ECONOMIC DIP, DECLINE OR DOWNTURN? AN EXAMINATION OF THE DEFINITION OF RECESSION

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'The point is that all important events in the real world - whether admirable or monstrous - always have their prologue in the realm of words'. This observation by Vaclav Havel seems especially appropriate when reading this essay. It is currently impossible to escape talk of the 'R-word' in academic circles, the government and the media. In this essay, Emma O'Donoghue goes beneath all the talk and examines the very definition of recession. Her analysis suggests that the current definition needs revision, and she explores other possible interpretations. She argues that an appropriate meaning of the word is necessary to combat this economic phenomenon's unfortunate consequences.

Introduction

'Due to cost-cutting, the light at the end of the tunnel has been turned off.'
- Anonymous.

The world economy is currently in the depths of a recession, a fact which has been debated, denied, and glumly accepted. Recession is a word that appeared in many a newspaper's and economic expert's vocabulary during the deepening financial crisis at the end of last summer, and evokes in all of us an intuitive idea about what it means for the economy. It is a necessary component of the business cycle, but the word itself seems to represent so much more than that. Yet it is interesting to note that despite all the talk of recession, there is not yet a consensus on how to measure one.

What constitutes a recession or a depression? There is an old joke among economists that has been revived recently: when your neighbour loses his job, it is an economic downturn; when you lose your job, it is a recession; but when an economist loses his job, it becomes a depression. This essay will examine the definition of a recession, and the current academic debate around the features of these definitions. It will seek to argue that the traditional 'negative GDP' measurement has become inadequate, and highlight the suggested alternatives and their various benefits and drawbacks.

Hands up who knows what a recession is?

Since the 1970s, it has been generally accepted that a recession is a period of two quarters of negative GDP growth.[1] Under this definition, Ireland was announced to be in recession in June 2008 following a contraction of 0.3% in the first quarter of 2008, and a 0.5% contraction

[1] 'GDP – gross domestic product – combines in a single figure the total market value of all final goods and services produced within a country's economic territory during a given period. It is the most frequently used indicator of market activity and the change in GDP over time is the principal indicator of economic growth' (Wesselink et al., 2007).

in the second; and the UK was declared to be in recession in January 2009 (see Figure 1). The idea behind two consecutive quarters is supposed to ensure that statistical aberrations or one-time events cannot create a recession; for a recession to occur, the real economy (production and consumption of goods and services) must decline. However, this definition is becoming increasingly unpopular due to several identified issues. *The Economist* recently published an article advocating the need to fundamentally redefine the term 'recession.' In fact, the definition of two negative quarters came about only as a result of a 1974 article written by Julius Shiskin, in which he included a list of factors for spotting a recession. For some reason, the particular idea of two negative quarters of GDP growth was seized upon and became the standard norm, but it is simply too narrow a rule.

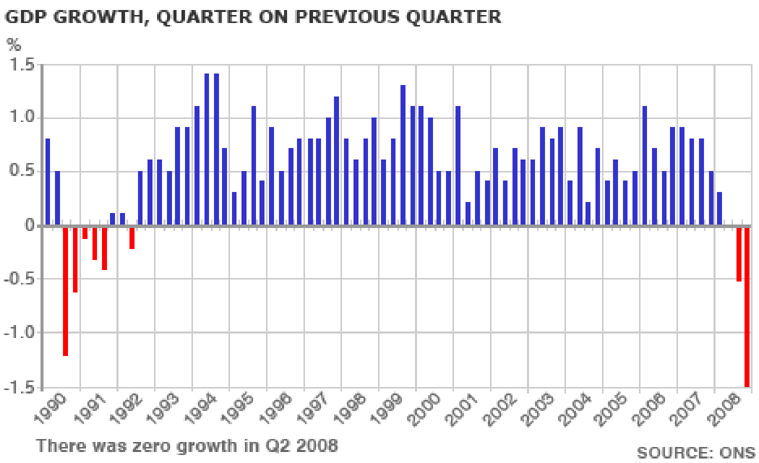

Figure 1: GDP growth in UK

Firstly, the definition of recession used above fails to take account of factors *other* than GDP. It has long been recognised that GDP is a somewhat crude measure of economic well-being or social welfare, and its exclusion of various factors which impact aggregate economic activity is well documented (Harding and Pagan, 1999). Such factors include employment, distribution of income, non-market goods etc. It is argued their inclusion is unnecessary as they will conform to trend over time; however, the speed of events during the financial crisis of 2008 would surely argue against the wisdom of such an assumption. 'Whilst the additional measures may be expected to show similar patterns to output over the long term, in particular macroeconomic episodes their time paths over the short term can be sufficiently different from measured GDP as to be of material importance to the task of properly and precisely dating the peaks and troughs in the business cycle' (Layton and Banerji, 2003: 1790).

