



Everyone's Smart
University

Introduction to economics

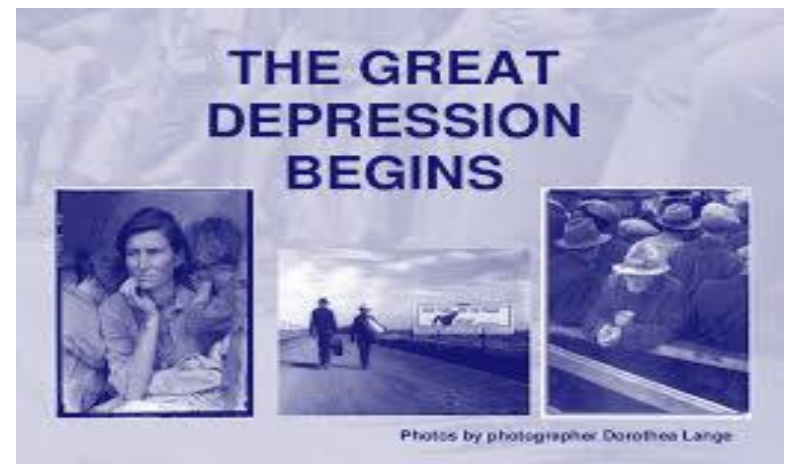
Chapter 4

THE BUSINESS CYCLE

Macroeconomics



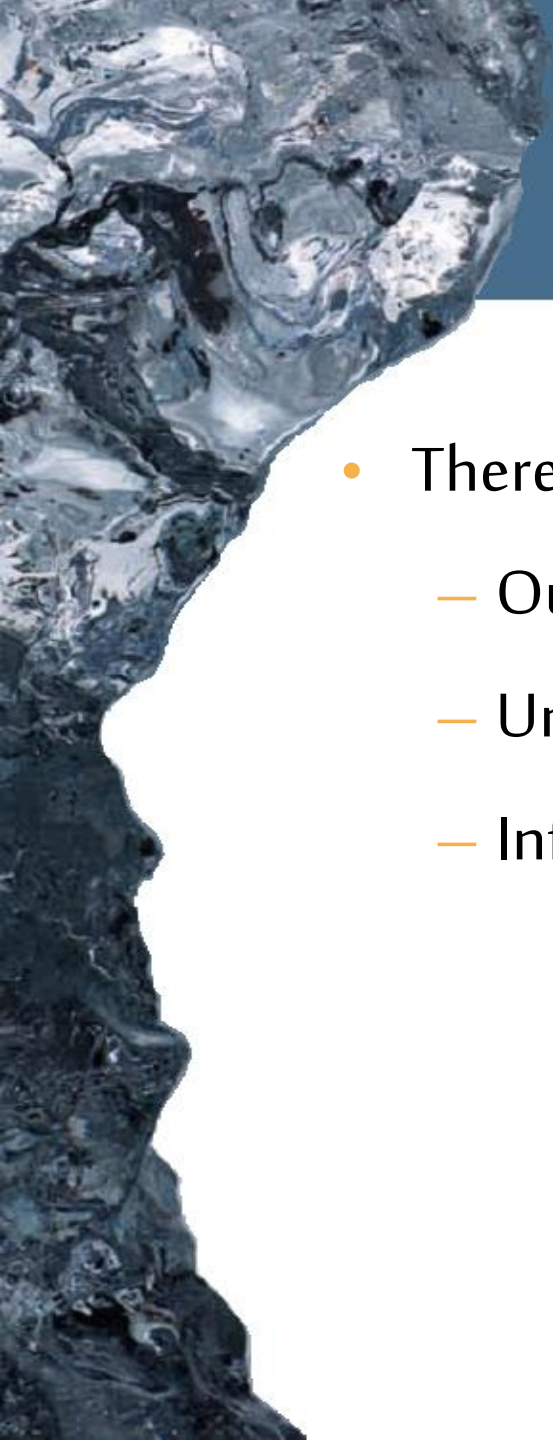
- The Great Depression was the springboard to modern macroeconomics.
- **Macroeconomics** is the study of aggregate economic behavior, of the economy as a whole.



