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IN FOCUS

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Risks to the 2024 Economic Outlook

The economy in 2023 was characterized by high but falling inflation, a tight labor market, and moderate to high growth. Many economists predicted that monetary policy tightening by the Federal Reserve (Fed) would result in a recession in 2023, but that did not come to pass. While inflation is still not back down to the Fed's target, and the path of interest rates remains uncertain, many economists are no longer forecasting a recession in the coming year. (For more information, see CRS In Focus IF12543, *Has the Federal Reserve Achieved a Soft Landing in 2023?*, by Lida R. Weinstock and Marc Labonte.)

The 2024 consensus forecast, as is typically the case, predicts a fairly moderate path for the economy. When the economy suddenly strays from a moderate path, it is often because of economic "shocks"—surprise events that could positively or negatively affect growth. The pandemic was a recent and extreme example of the effects that unexpected shocks can have on the economy.

Some surprises, such as COVID-19, cannot be predicted ahead of time. But there are a few risks to the 2024 forecast that are more visible at this point. This In Focus details selected risks to the economy in the coming year. For more information on the state of the economy in 2023 and moving forward, see CRS Report R48054, *State of the U.S. Economy: Policy Issues in the 118th Congress*, by Marc Labonte and Lida R. Weinstock.

Geopolitical Risks

Geopolitical risk is a common source of macroeconomic disruptions. Ongoing foreign wars could lead to new disruptions in commodity prices or supply chains. For example, recent supply chain disruptions due to attacks on ships in the Red Sea have increased shipping costs and have some economists worried about a resurgence in supply-driven inflation.

Rebalancing Risks

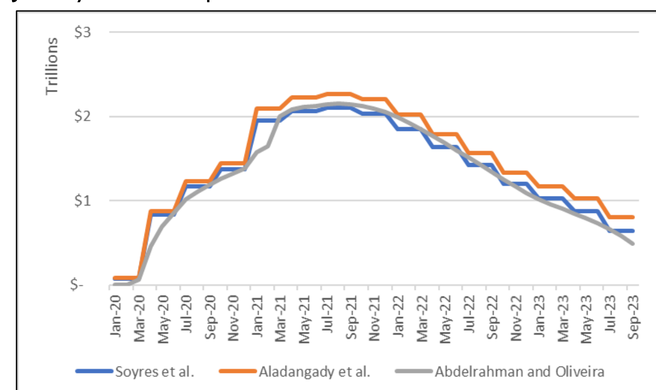
Other risks are related to the rebalancing of the economy following the pandemic disruption, including the shift from a very low interest rate environment to the highest interest rate environment that the economy has experienced since before the 2008 financial crisis. There are risks that borrowing or investment positions that were viable when rates were lower are no longer viable now that rates are high. This poses a downside risk to the economy, because businesses and consumers may reduce spending more than expected in response to higher rates, or financial institutions may experience higher losses than expected.

Another rebalancing risk is that consumers could retrench on spending due to the strain on their finances as they exhaust their surplus savings from the pandemic and resume student loan payments that were frozen during the 2020-2023 moratorium. CRS estimated that at least 38 million borrowers with $1.4 trillion in student loans outstanding had interest accrual paused during the moratorium. (For more details, see CRS In Focus IF12472, *Federal Student Loans: Return to Repayment*, by Alexandra Hegji.) Nevertheless, according to Wells Fargo, various analysts saw little macroeconomic impact because the impact is relatively concentrated, with a relatively small number of borrowers with large balances. An Oxford Economics estimate forecasts that the end of the moratorium will reduce gross domestic product (GDP) growth by 0.1 percentage points (pp) in 2023 and 0.3 pp in 2024, and Goldman Sachs forecasts that it will reduce consumer spending by 0.2 pp and GDP by 0.1 pp in 2023.

One study found that most of the stock of excess pandemic savings has been drawn down, falling to about 10% of annual disposable income in the second quarter of 2023 after peaking at around 14% at the end of 2021. The personal saving rate (i.e., the flow of new savings) has averaged between 3% and 5% of disposable personal income since 2022—very low by historical standards. As the stock of pandemic surplus savings is exhausted, the saving rate may rise back to historical averages, causing spending to fall. The effect on spending may be tempered by the fact that almost half of excess savings was held by households in the top income quartile at the end of 2022, according to one estimate.

Figure 1. Estimates of Pandemic Excess Savings

January 2020 to September 2023



Source: Data taken from FEDS Notes, *An Update on Excess Savings in Selected Advanced Economies*.

Note: Each line represents a different estimate of excess savings based on researchers using three different methodologies.

Financial Risks

In terms of higher interest rates and financial conditions, there are a number of risks.

