Research @ Citi Podcast, Episode 27: What's Next for the U.S. Economy?

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Transcript:

Nathan Sheets (00:01)

My expectation is that in five to ten years, the U.S. will certainly still be a very attractive target for foreign direct investors, that the dollar will still be the reserve currency, that Treasurys will still be the global safe asset. But more people are debating those issues today than was the case five or ten years ago.

Lucy Baldwin (00:27)

Hello, and welcome to the Research @ Citi podcast. I'm your host, Lucy Baldwin, Head of Research at Citi. Today, I'm delighted to be joined by our Chief Economist, Nathan Sheets. And, Nathan, given the amount of activity we've got going on in the world so quickly into 2025, there's going to be no end of things for us to talk about. Welcome to the podcast, Nathan.

Nathan Sheets (00:50)

Great to be here. Thank you.

Lucy Baldwin (00:52)

Well, maybe just to kick us off, given we're only a couple of months into 2025, and we've obviously had a super fast start from the new administration with a whole host of executive orders, et cetera, maybe the place to start is a bit of a mark to market on GDP and how we feel the year is looking, and then maybe we can dig into some of the particular policies and what we're seeing coming through in terms of growth and inflation, Nathan.

Nathan Sheets (01:18)

You know, Lucy, this is an issue that's fundamental, but it's also one that I spend a lot of time thinking about. And on the one hand, the economy had a lot of momentum entering the year, and in recent years, we've seen that both the U.S. and the global economy manifest significant resilience. So a few months ago, I was pretty optimistic. But I think it's also fair to say that Trump's policies have been a notch more aggressive than what I had anticipated and what many in the markets had anticipated. At the moment, I think we're at a point of maximum policy uncertainty, and that's prompting out in the economy many firms and even some consumers to implement a wait-and-see strategy. They want to see where these policies are headed and what they look like. I think a key date on my calendar that I've circled in dark ink about six times is April 2, where we get significantly more information on the tariffs. But as I put all this together, kind of bottom line, I think there's reasons to be a notch more concerned than when I entered the year. And wherever you were as you entered the year, if you thought growth was going to be a little over two, now I think it's reasonable to expect maybe a half a percentage point softer performance with growth in that scenario being a little less than two. I'm staying wide on my feet in my assessment, and I'm prepared to mark up or mark down as developments evolve.

Lucy Baldwin (03:04)

Nathan, when you think about the different policies that are obviously being implemented currently, you mentioned that potentially President Trump and the new administration's set of policies seem to be a little more aggressive, I think you said a notch more aggressive than you expected prior to this year. Talk us through within the different verticals, how different they have actually been. You know, one of the things we spent a lot of time on was thinking about the impact of tariffs and whether indeed tariffs would or wouldn't prove to be inflationary. There's obviously concern that inflation expectations seem to be rising for a number of U.S. consumers. Talk to us about how you see, you know, the tariffs evolving. Are we seeing evidence that, you know, what's been tabled so far, what's been implemented so far is going to cause a series of, like, negative demand and supply shocks? Is that going to be a challenge for growth? Talk us through maybe how you see tariffs, and then perhaps we can pivot to some of the other verticals, too, around taxation, the regulatory reset, and the DOGE.

Nathan Sheets (04:05)

Probably, for me, the biggest surprise on tariffs is I expected threats of tariffs on Mexico and Canada, but I really believed as we entered the year — and it's still my baseline, but as I said, I'm watching closely — that those tariffs were designed as a negotiation strategy to prompt Mexico and Canada to act on the border and on fentanyl. And it feels like there's more pressure in that space and more of a narrative that, well, in addition to the border, maybe there's something about trade imbalances that the administration is focused on. So definitely more tariff pressures on Mexico and Canada. Pivoting to Europe, I was expecting that we were going to see tariffs on Europe during the Trump administration. But again, I would say the tone has been a notch more muscular than what I was anticipating, and I worry that we could see, particularly on autos tariffs as high as 25% globally, but that would have particular restraining effects on Europe and indeed, maybe additional tariffs on Europe. The place where it's proceeded broadly in line with my expectations is China. When I put all this together, if I entered the year, my expectation was that the average tariff on an import entering the United States would rise by about 5 to 7 ½ percentage points. Now, I think it's reasonable to expect that that average tariff across all U.S. imports may be up 10% to 15% by the end of the year. And there are real growth implications to that.

Lucy Baldwin (05:53)

Got it. Yeah. And then just to take us through some of the other areas, Nathan, when you think about, you know, taxation, obviously coming into the year, the view was that you get an extension of existing tax cuts, what do you feel we've learned that's been new or surprising from a fiscal perspective so far?

