Measuring Economic Performance
Unit 2
AP Macroeconomics

How do we measure our economy?

GDP
Gross Domestic Product
The market value of all goods and services produced in a nation’s economy during a given year.
Considered the best measure of the size of our economy.

*Generally speaking, “The more that is produced, the healthier the economy.”*

Calculating GDP

The Expenditures Approach
Output approach; the sum of all the money spent in buying it.

The Income Approach
Income approach; income derived or created from producing it.

\[
\text{GDP} = C + I_g + G + X_n
\]

C - Personal Consumption Expenditures
I - Gross Private Domestic Investment
G - Government Sector Spending
X - Exports
M - Imports
\(X_n - (X-M)\) - Net Exports

C - Personal Consumption Expenditures
Spending by households on finished goods and services. (largest part of aggregate demand, 70%)
This money spent then is paid back out to households in the form of wages, interest, rents, and profits.
This results in new purchasing power for the households.
Largest class of spending
Makes up approximately 70% of GDP
Durable goods, nondurable goods, as well as services
I - Gross Private Investment
Private Industry spending on capital goods
Capital Investment
Money is invested into business; that money comes from households savings; and upon financial return that money could be reinvested or spent on finished goods & services.
Unstable component of GDP
New housing sold during the year is also included (part of government accounting method)

G - Government Sector Spending
The costs of government
Government purchases
Military, highways, police and fire protection, and schools.
Includes all levels of government

(X-M) - Net Exports
U.S. International Trade
The value of goods and services exported minus the amount spent on imported goods and services.
Remember, GDP only measures what is produced within our borders.

Aggregate Demand
GDP = C + I + G + (X - M) measures the current output of our economy.
Aggregate demand
The total effective demand for the nation’s output of goods and services.
GNP = Gross National Product

**GNP**
- The sum of all goods and services produced by residents of a country during a given year regardless of where that takes place.
- Includes earnings on foreign investments, but excludes foreign earning on investments in this country.
- GNP became less accurate when international investment increased.
- GDP is considered a more accurate measure of our nation’s productivity.

**What’s Wrong with GDP?**

Simply a measure of output; not well-being
Measures Size, but not accurately.
Takes into account goods & services sold.
Doesn’t take into account services you and I do within our households:
- Providing child care
- Preparing meals
- Changing our own oil or maintenance of our car
- Our own yard work; etc.

**What’s Wrong with GDP?**

What about our leisure time?
What about the illegal sale of drugs and other items sold in the “underground economy”.
What about increased production after a natural disaster - 9/11; Hurricanes; Earthquakes (What do we do in response in response to that?)
The growth from year to year is measured inaccurately. **WHY?**
- GDP doesn’t take INFLATION into consideration.
- Current Dollar GDP (Nominal GDP)
  - The dollar value of GDP unadjusted for inflation

**Nominal GDP**

Unadjusted for inflation
Value at time of production

**REAL GDP**

Economists have come up with a way to adjust the numbers to remove the effects of inflation.
Real GDP is the dollar value of GDP unadjusted for inflation.
Dividing real GDP by a country’s total population yields per capita real GDP.
What Determines Total Output?

Keynesian Economics
- Based on theories of economist John Maynard Keynes
- Demand-side analysis of domestic output
- Macroeconomic generalizations that lead to the conclusion that a capitalistic economy is characterized by macroeconomic instability.

Keynesian Economics
- Belief that investment spending is volatile - a decline in investment will lead to insufficient total spending. Inventories accumulate, and producers respond by reducing output and discharging workers.
- Belief that fiscal policy and monetary policy can and must be used to promote full employment, price-level stability, and economic growth. Opposite of classical economic thinking in that the economy will simply get itself out of the “slow down” without help from the government (laissez-faire approach)

What Determines Total Output?

Supply-side Economics (“Reaganomics” of 80s)
- A view of macroeconomics that emphasizes the role of costs and aggregate supply in explaining inflation, unemployment, and economic growth.
- Stress changes in the supply curve effect inflation, unemployment, and economic growth.
- Belief that U.S. tax system has impaired incentives to work, save, and invest.
- Goal is to reduce taxes.
- Belief is that high tax rate impede productivity.

Say’s Law
- Developed by economist J.B. Say
- States that “supply creates its own demand”
- Basis for Supply-Side Point of View