NORTHERN TRUST

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# WEEKLY ECONOMIC COMMENTARY

**IN THIS ISSUE:**

- **The U.S. Fiscal State Of Play**
- **A Frenzied Week For Tariffs**
- **Germany's New Deal**


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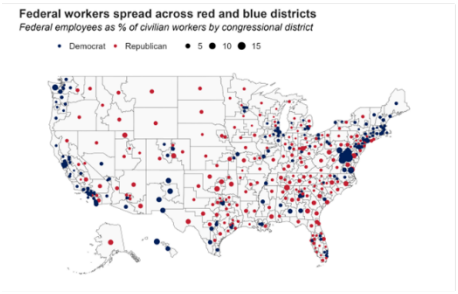
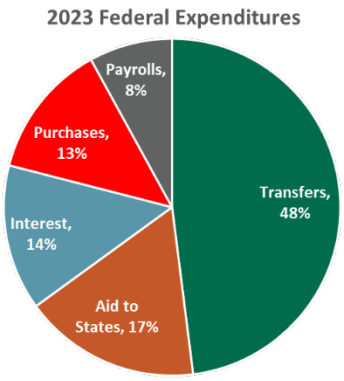
Working through a home renovation has reinforced the lesson that tearing down is easier than building up. The early phases of a construction project show rapid progress and can even be fun, excavating and swinging sledgehammers. But when the project moves on to the building phase, plans must be meticulous and precisely executed in order to avoid expensive mistakes.

Washington is in the midst of a rehabilitation project as well. Sledgehammers are being wielded by the executive branch at the same time that Congress sets to work designing a budget plan. Living through this construction project will be stressful for all involved – including U.S. taxpayers.

The fundamental framing of the U.S. fiscal situation has not changed: the nation has not balanced its budget since 2001. The many strengths of the American economy have allowed the nation to continually issue debt, which has been used to finance the budget gap. Demands on government programs are rising, but tax revenues have not kept pace. A fully balanced budget may no longer be achievable, and the trajectory of ever-increasing deficits is a stability risk. Solutions are easy to describe and hard to achieve.




*Sources: Eurasia Group, OMB, BEA, Cato Institute*

This year, the urgency around these issues has grown. Tactically, the nation faces urgent deadlines this year to fund the government, set a budget, lift the debt ceiling and amend the tax code. Strategically, the new administration is making a novel effort to cut costs.

The new Department of Government Efficiency (DOGE) has moved rapidly and unconventionally to scrutinize and halt government expenditures. The focus in these early days has been on reducing federal government headcount, first through voluntary resignations and then with layoffs. Most DOGE actions have been met with immediate litigation, as they appear to contravene the appropriations authority that the Constitution vests in Congress. Some actions could be overturned, and jobs could be reinstated.

Reviews to halt frivolous expenditures should be a routine part of governance, but they have proven politically difficult. DOGE is seeking to cut through this resistance, and claims savings of over $100 billion. Even if their actions survive legal challenges, this is below the magnitude required to close an annual deficit approaching $2 trillion.

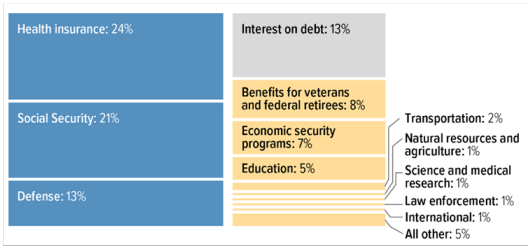
More meaningful reductions in spending will need to come through the appropriations process. The outline passed by the House in late February offers a hint of the difficult discussions ahead.

A fiscal reconciliation bill starts with a set of instructions from the House Budget Committee, setting high-level spending and revenue targets for each appropriations bill. The House's recent outline calls for a total deficit increase of $3.3 trillion over ten years: $4.5 trillion has been set aside to accommodate lower taxes, while partial offsets come from decreases to the budgets for the Departments of Energy, Commerce, Education and Agriculture.

**Debt Impact of House Reconciliation Instructions (Fiscal Years 2025-2034)**

| Committee | Reconciliation Instruction |
|---|---|
| Ways and Means | $4,500 |
| Judiciary | $110 |
| Armed Svcs. & Homeland Sec. | $190 |
| **Deficit Increases subtotal** | **$4,800** |
| | |
| Energy and Commerce | -$880 |
| Education and Workforce | -$330 |
| Agriculture | -$230 |
| Oversight, Transportation, Fin Svcs., Natural Resources | -$61 |
| **Deficit Reductions subtotal** | **-$1,502** |
| | |
| **Deficit Impact** | **+$3,298** |
| **Interest** | **+$700** |
| **Total** | **+$4,000** |

**Federal Budget Allocations**




*Sources: House Budget Committee, CRFB, OMB, CBPP*

**Cuts alone will not balance the budget.**

Medicare, Medicaid and other social safety net programs like nutritional assistance are the largest share of government spending, making them prime targets for cuts. But any reductions would be politically consequential. Reducing healthcare and food funding for the lowest-income populations would cause pain to voters across the country and across parties.

