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# Common Causes of Economic Recession

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## Common Causes of Economic Recession

In the short term, the economy fluctuates between periods of increasing economic activity—expansions—and decreasing economic activity—contractions, or recessions. Recessions are characterized by decreases in output and employment. The periods of recession, although temporary, can cause significant economic hardship. For this reason, smoothing, or decreasing the volatility of the business cycle, can help to ease the short-term output and employment losses caused by economic downturns. Countercyclical fiscal and monetary policy—policy that works to counter the business cycle—can be helpful on this front, although there may be situations in which policymakers would opt for pro-cyclical policies instead.

Recessions are determined and defined by the National Bureau of Economic Research (NBER), an independent nonprofit that performs economic research. NBER defines *recession* as a “significant decline in economic activity that is spread across the economy and that lasts more than a few months.” There is no single numerical criterion for recession; rather, NBER looks at a variety of factors in determining recessions, including income, employment, consumption, sales, and industrial production. Owing to the criteria and methodology for determining recessions, NBER normally officially declares the beginning and end of a recession several months after the fact, meaning that policymakers are often required to weigh policy options prior to the official declaration of a recession.

Recessions are the result of shocks to aggregate supply or aggregate demand in the economy or both. A supply shock occurs when something reduces the economy’s ability to produce output at a given price level. A demand shock occurs when something reduces businesses’ and households’ willingness to consume and invest at a given price level. Supply-induced recessions tend to be characterized by decreased output and increased prices, while demand-induced recessions tend to be characterized by both decreased output and prices. For this reason, supply shocks are often more challenging to deal with, because (1) demand-side policies that would increase output may result in further price increases, or (2) available supply-side policy tools may not be equipped or able to counter the shock (e.g., an increase in global oil prices).

The proximate causes of recession are many and varied. Any number of events can send the economy toward recession by affecting aggregate demand, aggregate supply, or both. Sometimes determining a single causal event is not possible—the belief by consumers and businesses that the economy may slow in the near future can result in large enough behavior changes to result in recession. Oftentimes, however, economists can point to a specific event. A few of those most common causes of recession in the United States are as follows:

- **Supply shocks.** Under certain circumstances, a sudden drop in the available supply of commodities crucial to the production process can result in sudden price increases and dysfunction in economic activity. If the shock is large and wide-reaching enough, the economy can enter into a recession.
- **Mistimed or outsized policies.** Contractionary monetary or fiscal policy can prove beneficial to the economy when timed and sized correctly. However, given lags in data and policy effects, it can also be challenging to properly scope such policies. The result can sometimes be a drop in aggregate demand large enough to result in recession.
- **Financial crises.** Dysfunction in financial markets, if widespread and deep enough, can result in greater economic problems. When financial markets do not function properly, this can lead to tightening credit conditions throughout the economy and decreased demand.
- **Housing market crashes.** Owner-occupied housing represents a significant share of household wealth in the United States. As with other assets, price bubbles can grow and then burst in the housing market, leading to greater economic stress and recession. Additionally, patterns of residential construction have historically followed a similar pattern to the business cycle, making the housing market a potential predictor of economic conditions.

## Contents

Introduction .....	1
The Business Cycle .....	1
Technical Definition of <i>Recession</i> .....	2
Common Causes of Recession .....	3
Supply Shocks.....	3
Demand Shocks.....	4
Contractionary Fiscal Policy.....	5
Contractionary Monetary Policy.....	6
Financial Crisis .....	8
Housing Market .....	10
Policy Options for Smoothing the Business Cycle.....	12

## Figures

Figure 1. Stylized Depiction of the Business Cycle .....	1
Figure 2. Effective Federal Funds Rate.....	7
Figure 3. Fixed Residential Investment.....	11

## Contacts

Author Information.....	14
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## Introduction

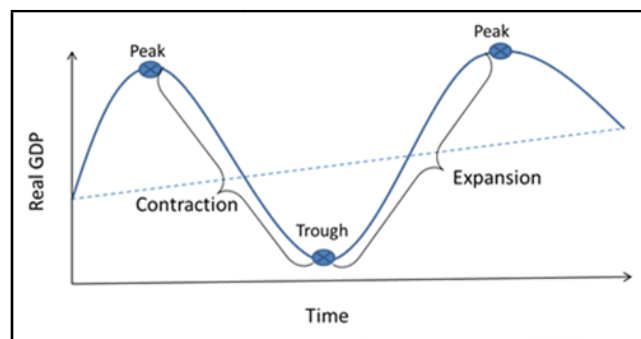
If and when a recession may occur is never completely predictable. However, there is a concern currently among some policymakers and economists that the U.S. economy may be headed for recession in the near term or is already there. The economy over the past two years has been characterized by unusually high inflation and uneven growth. Furthermore, policies that can lower inflation can also result in recession, depending on timing and size. Despite easing inflation and a low unemployment rate at present, many economists still predict that a recession is coming. For example, the January 2023 Wall Street Journal Economic Forecasting Survey (a quarterly survey of over 70 private sector economists) showed that forecasters estimated the probability of recession in the next 12 months to be 61%.<sup>1</sup>

A major reason that recessions can be difficult to predict (and why it is difficult to know if the United States is currently headed for recession) is that recessions can have several different proximate causes. Further, whether or not a policy stance, specific event, or trend in the economy results in recession is context dependent. However, there are certain fairly common causes of recession in the United States. This report provides an overview of recessions and discusses some common causes, both generally and in the current economic context. The report also considers policy options for Congress and the Federal Reserve if the economy were to enter a recession.

## The Business Cycle

Over time, economic activity tends to fluctuate between periods of increasing economic activity, known as economic expansions, and periods of decreasing economic activity, known as recessions. Real gross domestic product (GDP)—total economic output adjusted for inflation—is the broadest measure of economic activity. The economy’s movement through these alternating periods of growth and contraction (or recession) is known as the business cycle. The turning point between an expansion and contraction is known as a peak, and the turning point between a contraction and expansion is known as a trough, as shown in **Figure 1**.

