International Monetary Fund

Recession: When Bad Times Prevail

FINANCE & DEVELOPMENT

Stijn Claessens and M. Ayhan Kose

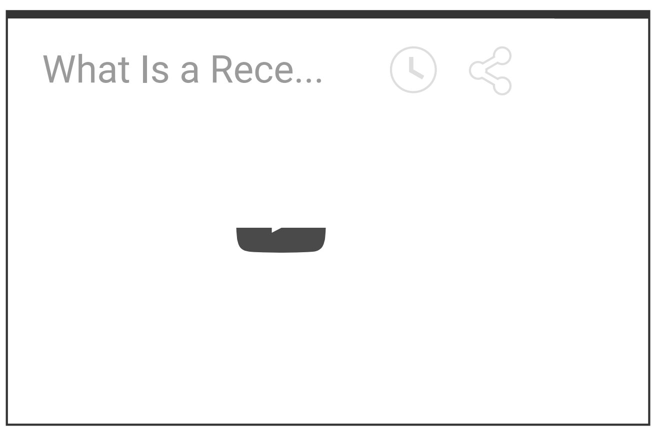
It is a sustained period when economic output falls and unemployment rises

Who will water the plants? (photo: Zuma Press/Newscom)

Following the onset of the recent global economic crisis, much of the news, especially in advanced economies, was dire. Unemployment was rising, company profits were falling, financial markets were tumbling, and the housing sector collapsed. Is there a single word to describe these developments? Yes: "recession."

The crisis was accompanied by recessions in many countries. This pattern is consistent with the historical record. Simultaneous, or synchronized, recessions have occurred in advanced economies several times in the past four decades—the mid-1970s, early 1980s, early 1990s, and early 2000s. Because the United States is the world's largest economy and has strong trade and financial linkages with many other economies, most of these globally synchronized recession episodes also coincide with U.S. recessions.

Although U.S. recessions had become milder over time, the recent global crisis reversed that trend. The latest episode was one of the longest and deepest recessions since the Great Depression of the 1930s. It led to a sharp increase in unemployment—along with substantial declines in output, consumption and investment.



Calling a recession

There is no official definition of recession, but there is general recognition that the term refers to a period of decline in economic activity. Very short periods of decline are not considered recessions. Most commentators and analysts use, as a practical definition of recession, two consecutive quarters of decline in a country's real (inflation-adjusted) gross domestic product (GDP)—the value of all goods and services a country produces. Although this definition is a useful rule of thumb, it has drawbacks. A focus on GDP alone is narrow, and it is often better to consider a wider set of measures of economic activity to determine whether a country is indeed suffering a recession. Using other indicators can also provide a timelier gauge of the state of the economy.

In the United States, the private National Bureau of Economic Research (NBER), which maintains a chronology of the beginning and ending dates of U.S. recessions, uses a broader definition and considers a number of measures of activity to determine the dates of recessions. The NBER's Business Cycle Dating Committee defines a recession as *"a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in production, employment, real income, and other indicators. A recession begins when the economy reaches a peak of activity and ends when the economy reaches its trough."* Consistent with this definition, the Committee focuses on a comprehensive set of measures—including not only GDP, but also employment, income, sales, and industrial production—to analyze the trends in economic activity.

Although an economy can show signs of weakening months before a recession begins, the process of determining whether a country is in a true recession often takes time. For example, it took the NBER committee a year to announce the beginning and end dates of the most recent U.S. recession. This is understandable. The decision process involves establishing a broad decline in economic activity over an extended period of time, after compiling and sifting through many variables, which are often subject to revisions after their initial announcement. In addition, different measures of activity may exhibit conflicting behavior, making it difficult to identify whether the country is indeed suffering from a broad-based decline in economic activity.

Why do recessions happen?

Understanding the sources of recessions has been one of the enduring areas of research in economics. There are a variety of reasons recessions take place. Some are associated with sharp changes in the prices of the inputs used in producing goods and services. For example, a steep increase in oil prices can be a harbinger of a recession. As energy becomes expensive, it pushes up the overall price level, leading to a decline in aggregate demand. A recession can also be triggered by a country's decision to reduce inflation by employing contractionary monetary or fiscal policies. When used excessively, such policies can lead to a decline in demand for goods and services, eventually resulting in a recession.

