



The Current State and Future Outlook of the US Economy

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ARTICLE INFO

Article History:

Received: September 08, 2023
Revised: November 04, 2023
Accepted: November 06, 2023
Available Online: December 02, 2023

Keywords:

US Economy
Interest Rates
Gross Domestic Product
Inflation

JEL Classification Codes:

A1, E0, E4

Funding:

This research received no specific grant from any funding agency in the public, commercial, or not-for-profit sectors.

ABSTRACT

The study examines the current state of the US economy after the interest rate increases implemented by the Federal Reserve from January 2022 to July 2023 to reduce the rise in inflation. Although the Federal Reserve has successfully reduced inflation during this time period, the thesis of this paper is that future interest rate increases would be damaging to the economy and result in a recession. The five key economic indicators reviewed to assess the current state of the economy are (1) national debt, (2) real GDP growth rate, (3) inflation, (4) interest rate yield curve, and (5) unemployment. The conclusion of the paper is that the US Federal Reserve would damage several components of the economy if interest rate increases continue into the future, and it would increase the likelihood of a recession. The benefit of continuing with this monetary policy would be to decrease inflation from 3% to the publicly stated target of 2%. However, costs associated with this would be significantly higher since it would result in an increase in the US national debt and annual budget deficit because the servicing costs of the debt would increase dramatically. This would have a major impact on the US economy and eventually lead to an economic downturn.



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Citation: Husain, A., & Mark, I. (2023). The Current State and Future Outlook of the US Economy. *iRASD Journal of Economics*, 5(4), 845–854. <https://doi.org/10.52131/joe.2023.0504.0165>

1. Introduction

The current state of the US economy was shaped over the past 18 months when the Federal Reserve began increasing interest rates to combat inflation. When the first interest rate increase occurred on March 16, 2022 GOVERNORS (2022), the inflation rate was 8.5% (Chokshu, 2022). Inflation has declined to 3.0% as of June 2023, and the unemployment rate has fallen to 3.6% (Statistics, 2023). This gives the impression that the US economy is now financially sound and well-positioned for future growth. However, the thesis of this paper is that although the increase in interest rates has curtailed inflation in the US, future interest rate increases would likely be damaging to the economy and result in a recession. The current pursuit of an inflation target of 2% per year by continuing to raise interest rates would create more severe damage to other components of the US economy. To date, the consensus in the community has been to passively wait for action by the Federal Reserve and to assess its effectiveness retroactively. However, going forward, it is more important to review the options available for policy decisions, such as interest rates, and to recommend the appropriate options rather than to be reactive.

This is important to both the US economy and the world economy due to the significant impact that the US economy can have globally (as evidenced by 2008). This paper will provide a review of the current state of the US economy and future outlook based on the review of the following five critical economic variables: (1) national debt, (2) real GDP growth rate, (3) inflation, (4) interest rate yield curve, and (5) unemployment. The significance of each of these variables, along with their current implications, will be analysed in the body of this report.

2. National Debt

The national debt is a key component of an economy since an excessively high debt level can result in interest payments that are difficult to service. It also restricts the ability of a government to respond to an economic crisis by using fiscal policy. The increase in interest rates has had a significant impact on US national debt because of the fact that interest payments have almost doubled in the past two years. In 2021, the US paid \$352 billion in interest to service its national debt, which has increased to \$659 billion Stein (2023) as of October 2023. This sizable increase in interest payments represents the fourth largest component of the annual US budget deficit of \$2 trillion.

As of Q1, 2023, the US national debt has reached \$31 trillion, which represents 118.5% of the annual GDP of the US (FRED, 2023a). The chart below shows that this has reached a concerning level on both an absolute and percentage basis, and it gives the implication that much of the growth of the past 15 years has been artificially induced by excessive government debt.

