Economic Ups and Downs

News reports about the economy often refer to data concerning economic growth, recessions, inflation, and unemployment. Students (and adults) should understand this information and how it both reflects and affects peoples' and companies' decisions to buy, save, invest, and produce. These measures of national economic performance have also become major topics in national elections and political debates. This is a chance to build *your* understanding of the economy.

Gross Domestic Product

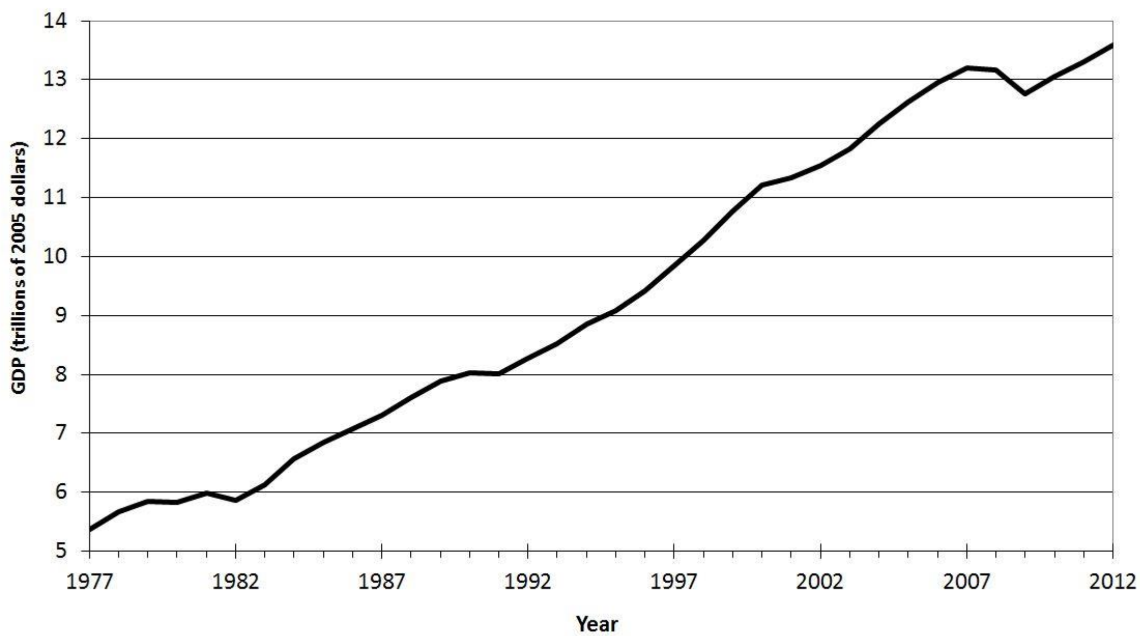
Gross domestic product (GDP) is a basic measure of a nation's economic output and income. It is the total market value, measured in dollars, of all final goods and services produced in the economy in one year. Only the goods and services produced within the borders of the United States are counted. If a U.S. company produces shoes in South Korea, then that output is not counted. If a Japanese company produces cars in Kentucky, that output is counted because it was produced within U.S. borders.

Only the value of final goods and services is counted – not the value of inputs used to make these goods and services. For example, economists count only the value of a loaf a bread in calculating GDP, not the value of the bread and the value of the wheat and flour used to make the bread. This helps to avoid double counting.

GDP is usually expressed as the annual value of output. GDP that is calculated as the output produced in a given year at the prices that prevailed in that year is called **Nominal GDP**. Because year-to-year changes in nominal GDP are affected by changes in the average price level (inflation), economists must eliminate the effects of price changes to determine changes in the level of output. Using nominal GDP, if output stayed the same but prices increased, it would appear that our economy grew, which would not be true. Therefore, economists and statisticians have developed ways to eliminate the price effects, to have a better account of how "real" output is changing – hence the term **Real GDP**.

One key factor on which an economy is judged is its ability to produce goods and services. Therefore, increases in real GDP are generally viewed as good economic performance, and decreases as poor performance.

Gross Domestic Product 1977-2012
(in trillions of 2005 dollars)



Source: Table B-2, Economic Report of the President, 2013, United States Government Printing Office, Washington: 2013.

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QUESTIONS

Use the information on page 1 to help you answer the questions below.

1. What is gross domestic product?

2. Would computers that are made by a U.S. company in Japan be counted in GDP? How about German cars produced in Ohio?

3. According to the chart on page 1, what was the GDP in 1992 (round to the nearest trillion dollars)? What does this mean in words?

