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Global Economics Analyst

Why a Recession Would Likely Be Mild (Hatzius/Struyven)

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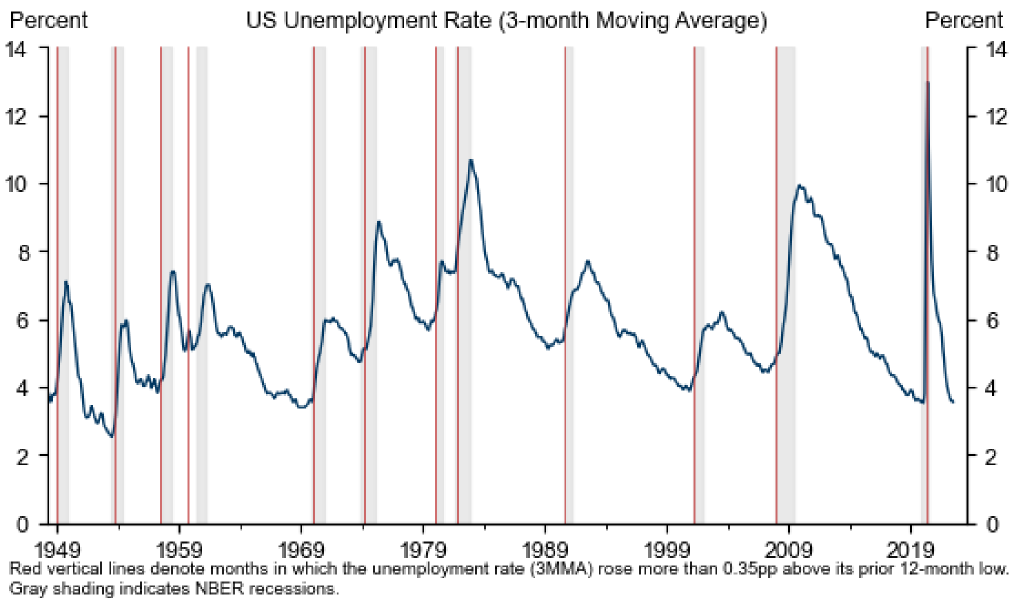
- Although we do not believe the US economy was in recession in the first half of 2022, we estimate the risk that this will change over the next 12 months at about one in three. And if there is a recession, one might reasonably fear that it will be fairly deep, at least in labor market terms. After all, the US unemployment rate rose by about 2pp even in the two mildest postwar downturns, in 1960-1961 and 2001.
- Nevertheless, we believe that any post-covid US recession would likely be mild, with a limited increase in the unemployment rate of around 1pp. This would be unprecedented in postwar US history, though recessions with similarly limited increases have occurred in other G10 economies, such as Germany and Canada.
- First, we have shown that an unusually high level of job openings dampens the employment effects of a negative output shock. More generally, the combination of excess demand and inelastic supply—not only for labor but also housing and durable goods—suggests that a decline in demand in these markets will have a bigger negative impact on prices than on output.
- Second, even if job growth does slow substantially, the feedback to consumer spending is likely to be weaker than in past cycles. For one thing, if a downturn in hiring coincides with sharply lower headline inflation, the net effect on real disposable income growth could well be positive. Moreover, the strength of private-sector balance sheets should continue to dampen spillovers from any real income weakness into spending.
- Third, even in a recession, we see structural reasons for continued growth in some important areas of the economy. Covid-sensitive sectors such as office-adjacent consumption and tourism still have room to normalize. Meanwhile, both infrastructure investment and climate-related spending are likely to grow, aided in part by long-lasting federal spending programs.
- These considerations mostly carry over to other G10 economies. The caveats are that a full stop to Russian gas deliveries could trigger a severe downturn in Europe, our conclusions and terminal policy rate forecasts would change if inflation proved significantly more entrenched than we anticipate, and the past 2½ years have taught us all not to rule out the risk of "unknown unknowns".

Why a Recession Would Likely Be Mild[1]

If any confirmation was needed, the strong July employment report showed that the US economy was not in a recession in the first seven months of 2022. However, we estimate the risk that this will change over the next 12 months at about one in three.

And if there is a recession, one might reasonably fear that it will be fairly deep, at least in labor market terms. After all, the US unemployment rate rose by about 3¾pp in the average US postwar recession and by about 2pp even in the two mildest postwar downturns, in 1960-1961 and 2001.[2] Moreover, our recent review of 77 DM recessions shows that high core inflation and high unit labor cost growth (and both are currently elevated) often precede severe recessions.

