SAUL ESLAKE
CORINNA ECONOMIC ADVISORY

What is a 'recession', and can we see one coming?

I have long disliked the widely used 'rule of thumb' which says that a recession occurs when real gross domestic product (GDP) declines for two or more consecutive quarters. A much better one, and one more readily comprehensible to people who aren't economists, is that a recession entails by an increase in the unemployment rate of 1½ percentage points or more in 12 months or less.

In the United States there is a group of eight academic economists called the [Business Cycle Dating Committee]() of the National Bureau of Economic Research which maintains a 'chronology of US business cycles', identifying the months in which economic activity peaks and troughs. Their pronouncements are almost universally accepted as identifying when US recessions begin and end.

The NBER Business Cycle Dating Committee (BCDC) explicitly rejects the two-or-more-quarters-in-a-row 'rule of thumb' for identifying recessions. Rather, it considers a suite of seven different monthly indicators, including two separate measures of employment, real personal income (excluding transfer payments) and consumption expenditure, real wholesale and retail sales, and industrial production, as well as real GDP and real gross domestic income.

Of the 12 US recessions which the BCDC has formally designated since the end of World War II, two (in 1960-1, and in 2001) did *not* include consecutive quarters of negative growth in real GDP; while there have been two instances where real GDP *did* decline in consecutive quarters (in the second and third quarters of 1947, and much more recently in the first and second quarters of 2022) which the Committee does *not* regard as constituting recessions.

Australia doesn't have any body analogous to the BCDC – so the consecutive-quarters-of-negative-real-GDP-growth 'rule of thumb' is widely used by economists, journalists and politicians to identify recessions.

But it is no less misleading here than it is in the US. Australia's real GDP shrank in the September and December quarters of 1977 – yet nowhere in any discussion of post-war Australian business cycles will you find any reference to the "1977 recession". On the other hand, you would find plenty of references to the 1974 recession, even though that entailed only one quarter of negative growth in real GDP.

Had it not been for the severe bushfires in south-eastern Australia at the end of 2019 and the beginning of 2020, which resulted in a 0.2% contraction in real GDP in the March quarter of 2020, a literal interpretation of this 'rule of thumb' would have held that Australia side-stepped recession during the first year of the Covid-19 pandemic because we would have had only one quarter of negative real GDP growth, even though the 6.7% contraction in real GDP in the June quarter of 2020 was larger than the shrinkages in the 1982-83 and 1990-91 recessions combined.

One practical shortcoming of the US' reliance on an academic committee to identify recessions is that, being academics, they take their time in deciding when the US economy has passed a turning point. As it says, "it waits until sufficient data are available to avoid the need for major revisions to the business cycle chronology". Thus, for example, the Committee did not formally designate the most recent recession, which according to it began in February 2020 and ended in April 2020, until July 2021 – a lag of 15 months.

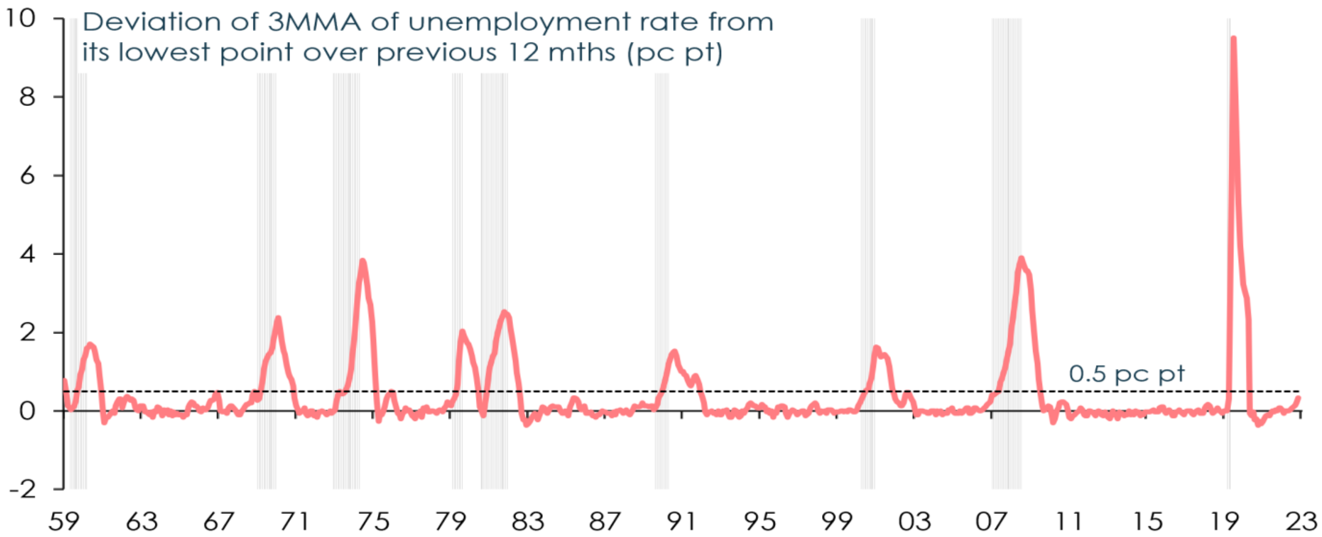
Financial market participants, policy-makers and journalists don't have the luxury of being able to wait more than a year to determine whether the economy is in, or out of, recession and what they should say, write or do about it. Which is why 'rules of thumb' such as consecutive-quarters-of-negative-real-GDP-growth are widely used, despite their flaws.

