Chapter 12: Gross Domestic Product and Growth
Section 2

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Objectives

1. **Identify** the phases of a business cycle.
2. **Describe** four key factors that keep the business cycle going.
3. **Explain** how economists forecast fluctuations in the business cycle.
4. **Analyze** the impact of business cycles in U.S. history.

Key Terms

ECONOMICS

- **business cycle:** a period of macroeconomic expansion followed by one of macroeconomic contraction
- **expansion:** a period of growth as measured by a rise in real GDP
- **economic growth**: a steady, long-term increase in real GDP
- **peak**: the height of an economic expansion, when real GDP stops rising
- **contraction**: a period of economic decline marked by falling real GDP

Key Terms, cont.

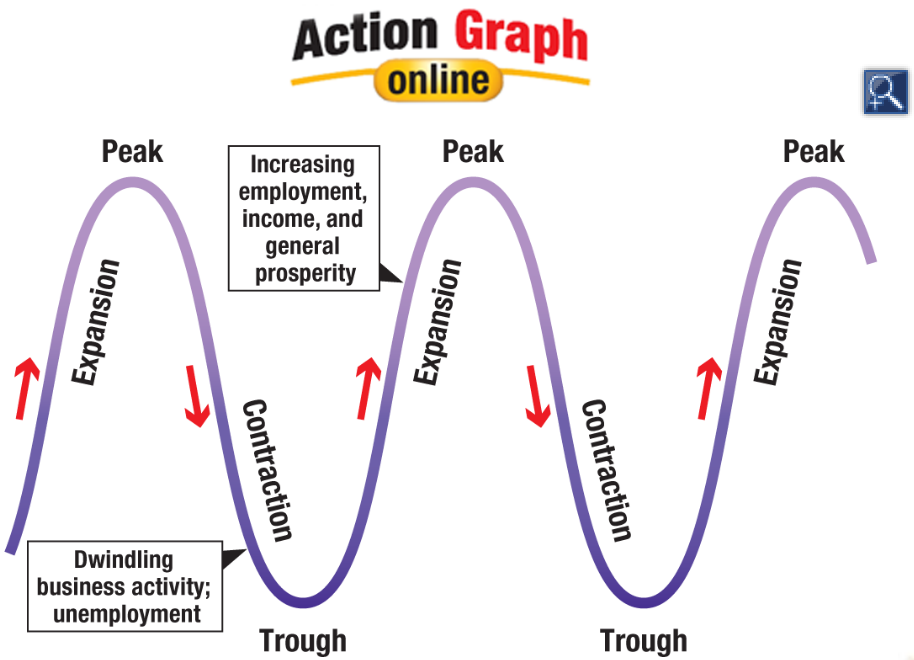
- **trough**: the lowest point of an economic contraction, when real GDP stops falling
- **recession**: a prolonged economic contraction
- **depression**: a recession that is especially long and severe
- **stagflation**: a decline in real GDP combined with a rise in the price level
- **leading indicators**: a set of key economic variables that economists use to predict future trends in a business cycle

Introduction

- What factors affect the phases of a business cycle?
  - Periods of economic growth
  - Periods of economic decline
  - Business investments
  - Interest rates and credit
  - Consumer expectations
  - External shocks

Phases of a Business Cycle

- Checkpoint: What are the four phases of a business cycle?
  - Business cycles are made up of major changes in real GDP above or below normal levels.
  - The business cycle consists of four phases:
    - Expansion
    - Peak
    - Contraction
    - Trough



