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Opponents of austerity are barking up the wrong tree

Business MONITOR

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GDP measures quantity, not quality. Specifically, it fails to distinguish between the economic contributions of the private and public sectors

Whenever I see television news footage of young Greeks or Spaniards protesting against public spending cuts, or hear an eminent economist railing against austerity measures in Britain or the US, I confess I have to scratch my head.

I'm familiar enough with their reasoning. The young *indignados* feel bitterly short-changed, unfairly deprived of both jobs and a future by government cuts.

Meanwhile, the economists complain that cutting spending to reduce debt doesn't work. It ends up depressing output, so that debt rises, not falls, relative to gross domestic product.

I don't doubt the sincerity of their arguments. I'm just not sure they make sense.

Given that the government spending those young protesters are so keen on is funded largely by debt, you would think they would heartily endorse cuts. After all, they are the ones who are going to be saddled with paying off all that debt in the future.

As for the economists, they are arguing that to prevent debt rising as a proportion of GDP, governments should support GDP by taking on more debt. In short, they seem to be saying that countries should try to borrow their way out of debt.

Yet if GDP has been artificially inflated in the past by unsustainable debt-funded public-sector spending, then it seems inevitable the necessary adjustment will involve a fall in GDP, and a resulting rise in the debt-GDP ratio.

As I say, it's a head-scratcher. So I was intrigued to receive an e-mailed note on Friday from Charles Gave, founder of independent research house GaveKal, which sheds some light on the matter.

The problem, Gave argues, is the measurement system everyone is using: GDP.

"GDP is a measurement system devised so economists could avoid thinking," he declares. "It is becoming more and more obvious that GDP is not only a lazy and inadequate measure, but that it can be criminally misleading."

He has a point. GDP was developed in the US during the Depression, and came into its own during the second world war as a measure of how many guns, ships and planes the US economy was able to produce. It has been the standard indicator of economic strength ever since.

But GDP measures quantity, not quality. And as Gave points out, specifically it doesn't distinguish between the economic contributions of the private and public sectors.

That's crucial. As Gave explains, private-sector transactions occur in the free market between parties who subjectively judge the deals to be beneficial. That means they give meaningful signals about value which assist the efficient allocation of resources.

In the public sector, there is no free market. As a result, the government's contribution to the economy is assessed not in terms of value, but of cost. As the Soviet Union demonstrated, that tends to be inefficient.

In any economy, trouble strikes when the public sector starts to grow faster than the private sector, as it did across much of the Western world during the past decade.

The higher taxes or increased government debt issuance needed to fund the bloated public sector reduce the amount of capital available to finance relatively efficient private investment.

As a consequence of this crowding-out, private-sector growth stalls, and may begin to contract. The result is a weaker overall economy.

The correct response in these circumstances, argues Gave, is to reverse the process by cutting government spending.

Yes, GDP will shrink. But GDP is a flow-based measure that does not take into account the resulting balance-sheet improvement.

In reality, Gave explains, by reducing the crowding-out effect, cuts to government spending can make people richer even as they eat into headline GDP.

It's an idea unlikely to find favour with either politicians or economists, who remain obsessed with GDP as an economic indicator.

But Gave is not the first to point out the weaknesses of the measure.

Simon Kuznets, the US economist who originally developed the idea of GDP, warned at the time: "Distinctions must be kept in mind between quantity and quality of growth, between its costs and return, and between the short and the long run. Goals for more growth should specify more growth of what, and for what."

It's a warning those indignant protesters should take to heart.

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