



Recessions 101:

When is a downturn a recession?

PHOTO BY GARY BARBER

When the official declaration was made in December, the U.S. economy had already been in a recession for one year. No one was surprised by the National Bureau of Economic Research's announcement, and many probably wondered what took so long to make it.

Although determining a recession is important to businesses, retailers and consumers, the NBER's goal isn't to make a quick call, but to correctly pinpoint when the economy enters a recession. This takes many months of data, especially now that our modern-day economy has become more stable in the past 25 years or so, says Troy Davig, an economist and assistant vice president at the Kansas City Fed.

"If the difference between booms and

busts has declined, then detecting whether the economy has shifted gears is more challenging," Davig says. "People certainly feel the effect of a downturn, but it takes time to officially identify it."

The economy generally behaves differently during a recession, which is marked by sharply rising unemployment that leads to a loss of income. In turn, the loss of income reduces demand for goods and services, and places even more jobs at risk.

To stem job losses during a recession,

policymakers want to know quickly when the economy may be deteriorating so they can formulate a policy response—such as the Federal Reserve’s reduction of the federal funds rate to nearly zero in late ’08 and provision of liquidity for the financial system. Additionally, the government sent out stimulus checks to consumers in mid-2008 and implemented another a stimulus package earlier this year.

“Putting a recovery plan in place requires a timely and accurate signal as to whether the economy may be entering a recession,” Davig says, “but determining this is easier said than done.”

What is a recession, how is it determined?

The economy fluctuates for a variety of reasons, such as boom in new technologies or disruptions in financial markets. Occasionally, the economy enters a period when the amount of new goods and services produced in the

United States, known as the real gross domestic product (GDP), declines. Periods of decline are recessions; periods of growth are expansions. Today, recessions are unusual and much shorter than expansions.

“It is commonly accepted that an economy has entered a recession after at least two consecutive quarters of negative GDP,” Davig says. “This rule of thumb is useful, but also a little simplistic. The 2001 recession, for example, did not fit this formula.”

In the United States, the NBER keeps track of when recessions begin and end. A committee analyzes several monthly indicators and makes an announcement after a sufficient amount of data is available, which creates the time lag between when a recession begins and when it is officially declared.

There are additional ways to get a snapshot of the current economic situation. The Fed’s *Beige Book*, for example, is anecdotal information collected from a sample of businesses by each of the 12 Federal Reserve

