



Global Economy Risk Assessment:

Monetary Policy Frameworks under Scrutiny

August 2025



Major central bank heads descended on Jackson Hole once again this year. The 2025 Jackson Hole Symposium brought together the leadership of the Bank of England, the European Central Bank, the Federal Reserve, and the Bank of Japan. The direction of travel for analytical frameworks is clear: greater levels of analytical transparency that have been demonstrated by smaller central banks such as the Riksbank, Reserve Bank of New Zealand and the Czech National Bank among others. We refer to these central banks as FPAS Mark I central banks where for starters greater levels of transparency means revealing the policy and exchange rate path that is consistent with the underlying assumptions and forces in the economy as judged by the central bank staff.



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Meanwhile, smaller innovators such as the Central Bank of Armenia have demonstrated that moving beyond a central baseline projection to a scenarios-based communication is both possible and effective. The new framework is called FPAS Mark 2 and represents a decisive shift in the practice of monetary policy: away from opaque forecasts and toward frameworks that expose a healthier range of risks, trade-offs, and policy choices.

Bank of England – Bernanke Review

The independent review led by Ben Bernanke exposed weaknesses in the BoE's analytical system, namely the omission of an explicit interest-rate path implied by the BoE's forecast. Analytical credibility requires publishing the policy path. Without it, the central bank does not fulfill its essential purpose — to explain where the economy stands, what forces are driving it, and what actions are required to achieve price stability. This is the standard that FPAS Mark I central banks have met for decades.

Federal Reserve – 2025 Strategic Review

The Fed revealed its update of the Statement on Long-run Objectives and reaffirmed the 2 percent inflation target but refined its articulation of maximum employment and the balance between competing objectives. Still the Fed uses peculiar language related to "moderate long-term interest rates" which relates to anchored inflation expectations but considering debt sustainability concerns could take on a new meaning if the Fed is not careful with its language. Furthermore, the Fed is potentially moving towards an FPAS Mark 2 direction if it adopts the approach presented by Ben Bernanke's speech at the Thomas Laubach conference where he advised that the Fed publish an abridged version of the Teal Book alongside its projections, revealing the staff's internal assessment of the economy and policy trade-offs. The lesson of the past decade is that without greater transparency, communication can get married to a particular narrative and risks policy mistakes.

European Central Bank – The Folly of not Publishing an Endogenous Interest/Exchange Rate Path

The ECB has embraced a scenarios-based approach to its macroeconomic projections. However, since the ECB uses an exogenous assumption for both the interest and exchange rate in its projections, the ECB is effectively communicating that monetary policy does not matter for the economy. While this was previously less evident when the ECB published only a baseline forecast, it becomes more apparent with the publication of multiple scenarios. Although the conditions in its macroeconomic projections differ, the implications for monetary policy remain unchanged.