Nathan Sheets (06:09)

Well, I think the administration's focus on getting the Trump tax cuts extended has been very much in line with my expectations, and I continue to see them signaling that that is at the core, that's job one from their perspective. But there's also been a lot more emphasis on efforts to reduce the fiscal deficit overall. Now, on the one hand, we have a fiscal problem. And if we're going to take constructive and focused and disciplined steps to reduce the budget deficit, I'd have to say over the medium to long run, that's probably welcome. But on the other hand, in the near term, as we're actually doing it, that's going to be an additional source of drag on GDP. And then finally, a related point that's obviously been in the headlines is this DOGE effort has been much more aggressive than what we'd expected and I think has created uncertainties about the capacity of the U.S. government to continue to attract high-quality workers and the capacity of the government to be able to implement the policies that Congress has approved. It's a lot more uncertainty in the DOGE government functioning and administration space than what I would have expected.

Lucy Baldwin (07:37)

And I suppose some of the efforts that were expected, designed to offset some of those nearer-term pressures that are created through the uncertainty were around the regulatory reset and sort of getting rid of red tape. What do you think we've seen there in terms of rhetoric or indeed momentum as we go into the middle part of this year, Nathan?

Nathan Sheets (08:00)

My judgment is that the administration is still fully committed to an aggressive deregulatory agenda, and that means in energy, in finance, consumer protections, labor market, climate, maybe antitrust. It's quite a long list, and I think that that is still a front-and-center objective. But that has evolved a little more slowly than, say, the tariff policies. And I think that that will come through over time as a supportive factor. But it's feeling like that may be more in play as the determinant of growth, say in 2026 than in 2025. Now, the other point that you referenced there is just absolutely critical, and that's the animal spirits and confidence. And going into January 20th, it was pretty clear that Trump's election was supporting confidence and sentiment, animal spirits, the markets quite meaningfully. At least in the United States, probably not in the rest of the world. But my sense is that the uncertainty associated particularly with the tariff policies has shifted the sign on that. And on balance, I think that at least at the moment, that that animal spirits term, so to speak, is tipping the scales now in a negative direction. And I think that may be something that President Trump and his advisors need to think about is the implications of their policies for animal spirits and how they're going to manage that going forward.

Lucy Baldwin (09:43)

Yeah. You know, let's talk a little bit about Canada and perhaps Mexico because, again, you mentioned at the beginning that was an area where the policies were somewhat different versus your expectations.

Nathan Sheets (09:55)

Mexico has been quite effective in its communication strategy and negotiations with the Trump administration because they have approached it in a very technocratic way. They've come in with a lot of analysis, they've used U.S. data. It's been very buttoned down and analytical. And President Trump has made comments saying, Mexico has given us great presentations and made good points we want to think about. And Canada, I don't think has done that to the same extent under Prime Minister Trudeau. And I think there's a good chance that Carney now being in place, given his background, is going to take an approach much more like Claudia Sheinbaum has in Mexico. And so maybe he's going to use the data and be analytical and make the case. And I do think there's a case to be made that when you think about fentanyl and flows into the United States, and when you think about immigration and flows into the United States, it's not a first-order Canadian issue, and Canada's role there is less clear. So it feels like that there is a technocratic case to be made, and Carney may be the right person to make it.

Lucy Baldwin (11:15)

How do you see Europe, Nathan, emerging from all of this and what do you expect perhaps in terms of Europe's reaction, but also its growth prospects on the back of it?

Nathan Sheets (11:25)

With President Trump and his administration scheduled to release tariffs on April 2, I think it highlights that the second quarter of 2025 is likely to be a critical period for Europe and European leaders. And I think a key question as these tariffs come on, does Europe coalesce and galvanize or do these pressures lead to further fragmentation? I think a key question if they are going to coalesce and galvanize is who is going to be the leader? And at the moment, it's not clear which— if this were seven or eight years ago, we would say, oh, it's Angela Merkel. Well, Merkel's not there. Maybe Merz, the recently elected German Prime Minister, will be able to do it. But who's going to be the leader in Europe? And I think that's a critical issue. And will Germany— Europe coming together, Germany traditionally thinks of as Germany writing checks, and will Germany be willing to bankroll it given the weakness of its economy?

Lucy Baldwin (12:35)

Well, and I guess the other point that it brings home to us is the importance of having some fiscal space, right? And who has that in order to do whatever it takes. And as you sort of say, like, you know, Germany has kind of led the way here, and then there's a question mark as to, you know, how others can join them, right? And I guess as you look around the world, you know, not everybody has got fiscal space to really step up and deliver, but how would you assess, you know, now that landscape or what would you draw out with respect to that theme around fiscal?

Nathan Sheets (13:08)

In the aftermath of first the Global Financial Crisis and then the pandemic, when you look around the world, there are a lot of countries with very challenging fiscal positions. Many of the major developed market economies, but also some of the major emerging market economies have both debt levels above 75% of GDP and are estimated by the IMF to continue to run budget deficits of 3% of GDP or higher in coming years. This includes the United States, of course, France, Japan, Italy, the UK, but also India, China, and Brazil. Spain is just a little bit below the 3% deficit mark. So you put all that together, there's not a lot of fiscal space in the world. Now that said, the notable exception where we've continued to see meaningful fiscal prudence is Germany. And if there is any place where there is scope for additional fiscal stimulus, it's with Germany. Just a quick factoid. This is an example of why Germany should consider stimulus. Over the last five years, Germany's economy has grown a total of zero. Zero growth over the last five years, it's stagnated for half the decade, and it really does signal that you need some changes in the mix of policies there.

