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Key Insights

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The Definition of "Recession"

Although it is commonly thought that a recession is defined as two consecutive quarters of negative GDP growth, the truth is more complicated. Recessions are officially declared by a committee of economics professors. The committee's decisions are typically based on four monthly economic indicators, and it is often hesitant to declare a recession until the evidence is overwhelming. Political considerations may have also contributed to the committee's reluctance to declare a recession before the November elections.

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It is often said that a recession is defined as "two consecutive quarters of negative GDP growth." The truth, however, is much more complicated. In fact, U.S. recessions are officially declared and dated by a committee of seven economics professors on the Business Cycle Dating Committee of the National Bureau of Economic Research (NBER) – a non-profit association of academic economists unaffiliated with the U.S. government.

Generally speaking, a recession is a significant decline in economic activity spread across the economy, lasting more than a few months. Recessions are typically visible in real GDP postings (reported quarterly), and in four other monthly data series: real income, employment, industrial production, and wholesale-retail sales. Importantly, recessions are dated by month, not quarter. This committee of experts focuses on the four <u>monthly</u> economic data series to determine if a recession has occurred. It is not uncommon for the committee to declare a recession if there is a clear downward movement in these monthly indicators, even if quarterly GDP remains positive.

For each recession, the committee defines a business cycle "peak" and "trough".

For each recession the dating committee defines a month of "business cycle peak" and month a "business cycle trough." A business cycle peak is when the committee judges that the overall momentum of the economy reaches its highest level. A recession officially starts in the month after the "business cycle peak." A trough is defined as the month when the committee feels business activity hits it lowest point. An "economic recovery" or "economic expansion" is considered to begin in the month after the trough.

Sometimes all four monthly economic indicators turn down beginning in the same month, in which case the committee would relatively easily decide that the month prior to the indicators' downturn was the business cycle peak. More often, however, one to three of these economic indicators will begin to decline, followed by the other measures a month or two later. Volatility across measures really means that the committee makes a "judgment call" about recession timing, based on their opinion of when the preponderance of evidence turned downward. Although the committee tends to put heavier weight on payroll employment and real income than the other measures, one individual committee member might put more weight on employment, for example, while another may place more emphasis on industrial production data. In this sense, recession dating is like a jury trial where a combination of facts, opinion, and debate between seven "jurors" result in a final verdict — recession or no recession.

Some cycles are very complicated to define. The U.S. economy suffered a downturn in 1980, then rebounded shortly for a few quarters in 1981, only to experience a recession again in 1982. The dating committee determined that two recessions had taken place, one in 1980 and one in 1982, but many economists believe the whole period from 1980-82 should have been declared as one long recession.

In the recession of 2001-02, the economy posted a negative quarter, followed by a positive quarter, then another negative quarter, and still the committee declared that a recession had taken place.

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In early December 2008 the dating committee determined that the U.S. economy is officially in recession. It declared that the "business cycle peak" was in December 2007, meaning that the recession started in January 2008.

The dating committee takes its job seriously and does not want to have to change its timing decisions if economic data are revised. This is a very significant issue. Economic data are typically revised for 2-3 months after their initial publication—sometimes decreases in a series are revised to increases, and vice versa, for example. In fact, some data series continue to be revised for years as more complete estimates become available. For this reason, the committee typically does not meet to even consider dating a possible recession until months after the economy may have entered that recession and a clear pattern of downturn has emerged. In fact, in the case of short 6-8 month recessions, the economy could already be in recovery mode by the time the committee meets to officially declare a recession.

The non-partisan committee may have delayed its announcement to avoid effects on the Presidential race.

Another consideration for the committee is the political cycle. The committee is non-partisan and tries not to inject itself into a presidential race, for example. The committee might have felt by late September or October 2008 that there was sufficient evidence to call the start of a recession, but it might also have worried that this would be interpreted as an attempt to influence the U.S. election, leading the committee to postponed its decision until after the election.

Monthly employment data from July-Aug '08 was influential in calling the current recession.

U.S. GDP fell in the fourth quarter of 2007, but increased slightly in the first quarter of 2008 and by a moderate amount in the second quarter. The committee was obviously aware of the steady if gradual decline in employment starting in January 2008 (about 60,000 jobs lost per month for the first half of the year), but probably thought that if GDP and incomes revived in the third quarter a formal recession might be avoided. When employment plummeted sharply starting in July and August 2008 and began to put downward pressure on income, the committee probably knew it would call a recession. Once the decision was made to formally call a recession, the second issue was to determine its starting date. Given that the committee relies heavily on monthly employment data, which peaked in December 2007, this was almost certainly the committee's basis for calling December 2007 as the business cycle peak.