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State of the U.S. Economy: Policy Issues in the 118th Congress

April 30, 2024

Congressional Research Service

<https://crsreports.congress.gov>

R48054



State of the U.S. Economy: Policy Issues in the 118th Congress

The onset of the COVID-19 pandemic caused the most severe shock to the U.S. economy since the Great Depression, with a 28% annualized quarterly decline in output and a 14.7% unemployment rate. The U.S. economy then experienced an extraordinary recovery, with a rapid rebound in output and employment in the second half of 2020 and 2021. Unprecedented fiscal and monetary stimulus helped make this rebound possible, but the recovery was imbalanced—demand rebounded more quickly than supply, as supply disruptions continued after the economy reopened and were then exacerbated by the Russian invasion of Ukraine in early 2022. This imbalance was reflected in the highest inflation rate since the 1980s in 2022 and an unusually tight labor market in 2022 and 2023.

In response to high inflation, the Federal Reserve (Fed) began rapidly raising its benchmark short-term interest rate in March 2022 and continued increases through July 2023, with rates reaching their highest levels since 2001. Tighter monetary policy and the end of supply disruptions led to a rapid cooling of inflation in 2023. Residential investment (home construction) is lower than it was before rates started rising, but other interest-sensitive spending has thus far remained resilient. Nevertheless, higher interest rates and other post-pandemic rebalancing in the economy pose various recession risks.

Historically, tighter monetary policy has sometimes resulted in recessions, and many economists feared that tighter monetary policy would trigger a “hard landing” in 2023—a return to recession. The Fed believed it could engineer a “soft landing”—a return to low inflation through a moderation of economic growth and better balance in the labor market. To date, inflation has improved but has not returned to the Fed’s 2% target, so it is too soon to declare success. After declining rapidly in 2023, inflation rose in the first quarter of 2024. It is also not clear if economic growth or the labor market have cooled off enough to reach a sustainable trend consistent with a soft landing. Job growth moderated in 2023 but was still relatively high, and economic growth was strong in the second half of 2023. Further progress toward price stability may be difficult if the economy is running too hot, and the potential for the economy to overheat poses a risk of a hard landing. GDP growth was more moderate in the first quarter of 2024, but job growth remained relatively strong, growing by over 250,000 jobs each month from December 2023 to March 2024.

The Fed believes that interest rates have peaked and expects to begin reducing interest rates in 2024 once it has more evidence that inflation is returning to its 2% target. Fed Chair Jerome Powell recently signaled that the rate cuts the Fed previously thought likely in 2024 were on pause until inflation makes further progress toward price stability. If no further progress is made, the Fed may eventually need to revisit whether additional rate increases are necessary to achieve 2% inflation. In that case, the longer it waits, the more rates may ultimately need to be raised. Congress could consider less stimulative fiscal policy to help ensure a soft landing. Although the federal budget deficit has declined from pandemic-era highs, it is still unsustainably high, because debt is projected to continue to grow more rapidly than economic output.

R48054

April 30, 2024

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Introduction

The U.S. economy has endured historic turmoil in recent years. The COVID-19 pandemic introduced a significant shock to the economy and briefly resulted in the deepest U.S. recession since the Great Depression. Spurred by unprecedented fiscal and monetary support, aggregate demand (overall spending) recovered relatively quickly, while disruptions to supply were longer lasting. The pandemic, further economic shocks in 2021 and 2022, and the fiscal and monetary policy response resulted in significant shifts in economic conditions compared to pre-pandemic trends. Notably, the economy in 2023 and first quarter of 2024 was marked by an unusually tight labor market and high inflation. To rein in inflation, the Federal Reserve raised interest rates swiftly and significantly in 2022 and 2023, leading to some concern that the Fed would overshoot and cause a recession (a “hard landing”). However, such a recession has not materialized, leading to speculation that the Fed might successfully rein in inflation without causing a recession (a “soft landing”).

This report discusses the current state of the economy and economic policy, the likelihood of recession in the coming year, and fiscal and monetary policy options in the near term.

Economic Overview

The principal economic indicators measuring output and the labor market point to a strong economy at present. Numerous other indicators not discussed in detail in this report tell a similar story, although some sectors are stronger than others, which is typical during economic expansion. After being unusually high in 2021 and 2022, inflation has fallen to more typical levels but remains above the rate associated with price stability.

Economic Growth

One of the main metrics economists use to judge the state of the economy is real (inflation-adjusted) gross domestic product (GDP), a measure of total spending in the U.S. economy on the part of consumers, businesses, the government, and foreigners.¹ **Figure 1** shows annualized quarterly GDP growth over the past several years. The decline in GDP from the pandemic was sudden and significant: The 28% decline in the second quarter of 2020 was the largest quarterly decline ever recorded.²

As shown in **Figure 1**, despite the deep recession in March and April of 2020, the economy bounced back relatively quickly,³ and growth was significantly above trend, largely due to “catch up” growth at 5.8% in 2021.⁴ GDP fell in the first two quarters of 2022, leading to some concern that the economy may have entered a recession,⁵ but growth then picked up to a moderate pace

¹ Unless otherwise noted, all references to GDP are in real and not nominal terms.

² The GDP series produced by the Bureau of Economic Analysis (BEA) goes back only to 1947, so it is possible that the quarterly decline in Q2 2020 may have been eclipsed by a decline during the Great Depression, which took place in the 1930s.

³ For comparison, real GDP did not surpass its pre-recession peak for three years following the start of the 2007-2009 recession and financial crisis.

⁴ Average growth for the decade prior to the pandemic was about 2%.

⁵ Although two consecutive quarters of negative growth is an informal rule of thumb for identifying recessions, recessions are officially declared by the National Bureau of Economic Research (NBER), which did not consider this episode to be a recession. Other indicators considered by the NBER, such as employment, did not decline in this (continued...)

more in line with the historical average in the second half of 2022 and first half of 2023. GDP growth then accelerated in the second half of 2023, resulting in a 2.5% increase for the year as a whole, compared to a 1.9% increase in 2022.⁶ Overall, GDP growth in 2022 and 2023 was comparable to the 2000s and 2010s expansions and slower than expansions before that. The advance estimate for GDP growth was 1.6% in the first quarter of 2024.

The 2023 increase in GDP was driven by increases in personal consumption expenditures (2.2%), nonresidential fixed investment (4.5%), government spending (4.1%), and exports (2.6%). These increases were somewhat offset by decreases in residential fixed investment (-10.6%) and the change in inventory investment (-65.9%).⁷ All told, GDP growth was relatively strong in 2023, particularly given tightening monetary policy, as discussed in a subsequent section. In particular, personal consumption expenditures (consumer spending) grew at a moderate pace, which is significant given that higher interest rates tend to dampen spending.

The Q1 deceleration in growth was driven largely by decelerating but still strong personal consumption expenditure growth (2.5%), decelerating growth in government purchases (1.2%), and falling net exports (imports rose 7.2% while exports rose 0.9%). Private investment growth accelerated, and of note, residential fixed investment picked up noticeably compared to 2023, growing at 13.9% in the first quarter. Inventories continued to be a drag on growth.⁸

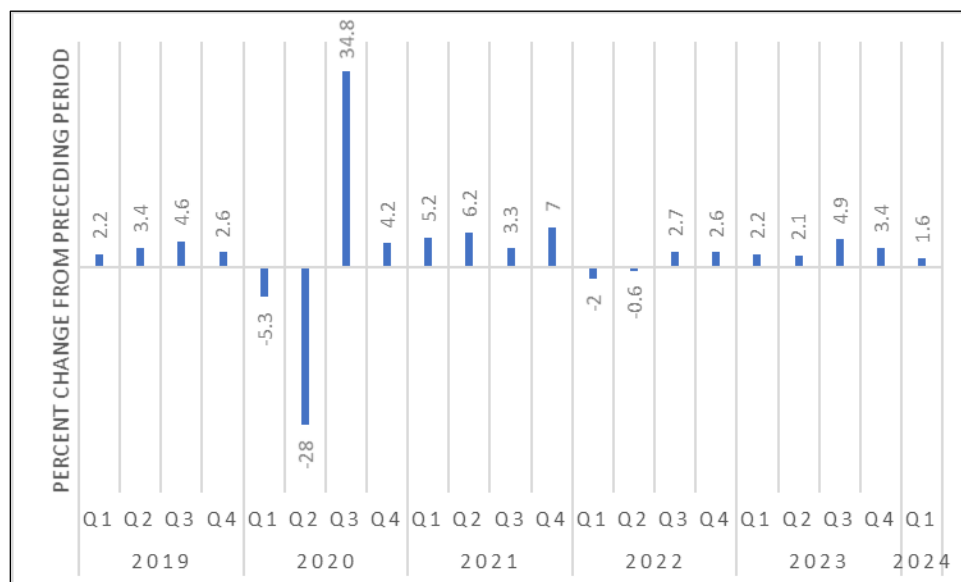
period. For more information, see CRS In Focus IF10411, *Introduction to U.S. Economy: The Business Cycle and Growth*, by Lida R. Weinstock.

⁶ In the National Income and Product Accounts framework, output (GDP) should be exactly equal to income (gross domestic income, or GDI). But because the two are measured from different surveys, there is always a statistical discrepancy between the two. Recently, GDP has grown more quickly than GDI has, leading to questions about which of the two measures is giving a more accurate portrait of economic activity. For more information, see Manuel Abecasis, “Making Sense of the GDP-GDI Gap,” Goldman Sachs, February 11, 2024.