Furthermore, the accepted definition would have failed to recognise the 2001 recession in America, as it never had two consecutive quarters of declining GDP, though it was preceded by two quarters of alternating decline and weak growth (revised figures later revealed *three* consecutive quarters of negative GDP). This is also true of the severe recession experienced in Japan during the 1970s. Thus, the definition of two consecutive quarters of falling GDP seems absurd. In a very practical application, if country A grows by 3% in one quarter but then declines by 0.25% in the two following quarters, it is deemed to be in recession. But if country B contracts by 2%, grows by 0.5%, then contracts again by 2%, it essentially escapes a recession, despite the fact that B's economy is fundamentally weaker. 'To use such a rule blindly to conclude that such a country was not in recession would be not only patently silly but also quite dangerous…if it meant that much needed policy changes were postponed for many months or not even implemented at all' (Layton and Banerji, 2003: 1792).

Problems with the GDP measurement were highlighted in the case of the US last year. Despite an unemployment rate that was rising since 2007 and other economic indicators of recession (such as a stagnant GDP per head growth), the second quarter of 2008 actually saw the US's GDP grow at an annualised rate of 3.3%. But GDP far from represents an economic certainty. 'The first observation for a given month or quarter is almost never the final word on what happened' (McKelvey, 2008:2). Later revisions mean pluses can easily become minuses, and vice versa. GDP is argued to be valuable in defining recession as it is a coincident indicator, but the fact the GDP data is subject to constant revisions argues against this, and offers the risk of policymakers having more faith in the economy than they rightly should.

There is a suggestion that recession starts when there are several consecutive quarters of slowing (but still positive) growth. Other economists argue that *real monthly GDP* measures would be the ideal measure of economic fluctuations, and that it is only because of the absence of such an index that we need to look at alternatives.[2] However, monthly GDP is likely to be subject to even more revisions than quarterly GDP would be and is unlikely to truly present a credible short-term forecast.

Recognising Recession: Alternative Options

So what alternatives are on offer as indicators of economic status? The Business Cycle Dating Committee at the National Bureau of Economic Research (NBER) provides a different method.[3] They look at the level of business activity in the economy, taking into account factors such as employment, industrial production etc. In the Eurozone, the Centre for Economic Policy Research (CEPR) sponsors a panel called the Euro Area Business Cycle Dating Committee. The CEPR broadly follows the NBER approach, except that the European committee dates in terms of quarters rather than of months.

The NBER defines a recession more broadly as 'a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP growth, real personal income, employment, industrial production, and wholesale-retail sales' (NBER, 2003:1). The use of this broader definition means a variety of factors are considered to enable an insight into the economic health of a nation. It also means it is possible to examine the 'depth' of a recession – for example, the 2001 recession was considered 'shallow'.[4] A further benefit is that they also make use of figures which are much less likely to be revised at later dates.

While the NBER's approach is advantageous in that it uses a broader array of indicators than just real GDP, it is not without problems. Again, defining recession as an absolute downturn in economic activity appears too simplistic. 'Suppose country A has a long-term potential

[2] 'We could define the *ideal* measure of aggregate economic activity as monthly real GDP… The ideal measure of monthly real GDP could also be used to provide the basis for identifying reference cycle chronologies and hence, phases of the business cycle' (Boehm and Summers, 1999: 13-14).

[3] Perhaps significantly, the NBER is a private, non-partisan, not-for-profit institution established in 1920.

[4] 'The 2001 recession lasted eight months, which is somewhat less than the average duration of recessions since WWII. The post-war average, excluding the 2001 recession, is eleven months' (NBER, 2003: 1).

(trend) growth rate of 3% and country B one of only 1.5%, due to slower labour-force growth. Annual GDP growth of 2% will cause unemployment to rise in country A (making it feel like a recession), but to fall in country B. Likewise, if faster productivity growth pushes up a country's trend rate of growth, as it has in America since the mid-1990s, an economic downturn is less likely to cause an absolute drop in output' (The Economist, 2008a).