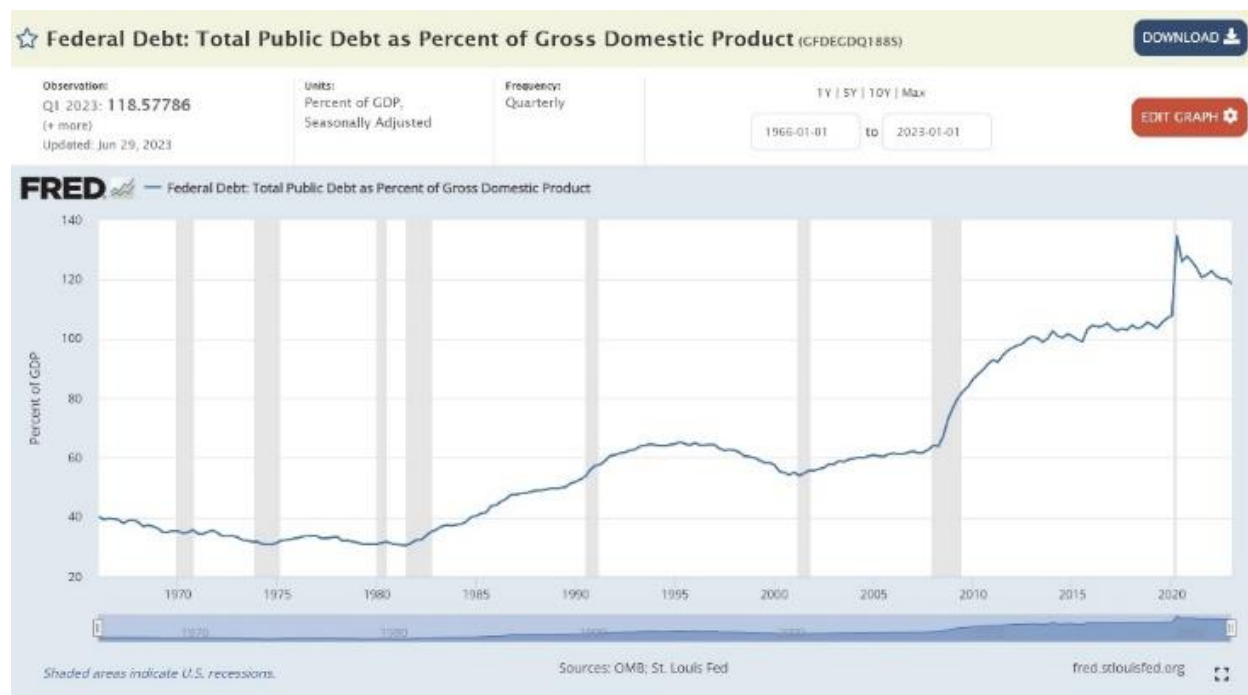


Figure 1: National Debt

Note: Rise in total public debt as a percentage of GDP. Graph from FRED Economic Data <https://fred.stlouisfed.org/>

The stimulus program offered in 2008 contributed to a significant portion of the debt, as did the lockdown stimulus of 2020, which was implemented to deal with short-term economic crises. While they achieved their goals of injecting capital into the economy and preventing a meltdown, they also increased the need for raising the US debt ceiling (Gurufocus, 2023). The most concerning part is that both stimuli resulted in short-term artificial economic benefits, but

they raised the debt level permanently. However, the government still needs to present a formal strategy or timeline on how these increases in debt will be repaid before they reach an unsustainable level. A modeling analysis prepared by the Penn Wharton at the University of Pennsylvania Gokhale (2023) concludes that “under current policy, the United States has about 20 years for corrective action after which no amount of future tax increases or spending cuts could avoid the government defaulting on its debt.” If this were to occur, the economic implications of a US Default on debt would be felt globally among the world economies.

3. Real GDP Growth Rate

The real GDP of the US is one of the five variables analysed because it is a useful method to value the size of the economy after it has been adjusted for the impact of inflation. As stated by the International Monetary Fund Callen (2012), “an increase in real GDP is interpreted as a sign that the economy is doing well.” The economic consensus is that developed countries should have an annual GDP growth range of 2% to 3% per year (Amadeo, 2019). Sustained growth above this range could be the sign of a developing asset bubble, while rates below could be the sign of a period of stagnation or recession arising.

As the following chart shows, the real GDP growth was within that range leading up to the COVID lockdown, when it went significantly negative due to the change in the economic environment (Macrotremds, 2023).