Exhibit 1: The US Unemployment Rate Rose by About 2pp Even in the Mildest Postwar Recessions



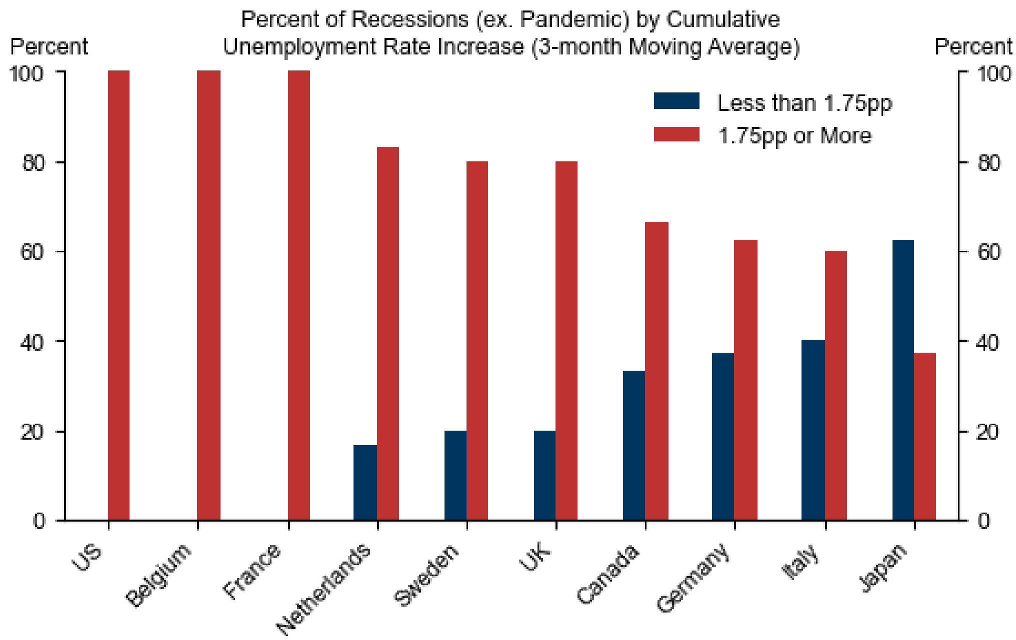
Source: NBER, US Bureau of Labor Statistics, Haver Analytics, Goldman Sachs Global Investment Research

Nevertheless, we see three reasons to believe that any post-covid US recession would likely be mild, with a limited increase in the unemployment rate of around 1pp. This would be unprecedented in postwar US history, though recessions with similarly limited increases have occurred in other G10 economies, such as Germany, Japan, the UK, Italy, and Canada (Exhibit 2).

[1] We thank Giovanni Pierdomenico for his contributions to this note.

[2] We define the change in the unemployment rate as the difference between the maximum and the minimum of its three-month moving average.

Exhibit 2: Recessions With Limited Increases in the Unemployment Rate Have Occurred in Other G10 Economies



We remove the pandemic recession from the sample because the significant expansion of short-time work schemes sharply limited the rise in the unemployment rate in many European economies and Japan.

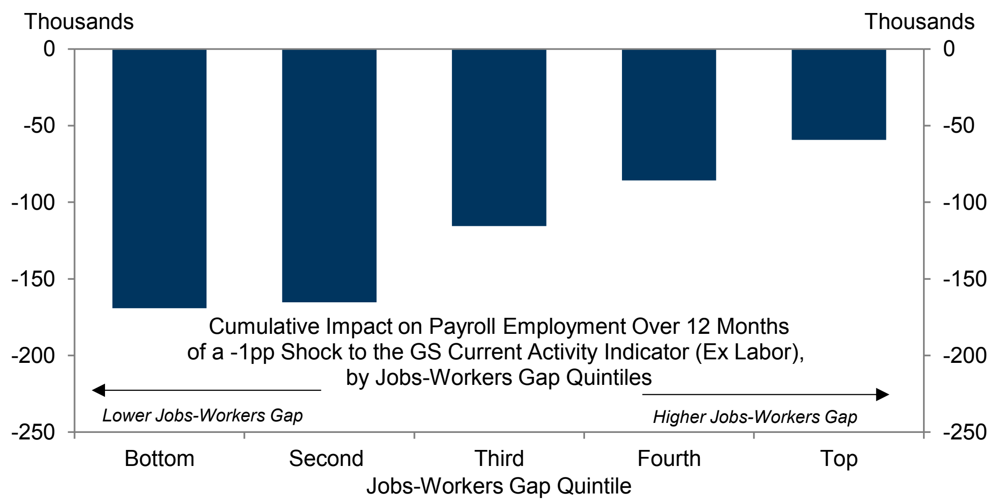
Source: Haver Analytics, Goldman Sachs Global Investment Research

Driver #1: Pent-Up Employment

First, we have recently shown that an unusually high level of job openings dampens the employment effects of a negative output shock.

