



Strategic Analysis

July 2026

Economic Prospects for the United States: Is the Current K-shaped Economy Sustainable?

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A country's economic and financial health is largely dependent on the trends of its growth drivers, i.e., consumption, investment, government expenditure, net exports, and access to financial services.

The latest report from the Bureau of Economic Analysis (BEA) indicates that nominal consumer spending increased in May 2026 by 0.7% from the previous month, but in real terms the increase was recorded at 0.3%. As we will discuss later, the decomposition of consumers into various household categories will show a mixed picture that doesn't appear encouraging toward equality.

Recent surveys also from the Fed of NY on household spending denote a slight decrease for the first four months of this year compared to December 2025 and a small increase from April 2025 for the median household. On the other hand, discretionary spending on a y-o-y basis for April of this year declined more notably –vacation spending, for example, was at 22.6% vs 30.4% —in concert with other non-basic expenditures.

Recent findings by a McKinsey survey on consumer spending and sentiment show anxiety on uneven hiring, continued rising inflation and geopolitical instability especially for the low-income households representing the larger share of consumers who planned to cut back on discretionary product and service categories, the result of their pessimistic feelings. “The [expenditure] pullback was most pronounced among low-income consumers, though even higher-income consumers said they may cut back on ‘nice to haves’” (Adams, Alldredge and Kilroy 2026). The behavioral difference between the two groups, in some sense, confirms the currently described K-shaped trajectory economy denoting the bifurcation between segments of population relating to their respective

disposable income. We return to the K-shaped economic trajectories characterized currently in the U.S. by both household groups and businesses. The preliminary University of Michigan overall consumer sentiment index (July) showed an increase –almost 5 points, at 54.4 above expectations— as compared to the lower level recorded in the previous month (June) at 49.5, even lower than the previous trough in June 2022, while the index on a y-o-y basis was lower by 19 points reflecting price increases and the overall cost of living. The University of Michigan also cautioned that “sentiment’s upward momentum may prove difficult to sustain if recent declines in gas prices continue to reverse course.”

On the other hand, household financial health shows a complementary picture of the economic and financial condition of various groups, and the last Survey of Economic Well-Being of U.S. Households in 2025 conducted by the St. Louis Fed indicates that households reporting “doing okay financially” or “living comfortably” are limited to those with educational levels higher than the high school degree while those of low-income, young and Black adults experience declines in their well-being. To be sure, the survey records the relatively good financial health of households in 2025, but conditions for low-income, unskilled adult-households haven’t improved in the first half of this year.

On the business side, manufacturing activity growth was mixed among sectors and States; in New York State, for example, business activity showed strong growth in July of this year in concert with the climbing of the headline business condition index to 15.6, but lower than the 19.6 recorded in May 2026 which was the highest level of the last four years. Business activity in the services sector, however, declined in the Eastern States and the business climate remains below zero at -46.9 (NY Fed, The Aggregate). Similarly, the Philadelphia Fed showed an activity surge in July reaching the level of 41.4 denoting a significant expansion since November 2021.

The overall manufacturing output is, however, flat with capacity utilization at 76.1% lower by 3.3% from the long-term 1972-2025 average (Fed 2026) while the national PMI fell to 53.3 in June lower than the 54 recorded in May.

Investment is on an increasing, but uneven trend with diverging trajectories concentrating mainly on industries and corporations that relate to the development of AI at the expense of other sectors’ investment needs –another aspect of the K-shaped economy. This concentration on AI investment leads to the acceleration of equity prices of AI related corporations creating financial wealth growing rapidly from rising asset values for the cohort of its owners who maintain

consumption of durable goods—the upper part of the K-shaped economy mentioned above. The lower part of the K-shaped trajectory consists of labor-intensive and small-scale businesses that unlike AI, may face financing difficulties and thus limit their investment plans.

Government outlays are shifted to military expenditure fueled by the continuing conflicts in Eastern Europe and the Middle East and strengthening the U.S. military readiness at the expense of declining appropriations toward social protection programs including Medicare. Lastly, net exports continue the declining trend with imports outpacing exports resulting in the widening of trade deficit despite President Trump's trade protection attempts.

Inflation expectations for both the short- and long run horizons have risen given the elevated oil prices, transportation and other oil-dependent products and services. The geopolitical uncertainty about the continuing conflicts between the U.S., Israel and Iran, and Russia and Ukraine continue to create disruption in the supply chain of products highly dependent on shipping costs, bottlenecks in delivery times causing shortages of imported raw material in many industries.

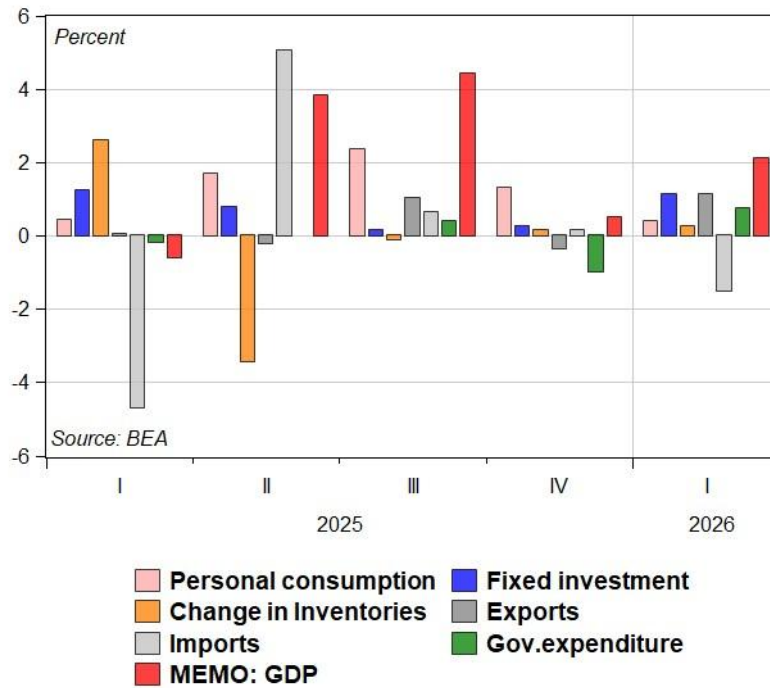
In a recent speech, Fed Governor Barr proudly reported that financial health abounds as 96 percent of adult Americans have access to a bank account marking an improvement of the corresponding 92 percent of fifteen years ago, but noted also that financial health is not only the capacity of financial access underscoring the large gap between the high percentage of access and the only 31% of Americans who felt financially healthy as reported from the Financial Health Network's annual pulse survey (Barr 2026, 2). Barr attributed the existence of the gap to factors including “income and wealth, job security,” but didn't mention the cost of tight monetary policy that keeps interest rates elevated affecting costs of borrowing. As it will be discussed later, borrowing has been increasing enhancing the challenges confronting American households.

U.S. Current Economic Conditions

The U.S. economy continued its post-Covid expanding trend recording a 2.1% annualized real GDP growth rate for the first quarter of this year significantly better than the growth rate of 0.5% in the fourth quarter of 2025 (BEA 2026).

The key drivers of growth in order of their contribution were investment, exports, government expenditures and private consumption as it can be seen in Figure 1. To be sure, GDP growth is negatively affected by imports that seem to grow despite President Trump's trade protection policy.

