

Assignment

Why can the Nominal GDP be higher or lower than the real GDP?

Solution

First of all it's necessary to define the concept of GDP. The Gross Domestic Product is the total market value of the production of final goods and services in an economy in one period of time (usually a year). The final goods and services are goods and services that are purchased for final consumption, for example, the final goods include clothing, food, utilities etc.

Gross domestic product shows the output in prices that existed at the time when this volume was produced. This total output of goods and services is called nominal GDP. However, nominal GDP doesn't show current state of GDP because it expresses only the prices of the period of time in which it was produced. Changes in the volume of GDP could occur due to an increase in prices (inflation), economic growth, etc. So, in order to assess the true picture of the economic situation, it is necessary to adjust the nominal GDP. Nominal GDP can be adjusted for inflation (increase in prices of goods and services) or deflation (decrease in prices for goods and services). The adjusted nominal GDP is called real GDP. So, we can write the following equation:

$$\text{Real GDP} = (\text{Nominal GDP} / \text{price index}) \times 100$$

$$\text{Nominal GDP} = (\text{Real GDP} * \text{price index})/100$$

Therefore, when the price index $> 100 \rightarrow$ Nominal GDP $>$ Real GDP

when the price index $< 100 \rightarrow$ Nominal GDP $<$ Real GDP