⁷ BEA, “Gross Domestic Product (Third Estimate), Corporate Profits, and GDP by Industry, Fourth Quarter 2023 and Year 2023 (Advance Estimate),” March 28, 2024, <https://www.bea.gov/sites/default/files/2024-03/gdp4q23-3rd.pdf>. CRS calculated the -60.5% change in private inventories (CPI) using BEA real GDP in chained dollars data. The decrease in CPI in 2022 compared to 2023 indicates that inventories accumulated less in 2023 than they did in 2022. For more details, see BEA, “Chapter 7: Change in Private Inventories,” in *National Income and Product Accounts Handbook*, updated November 2019, <https://www.bea.gov/system/files/2019-12/Chapter-7.pdf>.

⁸ BEA, “Gross Domestic Product, First Quarter 2024 (Advance Estimate),” press release, April 25, 2024, <https://www.bea.gov/sites/default/files/2024-04/gdp1q24-adv.pdf>.

Figure I. Real Gross Domestic Product Growth
Q1 2019-Q1 2024



Source: Bureau of Economic Analysis (BEA).

The Labor Market

The labor market has followed a similar pattern to GDP since 2020, with a large initial contraction following the onset of the pandemic, a relatively swift recovery, and sustained strength thereafter. The unemployment rate was low by historical standards throughout 2023, while the economy added jobs at a rapid pace (according to one measure, as discussed in the next section) and the size of the labor force increased. Nonetheless, there are signs that this labor market with a low unemployment rate may be too strong to be sustainable. Jobs have been unusually plentiful by historical standards, according to a number of different metrics, which is typically positive for workers but may also be pointing to labor demand (employers' desire to hire workers) that is exceeding labor supply (workers available to fill jobs). In order for unemployment to stay low while jobs continue rising at their current pace, the size of the labor force (i.e., the labor supply) would need to continue to grow faster than the adult population is growing, which is not certain at this point. Otherwise, the market could only come back into balance through a decrease in labor demand, which would result in fewer job openings, slower job growth, and possibly higher unemployment. How this gets resolved in the coming months will likely be an important factor in determining whether the economy experiences a soft or hard landing, as discussed in a later section.

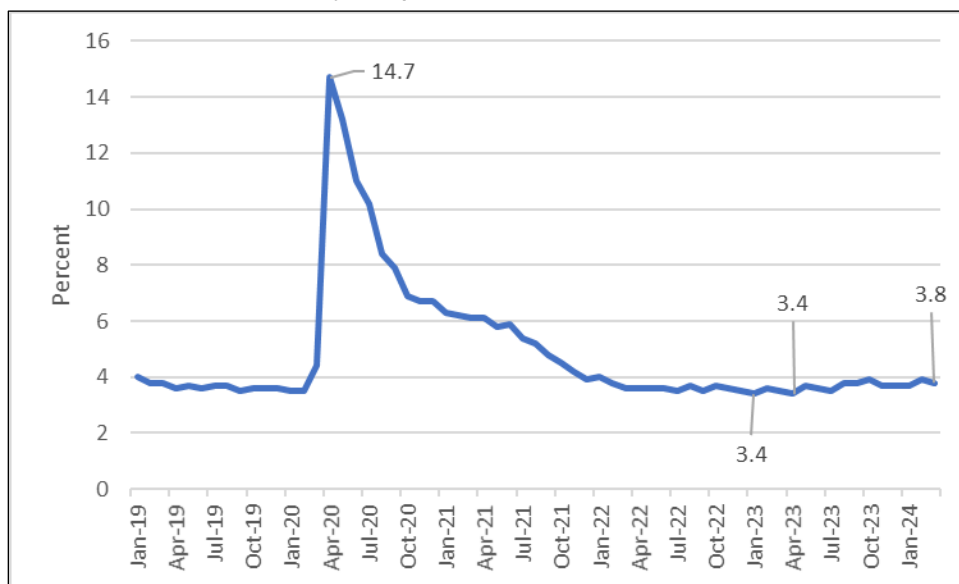
Employment and Unemployment

The labor market recovered quickly from the initial shock of COVID-19. As shown in **Figure 2**, unemployment (which measures how many people are currently looking for work but do not have jobs) hit 14.7% in April 2020, the highest rate seen since the Great Depression, but fell quickly beginning in the second half of 2020 as the economy started to reopen, and it has been below 4% since December 2021. The March 2024 unemployment rate is up to 3.8%, from lows of 3.4% earlier in 2023, but still low by historical standards. The decline in unemployment has been broadly based demographically, though certain racial disparities remain. For example, while the

unemployment rate for Black and Hispanic workers reached their lowest levels on record in 2023, as of March 2024, the unemployment rate for Black and Hispanic individuals, 6.4% and 4.5% respectively, was higher than the overall rate (3.8%) and the rate for White and Asian individuals (3.4% and 2.5%, respectively).

Figure 2. Unemployment Rate

January 2019 to March 2024



Source: Bureau of Labor Statistics, Current Population Survey.

Typically, if the economy were adding jobs at a brisk pace, the unemployment rate would be falling. Instead, it has stayed relatively constant for over two years. This is partly attributable to a rise in labor force participation, but there is also conflicting data on how quickly employment is growing.

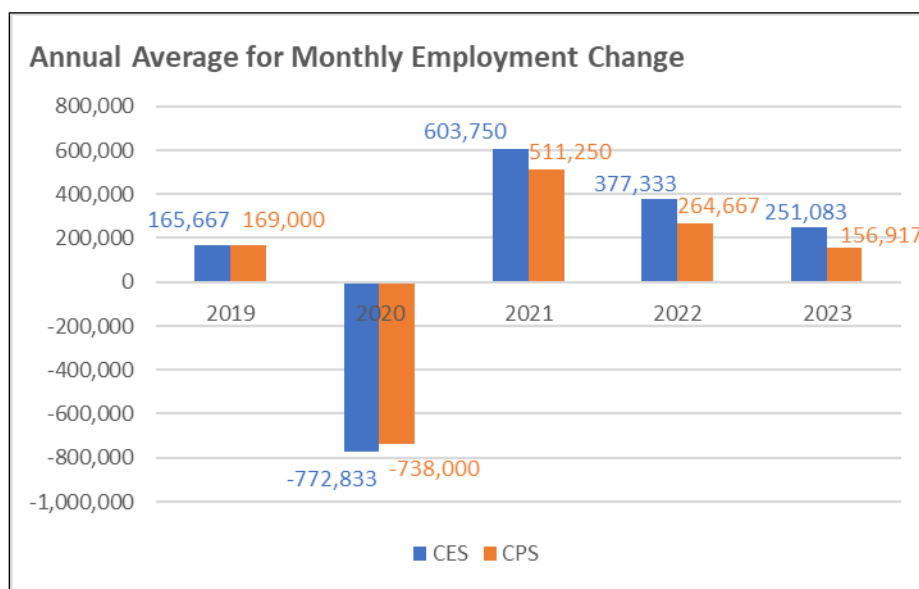
Figure 3 shows annual averages for jobs added each month based on two different official surveys—the Current Population Survey (CPS, a survey of households) and the Current Employment Survey (CES, a survey of employers and the primary measure of employment growth that is reported in the media). Both follow a similar overall pattern, with particularly high job growth in 2021 and then moderating job growth in 2022 and 2023. However, the recent divergence between the two is notable—CES has shown above-average growth in 2022 and 2023 (compared to pre-pandemic), whereas CPS has shown more moderate growth. Because unemployment comes from CPS, the lower employment growth rate in CPS (along with the other factors mentioned above) resolves the question of why the unemployment rate has stayed relatively constant.

The recent size and persistence of this CES-CPS divergence in employment growth (around 100,000 a month for the past three years) is somewhat puzzling. The two surveys would not be expected to yield the same figures, as their methodologies and coverages differ, but when a comparable definition is used, the divergence gets larger.⁹ This suggests that future data revisions

⁹ BLS, “Comparing Employment from the BLS Household and Payroll Surveys,” February 2, 2024, https://www.bls.gov/web/empsit/ces_cps_trends.htm#chart.

may partially close this gap, potentially reflecting a faster or slower pace of job growth.¹⁰ This is important, because if job growth has actually been high, it could indicate that the labor market is running too hot and that the economy is going to run out of workers to fill jobs, leading to labor shortages. However, if job growth has actually been more moderate, it may be more sustainable, meaning that the labor force is growing enough to continue to fill new jobs.

Figure 3. Employment
2019-2023



Source: BLS, Current Employment Survey and Current Population Survey.

Labor Market Tightness

The labor market is said to be “tight” when labor demand exceeds labor supply, meaning that job openings are so plentiful that employers have trouble filling positions. This can be considered a good thing for workers, as it typically gives them greater choice and bargaining power. However, it may also result in increased costs and inefficiencies for employers.

As employment grew and unemployment fell rapidly in 2021, an unusually tight labor market emerged that made it difficult for firms to fill positions, operate efficiently, and expand as quickly as desired. The rate of job openings and people quitting their jobs rose rapidly, while the layoff rate fell. This was initially caused by sudden swings in labor supply and demand in specific industries as a result of COVID-19 disruptions and re-openings.¹¹ When unemployment became very low, it was more emblematic of an overall mismatch between labor supply and demand. In

¹⁰ If immigration has been higher than the Census Bureau is estimating, which the Congressional Budget Office (CBO) recently posited, this could indicate that the CPS has been underestimating job growth. See CBO, *The Demographic Outlook: 2024 to 2054*, January 18, 2024, <https://www.cbo.gov/publication/59697>.

