Assignment

Explain what GDP is? why GDP MUST EQUAL THE SUM OF CONSUMPTION, INVESTMENT and how expenditure on the nations output result in income to resource owners?

Solution

The Gross Domestic Product is the total market value of the production of final goods and services in an economy in one period of time (usually a year). The final goods and services are goods and services that are purchased for final consumption, for example, the final goods include clothing, food, utilities etc.

Gross domestic product shows the output in prices that existed at the time when this volume was produced. This total output of goods and services is called nominal GDP. However, nominal GDP doesn't show current state of GDP because it expresses only the prices of the period of time in which it was produced. Changes in the volume of GDP could occur due to an increase in prices (inflation), economic growth, etc. So, in order to assess the true picture of the economic situation, it is necessary to adjust the nominal GDP. Nominal GDP can be adjusted for inflation (increase in prices of goods and services) or deflation (lower prices for goods and services). The adjusted nominal GDP is called real GDP.

The GDP growth shows the pace of economy growing and it is the increase in GDP volume compared to the previous period of time.

So the Gross Domestic Product measures the total value of all final goods and services in a country. It can be calculated in three ways: by adding up income and profits received from production of goods and services; by adding up expenditures on goods and services (adding money spent on exports and subtracting money spent on imports); and by adding up the value added by labor and capital when inputs purchased from other producers are transformed into output.

The most popular approach for measuring GDP is the Expenditure Approach. The expenditure approach involves counting expenditures on goods and services by different groups in the economy. So in obedience to this approach the main components are consumption expenditures by households (consumer spending - C), gross private investment spending principally by firms (I), government purchases of goods and services (G), and net exports (NE - exports minus imports (EX - IM)). So we can measure GDP using the following equation:

$$GDP = C + I + G + NE$$

Consumer spending is a personal consumer expenditures for all citizens that includes the costs of durable goods and the current consumption and the services. This is an expense for food, clothing, housing, cultural products, household products etc.

Investment costs cover the basic types of private investment in production by firms and entrepreneurs. These costs are used for the ultimate purchase of machinery and equipment, industrial buildings, the increase in reserves of inputs, housing etc.

The government spending is government purchases of goods and services. This group includes the costs of federal, national and local government purchases of the companies' final product for public use. The government spending does not include transfer payments.

Net exports shows how foreign spending on goods and services produced in the country exceed the country costs for the purchase of goods and services produced in other countries.

The expenditure on the nation's output will lead to increase in income of resource owners.