

The 9th Issue
(9/2025)
March 2025

بنك الكويت المركزي
CENTRAL BANK OF KUWAIT



The Concept of Gross Domestic Product: Economic Significance & Limitations



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Introduction

Complementing the Central Bank of Kuwait's series of quarterly reports being published since November 2022, this 9th edition (March 2025) titled **"The Concept of Gross Domestic Product: Economic Significance & Limitations"** is about Gross Domestic Product (GDP), highlighting its definition and significance as a measure of a country's economic performance, as well as GDP formula and limitations.

GDP becomes the standard tool for sizing up a country's economy since 1937. It is used to assess economic performance, measure growth rates, guide economic policies, and analyze trends of economic indicators. It is also a main tool for monitoring economic and global progress, in addition to its importance for businesses, investment and financial decision- making.

I. Gross Domestic Product (GDP) Definition and Conditions of Calculation

Gross Domestic Product (GDP) is the total monetary value of all final goods and services produced and rendered in a country in a given period of time. GDP is one of the most important economic indicators that reflect the economic performance of a country, and is usually measured on an annual or quarterly basis. The conditions for calculating GDP are as follows:



Monetary Value:

The value of goods and services must be denominated in currency. Monetary value is essential in economic analysis because it allows comparison of different goods and services using a standard unit of measurement.



Final Goods:

Goods that are produced for direct consumption and are not used as input to produce other goods (e.g., foodstuff, clothing, footwear, and personal transportation).



Final Service:

A service that is provided directly to the consumer and fulfills the purpose when it is provided and does not require further processing and conversion (such as medical tests, educational services).



Geographic Scope:

The economic activity must be within the country's borders regardless of the nationality of individuals and companies (for example, if a foreign company manufactures cars in the US, its production will be counted in the US GDP and not the country to which the company belongs).



Period of Time

Production is calculated during a given period of time on either an annual or quarterly basis. Previous production and accumulated stock of goods from previous periods are not counted.

The following are excluded from calculations of GDP:

Financial Transactions:

Social transfers and unemployment benefits, as these are not payments for goods or services. In addition, buying and selling stocks and bonds in the money markets, as these do not reflect new economic production.

Resale Operations (sale of used goods):

Used goods are not included in GDP because they have already been counted as part of GDP in the year that they were produced.

Intermediate Goods:

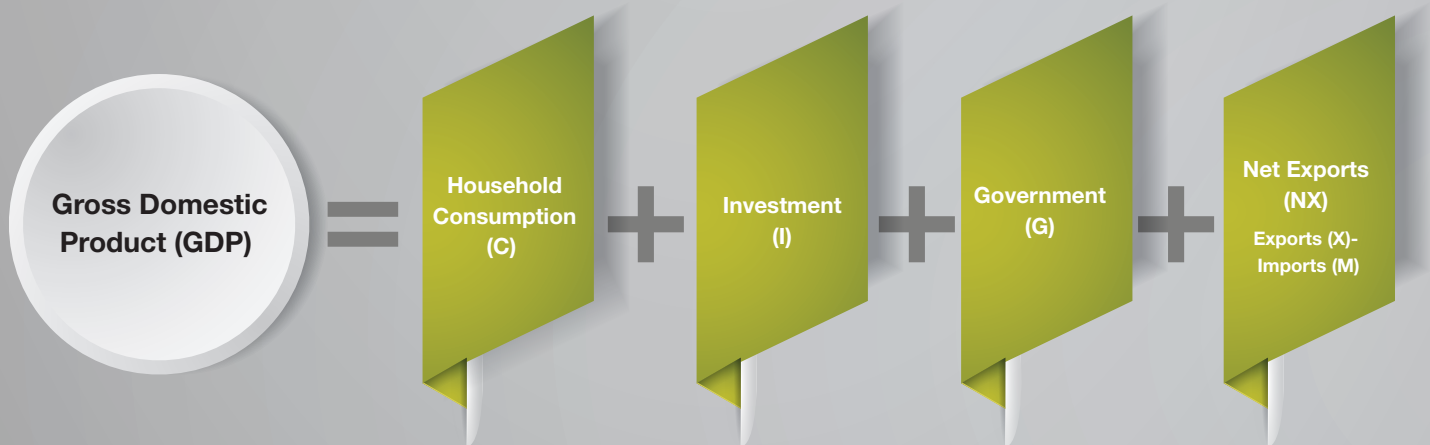
GDP only includes final goods. Intermediate goods that are used in the production of other goods, are excluded from GDP calculations.



