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Global economic outlook: Riding out the risks

In a world full of risks, we remain cautiously optimistic that major economies can enjoy a period of sustained economic growth as central banks gradually ease their monetary policies. Cyclical recoveries in the UK, the Eurozone and Japan can narrow the growth gap on the US and China.

Leaning back, one theme stands out. How economies ultimately fare will hinge on policymakers' choices and geopolitical developments. If the tail risks are avoided, growth in major economies can surprise to the upside.

Advantage UK. The shift back to the political centre after years of damaging uncertainty sets it apart as a place of relative stability. This should be a boon for the UK economy and its financial markets.

Picking up the slack – We anticipate a broadening economic expansion across major economies over the next three years: with continued growth in the US and China matched by cyclical upswings in the UK, Eurozone and Japan as these economies recover from the 2022-23 energy and interest rate shocks. Recovering global trade can lift production and investment while less tight financial conditions support consumer spending and housing market activity. For the US, after a likely upside surprise in 2024, we are in line with consensus in 2025. In 2026 we look for US growth to surprise to the upside again. We project Eurozone growth in line with consensus in 2024, before it surprises to the upside thereafter. For the UK, we are above consensus in each forecast year (Figure 1).

A little help from central banks – Major central banks are likely to react to a further moderation in inflation by cautiously turning their monetary policies from tight to close to neutral. We look for the US Federal Reserve to lower the Funds Rate corridor from 5.5% (upper limit) to 4.25% by end-2025; the Bank of England to reduce the Bank Rate from 5.25% to 3.75% by end-2025; and the European Central Bank to lower the Deposit Rate from 3.75% to 2.75% by mid-2025. Structural inflation pressures tilt the risks to our rate calls to the upside.

Mind the tail risks – Political disillusionment across major parts of the world combined with growing West versus East geopolitical tensions make for an uneasy economic backdrop. In addition to the standard risk of central bank policy mistakes, we need to keep an eye on a host of geopolitical tail risks that could destabilise economic growth and cause turmoil in global financial markets.

For our detailed forecast tables see 'Economic outlook: broadening expansion'

Figure 1: Peel Hunt real GDP projections versus Bloomberg consensus

	2024		2025		2026		Potential
	PH	*BB*	*PH*	*BB*	*PH*	*BB*	*PH*
North America							
US	2.5	2.3	1.8	1.8	2.2	2.0	*1.8 - 2.0*
Canada	1.3	1.0	1.6	1.8	2.1	1.9	*1.6 - 1.8*
Asia and Oceania							
China	4.8	4.9	4.4	4.5	4.2	4.3	*3.5 - 4.0*
Japan	-0.2	0.1	1.2	1.2	0.8	0.8	*0.4 - 0.6*
India	7.8	7.8	7.0	7.0	7.0	6.7	*6.5 - 7.5*
Australia	1.3	1.2	2.3	2.1	2.5	2.4	*2.0 - 2.2*
Europe							
UK	1.2	0.8	1.7	1.3	1.8	1.5	*1.5 - 1.7*
Eurozone	0.7	0.7	1.5	1.4	1.6	1.3	*1.2 - 1.4*
Germany	0.2	0.2	1.2	1.2	1.3	1.3	*1.0 - 1.2*
France	0.9	0.9	1.3	1.2	1.5	1.4	*1.4 - 1.6*

Annual data. Source: Peel Hunt estimates (PH), Bloomberg consenus (BB) taken on 26 July 2024

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Overview: more growth, some inflation

We look for cyclical recoveries in the UK, Eurozone and Japa, and continued growth in the US and China

Real GDP outlook – modestly above consensus

We anticipate a broadening economic expansion across major economies over the next three years: with continued growth in the US and China matched by cyclical upswings in the UK, Eurozone and Japan as these economies recover from the 2022-23 energy and interest rate shocks (Figure 1). Recovering global trade can lift production and investment while less tight financial conditions support consumer spending and housing market activity.

For the Eurozone, we are in line with consensus in 2024 but above consensus in 2025 and 2026 . . . For the UK we are above consensus in all forecast years

The UK can benefit from fading headwinds, positive fundamentals and a political feel-good factor

- For the **UK**, our GDP calls are above consensus over our three-year forecast as fading headwinds, positive fundamentals and a political feel-good factor lift momentum. We project YoY growth of 1.2%, 1.7% and 1.8% in 2024, 2025 and 2026, respectively, whereas consensus expects 0.8%, 1.3% and 1.5%. In the **Eurozone**, we are close to consensus in 2024 (0.7%), but ahead thereafter at 1.5% (1.4%) in 2025 and 1.6% (1.3%) – consensus in brackets. Our better-than-expected Eurozone outlook is driven by a continued catch-up in peripheral economies, and a small positive surprise in **France,** while **Germany** disappoints.

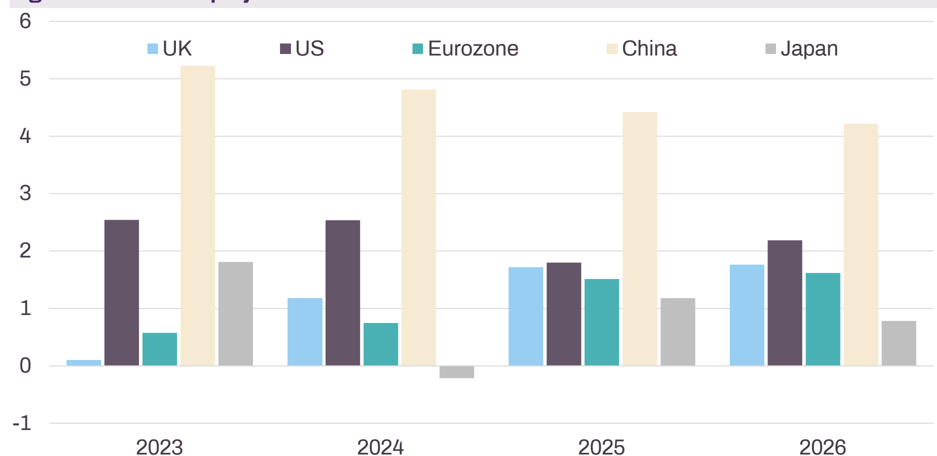
US momentum is set to slow as the impact of Fed hikes weigh on demand, but we expect momentum to improve in 2026

- In the **US**, resilient domestic momentum hints at a slight upside surprise in 2024 – our 2.5% call is a notch above consensus (2.3%). However, we expect the lagged impact of tight monetary policy to lower growth to 1.8% in 2025 – in line with consensus. In 2026, fiscal support and less tight financial conditions can lift growth to 2.2% - 0.2ppt above consensus.

China is likely to continue to slow on trend while Japan enjoys a period of above-potential gains after a recent soft-patch

- **China's** growth is slowing on trend as high debt and an ageing population hurt demand. Our GDP call for China of 4.8% in 2024, 4.4% in 2025 and 4.2% in 2026 are roughly 0.1ppt below consensus over the three-years, on average. In **Japan,** current Chinese weakness is likely to restrain activity in 2024 – and our -0.2% call is 0.3ppt below consensus. Thereafter, we look for a cyclical recovery in Japan that lifts growth to 1.2% in 2025, followed by an above-potential 0.8% gain in 2026. Our Japan calls for 2025 and 2026 are in line with consensus.

Figure 2: Peel Hunt projections for real GDP



% YoY. Peel Hunt projections for 2024-26. Annual data. Sources: ONS, BEA, Eurostat, China National Bureau of Statistics, Cabinet Office of Japan

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Monetary policy turns less tight as inflation moderates

We expect inflation across major western economies to moderate between 2024 and 2025 as the mostly energy-related surge in 2022 and 2023 fully fades, inflation expectations remain well behaved, and wage growth moderates further.

Inflation across western economies should moderate further in 2024 and 2025 . . .

In 2026, inflation is likely to rise again and stay modestly above central banks' 2% targets as long-term structural factors including rising trade frictions and labour shortages caused by ageing populations push up prices via higher input costs and wages.

. . . but start to edge higher again in 2026 as long-term structural factors push up wages and input costs

- In the **UK**, we project that inflation will fall from 2.5% YoY in 2024 to 2.1% in 2025, before ticking up to 2.3% in 2026. We expect a similar pattern for the **US** (2.9%, 2.5% and 2.4%) and **Eurozone** (2.4%, 2.0% and 2.1%) across 2024, 2025 and 2026, respectively. Stronger demand growth will likely keep inflation slightly higher in the US than in Europe.

Stronger demand growth will likely keep inflation slightly higher in the US than in Europe

- **Japan** appears to be tentatively on track to escape its decades-long disinflation. Although we expect inflation in Japan to moderate from a 2.5% overshoot in 2024, it can remain in the 1.8-2.0% range in 2025 and 2026. In **China**, inflation is on a different trajectory owing to a host of mainly domestic challenges. We expect headline inflation to pick up from 0.4% in 2024 to 1.5% in 2025 and to 1.9% in 2026.

Japan appears to be tentatively on track to escape its decades-long disinflation

Step-by-step, major central banks are likely to react to moderating inflation by lowering their key policy rates to close to, but still a notch above, longer-run neutral levels (Figure 3).

The Fed, the BoE and the ECB can turn their monetary policies from tight to almost neutral as inflation moderates

- In the UK, we expect the **Bank of England (BoE)** to cut the Bank Rate twice in 2024, by 25bp each time, followed by four more 25bp cuts in 2025 – reducing the Bank Rate from 5.25% to 3.75% by end-2025.

BoE to cut the Bank Rate from 5.25% to 3.75% by end-2025

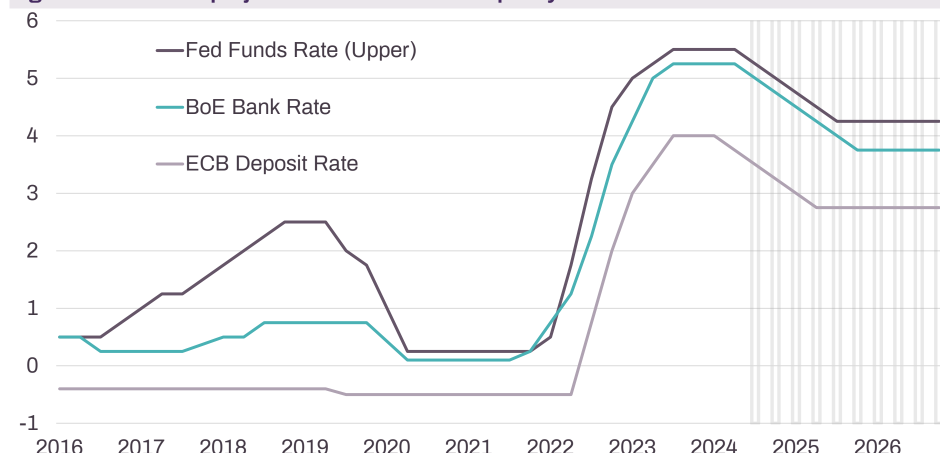
- In the Eurozone, we look for the **European Central Bank (ECB)** to lower the Deposit Rate from 3.75% at present to 2.75% by mid-2025, with two further 25bp cuts coming before the end of 2024.

ECB to lower the Deposit Rate from 3.75% to 2.75% by mid-2025

- In the US, we project that the **Federal Reserve (Fed)** will lower the Funds Rate corridor from 5.5% (upper limit) to 4.25% by the end of 2025, with two 25bp cuts coming before year-end.

Fed to reduce the Funds Rate corridor from 5.5% (upper limit) to 4.25% by end-2025

Figure 3: Peel Hunt projections for central bank policy rates



In %. Shaded area shows projection. Quarterly data. Sources: Federal Reserve, ECB, BoE, Peel Hunt

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Assumptions and risks

Our call for sustained economic growth across major economies rests on three key assumptions:

Our positive economic outlook rests on three key assumptions . . .

1. **Inflation moderates in 2024 and 2025** in line with the expectations of central banks and financial markets. A further moderation in inflation is necessary for the Fed, the ECB and the BoE to gradually remove monetary tightening and ease financial conditions to support demand growth and employment.

