

Finance Essentials: Recession Fundamentals

The concept of a recession is not a foreign one, especially today when that word has been passed around nonstop in the media. But do your clients truly understand what a recession is? What defines a recession? It is likely they have a working definition, but never really delved into the technical meaning of recession. However, we were able to do that for you.

What is a Recession?

The starting place of a discussion about recessions is to look at the technical definition. Chances are you have an idea in your head of what a recession is. You may be thinking, “Hey, I remember the financial crisis in 2008! I know what a recession is!” You might try to apply that experience as a definition, but I encourage you to reevaluate that approach. While there are many definitions out there for a recession, there are two that are widely accepted.

The first of which comes from economist Julius Shiskin in the 1970s. He defined a recession as when there have been two consecutive quarters of declining GDP. The declining GDP means the economy is getting smaller and we could be in a recession.[i]While this definition is very clear, it is not always correct.

The second widely accepted definition of a recession comes from the National Bureau of Economic Research which oversees defining the business cycles of the US economy. NBER defines a recession as “a significant decline in economic activity that is spread across the economy and lasts more than a few months”.[ii] This is almost too vague to be helpful.

Another not-so-fun part of NBER’s classification process is that, typically, you won’t know you have been in a recession until after it has finished, which isn’t exactly helpful, but hindsight is 20-20 I suppose.

What Happens in a Recession?

A recession affects many areas of the economy. Diffusion, referring to the reach of an economic event, is one of the criteria NBER uses for classifying a recession. A recession, unfortunately, usually leaves no one unscathed.

One of the more talked about effects of a recession is a rise in unemployment. According to research done by Deloitte, a post-WWII recession raises unemployment by 2.7 percentage points.[iii]

A recession typically affects GDP as well. According to Deloitte's research, gross domestic product, in an average recession, falls an average of 2%^[iii]. This is indicative of economic shrinking, which is a characteristic of a recession.

In general, in a recession, the economy begins to slow down, which means people are spending less. When people spend less, companies make less money, and therefore cannot afford to hire more people or may even lay people off. When companies can't hire more people and lay people off, unemployment rises, and people spend less money. This becomes a very unfortunate cycle.

How Long Does a Recession Last?

A typical recession, post-WWII, is estimated to last about 11 months. In the past, recessions have varied in their duration and severity. From 1854-1919, recessions in the US lasted an average of 21.6 months.^[i] Thankfully, we are not living in 1854.

According to NBER, there have been four recessions in the past 30 years. The longest of which is the Great Recession in 2008, lasting 18 months, and the shortest was the Covid-19 recession in 2020, which lasted a mere two months.^[iv]

How To Prepare for a Recession?

Because a recession is typically not classified until it is over, it can be hard to know how to prepare for one. Generally, it is suggested to watch your spending and ensure you are saving up an emergency fund^[v]. It can also be recommended that you stay invested and avoid making emotional decisions with your finances. We believe that the best thing to do in a recession is to remain calm and logical. No need to cry over shrinking GDP.

In conclusion, a recession is a relatively brief downturn in economic activity. It is widespread and affects many parts of the economy. It is characterized by rising unemployment, less consumer spending, and a lower GDP.

Sources

[i] <https://www.forbes.com/advisor/investing/what-is-a-recession/>

[ii] <https://www.nber.org/business-cycle-dating-procedure-frequently-asked-questions>

[iii] <https://www2.deloitte.com/us/en/insights/economy/issues-by-the-numbers/what-to-expect-when-expecting-recession-business-adapting-to-economic-cycles.html>

[iv] <https://www.nber.org/research/business-cycle-dating>

[v] <https://www.morningstar.com/articles/1105761/what-is-a-recession>