Figure 1. U.S. Contributions to Real GDP Growth



The trend of each of the key GDP component is depicted in Figure 2. You will notice the decline in government expenditure started last year (2025) which, if continued, could markedly affect the U.S. economy. As detailed elsewhere (Papadimitriou, et.al. 2025c), declining government expenditure can

Figure 2. U.S. GDP components

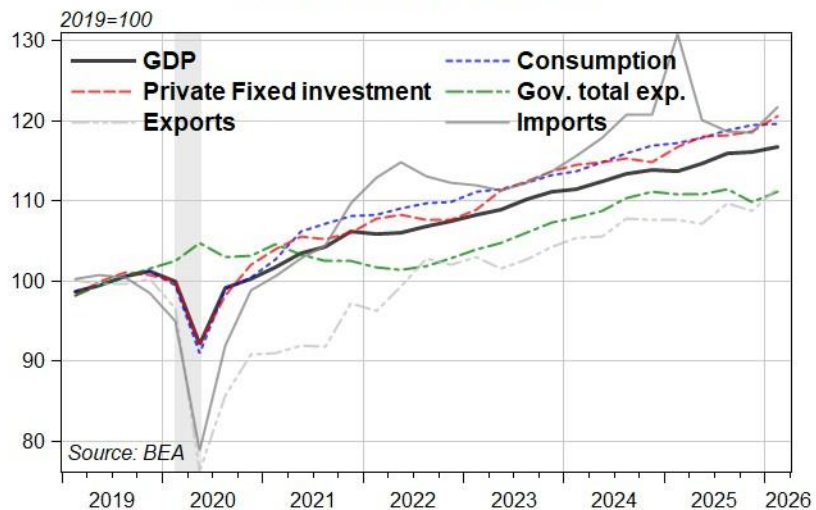
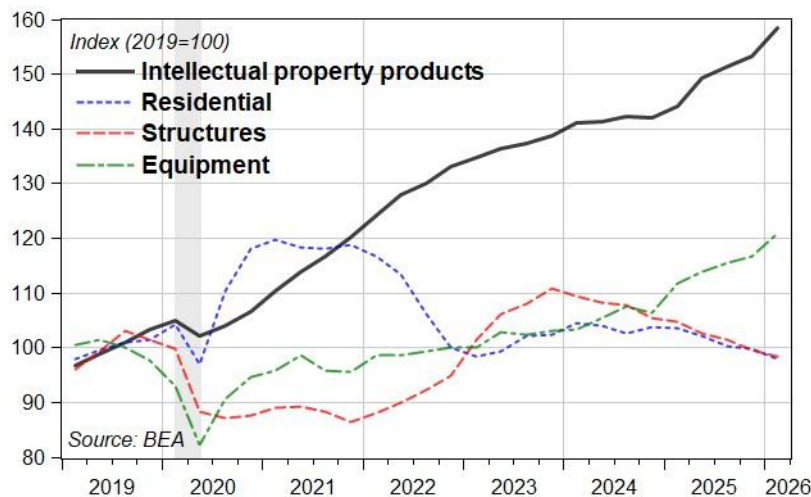


Figure 3 Private Fixed investment



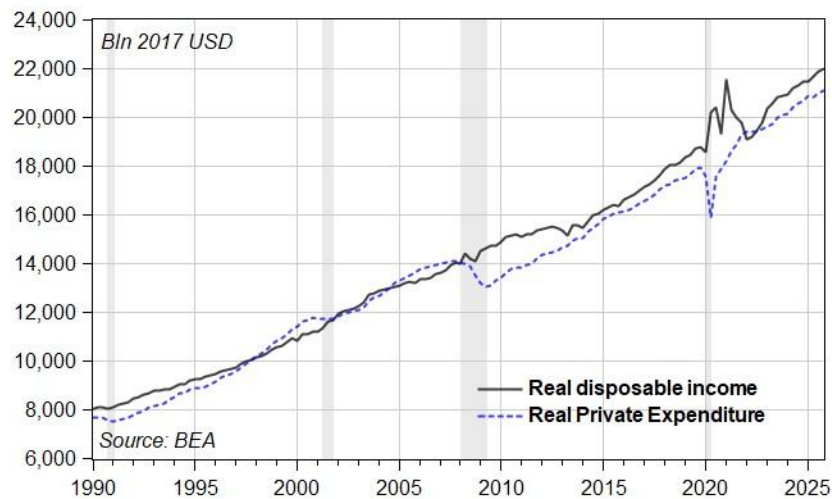
impact GDP growth as it was observed in the first quarter of 2025 most likely attributed to government cuts designed by the newly established federal agency DOGE.

In Figure 2, increasing trends are observed in private investment, exports and consumption. The more pronounced and generally increasing trend is that of imports. The dramatic spikes in 2022 and 2024-25 have come down, but the trend is still steadily increasing moving toward another spike in 2026.

Private fixed investment, a key driver of GDP growth, has since 2020 shifted its concentration substantially to intellectual property products (software and AI) as illustrated in Figure 3 which in turn, has fueled extraordinary amounts of financial investment driving equity valuations of the companies involved to unprecedented levels. Investment increases are shown in Figure 3 for equipment, especially since 2024 and continuing to date most likely relating to the economy's digital transformation, while residential investment and the "structures" category (public utilities, mining and transportation) have begun declining since 2024 for residential investment and 2023 for other structures.

Personal consumer spending is the largest component of growth accounting for the lion's share of GDP. As mentioned and illustrated in Figure 1, it has not been growing lately as in previous periods. Despite its anemic growth, real personal consumption spending is still resilient estimated to reach a level of about \$16.77 trillion in 2026 while disposable income at a level of about \$17.98 trillion (FRED 2026). Figure 4, illustrates the path of the trends of both as well as the trough in expenditure

Figure 4. Real Private Expenditure and Disposable Income



and hike in disposable income relating to the pandemic shock that reduced personal expenditures and the government's response with protection programs to stabilize disposable income.

A careful analysis of consumer spending, however, shows a mixed picture and a lot of variability among households. Given the continuing inflationary pressures, job security, slowing job hiring and geopolitical instability, spending is mostly focused on necessary goods and services postponing discretionary expenditures.

