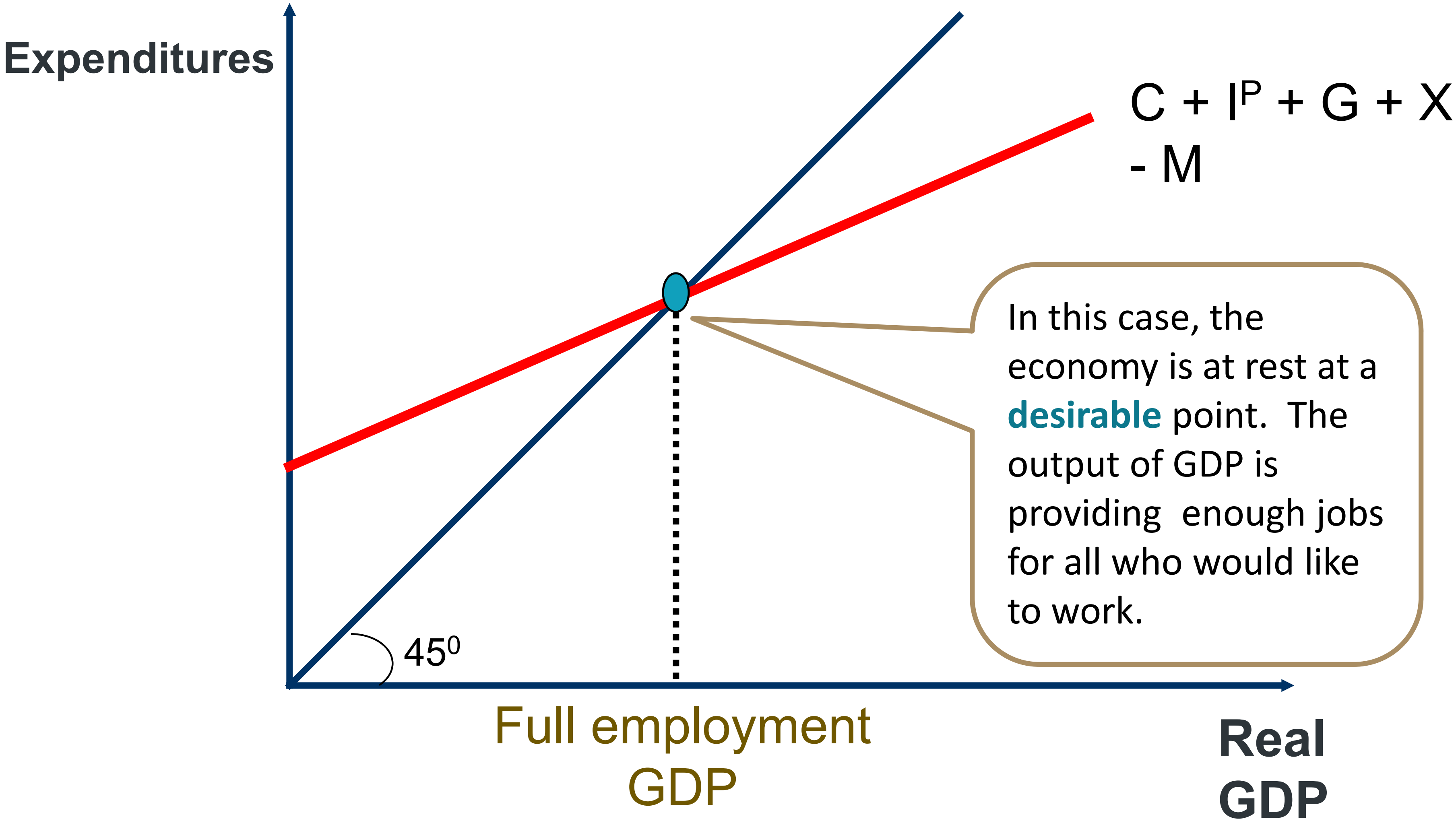
EC 202: Principles of Macroeconomics
Week 5: Aggregate Demand

