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Revisiting Recession Facts (Milo/Struyven)

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- We see the risk that the economy enters a recession in the next year at 30% in the US, 40% in the Euro area, and 45% in the UK. We revisit key facts about the frequency and severity of recessions analyzing 77 recessions in advanced economies since 1961.
- Our subjective recession probabilities are significantly higher than the average 15% annual unconditional probability of advanced economies to enter a recession since the 1960s.
- The unemployment rate has risen by 2.7pp in the median advanced economy recession since the 60s with larger increases in the 1980s and the UK but smaller increases in Japan. The distribution is slightly skewed towards larger increases in more severe recessions.
- We find that economic overheating—high unit labor cost growth and high core inflation—and large cumulative increases in the policy rate often precede severe recessions. In contrast, elevated private sector financial surpluses often foreshadow less severe recessions.
- Currently, across the advanced economies, unit labor cost growth, core inflation, and the expected total increase in the policy rate are generally running at levels similar to the runup of the typical advanced economy recession. Higher measures of economic overheating in the US, UK, and Canada than in Japan and the Euro area suggest that the next recession may be somewhat less shallow in these English-speaking G10 economies. In contrast, the private sector financial balance has been much higher than ahead of the typical recession for all economies, hinting at a shallow next recession.
- Other factors outside our historical dataset paint a mixed picture. On the pessimistic side, the monetary and fiscal policy response might be more limited than usual and energy disruptions are the main risk in Europe. On the optimistic side, long run inflation and wage expectations still appear mostly anchored and substantial supply side improvement opportunities remain.

Revisiting Recession Facts

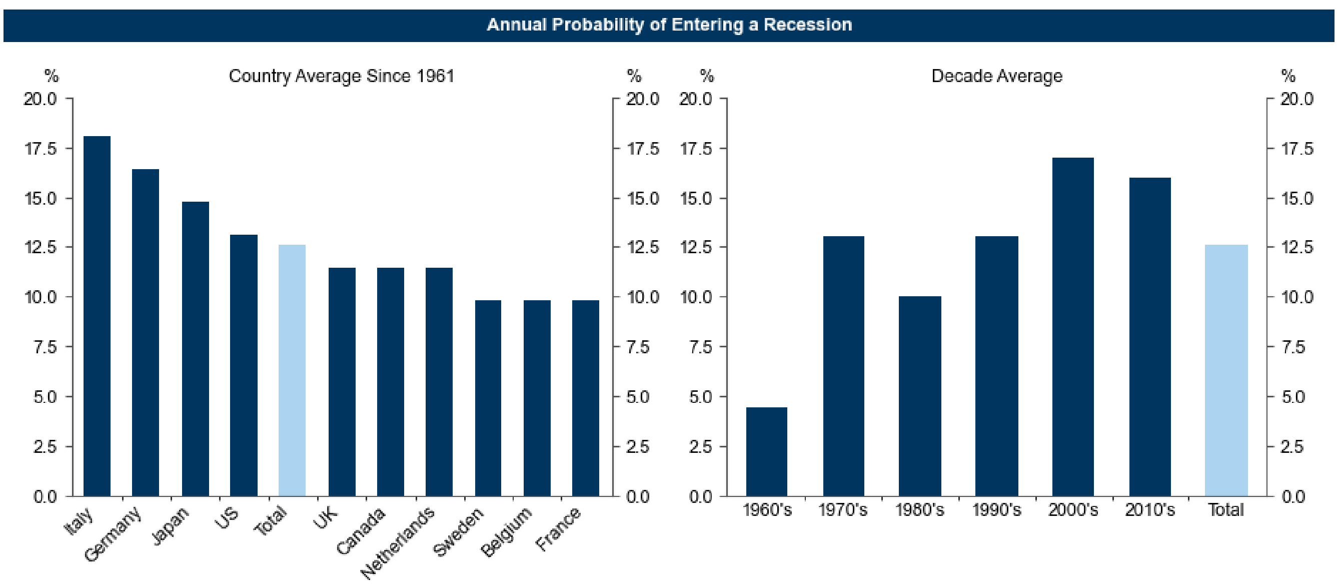
We see the risk that the economy enters a recession in the next year at 30% in the US, 40% in the Euro area, and 45% in the UK. We revisit key facts about the frequency and severity of recessions analyzing 77 recessions in advanced economies since 1961.