**Figure 1. Stylized Depiction of the Business Cycle**



**Source:** Congressional Research Service.

As the economy moves through the business cycle, a number of additional economic indicators tend to follow the same pattern as GDP. During an economic expansion, economy-wide

<sup>1</sup> Harriet Torry and Anthony DeBarros, “Economists in WSJ Survey Still See Recession This Year Despite Easing Inflation,” *Wall Street Journal*, January 15, 2023, <https://www.wsj.com/articles/despite-easing-price-pressures-economists-in-wsj-survey-still-see-recession-this-year-11673723571>.

employment, incomes, industrial production, and sales all tend to increase alongside rising real GDP. Additionally, over the course of an economic expansion, the rate of inflation tends to increase, although the 2009-2020 expansion showed that inflation can remain low throughout the expansion. During a recession, the opposite tends to occur. All of these indicators do not shift simultaneously, but they tend to shift around the same time.

Although these fluctuations in economic activity are referred to as a “cycle,” the economy generally does not exhibit a regular and smooth cycle as shown in **Figure 1**. Predicting recessions and expansions is notoriously difficult due to the irregular pattern of the business cycle. A single quarter of economic data can be too short to predict a trend, although this was not the case during the initial months of the COVID-19 pandemic. During an expansion, there may also be short periods of decreasing economic activity interspersed within an expansionary period, and vice versa.<sup>2</sup> Recessions are also not a consistent length or depth—the past two recessions, for example, were two months and 18 months but were both deep relative to most historical recessions—but they have all ended eventually with or without policy intervention.

Over the business cycle, the rate at which the economy is expanding or contracting can be significantly different. For example, during the 2009-2020 expansion, real GDP grew at an average pace of about 2.3% per year, whereas real GDP shrank at an annual rate of 31.4% in the second quarter of 2020 before growing at an annual rate of 33.1% in the third quarter.<sup>3</sup> (Most contractions and expansions are not as severe as those seen in 2020 as a result of the pandemic, but they can differ notably.) Over longer periods of time, the volatility of the business cycle averages out to reveal a pattern of growth in the economy. Determinants of long-term growth are out of the scope of this report, which focuses only on the short term.<sup>4</sup>

## Technical Definition of *Recession*

Recessions are not determined by the federal government and are not defined in statute. The National Bureau of Economic Research (NBER)—an independent nonprofit organization that conducts and disseminates economic research—defines *recession* as a “significant decline in economic activity that is spread across the economy and that lasts more than a few months,” but it does not have a set numerical formula to define a recession. Instead, NBER evaluates three criteria—depth, diffusion, and duration—using a variety of monthly economic indicators including income, employment, consumption, sales, and industrial production.<sup>5</sup>

A popular rule of thumb is that recessions feature at least two consecutive quarters of negative GDP growth, but this rule of thumb is not technically correct. Although NBER considers GDP growth in its quarterly business cycle dating, it cites several reasons for not using the two-quarter rule as a definition for recessions. NBER:

- does not rely on just one indicator,
- considers depth of declines in activity,

<sup>2</sup> For further discussion of the business cycle and the economy, see CRS In Focus IF10411, *Introduction to U.S. Economy: The Business Cycle and Growth*, by Lida R. Weinstock.

<sup>3</sup> For GDP data, see U.S. Department of Commerce, Bureau of Economic Analysis (BEA), “Gross Domestic Product,” <https://www.bea.gov/data/gdp/gross-domestic-product>.

<sup>4</sup> For discussion of determinants of long-term growth, see CRS In Focus IF10408, *Introduction to U.S. Economy: GDP and Economic Growth*, by Mark P. Keightley and Lida R. Weinstock.

<sup>5</sup> NBER, “US Business Cycle Expansions and Contractions,” <https://www.nber.org/research/data/us-business-cycle-expansions-and-contractions>.

- uses more frequent monthly data (so as to provide monthly dates for recessions), and
- accounts for discrepancies in output and income data.<sup>6</sup>

An outsized impact to one criterion can make up for a weaker impact to another. For example, NBER declared the United States to be in a recession from March to April 2020—less than two quarters—owing to the extreme drop in economic activity, despite the brevity of the contraction.

NBER considers length and depth of economic downturns in determining recessions. It dates recessions and expansions with a lag so as to consider economic activity over longer periods. This lag is not consistent across all business cycle dating, but it can be many months. Practically, this means that the economy enters recession before the recession is officially announced, which can make timing policy responses challenging.

## Common Causes of Recession

Economic growth is the result of the interaction between aggregate supply (total production) and aggregate demand (total demand). There are two general types of causes of economic recession: supply shocks and demand shocks. A supply shock occurs when something reduces the economy's ability to produce output at a given price level. A demand shock occurs when something reduces businesses' and households' willingness to consume and invest at a given price level. Supply and demand shocks happen unpredictably and irregularly, which is why expansions are not a regular length and recessions are hard to consistently avoid. Supply shocks and demand shocks can be caused by a variety of events, some of the most common of which are discussed below.

Not all economic shocks are so clear cut, and some have both supply and demand components. For example, the COVID-19 pandemic resulted in significant supply and demand disruptions. On the supply side, the pandemic caused disruptions in the production process as labor and trade became constrained. On the demand side, fears and mandated restrictions resulted in sudden decreases in consumer and business spending. While the following sections categorize shocks as purely supply or demand, in actuality, shocks may affect the economy through several channels.

### Supply Shocks

Supply shocks, depending on their severity and breadth, can result in recession. When an event disrupts an economy's productive capacity, typically by making an input to the production process scarce or relatively expensive, output will typically decrease and prices increase.<sup>7</sup> In other words, supply-shock-induced recessions tend to exhibit falling output and employment and increased inflation. Owing to the increase in prices, a supply shock can often dampen aggregate demand as well, further exacerbating the downturn.

