Recession Watch: identifying recessions with uncertain data

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Headlines

- In the words of IMF economists writing in 2019, ‘Recessions are not rare: economies are in a state of recession 10-12 per cent of the time. What is rare is a recession that is forecast in advance’
- Mindful of the difficulty involved, and given stronger-than-expected GDP data in a number of major economies since we published our *Global Outlook, Autumn 2022*, in this week’s Recession Watch we revisit our global recession call
- The very strong signals offered by record low levels of consumer confidence and near-double digit rates of inflation, combined with the tendency for early estimates of macroeconomic data to be too optimistic in the early stages of a downturn, mean that we are likely to retain our global recession call as a central case in our forthcoming *Global Outlook, Winter 2022*
- However, the news flow about both growth and inflation has been net positive over the past few weeks. We are minded to increase the weight we attach to a scenario where the US escapes recession; and signs that the EA has managed to substitute away from Russian gas to a greater extent than we had imagined, mean that the single currency bloc may suffer a less severe recession than we had at first imagined

Economists are not very good at forecasting recessions. In a blog post published almost four years ago, ‘The economist who cried wolf’, I analysed the IMF’s forecasting track record. I found that, of the 469 recessions that had taken place since 1988 across 194 countries, only 13 were correctly anticipated in the World Economic Outlook (WEO) published in the October of the preceding year.[1] Worse still, fewer than half were identified even by the October of the year in which the fall in GDP took place. Moreover, economists were prone to cry wolf, just like the boy in Aesop’s fable, with the IMF predicting recessions in the following year where none subsequently occurred 24 times in the Spring WEO and 23 times in the Fall WEO. Research from the IMF, published in the same year as my blog post, finds that private-sector forecasts are no better. The authors summarise the problem in the following way: ‘Recessions are not rare: economies are in a state of recession 10-12 per cent of the time. What is rare is a recession that is forecast in advance.’

1. For the purposes of the blog post I defined a recession as a fall in annual GDP.

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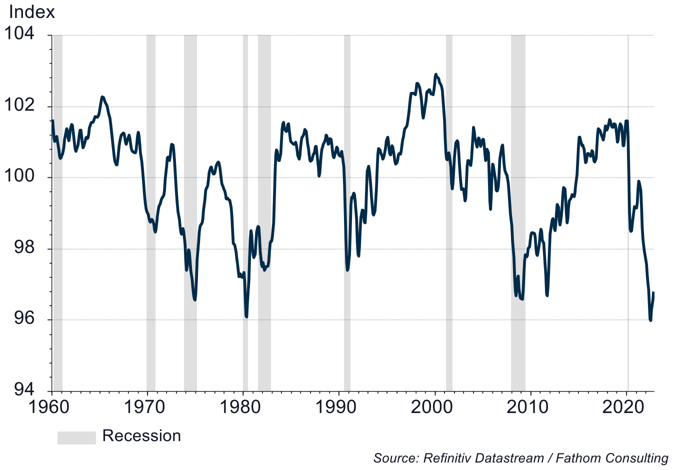
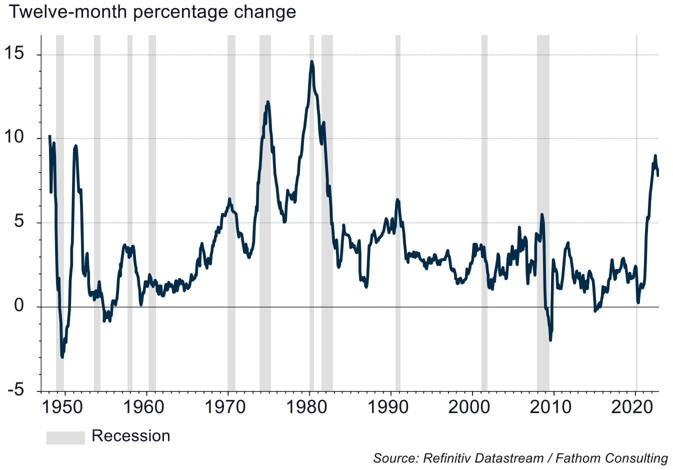
US consumer confidence



In its [World Economic Outlook, October 2022: Countering the cost-of-living crisis](), the IMF warned that global economic activity was experiencing 'a broad-based and sharper-than-expected slowdown'. The global financial crisis and the COVID-19 pandemic aside, the IMF described its forecast for global growth as the weakest since 2001. The consensus among private-sector forecasters is now for a recession across much of Europe, with the euro area as a whole suffering two consecutive quarters of contraction, beginning this year, and the UK five consecutive quarters. For the US, it is a close call, with the median projection in the latest Reuters Poll being for near-stagnation through the first half of next year, rather than outright contraction.

