Introduction to U.S. Economy: The Business Cycle and Growth

On June 8, 2020, the National Bureau of Economic Research (NBER), an independent, nonprofit, research group, determined that economic activity in the U.S. peaked in February 2020 and that the economy subsequently entered into a recession in the same month. On a quarterly basis, economic activity peaked in the fourth quarter of 2019. This In Focus discusses the business cycle, how recessions are determined, and potential causes and effects of these fluctuations in the economy.

What Is 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 is known as the business cycle. The business cycle has four phases: the expansion, peak, contraction, and trough, as shown in Figure 1.

Figure 1. Stylized Depiction of the Business Cycle

As the economy moves through the business cycle, a number of additional economic indicators tend to shift alongside GDP. During an economic expansion, economy-wide employment, incomes, industrial production, and sales all tend to increase alongside the 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 while the economy is growing. 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 with the Coronavirus Disease 2019 (COVID-19) pandemic. During an expansion, there may also be short periods of decreasing economic activity interspersed within an expansionary period, and vice versa.

Dating the Business Cycles
Business cycles are dated according to the peaks and troughs of economic activity. A single business cycle is dated from peak to peak or trough to trough. NBER’s Business Cycle Dating Committee is generally credited with identifying business cycles in the United States.

NBER does not define a recession as two consecutive quarters of declining real GDP, which is a popular metric used by the media. Rather NBER uses a broader definition of a recession, as a period where there is a significant decline in economic activity that spreads across the economy. NBER uses a number of indicators to measure economic activity, including real GDP, economy-wide employment, real sales, and industrial production.

Figure 2 presents real GDP from the first quarter of 1947 through the third quarter of 2020, along with recessions, as identified by NBER, represented with orange bars. Over this period, real GDP grew at a 3.1% average annual rate.

Figure 2. Real GDP and Recessions
1947:Q1-2020:Q3

The economy tends to experience longer periods of expansion than contraction, especially since World War II (WWII). Between 1945 and 2019, the end of the most recent business cycle, the average expansion has lasted about 65 months, and the average recession has lasted about 11 months. Between the 1850’s and WWII, the average expansion lasted less than half as long (about 26 months), and the average recession lasted about twice as long (about 21 months). The 2009-2020 expansion was the longest on record, at 128 months.
The most recently completed recession in the United States, the so-called Great Recession, began in December 2007 and ended in June 2009, a total of 18 months. Since the 1850’s, in the United States, 12 other recessions have lasted as long as or longer than the Great Recession; however, all these recessions occurred before the Great Depression of the 1930’s. It is too soon to tell if the current recession will surpass the Great Recession in length, and due to the lag between when a recession begins or ends and when NBER announces it, this may not be known for some time.

Marking the end of a recession does not necessarily mean that the economy has returned to its pre-recession level of economic activity. For example, one important economic metric, the unemployment rate, tends to continue to increase following a recession as individuals return to the labor force and begin searching for employment. Following the Great Recession, the economy did not return to what is considered “full employment” until summer 2015, six years after NBER had declared the recession over.

**Short-Term Economic Growth**

In the short term, the business cycle is primarily driven by fluctuations in consumer spending and business investment. 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 5.0% in the first quarter of 2020 and 31.4% in the second quarter, before growing at an annual rate of 33.1% in the third quarter. Over longer periods of time, the volatility of the business cycle fades to reveal a pattern of growth in the economy.

**Potential Causes of the Business Cycle**

In general, the business cycle is governed by aggregate demand (total spending) within the economy, but recessions can also be caused by sudden shocks to supply, which will impact both aggregate supply and aggregate demand. The current recession is unusual in that it displays elements of both demand and supply shocks. This section discusses these types of shocks in more detail.

**Demand Shocks**

Changes in consumer or business confidence can impact aggregate demand. If individuals believe the economy will perform poorly in the future, individuals 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.

The ongoing COVID-19 public health crisis has contributed to the current recession in this manner. Uncertainty surrounding the virus and the state of the economy combined with high unemployment levels has resulted in decreased consumption and increased saving (as a percentage of income) on the part of consumers and decreased desire to increase capital investment on the part of firms.

**Supply Shocks**

As part of a global economy, events outside of the United States can often impact aggregate demand inside the United States, such as the 1979 oil shock that led to increased prices across the U.S. economy, resulting in a recession. In some ways, the current recession is also an example of a supply shock; the need for social distancing has halted commerce significantly and created challenges in supply chains. Whereas demand for certain products has been high and led to corrections in some supply chains (e.g., toilet paper, cleaning products), demand for many products has been low. Should aggregate demand increase, the economy may experience more unforeseen supply issues.

**Policy Options**

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 level 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. During a recession, the government typically finances these policies by borrowing money, referred to as deficit financing. The government has used fiscal stimulus tools during the current crisis when, for example, it sent out stimulus checks directly to consumers or when it temporarily increased unemployment benefits.

Monetary policy can also be used to impact aggregate demand. The Federal Reserve implements monetary policy by changing short-term interest rates and the availability of credit in the economy. For example, lowering interest rates, which the Federal Reserve did in response to COVID-19, can encourage businesses to make new investments and individuals to buy new goods, as lower interest rates make it less expensive to borrow money.

Fiscal and monetary policy, when implemented successfully, can help reduce economic volatility. When unsuccessful, these policies may exacerbate the fluctuations of the business cycle. The fiscal and monetary policy options discussed in this section are countercyclical policies, meaning they work to counter the business cycle. For example, countercyclical fiscal policy might include increasing government spending during a recession and decreasing government spending during an expansion. However, growth-oriented policies, when timed improperly, can cause the economy to overheat (growing at an unsustainable rate) and subsequently cause a downturn.

**CRS Resources**

CRS In Focus IF10408, *Introduction to the U.S. Economy: GDP and Economic Growth*, by Mark P. Keightley and Lida R. Weinstock

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