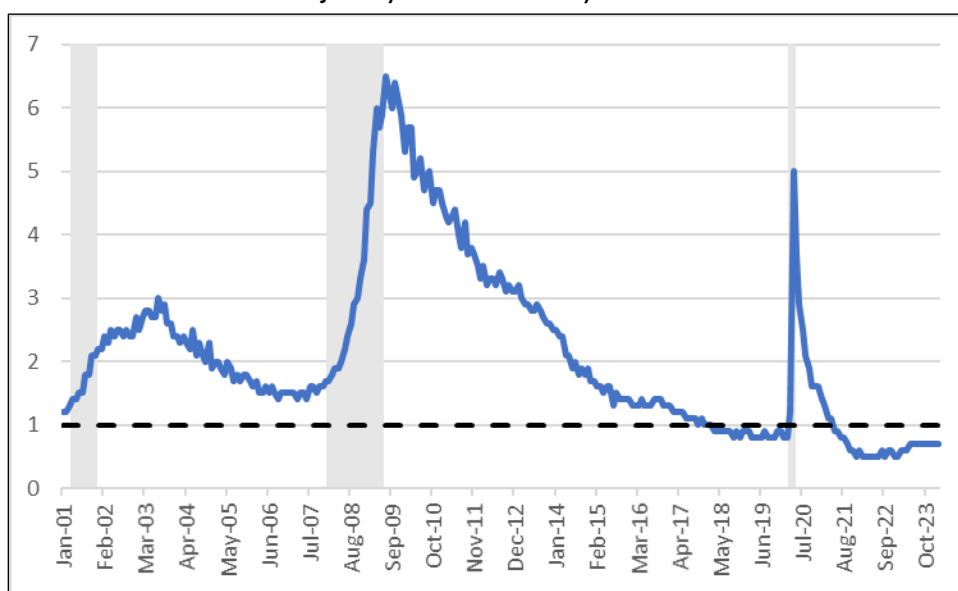
¹¹ While labor shortages occurred generally in 2022, labor shortages were more pronounced in certain industries. For example, many service industries experienced disproportionately large job loss during lockdown. For example, employment in service-providing industries decreased nearly 15% between February and April 2020, according to CES data. Many of those workers ended up switching jobs or leaving the labor force. When the economy reopened and demand came back for in-person services, employers had trouble filling those jobs. Perhaps unsurprisingly, therefore, job growth was also more pronounced in those industries—such as leisure and hospitality or health care—in 2023.

addition, some observers have hypothesized that employers, hamstrung by labor shortages, began hoarding workers they did not need.

Several measures indicate that the labor market is still tight at present, although not quite as tight as in 2023. For example, the ratio of unemployed workers to job openings has been less than one since May 2021, indicating there is more than one job opening for every person seeking work (see **Figure 4**)—a tighter labor market than the United States has experienced since data was first collected in 2001. A ratio below one is unlikely to be sustainable in the longer term, as more openings than available workers indicate a mismatch between labor supply and labor demand. The question remains how the labor market will come back into balance. At first, many economists assumed that the ratio would return to a more sustainable level only through an increase in unemployment (greater labor supply). So far, to the surprise of those economists, the ratio has recently risen closer to one with only a modest increase in unemployment, mostly through a reduction in job openings (reduced labor demand) instead. If this dynamic were to continue, better balance between supply and demand could be restored without a large increase in unemployment—in other words, a hard landing could be avoided.

Figure 4. Unemployed Persons Per Job Opening

January 2001 to February 2024



Source: BLS, Job Openings and Labor Turnover Survey.

Labor Force Participation

Unemployment alone does not indicate how much scope there is for employment to potentially increase in the future. Other indicators are needed to account for workers who are currently not in the labor force (meaning they do not have jobs and are not looking for work) but could be brought into it. Those indicators currently point to a less overheated employment situation at present and more potential capacity for future employment growth than the low unemployment rate would suggest.

The labor force participation rate (LFPR) measures the size of the labor force relative to the population (age 16 and older). If the LFPR increased, it would increase labor supply and help the labor market come back into balance without the need for job growth to slow or the

unemployment rate to increase. The LFPR remains relatively low by historical standards at 62.7% as of March 2024, lower than at any point between the 1970s and the start of the pandemic. This would generally indicate that there is still room for the LFPR to increase. However, the overall decline in the LFPR is now caused more by the aging of the population than by pandemic effects. The LFPR for prime-age workers (25-54 years) surpassed pre-pandemic levels in February 2023 and was 83.4% in March 2024. But because the LFPR is significantly lower (currently below 40%) for adults age 55 and over, as a greater share of the population falls into this cohort, the overall LFPR declines.

Given demographic considerations, it is unclear whether an increase in the size of the labor force large enough to ease labor market tightness is feasible.¹² There is more room for growth in some demographic groups than in others. Although the LFPR of older workers is still about 1.5 percentage points lower than it was before the pandemic, older workers who leave the labor market are the least likely to reenter. Prime-age female participation might not have much room to climb either, as it has already fully rebounded since the pandemic (77.7% in March 2024 compared to 77.0% in February 2020). Younger workers and prime-age men could potentially be a source of additional workers, as their participation is low by historical standards. However, these groups have seen a long-term decline in labor force participation (from January 2000 to March 2024 the LFPR fell from 92.1% to 89.2% for prime-age men and from 78.3% to 72.1% for individuals 20-24 years old), so the factors responsible for this long-term trend would have to be reversed. It is unclear whether a strong labor market alone could induce higher participation among some or all of the various groups or whether policy changes would be needed.

Moving forward, low labor force growth is expected due to the aging of the population. The Congressional Budget Office (CBO) projects that deaths will exceed births beginning in 2042, and thereafter the population will rise only to the extent that immigration exceeds emigration plus the difference between deaths and births. The level of future immigration depends on policy, making that policy stance an important determinant of future population and labor force growth. CBO projects that the potential labor force grew by 0.8% on average annually over the past 30 years but will grow by only 0.3% annually over the next 30 years.¹³ This will reduce long-term economic growth, all else equal, as output can be boosted only by increasing the workforce or increasing productivity.¹⁴ Given the largely pay-as-you-go nature of elderly entitlement programs, the lower labor force growth has also made it more difficult to finance federal spending, as there are relatively fewer workers to support more retirees.

Wages

In line with the tight labor market, *nominal* (not inflation-adjusted) wage growth accelerated in 2021 and remains above pre-pandemic levels as of early 2024 (the blue line in **Figure 5**).¹⁵ While inflation was still accelerating, this above-trend nominal wage growth had some worried that

¹² BLS, “Labor Force and Macroeconomic Projections Overview and Highlights, 2022-32,” September 2023, <https://www.bls.gov/opub/mlr/2023/article/labor-force-and-macroeconomic-projections.htm>.

¹³ CBO, *The 2023 Long-Term Budget Outlook*, June 2023, <https://www.cbo.gov/system/files/2023-06/59014-LTBO.pdf>.

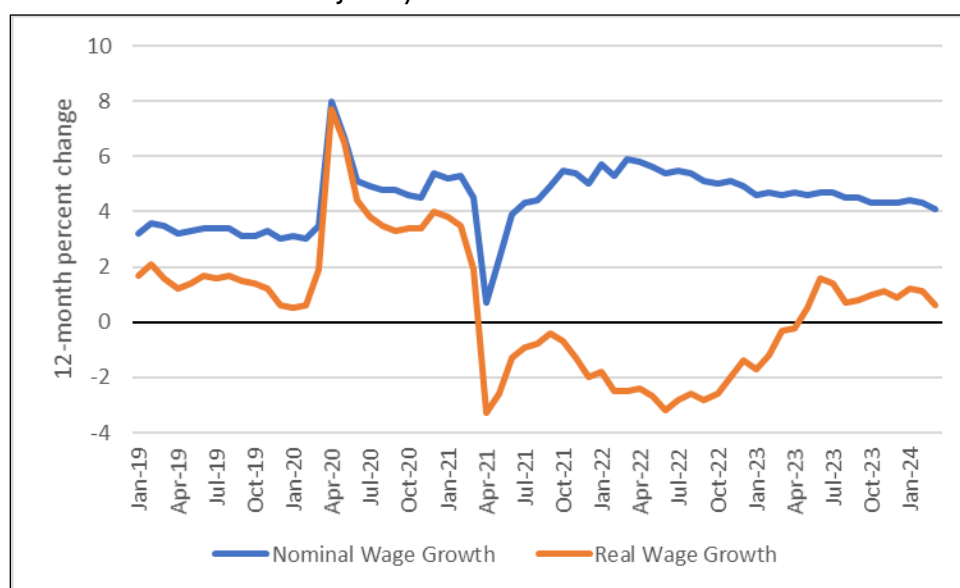
¹⁴ Productivity growth can come from technological progress, efficiency improvements, or increased skills or education.

