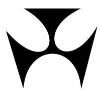

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Recession

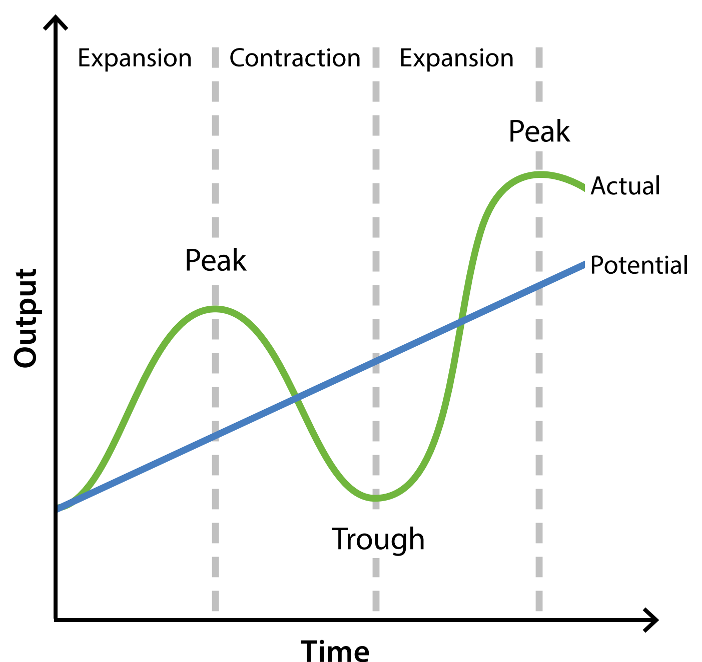
The output of an economy usually increases over time. However, growth in economic output fluctuates, forming a 'business cycle' in which there are peaks and troughs in economic activity. In the trough of a business cycle, output growth can be weak or negative. This usually results in job losses and an increase in the unemployment rate. While there is no single definition of recession, it is generally agreed that a recession occurs when there is a period of reduced output and a significant increase in the unemployment rate. Views differ about how to best identify this. Recessions inflict great hardship on households and businesses, and they can have long-lasting effects on both society and the economy. Consequently, central banks and other policymakers try to reduce the frequency and severity of recessions. Monetary policy is one of the main tools used to do this. (See Explainer: Economic Growth and Explainer: What is Monetary Policy?).

This Explainer describes the nature of the business cycle and discusses different approaches to identifying a recession. It also summarises some of the recessions that have occurred in Australia and the consequences of recessions.

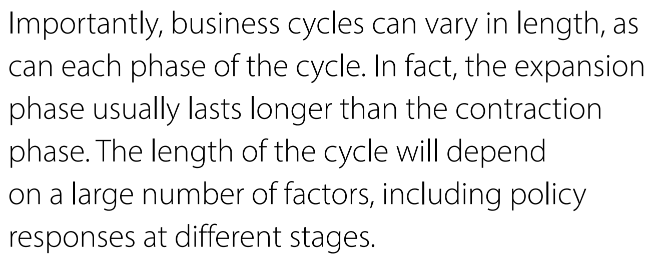
What is the Business Cycle?

The business cycle refers to fluctuations in growth in economic output taking into account the steady growth in the 'potential output' of the economy. Output is defined as real gross domestic product (GDP) and potential output is the level of output that the economy can achieve when using all its resources – people, equipment, natural resources and technology – in a sustainable way, without putting excessive upward pressure on prices in the economy.[1]

A business cycle has four main phases – expansion, peak, contraction and trough. In an expansion, households demand more goods and services, businesses hire more workers, and wages and prices typically increase. This phase ends with a peak in economic activity. In a contraction, households demand fewer goods and services, businesses reduce the number of workers they employ and growth in wages and prices slows. This phase ends with a trough in economic activity.



1 See Explainer: Economic Growth for an explanation of GDP, its measurement and the difference between real and nominal GDP.



Importantly, business cycles can vary in length, as can each phase of the cycle. In fact, the expansion phase usually lasts longer than the contraction phase. The length of the cycle will depend on a large number of factors, including policy responses at different stages.

What is a Recession?

There is no single definition of recession, though different descriptions of recession have common features involving economic output and labour market outcomes.

Indicated by weak output and rising unemployment rates

A recession can be defined as a sustained period of weak or negative growth in real GDP (output) that is accompanied by a significant rise in the unemployment rate. Many other indicators of economic activity are also weak during a recession. For instance, levels of household spending and investment by businesses are usually low. In addition, the numbers of households and businesses that are unable to pay back loans are unusually high, as is the number of businesses that close down. Because these indicators are typically present when there is a significant increase in the unemployment rate, the unemployment rate is considered a reliable and timely summary indicator of a range of negative developments in an economy.

