

7.20: Health of the Economy

Learning Objectives

- Explain the use of GDP as an economic indicator

Economic Indicators



When you go to the doctor with the flu, one of the first things they do is they take your temperature. If your temperature is much above 98.6 degrees, they declare you to have a fever. Depending on your other symptoms, they may prescribe you medication to bring down your fever and fight the infection. How might you (or an economist) take the temperature of an economy, so to speak, to check for health or sickness? No single measurement like body temperature will give a complete picture, so instead economists rely on what are called economic indicators. An **economic indicator** is a statistic that provides valuable information about the economy. There is no shortage of economic indicators, and trying to follow them all would be an overwhelming task. Many different economic indicators are tracked in order to evaluate the economy in different ways or from different perspectives.

Statistics that report the status of the economy a few months in the past are called **lagging economic indicators**. One such lagging indicator is the average length of unemployment. If unemployed workers have remained out of work for a long time, we may infer that the economy has been slow. Indicators that predict the status of the economy three to twelve months into the future are called **leading economic indicators**. For example, the number of building permits issued is often a good way to assess the strength of the housing market. An increase in this statistic—which tells us how many new housing units are being built—indicates that the economy is improving because increased building brings money into the economy not only through new home sales but also through sales of furniture and appliances to furnish these homes. If such a leading indicator rises, the economy is likely to expand in the coming year. If it falls, the economy is likely to slow down.

Governments, businesses, and investors use economic indicators as a measure of how well an economy is meeting its goals.

Economic Goals

The world's market-based economies all share the following three main goals:

1. Growth
2. High employment
3. Price stability

Economic indicators reveal information about how the economy is doing relative to these goals. Let's look more closely at growth, employment, and price stability and the means used to measure them.

Growth

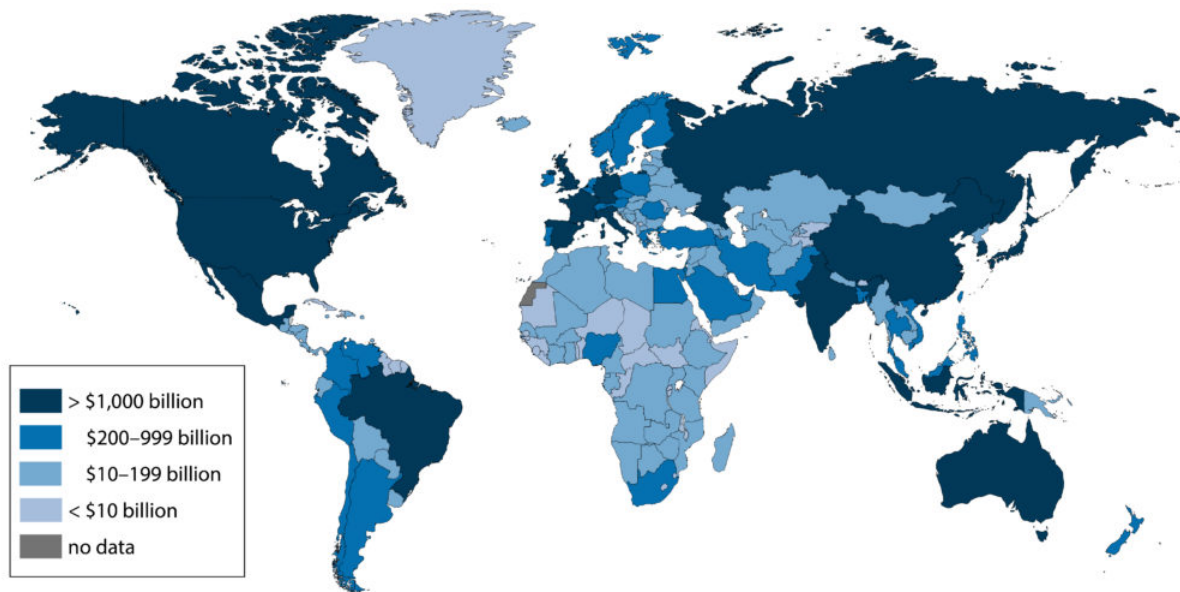
The size of a nation's overall economy is typically measured by its **gross domestic product (GDP)**, which is the value of all officially recognized final goods and services produced within a country in a given period of time (usually a year). **Intermediate goods** (goods such as steel or plywood that are used as inputs in the production of other goods) are not included because they would cause double-counting to occur. GDP only refers to goods produced within a particular country. For instance, if a firm is located in one country but manufactures goods in another, those goods are counted as part of the manufacturing country's GDP, not the firm's home country. BMW is a German company, but cars manufactured in the U.S. are counted as part of the U.S. GDP.

