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Global Economic Prospects: Fall 2026

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[00:05:32.42] - Maurice Obstfeld

Welcome everyone to the Peterson Institute for our fall 2026 Global Economic Prospects event. I'm Maury Obstfeld. I'm the C. Fred Bergsten Senior Fellow at Peterson, and we have a wonderful panel today to present their insights. It's certainly a fraught moment for the global economy. 2 major wars ongoing with regional implications, also implications for inflation, which is elevated, particularly energy prices and other key commodities. We're seeing bond rates spike across the world amid limited fiscal space. We have key elections coming up, including indeed in the US. We're experiencing AI worries both about the short term and the long term. And amid all this, Karen Dynan is going to fill us in on growth prospects around the world. Karen will be our first speaker. She is a Peterson Fellow since 2017, is Professor of the Practice of Economics at Harvard, was the Chief Economist at Treasury in the Obama administration, has extensive experience at the Federal Reserve, and is currently— it's no secret— advising the new Fed Chair on one of the expert panels he set up to look at all aspects of Fed policy. With all that's going on, we haven't been talking about trade very much, but in fact, trade frictions are still very much an ongoing matter, not only between the US and the rest of the world as it seeks to remake the global economy, but between the EU and China, and maybe a lot of other countries and China.

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Global imbalances remain a big topic. And on the trade front, we have Inu Manak, who will be talking about one important aspect of the trade environment, which is the renegotiation of USMCA among the US, Mexico, and Canada that is ongoing and what the prospects are for agreement there. Inu comes to Peterson from the Council on Foreign Relations where she was a fellow, joined Peterson this year, and previously was at the Cato Institute. A topic that is often off of our radar when we talk about the international economy but should be very much on our radar is international migration, movement of labor across national borders. Of course, this is a process that is going to be accelerated by climate change and by geopolitics. And it's also critical for global growth as we contemplate the movement of human capital to where it is more

productive. And we have Michael Clemens today who will be discussing a labor-related issue of great import for US future growth prospects, which is the migration of skilled workers into the US, skilled immigration. Michael joined Peterson as a Senior Fellow in 2023. He's also a professor at the School of Government and Policy at Johns Hopkins.

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Prior to coming to Peterson, he was at the Center for Global Development. Um, so with those introductions, um, I will turn it over to Karen to begin.

[00:10:00.12] - Karen Dynan

Welcome, everyone. Thank you, Maury. It's great to be sharing the stage with you and Inu and Michael today. Yeah, I think it's fair to say that we are in a challenging environment right now, given the adverse events of the last couple of years. And yet global growth is holding up. And I expect that the most likely outcome for next year is that we're going to see continued forward momentum in the global economy. So this chart shows my forecast for real GDP growth globally. And you can see this year, for which mostly we have data in hand, I'm expecting a step down in global growth to 3.2%, which is still a relatively high growth rate. It might be higher than you expect because of the shock to energy prices, which I'll talk about later. But basically, the AI boom along with government support in many countries seems to have cushioned the hit to demand from higher energy prices this year. Then next year, I'm expecting only a small, modest step down in growth. The AI buildout is going to continue to undergird things, and we are going to have higher interest rates, and that'll put a damper on growth, but we're also going to see an easing of energy prices next year that will offset some of that.

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The inflation picture isn't as happy as the growth picture. The higher energy prices have contributed to a pickup in inflation this year. At around $100 per barrel last time I checked, Brent oil prices are up close to 40% since the beginning of the Iran war. And the prices of natural gas in Europe, along with diesel and other refined products, are up by much more than that. So you can see on the right, I have consumer price inflation, the most recent readings. You can see there's been a rise this year. I know the rise pales in comparison to what we saw just after the pandemic, but it's been enough to be of concern to central banks, particularly given that so many central banks entered this period still wrestling with inflation rates that were above their targets. Anyway, the forecast assumes that prices will follow futures, that energy prices will recede gradually. So for example, Brent recedes to $80 per barrel by the end of next year, which is about $10 per barrel higher than where it started before the war. So the higher inflation

has pushed up interest rates. You can see central banks, they've already started to hike rates, and I think there are more hikes in store, as I'll talk about later.

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And you can see that in the left panel. But interest rates are also rising more broadly. So there's been a striking rise in government borrowing rates. You can see that on the right. And that's partly a story about the short-term rates and inflation, but it's also fiscal worries, which have been exacerbated by some of the fiscal support this year, and importantly, competition for loanable funds. related to the AI buildup that are contributing to this rise in interest rates. Okay, so this slide shows my forecast for the advanced economies. And actually, you can see the levels are different across these economies, and that has to do with differences in potential growth rates. Really, the contour is pretty similar across the economies. The AI boom, as I said before, is undergirding growth in many countries, but the support is particularly strong in the United States, both via increased investments and then importantly via wealth effects related to how the AI boom is affecting the stock market. Looking at the other economies, the euro area, I've got it picking up a little bit next year. That's related to the further recovery in Germany from its slump in the last couple of years.

