The Economist

Economics focus

Redefining recession

A new yardstick for measuring slumps is long overdue

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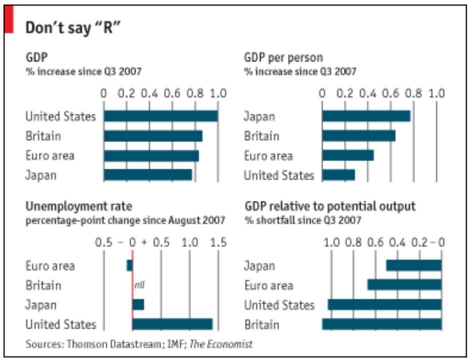
THERE has been a nasty outbreak of R-worditis. Newspapers are full of stories about which of the big economies will be first to dip into recession as a result of the credit crunch. The answer depends largely on what you mean by “recession”. Most economists assume that it implies a fall in real GDP. But this has created a lot of confusion: the standard definition of recession needs rethinking.

In the second quarter of this year, America’s GDP rose at a surprisingly robust annualised rate of 3.3%, while output in the euro area and Japan fell, and Britain’s was flat. Many economists reckon that both Japan and the euro area could see a second quarter of decline in the three months to September. This, according to a widely used rule of thumb, would put them in recession, a fate which America has so far avoided. But on measures other than GDP, America has been the economic laggard over the past year.

The chart looks at several different ways to judge the severity of the economic slowdown since the start of the credit crunch in August 2007. On GDP growth, America has outperformed Europe and Japan. Unemployment, however, tells a very different tale. America’s jobless rate hit 6.1% in August, up from 4.7% a year earlier, and within spitting distance of its peak of 6.3% during the previous recession after the dotcom bust. Other countries have so far published figures only for July, but their jobless rates have barely moved over the past year: Japan’s has risen by only 0.2%, the euro area’s has fallen slightly (though in absolute terms it is still a bit higher than America’s). Another yardstick, GDP per head, takes account of the fact that America’s population is rising rapidly, whereas Japan’s has started to shrink. Since the third quarter of 2007 America’s average income per person has barely increased; Japan’s has enjoyed the biggest gain.



To the average person, a large rise in unemployment means a recession. By contrast, the economists’ rule that a recession is defined by two consecutive quarters of falling GDP is silly. If an economy grows by 2% in one quarter and then contracts by 0.5% in each of the next two quarters, it is deemed to be in recession. But if GDP contracts by 2% in one quarter, rises by 0.5% in the next, then falls by 2% in the third, it escapes, even though the economy is obviously weaker. In fact, America’s GDP did not decline for two consecutive quarters during the 2001 recession.

However, it is not just the “two-quarter” rule that is flawed; GDP figures themselves can be misleading. The first problem is that they are subject to large revisions. An analysis by Kevin Daly, an economist at Goldman Sachs, finds that since 1999, America’s quarterly GDP growth has on average been revised down by an annualised 0.4 percentage points between the first and final estimates. In contrast, figures in the euro area and Britain have been revised up by an average of 0.5 percentage points. Indeed, there is good reason to believe that America’s recent growth will be revised down. An alternative measure, gross domestic income (GDI), should, in theory, be identical to GDP. Yet real GDI has risen by a mere 0.1% since the third quarter of 2007, well below the 1% gain in GDP. A study by economists at the Federal Reserve found that GDI is often more reliable than GDP in spotting the start of a recession.

Tapping the slumpometer

These are good reasons not to place too much weight on GDP in trying to spot recessions or when comparing slowdowns across economies. The Business Cycle Dating Committee of the National Bureau of Economic Research (NBER), America's official arbiter of recessions, instead makes its judgments based on monthly data for industrial production, employment, real income, and wholesale and retail trade. It has not yet decided whether a recession has begun. But even the NBER's more sophisticated approach is too simplistic in that it defines a recession as an absolute decline in economic activity. This can cause problems when trying to compare the depth of downturns in different cycles or across different countries. Suppose country A has a long-term potential (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.

This suggests that it makes more sense to define a recession as a period when growth falls significantly below its potential rate. The IMF estimates that America and Britain have faster trend growth rates than Japan or the euro area. The bottom-right chart shows that since the third quarter of last year, growth has been below trend in all four economies, but Britain, closely followed by America, has seen the biggest drop relative to potential.

But even if this is a better definition of recession, potential growth rates are devilishly hard to measure and revisions to GDP statistics are still a problem. One solution is to pay much more attention to unemployment numbers, which, though not perfect, are generally not subject to revision and are more timely. A rise in unemployment is a good signal that growth has fallen below potential. Better still, it matches the definition of recession that ordinary people use. During the past half-century, whenever America's unemployment rate has risen by half a percentage point or more the NBER has later (often much later) declared it a recession. European firms are slower at shedding jobs, so unemployment may be a lagging indicator. Even so, the jobless rate has usually started to rise a few months after the start of a recession.

As the old joke goes: when your neighbour loses his job, it is called an economic slowdown. When you lose your job, it is a recession. But when an economist loses his job, it becomes a depression. Economists who ignore the recent rise in unemployment deserve to lose their jobs.

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