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Ghost of GDP: Sponge, Myth or Moustache Twitching?

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Introduction:

GDP (Gross Domestic Product) and GDP growth are economic buzz words, widely discussed more in politics rather than economics. Many economists are skeptical and ask a curious question; whether Real GDP is real or ghost? Does a GDP growth number help individuals or government in taking decisions to improve life or economy? Can an economy be judged on strength based on GDP numbers? GDP discussion in politics reminds us of a modern proverb; “There is a lie, damn lie and there is statistics”. In a competitive world, economies attempts to prove superior to others, and in this endeavor they plays with GDP and GDP number like a magician. Does GDP demonstrates real strength or is like mustache twitching? Mustache twitching is symbol of muscular strength, but does it make you win in real fight? We argue that GDP is hollow like sponge. GDP is no less than a myth. GDP can be indicative, but not objective indicator enough to take business or managerial decision. For politician it could be a tool to show case strength like moustache twitching, as they are not going to lose anything except the election. A business can lose many things if it fails to take decision to generate profit. Even if Real GDP growth is real, but no growth in the sector in which company operates, GDP is irrelevant to take a business decision. On the contrary in spite of recession, a company may find business opportunity in product line where there is growth potential. Government executives play with the number to produce GDP numbers to please their political bosses. Therefore, majority of GDP growth estimates are revised downward and real numbers are even lower than revised numbers. There is no standard method to calculate GDP. GDP is not calculated on real basis. It is estimated based on proxies of selected goods and services. There is inherent bias in choice of goods and services to include in GDP calculation. Innovations are brought in new methods to calculate GDP without testing it on reality.

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GDP is akin to ghost, which never exists. It is only imaginary and myth. GDP, like ghost exists on paper and story. The way GDP is calculated through estimated complicated numbers of selected items of production and services, through methods, approaches and processes of choice; GDP numbers calculated by different experts will be different. Most likely of derived numbers will be a choice of political bosses. GDP numbers are like wheat flour from which you can make or prepare bread, biscuits, burns, pastries, croissants, chapatti or some innovative delicious dishes. GDP numbers are shown to scare or impress someone like story of ghost is narrated before children. Take example of populous emerging economy, which shouts loudly that in terms of total GDP we are one of the global top ten economies, while its per capita income ranking will be at bottom. They will shout that we are growing at double digit growth. But reality is that, their net per capita income growth minus inflation will be few cents, while top developed country's economy even if grows at less than 1%, per capita income gain will be hundreds of dollars. Thus, percentage growth looks impressive, but absolute numbers are meager or intangible. Net GDP growth of many emerging economy is set off by population and inflation growth, while population and inflation are almost steady or very low in America, Japan or Europe. Your claim or interpretation about a GDP number will dependent on whether you are in support of government or against? GDP numbers change if your export, import (quantity and custom/taxes) or foreign exchange rates change. In fact those rate changes frequently. The pro-government experts will welcome currency deprecation by citing its benefit for the exporters. On currency appreciation, they play moustache twitching to show currency strength. The opposition will tell exactly the opposite! Common men will be puzzled to infer what is good and what is bad?

Economist Types

There are four types of economists. (i) Pessimist economists are inclined to see the worst position of economy in time to come. They are conservative in their approach. They can be seen as people with negative mindset. They will generally under-estimate everything. Pessimism is a negative or depressed mental attitude in which an undesirable outcome is anticipated from present situation. They believe that demand, saving, investment and supply will decrease. They believe price, inflation, unemployment will increase. (ii) The optimist economists are exactly opposite. They are hopeful and confident about future. They have positive mindset and generally

over-estimate. They believe that demand, saving, investment and supply will increase. They believe price, inflation, unemployment will decrease.

(iii) Third type of economists are 'pesimist' (yes, PESIMIST and there is no spelling error). Irrespective of their belief; 'pesimist' economist are professionally inclined to oppose the government in all conditions. Because of inherent political compulsion, they will articulate data in a manner that economy will look gloomy. In other words, they are born to oppose the government. (iv) The fourth type of economists are 'optimisst' (no spelling error, it is in fact OPTIMISST'). Irrespective of their belief; 'optimisst' economist are professionally inclined to support the government in all conditions. Because of inherent political compulsion, they will articulate data in a manner that economy will look always rosy. In other words, they are born to support the government.