¹⁵ This section discusses wages as measured by BLS CES average hourly earnings. There are many different ways to measure wages, and not all measures show the same trends. For more information, see CRS Report R47381, *A Comparison of Selected Official Wage Measures*, by Lida R. Weinstock.

upward pressure on wages could be contributing to inflation.¹⁶ However, during this period, inflation was higher than nominal wage growth, resulting in negative real wage growth and a loss of purchasing power for wage earners (the orange line in **Figure 5**).¹⁷ As inflation moderated, so too did nominal wage increases, while real wages began increasing in early 2023. Real wage growth has been largely similar to pre-pandemic levels since mid-2023. If both inflation and nominal wage growth continue to moderate, current real wage growth would be in line with historical average growth and thus would be sustainable. Such a scenario would be in line with the labor market becoming more balanced.

Figure 5. Average Hourly Earnings Growth

January 2019 to March 2024



Source: BLS, Current Employment Survey.

Notes: The steep increase and then decrease in nominal and real average hourly earnings growth during the pandemic was largely due to pandemic-related compositional changes in the workforce and not indicative of longer-term trends in the labor market. For more details, see CRS Report R47380, *Average Wage Growth and Related Economic Trends in 2022*, by Lida R. Weinstock.

Inflation

Background

Inflation measures the rate of increase in the price level of goods and services in the economy. The most commonly referenced inflation rates measure price inflation of consumer goods and services. Inflation erodes purchasing power over time, but nonetheless economists generally

¹⁶ For example, see Charlotte Morabito, “Wage Hikes May Have Been a Key Driver of Inflation. They May Now Be Fueling Mass Layoffs,” *CNBC*, June 1, 2023, <https://www.cnbc.com/2023/06/01/main-driver-of-inflation-wage-hikes.html>.

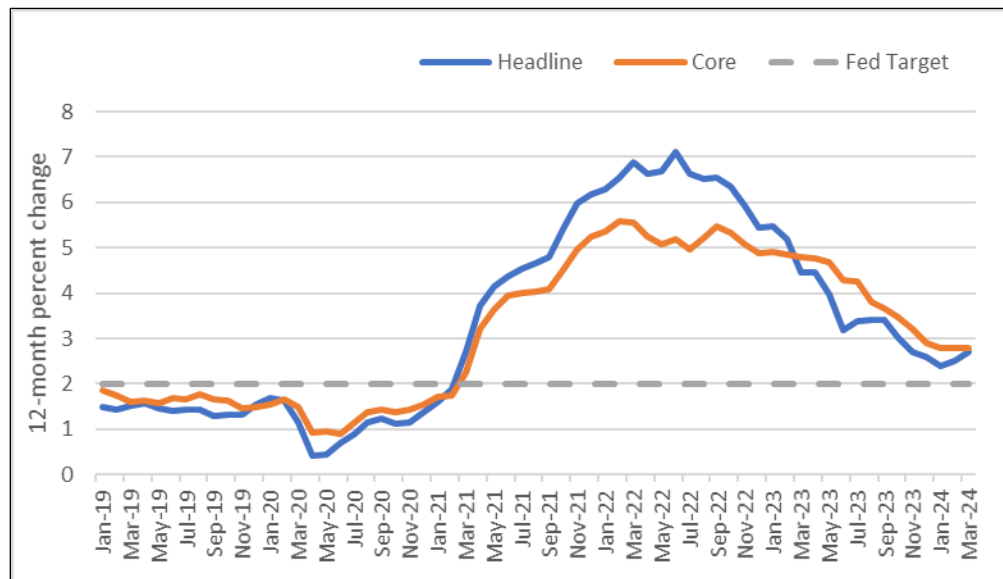
¹⁷ Several studies have found that wage growth did not contribute to inflation. For example, see Philippe Andrade et al., “Is Post-pandemic Wage Growth Fueling Inflation?,” Federal Reserve Bank of Boston, January 16, 2024, <https://www.bostonfed.org/publications/current-policy-perspectives/2024/is-post-pandemic-wage-growth-fueling-inflation.aspx>.

believe that some low but positive amount of inflation is healthy in an economy.¹⁸ Achieving low and stable inflation would mean that the economy would return to a state in which prices rose at a slow and steady rate over time, not that prices themselves would revert to some lower pre-pandemic level.

Recent Trends

Using the price index for personal consumption expenditures (PCE), both *headline inflation* (or total inflation, including all goods and services) and *core inflation* (a measure that removes volatile energy and food prices) have been above the Fed's 2% target since early 2021, as shown in **Figure 6**. Headline inflation first crept above 2% in March 2021, when it hit 2.7% and rapidly rose until peaking at 7.1% in June 2022, the highest it had been since December 1981. (The consumer price index, another well-known measure of inflation, has followed a similar pattern to PCE in recent years but has been consistently higher due to methodological differences.)

Figure 6. PCE Inflation
January 2019 to March 2024



Source: Bureau of Economic Analysis.

Inflation had been low and stable for decades prior to 2021. On an annual basis, inflation (as measured by the PCE) averaged a little under 2% from 1992 to 2020. But when COVID-19 first hit, it introduced a series of supply and demand shocks to the economy. Supply chains were disrupted, labor shortages emerged, consumer demand plummeted as lockdowns were initiated, and demand shifted toward goods and away from services that are not socially distanced.¹⁹ But then the economy began to reopen and demand began to recover, as evidenced by robust GDP growth. Although the economy would have eventually recovered after reopening, most economists believe that, without extraordinary fiscal and monetary stimulus (discussed below), the economy would have underperformed for years. Such successful demand-boosting policies, however, also had the unintended consequence of boosting demand to a point where supply,

¹⁸ For more details, see CRS In Focus IF10477, *Introduction to U.S. Economy: Inflation*, by Lida R. Weinstock.

¹⁹ For more information, see CRS Insight IN11926, *Supply Disruptions and the U.S. Economy*, by Marc Labonte and Lida R. Weinstock.

which was still disrupted, could not grow quickly enough to keep up. While the demand shock of COVID-19 had largely been unwound by 2021, the supply constraints that arose during the pandemic were still constraining supply at that point. In addition, there were sudden shifts in demand back to services that are not socially distanced, labor market participation was still low with simultaneously high wage growth,²⁰ and further supply shocks continued to occur, notably to commodity prices when Russia invaded Ukraine in 2022.²¹

Inflation came down significantly in 2023 as a result of several factors, notably the increasingly restrictive monetary policy that was put in place by the Fed and easing supply constraints, but the trend reversed in the first quarter of 2024, with inflation rising. Headline inflation was 2.7% in March 2024, up from 2.5% in January and February. Core inflation has also fallen, but whereas core was initially lower than headline, it is currently higher. This is largely a result of moderating food and energy prices in 2023, while certain major components of core inflation, such as shelter, continued to rise rapidly. Core inflation peaked at 5.6% in February 2022 and stands at 2.8% as of March 2024.

Despite the overall improvement in inflation, it remains above the Fed's 2% target, particularly when measured by core inflation, and it has increased in 2024. Barring future price shocks, the future path of inflation will largely depend on the success of monetary policy, as discussed below.

Recent Fiscal and Monetary Policy

The fiscal and monetary policy response to the pandemic was swift and significant. Unprecedented stimulus was provided to the economy through these channels, resulting in a rapid economic recovery that might not otherwise have been possible. However, the stimulative fiscal and monetary policy stance may also have contributed to rising inflation. Fiscal and monetary stimulus were withdrawn only gradually after economic conditions returned to normal, with important implications for the state of the economy.

Fiscal Policy

Background

In economic theory, fiscal policy describes policy changes to government spending and revenue in an effort to influence economic conditions. The government can impact the level of economic activity in the short term by changing its level of spending and tax revenue. Expansionary fiscal policy—an increase in government spending, a decrease in tax revenue, or a combination of the two—is expected to spur economic activity in the short term, whereas contractionary fiscal policy—a decrease in government spending, an increase in tax revenue, or a combination of the two—is expected to slow economic activity in the short term. When the government is running a budget deficit (when spending exceeds revenues), as it has for the past two decades, additional expansionary fiscal policy results in a larger deficit.

Expansionary fiscal policy is generally used to boost short-term GDP growth and the economic indicators that tend to move with GDP, such as employment and individual income. However,

²⁰ A smaller labor force would generally be a constraint on supply because it would decrease the economy's ability to produce more goods and services. Further, in order to increase labor force participation in certain industries or the labor market on the whole, employers may increase wages or benefits, which could lead to increased costs for companies that may be passed through in the form of higher prices to consumers.