Technical recession

The most common definition of recession used in the media is a 'technical recession' in which there have been two consecutive quarters of negative growth in real GDP. This definition often appears in textbooks and is widely used by journalists. On this definition, Australia had not recorded a recession for 29 years since the recession of the early 1990s. This length of time since a technical recession is very unusual compared with Australia's economic history and the experience of most advanced economies, which typically record a recession around every seven to ten years on average.

There are, however, a number of shortcomings of this definition of recession:

- GDP growth can be weak – but not negative – and still be associated with significant increases in the unemployment rate and hardship for households.
- Some components of GDP are volatile. Consequently, two consecutive quarters of negative growth in GDP can give a false signal about the underlying pace of economic growth.
- Measurement of the components of GDP is subject to revision as more data become available. Consequently, a negative quarterly growth figure can be revised away or a positive one can become negative, also increasing the possibility of a false signal about the underlying pace of economic growth.

Some commentators also consider alternative measures of economic output to assess periods where economic growth is easing or below trend. For example, some will focus on whether there have been two consecutive quarters of negative growth in GDP per person (or GDP per 'capita'), which is a way of excluding the contribution of population growth to economic activity. Other commentators focus on consecutive quarters of negative growth in GDP excluding some volatile parts of the economy, such as the farm sector, so as to avoid the effects of volatile movements on the pattern of economic growth.

As identified by the NBER

The National Bureau of Economic Research (NBER) in the United States (a leading research institution recognised for its work on business cycles) takes a different approach to defining recessions. The NBER defines a recession as a period between a peak and a trough in the business cycle where there is a significant decline in economic activity spread across the economy that can last from a few months to more than a year. While the NBER agrees that most recessions will, in fact, have two consecutive quarters of negative growth in real GDP, it says that this will not always be

so. It highlights the conflicting signals that can sometimes arise from the different approaches to measuring GDP (see Explainer: Economic Growth) and so it considers a broad range of economic indicators in addition to GDP. However, the judgements made by the NBER about whether the United States has recorded a recession are not usually arrived at quickly and it does not have a readily available formula for identifying recessions that can be applied to other economies.

Unemployment-based rules

Economists have also proposed definitions of recessions that rely only on the unemployment rate. These rules typically signal a recession when the unemployment rate increases by more than a pre-specified amount. These unemployment-based rules have the advantage of being simple, timely and not as susceptible to data revisions as GDP-based measures. However, the main limitation of unemployment-based rules is that the unemployment rate might not always capture a deterioration in other economic indicators, such as underemployment.

What is the Difference Between Recession and Depression?

As with 'recession', there is no single definition of a 'depression'. However, a depression can be thought of as a much bigger version of a recession, both in terms of scale and duration. Consequently, in a depression, there are periods of falling output and high unemployment rates that persist for a number of years.

The scale and duration of a depression means that there are often negative economic outcomes that are experienced in many countries around the world, so some definitions of depression say that it is a severe recession that occurs in one or more economies.

When Have Recessions or Depressions Occurred in Australia?

There are several episodes of very weak economic activity in Australia that are recognised as recessions or depressions by most economists. There are also some episodes of weak economic activity where there is disagreement among economists about whether these were recessions, in part because of the different definitions of recession that can be used.

Recessions

1974–1975: The mid-1970s recession followed a global oil price shock in which the world price of oil roughly quadrupled. The increase in world oil prices generated high rates of inflation which were made worse by domestic wage pressures. Significant increases in the costs of production, combined with reduced demand by other economies that were in recession, caused output to contract and reduced Australian firms' ability to employ workers. The unemployment rate rose sharply from very low levels. Despite falling output and rising unemployment, high rates of inflation persisted – a situation called 'stagflation'. (The unemployment rate peaked at 5½ per cent while inflation peaked at 18 per cent.)

1982–1983: Around the world, the high rates of inflation that emerged during the 1970s had become entrenched, with the inflationary effects of higher oil prices reinforced by excessive growth of the money supply and expansionary fiscal policies. Given the costs of high inflation,[2] in the early 1980s, central banks sought to reduce inflation through tighter monetary policy that resulted in recession in a number of economies (especially the United States). In Australia, the effects of tighter monetary policy and weak global demand were compounded by drought.

2 See Explainer: Australia's Inflation Target for a discussion of the costs of high inflation.

With the breaking of the drought, a rapid economic recovery followed, aided by the benefits of the recent floating of the Australian dollar and other economic reforms. (The unemployment rate peaked at 10½ per cent).

