Chapter 1 :: The Economic Environment
Section 1.3~ Healthy Economies

Jump Start

The Busy B's Bakery got off to a good start. Several stores began selling Busy B cookies, and customers loved them. Orders increased and additional workers had to be hired. But then something unexpected happened: the economy slowed down. Many people lost their jobs, and because of that, the demand for products, such as Busy B cookies, decreased. For a while, Brianna and Brittney could hardly meet expenses. They had to lay off their workers. By cutting other business costs, they managed to stay in business until the economy recovered and the demand for their cookies increased. Although their business was good once again, should they look ahead and make plans for another downturn in the economy?

Economic Measurements

One of the goals of an economy is to be healthy—to have a steady growth in the production of goods and services. The health of a nation's economy is measured in several ways. High employment and a low rate of business failures are two indicators of a healthy economy.

An important part of life is measuring performance. The grade you receive is a measurement of your performance in class. A point guard in basketball who averages 21 points and 6 assists per game is a valuable player. An increase in your savings account is a measurement of good money management.

Three measurements used in looking at the health of an economy are gross domestic product, labor productivity, and inflation and deflation.

Gross Domestic Product

Gross domestic product (GDP) is the total dollar value of all goods and services produced in an economy in one year. It is a basic measurement of how an economy is doing. Information is collected from producers, and data is gathered on the value of what is being produced, called *output.* GDP includes four major categories.

1. Consumer spending for food, clothing, and housing
2. Business spending for buildings, equipment, and supplies
3. Government spending to pay employees and to buy supplies and other goods and services
4. The exports of a country less the imports of the country

If GDP increases each year, that is a sign of good economic health. It means the economy is growing steadily. With GDP growing, there are more jobs and consumer satisfaction is increasing. Prices increase over the years. To make comparisons accurate, a *base year* is established. Prices in any year are then compared with that base year. Otherwise, price increases can make it appear that GDP is increasing when output actually is not increasing. When the effect of price increases is taken out, this result is called *constant dollar* or *real GDP.*

The following table shows GDP for the fictitious nation of Technoland which produces Techlatts, used in energy-saving ecoblatts. Technoland's GDP is shown in current and constant prices. Note the differences in the figures for GDP in each of those categories. Current price GDP takes into account inflation and has higher GDP figures. *GDP per capita,* which is another way to measure economic growth, is the total GDP divided by the total population.

GDP COMPARISONS OF TECHNOLAND					
Year	**Number of Techlatts Produced**	**Current Price per Techlatt**	**GDP at Current Prices**	**Prices Adjusted to 2000**	**GDP at Constant Prices**
2000	100,000	$1.50	$150,000	$1.50	$150,000
2005	150,000	$2.00	$300,000	$1.50	$225,000
2010	200,000	$3.00	$600,000	$1.50	$300,000

Labor Productivity

The measurement of the number of items produced per worker is called *productivity.* An increase in productivity is an important source of economic growth. Improvements in the quality of capital equipment, worker training, and management techniques can result in greater output from the same number of workers.

In a simple model, productivity is computed by dividing the *output* (the number of units produced) by the *input* (the number of hours worked). For instance, if Technoland's workforce produced 4,000 units of Techlatts in a total of 80 worker hours, productivity per worker would be 50 per hour.

$$\text{Productivity} = \frac{\text{Number of units produced (output)}}{\text{Number of hours worked (input)}}$$

$$\text{Productivity} = \frac{\text{4,000 units}}{\text{80 hours}} = 50$$

With additional training and/or improvement in equipment, the productivity figure would be expected to increase.

Worker productivity is the productivity of one worker. Worker productivity varies from one worker to another and is a measure of an individual worker's performance.

Inflation and Deflation

A sustained increase in the general level of prices for goods and services is called *inflation.* A controlled, general rate of inflation is one of the goals of governments. A moderate increase in prices and wages is a sign of a healthy, growing economy.