Additionally, waiting for the data tends to take some time. As a result, most recessions have not been declared by NBER until at least five months after they have ended, with some recessions declared eighteen months after they have started. The declaration that the recent peak of industrial output was in December 2007 did not come until December 2008: 'The committee determined that a peak in economic activity occurred in the U.S economy in December 2007. The peak marks the end of the expansion that began in November 2001 and the beginning of a recession' (NBER, 2008). Furthermore, despite the broadness of the factors they look at, the NBER have never announced a recession without at least one quarter of negative GDP growth – seemingly indicating GDP does play a large role in defining recessions no matter what other indicators are included.

A further alternative that has been suggested for measuring recessions is the use of unemployment figures. The one marker that seems to be a constant in most recessions is unemployment: rising unemployment generally indicates that growth has fallen below potential. To most people, when unemployment figures start rising, that means they are in a recession. Indeed, paying more attention to unemployment figures may be important, given that the numbers are not subject to revision and are available sooner and more frequently (from sources such as the Live Register). 'There has never, in the post-war U.S., been a one percentage point increase in unemployment without a recession having been declared, and much of that increase in unemployment occurs after the recession started', says Robert Gordon, a NBER Committee member from Northwestern University (Ramirez, 2008). But rising unemployment is a symptom of a recession, not a cause.

There are many other problems with exclusively using unemployment to define recession and thus economic performance. While figures on unemployment are available sooner, it is important to remember that unemployment is often a lagging indicator, and thus is not as relevant as those indicators that relate more directly to the economy, such as real GDP. Consider the fact that communist countries, in which all people are employed by the state (and thus have a constant 100% employment rate), would never experience recessions. Furthermore, if the critical cause of a recession is considered to be unemployment, then there exists a risk that the government would seek to minimise unemployment statistics without addressing the primary problems in the economy, instead manipulating data or replacing social security with government jobs to achieve full employment. The term recession would thus lose all meaning.

This suggests that it makes more sense to define a recession as a period when growth falls significantly below its potential rate, or perhaps simply as a slowdown in growth. Ultimately, defining recession must include several dimensions: output measures, employment and income. 'No single measure of aggregate economic activity is called for in the definition because several such measures appear relevant to the problem, including output, employment, income and [wholesale and retail] trade… Use of several measures necessitates an effort to determine what the consensus among them is, but it avoids the arbitrariness of deciding upon a single measure…' (Moore, 1982: 82).

Further complications: defining a global recession

There is even more confusion when the term 'global recession' gets thrown into things. The old 'rule of thumb' of two negative quarters is not applicable because of higher trend growths in emerging markets, which means the 'combined real GDP of the world has increased continually in the last four decades' (Abberger & Nierhaus, 2008: 75-76). The IMF defines a global recession as a period when global growth is less than 3%. In November 2008, the IMF released its global economic forecast; with global growth estimated to be 2.2% in 2009 (see Table 1). 'Using the IMF's definition (i.e. growth below 3%), the world economy has been in recession for 11 out of the past 28 years' (The Economist, 2008b). But again, can one really consider the global economy to be in a recession when there still exists positive growth of 2.2%?

