FIRST QUARTER 2012

POINT of VIEW

OUR PERSPECTIVE ON ISSUES AFFECTING GLOBAL FINANCIAL MARKETS

GDP: What's It Good For?

"Too much and for too long, we seem to have surrendered personal excellence and community values in the mere accumulation of material things. Our Gross National Product, now, is over $800 billion dollars a year, but that Gross National Product - if we judge the United States of America by that - that Gross National Product counts air pollution and cigarette advertising, and ambulances to clear our highways of carnage. Yet the gross national product does not allow for the health of our children, the quality of their education or the joy of their play. It does not include the beauty of our poetry or the strength of our marriages, the intelligence of our public debate or the integrity of our public officials... It measures everything in short, except that which makes life worthwhile. And it can tell us everything about America except why we are proud that we are Americans."

– Robert Fitzgerald Kennedy
1968 Campaign Trail[1]

A glance in the rear-view mirror suggests tangible economic progress over the last 60 years. If we look only at labor productivity in the United States since Robert F. Kennedy gave his speech, growth has been astounding. But labor productivity (the consequence of divison of labor) is only one of many metrics which measure economic output. It begs the question, how do we best measure economic progress and growth that spans decades? And what are the shortcomings and consequences of such growth? Professors and economists use myriad metrics to calculate growth and determine the magnitude of expansion or contraction within a specific country or entire region.

Yet, only one has endured the test of time. Notwithstanding R.F. Kennedy's words, for the last 80 years Gross Domestic Product (GDP) has been the most prominent measure of economic growth. But if Kennedy was correct regarding the shortcomings of GDP, then why has this measure remained so popular among policy-makers? And perhaps there are alternative measures that better reflect not only output, but overall progress and well-being of both the individuals within a country and the nation as a whole.

A HISTORY OF GDP

For centuries economists debated the cause of fluctuations in business activity (the "economy"). Some argued that a slump in the demand for goods led to the idleness in factory production while others identified production of the wrong mix of goods as the operative force leading to a decline in business activity.

Through the late 18th and most of the 19th centuries, economists such as, "[Jean Baptise] Say, James Mill and [David] Ricardo, following Adam Smith, opposed the view that a general lack of demand was the prime threat to prosperity, arguing that the main obstacle is inability or unwillingness to produce."[3] These thinkers argued that large-scale economic evaluation must take as an invariable point of departure, considerations of aggregate supply (or the ability "to produce").

Once in the 20th century, however, the prevailing winds of thought shifted. In the early 1930s, John Maynard Keynes was reading the work of Thomas Malthus, a British economist working in the early 1800s. As a result of his reading of Malthus, Keynes moved stridently away from considerations of aggregate supply, and reoriented (indeed, an orientation that persists to this day) economic thinking toward aggregate demand: "it was because Keynes was reading...[Malthus] in late 1932 that the General Theory was written as it was, focusing on effective demand as the central issue in the theory of unemployment and depressions."[4]

As theoretically impressive as Keynes' turn to aggregate demand was, he proposed no way of measuring his key indicator. However, in a 1937 report presented to congress, Simon Kuznets developed the concept of GDP as a means of measuring aggregate demand: GDP was effectively a national accounting system. Hence, GDP denoted (and denotes still) the total value of goods and services produced within a country over some unit of time. The initial goal of GDP was to make it easier for policy-makers to manage a national economy through crises and war, without consideration of utility.

As a result, Kuznets designed GDP to capture all economic production by individuals, companies, and the government in a single measure, increasing during economic expansion and declining during contraction.

The computational simplicity of GDP and the premise that spending patterns alone accurately measured growth made it attractive to most economists.

Although the measure was an immediate economic success, the pioneer of GDP warned of its shortcomings and cautioned against its use as a measure of welfare. Specifically, 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."[5] Ironically, Kuznets resigned from working with the U.S. Commerce Department in the 1940s over their refusal to include unpaid housework as a component of GDP, one of several omissions prevalent in the measure.

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In 1959, Stanford economist Moses Abramovitz became one of the first to publicly question how accurately GDP reflects a society's overall well-being. Abramovitz warned, "We must be highly skeptical of the view that long-term changes in the rate of growth of welfare can be gauged even roughly from changes in the rate of growth of output."[6] But such criticisms failed to win much support as academics and policy makers continued to rely on GDP data.

For example, Arthur Okun, former staff economist for John F. Kennedy, theorized that for every three-point increase in GDP, unemployment would fall by one percentage point and vice versa: this is now known as Okun's law. The message became clear to policy-makers, continue to increase the size of the economy and the welfare of your nation will reap the benefits.

MAKING SENSE OF GDP

The world has changed a great deal in the decades since Kennedy's speech, as innovation reshaped the economic landscape. Financial markets have become global, growing dramatically in both size and scope. Revolutionary strides in technology, most notably cell phones and computers, have made global communication possible, and knowledge a democratic commodity.

But how does this effect our day to day? How does GDP growth play out on a small scale? Take for example mowing the lawn. For anyone who wants their lawn mowed, the options are roughly three: mow yourself, pay a family member, pay a professional. While the differences between the three may seem trivial, the choice of who mows your lawn matters in terms of GDP.