GDP

GDP, short for Gross Domestic Product, is defined as the total market value of all final goods and services produced within a country in a given period. It includes private and public consumption, private and public investment, and exports less imports. In simple economic terms GDP is a monetary measure of the market value of all the final goods and services produced in a specific time period. The market value has range of explanations. Market value is the highest estimated price that a buyer would pay and a seller would accept for an item in an open and competitive market. Market value is what something is worth. Market value is the price at which an asset would trade in a market place. Market value is often used interchangeably with open market value, fair value or fair market value, GDP encompasses goods and services produced that are exchanged in the market and those not exchanged in the market. In other words, GDP includes goods and services that are not available in open market. In common parlance, the value is what the product is actually worth, without any outside expectations from the consumer or seller. Value is perceived what consumers think the product is actually worth. The perception is highly dynamic, value being perceived differently by different people. The value may be perceived differently by same person at different time, and differently at different place or circumstances. The other fundamental question, can all goods and services produced is

recognized? We discuss about parallel economies and under-world economies. How do we recognize goods and services produced that are not legal or that are not reported? If we recognize illegal goods and services to calculate GDP, are we failed State? We have recognized illegal activities, but do we initiate legal actions against perpetrators? If we cannot recognize certain goods and services produced, how can we determine the total value? How can we determine value of goods and services that are unique or not traded in market? Can we recognize and value all goods and services that are produced? Economists' attempts to use proxy to best estimate them. The privilege to estimate value of goods and services produced provide the leverage to stretch in the desired direction and desired length. Pro government economists will stretch to show higher GDP and anti-government economists will attempt to stretch exactly in opposite direction, what is real GDP? A government officer in power will tune to please government; but after retirement the same officer's tune for same GDP number will change.

So how much confidence should we place in these forecasts? A Bloomberg analysis found a wide variation in the direction and magnitude of errors. In 6.1 percent of cases, the IMF was within a 0.1 percentage-point margin of error. The rest of the time, its forecasts underestimated GDP growth in 56 percent of cases and overestimated it in 44 percent. The average forecast miss, regardless of direction, was 2.0 percentage points, but obscures a notable difference between the average 1.3 percentage-point error for advanced economies compared with 2.1 percentage points for more volatile and harder-to-model developing economies. Various central banks quarterly and annual estimates eventually turn to be overestimation. How can we rely on GDP data, if more than half of its prediction fails miserably? Several assumptions are taken to estimate GDP. Majority of assumption are far from reality and vague. One of the assumptions is price level. In emerging economies, inflation plays major role in determining prices. GDP is calculated for a quarter or year. Within a year, or even in a quarter, sometime the price fluctuation is quite high. Goods and services produced for export is influenced by foreign exchange rate fluctuations. Foreign exchange fluctuation is not only influenced by market forces, but international politics and business. GDP is aggregate of data captured from several sources; many of them are conflicting and overlapping in nature. GDP fails in recognizing unequal society. If income distribution is highly unequal, decision on socio-economic welfare of bottom of pyramid will be

highly screwed. It is very important to know how national income or wealth is distributed among citizens.

GDP numbers are used to take future decisions. With so many anomalies; how can individuals, businesses and government decide its future course of actions? And if decisions are taken based on GDP data, how sound the decisions could be?

Nominal vs. Real GDP

GDP can be expressed in two different ways—nominal and real GDP. Nominal GDP takes current market prices into account without factoring in inflation or deflation. This figure looks at the natural movement of prices and tracks the gradual increase of an economy's value over time.

GDP Approaches

There are two major approaches to determine GDP. Neither approach is perfect. Using different approach, the numbers derived will be different. How can we rely and infer out of confusing numbers? The expenditure approach attempts to calculate GDP by evaluating the sum of all final good and services purchased in an economy. The expenditure approach is basically an output accounting method. It focuses on finding the total output of a nation by finding the total amount of money spent. The basic formula for domestic output takes all the different areas in which money is spent within the region, and then combines them to find the total output. Several expenditures do not create value. GDP calculated by this approach ignore wealth creation. If crime rate is high or pollution level is high or in poor health environment; expenses will be high. But does it indicate sign of good economy? Expenditure incurred for installing a historical statue or pyramid will lead to public welfare? Off course, it may have artistic value, but certainly no public welfare. Many a time in long term projects; expenditures are incurred but due to one or another reason projects are delayed indefinitely. The project is incomplete, expenditure is incurred, but it does not offer any intended services. How GDP number thus generated offer any real benefits?

The income approach looks at the final income in the country, these include the following categories taken from the U.S. “National Income and Expenditure Accounts”: wages, salaries, and supplementary labor income; corporate profits interest and miscellaneous investment income; farmers’ income; and income from non-farm unincorporated businesses. Two non-income adjustments are made to the sum of these categories to arrive at GDP:

- i) Indirect taxes minus subsidies are added to get from factor cost to market prices.
- ii) Depreciation (or Capital Consumption Allowance) is added to get from net domestic product to gross domestic product.

