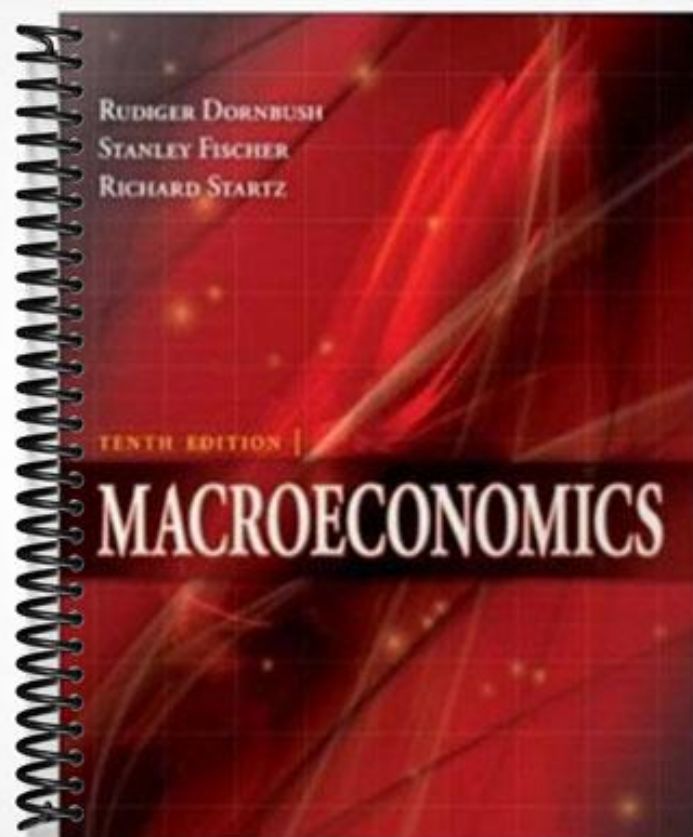


SOLUTIONS MANUAL



CHAPTER 2

NATIONAL INCOME ACCOUNTING

Chapter Outline

- Real and nominal GDP
- The composition of GDP
- The value added
- National income identities
- Price indexes
- Core inflation
- The unemployment rate
- Exchange rates
- Real and nominal interest rates

Changes from the Previous Edition

The basic structure of this chapter is unchanged. All figures and tables have been updated and Box 2-3 has been revised. Section 2-5 now includes a paragraph on core inflation and makes reference to the personal consumption expenditure deflator.

Introduction to the Material

Chapter 2 examines the meaning of gross domestic product (GDP), the basic measure of a nation's economic performance. The difference between gross domestic product (GDP) and gross national product (GNP) arises since part of a country's output is produced by foreign-owned factors of production. This difference is fairly small for the U.S., but it is important to stress this distinction, since in some other countries, such as Ireland and Switzerland, the difference is substantial. GNP is also sometimes called GNI, that is, gross national income.

Explaining GDP in terms of factor payments will help in the study of aggregate supply and economic growth. The aggregate production function shows the factors of production (inputs, such as labor and capital) that contribute to the production of final goods and services (output). Dividing GDP into its four main spending components—consumption (C), investment (I), government purchases (G) and net exports (NX)—will help in the study of aggregate demand.

The use of national income identities in this chapter provides a basic understanding of the relationship between important macroeconomic variables. Discussing these identities allows instructors to point out the ambiguities in cause and effect that are often present in macroeconomics. This is especially true when it comes to the relationship between private domestic saving, private domestic investment, the budget surplus, and the trade surplus. An in-depth discussion of these relationships will, of course, have to be delayed until later. Nonetheless, students will find it exciting and motivating to see that even the simple equations presented here can be used to address some rather complex real world problems.

It is particularly important to point out that the following two equations

$$Y \equiv C + I + G + NX \quad \text{and} \quad S - I \equiv (G + TR - TA) + NX$$

are treated as national income identities here but will also be used as equilibrium conditions in later chapters, with the second equation slightly redefined.

It is not always easy to measure inflationary trends accurately, especially since the prices of some goods can be volatile. Therefore policy makers often look at the trend of core inflation, which excludes energy and food prices. Alternative measures of inflation, such as the GDP-deflator, the consumer price index (CPI), the personal consumption expenditure deflator (PCE), and the producer price index (PPI), are discussed, along with some of the problems that come with measuring inflation. A brief discussion of the usefulness and shortcomings of these different measures of inflation should point out why the price indexes do not always change at the same rate even though their rates of change over long time spans tend to be fairly similar. The PPI measures price increases at an early stage of production from a market basket that includes raw materials and semi-finished goods. The CPI measures the average price increase of a market basket of goods and services that an average urban household might consume. The personal consumption expenditure deflator (PCE) is a chain-weighted index measuring inflation in consumer purchases, based on the consumer sector of the national income account. The GDP-deflator is the most comprehensive measure and includes all goods and services currently produced within a country. Unfortunately, early estimates of GDP—and thus the GDP-deflator—tend to be fairly unreliable due to measurement problems.

Another measure that can give an indication of how well a nation is performing economically is the unemployment rate, that is, the fraction of the labor force that is currently out of work but actively looking for a job or waiting to be recalled from a layoff.

The distinction between real and nominal interest rates is also very important. Nominal interest rates represent the actual rate of return on financial instruments as they are stated in the newspapers. However, a financial investor should be interested much more in the real rate of return, that is, the stated interest rate adjusted for inflation. Very few financial instruments guarantee a real rate of return and the U.S. government has only recently started to issue inflation-indexed government bonds.