First – Inflation moderates by enough to allow central banks to reduce interest rates

2. **No new negative global supply shocks.** The key sources of risk are energy and commodity markets. However, we also need to watch for sudden acute disruptions to global supply chains and key shipping routes. As past shocks fade, improving global supply growth can support real economic activity and keep input cost pressures under control.

Second – No new negative supply shocks, especially in energy and shipping

3. **No serious protracted bouts of financial instability.** We need to keep a close eye on the small but serious risk that misguided fiscal policies in the US (pages 14-15) and in France (page 19) could trigger bond market turmoil due to inflation and debt sustainability concerns. A tantrum in the US treasuries market could destabilise global markets.

Third – no serious bouts of financial instability . . . keep an eye on US bond markets

Two-sided macro risks

While an unusually high number of tail risks (see final section below) tilt the overall risk balance in our projections to the downside, if we abstract from these potential fault lines, the core macro risks are roughly balanced.

We see two-sided macro risks . . .

- **On the upside**: The diffusion of artificial intelligence (AI) technologies promises to revolutionise supply and lift productivity across a host of sectors. The prospect of a return to more historically normal rates of growth in per capita GDP and productivity could help to contain political and geopolitical tensions.

On the upside, AI promises to revolutionise supply in services and industry

- **On the downside**: We need to watch the risk that central banks leave it too long to cut interest rates. In case of surprise downturns in 2H24 or early 2025 caused by central bank policy missteps, we would look for V-shaped rebounds in 2H25 and 2026 as policymakers slash interest rates to levels well below those set out in our base case.

On the downside, central banks may keep interest rates too high for too long

Tail risks in the age of instability

Political disillusionment across major parts of the world combined with growing West versus East geopolitical tensions make for an uneasy economic backdrop. In addition to the two-side macro risks set out above, we need to keep a close eye on five serious, but low probability, downside tail risks that could destabilise the global economy and financial markets:

Mind the tail risks: political disillusionment combined with growing geopolitical tensions make for an uneasy economic backdrop

1. a US lurch towards isolationism under a second Trump presidency;
2. a major tit-for-tat trade war between the US, Europe and China;
3. a spillover of the Russian-Ukraine war into a NATO member;
4. a broadening of the Israel-Palestine conflict into neighbouring countries; and
5. any attempt by China to annex Taiwan using military means.

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UK: Reaping the benefits of stability

Mind the gap – healthy demand, impaired supply
After an initially strong rebound from the Covid-19 mega-recession in 2020, two major shocks interrupted the UK economic upswing in 2022. First, surging gas prices caused by acute supply disruptions following the Russian invasion of Ukraine in February 2022 curtailed production and squeezed real incomes. Second, the BoE's aggressive policy tightening to slow demand and curb the ensuing inflation dampened the flow of credit to the real economy. The result? Real GDP stalled for almost two years and the housing market slumped.

Surging energy prices and tight money intercepted the UK's economic recovery from the Covid-19 mega recession

Although the gas shock badly impaired output, spending remained surprisingly resilient – even as the BoE raised the Bank Rate from 0.1% in December 2021 to 5.25% in August 2023. By 4Q23, real GDP had fallen 6% short of the 2015-19 trend but nominal GDP, the broadest measure of aggregate demand, was 5% higher – rising 11.3% over the period (Figure 4).

Although supply shocks held back UK output growth, spending remained resilient as interest rates increased

Shock absorbers – balance sheets matter
It begs the question, why did UK spending remain so strong? Part of the reason is simply that consumers and businesses had no choice but to spend more to continue to purchase essential energy to provide power for their homes and factories. But that is only half the story. Reacting to the outbreak of war and ensuing inflation shock, the prevailing view, including by BoE, had been that the UK would fall into recession. Some commentators even feared that the sudden rise in interest rates after more than a decade of rock-bottom rates could trigger an economic and financial catastrophe. All such fears proved overblown.

The BoE's tight monetary policy did not impede demand momentum as badly as expected initially

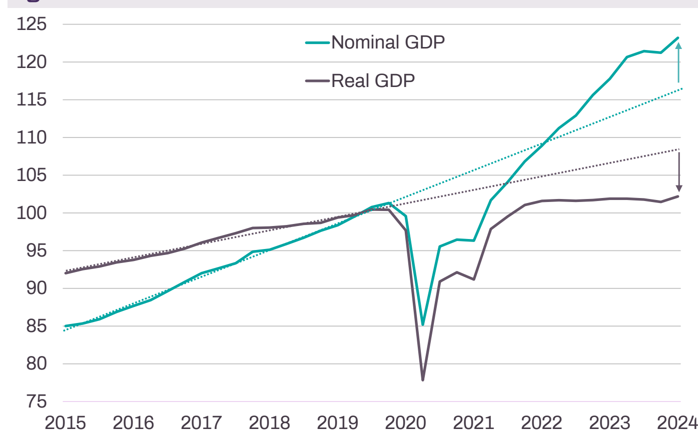
Instead, because banks, businesses and households had sufficiently strengthened their balance sheets in the years after the 2008 Global Financial Crisis, they could adjust to the return of interest rates to historically normal levels and absorb higher prices – see '*In focus – UK balance sheets*' on page 8.

Healthy balance sheets allowed the UK private sector to absorb the inflation and interest rate shock

The downside of the UK's extreme demand-supply imbalance in 2022 and 2023 was that inflation peaked at a higher rate (at 11.1% YoY in late 2022) than in the US (9.1%) and Eurozone (10.7%). However, now that external supply conditions are improving, the UK is benefiting from its demand-side resilience. Business and consumer expectations are surging – Figure 5.

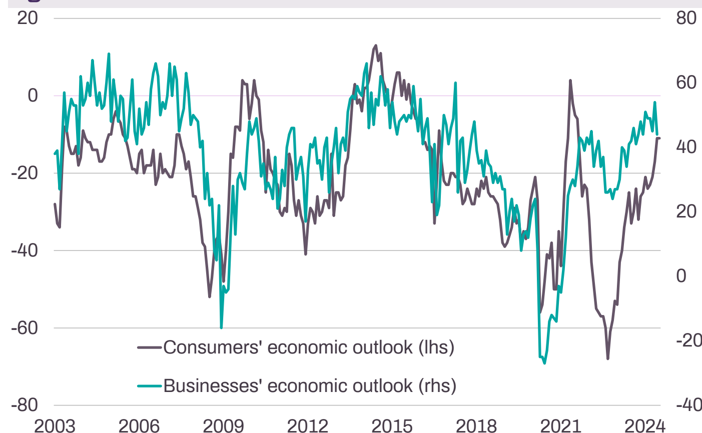
The UK suffered a higher inflation peak than the US and Eurozone due to a greater demand-supply imbalance

Figure 4: UK GDP in real and nominal terms



2019 = 100. Quarterly data. Source: ONS

Figure 5: UK consumer and business outlook



Outlook for the next 12 months. % balance. Monthly data. Source: GfK, Lloyds Bank

The improvement in sentiment has coincided with a strong start to 2024. The 0.7% QoQ rise in real GDP in 1Q exceeded the 0.3% and 0.4% increases in the Eurozone and US, respectively.

A brighter outlook – three reasons for optimism

Looking ahead, we expect the UK economy to enjoy a period of sustained recovery growth that puts its relative performance over the forecast roughly in line with the historical norm, that is, a notch behind the US but above the Eurozone.

We expect UK growth to fall short of the US but run ahead of the Eurozone

After a paltry 0.1% YoY rise in real GDP during 2023, we expect growth to accelerate to 1.2% in 2024, before ticking up further to 1.7% in 2025 and to 1.8% in 2026. Growth in the final year of our forecast is slightly above our 1.5-1.7% estimate of potential. Our calls are a cumulative 1.1ppt above consensus.

Building momentum can lift UK growth above its longer-run potential rate in 2026

Our positive assessment is based on three factors:

1. **Improving fundamentals:** Although long-run growth potential remains impaired, underlying conditions in the private sector are improving. Employment remains high and real wages are rising again after the gas shock (Figure 6). Meanwhile, productivity enhancing business investment is rebounding after the post-2016 Brexit-induced hiatus and sharp correction in 2020 during the pandemic (Figure 7).

UK real wages and business investment have been rising nicely on trend

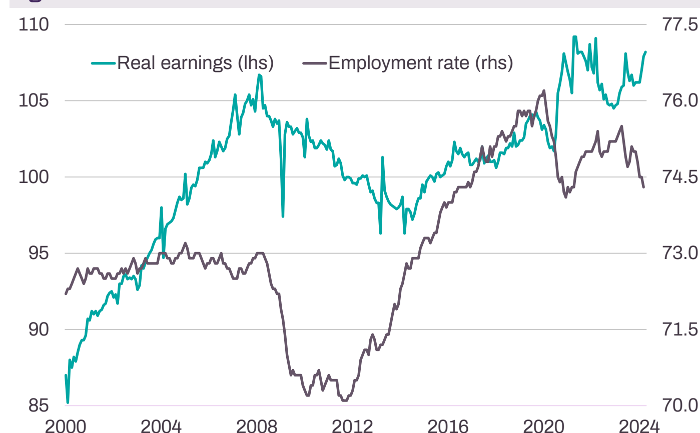
2. **Fading shocks:** In the UK and its key trading partners, inflation is moderating, energy markets are normalising, and financial conditions are turning easier. Together, these fading headwinds can support a cyclical recovery in domestic private demand, international trade and production. Strengthened by policy initiatives to boost supply, rebounding housing market activity can add another engine to the recovery in 2025.

As external supply shocks fade, UK policymakers are taking steps to lift domestic supply potential

3. **Goodbye populism:** Political uncertainty surged after the UK voted to leave the European Union (EU) in June 2016. Repeated delays in Brexit and EU trade negotiations hurt confidence and weighed on investment and GDP growth while two noisy surprise elections in 2017 and 2019 further damaged the UK's status as a safe haven. However, the worst is probably over. The 4 July election marked a de facto return to normal with Prime Minister Keir Starmer (Labour) winning a huge majority on a centre-left ticket after beating Rishi Sunak's centre-right Conservatives.

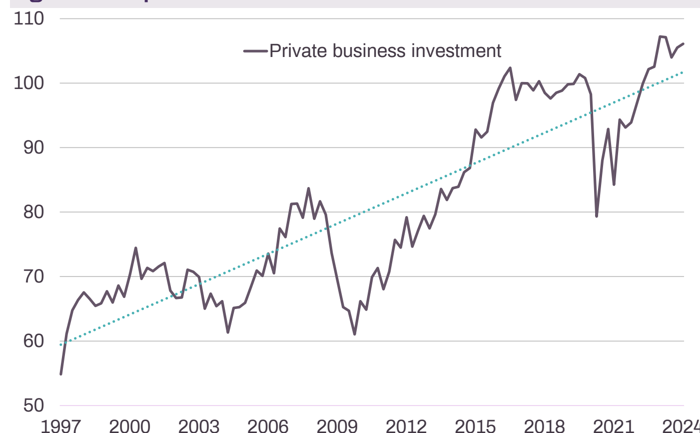
Following years of damaging uncertainty after the June 2016 Brexit vote, the UK has returned to the stable political centre

Figure 6: UK labour market fundamentals



Real earnings index, 2015 = 100. Employment rate in %. Monthly data. Source: ONS

Figure 7: UK private business investment



In real terms. Green dotted line shows long-run trend. 2016 = 100. Quarterly data. Source: ONS

Go-slow BoE worried about sticky inflation

From 7.3% YoY in 2023, we expect inflation to moderate to 2.5% in 2024, before falling to 2.1% in 2025. In 2026, we expect inflation to tick up to 2.3% as rising demand and tight labour markets contribute to price pressures via wages. The risks to our inflation calls are unusually wide and tilted to the upside. But upside risks should not stop the BoE from cutting rates. Instead, they will shape the profile and scale of reductions in the Bank Rate.