II. Calculating GDP Using the Expenditure Approach

The expenditure approach is the most common way for measuring GDP. Under this approach, GDP is calculated by the following formula:

$$\text{GDP} = C + I + G + (X - M)$$



(C) Household Consumption

Defined as household spending on final goods, whether non-durable goods such as food and clothing, or durable goods such as personal transportation and household appliances, as well as spending on final services such as education and healthcare.

(I) Investment

Includes companies' spending on fixed assets such as land, buildings and equipment, plus investment in unsold inventory; and home purchasing by families.

(NX=X-M)

Net Exports

It is the difference between the value of a country's exports and imports. It reflects the impact of foreign trade on the economy.

(G)

Government Spending

Includes government spending on education, healthcare, security, salaries, and infrastructure development such as construction or maintenance of roads and bridges. Social transfers and unemployment benefits are excluded.



III. Uses of GDP

Measuring Economic Performance of Countries

GDP measures the size of a country's overall economic activity. Higher GDP indicates economic growth, while lower GDP indicates a slowdown or an economic recession.

Comparing Countries' Economies

GDP is used as a metric by international institutions such as the World Bank and the International Monetary Fund to compare the economies of countries, as it helps assess the resilience of a country's economic activity.

Developing Economic Policies

GDP is a key factor for drawing economic policies, and guiding governments' fiscal policy and the monetary policy of central banks.

Forecasting Economic Indicators Trends

Economic analysts can predict future developments by analyzing GDP data and trends over different periods of time.

IV. Real GDP and Nominal GDP

Comparison

Nominal GDP

Real GDP

Nominal GDP is calculated using current market prices (i.e., the actual prices in the same year in which GDP is measured).

Definition

Real GDP is an inflation-adjusted measure, and calculated using constant prices from a base year. Real GDP is computed by dividing nominal GDP by a GDP deflator, used to remove the effects of inflation.

It tracks the quantities of goods and services produced and includes the general level of prices.

Pricing

It tracks the quantities of goods produced - without prices - and use constant prices that are adjusted for inflation

It is used as a metric for financial comparisons and for the general budget of countries, such as comparing different countries' GDPs or analyzing the total value of production at a specific time.

Uses

It is used for analyzing real economic growth over the years as it does not include the effects of inflation. It is valuable for evaluating long-term economic performance.

V. The Concepts of Economic Growth and Downturn

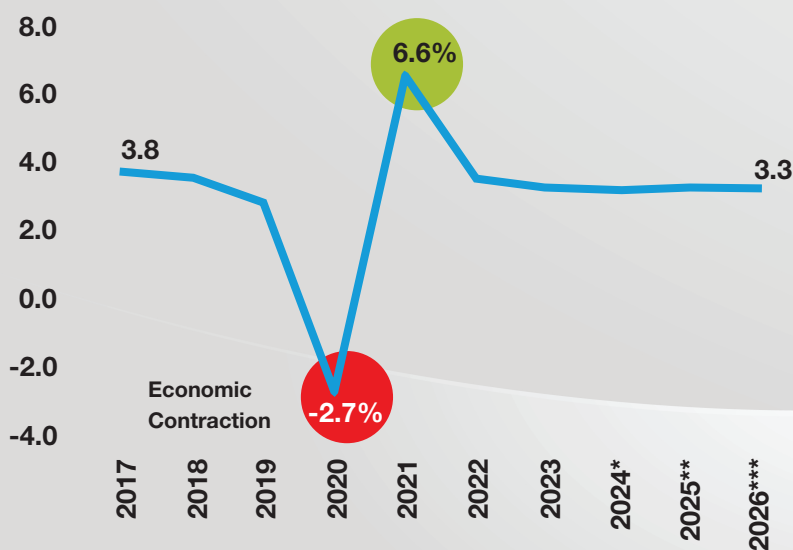


It is an increase in the production of goods and services within a country during a specific period of time, and is measured by the rise in real GDP. Economic growth creates new jobs, reduces unemployment rate and boosts individual incomes.



It is a significant decline in the economic activity and is measured by the decline in real GDP. Economic downturn increases unemployment due to lower levels of production, and individual income.

Example: Global real GDP grew by 6.6% in 2021, compared to a contraction of 2.7% in 2020, due to the effects of COVID-19 pandemic.



Source: IMF database, October 2024, IMF database estimates "updated", January 2025.

VI. Limitations of GDP

Does not reflect the distribution of income and wealth

GDP does not capture the distribution of wealth across a country's population.

Does not measure the quality of life and well-being

GDP focuses purely on economic production and ignores quality of life such as healthcare, education, and environment.

