Learning Objectives

Upon completion of this unit, students should be able to:

1. Explain the gross domestic product.
2. Discuss the circular flow of income and expenditure.
3. Assess the limitations of national income accounting.
4. Explain how to account for price changes.
5. Discuss the effects of unemployment on the economy.
6. Discuss the effects of inflation on the economy.

Unit Summary

Unit IV examines macroeconomic activity of nations in more detail. Several indicators are used to analyze the flow of money through an economy. These variables include the gross domestic product (GDP), inflation, unemployment rate, and the consumer price index. An understanding of each of these concepts is important for private and public administrators.

\[ GDP = C + I + GS + (X-M) \]

One of the most important indicators of economic activity is gross domestic product. GDP is a measurement of the market value for all final goods and services a nation produces annually. In Unit III, the link between GDP and national income was presented. Given this relationship, it is intuitive that a higher national GDP generally means more income for its citizens. Gross domestic product tends to be an excellent indicator of a nation’s economic development from year to year, and it is often used to compare nations across the globe to determine wealth, living standards, and more generally, economic status.
In Chapter 7, the circular flow diagram from Unit I is made complex through the addition of GDP and its elements. By adding government consumption and expenditure, and the interaction of financial institutions, a more realistic depiction of the flow of resources through an economy is presented. Finally, the complex flow of resources is opened to other world economies through exports and imports.

Since World War II, prices in the United States have risen steadily. An increase in the overall price level for a nation is called inflation. Inflation has a strong impact on the economy because it means the nation’s currency is depreciating, the goods sold in the nation are becoming more expensive, and the citizen’s wages are getting relatively smaller. In addition, inflation affects gross domestic product. If GDP increased by 10% from one year to another, but inflation increased 11%, then GDP did not increase at all. Additional definitions of GDP are used to describe this situation. In this case, nominal GDP increased by 10%, but real GDP, which is nominal GDP adjusted for inflation, decreased by 1%. In economics, it is important to compare variables, and adjust for relative changes, in order to accurately assess a nation’s growth.

The unemployment rate is also a very important indicator for national economies, especially since it pertains directly to people’s livelihoods. The unemployment rate is simply a percentage of the labor force that is unemployed. The labor force consists of all teenage and adult citizens eligible for employment that desire to work. When all members of the labor force are employed, the economy is said to be at full employment. (Full employment can be defined in more detail, but the aforementioned definition will suffice for this unit.)

Unemployment can occur for various reasons. Frictional unemployment occurs as workers move between jobs. (Friction occurs from movement between two objects.) Structural unemployment occurs when workers are replaced by improvements in capital. (An ATM machine is a structure, and it has replaced many bank tellers.) Seasonal unemployment occurs when workers are only needed for a certain time in the year. (Santa Clause impersonators may be seasonably unemployed for 10 months of a year.) The final form of unemployment is cyclical unemployment, which is a result of movements in the business cycle.

The rate of inflation is of equal importance for national economies to measure and track. Inflation often occurs when a nation approaches full employment. Conversely, if the demand for goods in a nation begins to decline, a business may decide to slow production. Some employees could lose their jobs, and deflation, or an overall decline in prices, may occur. In this situation, the economy will decelerate as unemployment rises and price levels fall. The result will be a lower gross domestic product for the nation.

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Inflation can manifest itself in several forms. Two sources of inflation that are unusually important are demand-pull and cost-push inflation. Generally, both of these forms of inflation occur due to substantial macroeconomic fluctuations. For example, cost-push inflation may happen with an extreme reduction in the availability of oil. Oil is used to transport most goods so a reduction would cause the cost of all goods to rise, thus causing cost-push inflation. Demand-pull inflation can happen if the government increases public spending. By putting more money into the economy, the nation’s income increases, and the demand for goods will rise. Unfortunately, so will prices.

A nation’s economy is a complex system but an understanding of the processes involved is essential for future business owners, government officials, educators, and responsible citizens alike. Unit IV provides a foundation for this understanding.