

An Unchanged Outlook Masks Complex Forces as the Policy Landscape Shifts

In April of this year, the United States announced the imposition of sizable tariffs against most of its trading partners, in a major departure from trade policy rules and norms. Given the complexity and fluidity of the moment, as well as the lack of certainty about announced policies, the April 2025 *World Economic Outlook* (WEO) offered a range of estimates of the downward revision in global growth, from modest to significant, depending on the ultimate severity of the trade shock.

Six months later, where do we stand? The good news is that the negative impact on the global economy is at the modest end of the range. Thanks to the agility of the private sector, which front-loaded imports in the first half of the year and speedily reorganized supply chains to redirect trade flows, the negotiation of trade deals between various countries and the US and the overall restraint from the rest of the world, which by and large kept the trading system open, global growth is now projected at 3.2 percent this year and 3.1 percent next year.

Should we conclude that the shock triggered by the tariff surge had no effect on global growth? That would be both premature and incorrect.

Premature because the US effective tariff rate remains high (at about 19 percent), and trade tensions continue to cast a shadow over the global economy, with trade policy uncertainty remaining high. The effect of these tensions could well increase over time as firms gradually pass the tariffs on to customers as trade is rerouted more permanently and the global economy gradually becomes less efficient. Past experience suggests that it may take a long time before the full picture emerges.

Incorrect because other important forces, besides trade policy, are shaping a complex outlook. In the United States, stricter immigration policies are reducing the labor supplied by foreign-born workers, another negative supply shock. Yet, so far, this has been offset by a roughly equivalent decline in labor demand,

coming from a cyclical cooling after many years of strong job growth. This leaves the labor market in a precarious balance, with a mostly unchanged unemployment rate. Second, financial conditions remain very accommodative, with a dollar that has lost some of its strength. And third, we are witnessing a strong boom in artificial intelligence (AI)-related investment coupled with a modestly expansionary fiscal policy in 2026. These demand forces are supporting output while adding to the price pressures from the tariffs.

In the rest of the world, other drivers besides tariffs—both temporary and structural—are at play too. In China, the country hardest hit by US tariffs, growth is projected to decline only modestly, owing to a sharp depreciation of the real effective exchange rate, a front-loaded surge in exports toward Asian and European partners, and some fiscal expansion. In the euro area, fiscal expansion in Germany has played a role in boosting growth in 2025. Emerging market and developing economies have benefited from easier financial conditions, on the back of a depreciated dollar. They have also continued to demonstrate significant resilience, in part because of strong and improving policy frameworks, a theme explored in Chapter 2.

Incorrect also because, despite the offsets from other drivers, the tariff shock is dimming lackluster growth prospects. Global growth is projected to slow in the second half of this year, with only a partial recovery next year. Compared with the projections in the October 2024 WEO, this results in a cumulative global output loss of about 0.2 percent by the end of 2026. In the US, growth is revised down and inflation is revised up compared with last year's projections, clearly suggesting a negative supply shock.

Thus, despite a steady first half, the outlook remains insufficiently bright, with risks tilted to the downside. These are some of the risks that are key to the balance of the evolving outlook:

First, the current AI boom presents some parallels with the dot-com boom of the late 1990s. Market optimism about a new technology—the internet then, AI now—is pushing up stock valuations, fueling

a tech-centered investment boom, and sustaining consumption on the back of strong capital gains. This could push the neutral interest rate up. Should the AI boom continue unabated, the risk is that demand pressures accentuate further, requiring tighter policies. Indeed, between June 1999 and May 2000, the Federal Reserve needed to raise its policy rate by a cumulative 175 basis points to contain inflationary pressures. But the risk is also that lofty profit expectations will ultimately be unmet—as often happens when new general-purpose technologies are introduced. A significant market repricing, explored in more detail in the October 2025 *Global Financial Stability Report*, could impact aggregate wealth and consumption and spill over to broader financial markets.