Financial investors seeking good yields from foreign securities also have to pay attention to the exchange rate, that is, the price paid to buy foreign currency. While an in-depth discussion of the importance of exchange rates will have to be delayed, instructors still may want to point out Figure 2-7, that shows an inverse relationship between the GDP-deflator and the value of the U.S. dollar.

As it becomes increasingly important for students to know how to access statistical data that are useful in interpreting the performance of the economy, Section 2-9 provides some links for obtaining data and students should be encouraged to make use of them.

Suggestions for Lecturing

Instructors should start this chapter by giving students the exact definition of GDP as the market value of all final goods and services currently produced within a country in a given time period

(usually a year), and then asking them to explain how certain events may affect GDP (for suggestions look under "Additional Problems" below).

In discussing the concept of GDP, instructors should make it clear that early data reports on GDP tend to be unreliable, since much of the data used to prepare them is based on estimates rather than direct measurement. In addition, some data, such as unreported activity, may never enter the GDP figure. Estimates of how much actual economic activity cannot be measured in the official GDP figure for the U.S. vary from 3% to over 30%, and the percentage may be even higher for developing countries. A discussion of the underground economy is always of interest to students. The fact that some of the estimates are based on currency holdings seems reasonable to them, since they are quite aware from watching movies that many illegal transactions (for example, those involving illegal drugs) require large sums of cash. However, few of them would suspect that many businesses that require cash payments for their goods and services might also underreport their income to avoid taxes. A discussion of whether the volunteer services of a candy striper or the services provided by a homemaker in raising his or her children should be counted in the official measurement of GDP will also prove to be very stimulating.

When asked to give estimates of the current GDP or the proportions of its main components (consumption, investment, government purchases and net exports) students often give values far from those indicated in Table 2-1. Figure 2-1 also deserves some attention since it shows not only these four components as percentage of GDP, but also the payments to the factors of production as percentages of GDP. This can lead to a useful discussion of the expenditure approach versus the value added approach to calculating GDP.

A discussion of actual, potential, real and nominal GDP, the GDP-deflator, the CPI and the PPI can be incorporated into the discussion of other important economic indicators. Relating the discussion of economic indicators to current news reports on economic issues may prove to be very interesting to students. Instructors who choose to devote some time to the discussion of economic indicators in Chapter 1 may find it helpful to assign Chapter 2 simultaneously. Familiarity with actual economic data is often lacking in today's students, and therefore tasks that involve looking up economic data are especially worthwhile. As noted earlier, the web sites listed in Section 2-9 are very useful in this regard. A worthwhile assignment requiring a data search is to ask students to make a comparison between the performance of the U.S. economy and that of another country of their choice.

Some time should be spent on the discussion of the differences between the GDP-deflator, the PCE, the CPI, and the PPI, and their respective usefulness as economic indicators. The GDP-deflator is a lagging economic indicator, as is the PCE, while the CPI is coinciding and the PPI is leading. The difficulties of measuring quality improvements, innovations, or the substitutability of goods should also be discussed. There is a great deal of discussion of how well the CPI actually measures the true cost of living. Since many contracts have cost-of-living adjustments (COLAs) that are based on the CPI, an overstatement of inflation by the CPI can be very costly.

When discussing measurements for inflation, it is important to mention the difference between nominal and real interest rates. Some instructors may want to mention the Fisher equation, named after Irving Fisher, who analyzed the linkage between inflation and interest rates. It states that the nominal interest rate (i) is the expected real rate of interest (r^e) plus the expected rate of inflation (π^e), or

$$i = r^e + \pi^e.$$

From this we can conclude that in the long run, when all adjustments have occurred, the real interest rate is equal to the nominal interest rate minus the rate of inflation, that is,

$$r = i - \pi.$$

Even at this early stage in the semester some instructors may want to attempt to give students at least a rudimentary understanding of how the unemployment rate is calculated or why the unemployment rate in the U.S. has been lower than that of many European countries in recent years (even though the opposite was true in the 1960s or 1970s). Similarly, a brief explanation of why the exchange rate between the currencies of two particular countries may not necessarily give much indication of whether specific goods are more or less expensive in these two countries may be appropriate. However, since these two issues are explained in much more detail in later chapters, instructors pressed for time may want to disregard these issues at this time.

As important as national income accounting is in assessing the performance of the economy, some instructors may want to leave much of the material up to students to read on their own, given the shortness of the semester and the amount of material still to be covered. However, a few national income accounting identities should be derived. If this is done in conjunction with a circular flow diagram, instructors can start out with the equation $Y \equiv C$ and gradually extend the diagram (and the corresponding equations) with additional injections and leakages up to the point where $Y \equiv C + I + G + NX$. This way it can be shown that the first equation is equivalent to $S \equiv 0$, while the latter is equivalent to $S + TA - TR \equiv I + G + NX$.

Other instructors may want to choose only an algebraic approach, starting with the following equations:

$$(1) \text{ GDP} - D \equiv \text{NDP} \quad (2) \text{ I}_g - \text{I}_n \equiv D \quad (3) \text{ I}_n \equiv \Delta K.$$

Equations (1) and (2) show that depreciation (D) is the difference between GDP and NDP; it is also the difference between gross investment (I_g) and net investment (I_n). Equation (3) shows that only net investment adds to a nation's capital stock (K). If we subtract indirect taxes from NDP, we get national income (Y) which has four spending categories, bringing us to the most fundamental national income accounting identity:

$$(4) Y \equiv C + I + G + NX.$$

Since (5) $YD \equiv Y - TA + TR$ and (6) $YD \equiv C + S$ we get

$$(7) Y \equiv C + S + TA - TR.$$

Equation (7) can be combined with Equation (4) to derive

$$(8) I + G + NX \equiv S + TA - TR,$$

that is, total injections equal total leakages. It should be noted here that net exports is defined as $NX = X - Q$, where exports (X) is an injection and imports (Q) a leakage. Similarly, $TA - TR$ can be viewed as “net taxes,” since taxes (TA) is a leakage, whereas government transfer payments (TR) is an injection.

