

## Chapter 6



# Measuring Economic Activity

**After reading this chapter, you will understand the following:**

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1. How the government measures gross domestic product
2. How domestic income differs from gross domestic product
3. The major types of international transactions
4. How the government measures inflation
5. The limitations of official economic statistics

**Before reading this chapter, make sure you know the meaning of the following concepts:**

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1. Real and nominal values
2. Indexation
3. Transfer payments
4. Domestic income and product

**I**n the Internet age, the latest data on GDP, prices, and trade deficits are available—and people act on them—instantly, throughout the world. An upward revision of the estimate for real output can send stock markets higher. News that a country's trade deficit has increased can send its exchange rate plunging. News that inflation remains unchanged at a time when traders expect it to increase can affect interest rates, bond prices, and the prices of commodities like gold and oil. Just having instant access to the numbers, however, is not enough. To use the latest data intelligently, you must know what they mean and where they come from. That means not only knowing the meaning of terms and concepts but also how they are measured.

Together, we call the official government data on aggregate economic activity the **national income accounts**. The economists and statisticians whose job it is to make these measurements for the U.S. economy are one of the best such teams in the world. Yet, as this chapter will show, they have a hard job. There are technical problems posed by sampling errors and survey methods. There are conceptual problems that arise when real-world institutions do not match the theoretical categories of economic models. Finally, there is a tradeoff between accuracy and timeliness of data. We will address all of these issues in this chapter.

## **6.1 The National Income Accounts in Nominal Terms**

We begin with an examination of the national income accounts in nominal terms—that is, in terms of the prices at which sales of goods and services actually take place. Nominal measures do not tell the whole story because they do not include adjustments for inflation. They do provide a starting point, however. Government statisticians first collect the data in nominal



### National income accounts

A set of official government statistics on aggregate economic activity

### Gross domestic product (GDP)

(1) A measure of the value of total output of goods and services produced within a country; (2) The value at current market prices of all final goods and services produced annually in a given country

### Final goods and services

Goods and services sold to or ready for sale to parties that will use them for consumption, investment, government purchases, or exports

### Intermediate goods

Goods and services that firms buy for use as inputs in producing other goods and services.

### Value added

The dollar value of an industry's sales less the value of intermediate goods purchased for use in production

form, and only after they have assembled a set of nominal accounts can they begin the process of adjusting for price changes.

## Gross Domestic Product

The most widely publicized number in the national income accounts is gross domestic product. Chapter 4 gave a preliminary definition of **Gross domestic product (GDP)** as a measure of the value of total output of goods and services produced within a country. We can now add a more technical definition: GDP is the value at current market prices (that is, the nominal value) of all final goods and services produced annually in a given country.

The term **final goods and services** is a key part of the definition of gross domestic product. GDP attempts to measure the sum of the economic contributions of each firm and industry without missing anything or counting anything twice. To do this, accurately, it is important to count only goods sold to *final users*—parties that will use them for domestic consumption, government purchases, investment, or export. **Intermediate goods**—those that firms buy for use as inputs in producing other goods or services—do not constitute part of GDP.

Table 6.1 shows why counting both final and intermediate goods would overstate total production. The table traces the process of producing a kitchen table with a retail price of \$100. The final stage of production takes place in a furniture factory, but the factory does not do \$100 worth of work. Instead, it produces the table by taking \$40 worth of lumber and adding \$60 worth of labor of factory workers. The \$40 worth of lumber is an intermediate good; the \$60 contribution made by the manufacturer is the **value added** to the product at its final stage. (In practice, the firm would also use other intermediate goods, such as paint and fuel for heating the plant, and other factors of production, like capital in the form of woodworking equipment. To simplify the example we assume that lumber and labor are the only inputs.)

The second section of Table 6.1 shows the next-to-last stage of production: making the lumber. The sawmill buys \$15 worth of logs, adds \$25 worth of labor and capital, and produces lumber worth \$40. The value added at the sawmill stage is thus \$25.

Going still further back, we come to the stage at which the forest products company cuts the logs that are the source of the lumber. Inputs at that stage include \$5 worth of fuel and purchased equipment, plus value added of \$10 that represents factors of production used in tending the trees and harvesting the logs. That is an additional \$10 of value added.

We could trace the process of making the table back to still earlier stages of production. The last section of the exhibit sums up the value added at all stages of production prior to timber farming—the fuel and equipment suppliers, their own suppliers, and so on. If we went back far enough, we could attribute every penny to the value added to the final product somewhere in the chain of production.

**TABLE 6.1 VALUE ADDED AND THE USE OF FINAL PRODUCTS IN GDP**

|                                       |        |       |               |
|---------------------------------------|--------|-------|---------------|
| Final stage—manufacturing:            |        |       |               |
| Value of one table                    | \$ 100 |       |               |
| Less value of lumber                  | –40    |       |               |
| Equals value added in manufacturing   | 60     | _____ | \$ 60         |
| Next to final stage—sawmill:          |        |       |               |
| Value of lumber                       | \$ 40  |       |               |
| Less value of logs                    | –15    |       |               |
| Equals value added at sawmill         | 25     | _____ | 25            |
| Second to final stage—timber farming: |        |       |               |
| Value of logs                         | \$ 15  |       |               |
| Less value of fuel, equipment, etc.   | –5     |       |               |
| Equals value added in timber farming  | 10     | _____ | 10            |
| All previous stages:                  |        |       |               |
| Value added in fuel, equipment, etc.  | \$ 5   | _____ | 5             |
| <b>Total value added</b>              |        |       | <b>\$ 100</b> |

This table shows why GDP must include only the value of final goods and services if it is to measure total production without double counting. We divide the value of sales at each stage of production into the value each firm adds at its own stage of production and the value of intermediate goods it buys. The selling price of the final product (a \$100 table, in this case) equals the sum of the values added at all stages of production.

Now compare the first and last lines of the table. The value of the final goods turns out to be exactly equal to the sum of the values added at each stage of production. This is why we count only final goods as part of GDP. Adding together the \$100 value of the finished table, the \$40 value of the lumber, the \$15 value of the timber, and so on would far overstate the true rate of productive activity (the true total value added) in the economy.

### Measuring the Economy by the Expenditure Approach

In principle, we could measure GDP by adding together the value of each good or service sold and adjusting for the cost of inputs to get the value added at each stage of production, as in Table 6.1. However, that is not the principal approach that government statisticians use. Instead, they make use of the equality of domestic product and total expenditure. It is easier to gather data on the total amount that households, investors, governments, and buyers of exports spend on final



goods than it is to stand at factory gates and count goods as they roll off production lines. We call this method of measuring GDP the *expenditure approach*. Table 6.2 shows how it works, using 2012 data for the U.S. economy.

