David Youngberg
ECON 201—Montgomery College

Lecture 13: Recessions and the Business Cycle

I. The Business Cycle
   a. The business cycle describes the expansion and contraction of economic activity. It's important to remember that the business cycle is a *cycle*; what goes down eventually comes up. It typically follows a four-phase pattern (the exact nature and names of each phase will vary between economists):
      i. Peak—a point of strong growth and low unemployment
      ii. Recession—the period when people start losing their jobs and production falls
      iii. Trough—the low point; when the recession has bottomed out
      iv. Recovery—the period when productivity rises and people are rehired
   b. This pattern typically lasts anywhere from two or three years to fifteen years.
      i. That fifteen year span was the Great Depression

II. Recession
   a. *Recession*—a significant, widespread decline in real income and employment
      i. National Bureau of Economic Research (NBER) defines it as two consecutive quarters of a decline in GDP, along with other considerations (e.g. for purposes of determining which exact month/week the recession occurred).
   b. Whom the recession hits the most
      i. When a recession hits, sales of toilet paper and alcohol don't change that much (though the type of alcohol people buy does change). What should change the most?
      ii. Things that people can put off buying, whether because they can stretch what they currently have or because they can do without one at all for a bit longer. These tend to be consumer durables and capital goods
      iii. Thus, an increase in private investment and consumer durables is a good sign of an economic recovery.

III. Wages During Recessions

a. Recoveries are often irregular. Productivity and GDP will rise before unemployment decreases. Unemployment decreases before wages rise. Why is this?
b. First consider a standard good or service. When demand falls, the price falls. We see this in a lot of different contexts:
    i. After Christmas, Christmas decorations are a lot cheaper.
    ii. When autumn begins, swimsuit prices drop.
    iii. Home prices fall when incomes fall, like during a recession. Car prices, too.
    iv. Hotel prices are lower during the off-season.
c. But when recessions occur, and the demand for labor falls, the price of labor—the wage—doesn't fall.
d. This is a major economic puzzle and a lot of ink has been spilled to try to explain why. Economist Truman Bewley make some great headway in determining which of the many theories are correct by conducting hundreds of interviews with business people, union leaders, and unemployment counselors during the recession of the early 1990s.
    i. Bewley finds that employers are deeply concerns about morale because they believe it fundamentally affects productivity. Pay is a key part of morale.
    ii. Thus employers prefer to fire half the staff than cut everyone's wages in half. If you don't get fired, you feel like a valued survivor!
    iii. Employers also fear high turnover in jobs that require a lot of training. Offering a low wage during a recession will probably result in the employee leaving when the economy picks up. The employee will feel insulted during this low pay period. The employer would have swallowed a big training cost and the employee will "jump ship" the moment the economy picks up.
e. Because wages don't fall, they are unusually high during a recession. Thus it takes a lot of economic stability for employers to hire again.
f. Because the wages were higher than the "pure" market rate, it takes a while for wages to catch up even after unemployment falls. There must be "labor market tightening" for wages to finally rise.
    i. This can take many, many years if the recession was severe enough (as the Great Recession was).