RESEARCH SEMINAR IN QUANTITATIVE ECONOMICS
UNIVERSITY OF MICHIGAN

Gabriel M. Ehrlich, Director

George A. Fulton & Saul H. Hymans
Directors Emeriti

University of Michigan, Ann Arbor
Department of Economics
611 Tappan Avenue
Ann Arbor, MI 48109-1120

lsa.umich.edu/econ/rsqe
734-764-2567

For Release: 05/19/2023

The U.S. Economic Outlook for 2023–2024
Executive Summary: May 2023

Playing With Fire

A wide range of economic scenarios remains in play for the next year and a half. The recent stress in the banking sector has added to the pre-existing uncertainty. While the primary focus is on regional banks, the broader banking system balance sheet is under pressure from declines in asset values, deposit outflow, and the prospect of an upcoming recession. We believe that the stress in the banking sector will persist until banks have had time to heal their balance sheets. Many banks are likely to tighten standards further to lower the average credit risk of their loan portfolios.

The debt ceiling was officially reached on January 19, 2023. The Treasury could run out of "extraordinary" measures for debt management as soon as early June. The level of stress in the debt markets is high, with steep discounts for Treasury bills maturing next month. The probability of a U.S. default, while still very low, is markedly higher than during previous debt ceiling fights. Nonetheless, we expect the current standoff to be resolved with minimal damage to the economy.

Diverging Narratives

These stressors aid the widespread narrative that recession is imminent. Tighter lending standards, low current and expected level of industrial activity, stalled business fixed investment, and declining service sector sentiment all support that view. While the unemployment rate remains exceptionally low, the labor market appears to be cooling meaningfully along several other key metrics, albeit from an overheated state.

On the other hand, consumption expenditures grew at a 3.7 percent annualized pace in 2023Q1, the fastest since 2021Q2. Vehicle sales have surprised on the upside so far this year. Wage growth remains brisk, supporting incomes. So, there are plenty of reasons for optimism that the U.S. economy will be able to avoid a recession in 2023–24. Our outlook lies somewhere in between these two scenarios.

Inflation Cooling, Not Decisively

Considerable year-over-year declines in energy prices, stabilizing food prices, and a substantial slowdown of inflation for goods are contributing to ongoing declines of all-items inflation. Measures of underlying trend inflation, however, remain stubbornly high. Despite shelter inflation finally beginning to slow, core CPI inflation has averaged an annualized pace of 5.1 percent from January to April 2023. Inflation in wage-sensitive service industries has yet to begin cooling. As shelter inflation slows further, core inflation will decelerate, but a meaningful slowing to levels consistent with the Federal Reserve's 2.0 percent target is likely to require noticeable labor market softening.

Housing Settling Down?

The 30-year fixed mortage rate topped 7.0 percent last fall, but has since settled into the mid-6.0 percent range. The demand for housing appears to have stabilized after plummeting during last year's run-up in rates. We therefore judge the remaining housing market correction to be marginal, with the market avoiding large volumes of distressed sales or mortgage defaults with major spillovers to the rest of the economy.

Current homeowners' reluctance to give up their low-rate mortgages has contributed to limited supply in the market for existing homes, cushioning prices against larger declines. As a result, the residential construction sector is likely already seeing an inflow of buyers unable to find an existing house to purchase.

Banking On Policy Lags

Despite stubbornly high measures of trend inflation and the still-tight labor market, the Fed is widely expected to pause its monetary tightening cycle. The Fed is hoping policy lags from the previously-administered 500 basis points of rate increases to cool off the economy without additional hikes.

Research suggests that the effects of monetary tightening ramp up gradually over the course of many quarters, and it can take a few years before the full impact is evident. Additionally, the anticipated disinflation is expected to deliver gradually rising short-term real interest rates over the next few quarters, effectively tightening monetary policy further.

We project the Fed will hold its current 5.0–5.25 percent target range for the federal funds rate steady for the rest of 2023. We expect the Fed to start cutting rates in early 2024, as inflation slides and the labor

market softens, decreasing at a pace of roughly 25 basis points at every other meeting.

Ceiling The Deal

House Republicans are demanding spending cuts in exchange for lifting the debt ceiling, and we expect that the eventual deal will feature some. Given the tight schedule, a short-term relaxation of the debt ceiling appears likely, with a broader deal passing later this summer.

