ACTIVITY 18.1, CONTINUED
INTRODUCTION TO KEY ECONOMIC INDICATORS

3. Economic Output: Real Gross Domestic Product (GDP)[3]

Real gross domestic product (real **GDP**) is a measure of economic output. It is defined as the market value of final goods and services produced in the United States in a year, adjusted for inflation. Real GDP is total output adjusted for inflation by holding prices constant.

- ***Gross*** measurement includes the total amount of goods and services produced, some of which replace goods that have depreciated or have worn out.
- ***Domestic*** production includes only goods and services produced within the United States.
- Current ***production*** is measured during the year in question.
- It is a measurement of the ***final*** goods and services produced because it does not separately include the value of an intermediate good that is part of a transaction between parties that do not involve the final customer. We count only the final sale.

Changes in real GDP from one year to the next reflect changes in the market value of the output of goods and services holding the prices of goods and services constant. Therefore, any changes in real GDP can only arise from a change in the quantities of goods and services produced. Prices are held constant in constructing real GDP measures. **Real GDP per capita** is the real GDP per person in the economy and is commonly thought of as the best measure of overall economic well-being in a country.

The GDP is calculated by totaling up consumption spending, investment spending, government purchases of goods and services, and spending on U.S. exports. To arrive at the amount actually produced in the United States (that is, U.S. Gross Domestic Product), our spending on imports is subtracted from those other amounts of spending. Thus,

GDP = Consumption spending + investment spending + government purchases of goods and services + (export spending – import spending)

Consumption spending consists of household spending on final goods and services. These purchases can account for 60 to 70 percent of GDP and include goods such as new cars, furniture, food, and clothing; and services such as rent paid on apartments, airplane tickets, legal advice, and entertainment. Services are the largest and fastest growing component of consumption spending.

Investment spending accounts for approximately 15 percent of GDP and can fluctuate a lot over time. It includes the production of tools, equipment, new business structures, machinery, etc., that are used in the production of other goods and services. These items are expected to yield a stream of returns over time, which is why expenditures in this category are referred to as economic

[3] Description created using S. Buckles (2006), "A Case Study: Gross Domestic Product," *EconEdLink*. Accessed at http://econedlink.org/lessons/index.cfm?lesson=EM225&page=teacher on April 23, 2007.

Activity 18.1, continued
Introduction to Key Economic Indicators

investment. GDP *does not* include financial investment such as purchases of stocks and bonds The investment category of GDP also includes the building of a new homes or apartments. Inventory changes are also found in investment expenditures.

Government purchases of goods and services includes federal, state, and local government spending on goods and services such as research, roads, defense, schools, and police and fire departments. This spending (approximately 20 percent of GDP) does not include transfer payments such as Social Security, unemployment compensation, and welfare payments, which do not represent production of goods and services. National defense spending now accounts for approximately 5 percent of GDP. State and local government spending on goods and services accounts for about 12 percent of GDP, while federal government purchases of goods and services are about 8 percent of GDP.

Exports are goods and services produced in the United States and purchased by foreigners. Currently exports account for about 10 percent of GDP.

Imports are items produced by foreigners and purchased by U.S. consumers; they account for about 16 percent of GDP.

Net exports (exports minus imports) have consistently been negative over the past three decades and are now about negative 6 percent of GDP.

Real GDP per capita is a measure of the claim on final goods and services of the average member of the U.S. population. This is the best measure of overall material standards of living and is commonly used in making comparisons of living standards across countries and over time.

While there are several measures of overall economic performance (such as inflation, unemployment, personal income, etc.), none is a more important indicator of our economy's health than rates of change in real GDP. When our real GDP increases, we are producing more "product" as a nation, and we are usually better off.

Changes in real GDP are discussed in the press and on the nightly news after every announcement of the latest quarter's newly released or revised data. Any change in the growth of real GDP will be discussed in news reports as an indicator of the health of the national economy.

Real GDP trends are prominently included in discussions of potential slowdowns and economic booms. Economic commentators use decreases in real GDP as indicators of recessions. For example, the most popular (although technically inaccurate) definition of a recession is at least two consecutive quarters of declining real GDP.

ACTIVITY 18.1, CONTINUED

INTRODUCTION TO KEY ECONOMIC INDICATORS

Study Guide: Real Gross Domestic Product (GDP). (Fill out the study guide in your expert group; you will share this information with your EFI group.)

1. The gross domestic product (GDP) is____________________________________.

2. Real GDP is____.

3. The components of GDP are
   a. ____.
   b. ____.
   c. ____.
   d. ____.

   Complete the formula: GDP =

4. GDP is an important measure of the nation's economic health because
   ____.

5. Increasing GDP indicates
   ____.

6. Decreasing GDP indicates
   ____.

7. Current level and growth rate of real GDP:
   ____.

8. Trend in the growth of real GDP over the last three years:_____________________________________.