Figure 5a. U.S. Households: Consumption by Quintiles, Post 2000

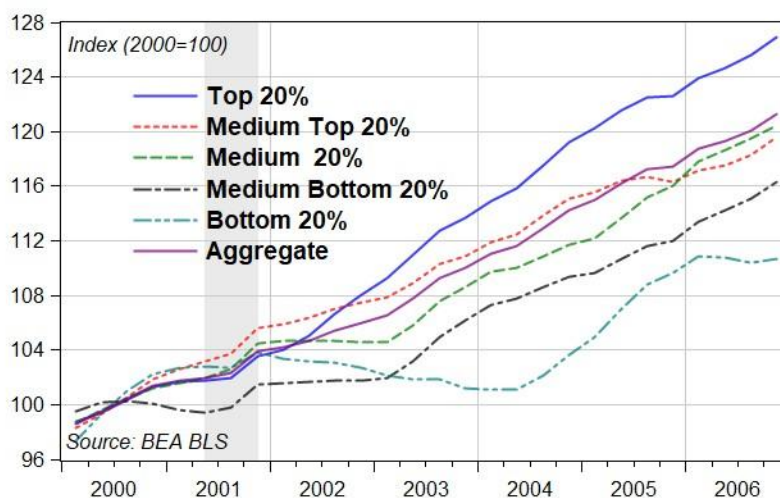


Figure 5b. U.S. Households: Consumption by Quintiles, Post GFC

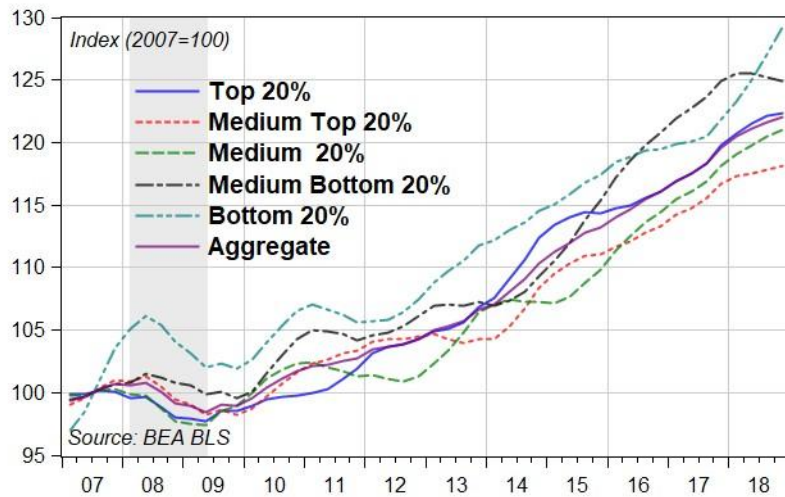
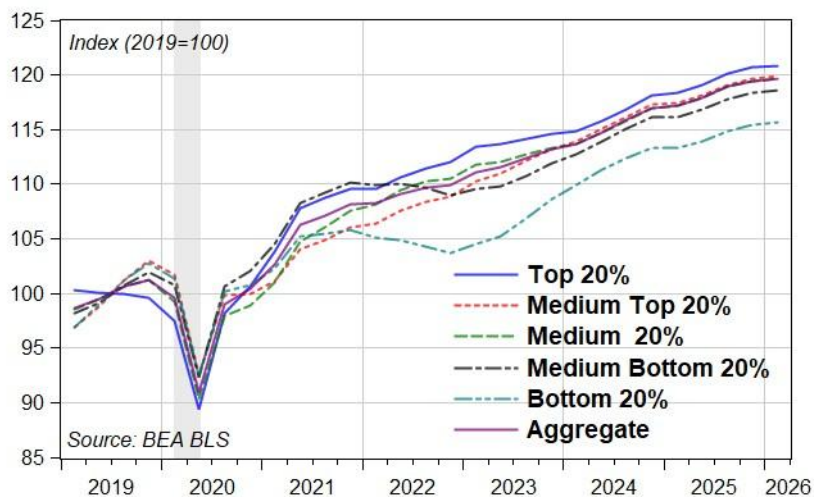


Figure 5c. U.S. Households: Consumption by Quintiles



The variability among households can be analyzed by tracking the evolution of consumption expenditures by quintiles. Figures 5a-5c demonstrate the increasing and changing patterns of consumption expenditures among income levels over the years since 2000. You will notice the bottom 20% quintile experiences a very significant gap from the top and medium top 20% and the aggregate in all periods as shown in the figures, but the medium bottom 20% has reduced the gap from the aggregate especially in the latter period since 2019 (figure 5c). It seems, therefore, that the top and medium top 20% quintiles are major drivers of consumption which most likely includes not only necessary goods and services, but also those of a discretionary nature as mentioned earlier.

An interesting question to raise is whether aggregate consumption would be dependent on the Veblenian notion of conspicuous consumption. A relatively recent paper (Ferrer, Gonzalez and Nesterova 2025) covering the 2010-18 period finds that in the US while conspicuous consumption represents a minority of total consumer spending, it is nevertheless significant accounting for (about 22%) of the average budget and includes goods and personal care serving both prestige-seeking and practical reasons. Fast forward to 2026, consumer spending in the top 20% quintile shows the same divergence as in 2018.

Overall, Figures 5a-5c significantly demonstrate the continuing maldistribution of consumption caused by the existing income inequality. It should be also noted that the periods shown in each of Figures 5a-5c represents the recovery periods subsequent to a crisis: recession in 2001, GFC in 2007-08 and the post-Covid pandemic. The bottom of the income distribution ladder experienced more difficulties in catching up to pre-crisis consumption levels than the top.

A related issue that can be raised is whether consumption and aggregate private demand is dependent on borrowing and increasing debt. Analyzing U.S. household loans by quintiles shows the top 20% to hold the major share of total loans both secured (mortgages) and unsecured (credit cards) while the bottom and medium bottom 20% have a much lower share. Debt-to-income burdens, however, faced by the lower quintiles are significantly higher and at times difficult to handle (Ruggeri, Pariboni and Yajima 2025).

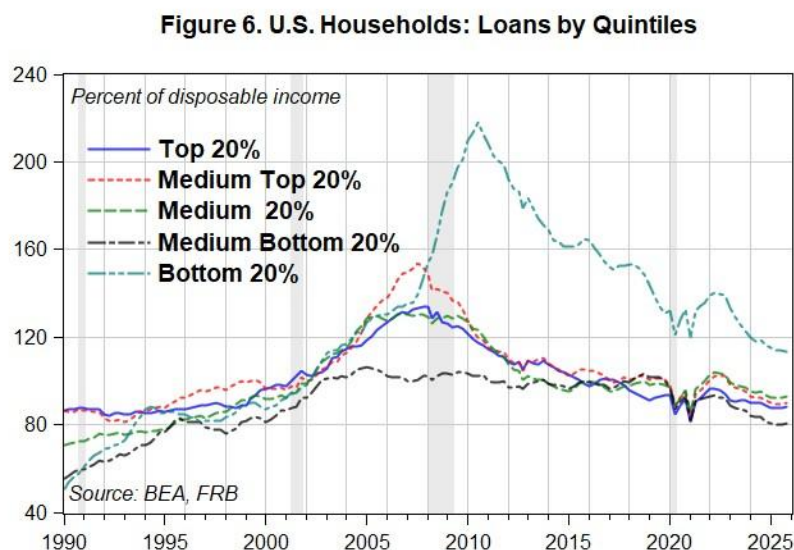


Figure 6 tracks household loans by quintiles in the U.S. since 1990. The figure shows the relative stability of debt of the lower quintiles until 2021 turning to declining trends. Recent reports from the Fed NY (2026) showed that total household debt increased by \$18 billion to a total of \$18.8 trillion in the first quarter of 2026. In the same quarter, the delinquency rates in unsecured credit (credit cards) including auto loans was reduced slightly while delinquencies on mortgages ticked up by \$21 billion reaching a total of \$13.19 trillion. Furthermore, home-equity lines of credit also rose by \$12 billion reaching a total of \$446 billion. These balances are quite large and will grow even larger if one considers the surge in new credit applications to a five-year high in June 2026 as reported in the Fed NY Credit Access Survey (2026). What is important in this survey is that loan applications for all types rose to the highest level since October 2021 and even more important the increase in loan applications to cover unexpected emergencies of \$2,000. The later demonstrates yet another affirmation of the financial fragility of the fortunes of the low-income individuals and the consequences on them of a possible financial crisis.

