

CHAPTER 24

Economic Growth, Business Cycles, and Unemployment

Chapter Goals

- Discuss the history of macroeconomics, distinguishing Classical and Keynesian macroeconomists.
- Define *growth* and discuss its recent history.
- Distinguish a business cycle from structural stagnation.
- Relate unemployment to business cycles and state how the unemployment rate is measured.

What Is Macroeconomics?

Macroeconomics is the study of problems that affect the economy as a whole (lack of economic growth, recessions, unemployment, and inflation) and what to do about them.

Throughout the world, there are spirited debates about appropriate the macroeconomic policy.

To understand the nature of current policy debate, it's helpful to review the historical development of macroeconomics

The Historical Development of Macro: Classical versus Keynesian

In 1930's focus of macroeconomics moved to include short run as well as long run issues.

There were two types of economics:

1. Earlier economists who focused on long-run issues were called ***Classical economists***.
2. Economists who focused on the short run were called ***Keynesian economists***.

The Historical Development of Macro

Classical economists believe that business cycles are temporary glitches, and generally favor laissez-faire, or nonactivist policies.

Keynesian economists believe that business cycles reflect underlying problems that can be addressed with activist government policies.

By the 1980s, Classical and Keynesian economics merged into a new conventional macroeconomics.

Following the crash of 2008, the U.S. economy experienced **structural stagnation** – a period of protracted slow growth.

Two Frameworks: The Long Run and the Short Run

The long-run growth framework focuses on incentives for supply.

- Sometimes called supply-side economics.
- Issues of growth are considered in a long-run framework.

The short-run business cycle focuses on demand.

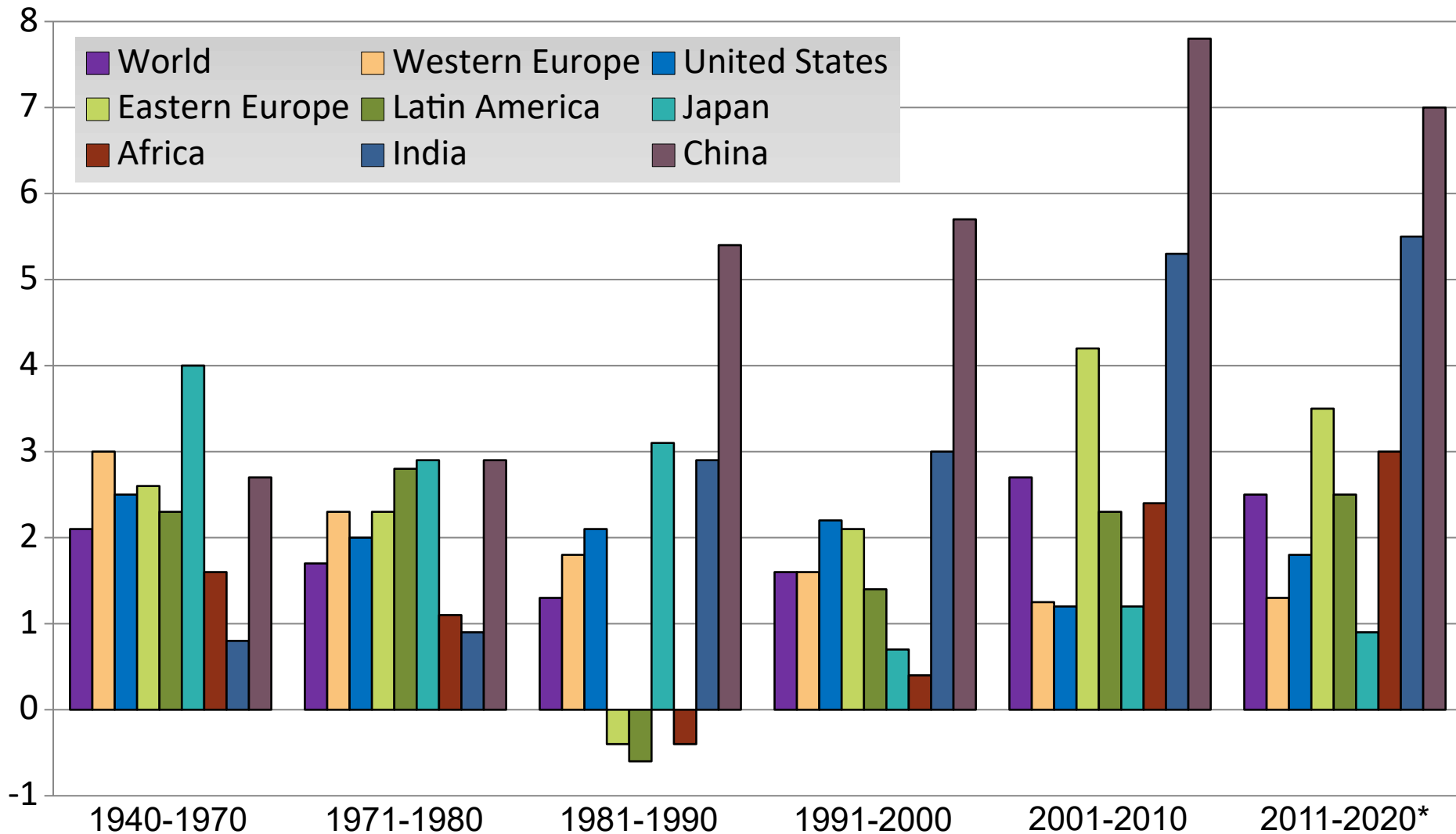
- Sometimes called demand-side economics.
- Business cycles are generally considered in a short-run framework.