**Consumption** The first line of Table 6.2 gives total household consumption of both domestically produced and imported goods and

services. The national income accounts divide consumption into three categories: durable goods like cars and appliances, nondurable goods like food and clothing, and services like medical care and banking. All three components of consumption contain some items that do not pass through markets on their way to consumers. One such item is an estimate of the quantity of food that farm families produce and consume themselves. Another is an estimate of the rental value of owner-occupied homes. However, the national income accounts do not capture many non-market goods and services—for example, unpaid childcare and housework.



Medical care is included in the services section of the national income accounts.

**Investment** The item *gross private domestic investment* is the sum of all purchases of newly produced capital goods (fixed investment) plus changes in business inventories (inventory investment). The fixed-investment component includes both business fixed investment—all new equipment and structures bought by firms—and the value of newly constructed residential housing. In effect, the national income accounts treat a family that owns a home like a small firm. When the family buys the home, the accounts treat the purchase as an investment. Then, as we saw earlier, they treat the firm’s “product”—the rental value of its shelter services—as part of annual consumption.

The gross private domestic investment item does not include investment in structures, software, and equipment by federal, state, and local governments. Those amounted to some \$503 billion in 2008, adding about 25 percent to the total of all investment for the economy. From the point of view of short-run business cycle theory, it makes sense to treat government and private investment differently since the motives for the investment are different. However, from the point of long-term growth theory, government investment, like private investment, adds to a country’s stock of capital and increases future natural real GDP.

**TABLE 6.2**  
**NOMINAL GROSS DOMESTIC PRODUCT BY TYPE OF EXPENDITURE, 2012**  
**(DOLLARS IN BILLIONS)**

|                                                               |            |             |
|---------------------------------------------------------------|------------|-------------|
| Personal consumption expenditure                              |            | \$ 10,058.5 |
| Durable goods                                                 | \$ 1,022.7 |             |
| Nondurable goods                                              | 2,966.9    |             |
| Services                                                      | 6,068.9    |             |
| Plus gross private domestic investment                        |            | 2,004.1     |
| Fixed investment                                              | 2,044.0    |             |
| Change in private inventories                                 | −39.9      |             |
| Plus government consumption expenditures and gross investment |            | 2,883.3     |
| Federal                                                       | 1,071.2    |             |
| State and local                                               | 1,812.1    |             |
| Plus net exports of goods and services                        |            | −665.1      |
| Exports                                                       | 1,867.8    |             |
| Less imports                                                  | −2,533.0   |             |
| Equals gross domestic product (GDP)                           |            | \$ 14,280.8 |
| Less allowance for consumption of fixed capital               |            | −1,623.9    |
| Equals net domestic product (NDP)                             |            | \$ 12,656.9 |

This table shows the procedure for estimating gross domestic product using the expenditure approach. This approach involves adding together the values of expenditures on newly produced final goods and services made by all economic units to get a measure of aggregate economic activity. Net domestic product is equal to gross domestic product minus the value of expenditures on replacement of worn-out or obsolete capital equipment.

Source: Bureau of Economic Analysis, News Release: Gross Domestic Product, April 27, 2012

**Government Purchases** As mentioned in Chapter 5, the item that economists call “government purchases” goes by the name “government consumption expenditures and gross investment” in the official national income accounts. Whether consumption-like or investment-like, government purchases enter into the national income accounts at cost. Accountants make no attempt to measure the value added by government because governments pay for most outputs—such as primary and secondary education or police protection, to name a few—with revenue from taxes and provide them to the public without charge. The expenditure approach to GDP also does not include transfer payments because they are not purchases of newly produced final goods and services.

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**Net Exports** The last item in the GDP account is net exports—exports minus imports. In calculating GDP, we must subtract imports from exports to avoid double counting. That is because some of the goods that consumers, firms, and governments buy come from outside the domestic economy. For example, a consumer might buy a Japanese television set, an insurance company might buy Korean computers for use in its offices, and a city government might buy a Swedish police car. The figures for consumption, investment, and government purchases, therefore, overstate the final use of domestically produced goods and services. Adding total consumption, total investment, total government purchases, and exports less imports yields the same sum as we would get by adding domestic consumption of domestically produced goods, domestic purchases of domestically produced capital goods, domestic government purchases of domestically produced goods, and total exports.

**Gross versus Net Domestic Product** What makes gross domestic product “gross”? It is the fact that gross private domestic investment measures total additions to the nation’s capital stock without adjusting for losses through wear and tear or obsolescence. For example, gross private domestic investment includes the value of each year’s production of new homes and factories without subtracting the value of old homes and factories that are torn down.

Gross private domestic investment minus an allowance for depreciation and obsolescence yields net private domestic investment, which is a measure of the actual net addition to the nation’s capital stock each year. Only net investment adds to the capital stock, thereby helping to expand the economy’s natural real output over time. The part of gross investment that covers depreciation and obsolescence only keeps the capital stock from shrinking.

Although depreciation and obsolescence are hard to measure accurately, national income accountants use an approximate measure called the *allowance for consumption of fixed capital*. Gross domestic product minus this allowance equals *net domestic product* (NDP).

### Measuring the Economy by the Income Approach

In addition to GDP, measured using the expenditure approach, the national accounts include a measure of national income that uses an income approach. The income approach measures wages, rents, interest, and profits as they flow into the household sector. Table 6.3 summarizes this approach.



**TABLE 6.3 NOMINAL DOMESTIC INCOME, 2012 (DOLLARS IN BILLIONS)**

|                                                        |             |
|--------------------------------------------------------|-------------|
| Compensation of employees                              | \$ 8,055.1  |
| Wages and salaries                                     | \$ 6,543.2  |
| Supplements                                            | 1,504.4     |
| Plus rental income of persons                          | 64.4        |
| Plus net interest                                      | 682.7       |
| Plus corporate profits                                 | 1,476.5     |
| Plus proprietors' income                               | 1,072.4     |
| Plus indirect business taxes, business transfers, etc. | 1,078.6     |
| Equals national income                                 | 12,429.7    |
| Less receipts of factor income from rest of world      | – 798.3     |
| Plus payments of factor income to rest of world        | 665.1       |
| Equals domestic income                                 | \$ 12,296.5 |

This table shows the measurement of national and domestic income according to the income approach, which adds together all forms of income earned by a country's residents. U.S. national income includes some income received in return for factors of production used abroad and excludes payments to foreign residents for the use of factors owned by them but located in the United States. Domestic income is the sum of all income that results from production that takes place on the territory of a country. To derive domestic income from national income, we first subtract factor income received by this country's residents from the rest of the world and then add factor income paid to residents of the rest of the world as a result of activities in this country.