4. What is the difference between nominal and real GDP?

5. Why is it important to use "real" GDP when measuring the economy?

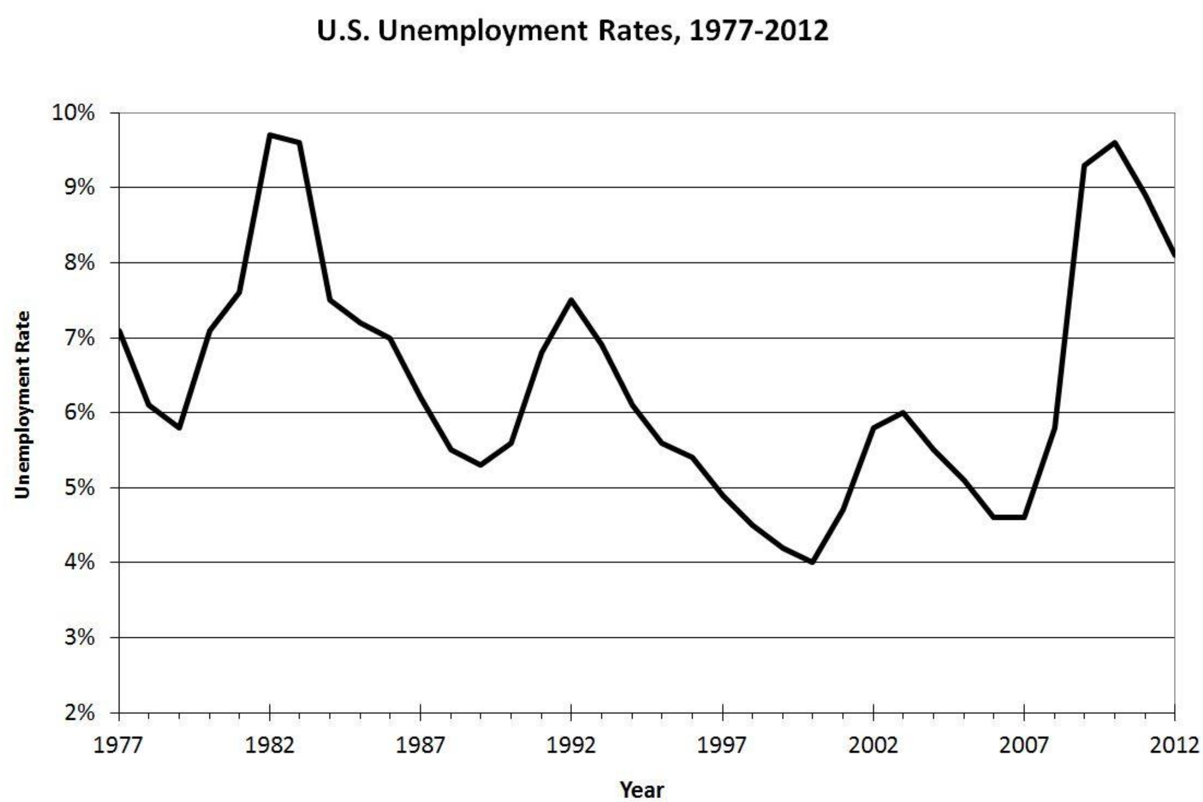
6. In 2012, real GDP was $13.6 trillion (see the chart on page 1). By comparison, nominal GDP for the same year was $15.7 trillion. Explain the difference between the two numbers.

Unemployment Rate

The unemployment rate is the percentage of the labor force that is willing and able to work, does not currently have a job, and is actively looking for work. The labor force is comprised of all people over the age of 16 who have jobs or who are not employed but have actively looked for a job in the past 30 days (it does not include individuals who are in the military or confined in institutions). Some people choose not to enter the labor force for a variety of reasons, such as age, illness, or choosing to engage in household production (such as raising their children) rather than taking a paying job. There are four major types of unemployment:

- Some people are unemployed simply because they are changing jobs, which is called frictional unemployment. They have quit one job and have not yet started a new one.
- Some people are between jobs because of seasonal fluctuations in demand, which is called seasonal unemployment. Summer jobs at pools and amusement parks are examples.
- Some people are unemployed because of changes in the skills employers expect their employees to have. This is called structural unemployment. For example, the widespread use of computers in many different kinds of jobs has left some people who do not have computer skills out of work, and others in low-paying jobs.
- In some periods, unemployment rates rise because of decreases in the level of national production. This is called cyclical unemployment, because it is caused by changes in the business cycle. For example, if the economy experiences a downturn and consumers are buying fewer cars, then some autoworkers will lose their jobs.

Most adult workers depend on the income from their jobs to maintain their economic well-being. Low unemployment rates are desirable, and high unemployment rates undesirable. Full employment is said to occur when there is only frictional unemployment in the economy.



Source: Table B-35, Economic Report of the President, 2013, U.S. Government Printing Office, Washington: 2013.

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QUESTIONS

Use the information on page 3 to help you answer the questions below.