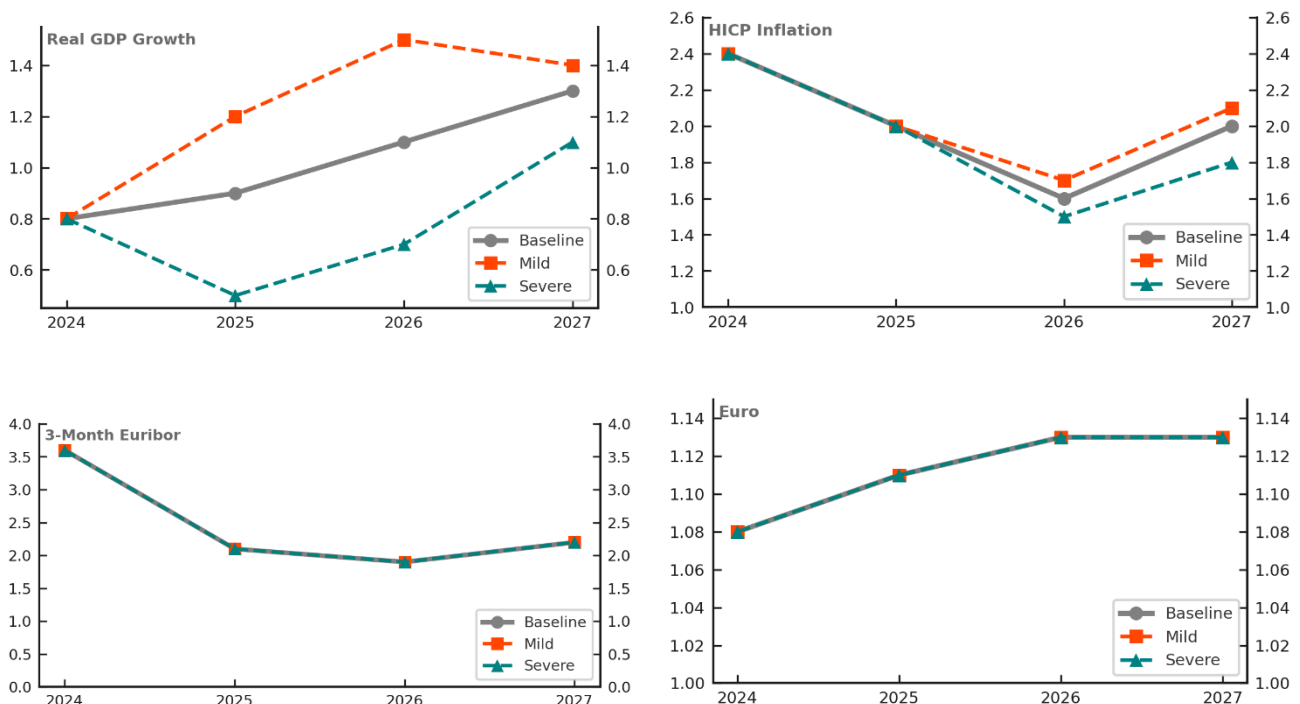


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The scenarios show that under alternative assumptions about the impact of tariffs on the economy can alter the trajectories for real GDP and HICP inflation but given the exogenous assumptions for the interest rate and exchange rate, there are no implications for monetary policy. This should be highly problematic for a central bank that communicates its purpose as an institution is to anchor the economy to an inflation target by using its instruments, namely the policy rate.



Instead, communicating scenarios-based forward guidance in this manner will likely just exacerbate potential threats to its credibility.

Analytical transparency might be the only antidote to threats of independence or credibility

The Fed's independence has been questioned, and the latest firing of Lisa Cook as an FOMC member adds fuel to this narrative. Now is more important than ever for the Fed to adopt a more transparent framework ahead of a potential major shift in the makeup of the FOMC once Chairman Powell leaves in 2026.



Global Economy Growth Outlook

Revision: Growth in 2025 is revised slightly higher on a stronger near-term US outlook. A modest slowdown in 2026 remains coming from tariffs and restrictive immigration. The rest of the regions remain unchanged.

Real GDP Growth						Key Assumptions
Country/Region	Scenario	2024	2025	2026	2027	
US	July	2.8	1.7	1.6	2.0	The likelihood of a large tariff war has diminished but remains relevant for Canada, Mexico and China. We assume the effective tariff rate rises to about 20% without major retaliatory tariffs. Restrictive immigration lowers aggregate supply while modest expansionary fiscal policy boosts demand.
	August Update	2.8	2.0	1.6	2.0	
Euro Area	July	0.8	1.2	1.4	1.5	Higher US tariffs weigh on growth but are counteracted by a weaker euro and expansionary fiscal policy boosts demand in 2026.
	August Update	0.8	1.2	1.4	1.5	
China	July	5.0	5.1	4.6	4.5	China's growth slows down but is supported by a weaker exchange rate partly in response to higher US tariffs. Expansionary fiscal policy is assumed to help smooth the transition towards lower potential growth.
	August Update	5.0	5.1	4.6	4.5	
Rest of the world	July	2.3	3.0	3.3	3.4	
	August Update	2.3	3.0	3.3	3.4	
World	July	3.2	3.0	3.1	3.2	
	August Update	3.2	3.1	3.1	3.2	



Global Economy Risks

Inflationary Risks	Disinflationary Risks
<p>US tariffs rise by more than expected.</p> <p>Retaliatory tariffs.</p> <p>Expansionary fiscal policy in the US, Germany and China.</p> <p>Restrictive immigration in the US reduces labor supply.</p> <p>Global equity prices reach new highs, spur a wealth effect.</p> <p>Inflation expectations may not be well anchored.</p> <p>Countries with low unemployment prevents wage disinflation.</p> <p>Geopolitical tensions reduce global oil supply.</p> <p>OPEC spare capacity falls to historic lows.</p> <p>Countries allow their currencies to depreciate to partially offset US tariffs.</p> <p>Fed independence questioned.</p> <p>Underestimating r star that is on the rise due to AI.</p> <p>Higher food prices driven by meat prices.</p>	<p>Global trade slows and the global economy slips into a severe growth recession.</p> <p>Rerouting China's exports to the rest of the world at a discount.</p> <p>Restrictive immigration in the US lowers housing demand.</p> <p>Crisis in confidence in equity markets from the US economic agenda leading to stagflation.</p> <p>US fiscal sustainability concerns reach a breaking point.</p> <p>Consumers lose confidence due to high levels of uncertainty leading to precautionary saving.</p> <p>China's property market worsens threatening financial stability.</p> <p>Increasing non-performing loans in Russia causes a banking crisis.</p> <p>AI raises potential output and higher unemployment.</p>



