Mastering Wealth Management Series

Unveiling the Mysteries of Recessions: From Unemployment to Changing Spending Habits

We understand that you may have often heard the word "recession" in the news lately. But do you truly know what a recession is? Let's explore it together!

What is a Recession?

A recession occurs when the economy experiences a significant decline in economic activity lasting more than a few months. It affects many areas of the economy; unfortunately, few are left untouched by its effects.

There are two widely accepted definitions of a recession. The first definition, proposed by economist Julius Shiskin in the 1970s, states that a recession happens when there have been two consecutive quarters of declining Gross Domestic Product (GDP). A declining GDP means the economy is getting smaller, indicating a possible recession. However, this definition is not always accurate.

The National Bureau of Economic Research (NBER) uses a definition to determine if there is a recession. According to the NBER, a recession happens when a big drop in economic activity affects many different parts of the economy, and this decline lasts for more than a few months.

The NBER looks at three things to decide if there is a recession: how much the economy shrinks (depth), how widespread the decline is across different areas (diffusion), and how long the decline lasts (duration).

Sometimes, even if one of these criteria is not strong, the NBER may still say there is a recession if another criterion is very strong. For example, in February 2020, a big drop in economic activity spread throughout the economy. Even though it ended up being a short downturn, the NBER still called it a recession because the drop was significant and affected many areas. The NBER later determined that the recession's lowest point was in April 2020, two months after the peak.

One not-so-fun part of NBER's classification process is that you typically won't know you have been in a recession until after it has finished. It's like looking back with perfect vision but not helpful at the moment.

What Happens in a Recession?

Unemployment

During a recession, various aspects of the economy are affected. One of the well-known effects is a rise in unemployment.

Unemployment and recessions are closely linked, and understanding their relationship can provide fascinating insights. In simple terms, recessions cause unemployment. When economic activity declines during a recession, businesses lose revenue and lay off workers.

Consequently, a recession in one sector of the economy can lead to unemployment, which triggers a recession in another part of the economy. This cause-and-effect relationship is complex and multi-faceted.

During a recession, higher unemployment can set off a downward spiral. As more people become unemployed, consumer spending drops, further slowing economic activity and growth. This slowdown in growth, in turn, leads to more layoffs and fewer job opportunities.

It is important to recognize that the economy operates in cycles, with phases of maximum business activity, recession, hitting bottom, and economic recovery. The severity of the Great Recession, triggered by the 2008 global financial crisis, was evident in its impact on the unemployment rate. At its peak, the unemployment rate reached 10.0% in October 2009, the highest since the Great Depression.

Lower Wages

During a recession, several factors contribute to changes in income. One significant impact is lower wages. Firms often keep wages low to reduce costs, resulting in wage cuts for certain workers, particularly temporary workers without contracts. These wage cuts were evident during the 2008-2012 recession, further aggravated by rising living costs, such as higher taxes and oil prices.

Another factor leading to lower wages is under-employment. Some workers may retain their jobs, but experience reduced working hours, transitioning from full-

time to part-time work (e.g., 20 hours a week). Consequently, while the increase in unemployment may be relatively subdued, many workers face substantial declines in effective income.

The self-employed are particularly vulnerable during a recession. Economic downturns often trigger cash-flow shortages for the self-employed, making it challenging to meet their financial obligations and make ends meet.

Consumer Spending

According to data from the Bureau of Labor Statistics, consumer spending patterns change in predictable ways during a recession. You see these changes in the relative importance of different spending categories, which show how much money people allocate to each category.

During a recession, people tend to spend less on eating out at restaurants, buying new cars, and durable goods in general. Instead, they increase their spending on food at home and used cars. This shift in spending reflects the need to be more cautious with money during tough economic times.

Interestingly, while you might expect people to spend less on travel during a recession, the data shows that spending on airfare actually increased. This increase in travel could be due to factors such as people looking for cheaper travel options or taking advantage of discounted prices during the recession.

The Bureau of Labor Statistics data indicates that consumer spending adjusts during a recession, with people changing their spending habits to cope with the economic downturn. These adjustments are reflected in the relative importance of different spending categories, giving us insights into how consumers respond to economic changes.

Recession Impact and Length

Although they don't happen very often, recessions can significantly impact the economy. They usually last about a year and can cause a decline in the country's total output of goods and services, known as Gross National Product (GDP). On average, GDP goes down by 2 percent during a recession, and in severe recessions, it can be as much as a 5 percent drop. This decline means that the economy becomes smaller and produces less.

During a recession, things like industrial production and investment also decrease, sometimes even more than the decline in GDP. When countries buy and sell goods with each other, international trade also drops because both exports and imports go down. People also have more difficulty finding jobs, and prices don't increase as much because people buy less. Recessions can also cause problems in the financial markets, like the value of houses and stocks going down.

Now, you might be wondering about depressions. A depression is like an even more severe recession. It happens when the decline in GDP is over 10 percent. Since 1960, there have only been a few depression episodes in advanced economies. The Great Depression of the 1930s was one of the most famous depressions. During that time, the U.S. economy shrank by about 30 percent over four years. Although serious, the 2008 Financial Crisis recession wasn't as bad as the Great Depression. It caused a decline in output of about 4.3% percent.

To summarize, a recession is a relatively brief period of economic decline. It affects various parts of the economy, characterized by rising unemployment, reduced consumer spending, and a lower GDP.

(1) Business Cycle Dating Procedure: Frequently Asked Questions, National Burea of Economic Research, N/D, https://www.nber.org/research/business-cycle-dating/business-cycle-dating-procedure-frequently-asked-questions

(2) Who calls a recession and how? Goldman Sachs, N/D, https://privatewealth.goldmansachs.com/us/en/insights/who-calls-a-recession-and-how

(3) Unemployment & Recession: Cause & Effect?, Management Consulted, updated July 20, 2021, https://managementconsulted.com/recession-unemployment/

(4) Recession: When Bad Times Prevail, International Monetary Fund, N/D, https://www.imf.org/external/pubs/ft/fandd/basics/recess.htm