Exhibit 3 shows our finding that the jobs hit from slower growth is less than half as large as normal when the jobs-workers gap—the difference between the total number of jobs (i.e. employment plus job openings) and the number of workers (i.e. the labor force)—is in the top 20% of its historical range. Although labor shortages should ease somewhat, we expect our US jobs-workers gap—which stands at 4.8 million in July based on our nowcast—to stay tighter than its 2019 peak for the next two years.

Exhibit 3: It Takes Longer for a Slowdown in Activity Growth to Generate a Slowdown in Hiring When Pent-up Demand for Workers Is Elevated

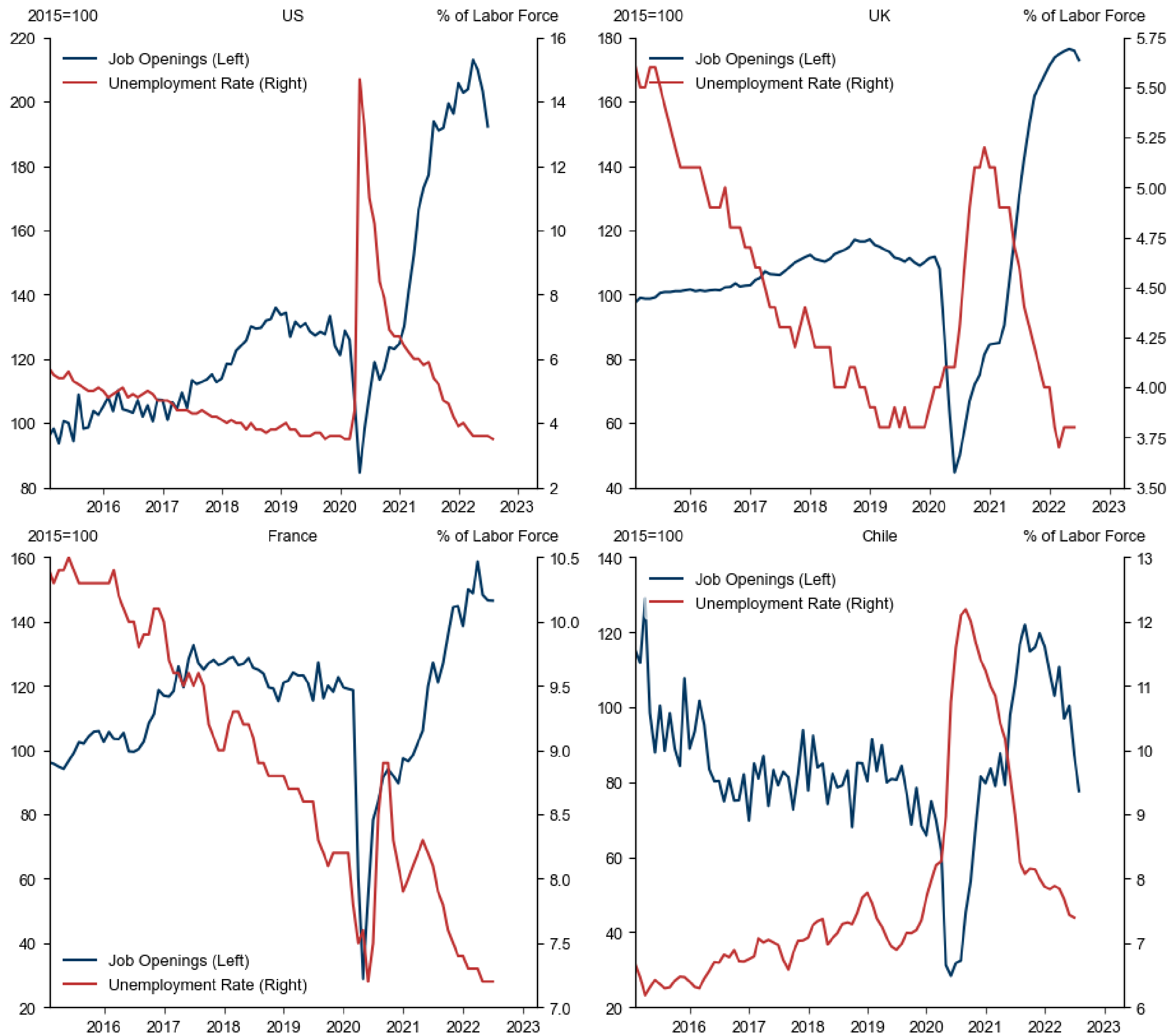


Source: Goldman Sachs Global Investment Research

Cooling wage growth and inflation while avoiding a significant labor market recession likely requires that job openings decline without a corresponding rise in unemployment. While modern US data suggest this is challenging, recent preliminary evidence points to little tradeoff between job openings and unemployment in the very tight post-pandemic labor market. In fact, the US job openings rate has declined by 0.7pp since March while the unemployment rate has actually declined by 0.1pp. Similarly, job openings have declined in France, the UK, and especially Chile (where goods spending also jumped and labor supply weakened sharply following major fiscal easing and pension withdrawals[3]) without any rise in the unemployment rate (Exhibit 4).