The risks to our UK inflation calls are unusually wide and tilted to the upside

Although headline inflation has fallen to the BoE's 2% target in recent prints and price pressures are moderating across the board, policymakers remain concerned about some remaining stickiness in domestic price pressures as well as longer-run structural inflation risks. At 3.5% YoY in June, core inflation remained above target (Figure 8), while the 5.7% YoY rise in wages in the three months to May is probably two percentage points above the longer-run sustainable rate. Furthermore, as the final base effects from past energy price gyrations wash out, headline inflation looks likely to temporarily tick up again slightly in late 2024.

BoE policymakers remain concerned about some remaining stickiness in domestic price pressures . .

BoE policymakers have emphasised that monetary policy is tight and that it is a question of when rather than if rates will come down. Money markets put a 50-50 chance on a first 25bp cut at the 1 August monetary policy committee (MPC) meeting, when the BoE will update its forecasts in the quarterly Monetary Policy Report (MPR) and host a press conference to discuss the decision. Markets expect a second 25bp cut before year-end to take the Bank Rate to 4.75%.

. . . but emphasise that it is a question of when rather than if interest rates will come down

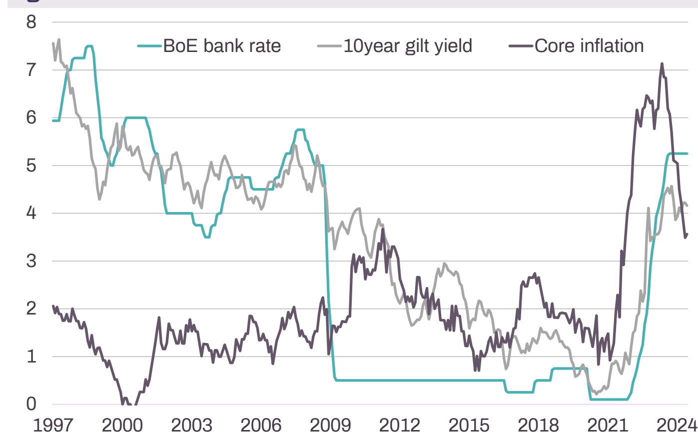
We also look for two cuts in 2024, but our call is finely balanced, and the risks are skewed towards just one cut. Any one of the upcoming three meetings is 'live' for a first cut, in our view. In case the BoE holds in August, it would be an open question whether the bank would choose the regular meeting on 19 September or wait until 7 November at the final MPR and press conference of the year to cut. In 2025, we look for four more 25bp cuts at a pace of one per quarter. In 2026 we expect the BoE to keep the Bank Rate unchanged at 3.75% – a notch above our 3.5% estimate of the neutral rate.

Our call for two 25bp cuts in 2024 is finely balanced – risks are skewed towards just one 25bp cut

The BoE's cautious approach, which will keep monetary policy tight through 2024 and most of 2025, is likely to contribute to a slight rise in the unemployment rate from 4.1% in 2023 to a peak of 4.8% in 2025 before it declines again to a 4.5% rate in 2026 as the upswing builds pace.

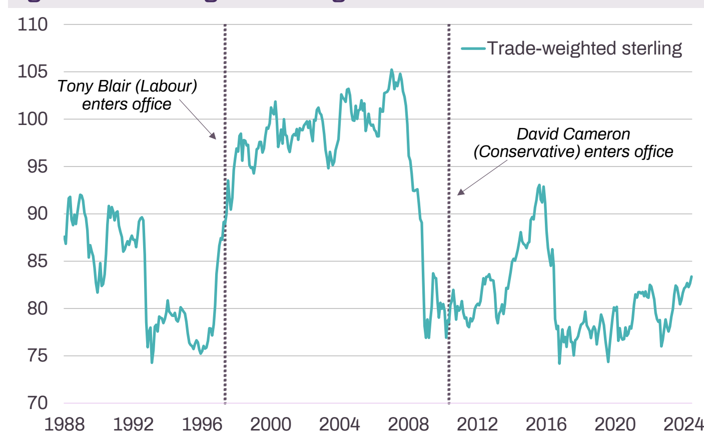
Still-tight monetary policy through most of 2025 will contribute to a small rise in the UK unemployment rate

Figure 8: UK inflation and interest rates



Core inflation (ex. energy, food, alcoholic beverages and tobacco) in % YoY. Interest rates in %. Monthly data. Source: BoE, ONS

Figure 9: Trade-weighted sterling



Monthly data. January 2005 = 100. Source: BoE

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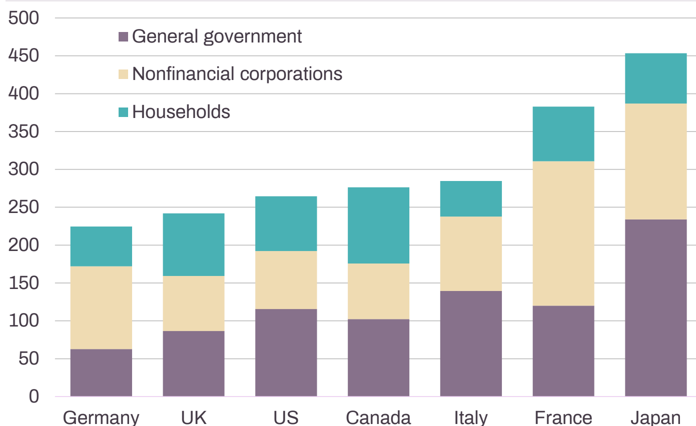
In focus: UK balance sheets

Strong balance sheets among UK banks, businesses and households offer protection against shocks and a springboard for recovery

After the 2008 Global Financial Crisis laid bare the credit excesses that had fuelled the preceding boom, the UK private sector turned towards balance sheet repair. Across the board, the UK now benefits from significant balance sheet strength. In bad times, it offers defence against shocks and financial volatility. In good times, it provides a basis for healthy consumption and investment growth.

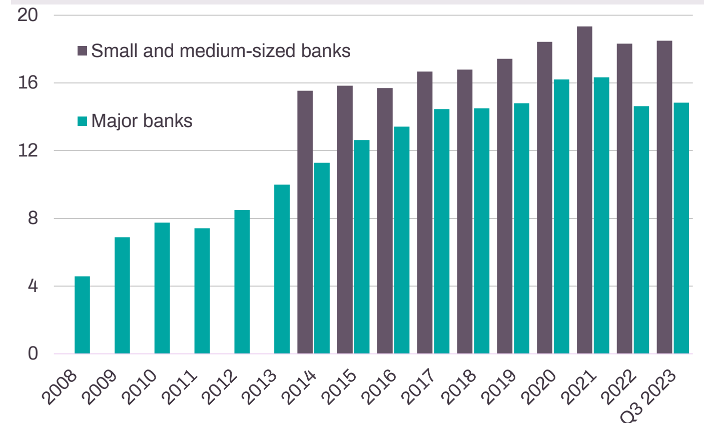
- Excluding financials, the UK has the second-lowest level of debt as a percentage of GDP in the G7 after Germany (Figure 10).
- The level of CET1 capital among major UK banks has increased from 4.6% of risk-weighted assets in 2008 to 14.8% in 2023 (Figure 11).
- Liquid deposits of non-financial institutions are worth 21% of GDP, up from 15% in 2008, while their debt has fallen to 72% of GDP – close to early 1990s levels (Figure 12).
- The stock of mortgage debt as a percentage of gross household disposable income has fallen to the early-2000s level while consumer credit has fallen to the mid-1990s level (Figure 13).

Figure 10: G7 debt balances



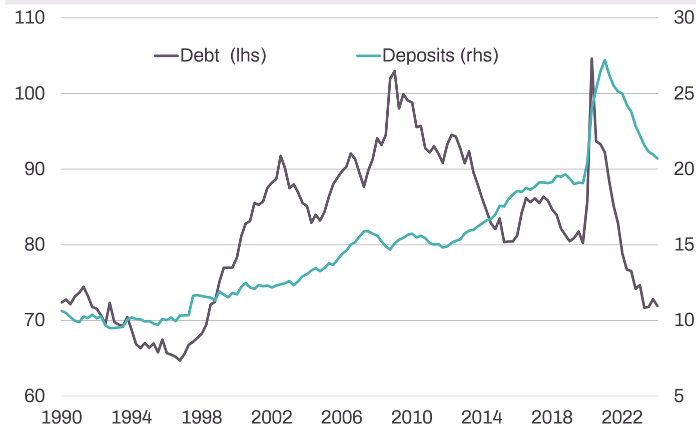
% of GDP. 2023 data. Sources: Statistics Canada, Banque de France, Deutsche Bundesbank, Banca d'Italia, Bank of Japan, ONS, Federal Reserve Board

Figure 11: UK capital ratios for banks and building societies



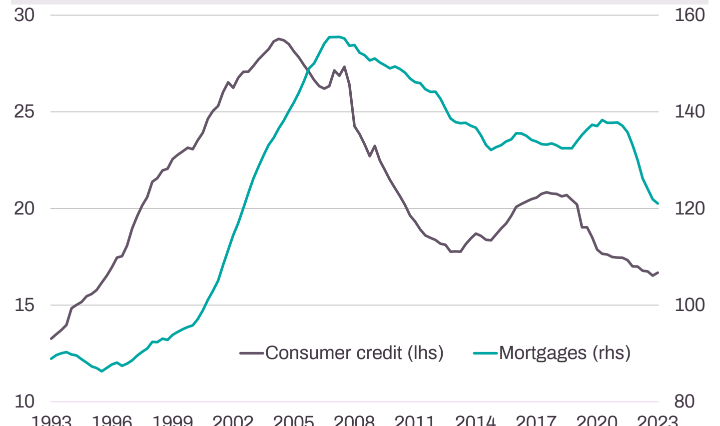
CET1 capital ratio as % percentage of risk-weighted assets. Annual data based on year-end values, except for 3Q23. Source: BoE

Figure 12: UK non-financial corporations balance sheet



As a % of GDP. Quarterly data. Source: ONS, BoE

Figure 13: UK household debt by type



As a % of household gross disposable income. Quarterly data. Source: ONS, BoE

Politics brief: can Starmer deliver?

In keeping with precedent, Labour Prime Minister Keir Starmer looks likely to leave the bulk of economic policy making to his Chancellor Rachel Reeves. Her self-titled approach, so-called 'securonomics', contains a wide range of initiatives, many of which look sensible in our view. These include:

The new Chancellor, Rachel Reeves, is undertaking some sensible intiatives that can lift UK gowth potential . . .

- the re-writing of planning laws to try to increase housing supply;
- no increases in income or corporation taxes;
- budget discipline with a stronger role for the independent Office for Budget Responsibility – the government's fiscal watchdog;
- new initiatives to increase capital investment in clean energy; and
- new legislation to encourage pension funds to invest more in the UK.

If Starmer and Reeves manage to enact most or all of these policies, the resulting improvement in long-run investment can lift UK growth potential. However, some aspects of their agenda look somewhat misguided. For instance, Starmer and Reeves also pledge to increase minimum wages and expand workers' rights.

. . . However, some aspects of the Chancellor's policy agenda could be misguided

While such labour market policies are no doubt well intentioned, if taken too far, they carry at least three risks. First, if firms simply pass on their higher wage costs to final prices, that would mitigate any positive effect on the prevailing level of average real wages. Second, higher wage costs that are not matched by improvements in worker productivity encourage firms to substitute capital for labour, creating unemployment. Third, in case minimum wage hikes impose an excessively high wage floor on the labour market, they can impede the crucial process of labour market clearing via falling wages in case of future recessions that cause a rise in unemployment. Instead of raising living standards and making jobs more secure, such initiatives can have the opposite effect.

Excessive labour market regulation and too-high minimum wages can increase unemployment

At this early stage, it remains an open question whether Starmer and Reeves can deliver on all of their promises. But after winning almost two-thirds of the seats in the House of Commons, Starmer probably has the momentum and political capital to drive through some difficult reforms, especially on planning. In addition, thanks to his big majority, Starmer should not need to rely much on the far left of his party to pass legislation. This may contain the risk that he pushes too hard on counterproductive labour market policies.

