



# Turning Points and Leading Indicators

## THE DEFINITION OF THE BUSINESS CYCLE

Each recession is unique, triggered by a different set of factors. This leads to wide latitude in assessing blame for a contraction, even among experts. For example, even though the 2001 recession began in March, some will forever link it to the terrorist attacks of September 11 or the corporate scandals that followed. Other recessions have been blamed on oil shocks, on the crisis in the Middle East, and on Federal Reserve interest rate hikes. While external shocks like these can help precipitate a recession, they are seldom the cause.

Similarly, each recovery has unique characteristics. In the recovery that followed the 2001 recession, the job market remained very

weak while growth was rebounding. One key difference between this and other recoveries was the dramatically accelerated loss of manufacturing jobs. But as we have suggested before, there are patterns common to all recessions and recoveries that can be used to understand and forecast the timing of turns in the cycle. Decades of observation have shown us that during a typical recession, companies fire employees, incomes fall, spending goes down, and output declines. By examining the historical record, we know that, during recessions, these four factors—employment, income, output, and sales—tend to decline together.

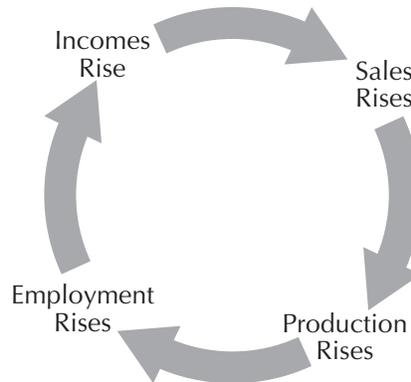
This comovement of all four factors is key. On occasion, a temporary dip in one or more of these variables may occur. But only during a recession—or cyclical downturn—will all four measures decline together. (During some mild recessions, income *growth* has slowed, though incomes did not drop.)

We also know that during a cyclical downturn, declines in employment, income, sales, and output feed on one another, snowballing into an avalanche. When people lose jobs, incomes fall. As a result, they buy less, which means companies produce less and therefore need fewer employees. Additional layoffs result, leading to a further drop in income, a further drop in sales, and a further decline in output.

When people lose jobs in one or more industries, they reduce their spending in many different areas. Because of this, the downturn spreads from industry to industry, often like wildfire, until it engulfs most of the economy. For similar reasons, recessions can spread from region to region.

At cyclical upturns, the vicious cycle turns virtuous and the mirror image of those events occurs. Sales, output, income, and

*A Virtuous Cycle*



*Feedback loop that occurs during a recovery, showing the linkage among the four key coincident indicators of the economy.*

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employment all increase in unison. With people buying more, industries produce more, which typically requires them to hire more people, causing incomes to rise. The effects spread from industry to industry and region to region, until the expansion encompasses most of the economy.

These observations form the basis of the classic definition of business cycles in market economies established by Wesley Mitchell in 1927. Here are the key points:

- Business cycles are fluctuations in aggregate economic activity.
- A cycle consists of simultaneous expansions in many economic activities, followed by similarly general recessions.

- This sequence of changes is recurrent but not periodic; cycles can last from one year to ten or twelve years.
- They are not divisible into shorter cycles of similar magnitude and character.

This definition provides clarity when it comes to determining if a recession has begun, unlike the popular misleading “two down quarters of GDP” rule of thumb, according to which, if GDP falls for two straight quarters, we have met the “technical” definition of a recession. GDP is just a measure of an economy’s output. But if employment, income, and sales do not fall at the same time, the temporary period of negative-output growth will not catch on and spread, and no recession will occur. That is why such simplistic “rules” can lead to greater risk for decision makers.

For example, in July 2002, when the data showed GDP falling only during the third quarter of 2001, U.S. Treasury Secretary Paul O’Neill asserted that the economy had not been in a recession. Later that month, when the revised data finally revealed that GDP had been negative in each of the first three quarters of 2001, the reality of recession dawned on many doubters, sixteen long months after it had started. Similarly, it was not until June 1998, when the two-down-quarters-of-GDP “rule” had been satisfied, that many finally accepted that Japan was in recession, fifteen months after it began.

In contrast to such simplistic “rules,” the classical definition of business cycles is a sophisticated description of what occurs at cyclical upturns and downturns and is used to officially date business cycles in the United States. Understanding it is vital. This knowledge will serve you well the next time confusion reigns about whether a recession has begun or if a recovery is for real.