

Measuring a Nation's Income

Microeconomics is the study of how individual households and firms make decisions and how they interact with one another in markets.

Macroeconomics is the study of the economy as a whole.

•Its goal is to explain the economic changes that affect many households, firms, and markets at once.

- Macroeconomics answers questions like the following:
- Why is average income high in some countries and low in others?
- Why do prices rise rapidly in some time periods while they are more stable in others?
- Why do production and employment expand in some years and contract in others?

THE ECONOMY'S INCOME AND EXPENDITURE

- When judging whether the economy is doing well or poorly, it is natural to look at the total income that everyone in the economy is earning.
- For an economy as a whole, income must equal expenditure because:
- Every transaction has a buyer and a seller.
- Every dollar of spending by some buyer is a dollar of income for some seller.

THE MEASUREMENT OF GROSS DOMESTIC PRODUCT

- Gross domestic product (GDP)* is a measure of the income and expenditures of an economy.
- It is the total market value of all final goods and services produced within a country in a given period of time.
- The equality of income and expenditure can be illustrated with the circular-flow diagram.

THE MEASUREMENT OF GROSS DOMESTIC PRODUCT

- GDP is the market value of all final goods and services produced within a country in a given period of time.

- “GDP is the Market Value . . .”
- Output is valued at market prices.
- “ . . . Of All Final . . .”
- It records only the value of final goods, not intermediate goods (the value is counted only once).
- “ . . . Goods and Services . . . “
- It includes both tangible goods (food, clothing, cars) and intangible services (haircuts, housecleaning, doctor visits).
- “ . . . Produced . . .”
- It includes goods and services currently produced, not transactions involving goods produced in the past.
- “ . . . Within a Country . . .”
- It measures the value of production within the geographic confines of a country.
- “ . . . In a Given Period of Time.”
- It measures the value of production that takes place within a specific interval of time, usually a year or a quarter (three months).

THE COMPONENTS OF GDP

- GDP includes all items produced in the economy and sold *legally* in markets.
- What Is Not Counted in GDP?
- GDP excludes most items that are produced and consumed at home and that never enter the marketplace.
- It excludes items produced and sold illicitly, such as illegal drugs.
- GDP (Y) is the sum of the following:
- Consumption (C)• Investment (I)• Government Purchases (G)• Net Exports

$$(NX)Y = C + I + G + NX$$

- Consumption (C)*:
- The spending by households on goods and services, with the exception of purchases of new housing.
- Investment (I)*:
- The spending on capital equipment, inventories, and structures, including new housing.
- Government Purchases (G)*:

- The spending on goods and services by local, state, and federal governments.
- Does *not* include transfer payments because they are not made in exchange for currently produced goods or services.
- Net Exports (NX)*:•Exports minus imports.

REAL VERSUS NOMINAL GDP

- Nominal GDP* values the production of goods and services at *current prices*.
- Real GDP* values the production of goods and services at *constant prices*.

The GDP Deflator

- The *GDP deflator* is a measure of the price level calculated as the ratio of nominal GDP to real GDP times 100.
- It tells us the rise in nominal GDP that is attributable to a rise in prices rather than a rise in the quantities produced.
- The GDP deflator is calculated as follows:

$$\text{GDP deflator} = \frac{\text{Nominal GDP}}{\text{Real GDP}} \times 100$$

- Converting Nominal GDP to Real GDP•Nominal GDP is converted to real GDP as follows:

$$\text{Real GDP}_{20XX} = \frac{\text{Nominal GDP}_{20XX}}{\text{GDP deflator}_{20XX}} \times 100$$

GDP AND ECONOMIC WELL-BEING

- GDP is the best single measure of the economic well-being of a society.
- GDP per person tells us the income and expenditure of the average person in the economy.
- Higher GDP per person indicates a higher standard of living.

- GDP is not a perfect measure of the happiness or quality of life, however.
- Some things that contribute to well-being are not included in GDP.
- The value of leisure.
- The value of a clean environment.
- The value of almost all activity that takes place outside of markets, such as the value of the time parents spend with their children and the value of volunteer work.

Summary

- Because every transaction has a buyer and a seller, the total expenditure in the economy must equal the total income in the economy.
- Gross Domestic Product (GDP) measures an economy's total expenditure on newly produced goods and services and the total income earned from the production of these goods and services.
- GDP is the market value of all final goods and services produced within a country in a given period of time.
- GDP is divided among four components of expenditure: consumption, investment, government purchases, and net exports.
- Nominal GDP uses current prices to value the economy's production. Real GDP uses constant base-year prices to value the economy's production of goods and services.
- The GDP deflator—calculated from the ratio of nominal to real GDP—measures the level of prices in the economy.
- GDP is a good measure of economic well-being because people prefer higher to lower incomes.
- It is not a perfect measure of well-being because some things, such as leisure time and a clean environment, aren't measured by GDP.

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N. Gregory Mankiw. 2007. *Principle of Economics*, 4th Edition, Thomson South-Western

How to calculate Real and Nominal GDP

Prices and Quantities				
Year	Price of Hot Dogs	Quantity of Hot Dogs	Price of Hamburgers	Quantity of Hamburgers
2001	\$1	100	\$2	50
2002	2	150	3	100
2003	3	200	4	150

Year	Calculating Nominal GDP
2001	$(\$1 \text{ per hot dog} \times 100 \text{ hot dogs}) + (\$2 \text{ per hamburger} \times 50 \text{ hamburgers}) = \200
2002	$(\$2 \text{ per hot dog} \times 150 \text{ hot dogs}) + (\$3 \text{ per hamburger} \times 100 \text{ hamburgers}) = \600
2003	$(\$3 \text{ per hot dog} \times 200 \text{ hot dogs}) + (\$4 \text{ per hamburger} \times 150 \text{ hamburgers}) = \$1,200$

Year	Calculating Real GDP (base year 2001)
2001	$(\$1 \text{ per hot dog} \times 100 \text{ hot dogs}) + (\$2 \text{ per hamburger} \times 50 \text{ hamburgers}) = \200
2002	$(\$1 \text{ per hot dog} \times 150 \text{ hot dogs}) + (\$2 \text{ per hamburger} \times 100 \text{ hamburgers}) = \350
2003	$(\$1 \text{ per hot dog} \times 200 \text{ hot dogs}) + (\$2 \text{ per hamburger} \times 150 \text{ hamburgers}) = \500

Year	Calculating the GDP Deflator
2001	$(\$200/\$200) \times 100 = 100$
2002	$(\$600/\$350) \times 100 = 171$
2003	$(\$1,200/\$500) \times 100 = 240$