Equation (8) can now be manipulated into

$$(9) \quad S - I \equiv (G + TR - TA) + NX \quad \text{or} \quad (9a) \quad S - I = BD + NX \quad \text{where}$$

$$(10) \quad (G + TR - TA) \equiv BD \text{ is the budget deficit, and}$$

$$(11) \quad NX \equiv X - Q \text{ represents net exports = exports - imports.}$$

Equation (9a) can then be manipulated into

$$(9b) \quad S - I \equiv BD - TD,$$

which states that the difference between private domestic saving and private domestic investment is equal to the difference between the budget deficit and the trade deficit. This equation implies that an increase in the budget deficit (unless accompanied by an equal increase in private domestic saving) will lead to the crowding out of private domestic investment and/or net exports. The equation can therefore be used to explain the development of the "twin deficits" in the early 1980s. Finally, it can be explained why the decrease in U.S. budget deficits that lead to budget surpluses in the late 1990s was not accompanied by a decrease in trade deficits. Many students are worried that the U.S. has moved from being the largest creditor nation to being the largest debtor nation in the world. A brief discussion of whether we should be concerned by this fact and whether foreign ownership of assets in the U.S. actually helps to maintain domestic jobs can be useful here, but a more in-depth discussion of these issues should probably be left for later.

Some instructors may want to use Figure 2-6, which shows the federal debt as a percentage of GNP from 1790-2005, indicating also periods of recession and war, as a way to solicit student opinions of what factors may cause a significant increase in the national debt and at what point a huge national debt may become a concern to policy makers. Chapter 19 stresses the fact that an increase in the national debt does not necessarily imply an increase in the debt-income ratio, that is, the debt as a portion of GDP, but some instructors may want to mention this here already.

Since later chapters use the concept of the budget surplus (BS) when discussing fiscal policy, some instructors may actually prefer to use the following equation rather than equation (10).

$$(10a) \quad BS \equiv TA - G - TR,$$

Multiplying equation (9b) by -1 , we can obtain the following equation

$$(9c) \quad I - S = BS - NX \quad \text{or} \quad (9d) \quad NX = S + BS - I,$$

which states that if national saving is not sufficient to finance private domestic investment (I), then funds have to be borrowed from abroad, causing net exports (NX) to become negative. National saving consists of private domestic saving (S) and government saving, which is positive if the government runs a budget surplus.

A distinction between government purchases (G) and government expenditures (G + TR) should also be made, as many students are not aware that transfer payments (TR) are treated separately from government purchases (G). Transfer payments do not directly enter GDP, since no productive activity takes place when such payments are made.

Additional Readings

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Houston, Joel, "The Underground Economy: A Troubling Issue for Policy Makers," *Business Review*, FRB of Philadelphia, September/October, 1987.

Lebow, D., and Budd, J., "Measurement Error in the Consumer Price Index: Where Do We Stand," *Journal of Economic Literature*, March, 2003.

Madigan, Kathleen, "Unveiling the Secrets of the CPI," *Business Week*, July 12, 1999.

Mandel, Michael, "Why the Economy Is a Lot Stronger Than You Think," *Business Week*, February 13, 2005.

Nordhaus, William, "Quality Change in Price Indexes," *Journal of Economic Perspectives*, Winter, 1998.

Pollak, Robert, "The Consumer Price Index: A Research Agenda and Three Proposals," *Journal of Economic Perspectives*, Winter, 1998.

Ritter, Joseph, "Feeding the National Accounts," *Review*, FRB of St. Louis, March, 2000.

Uchitelle, Louis, "Seizing Intangibles from the GDP," *The New York Times*, April 9, 2006.

Learning Objectives

- Students should become familiar with the four main components of spending as well as their magnitude relative to GDP.
- Students should become familiar with the relative importance of the factor payments (labor and capital).

- Students should gain an understanding of the difficulties that arise in accurately measuring GDP and the rate of inflation.
- Students should become familiar with the basic national income accounting identities presented in the text.
- Students should gain an understanding of the relationships between private domestic saving, private domestic investment, the budget deficit, and the trade deficit, and the complexity of issues that are associated with the interrelationships among these variables.
- Students should be able to differentiate between the three price indexes discussed, that is, the GDP-deflator, the PCE, the CPI, and the PPI.
- Students should be able to differentiate between real and nominal interest rates.

Solutions to Problems in the Textbook

Conceptual Problems

1. Government transfer payments (TR) do not arise out of any production activity and are thus not counted in the value of GDP. If the government hired the people who receive transfer payments, then their wages would be counted as part of government purchases (G), which is counted in GDP. Therefore GDP would rise even if these workers were paid to do nothing, as government purchases are measured on a cost basis.
- 2.a. If the firm buys a car for an executive's use, the purchase counts as investment (I). However, if the firm pays the executive a higher salary and she then buys a car, the purchase of her car is counted as consumption (C). In either case, GDP will increase.
- 2.b. The services that a homemaker provides are not counted in GDP (regardless of their value). However, if an individual officially hires his or her spouse to perform household duties at a certain wage rate, the wages earned will be counted in GDP and GDP will increase.
- 2.c. If you buy a German car, consumption (C) will increase but net exports ($NX = X - Q$) will decrease. Overall GDP will increase by the value added at the foreign car dealership, since the import price is likely to be less than the sales price. If you buy a new American car, consumption and thus GDP will increase by the full value of the car. (Note: If the car you buy comes out of last year's inventory at the car dealership, then the increase in C will also be partially offset by a decline in I due to a change in inventory, and GDP will only increase by the value added.)
3. GDP is the market value of all final goods and services currently produced within the country. The U.S. GDP includes the value of the Hondas produced by a Japanese-owned

assembly plant that is located in the U.S., but it does not include the value of Nike shoes that are produced by an American-owned shoe factory located in Malaysia.