Prime Minister Starmer is well positioned to push through some difficult and much-needed planning reforms

Remember Blair?

If history is any guide, Starmer's mostly pro-growth and pro-European tilt can go down well with financial markets. In May 1997, Tony Blair's New Labour won a landslide election after 18 years of Conservative rule. Blair and his Chancellor Gordon Brown inherited an economy on the rebound after a bout of inflation and high interest rates had toppled the economy in the early 1990s. Sound familiar?

Echoes of Blair – Starmer's mostly pro-growth and pro-European tilt can go down well with financial markets

Although the UK fiscal backdrop is more challenging today than in 1997 – see '*In Focus – UK fiscal policy*' on page 10, and potential growth is lower, a similar combination of stable politics, a recovery tailwind and rising confidence can lift sterling and improve the mood in UK markets. In the run up to Blair's win, which markets had anticipated, and in the months that followed, sterling surged (Figure 9, page 7) while UK stocks rallied. After a recent uptick on the back of fading uncertainty, we project that sterling will rise by c.9% against the dollar to 1.40 by the end of 2026 and by c.5% against the euro to 1.24 over the same period.

We project that sterling will rise by c.9% against the dollar to 1.40 by the end of 2026 and by c.5% against the euro to 1.24

Although there is little room for a debt-financed fiscal stimulus near term, two years of economic growth at moderate inflation may give Starmer and Reeves some scope to ease the purse strings from 2026 onwards.

For now, there is little scope for a fiscal stimulus, but that may change if economic conditions improve

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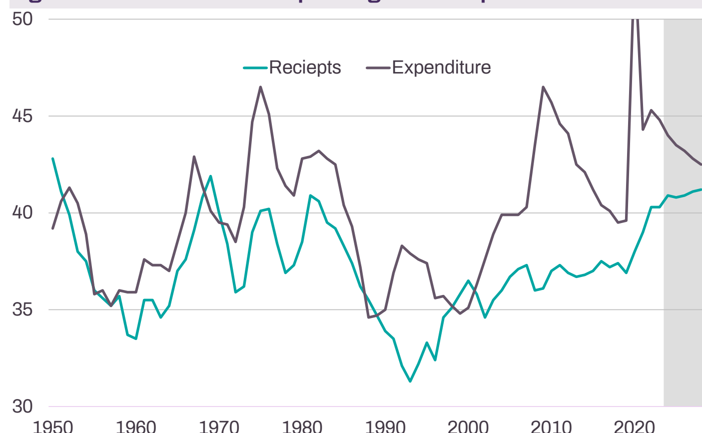
In focus: UK fiscal policy

High public debt plus a bloated and inefficient public sector present serious policy challenges

Labour Prime Minister Keir Starmer and his Chancellor Rachel Reeves inherit a difficult fiscal situation, to put it mildly. Although the public deficit at c.3% of GDP is in the safe zone and falling on trend, high public debt at close to 100% of GDP constrains the capacity for future borrowing. In addition, years of mismanagement have left a situation in which fiscal policy and the public sector more broadly frustrate UK growth potential.

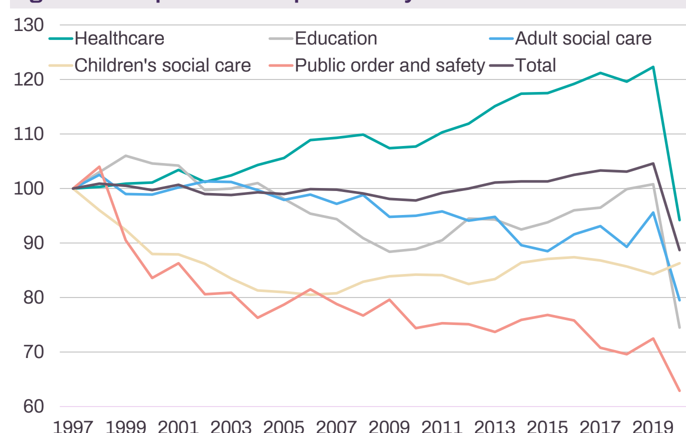
- As a share of GDP, taxes have risen to their highest level in 50 years and still fall short of fully financing the ballooning public sector (Figure 14).
- Public sector productivity has been virtually stagnant since 1997.
- Public investment makes up just 5% of total spending and has not risen much as the overall share of government spending has increased.
- The link between social benefits and unemployment is breaking down – falling unemployment no longer reduces social benefits spending.

Figure 14: UK Government spending and receipts



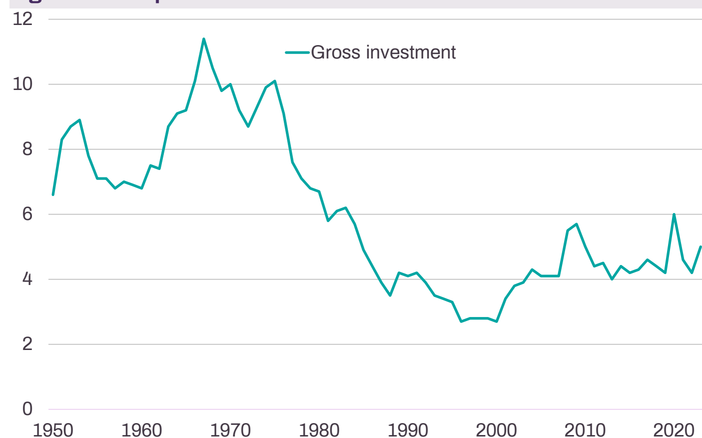
% of GDP. Grey area shows OBR March 2024 projections for 2024 to 2028. Annual data. Source: OBR

Figure 15: UK public sector productivity



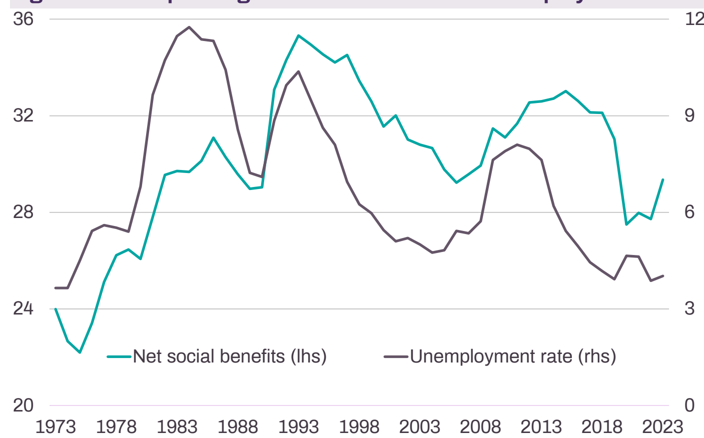
Quality adjusted, by service area, Index 1997 = 100. Defence, police, social security administration, and other are excluded, but do form part of the total. Annual data. Source: ONS

Figure 16: UK public investment



% of GDP. Annual data. Source: OBR

Figure 17: UK spending on social benefits and unemployment



Net social benefits as a % of total public expenditure. Unemployment rate in %. Annual data. Source: ONS

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US: Could a policy error trip goldilocks?

The US has enjoyed almost a textbook soft landing

Ever since the Fed started to tighten the monetary screws in early 2022 to cool an overheating US economy, the unlikely result has been almost a textbook soft landing. Between March 2022 and July 2023, the Fed raised the upper limit of the Fed Funds Rate corridor from 0.25% to 5.5%. In turn, inflation based on the personal consumption expenditure index (the Fed's preferred measure) has declined from a 7.1% YoY peak in June 2022 to around 2.5%.

More growth at less inflation . . .the US economy has far outpaced its peers

Contrary to widespread fears among financial market participants that the sharp policy tightening after years of ultra-low interest rates would tip the US into recession, real GDP momentum improved as inflationary pressures abated (Figure 18) and employment growth continued apace. In 1Q24, US real GDP was 8.6% above its pre-pandemic 4Q19 level. That compares to 3.6% for the Eurozone, 2.4% for Japan, and a paltry 1.8% for the UK over the same period.

Two factors have underpinned the outperformance of the US

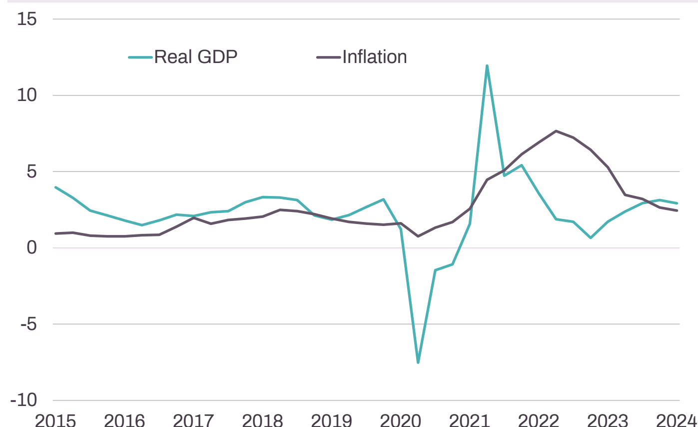
A small import share and huge domestic energy industry partly shields the US from global supply shocks

1. First, the US benefits from huge domestic production capacities and thriving energy and commodities industries. All other major advanced economies are much more reliant on foreign inputs and/or imported energy. For instance, whereas imports make up c.15% of US GDP, the share for Germany is 43%. With its smaller trade share, the US suffered less from external supply shocks and global demand weakness. Although the Russian invasion of Ukraine caused US energy prices to spike, the supply of gas to firms and households was never at risk. Instead, the US became an important supplier of energy to hard-hit Europe.

Exorbitant privilege – the US Government can borrow big thanks to the dollar's status as the main global reserve currency

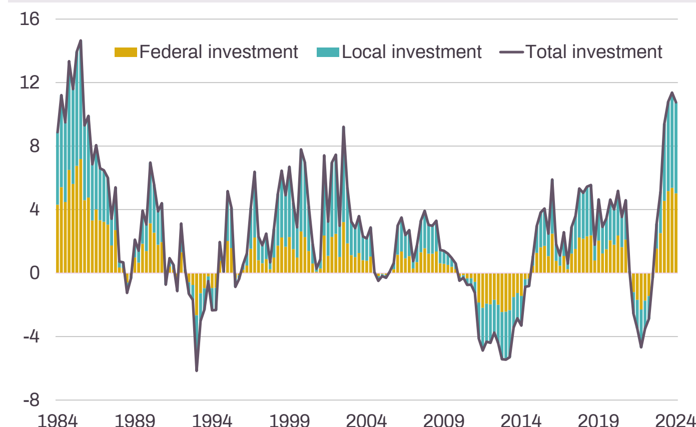
2. Second, in a world of heightened uncertainty, the US Government has benefitted from the dollar's status as the leading global reserve currency. Whereas governments in other advanced economies have been forced to pursue mostly cautious fiscal policies after the big borrowing binge during the Covid-19 pandemic, the US Government has managed to continue to borrow aggressively to finance President Biden's three big fiscal packages: the 2021 Infrastructure Investment and Jobs Act, the 2022 Inflation Reduction Act, and the 2022 CHIPS and Science Act. These large fiscal injections (Figure 19) have supported US domestic demand via public spending and investment and by offering a host of incentives for private business to grow their productive capacities.

Figure 18: US real GDP and inflation



% YoY. Inflation based on GDP chain price index. Quarterly data. Source: BEA

Figure 19: US real public investment



% YoY. Components show percentage point contribution. Quarterly data. Source: BEA

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Growth momentum likely into 2H and 2025

Whereas the US enjoyed more growth at less inflation through 2022 and 2023, the growth profile for the years ahead is likely to reflect the lagged impact of the Fed's past policy tightening and likely forthcoming easing (see next section). From 2.5% in 2023, we project another 2.5% gain in real GDP in 2024, followed by a slowdown to 1.8% in 2025, before momentum improves to 2.2% in 2026.