Macroeconomics



- A basic purpose of macroeconomic theory is to explain the business cycle.
- Macro policy tries to control the business cycle.
- We'll see why President Obama was determined to keep the 2008-09 recession from turning into another depression.



Assessing Macro Performance



- There are three basic measures of macro performance:
 - Output (GDP) growth
 - Unemployment
 - Inflation

GDP



- Recall that GDP is the total value of output (goods and services) produced in an economy during a given period of time.



GDP Growth



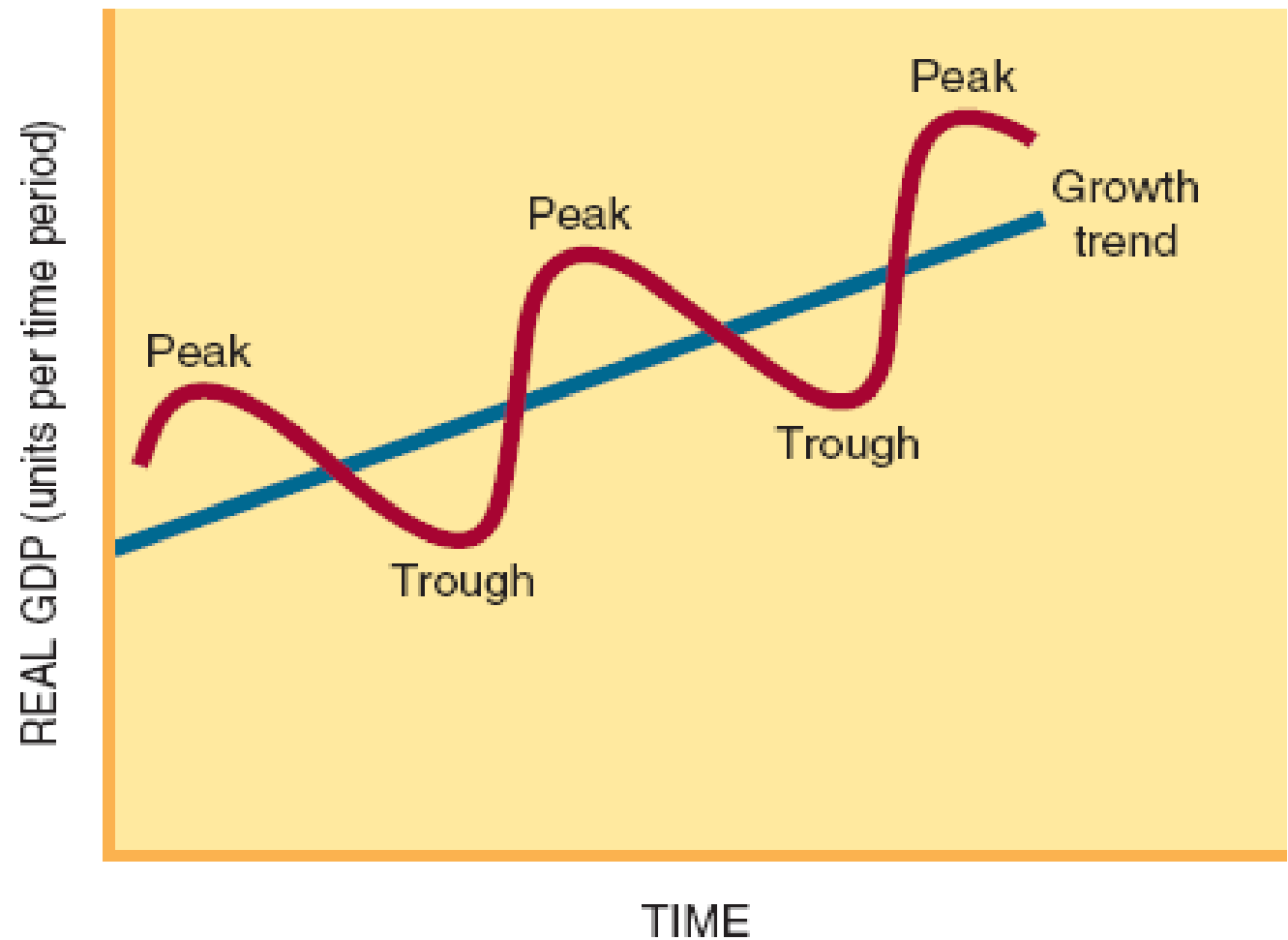
- An economy's **potential** output is reflected in its production possibilities curve:
 - **Production possibilities**—the alternative combinations of goods and services that could be produced in a given time period with all available resources and technology.
- When there is GDP growth, the production possibilities curve shifts outward.