GNP is the market value of all final goods and services currently produced using assets owned by domestic residents. Here the value of the Hondas produced by a Japanese-owned Honda plant in the U.S. is not counted in GNP but the value of the Nike shoes by the American-owned shoe plant in Malaysia is.

Neither is necessarily a better measure of the output of a nation. The actual values of the GDP and GNP for the U.S. are fairly close.

4. NDP (net domestic product) is defined as GDP minus depreciation. Depreciation measures the value of the capital that wears out during the production process and has to be replaced. Therefore NDP comes closer to measuring the net amount of goods produced in this country. If this is what you want to measure, then NDP should be used.
5. Increases in real GDP do not necessarily mean increases in people's welfare. For example, if the population of a country increases proportionally more than real GDP, then the population of the country is on average worse off. Also some increases in output come from events that reduce peoples' welfare. For example, increased pollution may cause more lung cancer, and the treatment of the lung cancer will contribute to GDP. Similarly, an increase in crime may lead to overtime work for police officers, whose increased salary will increase GDP. But the welfare of the people in the country will not have increased in either of these cases. On the other hand, GDP also does not always accurately measure quality improvements in goods or services (faster computers or improved health care) that improve people's welfare.
6. The CPI (consumer price index) and the PPI (producer price index) are both measured by looking at a certain market basket. The CPI's basket contains mostly finished goods and services that consumers tend to buy regularly. The PPI's basket contains raw materials and semi-finished goods, that is, it measures costs to the producer of a good. The CPI is a concurrent economic indicator, whereas the PPI is a leading economic indicator; so if you want to assess current inflation, you need to look at the CPI, but if you want to assess the possibility of future inflation, you need to look at the PPI.
7. The GDP-deflator is a price index that covers the average price increase of all final goods and services currently produced within an economy. It is defined as the ratio of current nominal GDP to current real GDP. Nominal GDP is measured in current dollars, while real GDP is measured in so-called base-year dollars. Even though early estimates of the GDP-deflator tend to be unreliable, the GDP-deflator can be a more comprehensive price index than the CPI or PPI (both of which are fixed market baskets). This is true for two reasons: first it measures a much wider cross-section of goods and services; second, a fixed market basket cannot account for people substituting away from goods whose relative prices have

changed, while the GDP-deflator, which includes all final goods and services produced within the country, can.

8. If nominal GDP has suddenly doubled, it is most likely due to an increase in the average price level. To calculate how much real output (GDP) has changed, the first thing you would want to check is how much the GDP-deflator has changed. If nominal GDP and the GDP-deflator have both doubled, then real GDP should remain unchanged.
9. Assume the loan you made yields you an annual nominal return of 7%. If the rate of inflation is 3%, then your rate of return in real terms is only 4%. If, on the other hand, the inflation rate is 10%, then you will actually get a negative real rate of return, that is, your yield will be -3%. One way to get protection against such a loss of purchasing power is to adjust the interest rate for inflation, that is, to index the loan. In other words, you can require that, in addition to a specified interest rate of the loan, the borrower also has to pay an inflation premium equal to the percentage change in the CPI. In this case, a specified positive real rate of return can be guaranteed.

Technical Problems

1. The text calculates the change in real GDP in 1996 prices in the following way:

$$[\text{RGDP}_{06} - \text{RGDP}_{00}]/\text{RGDP}_{00} = [3.50 - 1.50]/1.50 = 1.33 = \mathbf{133\%}.$$

To calculate the change in real GDP in 2006 prices, we first have to calculate the GDP of 2000 in 2006 prices. Thus we take the quantities consumed in 2000 and multiply them by the prices of 2006, as follows:

Beer	1 at \$2.00 = \$2.00
Skittles	1 at \$0.75 = \$0.75
<hr/>	
Total	\$2.75

The change in real GDP can now be calculated as $[6.25 - 2.75]/2.75 = 1.27 = \mathbf{127\%}$.

We can see that the growth rate of real GDP calculated this way is roughly the same as the growth rate calculated above.

- 2.a. The relationship between private domestic saving, private domestic investment, the budget deficit, and net exports is shown by the following identity:

$$S - I \equiv (G + TR - TA) + NX.$$

Therefore, if we assume that transfer payments (TR) remain constant, an increase in taxes (TA) has to be offset either by an increase in government purchases (G), an increase in net exports (NX), or a decrease in the difference between private domestic saving (S) and private domestic investment (I).

2.b. From the equation $YD \equiv C + S$ it follows that an increase in disposable income (YD) will be reflected in an increase in consumption (C), saving (S), or both.

2.c. From the equation $YD \equiv C + S$ it follows that when either consumption (C) or saving (S) increases, disposable income (YD) must increase as well.

