

CHAPTER 2

The Data of Macroeconomics

MACROECONOMICS SIXTH EDITION
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PowerPoint® Slides by Ron Cronovich
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In this chapter, you will learn...

...the meaning and measurement of the most important macroeconomic statistics:

- Gross Domestic Product (GDP)
- The Consumer Price Index (CPI)
- The unemployment rate

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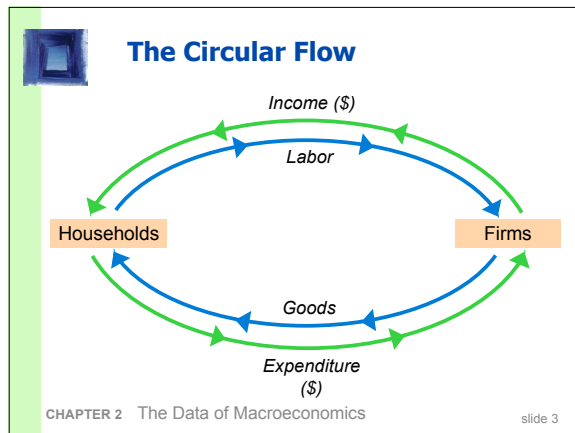
Gross Domestic Product: Expenditure and Income

Two definitions:

- Total expenditure on domestically-produced final goods and services.
- Total income earned by domestically-located factors of production.

Expenditure equals income because every dollar spent by a buyer becomes income to the seller.

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Value added

definition:

A firm's **value added** is
the value of its output
minus
the value of the intermediate goods
the firm used to produce that output.

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Exercise: (Problem 2, p. 40)

- A farmer grows a bushel of wheat and sells it to a miller for \$1.00.
- The miller turns the wheat into flour and sells it to a baker for \$3.00.
- The baker uses the flour to make a loaf of bread and sells it to an engineer for \$6.00.
- The engineer eats the bread.

Compute & compare value added at each stage of production and GDP

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Final goods, value added, and GDP

- GDP = value of final goods produced
= sum of value added at all stages of production.
- The value of the final goods already includes the value of the intermediate goods, so including intermediate and final goods in GDP would be double-counting.



The expenditure components of GDP

- consumption
- investment
- government spending
- net exports



Consumption (C)

definition: The value of all goods and services bought by households. Includes:



- **durable goods**
last a long time
ex: cars, home appliances
- **nondurable goods**
last a short time
ex: food, clothing
- **services**
work done for consumers
ex: dry cleaning, air travel.



U.S. consumption, 2006

	\$ billions	% of GDP
Consumption	\$9,268.9	70.0%
Durables	1,070.3	8.1
Nondurables	2,714.9	20.5
Services	5,483.7	41.4



Investment (I)

Definition 1: Spending on [the factor of production] capital.

Definition 2: Spending on goods bought for future use

Includes:

- **business fixed investment**
Spending on plant and equipment that firms will use to produce other goods & services.
- **residential fixed investment**
Spending on housing units by consumers and landlords.
- **inventory investment**
The change in the value of all firms' inventories.



U.S. investment, 2006

	\$ billions	% of GDP
Investment	\$2,212.5	16.7%
Business fixed	1,396.2	10.5
Residential	766.7	5.8
Inventory	49.6	0.4



Investment vs. Capital

Note: Investment is spending on new capital.

Example (assumes no depreciation):

- 1/1/2007: economy has \$500b worth of capital
- during 2007: investment = \$60b
- 1/1/2008: economy will have \$560b worth of capital

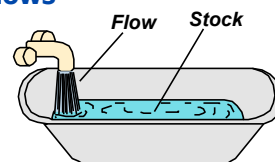


Stocks vs. Flows

A **stock** is a quantity measured at a point in time.

E.g., "The U.S. capital stock was \$26 trillion on January 1, 2006."

A **flow** is a quantity measured per unit of time.
E.g., "U.S. investment was \$2.5 trillion during 2006."



Stocks vs. Flows - examples

<i>stock</i>	<i>flow</i>
a person's wealth	a person's annual saving
# of people with college degrees	# of new college graduates this year
the govt debt	the govt budget deficit



Now you try:

Stock or flow?

- the balance on your credit card statement
- how much you study economics outside of class
- the size of your compact disc collection
- the inflation rate
- the unemployment rate



Government spending (G)

- G** includes all government spending on goods and services..
- G** excludes transfer payments (e.g., unemployment insurance payments), because they do not represent spending on goods and services.