Inflation can be a problem if it increases too rapidly. There have been periods of time when our country has had very high rates of inflation. Government, businesses, and individuals continued to increase their spending, and prices continued to rise. Even though wages—the price paid for labor—increase during inflation, prices of goods and services often rise faster, so workers never catch up.

Comparing the relative value of wages and prices of one year with another is difficult because of inflation. For instance, in the early 1900s, eggs cost 14 cents per dozen, sugar cost 4 cents per pound, and coffee was only 15 cents per pound. Sound good? Well, at the same time, the average worker in our country earned 20 cents per hour, so the buying power of wages was low.

The opposite of inflation is deflation. *Deflation* is a sustained decrease in the general level of prices for goods and services. It usually occurs during a period when the economy is not doing well and workers are being laid off. Prices of products decrease, but people have less money to buy them. The most notable deflationary period in our country was during the Great Depression of the 1930s. Between 1929 and 1933, prices dropped about 25 percent. But people definitely were not better off. They could not afford to buy things even at the much lower prices.

The Business Cycle

When people talk about the economy, they speak about good times and bad times. They discuss prices, new businesses, and new job creation. They also discuss businesses that close and jobs that are lost. Changes in the economy impact peoples' lives. Over the decades, economists have learned that an economy has ups and downs, good times and bad.

The movement of the economy from one condition to another and back again is called a **business cycle.** Business cycles are the recurring ups and downs of GDP. Business cycles have four phases: prosperity, recession, depression, and recovery.

Prosperity

At the high point of the business cycle, consumers enjoy prosperity. *Prosperity* is the phase where most people who want to work are employed and businesses produce goods and services in record numbers. Wages are good. The demand for goods and services is high. People are optimistic about the economy and feel good about themselves. Prosperity does not go on forever, however. Eventually the economy cools off and activity slows down.

Recession

An economy slowing down signals a recession. *Recession* is a phase of the business cycle where demand for goods and services begins to decrease, production decreases, unemployment begins to increase, and GDP growth slows down. This phase often means a decrease in sales for expensive goods, such as automobiles. When automobile companies cut back on production, businesses that supply steel, fabrics, and other goods needed in

producing automobiles are affected. This ripple effect often causes smaller supply firms to go out of business. A decrease in the use of economic resources and a lower demand for goods and services signal this phase of the business cycle.

Depression

If a recession gets worse and spreads throughout the economy, the result is depression. *Depression* is a phase of the business cycle marked by a prolonged period of unemployment, weak sales of goods and services, and business failures. GDP falls rapidly during a depression. During the Great Depression of the early 1930s, the unemployment rate reached 25 percent. Many people could not afford to provide for even their basic needs. Clothing and food were given out in “bread lines” at churches and charitable organizations. Depression described the emotional mood of the people as well.

Recovery

A welcome phase of the business cycle is known as recovery. *Recovery* is the phase in which unemployment begins to decrease, demand for goods and services begins to increase, and GDP begins to rise again. People are employed once again, and they buy more goods and services. When businesses begin to meet the increasing demand for their products, they hire more workers. More wages being earned increases demand for goods and services. Recovery leads an economy into the most-welcome business cycle, prosperity.

Think Critically

1. Why is it important to have a constant dollar GDP figure rather than one that just shows current prices? In what ways is GDP important to you?
2. Why is moderate inflation good for the economy? Would it be desirable to have no inflation and no increase in prices or wages? Explain.
3. What part of the business cycle is the U.S. economy in at the present time? What signs do you see that indicate this particular phase?
4. **Business Math** Compute the worker productivity for each worker in the table below.

PRODUCTIVITY AFTER TRAINING			
Worker	**Hours Worked**	**Units Produced**	**Productivity**
Alex	15	750	
Maria	20	900	
Natasha	15	50	

Compare the results with the results for “productivity before training” in the Business Math Connection on the PowerPoint.

Which worker had the most improvement in productivity?

What does this exercise reveal about productivity?