The ABCs of GDP

We all hear about GDP, or gross domestic product, in the news. Most recently, U.S. GDP declined by 6.1 percent compared to the year before. But what does that really mean? Why do people seem to care about GDP so much? The basic answer is that it is one of the major summary measures of the health and growth of the nation's economy.

GDP is the output (in a currency, such as the U.S. dollar) of final goods and services produced by labor and property located in a country. In other words, it is what residents produce in a country for end consumption, not as an input into another final good.

A simple mathematical definition of GDP is

GDP = Consumption + Investment + Government spending + Net exports.

Consumption is purchases of goods and services by households. It makes up more than two-thirds of GDP in the United States. *Investment* is purchases of fixed assets by businesses, new homes by households, and inventories. *Government spending* is final expenditures by federal, state, and local governments. Net exports is the amount a country exports minus the amount it imports. If the country imports more than it exports, as is the case in the United States, net exports are a negative and subtract from total GDP.

A couple of terms often discussed about GDP are nominal and real. But what's the difference? Nominal GDP is the measure of GDP in current dollars—everything added up in the currency value of that year. It can be misleading for trying to compare growth rates across years. Economists more commonly use real GPD, which is adjusted for inflation. For example, when real GDP grows by 3 percent, we know that 3 percent more goods and services have been produced, not that a 3 percent price increase occurred.

While GDP is an extremely useful measure of the economy's health, it is only one indicator. No one measure tells the whole story of the economy. To truly consider the health of the economy, the Federal Reserve and other organizations look at a broad array of measures, including talking to business leaders to understand what they are seeing firsthand in the economy.

GDP is also not meant to be a social measure. GDP per capita is a measure of the income per person in a country and can give an idea of the relative wealth of a country. But it does not measure income disparity within that country.

One commonly held misconception is that a recession is defined as two consecutive quarters of negative real GDP growth. However, calling a recession is more art than an exact definition. In the United States, the National Bureau of Economic Research (NBER) is a nonprofit research organization that declares start and end dates for business cycle activity, such as a recession. The NBER looks at five economic measures to make its decision: real GDP growth, real personal income, employment (nonfarm payrolls), industrial production, and wholesale-retail sales. Their definition of a recession is, "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in production, employment, real income, and other indicators." When we hear that we are or are not "officially" in a recession in the United States, people are generally referring to the NBER's analysis.

Of course, GDP, the broadest measure of our economy, includes many more detailed factors. But, by understanding what GDP is, how real GDP adjusts for inflation, and the limits of GDP, we gain a better idea of what is going on in our economy.