CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

Phillip L. Swagel, Director

November 30, 2022

Honorable Steve Daines
United States Senate
Washington, DC 20510

Re: Questions About CBO's Current View of the Economy in 2023 and 2024 and the Implications for Households and the Federal Budget

Dear Senator:

This letter responds to questions you and your colleagues asked about the Congressional Budget Office's current view of the economy over the next two years, how that view compares with projections that CBO made most recently and with those of the Federal Reserve, and the implications of that view for households and the federal budget.

- CBO currently expects rates of interest and inflation to be higher over the next two years than it projected most recently.

- CBO expects economic growth in 2023 to be slower than it projected most recently, reflecting recent developments (including higher interest rates), and faster in 2024, as the economy recovers.

- Higher interest rates, higher inflation, and slower economic growth lead to less purchasing power for households and increased deficits for the federal government.

CBO's current view of the economy incorporates available information through mid-November. The agency's most recent projections were published in May 2022.[1] The Federal Reserve's most recent projections were published in September 2022.[2]

CBO will publish its budget and economic projections early next year in the agency's annual *Budget and Economic Outlook*. As part of the process of preparing that report, CBO is in the midst of revising its economic forecast. In response to interest expressed by you and other Members of Congress, the agency released a report today that provides preliminary information about the revision.[3] The information is more comprehensive than would have been possible if CBO's standard process for developing its forecast had not already been underway. This letter draws on that report, focusing on the economic variables you and your colleagues asked about—interest rates, inflation, and output—and the implications that CBO's current view of the economy has for the budget.

Interest Rates

You and your colleagues asked how CBO's current view of interest rates compares with its previous forecast and the Federal Reserve's forecasts. CBO currently expects higher interest rates than it did in May 2022. In particular, the federal funds rate—the rate that financial institutions charge each other for overnight loans—is likely to be greater in 2023 and 2024 than, respectively, the 2.4 percent and 2.6 percent estimated most recently for the fourth quarters of those years. The revisions stem mainly from greater increases in 2022 in the federal funds rate set by the Federal Reserve and in inflation than CBO had projected.

The agency expects that the federal funds rate in 2023 is about as likely to be above the central tendency (roughly the middle two-thirds) of the most recent projections by Federal Reserve officials in September 2022 as below it. For 2024, those interest rates are more likely to be below that range from the Federal Reserve than above it.

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[1] See Congressional Budget Office, *The Budget and Economic Outlook: 2022 to 2032* (May 2022), www.cbo.gov/publication/57950. The projections in that report underlie the baseline that will be used in cost estimates for legislation at least through the end of 2022.

[2] See Board of Governors of the Federal Reserve System, "Table 1. Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents, Under Their Individual Assumptions of Projected Appropriate Monetary Policy, September 2022" (September 21, 2022), https://tinyurl.com/ycx5pchd.

[3] See Congressional Budget Office, *CBO's Current View of the Economy in 2023 and 2024 and the Budgetary Implications* (November 2022), www.cbo.gov/publication/58757.

Inflation

You and your colleagues also asked how CBO's current view of inflation compares with its most recent forecast and the Federal Reserve's forecasts. CBO currently expects higher inflation than it did in May 2022. The inflation rates in 2023 and 2024, as measured by the change in the personal consumption expenditures (PCE) price index in the fourth quarter relative to the fourth quarter of the previous year, are likely to be greater than the rates CBO projected previously, which were 2.3 percent and 2.1 percent for the fourth quarters of those years, respectively. The revisions stem mainly from stronger growth in the prices of housing and other services than previously projected. The agency expects that the PCE inflation rate in 2023 and 2024 is about as likely to be above the central tendency of projections by the Federal Reserve as below it.

Output

You and your colleagues asked about CBO's current view of output. From the fourth quarter of 2022 to the fourth quarter of 2023, CBO estimates, there is a two-thirds chance that growth in economic output—specifically, gross domestic product adjusted to remove the effects of inflation, or real GDP—will be between −2.0 percent and 1.8 percent. For 2024, that estimate ranges from 0.7 percent to 4.2 percent. Because CBO is in the midst of revising its economic forecast, this analysis focuses on the middle two-thirds of a range that indicates uncertainty about the possible outcomes. The forecast published early next year will include point estimates.

CBO now expects real GDP growth in 2023 to be less than the rate the agency projected in May 2022. The revision reflects the data available so far for 2022: Actual growth has been much slower than CBO had projected, and increases in interest rates by the Federal Reserve have been much greater than CBO had projected, along with other factors. The agency expects real GDP growth in 2024 to be greater than the rate it projected in May 2022, as the economy recovers from slow growth in 2022 and 2023.