²¹ See CRS Report R47273, *Inflation in the U.S. Economy: Causes and Policy Options*, by Marc Labonte and Lida R. Weinstock.

expansionary fiscal policy can affect interest rates and private investment, exchange rates and the trade balance, and the inflation rate in undesirable ways, limiting the long-term effectiveness of persistent fiscal stimulus. Contractionary fiscal policy can be used to slow economic activity if policymakers are concerned that the economy may be overheating, which can cause a recession. The magnitude of fiscal policy's effect on GDP—and the balance between its positive and negative effects—will also differ based on where the economy is within the business cycle (i.e., whether it is in a recession or an expansion). The effects on interest rates, investment, and inflation are likely to be greater when the economy is near full employment.²²

Recent Actions

Congress passed significant and mostly temporary stimulus with wide-ranging effects on spending, revenues, and the economy during the pandemic. All told, CBO estimated that stimulus passed early in the pandemic during FY2020—the Coronavirus Preparedness and Response Supplemental Appropriations Act, 2020 (P.L. 116-123); the Families First Coronavirus Response Act (P.L. 116-127); the Coronavirus Aid, Relief, and Economic Security Act (P.L. 116-136); and the Paycheck Protection Program and Health Care Enhancement Act (P.L. 116-139)—would increase the FY2020-FY2030 deficit by about \$2.4 trillion.²³ Later, in FY2021, more pandemic-related stimulus was passed—Divisions M and N of the Consolidated Appropriations Act, 2021 (P.L. 116-260), and the American Rescue Plan Act of 2021 (P.L. 117-2)—which CBO estimated would increase the FY2021-FY2030 deficit by \$2.7 trillion.²⁴ As a result of this stimulus and the weak economy, the deficit increased quickly and significantly, peaking at 14.9% of GDP in 2020 but remaining historically large in 2021 at 12.4% of GDP (see **Figure 7**). As the economy recovered and COVID-19 relief expired, the deficit shrank but has remained large by historical standards at 6.2% of GDP in FY2023. CBO projects that the deficit will remain large under current policy in the future.²⁵

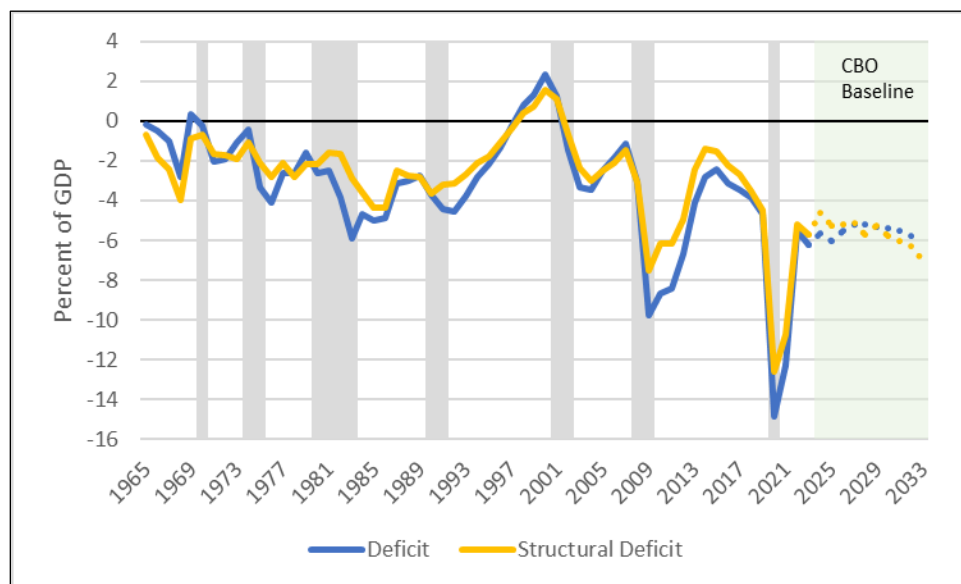
²² For more detailed information on the economic effects of fiscal policy, see CRS Report R45723, *Fiscal Policy: Economic Effects*, by Lida R. Weinstock; and CRS In Focus IF11253, *Introduction to U.S. Economy: Fiscal Policy*, by Lida R. Weinstock.

²³ CBO, *The Budgetary Effects of Laws Enacted in Response to the 2020 Coronavirus Pandemic, March and April 2020*, June 2020, <https://www.cbo.gov/system/files/2020-06/56403-CBO-covid-legislation.pdf>.

²⁴ CBO, *The Budgetary Effects of Major Laws Enacted in Response to the 2020-2021 Coronavirus Pandemic, December 2020 and March 2021*, September 2021, <https://www.cbo.gov/system/files/2021-09/57343-Pandemic.pdf>.

²⁵ CBO, *The Budget and Economic Outlook: 2024 to 2034*, February 2024, <https://www.cbo.gov/publication/59710>.

Figure 7. Federal Budget Deficit
FY1965-FY2033



Source: Congressional Budget Office (CBO) and CRS calculations based on CBO data.

Notes: Owing to the timing of data releases, estimates of the structural deficit are less recent than estimates of the total deficit.

Congress has passed other significant fiscal policy since the pandemic, although these policies were not designed to provide the same kind of short-term stimulus to the economy. In particular, the Infrastructure Investment and Jobs Act (IIJA; P.L. 117-58) and Inflation Reduction Act of 2022 (IRA; P.L. 117-169) both made significant fiscal policy changes with wide-ranging effects on the economy. CBO estimated significantly smaller deficit impacts from these bills than from the pandemic relief. CBO estimated the IIJA to increase deficits by about \$256 billion over the FY2021-FY2031 period and for the IRA to decrease deficits by about \$90 billion over the FY2022-FY2031 period.²⁶ Further, a majority of the deficit spending resulting from pandemic-related legislation took place in FY2020 and FY2021, providing immediate and significant stimulus.²⁷ The deficit effects of the IIJA and IRA, on the other hand, are projected to take place more incrementally over 10 years—CBO projected that the IIJA would *reduce* deficits by \$4.4 billion and the IRA would increase deficits by \$416 million in FY2022.

The fiscal policy response to the pandemic helped to restore aggregate demand to an adequate level and avoid a long-lasting recession. However, it may also have exacerbated inflationary pressures in the economy. The extent to which high inflation can be tied specifically to pandemic stimulus is not agreed upon, as it is difficult to disentangle its effects from the demand and supply changes that were happening simultaneously.²⁸ Fiscal stimulus may have been large enough to

²⁶ CBO, *Cost Estimate: Senate Amendment 2137 to H.R. 3684, the Infrastructure Investment and Jobs Act, as Proposed on August 1, 2021*, August 2021, https://www.cbo.gov/system/files/2021-08/hr3684_infrastructure.pdf; CBO, *Estimated Budgetary Effects of H.R. 5367, the Inflation Reduction Act*, August 2022, https://www.cbo.gov/system/files/2022-08/hr5376_IR_Act_8-3-22.pdf.

²⁷ See CRS Report R47273, *Inflation in the U.S. Economy: Causes and Policy Options*, by Marc Labonte and Lida R. Weinstock.

²⁸ For a working paper finding relatively large effects of fiscal policy on inflation, see Francois de Soyres, Ana Maria Santacreu, and Henry Young, “Demand-Supply Imbalance During the COVID-19 Pandemic: The Role of Fiscal Policy,” Federal Reserve, August 2022, <https://www.federalreserve.gov/econres/ifdp/files/ifdp1353.pdf>.

have a significant effect on demand in FY2021, although much of that effect may have occurred before inflation started rising. Stimulus in FY2022 was smaller and so would have had a smaller effect on demand, although inflation may have been more sensitive to changes in demand at that point. As mentioned, deficits have stayed large even as inflation increased and unemployment fell, which may have resulted in more monetary policy tightening to address high inflation than would have been required with less fiscal stimulus.

Monetary Policy

Background

Monetary policy is set by the Federal Reserve, which has been structured as a highly independent agency.²⁹ Congress gave the Fed a dual statutory mandate to achieve full employment and price stability—which the Fed has interpreted as an inflation rate of 2% as measured by the PCE index—but designed the Fed so it could make decisions about how to best meet that mandate independently of Congress and the President. Both monetary and fiscal policy can be changed at any time, but whereas significant changes in the overall fiscal policy stance occur fairly infrequently, the Fed reconsiders monetary policy every six weeks through regularly scheduled meetings of the Federal Open Market Committee (FOMC).

The Fed conducts monetary policy by setting a target range for the federal funds rate (FFR)—a short-term rate at which banks lend to each other. The FFR is not a rate that is charged to any business or consumer borrower, but it does heavily influence the myriad rates that businesses and consumers are charged, with other short-term rates paralleling movements in the FFR more closely than long-term rates. Higher rates slow economic activity by reducing interest-sensitive spending (i.e., anything that is bought using credit), such as consumer durables (e.g., cars and appliances), business capital spending on plant and equipment, and house building. Higher interest rates also cause the dollar to strengthen, which reduces spending on exports and import-competing goods. By reducing spending in the economy, higher rates reduce inflationary pressures. Lowering interest rates has the opposite effect.

The Fed can also affect economic activity through its asset purchases and lending activity. When the Fed purchases large quantities of assets, known as quantitative easing or QE, this puts downward pressure on long-term interest rates by driving down yields on the securities being purchased. QE also increases liquidity by increasing bank reserves, which is how the Fed balances its liabilities with its assets. The Fed is also able to lend to financial institutions in its role as lender of last resort, which can stabilize the financial system during times of distress.

