Now is not the time for inaction

With the spotlights of global media attention trying to shed some light on what the Trump administration's first appointments and announcements mean, the reality is that it is still too early to anticipate any economic policy guidance, beyond what the financial markets are already factoring in with the appreciation of the dollar, the gains in equities and the upward revision of interest rate expectations. The verdict is that in the US we are going to see more nominal growth in the short term, but anticipating how this growth will be spread between economic activity and inflation is a somewhat more difficult task. That will depend on whether the tariff hikes are applied in a surgical manner in order to limit the damage to value chains, the degree to which migration policies will impact the labour supply and how the expansive fiscal programme that is already on the table is finally implemented.

Therefore, the range of possible effects on the world economy remains wide open, as this will also be linked to the responses of the other actors involved (China has already announced restrictions on exports of metals and minerals), the ability of third countries to divert trade through connecting nations and the negotiating margin of each country. However, the greatest risk in 2025 to the orderly landing contemplated in the baseline scenario is the potential for further supply shocks, either as a result of tariff wars or due to distortions in energy markets, in a financial environment in which they are exhibiting a degree of complacency.

Focusing on the euro area, the trade channel is the main route through which the impact of the US administration's new economic agenda is likely to materialise, as foreign demand will be affected by the likely increase in tariffs. This effect could be partially mitigated by the appreciation of the dollar, at the cost of a rise in inflation caused by higher import prices and a possible tariff response from the EU. Secondly, a less dovish Fed in the face of higher inflation expectations could trigger a tightening of global financial conditions, including in Europe. Thirdly, the heightened uncertainty caused by these tariff conflicts could weigh down investor sentiment and risk appetite, potentially depressing economic activity. All of the above is due to the EU's high degree of sensitivity to changes in its relationship with the US, taking into account that the American economy is the destination of 20% of its exports of goods and services and that 3.4% of the region's GVA is linked to US demand, with significant exposure in sectors such as pharmaceuticals (22%), chemicals (10%) and machinery (8%). Therefore, raising the universal tariff in the US to 10% would have a significant impact, particularly given their current low levels (average tariff of just 2%).

In this context, Europe is not in the best shape to face the new challenges of the trans-Atlantic relationship (tariffs, Ukraine, defence policy/NATO), bearing in mind the weak growth outlook for next year (with Germany still very weak), the high dependence of the growth model on the foreign sector (an Achilles heel in the current environment), the fiscal fragility of France and Italy and the weak starting point of the new European Commission (with 41% of votes cast against it in the European Parliament). If we add to all of the above the political instability in France and Germany, which in the short term will limit the traction of the region's backbone, the starting point for next year is challenging. On a more positive note, the risk of «Italianisation» (minus the trans-alpine *finezza*) of the French political sphere has thus far only translated into an orderly realignment of risk premiums in the euro area, as the market has limited itself to pricing in France's evident fiscal deterioration (something which, on the other hand, had been on the table for a long time), but without penalising the rest of the peripheral economies. This also reflects the potential deterrent of the range of instruments designed in the last decade to address idiosyncratic crises in the euro area (ESM, TPI, etc.). That said, we already know from our own experience that being on the financial markets' risk radar is not the best recipe in turbulent times.

In short, we are facing a new year of strong economic emotions, so it is advisable to make the most of the Christmas break to take a respite. This is also a good time for us to wish the readers all the best for 2025 and to send our best wishes to our colleagues, customers and friends in Valencia.

José Ramón Díez
December 2024