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Japan has actually been outperforming at 1% growth this year. And I expect next year as higher than their potential growth rate. It's being bolstered by chip exports and fiscal expansion. The UK is also doing pretty well as well, and there seems to be a tech story there that is supporting growth. Looking at the emerging market countries, these are the major, the largest ones here on this slide. They're also being driven by these common global forces, but there are also important country-specific factors that are shaping growth in these different countries. China in particular, I'm looking for a further slowing. Aggregate demand there is just— it's weak. That has to do with overcapacity. It has to do with the property slump continuing to weigh on consumer demand. On top of that, we expect fading export strength next year that will slow it down further. India, in contrast, has very robust domestic demand right now, and that is really what's sustaining growth. You can see growth is slowing, but it's actually maintaining a pretty high level there. Russia continues to be very strikingly damped by financial sanctions and also by tight money related to the high inflation there.

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That's continuing to weigh on Russian growth. And then in Brazil, this year's been a good year, strong Commodity prices are helping offset other factors that are a drag. But Brazil will slow as

the fiscal boost fades and rates stay high. And I should say there's a certain— there's greater uncertainty than usual about Brazil given that they're going to have a runoff election. Okay, so this slide has a little more detail around my US forecast. So you can see real GDP growth on the left. I think the US is growing at a pace that's a bit above its potential rate right now. You can see in the slide, you can see this bumpiness around kind of the near term. That's just kind of the 3rd quarter. The data in hand have just come in very, very strong. And I, in fact, expect a little bit of payback in the 4th quarter, which is why that bar is lower than the ones that are to the right of it. And then I've got some more detail about the forecast on the right-hand side of this chart. With higher interest rates— and I'll talk more about Fed behavior in a moment— but you can see the unemployment rate rising to 4.4% by the end of next year.

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And then, you know, the inflation numbers are really very striking. So look at the big rise in both headline inflation and in core PCE inflation in 2026. So it's really not surprising that we are seeing, you know, consumers pretty unhappy or voicing poor sentiment about developments given how much higher inflation is. Next year, I'm expecting the combination of Fed tightening, tightening, cooling the economy along with the assumed decline in energy prices will bring inflation back down with core ending the year at 2.3%— or sorry, 2.7% and headline at 2.3%. The US labor market, it's solid. So you can see in the left-hand side of this chart the unemployment rate, which I think is the most robust indicator of conditions. And I should say, you can go and you can look at a bunch of other indicators. You get the same story. You can see right now it's like basically close to its natural rate. On the right, I actually have a chart that's speaking to what's going on with AI and jobs. So just so you understand what's going on in this chart, that blue dot, that's the 2025 average of monthly payroll growth. And then the red dot, that's the year-to-date average for 2026 in these different categories.

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And the first thing to notice is that top line is just, there's been this big increase in payroll growth this year. But then if you kind of look down the different categories, and these are my own groupings, I kind of grouped them according to kind of what I thought would be a good AI narrative. But you can see the explanation for that big increase in the total is in that goods production and distribution category, which includes construction too. So that really is where you would expect the AI buildup to show up. Now, whether there are people being laid off as a result of AI, Kind of look at that second category there. That's the office-based, information-intensive category where I would expect the layoffs to be. You can see that category is shrinking, but it's actually not shrinking that much, and it's not shrinking as much as it was shrinking last year. So I don't think there's, at this point, a strong narrative there. The US economy's really being kind of

bolstered by consumption growth. This is what I call my consumption function slide. But what I've got here is sets of bars and Again, I'm showing you 2025 averages compared to 2026 year to date.

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But if you look at kind of real PCE growth in that first panel, you can see it's just much higher this year than last year. And then you look at the different drivers and you can see consumer sentiment is actually down this year relative to last year. Real disposable income growth, it's up a bit, but not very much. And it's running much slower than consumption. So that is telling you something about the saving rate having declined. declined. Really what's driving consumption forward is wealth gains, real net worth gains powered by, you know, the stock market and AI optimism, which you see in the final panel. And that's suggesting one risk to the forecast, of course, because if equity prices were to correct, then we would see consumption probably weaken substantially and sharply. US business investment is also very strong. You can see that in the left panel. You can see the pickup in business fixed investment growth. And on the right, I've kind of broken out categories again to kind of tease out the AI-related effects. And what you can see there in that middle set of bars, which is showing you 2024, 2025, and then the first half of 2026, you can see just the contribution of the AI-related equipment investment is just growing and growing.

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Now, a couple of notes about this. And the first one is a lot of this equipment is actually imported. So this is a sense in which what's going on here is actually powering other economies as well. It's not actually mapping into our own GDP growth in the short run, although the greater investment will raise potential output over the longer run. A second note is just that look at that structures category. You can see it's down this year. And my first— I was puzzled at first until I looked into it. And what's going on there is that there are other components beyond the AI buildout, like commercial office space that are really very weak. But the other thing is that when you think about data centers, only kind of that building goes into the structures numbers as investment. Everything that's inside that building, that's all in equipment. So actually, the kind of building, the building itself is not really contributing that much to GDP. So anyway, turning to prices, as I said before, inflation is likely to retreat. You can see my forecast mapped out on this slide. This will be a result of Fed tightening, as well as the retreat of energy prices.

