3/4 of a percentage point above 2%. So the starting level is already above the Fed's target. Now you can see the tariffs over in PCE core goods inflation, they're creeping up a bit. You know, the level of inflation is nothing like we saw in 2021 and 2022. That's not showing through to core. Core is kind of moving sideways right now. And that's partly because, or that's largely because the increase in goods inflation is being offset by a continuing ongoing decline in housing services inflation as it goes back to its pre-pandemic level. And then over on the right, which you can see in SuperCore, is you can see inflation, maybe it's decelerating a bit.

[00:14:14.44]

I would say it's largely moving sideways at a level that is above the pre-pandemic norm. So in terms of what's going on here is that, that I think what's going on is that the inflationary effects of tariffs are still— they're not showing through. They've been delayed. They mostly still lie ahead. At this point, we can see that importers front-loaded shipments to beat the tariffs. We know that importers are storing stuff in bonded warehouses on the hope that tariffs will be reversed before they need to pay the tariffs. There are payment lags and deferrals of duties. And of course, the effective tariff rate I showed was just what's been put in place so far. There are additional tariffs that have been threatened or have been imposed but delayed. And then finally, and I think this factor is an important one, importers and wholesalers have been absorbing costs. But I should say, you know, the important point here is that none of these practices are sustainable. And so we should expect suspect that, you know, this good news that we've seen on inflation, tariff-related inflation so far, is not going to be sustained. Before I go to demand, let me talk about one more important background factor, which is productivity growth.

[00:15:37.38]

And productivity growth has been running surprisingly strong since the pandemic. I'm showing you the level of labor productivity in this chart. And so it's kind of the accumulation of the changes that we've seen, and it kind of cuts through some of the cyclical dynamics. But you We do see productivity, the level of productivity right now is above trend. And I think one important thing to recognize that this is probably not to much extent AI-related. I think instead it reflects better job matches and organizational changes in the post-pandemic period. Looking ahead, so that's kind of a one-time thing. Looking ahead, many believe that AI will drive strong productivity advances. Advances. And I've actually kind of pulled a quote here from my colleague at Harvard, David Deming, who cited the fact that Google Search, it took it 8 years before the number of daily searches reached a billion, whereas with ChatGPT it reached that milestone in

just 2 years. So adoption seems to be very fast. So there is this kind of case for AI optimism here. And I think it's really influencing the economy. On that note, turning to components of demand, US business investment, again, it's held up well this year.

[00:17:04.08]

You can see it's not as strong as it was in 2023, but still growing at 4%. That is surprisingly strong. What you can see on the right, and this is an important point, is that this growth in business fixed investments, it's very unbalanced. So I'm showing you 3 categories, The three groupings of bars are structures investment and then AI-related investment, which is information processing equipment, it's R&D, it's software. And then I've got everything else in fixed investment on the right. And in terms of the bars, the first two bars in each cluster are the 2023 and 2024 contributions to overall business fixed investment growth. And then the, The third bar is what we've seen so far in 2025. And the main point I want to make here is that, that middle grouping of bars, the AI-related investment more than accounts for the business fixed investment growth that we've seen so far this year. And the other categories are weak. The AI optimism is, of course, also showing up in the stock market. The S&P 500 is up on net, I think, about 15% this year. I'm not sure exactly what happened what's going on today, where we'll land, but it's about 15%.

[00:18:23.10]

But it's been very concentrated related to AI-related categories. In addition, the pink line on the left chart is the S&P 500, but then the black line is the IT component of the S&P 500. And you can see it's risen that much more this year. And then the blue line is the Magnificent Seven, those largest tech and social media firms. And you can see just how much they have risen. And in fact, on the right, you can see this rise, this concentrated rise in the stock market has resulted in the share of the Magnificent Seven now over 35% of S&P market capitalization. So that's certainly consistent with the AI optimism story. Now, turning to consumption, just to round out my comments about aggregate demand. We've got reduced immigration should be weighing on consumption, slower income growth, which you see on the left panel here. We've got lower consumer sentiment this year. They should all be weighing on consumption growth. And you can see indeed consumption growth has slowed a bunch, as you can see on the right. Now, the interesting thing here is that these other factors, I think, I think they're hard to disentangle, to parse the precise role.

[00:19:48.01]

Of course, they're all related to each other. But I think they overexplain the decline in consumption growth so far this year. And in terms of what's going on, I think it's a story about wealth effects. You can see just how high the ratio of household wealth to income has risen at this point. That spike that you saw in the early 2020s, that's related to kind of weak income during the pandemic. So you want to kind of smooth through that, and you can just see we have that household net worth has really risen a lot on both stock prices and home prices over the last few years. And this implies, if you apply traditional rules of thumb, considerable positive wealth effects supporting the economy this year and continuing into 2026. But I should point out that it cuts both ways. If stock prices were to, say, decline by 15% based on current market capitalization, that's about a \$10 trillion loss in wealth. And the standard rules of thumb imply that if that were to occur, there would be a considerable drag on consumption growth of about 1.5 percentage points cumulatively spread out over some time, but a considerable drag.