Frequency

To put these probabilities in historical perspective, we summarize the historical frequency of recessions using official recession classifications, such as the NBER in the US, when available. For Belgium and the Netherlands, we categorize recessions as periods starting with a quarter of negative year-over-year GDP growth per capita.[1]

Exhibit 1 shows that the annual unconditional probability of advanced economies to enter a recession since the 1960s has been roughly 15% on average. It also shows that recession risk has not varied much across countries or over time over the past several decades.

Exhibit 1: Historically, the Probability of Advanced Economies to Enter a Recession Has Been Roughly 15%



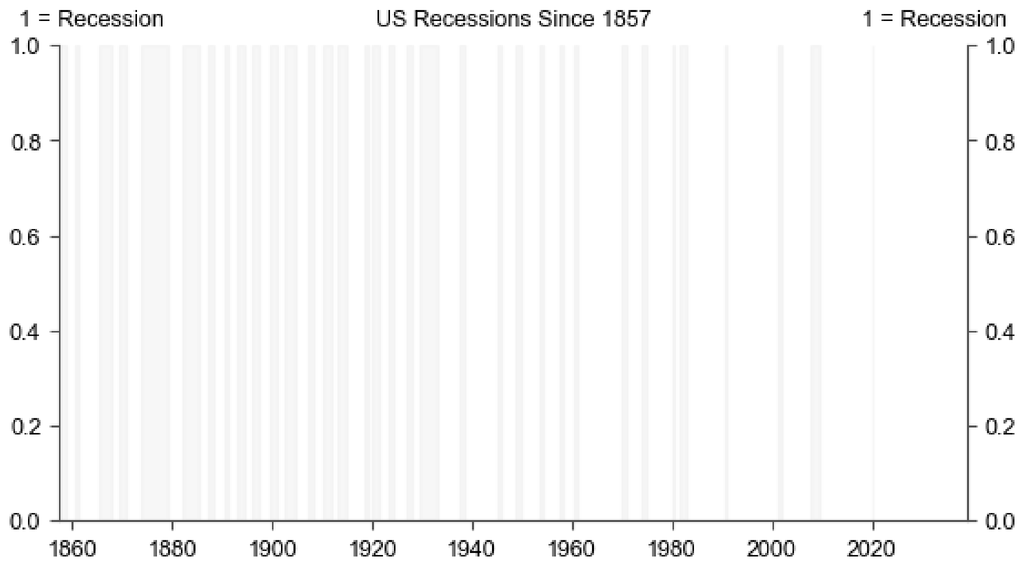
Sample begins in 1961 for all countries. The pandemic recession (on a quarterly basis) started in 2019 for France, the UK, Italy, Japan, Germany, and the US and in 2020 for Sweden, Belgium, Canada, and the Netherlands.

Source: Haver Analytics, Goldman Sachs Global Investment Research

Our subjective recession probability in the US of 30% over the next year is also elevated relative to its own extended history. The annual probability of entering a recession in the US has averaged 12% since the 90's (Exhibit 2), though it averaged a much higher 23% between 1855-1990. US recessions have become less frequent following the creation of the Federal Reserve, the anchoring of inflation expectations, and the decline in the relative importance of the cyclical manufacturing sector.

[1] We also require at least a six quarter gap between consecutive recessions.

