Lecture 2: Measurement I
Economic Aggregates

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Outline

3 Approach to Measure GDP

Source: National Income and Product Accounts (NIPA)

1. **Product (value-added) approach**: sum of value added to all goods and services across all productive units in the economy

2. **Expenditure approach**: sum of spending on all final goods and services produced in the economy

3. **Income approach**: sum of all income received by economic agents contributing to production

If no measurement error, all should give the same answer!

3 Approach to Measure GDP: Example

Variable	Coconut Producer	Restaurant	Government
Revenue*	20	30	5.5
sales for consumption	8	30	–
sales as intermediate	12	0	–
Costs	7	19	5.5
wages	5	4	5.5
interest on loan	0.5	–	–
cost of intermediates	–	12	–
taxes*	1.5	3	–
After-Tax Profits**	13	11	–

❯ government gets revenue from taxes on producers and consumers, spends wages to provide defense services

❯ profits are revenues minus costs

Question: how to calculate GDP?

The Product Approach

Question: What is the value added by each agent?

- **Coconut Producer**: Final good $20M$, no intermediate input

- **Restaurant**: Final goods $30M$, with intermediate input $12M$ from Coconut Producer
  - value added: $30 - 12 = 18M$

- **Government**: Defence services, valued at cost $5.5M$

- **GDP**: $20 + 18 + 5.5 = 43.5M$

The Expenditure Approach

Question: What is the total spending?

> **Formula**: $Y = C + I + G + NX$

> **Consumption** (C): "sale for consumption" row
>> To Coconut Producer: $8M$
>>
>> To Restaurant: $30M$

> No investment (I) and net export (NX).

> **Government** (G): defense service $5.5M$

> **GDP** (Y): $38 + 5.5 = 43.5M$

The Income Approach

Question: how much does agent earn?

› **Workers**: wages $5M$ from Coconut Producer, $4M$ from Restaurant and $5.5M$ from Government

› **Firms**:
  » After-tax Profits: $13M$ to Coconut Producer and $11M$ to Restaurant

  » Interest on loan: $0.5M$ for Coconut Producer

› **Government**: Taxes $1.5M$ from Coconut Producer and $3M$ from Restaurant
  » Expenditure is $5.5M \Rightarrow$ budget deficit

› **GDP**: $5 + 4 + 5.5 + 13 + 11 + 0.5 + 1.5 + 3 = 43.5M$

Income-Expenditure Identity: Income earned goes to expenditure

Outline

Prices in GDP measurement

› The revenue row is calculated by $10M$ coconuts $\times$ \$2 each
  » What if coconut price increases to \$3 next year?

› **Solution**: common price index across different time

› Two ways to build common price index:
  1. GDP deflator: common GDP standard

  2. Consumer Price Index (CPI): common consumption basket (Q)

Prices in GDP measurement (Cont.)

❯ GDP deflator: ratio between nominal and real GDP

1. Calculate real GDP relative to base year by base year price level

   - E.g. $RealGDP_{2020} = $ Cost of Q_{2020} at P_{2000}, use 2000 as base year

   - While $NominalGDP_{2020} = $ Cost of Q_{2020} at P_{2020}

   - Problem: choose which year? $\Rightarrow$ "chain-weighting" (rolling base)

2. Calculate ratio: $\frac{NominalGDP_{2020}}{RealGDP_{2020}} \times 100$

❯ CPI: normalize consumption basket of base year as 100, relative to other year

   ❯❯ E.g. $CPI_{2020} = \frac{\text{Cost of } Q_{2000} \text{ at } P_{2020}}{\text{Cost of } Q_{2000} \text{ at } P_{2000}} \times 100$, use 2000 as base year

   ❯❯ Problem:

   1. ΔP outside of consumption basket & not accounted

   2. new goods & services introduced, old goods & services obsolete

Example: Nominal v.s. Real GDP

> **Nominal GDP**: value of goods & services at current price

> **Real GDP**: value of goods & services at base year price

Year	Apples		Oranges		GDP Measure		
	Quantity	Price	Quantity	Price	Nominal	Real (base year = 1)	Real (base year = 2)
1	50	$1.00	100	$0.80	$130	$130	$222.5
2	80	$1.25	120	$1.60	$292	$176	$292

> Choice of base year affects the GDP measure!

> Alternative: chain-weighting

Data: Nominal v.s. Real GDP

Figure: Figure 2.1 Nominal GDP and Chain-Weighted Real GDP

- inflation growth + economics growth = nominal grows faster than real
- **Question**: What year is the base year on this graph?
- Ans: 2009, when Nominal = Real
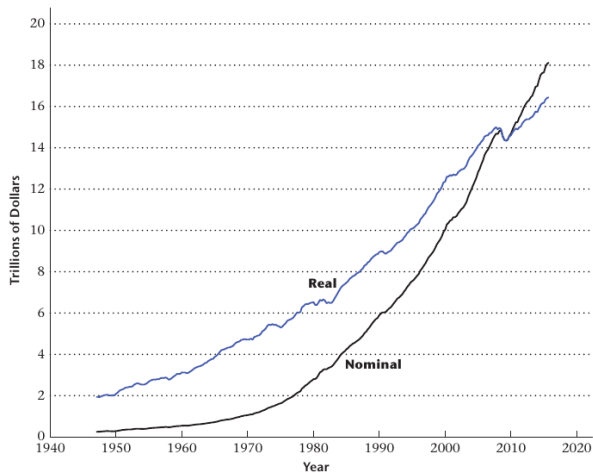
Outline

Population Composition
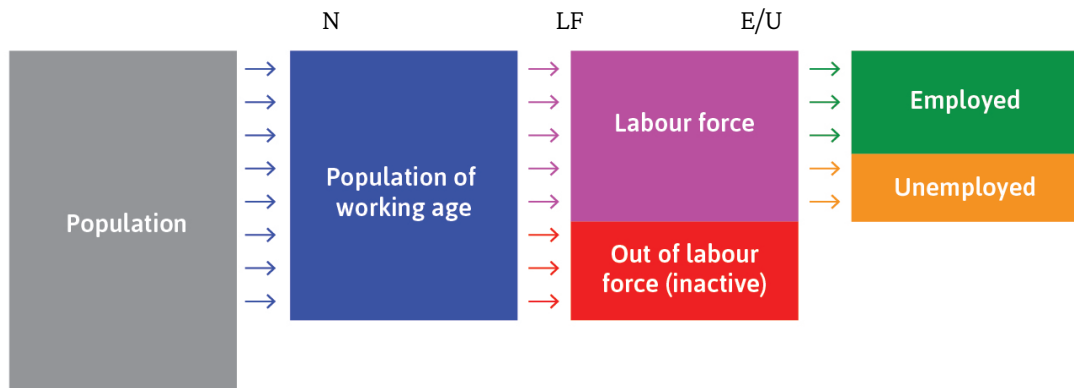
- participation rate $= \frac{LF}{N}$
- unemployment rate $= \frac{U}{LF}$
- employment rate $= \frac{E}{N}$