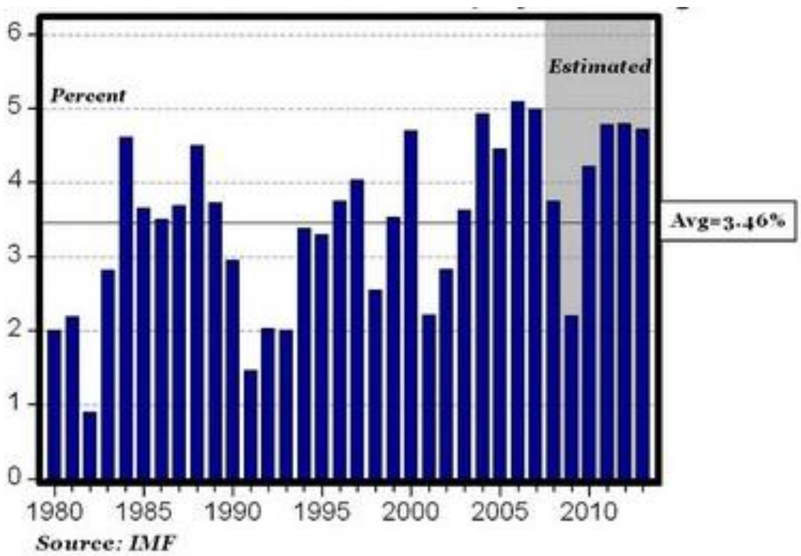

Figure 2: World Real GDP Growth, 1980-2013

The question then argued is why 3%? What does 3% represent? If the global economy is still growing, how is there a global recession? The problem with the data is that developing countries often do not present GDP in quarterly figures, and seasonal issues present comparison problems – it is the old adage of comparing apples and oranges. Also, usually any downturn that does occur in the international economy would normally not affect all countries at the same time. Thus it would be nearly impossible to ever manage to register a negative global GDP growth, and hence the need to set the bar at some level. World population growth is taken into consideration when determining this figure. 'The IMF suggests that a sufficient (although not necessary) condition for a global recession is any year in which world GDP per head declines' (The Economist, 2008a). The rate of 3% also attempts to account for differences in trends between emerging and developed economies. While for a developed economy like the UK, 6% would be a boom, '...for China, a growth rate of 6% would be equivalent to a recessionary hard landing' (Roubini, 2008). However, the IMF seems to have taken on board criticisms that the figure of 3% is likely too high, and to make things more confusing at the launch of the World Economic Outlook the IMF said that 'we're not defining global recession as something at 3% or less.'[5]

[5] Transcript of a Press Briefing on the World Economic Outlook Update by Olivier Blanchard and Jorg Decressin, available on http://www.imf.org/external/np/tr/2008/tr081106.htm

Latest IMF projections

(year over year percent change)

		Projections		Variance from last IMF forecast	
	2007	2008	2009	2008	2009
World output	**5.0**	**3.7**	**2.2**	**–0.2**	**–0.8**
Advanced economies	2.6	1.4	–0.3	–0.1	–0.8
United States	2.0	1.4	–0.7	–0.1	–0.8
Euro area	2.6	1.2	–0.5	–0.1	–0.7
Japan	2.1	0.5	–0.2	–0.2	–0.7
Emerging market and developing economies	**8.0**	**6.6**	**5.1**	**–0.3**	**–1.0**
Sub-Saharan Africa	6.8	5.5	5.1	–0.6	–1.2
Developing Asia	10.0	8.3	7.1	–0.1	–0.6
China	11.9	9.7	8.5	–0.1	–0.8
India	9.3	7.8	6.3	–0.1	–0.6
Middle East	6.0	6.1	5.3	–0.3	–0.6
Western Hemisphere	5.6	4.5	2.5	–0.1	–0.7

Source: IMF, *World Economic Outlook*, November 2008.

Table 1: The IMF's global economic forecast, 2008

Conclusion

'What's a recession? Sometimes it is a thingumajig.'
- *Time, 1953.*

This paper has sought to show that the 'two quarter negative growth rate' of GDP measure of a recession is obsolete, and racked with problems. There are those who argue that a sharp fall in the stock market is indicative of a recession. Siegel (1994) says that since 1948, ten recessions were preceded by a stock market decline, with a lead time of zero to thirteen months, but by this measure, as Paul Samuelson (1966) commented, 'The stock market has forecast nine of the last five recessions'. Should we focus on leading, lagging or coincident indicators? Procyclical or countercyclical? The NBER approach appears more sound, but also means we do not know we are in a recession until after it has started, and sometimes not until it is already over. At the root of the matter is the philosophical notion that what defines 'an economy' is much more than a broad measure of output (Layton and Banerji, 2003).

The power of the word 'recession' seems disproportionate to its meaning. Alfred Kahn, a Cornell university economist who became known as President Carter's 'anti-inflation' czar, was instructed never to use the word recession when he worked for the administration in the late 1970s. So when asked questions by Congress in 1979 about the economic situation, he replied, ‘I have been instructed not to say that we’re experiencing a recession. So I’ll tell you that we’re experiencing a banana’.[6]

Writing all throughout the 1930s, both Mises and Hayek tried to explain that the recession itself served a market purpose, in the same way a correction to an inflated stock market serves a purpose. It re-coordinates economic structures that have grown seriously out of balance. ‘The recession is the way that the economy tells the truth about the fundamentals’ (Rockwell, 2008). But defining a recession does not define how to pull ourselves out of one. It can, however, alert us to necessary policy changes and lessen the impact of a recession if it is recognised in time, and this is the key to why a universally accepted and comprehensive definition of recession must be adopted.

Thus, it can be debated when the recession started and when it will end, and how such instances will be recognised, but there can be no denying that we are currently in the midst of one. The one solace we can find is in the words of the author Bo Bennett, ‘As sure as the spring will follow winter, prosperity and economic growth will follow recession’.

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[6] When banana companies started to complain, he switched the fruit to ‘kumquat’.

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