[3] Chile and Norway are the only two OECD countries other than the US where real goods spending jumped well above its pre-pandemic trend in 2021.

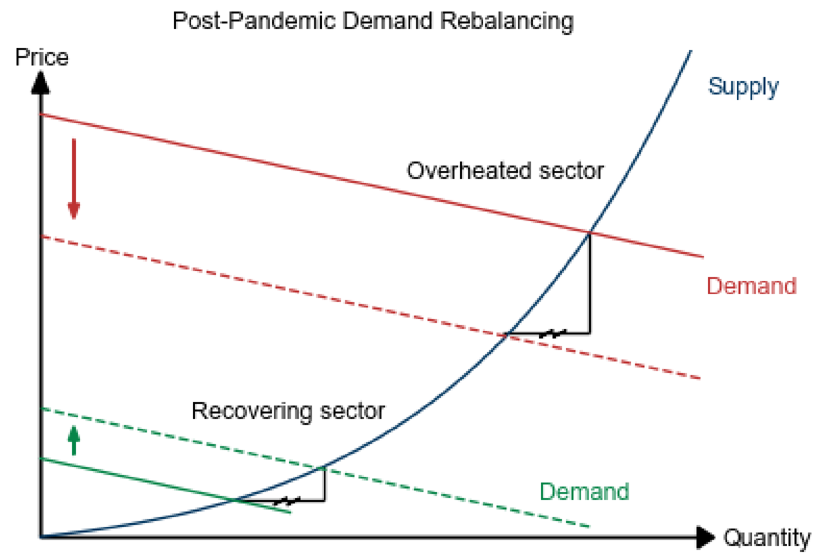
Exhibit 4: A Disproportionately Large Contribution to Labor Demand Softening From Job Openings in the US, France, and Chile



Source: Haver Analytics, Goldman Sachs Global Investment Research

More generally, the combination of excess demand and inelastic supply in overheated markets—not only for labor but also housing and durable goods—suggests that a decline in demand in these markets will have a bigger negative impact on prices than on output (Exhibit 5). On housing, we recently found that supply constraints dampen the hit to existing home sales and especially housing starts from a decline in demand from higher mortgage rates.

Exhibit 5: A Decline in Demand in Overheated Sectors Likely Has a Bigger Negative Impact on Prices Than on Output



Source: Goldman Sachs Global Investment Research

In contrast, a rise in demand in sectors that are still recovering from the pandemic (e.g. office-adjacent activities) likely has a bigger positive impact on output than on prices. The reason is that supply is likely more elastic at low activity levels.[4] The combination of pandemic demand shifts and a steepening supply curve thus helps explain why inflation surged during the pandemic, and supports our central forecast that inflation will come down sharply next year without a large drop in output.[5]

[4] Downward price and wage rigidities are one reason why supply tends to be more elastic at low activity levels. See also Veronica Guerrieri, Guido Lorenzoni, Ludwig Straub, and Iván Werning, "Macroeconomic Implications of COVID-19: Can Negative Supply Shocks Cause Demand Shortages?", American Economic Review, 2022.

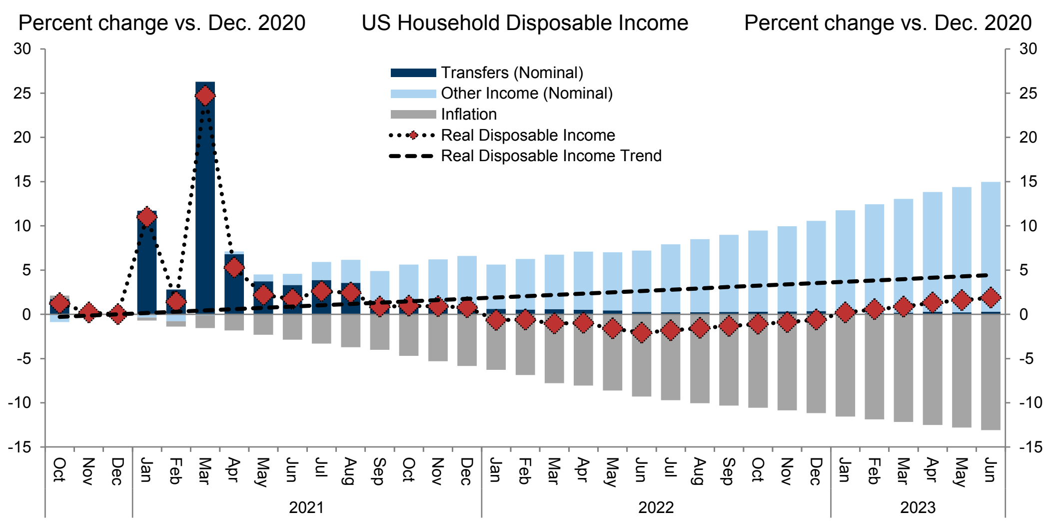
[5] Shifts in demand curves (e.g. outward due to fiscal easing) and supply curves (e.g. inward due to weakness in the labor force or lockdowns) have also contributed to higher inflation.