Source: Bureau of Economic Analysis

The first element of national income is *compensation of employees*, which consists of wages and salaries plus certain supplements. Employer contributions to social insurance (social security and Medicare) are the most important supplement. By law, employees pay only half of social insurance taxes; employers must pay the other half. However, because both halves contribute to employees' retirement benefits, the national income accounts include both halves as part of employee compensation. Other supplements include employer-paid health insurance and contributions to 401k and other private pension plans.

*Rental income of persons* consists of all income in the form of rent and royalties received by property owners. Net interest includes interest income received by households, less the interest they pay as consumers.

*Corporate profits* include all income earned by the shareholders of corporations. Firms pay part of that income to shareholders in the form of dividends. Another part of corporate profits goes to pay taxes. Firms hold back a third part, undistributed corporate profit, for reinvestment.

Because reinvestment of profits adds to shareholder wealth, we count it, too, as a part of household income. The accounts also adjust corporate profits for changes in the value of inventories and for consumption of fixed capital (depreciation).

Corporate profits account for only about 60 percent of all business income. The rest appears on the next line in Table 6.3, *proprietors' income*. This item lumps together all forms of income earned by self-employed professionals and owners of unincorporated business.

The final item, *indirect business taxes and business transfers*, is a catchall category that includes items that are expenses to firms, but unlike factor payments, do not generate income for individuals. Business property taxes are one such item. Business transfer payments are payments in return for which the firms do not receive services. They include corporate gifts, insurance settlements, and some other small items.

The total of these items is **national income**, the total income received by a country's residents. The term *national* means that this is a measure of income earned by a country's residents, regardless of whether their productive services take place in the home country or another country. For example, corporate profits shown in the table would include the profits earned on capital the Ford Motor Company has invested in a plant in Japan, but they would not include profits earned on capital that Honda Motors has invested in a plant in the United States. In contrast, *domestic* income and product are geographical concepts that measure activity that takes place on the territory of a country, regardless of who owns the factors of production involved. We can obtain a geographical measure of income, **domestic income**, by subtracting factor income received by U.S. residents from the rest of the world and adding factor income paid to foreign residents.<sup>1</sup>

### National income

The total income earned by a country's residents, including wages, rents, interest payments, and profits

### Domestic income

The total income of all types, including wages, rents, interest payments, and profits, earned by factors of production used in producing domestic product

**Reconciling the Income and Expenditure Approaches** The official accounts measure gross and net domestic product by the expenditure approach, using one set of data, and domestic and national income by the income approach, using a different set of data. No matter how careful the work, there will be some errors and omissions. That means the two sets of figures will not quite fit together. The difference between net domestic product and domestic income is statistical discrepancy. Most of the time this error is very small—well below 1 percent of GDP. Theoretical models, including those in this book, ignore the statistical discrepancy completely. They treat domestic income and domestic product as equal by definition.

## 6.2 Measuring International Linkages

The item “net exports” in the national income accounts gives a glimpse of the linkage between the domestic economy and the rest of the world. These ties have grown over time. In 1960, U.S. exports amounted to only 6 percent of GDP and imports to less than 5 percent.

By 2012, exports had grown to 13.6 percent of a much larger GDP. Imports grew even more rapidly over the same period, reaching 18.6 percent of GDP. In view of the growing importance of the foreign sector, then, it is worth taking a closer look at the international ties of the U.S. economy.

It is not easy to discuss an economy's balance of international payments because thousands of different kinds of international payments take place every day. Payments for exports and imports of goods and services are only part of the story. Equally important are long- and short-term international loans, purchases and sales of securities, and direct investments in foreign businesses. In addition, governments and private individuals make many kinds of transfer payments to residents of other countries, including outright gifts, pension payments, and official foreign aid. Finally, the U.S. Federal Reserve System and foreign central banks engage in many kinds of official transactions. Table 6.4 shows a simplified version of the accounts used to keep track of these international transactions for the United States.

## The Current Account

The first section of the international accounts shown in Table 6.4 is the current account. This section includes imports and exports of goods and services, payments of factor income between countries, and international transfer payments.

Imports and exports of merchandise (goods) are the most widely publicized items in the international accounts. During much of the nineteenth century, the United States was a net importer of merchandise. From 1894 to 1970, it was a net exporter. Since 1970, it has again become a net importer, as shown by the negative **merchandise balance** in Table 6.4.

In addition to trade in merchandise, there is a large international trade in services. Travel expenditures, airline passenger fares, and other transportation services account for somewhat more than half of these services. Other services include insurance, royalties, and license fees. In recent years, the United States has been a net exporter of services.

Earlier, in drawing the distinction between domestic and national product, we noted that U.S. residents receive substantial flows of factor income (wages, profits, interest, and so on) from production activities that take place abroad. The accounts record those payments as exports; they enter the current account with a positive sign. At the same time, some payments of factor income go to residents of other countries that participate in production activities in the United States. The accounts treat those payments as imports; they enter the current account with a negative sign. The United States typically receives more factor income from abroad than it pays.



*U.S. imports grew even more rapidly than exports reaching 18.6 percent of GDP by 2012.*

### Merchandise balance

The value of a country's merchandise exports minus the value of its merchandise imports

**TABLE 6.4 U.S. INTERNATIONAL ACCOUNTS FOR 2012 (DOLLARS IN BILLIONS)**

| Current Account               |                                                                                                                                                 |          |        |
|-------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------|----------|--------|
| 1.                            | Balance on goods                                                                                                                                |          | -821.6 |
| 2.                            | Exports of goods                                                                                                                                | 1,291.3  |        |
| 3.                            | Imports of goods                                                                                                                                | -2,112.9 |        |
| 4.                            | Services, net                                                                                                                                   |          | 139.7  |
| 5.                            | Exports of services                                                                                                                             | 544.4    |        |
| 6.                            | Imports of services                                                                                                                             | -404.7   |        |
| 7.                            | Net receipts of factor income                                                                                                                   |          | 127.6  |
| 8.                            | Income receipts from abroad                                                                                                                     | 755.4    |        |
| 9.                            | Income payments by the United States                                                                                                            | -627.8   |        |
| 10.                           | Transfers, net                                                                                                                                  |          | -119.7 |
| 11.                           | Current account balance (lines 1 + 4 + 7 + 10)                                                                                                  |          | -674.0 |
| Capital and Financial Account |                                                                                                                                                 |          |        |
| 12.                           | Net change in U.S. assets abroad<br>(- indicates increase in U.S. assets abroad, that is, a financial outflow)                                  |          | -52.4  |
| 13.                           | U.S. private assets                                                                                                                             | 481.8    |        |
| 14.                           | U.S. official reserve assets                                                                                                                    | -4.8     |        |
| 15.                           | Other U.S. government assets                                                                                                                    | -529.5   |        |
| 16.                           | Net change in foreign assets in the United States<br>(+ indicates increase in foreign assets in the United States, that is, a financial inflow) |          | 599.0  |
| 17.                           | Capital account transactions, net                                                                                                               |          | -2.6   |
| 18.                           | Capital and financial account balance (lines 12 + 16 + 17)                                                                                      |          | 544.0  |
| 19.                           | Statistical discrepancy                                                                                                                         |          | 130.0  |

This table gives details of U.S. international transactions for 2012. The first section shows current account transactions, consisting of imports and exports of goods and services, together with international flows of factor income and transfer payments. The second section shows capital and financial account transactions, consisting of international borrowing and lending, securities transactions, direct investment, and official reserve transactions. If all amounts were complete and accurate, the current account and financial account balances would be equal and opposite in sign. In practice, there is a statistical discrepancy that indicates errors and omissions in measurement.