[00:21:10.29]

OK, so the last thing I want to talk about is what the Fed's going to do and how that's going to influence the economy. So the starting point here is inflation expectations. As yet, inflation expectations, which I'm showing on the left part of this slide, I've got household surveys on the top panel, and I've got market expectations derived from the TIPS market in the bottom panel. The inflation expectations have been remarkably stable so far this year. I think under, you know, these circumstances, my expectation is that the Fed is likely to cut 2 more times this year and another time early next year on worries about the labor market deteriorating, as I discussed, and also perhaps taking out some insurance against the correction we could see related if expectations about AI become— are disappointed. So I will say that these cuts in the policy rate, these are— oh, and I think they're also going to be kind of looking through the tariff-related increases in inflation. These cuts in policy rates are likely to put a floor on growth next year, which is why I'm not expecting in my baseline the economy to crash by any means.

[00:22:37.40]

And you can see in this chart, I've got a slowing of GDP growth as we go from 2025 to 2026. And I think the story here on the demand side is that price increases from tariffs and other factors will reduce household purchasing power. And that's going to slow the growth of demand. And then on the supply side, I think the productivity growth from boost from AI, I think it's likely to develop too slowly to offset the impact of reduced immigration and other policy changes that are weighing on investment and innovation. And, you know, in terms of how this translates into inflation and unemployment, I see a rise in inflation next year. Adam's going to offer his views in a minute. I think inflation is probably— this is PCE inflation that I'm showing in the chart on the left here. I think it's going to top out around 3.5% in the first half of next year, but it will remain

above 3% through the end of next year. And then on the right, my forecast, I think it's consistent with a modest increase in the unemployment rate. The 1. 1.7% on year-over-year GDP growth or the 1.4% on the Q4-over-Q4 number.

[00:23:46.54]

I think it's a little slower than potential, but I think potential has been reduced a lot by the reduced immigration. The last thing I just want to say is that I think this outlook, it is my baseline outlook, but I think it's fragile. So I do think that further development and expanding use of AI, I think it will probably boost productivity and output growth substantially as time goes on. But I also worry that the road to reaping those gains could well be uneven. It's not going to happen as kind of a— it's not going to unfold as a gradual thing that's consistent with what I think current expectations are. And with so much business investment and consumer spending dependent on this exuberance about AI, that if we see disappointments around AI, even temporary ones, I think that could sap the current economic momentum. Then you could see a much larger negative drag from tariffs, immigration, and other policy changes. So that's all I have to say, and I'm going to turn things over to Arvid now.

[00:25:00.37] - Arvind Subramanian

Thanks, Karen, and thanks, Adam, for the overly generous introduction. So I'm going to speak on 'China Shock 2.0,' but a tropical view from the view of developing countries. This is joint work with my brilliant co-author Soumitra Chattopadhyay of Johns Hopkins, who's here as well. And I have only one message, simple message to offer, which is that we're all worrying about China Shock 2.0 for advanced countries. We should be worrying much more about China Shock 1.0 for developing countries. That's the bottom line, and I'll try and elaborate on that as we go along. So, a lot of talk about China Shock 2.0, David Autor, Brad, Michael Pettis, etc., etc. And this is a chart that Brad has done which shows the manufactured goods surpluses as a percentage of global GDP. You can see the US, you know, deficit, China's trade surpluses, mounting and as a share of global GDP, even greater than at the peak in 2007 at that point in time. I just want to say that this is a bit exaggerated because if you look at China Shock 1.0, this is imports from China of the Western, you know, the West as it were broadly defined, US, Europe, offshoots, Japan, Korea, imports from China as a percentage of GDP, importing country GDP.

[00:26:33.45]

And you see the China shock really clearly, 1995 to peaks around the global financial crisis, quite a big rise in imports, giving rise to the famous Autor, Dawn, and Hanson China Shock 1.0 analysis. But I think the key point I want to, we want to make here is that now we show on the

right axis, manufacturing employment share, again in the Western, in the West as it were. And it's declined from about 20 to just above 12. In the US, it's closer to 7 to 8. The point here is, and it's a point that I think Robert Lawrence has made often, our colleague, which is that the very combination of technological progress and China shock 1.0 that has led to the share of manufacturing decline means that specialization has changed in the West. You know, you cannot make iPhones here anymore, as we've learned from recent debates. Therefore, the China shock that the West should be thinking about is the blue line, which is mostly high-skilled imports from China. So that wedge between the black line and the blue line is basically low-skilled goods, which cannot be produced anymore in the US. And therefore, it's kind of irrelevant to talking about job losses, et cetera.

