GDP, what is it, how is it used?

Aaron J. Allen

Minnesota School of Business

SS145 – Introduction to Macroeconomics

Mr. Duke

September 17, 2012

Introduction

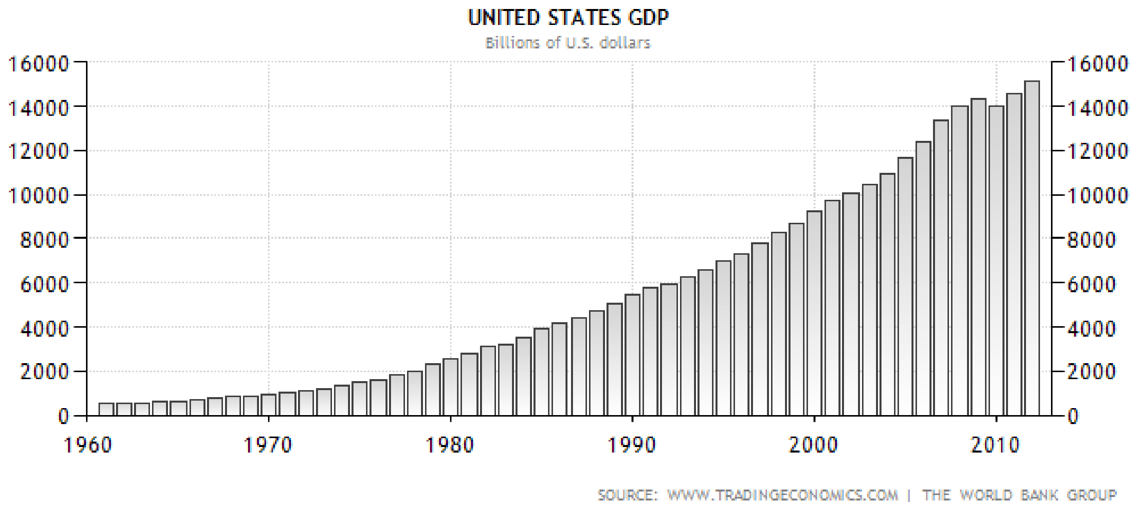
During my period in Principles of Macroeconomics, Gross domestic product (GDP) was the most interesting topic for me. I enjoyed learning about it because the term holds extensive value. GDP is used in analyzing a country's economic stature or its overall welfare. It is the ultimate measurement of a country's worth. In this paper I will discuss in great detail about GDP, how it works, the components of GDP, and how it is used. I will also examine the national dept as a percentage to GDP and explain why the debt to Gross domestic product ratio fluctuates. I will also give personal insight to probable cause to fluctuations throughout history (Amadeo, 2012).

Basic Description

As stated previously, GDP is a measurement of a country's overall output. In other words, everything produced by that country, make up its GDP. Generally speaking, GDP is made up of house hold spending on consumer goods, spending by firms and households on investments, government spending, and total exports minus imports. The concept was born in 1937 by Simon Kuznets, an economist. Kuznets worked for the National Bureau of Economic Research and reported to the U.S. Congress his formulation of all economic production by individuals, companies, and the government in a single measure. His idea is now being utilized worldwide as a tool of measure for economies (Dickenson, 2011).

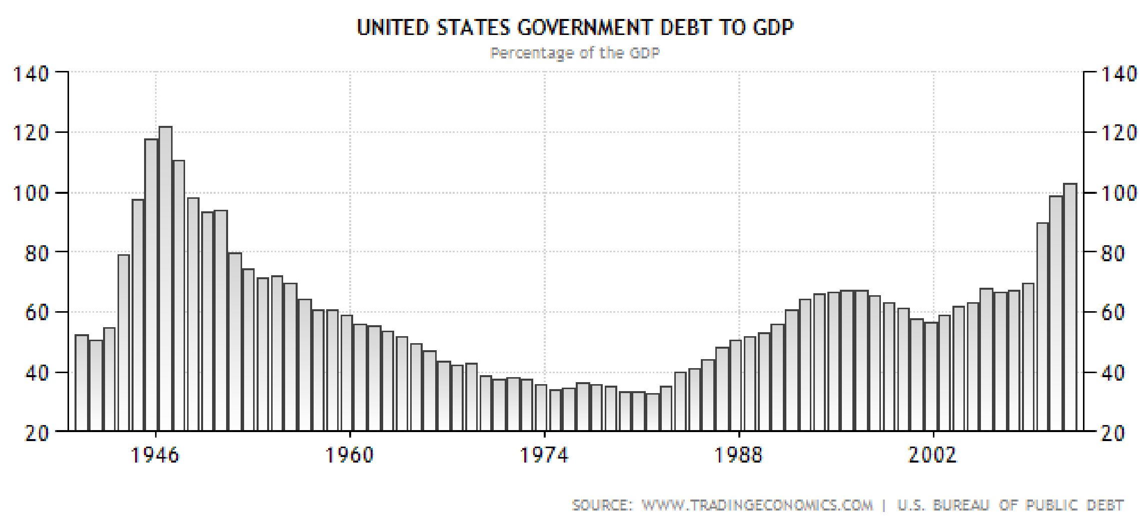
Gross domestic product is important because it is used to determine the speed of growth for the economy. Economists evaluate current GDP to the previous quarter, or previous year to determine growth. Another important purpose for GDP is to compare size of economies of other countries and also compare their economic growth rate quarter to quarter or year to year.