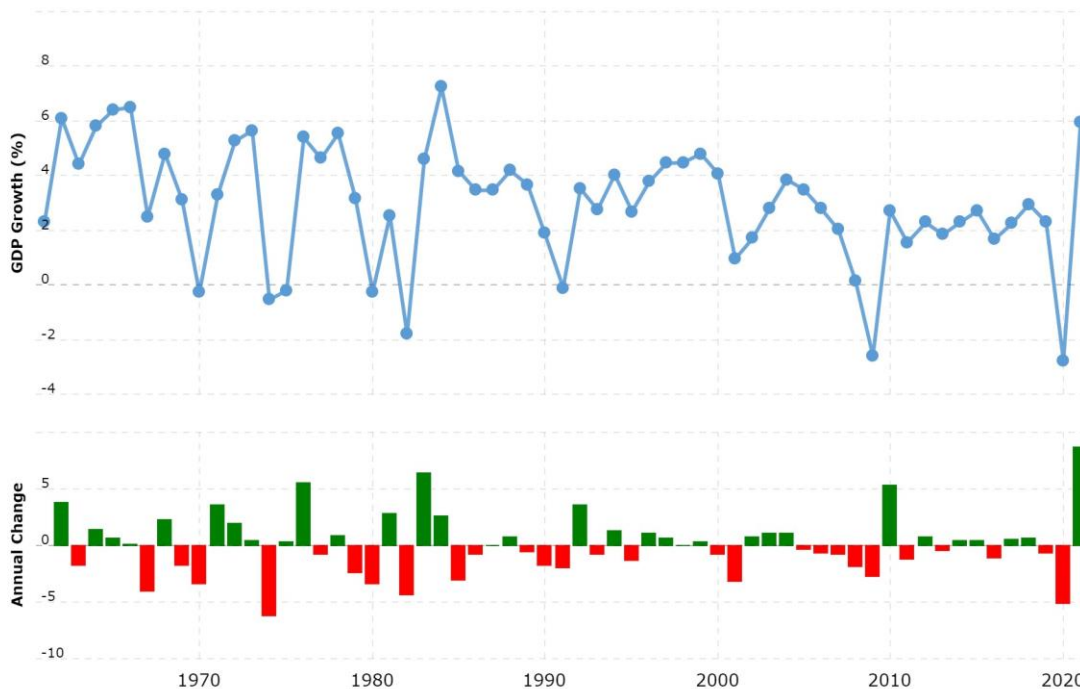


Figure 2: Real GDP Growth Rate

Note: Change in US GDP growth rate from 1961 to 2023. Graph from Macrotremds.net. <https://www.macrotrends.net/countries/USA/united-states/gdp-growth-rate>

The increase in stimulus payments caused the recovery of GDP in the following year, but it has settled back to a range below 2% annual growth.