1. Equilibrium GDP and Full Employment
2. The Great Depression
3. Business Cycles
4. Fiscal Policy

Equilibrium GDP and Full Employment

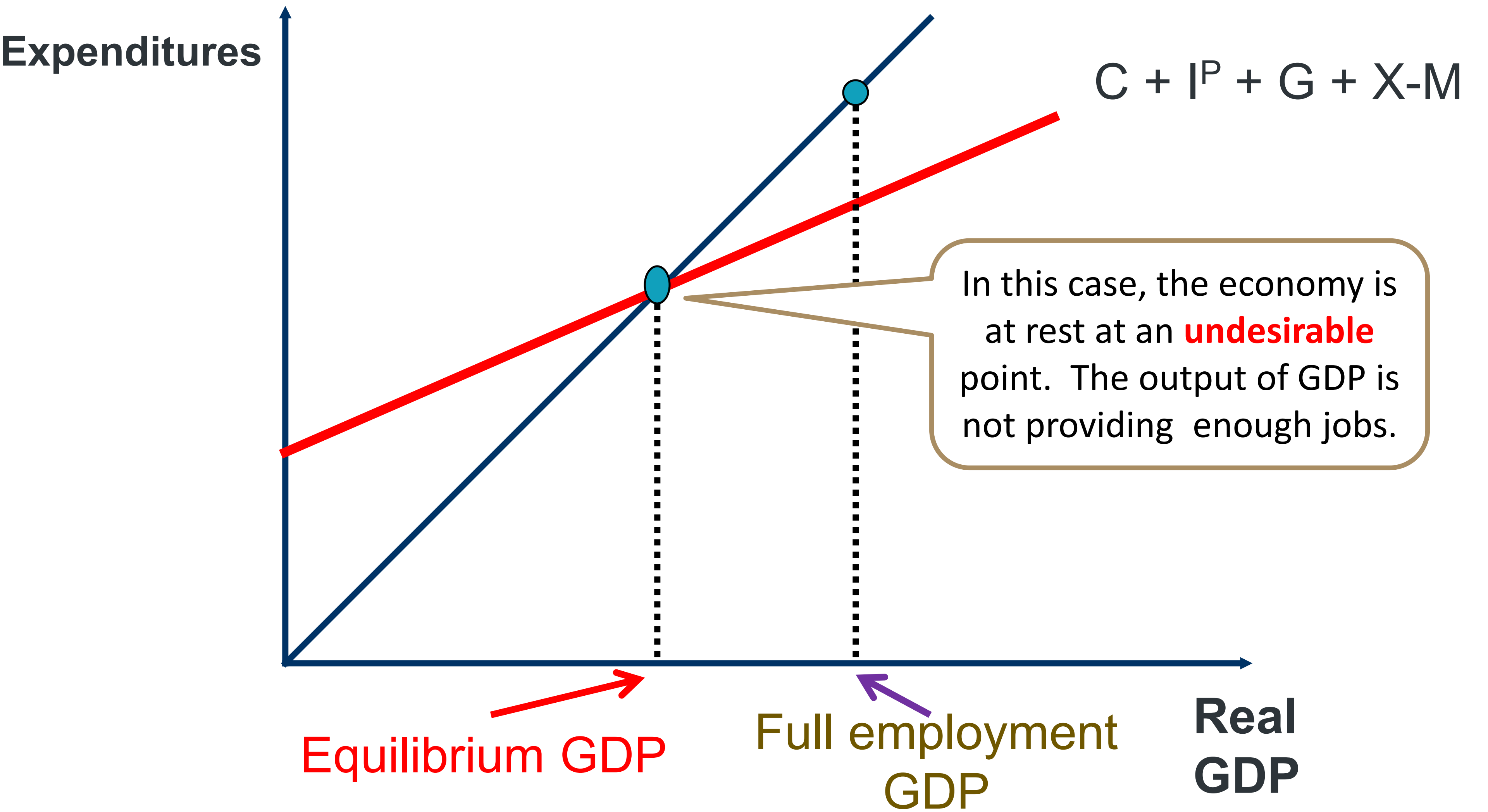
- What does Equilibrium GDP mean?
  - Equilibrium means that the economy has no tendency to change.
  - Does it **also** mean that the economy is at a level that will provide sufficient employment or income?

Equilibrium GDP and Full Employment



In this case, the economy is at rest at a **desirable** point. The output of GDP is providing enough jobs for all who would like to work.