7. What is the definition of the unemployment rate?

8. According to the chart on page 3, what was the unemployment rate in 2012 (approximately)? How does this compare to the past 35 years?

9. Who is included in the labor force? Are *you* considered to be in the labor force?

10. Describe the four types of unemployment.

11. Why is unemployment considered undesirable in the economy?

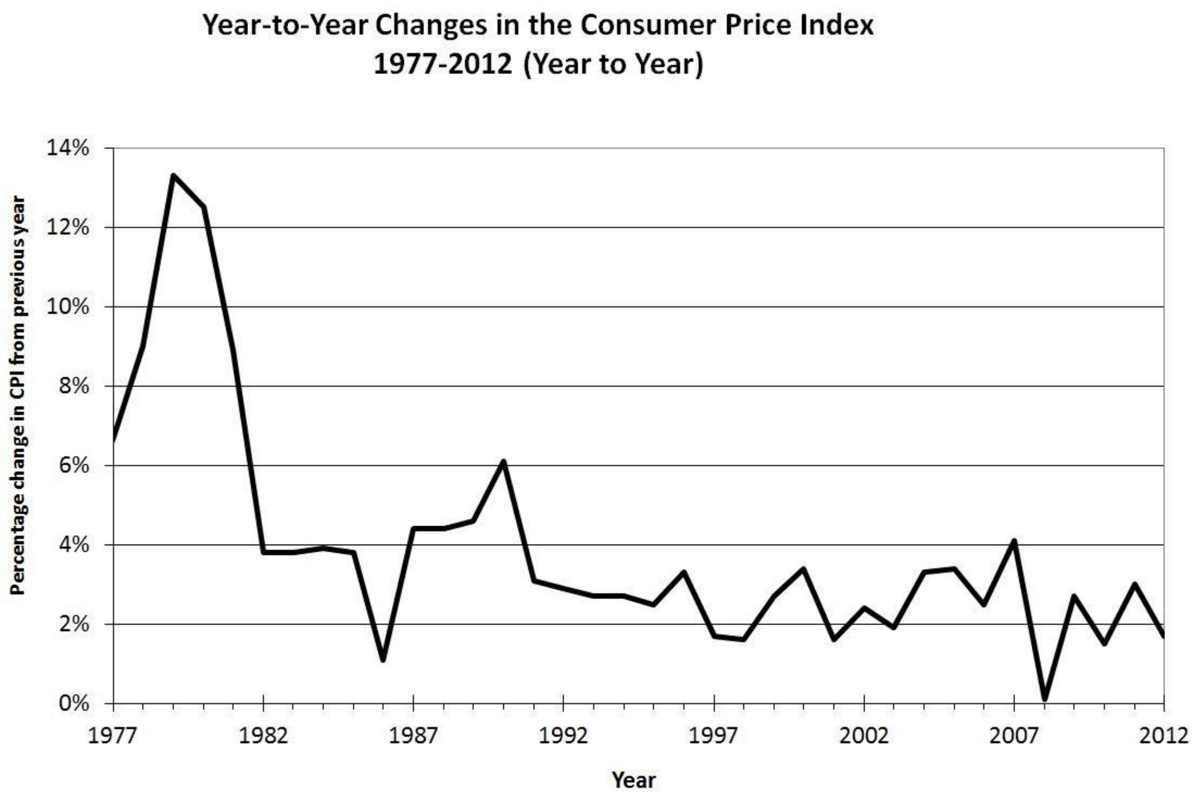
12. Why is there always going to be frictional unemployment in an economy?

Inflation Rate

Inflation is an increase in most prices; deflation is a decrease in most prices. The consumer price index (CPI) is the most commonly used measure of price-level changes. It can be used to compare the price level in one year with price levels in earlier or later periods. An increase in the overall price level (average prices) is called inflation; a decrease is called deflation. In times of inflation, some prices rise, some stay the same, and some decrease; but on average, prices are rising.

Both inflation and deflation are undesirable because they arbitrarily affect different people's purchasing power in different ways, depending largely on how difficult or easy it is for the dollar level of their income to change as the price level changes. The costs of inflation are different for different groups of people. Unexpected inflation hurts savers and people on fixed incomes; it helps people who have borrowed money at a fixed rate of interest.

People on fixed incomes are hurt by inflation because they can buy less with their income when prices are increasing. Debtors are harmed by deflation because as prices fall, they must repay their debts with dollars that will buy more goods and services than the dollars they borrowed.



Source: Table-B-64, Economic Report of the President, 2013, U.S. Government Printing Office, Washington: 2013.

QUESTIONS

Use the information on page 5 to help you answer the questions below.