Lucy Baldwin (14:41)

Got it. And I suppose when you pull all of this together, Nathan, around the globe, right, it probably creates a bit of a picture of CEOs maybe uncertain about whether to make that additional capex investment, whether to do the next deal or whether to wait a bit longer. I guess it's the same with a consumer. Do I make the house move? Do I make the big ticket item purchase or do I wait and see how some of these issues and policies pan out? Is that what you think we're seeing to some degree?

Nathan Sheets (15:10)

I think that's a perfect characterization of where we are. The uncertainties around U.S. policy at the moment are significant. I think they are the leading story in thinking about where the global economy is, and certainly with direct implications for the U.S. growth outlook. But if things get more challenging in the United States, the policies that cause a slowing in the U.S.

are also likely to create headwinds in many other countries and economies around the world. And in addition, as the U.S. slows, that's likely to further restrain the rest of the world. So I think this story of uncertainty, we're waiting to see, you know, where does this land? The centrality of April 2 is a U.S. story. It's very much also a global story.

Lucy Baldwin (16:08)

Very clear. And when you think about— one of the comments that we've heard from investors over the course of the last few years has been this notion of U.S. exceptionalism or pre-eminence, right? You know, what is it that you would say in response to that question around U.S. exceptionalism or whether there's any element of that that is at risk here or indeed for things like the role of the dollar, given some of the changes that you were speaking to, Nathan?

Nathan Sheets (16:34)

My sense is that at core, U.S. exceptionalism is something that's structural, it's deep, it's embedded in the economy. I think it reflects a sustained outperformance of the U.S. economy in terms of growth. It reflects cheap natural gas prices and energy prices and the attractiveness of U.S. production and assets as a result. It reflects ongoing reshoring into the United States, and also the sustained technological development, with AI being the latest example of that. So I think that the U.S. has some deep structural advantages. But at the same time, can policy uncertainty and question marks about where the government is headed and its policies blunt some of those structural advantages and create questions and uncertainties? Absolutely. And I think that's what we're kind of seeing play through in real time, is we have what I view as still favorable underlying fundamentals for the U.S. economy, but then you have this overlay of significant policy uncertainty. So as I put that together, my expectation is that in five to ten years, the U.S. will certainly still be a very attractive target for foreign direct investors, that the dollar will still be the reserve currency, that Treasurys will still be the global safe asset. But more people are debating those issues today than was the case five or ten years ago.

Lucy Baldwin (18:21)

Fantastic. And, Nathan, just to close out, I just want to pull those threads together, as it pertains to FDI, then, you know, clearly, then your expectation is to continue to see strong positive growth in net FDI going into the United States. Tell us how you see that, but also if there's any other bright spots around the world where you'd really draw out that expectation of seeing increased foreign direct investment on a net basis as we go forward.

Nathan Sheets (18:48)

It is striking that in recent years, the United States has seen a meaningful upsurge in the share of FDI that has been received in the U.S. economy. And I think it has reflected some of those favorable fundamentals that I described. And I think going forward, those fundamentals, as I noted, are still very much in place. But then we've got this policy question that on the one hand, as President Trump puts on tariffs, one of his explicit objectives is to incentivize more foreign direct investment and other investment in the United States. And so that's an objective. On the other hand, foreign direct investment usually prefers and seeks out climates where the business environment where policy is predictable, where uncertainty is minimized. And at the moment, that's certainly not the case for the United States. I think there are also some questions of to what extent U.S. can further expand its manufacturing production, given wage rates and availability of labor and cost here and so forth. But we'll see how that plays out. But in any event, baseline, the fundamentals are strong. There are these offsetting considerations with President Trump. But going forward, I would expect the U.S. will continue to be a significant recipient. Other places where we're seeing meaningful FDI flows really are related to what I call re-globalization or rebalancing of globalization. In recent years, we've seen a lot of flows that would have gone to China go elsewhere, some to the United States, but also to East Asia with Vietnam being a clear example. A lot of flows have gone to India, but that's a little complicated. Some of the data on FDI don't manifest this quite as clearly. India has received substantial inflows of FDI, but its stock market has done so well that many foreign investors have also taken profits and have exited. So when you look at the net FDI figures, it's not as clear. And a similar story with Mexico where I think the reshoring, nearshoring narrative in Mexico is quite strong, and we've seen increased announcements for projects and investment in Mexico's manufacturing sector, but that's been offset in some other sectors partially because of policy uncertainty there. But I do think India and Mexico were also beneficiaries of this.

Lucy Baldwin (21:30)

Nathan, that is absolutely fabulous. Plenty of issues and themes for everybody to think about there. Thank you for joining me.

Nathan Sheets (21:37)

Very much a pleasure. Thanks, Lucy.

Lucy Baldwin (21:39)

This episode of Research @ Citi was recorded on Monday, March the 17th, 2025. I'm your host, Lucy Baldwin.

[Disclaimer] (21:46)