The Business Cycle



- The **business cycle** is the alternating periods of economic growth and contraction experienced by the economy.
- It shows the rise and fall of the economy over time.

Figure 10.1



The Business Cycle



- The modern business cycle resembles a rollercoaster:
 - Output first climbs to a peak (high), then decreases.
 - After hitting a trough (low), the economy recovers, increasing again.



Real GDP



- Business cycles are measured by changes in real GDP:
 - **Real GDP** is the inflation-adjusted value of GDP or the value of output measured in constant prices.
 - **Nominal GDP** is measured in current prices.

Erratic Growth



- Real GDP doesn't increase in consistent, smooth increments, but in a pattern of steps, stumbles, and setbacks.

The Great Depression



- This was the most prolonged departure from our long-term growth path.
- Real GDP fell by 30% between 1929-1933.
- The economy started to grow again in 1934.
- Total output declined once again in 1936-1937



The Great Depression

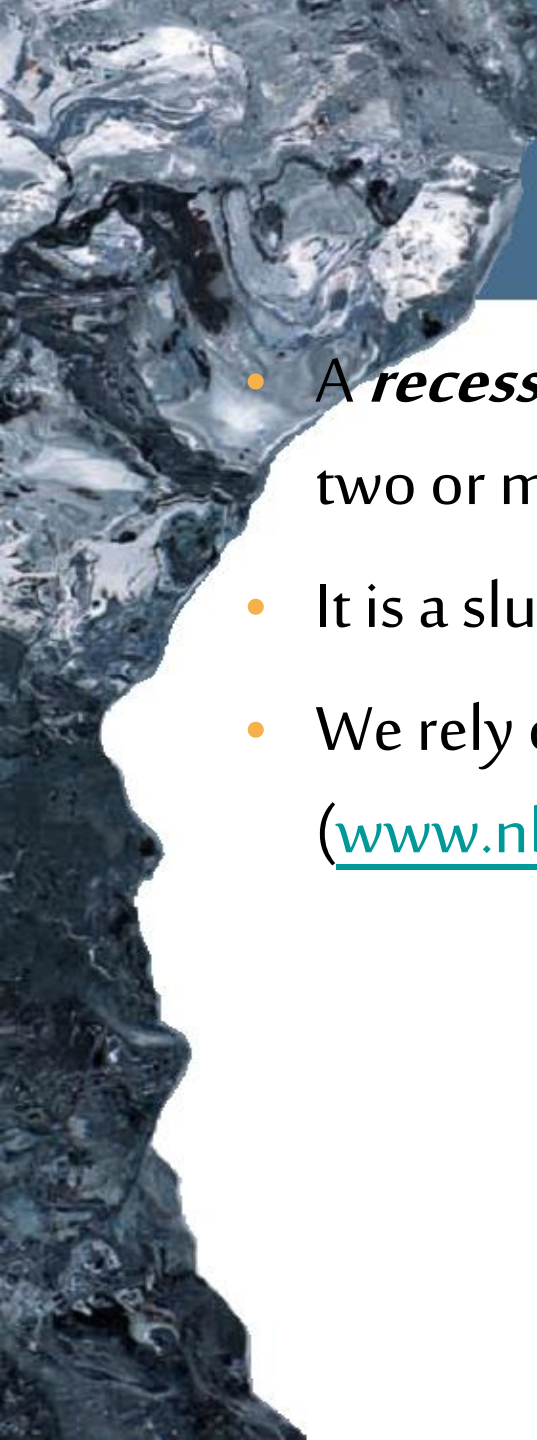


- Real GDP in 1939 was virtually the same as in 1929.
- GDP per capita was lower in 1939 than in 1929.

World War II



- World War II greatly increased the demand for goods and services and ended the Great Depression.
- Output grew by 19% in 1942 and the economy reached full employment.



Recession