Exports, another component of GDP, accounted for about 11% in Q1 2026 as reported by FRED representing a small increase of 0.3% from Q4 2025 and being flat on a y-o-y basis. Exports' contribution to GDP last year (2025) was a little over \$3.4 trillion compared to \$3.19 in 2024. Imports too accounted for about -13.6% of GDP in Q1 2026 causing the long-standing trade deficit trend. Net exports for Q1 2026 showed a deficit of -2.6% of GDP a small improvement from Q4 2025.

A decomposition of the U.S. trade components is depicted in Figure 7. Services exported from the U.S continue to contribute positively to net exports and so do petroleum products, but to a much,

Figure 7. U.S. Balance of trade

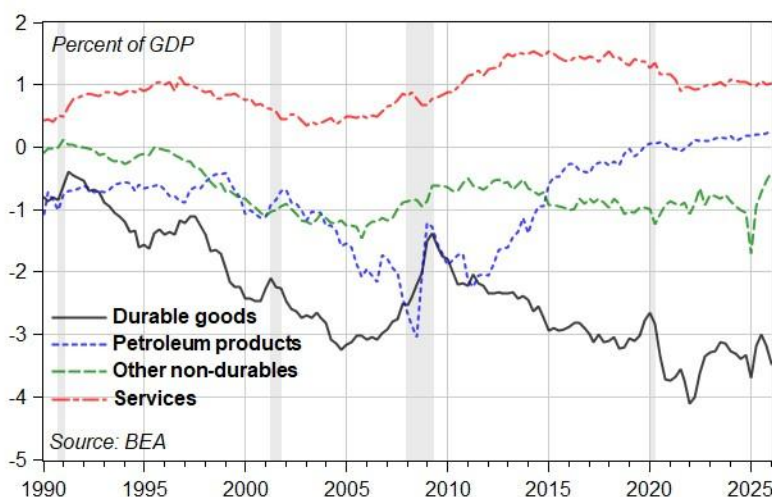
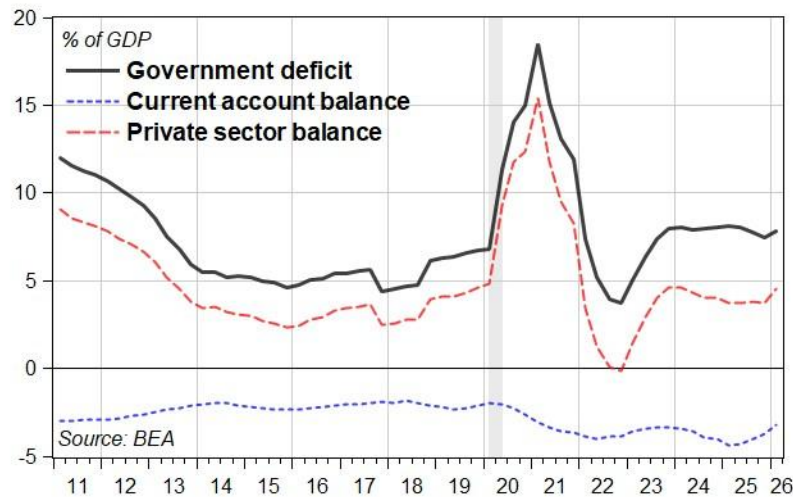


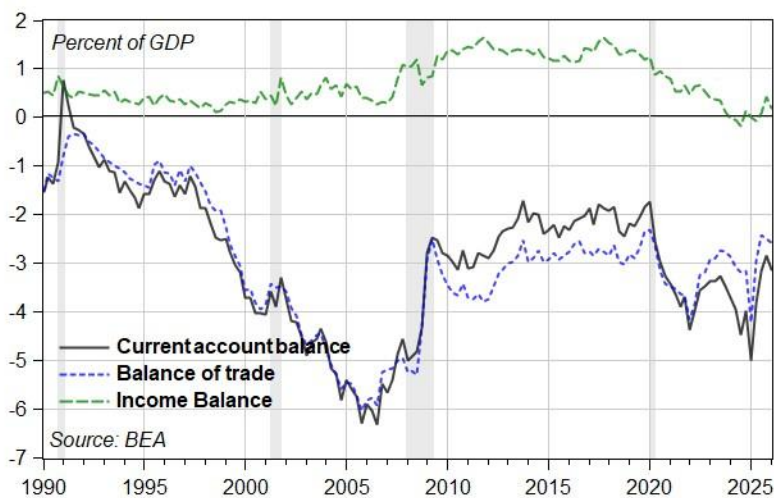
Figure 8 Financial balances



much lower extent. On the other hand, large volumes of durable goods and other durables (pharmaceuticals, other medicines, energy products) are the main imports creating the negative position of net exports. The trade deficit, in turn affects the current account balance continuing its long-term negative trend.

As we have documented in previous reports (Papadimitriou, et.al. 2024, 2025a) and elsewhere (Papadimitriou, et.al. 2025b), President Trump's frequently announced on and off tariffs have neither improved the wide trade deficit nor have helped bring jobs home to reinvigorate industrialization.

Figure 9. U.S. Balance of payments



In Figure 8 the current account balance for the U.S. in Q1 2026 is shown to be at 2.9% of GDP.

The U.S. balance of payments position is shown in Figure 9 and as reported in our previous report, the net financial investment income from abroad has been on a declining mode starting in 2016. A possible explanation might be that Americans are not as good investor as once were. The reason for the decline of foreign income may also be due to the opportunities offered in private equity investments mostly relating to AI and the U.S. equity markets showing the dramatic acceleration of value of the financial market indices achieving unprecedented levels. This acceleration primarily in companies relating to AI and the needed data centers, of course, cannot continue indefinitely and as we argue later an exogenous shock in equity market contraction could throw the U.S. and the world economy into a new financial crisis of the same magnitude and even larger as the GFC in 2007-08.

Employment, wages and the K-shaped economy

Professor Peter Atwater popularized the idea of a K-shaped economy, first used by an anonymous author in a Tweeter (now X) post to describe the uneven economic recovery between the high- and low-income individuals and households in the post-Covid period (Kelley 2025).

