Week 1: Measuring the Macroeconomy

ECO 305: Intermediate Macroeconomics

Goals

Describe measures of macroeconomic activity including the following:

- Total production
- Total income
- Aggregate price level
- Inflation
- Employment
- Worker compensation
- Unemployment

Reading and Exercises

- Textbook: Chapter 2
- **Canvas Quiz due Wed 11:59 PM**.
  Multiple-choice, 10 questions, unlimited attempts allowed, only best score counts
- **Homework/In-class Exercise due Fri 11:59 PM**. We will work together in class on Thursday.

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National income accounting

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Different measures of a country's overall economic activity in a given time period.

Why do we care?

- Assess the health of the economy by comparing output / person across countries and across time periods.
- Track long run growth of the economy.
- Assess the effectiveness of macroeconomic policies.

Measures

- **Gross domestic product**
- **Net domestic product**
- **National income**
- **Personal income**
- **Disposable income**

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Gross Domestic Product

- **Gross domestic product**: total market value of all *final* goods and services produced in a given year
- To avoid double counting, intermediate goods are not counted.
- Monetary measure: A common unit allows us to add apples and oranges and pickup trucks and everything else together
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Example: $350 suit

The birth of suit

1. Sheep rancher sells $120 wool to a wool processor.
2. Wool processor makes material and sells it to a suit manufacturer for $180.
3. The suit manufacturer makes a suit and sells it to a wholesaler for $200.
4. The wholesaler sells the suit to a retailer for $250.
5. The retailer sells the suit to you for $350.

Value?

- If we counted all these transactions in GDP we get: $\$120 + \$180 + \$200 + \$250 + \$350 = \$1{,}100$.
- When actually, in the end we are only left with a suit worth $350

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- Add to GDP only the value added at each step:
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What's not counted in GDP?

- Non-production transactions: any transactions that do not involve production of a good.
- Purely financial transactions
  - Public transfer payments such as social security payments and veterans payments
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  - Financial transactions: loans, trading financial assets
  - Stock market transactions
- Secondhand transactions: contribute nothing to production, just moving ownership of final goods between people.

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Expenditure approach

Expenditure approach: method of computing GDP by adding up all expenditures of final goods and services

- Consumption: consumption expenditures of households
- Investment: purchases of capital goods by firms
- Government expenditures
- Net exports

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Investment

- **Gross private domestic investment**
  - *Most important:* Capital - final purchases of machinery, equipment, and tools.
  - All construction: includes construction of new offices, factories, *and* residential houses.
  - Changes in inventories: "unsold" output (not counted in consumption, because never purchased).
- **Net private domestic investment** = gross private domestic investment - depreciation.
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- Export goods are produced in the U.S. and consumed outside the U.S.
- Imports are subtracted
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  - Subtracting imports from exports results in a net quantity of goods produced in the U.S. that are sold outside the U.S.

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Gross domestic product

Expenditure approach leads to the equation:

$$Y = C + I + G + X - M$$

- Y: Total Output $\equiv$ GDP.
- C: Private Consumption
- I: Investment
- G: Government Expenditures
- X: Exports
- M: Imports

Income approach

- **Income approach**: another method of computing GDP, add up total income.
- **National income** is composed of:
  - Compensation of employees (income earned from labor)
  - Rent (income earned from owning land)
  - Interest (income earned from owning capital)
  - Proprietors' income (income earned from organizing production)
  - Corporate profits (income earned from organizing production)
- National income is *almost* equal to GDP.
  - Requires some statistical adjustments (corporate income taxes, undistributed corporate profits)

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Disposable Income

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- **Disposable income** = Personal income - personal taxes.
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$$\text{Disposable income} \approx \text{GDP} - \text{Personal Taxes}$$

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- Use prices from a chosen **base year**.
- Example:
  - Suppose only two goods: Brats and Cheese
  - Let's use 2005 as a base year, compute real GDP for 2006

$$\text{Real GDP}_{2006} = P_{\text{Brats},2005} \times \text{Brats}_{2006} + P_{\text{Cheese},2005} \times \text{Cheese}_{2006}$$

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$$\text{Real GDP}_{2006} = P_{Brats,2005} Q_{Brats,2006} + P_{Cheese,2005} Q_{Cheese,2006}$$

Calculating Real GDP

- Don't use current year prices to compute real GDP.
- Use prices from a chosen **base year**.
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Example: Nominal GDP

	Year 2005	
Item	Quantity	Price
Brats	100	\$1.00
Cheese	20	\$5.00

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$$\text{Nominal GDP}_{2005} = 100(\$1) + 20(\$5) = 200$$

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$$\text{Real GDP}_{2005} = 100(2) + 20(7) = 340$$

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$$\text{Real GDP Growth} = \frac{475-340}{340} = 0.397 = 39.7\%$$

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Shortcomings of GDP

Non-Market Activities Not Counted

- Leisure: Average workweek in 1900 in U.S. was 53 hours. Today it's 35 hours.
- Improved product quality (eg. computers and electronic devices).
- Informal or "underground" economy not counted.
  - United States: 8.3% of total production
  - Georgia: 64.9% of total production

Other Shortcomings

- Externalities: Proudction that leads to costs or negative consequences to others (eg. polution)
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Calculating the price level

- **Price level**: an overall measure of prices in the economy
- **GDP deflator**: average of current year prices as a percentage of base year prices.