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Let me point out here, though, that I'm expecting a much more gradual retreat in core prices. They don't go as high, but they also just are stickier than headline prices. That's the blue line versus the red line. That is the result of the fact that First of all, there are important categories of core like non-housing services that just have been persistently sticky in recent years. So I think they'll be slow to come down, but we're going to have lingering upward pressure from lag pass-through from higher diesel costs and the cost of other refined prices. And then stuff related to AI, chip shortages. And the AI buildout is also raising homebuilding costs, like all that wiring in the data centers is actually— kind of the same stuff that you would put in homes. Anyway, kind of so that— so turning to the Fed, the Fed is watching inflation expectations carefully. I think the good news is they haven't risen much this year. What I've got on this slide on the left panel is that's kind of household expected inflation. On the right, it's market-based expectations of inflation. And then the blue lines are the shorter-term measures and the red lines are the longer-term measures.

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So Inflation expectations haven't risen that much this year, but I should, you know, a couple of cautions here. And one is I've kind of put the gray lines on to show you where inflation expectations were before COVID And 3 of the 4 measures on this slide are materially above where they were above before COVID On top of that, there's been talk from Fed leaders about the fact that, well, if you have a one-time supply shock, that isn't likely to create a, you know, a rise in longer-term inflation expectations. But when you have successive waves of adverse supply shocks, then you need to start worrying. And of course, there's been excellent work here at Peterson. I know Joe Gagnon is somewhere here, just showing that lived experience really matters, that inflation— the fact that we went through high inflation in the early 2020s, sorry, is probably going to make inflation expectations more likely to become unanchored. Okay, so quickly, here's my Fed forecast. You know, the Fed will be data dependent, but the most likely outcome I think is 3 more quarter point hikes. I don't expect a hike at the October meeting. It's too close to the election and we don't have the definitive data in hand that would justify that.

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But I do expect hikes at December, January, February. And I think the aim of the Fed, it's both to cool the economy, but also to maintain its inflation-fighting credibility given the concerns about inflation expectations. And you can see if you look at the red line, my forecast calling for more hikes than what the Fed said they were expecting in September. Okay. So I've been talking a lot about monetary policy and I feel like this is monetary policy. There's a lot of action there. Fiscal policy is always in the background and I feel like we all understand there are fiscal concerns, but I think the rise in interest rates this year is really sending us a message that we

should be looking more carefully at it. So I have just a few slides on that to conclude my presentation. This slide just shows you CBO estimates under current policy of federal debt on the left and the deficit on the right. I think the chart on the left is familiar to folks. You can see the hockey stick heading up into unprecedented territory. I actually think that's the deficit chart to me is more telling. If you look at the end of the solid line, the end of history, you can see that even where we are today, it's just really high for a period outside of like a bad recession or a crisis like the pandemic.

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And then deficits just head up from here. Now, we all know that kind of exogenous driver here is population aging, which is going to engender more spending related to supporting the incomes and healthcare of the older population. But I want you to pay attention, or we should all be paying attention, to the endogenous component of interest costs. I think that's really something we need to be watching. Net interest payments relative to GDP, they've actually surged. It's hard to— you can't appreciate that much on this slide here because then they surge further. But if you look at the end of that solid blue line, you can see where they are now is actually the highest they've been since the— 2008. the mid-1990s. And, you know, this is really, you know, a story about, you know, debt being so high, then you have these big interest rates and you get kind of a snowballing of debt because, you know, you pay a lot. These interest payments then contribute to your deficit and your debt. And then that means debt is even higher and then you have higher interest payments and so on. I should also say CBS forecasts, they were done early this year.

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And so, they assume a 10-year rate that is actually about a percentage point below where rates are now. And so, they recently released a projection of, well, what if rates follow a higher path? And you can see here, the snowballing is even more dramatic. Another concern, a thing that we should be watching, is big shift in ownership of Treasury debt. It has shifted towards leveraged price-sensitive investors, this is a nice graph based on data from a recent Fed paper that is showing share of Treasury bonds and notes held. So it's the longer-term stuff. And I've just pulled out 2 categories and compared 2025 with 10 years earlier. And you can see this kind of drop in foreign official of more than 15%age points, but you can see there's been a big step up in holdings by households and hedge funds, which the paper estimates to be very price sensitive. I should say the hedge fund component is not just US-based hedge funds. It's catching this stuff in the Cayman Islands, et cetera, where some of these hedge funds are domiciled. And so this should raise some concerns because hedge funds use leverage to hold Treasury securities.

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So then you have to worry that some sort of shock that increases interest rates and then creates losses then might be amplified into even higher interest rates by hedge funds' need to deleverage. And of course, if that happens, people say, well, the Fed will just step in and stabilize markets. Kind of easier said than done. That will happen. But it's complicated in general. And it's also complicated in a period where the Fed is trying to tighten. in policy. Then the last thing I want to speak to is the narrative around AI and the fiscal situation. This is a graph showing some simulations that I did in a paper that was released earlier this summer. What we do is we look at the path of debt. The blue line is CBO's baseline, and then we look at some alternative assumptions that are actually in line in these surveys of experts of how this might play out with AI. So they're not exotic choices here. And what you can see here is you can see, yes, AI, faster productivity growth, it does improve the fiscal situation, although debt still rises in these scenarios. Some caveats on the right, that faster productivity growth, it probably will come hand in hand with higher interest rates.

