Chapter 26: Business Cycles, Unemployment, and Inflation

If we now understand what causes economic growth, why does the American economy still endure wide swings in economic performance? From the deep lows of the Great Depression to the dizzying growth during the Baby Boom to the stagflation of the 1970s to the Great Recession of the late 2000s, why does short-run economic performance vary so much? Chapter 26 explores macroeconomic instability, explaining the phases and causes of business cycles. This information lays the foundation for understanding macroeconomic models, competing theories, and government policies to address macroeconomic instability.

While the United States experiences long-run economic growth, it also faces short-run business cycles, which are systematic changes in real GDP. During a recession, real output and employment decline. As aggregate demand falls, firms reduce production and lay off workers, leading to an even greater decline in aggregate demand. During expansion, real output, employment, and prices rise as aggregate demand rises.

Business cycles are primarily caused by unexpected changes in the level of spending in the economy. These shocks can be caused by a number of factors, including irregular innovation, changes in productivity, changes in the money supply, political events, or financial instability.

Unemployment is the condition of not having a job, but actively seeking work. The unemployment rate is the number of unemployed divided by the civilian labor force. While the unemployment rate gives us useful information about economic performance, it fails to consider underemployed workers who can only find part-time and discouraged workers, who have given up looking for work.

Frictional unemployment includes those who are temporarily between jobs or seeking a first job, while seasonal unemployment results from changes in the weather or other seasonal factors; these types of unemployment always exist. Structural unemployment results from permanent changes in demand for products (e.g., automation replaces workers, or plants close because we instead rely on imports). Workers facing structural unemployment must retrain for new careers or move to where those jobs may still exist. Cyclical unemployment is layoffs due to downturns in the economy, which disproportionately strike the construction, auto, and other durable goods industries.

Full employment is achieved when there is no cyclical unemployment, because there is always some level of frictional and structural unemployment. It is important to recognize that full employment does not mean the complete elimination of unemployment; the natural rate of unemployment simply recognizes that the economy is producing at its potential output. The GDP gap is the difference between potential GDP and actual GDP. When actual GDP is lower than the potential GDP, unemployment rises.

Inflation is the increase in the general level of prices. The Consumer Price Index measures the prices of a market basket of goods purchased by the typical urban consumer. Demand-pull inflation is caused by an increase in demand (often due to an increase in the money supply) beyond the ability of firms to supply products. Cost-push inflation results from an increase in the cost of production, which causes firms to reduce supply and raise prices.

Inflation affects consumers by reducing the value of the dollar. Nominal income is the wage in current dollars, while real income removes the effects of inflation, measuring the value of what the paycheck will actually buy in the economy. Unanticipated inflation harms people on fixed incomes because they cannot buy as much with the same income. Savers are hurt because the real value of their savings declines. Creditors are hurt because the money repaid does not have the same purchasing power as the money that was originally loaned. Those who have cost-of-living adjustments (COLAs) in their salaries are unaffected by inflation, because their salaries increase with the rate of inflation, holding their purchasing power steady. Borrowers actually win from inflation, because they repay their debts with dollars that hold less value than the dollars they borrowed. Workers try to anticipate inflation by seeking COLAs or pay increases that match or exceed the inflation rate. Banks and other creditors anticipate inflation by adding the expected rate of inflation to the real interest rate, to determine the nominal interest rate they will charge their customers for loans.

Material from Chapter 26 is very likely to appear in several multiple-choice questions on the AP Macroeconomics Exam, and occasionally is part of a free-response question, as well. It is important to be able to calculate nominal GDP, real GDP, the unemployment rate, and the inflation rate. An understanding of the causes and results of business cycles for GDP, unemployment, and prices is critical. It is also vital to be able to identify the types of unemployment and give examples of each, and recognize the meaning of full employment. It is also important to recognize the causes of inflation, the effects of unanticipated inflation, and the means by which people try to protect themselves from inflation.