Equilibrium GDP and Full Employment



Equilibrium GDP and Full Employment

1. Will the economy return to a **full employment equilibrium** on its own?
   - If so, how long will it take?
2. Is it possible for the economy to settle at an **underemployment equilibrium**?
   - If so, what is to be done?

Equilibrium GDP and Full Employment

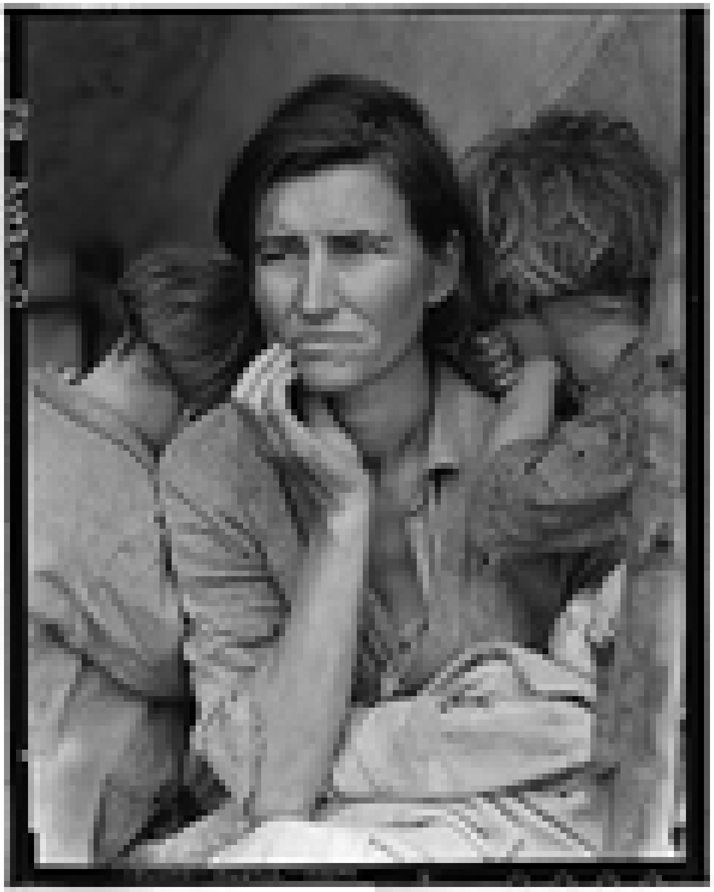
- Prior to the **Great Depression** in the 1930s, most economists believed that…
  - The economy would return to equilibrium on its own.
  - This equilibrium would be a full employment equilibrium.
  - The economy would respond fairly quickly., i.e. underemployment problems were temporary and would take care of themselves.

Equilibrium GDP and Full Employment

The Great Depression

- Began in 1929 and lasted until World War II began in 1941.
  - Output fell by 30%.
  - Prices fell to 1/5 previous levels.
  - Unemployment rose to 25%.

The Great Depression



Migrant Mother photograph, Dorothea Lange, Library of Congress
http://memory.loc.gov/ammem/fsowhome.html

The Great Depression

The Great Depression

Equilibrium GDP and Full Employment

The Great Depression

- Because of the widespread belief that economic problems were temporary and self-correcting, federal and state governments had no policies in place for such a severe economic downturn.
  - No unemployment compensation.
  - Only short-term or emergency aid was available and only in some cities or from private charities.

Equilibrium GDP and Full Employment

- Views changed after the Great Depression.

1. The economy *may return to full employment in the long-run.*
2. The economy *may not return to full employment equilibrium on its own*. It may be "stuck" at a low level of stagnation.
3. *In either case,* unemployment and/or inflation may cause considerable hardship for workers, businesses, farmers, etc.