The measurement of GDP involves counting up the production of millions of different goods and services—smart phones, cars, music downloads, computers, steel, bananas, college educations, and all other new goods and services produced in the current year

—and summing them into a total dollar value. This task is straightforward: Take the quantity of everything produced, multiply it by the price at which each product sold, and add up the total. In 2014, the U.S. GDP totaled \$17.4 trillion, the largest GDP in the world.

When a country's GDP grows, its economy is likewise considered to be expanding and growing. Increases in GDP are expressed as a percentage rate of increase, and they are often expressed as GDP per capita (per person). In order to calculate GDP per capita, the GDP is divided by the total population of a country. Also, when measuring economic growth, agencies use “real GDP,” which is adjusted for inflation. If the GDP figures were not adjusted for inflation, then steep rises in prices (inflation) could be mistaken for growth. Likewise, if GDP is not expressed per capita, then a country like India with a massive population would always be regarded as having one of the largest, fastest growing economies. The map, below, shows the world's GDP per capita by country.

Nominal GDP of Countries in 2017 (According to the IMF)



If you want more information, you can download the [IMF dataset of 2017 Nominal GDP by Country](#) or you can [visit the IMF Website for more information on country GDP](#).

High Employment

A country's employment level—as defined by cyclical, structural, and frictional unemployment—is one of the most important economic indicators. Unemployment has an enormous impact on business operations, from the largest multinational corporation to the smallest mom-and-pop gift shop. When people are unemployed, even temporarily, they stop spending money on nonessential goods and services, which slows down the economy. Such a slowdown leads to a decrease in revenue for businesses, which causes companies to lay off more workers, which means more unemployed people who can't purchase their goods and services. Because of this spiraling effect, unemployment is a closely watched economic indicator.

There are three important categories of unemployment levels that need to be understood in order to evaluate the effect of employment levels on overall economic performance: cyclical unemployment, structural unemployment, and frictional unemployment.

Cyclical unemployment occurs when there is not enough total demand in the economy to provide jobs for everyone who wants to work. When demand for most goods and services falls, less production is needed, and, as a result, fewer workers are needed; wages generally stay put and do not fall to meet the equilibrium level, and mass unemployment results. With cyclical unemployment, the number of unemployed workers exceeds the number of job vacancies, so that even if full employment were attained and all open jobs were filled, some workers would still be without jobs. In economics, **full employment** is the level of employment rate where there is no cyclical unemployment.

Structural unemployment occurs when a labor market is unable to provide jobs for everyone who wants to work because there is a mismatch between the skills of the unemployed workers and the skills needed for the available jobs. Structural unemployment may develop or increase as a result of persistent cyclical unemployment: If an economy suffers from long-lasting low aggregate demand, many of the unemployed may become disheartened, and their skills (including job-searching skills) become rusty and obsolete. The implication is that sustained high demand may lower structural unemployment. Seasonal unemployment can be seen as a kind of structural unemployment, since it's a type of unemployment that is linked to certain kinds of jobs (construction work or migratory farm work, for instance).