[00:27:57.54]

I mean, there may be some, but essentially because specialization has changed because of China Shock 1.1 and technological progress, it's therefore now a level much lower and probably also rising at a much slower pace than China Shock 1.0. So this is not to say that there's no China shock on the West, but it's very much sectoral, think Germany and EVs, technological security because of the race for all these, you know, sensitive technologies and so on. The flip side of that is the new China shock is on low and middle income countries. This chart shows imports from China again for two sets of countries. And as you can see, both level and pace. This is rising very rapidly for lower middle countries and, you know, it's gone up now 4% of GDP, which is quite substantial. How big is— how should we think about this shock is the question, right? So this is a chart that shows, and remember the flip side of saying that low skill low-skill imports from China are no longer that relevant for advanced economies. For developing countries, it's only those low-skill imports which are really relevant in terms of how Chinese exports affect developing country, you know, specialization in low and middle income, in low-skill commodities.

[00:29:34.18]

So this is a chart which shows China's export market share, but amongst the group of developing countries. And you can see that, you know, it's very high, more than 50% of global market share in low-skilled goods is occupied by China. So, and one can sort of say, look, after the peak around 2015, after the first Trump China tariffs, actually China's global market share has declined to some extent. So perhaps that's a cause for some optimism in developing countries. However, I think what Soumitra and I think a kind of more intuitive way of thinking about this is not to look at the export market share per se, but on the right axis we show China's share of the working age population. I mean, roughly the kind of trade intuition is that, you know, if amongst— if specialization were kind of equally, you know, distributed among developing

countries, low skill production would be distributed roughly in line with your labor endowment. And what you find here is in fact that, you know, of course China's share of global working—global, I mean, amongst developing countries, share is declining. So in some sense, it's the wedge between the market share in exports and the population share that gives you a sense of how much more, how kind of, quote unquote, unnatural or excessive is China's occupation of global exports, and therefore so on.

[00:31:24.38]

The peak 55% global market share, China's working age population's population share was 28%. But even today, even though the global market share has come down, China's population share has come down. So in some ways, it hasn't really vacated space for developing countries. And some very rough back-of-the-envelope calculations that we do is that this excess 28%age point share could lead to a lot of millions of direct jobs in low-skill exports in developing countries. That's the sense of how big this shock might be. I mean, obviously, developing countries themselves have to do enough to kind of attract this investment away from China. But this tells you what the potential problem is or the opportunity is. Now, I guess a flip side of this is essentially, it's really striking how China continues to export so much relative to its— despite wages in manufacturing being 3 to 5 times and rising relative to other developing countries. So we show this for one canonical low-skill intensive sector, apparel. You can see Chinese wages are \$10,000 and, you know, India is a quarter, Bangladesh maybe about a fifth, Indonesia is about a third. And despite this high and rising wages, China's global export market share is kind of unrelentingly high and rising.

[00:33:01.55]

Of course, open question, important question, is it because of robots and technology that China has adopted? Or is it because of distortions, Chinese exchange rate, excess capacity, subsidies, et cetera, open question. But the more China continues to maintain this in the face of rising wages, the more one would think that something funny is going on or something odd is going on, which we need to focus on. This is the counterpart exports to China of low-skilled goods. From developing countries. It peaked around the global financial crisis, and though there's been some pickup now, it's actually declined. So developing countries are not able to access Chinese markets to the extent that they were even around the global financial crisis. So is the Chinese market open or closed is kind of the implication that follows from this. Last two slides, self-referential, self-promoting, a book that I wrote called Eclipse with that controversial cover. And the point is that, you know, China has aspirations to becoming a global hegemon. And so the question is, we know hegemonies provide key public goods, emergency financing, resources for development, and critically open markets. This is the kind of Kindleberger trifecta.

And as Adam has very sharply and eloquently written in Foreign Affairs, that, you know, the US has kind of gone from public good provider to what he calls, you know, running an extortion racket, as it were, by imposing all these things.

[00:34:50.14]

China, to be fair, has stepped up, has recently renounced this special and differential special country status. It has offered duty-free access to Sub-Saharan African imports, exports from these countries into China. But the point is that the proof of the pudding of China's, you know, claims and aspirations to being a good hegemon, as it were, vis-à-vis, I mean, I think one has to be really fair to the United States because it really did provide a lot a lot of space for all the other countries poorer than the US that followed. So if that's the metric by which we must judge China, it must do more for all the countries that follow, and its mercantilism towards those countries must be reversed. Thank you very much.