3.a. Since depreciation is defined as $D = I_g - I_n = 800 - 200 = 600 \implies$

$$NDP = GDP - D = 6,000 - 600 = \mathbf{5,400}.$$

3.b. From $GDP = C + I_g + G + NX \implies NX = GDP - C - I_g - G \implies$

$$NX = 6,000 - 4,000 - 800 - 1,100 = \mathbf{100}.$$

3.c. $BS = TA - G - TR \implies (TA - TR) = BS + G \implies (TA - TR) = 30 + 1,100 = \mathbf{1,130}$

3.d. $YD = Y - (TA - TR) = 6,000 - 1,130 = \mathbf{4,870}$

3.e. $S = YD - C = 4,870 - 4,000 = \mathbf{870}$

4.a. $S = YD - C = 5,100 - 3,800 = \mathbf{1,300}$

4.b. From $S - I = (G + TR - TA) + NX \implies I = S - (G + TR - TA) - NX = 1,300 - 200 - (-100)$

$$\implies I = \mathbf{1,200}.$$

4.c. From $Y = C + I + G + NX \implies G = Y - C - I - NX \implies$

$$G = 6,000 - 3,800 - 1,200 - (-100) = \mathbf{1,100}.$$

$$\text{Also: } YD = Y - TA + TR \implies TA - TR = Y - YD = 6,000 - 5,100 \implies TA - TR = 900$$

$$\text{From } BS = TA - TR - G \implies G = (TA - TR) - BS = 900 - (-200) \implies G = 1,100.$$

5. According to Equation (2) in the text, the value of total output (in billions of dollars) can be calculated as: $Y = \text{labor payments} + \text{capital payments} + \text{profits} = \$6 + \$2 + \$0 = \mathbf{\$8}$.
- 6.a. Since nominal GDP is defined as the market value of all final goods and services currently produced in this country, we can only measure the value of the final product (bread), and therefore we get \$2 million (since 1 million loaves are sold at \$2 each).
- 6.b. An alternative way of measuring GDP is to calculate all the value added at each step of production. The total value of the ingredients used by the bakeries can be calculated as:

1,200,000 pounds of flour (\$1 per pound)	= 1,200,000
100,000 pounds of yeast (\$1 per pound)	= 100,000
100,000 pounds of sugar (\$1 per pound)	= 100,000
100,000 pounds of salt (\$1 per pound)	= 100,000
	= 1,500,000

Since \$2,000,000 worth of bread is sold, the total value added at the bakeries is **\$500,000**.

7. If the CPI increases from 2.1 to 2.3 in the course of one year, the rate of inflation can be calculated in the following way:

$$\text{rate of inflation} = (2.3 - 2.1)/2.1 = 0.095 = \mathbf{9.5\%}.$$

The CPI often overstates inflation, since it is calculated by using a fixed market basket of goods and services. But the fixed weights in the CPI's market basket cannot capture the tendency of consumers to substitute away from goods whose relative prices have increased. Quality improvements in goods also often are not adequately taken into account. Therefore, the CPI will overstate the increase in consumers' expenditures.

8. The real interest rate (r) is defined as the nominal interest rate (i) minus the rate of inflation (π). Therefore the nominal interest rate is the real interest rate plus the rate of inflation, or

$$i = r + \pi = 3\% + 4\% = \mathbf{7\%}.$$

Empirical Problems

1. The values obtained for GNP and NNP based on the formulas correspond with the numbers reported by www.economagic.com.

	GDP	Income receipts from ROW	Income payments to ROW	GNP	Depreciation (consumption of fixed capital)	NNP
	1	2	3	4=1+2-3	5	6=4-5
2003	10960.8	336.8	280	11017.6	1336.5	9681.1
2004	11712.5	410.2	363.9	11758.8	1436.2	10322.6
2005	12455.8	513.3	481.5	12487.6	1604.8	10882.8

2. U.S. real GDP growth in the year 2005 was 3.2 percent. The growth rate of the population in the U.S. in 2005 was 0.98 percent. Since real output grew faster than the population, U.S. real GDP per capita increased by about 2.2 percent ($= 3.2\% - 0.98\%$) in 2005.

Additional Problems

1. **Explain the initial effect of each of the following events on GDP.**
- a. **You sell your used car to a friend.**
 - b. **Firms decrease their inventories.**
 - c. **The value of your AT&T stock holdings decreases.**
 - d. **You buy a piece of land with the intention of building a new house.**
 - e. **A sports card dealer sells a Derek Jeter rookie card for \$50.**
 - f. **A German tourist drinks Canadian beer in an American restaurant.**
- a. GDP will not change, since a used car is not part of current production. (Only if you sell the car through a dealer will GDP increase by the value of the services rendered.)
 - b. Inventory changes are part of investment, so investment will decrease if inventories are depleted. However, someone will have to buy the inventories, so consumption will increase. If the inventories are sold at a price higher than invoice, then GDP will increase by the value added.
 - c. A loss in stock values means a loss in wealth; therefore GDP is not directly affected. Your income (and thus GDP) would only be affected if your dividend payments decrease.
 - d. When you use savings to buy land, a transfer of wealth takes place and GDP is not affected. However, if a real estate agent receives a commission, then GDP will go up by the value of the services rendered.
 - e. When the card dealer sells the rookie card, inventory decreases, so investment goes down. But selling the card to a customer increases consumption, so GDP increases but only by the value added by the dealer for the services rendered.

- f. GDP will increase by the value added in the restaurant. If the beer was imported from Canada for \$1.80 and sold (exported) to a German tourist for \$3.75, then net exports will increase by \$1.95.

