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Which is better, real, or nominal GDP?

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A rise in nominal GDP makes you feel good, but only a rise in real GDP can make you wealthier.

In a normal functioning economy prices change all the time. Some prices will rise but others will fall, leaving aggregate prices relatively unchanged. Fluctuating price is not inflation; it is only when prices in aggregate begin to rise together that we can say inflation has taken hold.

Nominal GDP measures the total output of an economy in terms of current prices. It measures the changes in the price of goods (and services) from one period to the next, but it ignores the change in volume.

The problem with that, of course is that if nominal GDP doubles over time but the volume of goods and services produced remains flat, the underlying "real" economy has not grown at all, and if incomes remain static then everyone is 50% poorer than they were at the start of the period.

Nominal GDP measures do not adjust for inflation, but "real" GDP does. Nominal GDP makes the economy look larger than it is; real GDP tells the truth.

It is often said that inflation erodes the value of debt but that is only true if incomes rise in line with inflation. If they don't, people simply become poorer. John Keynes remarked that, "By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens."

Real GDP looks at the volume of goods and services produced in an economy from one period to the next. You will come across the "GDP deflator" in British statistical releases and the PCE deflator (Personal Consumption Expenditure deflator) in US releases.

These numbers are attempting to measure the real growth in the economy by removing the impact of price changes. If an economy is producing more goods and services in volume terms, it is becoming wealthier; if it is doing that with fewer inputs, it is becoming more productive as well. Wealthy, productive economies are exactly the type of economies in which we want to invest.

A rise in inflation is the same thing as a fall in your purchasing power. That is why inflation is so pernicious and why rising nominal GDP can disguise a fall in living standards hence Keynes' observation.

This may be an oversimplification, but all the productive capacity of the economy may be viewed as a function of all expenditure and incomes in the economy at any one time. If the capacity of the economy fails to grow, then any increase in salary or dividend or rent will simply be counterbalanced by a rise in the money supply leaving nobody any better off in real terms.

Since the Paul Volcker regime of the 1980s, about which we have spoken many times, the dominant economic policy regime around the developed world has come to be "inflation targeting." Central bankers have been tasked with keeping inflation at or around 2% per annum, positive but not strongly positive, and nominal GDP close to real GDP.

But there are downsides to a rigid adherence to low inflation. What if inflation becomes too low?

That is exactly what happened in Japan in the 1990s and then more widely around the world in the aftermath of the financial crises of 2008.

In these periods, it was found that an inflation target of 2% could push inflation into negative territory where demand was insufficient to absorb the available supply of goods produced by the world economy.

In that situation, firms found themselves having to reduce prices to clear goods. However, that reduces revenues, which depresses investment, which raises unemployment, and increases budget deficits. Moreover, available resources in the economy go unused and in extremis you enter a period of depression analogous to the 1930s.

It was this that led John Keynes to the notion that deflation was much the more dangerous threat to economic well-being and stability than moderate rates of inflation. It was also the reason why central banks adopted the extreme and unusual policies of negative interest rates and Quantitative Easing in the immediate aftermath of the global financial crisis; very specifically to avoid a re-run of the Great Depression.

It is this that is behind the gathering momentum for targeting nominal GDP rather than inflation.

Ironically, due to the war in Ukraine, nominal GDP is galloping away but few of us feel any better off when we receive our newly revised energy estimates.

Almost always, arguments surrounding economic policy are really arguments about distribution. You hear very few politicians talking about productivity being at the heart of wealth creation and higher living standards. To quote John Keynes again, “You have not, I suppose ever mixed with politicians at close quarters. They are awful, their stupidity is inhuman…”

So, which is better, real, or nominal GBP? Whilst nominal GBP growth makes you feel better off, the former means you are better off.