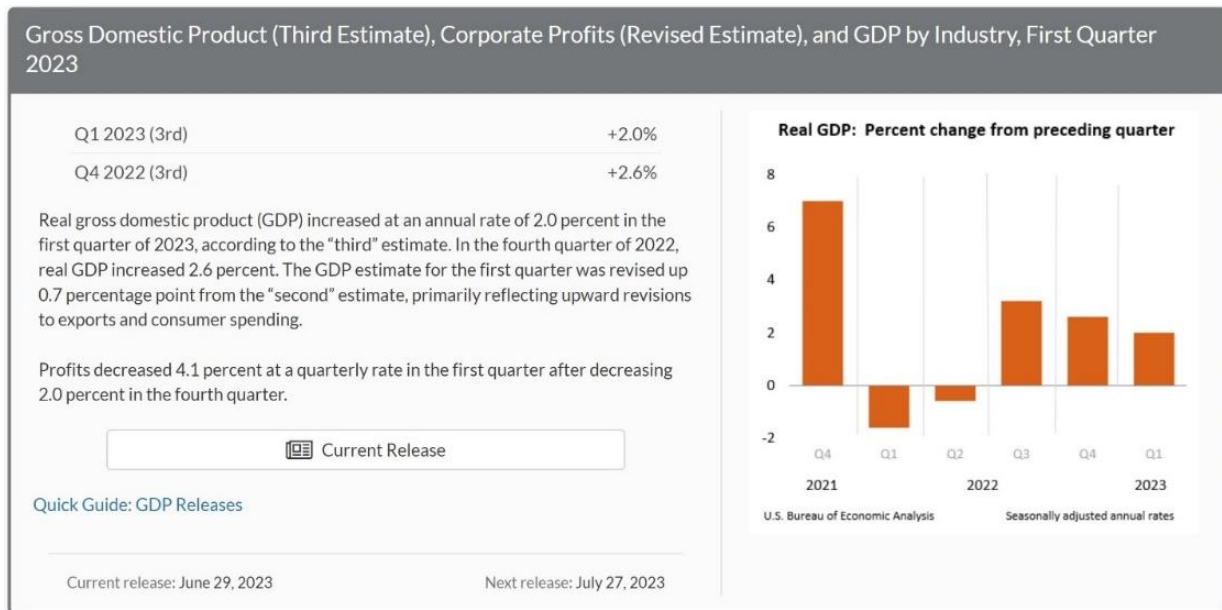


Figure 3: Real GDP Growth Rate (Quarterly)

Note: Change in US quarterly GDP from 2021 to 2023. Graph from <https://www.bea.gov/data/gdp/gross-domestic-product>

While this would not necessarily be a significant negative signal in average years, it is a concern given the post-COVID environment. The US government spent substantial amounts of money on COVID-related stimulus packages for the economy during this period, so the expectation would be that the GDP growth rate would be close to their goal of 3%. As most of the government intervention has ended, it would imply that the current economy is forecasted to enter either a period of stagnation or recession in the upcoming years.

4. Inflation

The management of inflation is a prudent goal for every national bank because low and stable levels of inflation are beneficial for the economy. This allows the purchasing power of the currency to be preserved and also maintains consumer confidence. The publicly stated goal of the Federal Reserve has been to maintain inflation at 2% per year (Reserve-Federal, 2020). While it could be debated whether this is an appropriate target for a healthy economy, it is the primary target that has been pursued with monetary policy. The chart below shows that this target was maintained until inflation peaked at 9% after the COVID lockdown, so there was clear justification for the Federal Reserve to take action to prevent further inflation increases.

The actions of the Federal Reserve in raising interest rates have been successful since they brought inflation back down to 3% in June 2023 (Federal-Reserve, 2013). However, suppose the Federal Reserve rigidly maintains its stated goal of 2% inflation. In that case, interest rates would be increased further, which would cause significant other economic problems like higher servicing costs of the US debt and likely a recession. In the early 1980s, when the inflation rate was double-digit, Paul Volker's dramatic increases in interest rates showed how quickly the economy could decline. While today's inflationary situation is not in the same category as the 1980s, when it reached almost 15%, Federal-Reserve (2013) it remains to be seen how serious the Federal Reserve considers the goal of 2% inflation.