Looking at the GDP by itself does not provide much information, except the total amount of money the country produced. Economists need a contrasting value to make the GDP have more significance. Without a contrasting number, the value has little meaning (Amadeo, 2012).



There are a couple methods for this tactic. When analyzing the economy, Gross domestic product growth rate is one tool used. The Bureau of Economic Analysis (BEA) measures the GDP and compares it to the previous quarter as a percentage of change. Below is the most recent growth

Another form of measurement of GDP is using the debt to GDP ratio. This method can be used for many things, but mainly to get better understanding of the country's debt. The country's debt is a sum of its running annual deficit owed by the federal government. Comparing a country's output to its total debt is a good tool used to evaluate the economy and overall status of the country. This type of measure also shows ability of a county to pay its debt. The higher the debt percentage the less likely the country will be able to pay their debt and possibly default. Investors will not want to invest in a country that is likely to default. The graph below depicts the history of our debt to GDP percentage.



There are two types of GDP that economists use. Real GDP is used by the BEA to configure the GDP growth rate. Real GDP takes out the effect of inflation to give a more accurate reading from quarter to quarter. Nominal GDP is the raw value that is the country's output. Now that the basics of GDP have been discussed, a general understanding of Gross domestic product should be understood (United, 2012)

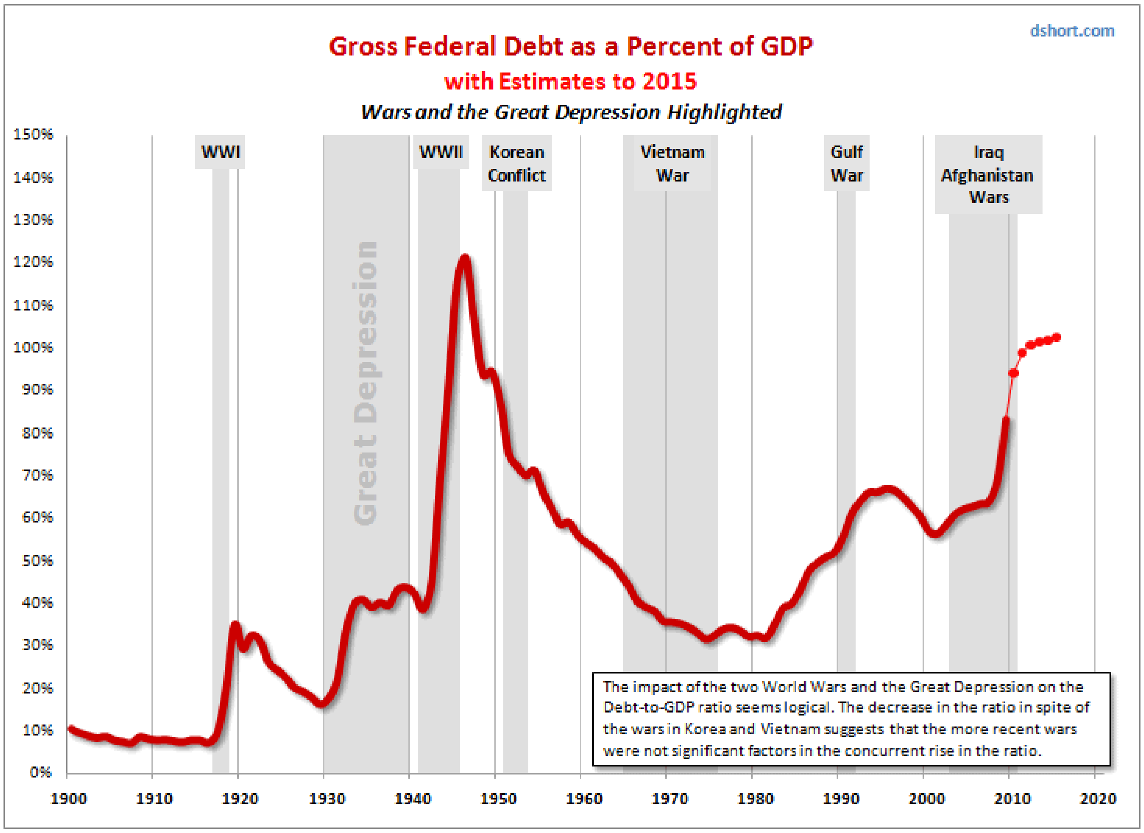
Discussion

The topic of GDP is a very large concept to try and discuss in its entirety. The intentions of this research paper is to relay the basics of GDP, explain in detail about different concepts of GDP, and discuss the debt as a percentage of GDP, and possible reasons as to why the debt to GDP ratio has fluctuated in history.