1991–1992: The early 1990s recession mainly resulted from Australia's efforts to address excess domestic demand, curb speculative behaviour in commercial property markets and reduce inflation. Interest rates were increased to a very high level because the transmission of tighter monetary policy took longer than expected to put downward pressure on demand and inflation. At the same time, countries in other parts of the word, in particular the United States, also entered recession, compounding the effect of tighter monetary policy in Australia. (The unemployment rate peaked at just over 11 per cent.)

Depressions

The Great Depression of the 1930s: The Great Depression is the most well-known economic depression, owing to its depth and duration in economies around the world. It pre-dated modern social security systems and its social consequences remain a defining example of the potential cost of economic policy failures. The Great Depression lasted from 1929 to 1931. The official *Australian Year Book* of 1933 records that the unemployment rate reached 30 per cent. This is the most widely reported figure and reflects unemployment rates among trade union members; experts who have sought to construct historical economic statistics on a similar basis to contemporary statistics have estimated that the unemployment rate peaked at nearly 20 per cent.[3] The social and economic consequences of The Great Depression were severe, though Australia was less affected than some other economies.

3 Butlin M, R Dixon and P Lloyd (2014), 'Statistical Appendix: Selected Data Series, 1800-2010', in S Ville and G Withers (eds), *The Economic History of Australia*, Cambridge University Press, Cambridge, pp 555-594.

The Depression of the 1890s: Following a long resource and property boom, foreign investors began winding back their activities and withdrawing their funds from Australia. At the time, Australia did not have its own currency, so the exchange rate could not depreciate to cushion the effects of this withdrawal. This occurred alongside a collapse in wool prices. There was a 'run' on the banks in which many depositors withdrew their deposits and Australia experienced its deepest financial crisis. The resulting financial instability was associated with a deeper fall in production than in The Great Depression and a higher rate of unemployment. The 1890s Depression had far-reaching consequences for Australia, giving rise to the organisation of labour, formation of the Australian Labor Party and the achievement of Federation (with the scale of the crisis across the country making clear the benefit of national government).

