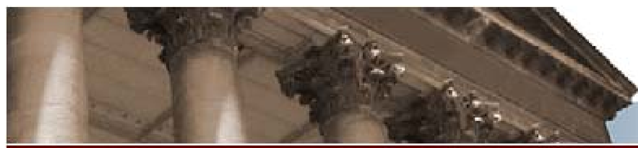

JOINT ECONOMIC COMMITTEE
SENATE REPUBLICANS

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A PRIMER ON ECONOMIC RECESSIONS

What is a recession?

A recession generally means a period of time with declines in economic activity spread across the economy. In a recession, output of goods and services in the overall economy declines and employment of resources, including labor and capital, also declines.

According to the Business Cycle Dating Committee of the National Bureau of Economic Research (NBER), the semi-official arbiter of dates identifying periods of economic recession: "A recession is a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real (inflation-adjusted) GDP (gross domestic product), real income, employment, industrial production, and wholesale-retail sales."[1]

As a rule of thumb, most people identify an economic recession as two or more consecutive quarters with declines in real GDP, a broad measure of the market value of goods and services produced within the U.S. in a given period of time. While most past periods in which the U.S. economy was believed to have been in recession have consisted of two or more consecutive quarters with declines in real GDP, it is not necessarily the case that two quarters with declines occurs. For example, according to current data, real GDP declined in the third quarter of 2000 and in the first and third quarters of 2001. While there were not, during that period, two consecutive quarters with declines in real GDP when looking at revised data, the economy was labeled by the NBER to have been in a recession between March 2001 and November 2001 given information that was available to its dating committee when the labeling decision was made.

Are we in a recession?

No one knows right now. We typically learn whether the economy has slipped into a recession after the fact, either by applying the two-consecutive-quarters with real GDP declines rule-of-thumb or by awaiting the NBER proclamation that a recession has occurred. We will not know, in association with recent signs of weakness in the economy, whether there will be two consecutive quarters with declines in real GDP until after those quarters have elapsed. And the NBER's approach to determining whether the economy has slipped into a recession is similarly retrospective, so a verdict from the NBER is unlikely to be delivered in the next couple of months.

Thus far, the majority of private forecasters place the odds of a recession at anywhere from 40% to 60%, with risks weighted toward the downside. Some economists believe that we already are in a recession, but that view does not currently represent consensus thought. The *Blue Chip* consensus forecast, an average from a panel of private forecasters, sees annualized growth in real GDP slowing to 1.3% in the 4th quarter of 2007 and in the 1st quarter of this year, but none of the consensus forecasts (or even the average of the 10

[1] See http://www.nber.org/cycles/jan08bcdc_memo.pdf .

most pessimistic forecasts) are for growth below 1.0% for any quarter between now and the end of 2009. That is, private forecasters are not forecasting a recession. However, the most recent Blue Chip forecast averages were compiled prior to the announcement of weak job growth and a significant rise in the Nation's unemployment rate in December.

According to Federal Reserve Chairman Ben Bernanke, in Testimony before the House Committee on the Budget on January 17, the Federal Reserve sees a slowing of growth in the economy, but is not forecasting a recession.

According to "The Budget and Economic Outlook: Fiscal Years 2008 to 2018," released by the Congressional Budget Office (CBO) on January 23 of this year: "Although recent data suggest that the probability of a recession in 2008 has increased, CBO does not expect the slowdown in economic growth to be large enough to register as a recession."

Thus, neither CBO, the Federal Reserve, nor even an average of the 10 most pessimistic forecasts contained in the *Blue Chip* consensus of private professional forecasters is forecasting a recession for the U.S. economy.

What data suggest that the economy may slip into a recession?