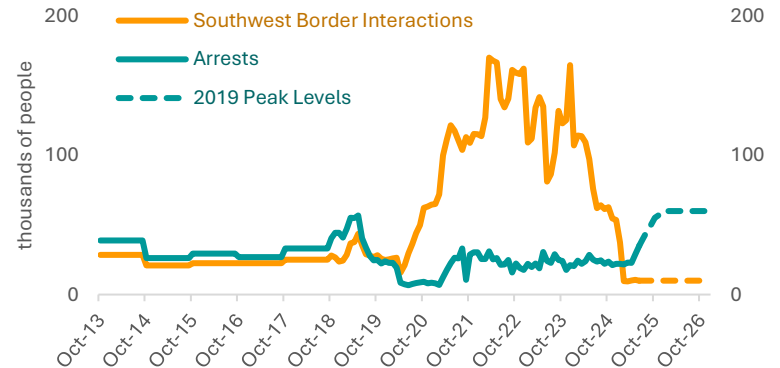
United States: Restrictive immigration, tariffs and fiscal policy threaten a more persistent inflation scenario while Chris Waller argues for an alternative

Foreign-born labor supply is likely to come under major strain in the coming months. Southwest border encounters have dropped to historic lows amid new restrictions, while arrests of immigrants inside the country have surged to 35,000/month, with expectations to hit 60,000/month — levels last seen in 2019. This dual dynamic — fewer inflows and rising outflows of foreigners — is expected to trigger an outright decline in the foreign-born labor force. Beyond literal deportations, a chilling effect could discourage informal work and depress labor participation further.

Chris Waller has argued the case for why interest rates ought to fall more than financial markets presently anticipate. He highlights a clear weakening in the labor market, specifically the decline in payroll growth over recent months. While he concedes this may partly reflect restrictive immigration limiting labor supply, he does not interpret it as an outright contraction, which would be required to explain slowing payrolls without unemployment rising because of inadequate labor demand. However, if we assume native-born labor force growth remains flat from slowing population demographics combined with a net outflow of 40,000 immigrants would result in an outright contraction of the total labor supply. Such a scenario would still imply a tight labor market going forward despite a major slowdown in payroll numbers.

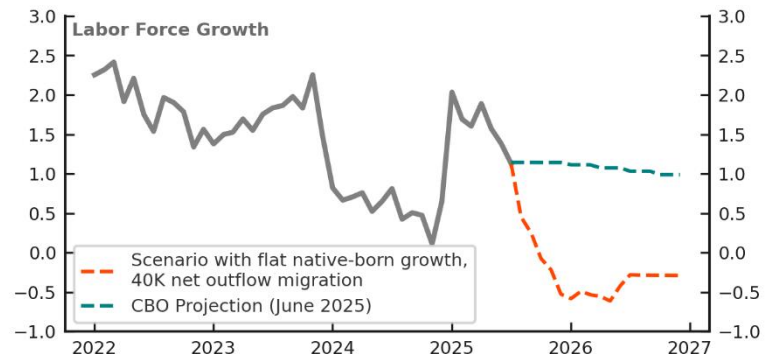
Tariff-related price increases are visible at the product level, with steel, aluminum, and other import-sensitive categories showing meaningful rises. The muted response in aggregate CPI is because the weight of these categories is small. However, seeing the pass-through is not encouraging as there are many categories with tariffs applied to them that have yet to show up. One such category is new and used vehicles — a heavyweight in the CPI — have yet to reflect auto tariffs. One likely reason: retailers stockpiled inventory before tariff implementation. However, those buffers should decline over time. Once inventories run dry, tariff pass-through will likely hit the sticker price of new vehicles.

ICE/CBP arrests on the rise while Southwest border interactions continue at historic lows



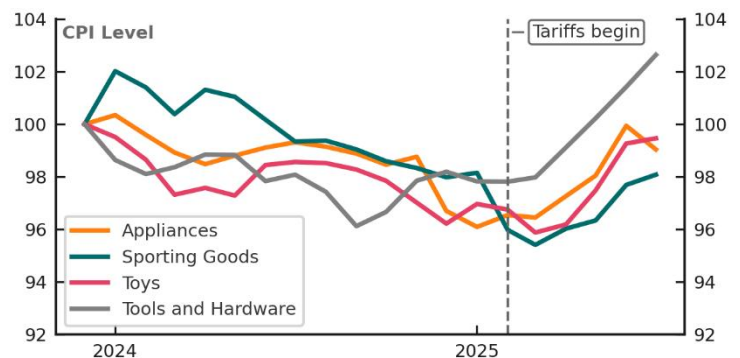
Source: US Immigration and Customs Enforcement and Border Protection

Can an outright decline in the labor force happen?