Driver #2: Weaker Feedback From Job Slowdown to Spending

Second, even if job growth does slow substantially, the feedback to consumer spending is likely to be weaker than in past cycles.

For one thing, if a downturn in hiring coincides with sharply lower headline inflation, the net effect on real disposable income could well be positive. The roughly 20% decline in gasoline prices over the past two months suggests that headline inflation will slow further. In fact, our central forecast is that real disposable income grows by nearly 6% by end-2023 despite a slowdown in monthly payroll gains to 50k.[6]

Exhibit 6: We Expect Real Income to Pick Up as Headline Inflation Moderates (Despite Slower Job Growth)

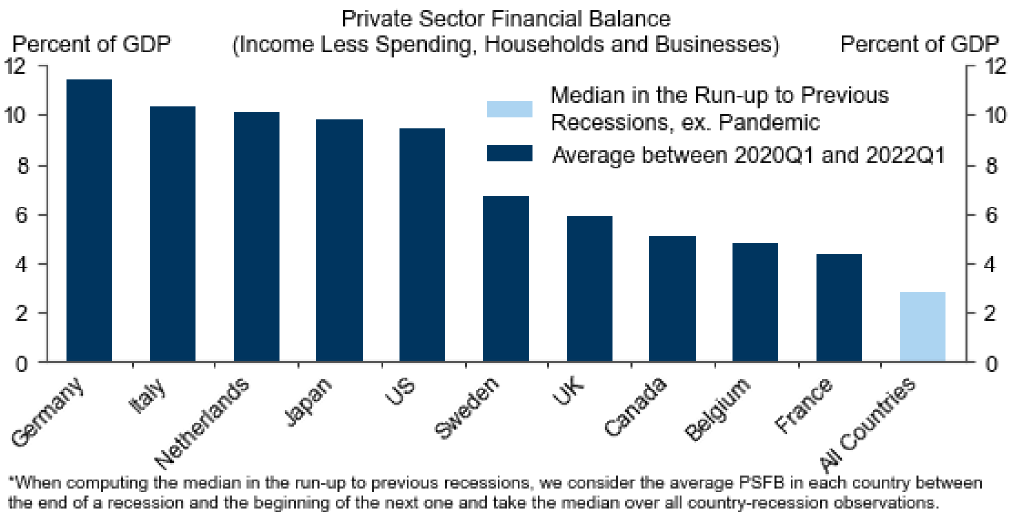


Source: Department of Commerce, Goldman Sachs Global Investment Research

Moreover, the strength of private-sector balance sheets—among households, businesses, and banks—should continue to dampen spillovers from any potential real income weakness into spending. We have shown that large private sector saving surpluses reduce the probability of any recession and often precede a less severe recession if one occurs. Exhibit 7 shows that the US private sector has been running a large saving surplus worth nearly 10% of GDP on average since 2020.

[6] We also expect a boost to real income growth in 2023 from a normalization in effective tax rates from their elevated 2022 levels.