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It's actually built into our forecast here. If interest shifts if income shifts towards capital owners, which is the gray line in this plot, that's not going to be as great for the deficit as one might imagine because of the low average tax rate on capital. And then finally, not built into all of our projections at all is the choices that society and Congress might make in a world with much more AI, job losses, potentially higher income inequality. Those things could spur new federal programs, which would raise deficits. So let me just wrap up on fiscal to say I do think fiscal policy changes will be needed ultimately, but they're unlikely in the near term. I think in terms of the forecast, the risk of fiscal crises has been boosted by the significant increase in interest rates this year, growing federal debt, The increase in future deficits from last year's tax cut, a shift in ownership towards leveraged hedge funds, and a productivity boost from AI will probably help, but it's not a panacea. I do think kind of the costs of the situation are probably more over the longer run than the short run. At this point, interest rates remain below their level in the 1980s and 1990s, so I don't think a fiscal crisis— it doesn't appear to be imminent.

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And I'm sure everyone's wondering when we're going to kind of get on track in the United States. And I should say there are many other countries. I kind of did a US presentation here, but you could have done a similar presentation for many other countries. I think the increases in interest rates and in interest payments relative to GDP, I think that may build public pressure for

action. But I'm actually not too optimistic. I think the fact that we haven't seen Congress act in a couple of decades, even though they've seen these problems coming, And just generally political polarization that augurs against near-term results. So thank you. And with that, I will turn things over to Inu. Perfect.

[00:31:40.03] - Inu Manak

Thank you, Karen, and thank you, Maury. As Maury mentioned, I'm here to chat with you about the future of the US-Canada Canada-Mexico Agreement, which is the updated North American Free Trade Agreement that was approved by Congress in July 2020. At the time, President Trump called it the greatest deal ever negotiated. The mandatory 6-year review that began this year has passed, and Trump chose not to renew it. This started a process of annual discussions that have to be resolved for the renewal to actually take place. But it's left many people asking, what's next for USMCA? Now, while US trade policy over the last year has been part mystery novel, part thriller, I'm going to walk you through why I think the USMCA negotiations are the central plot in this story. We've had 3 decades of deep economic integration in North America that now hang in the balance. The primary goals of US trade policy stated by the administration to build resilient supply chains, reduce dependence on China and to increase regional competition require closer cooperation between our countries. Yet if you look at current tariff policy, it may just undermine all of those goals. So what caught most trade experts off guard when Trump returned to office was that the tariff drama started with a bit of a surprise.

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Canada and Mexico were the first targets alongside China. However, both countries were spared the infamous Liberation Day tariffs while facing rising sectoral tariffs on things like steel, aluminum, and autos. Canada has received higher tariffs in response to its retaliation, but both countries continue to receive an exemption on broad-based tariffs for goods compliant with the USMCA. The bottom line with this tariff story is that it's been a messy one. but that the endgame has not really been clear with the many ups and downs. If you look, however, at the average US tariffs towards USMCA partners, they are actually quite low, 3% compared to 8% toward the rest of the world. This suggests to me that the administration actually understands the importance of North American trade to the US economy. But once you dig deeper, a more complicated story emerges. Let's look at the automotive sector, the region's most integrated industry, where US tariffs have narrowed the USMCA advantage for Canada and Mexico, reducing their competitive edge with Japan, Germany, and South Korea in finished autos. Here, it looks like the administration is trying to pull this part of the value chain closer toward the United States.

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What's worth keeping in mind is that even before Trump's latest trade wars, Canada and Mexico were actually on divergent paths for finished autos, with the Canadian share of the US import market actually decreasing from 23% to 13% from 2018 to 2024. Mexico's story is actually the inverse of that. This explains in large part why Canada walked away from the negotiations in August that purportedly left in place high tariffs on light and medium-duty trucks. That would target things like the Ford Super Duty trucks, which are a key export for Canada. Now, several administration officials have also publicly stated that Canada does not need to assemble vehicles at all, and that this approach on the value chain should be America first and Canada second. The reality is that Mexico is actually second and Canada actually finishes third. Now, if we look at another part of the auto sector, the US approach is actually different here. In auto parts, Canada and Mexico have retained significantly lower tariffs compared to the rest of the world. This is in many ways not surprising because auto parts account for the bulk of a vehicle's value. So raising costs in this value chain would hurt the US as much as Canada and Mexico, especially because the US share of this value chain is actually higher.

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And so you need to have a much more integrated approach to this. We can see that the share of auto parts trade from Mexico has actually remained really steady since 2017, making up one-half of US auto imports. The slight uptick that you see in the recent data is partly because you've had more compliance with the USMCA. It went up to 70.9% from 62% in 2023. Now, why does the specific story with USMCA partners in tariffs matter so much. I argue that it's because it tells us what trade-offs the US administration is willing to make to support some reshoring of US manufacturing. But it also reveals that the United States is sending a lot of mixed signals with its tariff policy, which is confusing a lot of US trading partners. It's clear that current tariffs weaken the USMCA tariff advantage and thus reduce the incentive for Canada and Mexico to engage in deeper cooperation on economic issues and other issues as well. If the tariffs persist, they will make economic integration much harder to sustain. And most importantly, current US trade policy toward Canada and Mexico may actually serve to undercut stated US economic security goals, such as reducing vulnerabilities to China, which requires a low tariff and continental approach.