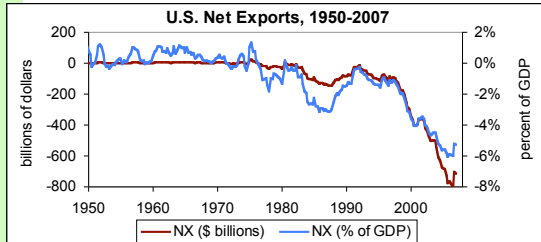
U.S. government spending, 2006

	\$ billions	% of GDP
Govt spending	\$2,527.7	19.1%
Federal	926.6	7.0
Non-defense	305.6	2.3
Defense	621.0	4.7
State & local	1,601.1	12.1



Net exports: $NX = EX - IM$

def: The value of total exports (**EX**) minus the value of total imports (**IM**).



An important identity

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

value of total output

aggregate expenditure

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A question for you:

Suppose a firm

- produces \$10 million worth of final goods
- but only sells \$9 million worth.

Does this violate the expenditure = output identity?

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Why output = expenditure

- Unsold output goes into inventory, and is counted as “inventory investment” ... whether or not the inventory buildup was intentional.
- In effect, we are assuming that firms purchase their unsold output.

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GDP: An important and versatile concept

We have now seen that GDP measures

- total income
- total output
- total expenditure
- the sum of value-added at all stages in the production of final goods

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Real vs. nominal GDP

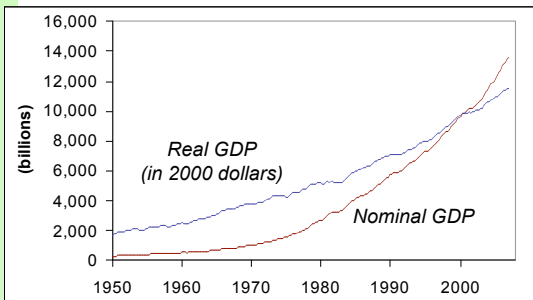
- GDP is the value of all final goods and services produced.
- nominal GDP** measures these values using current prices.
- real GDP** measure these values using the prices of a base year.

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U.S. Nominal and Real GDP, 1950–2007



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GDP Deflator

- The **inflation rate** is the percentage increase in the overall level of prices.
- One measure of the price level is the **GDP deflator**, defined as

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

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Chain-Weighted Real GDP

- Over time, relative prices change, so the base year should be updated periodically.
- In essence, **chain-weighted real GDP** updates the base year every year, so it is more accurate than constant-price GDP.
- Your textbook usually uses constant-price real GDP, because:
 - the two measures are highly correlated.
 - constant-price real GDP is easier to compute.

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Consumer Price Index (CPI)

- A measure of the overall level of prices
- Published by the Bureau of Labor Statistics (BLS)
- Uses:
 - tracks changes in the typical household's cost of living
 - adjusts many contracts for inflation ("COLAs")
 - allows comparisons of dollar amounts over time

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How the BLS constructs the CPI

1. Survey consumers to determine composition of the typical consumer's "basket" of goods.
2. Every month, collect data on prices of all items in the basket; compute cost of basket
3. CPI in any month equals

$$100 \times \frac{\text{Cost of basket in that month}}{\text{Cost of basket in base period}}$$

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Exercise: Compute the CPI

Basket contains 20 pizzas and 10 compact discs.

prices:	pizza	CDs
2002	\$10	\$15
2003	\$11	\$15
2004	\$12	\$16
2005	\$13	\$15

- For each year, compute
- the cost of the basket
 - the CPI (use 2002 as the base year)
 - the inflation rate from the preceding year

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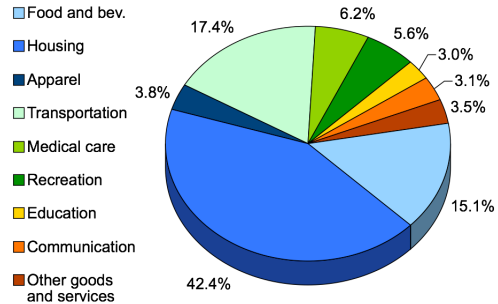


Answers:

	Cost of basket	CPI	Inflation rate
2002	\$350	100.0	<i>n.a.</i>
2003	370	105.7	5.7%
2004	400	114.3	8.1%
2005	410	117.1	2.5%



The composition of the CPI's "basket"



Reasons why the CPI may overstate inflation

- **Substitution bias:** The CPI uses fixed weights, so it cannot reflect consumers' ability to substitute toward goods whose relative prices have fallen.
- **Introduction of new goods:** The introduction of new goods makes consumers better off and, in effect, increases the real value of the dollar. But it does not reduce the CPI, because the CPI uses fixed weights.
- **Unmeasured changes in quality:** Quality improvements increase the value of the dollar, but are often not fully measured.