In 2019, Claudia Sahm, a US Federal Reserve economist, proposed an alternative yardstick for identifying economic downturns that were sufficiently serious as to warrant the payment of 'automatic lump-sum payments to individuals' – a policy which was implemented in many economies a year later following the onset of the Covid-19 pandemic.

What has since become widely known as the 'Sahm Rule' holds that the onset of a recession can be identified by a rise in the three-month moving average of the unemployment rate of 0.5 percentage point from its lowest level in the preceding twelve months.

And it seems to work. As Chart 1 shows, the 'Sahm Rule' correctly identifies every BCDC-designated US recession since at least 1960, without giving any false signals – and it does so within a shorter time frame than the 'consecutive-quarters-of-negative-real-GDP-growth' rule.

Chart 1: The 'Sahm Rule' as an indicator of US recessions



Note: Shaded areas denote recessions as designated by the NBER BCDC.
Sources: US Bureau of Labor Statistics; National Bureau of Economic Research Business Cycle Dating Committee.

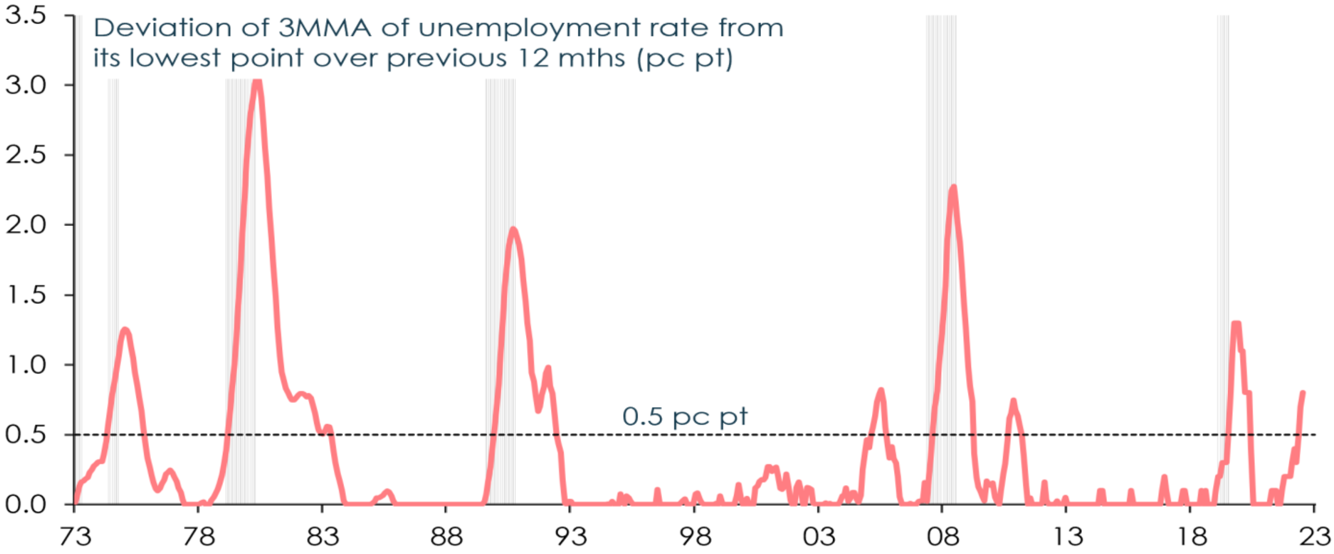
Sahm herself emphasizes that her 'rule' is an 'empirical regularity', not a 'law of nature'. Now out on her own (under the rather clever title Stay-At-Home Macro), she suggests that it may not be as accurate in 2023-24 as it has been in the past – if the influx of workers into the US labour force co-incides with a slowing rate of employment growth (thanks to the Fed's tightening of monetary policy over the past 18 months), resulting in a rise in unemployment of at least another 0.2 pc point (the unemployment rate over the three months to October was already 0.33 pc point above its low in the three months to April), without a sufficiently sharp or widespread slowing in the economic indicators that the BCDC uses to designate a recession.