US inflation and recessions



In our [Global Outlook, Autumn 2022](), finalised in early September, our central scenario saw a period of recession across all the major economies. The historical precedents for us were compelling. Falling real wages had pushed levels of consumer confidence in the US, the EA and the UK down to levels that in the past had always signalled recession. If that were not enough, rates of inflation in the US and the UK had reached levels from which recession had been avoided only once – in 1952. Rates of inflation in the euro area, available over a shorter time period, had reached levels from which recession had never been avoided. As a net exporter of energy, the US terms of trade had improved over the past year. That put it in a fundamentally stronger position than the EA or the UK. Put together with the fact that pandemic savings offered some protection against falling real wages, and with the Fed acting more decisively than either the ECB or the Bank of England to get inflation under control, we felt that the US stood the best chance of avoiding recession – though we gave it no more than a 1-in-3 chance.

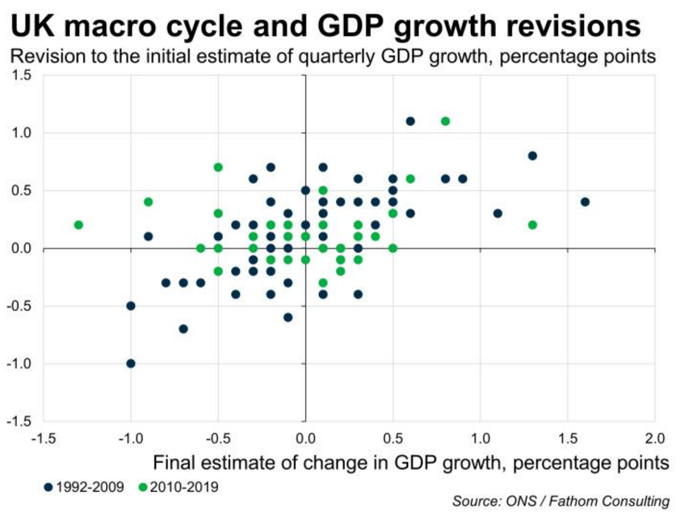
Quarterly GDP growth revisions, 2012-2019

	Percentage points		
	US	EA	UK
Mean revision	0.04	0.09*	0.12*
Mean absolute revision	0.22	0.18	0.17
Standard deviation	0.28	0.19	0.24

*Statistically significant at the 10% level

Source: Refinitiv Datastream / Fathom Consulting

The conventional wisdom has been that data revisions tend to be pro-cyclical: in a boom, initial estimates of growth tend to get revised up, and in a slump they tend to get revised down. There is a logic to this. Statistical agencies base early estimates of GDP at least in part on a survey of firms. They then need to scale up estimates of gross value added in their sample to match the number of firms in the country as a whole. In a boom, the total number of firms will tend to be growing faster than the statistical agency's working assumption, giving a downward bias to initial estimates of growth. In a slump, the number of firms nationwide will tend to be growing more slowly than the statistical agency's working assumption, or perhaps falling outright, giving an upward bias to initial estimates of growth.



In our own analysis, we find evidence of pro-cyclical revisions to initial estimates of growth in the UK, but only up until the global financial crisis. Before 2010, there was a strong, positive correlation between the final estimate of the change in GDP growth from one quarter to the next, and the revision to the initial estimate of GDP growth, as our chart above shows. But since 2010 that correlation has gone away. In the US and the EA, by contrast, we find that pro-cyclical revisions to initial estimates of GDP

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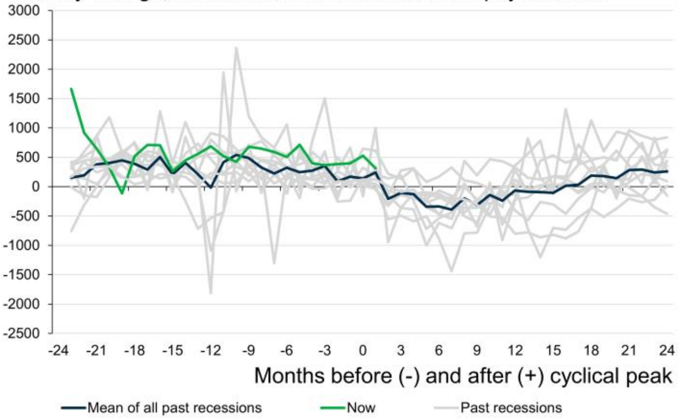
growth have persisted, at least until the eve of the pandemic. More specifically, using all available data from 2010 up to 2019, we find that the economic cycle can explain 55% of the revisions to US GDP growth and 61% of the revisions to EA GDP growth. For what it's worth, if we take our model of EA revisions at face value, then in a world where true EA GDP growth was actually zero in Q3, then given the pace of the implied slowdown, our best guess is that the initial estimate of GDP growth would have an upward bias of 0.2 percentage points. The initial estimate of EA GDP growth in Q3 was, of course, 0.2%.