- A ***recession*** is a decline in total output (real GDP) for two or more consecutive quarters.
- It is a slump or downturn in the economy.
- We rely on the National Bureau of Economic Research (www.nber.org) as our official designator of recessions.

Table 4.1



Dates	Duration (months)	Percentage Decline in Output	Peak Unemployment Rate
Aug. '29–Mar. '33	43	35.4%	24.9%
May '37–June '38	13	9.4	20.0
Feb. '45–Oct. '45	8	23.8	4.3
Nov. '48–Oct. '49	11	9.9	7.9
July '53–May '54	10	10.0	6.1
Aug. '57–Apr. '58	8	14.3	7.5
Apr. '60–Feb. '61	10	7.2	7.1
Dec. '69–Nov. '70	11	8.1	6.1
Nov. '73–Mar. '75	16	14.7	9.0
Jan. '80–July '80	6	8.7	7.6
July '81–Nov. '82	16	12.3	10.8
July '90–Feb. '91	8	2.2	6.5
Mar. '01–Nov. '01	8	0.6	5.6
Dec. '07–Aug. '09	19	2.1	10.1

Recent Recessions



- 1981-1982: Lasted 16 months, with an unemployment rate of 10.8%, the highest since the 1930s.
- 1990-1991: A very brief recession, lasting only 8 months.
- 2001: A brief and mild recession occurred from March to November
- 2008-09: A significant decline in output along with failures in financial and real estate markets.

Unemployment



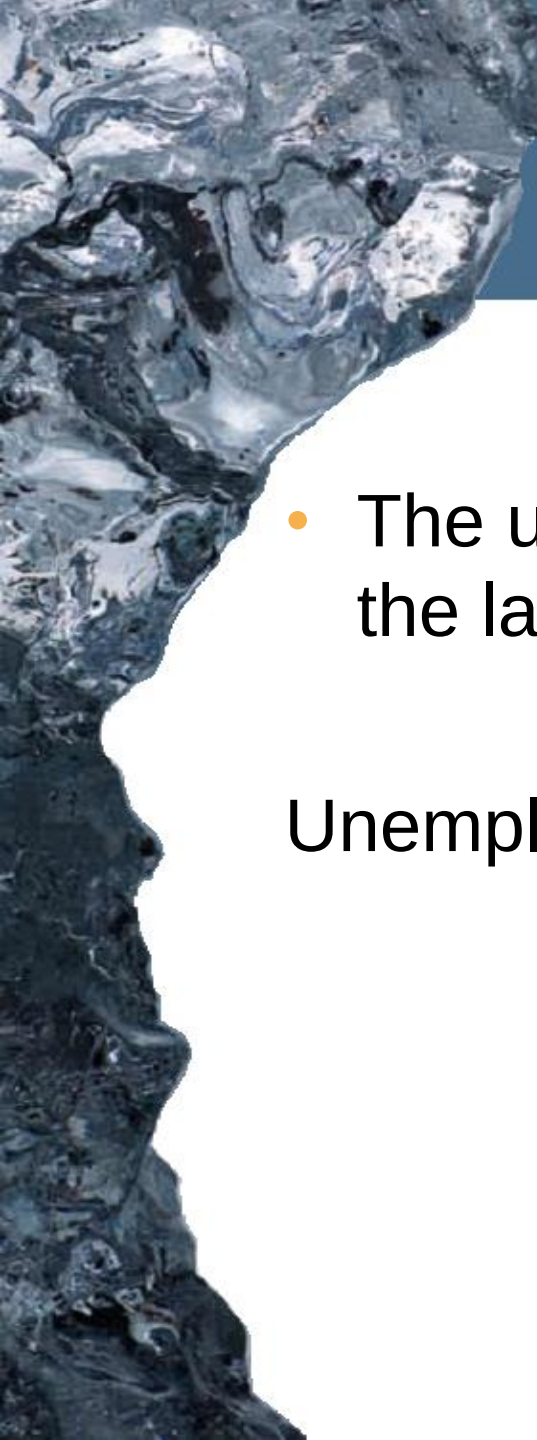
- Unemployment is the inability of labor-force participants to find jobs.
- When output declines, *jobs* are eliminated.
- It is measured by the Bureau of Labor Statistics (www.bls.gov), an agency within the Department of Labor.



