UNITED STATES

GROWTH AND FULL EMPLOYMENT TESTED BY UNCERTAINTY

US growth remains robust, exhibiting strong momentum, but is still reliant on a narrow base – AI on the activity side and healthcare for jobs. The energy shock presents a new challenge, and its impact will depend on both the duration and severity of the Iran war. In any case, this situation is likely to drive inflation further above the target. Our baseline scenario projects 2.4% annual GDP growth in 2026 (down 0.3pp vs. the pre-conflict outlook) and 2.5% in 2027 (+0.3pp). Inflation is expected to reach 3.2% y/y in 2026. Against this backdrop, we expect the Fed to adopt a two-sided stance, with balanced risks around the Fed Funds rate and a hold as the baseline scenario. Tariffs continue to pose significant uncertainty, as does the trajectory of the federal deficit, which is set to widen, notably due to conflict-related outlays.

GROWTH: WILL AI-LED OUTPERFORMANCE WITHSTAND HIGHER ENERGY PRICES?

In 2026, growth should continue to be driven by the same factors as in 2025 – AI-related CapEx, wealth effects stemming from high equity valuations (until February), and healthcare outlays (up 0.4% to 6.0% of GDP in 2025, with stability expected in 2026). AI diffusion, coupled with near-stagnant employment, underpins productivity gains that significantly exceed pre-pandemic trends (2.3% y/y on average since 2023, vs. 1.4% from 2014 to 2019; see Chart 1). The Congressional Budget Office (CBO) expects productivity gains to continue in 2026 (at 2.2%). Nevertheless, growth remains narrowly based, with limited spillover effects and a "K-shaped" investment pattern (see Chart of the Week on this topic).

The Iran conflict introduces downside risks. Moreover, the US status as a net energy exporter does not fully shield its economy from the effect of higher inflation and rising costs on household purchasing power and corporate profit margins (which are already under strain due to tariffs). Consequently, GDP growth may be reduced by a few tenths in 2026, depending on the duration and severity of the conflict. In summary, the primary risk is not a shortfall relative to potential growth (1.8%), but rather a more uneven economic landscape, characterised by increasing fragility outside of AI-driven sectors.

A PUSH FOR BANK LENDING?

On 19 March, US banking regulators proposed a comprehensive review of the regulatory framework. The primary objective is to encourage banks to increase lending to households and businesses by reducing the capital requirements associated with lending activities, and to curb competition from the largely unregulated non-banking sector. While the expected benefits are unlikely to materialise in the short term (pending the finalisation and implementation of the regulations), their impact in the medium to long term may be constrained by other factors (paperwork and leverage requirements will remain unchanged, and some of the released capital could be allocated to other activities). More immediately, the uncertainties and inflationary pressures triggered by the Middle East conflict are likely to dampen credit demand. While 30-year mortgage rates had been trending downward since May 2025 (-90bp), they have rebounded by 25bp since late February, standing at 6.23% in late April. Therefore, the strong momentum observed in H2 2025 for both outstanding household loans and corporate financing flows could run out of steam.

1 Summary of Economic Projections, Federal Reserve, March 2026.

Growth and inflation

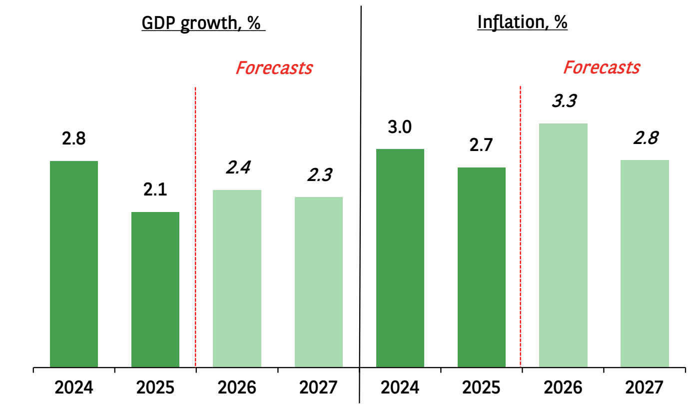

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

LOW PAYROLL GROWTH, YET FULL EMPLOYMENT PERSISTS

The labour market should remain close to full employment, with the unemployment rate hovering at 4.3%-4.4%, compared with an estimated long-term level of around 4.2%[1]. Job creation has significantly decelerated in recent quarters, deviating from the post-pandemic dynamism. In Q4 2025, non-farm payroll growth stood at 0.2% y/y, marking the slowest rate (excluding recessions) since 2003. In addition, job growth is increasingly concentrated in education and health services (682k y/y in 2025, vs. 116k aggregate; see Chart 2). Those jobs are largely non-cyclical, which is positive, yet they are also low-value-added (17% of employment, 9% of GDP). The low rate of layoffs and discharges (1.1% in 2025, unchanged from 2024) reinforces the full employment scenario. The US economy is effectively in a 'low hiring, low firing' regime, as firms are reluctant to both recruit and reduce staff amid heightened uncertainty. Consequently, a slowdown linked to the Iran conflict would likely only marginally increase the unemployment rate – by 0.1pp to 0.3pp – compared with a flat baseline scenario.

INFLATION RETURNS TO CENTRE STAGE

CPI and core CPI are set to keep overshooting the 2% y/y target, at least until 2028. The pass-through from higher oil prices, coupled with partial, but likely, second-round effects from rising production costs, is driving inflation forecasts upward. Firms have already absorbed tariff costs into their margins over the past year, leaving little scope for further absorption. The uncertainty around this outlook remains high, hinging on the trajectory, duration and severity of the Middle East conflict. Any extension or escalation would further intensify price pressures. That said, the inflationary spike is likely to be far less pronounced than in 2022, when CPI peaked at 9.1% (June). Current conditions are, in fact, less conducive to second-round effects, on both the supply and demand sides (see Chart of the Week on this topic).