Exhibit 2: Recessions Used to Be Much More Frequent in the US



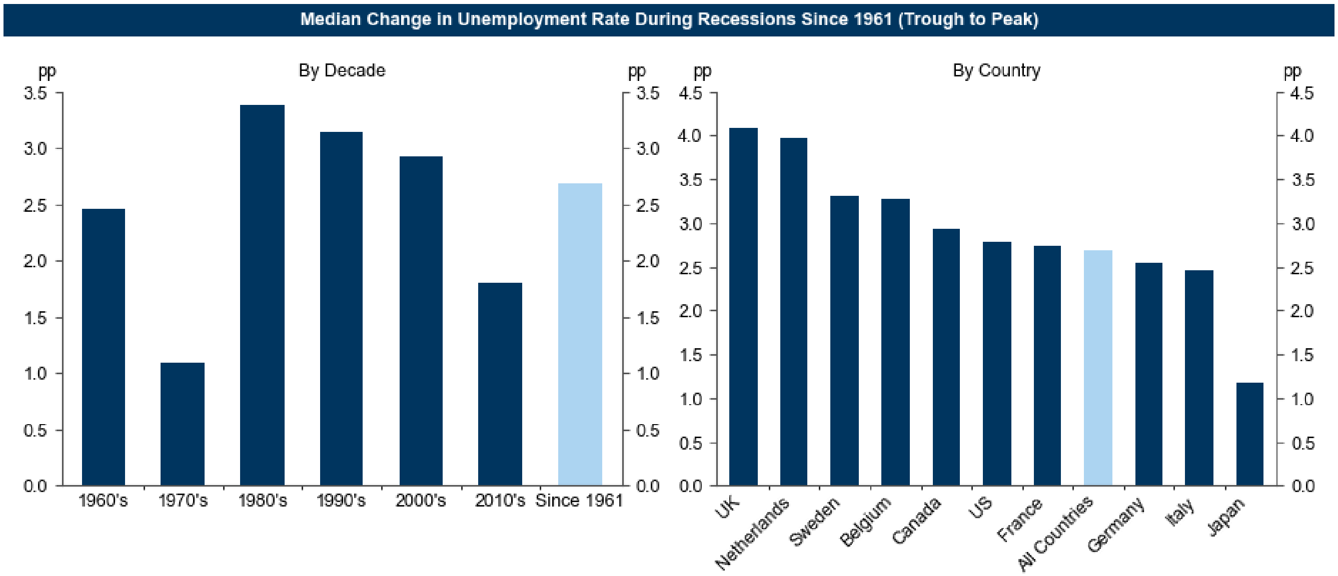
Source: Haver Analytics, Goldman Sachs Global Investment Research

Severity

We next define the severity of recessions using the trough to peak change in the unemployment rate. We exclude the "exogenous" pandemic recession of 2020 as increases in the unemployment rate were either outsized outliers in countries such as the US and Canada or significantly limited by furlough schemes in Europe and Japan.

Exhibit 3 shows that the unemployment rate has risen by 2.7pp in the median advanced economy recession since the 60s, with somewhat larger increases in the 1980s (Exhibit 3, left). Countries with larger increases in the unemployment rate also tend to have less frequent recessions—including the UK, Netherlands, and Sweden. In contrast, countries with smaller increases in the unemployment rate tend to have more frequent recessions, such as Germany, Italy, and Japan.

Exhibit 3: Median Rise in the Unemployment Rate of 2.7pp; More Severe Recessions in the UK and the 1980s