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Now let's take a look at how one of those goals could prove to be out of reach. Take, for example, the role that China's inputs play in Mexico's exports. Since 2017, China's value added in Mexico's exports actually grew in some sectors. This not only complicates the USMCA renegotiation because Mexico would need to actively adjust its supply chains while facing higher

tariffs from its once trusted market, but this should also be a red flag for the United States that motivates more cooperation, not less, and creates incentives for Mexico to move away from these Chinese inputs. Yet we are not seeing the administration take up this approach. In fact, it's all sticks and no carrots. So this brings me to the real political constraints for a renewal of USMCA. For Mexico, this is more than just about trade. It's about its economic opportunities. its internal security, and its border management. These other issues cannot be disentangled from the talks, which elevates the conversations to the highest level in politics. It is why President Sheinbaum has been firm on sovereignty, but careful on how she has approached President Trump as well. For Canada, the backlash against the United States gives Prime Minister Carney some time to secure a deal, but it also opens him up to demands from provincial leaders facing scrutiny from their voters.

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The deal that Carney needs to seal has to be a good one, and he could see his popularity take a hit if he does not succeed. The bottom line for both of those countries is that stability in their trade relationship with the United States is paramount, but preserving the advantages of USMCA are essential because anything less will be seen as a bad deal, and it could reverse decades of economic integration that both countries have been firmly committed to. But for the United States, there are also some constraints. And a major one comes from Congress, which is unlikely to approve any textual changes to the USMCA itself because it already thinks the deal that exists is a good one. This also means that the durability of any changes that are made could be in doubt. So what should we expect to see for the USMCA going forward? There are 3 things I'd like to focus on. First, that there should be a persistent gap in the rhetoric on tariffs and the reality of what's actually applied when it comes to Canada and Mexico. I would say for all future tariff actions, let's keep an eye on those exemptions and see how USMCA gets carved out.

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Second, we're likely to see some new institution layered on top of existing obligations. The history of North American integration is one of institutional layering. There are 2 ways that this could happen. In the Trump administration itself. They've had 2 approaches. One is to sign framework agreements. These are agreements that are kind of like term sheets. They're just an agreement to have some sort of deal on certain aspects of the relationship over time. So ongoing negotiations. The second looks more similar to a trade agreement, but highly asymmetric. These agreements on reciprocal trade that have been negotiated with several countries as well. This could be something that the administration decides to pursue with Canada and Mexico separately. So you could have 2 bilateral deals there. The third thing that

we're likely to see is stricter rules of origin in some sectors, including on autos, and more alignment with Canada and Mexico on US trade policy, which is also going to continue to increase tension between the 3 partners because it will restrain Canada and Mexico's diversification efforts and potentially put them in violation of existing trade agreements. So the final point I'd like to make here is that while Canada and Mexico will seek other markets, Their relationship with the United States is irreplaceable.

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And this, in fact, will weigh in on every decision that both countries make in both their domestic and foreign policies. But at the end of the day, trade with Canada and Mexico is also very important to the US economy. So there's a strong incentive domestically to resolve this trade war sooner rather than later. And I look forward to talking to you about that in the Q&A. Thank you. Thank you.

[00:41:38.52] - Michael A. Clemens

Thank you so much for being here. Thank you for joining online. Switching gears from goods trade to services trade, the US government right now is in the midst of an unprecedented range of restrictions on lawful immigration. Large enough to have effects on macroeconomic performance. So what I'm going to talk about very briefly are macroeconomic implications of restrictions on one part of that policy agenda, restrictions on high-skilled immigrants, limits on high-skilled immigrants, taxes on high-skilled immigrants. So if we're talking about economic growth and immigration, there are fundamentally 2 channels Immigration is a change in economic terms in the size and the composition of the labor force. So there's a direct channel, just more people doing stuff. And there's an indirect channel, immigrants that cause all of us to do different stuff. By analogy, more workers in the restaurant delivering the same recipes to your table versus more creative chefs in the kitchen coming up with new recipes that make everybody in the restaurant more productive. And so if we're thinking about the effects of— on, on economic growth from immigration restrictions, we can think of a, of a direct channel, uh, that, that can in principle be, be fast, even immediate, and an indirect channel through productivity, uh, reduced, uh, innovation.

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And, uh, innovation comes from sectors that are highly exposed to immigration limits. A lot of the innovation in our economy comes from specific places, very concentrated places that are exposed to any barrier on high-skilled foreign STEM workers— STEM: science, technology, engineering, and mathematics. And even though high-skilled foreign STEM workers are just

1.6% of all employment in the U.S., if you narrow down to people with PhDs who are employed in science and engineering, jobs, 43% of the current employed workforce are foreign. And narrowing down further to computer and math jobs, we're talking about 58%. So really a dominant force in, in these areas. And I want to point out that, that two-thirds of those people with PhDs didn't come with PhDs. They, they got their degrees here. They came as, uh, as international students. And these people are a taproot of innovation in the US by any measure. A team of economists based at Harvard Business School estimates that they cause a third of all patenting in the US. That includes patents filed directly by themselves and their spillover effects on US inventors. Uh, 59% of the unicorn billion-dollar startups were founded or co-founded by one of these people.