Second, China's prospects remain weak. More than four years after the property bubble burst, the sector has still not been put on a firm footing. Real estate investment continues to shrink while the economy teeters on the verge of a debt-deflation cycle. Even more concerning, it is difficult to see how the strong contribution of manufacturing exports to the country's growth can be sustained. The signs are mounting that large-scale subsidies to the manufacturing sector have reached their limit and are contributing to significant misallocation of resources in the economy. This is evident in the contrast between strong productivity gains in some key industrial sectors, such as electric vehicles and solar panels, and the absence of *aggregate* productivity gains. As documented in Chapter 3, while industrial policy is increasingly used by countries to reshape their economies, this often comes with many fiscal and hidden costs.

Third, countries need to seriously address the strains on their public finances. With lower growth prospects, higher real interest rates, more elevated debt levels, and new spending needs for some countries on items such as defense or national security, the fiscal equation is becoming more challenging to solve and leaves countries vulnerable, should a large external shock occur. All major advanced economies saw their spreads rise during the April sell-off, and only a handful of safe haven countries, such as Switzerland, experienced a pronounced fall in longer-term yields—reflecting broader fiscal concerns in core bond markets. Low-income countries are even more vulnerable, given reduced official aid flows. For a rising number of countries, the lack of job opportunities could quickly translate into rising social unrest,

especially among an unemployed and disenfranchised young population.

Fourth, we are witnessing increased pressure on policy-setting institutions such as central banks. Should these pressures succeed, many of the hard-won credibility gains achieved in policymaking over many decades could be lost. Trust in central banks and in their ability to deliver price stability allows inflation expectations to remain well anchored even when the economy is hit by large shocks, such as during the recent cost-of-living crisis, as previous WEO reports have documented.

While downside risks dominate, all is not gloomy. A few important upside risks could quickly brighten the outlook. First, resolving and reducing policy uncertainty would provide a significant lift to the global economy. The October 2025 WEO shows that a material decrease in global economic policy uncertainty as a result of clearer and more stable bilateral and multilateral trade agreements can raise global output by 0.4 percent in the very near term. Lowering tariffs based on these agreements adds even more upside, of about 0.3 percent. Second, AI, beyond its effects on investment, could well improve total factor productivity. This WEO report finds that, under modest assumptions, this factor could add another 0.4 percent to global output in the near term.

This reiterates that policies can and should help restore confidence and predictability, which would improve growth prospects. For trade policy, the objective should be to update trade rules to reflect the changing nature of trade relations, looking to deepen trade relations where possible.

Fiscal policy should aim to reduce fiscal vulnerabilities gradually and credibly. Improving the efficiency of public spending is key and can help address crowding in private investment, as discussed in the October 2025 *Fiscal Monitor*. Monetary policy should remain tailored and transparent. Preserving the independence of monetary policy institutions is a precondition for macroeconomic stability. Technocratic institutions should be allowed to focus on their core mandate and provided with the tools to do so, including in terms of data provision.

Efforts to improve longer-term prospects must continue. While macroeconomic stability is a necessary precondition, governments should ensure that private entrepreneurs can innovate, thrive, and generate the growth of tomorrow. While it might be tempting to

implement sectoral industrial policies, the evidence suggests that their effectiveness can be very limited and the side effects considerable. The use of horizontal policies should instead be preferred: investment in education, public research, public infrastructure, good governance, financial and macroeconomic stability, and a regulatory environment that balances carefully the need for flexibility and innovation in the private sector and the need to contain risks.

Finally, work to strengthen the multilateral frameworks and institutions that have helped deliver considerable gains over the past decades must continue. If anything, an important reason for global resilience

so far is also that most countries have exercised restraint in trade policy retaliation, have sought to forge better trade deals, and are still operating under well-established global trading norms. The recent geopolitical tensions highlight how the need for an adaptive and pragmatic multilateral system is even greater than before. Because while it is easy to focus on the short-term costs and interests, cooperation in the face of global challenges remains the bedrock upon which to build a more prosperous and resilient global economy.

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