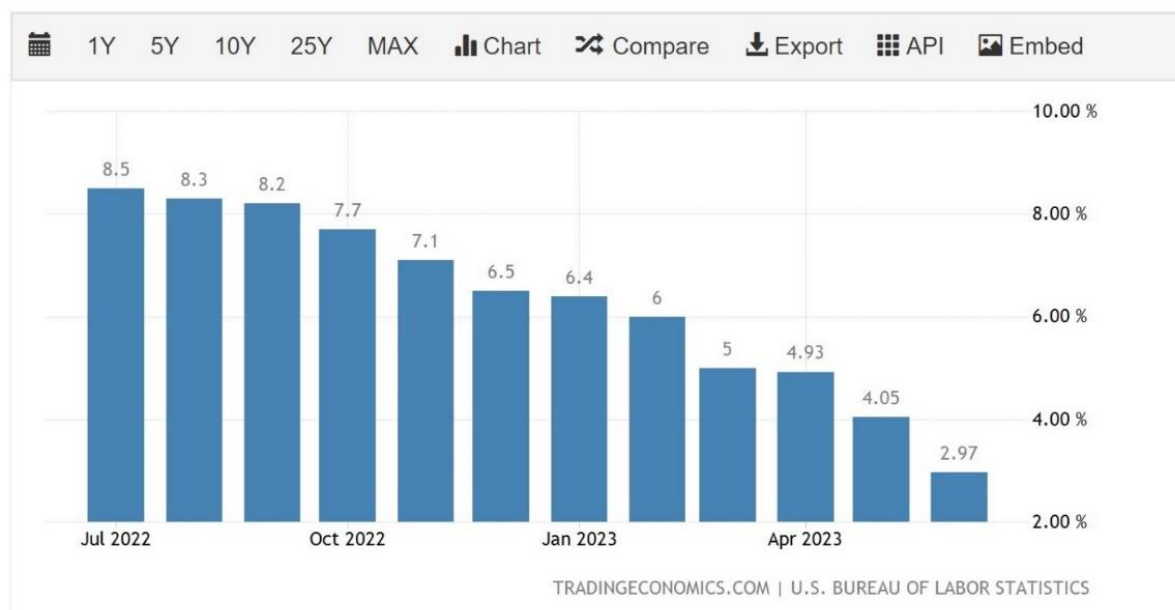


Figure 4: Inflation Rate

Note: Change in US quarterly inflation from 2022 to 2023. Graph from TradingEconomics.com. "United States Inflation Rate," July 2023. <https://tradingeconomics.com/united-states/inflation-cpi>

Although the current level of inflation does not imply any economic concerns for the US, the unknown potential actions of the Federal Reserve are a cautionary indicator. To date, all indications are that they are rigid in pursuing this target, so they will need to continue increasing interest rates in the future, which will likely slow down the economy further and lead to a recession.

5. Interest Rate Yield Curve

The interest rate yield curve is one of the economic variables that this paper has included since it is a common leading indicator of an economy. The shape and slope of the yield curve provide a summary of the expectations built in by the market, so it is a significant predictor. The chart below shows that the Federal Funds Effective Rate increase of 5.04% over the last 18 months was the largest in the past 40 years (FRED, 2023b). As discussed earlier in this paper, this monetary policy strategy has achieved its goal of reducing inflation, but it has also slowed down the real GDP growth rate.

The main positive signal associated with this strategy is that the Federal Reserve believes the economy is fundamentally strong and no longer in the dangerous position of the zero lower bound (Summers, 2016). If they did not think the economy was strong, the Federal Reserve would not increase interest rates at this speed since it would risk entering a deep recession or depression. Although the Federal Reserve may have a positive expectation, the actual economy's performance will depend on the response to the magnitude of future interest rate increases. The increases over the previous 18 months slowed the economy significantly, so future interest rate increases will likely slow it further. Since the current GDP growth rate is below the target range of 2-3% per year, future interest increases may cause economic growth to actually flatten.

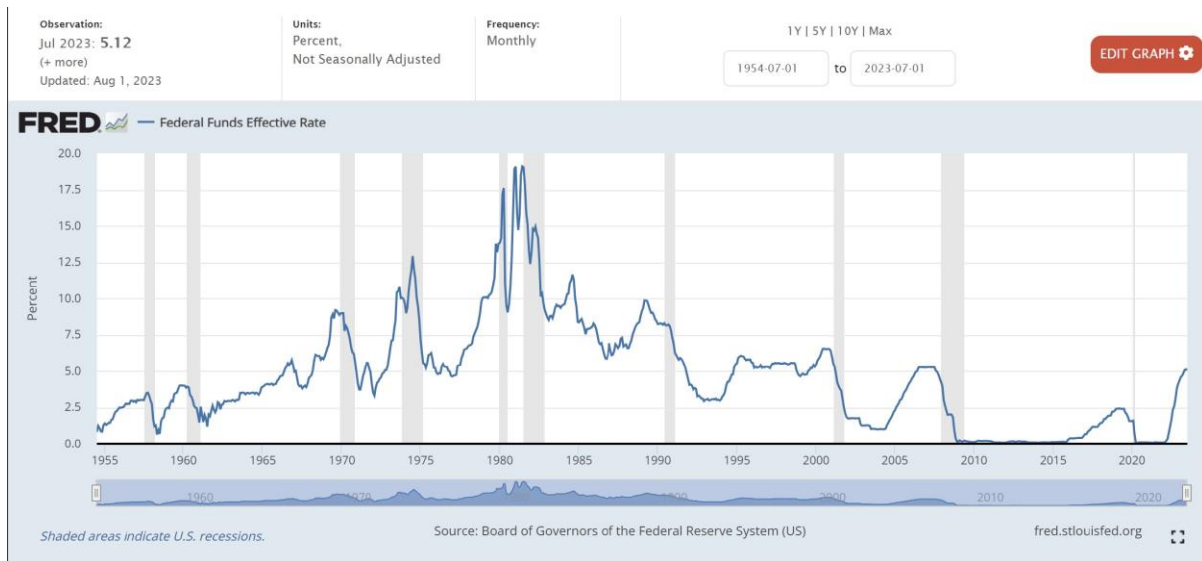


Figure 5: Annual Inflation Rate

Note: Annual inflation rate in the US from 1955 to 2023. Graph from FRED Economic Data <https://fred.stlouisfed.org/>