13. What is the CPI? What does it measure?

14. What is inflation? What is deflation?

15. Why are inflation and deflation considered undesirable?

16. Who is hurt by inflation and deflation?

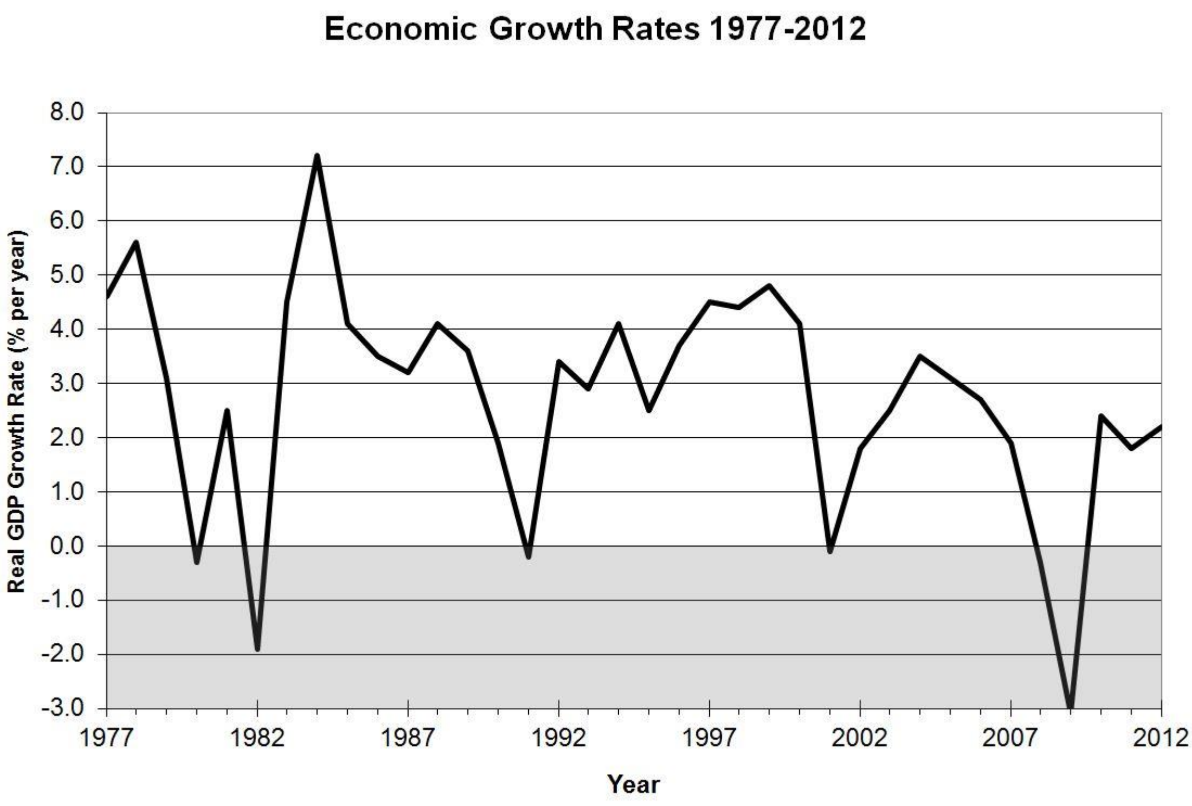
17. According to the chart on page 5, when did the highest rate of inflation occur? When did the lowest rate of inflation occur? What was the inflation rate in 2012?

Economic Growth

Economic growth is a sustained increase in real GDP. Historically, the economy has moved in cycles, or ups and downs, over time. These **Business Cycles** are the series of increases and decreases in real (inflation-adjusted) gross domestic product (GDP), a basic measure of national economic output. Business cycles typically consist of four phases: a period of expansion; a peak; a period of contraction; and a trough or bottoming-out period. Then another expansion begins, and the whole cycle is repeated.

- **Economic Expansion:** During expansionary periods, productive capacity and GDP increase, unemployment decreases, and wages and prices tend to rise.
- **Economic Contraction:** During contractionary periods, the reverse is usually true: there is typically higher unemployment; underutilized productive capacity; stagnant or declining GDP; and falling, constant, or at least slowly increasing wages and prices.

There is no economic law that says these cyclical patterns of macroeconomic activity have to happen, and during the past century, government policies have been used to try to moderate, if not eliminate, these cycles. But history and current events suggest that the business cycle is still with us, and probably will be for the foreseeable future.



Source: Table-B-4, Economic Report of the President, 2013, U.S. Government Printing Office, Washington: 2013.

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QUESTIONS

Use the information on page 7 to help you answer the questions below.

18. What is the business cycle?

19. Did the U.S. economy always grow in your lifetime? If not, when did it decline?

20. Real GDP increases (the growth rate is positive) during a period of economic expansion. During which years did the economy expand?

21. What was the longest period of economic expansion? What was the shortest period of economic expansion?

22. In what periods did the U.S. economy experience negative economic growth rates?

23. What is another name for periods of negative economic growth?