Recent Actions

The Fed acted very aggressively to stabilize the economy following the onset of the pandemic. It reduced the FFR to zero, purchased over \$4.5 trillion worth of Treasury securities and mortgage-backed securities, and created an alphabet soup of temporary emergency lending programs.³⁰ It held those policies in place well after the economy had reopened and inflation had taken off. In response to high inflation, the FOMC initiated a series of increases in the FFR target between March 17, 2022, and July 27, 2023 (see **Figure 8**). By the time the Fed started raising rates, the

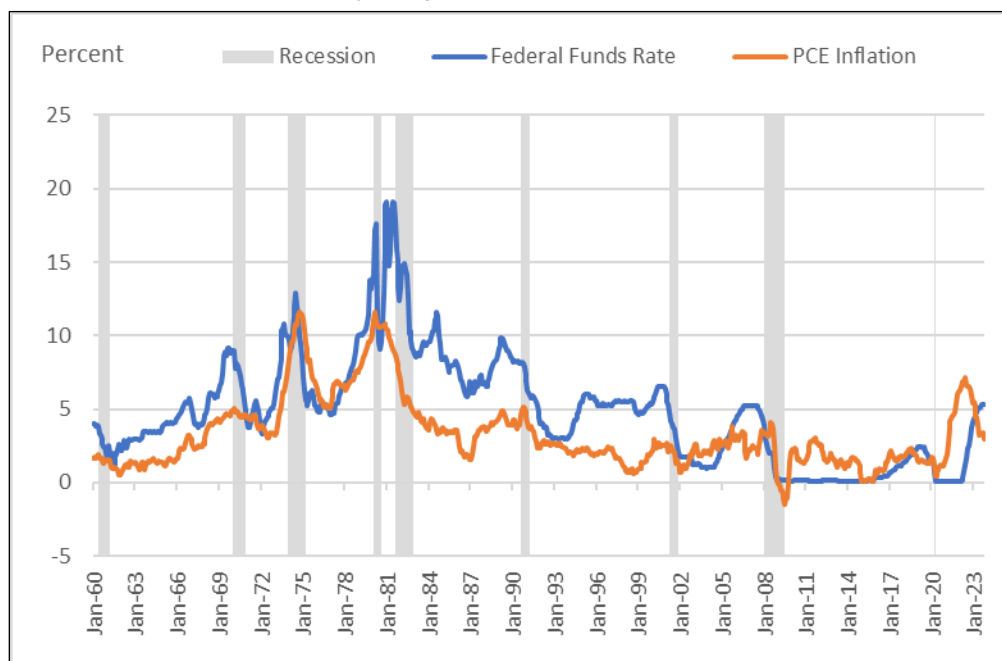
²⁹ For more information, see CRS In Focus IF10054, *Introduction to Financial Services: The Federal Reserve*, by Marc Labonte; and CRS In Focus IF11751, *Introduction to U.S. Economy: Monetary Policy*, by Marc Labonte.

³⁰ For more information, see CRS Report R46411, *The Federal Reserve's Response to COVID-19: Policy Issues*, by Marc Labonte.

12-month rate of PCE inflation had reached 6.9% and core inflation had reached 5.6%. Some critics argued that the Fed should have started raising rates sooner to comply with its price stability mandate. Rate increases at some meetings were large by historical standards—the Fed raised rates by 0.75 percentage points at four consecutive meetings in 2022. The last increase in the FFR target was in July 2023. The current target range (5.25%-5.50%) is the highest since 2001.

Figure 8. Federal Funds Rate and Inflation

January 1960 to March 2024



Source: Federal Reserve, Bureau of Economic Analysis.

As a result of tighter monetary policy, higher inflation, and a stronger expansion, nominal long-term interest rates in some cases more than doubled in 2022. Long-term rates peaked in late 2023 at their highest rate since before the 2008 financial crisis, or in some cases in the 21st century. As debt is gradually refinanced at higher prevailing rates, borrowing costs increased significantly for households, businesses, and the government.

As noted above, tighter monetary policy reduces inflation by slowing economic activity. Yet overall economic growth got stronger in the second half of 2022 and throughout 2023 despite rates rising. The effects of higher interest rates on interest-sensitive spending were most obvious in the residential investment (primarily home construction) sector. Inflation-adjusted residential investment peaked in the first quarter of 2021 (before the Fed started tightening policy), and then began a steep decline. Even after strong growth in the first quarter of 2024, residential investment was still almost \$150 billion lower in real terms than it was when rates started rising in the first quarter of 2021. Other interest-sensitive spending categories show less evidence that tighter monetary policy has achieved a desired moderation in spending. Business investment in equipment grew, albeit more slowly than overall GDP since the first quarter of 2022, whereas business investment in structures and consumer spending on durable goods grew more quickly than GDP. The dollar rose in value when the Fed started raising rates in 2022 and stabilized in 2023 when interest rates in other countries started catching up with U.S. rates. Nevertheless, exports rose and imports fell after adjusting for inflation in 2023.

Soft Landing or Hard Landing?

Achieving a soft landing—a return to low inflation without causing a recession—after sustained monetary policy tightening is notoriously difficult. Historically, periods of rapid and substantial interest rate increases comparable to the current period have resulted in a hard landing—a recession (see **Figure 8**).³¹ Some of the more obvious parallel periods, in terms of starting inflation rate and magnitude of rate hikes, are recessions during the so-called Great Inflation of the late 1960s to the early 1980s, which featured both double-digit inflation and interest rates at their peaks. Even so, not every monetary tightening has resulted in a recession. Fed Chair Jerome Powell has pointed to soft landings after monetary tightening in 1965, 1984, and 1994.³² Those episodes were arguably less challenging than the current one, however. They featured smaller cumulative rate increases than this most recent period of tightening, because inflation was already low in 1965 and 1994 and below 5% in 1984. A recent study of historical soft and hard landings found:

If the need to fight inflation is not too extreme, and serious adverse events like wars or supply shocks do not intervene, the Federal Reserve has shown itself capable of engineering a landing that either does not induce a recession or, if it does, induces a small one. It has done so several times.³³

How Did the Economy Avoid a Hard Landing in 2023?

In January 2023, 65% of private sector economists surveyed expected a recession within 12 months.³⁴ But monetary tightening did not result in the predicted recession in 2023—in fact, GDP growth accelerated in the second half of the year. Growth was broadly based in 2023, as all sectors of the economy performed well except for residential investment.

There are several reasons that the forecasted recession did not occur. Supply chain issues have largely been resolved, the labor force participation rate has increased notably in the past year, and commodity prices have generally fallen. Easing supply constraints has made it easier for the Fed to pursue low inflation without any significant rise in unemployment, a scenario consistent with a soft landing.³⁵

Additionally, consumers accumulated excess savings during the pandemic, when travel and certain types of commerce constrained consumption and government transfers in pandemic relief legislation led to a temporary spike in personal income. According to one study, excess savings peaked at \$2.3 trillion in the third quarter of 2021.³⁶ The increased stock of savings may have supported moderate consumer spending through 2023, even as higher interest rates and prices

³¹ Not all recessions have been direct results of monetary tightening. For example, the 2020 recession was a direct result of the COVID-19 pandemic and its effects on economic activity.

³² Chair Pro Tempore Jerome H. Powell, “Restoring Price Stability,” speech at 38th Annual Economic Policy Conference National Association for Business Economics, Washington, D.C., March 21, 2022, <https://www.federalreserve.gov/newsevents/speech/powell20220321a.htm>.

³³ Alan Blinder, “Landings, Soft and Hard: The Federal Reserve, 1965–2022,” *Journal of Economic Perspectives*, vol. 37 (Winter 2023), pp. 101–120.

³⁴ Wolters Kluwer, “Blue Chip Economic Indicators,” January 10, 2023.

³⁵ Nick Timiraos, “The Hidden Hero Fueling Soft-Landing Hopes: A Boost in Supply,” November 19, 2023, https://www.wsj.com/economy/central-banking/the-hidden-hero-fueling-soft-landing-hopes-a-boost-in-supply-3a32bf3e?mod=djemRTE_h.

³⁶ Aditra Aladangady et al., “Excess Savings During the COVID-19 Pandemic,” Federal Reserve, October 21, 2022, <https://www.federalreserve.gov/econres/notes/feds-notes/excess-savings-during-the-covid-19-pandemic-20221021.html>.

eroded borrowing capabilities and purchasing power. As evidenced by recent drawdowns in the stock of savings and robust personal consumption expenditures of recent quarters, the excess savings may have played an important role in supporting demand.³⁷ By its nature, however, this support to spending is only temporary.

Finally, as noted above, most categories of interest-sensitive spending remained strong despite higher interest rates, with the exception of residential investment. This may be because of lags in the effects of monetary policy or because monetary policy was not sufficiently restrictive.

Is a Soft Landing in 2024 Assured?

By many measures, the economy looks like it is headed for a soft landing. There are no signs of the economy having entered a recession so far—employment and GDP grew consistently throughout 2023, and while growth in the first quarter of 2024 was lower, it was not negative and showed relatively strong consumer demand. Additionally, there are signs that the labor market, while still tight, is not as tight as it was last year. For example, the unemployment rate, although still low, is up from its low of 3.4% in April 2023, and both job growth and nominal wage growth have fallen to more sustainable rates (see **Figure 3** and **Figure 5**). This easing in labor market conditions may have given inflation room to decrease without necessitating a recession. Improvements in labor force participation, particularly for prime-age workers (25-54 years old)—which surpassed pre-pandemic levels in 2023—have also allowed conditions in the labor market to ease without causing a disruptive increase in unemployment. And despite the pause in rate increases, inflation decelerated in 2023. If inflation reaches the Fed’s target of 2% without a recession, a soft landing will have been achieved.³⁸

Nevertheless, there is still a risk of a hard landing in 2024. Recent inflation and labor market performance suggest that the economy is still running too hot, leaving open the possibility of a hard landing later on. Inflation is much lower than it was at peak, but it is still not low enough to be consistent with price stability—that is, the downward trend toward price stability may have stalled out or may even be reversing. While 12-month core measures for both CPI and PCE decreased slightly over the first quarter of 2024, both headline measures increased over the same period. Further, short-term changes in prices seem to be getting worse, not better: The monthly increase in core and headline inflation in the first quarter has been too high to be consistent with price stability. After the recent bout of high inflation, inflation may not revert back to 2% as easily if individuals’ expectations of low inflation are not as well anchored anymore.