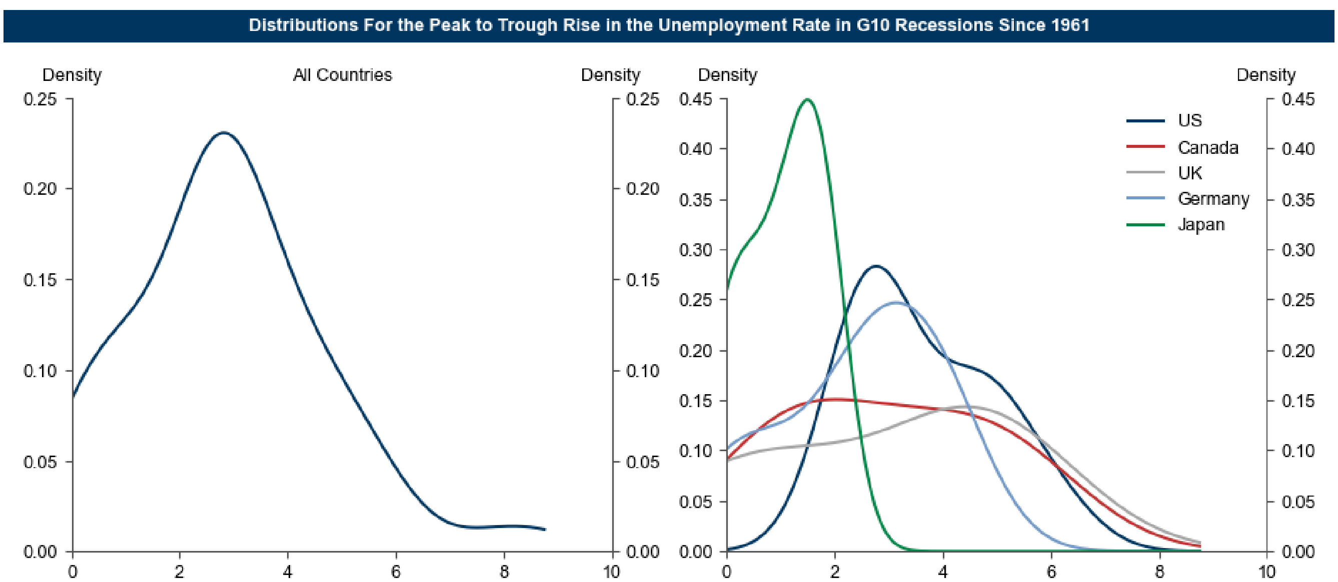


Excludes pandemic recession.

Source: Haver Analytics, Goldman Sachs Global Investment Research

The distribution of the change in the unemployment rate during recessions shows a slight skew towards more severe recessions. The distributions in the UK and Canada are especially skewed towards more severe recessions, while the distribution in Japan is skewed towards less severe recessions.

Exhibit 4: The Distribution of Recession Severity Is Slightly Skewed Towards More Severe Recessions



Excludes pandemic recession.

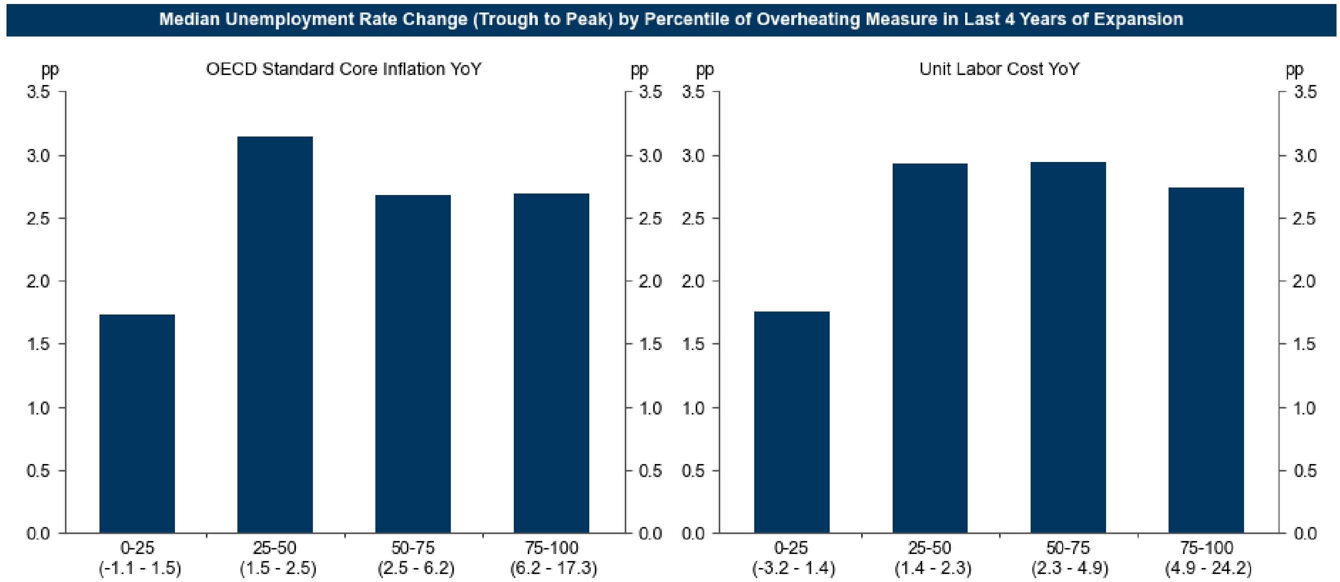
Source: Haver Analytics, Goldman Sachs Global Investment Research

Predictors of Severity

We now summarize the predictors of recession severity focusing on variables that have a long history.