The most recent data on real GDP show that the economy grew at a rapid 4.9% annualized rate in the 3rd quarter of last year, well above what most believe is the long-run trend. However, most indicators suggest that growth in the 4th quarter will be significantly lower, and some believe that real GDP may have actually fallen. More importantly, there has been a string of reports on economic and financial activity in December of last year and thus far in January that have increased the downside risks to growth. Among the information revealed in these reports and associated trends:

- Job growth has fallen, with an outright decline in *private* payroll employment in December;
- The unemployment rate increased 0.3% in December, to 5.0% from 4.7% in November;
- The housing market correction continues along with a continuation of fallout from increased mortgage delinquencies and associated financial losses;
- Equity prices have fallen in stock markets, reducing household wealth;
- Credit conditions remain tight in some areas;
- Heightened risk aversion and uncertainties seem to continue in many segments of financial markets, which have led to tightening of the supply of credit to households and businesses;
- Measures of consumer confidence have generally trended down since last summer;
- Retail sales declined by 0.4% in December relative to November, a possible signal of slowing of consumer spending (consumer spending accounts for 70% of all spending and output in the economy, so what happens to consumer spending is very important);
- The Institute for Supply Management (ISM) index of activity in manufacturing fell below 50 in December, indicating contraction in the Nation's manufacturing sector (a value of the index above 50 signals expansion, while a value below 50 signals contraction). The ISM index for the non-manufacturing, or "service," sector has been trending down since last summer, but remains above 50.

In addition to several signals of a slowdown in economic activity, there are concerns that increases in energy and food prices could begin to weigh on consumer spending. Energy prices remain elevated (crude oil prices have been above $90 a barrel for two consecutive months) and both energy and food prices have been rising (in December of last year,

relative to a year earlier: home heating oil prices doubled to around $3.30 a gallon; the average retail price of a gallon of regular gas was up 30.5% to over $3.00 a gallon; food prices as measured in the consumer price index were up 4.9%).

Does it matter if we are in a recession for purposes of providing fiscal stimulus?

According to some proponents of enactment of fiscal stimulus in the current environment, it doesn't matter whether the economy necessarily slips into recession defined either by the NBER dating committee or by the two-consecutive-quarters with declines in real GDP rule-of-thumb. What matters is that there have been indications that economic growth in output, demand, and jobs has been falling and, to many in the country, even slow and sluggish growth will "sure feel like a recession." Whatever the truth of that argument, caution will have to be exercised in formulating a fiscal stimulus plan that could end up being implemented in an economy in which growth has already, independently, turned up again. As Fed Chairman Bernanke has pointed out, stimulus that comes at a time when growth is already improving could end up being "actively destabilizing." That is, if fiscal stimulus serves to actually provide a boost to demand in the economy for goods and services at a time when demand is already rising, the boost to demand could lead to excess demand and inflation pressures.

Concerns about current conditions in the economy are not only about recession, but also about the possibility that a recession could end up being longer and deeper than average. Each of the past two recessions were eight months long, and the average duration of the past seven recessions is around eleven months. The past two recessions were relatively mild, with periods of only moderate declines in economic activity. Some are currently concerned that a recession could prove to be deeper than recent experience, and perhaps longer, given the heightened uncertainties that have prevailed in financial markets since last summer and given the expected depth and duration of the housing market slowdown. Should significant declines in housing values materialize, there would be substantial declines in household wealth. Home equity withdrawals are likely to have contributed to consumer spending over the current economic expansion. With home equity vanishing as a source of financing for consumer spending, a fear is that consumer spending (which, again, accounts for around 70% of overall GDP) will slow substantially or even fall, leading to a more severe recession than we have seen in recent experiences.

Important upcoming data releases.

Because of recent signs of economic weakness and because many in Congress and the administration are gearing up to put together a package of short-term fiscal stimulus measures intended to boost growth in the economy, it will be particularly important to monitor the evolution of the economy very closely in months to come. Important data scheduled for release between now and the end of March includes the following:

Date	Release	Date	Release
Jan 30	GDP- Q4 advance estimate	Feb 28	GDP- 4Q preliminary estimate
Jan 30	FOMC meeting	Feb 29	Personal Income (January)
Feb 1	Employment (January)	March 3	ISM Mfg. Index (February)
Feb 1	ISM Mfg. Index (January)	March 5	ISM Non-Mfg. Index (February)
Feb 5	ISM Non-Mfg. Index (January)	March 7	Employment (February)
Feb 13	Retail Sales (January)	March 13	Retail Sales (February)