Source: U.S. Department of Commerce, Bureau of Economic Analysis

The final item on the current account consists of net transfer receipts. This typically is a negative item in the U.S. international accounts because transfers to other countries exceed transfers received



from them. This item takes into account both government transfers, (for example, foreign aid and social security payments to retired workers living abroad) and private transfers (for example, remittances sent to relatives abroad by U.S. residents and private charitable contributions to beneficiaries overseas.)

The sum of merchandise trade, services, factor income, and net transfers is the country's **current account balance**. The United States has had a current account deficit every year since 1981.

Sometimes the official term "current account balance" appears in news reports and other popular discussions, but not everyone is careful in their use of terminology. Sometimes people use the terms "balance of payments" or "balance of trade" when they mean the current account balance. To add to the confusion, people sometimes use the term "balance of trade" to mean the merchandise balance, or even the sum of trade in goods and services.

The current account balance is a close relative of the concept "net exports" used in macroeconomic models. For purposes of this book, we will treat them as being equal although in practice, for reasons arising from the methodology of national income accounting, the correspondence is not quite exact.

### Current account balance

The value of a country's exports of goods and services minus the value of its imports of goods and services plus its net transfer receipts from foreign sources

## The Capital and Financial Account

Current account transactions are not the only ones that take place among residents of different countries. International lending and borrowing, and international sales and purchases of assets, also account for an enormous volume of daily transactions. A U.S. company, for example, might obtain a short-term loan from a London bank to finance the purchase of a shipload of beer for import to the United States. The Brazilian government might get a long-term loan from Bank of America to help finance a hydroelectric project. A wealthy U.S. resident might open an account in a Swiss bank. All such transactions appear in the capital and financial account section of Table 6.4.

In this book, we will use the shorter term "financial account" to refer to that section of the international accounts. Some writers, instead, use the term "capital account" as shorthand to refer to the entire capital and financial account.

Purchases of U.S. assets by foreign residents and borrowing from foreign financial intermediaries by U.S. firms and individuals create



International borrowing and lending appears in the financial section of the U.S. international accounts.

### Financial inflow

Purchases of domestic assets by foreign buyers and borrowing from foreign lenders, also often called capital inflows

### Financial outflow

Purchases of foreign assets by domestic residents or loans by domestic lenders to foreign borrowers, also often called capital outflows

flows of funds into the United States that we call **financial inflows**. (Many writers instead use the term *capital inflows*.) Purchases of foreign assets by U.S. residents or loans by U.S. financial intermediaries to foreigners create flows of funds out of the United States that we call **financial outflows**. (Many writers use the term *capital outflows*.)

Table 6.4 lists several types of capital and financial account transactions. Changes in U.S. private assets include *direct investments*, for example, construction of foreign plants by U.S. firms and portfolio investments, that is, purchases of foreign securities like stocks or bonds. Accumulation of short-term foreign assets like foreign bank balances and foreign currency are also included on this line.

Changes in U.S. official reserve assets include foreign currency and other foreign assets acquired by the Federal Reserve System and the U.S. Treasury. Changes in other U.S. government assets relate to short- and long-term credits and other assets by government agencies other than the Federal Reserve System and U.S. Treasury.

Changes in foreign assets in the United States include both private and government transactions. Construction of U.S. plants by foreign firms, purchases of U.S. securities by foreign financial institutions, accumulation of U.S. currency by foreign residents, and purchases of U.S. securities as official reserve assets by foreign central banks are all included on this line.

The “capital account,” in the narrow sense in which the term is officially used, is a small item that refers to transactions in nonfinancial assets such as ownership of patents and copyrights, and also includes private and governmental debt forgiveness and defaults on debt.

## Relationship of the Accounts

There is a close logical relationship between the balance on the capital and financial account and the current account surplus or deficit. Because the United States runs a current account deficit, its earnings from the sales of exports will not be enough to pay for all of its imports. It gets the additional funds it needs to finance the excess imports through net financial inflows, that is, through net U.S. borrowing from abroad or net sales of U.S. assets to foreign residents. In this case, the country shows a positive balance on the capital and financial account that offsets the current account deficit.

Countries like Russia or China that usually have current account surpluses are in the opposite position. They need to find something to do with the extra export earnings not used to buy imports. They can use them to make net loans to foreign borrowers or to accumulate foreign assets through direct foreign investment, portfolio investment, or accumulation of foreign currency and bank balances. For that reason, countries with current account surpluses have negative balances on their capital and financial accounts.

In principle, the balances of the current and financial accounts should be equal and opposite in sign. If there is a current account surplus of \$100 billion (entered with a plus sign in the accounts), there should

be a net financial outflow of \$100 billion (entered with a minus sign in the accounts). If there is a current account deficit of \$500 billion, there should be a net financial inflow of \$500 billion. The reason for the symmetry is that the two sections of the accounts, taken together, include all the sources and uses of the funds that change hands in international transactions. Because every dollar used must have a source, when the sources (+) and the uses (–) are added together, the sum should be zero.

In practice, though, government statisticians always miss some items when they tally up imports, exports, and financial flows. As a result, the numbers do not quite add up. The difference between the current and financial account balances is the *statistical discrepancy*. Much of the discrepancy probably reflects unrecorded financial flows, for example, investments made in the United States by residents of other countries but never officially reported. Part of it also reflects incomplete recording of U.S. exports, especially to Canada. A small part of the statistical discrepancy also arises from criminal activity, including drug smuggling (unrecorded current account activity) and money laundering (unrecorded financial account activity).

## 6.3 Measuring Real Income and the Price Level

Between 1996 and 2012, the nominal value of U.S. gross domestic product approximately doubled, rising from about \$7.7 trillion to about \$15.4 trillion. However, that does not mean that the economy produced twice as much by way of real goods and services. Part of the increase in nominal GDP over the period reflected increases in prices. Unless we know how much prices increase from one year to another, we cannot know how much of the change in nominal output was real and how much was the result of inflation. This section discusses two of the most important approaches to measuring changes in the price level.

