Econ 101 revisited: Do you remember Professor Irwin Corey? He was the TV comic with wild hair who used to dress in tails and sneakers. Corey, who billed himself as the “foremost authority on everything” would start most statements with “however” and then proceed to spew gibberish about any topic. He did the funniest impression ever of an economics professor that went something like “However, the angle of the CPI is bisected by the GDP.” Corey made no sense, but neither do many real professors.

However, (see how Professor Corey has influenced me?) I thought it might be useful to take a closer look at the Gross Domestic Product. We’ll start with how it’s put together and then see how GDP has been behaving nationally and in our region.

Some background: The Gross Domestic Product measures the total output of all goods and services produced within a region such as the United States or, say, Massachusetts. It is probably the most important measure of economic performance that we have. When compared with employment, it shows productivity. When compared to population, it measures how well people are (or aren’t) doing. Most recessions are said to start when GDP begins to fall and they end when GDP rises again. During “The Great Recession” of 2007-09, employment rose for a while after the recession’s onset and didn’t climb again until a few quarters after the GDP improved.

If you took Econ 101 then you’ll remember that GDP = C + I + G + (X-M) as shown in the table where I used “current dollar” GDP. There’s also a measure of “constant dollar” or “real” GDP that is obtained by “deflating” those current dollar numbers with a variety of price indexes. The growth rate of real GDP is used extensively. The current dollar measure is used when people talk about the federal deficit or debt as a percent of GDP.

Consumer spending is the largest piece of GDP, accounting for 70 percent of the total. It is more than double the size of retail sales since GDP covers many categories not sold at retail outlets, e.g., electricity and education. It also includes “imputations” such as the calculation that homeowners pay themselves rent to live in their homes.

Business Fixed Investment is more commonly called plant & equipment or capital expenditures. Included are purchases of heavy equipment and machinery as well as the software used to run factories and offices.

The change in inventories is needed to convert the sales figures into the GDP production measure. If a car is sold out of inventory, it shows up in consumer spending but does not add to the GDP in that quarter. The car added to the GDP during the quarter it was built. If it is built but not sold, the car shows up in inventories but not consumer spending.

Residential construction is the “value put in place” during that period for new construction: foundations, framing, sheetrock, etc. It includes home renovations. For the sales of existing homes, only the “value added” associated with the sale, such as realtors’ commissions, enters the GDP. The figures tend to underestimate the importance of housing to the economy.

Appliances and furnishings are included in consumer spending. And the rise and fall in the value of homes has a substantial impact on consumer spending.

The government category covers purchases of goods and services: payrolls, supplies, aircraft, etc. It does not include transfers such as Social Security, government pensions and welfare benefits since these are not payments in return for current production.
Exports are added in order to get domestic production. Imports are subtracted because they are included in the other categories: imported autos are in consumer spending.

**National Performance:** Real GDP growth has been disappointing over the past year – averaging less than two percent. The main reasons for this are uncertainty over federal budget policy, the drag on exports from the recessions in Europe, as well as the impact of federal spending cuts and tax hikes.

Despite the small rise, the unemployment rate fell about half a point in 2012. This was not the result of people dropping out of the work force. Instead, the labor force rose by a respectable 1.6 million people and employment rose even faster. Since we can’t explain why this happened, I wouldn’t count on a repeat performance. Indeed, we could face small declines in the unemployment rate when GDP growth accelerates next year as people who had previously given up looking for work re-enter the labor force.

Despite all the uncertainties, the 50 illustrious and renowned economists who participate in the *Wall Street Journal’s* monthly forecast survey have managed to come up with some forecasts of GDP and other key indicators. (In case you haven’t figured it out, I’m one of the participants. Last year, my predictions were in the top quintile for forecast accuracy.) The February survey shows an economy growing modestly this year with relatively low inflation. The respondents are assuming that the Treasury does not default when the debt ceiling issue re-emerges this summer.

GDP growth accelerates in 2014 and 2015 since consumers need to replace aging vehicles and step up home purchases as jobs and confidence rise. Businesses will increase their capital expenditures to meet rising demand for their products. While Federal spending is held in check, state and local governments start increasing purchases after a long slide. Recovery in Europe helps pull exports along.

Fed Chairman Bernanke has made forecasting short-term interest rates a relatively easy job! Late last year, the Federal Reserve announced that it would keep the fed funds rate at near-zero levels until labor markets showed signs of significant improvement, specifically when the unemployment rate falls to the vicinity of 6.5 percent, about a year and a half from now.

Unfortunately, the Fed didn’t provide similar guidance for long-term yields which are influenced by GDP growth, inflation, the Federal deficit and foreign capital inflows. They will also be affected by what happens with the Fed’s so-called “Quantitative Easing Program” in which huge amounts of Treasury and mortgage-backed securities have been purchased in order to lower long-term interest rates. The forecasters see bond yields rising faster than short-term rates.

Looking ahead, the economists at Moody’s Analytics, who are known for their regional expertise, use their national economic forecast to help “drive” the state economies. They see the national economy doing well over the next several years as the problems in Europe and Washington subside. Connecticut, Massachusetts and Rhode Island grow at least as fast as the U.S. And while New York lags a little, it still grows at a rather decent rate.

In a future issue I’ll extend the GDP analysis to include foreign countries. Comparing the size of, say, the U.S. and China or Germany is not so simple. One has to use exchange rates to convert foreign economic activity into dollars. But exchange rates are constantly changing. Professor Corey might well have said, “However, the purchasing power of the GDP is in direct propensity to the derivative of the exchange rate.”