[00:35:49.30] - Adam S. Posen

Thank you, Arvind. Thank you, Karen. Um, so shifting back to the U.S., um, I'm going to try to make a very simple, narrow point. Uh, inflation is going to be a lot higher over the next 2 years than most forecasts have it, than even what Karen has forecast. Um, and I view this as complementary, although obviously distinct from a lot of what Karen has said, and it draws on work by a number of our colleagues at Peterson, but this is my view. So just some of you may recall last April I gave a presentation, and I talked about unanchored inflation expectations will be pushed. And it was basically the right call. Inflation has been higher over the last 6 months than most people expected, and the Fed has cut less than was priced. And it's worth noting that going forward, if we look at the last 6 months, as Karen mentioned, unemployment's been lower, the dollar's been lower, growth has been higher. And so even on just that simple-minded basis, if you update, you should expect more inflation. But I want to make a 3-bucket argument. The first is talking basically about the macro outlook.

[00:37:08.42]

Being more inflationary in sort of cyclical ways. And this builds a lot on what Karen mentioned and what some of our colleagues here have worked on about tariffs and deportations and the eventual effects. But I also want to talk about the labor market and in particular fiscal policy. Secondly, and I think the monetary policy is actually much looser right now. The Fed still keeps talking about monetary policy as restrictive, obviously, as we saw in the minutes just released, there's debate about this. But I think there's several reasons, some of which tied to observable data, for arguing why monetary policy is actually not that tight right now. And so cutting further is

probably ill-advised. And then third, and this is the most speculative part, certainly, I want to give some reasons based on my own interpretation and some colleagues' research why inflation expectations are less well anchored. Many of you are probably sick to death of hearing Fed officials and others talk about it's a one-time shock, it's a one-off, it's— inflation expectations are anchored, we can look through this. As a co-author of what is now, thanks to Ben Bernanke, one of the canonical books in this literature, yes, you can look through first-round effects of supply shocks contingent on various things, one of which is anchored inflation expectations., but just because you say they're anchored doesn't mean they're anchored.

[00:38:34.53]

So, first off, let me talk a bit about tariffs. And here, of course, we're building on major work by Work McKibben, Marcus Nolan, Meg Hogan, and others. And as many people have pointed out, if you look at import prices, they haven't risen. So, so far, it's not the foreigners paying the tariffs, it's the companies. And what I want to emphasize is it's not surprising that the tariffs haven't passed through yet because businesses need time to react. Initially, there was a great deal of disbelief and uncertainty about whether inflation, whether the tariffs would actually stay or be negotiated away. As Karen mentioned, companies stockpiled inputs and final products ahead of the tariffs coming in, and there was no point, given uncertainty, in raising prices until you got through those stockpiles and inventories. I think we should remember that President Trump made direct personal threats to, among others, the CEO of Walmart, the CEO of GM, and said, "Don't you raise prices." In that kind of environment, it's understandable that no one wants to be the first to raise prices. And then finally, though, and this is something I want to emphasize, this builds on work Peterson Institute did in the aftermath of the supply shocks during COVID It's not trivial even for the most sophisticated companies.

[00:39:50.41]

We have friends from Toyota, from Caterpillar, from other sophisticated manufacturers in the room. It's not trivial even for those companies to make decisions about where do you do production? How much do you move back to the US? Is Mexico a substitute for China? Should we get out of this business? When you've had supply chains grow up organically through the years. And if it's difficult for those companies, imagine how difficult it is for your mid-sized companies, your, your other companies. It takes time. This is why our friends at EY are making profit.. It takes time and unfortunately consulting money for companies to make these decisions. And so I think there is no surprise that the tariffs have not yet been passed through and plenty of reason to think they will be passed through in the next several months. I think more importantly and interestingly is the question of deportation. As Karen mentioned, Marcus, Warwick, Meg did this work on deportations. Our colleague Michael Clemens did some

important work, Jed Kolko, Basically, we have forecasts that if 1-point-plus million immigrants were deported, this would have very large stagflationary effects on the US economy. Obviously hasn't happened yet.

[00:41:06.25]

What's going on? Well, the first thing I did is create the world's most boring chart. That's 4 different sectors in which we know migrant workers, including particularly undocumented migrant workers, are a large part of the workforce. That's agriculture, construction, residential construction, mining, leisure and hospitality, home healthcare. And as you can see, there's been no change in employment. If domestic documented workers or native workers were taking these jobs, you would see those trends going up. That has not happened. So it's not substitution of labor that's enabling these things to keep going. So if substitution of either capital, it's not, we're not seeing, you'd see the same flat lines of investment in these industries as Karen had on her bar chart. If neither capital or labor is going in to substitute for the migrant labor and output's the same, therefore the migrant labor still has to be there. So what's going on? Is there mismeasurement? Is the measurements that we had when we were not actively driving people out of the country not fit for Is it perhaps akin to body counts in the Vietnam War? The Trump administration is busy saying they're deporting a lot more people than they actually have.