The high-income segment of the population in the post-pandemic period recovered much faster and more robustly (the upper arm of the K-shaped) while the low-income segments –the majority—would not (the lower arm), a condition with divergent economic trajectories as we have

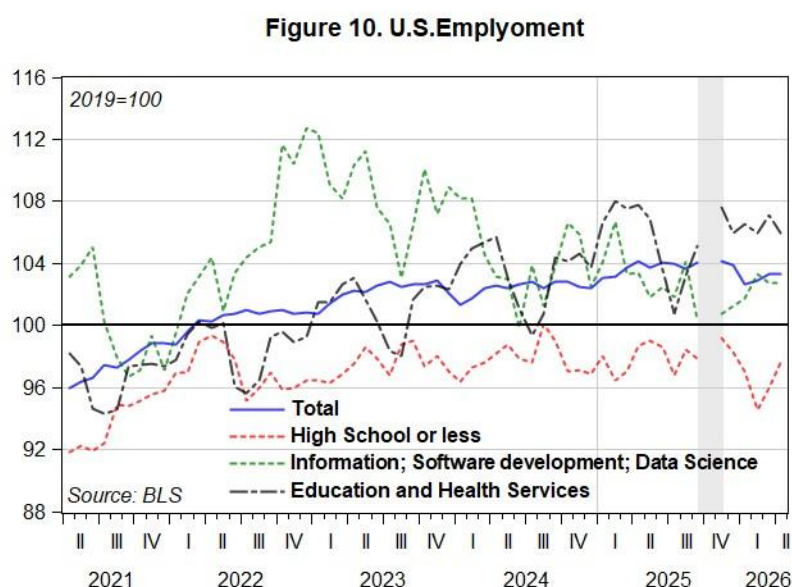
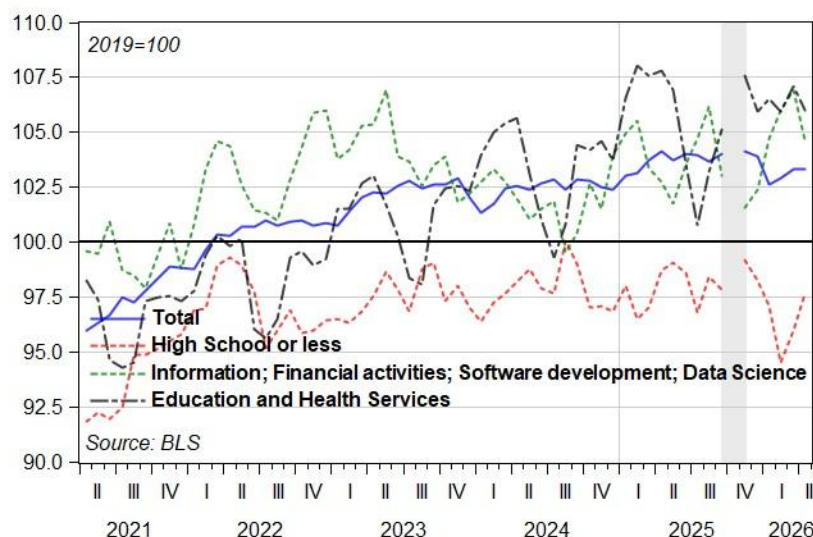


Figure 11. U.S. Employment



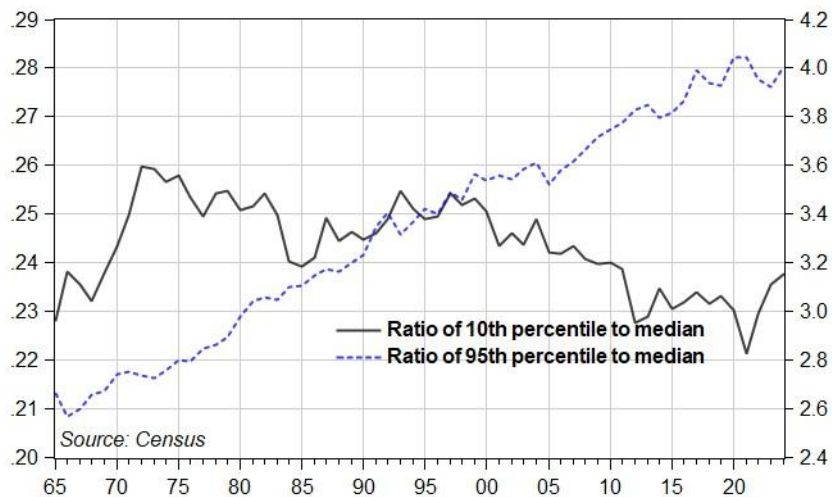
seen in consumption, emergency loans, etc. The divergence has become more pronounced when we examine the employment conditions along with the trajectory of the labor share of the Gross National Income. Employment growth as shown in Figures 10 and 11¹ has concentrated on education and health services, but also in information, software development and data sciences commensurate with acceleration of investment in this sector as we have seen in Figure 3 above leaving unskilled labor to struggle with limited employment prospects, precarious conditions of work and job security concerns.

In Figure 11, we add the financial services sector observing the significant increase overtaking the education and health services sector. Clearly, the information sector will experience a net increasing trend in job growth due to further development of AI and data sciences creating skilled jobs and eliminating others, mostly of the unskilled variety leaving the unskilled with no educational training beyond high school diploma more insecure than before. There is, therefore, an urgent need to design programs for training and apprenticeship to offset the AI-related job challenges ahead.

The K-shaped economy in the U.S. is more vividly represented in Figure 12 showing a comparison of the income conditions of the 10th and 95th percentile respectively, represented as ratios to the median income. The distance between the two is overwhelming and it is the consequence of other prevailing economic conditions in the U. S. among many the pay-productivity gap. Figure 13 illustrates the gap between wage and productivity growth.

¹ Shades in Figures 10 & 11 indicate data unavailable due to the 2025 lapse in appropriations.

Figure 12. Income distribution



These two variables are supposedly closely linked, yet as shown in figure 13, they have decoupled especially in a more pronounced manner in the post pandemic period. The pay-productivity gap ultimately reappears when we examine the labor share of the national income.

Figure 14 exhibits the declining labor share trend in the U.S., again more pronounced in the post-pandemic period. Notice the positive effects on the trend when higher government appropriations are directed to social protection programs in contraction periods and during the pandemic 2019-20. On the other hand, the other large share of the national income, profits, is recording stability of its trend as shown in Figure 15. Figure 15 also tracks the accelerated growth of

Figure 13. Real wages and productivity

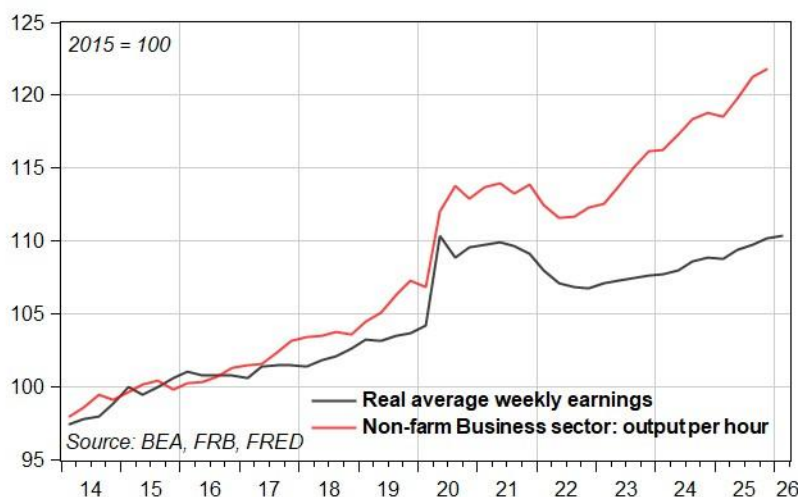
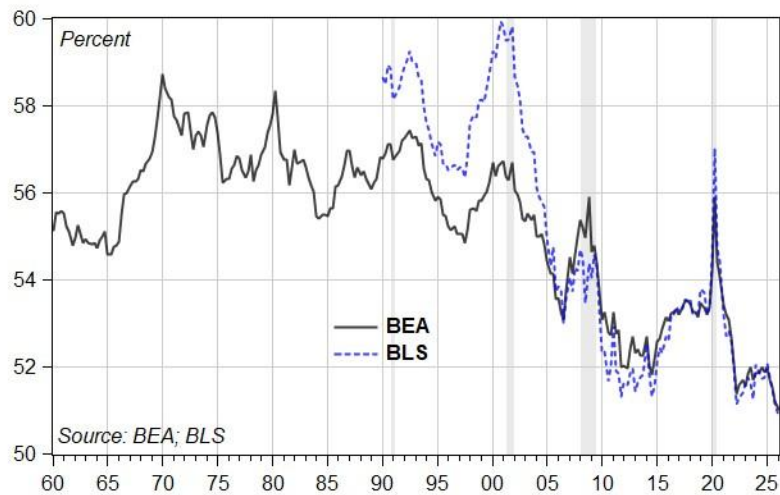


