Measuring economic health memo

Teacher 7 Re: GDP and the Business Cycle – Economic Health Memo GDP and the business cycle are closely tied together. But how much? Is GDP actually good at predicting the future of the market?

GDP is different from GNP. GDP is the domestic product: It is all the things and services that were produced domestically, no matter who owned them, even if it was foreign buyers. GNP, meanwhile, is the amount held by the nation, including the value of its overseas investment. GDP is about the borders of the nation, GNP about the national ownership. But both are used to predict the business cycle.

GDP is designed to help firms manage uncertainty (Roubini). By getting a feeling for how the whole economy is doing, business managers can decide whether or not to pursue risky policies or batten the hatches and wait for things to get better. In general, markets go through boom-bust cycles about every twenty years (Mead, 1992). Knowing how GDP is doing now helps to predict if were in a boom or a bust, which is important to the business cycle. However, GDPs value as an economic indicator, and therefore a predictor of the business cycle, is coming under attack now. Roubini, for example, points out that, “ The best advice I can give you is to realize that there is an unavoidable amount of uncertainty in the economy. This is even more true of firms and their financial statements. So what do we do? My choice is to get out of this game altogether, but not everyone has this option---a firm, for example, has to forge ahead the best it can. The first thing you should know is that theres a lot of uncertainty out there, and no amount of commercial forecasting is going to change that”. Roubini is saying that GDP isnt ever for certain: It can be determined one year then the same year can be revised a whole percentage point later! Its hard to predict things like wars or terrorist

attacks.

In fact, GDP is very easy to “ game” (Ritholtz, 2010). “[Y]ou simply under-report inflation, and GDP appears to be better than it is”. Since inflation depends on counting the value of a good last year, and doing so across many goods to make sure that its not just one or two goods that grew in price for other reasons, theres a lot of subjectivity and uncertainty in making it.

GDP is also not as helpful as it could be because it positively counts negative externalities (Ritholtz, 2010). That means that pollution, which is a bad thing, is counted as a good thing because it makes people spend money to go to the doctor or buy new houses to move. “ If you buy a car, the GDP goes up. If you cut a tree, the GDP goes up. But if you preserve the tree, the GDP does not grow. Now you have to decide whether you need the tree or the GDP” (Sharma, 2010).

Thus, it is hard to use the GDP to predict the business cycle, and economists are looking for a better indicator of economic health.

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