[00:42:24.04]

I think a big part of it, and there's a lot of anecdotal evidence, but no, for obvious reasons, no hard data, that what, like business firms, households are having a difficult time deciding what to do. Is ICE really gonna come for me? Is this just a temporary threat? Do I take part of the family with me? Do I just go? Do we wait? Do we come back? How do we make up our mind what's the right thing to do for a major change in our lives? This takes time. And what has happened, and my wife is chair of a charity and we talk a lot with social safety net people, a lot of migrants seem to have gone underground, meaning they're continuing to work, they haven't left the country, but they're avoiding public transportation, they're avoiding all these things. And then this, and Karen and I have talked about this, this has spillovers in all the labor market data in the US. And the employers may be perfectly or reasonably happy with this because they're probably paying them even less now and they don't have to worry about replacing the labor yet. This is probably not a sustainable equilibrium if the Trump administration continues with its campaign.

[00:43:37.17]

And so as with tariffs, I think it's only a matter of lags before we start seeing the very large negative impacts. Again, leaving aside the human side, this is just economic forecasting. I also want to stress, picking up as Karen did on our colleague, Jed Kolko's work and others, that the labor market, I think, is not showing very much slackening. It's structural change that without the migrants, the run rate or the break-even jobs level, as Jed puts it, is much lower than it used to be. I would also argue, I won't go into it right now, but I would argue that the rising youth unemployment rate, including for college graduates, may not be AI, but it's mostly structural. You can't see it very well, but basically around 2023, the youth unemployment rate starts moving up, whereas the prime age unemployment rate, the green dashed line in the right chart, is flat. And that's unusual in the US. Usually those two move together. There's slightly more amplitude in the youth unemployment, but we know from other countries that you can have extended periods of youth employment mismatch that have nothing to do with the business cycle.

[00:44:49.50]

So I would not read this labor market as terribly much slack. A thing which I pointed out in April and which I've done a little more work on, but again, based on others that I would point out, but nobody else seems to Zhu point this out, is that I think fiscal policy is going to be meaningfully looser in 2026 than it's in 2025 and that most official sector and other forecasters have. Saren and Summers have a very nice paper in 2020 building on CBO work showing that there's a direct linear correlation, positive, between how much money the IRS has to do collection of taxes and how much taxes they actually collect. If you run their exercise in reverse, we've seen, we know what the budget and rescissions are for the IRS roughly. You're going to lose somewhere on the order of \$20 billion at a minimum in tax collection. In addition, this is a period where the direction of enforcement, as on other regulation, is against heavy enforcement. We have changing tax code. We have loss of senior IRS staff. I am probably underestimating the decline in tax revenues. More importantly in size, tariff revenues, and our colleagues Kimmerly Klossing and Maury Obstfeld in their recent paper on tariff policy as a fiscal policy have dealt with some of this, and I'm going to extrapolate.

[00:46:12.15]

Basically, we're at the peak already of tariff revenues at \$31 billion in the month of September. Once the tariff hits, people will reduce their consumption of imported goods. Once the companies shift sourcing, tariffs will reduce. Once the US government starts giving out more exemptions and starts bailing out farmers like in soy, the net revenue effects go down. Once Trump decides he actually thinks Lula's okay, he likes Modi, and he loves Xi, and does a trade deal, tariffs will go down. And this is even before we get to the issues of tariff evasion, which are

inherent, and in US history, once you have high tariffs. So we are going to see tariff revenue decline sharply from here. I think the run rate's going to be down to \$200 billion a year roughly rather than \$300+—\$350+. So we're talking about a swing here, a reduction in tax revenues next year of around 2/3 of a percent of GDP. That's real money and that also helps overheat the economy. Now, let me move on to the monetary policy side. One of my contributions when I was at the Bank of England during the financial crisis was to repeatedly insist, don't look at what you've cut interest rates to or how much QE you bought, look at the impact on financial and monetary conditions.