The 'Sahm Rule' appears to work in other countries too. For example Chart 2 shows that it has accurately signalled every downturn entailing two or more quarters of negative real GDP growth in the UK over the past 50 years, again without giving any false signals – although it was slower to pick up the onset of recession in 2020 in the UK than it was in the US.

Interestingly, the 'Sahm Rule is now foreshadowing a recession in the UK, with the three-month moving average of the UK unemployment rate as of July being 0,8 pc point above its lowest level in the preceding 12 months.

SAUL ESLAKE
CORINNA ECONOMIC ADVISORY

Chart 2: The 'Sahm Rule' as an indicator of UK recessions

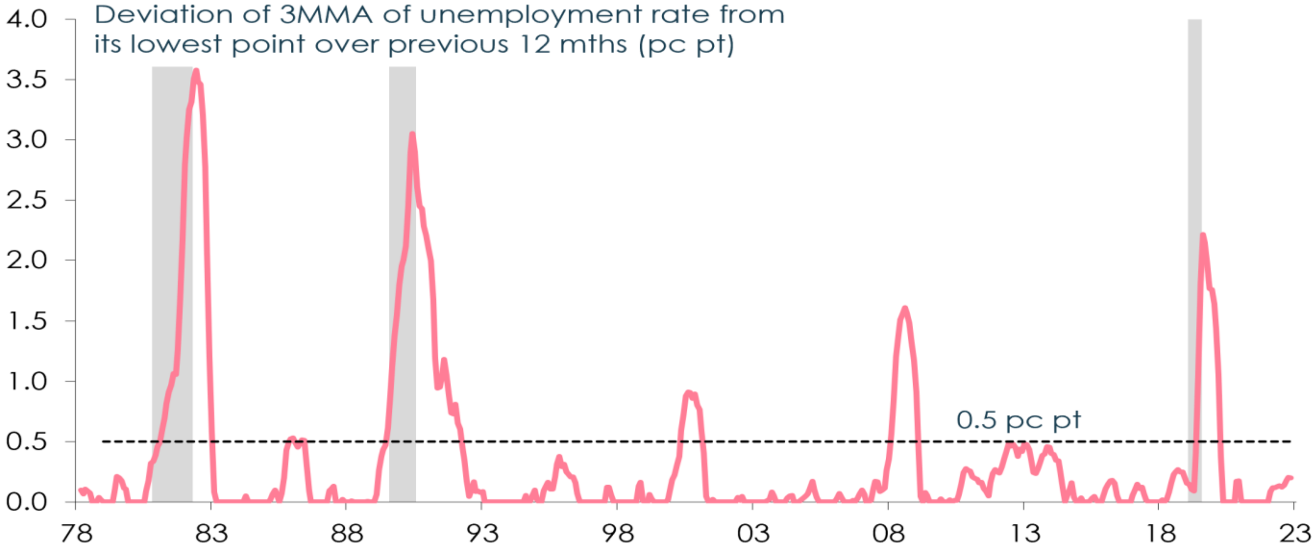


Note: Shaded areas denote consecutive quarters of negative real GDP growth.
Source: UK Office for National Statistics.

That's not altogether surprising given that the Bank of England's bank rate has risen by only 10bp less than the US Federal Reserve's fed funds rate since the beginning of their respective monetary policy tightening cycles, that fiscal policy in the UK has been contractionary (in contrast to the stimulatory stance of fiscal policy in the US this year), and that the rise in energy prices has conferred a much smaller 'terms of trade gain' on UK national income than it has on the US equivalent.

The 'Sahm Rule' also correctly identifies the three recessions (delineated by multiple quarters of negative real GDP growth) experienced in Australia since the Australian Bureau of Statistics began conducting monthly labour force surveys in February 1978.

Chart 3: The 'Sahm Rule' as an indicator of Australian recessions



Note: Shaded areas denote recessions as delineated by multiple quarters of negative growth in real GDP.
Source: Australian Bureau of Statistics.

As shown in Chart 3 above, the 'Sahm Rule' also identifies two other episodes as recessions - between April and December 2001, and between January and December 2009. These were not recessions according to the 'consecutive-quarters-of-negative-real-GDP-growth' rule – which underpins the claim, frequently made after 2017, that Australia holds the record for the longest period of uninterrupted growth since the end of World War II. However Australia's unemployment rate rose by 1.2 percentage points in the first of these episodes, and by 1.9 percentage points in the second.