While supply shocks can come from anywhere in supply chains, typically shocks to inputs of the production process that are integral to production across the economy are the most likely to result in recession. For example, oil shocks are one of the most common causes of supply-related recession, as oil products (and other sources of energy) are used in the production of nearly all goods and services within the United States in addition to being a direct-to-consumer commodity.

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<sup>6</sup> NBER, "Business Cycle Dating Procedure: Frequently Asked Questions," <https://www.nber.org/research/business-cycle-dating/business-cycle-dating-procedure-frequently-asked-questions>.

<sup>7</sup> Olivier Blanchard and David R. Johnson, *Macroeconomics*, 6<sup>th</sup> ed. (London: Pearson, 2013), pp. 133-160.

Other major commodities and inputs in the production process, such as labor or technology, can significantly boost or restrain aggregate supply in the economy. Thus, supply shocks can and have had their origins within the United States, but events outside of the country also affect domestic aggregate supply.

### ***Example: 1970s Oil Crises***

The 1970s were marked by two oil shocks. The first, taking place over several months in 1973-1974, occurred when the Organization of the Petroleum Exporting Countries instituted an oil embargo on the United States. The embargo significantly decreased U.S. oil imports and increased the price of oil nearly fourfold.<sup>8</sup> The United States experienced another oil shock in 1978-1979 when the Iranian Revolution resulted in decreased global production of oil. The shock also resulted in an increase in demand for oil, perhaps due to fear of further disruption. Altogether, the price of oil roughly doubled.<sup>9</sup> Both shocks were followed by recessions (November 1973 to March 1975 and January 1980 to July 1980), and inflation remained high into the 1980s. Although they played a large role in these recessions, the oil shocks were not the sole contributing factors to the recessions, and oil shocks have not been the primary cause of recessions since then owing to a variety of factors, including increased domestic production and the buildup of oil reserves.<sup>10</sup> The U.S. economy is continually experiencing various supply shocks, but most are not significant enough to cause a recession.

### ***Current Conditions***

The U.S. economy has seen several significant supply shocks in the past few years. In some ways, the COVID-19 recession was a supply shock: The need for social distancing halted commerce significantly, creating challenges in supply chains and resulting in idle productive resources (e.g., workers and factories). The Russian invasion of Ukraine also created significant supply disruptions in several commodities markets in 2022. Although this did not result in recession in the United States, these frictions can be seen in large price increases in several commodities, most notably energy, which fed through to high inflation.<sup>11</sup> Many supply chain issues improved in the latter half of 2022, and most economists expect these issues to continue to improve absent further shocks.<sup>12</sup>

### **Demand Shocks**

A demand shock is characterized by an event or series of events that result in consumers and businesses cutting back on spending. Recessions induced by demand shocks exhibit lower output, but unlike supply shocks, they tend not to result in price increases and at times can even result in overall price level decreases (deflation).<sup>13</sup> For this reason, countercyclical monetary and fiscal

<sup>8</sup> Michael Corbett, "Oil Shock of 1973-74," *Federal Reserve History*, November 22, 2013, <https://www.federalreservehistory.org/essays/oil-shock-of-1973-74>.

<sup>9</sup> Laurel Graefe, "Oil Shock of 1978-79," *Federal Reserve History*, November 22, 2013, <https://www.federalreservehistory.org/essays/oil-shock-of-1978-79>.

<sup>10</sup> Nico Valckx, "Lower Oil Reliance Insulates World from 1970s-Style Crude Shock," International Monetary Fund, May 5, 2022, <https://www.imf.org/en/Blogs/Articles/2022/05/05/lower-oil-reliance-insulates-world-from-1970s-style-crude-shock>.

<sup>11</sup> For example, see Bureau of Labor Statistics, "Archived CPI News Release Table 1," March 2022, <https://www.bls.gov/cpi/tables/supplemental-files/news-release-table3-202203.xlsx>.

<sup>12</sup> See CRS Insight IN12091, *Will Inflation Continue to Fall?*, by Lida R. Weinstock and Marc Labonte.

<sup>13</sup> Blanchard, *Macroeconomics*, pp. 133-160.



policy may work better (or have more desirable outcomes) in dealing with demand as opposed to supply shocks.

### **Spontaneous Changes to Private Demand**

Changes in consumer or business confidence can impact aggregate demand. If individuals believe the economy will perform poorly in the future, they are likely to increase how much they save to prepare for lean times ahead. The associated decrease in spending would lower aggregate demand. Similarly, if businesses perceive that the economy is about to enter a recession, they are less likely to make investments in new machinery or factories because consumers would not be able to afford their new products during the recession. These types of changes in behavior can occur spontaneously and be the proximate cause of recession. These types of behaviors can also result from a specific shock and further deepen the shock's demand impact.

There are many distinct events that can cause decreased demand and recession, several of which are discussed below. They could be caused by policy changes (e.g., contractionary fiscal or monetary policy) or developments in the private sector (see text box above).

### **Contractionary Fiscal Policy**

During an economic expansion, economic conditions are generally strong. Unemployment falls or is low and wages and private spending both tend to increase. During such periods of strong or improving economic conditions, policymakers may choose to enact contractionary fiscal policy—a decrease in government spending or transfers or an increase in taxes. When such policy is timed appropriately, it can be beneficial to the economy and stop the economy from overheating. From another perspective, it can be challenging to parse economic conditions in real time, and sometimes such policies can be mistimed, resulting in overtightening and recession.

Contractionary fiscal policy works to temper aggregate demand. When the government raises individual income taxes, for example, individuals have less disposable income and decrease their spending on goods and services in response. The decrease in spending reduces aggregate demand for goods and services, slowing economic growth temporarily. Alternatively, when the government reduces federal spending, it reduces aggregate demand in the economy, which again temporarily slows economic growth. Contractionary fiscal policy could also be expected to result in lower interest rates and more investment, a depreciation of the U.S. dollar and a shrinking trade deficit, and a slowing inflation rate.<sup>14</sup> These effects tend to spur additional economic activity, partly offsetting the decline resulting from the initial policy. Whether the decrease in aggregate demand is problematic for overall economic performance depends on the overall state of the economy at that time. If private demand is strong enough, contractionary policy would not result in recession.