### Real Gross Domestic Product and the GDP Deflator

Nominal GDP is the answer to the question: What was the value of the country's output of goods and services evaluated using the prices at which sellers actually sold the goods? Real GDP is the answer to a different question: What would the value of the country's goods and services have been if prices had not changed from year to year?

The first step in answering that question would be to choose a year as a basis for comparison, that is, a **base year**. For example, we could ask what the value of the output of the U.S. economy would have been in 2012 if prices in that year were the same as in the base year 1996. That would mean multiplying the number of chocolate bars sold in 2012 at their 1996 price, adding the quantity of gasoline sold in 2012 at its 1996 price, and so on.

The answer to our question would be that the value of the goods and services produced in 2012 would have been worth approximately \$11.2 trillion. That is quite a bit less than the \$15.4 trillion nominal GDP

#### Base year

The year used as a basis for comparison when computing real GDP or a price index

### GDP deflator

A measure of the average price level of goods and services based on the ratio of nominal GDP to year real GDP, stated relative to the prices of a chosen base year

### Price level

A weighted average of the prices of goods and services expressed in relation to a base year value of 1.0

### Price index

A weighted average of the prices of goods and services expressed in relation to a base year value of 100

for 2012. While nominal GDP doubled between 1996 and 2012, real GDP increased by only about 45 percent.

If current year nominal GDP is \$15.4 trillion and current year real GDP is only \$11.2 trillion, the difference must be due to price changes. The ratio of nominal GDP to real GDP gives us a measure of change in the price level that we call the **GDP deflator**. In our example, the ratio of 2012 nominal GDP to 2012 real GDP, calculated using 1996 as the base year, is  $15.4/11.2$ , or 1.375.

We can use the base year in one of two ways in stating a measure of average prices, such as the GDP deflator. One way is to let the base year value equal 1.0. We call a statement of average prices relative to a base year value of 1.0 a statement of the price level. In our example, the 2012 **price level**, relative to the 1996 base year, is 1.375. The other way is to let the base year value equal 100. A statement of average prices relative to a base year value of 100 is a **price index**. In our example, the 2012 price index relative to the 1996 base year was 137.5. The price level and price index are two different ways of stating the same information. News reports more frequently use the index form. In building economic models, the price level form is more convenient.

The Bureau of Economic Analysis computes official data for GDP using a procedure very similar to that of our simple example. The main difference is that, rather than making the calculation over a wide interval (1996 to 2012 in our example), the BEA uses a “chained” methodology, which means calculating each year’s GDP deflator relative to the immediately preceding year. It then restates the chained deflators for each year in terms of a chosen base year that changes only occasionally. The BEA currently states the GDP deflator in terms of “chained 2005 dollars,” meaning that the price level for 2005 is 1.0 and the 2005 price index is 100.

In addition to the economy-wide GDP deflator, it is possible to calculate GDP deflators for individual components of GDP. The deflator for personal consumption expenditures is one example, to which we will return shortly.

## The Consumer Price Index

The GDP deflator is the most broadly based price index for the U.S. economy, but “broad” is not always what we want. Instead, what is often of most interest is not the price level for the whole economy but the cost of living, as determined by the prices of goods that consumers typically buy. That requires an index that omits elements of GDP like industrial equipment, office buildings, fighter planes, and fire engines that are not directly relevant to the cost of living.

The most widely used measure of the cost of living is the **consumer price index (CPI)**. In fact, the CPI is not just one index but a whole family of indexes that cover different population groups and regions. The best known is the CPI for all urban consumers. Its official designation is CPI-U, but more often than not people refer to it just as the CPI.

The CPI currently uses the period 1982–1984 rather than a single year as its base. *Applying Economic Ideas 6.1* explains the method for calculating the CPI.

### Consumer price index (CPI or CPI-U)

A price index based on the market basket of goods and services for a typical urban household





## Applying Economic Ideas 6.1

### How to Calculate a Consumer Price Index

To calculate the consumer price index each month, statisticians at the Bureau of Labor Statistics sample the prices of hundreds of goods in hundreds of locations. We do not need all that detail to understand the basic concept of the CPI, however. Here, we explain five steps for calculating the CPI for a simple economy in which there are only three goods: movies, apples, and shirts.

**Step 1** is to choose a base year. For our simplified CPI, we will use the year 2000.

**Step 2** is to measure the base-year market basket, that is, the quantities of various goods that consumers bought in the base year. In this example, we see that in 2000, consumers bought tickets to 50 movies, ate 1,000 apples, and purchased 10 shirts.

**Step 3** is to record the prices of the goods in both the base year (2000) and the current year (2012). We learn that a movie ticket cost \$5 in 2000 and \$6 in 2012; an apple cost \$.60 in 2000 and \$1.20 in 2012; and a shirt cost \$15 in 2000 and \$20 in 2012.

**Step 4** is to evaluate the base-year market basket at each year's prices. The table shows that it would have cost \$1,000 to buy the full basket in 2000 and \$1,700 to buy the same goods and services at the higher prices of 2012.

**Step 5** is to calculate the CPI itself. To do that, we first take the ratio of the value of the market basket at 2012 prices to its value at base-year prices. Then, to state it as an index, we multiply the ratio by 100.

The bottom line: the CPI for our three-good economy rose from 100 in 2000 to 170 in 2012.

A Consumer Price Index for a Simple Economy

| Goal                                                      | 2000 Quantity | 2000 Price | Value of 2000 Quantity of 2000 Price | 2012 Price | Value of 2000 Quantity of 2012 Price |
|-----------------------------------------------------------|---------------|------------|--------------------------------------|------------|--------------------------------------|
| Movies                                                    | 50            | \$ 5.00    | 250                                  | \$ 6.00    | \$ 300                               |
| Apples                                                    | 1,000         | .60        | 600                                  | 1.20       | 1,200                                |
| Shirts                                                    | 10            | 15.00      | 150                                  | 20.00      | 200                                  |
| Totals                                                    |               |            | \$1,000                              |            | \$1,700                              |
| $\text{CPI} = \frac{\$1,700}{\$1,000} \times 100 = 170.0$ |               |            |                                      |            |                                      |

### Producer price index (PPI)

A price index based on a sample of goods and services bought by business firms

## Producer Price Indexes

The **producer price indexes** are still another way of measuring price changes. These are price averages for three classes of goods that business firms buy and sell among one another. The producer price index we encounter most often is that for *finished goods*—investment goods sold to businesses plus other goods that are ready for final use but have not yet reached consumers, for example, wholesale sales of clothing to retail stores. Other producer price indexes cover intermediate goods and crude materials ready for further processing. The producer price indexes currently use a base year of 1982. Because producer price indexes measure prices at early stages in the production process, they can give hints for future trends in consumer prices. Firms also often use them to index payments that they make to one another.