Reconciliation bills cannot result in a deficit any larger after ten years than it is upon signing. This creates a window to expand the deficit, so long as expenditures are wound down or tax revenues rise at the end of the decade ahead. House leaders hope to create fiscal space to fund other priorities, especially tax cuts. A Trump campaign pledge included eliminating income tax on tips, overtime and Social Security; this lower revenue will need to be offset by some cost reduction.

Debate will also center on the baseline forecast used to determine whether a bill meets deficit requirements. The current Congressional Budget Office (CBO) scoring shows moderate deficit growth, because it includes higher tax rates after the expiration of the Tax Cuts and Jobs Act next year. Advocates of a more generous tax plan would prefer to treat the current tax regime as permanent, which would set the baseline deficit outlook on a higher trajectory. Though fiscally burdensome, a forecast of a larger deficit would afford more space for reforms and tax cuts in the reconciliation package.

Sorting all of these questions and priorities will be a months-long process, and Congress does not have time on its side. On Friday, March 14, the current continuing resolution (CR) that extended

last year's budget will expire, and the government will enter a shutdown. Passing a "clean" extension of the CR through the full fiscal year will meet resistance on many fronts. Some representatives are eager to see lower spending immediately, while Democrats will withhold their support for any Republican proposal unless efforts like DOGE are curtailed. A government shutdown looms.

**A government shutdown will complicate negotiations.**

Past shutdowns have not been economically consequential. Essential government workers, like those in defense and law enforcement, continue to work, while others are furloughed. This time could be different, as agency leaders have been asked to create plans to reduce their staffing levels, including "positions not typically designated as essential during a lapse in appropriation." Temporary furloughs could become permanent reductions in force.

Home renovations inevitably encounter an unforeseen problem, challenging the architects and contractors to find a quick solution. The demolition and remodeling of the federal government is moving fast; we might advise Congress to come to work in hard hats.

## On Again, On Again

British Prime Minister Keir Starmer had a productive visit with President Trump last month. Observers attributed Starmer's success to an affable style, but it may have had more to with the trade surplus the United States runs with Britain. That puts the U.K. well down the list of regions attracting the administration's attention under the new American trade policy.

One little-known export that the U.S. received from England some years ago was the term "stagflation." This elision of "stagnation" and "inflation" became the single best descriptor of the American economy of the 1970s. During that era, sluggish growth and rising prices proved a toxic combination for households and the Federal Reserve.

In the past few weeks, economists have been using the word stagflation to describe what might lie ahead for the U.S. The size and scale of tariffs confirmed this week, along with retaliatory measures announced by China and Canada, will depress economic activity and place upward pressure on inflation.

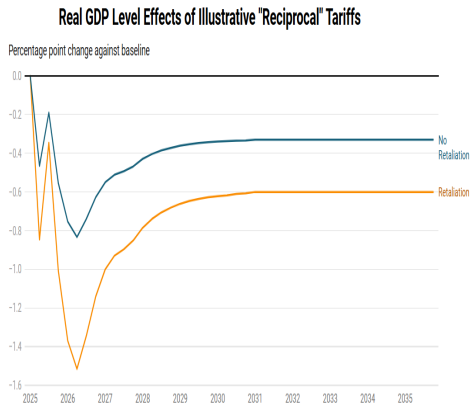
To say that tariff policy is fluid at present is an understatement. Charges on Canadian and Mexican imports had been deferred for a month; as we approached last Monday's deadline, most expected the deferral to be extended. The President surprised by forging ahead, prompting retaliatory measures from America's trading partners.

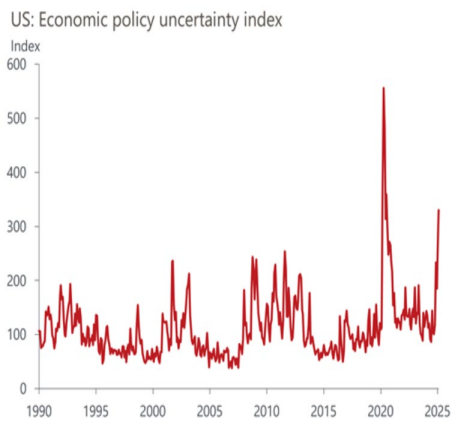
In the wake of a market correction, the Commerce Secretary announced thirty-day reprieves: first for domestic automakers, and then to a slightly broader range of imports from Mexico and Canada. Still to come are potential measures against the European Union, and selected emerging markets.

Tariffs act like taxes, paid largely by households. They depress consumption and economic growth. Tariffs add to inflation by raising the prices of imports; domestic producers in affected sectors often increase their prices, as well. (The case of washing machines is illustrative here.)