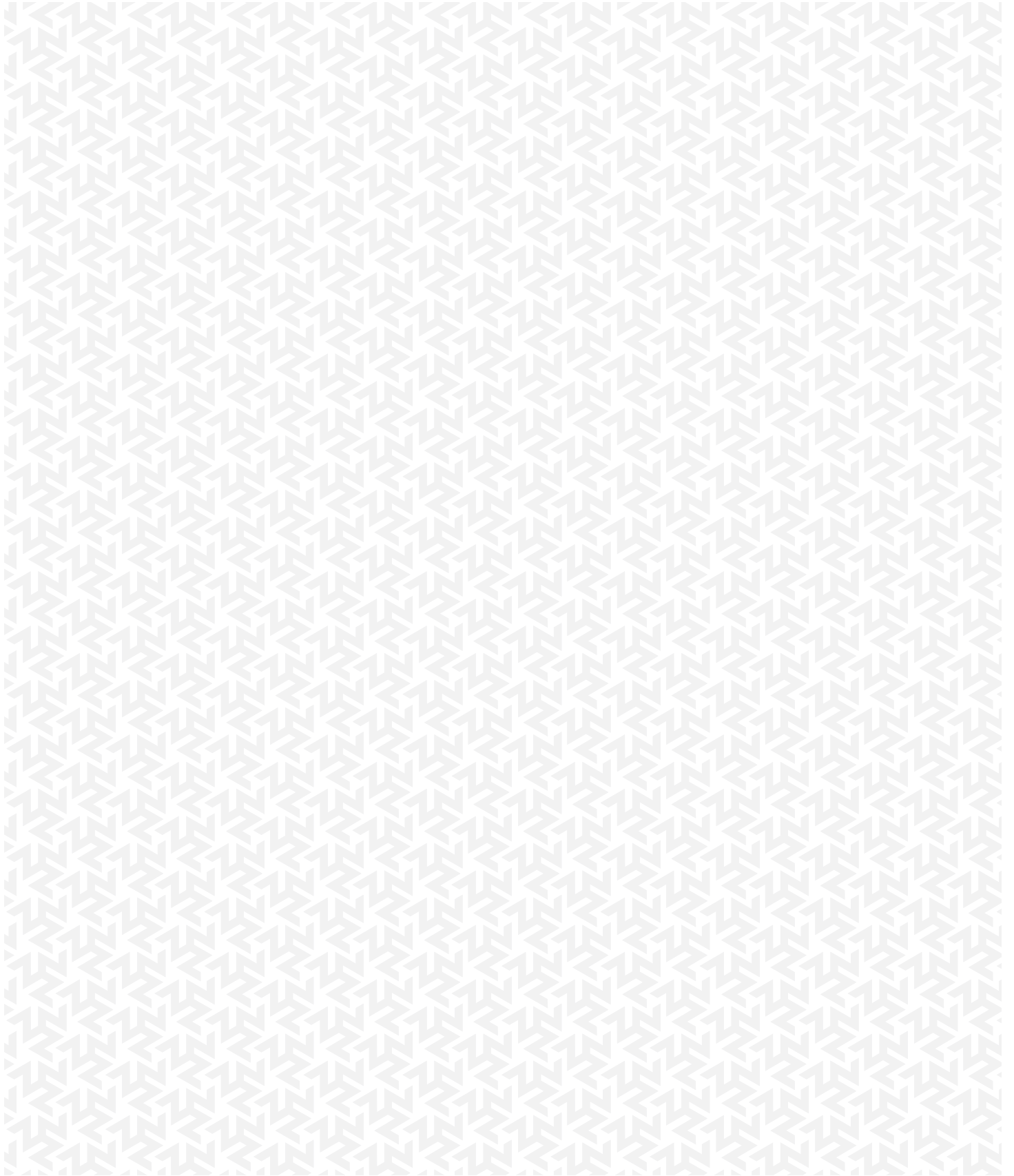
Does not include the value of non-market activities

GDP excludes activities that are not provided through the market, such as household service work, volunteer work and any unpaid services.

Conclusion

Gross Domestic Product (GDP) is a key criterion for understanding the size and level of activity of an economy. It reflects the performance of the different sectors and used to assess growth rate. Although it does not include all aspects that affect the well-being of individuals, it remains a key tool for measuring the economic strength of countries.

The **economic significance of GDP** is represented in its significant role in guiding economic and financial policies, as it enables policymakers in governments and central banks in formulating fiscal and monetary policies, such as setting levels of taxes, public spending and interest rates. It is also used by investors to evaluate investment opportunities in different markets. In addition, GDP is relied upon in **international comparisons** to measure the performance of economies and determine the ranking of countries in terms of their economic activity. Despite its **limitations**, such as neglecting the quality of life or the distribution of wealth, GDP remains an indispensable tool for understanding and analyzing the economies of countries



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