We think that mandatory spending reform is unlikely and that defense spending will probably be spared from cuts. Hence, discretionary nondefense spending growth is set to bear the brunt of cuts in the debt ceiling deal and the upcoming fiscal 2024 budget fight.

The modest projected slowdown of federal spending growth will not be enough to lower the deficit due to the ballooning interest payments on debt. The federal deficit grows from 4.3 percent of GDP in fiscal 2022 to 5.9 percent in fiscal 2024.

The 2023–24 Outlook

We expect growth to falter by late 2023, driven by a slowdown in consumer spending. Headline growth slows but remains positive in 2023Q2–Q3. By 2023Q4, economic momentum fades, as the effects of prior monetary policy tightening accumulate and scarcer credit bites. Headline growth turns slightly negative in 2023Q4–24Q1, with a cumulative contraction of about 0.2 percent of GDP. By early 2024, conditions warrant some monetary policy easing, which helps GDP growth to rebound above the 2.0 percent pace by 2024H2. Weak quarterly growth readings late in 2023 and early in 2024 contribute to the slowdown of calendar year GDP growth from 1.3 percent in 2023 to 0.5 percent in 2024.

We project significant progress on inflation over the next year as consumers pull back due to higher interest rates and the rental market cools. Core CPI inflation falls from 4.9 percent in 2023 to 3.1 percent in 2024. Headline CPI inflation is expected to stay below core inflation throughout the forecast, with food and energy price growth lagging behind.

The downward trend in job gains continues in the forecast. The economy sheds 522,000 jobs between 2023Q4 and 2024Q3 before adding back 90,000 jobs in 2024Q4. On a calendar year basis, payroll employment adds 3.3 million jobs in 2023 and loses 0.1 million in 2024. The unemployment rate stays flat in 2023, and climbs to 4.1 percent in 2024.

The pace of light vehicle sales is expected to stall for the next several quarters at around 15.5 million units as the economy goes through a soft patch and high vehicle financing interest rates bite. As economic growth returns in the second half of 2024, and interest rates fall, the vehicle sales pace turns up, topping 16 million units late in the year.

With the recent peak in mortgage rates behind us, the pace of single-family starts bottoms out in the third quarter of 2023 before embarking on a slow recovery. As a wave of new supply comes to the market and a slowing economy puts further downward pressure on rents, multi-family starts fall modestly throughout the forecast. As a result, total housing starts edge down during 2023 and stabilize in 2024, averaging 1.4 and 1.3 million units, respectively.

	Actual		**RSQE Forecast**	
	2021	2022	2023	2024
GDP (billions of current $)	23315.1	25462.7	26847.5	27701.0
Real GDP (billions of 2012 $)	19609.8	20014.1	20283.9	20387.7
% change: year-over-year	5.9	2.1	1.3	0.5
% change: 4th-qtr-to-4th-qtr	5.7	0.9	0.5	1.2
Nonfarm payroll employment (millions)	146.3	152.6	155.9	155.8
Civilian unemployment rate (%)	5.4	3.6	3.6	4.1
Capacity utilization, total industry (%)	77.6	80.3	78.6	75.3
Inflation (private nonfarm GDP deflator, % change)	4.5	7.0	4.0	2.7
Inflation (CPI-U, % change)	4.7	8.0	4.1	2.7
Inflation (core CPI, % change)	3.6	6.1	4.9	3.1
Light vehicle sales (millions)	14.9	13.8	15.4	15.7
Private housing starts (thousands)	1605.2	1553.7	1365.8	1311.3
3-month Treasury bill rate (%)	0.0	2.0	4.9	4.5
10-year Treasury note rate (%)	1.4	3.0	3.5	3.4
Conventional mortgage rate (%)	3.0	5.3	6.1	5.5
Real disposable income (billions of chained 2012 $)	16130.0	15148.9	15609.0	15641.1
% change	1.9	-6.1	3.0	0.2
Corporate profits after tax (billions of current $)	2749.8	2872.2	2767.3	2819.9
Value of U.S. $ (FRB broad index), % appreciation	-3.9	6.7	-0.9	-0.2
Current account balance (NIPA basis, billions of current $)	-861.4	-994.7	-890.9	-723.2
Federal surplus (FY, NIPA basis, billions of current $)	-2948.9	-1087.1	-1479.6	-1617.8