The size of the CPI's bias

- In 1995, a Senate-appointed panel of experts estimated that the CPI overstates inflation by about 1.1% per year.
- So the BLS made adjustments to reduce the bias.
- Now, the CPI's bias is probably under 1% per year.

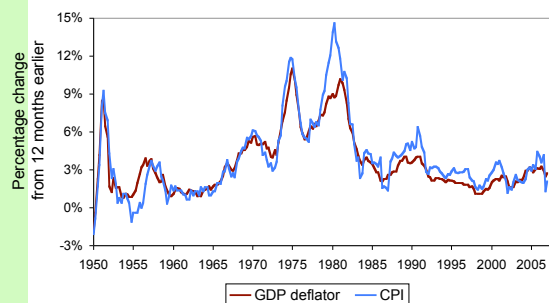


CPI vs. GDP Deflator

- prices of capital goods
 - included in GDP deflator (if produced domestically)
 - excluded from CPI
- prices of imported consumer goods
 - included in CPI
 - excluded from GDP deflator
- the basket of goods
 - CPI: fixed
 - GDP deflator: changes every year



Two measures of inflation in the U.S.





Categories of the population

- **employed**
working at a paid job
- **unemployed**
not employed but looking for a job
- **labor force**
the amount of labor available for producing goods and services; all employed plus unemployed persons
- **not in the labor force**
not employed, not looking for work

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Two important labor force concepts

- **unemployment rate**
percentage of the labor force that is unemployed
- **labor force participation rate**
the fraction of the adult population that “participates” in the labor force

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Exercise: Compute labor force statistics

U.S. adult population by group, June 2007

Number employed	=	146.1 million
Number unemployed	=	6.9 million
Adult population	=	231.7 million

Use the above data to calculate

- the labor force
- the number of people not in the labor force
- the labor force participation rate
- the unemployment rate

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Answers:

- data: $E = 146.1$, $U = 6.9$, $POP = 231.7$
- labor force
 $L = E + U = 146.1 + 6.9 = \underline{153.0}$
- not in labor force
 $NILF = POP - L = 231.7 - 153 = \underline{78.7}$
- unemployment rate
 $U/L \times 100\% = (6.9/153) \times 100\% = \underline{4.5\%}$
- labor force participation rate
 $L/POP \times 100\% = (153/231.7) \times 100\% = \underline{66.0\%}$

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The establishment survey

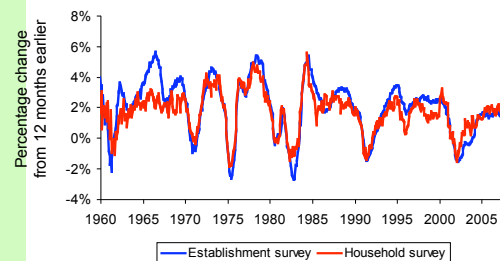
- The BLS obtains a second measure of employment by surveying businesses, asking how many workers are on their payrolls.
- Neither measure is perfect, and they occasionally diverge due to:
 - treatment of self-employed persons
 - new firms not counted in establishment survey
 - technical issues involving population inferences from sample data

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Two measures of employment growth



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Chapter Summary

1. Gross Domestic Product (GDP) measures both total income and total expenditure on the economy's output of goods & services.
2. Nominal GDP values output at current prices; real GDP values output at constant prices. Changes in output affect both measures, but changes in prices only affect nominal GDP.
3. GDP is the sum of consumption, investment, government purchases, and net exports.



Chapter Summary

4. The overall level of prices can be measured by either
 - the Consumer Price Index (CPI), the price of a fixed basket of goods purchased by the typical consumer, or
 - the GDP deflator, the ratio of nominal to real GDP
5. The unemployment rate is the fraction of the labor force that is not employed.