US nonfarm payrolls around cyclical peaks

Monthly change, thousands, converted to current payrolls level

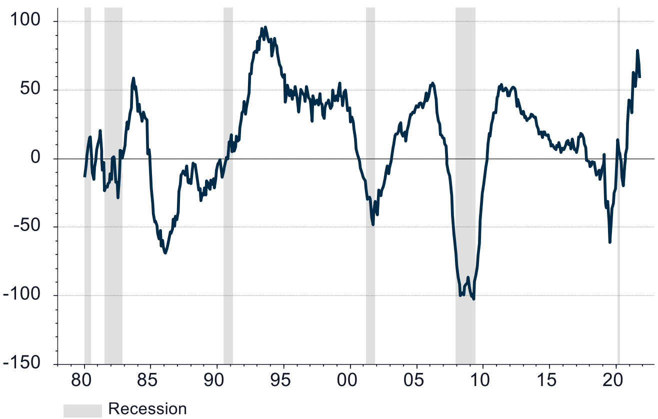


Source: Refinitiv Datastream / NBER / Fathom Consulting

In our *Global Outlook, Autumn 2022*, we argued that, while non-farm payrolls data were a lagging indicator of economic activity, their timeliness meant they might still provide a useful cross-check on whether the US had entered recession. As the chart above shows, the monthly change in non-farm payrolls tends to flip from around +240,000 in the month when activity peaks, to around –210,000 in the first month of recession. But our next chart, which shows a smoothed measure of revisions to the initial estimate, casts some doubt on the usefulness even of non-farm payrolls as an arbiter of recession, at least in the short term. In the period following the dotcom bust, and again during the global financial crisis, initial estimates of the change in non-farm payrolls were revised down significantly.

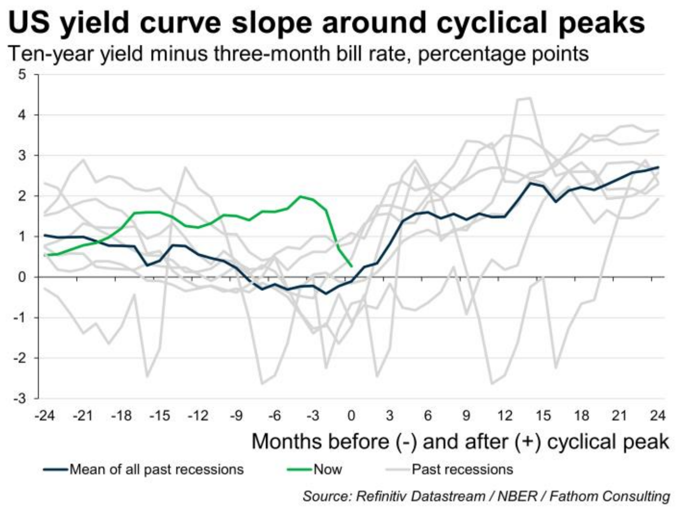
US revisions to monthly change in payrolls

Thousands, two-year centred moving average



Source: Refinitiv Datastream / Fathom Consulting

The yield curve is thought by many to provide a useful leading indicator of the macroeconomic outlook. As our final chart shows, the slope of the US yield curve tends to turn negative some six to nine months before the peak in economic activity. As the green line in our chart shows, the US yield curve has flattened dramatically since the summer, with the ten-year yield lying some 15 basis points below the three-month bill rate on average through November to date. That would be consistent with the US entering recession early next year.



Where does this leave us, in terms of the current outlook? For now, we persist in our judgment that a recession in the European single currency bloc is almost inevitable, despite the stronger-than-expected initial estimate of EA growth. Indeed, given the tendency for early estimates of EA growth to be revised pro-cyclically, it may well have entered recession in Q3. Nevertheless, signs that EA economies have managed to substitute away from Russian gas to a greater degree than we had imagined, means the recession may be less severe than we had at first imagined. We had always assigned a greater weight to the notion that the US might escape recession, and we may raise the weight we attach to that scenario in our *Global Outlook, Winter 2022*, due to be finalised on 2 December. As for the UK, initial estimates suggest the economy contracted in Q3, and we expect it will do so again in Q4.

Further reading

Recession Watch: leverage spotting

Recession Watch: no rescue from excess savings

Recession Watch: delaying the inevitable?

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