2. How will each of the following events affect GDP and why?

- a. **Hurricane Katrina destroys large parts of New Orleans.**
 - b. **You sell your old macroeconomics textbook to another student.**
 - c. **You sell your holdings of IBM stock.**
 - d. **Your local car dealership decides to reduce its inventory by offering price reductions.**
 - e. **A retired worker gets an increase in Social Security benefits.**
- a. When a hurricane destroys property, wealth is affected, not income (or GDP). However, if a significant amount of the capital stock is destroyed and/or many people die, then less can be produced later, leading to a decrease in GDP. On the other hand, the rebuilding of destroyed property results in increased economic activity that will lead to a rise in GDP.
- b. The sale of your textbook to another student will not constitute an official market transaction, since you probably will not report your income to the IRS. In addition, the textbook has already been used and is not part of current production. Therefore GDP will not be affected.
- c. The sale of existing stock holdings is a transfer of wealth and, as such, does not affect GDP. Any fees that you may have to pay your broker for his or her services, however, constitute payment for services rendered. GDP will increase by that amount.
- d. Inventory changes are counted as part of investment. A reduction in business inventories will lower the level of investment (I) and thus GDP. However, the sales of the cars will count as consumption (C) if consumers buy them, or investment (I) if firms buy them. Thus the net effect on GDP depends on the value added, that is, the difference between the cost of the cars to the dealership and the sales price of the cars.
- e. Transfer payments that do not arise from productive activity are not counted in GDP. Thus GDP will not be affected when Social Security benefits are paid. Only later, when these payments are spent, will consumption increase.

3. “I bought a new home last year. If I sell it today, I will raise the level of economic activity.” Comment on this statement.

This statement would be true if a realtor sold you the home, as the realtor would have provided a current service for which she would have to be paid. Transactions involving existing assets such as residential housing (or artwork) do not create economic activity in an amount equal to the value of the sale. New home construction, on the other hand, is included in the calculation of current GDP as it does represent current economic activity.

4. **Comment on the following statement:**
“Any accumulation of inventories by firms is not included when measuring GDP.”

National income accounts do include changes in inventories when measuring investment. Inventories rise when production exceeds sales, but fall if production falls short of demand. These changes must be allowed to affect investment. But if investment is affected, so is GDP. Otherwise total economic activity will be over- or underestimated to the extent that inventory changes are not accounted for.

5. **Comment on the following statement:**
“Real per-capita GDP is a good measure of economic welfare.”

Real GDP per capita is an imperfect measure of economic welfare as it does not include non-market activities which affect well being, such as the value of household services, volunteer work, the loss of natural wilderness areas resulting from economic development, pollution, and so on. In spite of these limitations, however, real GDP per capita still does provide some measure of economic welfare.

6. **If nominal GDP in Germany increased by 2.8% last year, but U.S. GDP increased by 4.2%, can we conclude that the welfare of U.S. citizens increased by more than that of German citizens? Why or why not?**

A country's nominal GDP is not a good measure of the economic welfare of its people, since nominal GDP can change solely due to inflation. Only if real GDP grows faster than population, will real income per capita increase. But real GDP per capita still does not take into account changes in income distribution, changes in environmental quality, or leisure, all of which influence the economic welfare of the people in a country. Therefore we cannot say whether the welfare of the people in the U.S. has increased more than that of the people in Germany.

7. **Assume last year's real GDP was \$7,000 billion, this year's nominal GDP is \$8,820 billion, and the GDP-deflator for this year is 120. What was the growth rate of real GDP?**

$$RGDP(1) = [NGDP(1)/GDP-deflator]*100 = [8,820/120]*100 = 7,350$$

Since $RGDP(0) = 7,000$ it follows that the growth rate of RGDP is

$$y = [7,350 - 7,000]/7,000 = 0.05 = 5\%.$$

8. Assume real GDP in 2000 was \$7,000 billion, nominal GDP in 2004 was \$8,316 billion, and the GDP-deflator has increased from 100 to 110 between 2000 and 2004. What is the average annual growth rate of real GDP from 2000 to 2004? Do you think the welfare of all people in the country has increased during that time? Why or why not?

$$RGDP = (NGDP/deflator)*100 = (8,316/110)*100 = 7,560$$

$$\text{Growth rate of GDP} = (7,560 - 7,000)/7,000 = 560/7,000 = 0.08 = 8\%$$

Therefore real GDP has grown 8% in four years, or at an average annual growth rate of 2%.

An increase in a country's GDP is not a good measure of an increase in the economic welfare of its people. For example, nominal GDP can change solely due to inflation, and real GDP has to grow faster than the population for real income per capita, and thus living standards, to increase. But real GDP per capita still does not take into account changes in the distribution of income, changes in environmental quality, or changes in leisure, all of which influence peoples' economic welfare.

9. Assume a Hyundai dealership in Chicago bought 30 Hyundais from Korea at a cost of \$15,000 per car in September of 2006. By December 31, 2006 they had sold 20 of the Hyundais at a price of \$18,000 each. The remaining Hyundais were sold in January of 2007 at a price of \$16,000 each. How exactly does this affect the GDP in the U.S. in 2006 and 2007, and which categories of GDP (C, I, G, or NX) are affected?

$$\begin{aligned} \text{2006: } \Delta NX &= - (30*15,000) = - 450,000 \\ \Delta C &= + (20*18,000) = + 360,000 \\ \Delta I &= + (10*15,000) = + 150,000 \end{aligned}$$

$$\Delta GDP \qquad \qquad \qquad = + 60,000$$

Check: The value added in 2006 is $20*3,000 = \mathbf{60,000}$.

$$\begin{aligned} \text{2007: } \Delta C &= + (10*16,000) = + 160,000 \\ \Delta I &= - (10*15,000) = - 150,000 \end{aligned}$$

$$\Delta GDP \qquad \qquad \qquad = + 10,000$$

Check: The value added in 2007 is $10*1,000 = \mathbf{10,000}$.