[00:47:37.04]

You can only tell how effective a policy is not by its setting, but by its there. If I'm cooking something on the stovetop, it doesn't matter where my dial says 8 or 5, What matters is whether the piece of meat or fish is getting browned. The US and many others are starting to make this point. The US right now doesn't look like there's any financial constraints. Household balance sheets are still solid, as Karen mentioned. Credit risk spreads remain extremely low. That's the Moody's versus Treasury spreads, short and long, short green, long blue. These are historically not absolute bottoms, but quite low credit spreads. Monetary policy is looser than the FOMC says it is. In particular, and there's a lot of interesting work being done on this, is monetary transmission as effective in this cycle as it's been in the past? So you've tightened 550 basis points, what have you gotten for it? Well, you sure didn't have credit spreads widen. We know that the huge investment by the Magnificent Seven and related that Karen does is primarily internally financed. It's not interest rate sensitive. We know private credit and private equity, which are not the same thing, are taking increasing share of corporate financing and they are less sensitive to short-term interest rates than normal financing.

[00:48:55.15]

We know financial fragility is low in the non-financial corporate sector. We know banks, God sei Dank, thank you, have well-provisioned capital and liquidity, and we have the equity prices. There's a whole bunch of reasons. You can pick a company's financial conditions index if you want, but even though they've moved the federal funds rate tight policy is not that tight. Moreover, and we've done a lot of work and discussions about this at the Peterson Institute going back to Olivier Blanchard and the discussion with Larry Summers and many others, there's a lot of reason to believe our star is much higher in this cycle than people have raked it up to. In particular, looking at Hanson and Summers, not as co-authors, but as intellectual lineage, if you have sustained defense spending and industrial policy spending across the high-income world plus China, increase, that pushes up r^* . If AI is pushing up prospects for productivity growth and the allocation of capital, that pushes up r^* . If, as I've been arguing, there

is decoupling between China and the US, and so less of the savings glut moves from China into the US, there's fewer savings out there to fund US.

[00:50:03.06]

That pushes up r^* . Might be deflationary for China, but it pushes up r^* in the West. And then finally, Arvin kindly cited my recent piece. If we're in a world of self-insurance, you're going to be more risk-averse. I also want to give a shout out to a paper by our colleague Joseph Gagnon and Steve Kamin from AEI, really interesting paper looking at the recent past experience of higher inflation having lasting impact. And they show this with COVID data across countries that if you have recent memory of inflation, a given inflation shock tends to be higher and more persistent. And I think we're going to get a bunch of staggered salient price hikes. When Governor Chris Waller and others, and again, we wrote about this in the past, talk about a one-off shock with supply, it's a little misleading because if it's an oil price, it's a one-off shock. But if it's across a range of industries and goods with different timing of when each price increase comes and how much, to the average consumer, and then you start looking at the literature by Koyban and Gorodchenko and others like that, you've got a sequence of highly salient shocks.

[00:51:07.58]

Think of eggs under Biden. You're just going to see a whole sequence over a lot of time of discrete jumps in consumer-visible goods. And we have, as our colleague Gary Hufbauer and others have emphasized, we've had the wiping out of the de minimis exception in tariffs, which also is a price increase for low-income people buying household goods and clothes. So I think in addition to everything else, there's going to be more salient price increases. Increases. Now, finally, and meaning no disrespect and not saying this is a good thing, we have to recognize Federal Reserve independence is being weakened. As some of you know, my first contributions professionally as an economist were on the literature in the '90s and early 2000s on central bank independence. And one of the conclusions of that literature is that there are two key components to what keeps inflation down. First, you don't fire the governor. Second, you don't force the central bank to buy debt. Both of these are in play, obviously the first one more than the second one in the US case. Also, a lot of people take reassurance, as they should, the FOMC is a committee, and so they think, well, if inflation's high, no matter who Trump appoints as chair, they're going to have to react.

[00:52:23.53]

I think that's, in the end, true. But you gotta remember, and maybe people now in this audience realize this, but as recently as 2 months ago, people didn't seem to get this. Every Reserve

Bank president comes up for reappointment February 28th simultaneously. The Federal Reserve Board, not the FOMC, has the right to veto any Federal Reserve Bank president appointments. If the Trump administration gets a majority of 4 loyalists on the FOMC, excuse me, on the Board of Governors, they can block and change essentially all the presidents. We can get into the minutiae of, oh, they can only block a president, they can't nominate a president, how does it play out? If you want to come back and talk with me about that in 2 months' time, happy to do so. But basically, don't be totally reassured that the FOMC gets to run the show. And this is very substantial. Our colleagues McKinnon, Noland, and Hogan have a simulation about what this might mean. We have recent examples from the Reserve Bank of India, the Central Bank of Republic of Turkey, where the governors were pressured out and replaced rapidly and inflation spiked very much. This is an advertisement.