#### ***Example: Post–World War II Recession***

The U.S. economy experienced a recession in 1945 as World War II was ending. This recession largely resulted from large decreases in government spending. Wartime spending had been large, resulting in the largest deficit-to-GDP ratio to date, peaking at nearly 30% in 1943. The removal of such large stimulus—the government was running a budget surplus of 1.7% by 1947—

<sup>14</sup> Blanchard, *Macroeconomics*, pp. 450-451.



tightened economic conditions to the point of recession.<sup>15</sup> The recession lasted from February to October of 1945, and unemployment remained quite low, with a recession peak of 3.1%.<sup>16</sup>

### *Current Conditions*

The scale of the fiscal tightening that resulted in recession in 1945 was much larger than policy changes in the recent past. The government has not undertaken significant tax increases or spending decreases in recent decades and has typically run a budget deficit. The likelihood of more marginal fiscal tightening resulting in recession is uncertain but perhaps not likely. Relatively large fiscal stimulus was enacted during the pandemic. As the economy recovered, much of the temporary stimulus expired or was exhausted. The Congressional Budget Office has estimated that further tightening legislation, such as P.L. 117-169, often referred to as the Inflation Reduction Act of 2022, will reduce 10-year deficits, mostly in future years.<sup>17</sup> Given the current context of high inflation, further tightening could help bring down prices but also increases the risk of recession, depending on the timing and scope of any such future policy.

### **Contractionary Monetary Policy**

The Federal Reserve (Fed) controls monetary policy and has a mandate to use monetary policy to promote maximum employment, stable prices, and moderate long-term interest rates. Stable prices should lead to moderate long-term interest rates, so it is common for analysts to refer to the Fed’s “dual mandate” of promoting maximum employment and stable prices. While the Fed has several monetary policy tools it can use in times of severe crisis, under the normal ebbs and flows of the business cycle, the primary tool it uses is the federal funds rate (FFR), a short-term private rate that the Fed can manipulate in order to affect interest rates throughout the economy.<sup>18</sup>

The Fed typically uses contractionary monetary policy—raising the FFR—during periods of high inflation. Rising interest rates work to lower prices by decreasing demand through two main avenues. First, higher interest rates tend to reduce interest-sensitive spending and investment by consumers and businesses. Second, higher interest rates domestically tend to cause the dollar to appreciate as U.S. assets become more attractive relative to foreign assets. An appreciated dollar makes imports relatively cheaper and exports relatively more expensive, reducing net exports.<sup>19</sup>

The Fed’s efforts to achieve and maintain both maximum employment and stable prices is challenging. Contractionary monetary policy may be needed to maintain stable prices, but it is usually eventually followed by recession (see **Figure 2**). Most recessions since the 1940s were preceded by periods of rising interest rates. Periods of contractionary monetary policy followed by recession are called “hard landings,” and those that are not are called “soft landings.” Soft

<sup>15</sup> Office of Management and Budget, “President’s Budget Historical Tables,” Table 1.2—Summary of Receipts, Outlays, and Surpluses or Deficits as Percentages of GDP: 1930-2027, <https://www.whitehouse.gov/omb/budget/historical-tables/>.

<sup>16</sup> Bureau of Labor Statistics, “The Current Population Survey—Tracking Unemployment in the United States for over 75 Years,” Figure 1: Unemployment rate and timing of changes to Current Population Survey measurement, 1940-2017, January 2018, <https://www.bls.gov/opub/mlr/2018/article/the-current-population-survey-tracking-unemployment.htm>.

<sup>17</sup> Congressional Budget Office, *Estimated Budgetary Effects of H.R. 5376, the Inflation Reduction Act of 2022*, August 5, 2022, p. 3, [https://www.cbo.gov/system/files/2022-08/hr5376\\_IR\\_Act\\_8-3-22.pdf](https://www.cbo.gov/system/files/2022-08/hr5376_IR_Act_8-3-22.pdf).

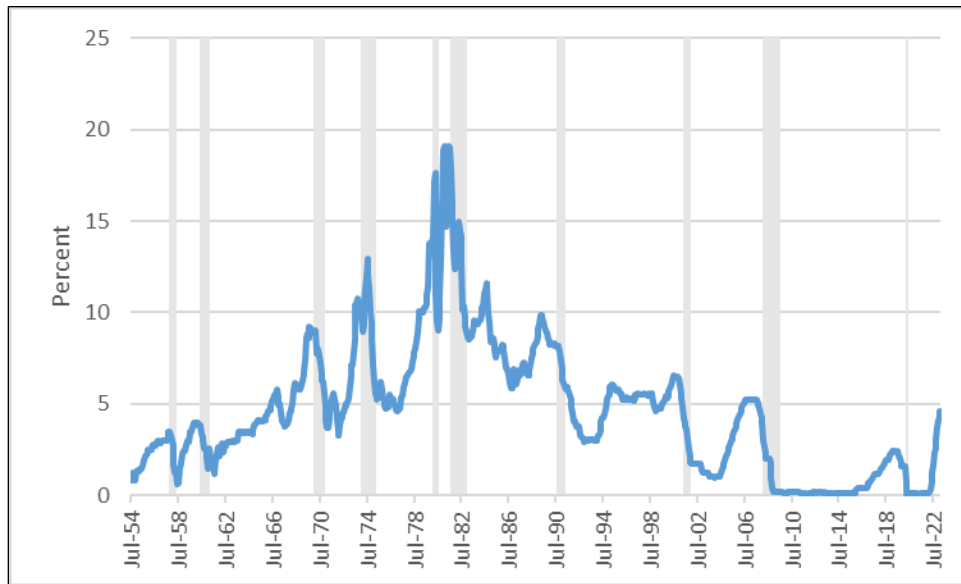
<sup>18</sup> For a discussion of unconventional monetary policy tools, see CRS Report R42962, *Federal Reserve: Unconventional Monetary Policy Options*, by Marc Labonte.