FOMC: TWO-SIDED OUTLOOK, STEADY POLICY RATE

Risks appear to be evenly distributed, given expectations of a slight uptick in inflation alongside ongoing labour market concerns. In this context, we project that the Fed Funds target range will hold steady at 3.5% - 3.75% until 2027. Nonetheless, we expect the FOMC to adopt a two-sided outlook, signaling equal readiness to implement rate hikes or cuts if necessary – marking a departure from the previous downward bias. This stance would allow for a wait-and-see approach on core inflation and economic activity, while keeping market inflation expectations anchored and allowing for the possibility of a rapid policy shift.

As a result, policy will lean more on communication than on adjustments in rates. This reflects the macroeconomic conditions that prevailed prior to the shock. Compared to 2022, the policy rate is significantly higher (3.75% upper bound in February 2026, vs. 0.25% in 2022), while CPI inflation is considerably lower (2.9% y/y in Q4 2025, vs. 6.8% in Q4 2021). Furthermore, the Fed tends to react more forcefully when inflation is demand-driven rather than supply-driven (NBER Working Paper, 2026), as monetary policy tools are more effective on the latter (Powell, 2022).

Finally, the upcoming replacement of Jerome Powell (Chair since 2018) does not alter our outlook. The incoming chair, Kevin Warsh, has recently called for rate cuts, which is at odds with the "hawk" reputation he earned during his governorship (2007–2011). However, the FOMC will continue to be governed by majority rule, and we do not foresee a dovish shift unless macroeconomic data dictate otherwise (see our Eco Insight on this topic).

THE FISCAL RISK OF WAR

The US federal deficit is susceptible to a potential decline in the near to mid-term, after narrowing to -5.9% of GDP (+0.4pp) in FY 2025, bolstered by student loan reform and additional tariff revenues. The latter were expected to stabilise at around USD 300 bn annually, allowing the budget deficit to hold at -5.8% of GDP in 2026 and 2027. However, the Supreme Court's ruling that struck down "reciprocal" tariffs could trigger refunds on duties collected in 2025. At the same time, the Iran conflict is likely to exert pressure on public finances, primarily through higher defence spending, while no tangible measures to support demand have been implemented so far. The upward pressure on bond yields is set to extend, particularly on the long-end of the curve (10- and 30-year yields at 4.55% and 5.15% respectively by end-2026), notably reflecting the fiscal risk of the conflict.

Strong productivity growth is driving economic growth

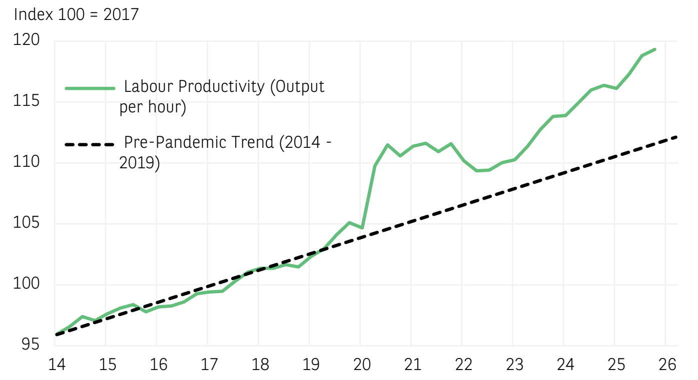

CHART 2 SOURCE: BEA, BNP PARIBAS

In summary, according to our forecasts, the federal deficit could widen to -6.5% of GDP as early as this year. Should plans to ramp up military spending materialise (President Donald Trump has called for a permanent USD 500 bn annual increase, or 1.6% of GDP), against the backdrop of ongoing war (and its associated costs), we anticipate that the deficit could exceed -8.0% of GDP by 2027. Additionally, debt-service costs, estimated at 3.3% of GDP in 2026–2027, could also rise accordingly. In any case, federal debt remains on an upward trajectory and is expected to exceed 100% of GDP as early as 2026.

FOREIGN TRADE: UNCERTAINTY PERSISTS

Following the Supreme Court's ruling that terminated both "reciprocal" and fentanyl-related tariffs, a universal 10% tariff (excluding exemptions and bilateral agreements) has been implemented under Section 122 of the Trade Act of 1974[2], in force until 24 July 2026. By then, President Trump is expected to roll out a new tariff framework: i) sector-specific measures under Section 232 of the Trade Expansion Act of 1962 (pertaining to "national-security"); and ii) country-specific measures, under Section 301 of the Trade Act of 1974 (addressing "unfair trade practices"). According to our estimates, the average effective tariff rate is expected to reach at 8.4% to 10.6% in 2026, down from 10.1% in H2 2025, yet significantly higher than the 2.3% recorded at the end of 2024. While uncertainty is set to persist (particularly regarding the future of the USMCA), the US administration appears inclined to uphold the trade agreements concluded in 2025, notably with the EU and Japan.

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Anis Bensaidani
anis.bensaidani@bnpparibas.com
Céline Choulet
celine.choulet@bnpparibas.com

2 "Section 122 authorises the President to impose temporary import duties or surcharges «[w]henever fundamental international payments problems require special import measures to restrict imports (1) to deal with large and serious United States balance-of-payments deficits" (Congress).