



# What Is a Recession?

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**F**OR more than a year, barely a day has passed that we have not heard dire economic news about the United States, Europe, or Japan. Unemployment has been rising, company profits have been falling, financial markets have been tumbling, and the housing sector has been collapsing. Is there a single word to describe these developments? Yes: “recession.”

The ongoing global financial crisis has been accompanied by recessions in many countries. This pattern is consistent with the historical record. Synchronized recessions have occurred in advanced economies several times in the past four decades—the mid-70s, early 80s, early 90s, 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 have become milder over time, the current recession is likely to change this trend. Already 16 months old—with sharp declines in consumption and investment—it could become one of the longest and deepest recessions since the Great Depression of the 1930s.

## 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 (see “Back to Basics,” *F&D*, December 2008). 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 more timely gauge of the state of the economy.

The National Bureau of Economic Research (NBER), a private research organization, 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 decide 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 (or not) often takes time. For example, it took the NBER committee a year to announce that the current U.S. recession started in December 2007. This is understandable, because 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 sharp increase in oil prices can be a harbinger of a coming 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.

Some recessions, including the current one, 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 (see “Picture This,” *F&D*, September 2008).

### 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 propor-

tion 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 (see chart). 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 current U.S. recession is the eighth the country has experienced since 1960. The typical U.S. recession in that period lasted about 11 months, with the longest (in 1973 and 1981) 16 months and the shortest (1980) eight months. The peak-to-trough output decline was on average 1.7 percent, with the single worst recession (in 1973) leading to a slightly more than 3 percent output loss. Although investment and industrial production fell in every recession, consumption registered a decline in only three.

One question sometimes asked is how the ongoing 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 current recession is obviously severe, its output cost so far has been much smaller than that of the Great Depression. ■

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#### Suggestions for further reading:

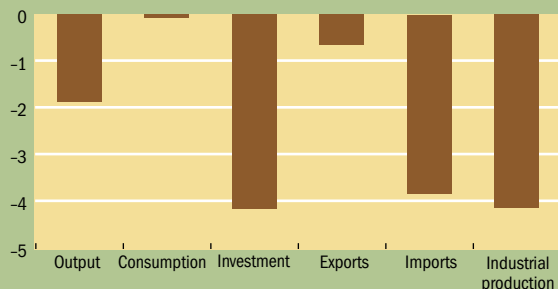
Claessens, Stijn, M. Ayhan Kose, and Marco Terrones, 2008, “What Happens During Recessions, Crunches, and Busts?” IMF Working Paper 08/274 (Washington: International Monetary Fund).

———, forthcoming, “American Recessions: Domestic and Global Implications” IMF Working Paper (Washington: International Monetary Fund).

### Recessions are costly

They are characterized by substantial declines in output (real gross domestic product), investment, imports, and industrial production, whereas declines in consumption are smaller.<sup>1</sup>

(percent change)



Source: Claessens, Kose, and Terrones (2008).

<sup>1</sup>The average of 122 recessions in 21 advanced economies that occurred between 1960 and 2007.