The Labor Force



- The labor force consists of everyone over the age of 16 who is actually working, plus all those who are not working but are actively seeking employment.



The Unemployment Rate

- The unemployment rate is the proportion of the labor force that is unemployed:

Unemployment rate = $\frac{\text{number of unemployed}}{\text{number in labor force}}$

The Full-Employment Goal



- There are good reasons for pursuing a low, but not a zero, unemployment rate.

Seasonal Unemployment



- This is caused by seasonal changes:
 - An example is when school is out in the summer and teens are looking for summer jobs.

Frictional Unemployment



- This is a brief period of unemployment associated with a job search.
 - Examples include students with marketable skills entering the work force after graduation, and workers in between jobs.

Structural Unemployment



- This results from a mismatch between the skills of labor force participants and the skills needed by employers.
 - Another example is skilled craft workers in the 2006-2008 housing contraction.

Cyclical Unemployment



- When there are not enough jobs to go around due to downturns in the business cycle.
- This is unemployment due to a *recession*.
 - The Great Depression is the most striking example of cyclical unemployment.

The Policy Goal



- To avoid as much cyclical and structural unemployment as possible.
- To try to achieve full employment.
- **Full employment** is the lowest rate of unemployment compatible with price stability:
 - It is estimated to be between 4 and 6 percent.

Inflation



- The biggest fear as an economy reaches full employment is inflation.
- As an economy reaches its production possibilities, costs rise, pushing up prices.

Relative versus Average Prices



- **Inflation** is an increase in the average level of prices, not a change in any specific price.
- **Deflation** is a decrease in the average level of prices of goods and services.
- The **relative price** is the price of one good in comparison with the price of other goods.

Redistributions



- Although inflation makes some people worse off, it makes other people better off.
- Inflation acts just like a tax, taking income or wealth from some people and giving it to others.

Income Effects



- What looks like a price to a buyer looks like income to a seller.
- If prices are rising, incomes must be rising, too.

Wealth Effects



- Inflation may reduce the real value of your savings.

Uncertainty



- The uncertainties of inflation may cause people to change their consumption, saving, or investment behavior.
- Fear of rapidly increasing prices may deter consumers from making long-term purchasing decisions.
- Firms may postpone construction or not finish new construction.

Uncertainty



- Changing price levels may induce people to buy *more* goods and services now, before prices rise further.
- Consumers and producers may make foolish decisions, buying goods or services they don't really need or want.

Price-Stability and Policy Goal



- Price stability is the absence of significant changes in the average price level.
 - The Full Employment and Balanced Growth Act of 1978 establishes a goal for economic policy to hold the rate of inflation at under 3%.

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- End chapter 4