<sup>19</sup> For more information on monetary policy, see CRS In Focus IF11751, *Introduction to U.S. Economy: Monetary Policy*, by Marc Labonte.

landings are the intention of contractionary monetary policy, but hard landings often result instead.

**Figure 2. Effective Federal Funds Rate**

July 1954 to February 2023



**Source:** Federal Reserve

**Notes:** Gray bars denote recessions.

### *Example: Double-Dip Recession Under Federal Reserve Chair Volcker*

The U.S. economy experienced high inflation from the second half of the 1960s to the early 1980s.<sup>20</sup> The high inflation period was eventually brought to an end after the Fed sharply tightened monetary policy under then-new Fed Chair Paul Volcker. Volcker took office in August 1979. In his confirmation hearings prior to taking office, he pledged to make reducing inflation his top priority.<sup>21</sup> The FFR rapidly increased from about 11% when he took office to about 18% in April 1980.<sup>22</sup> As this tightening was implemented, the U.S. economy entered a recession from January 1980 to July 1980. In response to the recession, the Fed eased monetary policy and the FFR fell, but inflation decreased little despite the recession.<sup>23</sup> Beginning in July 1980, the Fed began tightening monetary policy and the FFR began increasing again. It peaked at over 19%, and the economy entered another recession from July 1981 to November 1982.

<sup>20</sup> See CRS In Focus IF12177, *Back to the Future? Lessons from the “Great Inflation”*, by Marc Labonte and Lida R. Weinstock.

<sup>21</sup> The chair has one equal vote of 12 on monetary policy decisions. Nevertheless, the chair has traditionally been viewed as wielding an outsized influence over monetary policy decisions.

<sup>22</sup> All data cited for the FFR are the monthly average of the effective FFR, which is the actual rate that federal funds are lent in the marketplace.

<sup>23</sup> Part of the decline in interest rates at this time was due to credit controls imposed by President Jimmy Carter, not an easing of monetary policy.

Volcker is often credited with restoring low and stable inflation by bringing inflation expectations back under control and restoring Fed credibility on its commitment to price stability.<sup>24</sup> However, the aggressive tightening of monetary policy came with the tradeoff of relatively high unemployment that recovered more slowly than low inflation was restored. During the recession of 1981-1982, inflation decreased by over 6 percentage points while unemployment increased over 3 percentage points and stood at 10.8% in November 1982, the last month of the recession.

### ***Current Conditions***

In response to high inflation, the Fed has been raising rates since March 2022. However, because interest rates were zero when the Fed started raising rates, it took several rate hikes before stimulus was largely considered to be fully withdrawn.<sup>25</sup> Since the Fed has started tightening, it has repeatedly pledged that it is committed to do what it takes to restore price stability.<sup>26</sup> The Fed has indicated that it anticipates continuing to raise rates for some time to come.<sup>27</sup> Inflation has been falling since peaking in June 2022, but output has remained relatively strong and the labor market remains quite tight. Fed Chair Jerome Powell stated in February 2023 that “reducing inflation is likely to require a period of below-trend growth and some softening of labor market conditions.”<sup>28</sup>

### **Financial Crisis<sup>29</sup>**

Financial instability and crises can result in recession and vice-versa (see text box). Financial crises can be precipitated by any number of specific events and underlying risks, such as asset bubbles, debt crises, or inadequate supervision or regulation of financial markets.<sup>30</sup> Generally, financial crises result in financial market disruptions, declining asset prices, tightening credit conditions, and liquidity and solvency issues for financial institutions. All told, these conditions, if widespread enough, decrease credit availability, and declining financial wealth can lead to significant decreases in personal consumption expenditures and gross private domestic investment, resulting in recession.<sup>31</sup>

<sup>24</sup> See, for example, William Poole, “President’s Message: Volcker’s Handling of the Great Inflation Taught Us Much,” Federal Reserve Bank of St. Louis, January 1, 2005, <https://www.stlouisfed.org/publications/regional-economist/january-2005/volckers-handling-of-the-great-inflation-taught-us-much>.

<sup>25</sup> Depending on how it is being measured, the point at which monetary stimulus has been fully withdrawn is debated. According to some models, monetary policy is still stimulative at present.

<sup>26</sup> For example, Chair Jerome Powell recently stated, “My colleagues and I understand the hardship that high inflation is causing, and we are strongly committed to bringing inflation back down to our 2 percent goal.” See Federal Reserve, “Transcript of Chair Powell’s Press Conference,” February 1, 2023, <https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20230201.pdf>.

<sup>27</sup> Federal Reserve, “Federal Reserve Issues FOMC Statement,” press release, February 1, 2023, <https://www.federalreserve.gov/newsevents/pressreleases/monetary20230201a.htm>.

<sup>28</sup> Federal Reserve, “Transcript of Chair Powell’s Press Conference.”

<sup>29</sup> While financial crises generally show aspects of both demand and supply shocks, recent research suggests that historically, financial crises behave more as demand shocks. See Felipe Benguria and Alan M. Taylor, *After the Panic: Are Financial Crises Demand or Supply Shocks? Evidence from International Trade*, NBER Working Paper no. 25790, April 2019, [https://www.nber.org/system/files/working\\_papers/w25790/w25790.pdf](https://www.nber.org/system/files/working_papers/w25790/w25790.pdf).

<sup>30</sup> For more information on the causes of financial crisis and financial market risks, see CRS In Focus IF10700, *Introduction to Financial Services: Systemic Risk*, by Marc Labonte; and CRS Report R47026, *Financial Regulation: Systemic Risk*, by Marc Labonte.

