Gross Domestic Product and Growth

SECTION 1  GROSS DOMESTIC PRODUCT

TEXT SUMMARY

Economists study economic performance using national income accounting, a system of collecting statistics on the economy. The U.S. Department of Commerce collects this data in the form of National Income and Products Accounts (NIPA).

The most important NIPA measure is gross domestic product (GDP), the dollar value of all final goods and services produced in a country's borders in a given year. GDP does not include intermediate goods, goods used to produce final goods. For example, the price of a new house that is sold is included in GDP, but not the nails and lumber used to build that house. GDP includes goods produced in the country by a foreign company, but not goods that an American company produces in another country.

Changing prices can distort GDP. To correct this, economists determine real GDP, GDP expressed in constant, or unchanging, prices.

Another important NIPA measure is gross national product (GNP). GNP includes income earned by U.S. companies outside of the country, but does not include the income earned by foreign firms doing business in the country.

As you might expect, supply and demand affect GDP. Economists calculate the price level, the average of all prices, to determine aggregate supply, the total amount of goods and services in the economy available at all possible price levels. Aggregate demand is the amount of goods and services in the economy that will be purchased at all possible price levels. The intersection of aggregate supply and aggregate demand on a graph indicates the equilibrium price level of the economy.

GRAPHIC SUMMARY: Measurements of the Macroeconomy

<table>
<thead>
<tr>
<th>Gross Domestic Product</th>
<th>+ income earned outside U.S. by U.S. firms and citizens</th>
<th>- income earned by foreign firms and foreign citizens located in the U.S.</th>
<th>= Gross National Product</th>
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</thead>
<tbody>
<tr>
<td>Gross National Product</td>
<td>- depreciation of capital equipment</td>
<td>= Net National Product</td>
<td></td>
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<tr>
<td>Net National Product</td>
<td>- most business taxes</td>
<td>= National Income</td>
<td></td>
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<tr>
<td>National Income</td>
<td>- firms’ reinvested profits</td>
<td>+ other household income</td>
<td>= Personal Income</td>
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<tr>
<td>Personal Income</td>
<td>- individual income taxes</td>
<td>= Disposable Personal Income</td>
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1. What is GDP?

2. Diagram Skills  Explain the difference between gross domestic product and gross national product.
A business cycle is a period of economic expansion followed by a period of contraction. Business cycles are major changes in GDP above or below normal levels. Business cycles have four phases. Expansion is a period of economic growth, as measured by a rise in real GDP. The peak is the height of expansion, when real GDP stops rising. A contraction, marked by falling real GDP, follows the peak. The trough is the contraction’s lowest point, when real GDP stops falling. A contraction that lasts for at least 6 months is called a recession. A depression is a long and severe recession.

Business cycles are affected by four main factors: business investment, interest rates and credit, consumer expectations, and external shocks that are unexpected. For example, increased business investment usually leads to increased output and jobs, helping to increase GDP and expand the economy. However, a drop in business spending reduces output and income, which may lead to a decline in GDP. Economists study these factors in order to predict the next turn of the business cycle.

Economic activity in the United States has followed a pattern of cycles. The Great Depression, which began in 1929, was the most severe economic downturn. Since then there have been several recessions, including a short one in 1991. Following that year the economy entered a period of growth that lasted throughout the 1990s.
SECTION 3  ECONOMIC GROWTH

TEXT SUMMARY

The basic measure of a nation's economic growth rate is the percentage change of real GDP over a given period of time. A nation's population tends to grow. Real GDP must keep up with the population growth rate. The best measure of a nation's standard of living is real GDP per capita. That divides the nation's real GDP by the number of people it has (per capita means per person). Real GDP per capita lets economists compare economies for different time periods and different nations.

Physical capital contributes to an economy's output and aids economic growth. Capital deepening, the process of increasing the amount of capital per worker, is an important source of growth in modern economies. Increases in human capital also lead to economic growth. Better educated workers can produce more output per hour of work.

An economy increases its capital through saving and investment. Saving is income that consumers do not spend to purchase goods and services. Money that is saved, which may be held in a bank, is then available for investment. The savings rate is the proportion of disposable income spent to income saved. In the long run, a higher savings rate means more growth in real GDP.

Besides capital deepening, the other key source of economic growth is technological progress. This is an increase in efficiency gained by producing more output without using more inputs.

THE BIG IDEA

Economic growth is a steady, long-term increase in a nation's real GDP that tends to raise living standards.

GRAPHIC SUMMARY: How Saving Leads to Capital Deepening

The money people save becomes available to businesses for investment. Higher savings leads to higher output, raising GDP and living standards.

REVIEW QUESTIONS

1. What is capital deepening?

2. Diagram Skills  How do firms make use of borrowed money?
Chapter 12

Test

Identifying Main Ideas

Write the letter of the correct answer in the blank provided. (10 points each)

1. The most important measure in national income accounting is
   A. intermediate goods.
   B. final goods.
   C. gross national product.
   D. gross domestic product.

2. Real GDP
   A. distorts the price level in the GDP.
   B. expresses GDP in constant prices.
   C. measures only intermediate goods.
   D. is another term for GNP.

3. Which of the following is included in GDP?
   A. an intermediate good
   B. a service produced and used in another country
   C. a fish that you catch and eat yourself
   D. a fish that you buy at a store

4. The average of all prices in the economy is the
   A. aggregate supply.
   B. aggregate demand.
   C. price level.
   D. gross national product.

5. What is a business cycle?
   A. a period of increased economic growth
   B. a period of economic growth followed by economic contraction
   C. the amount of time it takes a business to produce its products
   D. a dangerous time for all businesses

6. The period in a business cycle when real GDP stops falling is
   A. expansion.
   B. peak.
   C. contraction.
   D. trough.

7. What is a recession?
   A. a period when real GDP falls for at least 6 months
   B. a long and severe depression
   C. a very mild and short expansion
   D. a period of when the economy is neither expanding nor contracting

8. What is the best measure of a nation's standard of living?
   A. real GDP per capita
   B. population growth
   C. savings
   D. national income

9. An increase in capital is called
   A. human capital.
   B. the savings rate.
   C. capital deepening.
   D. economic output.

10. Technological progress leads to
    A. an increase in efficiency.
    B. a decrease in efficiency.
    C. a loss of interest in human capital.
    D. lower savings rates.