Frictional unemployment is the time period between jobs when a worker is searching for or transitioning from one job to another. It's sometimes called "search unemployment" and can be voluntary depending on the circumstances of the unemployed individual. Frictional unemployment is always present in an economy, so the level of *involuntary* unemployment is really the unemployment rate minus the rate of frictional unemployment. Frictional unemployment exists because both jobs and workers are heterogeneous, and a mismatch can result between the characteristics of supply and demand. Such a mismatch can be related to any of the following reasons:

- Skills
- Payment
- Worktime
- Location
- Seasonal industries
- Attitude
- Taste

There can be a range of other factors, too. New entrants (such as graduating students) and reentrants (such as former homemakers) can also suffer a spell of frictional unemployment. Workers as well as employers accept a certain level of imperfection, risk, or compromise, but usually not right away; they will invest some time and effort to find a better match. This is in fact beneficial to the economy, since it results in a better allocation of resources.

? Practice Questions

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Price Stability

The third major goal of all economies is maintaining price stability. Price stability occurs when prices remain largely unchanged and there isn't rapid inflation or deflation. **Inflation** is a rise in the general price level of goods and services during a period of time; **deflation** is a decrease in the general price level of goods and services. Price stability means that the average price for goods and services either doesn't change or changes very little. Most economists believe that steady levels of low-to-moderate inflation are ideal.

As inflation pushes prices higher (slowly), businesses increase their revenues, people put more money into the system, and assets increase in value, which are all positive economic indicators. This is why economists are careful to say that a steady level of *low* inflation is a positive sign in the economy. As inflation rises, prices rise and values rise, which both contribute to an increase in GDP—another measure of the health of an economy. During the past three decades, inflation has been relatively low (well below 10 percent) in the U.S. economy, and this has contributed to the general stability of the economy. Inflation doesn't always increase slowly. A sudden, rapid rise in inflation is called **hyperinflation**. Argentina has recently (and repeatedly) experienced runaway inflation, with consumer prices increasing in some cases by 50 percent in a matter of days.

Figure 7.20.1, below, shows the U.S. inflation rate from 1910 to 2012. Looking back at the twentieth century, there have been several periods when inflation caused the price level to rise at double-digit rates, but nothing has come close to hyperinflation.

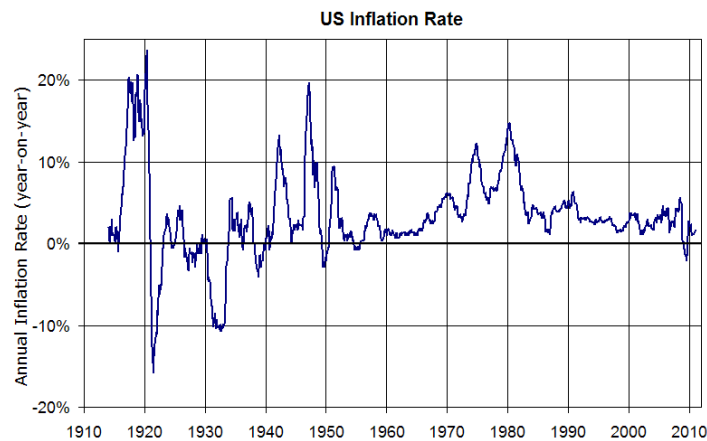


Figure 7.20.1: U.S. inflation rate from 1910 to 2012

The most commonly cited measure of inflation in the United States is the **consumer price index (CPI)**. The CPI measures changes in the price level of consumer goods and services purchased by households. The CPI in the United States is defined by the Bureau of Labor Statistics as “a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.”

The CPI market basket represents all the consumer goods and services purchased by urban households. Price data are collected for over 180 categories, which BLS has grouped into 8 major groups. These major groups, with examples of categories in each, are as follows:

- Food and beverages (ham, eggs, carbonated drinks, coffee, meals and snacks);
- Housing (rent of primary residence, fuel oil, bedroom furniture);
- Apparel (men’s shirts and sweaters, women’s dresses, jewelry);
- Transportation (new vehicles, gasoline, tires, airline fares);
- Medical care (prescription drugs and medical supplies, physicians’ services, eyeglasses and eye care, hospital services);
- Recreation (television sets, cable TV, pets and pet products, sports equipment, admissions);
- Education and communication (college tuition, postage, telephone services, computer software and accessories);
- Other goods and services (tobacco and smoking products, haircuts and other personal care services, funeral expenses)