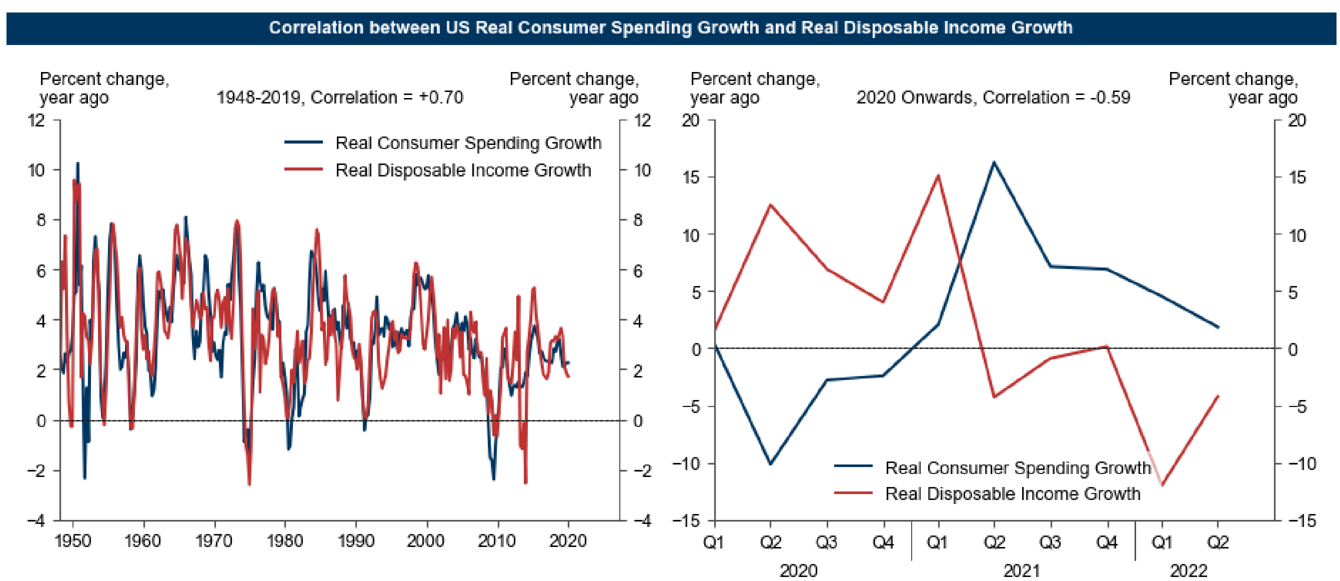
Exhibit 7: The Private Sector Has Accumulated Large Saving Surpluses in this Cycle



Source: Haver Analytics, Goldman Sachs Global Investment Research

To be clear, job growth obviously still matters for spending growth. However, job growth may continue to pale in importance compared with the other forces driving income and spending in this pandemic cycle. These other forces include swings in fiscal transfers and headline inflation on the income side, and the opportunity and willingness to spend on the spending side. Exhibit 8 illustrates that the relationship between real income growth and real spending growth is indeed weaker in this cycle.

Exhibit 8: A Weaker Link Between Income and Spending in this Cycle



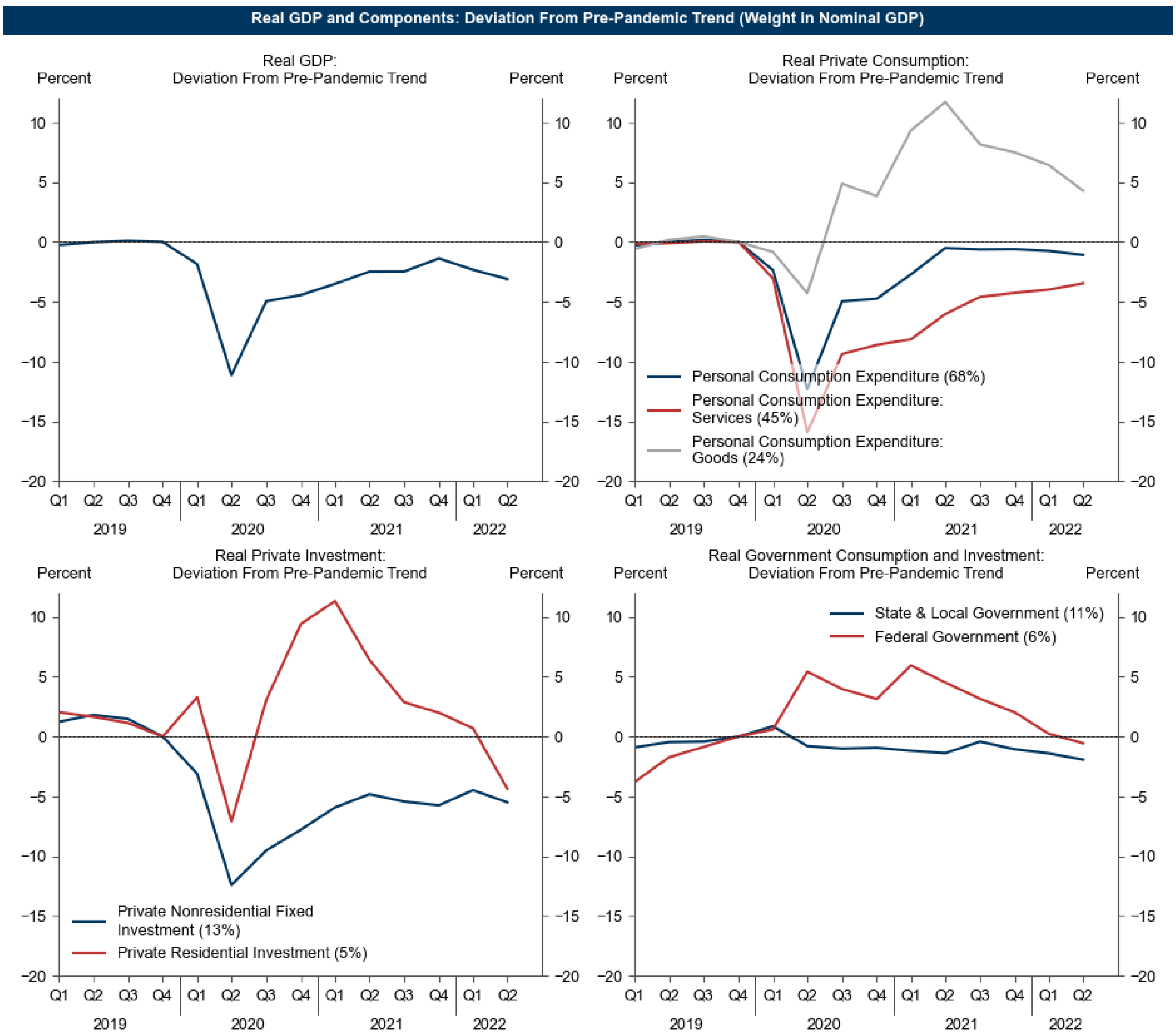
Source: Bureau of Economic Analysis, Haver Analytics, Goldman Sachs

