What is GDP and Why is It So Important to Economists and Investors?

By LESLIE KRAMER | Updated Dec 2, 2019

Gross domestic product (GDP) is one of the most common indicators used to track the health of a nation's economy. It includes a number of different factors such as consumption and investment. It's also a key factor in using the Taylor rule. In this short article, we look at why GDP is such an important economic factor, and what it means for both economists and investors.

It represents the total dollar value of all goods and services produced over a specific time period, often referred to as the size of the economy. GDP is usually expressed as a comparison to the previous quarter or year.

KEY TAKEAWAYS

- Gross domestic product tracks the health of a country's economy.
- It represents the value of all goods and services produced over a specific time period within a country's borders.
- Economists can use GDP to determine whether an economy is growing or experiencing a recession.
- Investors can use GDP to make investments decisions—a bad economy means lower earnings and lower stock prices.

Gross Domestic Product (GDP) Defined

GDP is primarily used to gauge the health of a country's economy. It is the monetary value of all the finished goods and services produced within a country's borders in a specific time period and includes anything produced by the country's citizens and foreigners within its borders.

FAST FACT

According to the International Monetary Fund, the United States is the world's largest economy, followed by China and Japan.

[1]

GDP is calculated by adding together:

- Personal and public consumption
- Public and private investment
- Government spending
- Exports fewer imports

The figure is generally expressed as a percentage. The figure is calculated reported in the United States on a quarterly basis in the U.S. by the Bureau of Economic Analysis. While quarterly growth rates are a periodic measure of how the economy is faring, annual GDP figures are often considered the benchmark for the overall size of the economy.

Nominal vs. Real GDP

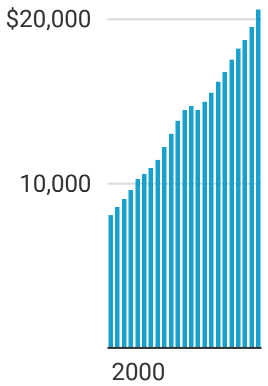
GDP can be expressed in two different ways—nominal and real GDP. Nominal GDP takes current market prices into account without factoring in inflation or deflation. This figure looks at the natural movement of prices and tracks the gradual increase of an economy's value over time.

2.2%

The annual rate at which real GDP increased in the U.S. in the fourth quarter of 2018, according to the Bureau of Economic Analysis levels. Economists generally prefer using real GDP as a way to compare a country's economic growth rate. It is calculated using a price deflator—the difference in prices between the current and base year, which is the reference year. This is how economists can tell whether there is any real growth between one year and the next.

U.S. GDP, 1996-2017

Billion USD, end of period



Not adjusted for inflation

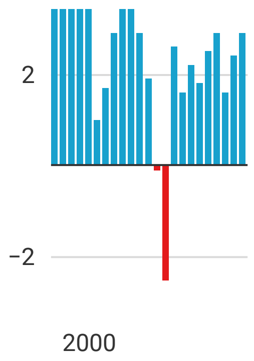
Source: St Louis Federal Reserve

[3]

Measuring GDP

This can be complicated. But, at its most basic, the calculation can be done in one of two ways: either by adding up what everyone earned in a year (income approach) or by adding up what everyone spent in a year (expenditure method). Logically, both measures should arrive at roughly the same total.

The income approach, which is sometimes referred to as GDP(I), is calculated by adding up total compensation to employees, gross profits for incorporated and nonincorporated firms, and taxes less any subsidies. The expenditure method is the more common approach and is calculated by adding total consumption, investment, government spending, and net exports.



Percent change from preceding period, not seasonally adjusted.
Source: St Louis Federal Reserve

[4]

GDP for Economists and Investors

As one can imagine, both economic production and growth–which GDP represents–have a large impact on nearly everyone within that economy. For example, when the economy is healthy, there will typically be low unemployment and wage increases as businesses demand labor to meet the growing economy. Economists look at positive GDP growth to determine how much an economy is flourishing. Conversely, they can use negative GDP growth to determine whether the economy is in a recession.

A significant change in GDP, whether up or down, usually has a significant effect on the stock market. It is not difficult to understand why—a bad economy usually means lower earnings for companies. This, in turn, translates into lower stock prices. Investors often pay attention to both positive and negative GDP growth when assessing an investment idea or devising with an investment strategy. But keep in mind, because GDP is a measurement of the economy in the previous quarter or year, it can help explain how it has affected stocks and your investments. It should not, therefore, be used as a means to predict how the market will move.

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Related Terms

Real Gross Domestic Product (GDP) Definition

Real gross domestic product is an inflation-adjusted measure of the value of all goods and services produced in an economy. more

Expenditure Method Definition

The expenditure method is a method for determining GDP that totals consumption, investment, government spending, and net exports. more

Gross Domestic Product – GDP

Gross Domestic Product (GDP) is the monetary value of all finished goods and services made within a country during a specific period. more

Nominal Gross Domestic Product

Nominal gross domestic product measures the value of all finished goods and services produced by a country at their current market prices. more

How the GDP Price Deflator Provides a More Accurate Reading on Growth

The GDP price deflator measures the changes in prices for all of the goods and services produced in an economy. more

Aggregate Demand Definition

Aggregate demand is the total amount of goods and services demanded in the economy at a given overall price level at a given time. more