Despite the positive signal implied by the Federal Reserve’s decision to raise interest rates, the yield curve for interest rates sends the opposite signal. A traditional yield curve is upward sloping to the right since it expects long-term interest rates to pay investors a higher rate of return for locking in their investments. On the other hand, the inverted yield curve (like the one that currently exists) is often an effective predictor of an upcoming recession (Benzoni, Chyruk, & Kelley, 2018). Essentially, the market expects interest rates to decline in the future, even though the Federal Reserve has indicated that it will maintain or raise them at the current level or raise them. The only reason they would deviate from that would be if the economy entered a recession, which the bond market has priced in based on the inverted yield curve below (Gurufocus, 2023).

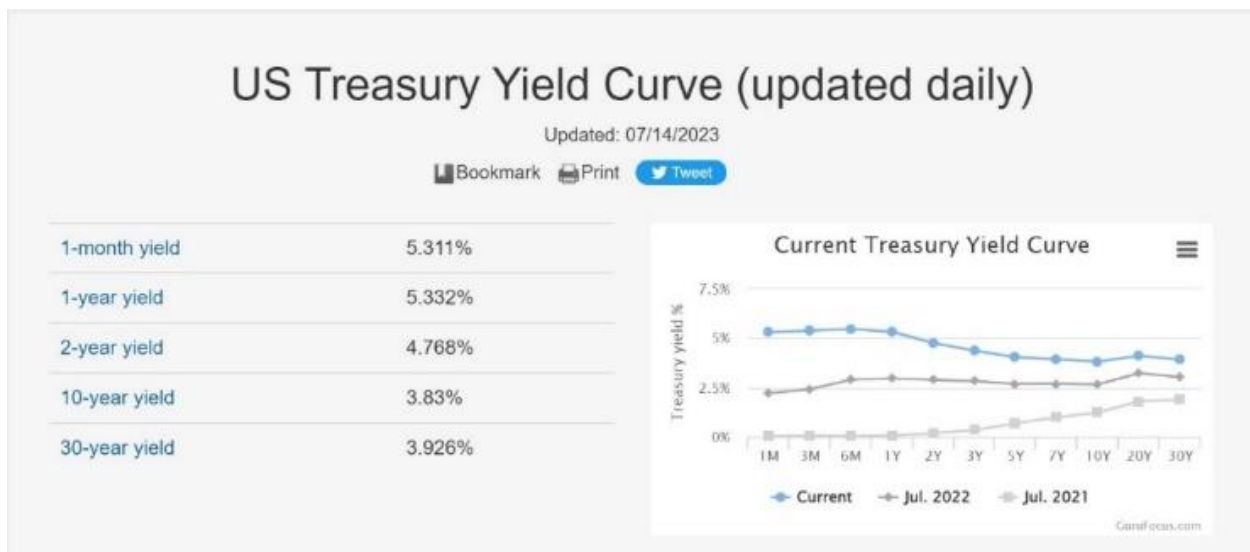


Figure 6: US Treasury Yield

Note: The US Yield curve as at July 14, 2023. Graph from Gurufocus.com. “US Treasury Yield Curve,” July 14, 2023. https://www.gurufocus.com/yield_curve.php

6. Unemployment Rate

Although unemployment is a lagging indicator rather than a leading indicator Oner (2017), it is still an important economic variable to review when assessing the state of a country's economy. The current unemployment rate for the US economy of 3.6% Statistics (2023) is below the desired target of 5% associated with full employment, which implies that the economy is in a healthy state. As the chart shows, other than a spike during the COVID lockdown, the unemployment rate has trended downward for the last decade, implying that the economy is in a state of growth (FRED, 2023d).

