The Recession Will Begin Late 2023 Or Early 2024

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Recession is very likely in America’s future, but it will take its time arriving. Although we often want bad things to be done and over with, a long time to prepare will be valuable to those with foresight.

A recession might be avoided, but that’s highly unlikely. The only policy actions that could deter a recession would worsen inflation, thus setting the stage for an even worse downturn sometime in the future. Fortunately, Federal Reserve chairman Jerome Powell and most of his colleagues have decided that returning to low inflation should be their top priority. Powell said at his Jackson Hole speech, “History shows that the employment costs of bringing down inflation are likely to increase with delay, as high inflation becomes more entrenched in wage and price setting.“ Multiple Fed officials have stated that the harm from mistakenly ending the anti-inflation efforts too soon would be much greater than the harm from mistakes in the other direction. So in uncertain circumstances, the Fed will keep monetary conditions tight.

Assuming that the Fed keeps tightening, when will the recession hit the United States economy? Third quarter 2022 data indicate recession has not hit, as real GDP grew by 2.6% (annualized rate of change.) That advance estimate is subject to revision as more data become available.

The time lag between monetary policy changes and real economic changes is roughly one year. That’s a simplification of what is really a distributed lag, with some small effects early, growing impacts, then tapering effects. Even worse for forecasters, the magnitude and timing of the effects are not identical from one episode to another. The time lag for the current monetary tightening could be shorter or longer than the historical average.

The arguments for a shorter time lag—which means a sooner recession—include that the Fed communicated its plan to tighten well in advance of its actual actions. Prior to 2004, the Fed’s policy changes were not announced. Major financial institutions employed “Fed watchers” to dissect the evidence for changes in policy. As a result, in most of the historical period, private responses came well after the Fed changed policy. This time around, though, things were different. The Fed communicated in December 2021 its intention to tighten, and long-term interest rates rose before the Fed actually did anything. That argues for recession coming soon after the Fed began tightening.

Another argument for a shorter time lag comes from the global economy, in which most countries are tightening simultaneously. One indicator that covers 54 countries shows that almost all are tightening monetary policy. As the world has become more interconnected, simultaneous changes in policy have greater and quicker impacts.

On the other side of possibilities, the greatest argument for a slower response of the economy to monetary tightening is consumers’ high bank balances. In the pandemic, spending fell due to lockdowns, but incomes rose. Stimulus checks went to most families, working people got pay raises, and those laid off received extra unemployment insurance that, in many cases, more than compensated for lost wages. Savings in excess of the normal trend zoomed for a year, then started declining as people slowly spent more money relative to their earnings. By my estimate, the accumulated excess savings now totals $1.5 trillion, an amount that is declining by about $90 billion per month. At that rate, consumers’ bank balances will return to normal in 16 months.

Another good reason to expect a long time lag before monetary policy triggers a recession is the excess demand for labor relative to the number of unemployed people. As companies re-think their hiring plans, their first step will be to cut open positions, not lay off working people. The response will vary by company and industry, of course.

Monetary tightening works through two channels. First, higher interest rates stifle some economic activity, especially housing construction, car sales and business capital spending (both structures and equipment). Second, the decline in demand lowers income of the people who had been working in the interest-sensitive sectors. Right now, in November 2022, the decline in housing construction is clear, but consumer spending has not dropped. If employment does not decline in response to the monetary tightening, then consumer spending won’t fall and either no recession ensues or it’s very minor.

A later recession is most likely, one beginning in late 2023 or early 2024. Predictions of recession timing are much more difficult than the eventual arrival of recession, so this forecast should be taken with a grain a salt.

What can businesses do now to prepare for recession? The best first step is contingency planning. Sketch out the steps that should be taken, such as staff cuts, reductions in capital spending, tightening credit terms, and so forth. Each industry and business is different, so the generic list won’t apply to every organization. With the outline of contingency plans in place, top leadership should identify what the trigger points for action will be and who will take responsibility for the different actions. Finally, contingency planning for recession should include opportunities for growth. In every recession, some company picks up productive assets cheaply, increases market share by being more adept in the changing conditions, and hires great talent that has been laid off or under-appreciated by competitors. A growth plan for recession can set a company up for great gains in the subsequent recovery.