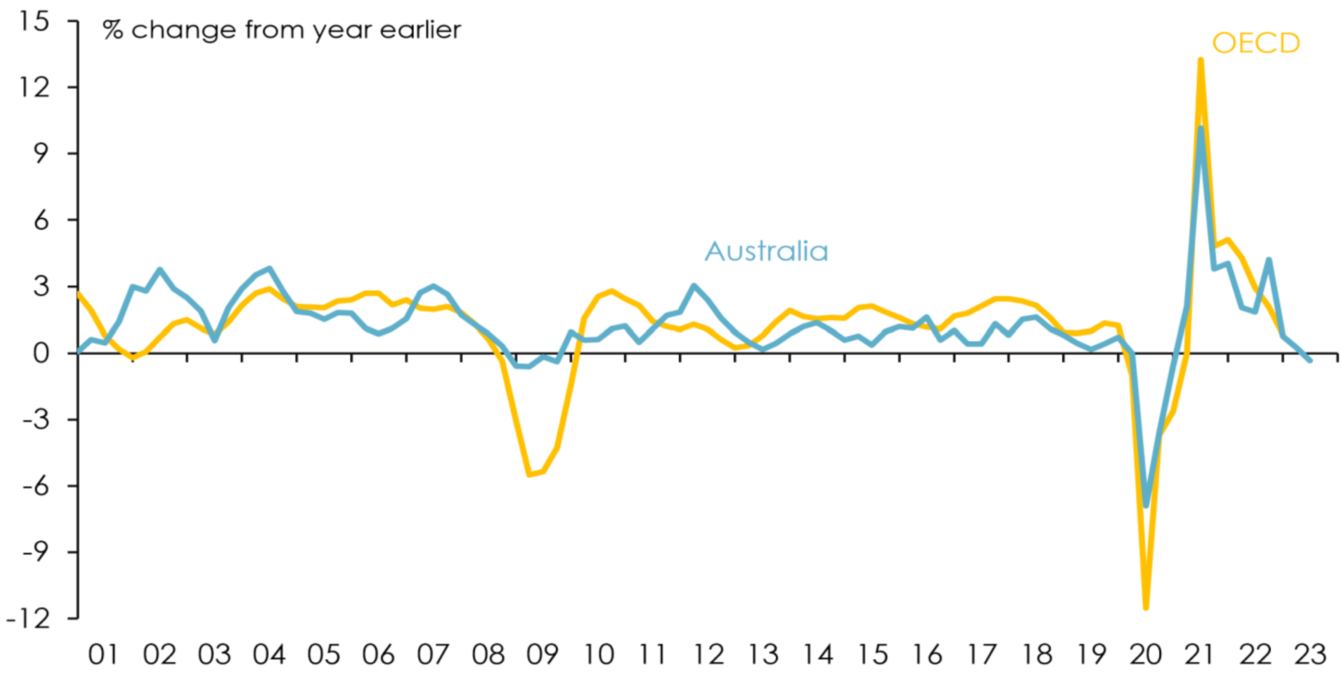
I'd argue, using the alternative definition of a recession that I proffered at the beginning of this piece, that Australia *did* have a recession in the aftermath of the global financial crisis, and that we came close to having one in the aftermath of the 'tech wreck' (and probably would have had one if we had much of a 'tech sector').

The 'Sahm Rule' is thus far *not* signalling that a recession is imminent in Australia, but rather that the narrow path to which former RBA Governor Phillip Lowe often referred during his last year in the job – of returning inflation to its 2-3% target band "while the economy continues to grow and we hold on to as many of the gains in the labour market as we can" – remains open.

If Australia does manage to avoid a recession by the 'consecutive-quarters-of-negative-real-GDP-growth' rule, it will owe a lot to the rapid growth now occurring in Australia's population – as indeed did the previously-mentioned 'record-breaking run' of 'uninterrupted economic growth' between 1991 and 2020, a point picked up by two economists at the Federal Reserve Bank of St Louis in September 2019.

In per capita terms, the growth rate of Australia's real GDP was actually only 0.2 of a percentage point per annum above the OECD average over the two decades prior to the onset of the Covid-19 pandemic, and indeed over the second half of that period was 0,5 of a percentage point per annum *below* the OECD average, as shown in Chart 4.

Chart 4: Australian and OECD average real per capita GDP growth



Sources: Australian Bureau of Statistics; OECD.

Australia's population is currently growing at almost 2½% per annum – more than four times the OECD average. It's very much a double-edged sword in current circumstances. Rapid population growth is undoubtedly adding to inflationary pressures, most obviously in housing costs: but it's also helping to keep the recessionary wolf at bay.

Of course we've already had two quarters of negative growth in real per capita GDP growth (-0.3% in both the March and June quarters) – and I wouldn't be surprised if we had a third in the September quarter (we'll find out on 6th December). But I will be surprised if the unemployment rate rises by a percentage point between now and the end of 2024.

Saul Eslake
Corinna Economic Advisory
www.sauleslake.com