The income approach equates the total output of a nation to the total factor income received by residents or citizens of the nation. The main types of factor income are:

Employee compensation (cost of fringe benefits, including unemployment, health, and retirement benefits);

Interest received net of interest paid;

Rental income (mainly for the use of real estate) net of expenses of landlords;

Royalties paid for the use of intellectual property and extractable natural resources.

All remaining value added generated by firms is called the residual or profit or business cash flow. The output approach focuses on finding the total output of a nation by directly finding the total value of all goods and services a nation produces. Because of the complication of the multiple stages in the production of a good or service, only the final value of a good or service is included in the total output. This avoids an issue referred to as double counting, where the total value of a good is included several times in national output, by counting it repeatedly in several stages of production. Informal economy is ubiquitous equally with different proportions in developed and developing countries. In calculating a formal GDP numbers, how informal economy incomes are counted? Parallel economy volume is sometime exceeding formal economy in a developed country. All informal economy transactions are not always illegal, but the key question is how they are captured? Or, more fundamental question arises, are they captured? Some businesses up to a threshold limit are not required to maintain accounts, register

or pay tax. How their income is shown in calculating GDP? GDP growth is derived based on formal economy, can we assume formal and informal economy grows at same rate?

One of the discrepancies for calculation of GDP is double counting. This is an error caused due to adding the value of a commodity twice once before adding value to it and once after adding value to it. Data collection agencies classify income, expenditure or output across specific industry. Some data overlaps across industry, which leads to double counting,

As per *Economists*², GDP forecast fared well over brief time periods, but got worse the further analysts peered into the future—a trend unsurprising in direction but humbling in magnitude. If a recession lurks beyond 2019, economists are unlikely to foresee it this far in advance. Economies are fiendishly complex, but forecasters usually predict short-term trajectories with reasonable accuracy. Projections made in early September for the year ending four months later missed the actual figure by an average of just 0.4 percentage points. Errors rose to 0.8 points when predicting one year out. But over longer horizons forecasts performed far worse. With 22 months of lead time, they misfired by 1.3 points on average—no better than repeating the previous year’s growth rate. Simon Kuznets, the economist who developed the first comprehensive set of measures of national income, stated in his first report to the US Congress in 1934, in a section titled “Uses and Abuses of National Income Measurements”: “Economic welfare cannot be adequately measured unless the personal distribution of income is known. And no income measurement undertakes to estimate the reverse side of income, that is, the intensity and unpleasantness of effort going into the earning of income. The welfare of a nation can, therefore, scarcely be inferred from a measurement of national income. ” Following on his caution with respect to economic extrapolations from GDP, in 1962, Kuznets stated: “Distinctions must be kept in mind between quantity and quality of growth, between costs and returns, and between the short and long run. Goals for more growth should specify more growth of what and for what. ”

The sensitivities related to social welfare has continued the argument specific to the use of GDP as economic growth or progress metric. Austrian School economist Frank Shostak has noted: “The GDP framework cannot tell us whether final goods and services that were produced during a particular period of time are a reflection of real wealth expansion, or a reflection of capital

² <https://www.economist.com/graphic-detail/2018/12/15/gdp-predictions-are-reliable-only-in-the-short-term>

consumption. For instance, if a government embarks on the building of a pyramid, which adds absolutely nothing to the well-being of individuals, the GDP framework will regard this as economic growth. In reality, however, the building of the pyramid will divert real funding from wealth-generating activities, thereby stifling the production of wealth.” It is time to find better measures than GDP. GDP may be useful to academics and researchers; but more sacred duty is cast on them to find alternatives that can meet the objectives of GDP. Debate, dialogue and discussion among stakeholders may give lead to researchers if GDP science can be improved or its limitations are well understood.

Conclusion

GDP data should be used with caution by individuals, businesses or governments. Although GDP provides a single quantitative metric by which comparisons can be made across countries, the aggregation of elements that create the single value of GDP provide limitations in evaluating a country and its economic agents. Given the calculation of the metric, a country with wide disparities in income could appear to be economically stronger than a country where the income disparities were significantly lower (standard of living). However, a qualitative assessment would likely value the latter country compared to the former on a welfare or quality of life basis. GDP is not absolute quantitative measure. GDP numbers are influenced by subjective matters. It is highly influenced by aptitude, attitude and individual objective/s of people who capture, analyse, infer and use data. The best way to use GDP number is along with other socio-economic data. It is pertinent to note that the purpose of using GDP data will determine what other socio-economic data you should look into. In any case, rather than using the final GDP or GDP growth number; one should dissect it thoroughly. Unless underlying assumptions, components, methods and approaches used in deriving GDP or GDP growth are not known to the user, decisions taken using those numbers will be meaningless. Significant business decisions should be taken based on sectoral data in which the firm is operating. Collective actions and cooperation among stakeholders is the need of hour to augment GDP science.

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