The Business Cycle: Introduction to Macroeconomic Indicators

Overview

The 1930s were marked by periods of chronically high unemployment in the United States. After World War II, Congress passed the Employment Act of 1946, which stated that it was the policy and responsibility of the federal government to use all practical means to promote maximum employment, production, and purchasing power. The Employment Act of 1946 established three important goals for the economy:

1. *Full employment* exists when most individuals who are willing and able to work at the prevailing wages in the economy are employed. Even under conditions of full employment, there will be some temporary unemployment as workers change jobs and as new workers seek their first jobs.
2. *Price stability* exists when the average level of prices in the economy is neither increasing nor decreasing. The goal of price stability does not imply that prices of individual items should not change—only that the average level of prices should not change.
3. *Economic growth* exists when the economy produces increasing amounts of goods and services over the long term. If the increase is greater than the increase in population, the amount of goods and services available per person will rise, and thus the nation's standard of living will improve.

Measuring the Achievement of Economic Goals

To determine how well we are achieving economic goals requires measuring the levels of employment, prices, and economic growth.

Measuring Employment

The civilian *unemployment rate* measures how well we are achieving the goal of full employment. The unemployment rate is derived from a national survey of about 60,000 households. Each month the federal government asks the households about the employment status of household members aged 16 and older (the adult population). The survey puts each person in one of three categories: employed, unemployed, or not in the labor force. People who are at work (the employed) plus those who are not working but are willing and able to work and are actively looking for work (the unemployed) make up the *labor force*. The labor force is much smaller than the total adult population because many individuals are not willing or able to work.

Measuring Price Changes

A *price index* measures price changes in the economy. By using a price index, you can combine the prices of a number of goods and/or services and express in one number the average change for all the prices. The consumer price index, or CPI, is the measure of price changes that is probably most familiar to people. It measures changes in the prices of goods and services commonly bought by consumers.

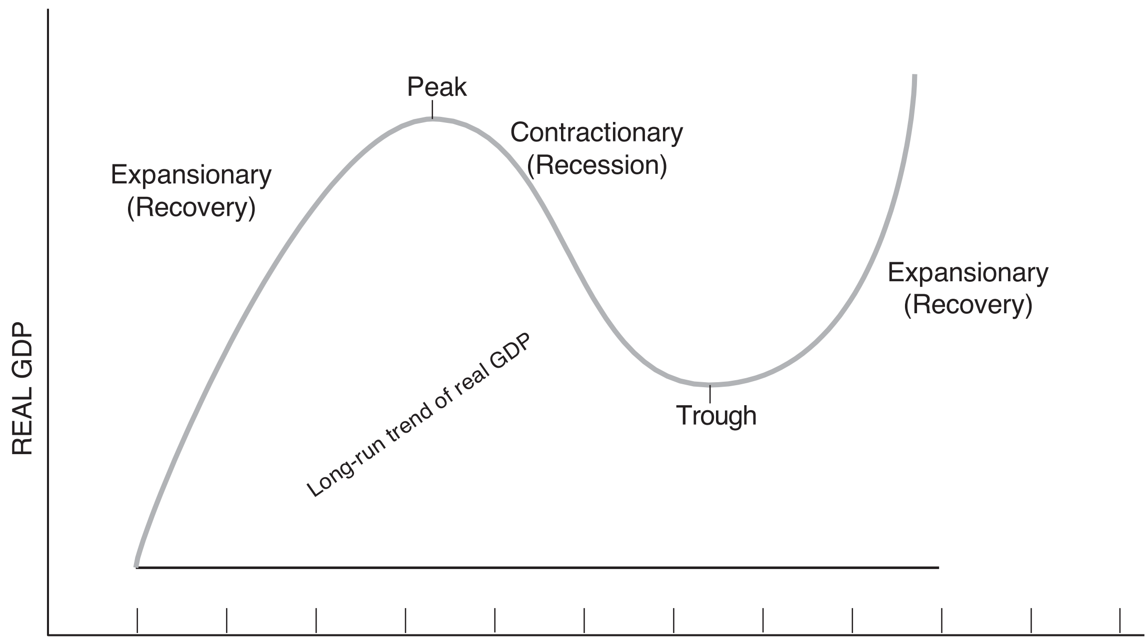
Measuring Short-Run Economic Growth

To measure fluctuations in output (short-run economic growth), we measure increases in the quantity of goods and services produced in the economy from quarter to quarter or year to year. The *gross domestic product*, or GDP, is commonly used to measure economic growth. The GDP is the dollar value at market prices of all final goods and services produced in the economy during a stated period. Real GDP is the GDP adjusted for changes in the price of goods.

The Business Cycle

The *business cycle* refers to the ups and downs in an economy. In the short run, the economy alternates between upturns and downturns as measured by the three macroeconomic indicators. Figure 1-10.1 shows a graph of the business cycle.

Figure 1-10.1
The Business Cycle



The curved line on Figure 1-10.1 shows a sample business cycle for an economy. The straight line represents the long-run trend of real GDP.

The business cycle can be divided into four phases:

1. ***Expansionary*.** Real output in the economy is increasing and the unemployment rate is declining. As the economic expansion continues, inflation may begin to accelerate. The early part of an expansionary phase is also called a recovery phase.
2. ***Peak*.** Real output, GDP, is at its highest point of the business cycle.
3. ***Contractionary***. Real output in the economy is decreasing, and the unemployment rate is rising. As the contraction continues, inflationary pressures subside. The later stage of a contractionary phase is also called a recession.
4. ***Trough***. The lowest point of real GDP reached during the business cycle is known as the trough. If the trough is particularly deep, it may be called a depression. A depression is an economic situation where the level of output falls to especially low levels and unemployment climbs to very high levels. There is no precise decline in output at which a serious recession becomes a depression. However, most business cycles do not end in a depression.

Draw a graph of a business cycle using unemployment as your measure of economic activity. That is, label the vertical axis with the unemployment rate. Make sure that you also label the horizontal axis. Label the phases of the business cycle on your graph. Remember that you are graphing the unemployment rate (rather than output) on your graph. Think about what happens to the unemployment rate during each phase of the business cycle!

On your graph, plot a point indicating where in the business cycle you think the economy is currently operating. Explain how you selected that location.

<u>**Excerpted from:**</u>

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