Source: BLS, CBO, BPP

The overall effect on CPI has been small but commodities exposed to tariffs still show up



Source: BLS



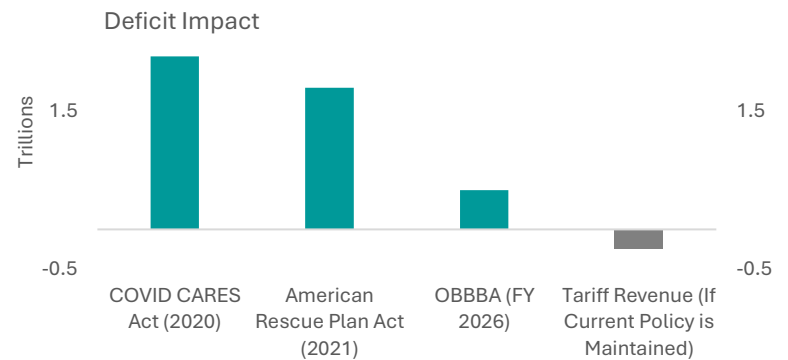
United States: Restrictive immigration, tariffs and fiscal policy threaten a more persistent inflation scenario while Chris Waller argues for an alternative

The FY2026 “Big Beautiful Bill” (OBBBA) adds roughly \$500 billion in new deficit spending — about 25% the size of the American Rescue Plan in 2021. But context matters more than size: in 2021, the economy faced 6.4% unemployment; today it’s 4.1%, well below most estimates of the natural rate. Injecting stimulus now could further fuel excess demand conditions. However, based on observed and expected tariff revenues have the potential to completely offset the deficit impact from the OBBBA.

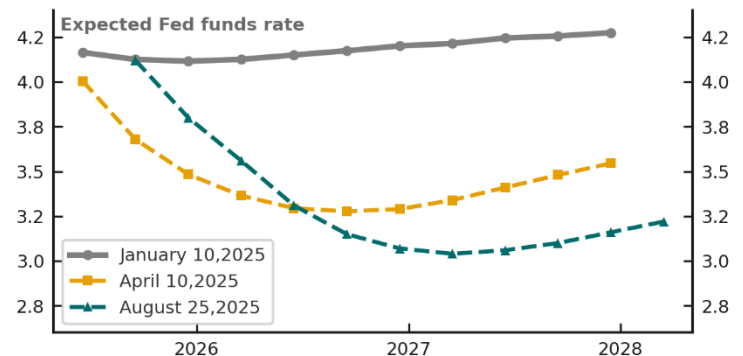
Since January, financial markets have revised the expected path of the fed funds rate substantially downward with the biggest revision happening after the announcement of widescale tariffs in April. Despite the near-term inflation risk posed by tariffs, financial markets have adopted the view that the tariff shock requires a significantly looser policy stance than previously assumed.

However, immigration-related labor shortages, and tariff spillovers when underlying inflation is already above the target may force the Fed to delay easing or even consider tightening monetary policy if inflation turns out to be more persistent.

The Big Beautiful Bill is estimated to increase deficit spending by \$500 billion next fiscal year, while if tariff revenue is maintained could raise about \$250 billion



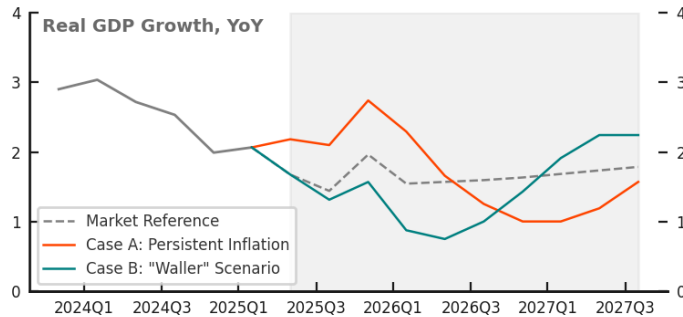
Financial markets have taken a pretty strong stance on the implications of tariffs towards easier monetary policy





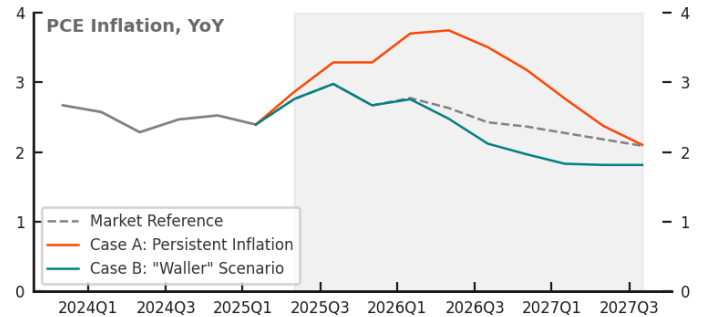
United States Scenarios: Restrictive immigration, tariffs and fiscal policy threaten a more persistent inflation scenario while Chris Waller argues for an alternative

In the Case A scenario, real GDP growth continues to exceed potential growth and labor market tightens while in the Case B scenario, the labor market deteriorates as Waller fears