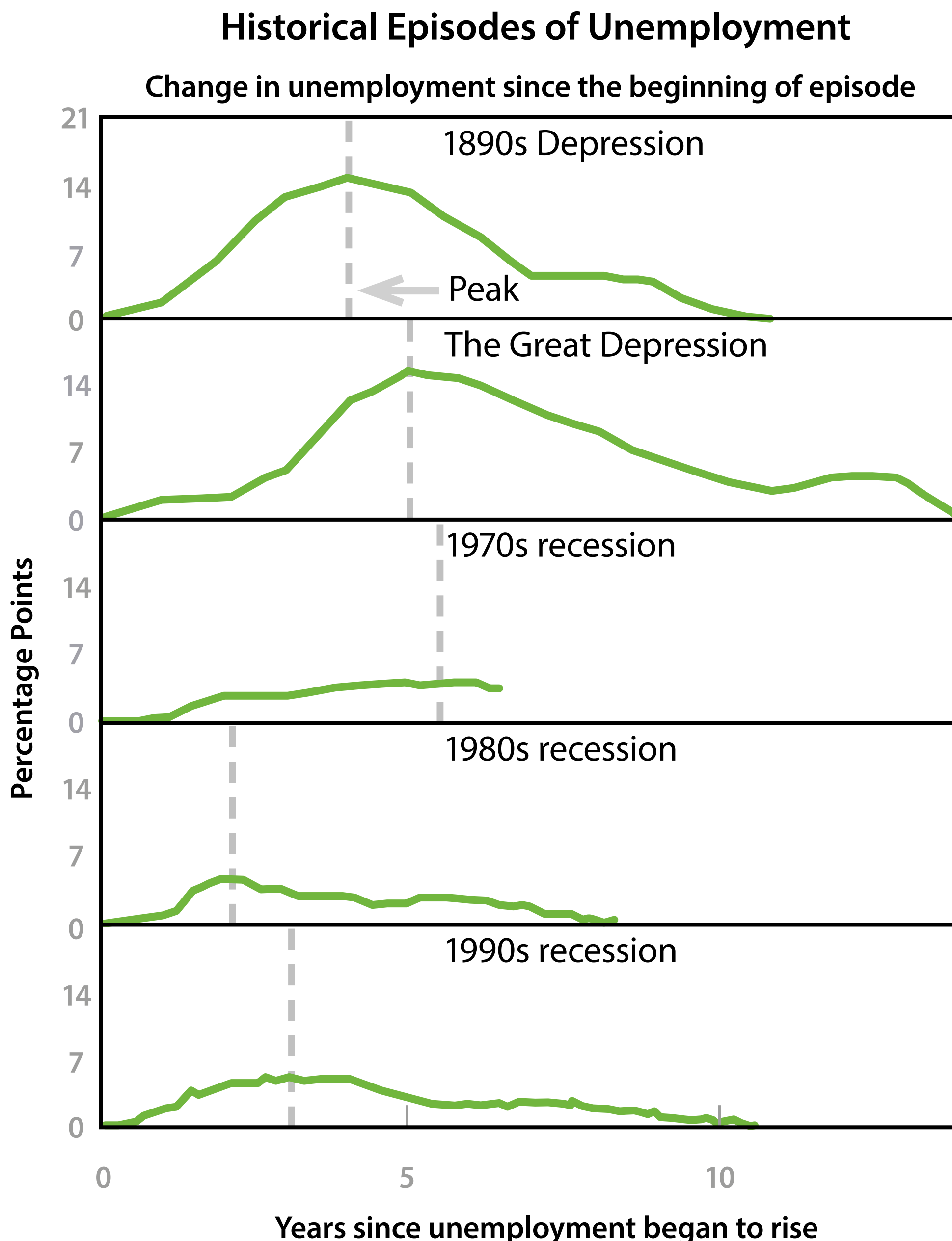
Other downturns

There have been a number of brief slowdowns in economic activity over the decades, most recently during the global financial crisis (GFC), with the GFC resulting in significant negative shocks to the Australian economy.

The global financial crisis (2008–2009): International financial markets and banking systems experienced a period of extreme stress and volatility in 2008 (see Explainer: The Global Financial Crisis). The damage done to financial markets and the banking systems of many other countries triggered large-scale losses of economic activity and large increases in unemployment. For many countries, this was the most severe recession since The Great Depression. However, the Australian economy fared much better than most because it had a sound financial system, a relatively large exposure to the buoyant Chinese economy, and strong macroeconomic stimulus to cushion it from the global downturn. Australian GDP only declined in one quarter, although the unemployment rate increased to close to 6 per cent and the underemployment rate rose sharply.

COVID-19 pandemic

The COVID-19 pandemic caused large contractions in many economies, including Australia. Because management of the public health issue required the immediate suspension of many economic activities, the economic effects of the pandemic have been notable for the speed at which output fell and unemployment rates rose, as well as for the scale of these effects. For instance, in Australia GDP fell by 7 per cent in June quarter 2020, the largest quarterly decline for which records are available. The unemployment rate peaked at close to 7½ per cent in mid-2020 and the underemployment rate also increased sharply. Economic activity rebounded as COVID-19 restrictions were lifted and vaccination programs were rolled out, with households and businesses supported by historically large monetary and fiscal stimulus.



Can Recessions Have Long-term Effects?

The social and economic costs of recessions can be large and persistent. The central bank and other economic policymakers seek to ensure the economy continues to grow at a sustainable rate to avoid any unnecessary slowdown in economic activity. If a negative shock does occur that causes activity to slow, policymakers will attempt to stimulate the economy to try to avoid a recession and minimise the economic costs faced by households and businesses.

There can be long-term consequences from an increase in unemployment and business failures that occur during recessions. Some people who become unemployed in recessions face long-term unemployment, even when normal rates of economic growth resume.[4] This is because during a recession their work skills may have reduced through lack of use, or because employers may think that this has occurred. Long-term unemployment can also occur because a recession can speed up structural changes to the way the economy works. Reflecting these developments, the unemployment rate after each recession tends to be higher than before the economy entered a recession and takes a long time to decline.

The rise in unemployment that occurs during a recession results in increased economic hardship that is borne unequally across society (with different groups being affected in different recessions).[5] This, in turn, reduces the opportunities available to households directly affected by the recession and can have long-term effects on their health, learning, achievement of qualifications and social mobility (that is, the ability to improve their circumstances).

The business failures that occur during a recession result in a permanent loss of output by these businesses and a destruction of productive capacity. This is especially costly when businesses had been innovative, had specialist knowledge, or formed a key part of a supply chain or network.

A recession can also have a longer-term impact on a nation's public debt as governments experience a reduction in taxation revenue but need to fund increased expenditure and transfer payments (through their efforts to stimulate the economy, provide social welfare and support businesses).

4 For more details about the different types of unemployment see Explainer: Unemployment – Its Measurement and Types.

5 In some recessions youth and those with less education have been more affected, while in other recessions people of prime working age have been more affected (with the early 1980s and 1990s recessions in Australia having long lasting effects on prime working age males). The cause of the recession, its duration and whether it accelerates structural change has bearing on which groups are most affected by a recession.