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The Outlook for the U.S. Economy in 2025

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Summary: *Amid much policy uncertainty, output will likely grow about 2.2% in 2025, a bit slower than in 2024. Inflation should fall gradually to 2.4%, the unemployment rate should remain unchanged, and the Fed will cut interest rates more slowly than previously expected.*

By most measures, the United States economy is in fine shape. The recession that many dreaded for 2023-24 never happened. Gross domestic product grew at accustomed rates in 2024. Though the unemployment rate increased, it remains at historically low levels. Inflation continued to fall, though not yet to the target 2%. Interest rates are higher than we're used to but are coming down. The Federal Reserve achieved its "soft landing" and anticipates more interest rate reductions in the coming year.

But prices are higher than they were. Housing is less affordable. Job opportunities in some industries have dried up. People are unhappy with the economy. They say so in surveys. They said so with their votes. They elected a new administration to shake things up. The potential for higher tariffs, deportations, tighter immigration policy, tax cuts, and large Federal spending reductions creates more than usual uncertainty for forecasts.

But that's no excuse. What might happen in 2025?

How Much Can Output Grow?

We are near full capacity. The economy can only produce so many goods and services, which limits how much people, businesses, and the government can buy. Output growth in 2025 may depend more on the availability of resources and advances in productivity than on people's willingness to spend.

If the fourth quarter is like the first three, 2024 gross domestic product will have grown 2.8% above inflation. We can break this down into four components. Working-age population grew 0.6%. The share of that population participating in the labor force rose 0.1%. The share of the labor force actually employed went down 0.5%. And productivity—output produced by the average worker—increased 2.6%. Those percentages sum to 2.8%, the rate of real GDP growth. We can project these four components to forecast growth for 2025.

Working age population growth depends on long-term fertility, which has been mostly decreasing since the end of the baby boom. It also depends on net immigration, which increased after the pandemic but seems likely to slow in 2025 if immigration policy is tightened. With immigration down, let's set the population increase at 0.3%

Labor force participation is also on a downward trend. In 1997, 67.1% of the population was employed or looking for work, and now it's 62.7%. This is mostly due to baby boomer retirements. The percentage tends to fall during recessions and rise in expansions but usually does not reach its former peak. With the expanding economy, labor force participation may rise a tick, perhaps another 0.1%.

The unemployment rate increased from 3.6% in 2023 to 4.1% in 2024. That means the "employment rate" fell from 96.4% to 95.9%. The Federal Reserve's interest rate hikes slowed the economy, as intended. The unemployment rate stabilized in the second half of 2024 in the low 4% range. It's unlikely to change much in 2025. Let's say the employment rate will be unchanged.

That leaves productivity growth, which was the biggest contributor to output growth in 2024. Productivity growth boomed from 1995 to 2005, rising 2.1% per year on the first wave of information technology adoption. Then, it slumped, rising only 1.3% per year from 1995 to 2022. In the past year and a half, though, productivity has grown at twice that rate.

More rapid productivity growth may be a blip or a trend. It may be a blip resulting from the recovery from the pandemic. But it may be a trend based on rising new business formation and a new wave of IT. Let's split the difference and put productivity growth at 1.8%, which is also the average over the past 75 years.

Adding up those four components sets real **GDP growth at 2.2% for 2025.**

Can a case be made on the spending side for 2.2% growth? Consumers remain pessimistic, though not as sour as they were at mid-year, according to the University of Michigan survey of consumer sentiment. Businesses have been ordering fewer consumer goods, which implies more pessimism about how much they'll spend. Consumer spending above inflation rose 3% in 2024. Perhaps 2% is more likely in 2025.

Real business investment rose 3.3% in 2024. High interest rates discouraged investment, but interest rates will be coming down. New opportunities in information technology may increase intellectual property investment. Housing starts were down slightly in 2024, and building permits continue to be low at the end of the year. Home building has lagged since the Great Recession of 2007-09, even when mortgage rates were very low between 2015 and 2021. Home construction seems unlikely to accelerate. Overall business investment could rise 5% in 2025.

Exports rose 4.6%, and imports rose 7.1% in 2024. A rise in U.S. tariffs would depress imports. Our trading partners would respond with higher tariffs on our exports. International trade generally would be reduced. For 2025, suppose both import and export growth are cut by half, to 2.3% for exports and 3.6% for imports.

Government spending above inflation rose 3.4% in 2024. Budgets are likely to be tighter in 2025. Federal tax cuts and efforts to reduce the budget are likely to slow Federal spending growth, and a survey of state budget officers showed reduced plans for spending among state governments in 2025. Put the overall government spending increase at 2.5% for 2025.