Other recessions, such as the one that began in 2007, are rooted in financial market problems. Sharp increases in asset prices and a speedy expansion of credit often coincide with rapid accumulation of debt. As corporations and households get overextended and face difficulties in meeting their debt obligations, they reduce investment and consumption, which in turn leads to a decrease in economic activity. Not all such credit booms end up in recessions, but when they do, these recessions are often more costly than others. Recessions can be the result of a decline in external demand, especially in countries with strong export sectors. Adverse effects of recessions in large countries—such as Germany, Japan, and the United States—are rapidly felt by their regional trading partners, especially during globally synchronized recessions.

Because recessions have many potential causes, it is a challenge to predict them. The behavioral patterns of numerous economic variables—including credit volume, asset prices, and the unemployment rate—around recessions have been documented, but although they might be the cause of recessions, they could also be the result of recessions—or in economic parlance, endogenous to recessions. Even though economists use a large set of variables to forecast the future behavior of economic activity, none has proven a reliable predictor of whether a recession is going to take place. Changes in some variables—such as asset prices, the unemployment rate, certain interest rates, and consumer confidence—appear to be useful in predicting recessions, but economists still fall short of accurately forecasting a significant fraction of recessions, let alone predicting their severity in terms of duration and amplitude.

Recessions are infrequent but costly

There were 122 completed recessions in 21 advanced economies over the 1960–2007 period. Although this sounds like a lot, recessions do not happen frequently. Indeed, the proportion of time spent in recession—measured by the percentage of quarters a country was in recession over the full sample period—was typically about 10 percent. Although each recession has unique features, recessions often exhibit a number of common characteristics:

● They typically last about a year and often result in a significant output cost. In particular, a recession is usually associated with a decline of 2 percent in GDP. In the case of severe recessions, the typical output cost is close to 5 percent.

● The fall in consumption is often small, but both industrial production and investment register much larger declines than that in GDP.

● They typically overlap with drops in international trade as exports and, especially, imports fall sharply during periods of slowdown.

● The unemployment rate almost always jumps and inflation falls slightly because overall demand for goods and services is curtailed. Along with the erosion of house and equity values, recessions tend to be associated with turmoil in financial markets.

What about a depression?

The latest U.S. recession—which began in December 2007 and ended in June 2009—was the longest (18 months) and deepest (about a 3.7 percent decline in output) the country has experienced since 1960. The typical U.S. recession prior to 2007 lasted about 11 months and resulted in a peak-to-trough output decline of 1.7 percent. Although investment and industrial production fell in every recession, consumption registered a decline in only four out of eight episodes since 1960.

One question sometimes asked is how a recession compares with a depression, especially the Great Depression of the 1930s. There is no formal definition of depression, but most analysts consider a depression to be an extremely severe recession, in which the decline in GDP exceeds 10 percent. There have been only a handful of depression episodes in advanced economies since 1960. The most recent was in the early 1990s in Finland, which registered a decline in GDP of about 14 percent. That depression coincided with the breakup of the Soviet Union, a large trading partner of Finland. During the Great Depression, the U.S. economy contracted by about 30 percent over a four-year period. Although the latest recession is obviously severe, its output cost was much smaller than that of the Great Depression.

Stijn Claessens is an Assistant Director and **M. Ayhan Kose** is an Assistant to the Director in the IMF’s Research Department.

References

Claessens, Stijn, M. Ayhan Kose, and Marco Terrones, 2009, “What Happens During Recessions, Crunches, and Busts?” Economic Policy*, Vol. 60, pp. 653–700. Also IMF Working Paper, No. 08/274, (Washington).*

———, 2011a, “Financial Cycles: What? How? When?” forthcoming, NBER 2010 International Seminar on Macroeconomics*, Richard Clarida and Francesco Giavazzi (eds.). Also IMF Working Paper, No. 11/76 (Washington).*

———, 2011b, “How Do Business and Financial Cycles Interact?” IMF Working Paper, No. 11/88*, (Washington).*

Updated: March 28, 2012