<sup>31</sup> Stijn Claessens and M. Ayhan Kose, *Recession: When Bad Times Prevail*, International Monetary Fund, <https://www.imf.org/external/pubs/ft/fandd/basics/recess.htm>.

### Macro-Financial Linkages

The financial sector and larger economy are closely tied, meaning that a financial market shock can lead to macroeconomic disruption and an exogenous (external) macroeconomic shock can lead to financial market disruption.<sup>32</sup> Regardless of the type of initial shock, the interrelated nature of financial markets and the macroeconomy means that feedback loops can be created during recessions and financial crises whereby tightening financial conditions can further dampen demand, which can lead to further tightening, and so on. For example, some research suggests that credit disruptions exacerbate economic downturns, and other research suggests that some asset price cycles may be closely related with the business cycle.<sup>33</sup> Research from the International Monetary Fund analyzing macro-financial linkages in the United States found that an exogenous one-percentage-point drop in banks' capital-asset ratio would reduce real GDP by roughly 1.5% via credit availability effects. Similarly, the authors found that an exogenous drop in demand by 1% of GDP would eventually become a 2% drop via financial feedback effects.<sup>34</sup>

#### *Example: 2007-2008 Financial Crisis*

The financial crisis that began in 2007 led to one of the longest recorded U.S. recessions, often nicknamed the “Great Recession” owing to its deep and prolonged nature, followed by a sluggish economic recovery. The financial crisis was precipitated by a housing market crash. In the lead up there was a housing bubble, where prices rose rapidly and unsustainably, mortgage borrowing increased, and underwriting standards deteriorated. As the housing market turned and home prices fell, financial markets faced uncertainty surrounding the value of mortgage-backed securities and the performance of other securities backed by bundled private credit. A quick selloff of mortgage-related securities led to broader selloffs of other securitized products.<sup>35</sup> The extreme tightening of credit conditions led to illiquidity among several large financial institutions and, in some cases, insolvency. Households, faced with tightening credit conditions in addition to the economic effects of the housing market crash, saw increased debt and were forced to decrease spending. Altogether, a painful recession resulted, and Congress and the Fed took unprecedented actions to restore financial and economic stability.<sup>36</sup>

#### *Current Conditions*

Financial crises are unpredictable because risks to financial stability are diverse and hard to identify beforehand. Many financial risks can result in crisis but never become systemically destabilizing. The Financial Stability Oversight Council (FSOC)—a council of regulators headed by the Treasury Secretary that was created after the 2008 financial crisis to monitor the stability of the financial system—is tasked with identifying potential threats to financial stability. In its 2022 annual report, FSOC identified 14 sources of vulnerability: commercial real estate,

<sup>32</sup> The economy is also interrelated to the other types of shocks described in this report. However, these interactions may not always result in the kind of feedback mechanisms characteristic of financial crises.

<sup>33</sup> Stijn Claessens and M Ayhan Kose, *Frontiers of Macrofinancial Linkages*, Bank for International Settlements, January 2018, pp. 104-105, <https://www.bis.org/publ/bppdf/bispap95.pdf>.

<sup>34</sup> Tamim Bayoumi and Ola Melander, *Credit Matters: Empirical Evidence on U.S. Macro-Financial Linkages*, International Monetary Fund, July 1, 2008, <https://www.elibrary.imf.org/view/journals/001/2008/169/article-A001-en.xml>.

<sup>35</sup> For more information about securitization, see Andreas Jobst, *What Is Securitization?*, International Monetary Fund, September 2008, <https://www.imf.org/external/pubs/ft/fandd/2008/09/pdf/basics.pdf>.

<sup>36</sup> Ben Bernanke, “Financial Panic and Credit Disruptions in the 2007-2009 Crisis,” Brookings Institution, September 13, 2018, <https://www.brookings.edu/blog/ben-bernanke/2018/09/13/financial-panic-and-credit-disruptions-in-the-2007-09-crisis/>; and John Weinberg, “The Great Recession and Its Aftermath,” *Federal Reserve History*, November 22, 2013, <https://www.federalreservehistory.org/essays/great-recession-and-its-aftermath>.

residential real estate, nonfinancial corporate credit, short-term wholesale funding markets, digital assets, large bank holding companies, investment funds, central counterparties, Treasury markets, alternative reference rates, provision of financial services by nonbank financial institutions, cybersecurity, third-party service providers, and climate change.<sup>37</sup>

## Housing Market

Many economists look to the housing market as an indicator of the business cycle. Residential fixed investment—spending on the construction of new single- and multi-family structures, residential remodeling, and brokers’ fees—is a component of GDP, and a majority of past recessions have been preceded by decreases in residential investment.<sup>38</sup> Residential building construction employs nearly 1 million people.<sup>39</sup>

Rising home prices typically encourage additional construction spending to take advantage of higher prices, leading to more robust economic growth. A decline in housing prices typically depresses construction spending, leading to more anemic economic growth. Fluctuations in the housing market, particularly housing prices, can also have broader effects on the economy through wealth effects. While houses in some ways behave as goods—for example, by providing shelter to be consumed—economists typically think of houses as assets, similar to stocks or bonds. In many ways houses are investments, and many view purchasing a home as a way to build wealth. An increase in housing value encourages homeowners to spend more by borrowing against greater home equity or saving less in response to greater equity, while decreasing or stagnant value may result in less robust spending.<sup>40</sup>

The question is whether housing downturns cause or are caused by recessions. Residential investment, although not a huge slice of GDP (it has fluctuated between 3% and 5% of GDP for the past decade), tends to fluctuate more widely than other components of GDP (or other industries’ contributions to GDP) and tends to account for a larger portion of decreases in GDP immediately preceding recessions.<sup>41</sup> Some economists argue that the housing market is becoming less closely tied to the business cycle given that residential investment decreased significantly as a percentage of GDP in the wake of the 2007 housing market crash and has not, to this point, recovered.<sup>42</sup> Additionally, some models have not been able to reproduce observations that residential investment leads GDP with statistical significance.<sup>43</sup> However, historically, periods of decreases in residential investment (negative growth) have often preceded recessions (see **Figure 3**).