A strong economy could keep inflation elevated, making it less likely the Fed will reduce rates. According to the median projection, Fed leadership believes that the economy can sustain growth of 1.8% per year in the long run.³⁹ GDP growth was significantly higher than that in the second half of 2023. The lower growth in the first quarter of 2024 could signal that demand is cooling to a more sustainable level, but the data is preliminary, and more data is needed to determine if this trend will last (see **Figure 1**).

³⁷ Federal Reserve Bank of San Francisco, “The Rise and Fall of Pandemic Excess Savings,” May 8, 2023, <https://www.frbsf.org/economic-research/publications/economic-letter/2023/may/rise-and-fall-of-pandemic-excess-savings/>.

³⁸ This report defines *soft landing* in terms of whether the Fed hits its inflation target without a recession. It makes no judgment about whether reaching precisely 2% inflation is the ideal scenario. Economists debate whether 2% inflation is the optimal inflation rate, and the Fed attempts to achieve an average of 2% inflation over time, as opposed to exactly 2% inflation at all times.

³⁹ Federal Reserve, *Summary of Economic Projections*, March 20, 2024, <https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20240320.pdf>.

Another concern is that unemployment is too low currently and may make it difficult to achieve price stability. Unemployment that is “too low” to be sustainable can cause overheating as more jobs beget higher incomes and higher demand, which may outpace supply. The level at which unemployment becomes unsustainable is not directly observable and likely changes over time, making it challenging to know if unemployment is unsustainably low currently. Although unemployment has been consistently a little higher than it was in the first half of 2023, it has remained below 4%. Historically, periods of sub-4% unemployment have typically ended in recession and high unemployment relatively quickly, however.⁴⁰ Fed leadership currently believes that the economy can sustain an unemployment rate of 4.1% in the long run—the unemployment rate has been lower than that since 2021.⁴¹

Fed leadership envisions a soft landing in its projections for 2024—the median projection was for GDP growth to slow to 2.1%, unemployment to rise slightly to 4.0%, and inflation to continue to fall to 2.4%.⁴² Moreover, the Fed expects to be able to reduce interest rates in 2024 while achieving these results—although since these projections were made, Fed Chair Jerome Powell said that inflation has not shown enough improvement to start cutting rates yet.⁴³ These projections are subject to uncertainty but consistent with outside consensus projections. This scenario supposes the moderate slowdown in growth and the labor market will not overshoot into a recession.⁴⁴

If instead high inflation persists, the Fed may be forced to start raising rates again, potentially resulting in the hard landing that was avoided in 2023. Further rate increases would not necessarily cause a recession, however. After all, the Fed has thus far managed to raise rates rapidly without a significant increase in the unemployment rate.

Another possibility is that the Fed’s actions to this point have already made a recession likely, but it just has not started yet. Monetary policy changes affect the economy with a long and variable lag, so growth may yet slow. One of the reasons the Fed has paused rate hikes for the time being is to see how previous increases are affecting the economy.

Lastly, were economic activity to significantly weaken while inflation remained above target (called “stagflation”), the monetary stimulus needed to avoid a recession could exacerbate inflationary problems. This might make the Fed unwilling to provide that stimulus. In this scenario, the Fed would face a choice between easing policy to prop up growth or tightening policy (or at least maintaining the tight policy already in place) to tackle inflationary pressures. Either way, a soft landing would likely be missed—because inflation would stay too high if the Fed chose the former or because the economy would enter a recession if it chose the latter.

For the time being, projections of the economy remain mixed. While some private forecasters are increasingly convinced that the Fed has navigated a soft landing, others think this is too optimistic and have shifted their 2023 recession predictions to 2024, citing risks from high interest rates, high inflation, and low unemployment. For example, the Wall Street Journal Survey of Economists from April 2024 showed a median probability of recession in the next 12 months at 29%, significantly lower than 63% in 2022. Nonetheless, respondents on average expected

⁴⁰ See CRS In Focus IF12554, *Low Unemployment in 2023: Can It Last?*, by Marc Labonte and Lida R. Weinstock.

⁴¹ Federal Reserve, *Summary of Economic Projections*.

⁴² Federal Reserve, *Summary of Economic Projections*.

⁴³ Nick Timiraos, “Powell Dials Back Expectations on Rate Cuts,” *Wall Street Journal*, April 16, 2024, <https://www.wsj.com/economy/central-banking/powell-dials-back-expectations-on-rate-cuts-00e3e5d0>.

⁴⁴ For example, CBO projects a similar growth rate and higher unemployment over the next 10 years. See CBO, *The Budget and Economic Outlook: 2024 to 2034*, Table 2-1.

growth to slow to 1% and unemployment to rise to 4.3% by the end of the year.⁴⁵ In addition, a hard landing is always possible because of some unexpected external event that causes growth to contract or inflation to rise, as will be discussed next.

Risks to the 2024 Outlook

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. 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.⁴⁶

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.⁴⁷ Nevertheless, various analysts saw little macroeconomic impact because the impact is relatively concentrated, with a relatively small number of borrowers with large balances.⁴⁸ One estimate forecasts that the end of the moratorium will reduce GDP growth by 0.1 percentage points (pp) in 2023 and 0.3 pp in 2024,⁴⁹ and another forecasts that it will reduce consumer spending by 0.2 pp and GDP by 0.1 pp in 2023.⁵⁰

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

⁴⁵ Sam Goldfarb and Peter Santilli, “Where Are Growth, Inflation and Interest Rates Headed? We Asked the Economists,” *Wall Street Journal*, April 17, 2024, <https://www.wsj.com/economy/where-are-growth-inflation-and-interest-rates-headed-we-asked-the-economists-2a48c8a4>.

⁴⁶ *Wall Street Journal*, “Red Sea Attacks Will Hold Inflation Higher,” February 27, 2024, <https://www.wsj.com/articles/red-sea-attacks-will-hold-inflation-higher-ea9e5b6e>.

⁴⁷ For more information, see CRS In Focus IF12472, *Federal Student Loans: Return to Repayment*, by Alexandra Hegji.

⁴⁸ Shannon Seery et al., “Don’t Make a Mountain Out of Loan Bill,” Wells Fargo, October 2, 2023.

⁴⁹ Nancy Vanden Houten, “Student Loan Relief Is Ending—What’s Next,” Oxford Economics, July 30, 2023, https://info.oxfordeconomics.com/1/1022713/2023-07-20/9gw7/1022713/1689875907bDofpoL1/US_Student_loan_relief_is_ending_whats_next.pdf.

⁵⁰ Alec Phillips, “Student Loan Payments After the Pause: A More Than Manageable Headwind,” Goldman Sachs, June 1, 2023.

14% at the end of 2021.⁵¹ 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.⁵²

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.⁵³ 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.⁵⁴) 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.⁵⁵ Debt service costs for these businesses were low following the pandemic because rates were low, but they are now rising.⁵⁶ 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.⁵⁷

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 because high rates led to losses on debt securities or mortgages they held and because deposits were less “sticky”⁵⁸ and plentiful in a higher rate and tighter credit environment. Other banks face similar challenges, with falling asset

⁵¹ Thomas Klitgaard and Matthew Higgins, “Spending Down Pandemic Savings is an ‘Only-in-the-U.S.’ Phenomenon,” Federal Reserve Bank of New York, October 11, 2023, <https://libertystreeteconomics.newyorkfed.org/2023/10/spending-down-pandemic-savings-is-an-only-in-the-u-s-phenomenon/>.

⁵² Aladangady et al., “Excess Savings During the COVID-19 Pandemic.”

⁵³ Federal Reserve, “Financial Stability Report—October 2023,” Chapter 1, <https://www.federalreserve.gov/publications/2023-october-financial-stability-report-asset-valuations.htm>.

⁵⁴ In the case of housing, the future cash flow is the implicit rent that an owner could earn if the house were rented out. 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.

⁵⁵ Federal Reserve, “Financial Stability Report—October 2023,” Figure 2.2.

⁵⁶ Federal Reserve, “Financial Stability Report—October 2023,” Figure 2.6.

⁵⁷ Federal Reserve Bank of New York, *Quarterly Report on Household Debt and Credit*, February 2024, https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/HHDC_2023Q4.

⁵⁸ A key feature of the 2023 bank failures were large and sudden deposit outflows, particularly by uninsured depositors.

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.”⁵⁹

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.⁶⁰ 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.⁶¹

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.⁶² 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.⁶³ 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.⁶⁴

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 financial institution failure that leads

⁵⁹ Some financial intermediaries, such as banks, 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.

⁶⁰ Nathan Borney, “U.S. Office Vacancy Rate Hits All Time High: ‘Hybrid’ Work Takes a Toll on Landlords,” *Axios*, April 13, 2023, <https://www.axios.com/2023/04/13/office-vacancy-rate-remote-work-hybrid-work>.

⁶¹ Brian Pietsch, “WeWork to Renegotiate Most of Its Leases Amid Financial Trouble,” *Washington Post*, September 7, 2023, <https://www.washingtonpost.com/business/2023/09/07/wework-lease-renegotiate/>.

⁶² Federal Reserve Bank of St. Louis, “Real Estate Loans: Commercial Real Estate Loans, All Commercial Banks,” <https://fred.stlouisfed.org/series/CREACBM027NBOG>.