Implications for Households

You and your colleagues asked what the effects on a middle-class American worker would be over the next two years if inflation (as measured by the consumer price index for all urban consumers, or CPI-U) was above 8 percent and was greater than nominal wage growth. CBO has not analyzed that scenario, and doing so would be difficult in part because of how much higher that rate of inflation is than the rates CBO expects over the next two years.

The scenario you asked about is similar to what has been occurring in 2022, which CBO has analyzed. For this year, the agency estimates, the price of a standard consumption bundle will increase by 7.7 percent for households in the middle fifth of the income distribution, amounting to a reduction in purchasing power of about $5,500; those households' market income is estimated to increase by an average of about $3,000 this year—partially offsetting the decrease in purchasing power.[4]

You and your colleagues also asked what the effects on households would be if the interest rates on 10-year Treasury notes were at or above 4 percent over the next two years. Interest rates over the next two years that were higher than they have been in previous years would have various effects, including increasing the costs of buying homes and motor vehicles and boosting the amount of interest received on savings. Higher rates would weaken the demand for workers in sectors sensitive to interest rates, such as residential construction, and more broadly because of reduced investment by businesses and reduced net exports (stemming from a higher international exchange value of the dollar).

Implications for the Federal Budget

You and your colleagues asked about the effects on the federal budget if real GDP growth stalls or turns negative over the next year and if interest rates on 10-year Treasury notes are at least 4 percent during the next two years. In CBO's assessment, at least one quarter of negative real GDP growth between now and the end of 2023 is likely, and interest rates on 10-year Treasury notes are roughly as likely as not to be above 4 percent during the next two years. Broadly speaking, slower economic growth and higher interest rates would increase federal deficits and debt.

Because the scenario you and your colleagues asked about is similar to CBO's current view of the outlook for real GDP and interest rates, the agency used those expectations along with others as the basis for answering your question. To indicate uncertainty about the possible outcomes, CBO used 100 simulations of economic conditions over the next two years that underlie the range of estimates for output discussed above. The agency then made rough estimates of how its May 2022 baseline budget projections

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[4] See Congressional Budget Office, *How Inflation Has Affected Households at Different Income Levels Since 2019* (September 2022), footnote 9, www.cbo.gov/publication/58426. That report defines the measures of consumption, prices, and income used in the analysis. Market income consists of labor income, business income, capital income, and other income from nongovernmental sources.

would have differed if it had used each simulation as its economic forecast.[5]

The analysis did not include estimates stemming from legislative or technical changes to the budget projections. Those legislative and technical effects, which have often been larger than the economic effects, will be included when CBO updates its budget projections early next year. In that update, the agency will incorporate the details of its economic forecast into its budget projections by considering each spending account in the budget and each revenue provision in effect. That method captures the effects of numerous factors, such as changes in asset values, that are not reflected in the rough estimates discussed here.

Analysis using the 100 simulations of economic conditions finds that if any one of them had been used as the forecast underlying CBO's baseline budget projections in May 2022 rather than the forecast used at that time, the federal deficit would almost surely have been greater. In the middle two-thirds of the cases, the May 2022 baseline projections would have differed in the following ways:

- For fiscal year 2023, the deficit would have been larger by between $200 billion and $300 billion, or between 20 percent and 30 percent, and

- For fiscal year 2024, it would have been larger by between $210 billion and $480 billion, or between 20 percent and 46 percent.

Increases in net interest costs in almost every case are the primary contributor to greater deficits. The effects on revenues and noninterest spending also contributed to greater deficits in most cases.

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[5] For details about the analytic methods used, see Congressional Budget Office, *CBO's Current View of the Economy in 2023 and 2024 and the Budgetary Implications* (November 2022), Box 1, www.cbo.gov/publication/58757.

I hope this information is useful to you. Please contact me if you have further questions.

Sincerely,

Phillip L. Swagel
Director

cc: Honorable John Barrasso, Honorable Bill Cassidy, Honorable John Cornyn, Honorable Kevin Cramer, Honorable Mike Crapo, Honorable Charles Grassley, Honorable Bill Hagerty, Honorable James Lankford, Honorable Cynthia Lummis, Honorable Mike Rounds, Honorable Tim Scott, Honorable John Thune, Honorable Pat Toomey, and Honorable Todd Young