## 6.4 How Good Are the National Income Accounts?

The national income accounts of the United States are among the best in the world, but they are far from perfect. In this section, we focus on four possible problem areas: the accuracy and timeliness of the data, the underground sector of the economy, bias in price indexes, and non-material aspects of the standard of living.

### Accuracy versus Timeliness

As we have emphasized, the measurement of GDP involves an enormous amount of data collection.<sup>2</sup> Both government and private decision makers want the data they use to be timely and accurate; but in practice, there is a trade-off. It is not feasible to station a monitor at every factory gate and supermarket checkout counter to record real-time data on all production and expenditures. Instead, national income accountants rely on detailed data that are collected at wide intervals and then update them with more frequent, but less complete, sampling.

The most detailed data are those in “benchmark” estimates every five years. The benchmarks use an economic census that covers about 95 percent of all expenditures in GDP. Between the benchmarks, statisticians conduct annual surveys for about 150,000 reporting units and monthly surveys for about 35,000 units. The quarterly GDP estimates use a combination of the benchmark, annual, and quarterly surveys. Estimates based on past trends fill in the gaps where complete data are not yet available.

The Bureau of Economic Analysis (BEA) releases its first estimate of GDP for each quarter, called the “advance” estimate, about four weeks after the end of the quarter (for example, near the end of January for the fourth quarter of the preceding year). The advance estimate incorporates actual data for about 45 percent of expenditures, with the rest

coming from partial monthly data and trends. A month later, the BEA releases a second estimate, and a month after that, a “final” estimate.

About 85 percent of the final estimate comes from actual data collected in the quarter, with the remaining 15 percent based on trends for data that are still missing. To call it the “final” is a misnomer since the quarterly data are subject to a still more complete annual revision and to further revisions as much as several years later.

Not surprisingly, the advance estimates, which give a first look at activity for a given quarter, are not perfectly accurate. On average, the advance estimate of real GDP is revised up or down by six-tenths of one percent by the time of the “final” quarterly estimate, and on average by a little over one full percentage point by the time all eventual revisions are made. For example, the advance estimate for the fourth quarter of 2011, released in January 2012, showed real GDP increasing at a 2.8 percent annual rate. If the final estimate released in March 2012 had shown an average revision, it would have shown GDP growth in the range of 2.2 to 3.4 percent. In fact, the final estimate actually showed growth of 3 percent for fourth quarter, 2011 GDP.

**BVT Lab**

Visit [www.BVTLab.com](http://www.BVTLab.com) to explore the student resources available for this chapter.

## The Underground Economy

The national income accounts provide a reasonably accurate measure of economic activity in the visible sector of the economy; much production, consumption, and investment escapes official measurement, however. The official accounts try to include some of that when they include estimates of the rental value of owner-occupied housing and the value of food produced and consumed on farms, but those items are only the tip of the iceberg.

Some underground activity is criminal. Economists have estimated that organized crime produces some \$150 billion a year in illegal goods and services such as drugs, gambling, and pornography. If those estimates are anywhere near correct, they make organized crime the second-largest industry in the United States after the oil industry.

Even so, organized crime is probably not the largest part of the underground economy. The unreported income of businesses and self-employed people may add as much as \$250 billion. That figure includes cash income that goes unreported to escape payment of taxes (for example, a concert pianist failing to report income from occasional piano lessons) and barter transactions that involve no cash at all. (For example, the pianist gets her teeth straightened in exchange for giving piano lessons to her orthodontist's child.)

Even if the U.S. underground economy amounts to as much as 10 percent of officially measured GDP, that proportion is moderate by world standards. Economists estimate that the French underground economy equals one-third of that country's GDP. For Italy, the figure may be as high as 40 percent. In some third-world countries, the official GDP data bear only the haziest relationship to what actually goes on in the economy.

## Biases in Price Indexes

The accuracy of price indexes is the third problem for the national income accounts. The measurement of changes in price levels became a matter of growing concern as inflation increased in the late 1970s, and indexing and automatic cost-of-living adjustments became more widespread. If official price indexes overstate inflation, the adjustments may be too generous.

Specialists have identified two sources of bias that are of particular concern for the consumer price index. One arises from the way consumption patterns react to price changes, and the other from changes over time in the quality of goods and services.

**Substitution Bias** The first reason that the consumer price index tends to overstate the true rate of increase in the cost of living is the so-called substitution bias. As we explained in Applying Economic Ideas 3.1, the CPI is a weighted average of the prices of goods purchased by urban consumers. The weights for calculating the index are the quantities of goods that made up the consumer market basket in some past year. However, because buying habits change over time, the weights typically are not those of the most recent year under observation.

If changes in buying habits were random, an obsolete set of weights would cause only random errors, not a systematic bias, in the CPI. The bias results from the way changes in relative prices affect demand. When prices change, people tend to buy less of goods that have become more expensive and more of those whose prices have risen less than average or have actually fallen. As a result, the CPI, which uses weights from the past, tends to overstate the increase in the cost of living because it assigns unrealistically large weights to products whose prices have increased.

For example, suppose the price of gasoline rises faster than the average of all consumer prices. If so, consumers buy more fuel-efficient cars, move closer to work, start using public transport, and take other steps to reduce their use of gasoline. That means that quantitatively speaking, gasoline will have a lower weight in their current market basket than in the weight of the base-year market basket. As a result, the CPI will exaggerate the impact of gas prices on the cost of living.

The Bureau of Labor Statistics adjusts the market basket for the CPI every two years to reflect changes in buying patterns. It also makes certain technical adjustments to samples collected in different areas to try to reduce quantity bias. Those adjustments reduce the substitution bias for the official CPI. In a further effort to minimize the substitution bias in the CPI, the Bureau of Labor Statistics now publishes a supplemental “chained” version of the CPI, which it calls C-CPI-U. That new measure has not yet been widely adopted as a basis for indexing, however.

One of the reasons that biases in the consumer price index are so important is that a variant of the CPI is used to index social security payments to tens of millions of older Americans. The issue is the subject of Applying Economic Ideas 6.2





## Applying Economic Ideas 6.2

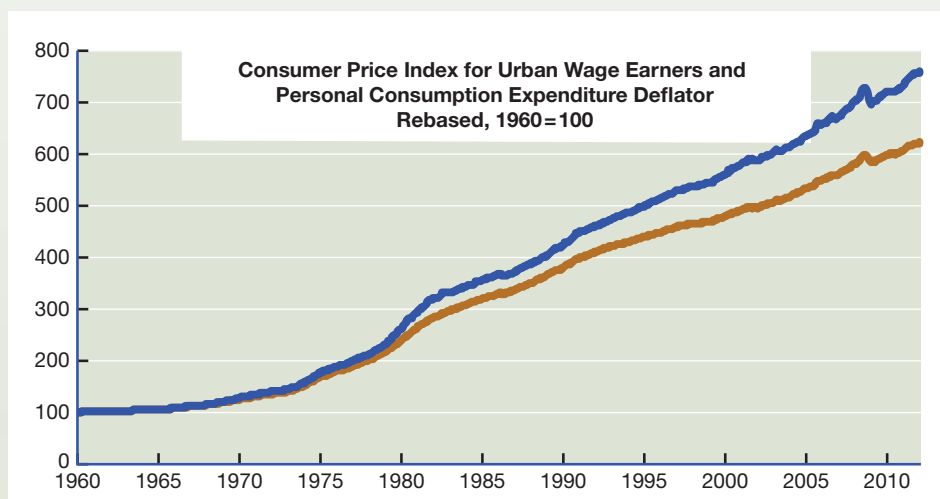
### How Should We Index Social Security Payments?

