Guide To…

Economic Growth

What is economic growth?

Economic growth is when the overall level of production by an economy increases. The concept of "overall level of production" is an important one. This means that the economy is not simply producing more of one good at the expense of another, but rather, the economy is generally producing more of all goods and services.

Theoretically, the total production of an economy should be roughly equal to the total income (wages, rent, interest and profit) earned by the economy. Similarly, the total production of an economy should theoretically be roughly equal to the total expenditures (consumption, investment, government purchases and net exports) made by the economy.

How do we measure economic growth?

In order to assess an economy's aggregate production of goods and services, we need a form of measurement. A standard measure allows us to determine whether the level of aggregate production in an economy has increased or decreased. The two most commonly used measures of economic growth are Gross Domestic Product (GDP) and Gross National Product (GNP). However, today GDP is predominantly used over GNP.

The GDP measure refers to the total market value of all final goods and services produced in a country in a given year. The GDP of a country includes all goods and services produced within it, regardless of the producer's nationality. For example, if a US firm is operating within Australia, then its production will be included in Australia's GDP measure.

The GNP measure adjusts GDP to include the production of domestic firms from overseas operations and minuses the production of a foreigner within the domestic economy. That is, the GNP of a country doesn't include goods and services produced by foreign producers, but do include goods and services produced by domestic firms operating in foreign countries. For example, if an Australian firm is operating in the US, then whatever the firm produces within the US is not included in Australia's GDP, however it is included in Australia's GNP.

The difference between GDP and GNP is relatively small for developed countries such as the US, but for smaller developing countries, the difference can be substantial. The growth in GDP is usually a good indication of economic growth, but in an economy where earnings from overseas are substantial in relation to domestic production, it may be better to look at Gross National Product. For the purposes of this "Guide To…" document, we will concentrate on GDP.

What factors make up economic growth?

As we have already mentioned, the growth in GDP is usually a good measure of economic growth. Formally, GDP is equal to total consumer, investment and government spending, plus the value of exports, minus the value of imports.

GDP = Consumer Spending + Investment Spending + Government Spending + (Exports – Imports)

Consumer Spending

Consumers in an economy (also known as the private/household sector) are defined as individuals who buy products or services for personal use (ie. private consumption) and not for manufacture or resale. That is, consumers buy goods or services to 'consume' and not to generate more income. Consumer spending is the total expenditure on goods and services by these people in an economy.

How does consumer spending contribute to GDP? Generally speaking, the greater the demand for goods and services from consumers, the more the economy needs to increase production to meet this demand. In consumer dominated societies such as Australia and the US, consumer spending accounts for approximately two-thirds of total GDP growth.

Investment Spending

Investment spending is defined as the expenditure by businesses and individuals that result in an increase of assets. This includes capital spending on plant and equipment (ie. goods that will increase the future production as well as the current production), but it also includes expenditure that builds up inventory (ie. finished products that are ready for sale, but have not been sold yet).

How does investment spending contribute to GDP? Firstly, the more money that firms spend on capital goods such as equipment and technology, then the more potential they have to increase production efficiently in the future, which will result in economic growth. Secondly, the inventory that firms hold is made up of the portion of economic production that is not sold.

Suppose that a retailer stocks and successfully sells a product, and then this will count towards the "consumer spending" component of GDP. However if the retailer doesn't sell the product, then it will be included as the retailer's inventory and count towards the "investment spending" component of GDP. That is, the retailer "invests" in the product with the intention of selling it at a marginal profit.

Government Spending

Government spending is defined as production-generating expenditure by the federal, state, and local governments. This type of government expenditure is made up of certain types of current government spending and capital spending. Current government spending that is included in GDP mainly consists of salaries paid to public sector employees and other goods and services such as medicine for public hospitals and uniforms for public sector employees. This component of GDP will be larger for countries where many services are supplied by the government rather than the private sector. Current government spending also includes interest payments on national debt. Capital government expenditure refers to the government spending on investment goods. This includes investment into hospitals, schools, highways and equipment. The government funds these expenditures mainly through taxes levied on individuals or companies.

How does government spending contribute to GDP? The government has the ability to adjust their revenue (taxes) and expenditure in order to stimulate or slow down the economy. This is known as fiscal policy, which the government implements predominantly through its release of the annual Budget. The government manipulates the amount of stimulus in the economy by creating budget deficits and budget surpluses. A budget deficit arises when the government injects more money into the economy than what they receive in taxes. This is done with the intention of increasing the aggregate demand of the economy. In contrast, a budget surplus is when the government injects less money into the economy than what they receive in taxes. This is done with the intention of decreasing the aggregate demand of the economy.

Trade Balance (Exports – Imports)

In an open economy, where overseas trading occurs, it is essential to also include the international (or external) sector. Hence, the GDP measure must also include the trade balance. The trade balance refers to the value of exports that a country sells to other countries relative to the value of imports that a country buys from other countries. This component of GDP (Exports – Imports) is also known as net exports and represents the effect that the global economy has on a country's overall growth. A country's economy may be very strong domestically, but weaker global economies will detract from overall growth.

If the country has a trade balance surplus (positive net exports), then referring to the GDP equation above, Exports>Imports, which means that the country has earned more by selling exports than it has spent on imports. Conversely, if the country has a trade balance deficit (negative net exports), then Exports<Imports. This means that the country has spent more on imports than it has earned by selling exports.

How does the trade balance contribute to GDP? Generally speaking, if a country has a trade balance surplus (positive net exports), then this adds to overall economic growth. In contrast, if a country has a trade balance deficit (negative net exports), then this generally detracts from overall economic growth.

If you have any queries in relation to the content of this material, please do not hesitate to contact Kate Kimmorley the Principal Financial Adviser at Kimmorley Financial Management on (07) 5591 1725.

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