[00:53:34.32]

Halloween Day, October 31st, right here. High-level conference on central bank independence in practice. Nonpartisan, bipartisan, Republicans, Democrats, nonpartisan people. We're going to hash out the real issues, and there are real issues, not just is independence in the broad good. Please join us. End of advertisement. Conclusions. Inflation is going to be higher and more persistent, in my view, in 2025— excuse me, in 2026 and 2027 than most forecasts have it in the US. It's partly due to labor market conditions, partly due to fiscal policy, partly because The tariffs and migration effects are yet to come. Monetary policy is looser than the FOMC thinks it is. This is partly because of the absence of financial stress, which is a good thing, and partly because of the investment and other developments that are not as interest rate sensitive as they used to be, and partly because r^* is higher than it used to be. So therefore, any given interest rate is looser. And finally, more speculatively, but I want to raise at least the probability that inflation expectations are less well anchored than surveys indicate. This is more about the first-round effect persisting and becoming a second-round effect than the size of the initial shock.

[00:54:58.47]

But in bottom line, I think headline inflation is going to be 4.5% plus by third quarter of 2026, and that will persist into 2027. Thank you very much. Arvin, Karen, if you could join me up here, please. We ran a bit over, which I have no possible idea how that could have possibly happened. So unless one of my colleagues has something particular to say, let's just open our up to questions. Jessica has a traveling mic. Also near the back, there's a standing mic. If someone would like to make a question or a comment, please volunteer yourself. Please, if you could identify yourself when asking a question.

[00:55:56.01] - Audience

Jim Malonis, QIG Macro. Thank you very much for the presentation. I appreciate it. I just want to give some context and step back to think it's pretty incredible to look at real disposable income or consumption at 2% with the Fed funds near 5% for 2 years. You know, I think if a couple years ago you laid out the data that we're seeing today, 4.5% unemployment, claims under 250,000, income growth pretty decent, and Fed funds has been around 5%, very few people would have accepted that view.

[00:56:27.49]

So I think that speaks to the higher R^* . So I guess my question is related to the Fed's reaction function. I think there is recency bias at the Fed. I think it's part of the reason monetary policy was too easy after the COVID shock. They applied the GFC playbook to what ultimately was a transitory shock. So I think they're likely going to respond to the inflation.

[00:56:47.40] - Adam S. Posen

Sorry, I apologize. I agree with you completely, but can we get to a question?

[00:56:51.40] - Audience

Adam, I think if inflation does unfold the way you believe it will, it seems like the Fed is likely to raise rates or at least become much more hawkish., but does that ultimately hurt its credibility and accelerate the path to it losing its independence? Thank you very much. Karen, why don't you take that?

[00:57:12.14] - Karen Dynan

So I think one threat to Adam— that Adam didn't mention— to central bank independence is what happens if there is a recession. And I think maybe that's part of what you're getting at there, that if there is a recession, that too would be bad. For central bank credibility. And I do think that is— I mean, I don't know what their reaction function is. But if I were thinking about protecting Fed independence, it would be one factor that led me to kind of lean towards easier policy.

[00:57:46.08] - Adam S. Posen

I think without wanting to pile on, because as I hope is obvious, Karen and I are both proud alums of different parts of the Fed system. We believe they're doing their best. Sincerely, but I would pick up on two things you said. One, the idea of fighting the last war, that I spent the

period from 2012 to '20 trying to convince them to take labor market weakness more seriously, and we've spent the last 5 years trying to convince them to take inflation risks and fiscal risks more seriously. So I think that's real. And I think also I agree with you and our colleague across the street, Michael Strain, has written about this at AEI. It is very difficult to come up with why this constellation of macro outcomes at the moment leads you to be cutting rates right now. It's more strange, as I think you did a good job of putting it, it's more strange than I think people really seem to recognize. And there are justifications, there are sincerely reasonable justifications, but it is odd. And that to me is also— so if I have a criticism, at some point, data dependency is not a strategy.

[00:59:05.35]

You got to make a forecast and stand by it. And it's a little disturbing and weird that this is where we are. Are, in my view. I promise not to cut people off. I'm just trying to make sure people get in. Do you have a question? Jessica, could you bring him the mic, please? Thank you.

[00:59:25.52] - Audience

My name is Hector Torres. I was at the IMF and now I'm at CGE. My question is— actually, I want you to develop a little bit on how much consistent— how consistent is interested to have the dollar's dominance and self-sufficiency, pursuing self-sufficiency on the other side. The point is Trump is having an import substitution policy which we are very familiar with it in Latin America. Latin America failed for two reasons that I don't find in the United States. One is narrow markets, not enough to have economies of scale. And the other one is that we had balance of payments problems because the industries that settled in Latin America were not export-oriented but oriented to— In the US, you cannot have, you have a large market, you can have economies of scale. On the other hand, you import your inputs, you pay them with your own currency. But then comes the story of, about the dollar's dominance, whether it is consistent or not with that.