Inflation and unemployment fall within both frameworks.

Two Frameworks: The Long Run and the Short Run

- The stark division between the short-run and the long-run frameworks is problematic.
- The economy is simultaneously in the long run and short run.
- Both frameworks have to be blended into a composite framework in which both supply and demand influence long-run and short-run forces.
- The long run is just a combination of short runs that cannot be separated.

Growth Rates around the World



*Estimates based on World Bank and government data and projections.
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Growth

Economists measure growth with changes in total output over a long period of time.

Potential output is the highest amount of output an economy can sustainably produce and sell using existing production processes and resources.

U.S. economic output has grown at an annual 2.5 to 3.5 percent rate, *the secular growth trend*, which represents the rise in potential output.

Growth

Per capita output is output divided by the total population.

Even if total output is increasing, the population may be growing even faster, so per capita output would be falling.

When the population is growing, per capita growth is lower than overall growth.

Example: If the population is growing at 1% and the economy is growing at 3%, per capita growth is 2%.

Business Cycles and Structural Stagnation

A **business cycle** is the upward or downward movement of economic activity that occurs around the growth trend.

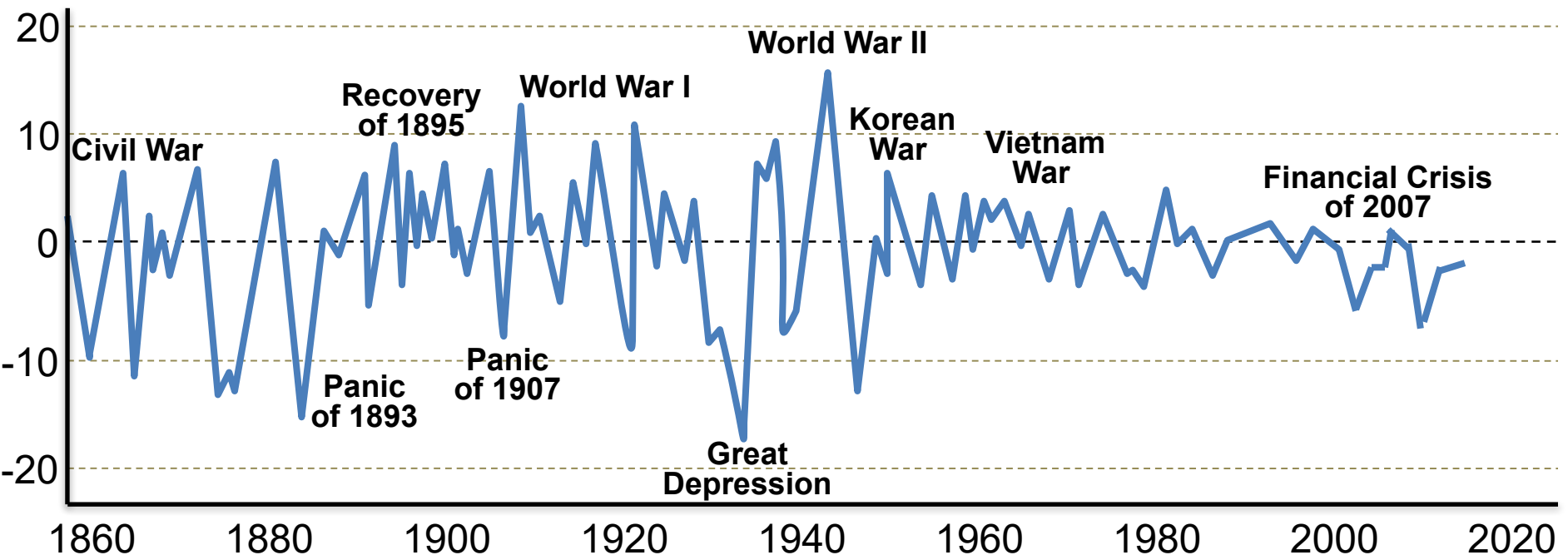
Classical economists argue that the government should just accept that business cycles occur and take a laissez-faire stance.