Each month, tens of millions of elderly Americans receive payments from the Social Security Administration. For many of them, social security is their primary source of income. Without the protection of social security benefits from inflation, their income security would be fragile.

In recognition of the threat that inflation poses to retirees, the Social Security Administration adjusts payments each year to reflect inflation. Rather than the more widely known CPI-U, which uses a market basket of goods consumed by all urban residents, the SSA uses the index CPI-W, which covers urban wage earners and clerical workers. In practice, the difference between CPI-W and CPI-U is very small.

Not all economists agree that CPI-W is the best basis for indexing social security payments. One problem is the CPI-W is subject to substitution bias. If CPI-W overstates the true rate of increase in the cost of living, social security beneficiaries would become gradually better off over time, at the expense of working-age people who pay the taxes that support the system.

One suggestion for correcting the situation would replace CPI-W with the deflator for personal consumption expenditures (PCE deflator) from the national income and product accounts. Because the PCE is a chained deflator and uses a current-year, rather than a base-year market basket, it is relatively free of substitution bias. The chart shows that over the period 1960 to 2012, the cost of living, as measured by CPI-W, increased by almost 18 percent more than it would have if measured by the PCE deflator.



Because use of the CPI deflator would slow the growth of social security benefits, it has won favor with some policymakers who are concerned about the effect of rising entitlement spending on the federal budget deficit.

(Continues)

Not everyone agrees that switching social security indexation to the PCE deflator would be a good idea. Some advocates for the elderly deny entirely that CPI-W overstates the rate of increase in the cost of living for the elderly. On the contrary, they argue that the cost of living for senior citizens is increasing faster than that for the working-age population. The chief reason, they say, is that the elderly spend more on medical care, which has experienced faster-than-average inflation over the years.

Economists who take this position point to an experimental price index for the elderly called CPI-E. The Bureau of Labor Statistics does not publish CPI-E, but it makes it available for research purposes. Largely because it includes a larger weight for healthcare services, CPI-E rises more rapidly than CPI-W by about a third of a percentage point per year. However, serious methodological problems in measuring prices and quality for medical services have prevented wider use of the CPI-E so far.

Sources: Data for the graph are from the Federal Reserve Bank of St. Louis. Further information about CPI-E and social security can be found in the Social Security Bulletin, Vol. 76, No. 3, 2007 (<http://www.ssa.gov/policy/docs/ssb/v67n3/v67n3p73.html>).

**Quality Bias** A second source of bias in the consumer price index is the failure to adjust product prices for changes in quality. It would be highly misleading, for example, to say that a 2012 model car costs

three times as much as a 1982 model without considering the fact that the new model requires less routine maintenance, uses less fuel, and is much safer than the old one. In terms of dollars per unit of transportation service, the newer model is clearly less than three times as expensive.

For automobiles, computers, and a few other major goods, the Bureau of Labor Statistics does try to make quality adjustments. To take an extreme case, as recently as the late 1960s, it cost over \$1,000 to buy a desk-size electromechanical calculator that would add, subtract, multiply, and divide. Today, \$1,000 will buy a laptop with many times the power of the 1960s-era computers used to send the Apollo astronauts to the moon. Official price indexes do, at least in part, incorporate those stupendous

changes in computer quality; but government statisticians do not have the resources to make detailed studies of all items that enter into GDP.

Taken together, the substitution bias and quality bias are substantial. At one time, they may have added one to one and a half percent per year to the rate of inflation as measured by the CPI. Recent changes in methodology have reduced the bias, but it still probably amounts to from a half percent to one percent per year.



Today's basic laptop costs about half of what an electro-mechanical calculator went for in the 1960s.

## Nonmaterial Sources of Welfare

The final problem with GDP is that it measures only material sources of welfare. That is hardly a surprise since that is the only thing it tries to do. Although we often use per capita GDP as a basis for comparing living standards over time and across countries, nonmaterial sources of welfare are important, too.

One key nonmaterial component of the standard of living is the quality of the environment. This not only varies widely from one place to another but also has changed greatly over time. The effects of climate change and toxic wastes are “bads” that, in principle, should reduce GDP just as “goods” add to it. Some economists also recommend adjustment of GDP for depletion of natural resources, such as oil fields and forests, much like adjustments for the capital consumption allowance.

A second nonmaterial source of welfare is the state of human health. By broad measures, especially that of life expectancy, standards of health in the United States appear to be improving. For example, since World War II the life expectancy of a typical 45-year-old American has increased from 72 years to 77, and a 65-year-old American can now expect to live to the age of 81. This increase clearly improves human welfare, even if many of the added years of life occur after retirement, when people contribute little or nothing to measured GDP.

Education and literacy also contribute to human welfare, independently of income level. The United Nations Development Program publishes an index called the Human Development Index (HDI) that combines information on health, education, and literacy with real GDP. According to the HDI for 2011, Norway, Australia, and the Netherlands had the world’s highest standards of living, with the United States in fourth place among the 179 countries studied. Burundi, Niger, and the Democratic Republic of the Congo were at the bottom of the list.

The HDI is hardly the last word in alternative measures of welfare. It contains no environmental component, except to the extent environmental quality has an impact on health. The HDI also pays no attention to human rights, political freedom, or corruption—all of which are arguably important for human welfare. In short, despite all of its defects, GDP remains the most widely used measure for international comparisons of economic achievement.

## BVT Lab

Flashcards are available for this chapter at [www.BVTLab.com](http://www.BVTLab.com).