[01:00:39.26] - Adam S. Posen

Thank you. It's a very astute question. I should mention Hector is going to be with our colleagues Cecilia Malmström and Mari Pangestu next week on Trade Winds for a discussion worth listening to. Arvind, you're great about systemic big things. Do you want to say something about this, or did you tune out when he said the word dollar?

[01:00:59.47] - Arvind Subramanian

I'll pass. Okay.

[01:01:01.53] - Adam S. Posen

He tried out the word dollar. So yeah, so since Kindleberger and others, and as Arvin said in his presentation, part of being a hegemon in the broad sense is you have to have reasonably open markets and you have to be the swing consumer and you have to set some precedent for letting others export to you. It's not quite lockstep. One can still have a dollar that's dominant because of lack of a bad alter— lack of a better alternative because of positive attributes like liquidity and depth of markets, because of the lack not just of better alternative currencies, but the relative shortage of safe assets in the world. There are various things along with monetary independence that can make it there, but that doesn't mean the dollar remains as central, as powerful, or even as safe as it used to. We've started talking about that here using this concept of decentering the dollar. Maury Obstfeld and I and some colleagues, and Maury and Joe and our colleague from Europe, Moritz Schularick, will be talking about this next week on Thursday. But as I've argued recently, I think, you know, you have to look at some of these hegemony foreign policy things as interacting in a feedback loop with the monetary, and you have to look at a world where nothing else has gotten any better, but dollar assets have become less attractive.

[01:02:37.20]

And so it's a world where we have an even higher shortage of safe assets, a world in which you see people putting a lot of money in gold and crypto and small country reserves, New Zealand, Norway, Singapore. So it's a tension. It's not a contradiction, but it definitely goes the way you're implying, that it's not a good look for a country who wants to have a dominant currency. It's probably not going to hold up long term if you do that, meaning if you restrict imports. We should probably cut this off, but we have time for one more question or comment if somebody would like to speak.

[01:03:19.17] - Arvind Subramanian

Can I just say— Oh, please. Just one thing, just following up on what Adam said. I mean, we have the curious outcome now that the undermining of the dollar dominance and the decline in the dollar that we've seen since, at least since January, February, actually offsets some of the import substitution that's happening via tariffs. In the old days, it was tariffs and overvalued exchange rates that gave you really hardcore import substitution. Ironically, the development of the dollar is to some extent offsetting the tariff policy.

[01:03:58.59] - Karen Dynan

I don't know much to add to what you were saying. I think the lack of alternatives is the primary story. And so loss of dominance can only happen slowly. I will point out that if good alternatives do emerge, it's going to be kind of an irreversible thing that we lose is dominance and the benefits that come with it.

[01:04:18.36] - Adam S. Posen

So with that, I'm going to give one more plug for an event coming up next week. This is our busy season. On Friday, October 17th, we're having an event on Europe in a Changing International Monetary System, which is really— even though we're being more polite— is really about how much is the euro going to step up and various associated financial and fiscal things with that. Jacob Kierkegaard is going to chair. We're going to have Klaas Knot, the former chair of the FSB, Signe Krogstrup, the Danish Central Bank Governor and a PIE alumna, Olli Rehn, the current Governor of the Bank of Finland, a member of the ECB Governing Council, and our colleague Ángel Ubide of Citadel, who's co-authored with Olivier Blanchard, Calls for Eurobonds. So I think it's worth both, for those of you interested in this issue, to pay attention, if not come in person, to both our dollar event on Thursday and our Europe in an International Changing Monetary System on Friday. And in particular, what I think would be common among Karen, Arvind, and I is, not that any of you would believe this, but for all the thousands out there watching, it's not all or nothing.

[01:05:32.24]

It's not that the dollar one day ceases to be dominant and something else comes right It's does the dollar become less dominant, less central? Do other things step up in part? How much do they step up? And then what are the spillover effects of alternative assets, of instability, of weird savings behavior that occur in a world where dollar's receded in attractiveness, nothing else has come, or things have only partially offset? That this is our research agenda, and it means a lot what third countries, not China, not the US, and not necessarily Europe, but ASEAN in particular and others decide to do in this environment. With that, thank you all very much. Thanks to my colleagues, Arvind Subramanian, who gave us a lot to think about long-term on the big questions of China and trade in the developing world. China Shock 2.0 is more about the developing world or low and middle income economies, not about American middle class. And thanks as always deeply to Karen Dynan, who leads our Global Economic Prospects and gives us the baseline for thinking about growth developments in the U.S. and beyond. Thank you very much.