

The onset of a downturn is as much a matter of mood as of money

How recessions start

The Economist, August 20, 2019

IN RECENT WEEKS the human and silicon brains at Google have registered an alarming rise in searches related to “recession”. It is easily explained. As markets gyrate, talk in the press (including this very column) turns to the risk of a slump. Even so, the stories must leave some Googlers baffled. In July, after all, the American economy added 164,000 jobs and retail sales kept climbing. President Donald Trump, too, is bemused. He has taken to warning darkly that conspirators are attacking his presidency by frightening the economy into an unnecessary downturn. The claim of conspiracy is absurd, but the threat of recession is not. Recessions can indeed appear as if out of the blue.

Today’s confusion owes something to the world’s odd recent economic history. The last global slump occurred amid an epic financial crisis. The one before that began nearly two decades ago, accompanied, again, by a stockmarket crash. (Between August 2000 and September 2001 the S&P 500 index fell by more than 30% and the NASDAQ by more than 60%. Now, by contrast, those indices are pretty much where they were a year ago.) Most people working today cannot remember a recession not linked to financial chaos. But downturns can occur without market meltdowns. Indeed, many economists think recessions need not occur at all.

A recession is commonly taken to mean two or more consecutive quarters of falling output. More broadly, recessions happen when many economic variables—GDP, industrial production, employment and so on—flip from expansion to contraction. In their models, macroeconomists get such episodes going by introducing a “shock”: a

random perturbation which knocks an economy off kilter. A sharp rise in oil prices might do the trick, or a financial panic, or a change in policy like a jump in interest rates or an austerity budget. Shocks can impose new constraints on firms and households by cutting off sources of credit or sales. Or they may force people to reconsider their plans—nudging them to shelve proposed investments until the dust raised by a shock settles. Shock-based explanations of recessions make intuitive sense. They allow people to say that x caused y : that unemployment rose because share prices fell, for instance.

But economic causation is rarely so clear-cut. Higher interest rates hurt some people but leave others better off or unaffected. The failure of a large manufacturer creates pain for workers and shareholders but opportunities for rivals, who can Hoover up displaced labour and capital. Not all shocks lead to recessions. When they do, it is often because something goes wrong with an economy's ability to roll with the punches: spending falls somewhere but is not offset by increases elsewhere. Perhaps the creditors who benefit from higher interest rates park their windfalls in the safe haven of government bonds, rather than recycling them into job-creating expenditure. Housing investment in America began to subtract from GDP growth in the fourth quarter of 2005. But the economy did not fall into recession for two more years, when other sources of spending ceased to outweigh the housing drag.

Recessions, then, are not just the after-effects of shocks, but periods when people and firms fail to use valuable resources as they become available. As demand slackens, bargains bloom in the form of cut-rate goods, willing and available workers, and appealingly priced assets. In the depths of a catastrophic financial crisis no one but Warren Buffett may have the guts and the means to spend more as others cut back. But most recessions are not associated with such calamities. The downturn of the early 1990s was an example of what Paul Krugman, a Nobel economics laureate, has called a “smorgasbord recession”, the product of a mix of troubles in modest portions. In these garden-variety slumps, people and firms with the capacity to spend more, who might normally

leap at the chance to buy discounted goods or hire overqualified workers, instead allow their cash to pile up.

At its heart this behaviour is a matter of mass psychology, or “animal spirits”, as John Maynard Keynes put it. Economies are great chains of earning and spending, held together by shared expectations that all will continue as normal. People spend their incomes freely, on everything from homes to haircuts, in the belief that their jobs will not disappear and their incomes wither. Consequently, builders and stylists have jobs and incomes from which they too can spend. Faith in economic expansion is self-fulfilling. But it is not invulnerable. Contagious pessimism can flip an economy from one equilibrium to another, in which cautious consumers spend less and hiring and investment fall accordingly, validating the initial outbreak of pessimism. Shocks can precipitate a switch in sentiment by weakening links in the great chain. But if the public is confident enough of the durability of an expansion then even a big shock may not halt it. Conversely, if the mood in markets and on Main Street is sour enough, even a modest nudge may push an economy into a slump.

Confidence **men**

Over the past century, as governments assumed responsibility for preventing downturns, economic expansions grew longer and recessions became milder and less frequent. When drooping demand threatens an economy, governments and central banks use fiscal and monetary policy to deliver an offsetting rise in spending. But their commitment to fighting recessions also plays a psychological role. The credible promise to resist downturns gives markets confidence that the economy will keep up its strength.

Confidence, though, is slippery. It may wane as interest rates fall, leaving central banks less room to jolt economies out of their pessimism, and as government policymakers fumble their fiscal tools. It may wilt in the face of leaders’ erratic and self-defeating behaviour. Recessions, to no small degree, are a state of mind. You don’t need a conspiracy theory to see that just now the world’s mood is troubled.