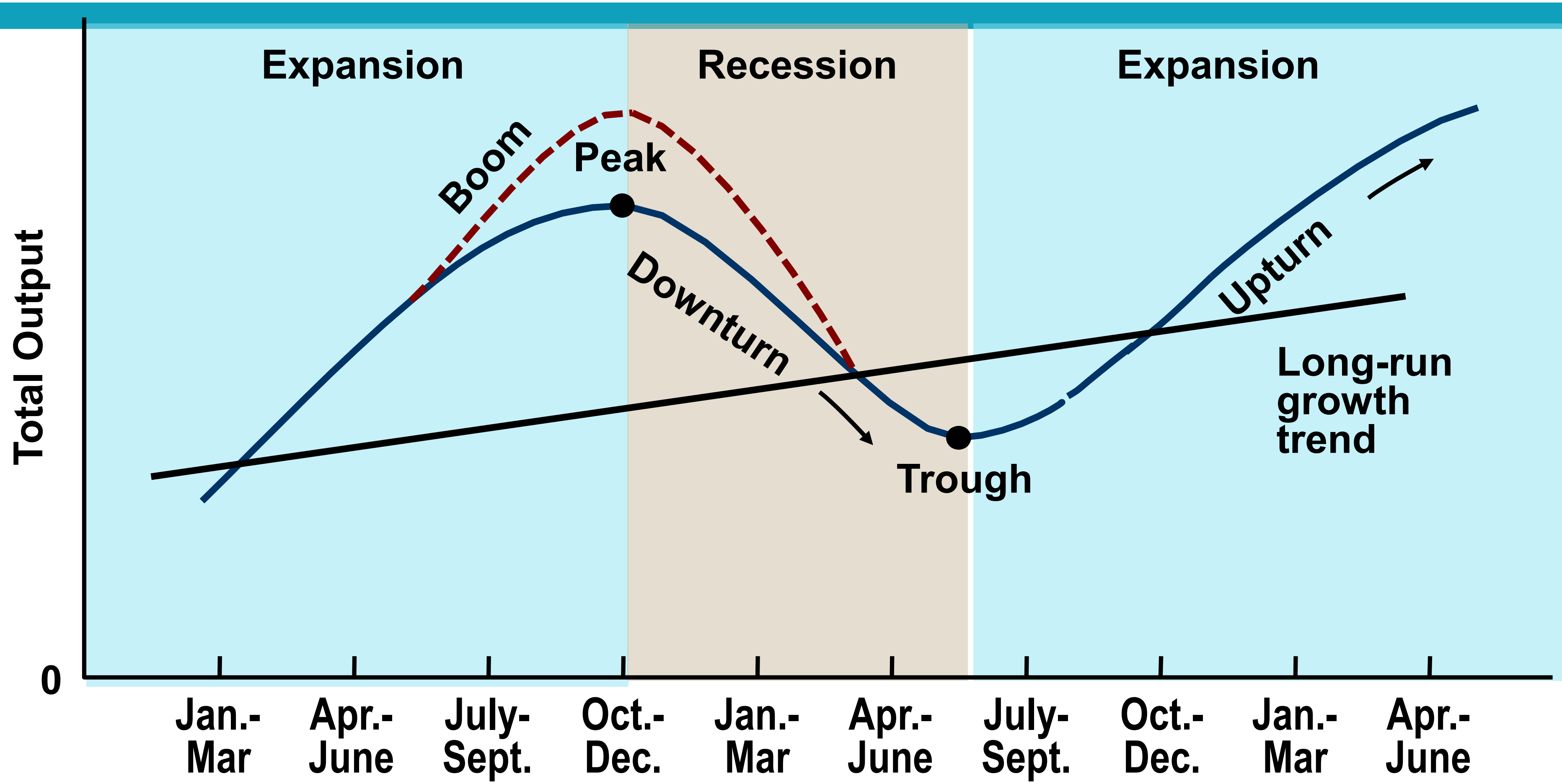
Business Cycles

- Economic fluctuations
  - Recession (or contraction)
    - A period in which the economy is growing at a rate significantly below normal
    - Output declines, occasionally sharply
    - Employment falls
  - Depression
    - A particularly severe or protracted recession

Business Cycles

- Economic fluctuations
  - Expansion
    - A period in which the economy is growing at a rate significantly above normal
    - Output rises quickly - faster than potential output
    - Employment rises
  - Boom
    - A particularly strong and protracted expansion

Business Cycles



Business Cycles

- Peak
  - The high point of economic activity prior to a downturn
- Trough
  - The low point of economic activity prior to a recovery
- Measurement
  - A recession is measured from the peak to the trough.
  - An entire business cycle is measured peak to peak.