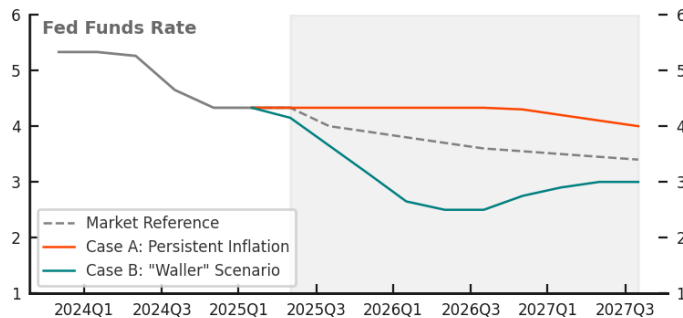
Source: Fed, BPP

In the Case A scenario, elevated wage growth exacerbates tariff-driven inflation leading to a more persistent inflation outlook. Case B assumes tariff-driven inflation will be lower and aggregate supply will exceed demand leading to faster disinflation



Source: Fed, BPP

In Case A, the Fed cannot cut interest rates for the foreseeable future to prevent the labor market from overheating while in the Case B scenario the Fed should be more aggressive to getting rates to their perceived neutral rate as described by Wallers



Source: Fed, BPP

- * The Market Reference Scenario is constructed using the Fed's median dot plot as a guide
- * Case A assumes stronger tariff-related and underlying inflation materializes. Specifically, prices move towards 3.6%, reflecting elevated sticky price inflation.
- * Case B assumes the labor market deteriorates causing a growth recession



Euro Area Current Conditions: The ECB must balance the risks from heightened global trade tensions and elevated underlying inflation

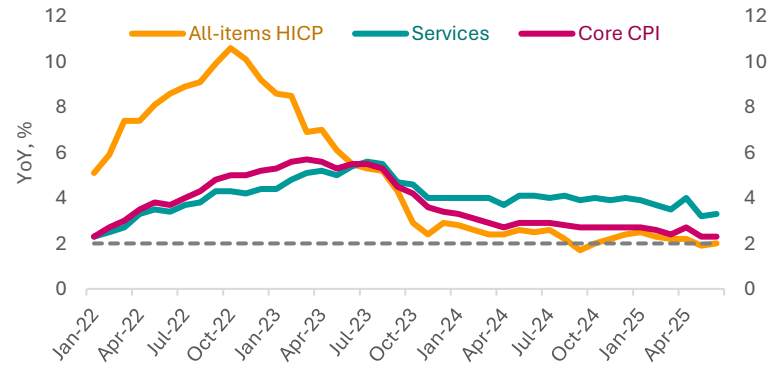
Headline inflation in the Euro Area remained unchanged at 2.0% in July, aligning with the ECB's target. Despite visible progress in headline measures, services inflation remains sticky at 3.1%, reflecting somewhat persistent wage pressures and tight labor market conditions.

While wage inflation has seen some signs of cooling, a 3.4% wage growth would still be above what is considered consistent with the inflation target. Coupled with an unemployment rate that remains at a historic low of 6.2% may suggest that wage disinflation hits a snag as tight labor market conditions take hold going forward.

GDP slowed to 0.1% in 2025Q2. Weak consumption and a decline in investment are both concerning in terms of the prospects moving into the second half of the year as US tariffs begin to weigh on exports. However, fiscal policy has turned more supportive, with Germany scaling up infrastructure and defense spending, the overall impact on growth will depend on whether momentum is maintained across countries. The scale of stimulus—estimated near one trillion euros—has the potential to lift domestic demand, but its effectiveness may be dampened if it raises the financing costs for other member states.

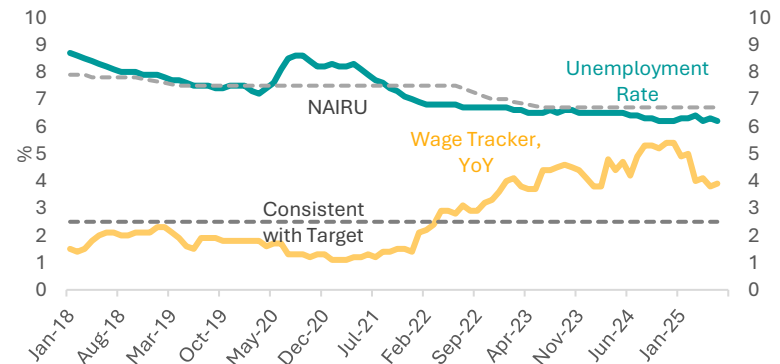
In this context, the ECB's room to ease policy hinges on how monetary policy will evolve in the US. If tariffs come into full effect and US interest rates begin to rise reflecting a more inflationary outlook, then the Euro would naturally weaken as a result. Under these circumstances a depreciation could be welcomed to help absorb the shock from tariffs however, the extent to which this is effective will depend on how well anchored inflation is to the target. Renewed inflation with tight labor market conditions could re-accelerate wage growth requiring a monetary policy response despite weak growth.