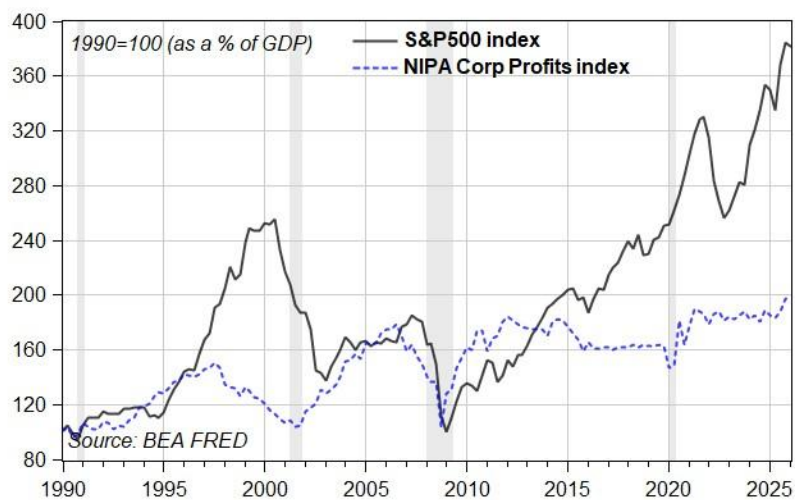
Figure 14. U.S. Labour share



the S&P 500 which benefits the upper end of the income ladder, but as we discuss later causes concern for the stability of the fortunes of the vulnerable should a severe correction were to occur as we have experienced in previous periods.

Against this background, using the by now well-established SFC Levy Economics Institute macroeconomic model, we simulate the growth trajectory of the U.S. economy in the intermediate run. As is customary in these periodic Strategic Analyses reports, we begin by determining a baseline scenario followed by alternative scenarios dependent on varying the assumptions on which the baseline scenario is determined. The alternative scenario we construct is what one might call a

Figure 15. U.S. Real S&P500 and NIPA Corporate Profits indices



Cassandra scenario which we base on a severe correction in the financial markets and a reversal of the concentration on AI both affecting private demand.

Many have likened the AI-related investments as fueling a new bubble and its ultimate bust in the order of the dot-com bubble experienced in the 1990s with severe economic consequences. The increasing trend of the S&P 500 in both the dot-com and AI current periods are shown in figure 15 causing well-founded concerns. We begin constructing the baseline scenario to which we turn next.

Baseline scenario

The baseline scenario is constructed using neutral assumptions affecting the behavioral paths of all exogenous variables during the simulation horizon. We consider both their official projected values as determined by the CBO and other forecasts and our own assumptions of their trajectories based on their most recent observed values.

First, government expenditures, in the medium-term, are assumed to follow the projected path outlined in the CBO (2026) forecast earlier this year (February). Public investment is assumed to increase at an annualized rate of 1.6% during the remainder of 2026 slowing to 0.2% in 2027 and stabilizing at a constant rate thereafter. Government social transfers are to continue expanding at their average quarterly growth rate observed during the four years preceding the COVID-19 pandemic, while government purchases of goods and services are expected to remain flat in real terms. Subsidies and unemployment benefits to be continued at their latest observed levels assuming no dramatic changes in the employment conditions despite the low expectations of job security or hiring. Government revenues are expected to increase in concert with increases of income as tax policy is assumed to remain unchanged throughout the projection period: stable direct and indirect tax rates, taxes on production and tariffs.

Second, monetary policy is assumed to continue focusing on price stability by maintaining the present regime of high interest rates. We assume the debt positions of both households and firms to be held at present high levels during the projection period implying no abnormal financial deleveraging and/or leveraging occurs.

Third, external demand is assumed to follow the projected path as determined and shown in the latest edition of the IMF's World Economic Outlook (WEO 2026), reflecting the expected evolution of economic activity of the United States' main trading partners. Moreover, exchange rates

are kept constant throughout the simulation period, while oil import volumes and several current account-related variables—including incomes and transfers from the rest of the world—remain at their latest observed values. Household transfers abroad are assumed to continue growing at an annual rate of 2%. Oil exports are projected to increase at an annualized rate of 3% and the ratio of imports of services to imports of non-oil goods remains the same in real terms.

Price increases are assumed to continue the current upward trend for the rest of year. Both the GDP deflator and the government expenditure deflator to increase at an annual rate of 3% until the first quarter of 2027 and then begin to come down gradually to 2% for the remainder of the simulation period. Commodity prices, oil prices, and export prices to follow similar trends, experiencing a temporary period of relatively rapid growth before stabilizing at lower rates in concert with the expected return to normal international inflationary pressures. Financial asset prices are assumed to increase moderately, with stock prices increasing at an annual rate of approximately 2%, while house prices rise modestly until early 2027 before stabilizing in real terms. Government capital consumption and the operating surplus of public enterprises are likewise assumed to grow temporarily before stabilizing.

The baseline scenario incorporates a gradual return to normal monetary conditions. Both the federal funds rate and the average interest rate on government debt are assumed to rise during the initial phase of the projection period before declining after the first quarter of 2027 with inflation easing, capturing the scenario described in the June FOMC meeting whereby monetary policy continues its restrictive stance initially, followed by a progressive easing (FOMC 2026).

Finally, population growth is assumed to hold stable at the average rate observed during the previous sixteen quarters with absent changes in employment rates, while residual GDP components are held constant over time.

Our baseline scenario projections along with the comparable projections of CBO, FOMC and IMF are shown in Table 1 that follows:

Table 1. United States: Real GDP projections

<i>Annual growth rates</i>	2026	2027	2028
<i>Baseline scenario (Levy Institute)</i>			
Real GDP	1.95	2.27	2.26
Private expenditure	1.72	2.67	2.75
Government expenditure	0.19	0.10	0.00
Exports of goods and services	0.44	0.30	0.32
Imports of goods and services	-0.37	-0.80	-0.82
<i>CBO (February 2026)</i>			
Real GDP	2.36	1.86	1.81
Private expenditure	1.81	1.78	1.61
Government expenditure	0.27	0.04	0.00
Exports of goods and services	0.14	0.26	0.24
Imports of goods and services	0.15	-0.22	-0.05
<i>FOMC (June 2026)</i>			
Real GDP, Median	2.20	2.30	2.20
<i>IMF (July 2026)</i>			
Real GDP, Median	2.32	2.20	2.10

Source: Authors' calculations

The baseline projections as shown in the table track closely the medium-term real GDP growth rates provided by the FOMC and the IMF. It deviates from the CBO growth rates and in addition reflects the assumed differences in the composition of aggregate demand.