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

- **Inflation:** Growth rate of the price level

$$\text{inflation}_t = \frac{\text{GDP Deflator}_t - \text{GDP Deflator}_{t-1}}{\text{GDP Deflator}_{t-1}}(100\%)$$

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- **Consumer price index (CPI)**: another measure of the aggregate price level.
- Bureau of Labor Statistics (BLS) chooses a basket of goods: specific goods with specific weights.

$$\text{CPI}_t = \frac{\text{Price of basket at time } t}{\text{Price of same basket in base year}}(100)$$

- CPI inflation rate: percentage change in CPI.

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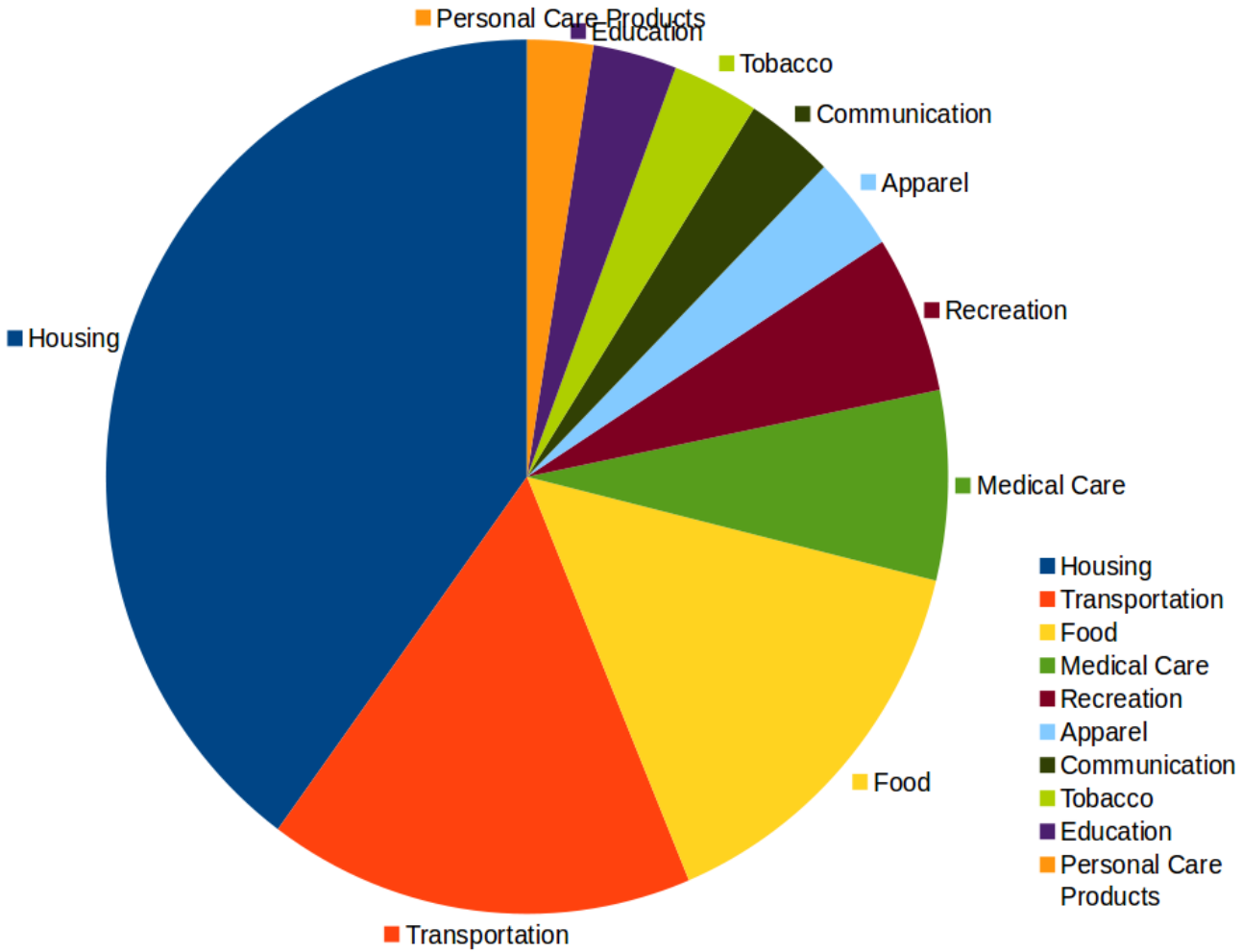
CPI Basket



Source: Bureau of Labor Statistics

Labor force

- **Labor force**: people in the population who are *willing* and *able* to work.
- The labor force does *not* include:
  - Children
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  - Active-duty military personnel
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  - People not employed who are not looking to be employed (eg. some students, retired people).
  - **Discouraged workers**: people who are not employed and gave up looking for work because they don't think any jobs are available
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- **Structural unemployment**: caused by changes in demand for types of work.
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Reading and Exercises

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- **Canvas Quiz due Wed 11:59 PM**.
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