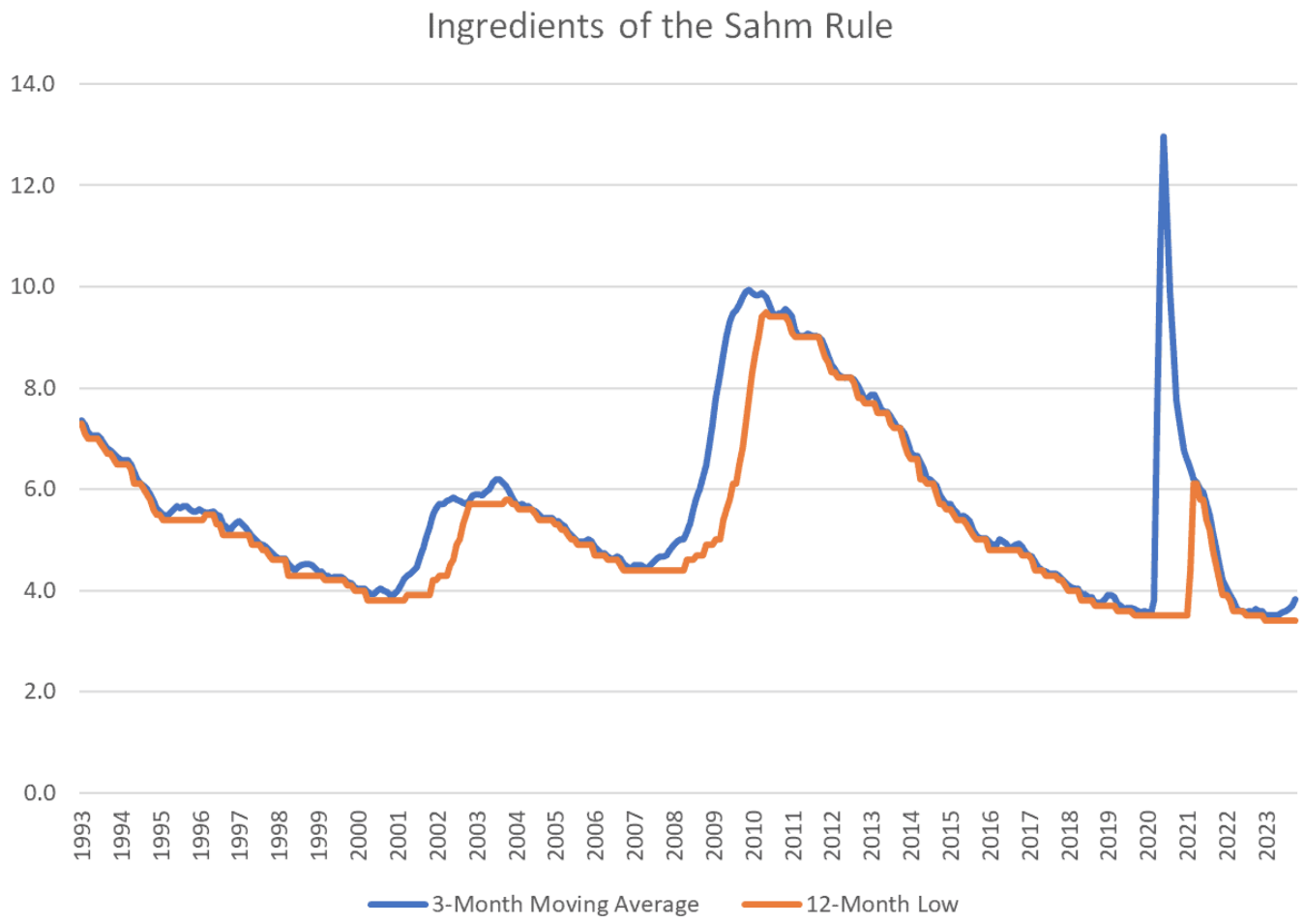
Get Ready for the Sahm Rule

DOUGLAS HOLTZ-EAKIN | NOVEMBER 7, 2023

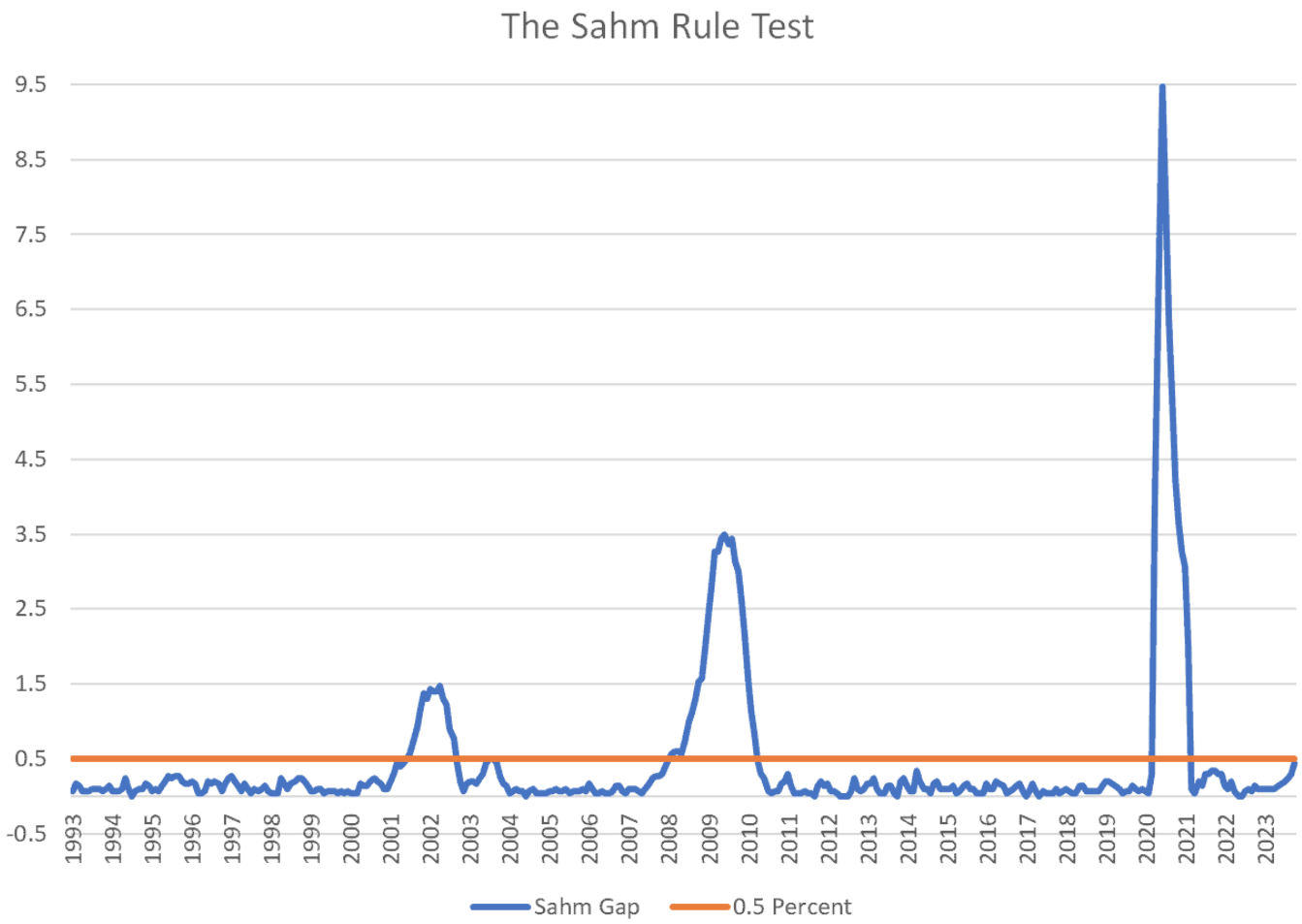
With financial markets and policymakers alike focused on the Fed's attempt to engineer a return to 2 percent inflation without triggering a recession – the unicorn known as a "soft landing" – get ready for lots of invocations of the "Sahm Rule."

The Sahm rule was introduced by former Fed economist Claudia Sahm in a chapter of a Brookings Institution publication. It is an empirical relationship that fits well in the historical data and, perhaps, would be a reliable indicator of the onset of a recession.

The essence of the Sahm rule is to compare the three-month moving average of the unemployment rate with the low over the previous 12 months. The components of the Sahm rule for the past 30 years are graphed below. The blue line is the three-month moving average of the unemployment rate, while the orange line tracks the low unemployment rate over the previous 12 months. As you can see, the moving average at times becomes elevated quickly, and these periods have been associated with recessions.



The actual Sahm rule test is to compare the difference between the two lines in the previous graph with the threshold of 0.5 percent. This comparison is shown below.



The Sahm rule is informative of the mild recession at the turn of the century, the Great Recession, and the Pandemic Recession. Of note, the recent rise in the unemployment rate is tiptoeing up to the Sahm rule threshold.

Now, like all "rules" developed based on empirical regularities in historical data, there is no guarantee that the Sahm rule will continue to be reliable in the future. But it provides a convenient way to summarize information regarding the labor market in a business cycle context.