The CPI simplifies the measurement of changes in prices over time. By selecting an appropriate reference base and setting the average index level for that time period equal to 100, it is possible to compare this month’s (or last year’s) price index level with the reference base period or to any other time period. The current standard reference base period is 1982–1984=100. That is, all price changes are measured from a base (100) that represents the average index level of the 36-month period encompassing 1982, 1983, and 1984.^[1]

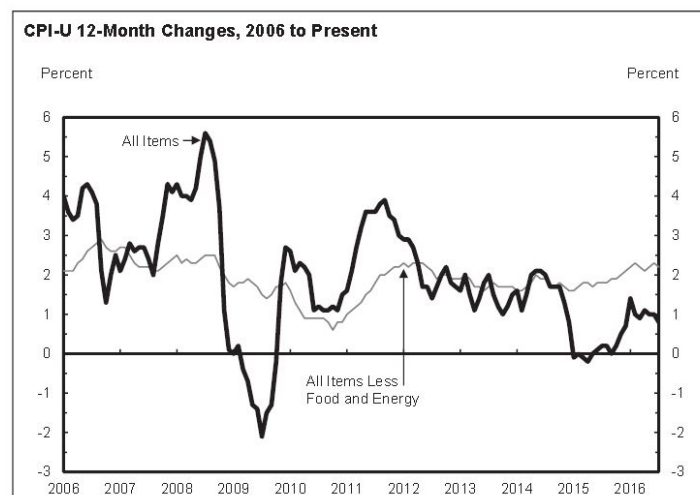


Figure 7.20.2: Consumer Price Index 2006 to 2016 (Source: US BLS)

Table 7.20.1. Consumer Price Index 2006 to 2016

Year	All Items (CPI)	All Items Less Food and Energy (CPI)
2006	4%	2%
2007	2%	3%
2008	4%	3%
2009	negative 2%	2%
2010	2%	1%
2011	1%	1%
2012	4%	2%
2013	3%	2%
2014	2%	2%
2015	0%	2%
2016	1%	2%

Consumer Confidence Index

Another important economic indicator is the **consumer confidence index**. This indicator measures the degree of optimism that consumers feel about the overall state of the economy and their personal financial situation. How confident people feel about the stability of their incomes determines their spending activity and therefore serves as one of the key indicators for the overall shape of the economy. In essence, if the economy expands, causing consumer confidence to be higher, consumers will be making more purchases. On the other hand, if the economy contracts or is in bad shape, confidence is lower, and consumers tend to save more and spend less. A month-to-month diminishing trend in consumer confidence suggests that in the current state of the economy most consumers have a negative outlook on their ability to find and retain good jobs.

The ability to predict major changes in consumer confidence allows businesses to gauge the willingness of consumers to make new purchases. As a result, businesses can adjust their operations and the government can prepare for changing tax revenue. If confidence is dropping and consumers are expected to reduce their spending, most producers will tend to reduce their production volumes accordingly. For example, if manufacturers anticipate that consumers will reduce retail purchases, especially for expensive and durable goods, they will cut down their inventories in advance and may delay investing in new projects and facilities. The government will get ready for the reduction in future tax revenues. On the other hand, if consumer confidence is improving, people are expected to increase their purchases of goods and services. In anticipation of that change, manufacturers can boost production and inventories. Large employers can increase hiring rates. Government can expect improved tax revenues based on the increase in consumer spending.

Consumer confidence is formally measured by the Consumer Confidence Index (CCI), a monthly release designed to assess the overall confidence, relative financial health, and spending power of the average U.S. consumer. The CCI is an important measure used by businesses, economic analysts, and the government in order to determine the overall health of the economy.

? Practice Question

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1. Source: US Bureau of Labor Statistics <http://www.bls.gov/cpi/>↵

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