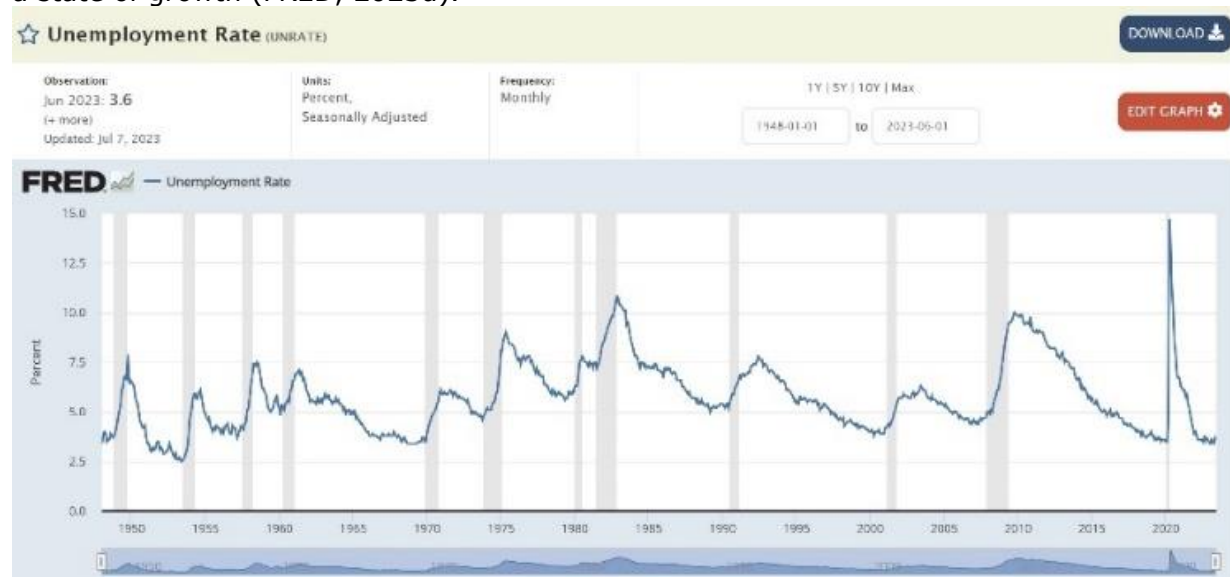


Figure 7: Unemployment Rate

Note: Annual unemployment rate in the US from 1950 to 2023. Graph from FRED Economic Data <https://fred.stlouisfed.org/>

Usually, this is a positive indicator that implies that the country is positioned for continued economic growth. However, the unemployment rate is impacted by a few unique factors in today's environment. Traditionally it is accepted that one of the problems with using the unemployment rate as a benchmark for economic performance is that it does not factor in people who have stopped looking for jobs. As indicated by the chart below, the participation rate has steadily declined over the last decade FRED (2023c), and one of the reasons is the more significant number of people who have approached retirement age.

The participation rate is currently around 63%, well off the peak of 67% at the start of the century. As retiring people are not included in the unemployment numbers, it shows that one of the major causes of the lower unemployment rate is not a growing economy but fewer people in the workforce. Since people have left the workforce, it also implies that future production and GDP would decline from current levels.

The other issue with the unemployment rate is assessing whether it is truly at the target full-employment level. Using the "U-6" unemployment level instead would include people who are marginally attached to the labor force and part-time workers. This would be a more accurate representation of the number of people who do not have full employment. As shown in the chart below FRED (2023b), the U-6 rate is 6.9% as of June 2023, which implies that the economy is not operating at full employment target of 5% unemployment.



Figure 8: Labor Force Participation Rate

Note: Annual labour participation rate in the US from 1950 to 2023. Graph from FRED Economic Data <https://fred.stlouisfed.org/>