<sup>37</sup> FSOC, *2022 Annual Report*, <https://home.treasury.gov/system/files/261/FSOC2022AnnualReport.pdf>.

<sup>38</sup> Edward E. Leamer, *Housing Is the Business Cycle*, NBER Working Paper no. 13428, September 2007, p. 4, [https://www.nber.org/system/files/working\\_papers/w13428/w13428.pdf](https://www.nber.org/system/files/working_papers/w13428/w13428.pdf).

<sup>39</sup> For industry employment data, see Bureau of Labor Statistics, “Current Employment Statistics,” <https://www.bls.gov/ces/data/>.

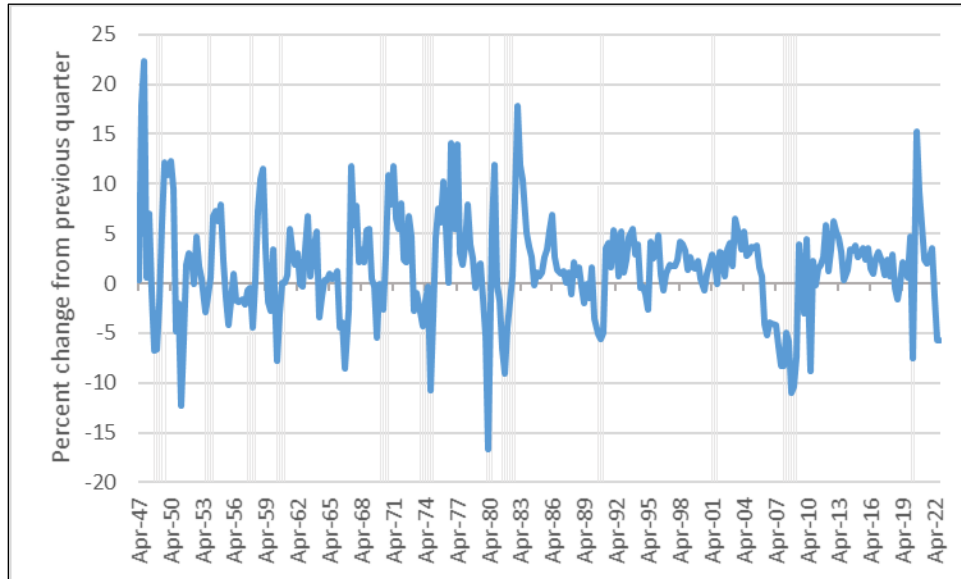
<sup>40</sup> While rising house prices can be beneficial for those who already own homes and can lead to economic growth, these higher prices can also create affordability issues for non-owners. For more information on the housing market and economy, see CRS In Focus IF11327, *Introduction to U.S. Economy: Housing Market*, by Lida R. Weinstock.

<sup>41</sup> *The Economist*, “Housing Was the Business Cycle,” July 18, 2020, <https://www.economist.com/finance-and-economics/2020/07/18/housing-was-the-business-cycle>.

<sup>42</sup> *The Economist*, “Housing Was the Business Cycle.”

<sup>43</sup> Morris Davis and Jonathan Heathcote, *Housing and the Business Cycle*, Federal Reserve, November 1, 2003, p. 2, <https://www.federalreserve.gov/pubs/feds/2004/200411/200411pap.pdf>.

**Figure 3. Fixed Residential Investment**  
Q2 1947-Q4 2022



**Source:** Bureau of Economic Analysis

**Notes:** Gray bars denote recessions. Underlying data are annualized.

### *Example: Housing Market Crash of 2007*

While housing markets can potentially be used as an indicator of recession without being the underlying cause of the recession, disruptions in the housing market have also directly resulted in recession. The most recent example of this is the housing market crash that began in 2007 and led to a financial crisis and ultimately the Great Recession. A key reason the housing crash led to a financial crisis was the housing bubble that preceded it.

In 2007, after a long period of steadily rising house prices and increased lending, house prices began to fall.<sup>44</sup> Residential investment began falling in 2006 and ended up falling over 50% in real terms between 2006 and 2009.<sup>45</sup> Output fell as a direct result of the drop in residential investment and as an indirect result of decreased home value, which likely contributed to a drop in consumer spending. The crash also led to a rise in mortgage defaults and foreclosures, contributing to both decreases in demand and the financial crisis that shortly followed.

It is difficult to separate the effect of the housing crash from the effect of the financial crisis when evaluating whether the crash caused a recession. The beginning of the recession came after the crash and the beginning of the financial downturn but before the worsening of the financial crisis. Had there been a housing crash but no financial crisis, the recession would not have been as long and deep, but whether there would have still been a recession is subject to debate.

<sup>44</sup> For example, see Federal Housing Finance Agency, "Purchase Only House Price Index," <https://www.fhfa.gov/DataTools/Downloads/Pages/House-Price-Index.aspx>.

<sup>45</sup> BEA, National Income and Product Accounts, Table 1.1.6 Real Gross Domestic Product, Chained Dollars, <https://apps.bea.gov/iTable/?reqid=19&step=2&isuri=1&categories=survey>.



### ***Current Conditions***

After a rapid increase in housing prices beginning in mid-2020, house prices began to moderate in mid-2022.<sup>46</sup> To this point there have not been consistent price decreases, but it is possible that this could occur as the Fed continues to raise interest rates, making mortgages more expensive. The housing sector is generally very sensitive to monetary policy, so while it is hard to disentangle the primary cause of a recession under such circumstances, the pattern of residential investment may nonetheless provide an indicator of whether a recession is imminent, regardless of whether the housing sector is the actual cause. Residential investment has been falling since the second quarter of 2022, most recently falling by over 20% in the third and fourth quarters of 2022, and by 10.7% for 2022 as a whole.<sup>47</sup> If residential investment does lead GDP, this could be a sign of a recession to come. Further, if it turns out that the rapid increase in housing prices led to an asset bubble similar to 2007, the housing market itself could result in recession in the future.