Inflation is on target, but its sustainability is challenged by persistently elevated service and wage inflation



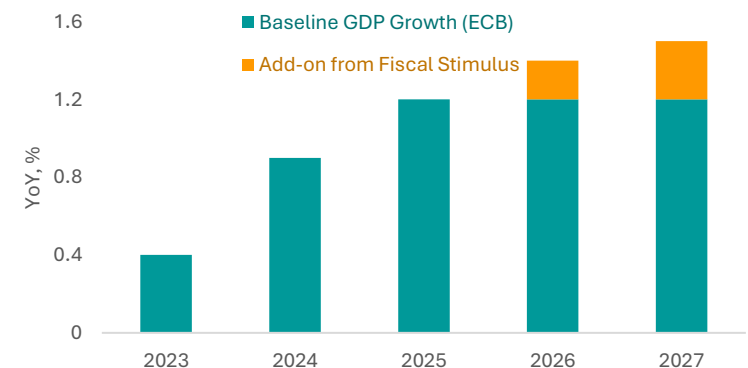
Source: Eurostat

Despite wage inflation cooling, a premium can still be observed which would be consistent with a historically low unemployment rate and a plausible estimate of the NAIRU



Source: Eurostat, FRED, BPP estimates

Germany's expansionary fiscal package in the pipeline has the potential to offset the negative effects from US tariffs



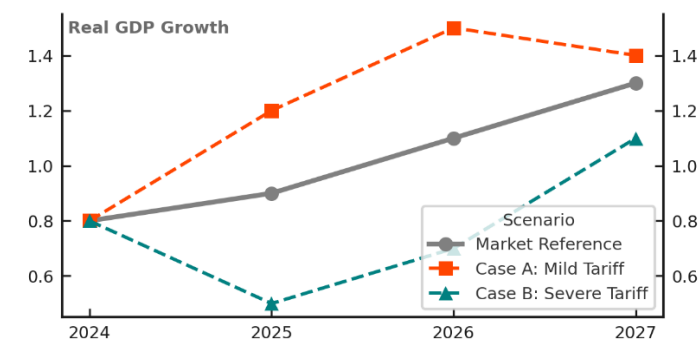
Source: ECB, BPP estimates



Euro Area Scenarios: We apply some macroeconomic consistency to ECB's June scenarios

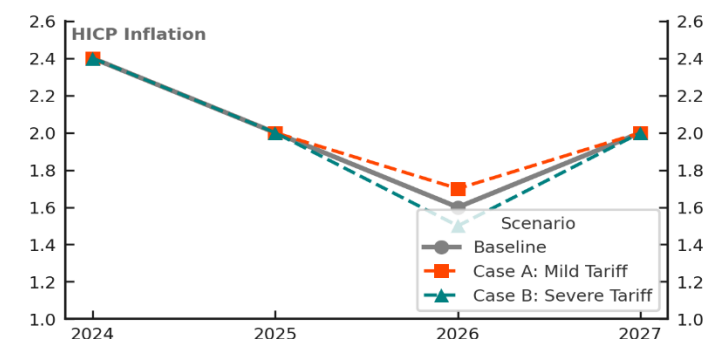
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In Case A, tariffs are assumed to have a weaker negative impact than in the market reference, which improves growth prospects; the opposite holds for Case B.



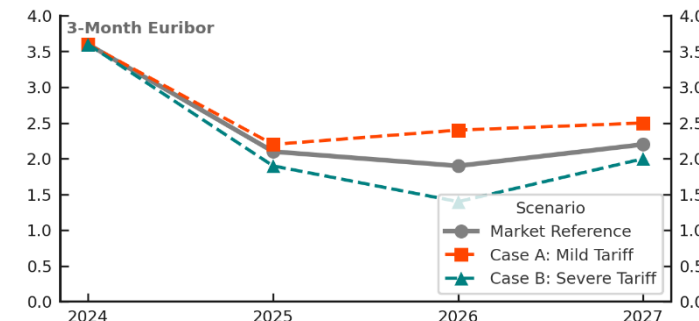
Source: ECB, BPP

Inflation rises above the market reference in Case A and below in Case B, but monetary policy responds to bring inflation back to target in 2027.



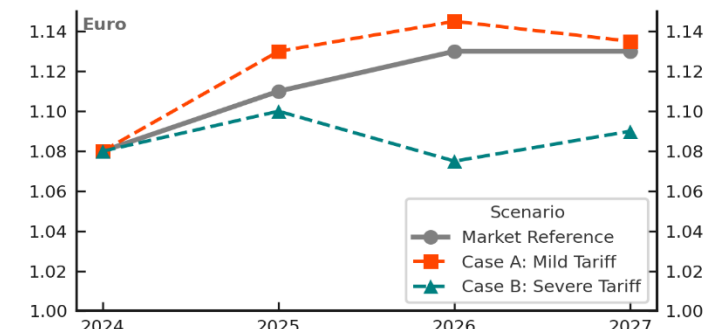
Source: ECB, BPP

The ECB responds with moderately tighter policy in Case A with the terminal rate moving towards 2.5% and in the Case B scenario, the policy rate moves towards 1.5% in 2026 to support sluggish growth and inflation.