The magnitudes of these impacts depend on many things, including the presence of substitutes for imported goods and the ability of households to defer spending on them. For tariffs as widely ranging as those proposed in the last six weeks, the modeling can be very complex. But several sources have estimated declines of U.S. real growth in excess of 1% next year, and increases in inflation of more than 0.5%. The consequences for Canada and Mexico are much more severe.

The uncertainty surrounding process and policy has put businesses in a difficult position. When the rules of commerce are in flux, it is hard to commit to productive investment. The manner in which measures are forwarded has created considerable day-to-day drama, which hasn't helped. There are those who suggest that being hard to read will provide an advantage as negotiations progress. Others worry that recent tactics will cause trading partners to lose interest in bargaining, and encourage them to deepen alliances that don't include the United States.




*Sources: Yale University Budget Lab, Oxford Economics*

**U.S. trade policy, and financial markets, have been volatile.**

After remaining somewhat sanguine through the month of February, investors are recalibrating. Equity indices and long-term interest rates have returned to their standings on Election Day. Daily volatility in both arenas has jumped. Markets now expect the Federal Reserve to reduce rates more aggressively this year, betting that diminished growth will take precedence over higher inflation in the Fed's deliberations.

We have been frequently asked to identify the end-game sought by the new administration. There is certainly a wish to see more production performed in the United States, and to ensure that trade terms create a level playing field for American exporters. Tariffs are also being used as a lever to open deeper discussions on issues like migration and drug interdiction. What remains unknown is when these efforts will be seen as reaching their goals; measures of policy success have not yet been defined.

By the early 1980s, the combination of inflation and unemployment, also known as the "misery index," exceeded 20%. Today's misery index is only 7%, so increases from here would have to be classified as "mini-stagflation." But misery is something that we shouldn't welcome, or export.

## Breaking the Brake

At times this year, it seems as if the world is changing at breakneck speed. Understandings, practices and institutions built over decades are changing in days.

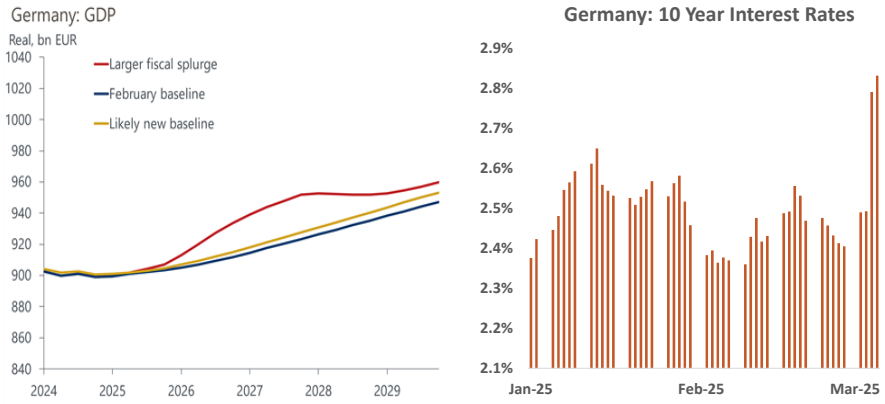
Germany provides a poignant case study on this front. The country is a leading member of the North Atlantic Treaty Organization (NATO) and the European Union (EU); Frankfurt is the headquarters of the European Central Bank. German economic policies, focused on fiscal discipline and inflation control, have been central to the compact binding euro area countries together.

Rapidly changing circumstances, however, have forced a re-evaluation of Germany's core principles. With U.S. support for NATO wavering and a trade war brewing, the German

government has proposed an amendment to its constitution to address growing challenges.

Up until now, Germany has adhered to a debt "brake" which limits budget deficits to 0.35% of gross domestic product (GDP). By contrast, the United States is dealing with annual shortfalls of 6% of GDP; the average across Western Europe is over 4%. The lack of fiscal space has challenged Germany's economy, which has gone from triumph to travail.

American foreign policy, however, has encouraged Europe to become more self-sufficient for their security. And reciprocal tariffs against the EU have been threatened for April 1. These developments prompted the German parliament to amend the national constitution.




*Sources: Oxford Economics, Haver Analytics, Bloomberg*

**Germany has made generational change in just a few weeks.**

If ratified, defense spending in excess of 1% of GDP will be exempt from annual deficit restrictions. An infrastructure fund of €500 billion will be created. German states will gain the ability to run modest budget deficits. Taken together, these measures will provide substantial stimulus: early estimates suggest that they could eventually add more than 1% to annual real growth.

The prospect of higher deficits led bond markets to add more than 40 basis points to long-term German yields. Still, German interest rates remain well below those in other countries. And the ratio of German debt to GDP is well below that seen elsewhere.

Observers have been suggesting for some time that Germany needed to stimulate its economy, which has been very sluggish. While the circumstances under which change is occurring may not be ideal, the economic outcomes will be positive for Germany…and for the rest of Europe.

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