## **Policy Options for Smoothing the Business Cycle**

Government policy, specifically monetary and fiscal policy, can impact aggregate demand either directly or indirectly. Congress, together with the President, is responsible for fiscal policy in the United States through changes in the levels of government spending and tax revenue. Fiscal policy can directly increase aggregate demand by increasing government spending, reducing taxes, increasing government transfers to individuals, or a combination of the three.<sup>48</sup> To maximize the effect on aggregate demand, the government can finance these policy changes by borrowing money from the public (i.e., increasing the publicly held federal debt), referred to as deficit financing.<sup>49</sup> Most recently, the government used fiscal stimulus tools during the pandemic when, for example, it sent out stimulus checks directly to consumers and when it temporarily increased unemployment benefits.

Monetary policy can also be used to impact aggregate demand.<sup>50</sup> The Fed implements monetary policy by changing short-term interest rates and the availability of credit in the economy. For example, lowering interest rates can encourage businesses to make new investments and individuals to buy new goods that are financed by credit, as lower interest rates make it less expensive to borrow money.

Fiscal and monetary policy are determined independently, so Congress may choose to defer to the Fed to stabilize the business cycle, or the Fed may judge that it can reduce its response in light of fiscal actions. Congress and the Fed may independently choose complementary policies that increase the effectiveness of their respective policies or conflicting policies that neutralize each other's effects.

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<sup>46</sup> For more information on trends in housing prices, see CRS In Focus IF12048, *High Home Prices: Contributing Factors and Policy Considerations*, by Mark P. Keightley and Lida R. Weinstock.

<sup>47</sup> BEA, Gross Domestic Product, Fourth Quarter 2022 and Year 2022 (Advance Estimate), January 26, 2023, [https://www.bea.gov/sites/default/files/2023-01/gdp4q22\\_adv.pdf](https://www.bea.gov/sites/default/files/2023-01/gdp4q22_adv.pdf).

<sup>48</sup> For further discussion of fiscal policy, see CRS In Focus IF11253, *Introduction to U.S. Economy: Fiscal Policy*, by Lida R. Weinstock; and CRS Report R45723, *Fiscal Policy: Economic Effects*, by Lida R. Weinstock.

<sup>49</sup> For discussion of specific policy options for countering recessions, see CRS Report R45780, *Fiscal Policy Considerations for the Next Recession*, by Mark P. Keightley.

<sup>50</sup> For further discussion of monetary policy, see CRS In Focus IF11751, *Introduction to U.S. Economy: Monetary Policy*, by Marc Labonte.



Countercyclical fiscal and monetary policy, when implemented successfully, can help smooth the business cycle. For example, countercyclical fiscal policy might include increasing government spending during a recession to help stabilize demand and return the economy to (sustainable) full employment and then decreasing government spending during an expansion to stop the economy from growing too quickly and resulting in high inflation. When unsuccessful, these policies may exacerbate the fluctuations of the business cycle, which is most likely to occur when countercyclical policies are mistimed or improperly sized—too much contraction even during an expansion can result in recession, for example, or too little stimulus during a recession can prolong the downturn. Because of lags in policy effectiveness and economic uncertainty, often it is not possible to tell in real time that a policy change is needed until it is too late.<sup>51</sup>

There are reasons why policymakers would choose not to use countercyclical policies in certain circumstances. For example, inflation sometimes occurs during recessions. In such a case, the Fed may decide that contractionary monetary policy is appropriate despite recessionary conditions if the Fed prioritizes inflation reduction over employment concerns. On the other hand, Congress might decide to prioritize stabilizing the size of the federal debt over counteracting a recession through expansionary fiscal policy. Policymakers weigh the tradeoffs of these costs against the benefits of ameliorating the recession. One key factor determining the size of the benefits is the potential length and severity of the recession with and without countercyclical policy.

#### **Automatic Stabilizers**

Levels of federal spending and revenue (and therefore, the deficit) differ over time due to changes in the state of the economy in addition to deliberate choices made each year by Congress. During economic expansions, tax revenue tends to increase automatically as rising incomes and employment result in greater individual and corporate income tax revenues. Likewise, spending tends to decrease automatically as federal spending on income support programs, such as food stamps and unemployment insurance, tends to fall during economic expansions as fewer people need financial assistance and file unemployment claims. The combination of rising tax revenue and falling federal spending tends to improve the government's budget deficit. The opposite is true during recessions, when federal spending rises and revenue shrinks automatically. These cyclical fluctuations in revenue and spending are often referred to as automatic stabilizers. Even in the absence of congressional action, these automatic stabilizers provide some amount of countercyclical support. Therefore, when examining fiscal policy, it is often beneficial to take into account these automatic stabilizers to get a sense of the stance of fiscal policy.<sup>52</sup>

Most countercyclical policies are demand focused. Economists often consider supply-driven recessions to be particularly pernicious given that fiscal and monetary policy may not be well suited to affect supply in the short term, policy tools that can affect supply tend to take longer than tools that affect demand, and policy tools that affect demand in the short term can decrease unemployment or prices but not both.

<sup>51</sup> For example, the Fed's interest rate decisions are often viewed in retrospect as having been too aggressive or not aggressive enough given what economists came to learn about economic conditions after the fact, information that the Fed has to estimate in real time. For more information, see CRS In Focus IF10207, *Monetary Policy and the Taylor Rule*, by Marc Labonte.

<sup>52</sup> For further discussion of automatic stabilizers, see CRS Report R45780, *Fiscal Policy Considerations for the Next Recession*, by Mark P. Keightley.

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