LECTURE FIVE - PART THREE

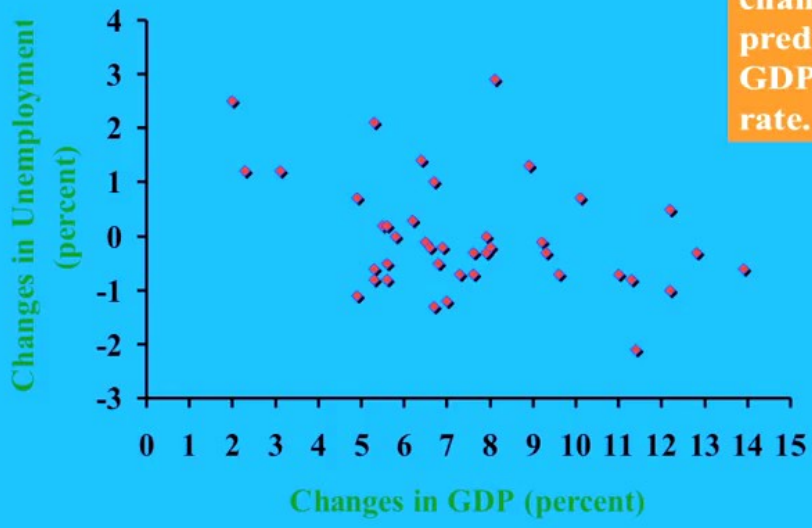
	Lost Output		
	Average Unemployment Rate (%)	GDP loss ($, billion, real)	As percent of GDP during the period
Great Depression (1930-1939)	18.2	4,400	38.5
Sluggish fifties (1954-1960)	5.2	70	0.3
Oil and inflation crises (1975-1984)	7.7	2,100	3.6

Okun's Law

- The previous table uses *Okun's Law*.
- Through data analaysis, Okun found an important "co-movement" between output and unemployment.

When GDP falls, unemployment rises!

Okun's Law



Graph shows unemployment changes well predicted by GDP growth rate.

Okun's Law: For every 2% GDP falls, unemployment rises by 1%.

Question

- Assume GDP begins at 100% of its potential and falls to 98%.
- Further assume unemployment rate is 6%.

QUESTION
How will that rate change?

Answer

- According to Okun's Law, the unemployment rate will rise from 6% to 7%.

REMEMBER OKUN'S LAW
For every 2% actual GDP falls relative to potential GDP, the unemployment rate rises by 1 percentage point.

An Historical Example of Okun's Law

- 1979: Unemployment rate = 5.8%.
- Over next three years, actual real GDP doesn't grow.
- BUT Potential GDP increases 9% percent.

EXERCISE

Use Okun's Law to predict the unemployment rate in 1982.

Figuring Out the Answer

- Okun's Law says a 2% fall in GDP should result in a 1% rise in unemployment
- So a 9% GDP shortfall should increase unemployment rate by 4.5%.
- With unemployment rate at 5.8% in 1979, Okun's Law predicts a 10.3% unemployment rate by 1982.
- Actual rate was very close – 9.7%.

Okun's Law and Potential GDP

- Okun's Law implies actual GDP must grow as rapidly as potential GDP just to keep the unemployment rate from rising.
- GDP has to keep growing just to keep unemployment in the same place.
- If you want to bring the unemployment rate down, actual GDP must be growing faster than potential GDP.