First, the Fed reports that asset prices are currently high relative to fundamentals. Financial asset and house prices have been resilient to higher rates overall so far. Asset values should fall (all else equal) when rates rise, because future cash flows are worth less on a present discounted value basis. Other market forces may be affecting asset values, causing some to hold value. For example, house prices are likely holding value as a result of lagging supply conditions in the housing market. (For more information, see CRS Report R47617, *U.S. Housing Supply: Recent Trends and Policy Considerations*, by Lida R. Weinstock.) There are multiple explanations—rational and irrational—as to why asset prices are high relative to fundamentals, but it increases the risk that asset prices may fall. A sudden and steep decline in, say, stock prices or house prices could potentially undermine consumer, business investment, or residential investment spending. Falling asset prices have been a cause or at least a feature in multiple past recessions, most starkly in the 2008 financial crisis, which demonstrates that in the worst-case scenario, falling asset prices can cause financial instability.

Second, household and business debt grew when rates were low and liquidity was overly abundant. Higher rates increase the costs of debt service, which might cause financial stress for debtors or lead them to reduce their consumption spending. Nonfinancial business debt peaked relative to GDP in 2020 and remains higher than it has been in previous decades. Debt service costs for these businesses were low following the pandemic because rates were low, but they are now rising. Household debt is lower than during the financial crisis but higher than in the 1980s or 1990s relative to GDP, and households are no longer benefiting from pandemic debt relief programs, such as the student loan moratorium discussed above. Loan delinquencies and defaults are low but are now rising across a number of asset classes.

Third, financial institutions may realize higher-than-expected losses on their asset holdings as a result of high interest rates, slower growth (in a soft-landing scenario), or specific problems in narrower sectors. For example, three large banks failed in 2023 in part because high rates led to losses on debt securities or mortgages they held and because deposits were less "sticky" and plentiful in a higher-rate and tighter-credit environment. A key feature of the 2023 bank failures was large and sudden deposit outflows, particularly by uninsured depositors.

Other banks face similar challenges, with falling asset values and rising delinquency rates. Further failures could potentially disrupt financial stability, or further losses could lead to a reduction in the availability of credit through "leveraged losses." Banks and some other financial intermediaries are leveraged, meaning that their debt levels greatly exceed their equity levels. Losses can force such intermediaries to sharply reduce their lending in order to maintain a stable relationship between their debt and equity. If losses reduce equity and the institution cannot or does not want to raise more equity, then the institution's overall balance sheet must drop by a multiple of that loss to maintain existing debt-to-equity ratios. If the institution were already at its mandatory minimum equity level, then it would not be allowed to increase its leverage.

One sector of particular concern is commercial real estate (CRE). The pandemic resulted in a structural shift away from in-office work, resulting in high vacancy rates for this segment of CRE that persist today. Due to the convergence of work-from-home policies and other economic pressures, many companies that would typically rent space from the office subsector of CRE owners are not renewing their leases. This is evidenced by office vacancy rates, which hit all-time highs earlier this year. Consequently, office property leases have fallen, generating lower revenues from rent, potentially imperiling the ability of the property owners to pay back financing costs. To minimize losses, some CRE owners have been willing to break leases and renegotiate terms with tenants.

Such stress in the office subsector might stress banks that hold a significant amount of CRE debt on their books. As of January 2024, banks in total hold around $3 trillion in CRE debt, with some banks having more concentrated holdings than others. CRE mortgages are financed on shorter terms than are residential mortgages, often with balloon payments due at maturity. Trepp, an industry analysis firm, estimates that $544 billion in CRE loans will mature in 2024, with a little more than half of that coming from bank and thrift loans. Further, regarding the retail subsector, many tenants—some of whom were also affected by post-COVID-19 structural shifts—are considering whether or not to renew their leases. A loss of rental income would lead to higher default rates among CRE owners. This is compounded by the coinciding maturities of many CRE mortgages, which will accelerate defaults if rental income cannot sufficiently offset the balloon payment obligations or if alternative financing cannot be procured. (For more information, see CRS Insight IN12278, *Bank Exposure to Commercial Real Estate*, by Andrew P. Scott; and CRS Insight IN12283, *Commercial Real Estate Markets and Potential Macroeconomic Stress*, by Lida R. Weinstock and Andrew P. Scott.)

Finally, the long-term relative shift in credit provision from banks to nonbank financial institutions (sometimes called "shadow banking") since the 2008 financial crisis may have increased or decreased systemic risk in unpredictable ways, in part because it has reduced risk transparency.

Interest rates and economic conditions cause—and are caused by—each other (i.e., they are "endogenous"), so high rates will not necessarily result in a recession. If growth falters because rates are high, rates are likely to fall, especially if inflation becomes well contained. If rates fall, the pressures on borrowers and financial institutions described in this section would somewhat subside. Therefore, a sudden and unexpected shock (e.g., a failure that leads to broad financial turmoil) is more likely to lead to a recession than is the gradual and orderly adjustment to higher rates.

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