Slower consumer and government spending growth, somewhat faster investment growth, and both imports and exports falling are one way to get 2.2% growth in real GDP. It's a plausible forecast for output growth.

Unemployment and Inflation

At the start of 2024, according to the U.S. Bureau of Labor Statistics, businesses were trying to fill 8.7 million job openings, but there were only 6.1 million people searching for work. That's 2.6 million more openings than searchers. The labor market was very tight. In November, the most recent estimate, there were 8.1 million openings and 7.1 million searchers, a gap of one million. The labor market is not as tight as it was. The Fed's interest rate hikes were intended to cool the labor market, and they did.

Real GDP growth of 2.2% is likely to increase the number of job openings, but labor force growth will increase the number of job searchers, too. This means the 2025 unemployment rate is likely to remain unchanged, with a few small ups and downs. It was 4.2% in November. **The unemployment rate should still be 4.2% by the end of 2025.**

The 12-month Consumer Price Index (CPI) inflation rate peaked at 9.0% in June 2022. It was 3.1% at the beginning of 2024 and is 2.7% now. This is partly the achievement of the Federal Reserve's interest rate increase but mostly the result of the easing of supply chain pressures as business got back to normal after the pandemic. The New York Federal Reserve's index of global supply chain pressure has an average of zero, but it peaked at 4.4 at the end of 2021 then fell rapidly. It is -0.3 now.

The components of the CPI inflation rate are revealing. Twelve-month durable goods inflation peaked at 18.8% in February 2022. In 2024, it was -2.0%, which is less than the -0.3% rate at the end of 2019. Manufacturing productivity usually rises fast enough to reduce prices (or deliver higher quality products per dollar spent). Non-durable goods inflation peaked at 16.1% in June 2022 and is 0.4% now. It was 2.3% at the end of 2019. Non-durable goods include energy prices, which rise and fall with the price of oil. Gasoline prices are about the same now as they were at the beginning of 2024, so non-durable inflation is low.

Service price inflation peaked at 7.6% in January 2023. Now it's 4.5%, compared to 2.7% at the end of 2019. This is the component that is keeping overall inflation above the Fed's 2% target. Service inflation is dominated by the cost of housing, which the BLS measures with data on rents. Lagging residential construction has created a short supply, which is raising housing prices faster than the prices of other goods and services.

Service inflation has been falling very gradually, just half a point through all of 2024. That will likely continue. At that rate, though, it will be two more years until the overall inflation rate hits the Fed's 2% target. **The inflation rate is likely to be around 2.4% over the twelve months of 2025.**

Interest Rates

The Federal Reserve raised its policy interest rate, known as the "federal funds rate," from near zero in February 2022 to 5.3% in July 2023, a very rapid increase. It remained at that rate until September 2024 and now varies around 4.4%. The Fed cut the rate a quarter point at each of their last three meetings.

At the December policy meeting, the median projection of Federal Reserve Board members was for two quarter-point rate cuts in 2025, which would put the federal funds rate at 3.9%. This reflects a pessimistic turn in Fed opinion. In September, members anticipated four rate cuts. It's a recognition that the inflation rate is falling more slowly than expected and perhaps a hedge against possible tariff hikes from the new administration.

The yield on 3-month Treasury bills rises and falls with the federal funds rate, so expect a **3-month Treasury bill interest rate of 3.9% by this time next year.** That's a half-point decline from the current rate.

In December, the Treasury yield curve righted itself for the first time in two years. The 10-year bond yield was 4.4%, slightly higher than the 3-month yield. For two years, the short-term rate exceeded the long-term rate, which is an inverted yield curve. That's often an indicator of approaching recession, but we've avoided that. Interest rates are likely to fall with the Fed's rate cuts, but the spread is likely to keep increasing. That implies a **10-year Treasury bond interest rate of around 4.2% by the end of 2025.**

Uncertainty

This forecast will be wrong, as all forecasts are. One reason is unusually high uncertainty about policy. Tariffs might be universal or targeted, or they might be a negotiating ploy and not raised at all. If tariffs are large and general, inflation will be higher. Deportations of undocumented immigrants might be widespread or targeted at people with criminal records. Or perhaps border security and immigration rules will be tightened without many people deported. Widespread deportations would reduce the labor force, decreasing output growth and raising inflation. Bigger tax cuts would increase growth and inflation. Budget cuts would decrease growth and inflation.

Then there are the wild cards. War over Greenland and the Panama Canal. Widespread natural disasters. A new pandemic. More rapid than expected adoption of AI technology. The usual risks of big oil price changes. Plus, economic shocks that we can't anticipate.

Let's face it. Forecasting is hard.