

GDP: Does It Measure Up?

We can measure our national progress in many ways. But even if we restrict our measurement to the economy—and set aside social, cultural, and political progress for a moment—the total value of the goods and services produced in the economy can be mind-boggling.

Think of all the goods (shoes, oranges, computers . . .) and services (haircuts, doctor visits, car repairs . . .) produced in the United States. Even more intimidating is trying to capture that production in a single number. One common and fairly comprehensive measure is gross domestic product (or GDP), which is a statistic calculated by the U.S. Department of Commerce; it measures the total market value of all final goods and services produced in an economy in a given year.

Simply put, GDP measures the size of the economy. It is among the most important and widely reported pieces of economic data. A variety of people, from business owners to policymakers, use GDP in their decisions. The general rule of thumb says **two consecutive quarters of negative real GDP constitutes a recession**. In short, GDP is central to our understanding of the state of the economy.

What happens to the goods and services produced? U.S. consumers, businesses, and the government—and those same groups in foreign countries—buy them. *The largest portion of GDP is consumer spending, the money you and I spend on goods and services*. This portion has grown from 59 percent of GDP in 1951 to its current level of just over 70 percent. Because spending on output by one group of people becomes income for others, GDP can be described in terms of either expenditures or income.

Let's Get Real

Even though GDP is a valuable measurement tool, prices are used in calculating the value of output. This causes difficulty with calculating changes in GDP over time because an increase in GDP could mean any of the following:

- (i) The country has produced more goods and services.
- (ii) The country has produced the same amount of goods and services, but the prices of those goods and services are higher.
- (iii) Some combination of higher production levels and higher prices has caused GDP to increase.

If we want to use GDP to measure the “real” increase or decrease over time in the level of final goods and services produced, *we must remove the effect of price changes from the data*. Therefore, real GDP controls for inflation and more accurately reflects actual economic growth. When economists discuss GDP, they are usually referring to real GDP. When GDP is presented in its unadjusted form, it is often labeled **nominal GDP**.

Growth Is Good, but Is It Everything?

Economists measure economic growth by comparing real GDP over time. Economic growth is usually presented as a percentage increase or decrease from an earlier period. For example, it might be useful to know that nominal GDP in the fourth quarter of 2012 was \$15.864 trillion, but it is probably more meaningful to know that real GDP increased by 0.4 percent from the fourth quarter of 2011 to the fourth quarter of 2012; in other words, the economy grew, but only by a fraction of 1 percent. To put that number in context, real GDP has grown at an average annual rate of 3.3 percent since 1950. The Federal Open Market Committee has projected real GDP growth of 2.3 to 2.5 percent (central tendency) in the longer run. Why is economic growth important? A growing economy produces more goods and services for its population, including more health care and education. And, generally speaking, more is better.

In addition, GDP does not measure economic activity that occurs outside markets. So, if you mow your own lawn, the value of that activity does not show up in GDP, but if you hire a lawn service it does. Another category not captured by GDP includes the nonmarket by-products of market production, such as pollution. Finally, GDP does not capture illegal activities in the underground economy or the “black market” because such transactions are not recorded.

Conclusion

GDP measures production levels during a period of time, which can be adjusted for inflation and compared with earlier periods as an indication of economic growth. And, in general, growth is good.