Business Cycles

- Business cycles are measured officially by the National Bureau of Economic Research.
- Often, a statement about the beginning and end of a recession comes out several months or more *after the fact*.
- This lag occurs, because it's hard to know if you have reached the peak (or the trough) until after it has passed.

- http://www.nber.org/cycles/cyclesmain.html

Business Cycles

(National Bureau of Economic Research)

BUSINESS CYCLE REFERENCE DATES		DURATION IN MONTHS			
Peak	**Trough**	**Contraction**	**Expansion**	**Cycle**	
Quarterly dates are in parentheses		*Peak to Trough*	*Previous trough to this peak*	*Trough from Previous Trough*	*Peak from Previous Peak*
	December 1854 (IV)	--	--	--	--
June 1857(II)	December 1858 (IV)	18	30	48	--
October 1860(III)	June 1861 (III)	8	22	30	40
April 1865(I)	December 1867 (I)	32	46	78	54
June 1869(II)	December 1870 (IV)	18	18	36	50
October 1873(III)	March 1879 (I)	65	34	99	52
March 1882(I)	May 1885 (II)	38	36	74	101
March 1887(II)	April 1888 (I)	13	22	35	60
July 1890(III)	May 1891 (II)	10	27	37	40
January 1893(I)	June 1894 (II)	17	20	37	30
December 1895(IV)	June 1897 (II)	18	18	36	35
June 1899(III)	December 1900 (IV)	18	24	42	42

Business Cycles

(National Bureau of Economic Research)

BUSINESS CYCLE REFERENCE DATES		DURATION IN MONTHS			
Peak	**Trough**	**Contraction**	**Expansion**	**Cycle**	
Quarterly dates are in parentheses		*Peak to Trough*	*Previous trough to this peak*	*Trough from Previous Trough*	*Peak from Previous Peak*
September 1902(IV)	August 1904 (III)	23	21	44	39
May 1907(II)	June 1908 (II)	13	33	46	56
January 1910(I)	January 1912 (IV)	24	19	43	32
January 1913(I)	December 1914 (IV)	23	12	35	36
August 1918(III)	March 1919 (I)	7	44	51	67
January 1920(I)	July 1921 (III)	18	10	28	17
May 1923(II)	July 1924 (III)	14	22	36	40
October 1926(III)	November 1927 (IV)	13	27	40	41
August 1929(III)	March 1933 (I)	43	21	64	34
May 1937(II)	June 1938 (II)	13	50	63	93
February 1945(I)	October 1945 (IV)	8	80	88	93

*Great Depression

Business Cycles

(National Bureau of Economic Research)

<u>**BUSINESS CYCLE REFERENCE DATES**</u>		<u>**DURATION IN MONTHS**</u>			
Peak	**Trough**	**Contraction**	**Expansion**	**Cycle**	
Quarterly dates are in parentheses		*Peak to Trough*	*Previous trough to this peak*	*Trough from Previous Trough*	*Peak from Previous Peak*
November 1948(IV)	October 1949 (IV)	11	37	48	45
July 1953(II)	May 1954 (II)	10	45	55	56
August 1957(III)	April 1958 (II)	8	39	47	49
April 1960(II)	February 1961 (I)	10	24	34	32
December 1969(IV)	November 1970 (IV)	11	106	117	116
November 1973(IV)	March 1975 (I)	16	36	52	47
January 1980(I)	July 1980 (III)	6	58	64	74
July 1981(III)	November 1982 (IV)	16	12	28	18
July 1990(III)	March 1991(I)	8	92	100	108
March 2001(I)	November 2001 (IV)	8	120	128	128
December 2007 (IV)	June 2009 (II)	18	73	91	81

Business Cycles

- Business cycles are an inherent part of any market economy.
  - i.e. the existence of recessions and expansions is *normal.*
  - The problem arises when the fluctuations are severe.
- The most severe downturn in US history was the Great Depression in the 1930s.
- The second worst downturn was the Great Recession that officially ended in 2009.

Employment Act of 1946

The Employment Act of 1946

After World War II, fears that the Depression and mass unemployment would return led to the Employment Act of 1946.

The Employment Act of 1946 establishes a responsibility for the Federal government to “promote maximum employment, production, and purchasing power.”