Notice our baseline scenario projects a GDP growth rate for the current year of 1.95%, rising to 2.27% in 2027 and 2.26% in 2028. The corresponding growth rates projected by the CBO are more

optimistic for the current at 2.36%, but pessimistic for the next and following year at 1.86% and 1.81% respectively.

The differences in the growth components center first, on government expenditure which we project will contribute 0.19% to GDP growth in 2026 as opposed to the higher assumed contribution of 0.27% in the CBO forecast while the differences for the following year to be in the opposite direction: our baseline 0.10% contribution while only 0.04% in the CBO.

Both projections (baseline and CBO) assume government makes no significant contribution for the next following year 2028.

Second, export demand contribution to GDP growth we assume to be at higher rates (0.44%, 0.30%, and 0.32% for the respective projection years) than the corresponding CBO estimates (0.14%, 0.26%, and 0.24%).

Third, the behavior of imports is assumed in our baseline to subtract a higher proportion of GDP growth in all years of our projection period (0.37%, 0.80%, and 0.82%) than the assumed effects in the projections of CBO especially in 2027 and 2028.

Lastly, private expenditure, the principal driver of economic activity throughout the projection horizon, contributes 1.72% to GDP growth in 2026 increasing to 2.67% and 2.75% in 2027 and 2028 respectively exceeding the corresponding CBO estimates (1.81%, 1.78%, and 1.61%).

The significant differences in private expenditure are the main cause for the deviation of our baseline growth projected rates from the corresponding rates in the CBO: lower rates in both private expenditure and growth for the current year in our baseline than the CBO that projects higher rates in both and a rather significant increase in private expenditure, assumed in our baseline, for the latter two years contributing higher growth as opposed to the CBO lower rates in both. The increased rates of private expenditure compensate, to a large extent, the stronger drag from the increased imports allowing aggregate growth to be above the CBO projected lower growth rates in 2027-28.

The baseline scenario assumes the economy proceeds on its current trajectory in the proverbial “business as usual” mode. As indicated above, we are particularly concerned with the unprecedented increases in the U.S. equity markets exhibiting what appears to us as “irrational exuberance” and agree with similar concerns raised by the captains of the finance industry. In the words of Jamie Dimon, CEO of JPMorgan, stating in an interview that “When I look at AI itself, the amount of money being

spent is huge.....Will it pay off the way you expect in the timetable you expect? Definitely not” (Hollerith 2026). Based on these concerns we undertake the construction of an alternative scenario.

Alternative Scenario

Unlike the established tradition followed in previous reports, where alternative growth scenarios are simulated reflecting changes in the fiscal policy stance to reflect additional government expenditure for public programs of various kinds including greening of the economy transition programs, funding infrastructure deficits or changing tax revenues, the alternative scenario, in this report, is designed as a stress test on the resilience of the economy rather than a projection exercise.

In the alternative scenario we adjust a number of the assumptions of the baseline. The purpose of this stress test is to assess the effects on the economy should an adverse yet plausible macroeconomic shock occurs—a dramatic stock market correction—and the likelihood of the economy being thrown into recession. We examine, specifically, the consequences of a sharp reversal in private demand following the exceptionally strong recovery observed after the COVID-19 pandemic. The results should therefore be interpreted as illustrating the transmission mechanisms and potential macroeconomic effects of such a shock, rather than as the most likely future path of the economy.

The motivation for this exercise stems from recent concerns that the current expansion of private expenditure may prove difficult to sustain. In particular, the rapid increase in investment

Figure 16. U.S. S&P500, Mag 7 Net Income indices

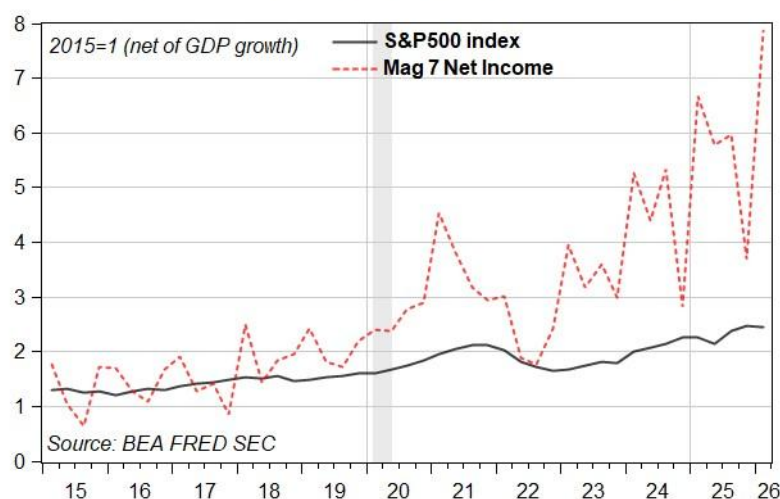
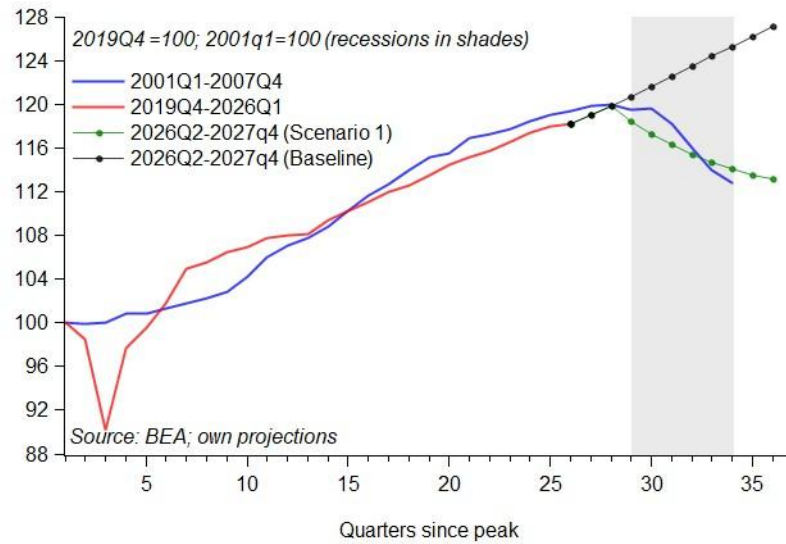


Figure 17 Private Expenditure Recovery since recessions, 2000s and 2020s



associated with artificial intelligence, together with the strong appreciation of financial asset prices, has raised questions about the sustainability of the excessive market optimism and asset overvaluation (Papadimitriou 2026). Nersisyan and Wray (2026) argue that the current AI-driven boom exhibits several characteristics reminiscent of previous episodes of financial exuberance, while the Bank for International Settlements (BIS 2026) similarly highlights the increasing disconnect between financial valuations and macroeconomic fundamentals. The dramatic increased and unstable trend of the main players –magnificent 7—in AI development is shown in Figure 16 confirming the disconnect referred to by the BIS.²

We compare the historical trends of real private expenditure recoveries following the Global Financial Crisis and after the COVID-19 recession. As shown in Figure 17, the two episodes display remarkably similar trajectories during approximately the first twenty-eight quarters following the cyclical trough. In the earlier episode, however, the expansion came to an abrupt end with the onset of the financial crisis in 2007. Building on this historical analogy, the scenario assumes that private expenditure begins to follow the same adjustment path experienced during the 2007–09 crisis once the current expansion reaches a comparable stage. To distinguish historical observations from simulations, solid lines represent the observed private expenditure indices for the two recovery

² Magnificent 7 includes Apple, Amazon, Alphabet/Google, Meta, Microsoft, Nvidia, Tesla-

episodes, while dotted lines show the simulations of the baseline projection and alternative stress-test scenario.