Debt as a percentage of debt can be a very informative tool. As previously stated, economist use it to evaluate the strength of an economy and its ability to repay its debt, while investors use the ratio to predict future growth or default of an economy. Debt to GDP ratio is not always the best method when analyzing an economy. When examining a countries debt, an important fact to be known is who holds the debt. Public debt is owed to the people, businesses, and foreign governments. The government portion of debt is the portion the government owes itself from overspending. Essentially, government debt is money borrowed from the future. The reason this is important is because countries like Japan have been over 100% debt to GDP for over a decade. Japan's debt to GDP was recorded as 211.70% in 2011. The reason this doesn't cause issues for Japan is because a majority of their debt is held by Japanese entities. Greece on the other hand had a debt to GDP of 165.30% for 2011 and is in the process of receiving their third bailout from the International Monetary Fund (IMF) and European Union (EU) (Amadeo, 2012). The IMF is an organization of 188 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world (About, n.d.). Greece's debt is mostly held by foreign governments and banks. So when it was time for Greece to pay their debt, they didn't have the funds to do so. Greece then asked for assistance from the IMF. Greece is currently still trying to dig their way out of their economic crisis (Amadeo, 2012).

The debt to GDP is a look at the status of the economy. Generally, one can look at the percentile and determine if the country is prospering or struggling economically. Different points in the past show how the status of economy changes. Currently we are at approximately103%, which is the worst it has been in over 60 years. The causes for this massive debt to GDP percentage is simply a bad mix of national debt and GDP. The chart on page 3 shows how gross domestic product has a very strong upward trend. So the national debt is where the issues lie. The GDP and a strong/weak economy play a part in the percentage, but not as much as the debt accrued. The responsibility of the economy falls on the president of the U.S. The current debt the United Stated has is the largest in the world and the largest contributor to that debt total has been President Obama. The total in tax cuts, economic stimulus packages, and about $800 billion a year in military spending has put the United States over $16 trillion in debt (United, 2012).

The highest the Debt to GDP ratio has ever been was 121.70% in 1946 following WWII (Amadeo, 2012). World War II generated a lot of debt and simultaneously prevented the economy from any real growth. All government spending was geared toward the war and concepts such as investments held little to no value. Even though the war was over, repercussions of WWII was still in play. After that peak, debt to GDP declined dramatically for the next 35 years until it hit its lowest point in history. In 1981, the ratio dropped to 32.50% (Amadeo, 2012). Using the data from the graph below, a trend is evident. Debt incurred from wars leads to a bad economy. The economy doesn't have growth in time of war. The country's focus and concern is geared toward the horrific event. Besides lack of output, military funding is very excessive during time of war and exceeds the budget. This bad combination is depicted by the peaks on the chart on the following page.



Conclusion

To conclude, it is important to know and understand the economy. The concept of GDP can be complex, but is an important concept to learn and understand. GDP by itself is almost arbitrary, however in contrast with itself, or other data, the value of GDP improves significantly. Gross domestic product can help one determine the speed of growth of an economy and compare size to other economies. Utilizing the debt to GDP ratio gives a clear understanding of the status of the economy and how well they can repay their debt. The status of the U.S. economy is currently weak, but as history has shown, we will find a way to recover and prosper once again. The United States does have the largest debt in the world, but we also are the country with the largest economy. In closing one fact is clear, the best way to understand the U.S. economy, or economies of other countries, is by looking at the GDP.

References

About the IMF (n.d.) *International Monetary Fund.* Retrieved September 13, 2012: http://www.imf.org/external/about.htm

Amadeo, K. (2012, April 4) What is gdp. *About.com: Part of the New York Times Company.* Retrieved September 12, 2012 from: http://useconomy.about.com/od/grossdomesticproduct/p/GDP.htm

Dickinson, E. (2011, February) GDP: a brief history. *Foreign Policy.* Retrieved September 13, 2012: http://www.foreignpolicy.com/articles/2011/01/02/gdp_a_brief_history

United states gdp. (2012) *Trading Economics.* Retrieved September 12, 2012 from: http://www.tradingeconomics.com/united-states/gdp