Source: ECB, BPP

The exchange rate operates as a shock absorber in both cases; the Euro appreciates in the more inflationary scenario and weakens in the more disinflationary scenario.



Source: ECB, BPP

- * The Market Reference Scenario is taken from the ECB's baseline
- * Case A assumes the same conditions as the mild scenario by the ECB but allows the interest and exchange rate to adjust to make it more macroeconomic consistent
- * Case B assumes the same conditions as the severe scenario by the ECB but allows the interest and exchange rate to adjust to make it more macroeconomic consistent



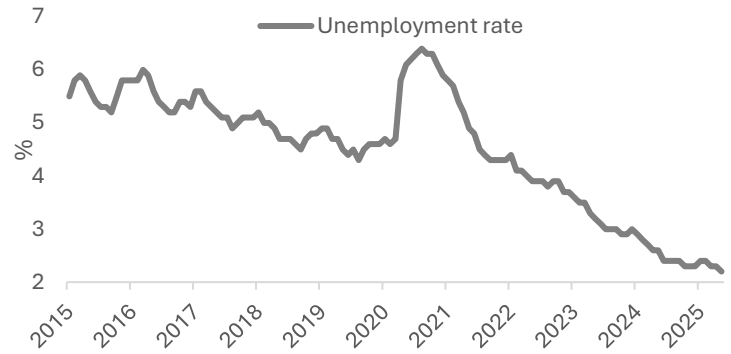
Russia Current Conditions: Tough stagflation conditions have settled in, any further deterioration in the real economy could increase non-performing loans and risk financial instability

Low real growth is expected for the Russian economy. In 2025Q2, real GDP rose by only 1.1% YoY, and more recent indicators suggest that the economy is losing further momentum entering the second half of the year. Civilian sectors—such as manufacturing, wholesale trade, construction, and extractive industries—have shown signs of stagnation or mild contraction, while defense-related production continues to dominate growth. High borrowing costs, softening external demand, and weak private sector investment are weighing on overall activity.

Inflation remains high and broad-based, with June 2025 headline and core inflation both around 9% YoY. While MoM readings show slight easing, price pressures remain widespread, especially in services and food. Meanwhile, real wage growth has fallen—from double-digit gains in late 2024 to middle single digits in 2025. This marks a deterioration in purchasing power and contributes to the stagflation scenario taking hold in the economy: low real growth, low unemployment and persistently high inflation.

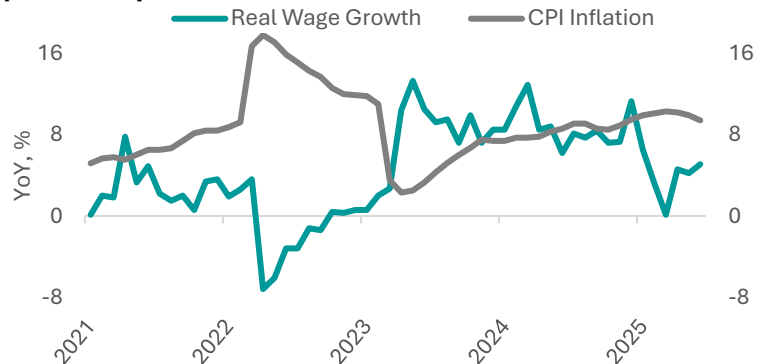
The risk of a financial deterioration in Russia is rising as the economy slows. With real GDP growth decelerating toward sub-1% levels, signs of strain are emerging in the banking sector, particularly through a rise in non-performing loans past 90 days. Historical experience shows that downturns in Russia tend to be followed by significant credit deterioration. Delinquencies in consumer lending have already surpassed 10%, and corporate credit quality is weakening. If growth continues to slow, the BoR may need to accelerate monetary easing or consider targeted financial support to prevent further stress. However, acting too quickly could reignite inflation risks or weaken the ruble. The central policy challenge is how to balance disinflation progress with early action to preserve financial stability—especially as underlying fragilities in the credit system become harder to contain.

Unemployment continues to hit record lows with stagflation threatening to become an entrenched condition



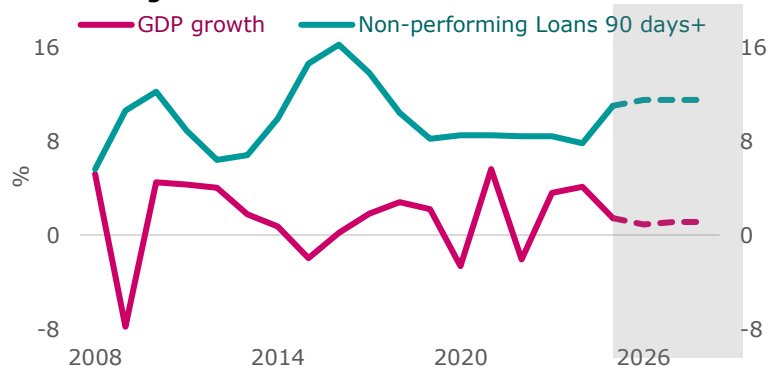
Source: Rosstat

Persistent labor shortages continue to exert wage-driven pressures on inflation without a corresponding rise in productivity