We find that economic overheating—unit labor cost growth and high core inflation (Exhibit 5)—and large cumulative increases in the policy rate often precede severe recessions.[2] In contrast, large private sector financial surpluses often foreshadow less severe recessions (Exhibit 6).

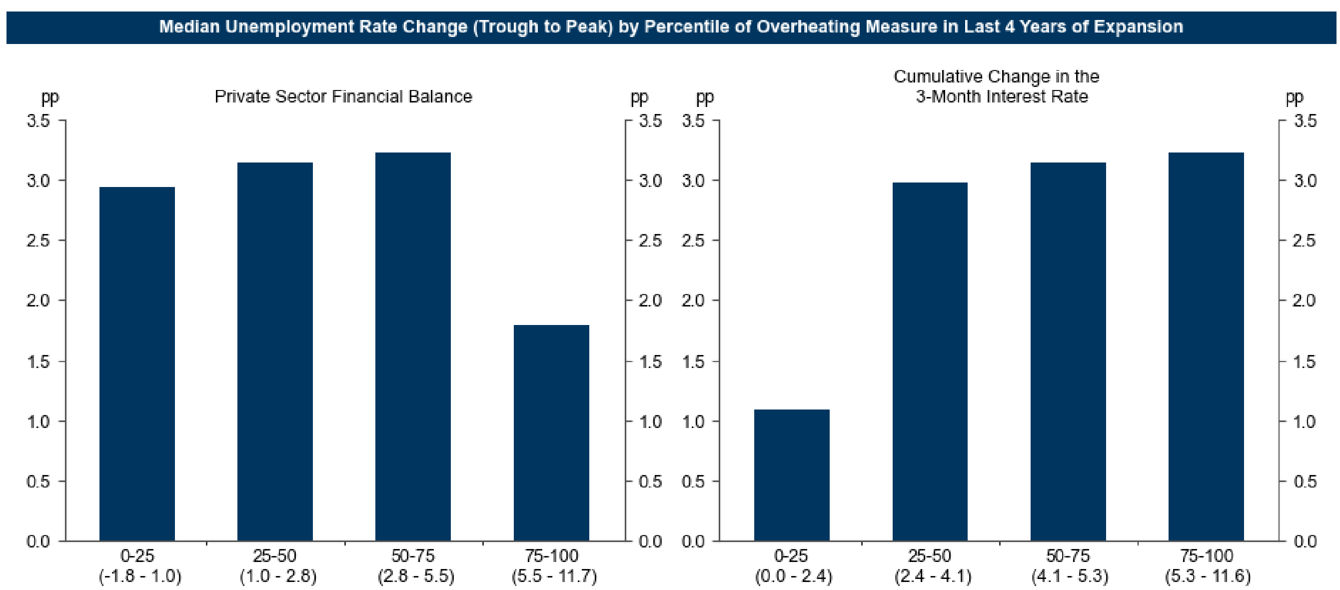
Exhibit 5: A Link Between Recession Severity and Economic Overheating…



Excludes pandemic recession.

Source: Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 6: … As Well as Financial Overheating and Monetary Tightening



Excludes pandemic recession.