Driver #3: Room for Growth

Third, even in a recession, we see reasons for continued growth in some important areas of the economy related both to the incomplete recovery from the pandemic and longer-run investment programs.

Exhibit 9 shows the gap between real GDP and its counterfactual level had output continued to grow at its pre-pandemic 2012-2019 average pace from 2020Q1 onwards. On this measure, real GDP remains 3% below its pre-pandemic trend in Q2. The deviations from the pre-pandemic trend are the largest for consumer spending on services (-3½%) and private nonresidential fixed investment (-5½%).

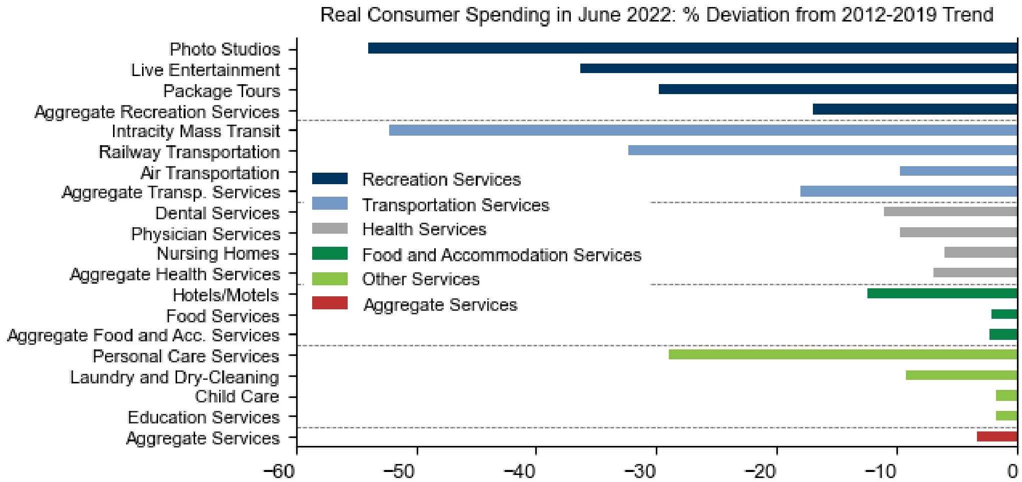
Exhibit 9: Softness in Consumer Services Spending and Business Investment…



Source: Bureau of Economic Analysis, Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 10 shows that covid-sensitive services sectors still have room to normalize. The key sectors with room to grow are tourism (e.g. package tours, live entertainment, hotels), office-adjacent consumption (e.g. transportation services, laundry and dry cleaning), and several medical services.

Exhibit 10: …Particularly in Tourism and Office-Adjacent Activities



Source: Bureau of Economic Analysis, Haver Analytics, Goldman Sachs Global Investment Research

Climate-related spending and infrastructure investment are likely to grow too, aided in part by long-lasting federal spending programs.[7]

The world likely needs incremental annual investments to achieve net zero worth around 1¼% of global GDP. The new Inflation Reduction Act includes $369bn of energy and climate incentives over the next 10 years to curb US carbon emissions by 40% by 2030. US infrastructure investment has already started to edge up (although it remains low as a share of GDP relative to history and to other advanced economies). Infrastructure investment is set to rise further, aided in part by the bipartisan infrastructure legislation Congress enacted last year (boosting spending by 0.1-0.2% of GDP over the next few years).

Risks of a Deeper US Recession

Risks of a deeper recession would increase if inflation proved more entrenched than we anticipate or the economy were hit by additional negative supply shocks, which could lead the Fed to hike the funds rate far beyond our 3¼-3½% base case.

