Lesson 5: Business Cycles and the Labor Market

Reading: Chapter 8

In this lesson we will:

- Discuss fluctuations in growth and in the labor market
- Explain what inflation is and list its harmful effects

On average, real GDP in the US grows by 3% annually. However, the economy moves in business cycles with periods of contractions and expansions (see figure 5-1).

- The US experienced recessions in 74, early 80s and in 92. These recessions were followed by long periods of growth. What were the last expansion and recessions?

An expansion is a period in which the economy grows at above the average rate and a contraction is a period in which the economy grows below the average rate of growth.

**Recession:** Two or more quarters in which real GDP decreases.

**Depression:** A prolonged recession with high levels of unemployment. Great depression?

Fluctuations in output change employment. The US Census Bureau surveys 60,000 households to obtain relevant information about employment.

**Eligible Population:** The number of individuals 16 or over who are not institutionalized or severely handicapped. Are retirees part of the eligible population?

**Labor Force:** The number of people who are either working or are actively seeking employment. The labor force is made up of employed and unemployed individuals.

- Some people are eligible to work but choose not to participate in the labor force. Why?

**Employed Individuals:** Individuals who are working for a firm or are self-employed.

**Unemployed Individuals:** Individuals who are not working but have made an effort to find a job in the last four weeks or are waiting for a call from a prospective employer.

- The Census misrepresents true unemployment in the economy because people lie on the survey (why?) and due to underemployment and discouraged workers. Explain
The Census Bureau reports the following rates:

- Labor Participation Rate = Labor Force/ Eligible Population
  - Labor Participation Rate has been slowly climbing since World War II. Why? Why might it decrease?
- Unemployment Rate = Number of Unemployed Individuals/ Labor Force
- Employment to Population Ratio = # Employed / Eligible Population. Currently 64%

**US Population** (290 million)

<table>
<thead>
<tr>
<th>Eligible Population</th>
<th>Labor Force</th>
<th>Employed</th>
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<td>(221.2 million)</td>
<td>(146.5 million)</td>
<td>(137.7 million)</td>
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**Figure 5-2:** Employment in US

Ineligible Population (69 million)

Non-participants (74.7 million)

Unemployed (8.8 million)

Employment and Unemployment

**Frictional Unemployment:** Results from people leaving their job (why?) or getting fired

**Structural Unemployment:** People who are unable to find a job because their skills are no longer needed. (Example?) Frictional and structural unemployment are natural.

**Cyclical Unemployment:** Fluctuations in unemployment caused by business cycles.

**Full Employment:** A situation in unemployment is at its natural level.

**Natural Level of Unemployment:** Frictional plus structural unemployment. About 5%.

**Inflation:** A continuous rise in prices that causes money to lose purchasing power.

\[
\text{Inflation}_t = \frac{(\text{CPI}_t - \text{CPI}_{t-1})}{\text{CPI}_{t-1}}
\]

An anticipated inflation will have the following effects:

- It will create a *menu cost* because firms will have to change prices on their menus, brochures, advertisement, etc. Do Internet firms have a larger or smaller menu cost?
- A very high level of inflation (hyperinflation) will cause people to buy things more quickly creating additional transactions costs. Why? Can you think of an example?

An unanticipated inflation is going to have several additional effects:

- If inflation is higher than anticipated, real wages (Nominal Wage/ Price Level) will fall, creating shortages in the labor market. Why a shortage?
- If inflation is higher than anticipated nominal interest rates will not be set high enough to compensate lenders for the falling value of money. Who will benefit in the short run? Why is high inflation detrimental for growth?
- People with fixed income or fixed-income assets (examples?) will suffer during periods of high inflation while people with variable-income assets tend to gain or at least stay as well off. Why do stock prices tend to go up during moderate inflations?

**Review:** pp. 186-87, problems 3, 6, 8, 10 & 13.