Source: Haver Analytics, Goldman Sachs Global Investment Research

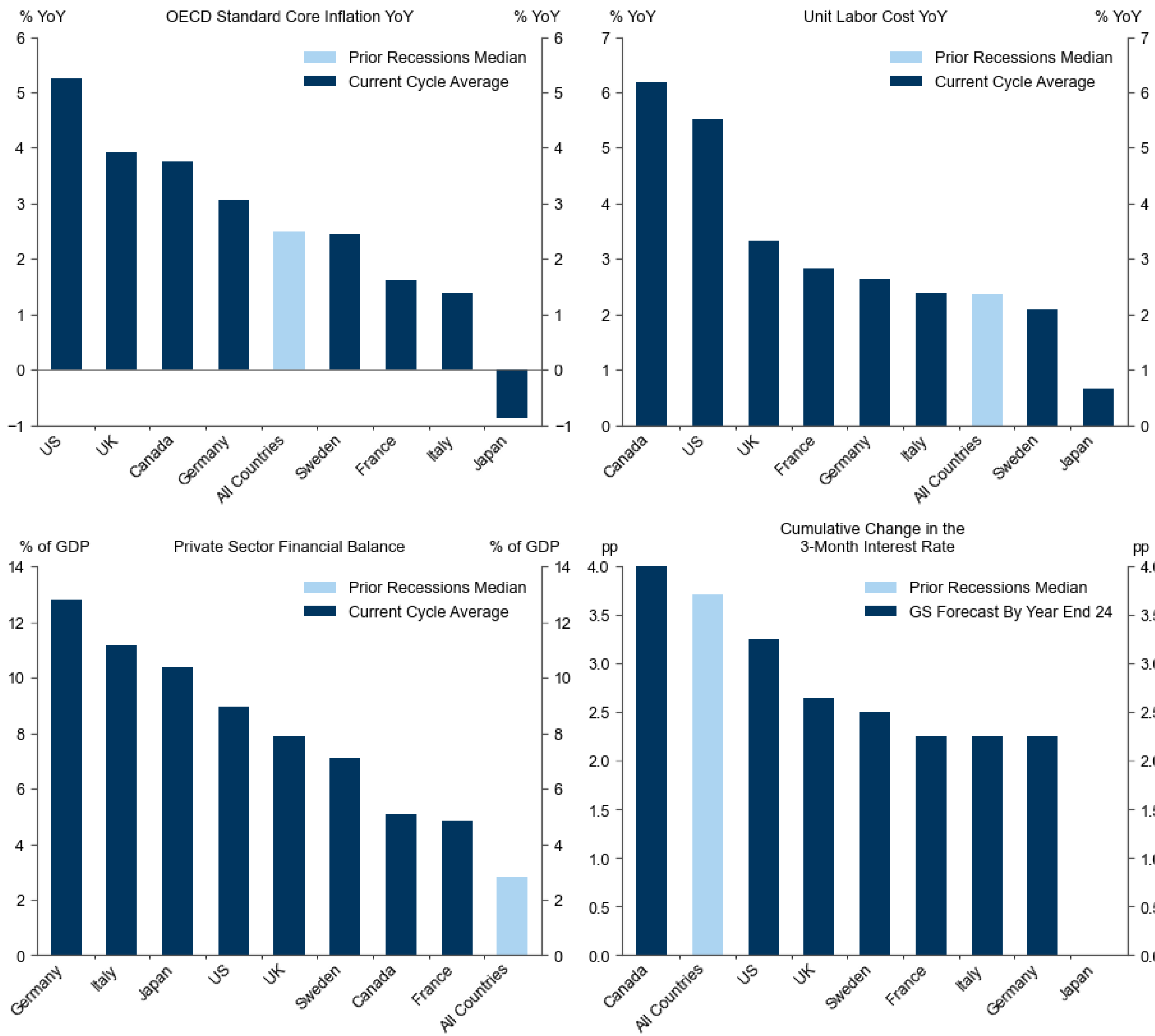
[2] Arguably, a recessionary scenario would likely involve a bigger increase in policy rates than our baseline forecast.

Implications

What do these findings imply for the size of the next recession?

Across advanced economies, unit labor cost growth, core inflation, and the expected total increase in the policy rate are generally running at levels similar to the runup of the typical advanced economy recession (Exhibit 7), with more overheating in the US, UK, and Canada and less in Japan and the Euro area. In contrast, the private sector financial balance has been much higher than ahead of the typical recession across advanced economies.