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Uh, 65% of the Forbes AI 50 were founded or co-founded by these people. And, and these are the people targeted by high-skilled immigration restrictions. And so to understand the, the sweep of those restrictions currently, we have to look at the, the pipeline by which people, uh, by which they arrive, uh, in the U.S. The large majority arrive through a very well-developed foreign talent pipeline that I'm depicting here with flows that are— whose proportions are, are quantitatively accurate in the latest data that we have. As I mentioned, a lot of them start out as international students studying a STEM discipline at a U.S. university. About 2/3 of those graduate and transition into the U.S. labor force via a work permit that attaches to their student visa called Optional Practical Training, or OPT. About half of those transition to a work visa, overwhelmingly the, uh, the H-1B a visa, and something like 40% to 50% of those stay long-term, eventually through a green card. What's happening currently is a policy program that targets every step of this waterfall— student visas. The US administration has restricted the duration of student visas to be shorter than the degree completion time for many international students.

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It has banned student visas entirely for 39 countries and counting. On optional practical training, the administration is in the midst currently of enacting a $100,000 tax on each and every person who graduates from a US university and takes up optional practical training, charged to the university. It has enacted a separate and additional $100,000 tax on each and every worker in the private sector who uses an H-1B visa, charged to the employer. On green cards, it has announced sweeping measures to limit the ability of people to change status within the United States— excuse me, adjust status within the United States from an H-1B visa to an employment-based green card, demanding that most people do that abroad where they often face years-long waiting times. Separately from that, for 9 months of this year, almost all of this

year, the administration stopped processing exactly those those green card requests from abroad for 75 countries until forced to resume processing them by a court. Really, a sweeping program of dissuading people from entering and proceeding through this entire pipeline. This policy program has been spectacularly successful. We can see it in leading indicators. This is what happened to student visas last year.

[00:47:12.31]

The red line you see there is the month-by-month cumulative issuance of of F-1 international student visas to the United States in 2025 compared to other recent typical years. That's a drop, that's a sudden drop of 34%. Another leading indicator is H-1B visas. After the first $100,000 H-1B tax was announced in September of 2025, this is what happens to H-1B petitions subject to the tax in the subsequent 8 months versus the, the same calendar period of previous years, from, from the previous year to, uh, to last year, that's a drop of 91%. So it's very clear that these, uh, these actions are, are, uh, are quickly and massively affecting the, the talent pipeline to the U.S. So how can we estimate the, the economic growth impact? There, there is quite a lot of research on this. I'm going to focus on the 2 studies that are that are, that are among the best and, and on which the Congressional Budget Office, uh, uh, relies in addition to a couple of others when making their forecasts. A paper by Marta Prat-Mex and a paper by Giovanni Peri and his co-authors in the Journal of Labor Economics. Um, I'm doing 3 scenarios here of a, a 1/3, uh, 1/2, and 2/3 sustained cut to the annual inflows of high-skilled foreign STEM workers I would consider at this point 1/3 to be conservative.

[00:48:40.58]

That's why I'm starting with that. I'll focus more on the middle of this table. The estimates using Prato's method are intended to capture direct effects of innovation per se. And the methods of Peri et al. are better at capturing not only the effects of innovation itself, but agglomeration and specialization which comes from innovation. So by analogy, you could think of the lower estimates from Prato's method capturing the effect of new recipes on the restaurants and the higher Peri et al. estimates as capturing the effects on the whole restaurant district, including the theaters and the nightclubs and the delivery services and the hotels and the high-end apartments and that sort of thing. Bottom line, Uh, it would be consistent with this research for a sustained one-half decline in annual high-skilled foreign STEM worker inflows to cause a decline in total factor productivity growth that over a 10-year period would culminate in, in a U.S. economy that is, is 1% to 3% smaller than it otherwise would have been. And over a 20-year period, that would culminate to something between a, a 3% to 7% decline in the level of US GDP by the end. These are effects of macroeconomic importance, certainly substantial, but as you can see, somewhat slow to accumulate.

[00:50:07.28]

Obviously, I can't make precise or confident forecasts, but I'll close by just talking about 3 scenarios that I think are plausible. The first I'll call a persistence and relocation Um, consider a scenario where the— these restrictions on high-skilled immigration do not escalate, but one way or another there's going to be a persistent effect on global talent flows. To some, to some extent, the damage to the US as a, as a, uh, as the top destination for foreign talent, uh, has been done, and that will persist over time in some measure. That, that's going to have a tendency that is, that is lesser known to reduce productivity overseas as well, beyond the effects that I've talked about here, because the research literature has documented productivity spillovers from especially the H-1B program. Work by Gaurav Khanna and his co-authors, work by— also in the same study by Marta Prato, suggests positive productivity spillovers from the H-1B program in the United States to India. To Europe. The effects in India arising in Gaurav Khanna et al.'s research from sparking the development of the IT sector in India, encouraging Indians to be more likely to go into computer science, an effect that they measure and quantify.