US growth to slow in 2H24 and into 2025 before picking up in 2026

The strong headline number for 2024 hides an appreciable slowdown in momentum over the course of the year. After an ultra-strong 2H23 in which real GDP expanded at 4.1% annualised, well above the Fed's 1.8% estimate of potential, momentum moderated to closer to trend in 1H24. In 2H24, we expect real GDP growth to soften further to 1.55% YoY annualised – led by moderating real private consumption (Figure 20) as net-trade continues to drag. Real private investment gains are likely to remain stable while interest-rate sensitive residential activity improves. From mid-2025 onwards and through 2026 we look for a pick-up in consumption growth.

Our growth profile for the US broadly reflects the lagged impact of Fed policy changes

Fed to turn monetary policy from tight to almost neutral

At 5.5%, the Funds Rate is above the Fed's longer-run estimate of neutral (2.8%). Even though the neutral rate is probably closer to 4.0%, in our view, the present policy rate implies that Fed policy is tight – Figure 21.

At 5.5% the Funds Rate is above the Fed's own long-run estimate of 2.8%

With its dual mandate – price stability and maximum employment, to balance both objectives, the Fed can cut rates before inflation fully reaches 2%. That the unemployment rate had already ticked up to a still low 4.1% in June from 3.4% in April 2023 strengthens the case for an insurance cut. We expect the unemployment rate to peak at c.4.5% in 1H25 before edging down thereafter.

The dual mandate Fed can ease monetary policy before inflation has fully reached the 2% target

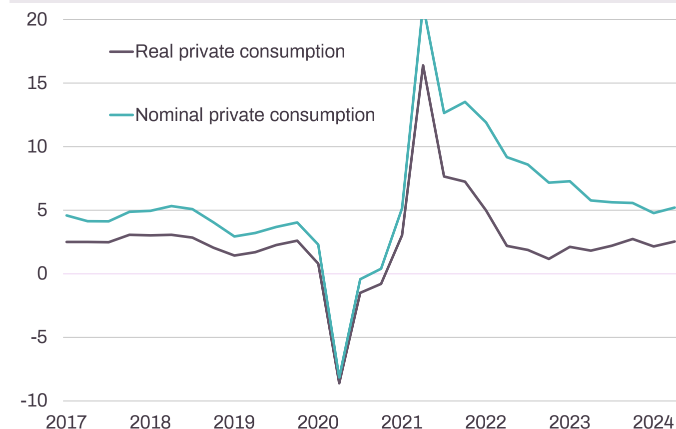
After reacting late to surging inflation in 2021/22, the Fed is wary of undermining the US upswing by holding interest rates too high for too long. Judging by the recent commentary of Federal Open Market Committee (FOMC) members, the Fed looks likely to make the first cut to the Funds Rate by 25bp at the 17-18 September meeting, before a well-flagged pause at the 6-7 November meeting, followed by a further 25bp cut at the 17-18 December meeting.

The Fed is wary of undermining the US upswing by keeping monetary policy too tight for too long

Our calls take the Funds Rate corridor to 4.75-5.00% by end-2024. In 2025 we expect three further 25bp cuts to take the corridor to 4.00-4.25% by year-end. In 2026 we do not expect the Fed to make any changes to the Funds Rate.

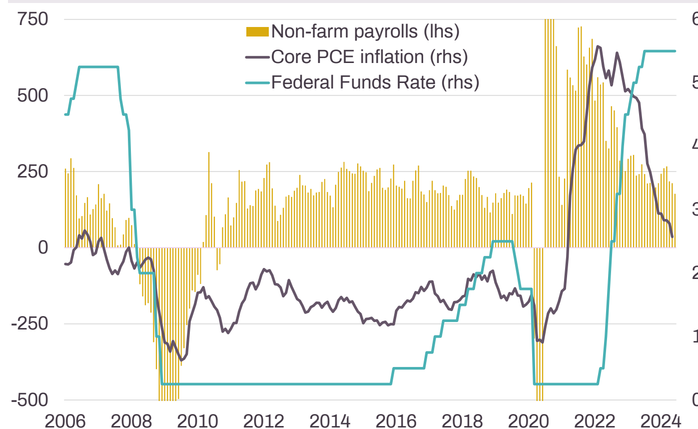
We look for a total of 125bp of cuts from the Fed, to take the Funds Rate corridor to 4.00-4.25% by the end of 2025

Figure 20: US private consumption



% YoY. Quarterly data. Sources: BEA

Figure 21: US employment, inflation and policy rate



Core (ex. food and energy) inflation based on the personal consumption expenditures index, % YoY. Non-farm payrolls based on three-month average change in thousands. Fed Funds Rate upper limit in %. Monthly data. Sources: BEA, Federal Reserve Board

Significant upside surprises to inflation, inflation expectations or wages in upcoming data may yet persuade policymakers to hold off in September while the uncertain fiscal consequences of the 5 November Presidential election may impact the December decision along with the path for rates thereafter. For more detail see '*US election special: the Trump factor*' on page 14.

Although a first cut in September looks likely, upside surprises to key data could lead the Fed to wait a little longer

A more balanced economy – but significant uncertainty ahead

Tight Fed policy has moderated demand while mostly sensible fiscal policies and a high inflow of foreign workers have boosted supply and cooled labour markets. By and large, policymakers have succeeded at bringing spending and production into better balance. The US no longer looks like an overheated economy.

US policymakers have mostly succeeded at bringing spending and production into better balance

We look for inflation measured by the personal consumption expenditures (PCE) index, the Fed's preferred metric, to fall from 3.7% YoY in 2023 to 2.5% in 2024, and to 2.2% in 2025 and 2026. Measured by the consumer price index, we project a similar inflation pattern: from 4.1% in 2023 to 2.9% in 2024, 2.5% in 2025 and 2.4% in 2026. Higher CPI rates relative to the PCE measure are largely due to measurement differences in housing costs. Risks to our inflation calls are tilted to the upside.

We do not expect US inflation to fully fall to the 2% target – and the risks to our calls are skewed to the upside

The era of low inflation in open economies is over as the ageing global population squeezes labour supply and adds to wage costs. The return of East versus West geopolitical tensions is encouraging policymakers in Washington on both sides of the political aisle to turn more protectionist and, among some Trump-leaning Republicans, even isolationist. Although the diffusion of artificial intelligence technologies promises to lift productivity and real per capita GDP growth, it may inflict job losses in concentrated parts of services and industry.

Due to major structural shifts, the era of low inflation in open economies is over

Taken together, these structural shifts cast doubt over the Fed's estimates of potential real GDP growth, the equilibrium rate of unemployment that reflects a balanced economy and estimates of longer-run 'normal' rates of interest. The upside surprises to US performance since 2022 in contrast to the strong recession signals coming from the US yield curve speak to these uncertainties and highlight the policy challenges ahead for the Fed.

Uncertainties over US growth potential and the neutral interest rate pose policy challenges for the Fed

Although the Fed, along with other central banks, is not quite driving blind, a more data dependent approach that puts less weight on economic forecasts makes monetary policy more backward looking. This raises the risk of policy accidents by the world's most systemically important central bank.

A more backward looking approach to monetary policy raises the risk of policy accidents by the Fed

US election special: the Trump factor

Mark it on the calendar – on 5 November the US will elect a new president

On 5 November, the US heads to the polling booths. Voters will elect a new president and vice president along with all 435 voting seats in the House of Representatives (House) and a third of the 100 seats in the Senate (Senate). At present, the US executive branch is held by Democrats' President Joe Biden and Vice President Kamala Harris while congress is divided. The Republicans hold a narrow majority in the House with 220 seats, while the Democrats hold a one seat majority in the Senate with 47 seats plus four Democrat-leaning independents.

The situation is in flux, but current polling points to a full sweep for the Republicans

Current polling indicates that Republican presidential nominee Donald Trump is on course to win a second non-consecutive term after his 2017-21 term, while the Republicans look set to win narrow majorities in both houses. The situation remains in flux, however, following the decision by Biden to not run for a second term. While Vice President Harris looks most likely to run as the Democrat nominee, that outcome is not clear cut and will probably be decided at the 2024 Democratic National Convention on 19-22 August. Depending on how the Democrats fare under a new nominee, the polls may yet swing against Trump.

Economic impact of Trump 2.0

Trump's economic plan includes tax cuts, deregulation, import tariffs and immigration cuts

Although the policy details remain scarce, Trump has signalled four components to his policy agenda:

1. extending or making permanent the parts of his 2017 Tax Cuts and Jobs Act (TCJA) that are due to expire in 2025, including individual taxes, alongside a further reduction in corporate tax rates;
2. further deregulation of the private sector;
3. increasing barriers to trade – Trump is apparently mulling over sharp increases in tariffs on imports from China as well as a smaller increase on tariffs to imports across the board; and
4. curbs on legal immigration and mass deportation of illegal immigrants.

Trump's first term was mostly positive for the US – until the Covid-19 pandemic hit in 2020 . . . but a mixed bag for the global economy

In the first three years of his first term, up until the 2020 pandemic, Trump presided over a mostly solid US economy, with healthy jobs gains, strong investment-led GDP growth and a rally in stocks. Businesses and households benefitted from the rolling back of regulation and a boost to disposable incomes coming from tax cuts. Abroad, the global economy benefitted initially from his big stimulus. Financial markets rallied as the global economy enjoyed a synchronised upswing. But the good run came to an end in 2018 when Trump escalated trade tensions with China and triggered smaller tit-for-tat trade wars with key allies including the European Union and Mexico.

Trump's 'America first' rhetoric carries risks – but he may yet be partly constrained by moderate Republicans

Judging by Trump's 'America first' rhetoric, he looks likely to pick up where he left off in 2021 – which tilts the risks to global economy to the downside. But whether history will repeat in a potential second term hinges on the eventual scope of Trump's policies, whether the more fiscally cautious and pro-trade Republicans act as a moderating force, and, of course, what events happen outside of the US that he may be forced to react to.

Mind the two-sided risks

The US economic backdrop is decidedly different today than during Trump's first term – the tricky fiscal situation increases the risk of policy accidents

The US faces a challenging fiscal backdrop. At c.6% of GDP, the Federal deficit is twice as high as in 2016, while long-term borrowing costs are c.150bp higher (Figure 22). Trump would also inherit a full-employment economy on the tails of an inflationary boom. In 2017, Trump took over an economy that had suffered a long period of sluggish growth and subdued price pressures.

Against this backdrop, Trump's proposed policy mix should strike a cautious note. Demand boosting tax cuts combined with supply reducing immigration curbs could restoke inflation pressures. While regulation can help lift supply,

even ultra-aggressive red tape cutting probably would not fully offset the likely inflationary effects of higher import tariffs and immigration curbs. While Trump has signalled the possibility of spending cuts, the details are yet unspecified.

If Trump's worst excesses are curtailed, the most likely result would be more US growth at more inflation and upward pressure on the overvalued dollar

In the most likely scenario, however, Trump's worst excesses would be partly curtailed by moderate Republicans in congress. The result would probably be a bit more growth and a bit more inflation – this view is embedded in our US economic projections. Higher medium-term expectations for interest rates, as well as uncertainty over the outlook for global trade and geopolitics, would likely put upward pressure on an already overvalued dollar.

In a tail-risk scenario, treasury yields may spike while the dollar weakens as money flows out of the US

While the US has extensive checks and balances to curb a frenzied president, they are not automatic. We would have to watch the tail risk that Trump goes too far, and that bond markets and currency markets begin to lose confidence in the sustainability of US fiscal policy – especially in case of higher inflation that is attributed to excessive deficits. In that scenario, treasury yields may spike while the dollar weakens as money flows out of the US. In real terms, the dollar is approaching past levels that preceded sustained depreciations (Figure 23).

Mind the upside risk – tax cuts and deregulation with only a modest tilt towards isolationism can still be a net-positive for the global economy

Of course, if Trump were to combine a fiscal easing with deregulation and only modest curbs on immigration and imports, the result would likely be a robust cyclical US upswing with only a small amount of excess inflation. Solid US growth would support world trade and cyclical recoveries in open economies.

A divided congress would narrow the risks . . .