Exhibit 7: Private Sector Financial Balances Are Well Above the Recession Average



Excludes pandemic recession.

Source: Haver Analytics, Goldman Sachs Global Investment Research

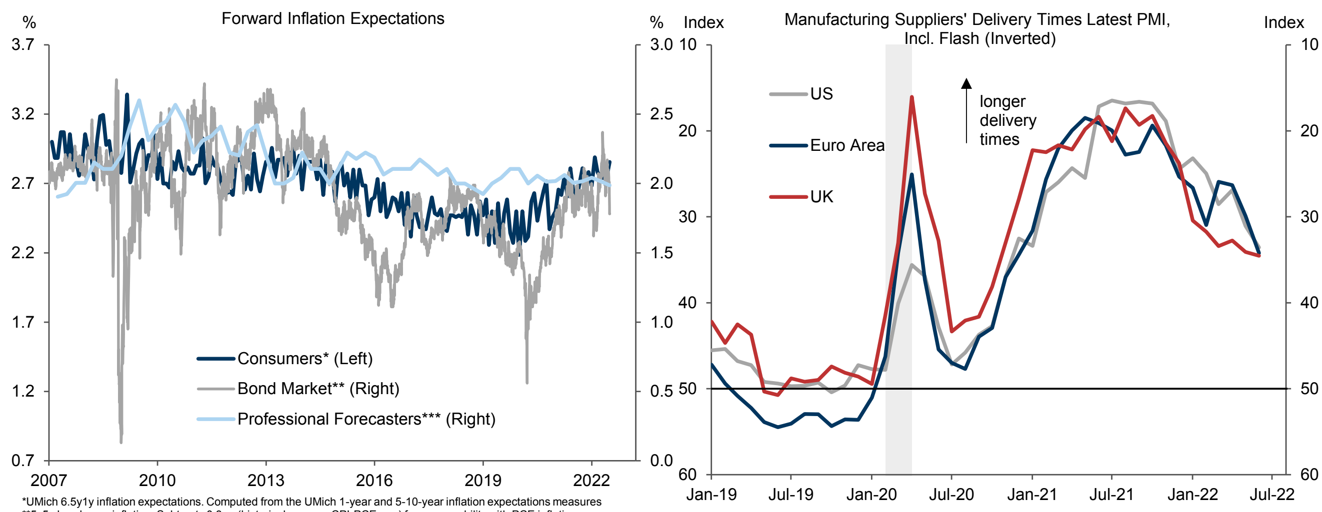
Taken together, Exhibits 6 and 7 paint a mixed picture about the size of the next recession in the English-speaking G10 economies.

On the pessimistic side, somewhat elevated economic overheating measures point to a somewhat higher than usual right tail risk of severe recession. On the optimistic side, the large private sector surplus points to a shallow recession. In contrast, the four factors all paint a reassuring picture in Japan and the Euro area suggesting that the next recession will likely be shallow.

Turning to other factors outside our historical dataset, we again see a mixed picture.

On the pessimistic side, the monetary and fiscal policy response might be more limited than usual because policy rates remain close to their effective lower bound while both central bank balance sheets and government debt levels are very large by historical standards. Moreover, the exposure to the war in Ukraine and the risk of energy supply shortages paint a relatively negative view for Germany and Italy, especially with the possibility of gas shutdowns in the winter. On the more optimistic side, long run inflation and wage expectations still appear mostly anchored (Exhibit 8, left). Moreover, substantial supply side improvement opportunities remain in both global supply chains—where delivery times have shortened—and in the labor market.

Exhibit 8: Long Run Inflation Expectations Have Been Fairly Well Anchored So Far; Supply Chain Problems Continue to Ease



*UMich 6.5y1y inflation expectations. Computed from the UMich 1-year and 5-10-year inflation expectations measures
**5y5y breakeven inflation. Subtracts 0.3pp (historical average CPI-PCE gap) for comparability with PCE inflation
***SPF 5y5y inflation expectations.

Note: grey bars denote US recession.

Source: Haver Analytics, Markit, Goldman Sachs Global Investment Research

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Disclosure Appendix

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