Keynesians economists argue that government can temper these fluctuations with policy actions.

U.S. Business Cycles

Percentage fluctuations
in real GDP around trends

Business cycles have always been
a part of the U.S. economic scene.

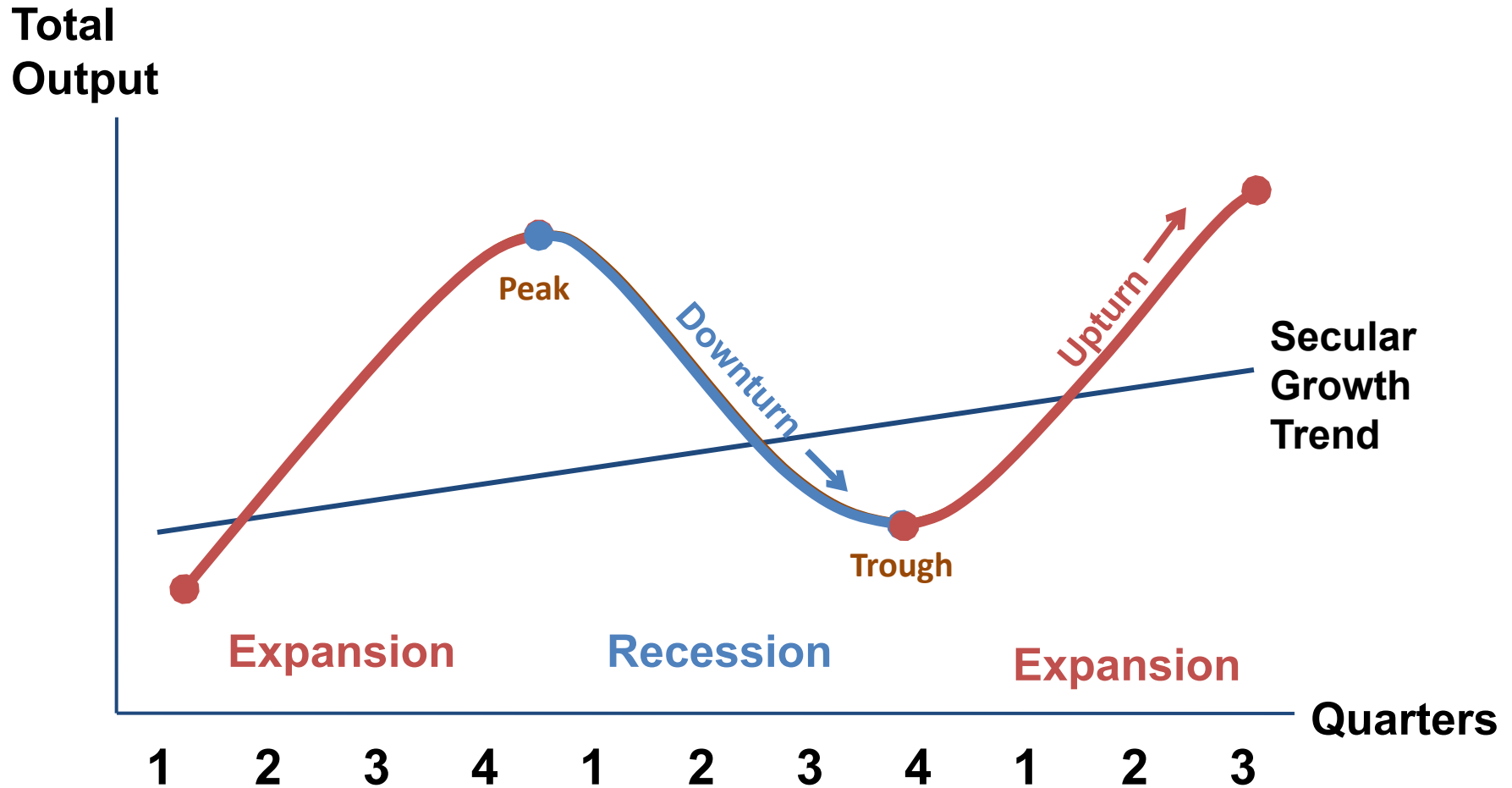


Describing the Business Cycle

Four phases of the business cycle: peak, downturn, trough, and upturn.

1. The top of a business cycle is called the **peak**.
2. Eventually the economy enters a **downturn** and may enter a *recession*.
 - A **recession** is a decline in real output that persists for more than two consecutive quarters of a year.
3. The bottom of a recession or depression is called the **trough**
4. As total output begins to expand, the economy comes out of the trough; economists say it's in an **upturn**.

Business Cycle Phases



Duration and Timing of Business Cycles Since 1854

Business Cycles	Duration (in months)	
	Pre-World War II (1854 – 1945)	Post-World War II (1945 – 2018)
Number	22	11
Average duration	50	66
Length of longest cycle	99 (1870-79)	128 (1991-2001)
Length of shortest cycle	28 (1919-21)	28 (1980-82)
Ave. length of expansions	29	59
Length of shortest expansion	10 (1919-20)	12 (1980-81)
Length of longest expansion	80 (1938-45)	120 (1991-2001)
Ave. length of recessions	21	11
Length of shortest recession	7 (1918-19)	6 (1980)
Length of longest recession	65 (1873-79)	18 (2007-2009)

Structural Stagnation

Structural stagnation is a downturn that leads to slow economic growth that prevents the economy from returning to its past trend for a long time unless the structure of the economy changes significantly.

- Unemployment is not due to temporary layoffs, as it is in a business cycle; but to longer-term changes.
- A depression is a deep and prolonged recession.

The distinction between a business cycle and structural stagnation goes to the heart of the modern macro policy debates.

Unemployment and Jobs

The **unemployment rate** is the percentage of people in the economy who are willing and able to work but who cannot find jobs.

Cyclical unemployment is that which results from fluctuations in economic activity.

Structural unemployment is that caused by the institutional structure of an economy or by economic restructuring making some skills obsolete.

Calculating the Unemployment Rate

The U.S. unemployment rate is determined by dividing the number of people who are employed by the number of people in the *labor force*.

Labor force – those people in an economy who are willing and able to do work.