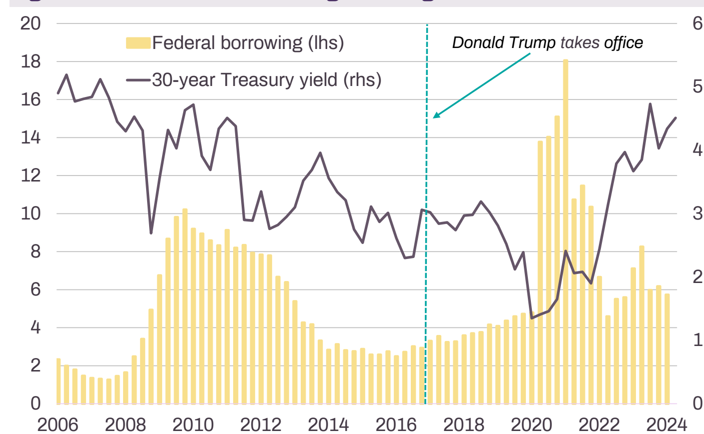
Checks and balances – a still-divided congress would make life hard for either Trump or the next Democrat president

A still-divided congress would make life hard for either Trump or the next Democrat president. Gridlock in Washington would constrain their ability to enact tax cuts or spending increases. Fiscal policy may even turn into a headwind if parts of the TCJA expire. On regulatory policy, immigration policy and trade policy, presidents have some scope to change the law via executive order. Trump may try his luck with unconventional tactics and legal grey areas. Noisy political jostling between the branches of US Government could trigger damaging policy uncertainty that spills over into US and global financial markets.

An unlikely full-sweep for the Democrats could be slightly negative for the US growth outlook but would contain inflation risks

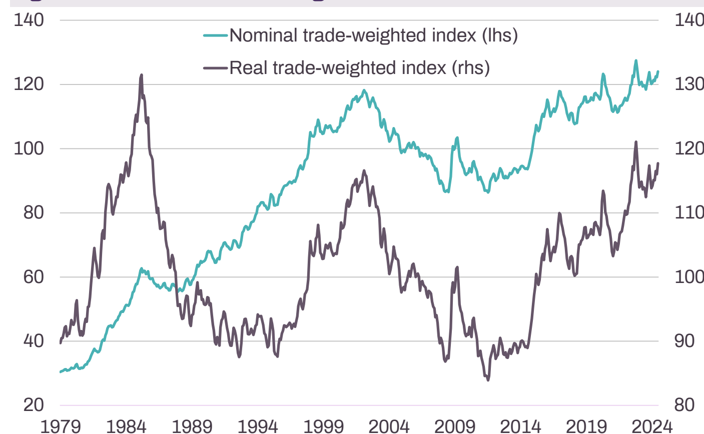
In the unlikely scenario of a Democratic full sweep, a lot would depend on who ended up in the White House. We could probably expect a further tilt towards increasing 'green' regulations, a modest fiscal tightening to narrow the deficit with the possibility of large increases in the level of both spending and taxation; targeted increases in trade barriers – mainly on China; and perhaps some efforts to curb illegal immigration. The outcome for the US economy could be mildly negative – that is, growth at close to trend but with limited inflation risks.

Figure 22: US Federal borrowing and long-term interest rates



Borrowing as a % of GDP, four quarter moving average. Treasury yield in %. Quarterly data. Sources: US Treasury, Federal Reserve Board, Haver Analytics

Figure 23: US dollar trade-weighted indexes



Broad trade-weighted exchange rates. January 2006 = 100. Monthly data. Sources: Federal Reserve Board

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Eurozone: rebounding after the shocks

After bouncing back well from the Covid-19 mega recession in 2020, three successive shocks have disrupted Eurozone economic activity since 2022. First, the Russian invasion of Ukraine in February 2022 reduced gas supplies and caused producer and consumer prices to surge. Production and consumption stalled as people genuinely worried if the lights would stay on through winter 2022/23. The ECB then delivered a second blow when it started to aggressively tighten policy from mid-2022 onwards to curb the energy-related inflation surge. Finally, industry suffered a downturn and inventory correction last year.

Three sucessive shocks have impaired Eurozone activity since 2022

These shocks are now in the rear-view mirror. Inflation has moderated, energy markets have adjusted, and financial conditions are turning easier as the ECB progresses with its gradual rate-cutting cycle. While consumer confidence is recovering from a low level, fading headwinds have halted the decline in business sentiment (Figure 24). As confidence improves, business investment can turn up alongside housing demand and consumer spending, helped by rising real purchasing power. If no new shocks impede the recovery, the Eurozone can build momentum over the next three years. After a subdued 0.6% rise in real GDP in 2023, we look for growth of 0.7%, 1.5% and 1.6% in 2024, 2025 and 2026.

The situation in the Eurozone is improving as the inflation shock fully fades and financial conditions turn easier

In trade-oriented industry, the situation could remain difficult. Although producers benefit from the fading gas supply shock, the inventory correction may have further to run and export orders remain weak (Figure 25). Further out, higher barriers to global trade, a costly green energy transition, as well as slower growth in China – an important source of demand for core European producers – cast uncertainty over the long-run growth rate in exports and industry.

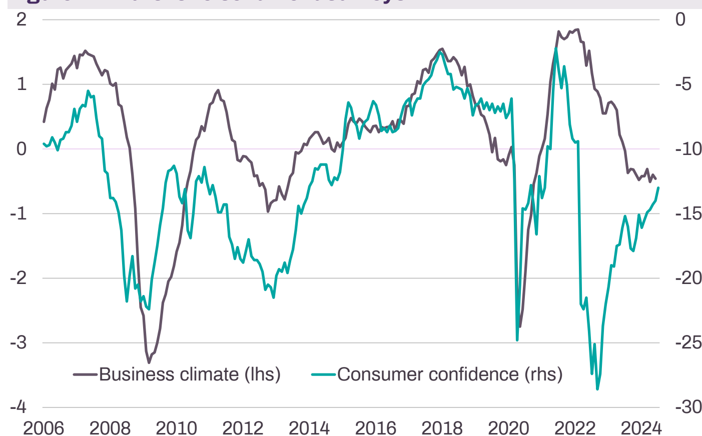
Long-run challenges for the Eurozone's export-oriented producers include rising global trade barriers and a costly green energy transition

ECB to ease cautiously as the rate corridor narrows

Although Eurozone inflation remains vulnerable to geopolitically-driven gyrations in energy markets, price pressures are likely to continue to fall towards the ECB's 2% target over the medium term. From 5.4% in 2023, we expect inflation to ease to 2.4% in 2024 and to 2.0% in 2025 before ticking up slightly to 2.1% in 2026. The ECB's cautious monetary easing combined with a still-elevated risk backdrop will likely constrain any serious exuberance in wage and price setting. We look for the unemployment rate to continue to edge lower on trend, from 6.6% in 2023 to 5.9% by 2026.

Inflation risks should ease significantly in the Eurozone – inflation can hit 2% in 2025 before rising a notch in 2026

Figure 24: Eurozone sentiment surveys



Consumer confidence as % balance. Business climate as standard deviations with a standardised zero mean. Monthly data. Source: European Commission

Figure 25: Eurozone export orders and stocks of finished goods

In % balance. Monthly data. Source: European Commission

After nine months of keeping its policy unchanged, the ECB lowered all three of its policy rates by 25bps at its 6 June meeting. The move cut the Marginal Lending Rate, the Main Refinancing Rate and the Deposit Rate to 4.5%, 4.25% and 3.75%, respectively (Figure 26). From 18 September, the ECB will narrow the corridor of its three policy rates to 40bps: keeping the gap between the middle and upper rate at 25bp but reducing the gap between the lower and middle rate to 15bp.

The ECB intends to narrow its three rate corridor in September from 75bp to 40bp

The ECB has emphasised that, while it expects to ease monetary policy over the medium term, further steps to lower interest rates will be data dependent and decided on a meeting-by-meeting basis. After the ECB kept policy rates unchanged at its 18 July meeting, but signalled further cuts to come, policymakers seem to be heading for a repeated cut-and-pause approach to easing. We look for two more 25bp cuts in 2024, coming at the 12 September and 12 December meetings with a hold at the interim 17 October meeting.

The ECB will cautiously proceed with its rate cutting cycle – we look for two more 25bp cuts in 2024

This path would lower the Deposit Rate to 3.25% by year-end. We look for two further 25bp cuts in 2025 to take the Deposit Rate to 2.75% by the end of 2Q. We do not expect any further changes to ECB policy rates in 2H25 or 2026.

We expect a total of 100bp of ECB cuts by mid-2025 to take the Deposit Rate to 2.75%

Although the Eurozone economy will benefit from less tight monetary policy, the unconventional staggering of rate cuts opens the door for bouts of financial market volatility if expectations shift month-to-month. The ECB will need to set out clearly under what conditions it will cut, and under what conditions it may need to pause for longer than just one meeting. As both the Fed and the BoE may follow a similar cut-and-pause approach to rate reductions, market participants should pay close attention to upcoming ECB decisions and as well as how data surprises impact money market rate expectations.

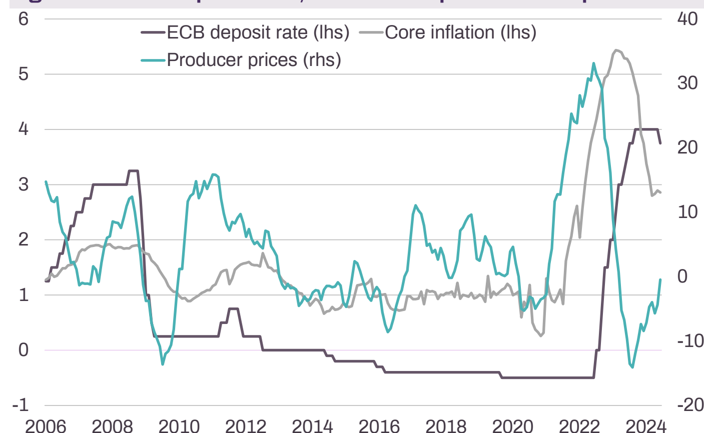
The unconventional staggering of ECB rate cuts opens the door for bouts of financial market volatility

Narrowing the gap – Eurozone core versus periphery

The 20 economies that make up the Eurozone are a mixed bag, to put it mildly. Our call for a rebound in economic activity over the medium term to slightly above potential hides a likely wide divergence in performance between underperformers such as Germany (page 18), Italy and perhaps France in case of policy errors (page 19), and stronger growth at the periphery – see Figure 27. After getting their fiscal houses in order and undertaking pro-growth supply-side reforms, the worst hit economies during the 2009-10 European debt crisis are likely to enjoy growth at rates above the Eurozone average in the years ahead. This growth includes Spain, Portugal, the Republic of Ireland and Greece.

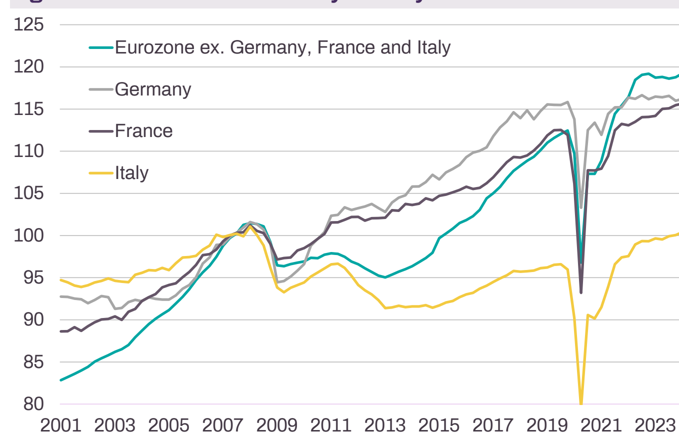
We expect a further catch-up in peripheral economies, as well as a small positive surprise in France, while Germany continues to disappoint

Figure 26: ECB Deposit Rate, Eurozone import and core prices



Import prices and core inflation (ex. energy, food, alcohol and tobacco) in % YoY. ECB Deposit Rate in %. Monthly data. Sources: ECB, Eurostat.