Source: Rosstat

NPLs are rising again as growth slows, signaling rising financial fragilities



Source: BoR, BPP estimates



China Current Conditions: The roadmap is clear: ease monetary policy to allow the exchange rate to act as a shock absorber to tariffs and weak domestic demand

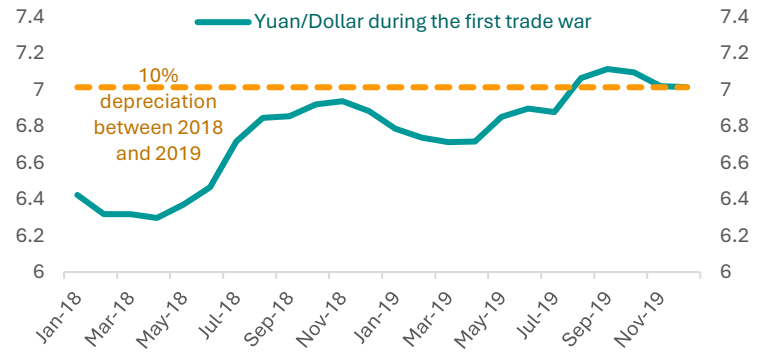
In the previous trade war with the US, the Yuan depreciated by 10% between 2018 and 2019. The extent of tariffs back then was far less severe as compared to the potential tariffs being discussed today. The 90-day truce ends on August 12 with potential for more delays but in any case, tariffs are likely to remain significantly higher.

If China was an Inflation Targeting central bank, then the path forward would be clear when facing higher US tariffs and subdued domestic demand: monetary easing that encourages the exchange rate to operate as a shock absorber. This type of macroeconomic policy would help avoid the costly alternative of re-routing China's goods to other countries at a discount.

We see a depreciation of 15% as being a possible outcome for the Yuan that helps support weaker growth and export prospects. Furthermore, the direct effect from higher imported inflation would result in about a 2 pp increase in overall inflation, something that would help raise inflation for zero.

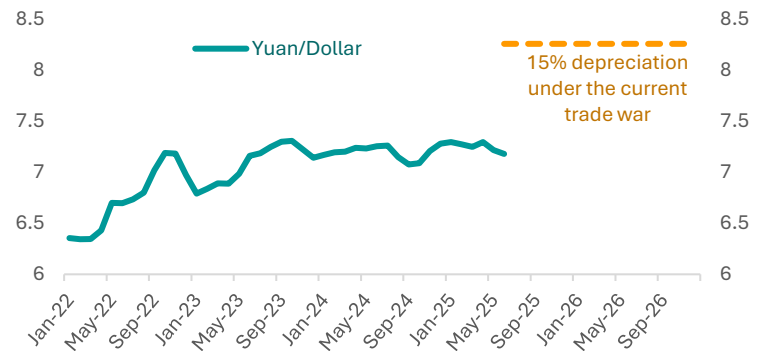
However, if China were to pursue this type of policy, then the US could merely raise the tariff rate more and we would fall back to the tit-for-tat trade war escalation experienced in April this year. Bottomline is that China still has options for managing the trade war before resorting to exporting deflation to the rest of the world.

The Yuan depreciated 10% during the first trade war in 2018 which was far less extreme than the current one



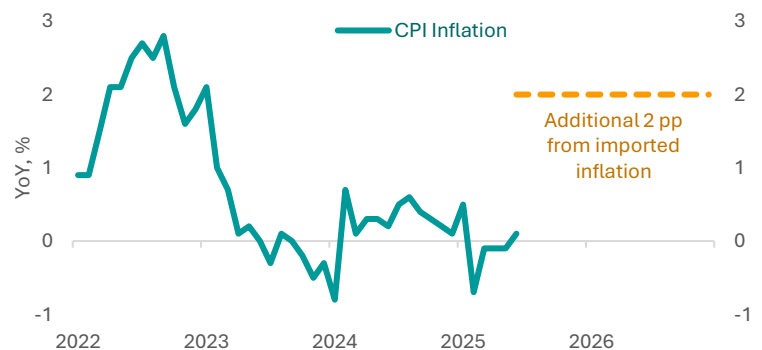
Source: Bloomberg

A weaker Yuan is perfectly natural to help absorb the negative effects from the tariffs and help raise inflation



Source: Bloomberg, BPP estimates

A 15% depreciation would also help raise inflation by about 2 pp, which has been hovering around zero for over 2 years now



Source: National Bureau of Statistics of China, BPP estimates