⁶³ Orest Mandzy, “The Year-End 2023: CRE at a Crossroads,” Trepp, January 8, 2024, <https://www.trepp.com/trepptalk/the-year-end-2023-cre-at-a-crossroads>.

⁶⁴ For more on bank exposures to CRE, see CRS Insight IN12278, *Bank Exposure to Commercial Real Estate*, by Andrew P. Scott. This section uses material from CRS Insight IN12283, *Commercial Real Estate Markets and Potential Macroeconomic Stress*, by Lida R. Weinstock and Andrew P. Scott.

to broad financial turmoil) is more likely to lead to a recession than is the gradual and orderly adjustment to higher rates.

Policy Issues Going Forward

Fiscal and monetary policy both have the ability to boost or constrain the economy in the short term and therefore are important factors in both recent and future trends in inflation, the labor market, and growth. Congress may consider adjustments to fiscal policy to help achieve a soft landing if desired. Congress also conducts oversight of the Fed, including its efforts to guide the economy to a soft landing.

Fiscal Policy

Standard economic theory suggests that countercyclical fiscal policy—expansionary (higher deficits) during recessions and contractionary (lower deficits) when the economy is running too hot—can lessen the negative impacts of a recession or hasten a recovery. Currently, however, fiscal policy is not being used countercyclically. Given that the economy is currently in an expansion, with low unemployment and above target inflation—which as discussed previously may have been, in part, a result of expansionary fiscal policy to begin with—sustained high deficits may be more likely to cause offsetting effects to interest rates and investment, exchange rates, and the trade balance⁶⁵ and lead to unsustainably high demand, an overheating economy, and rising inflation.

The government has run a budget deficit for most years during economic expansions since the 1960s, and the deficit has not been an impediment to achieving price stability for long periods of time. However, deficits today are significantly larger than they were during the expansions that did not see inflationary pressures (with the exception of the initial recovery from the 2008 financial crisis), leading to concern that deficits are more likely to lead to overheating than they were previously. Further, the structural deficit, which removes cyclical fluctuations in revenue and spending that are not the result of deliberate policy choices made each year by Congress, is also currently high by historical standards, and CBO projects it will continue to grow in coming years as well.⁶⁶

Current and projected deficits are unsustainably large in the long term as they contribute to the stock of debt, which is currently (and projected to continue) growing faster than the economy.⁶⁷ At some point, deficits would need to be reduced to put the debt on a sustainable growth path. The advantage of doing so at full employment is that deficit reduction is less likely to derail the

⁶⁵ For a more detailed discussion, see CRS Report R45723, *Fiscal Policy: Economic Effects*, by Lida R. Weinstock.

⁶⁶ During economic expansions, tax revenue tends to increase and spending tends to decrease automatically, as rising incomes and employment result in higher average incomes and therefore greater individual and corporate income tax revenues. Federal spending on income support programs, such as food stamps and unemployment insurance, tends to fall as fewer people need financial assistance and unemployment claims fall during economic expansions. The combination of rising tax revenue and falling federal spending tends to improve the government's budget deficit. The opposite is true during recessions, when federal spending rises and revenue shrinks. These cyclical fluctuations in revenue and spending are often referred to as *automatic stabilizers*. Therefore, when examining fiscal policy, it is often beneficial to estimate the budget deficit excluding these automatic stabilizers, referred to as the structural deficit, to get a sense of the affirmative fiscal policy decisions made each year by Congress.

⁶⁷ For more information about debt sustainability, see CRS Report R47877, *Deficit Spending During Higher Inflation and Interest Rates: Implications for Debt Sustainability*, by Lida R. Weinstock.

expansion compared to when the economy is in recession or recovery.⁶⁸ A large deficit may also (politically or economically) limit the ability to provide additional stimulus if the economy were to reenter a recession: Reducing the deficit now could create more “fiscal space” for future countercyclical policy. A large deficit also requires more borrowing from abroad, which, by accounting identity, manifests itself in a larger trade deficit.

Further, expansionary fiscal policy is currently working at cross purposes with contractionary monetary policy. While fiscal policy is generally seen as playing a secondary role to monetary policy in achieving price stability, and models generally suggest that very large changes in short-term deficits are needed to generate significant reductions in inflation, a stimulative fiscal stance can still make it harder for the Fed to achieve price stability. Absent large fiscal policy changes, the federal budget deficit is providing stimulus and placing upward pressure on long-term interest rates when the economy is already at full employment and high interest rates are challenging households and firms. While this is unlikely to single-handedly derail a soft landing, it may complicate the Fed’s ability to bring inflation fully back to target or reduce interest rates without adverse consequences.

Monetary Policy

September 2023 was the first FOMC meeting where rates were held steady after a series of increases, at which point PCE inflation was 3.4% and core inflation was 3.6%, still above the Fed’s target. The Fed reasoned that lags between changes in monetary policy and their effects on the economy meant that additional rate increases were not needed for inflation to continue to fall. Inflation trended downward since then but increased in recent months, with headline inflation increasing to 2.7% in March 2024 from a low of 2.5% in January, and has not yet reached the Fed’s 2% target.

In March, Chair Powell stated that the FOMC believed it would not raise the FFR higher.⁶⁹ The FOMC also said at that time that it “does not expect it will be appropriate to reduce the [FFR] target range until it has gained greater confidence that inflation is moving sustainably toward 2%.”⁷⁰ That can be understood to mean that the FOMC is likely to reduce rates before inflation has reached 2% so long as progress toward price stability continues. In March 2024, most FOMC members thought it would be appropriate to reduce the FFR in 2024, although all thought inflation would still continue to be above target. (Their projections fell between 2.4% and 3% for core inflation in 2024.⁷¹) The Fed is also predicting that unemployment will remain around 4% for the next two years, even though that would be unprecedented. In other words, the Fed is projecting the perfect soft landing—low inflation without materially higher unemployment.

Currently, the main policy debate is when to start reducing rates. In March, Chair Powell acknowledged that there are risks to reducing rates too quickly in 2024—inflation could start rising again, ultimately requiring even tighter monetary policy. But he also acknowledged risks to

⁶⁸ Fiscal policy consists of the sum of all government spending and revenue provisions. As such, fiscal policy options reflect the innumerable competing policy goals that make up those provisions. This section analyzes fiscal policy only from a macroeconomic perspective and does not consider the merits of the individual provisions that go into it. As such, it mainly focuses on the overall budget deficit and does not consider the limitless array of alternative policy changes that could be adopted to increase or decrease it.

⁶⁹ Federal Reserve, “Transcript of Chair Powell’s Press Conference Opening Statement,” March 20, 2024, <https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20240320.pdf>.

⁷⁰ Federal Reserve, “Federal Reserve Issues FOMC Statement,” press release, March 20, 2024, <https://www.federalreserve.gov/newsevents/pressreleases/monetary20240320a.htm>.

⁷¹ Federal Reserve, *Summary of Economic Projections*.

leaving tight monetary policy in place too long—it could trigger a hard landing.⁷² If inflation is already on a path back to 2%, it could be appropriate to reduce rates before inflation reaches 2% because of lags between changes in monetary policy and their effects on the economy. But inflation may not be heading back to 2%. In recent months, disinflation has stalled out, as discussed above. In April, Chair Powell stated that inflation had not shown enough improvement so far for the Fed to start cutting rates.⁷³ If inflation does not gradually fall as predicted, the Fed may ultimately be forced to reverse its view that rates have already peaked. In that case, the longer it waits, the more rates may ultimately need to be raised.

How contractionary is monetary policy now? As seen in **Figure 8**, rate increases were more rapid than in other tightening episodes in recent decades, but because rates were zero at the start of the tightening, rates never became that high relative to historical standards. The FFR has been higher than actual inflation only since 2023 and thus not contractionary before then. In nominal terms, the FFR is comparable to its level in 2006 and 2007 and the second half of the expansion ending in 2001 and lower than it was from the 1970s to the 1990s.

Where will rates end up once monetary policy is no longer contractionary? What is unusual by historical standards is how low rates were from 2008 to 2022. This is partly because of the two historically significant economic disruptions over that period that depressed rates—first, the 2008 financial crisis and then COVID-19. But rates were also low by historical standards throughout the 2009-2019 economic expansion that was in between the financial crisis and COVID-19, with no significant increase in inflation. This caused the Fed and many economists to believe that the economy had entered a new era of permanently low interest rates. The *neutral rate* (sometimes called “r star”) is the concept of the rate that is consistent with neither contractionary nor expansionary policy. It cannot be directly observed, but economists believe that the experience from 2008 to 2022 is consistent with a lower neutral rate.⁷⁴ The high inflation and high interest rate experience since 2022 could be a temporary blip or could be consistent with a longer-term increase in the neutral rate. If the neutral rate has remained low, then current monetary policy is tighter than in historical periods when rates were at a similar level, and interest rates can eventually return to low levels once price stability has been re-established. But if the neutral rate has risen, an effort to return rates to low levels that prevailed before the pandemic would be inconsistent with price stability.

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⁷² Federal Reserve, “Transcript of Chair Powell’s Press Conference Opening Statement.”

⁷³ Timiraos, “Powell Dials Back Expectations on Rate Cuts.”

⁷⁴ For more information, see CRS Insight IN11074, *Low Interest Rates, Part 3: Potential Causes*, by Marc Labonte.

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