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And in Marta Pratto's research, the spillover effects on Europe arise from knowledge transfer via colleagues who emigrated back to research colleagues within Europe. But there's a countervailing opportunity there, for countries that would be willing to make the large investments it would take to take advantage of this suddenly displaced foreign talent, attracting, retaining, and empowering them to be innovative elsewhere. That could lead in principle to a relocation of global innovation. What I personally think is somewhat more likely is the second scenario in which these restrictions escalate and other countries fail to attract, retain, and empower these displaced people, and global innovation falls, especially in the AI sector. That could lead to what I'm calling the splintering of the AI sector, in which compute, which is immobile, starts to be more and more disjointed geographically from talent, which is highly mobile. As I'll close with just a couple of leading indicators to watch to see which direction we're headed. Counting student visas, counting high-skilled work visa applications, counting the completions of AI-related PhDs in some of the key countries would be a great way to understand how these actions by the US are reshaping global talent flows.

[00:52:48.32]

Thank you.

[00:53:12.52] - Maurice Obstfeld

Okay, well, let me first thank the panelists for those great presentations. I'm going to have a lightning round here where I pose one question to each panelist, which I will try to be brief. I hope they can be brief so that we can move to questions. But for Karen, you ended by raising the specter of fiscal crisis in the US. And of course, if you read the papers today, there's talk about the French crisis and whether the ECB might activate its transmission protection instrument to buy French debt. So I wonder if in the current fiscal situation you see any longer-term risk to Fed independence. For Inu, I'm just going to run through all 3 of them, which is unfair to you. But, you know, the USMCA was ratified in 2020 at a time when President Trump still had trade Promotion Authority, which expired in 2021. So it would seem that, that the prospect even of getting, uh, you know, a willing Congress to do something would be very, very, very complicated. Given that, isn't it, um, in, in the, uh, interest of Mexico-Canada to basically continue diversifying, um, slow-walk negotiations, hope that in 2 years A new administration comes in.

[00:54:51.57]

Anything that they negotiate with the administration would have significant commitment problems from the US end and maybe from their end, it seems. So you can comment on that. And finally, for Michael, Karen's numbers showed that recently a big source of growth in employment has been in the goods production and distribution sector, which I would guess is relatively low-skilled, but yet the administration has been imposing serious restrictions on low-skilled immigration and indeed deporting a lot of people. So how sustainable is that robust employment increase in those conditions? So Karen first.

[00:55:31.44] - Karen Dynan

Thank you, Maury. I think you were asking about— I mean, you were pointing out, as I pointed out, that the US fiscal situation is not unique to the United States, that we're seeing it in other countries, and you were asking about implications for Fed and other central bank independence, right? Okay, I got that correctly. Yeah, so yeah, I think this is an issue we need to think about. This is basically the topic of fiscal dominance and whether we could see a rise in fiscal dominance. I feel like that's a term that really wasn't in my standard vocabulary until a couple of years ago. But even now, I feel like, you know, as I teach, I feel like it's a topic I need to cover. Yeah, we can expect that governments are going to want to put pressure on their central banks to do what they can to lower interest rates because that would help with the important issue of net interest payments. I think the question is whether it really would help because it's an issue of whether markets buy it or whether they see the loss of central bank independence and therefore they expect much higher inflation.

[00:56:36.25]

and the whole effort backfires. But it's definitely something we need to be thinking about it.

[00:56:47.01] - Inu Manak

That's a great question in terms of timing because I think that's something that both Canada and Mexico have been thinking a lot about in figuring out what they should agree to in writing with the United States. I think that if you're looking at the timeline this year, Yes, it absolutely makes sense to me that Canada and Mexico would wait out until after the midterm signing any framework agreement or temporary agreement that resolves some of the tariff impasses. I think the stability on the tariffs is essential and getting a short-term deal to get those to a predictable place is really important, particularly because President Trump said that he would increase the tariffs on Canada in January quite significantly on autos, and that would be a very big problem for Canada. On the textual changes, I think it's very important for Canada and Mexico to probably wait this one out until the next president is in office. I say that because this would lock in some changes that would be very difficult to unwind once they're made. The Congress probably is not going to help with this either. I think Congress is quite skeptical of making changes to USMCA.

[00:57:56.19]

Of course, they want to improve it in some ways, but also I would see that a Democratic-held Congress, if that ends up being the case, would not be willing this time around to also approve a deal that President Trump has signed. So this is one thing politically I think is going to be really interesting to watch in the coming months.