Contractions

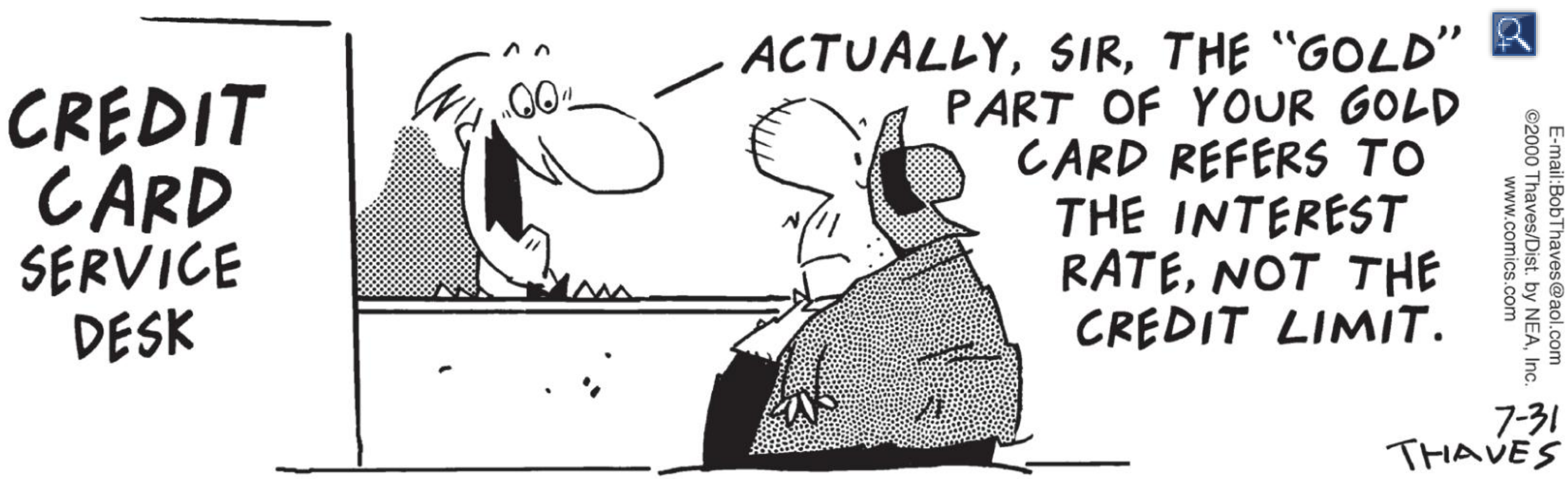
- There are three types of contractions, each with different characteristics.
  - A **recession** is a prolonged economic contraction that generally lasts form 6 to 18 months and is marked by a high unemployment rate.
  - A **depression** is a recession that is especially long and severe characterized by high unemployment and low economic output.
  - **Stagflation** is a decline in real GDP combined with a rise in price level, or inflation.

Business Investment

- Business cycles are affected by four main economic variables.
- Business Investment
  - When the economy is expanding, business investment increases, which in turn increases GDP and helps maintain the expansion.
  - When firms decide to decrease spending, the result is a decrease in GDP and the price level.

Interest Rates and Credit

- Consumers often use credit to buy new cars, home, electronics, and vacations. If the interest rates on these goods rise, consumers are less likely to buy them.
- The same principle holds true for businesses who are deciding whether or not to buy new equipment or make large investments.

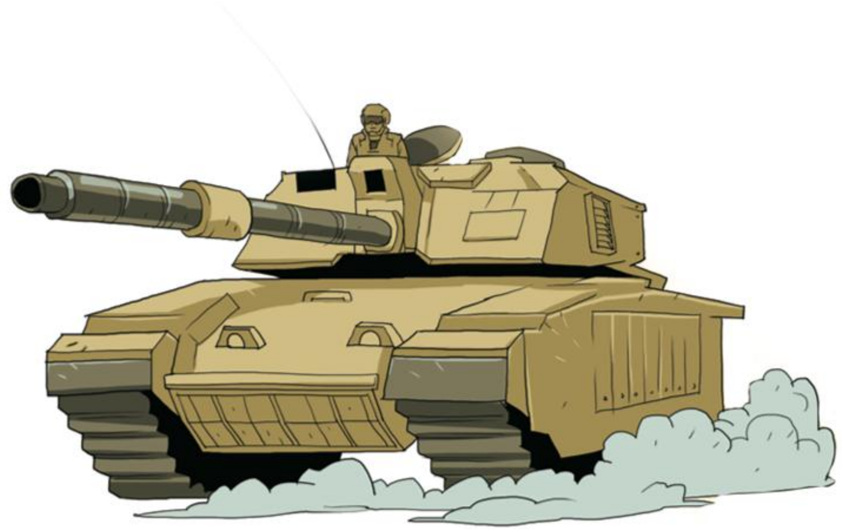


Consumer Expectations

- If people expect that the economy is going to start to contract, they may reduce spending.
- High consumer confidence, though, will lead to people buying more goods, pushing up GDP.

External Shocks

- Negative external shocks, like war breaking out in a country where U.S. banks and businesses have invested heavily, can have a great effect on business, causing GDP to decline.
- Positive external shocks, like the discovery of large oil deposits, can lead to an increase in a nation's wealth.