Table 2. United States: Alternative Scenario GDP projections

	2026	2027	2028
Real GDP (% growth rate)	1.63	-0.99	-0.61
Government balance (% of GDP)	-9.67	-10.93	-11.41
Government primary surplus (% of GDP)	-5.51	-6.40	-7.12
Government debt (% of GDP)	128.06	136.06	145.15

Source: Authors' calculations

Table 3. Alternative Scenario: Differences from baseline

	2026	2027	2028
Real GDP (% growth rate)	-0.31	-3.26	-2.87
Government balance (% of GDP)	-0.13	-1.54	-2.78
Government primary surplus (% of GDP)	-0.12	-1.36	-2.44
Government debt (% of GDP)	0.44	5.70	11.86

Source: Authors' calculations

This scenario reproduces not only the contraction in aggregate demand, but also the deterioration in financial conditions that characterized the Global Financial Crisis. In addition, it incorporates a decline in stock prices consistent with the magnitude observed during the earlier (GFC) episode.

The fall in equity prices reduces household wealth and further weakens private demand, reinforcing the contraction in consumption and investment through the financial channels embedded in the model. From the third quarter of 2026 onward the path of real private expenditure is adjusted to mirror the pace of deceleration observed after the Global Financial Crisis, while stock prices are simultaneously shocked to replicate the historical correction in financial markets. All exogenous variables—including fiscal policy, external demand, commodity prices, exchange rates, and monetary policy—continue to follow the assumptions of the baseline scenario.

The macroeconomic implications of the stress-test scenario are reported in Table 2. The contraction in private expenditure, reinforced by the decline in stock prices, is sufficient to push the economy into recession without discretionary fiscal adjustment or adverse external shocks. As shown in Table 2, real GDP growth slows to 1.63% in 2026, before turning negative at -0.99% in 2027 and -0.61% in 2028. Relative to the baseline, this represents a cumulative deterioration of 0.31, 3.26, and 2.87 percentage points, respectively, illustrating the central role of private expenditure in sustaining aggregate demand in the U.S. economy (Table 3).

An important implication of the simulation in this scenario concerns the behavior of the public finances. In the present framework, neither government deficit nor public debt are imposed exogenously. Instead, both variables emerge endogenously from the interaction between macroeconomic activity and the sectoral accounting identities. As economic activity weakens, tax revenues decline while transfers and other countercyclical outlays increase, leading to a deterioration of the fiscal balance even though fiscal policy itself remains unchanged. Consequently, the overall government deficit widens from 9.67% of GDP in 2026 to 10.93% in 2027 and 11.41% in 2028, while the primary deficit increases from 5.51% to 7.12% of GDP over the same period.

The deterioration of the fiscal position is accompanied by a substantial increase in the public debt ratio. Government debt rises from 128.1% of GDP in 2026 to 136.1% in 2027, reaching 145.2% in 2028. Compared with the baseline scenario, the debt ratio results almost 12 percentage points higher by the end of the simulation horizon. These results indicate that recessions can rapidly generate sizeable increases in both fiscal deficits and debt ratios even in the absence of discretionary fiscal stimulus, simply through the operation of automatic stabilizers and the endogenous decline in government revenues.

This perspective differs from much of the recent literature on U.S. fiscal sustainability, where increases in public debt are typically generated by exogenously assumed expansions in government expenditure or persistent primary deficits (Smetters and He, 2026). In contrast, the present exercise highlights the reverse causal mechanism: a collapse in private demand itself can produce a rapid deterioration in public finances, as it was the case during previous recessionary episodes. From a stock-flow consistent perspective, the worsening of the fiscal balance is largely the consequence—not the cause—of the recession.

Whether higher public debt subsequently translates into broader macroeconomic effects depends critically on the financing conditions under which Treasury securities are rolled over. In

particular, if financial markets continue to absorb government liabilities without requiring a substantial increase in interest rates, or if the Federal Reserve is willing to stabilize Treasury markets through its balance sheet operations, the principal macroeconomic consequence of the recession remains the collapse of private expenditure rather than the increase in the debt ratio itself. Conversely, if higher debt were accompanied by a persistent increase in borrowing costs—especially on debt held by foreign investors—the recessionary effects could be amplified through higher interest payments and weaker domestic demand. In this sense, the current stance of the new Chair of the Federal Reserve who has signaled the need to reduce the size of the Fed balance sheet and hike rates to combat inflation might prove more destabilizing than anything else – as again happened in the past (Papadimitriou and Wray 2021).

Concluding remarks

The U.S. economy is continuing on its established, but uneven post-pandemic growth path of around 2%. The economic and financial conditions among individuals and households diverge significantly worsening the maldistribution of income. Reviewing the fortunes among households, we observed the widening gap between the top 20% quintile with the bottom 20% confirming once again the K-shaped economy started in 2020. This phenomenon can be seen from a variety of variables be they consumption, stagnant wages, employment growth and decline of skilled and unskilled, increasing emergency loans and labor and profit shares of the national income. The observed trajectories of these variables point to the worsening economic conditions of the low-income families while the haves do quite well. Government expenditure is focused mainly on expanding the military complex including the huge amounts of funding to cover the costs related to the conflict with Iran and anti-immigration enforcement policy while social protection programs have either been or scheduled to be cut including Medicare.

The trade protection policy of the current U.S. Administration with frequent announcements of on and off tariff implementation isn't delivering improvements in the trade deficit which is still very large while investment income from abroad has ceased to improve the current account balance of payments. Significant investments are concentrated on software development relating particularly to AI and data sciences and data centers which from the positive side have increased exports somewhat, but on the negative, they are fueling a new stock market bubble in the order or even larger of the dot-

com bubble. Many concerns have been raised affecting private equity funds loaded with AI investments wishing to diversify, but are faced with unwilling buyers.

In this report, we use the existing economic conditions to draw assumptions on the behavior of the public and private sectors enabling us to run simulations of the likely path of GDP growth in the intermediate run (2026-28). Our projections differ significantly from those provided by the CBO, but are in line with those recently published by the last FOMC meeting and the IMF. Following our usual practice, we provide an alternative set of projections based on the possibility of substantial decline in private demand should an exogenous macroeconomic shock hit the economy such as an AI bust causing a large financial crisis of the GFC variety.

The outcome of this alternative scenario, unlike the alternative scenarios of our previous reports, provides a stress test on the resilience of the U.S. economy to meet the challenges of a severe exogenous shock. The results are unfortunately discouraging; the economy will be thrown into a recession and once again fiscal and monetary policy will need to rescue it. The world climate, at present, is fragile with an unstable situation in the Middle East which is not going well while the oil markets are changing daily. The choppy waters in the financial markets show that investors recognize pockets of overvaluation with AI investments and are beginning to unwind. We hope fiscal and monetary policies become more in tune with the risks entailed on the AI gold rush.

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