Figure 27: Eurozone real GDP by country



2007 = 100. Quarterly data. Source: Eurostat

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Germany: cyclical and structural strains

While Germany enjoys fundamental strengths, a host of cyclical and structural factors are holding back growth potential

Despite healthy labour markets and a well-deserved reputation for fiscal discipline, the German economy faces a host of difficulties. Even though the inflation and interest rate shocks are fading, uncertainty over the underlying health of export-and-production industries after a protracted period of decline, as well as the ongoing housing market correction, have badly hurt confidence. In addition to these short-run cyclical headwinds, structural factors are also restraining growth momentum. They include: (1) the rising costs of decarbonising production and the shift towards more sustainable energy consumption; (2) increasing global barriers to trade; (3) a structural slowdown in China; (4) and demographic-related labour shortages.

German industrial production has fallen by c.14% since it peaked in 2Q18

Structural headwinds had already started to weigh on economic activity before the Covid-19 pandemic struck in early 2020 (Figure 28). German industrial production has been on a downward trend since 2Q18 – output has fallen by c.14%, with broad-based declines across key subsectors including metals, transport and chemicals. Energy-intensive sectors have suffered disproportionately from the 2022 energy supply shock.

We expect a gradual recovery in German GDP – but gains are likely to remain subdued and below the Eurozone average

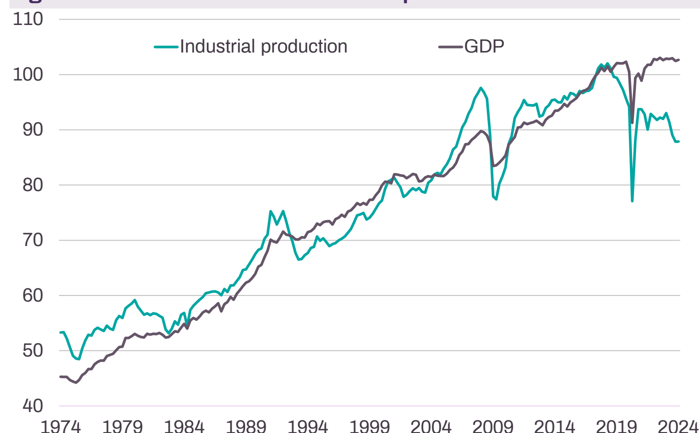
Following a flat 2023, we expect real GDP to recover only gradually over the medium term as the cyclical shocks fade and structural challenges restrain overall momentum. We project growth of 0.2% YoY in 2024, 1.2% in 2025 and 1.3% in 2026, driven by rebounding production and consumption. The unemployment rate is likely to oscillate in the 3.3-3.6% range, while inflation falls from 6.0% in 2023, to 2.4% in 2024 before settling at 2.2% in 2025 and 2025. The risk that Trump wins a second term as US president and triggers a tit-for-tat trade war tilts the risks to our German calls to the downside.

Time for policy action?

Fiscal policy holds the key to higher growth if it can address Germany's consumption shortfall

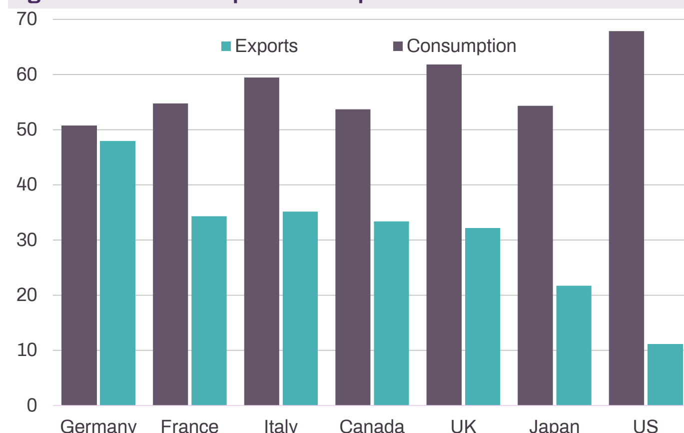
From the early 1990s up until the late 2010s, the highly open German economy benefitted from the liberalisation of global trade. Germany has the largest export share in the G7 – Figure 29, but also the lowest consumption share. In a world of trade frictions, Germany would benefit from fiscal policies designed to raise consumption on trend. For now, however, Germany's strict constitutional debt brake – which restricts the structural deficit to 0.35% of GDP in normal times – is an obstacle to even a modest debt-financed fiscal expansion. With any luck, the winners of the next federal election, due in Autumn 2025, will make the necessary constitutional and policy changes to shift Germany's fiscal focus toward growth.

Figure 28: German GDP and industrial production



In real terms. 2017 = 100. Industrial production ex. construction. Quarterly data. Sources: Federal Statistics Agency, Deutsche Bundesbank

Figure 29: G7 consumption and export shares as a % of GDP



Annual data. Sources: BEA, Cabinet Office of Japan, ONS, Statistics Canada, Istituto Nazionale di Statistica, Institut National de la Statistique, Deutsche Bundesbank

France: project Macron at risk

France managed to grow its economy by a respectable 1.1% YoY in 2023 – above the 0.6% rate for the Eurozone overall. As a net-energy exporter, France is less exposed to the Russian gas supply disruptions than other major European economies. However, after a soft start to 2024 caused by the European-wide weakness in industrial production, real GDP growth is likely to moderate to 0.9% this year, before picking up to 1.3% in 2025 and to 1.5% in 2026.

As a net-exporter of energy, France suffered less badly in 2022 and 2023 than its European neighbours

Improving demand labour and rising labour market participation thanks to past reforms can push the unemployment rate lower on trend from 7.4% in 2023 to 6.6% in 2026, while inflation settles at 2.2% in 2026 from 5.7% in 2023. The risks to the French economy are large and two-sided. If policymakers get it right, France can continue to enjoy better-than-expected growth at rates above the Eurozone average. If policymakers make mistakes, France could falter badly.

France can continue to benefit from past reforms, but recent political developments risk damaging policy U-turns

Politics brief: can France stay on track?

The French economy has improved under the stewardship of President Macron, who became president in 2017 and was re-elected for a second term in 2022. Macron has lowered business taxes, pushed through reforms to liberalise labour markets and enhance competition, and has made some progress toward reforming France's broken pension system. The result, a sustained decline in unemployment and surge in business creations (Figure 30).

Policy reforms under the stewardship of Macron have strengthened the French economy

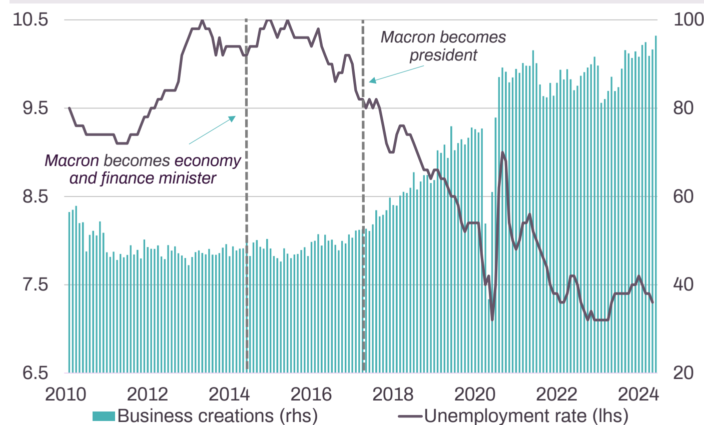
But fate has dealt Macron a tough hand. Under normal circumstances, France would have enjoyed a period of healthy supply-driven growth. Instead, Covid-19 disruptions, geopolitical shocks and a global tightening of financial conditions have prevented a stronger expansion. The combination of bitter policy medicine and subpar growth has worsened political disenchantment. July's noisy parliamentary elections – which Macron called three years earlier than needed – resulted in a hung parliament and cast policy uncertainty over the outlook.

But rising political challenges cast doubt over future progress and increase the risk of policy reversals

For now, a haphazard coalition of centrists and left-wingers (led by Jean-Luc Mélenchon) have come together to keep out the hard-right led by Le Pen and her National Rally. However, the new coalition looks set to unwind some of Macron's reforms. Further out, the 2027 presidential election may yet result in a victory for Le Pen or another populist set on a wholesale reversal of Macron's reforms. With its already massive debt pile – Figure 31 – and a public deficit of c.5% of GDP, the risk of a genuine bond market panic hangs over France.

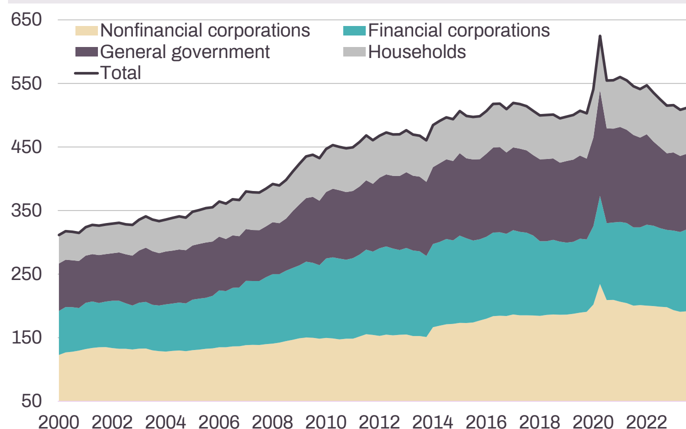
All eyes on the 2027 presidential election – which could result on a wholesale reform reversal

Figure 30: French unemployment and business creations



Business creations in thousands. Unemployment rate in %. Monthly data. Source: Eurostat, Insee

Figure 31: French debt by sector



% of GDP. Quarterly data. Source: Banque de France

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China: Serious structural challenges

China's economic performance over the past four decades has been nothing short of astonishing. Driven by pro-market reforms and trade liberalisation, China grew from just a 4% share of global GDP in 1990 to 19% in 2023 (in purchasing power parity terms). Even though living standards have risen enormously, large parts of China remain poor. Per capita GDP is roughly a third of the advanced world average – with huge disparities between rich urban and poor agricultural regions. Internal imbalances present a challenge for policymakers.

China grew from just a 4% share of global GDP in 1990 to 19% in 2023 . . . but its growth potential is slowing on trend

With its mediocre per capita GDP, China can still enjoy many more years of catch-up growth that comfortably exceeds typical rates in advanced economies. Nevertheless, the era of ultra-fast expansion is over. China is encumbered by serious structural issues that will gradually weaken its growth on trend. They include: (1) increasing labour costs and shortages due to its ageing and shrinking population; (2) rising global trade barriers and geopolitical tensions which hurt export-oriented industries; and (3) an impaired financial system – decades of capital misallocation have been laid bare by the unfolding real estate correction.

China is encumbered by serious structural issues that will gradually weaken its growth on trend – its 5% target is ambtious

China continues to rely too much on investment for growth and as a policy tool to stabilise its spluttering economy (Figure 32). Excessively high debt levels (Figure 33) hamper China's efforts to transition from an export-and-investment-led economy towards a consumer and services driven one. Policy errors combined with falling home values have left consumers chronically pessimistic.

Policy errors combined with the bursting of the debt-fuelled real estate bubble have left Chinese consumers chronically pessimistic

China is shifting focus from growth to redistribution

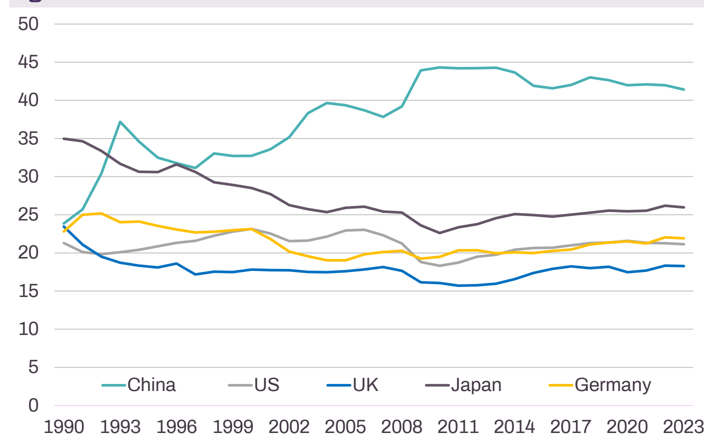
Step-by-step, the ruling Chinese Communist Party, led by President Xi Jinping, is shifting China's economic model from rapid growth at any cost towards more stable growth with a greater emphasis on redistribution. The policy includes lower official growth targets – the current is 5% YoY, a crackdown on perceived excesses in the private sector and a controlled deflation of the property bubble.