To assess entrenchment risk, we monitor the underlying core inflation trend, the breadth of wage and price pressures, especially for core services, and business, consumer, and market-based measures of inflation and wage expectations. The key downside supply side risks are potential further disappointments in the labor force participation rate, renewed lockdowns in China, escalation of the war in Ukraine, and a renewed surge in global commodity prices.

Europe Is Different

The private sector has run large saving surpluses and the incomplete recovery leaves

[7] On the other hand, countercyclical fiscal easing may be more limited in the next recession if inflation is still elevated.

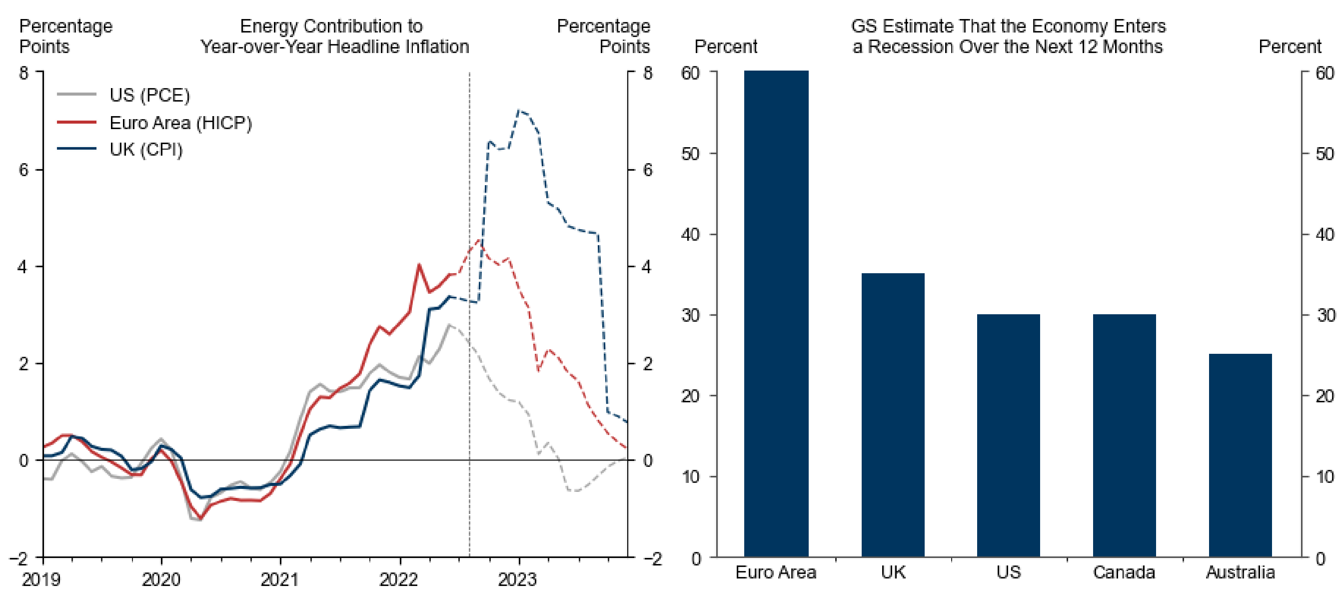
room for growth in services outside the US too (Exhibit 7). Will the next recession therefore likely also be mild in the other G10 economies?

Our current answer is yes for Canada, Australia, and Japan. As in the US, the unusually high level of job openings in Canada and Australia should dampen the employment effects of a negative output shock there too. And later reopening, if anything, implies somewhat more room to grow in face-to-face services in both economies. Finally, most recent recessions have been mild in Japan, and soft wage growth suggests the Japanese economy is not overheated.

The answer is less clear in Europe. Our central forecast is that the Euro area will experience a mild recession, with annualized growth of -0.3% and -0.6% in Q3 and Q4, respectively. On the optimistic side, there is still substantial room for reopening in Southern Europe, and especially Spain. On the pessimistic side, the contribution from energy to inflation is much larger and more back-loaded in the Euro area and especially the UK than in the US (Exhibit 11, left panel). This implies a worse central outlook for real income, consumer spending, and industrial activity in Europe. Similarly, larger gas supply disruptions, energy prices increases, or second-round effects via supply chains and confidence channels could make the Euro area recession deeper than our central case.

The arguments for why the next recession is more likely to be severe in Europe are similar to the arguments for a higher risk of any recession. Consistent with this, our subjective probability that the economy enters a recession in the next 12 months is the highest in the Euro area (60%) and the UK (35%), followed by the US (30%), Canada (30%), and Australia (25%).

Exhibit 11: A Larger Energy Shock in Europe Implies Larger Recession Risks



Source: Haver Analytics, Goldman Sachs Global Investment Research

Jan Hatzius

Daan Struyven

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