10. Calculate the values for government purchases (G), private domestic saving (S), and private domestic investment (I) from the following information (all variables are in billions of dollars).

national income	Y = 5,200	budget deficit	BuD = 150
disposable income	YD = 4,400	trade deficit	TD = 110
consumption	C = 4,100		

$$\text{From } YD = C + S \implies S = YD - C = 4,400 - 4,100 = \mathbf{300}.$$

$$\text{From } S - I = \text{BuD} - \text{TD} \implies 300 - I = 150 - 110 \implies \mathbf{I = 260}.$$

$$\text{From } Y = C + I + G + \text{NX} \implies G = Y - C - I - \text{NX}$$

$$\implies G = 5,200 - 4,100 - 260 + 110 = \mathbf{950}.$$

11. From the following information calculate the value of government purchases (G), consumption (C), and private domestic investment (I) (all variables are in billions of dollars).

national income	Y = 6,000	tax revenues	TA = 1,500
private domestic saving	S = 1,000	transfer payments	TR = 700
net exports	NX = -120	budget deficit	BuD = 230

$$\text{From } YD = Y - \text{TA} + \text{TR} \implies YD = 6,000 - 1,500 + 700 \implies YD = 5,200.$$

$$\text{From } YD = C + S \implies C = YD - S = 5,200 - 1,000 = \mathbf{4,200}.$$

$$\text{From } S - I = \text{BuD} - \text{TD} \implies 1,000 - I = 230 - 120 \implies \mathbf{I = 890}.$$

$$\text{From } Y = C + I + G + \text{NX} \implies G = Y - C - I - \text{NX}$$

$$\implies G = 6,000 - 4,200 - 890 + 120 = \mathbf{1,030}.$$

$$\text{Check: } \text{BuS} = \text{TA} - \text{TR} - G \implies -230 = 1,500 - 700 - G \implies \mathbf{G = 1,030}.$$

12. From the information below (all variables are in billions of dollars) calculate the level of private domestic investment (I), consumption (C), and national income (Y).

government purchases	G = 1,200	budget surplus	BuS = 60
disposable income	YD = 4,500	net exports	NX = -110
private domestic saving	S = 500		

$$\text{From } YD = C + S \implies C = YD - S = 4,500 - 500 = \mathbf{4,000}.$$

From $S - I = \text{BuD} - \text{TD} \implies 500 - I = -60 - 110 \implies I = 670$.

From $Y = C + I + G + \text{NX} \implies Y = 4,000 + 1,200 + 670 - 110 = 5,760$.

13. Assume the government cuts its purchases by \$120 billion. As a result, the budget deficit shrinks by \$40 billion, disposable personal income decreases by \$80 billion, private domestic saving decreases by \$10 billion, and the trade deficit decreases by \$15 billion. By how much have consumption(C), private domestic investment (I), and national income (Y) changed?

From $I - S = \text{BuS} - \text{NX} \implies I = S + \text{BuS} - \text{NX} \implies \Delta I = \Delta S + \Delta \text{BuS} - \Delta \text{NX}$

$\implies \Delta I = -10 + 40 - 15 = +15$.

From $\text{YD} = C + S \implies \Delta C = \Delta \text{YD} - \Delta S = -80 - (-10) = -70$.

From $Y = C + I + G + \text{NX} \implies \Delta Y = \Delta C + \Delta I + \Delta G + \Delta \text{NX}$

$\implies \Delta Y = -70 + 15 - 120 + 15 = -160$.

14. Briefly describe the advantages and disadvantages of using the GDP-deflator, the CPI, and the PPI as economic indicators.

The GDP-deflator is probably the most useful price index for macroeconomists, since it measures the average price level of all goods and services currently produced in a country. It does not include imported goods or used goods, and early estimates are often unreliable and have to be revised repeatedly. The GDP-deflator is the most complete of the price indexes, but it is a lagging indicator.

The consumer price index (CPI) measures the average price level of a fixed market basket of goods and services purchased by an average urban wage earner. Not all goods and services are reflected in this market basket and substitution among these goods is not possible. Therefore the CPI is not a perfect measure for inflation. However, the CPI is easily available on a monthly basis, is fairly reliable, and is a concurrent indicator.

The producer price index (PPI) measures the average price level of a fixed market basket of raw materials and intermediate goods up to the retail stage, but it does not include services. The PPI is relatively easily available on a monthly basis and is used to show future price trends. Thus it is a leading indicator. One has to be careful to avoid double counting, since the PPI deals with intermediate goods. The PPI does not necessarily correspond with the CPI, since firms can't always shift higher producer prices onto consumers.

15. True or False? Why?

“The PCE measures the cost of buying a fixed bundle of consumer goods.”

False. The Consumer Price Index (CPI) measures the cost of buying a market basket of consumer goods. The personal consumption expenditure deflator (PCE) is a chain-weighted index measuring inflation in consumer purchases, based on the consumer sector of the national income account.

16. True or false? Why?

“Using the consumer price index or the GDP-deflator to calculate changes in the average price level should produce identical inflation rates.”

False. The CPI measures the cost of a representative household's consumption bundle whereas the GDP-deflator is a more comprehensive measure of the prices of all goods and services produced in the economy. Rates of change in these indices vary due to the differences in their construction.

17. Do the CPI and the GDP-deflator always show the same increase in the inflation rate?

The GDP-deflator measures the average price increase of all final goods and services that are currently produced in an economy. These goods differ from year to year depending on what is produced. The CPI measures only the average cost increase of a specified market basket of goods and services. The CPI also includes prices of import goods that the GDP-deflator does not include. Thus, when import prices go up, the CPI will most likely increase more than the GDP-deflator.