[00:58:16.03] - Michael A. Clemens

Yes, thank you. Great question. I played into the stereotype that you see in the media, which is that people kind of get that immigrant scientists are associated with productivity. But we forget that Silicon Valley doesn't just run on immigrant scientists. Silicon Valley runs on delivery workers and security people and construction workers and childcare workers and eldercare workers and many others. They contribute to productivity in their own way. The best estimates of the effects of current policy on the broader prevalence of immigrants in the labor force that I know of come from Stan Voiger, Tara Watson, and others across the street at AEI and Brookings. They estimate that in 2025, there was net negative immigration for the first time in the lifetimes of, I think, everybody in this room, of a negative 50,000 to 200,000 people. And that's especially notable because we're in the midst of demographic decline for natives in the US. And in the estimates of the Census Bureau, the US lost in 2025 net 800,000 working-age

people just from demographic change. So that in itself is going to have a productivity effect. And some of that can be compensated by automation. I have a study in the American Economic Review where I studied the Bracero Exclusion of farm workers in the 1960s, finding that it was partially compensated for by rapid automation, but not fully.

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In other words, there was rapid enough automation to prevent wages from going up, but not to prevent the value of farmland from going down, the productivity of farms from from not catching up. So certainly in the short term, until it is— certainly I can't rule out with any crystal ball of mine total automation of some of the sectors you referred to, Mari. But in the short term, that's certainly not going to happen. And the absence of labor is right now. So I could easily imagine the other kinds of restrictions that you're talking about being a restriction on productivity growth. as well.

[01:00:24.26] - Maurice Obstfeld

Ok, thank you. So we have time for a couple of audience questions now. There is a standing mic over there. Jess has a mobile mic. Please, if you have a question, identify yourself first, and also please be brief because we really only have 5 minutes.

[01:00:41.20] - Audience

Merrilee, International Trade Today. My question is for Dr. Manick. Um, so you talked about how Mexico wouldn't want to have, um, textual commitments during this administration. How could the US get the kind of rules of origin changes, especially outside of autos, that they keep talking about if there isn't text? Also, would you like to take a crack at the possibility of Congress at a veto-proof majority level repealing 338?

[01:01:18.41] - Inu Manak

So on the rules of origin question, I think there's probably a way for the administration to do this without Congress. If you look at the original changes to rules of origin after NAFTA, there were strengthened rules of origin that were done outside of the congressional pathway. So I do think that's entirely possible this time around. And I think we're starting to see that in some of the agreements on reciprocal trade that the administration has already signed. 338 repeal, I do think there'll probably be a push for this. Is there a chance it'll get through? I'm skeptical. I don't think there's enough votes to make it happen, and it's going to be very difficult to rally Republican support for this.

[01:02:08.04] - Audience

Thank you. Joe Bulyeu from Brevin Howard. This is also a question for Anu. I was wondering if you could comment on US-Canadian relationships and the leverage that Canada could possibly put on the US by expanding the talks to other things like critical minerals. My Michigan relatives want to know if their electricity is going to still be on, things like that. Thank you.

[01:02:36.29] - Inu Manak

I think Canada has been really careful in when it plays certain cards. So for example, they did not join the critical minerals discussions that the United States was hosting earlier this year with other partners and have left that sort of to wait to leverage it later. So I agree that there is plenty of leverage that Canada has in terms of commodities that they have not used yet. And I think part of it is this wait-and-see approach to say, okay, when we see other things get resolved, particularly on the auto tariffs, which are really, really sensitive, then they're willing to negotiate on these other issues. So I think those will be brought in very soon as we get closer to a resolution on the tariff issue.

[01:03:21.29] - Audience

Thank you. Hi, Edward Tilley with the Australian Embassy. I had a question for Michael. In Australia, we're having a lot of conversations like the rest of the world about immigration, and particularly international students, and thinking about what makes a high-quality international student. I noticed you called out to STEM as sort of contributing to the productive capacity of the American economy. Just wondering if you had any more sort of insights into what kinds of students are the most helpful for an economy.

[01:03:58.23] - Michael A. Clemens

Thank you. You could correct me if I'm wrong, but when I mentioned the responses of other countries to the current situations, if I had to make the broadest brush caricature of what's happening, it would be that several countries are generally restricting international students, including Australia, to my knowledge, the UK, Canada, several— and several countries for more senior potential innovators have piecemeal initiatives. There's Choose Europe for Science. There's the new K visa in China intending to to attract younger STEM workers with no job offer, which I generally characterize as being kind of small and untested so far. So not only are countries not shifting in to attract international students, it's more the opposite at the moment. But a more promising way forward, certainly STEM, we know, for example, The number of patents granted per year to STEM graduates from US universities is double the rate for high-skill natives. Jenny Hunt at Rutgers University first documented that. That's highly

heterogeneous. That's a substantial number of stars and then a substantial number who don't patent at all, which Of course, it's a portfolio decision. But how to identify those people is, I think, not very well known. Within STEM, there is some heterogeneity, but not an enormous amount.

[01:05:42.01]

What's much more crucial is allowing the stars in the portfolio access so that they can self-sort into employers who will take them so that they can stay in the country instead of fighting to stay in the country. Which most of this cohort is going to have to do. So you pose a really interesting question, how do I identify stars on the front end? And I think economics doesn't have much to say about that and should. But in the short term, the focus needs to be much more on allowing continuity and stability and predictable returns to investment so that the stars can identify themselves.

[01:06:24.59] - Maurice Obstfeld

Okay, those were great questions. Unfortunately, we are now out of time, so, um, I thank you all for coming. I thank the panel, and see you in April, I hope. Thank you.