Business Cycle Forecasting

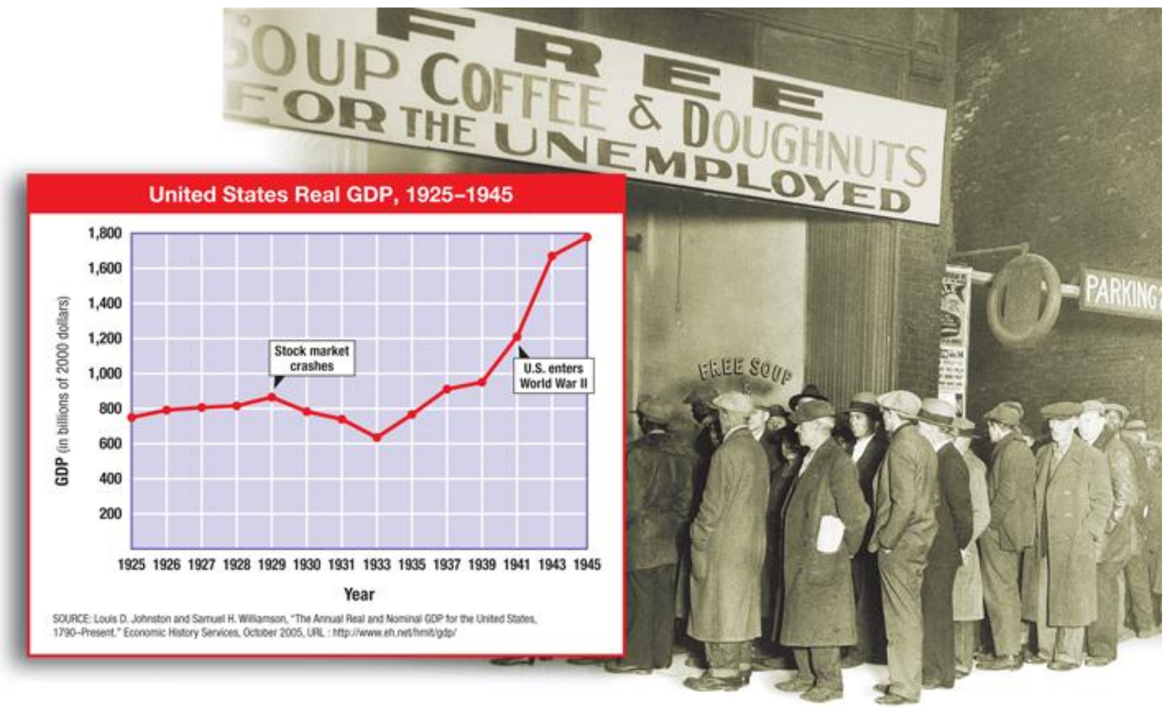
- Checkpoint: Why is it difficult to predict business cycles?
  - To predict the next phase of a business cycle, forecasters must anticipate movements in real GDP before they occur.
  - Economists use leading indicators to help them make these predictions.
    - The stock market is a leading indicator.
    - Today, the stock market turns sharply downward before a recession.

The Great Depression

- Before the 1930s, many economists believed that when an economy declined, it would recover quickly on its own.
- The Great Depression changed this belief and led economists to consider the idea that modern market economies could fall into long-lasting contractions.
- Not until World War II, more than a decade later, did the economy achieve full recovery.

The Great Depression, cont.

- Declining GDP and high unemployment were two major signs of the Great Depression, the longest recession in U.S. history.
  - In what year did the Great Depression hit its trough?
  - How long did it take GDP to return to its pre-Depression peak?



Later Recessions

- OPEC Embargo
  - In the 1970s, the United States experienced an external shock when the price of gasoline and heating fuels skyrocketed as a result of the OPEC embargo on oil shipped to the United States.
- The U.S. economy also experienced a recession in the early 1980s and another brief one in 1991, followed by a period of steady economic growth.
- The attacks of 9/11 led to another sharp drop in consumer spending in many service industries.

The Business Cycle Today

- The economy began to grow slowly in 2001 and was surging by late 2003 with GDP growing at a rate of 7.5 percent over three months.

- However, growth slowed again as a result of high gas prices in 2006.
  - The sub-prime mortgage crisis caused further decline in 2007.
  - The stock market decline in 2008 appeared to be bringing the country into yet another recession.

Review

- Now that you have learned about the factors that affect the phases of a business cycle, go back and answer the Chapter Essential Question.
  - How do we know if the economy is healthy?