Recession dynamics

financial market disruption

consumers reduce spending

tighter access to credit

companies’ profits fall

fewer homes sold

firms lay off workers

home prices fall

United States in recession

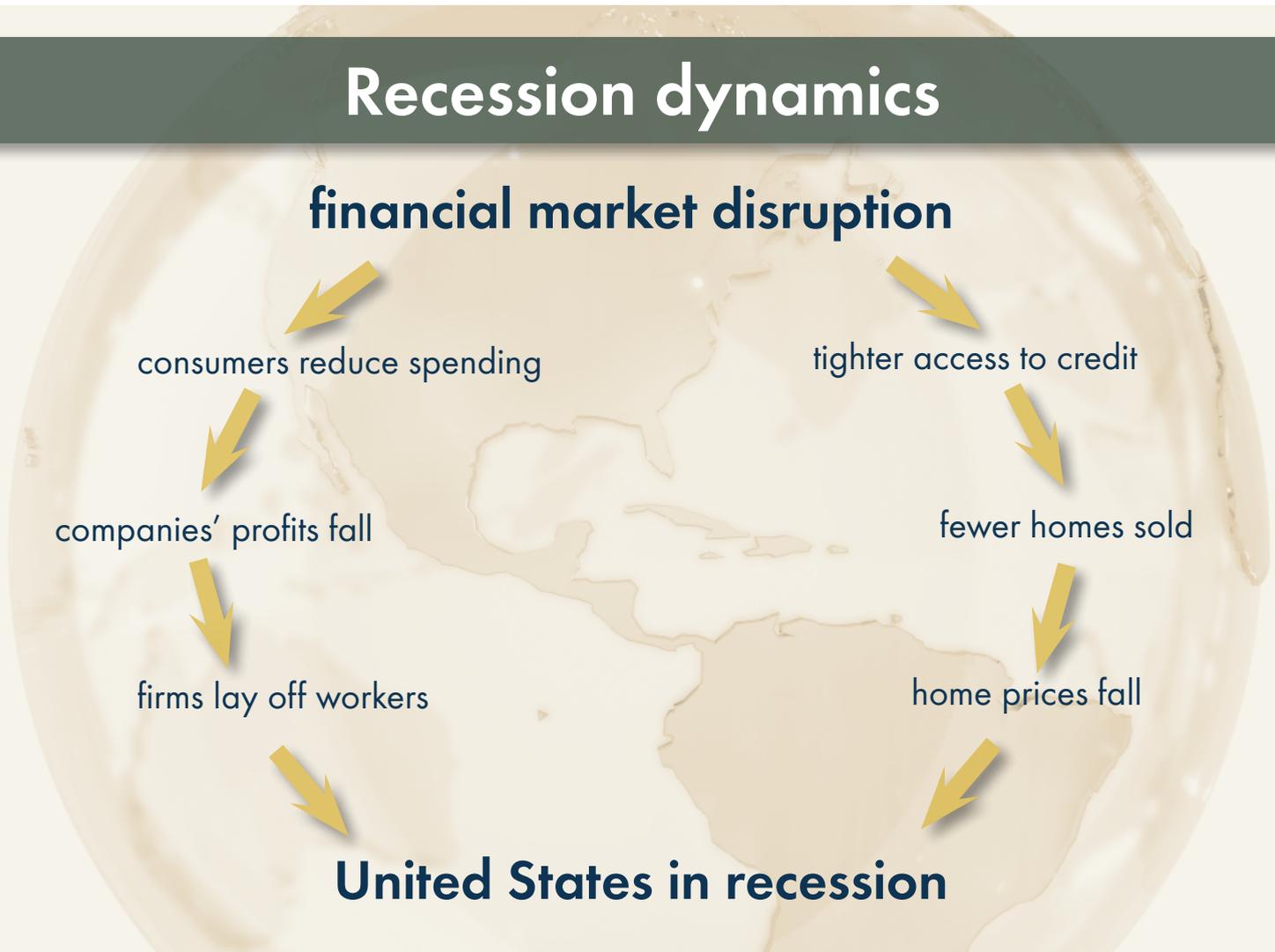




PHOTO BY GARY BARBER

Has the recession reached rural America?

Rural economies have weathered this recession much better than metro economies, says Jason Henderson, economist and Branch executive at the Kansas City Fed's Omaha Branch.

Fallout from the housing and financial markets crises has been less severe while a summer surge in commodity prices boosted farm and energy activity.

The global downturn hasn't left rural economies unscathed, though. Weaker commodity prices threaten farm incomes while demand from Main Street has lessened.

Economic forecasts indicate a modest recovery in the second half of '09, hinging on fiscal and monetary policies' ability to boost demand in the world economy.

For more information, read "Recession catches rural America" by Jason Henderson and Maria Akers at KansasCityFed.org/TEN.

Banks and is published eight times a year. GDP may be the best overall indicator of economic performance, Davig says, though its quarterly availability is a limiting factor.

To obtain a timely read on the economy, it may be useful to look at an indicator such as the Chicago Fed National Activity Index, Davig says. This index is available every month and covers a broad array of economic data, providing a good snapshot of current economic conditions.

Now vs. then

In the United States, recessions have become rarer in recent decades.

- From the end of the Civil War in 1865 until the end of World War I in 1918, the economy was in recession about half the time.

- From the end of WWI to WWII in 1939, the U.S. economy was in recession about one-third of the time.

- From the end of the Korean War in 1953 until 1984, the economy was in recession about 20 percent of the time.

- Since 1984, the economy has been in recession only 7 percent of the time, with a recession occurring roughly once every 12 years.

Recessions also have become shorter on average. Prior to WWII, recessions averaged 22 months. Since then, recessions average 10 months.

The two most recent recessions, in 1990 and 2001, were relatively mild and short by historical standards. The 1981-82 recession, however, lasted longer than average and led to a peak unemployment rate of 10.8 percent. The 1973-75 recession also lasted longer than average and led to a peak unemployment rate of 9 percent.

Today, media reports note the current recession is the most severe in recent decades, and some liken it to the Great Depression of 1929-33. Then, roughly 9,000 banks failed and the unemployment rate peaked at 25 percent. In contrast, the unemployment rate was just above 8 percent in early '09. One major difference since the Great Depression



To read about the 12 regional Federal Reserve Bank presidents' role in forming the nation's monetary policy, see Page 22.

is the inception of FDIC insurance to secure deposits and avoid bank runs, resulting in just a fraction of bank failures today.

"We've learned a lot on how to conduct monetary policy, making an outcome like the Great Depression very unlikely," Davig says. "That said, this recession is the longest we've had since the Great Depression."

Current economic climate

The current downturn is longer than average because of the ongoing housing bust and resulting credit crisis. This, along with soaring summer gas prices and mounting job losses, has caused a dramatic drop in consumer spending. These factors were apparent in 2007 in some of the anecdotes in the *Beige Book*

KANSAS CITY FED PRESIDENT TOM HOENIG travels around the seven states of the Tenth Federal Reserve District to speak to a variety of audiences, including the Tulsa Metro Chamber in Oklahoma. More recently, components of the current financial crisis have been his focus. Read his speech "Too big has failed" on Page 1.

and also in the Chicago Fed National Activity Index, Davig says.

However, real GDP expanded throughout the first half of 2008 despite the ongoing housing and credit crises. The sustained decline in GDP began in the third quarter of 2008, and many believe the economy won't begin a recovery until late in 2009 or 2010.

The government can help make the recession less painful, but the recovery will have to be driven by a rebound in demand and private firms' willingness to hire more workers.

"This recession is unlikely to be much worse than those in the 1970s and early 1980s, though longer than more recent downturns," Davig says. "But it will eventually end—recessions always end."

BY BRYE STEEVES, SENIOR WRITER

FURTHER RESOURCES

"TRACKING THE BUSINESS CYCLE IN THE GREAT MODERATION"

By Troy Davig

THE BEIGE BOOK

THE CHICAGO FED NATIONAL ACTIVITY INDEX

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COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.