18. Will an increase in the federal budget surplus necessarily lead to a decrease in the foreign trade deficit? Why or why not?

The equation $I - S = BS - NX$ states that the difference between private domestic investment and private domestic saving is equal to the difference between the budget surplus and the trade surplus. If the budget surplus increases (or the budget deficit decreases), then domestic interest rates are likely to decrease. This will cause an outflow of funds, depreciating the value of the domestic currency and making domestic goods more competitive on world markets. Therefore we will see an increase in the trade surplus (or a decrease in the trade deficit). However, this does not necessarily always happen, since the other two variables in this equation, namely private domestic investment and private domestic saving, may also change. For example, if there is a significant increase in investment spending due to the lower interest rates, then we may not see a change in the trade surplus.

19. Comment on the following statement:

“A country that spends more than its total national income must have a trade deficit.”

National income is defined as $Y = C + I + G + NX$. The four main components of aggregate demand are consumption (C), investment (I), government purchases (G) and net exports (NX). But if spending on consumption, investment, and government purchases is greater than national income, it follows that net exports ($NX = X - Q$) must be negative, that is, imports (Q) must exceed exports (X), and the country must have a trade deficit.

20. Comment on the following statement:

“High budget deficits ultimately lead to foreign trade deficits.”

From $S + TA - TR = I + G + NX \implies S - I = - (TA - G - TR) - (-NX) = BuD - TD$, that is, the difference between private domestic saving and private domestic investment is equal to the difference between the budget deficit and the trade deficit. In the early 1980's the size of the U.S. federal budget deficit increased sharply. Private domestic saving remained low and thus interest rates increased. High U.S. interest rates attracted funds from abroad, which drove the value of the U.S. dollar up, making U.S. goods less competitive on world markets. Thus the increase in the budget deficit in the 1980's was largely responsible for the increase in the trade deficit. However, an increase in the budget deficit does not necessarily increase the trade deficit, since the other two variables in this equation, namely private domestic investment and private domestic saving, may also be affected. As long as we can finance the increase in the budget deficit domestically, a trade deficit is not inevitable. Instead private domestic saving may increase or private domestic investment may be crowded out.

21. In the early 1980s, the U.S. changed from being one of the biggest creditor nations to being the biggest debtor nation in the world. Explain how this happened.

In the early 1980s, the U.S. changed from a creditor nation to a debtor nation, as its competitiveness in foreign markets decreased. A variety of factors contributed to this change, including a decrease in productivity growth, emphasis on short-term profits by U.S. corporations, and lack of long-term planning and research and development. However, to a large extent the low private domestic savings rate, combined with huge federal budget deficits were also responsible. From $S - I = BuD - TD$, we can see that if the budget deficit increases and private domestic saving is not adequate to finance it, then either private domestic investment has to decrease or the U.S. has to borrow funds from abroad, which will then lead to a trade deficit. The increased borrowing needs by the U.S. government in the early 1980s caused U.S. interest rates to increase, which led to an inflow of funds from abroad. This led to a sharp appreciation in the value of the U.S. dollar, making U.S. goods less competitive on world markets. While U.S. corporations sold fewer export goods on world markets, U.S. consumers developed a taste for imported goods. The result was a trade imbalance.

22. Comment on the following statement:

“If the number of unemployed workers in the country stays the same but the number of people living in the country increases, the unemployment rate will decrease.”

The unemployment rate is defined as the number of unemployed (those out of work and either actively looking for a job or waiting to be recalled from a layoff) divided by the total work force. It is not clear whether the new residents of the country will become part of the work force (either working or unemployed) or not. Thus we cannot tell what happens to the unemployment rate in this situation.

23. Assume you are a banker and you'd like a 4% real rate of return on your loans. If you expect that the inflation rate will average about 6% over the next thirty years, what is the most likely rate you would charge your customers for a thirty year fixed rate mortgage? How would your answer change if you expected a 4% average inflation rate over the length of the mortgage? Explain your answers.

The Fisher equation states that the nominal interest rate is the expected real rate of interest (r^e) plus the expected rate of inflation (π^e), or

$$i = r^e + \pi^e.$$

In other words, if you expected an inflation rate of 6%, you would charge your customers a 10% mortgage interest rate since

$$i = 4\% + 6\% = 10\%.$$

But if you expected only a 4% inflation rate, you would charge your customers a mortgage interest rate of

$$i = 4\% + 4\% = 8\%.$$

24. Assume a government bond pays you a fixed interest rate of 5.5% per year and the average annual rate of inflation is 4.4%. What is your real rate of return? How would this real rate of return change if inflation increased to 6.4%?

The real interest rate is defined as the nominal interest rate minus the inflation rate, that is,

$$r = i - \pi$$

Therefore your real rate of return is

$$r = 5.5\% - 4.4\% = 1.1\%$$

if the inflation rate is 4.4%. But if the inflation rate increases to 6.4%, then your real rate of return will be negative, that is,

$$r = 5.5\% - 6.4\% = -0.9\%.$$

25. Comment on the following statement:

“If a British tourist can buy one U.S. dollar for 0.65 British pounds and a Japanese tourist can buy one U.S. dollar for 130 Japanese yen, we can conclude that, on average, goods in Japan are about 200% more expensive than in Great Britain.”

The price of U.S. dollar in another currency does not give any indication of whether goods in that country are more or less expensive than in the U.S.; it simply means that these currencies are exchanged at a certain rate. Similarly, the fact that the British pound is worth more than the Japanese yen when it comes to buying one U.S. dollar does not imply that product prices in Japan, on average, are more expensive than product prices in Great Britain.