Recession Basics

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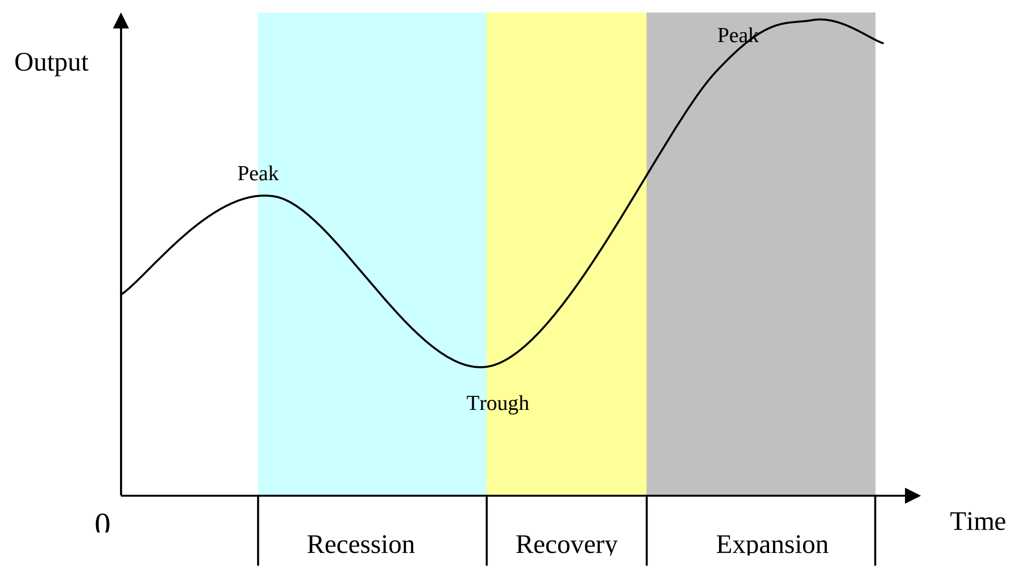
With recent economic developments in the United States on the minds of all investors the term “recession” has come to the fore. Many people may hear the word mentioned and immediately get pictures of the doom and gloom associated with recessionary periods but do not have a clear understanding of what a recession is. Here I intended to go through the basics of a recession so that all are up to speed.

A recession is part of the business cycle (various levels of economic activity that a country’s economy may go through over a period of time) of an economy. It is made up of five sections – Peak, Recession, Trough, Recovery and Expansion (as illustrated in Fig. 1.) It is expected to happen to almost every economy at some point in time however its duration and severity is hard to predict.

Fig. 1



The Business Cycle

There are many definitions which help to explain this recessionary period further. They include:

- A significant decline in general economic activity extending over a period of time (ArgMax.com)

- Broadly defined, a recession is a downturn in a nation's economic activity. If national productivity, or gross domestic product (GDP), declines for at least two consecutive quarters, it is usually considered a recession (Morganstanleyindividual.com)
- A decline in business activity. Often defined as two consecutive quarters with a real fall in gross national product (sterlingexchange.co.uk)
- The contracting phase of the business cycle when output declines and unemployment increases (economicadventure.org)

There are many other variations used today however a large number of them attempt to attach a time frame for a recession. While the use of two consecutive quarters aids in determining if the economy has begun entering a recessionary phase, the duration of the recession cannot be restricted to a time period.

The National Bureau of Economics Research (NBER) is a private, non-profit, non-partisan research organization which aims at providing unbiased economic research. A major role of this organization is the examination of the business cycle and long-term economic growth. It can actually be regarded as having the final say on whether the economy has moved into a recessionary phase. This organization has its own variation on what a recession is. It regards it as a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production and wholesale-retail sales.

In order to achieve a better understanding of a recession we shall now look at the indicators used by NBER along with some recently released economic data.

Real GDP represents the total value of goods and services produced within an economy during a given year adjusted for inflation. For the U.S. economy, data released by the Bureau of Economic Analysis (BEA) showed that for the third quarter of 2007 real GDP was up by 4.9% but between the third and fourth quarters growth rate had slowed down to 0.6%. This represents three months of decline however; GDP figures for the first quarter of 2008 due on March 27th will provide further details as to the direction of the economy.