If you mow your lawn, you pay for your equipment, but not for labor. If you pay your child to mow your lawn, you pay for your equipment, pay for labor, but presumably save because the child is not a professional. Finally, if you pay a professional to mow your lawn, you pay only for labor (and, one hopes, for quality).

How does this breakdown factor into GDP? Take the last option. Paying a professional to mow your lawn, divides labor more efficiently: you need not spend the time to mow it yourself, nor must you supervise in the case of a child mowing. Division of labor relates directly to productivity, which relates to employment, which relates to increased consumer spending (the primary driving force of GDP).

Indeed, Joseph Schumpeter once wrote of Adam Smith's thinking on the division of labor: "nobody, either before or after Adam Smith, ever thought of putting such a burden upon division of labor. With [Smith] it is practically the only factor in economic progress."[2] Therefore, taking Adam Smith as the guide to our example, hiring the professional to mow your lawn contributes with significance to economic growth. Rather than paying your self (via your opportunity cost), or paying your child, paying the professional encourages increased division of labor, enhances productivity and grows GDP. In brief, it means as a society we are wealthier.

SHORTCOMINGS OF GDP

GDP measures economic growth by adding Consumption + Investment + Government Spending + (Exports-Imports). In most developed countries, consumption is the largest component of GDP. But does all consumption result in productive growth, or simply an additional dollar spent? In other words, how can we be sure "whether the final goods and services that were produced during a particular period of time are a reflection of real wealth expansion, [not simply] a reflection of capital consumption."[7]

For example, US construction and home-building were booming during the early to mid-2000s, with capital pouring into the sector. GDP was reported in positive territory from 2002 to 2007 with residential investment's share of total output, reaching a high of 5.1% in Q1 2006. Though new homes were built at an unsustainable or even undesirable pace, according to GDP growth, all was well.

DID YOU KNOW: GDP VS. GNP

The United States did not formally adopt GDP until 1991, but instead used Gross National Product (GNP) as its measure for economic growth. Similar to GDP, GNP was also created during the 1930s, by a U.K. economist named Richard Stone.

GNP is quite similar to GDP, but differs slightly in composition. Both GDP and GNP measure the final goods and services produced by domestically-owned means of production. However, GDP defines its scope within the borders of a country, while GNP defines its scope according to ownership of production, regardless of location. Thus, GNP should better encapsulate multi-national operations and recognition of investment income earned abroad.

It took less than two years for the real estate market to collapse, with national home prices declining by 30%. To this day, a flood of homes built during the boom remain vacant. In retrospect, the excessive build-up of housing was predicated on spending capital, rather than sustainable and healthy growth. Perhaps all consumption is not created equal.

Even in normal times there are several ways that, when evaluated alone, GDP provides incomplete or misleading data. GDP reporting omits business cut-backs in intangible assets such as research and development, product design, and employee training. These cutbacks enable corporations to reduce costs and temporarily increase profits. Many economists argue the omission of intangible assets such as research and development grossly overstates the GDP measure and does not truly reflect the prospect for long-term sustainable growth.

GDP excludes underground economic activity such as illegal trade, gambling, drug trafficking, and other black-market activities. GDP also excludes economic activity where money is not involved, such as bartering.

Not only does GDP fail to capture important economic contributors to growth, GDP ignores the potential social costs of negative by-products of growth, such as pollution, toxic waste, and traffic. GDP does not include items that significantly impact social welfare such as crime reduction, peaceful international relations, and reduced drug and alcohol abuse. GDP does not include the benefit of leisure items such as paid vacation and holidays. And perhaps most important to some critics, GDP fails to measure the happiness of a nation. Hence we see that GDP, as RFK suggested, misses much when it comes to measuring national well-being.

ALTERNATIVES AND THE FUTURE OF GDP

It is remarkable that the GDP measure has withstood the test of time, enduring largely unchanged since its creation over 80 years ago. In fact, in 1999, the US Department of Commerce declared GDP to be one of the great inventions of the 20th century (this is not a joke).

However, as the world evolves, so should the methods we use to measure progress and growth. GDP was originally created to measure national output and aggregate economic growth, not social and economic welfare.

Indeed, we cannot, as RFK does, lose sight of one simple fact. No matter the problems with GDP, what it leaves out and what it misses in capturing general happiness, no

discussions of the adequacy of GDP nor concerns about the happiness of a nation would be possible without an already high standard of living.

Our obsession with the "happiness" of our children, our students, and our nation, while certainly important, depend on our historically high standard of living. Brad DeLong reminds us that, "those of us living in the United States today have a level of productivity--a material standard of living-- somewhere between 14 and 25 times that of our counterparts back in the late nineteenth century."[8]

We now understand that even if GDP misses much, the fact that our current discussions about human prosperity rarely have anything to do with basic survival is a testament to the progress we have already made. Only because we no longer have to worry about simply feeding ourselves and finding shelter, do we have the luxury of choice: only with the supreme luxury of choice do considerations of happiness obscure concerns for more primitive needs.

Given its ease of calculation and historical consistency, GDP remains relevant. Despite the plethora of suggested alternatives to GDP, none has yet proven an appropriate substitute. For now, GDP remains the bellwether economic measure of output and growth within a nation, playing a critical role in the formation of both fiscal and monetary policy.

SOURCES

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