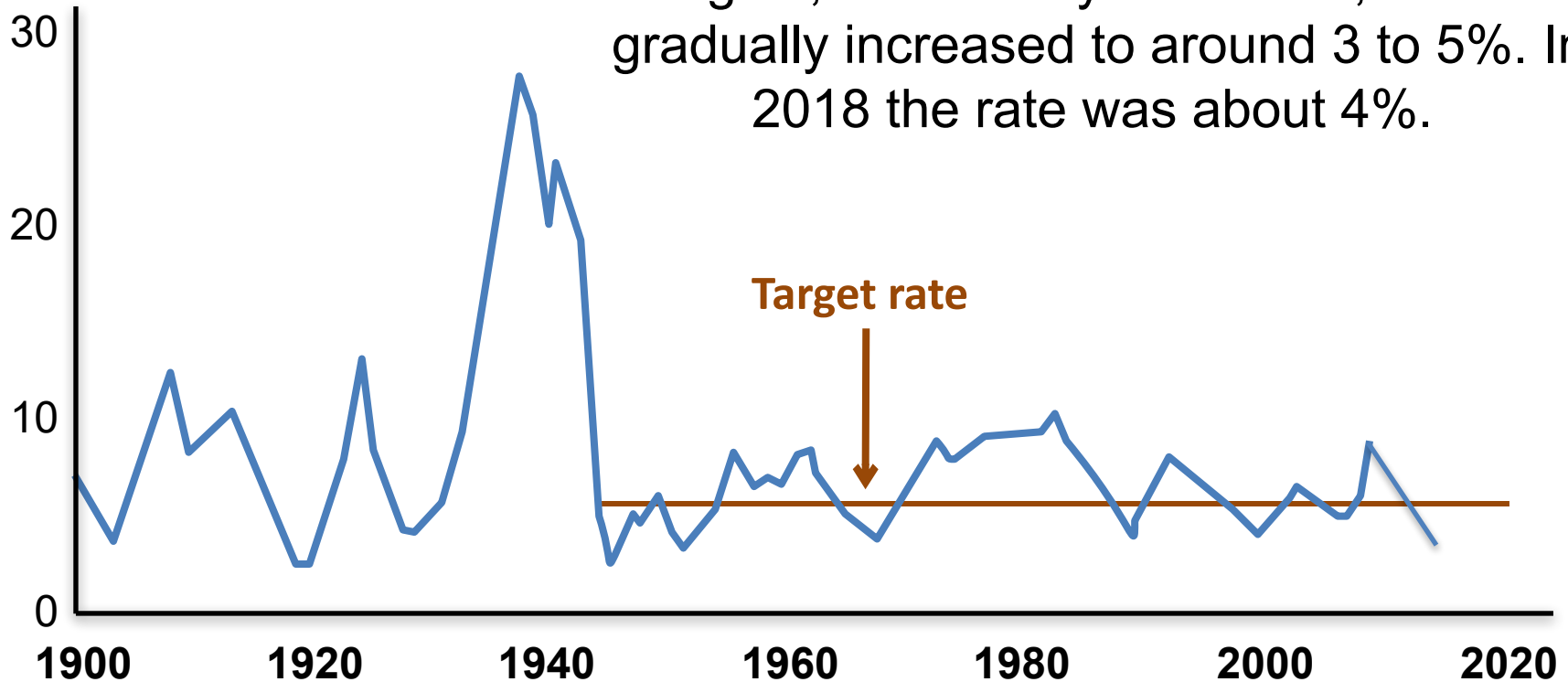
For example, if the total unemployed stands at 8 million and the labor force stands at 160 million, the unemployment rate is:

$$8 \text{ million} \div 160 \text{ million} = 0.05 \times 100 = 5\%$$

Unemployment Rate since 1900

Percentage of labor force unemployed

In the mid-1940s, the U.S. government started focusing on the unemployment rate as a goal, and initially chose 2%, but it was gradually increased to around 3 to 5%. In 2018 the rate was about 4%.



Unemployment as a Social Problem

- The Industrial Revolution changed the nature of work and introduced unemployment as a problem for society.
- There was a shift to wage labor and to a division of responsibilities.
- The Industrial Revolution changed how families dealt with unemployment.
- Early capitalism had an unemployment solution: *the fear of hunger*.

Unemployment as Government's Problem

As capitalism evolved, the fear of hunger was no longer an acceptable answer to unemployment.

In the Employment Act of 1946, the U.S. government took responsibility for unemployment.

Full employment is an economic climate where nearly everyone who wants a job has one.

Frictional unemployment is unemployment caused by people entering the job market and people quitting a job just long enough to look for and find another job.

Target Rate of Unemployment

The **target rate of unemployment** is the lowest sustainable rate of unemployment that policy makers believe is achievable given existing conditions.

The appropriate target rate of unemployment has been a matter of debate.

Chapter Summary (1 of 3)

Classical economists use a laissez-faire approach and focus on long-run growth while Keynesian economists use an active government approach and focus on short-run fluctuations.

Modern conventional economics has been a blend of the Keynesian and Classical approaches.

Growth is measured by the change in total output over a long period of time and the change in per capita output. Per capita output is output divided by the population.

While the secular trend growth rate has been 2.5 to 3.5 percent, some expect it to fall.

Chapter Summary (2 of 3)

Business cycles are fluctuations of real output around the secular trend growth rate. Phases of the business cycle include peak, trough, upturn, and downturn.

Structural stagnation is a cyclical downturn not expected to end soon without major changes to the structure of the economy.

Whether the economy is experiencing structural stagnation or a recession has significant implications for macroeconomic policy. Conventional macroeconomic policies can pull an economy out of a recession, but not out of a structural stagnation.

Chapter Summary (3 of 3)

Cyclical unemployment fluctuates with the business cycle. Structural unemployment is caused by economic restructuring.

The unemployment rate is calculated as the number of unemployed divided by the labor force.

The official measure of unemployment is based on judgments about who to count as employed.

The target rate of unemployment is the lowest sustainable rate of unemployment possible under existing institutions.