## Summary

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1. **How does the government measure gross domestic product?** The official accounts of the United States feature several domestic product concepts. Gross domestic product (GDP) is the value at current market prices of all final goods and services produced annually in a given country. Gross national product is the product produced by a country's factors of production, regardless of their location. Net domestic product is equal to GDP minus an allowance for consumption of fixed capital that reflects the value of capital goods worn out during the year.
2. **How does domestic income differ from gross domestic product?** Domestic income is the sum of wages and supplements, rental income of persons, corporate profits, and proprietors' income earned in a country. In principle, domestic income and gross domestic product should be equal; but in the official accounts, they differ because of the capital consumption allowance, indirect business taxes, and a statistical discrepancy that results from the use of different data sources for income and product measurements.
3. **What are the major types of international transactions?** Many types of transactions appear in the nation's international accounts. Exports less imports of goods constitute the merchandise balance. Adding services yields net exports of goods and services. Adding net international transfers (normally a negative number for the United States) yields the most widely publicized measure, the current account balance. In addition, the international accounts record financial inflows and outflows resulting from private financial transactions and official reserve transactions by the Federal Reserve and foreign central banks.
4. **How does the government measure inflation?** The GDP deflator is the broadest measure of the price level. It is the ratio of nominal GDP to real GDP in any given year. The consumer price index (CPI) includes only the market basket of goods purchased by a typical urban household. The producer price indexes (PPI) include goods that business firms typically trade among one another.
5. **What are the limitations of official economic statistics?** The national income statistics of the United States are among the best in the world, but they are far from perfect. Problem areas include timeliness of data, the unobserved sector of the economy, price index biases, and nonmaterial aspects of the standard of living.



| <b>Key Terms</b>                    | <b>Page #</b> |
|-------------------------------------|---------------|
| Base year                           | 179           |
| Consumer price index (CPI or CPI-U) | 180           |
| Current account balance             | 177           |
| Domestic income                     | 174           |
| Final goods and services            | 168           |
| Financial inflow                    | 178           |
| Financial outflow                   | 178           |
| GDP deflator                        | 180           |
| Gross domestic product (GDP)        | 168           |
| Intermediate goods                  | 168           |
| Merchandise balance                 | 175           |
| National income                     | 174           |
| National income accounts            | 168           |
| Price index                         | 180           |
| Price level                         | 180           |
| Producer price index (PPI)          | 182           |
| Value added                         | 168           |

## Problems and Topics for Discussion

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1. **Updating the national income accounts** Data on national income accounts and international transactions for the United States are available from several sources on the Internet. The downloadable tables attached to each year's Economic Report of the President (<http://www.gpoaccess.gov/eop>) are one convenient source. A more comprehensive source is the FRED database maintained by the Federal Reserve Bank of St. Louis (<https://research.stlouisfed.org/>). If you plan to continue your study of economics beyond this introductory course, you will definitely want to become a friend of FRED! Use one of these sources to update the tables in this chapter and the charts of Chapter 4 to the most recent year or quarter. If you do not live in the United States, search the Internet for similar data for your home country and compare them to the U.S. data given in this chapter.
2. **Inventory in the national income accounts** Suppose that a firm sells \$10,000 worth of shoes that it has held in inventory for several years. What happens to GDP as a result? Which of its components are affected, and how?
3. **International accounts** Following the pattern in Table 6.4, show how the international accounts might look for a year in which there was a \$50 billion surplus on current account, no official reserve transactions, and no statistical discrepancy. What would the capital and financial account balance have to be?
4. **The current account deficit** "A current account deficit is a very healthy thing. If we can get foreigners to give us real goods and services and talk them into taking pieces of paper in return, why should we want anything different?" Do you agree or disagree with this statement? Discuss.
5. **Real and nominal quantities** In 1982 to 1984, the base period used for the consumer price index, the average earnings of construction workers were \$442.74 per week. By 1989, the earnings of construction workers had reached \$506.72 per week, but the consumer price index had risen to 124.0. What were construction workers' real earnings in 1989 stated in 1982–1984 dollars?

## Case for Discussion



### *A Wishbook Journey into a Past Shopper's Fantasyland*

The website [www.wishbookweb.com](http://www.wishbookweb.com) archives full-color, page-by-page images of dozens of old mail order catalogs. They provide a vivid picture of how the price and quality of goods has changed over the generations. If you could jump through the screen for a day of shopping in one of these consumer fantasylands of the past, what would you bring home with you? What would you look at, laugh, and leave behind?

Start by jumping back an even half-century to the Sears Christmas Catalog for 1962. How about a turtleneck sweater for \$6.94, or a pair of fleece-lined leather gloves for the same price? Classic style, quality materials, and a price that seems quite reasonable today. You'd snap those up for sure.

Need a watch? Here are the men's models on p. 164. There's a nice, basic Timex for just \$14.95. Good deal, huh? Oops! You have to wind it every day, and probably set it up or back a minute or two as well. Ah, there at the bottom of the page is the newest thing, an electric watch. Before you grab it, though, better check out today's offers from the on-line store at [Timex.com](http://Timex.com). The 1962 model had a price of \$43.95; the 2012 model costs just four bucks more, and you can bet it keeps better time. So you won't come back from 1962 with a watch, after all.

How about a TV? Here's the top-of-the line 1962 model on p. 200, a 23-incher for \$189.95. And check this out: "Silicon rectifiers as used in military missiles provide great reliability and long life." Tempted? But ... uh ... "controls conveniently grouped on the front?" No remote? And color? Ya gotta be kidding! That was 1962!

Before you grab that Sears Silvertone beauty, you'd better check out this 2012 23-inch model from [Amazon.com](http://Amazon.com). Color? Yep. Remote? Yep. Built-in DVD? Of course, dummy, this is 2012, after all! True, it costs \$50 more, at \$229; still, I think I'd take the new one. How about you?

OK, now you're back from your shopping trip. Time to take off those great gloves, slip into your classic turtleneck, and sit down in front of the TV to watch some politician ranting about how much better things were in the good old days before inflation ruined our lives!

## Questions

1. How would you adjust the price of the 1962 TV to allow for the difference in quality from the 2012 model? Was it half as good? A tenth as good? Is it something you can even start to put a number on?
2. In 1962, the average hourly wage for U.S. workers was about \$2.50. In 2012 it was about \$19. Use those wage rates to convert all the prices in the story to hours of work. What would you buy from the 1962 Sears catalog if you had to work for the money at 1962 wages, but could buy things now being sold by working at today's wages?
3. Spend some time with [wishbookweb.com](http://wishbookweb.com). Check out some buys from the oldest catalogs, which date back to the 1930s. Take a look at a catalog from the year you were born, or as close to it as you can find. What would you buy from those catalogs? What would you not buy?

## Endnotes

1. Following the same logic, it is also possible to calculate gross national product (GNP), a measure of goods and services produced by factors of production owned by a country's residents, including factors of production physically located in another country. Until the early 1990s, U.S. accounts emphasized GNP rather than GDP. In practice, the difference between GDP and GNP is small for the United States.
2. The source for much of the material in this section is J. Steven Landefeld, Eugene P. Seskin, and Barbara Fraumeni, "Taking the Pulse of the Economy: Measuring GDP," *Journal of Economic Perspectives* (Spring 2008): 193–216.