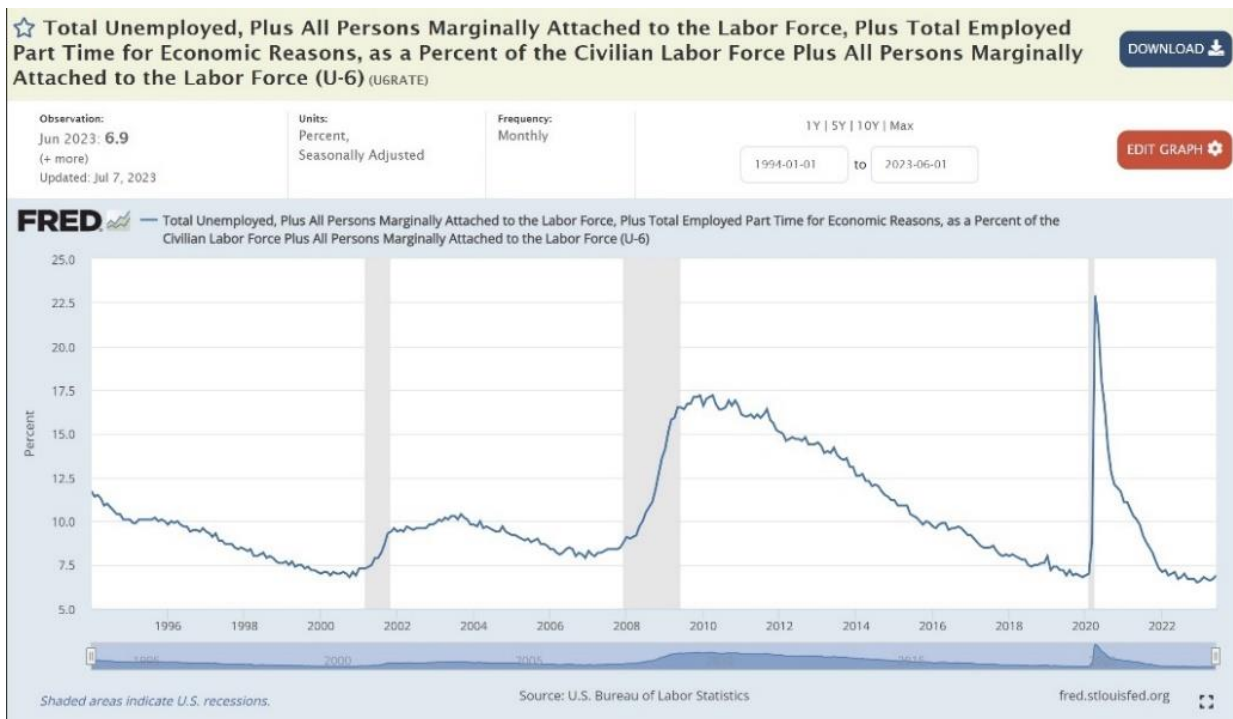


Figure 9: Unemployment Rate

Note: Annual US unemployment rate (U6) from 1990 to 2023. Graph from FRED Economic Data <https://fred.stlouisfed.org/>

7. Conclusion

The analysis of the five critical variables reviewed highlights some cautionary points about the future of the US economy. Although the Federal-Reserve (2002) has resulted in reasonable levels of inflation and unemployment, the other three variables offer cause for concern. The US national debt has continued to grow to a historically high level, and the dramatic increase in interest rates has caused debt servicing costs to double over the past two years. Also, the real GDP growth rate has declined despite the US fiscal policy used to provide substantial amounts of COVID-related stimulus packages. In addition, the inverted yield curve indicates that the market expectations are that the economy is positioned for a recession.

Although the analysis of these variables implies a scenario of an economic downturn in the US, this is based on the current economic policy in place. The thesis of this paper is that the past increase in interest rates has curtailed inflation in the US; however, future interest rate increases would damage the economy and result in a recession. The most significant impact of pursuing this monetary policy would be the excessive interest costs the US government would need to pay on its existing national debt. The annual deficit would not be able to return to a sustainable level under this monetary policy environment. The benefits of pursuing a rigid policy of decreasing inflation from 3% down to the target of 2% are far outweighed by the cost associated with the increase in US national debt and the impact on the economy overall. Since the problem of excessive inflation has been removed, the US Federal Reserve should shift its focus from the current monetary policy to more pressing economic variables such as the national debt and its related servicing costs.

Authors' Contribution

Anwar Husain: Original Draft, Idea, Conceptual Framework, Methodology, Editing, Formatting, Data Analysis, Literature Review.

Ian Mark: Proofreading, Data Collection.

Conflict of Interests/Disclosures

The authors declared no potential conflicts of interest w.r.t the research, authorship and/or publication of this article.

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