China's economic model is shifting from growth at any cost towards a greater focus on distribution – but policymakers face serious challenges

After a 5.2% rise in 2023, we project real GDP growth of 4.8% in 2024, followed by 4.4% in 2025 and 4.2% in 2026. The threat of periodic domestic financial instability tilts the risks to our calls to the downside. We look for inflation to remain roughly stable from the 0.3% rate in 2023 to 0.4% in 2024, before accelerating to 1.5% in 2025 and to 1.9% in 2026, while the unemployment rate edges down to 4.9% from 5.2% over the same period. We expect policymakers to cautiously stimulate credit and public investment to backstop demand during episodes of weak consumer spending or soft export demand.

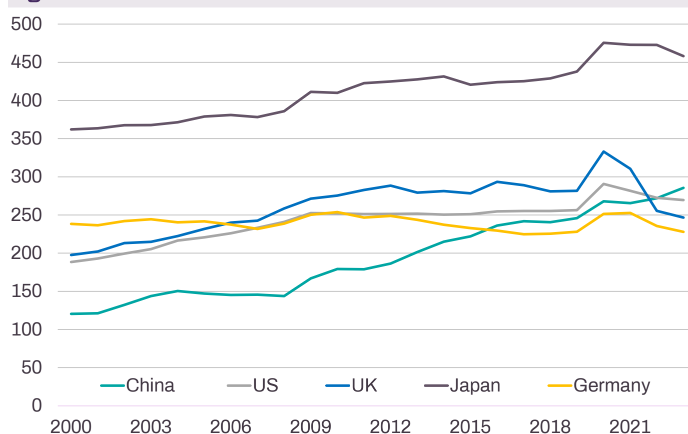
We expect policymakers to cautiously stimulate credit and public investment to backstop demand

Figure 32: Investment as a share of GDP



In %. Annual data. Sources: China National Bureau of Statistics, BEA, Cabinet Office of Japan, ONS, Deutsche Bundesbank

Figure 33: Total debt ex. financial institutions as a share of GDP



In %. Annual data. Sources: Center for National Balance Sheets, BEA, Cabinet Office of Japan, ONS, Statistisches Bundesamt

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Japan: Escaping the disinflation trap

After a solid rebound from the pandemic, Japan's upswing ended abruptly during 2H23 . . . but a rebound is underway

After a solid rebound from the 2020 pandemic downturn, Japan's upswing ended abruptly during the second half 2023 (Figure 34). Rising inflation crimped real consumption while soft global demand hurt international trade and production. Real GDP slumped from 4.2% annualised growth in 1H23 to a 2.3% decline in 2H23 and 1Q24. While near-term risks are tilted to the downside owing to China's economic troubles, surveys point to an upturn 2Q. Recovering exports, production and consumption can add momentum to the recovery in 2H24.

We expect growth to remain above Japan's subdued potential rate in 2025

After growing by 1.8% YoY in 2023, we expect real GDP to decline by 0.2% in 2024. However, base effects hide an expected healthy 2.2% annualised gain in 2H24. In 2025, we expect cyclical momentum to lift real GDP growth to 1.2% YoY before growth moderates to 0.8% in 2026 – still above Japan's subdued potential.

Inflation and easy money have finally reset expectations

Although growth potential will remain anaemic, we see promising signs that Japan is escaping the disinflation trap

Although the labour market drag from an ageing population will continue to restrain Japan's anaemic growth potential, we see promising signs that it is escaping the disinflation trap into which it had fallen after the asset price bubble burst in the early 1990s. Between 1995 and 2021, inflation measured by the consumer price index averaged just 0.15% YoY – well below the Bank of Japan's (BoJ) 2% target. However, since 2022 inflation has averaged a punchy 2.8% YoY.

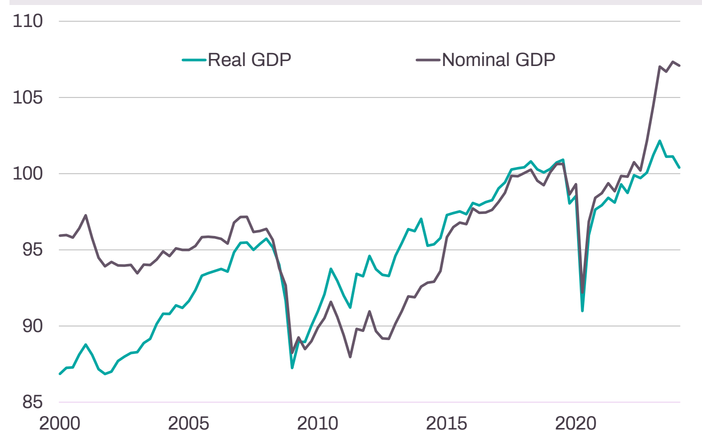
Easy money and inflation shocks have reset expectations as well as price and wage setting behaviour

Repeated ultra-aggressive efforts by the Bank of Japan (BoJ) – negative policy rates, yield curve control (YCC), and quantitative and qualitative easing (QQE) – combined with the recent global inflation shock have reset inflation expectations as well as price and wage setting behaviour (Figure 35). Looking ahead, although we expect inflation to moderate from 3.3% in 2023 to 2.5% in 2024 as the energy price shock fades further, consumer prices growth can stabilise at around 1.8-2.0% in 2025 and 2026. The unemployment rate is likely to hover in an ultra-low 2.2-2.5% range through 2024 to 2026.

The cautious BoJ will remain out of sync with other major central banks

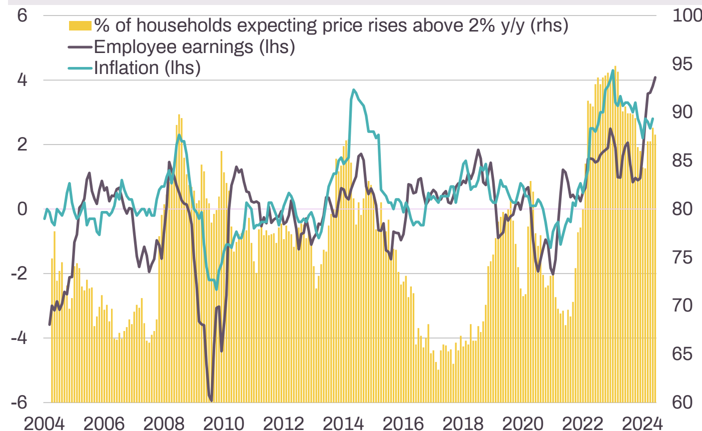
With Japan's unique inflation dynamics, the cautious BoJ will remain out of sync with other major central banks as it delicately tries to normalise monetary policy. Policymakers are fearful of disturbing what they refer to as a 'virtuous cycle between wages and prices'. The BoJ appears prepared to run the risk of keeping monetary policy too easy for too long to ensure that underlying inflationary dynamics are sustained.

Figure 34: Japanese GDP in nominal and real terms



2019 = 100. Quarterly data. Source: Cabinet Office of Japan

Figure 35: Japanese wages, prices and inflation expectations



Inflation expectations one-year ahead based on consumer confidence survey. Inflation and employee earnings (three-month moving average) in % YoY. Inflation based on consumer price index. Monthly data. Sources: Cabinet Office, Ministry of Health, Ministry of Internal Affairs and Communications

Summary of projections

Figure 36: Peel Hunt economic projections

	GDP				Inflation				Unemployment				Industrial production			
	2023	2024	2025	2026	2023	2024	2025	2026	2023	2024	2025	2026	2023	2024	2025	2026
North America																
US	2.5	2.5	1.8	2.2	4.1	2.9	2.5	2.4	3.6	4.1	4.4	4.0	0.2	0.0	2.1	1.9
Canada	1.2	1.3	1.6	2.1	3.9	2.5	2.2	2.1	5.4	6.3	6.3	6	n/a	n/a	n/a	n/a
Asia and Oceania																
China	5.2	4.8	4.4	4.2	0.3	0.4	1.5	1.9	5.2	5.1	5.0	4.9	4.4	5.1	4.6	4.4
Japan	1.8	-0.2	1.2	0.8	3.3	2.5	2.0	1.8	2.6	2.5	2.3	2.3	-1.5	-1.2	3.1	1.6
India	8.2	7.8	7.0	7.0	5.7	4.8	4.7	4.7	8.1	n/a	n/a	n/a	5.8	5.8	5.5	6.5
Australia	2.0	1.3	2.3	2.5	5.6	3.4	3.0	2.8	3.7	4.2	4.5	4.5	n/a	n/a	n/a	n/a
Europe																
UK	0.1	1.2	1.7	1.8	7.3	2.5	2.1	2.3	4.1	4.6	4.8	4.5	-0.4	0.0	1.5	1.8
Eurozone	0.6	0.7	1.5	1.6	5.4	2.4	2.0	2.1	6.6	6.4	6.1	5.9	-2.1	-2.0	2.6	2.3
Germany	0.0	0.2	1.2	1.3	6.0	2.4	2.2	2.2	3.0	3.4	3.6	3.3	-1.9	-2.5	2.8	2.9
France	1.1	0.9	1.3	1.5	5.7	2.5	2.1	2.2	7.4	7.3	7.0	6.6	0.6	-0.3	1.5	2.1

GDP, inflation (CPI basis) and industrial production data in % YoY. Unemployment rate in %

Figure 37: Peel Hunt financial projections

	Current	4Q24	2Q25	4Q25	2Q26	4Q26	Change
Central banks							
BoE Bank Rate	5.25	4.75	4.25	3.75	3.75	3.75	-1.50
Fed Funds Rate (Upper)	5.50	5.00	4.50	4.25	4.25	4.25	-1.25
ECB Deposit Rate	3.75	3.25	2.75	2.75	2.75	2.75	-1.00
10year bond yields							
UK	4.13	4.15	4.15	4.30	4.30	4.30	0.17
US	4.24	4.40	4.20	4.20	4.45	4.50	0.26
Germany	2.42	2.45	2.50	2.80	3.00	3.00	0.58
Japan	1.06	1.30	1.35	1.40	1.45	1.50	0.44
Currencies							
GBPUSD	1.29	1.32	1.34	1.36	1.38	1.40	8.83
GBPEUR	1.18	1.20	1.21	1.22	1.23	1.24	4.67
USDEUR	1.09	*1.10*	*1.11*	*1.11*	*1.12*	*1.13*	3.98

Notes: 1. Current data based on Bloomberg taken on 26 July 2024 at 07:00 BST 2. Interest rates in % 3. All estimates are for end of period 4. Currency projections may not add up due to rounding 5. Change in percentage points for interest rates and percent for currencies

	Recommendation distribution at Today's Date					Recommendation distribution for publications in the last 90 days				
	Total	Investment Banking Clients		Other		Total	Investment Banking Clients		Other	
Structure	No.	No.	%	No.	%	No.	No.	%	No.	%
Buy	232	114	49	118	51	375	212	57	163	43
Add	50	4	8	46	92	61	4	7	57	93
Hold	62	3	5	59	95	71	5	7	66	93
Reduce	5	0	0	5	100	4	0	0	4	100
Sell	1	0	0	1	100	1	0	0	1	100
Under Review	7	2	29	5	71	2	1	50	1	50

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Add, +5-15% range expected absolute price performance over 12 months
Hold, +/-5% range expected absolute price performance over 12 months
Reduce, -5-15% range expected absolute price performance over 12 months
Sell, > -15% expected absolute price performance over 12 months
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NB The recommendation is the primary driver for analyst views. The target price may vary from the structure due to market conditions, risk profile of the company and capital returns

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