MACROECONOMIC *view*

March 12th, 2025

Bruno Cavalier
Chief Economist ODDO BHF

Mr Trump's tariff machine gun and Mr Merz's fiscal bazooka

KEY HIGHLIGHTS:

- Donald Trump launched a tariff war earlier and more aggressively than during his first term.
- This has led to economic instability which has lowered household and market confidence
- The US economy is likely to slow down even more sharply than initially anticipated
- Doubting the military support of the United States, European leaders are determined to rearm
- In Germany, the future chancellor wants to completely change the budgetary doctrine in order to implement a major recovery plan

●○●

'*There are decades where nothing happens; and there are weeks where decades happen.*' This quote from Lenin comes to mind in view of the recent upheavals in the world caused, directly or indirectly, by Donald Trump. In recent weeks, there have been changes not seen for decades.

Let's look at a few examples. Firstly, by raising their tariff barriers, **the United States has increased its average customs duty to a level not seen since the end of the 1940s.** And this is certainly not the end of it, as other threats loom over world trade. Secondly, the obvious desire of the United States to disengage from the security of Europe **calls into question the principles of a transatlantic alliance created in 1949**. Thirdly, and in response to the previous risk, the future German Chancellor has made a U-turn on fiscal policy. **The balanced budget that seemed an intangible dogma in Germany is no longer relevant**. These are just a few of the events that will continue to have far-reaching effects.

Two months into his second term, Donald Trump has already done so much to impose his 'America First' policy that he has destabilised the global economic and geopolitical order. We can venture to make a provisional assessment of his actions by looking at what he has and has not done. **During the election campaign, he promised significant tax cuts**, which generated a great deal of optimism on the markets. To date, this issue has made almost no progress because the Republicans in the Senate and the House have to agree on how to implement these tax measures.

Another campaign promise was deregulation. This was also intended to reduce federal spending. This matter has been entrusted to Elon Musk, whose management practices are reputed to be rather harsh. **The DOGE, the department responsible for cutting spending, has so far identified savings representing only 0.3% of GDP,** a gold drop in the ocean of a deficit approaching 7%. Here again, more talk than action, but talk that is contributing to the recent anxiety in the markets.

Donald Trump had also announced a **massive deportation of illegal workers, estimated at millions of people. Nothing has happened in this respect, which is good news for the economy** as it could have destabilised the labour market. It should also be noted that the White House did not seek to put pressure on the central bank either, as had been suggested. To date, the Fed's independence has been preserved; it is a pillar of the proper functioning of the markets and of investor confidence.

In fact, in the two months that Donald Trump has been in office, all initiatives relating to economic policy have focused on tariffs. They have been raised twice on Chinese products. They are hitting imports of some industrial metals. They are also expected to be extended soon to Canada, Mexico, Europe and finally to the whole world. However, these measures, which can hit the countries concerned hard, do not fail to weaken the United States. First, customs duties are paid by the importer and therefore risk making foreign products consumed by Americans more expensive. Secondly, tariff announcements are so numerous and fluctuating that they create unprecedented instability. This can lead to a reduction in investment and have a negative impact on activity.

All in all, the US economy is still strong with very low unemployment, but business climate indices, as well as household confidence and the stock market, point to a downside risk. Donald Trump wanted to lower long-term interest rates. He has succeeded in doing so in recent weeks, but not by reducing inflation, but rather by rekindling certain fears of recession.

Outside the economic sphere, Donald Trump has also been very active in trying to achieve peace or at least a ceasefire in Ukraine, even if it means aligning himself with Russia's positions. Going forward, Donald Trump seems determined to withdraw the American security umbrella, which is enough to cause panic among Europeans. **It is often in these moments of acute crisis, as we have seen several times in the past (debt crisis, pandemic), that leaders then make decisions that seemed unthinkable.**

What are these decisions? **Firstly, the EU countries, as well as the United Kingdom, have decided to significantly increase their military spending.** Currently estimated at an average of 2% of GDP, this could rise to around 3% or 3.5% in the coming years, a level not seen for several decades. This is a huge effort (graph). In the case of Germany, the rearmament plan is coupled with a vast infrastructure spending plan. Here again, the figures are massive (12% of GDP over ten years), enough to compensate for the lack of public investment over many years.

If all these announcements are actually implemented, what could be the consequences for the European economy? The positive side is undeniable for Germany because stimulating an economy to the tune of 2% to 2.5% of GDP per year is enough to get the economy off the ground again after years of stagnation. If economic activity picks up in Germany, it will have a knock-on effect elsewhere in Europe.

The negative side is due to the evolution of financing conditions. Germany has little debt (62% of GDP, almost half as much as France) and can afford to bear increased deficits for several years. **But with this change in the fiscal doctrine, interest rates have already jumped in anticipation of the increase in debt issuance.** The rise in German rates has pushed upwards those of other countries with more fragile public finances. For them, debt refinancing is becoming more expensive, requiring additional consolidation efforts. This can also lead to trade-offs between categories of expenditure (more military, less social), which is risky politically.

Unlike the United States, Europe began 2025 on a fairly weak footing. However, the business climate has passed its cyclical low point. The horizon is divided between two risks. A positive risk linked to the German stimulus, but this is more likely to happen in 2026 and beyond. And a negative risk if Donald Trump imposes high tariffs on European goods in the near future. In the short term, economic risks are still pointing downwards in Europe, but in the longer term, reasonable optimism is finally in order.

MILITARY SPENDING

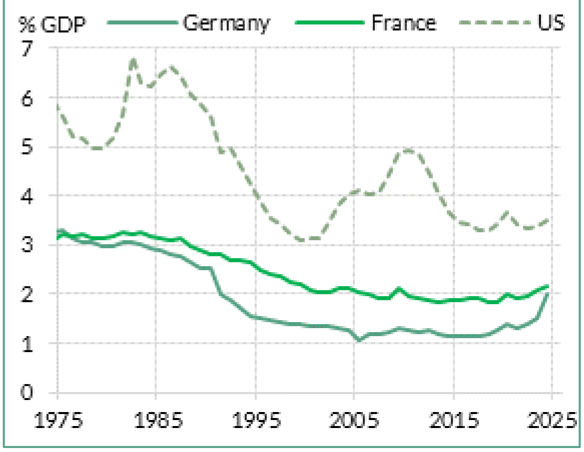

Chart sources: SIPRI/NATO, ODDO BHF

Past performance is not a reliable indicator of future returns and is subject to fluctuation over time. Performance may rise or fall for investments with foreign currency exposure due to exchange rate fluctuations. Emerging markets may be subject to more political, economic or structural challenges than developed markets, which may result in a higher risk

ODDO BHF
12, boulevard de la Madeleine - 75440 Paris Cedex 09 France - Phone: 33(0)1 44 51 85 00 - Fax: 33(0)1 44 51 85 10 – www.oddo-bhf.com ODDO BHF SCA, a limited partnership limited by shares with a capital of €73,193,472 - RCS 652 027 384 Paris – approved as a credit institution by the Autorité de Contrôle Prudentiel et de Résolution (ACPR) and registered with ORIAS as an insurance broker under number 08046444. - www.oddo-bhf.com