eLearneconomics: Inflation – Real Values (1)

Student response ____________________

(a) Complete the table below.

Economic term or idea	Definition or description
(i) Disinflation	
(ii) Deflation	
(iii) Inflation	
(iv) Nominal value	
(v) Real value	
(vi) Base year	

(b) Explain the difference between nominal GDP and real GDP.

(c) Distinguish between nominal wages and real wages.

(d) Explain the reason for the error in this statement:

'Inflation has to be higher than 3.5% because the price of petrol has gone up by 10%.'

eLearneconomics: Inflation – Real Values (1a)

Solutions

(a) Complete the table below.

Economic term or idea		Definition or description
(i)	Disinflation	A fall in the inflation rate
(ii)	Deflation	A fall in the general price level
(iii)	Inflation	A rise in the general price level of a country
(iv)	Nominal value	A value that refers to the face value of something
(v)	Real value	A value that is inflation adjusted
(vi)	Base year	A reference point for an index from which all other values are compared

(b) Explain the difference between nominal GDP and real GDP.

Nominal GDP measures GDP in current prices whereas real GDP measures the value of output using base year or constant prices, to see if there is an actual increase in output.

(c) Distinguish between nominal wages and real wages.

Nominal wages are the return to labour measured in current dollars, whereas real wages are wages adjusted for change in the level of prices.

(d) Explain the reason for the error in this statement:

'Inflation has to be higher than 3.5% because the price of petrol has gone up by 10%.'

If petrol prices go up by 10% then this is the price rise for one product. Inflation of 3.5% implies that the average of all prices has risen by this amount in the whole economy.

eLearneconomics: Inflation – Real Values (2)

Student response

Year	Nominal wage settlement	Inflation rate	Real wage
1	4.0% increase	5.0% increase	1.0% decrease
2	4.0% increase	4.0% increase	No change
3	4.0% increase	2.5% increase	1.5% increase

Compare and contrast nominal and real wages, with reference to the table.

In your answer you should:

- Explain the difference between nominal and real wages.
- Explain how real wages are calculated and how an individual might have an increase in nominal wages but a fall in real wages.

eLearneconomics: Inflation – Real Values (2a)

Solutions

Year	Nominal wage settlement	Inflation rate	Real wage
1	4.0% increase	5.0% increase	1.0% decrease
2	4.0% increase	4.0% increase	No change
3	4.0% increase	2.5% increase	1.5% increase

Compare and contrast nominal and real wages, with reference to the table.

In your answer you should:

- Explain the difference between nominal and real wages.
- Explain how real wages are calculated and how an individual might have an increase in nominal wages but a fall in real wages.

The nominal wage is the return to labour measured in current dollars or the money wage received by wage and salary earners in the workforce.

The real wage or purchasing power of wages is the nominal wage adjusted for changes in inflation. If inflation increases and nominal wages remain constant, individuals can buy fewer goods and services than before. Their purchasing power or real wage has fallen. Workers will probably supply additional labour in response to a higher real wage.

To calculate real wages when the inflation rate is given, the real wage equals the nominal wage minus the inflation rate, for example, in Year 3 nominal wages increased by 4.0% and the inflation rate was 2.5%, then real wages have increased by 1.5% (4.0%–2.5%).

It is possible for an individual to have an increase in nominal wages but a fall in real wages, e.g., in Year 1 nominal wages increased by 4% while the price level (or inflation) increased by 5.0%, then real wages have declined by 1.0%.

eLearneconomics: Inflation – Real Values (3)

Student response

Real GDP is a better measure of economic growth than nominal GDP.

Compare and contrast Real GDP and nominal GDP as a measure of growth.

In your answer you should:

- Define Real GDP and nominal GDP.
- Explain why Real GDP is a better measure of economic growth.

eLearneconomics: Inflation – Real Values (3a)

Solutions

Real GDP is a better measure of economic growth than nominal GDP.

Compare and contrast Real GDP and nominal GDP as a measure of growth.

In your answer you should:

- Define Real GDP and nominal GDP.
- Explain why Real GDP is a better measure of economic growth.

Nominal GDP measures the total market value of all final goods and services produced in an economy in a year and measured in the current year prices. Nominal GDP may increase despite the fact that fewer goods and services are produced, i.e., an increase in nominal GDP may be caused by an increase in the general price level (inflation) without any increase in output or in fact output may fall.

Real GDP is the total market value of all final goods and services produced in a year measured in constant prices. Real GDP has the effects of inflation removed, therefore real GDP will reflect changes in real output. An increase in real GDP means that more goods and services have actually been produced when compared with the previous time period, which signifies that economic growth has taken place.

Real GDP is a better measure of increases in national output or the purchasing power of national income because it deflates nominal GDP to remove changes caused by inflation by using a price index to remove the effects of changes in the general price level.