Real income represents inflation adjusted income level i.e. it shows the current purchasing power of income received. Between July and November 2007, real disposable income levels released by the BEA showed a decline from 0.5% to -0.4% however there was an improvement of 0.5% from November to December. The general trend for the last seven months still remains downward.

The unemployment rate can be defined as “the percentage of the total labor force that is unemployed but actively seeking employment and willing to work” (Investopedia.com).

Unemployment data for the U.S. has decreased over the last three months with the national rate moving from 5% at the end of 2007 to 4.8% at the end February 2008. This was in spite of a continued decline in the non-farm (non-agricultural) sector where job losses fell by a further 63,000 as compared to the 17,000 job loss in January. This was because, 1.6MM persons in February were considered to be marginally attached to the labor force and were not counted as being unemployed because they were willing and available for work but did not seek any opportunities within the last month.

Another piece of data used to determine the health of the economy is Industrial Production. This shows the total output of factories, utilities and mines. It can be used to gain an idea of what GDP levels may be like on a month to month basis. Industrial production levels have seen a reduction in growth over the last three months moving from 0.4% in November to 0.1% in January. This trend in output levels, if continued, may go into negative territory. This may point to pending GDP figures being negative and indicate the start of a recession.

Finally, the level of wholesale – retail sales is important as it gives an idea of the level of expenditure in the economy. This is tied into inflation and real income levels as reduced retail sales in the face of declining real income levels and rising inflation may signal a serious downturn in economic growth. For the U.S, retail store sales improved in January ending at 0.3% up from -0.4% in December 2007.

With almost all recent data on the aforementioned indicators of economic growth pointing downwards, what can be done to alter their current direction? The Federal Reserve or Fed is the institution entrusted to manage such situations .

The Fed has three tools at its disposal to affect the expansion of the economy. They are:

1. Open Market Operations
2. Discount Rate Adjustments

3. Reserve Requirement Adjustments

The Open Market Operations undertaken by the Fed are very similar to those of our Central Bank where securities of varying tenors are made available to commercial banks. The aim of issuing securities would be to reduce the money supply as commercial banks take up these securities. If the Fed on the other hand repurchases more of the securities than it intends to issue then it is in effect increasing the money supply. This strategy would be of vital importance if they are attempting to avoid a recession as they would be effectively reducing the cost of borrowing money and encouraging consumers to exercise their credit facilities. Increased spending would then lead to greater demand for goods produced and associated jobs in producing these goods thereby causing increases in production levels and the GDP of the country.

The Fed can also adjust the discount rate in an attempt to manipulate economic growth. The discount rate is the rate at which the Fed lends to commercial banks. Therefore if the Fed wanted to help expand the economy it can reduce the discount rate which would allow commercial banks to increase their reserves and create more loans.

The reserve requirement can also be adjusted in an attempt to affect the creation of loans. The reserve requirement is the percentage of reserves which a commercial bank holds against its deposits.

The Federal Reserve, seeing the direction of the economy has already taken steps to prevent its continued path. On January 22nd, they reduced the federal funds rate by 75 basis points from 4.25% to 3.5% in a “surprise” move. A further 50 basis points cut was made on January 30th at their scheduled rate announcement meeting, bringing the rate down to 3.0%

With continued negative data expected for the coming periods, the market is predicting that there would be further rate cuts at the coming rate decision meeting. Some analysts are even expecting another “surprise” rate cut before the scheduled March 18th meeting. By reducing rates in this manner, it is hoped that consumer spending will be back on the increase which would aid in bolstering the economy. This will however take some time to be reflected as many banks after being affected by the fallout of the sub-prime mortgage crisis are unsure about the state of the economy and the credit-worthiness of potential clients.

In conclusion, the economic data releases have so far pointed in the same direction leading many analysts to declare that the U.S. economy has already entered into a recessionary phase, however, more time is still needed to fully asses the situation along with the effectiveness of the Fed's efforts.

All eyes and ears are now open for the NEBR statement on the current economic situation which so far looks as though it would confirm the fears which are already in the market.

Information sourced from:
National Bureau of Economic Research
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