Why GDP is complete nonsense

GDP is an economic planners' concept, and is the yardstick by which their success or failure is judged. As the definition used by Wikipedia puts it: "GDP refers to the market value of all final goods and services produced in a country in a given period". Only refers. This article questions the validity of GDP as a meaningful statistic, and finds it to be valueless and even worse, misleading, with profound implications for mainstream Keynesian economics.

If you really want to know how an economy is growing, you must take every item of manufactured product and every service sold, and estimate the change in their individual quantities and qualities over time. You should only include products and services freely exchanged for value, otherwise there is no sound transactional basis for their existence. You must somehow capture technological improvements in each product, and changes to benefits in each service. It amounts to an impossible task, given its complexity and the degree of subjectivity involved: this is why it is far simpler to use money values instead for central planning purposes. And therein lies the trap, which is readily exposed by considering the application of money GDP in a sound money environment.

If a nation has completely sound money, there is no expansion or contraction in its quantity, or of bank credit. Let us also assume that there are no net cross-border flows. This being the case, GDP in *Year 1* obviously will be exactly the same as in *Year n*, irrespective of the actual economic activities in those years. This makes it obvious that GDP is a measurement of total money deployed in an economy, and not of the goods and services themselves, which are free to vary within the confines of the money total. The only money variances that can occur are from changes in cash levels (hoarding and liquidity) and exclusion of activities from the statistics (black markets). It is the nature of sound money that these errors will be very small, reflecting public and business confidence in the medium of exchange. And with sound money, there is no statistical error to consider since there is no change in its quantity.

History has shown that in a sound-money economy, the prices of goods fall over time, reflecting increased production efficiencies and technological advancements. So, in real terms, this impossible-to-measure annual economic growth probably works out at a few per cent annually, and the purchasing power of money can be said to have risen to reflect that improvement. And it is the certainty of this return on savings from the gradual increase in their purchasing power that helps keep nominal interest rates low.

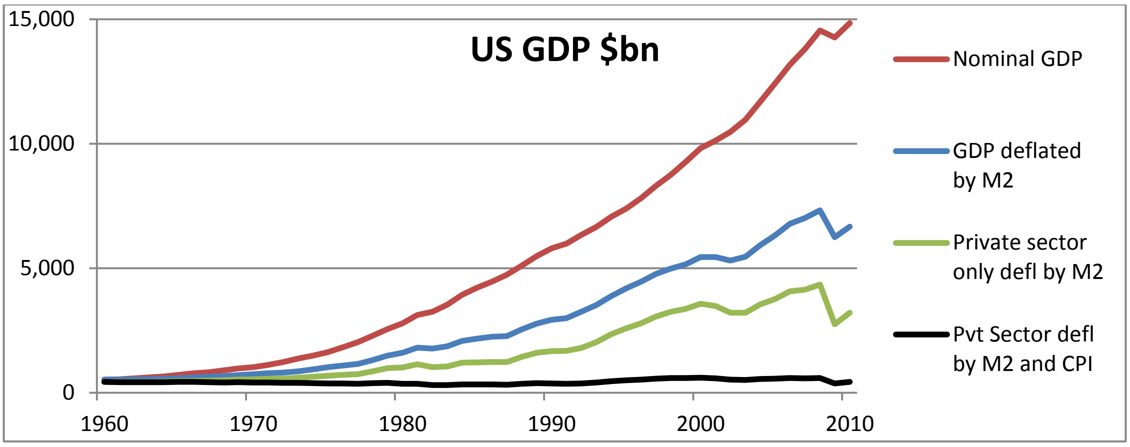
In practice, economic performance is always a combination of private and public sector activities. As any thinking economist with experience in the commercial world should know, the difference between the two is that the private sector, left to its own free choices, uses the available resources of consumption and savings to maximum efficiency because waste is abhorred; while the public sector, which deploys economic resources primarily for social and bureaucratic purposes is considerably less efficient in its use of them. There is no way of measuring the loss of economic resource from its redeployment to the public sector, and it will be greater or lesser across different government functions. In all instances of government-provided goods and services, there is no independent pricing mechanism to establish their true value. To the loss of economic resources from government transactions must be added the loss of the economic production that the private sector would otherwise have enjoyed if its economic resources had not been redeployed to finance government spending. These two losses together can be considerable.

We can begin to see the differences emerging between the changes that can occur in an economy despite a fixed monetary value for total market transactions. Furthermore the cost of government in a sound money environment becomes immediately obvious to the public, because the government cannot use the hidden tax of inflation as a source of revenue, or as an economic management tool. In a sound money environment, when a government borrows to finance its spending, it drives up interest rates against both itself and against the productive private sector, because it is unable to increase money in circulation to compensate. Because all government intervention is immediately noticed for what it costs, democracy in a sound money economy can be expected to elect small efficient governments. Consequently, the drag on an economy from government spending and intervention should be minimised in a sound money environment.

Now let us consider the conditions we have today, whereby governments manage the quantity of money at will, and banks are licensed by the authorities to vary credit supply. Our task is to identify the factors that enable nominal GDP, as reported by statisticians, to grow over time. The information that makes up GDP is based on *domestic* product, so trade imbalances are already compensated for, and capital transactions are not included.

The first factor is the addition into the economy of fiat money itself. This additional money and bank credit must be reversed out, because it is solely extra money and does not represent an increase in the market value of goods and services, which became clear when we considered the sound money example. Secondly, government spending is also an additional statistical distortion, because it is included as if it were a normal productive activity, but again we know from our sound-money example that it is actually a net economic cost; so here again, an increase in government spending artificially increases GDP above its true worth and should also be removed. And finally, the change in the general price level which accompanies monetary and credit expansion further boosts nominal GDP, rather than the other way round as is commonly supposed: this is a misleading impression caused by the use of a GDP deflator to compensate for price inflation.

Accordingly, the increase in GDP in a fiat currency over a period of time is the simple monetary result of these three distortions. If they are removed from official GDP figures, there should be no growth in an adjusted GDP statistic at all. The chart below, which is of US GDP from 1960 to 2010 showing the relevant adjustments, supports this conclusion.



The chart reflects the removal of the three distortions we have identified that make up nominal GDP (the red line) in individual steps to arrive at a sound money equivalent (the black line). Nominal GDP grew from $526.4bn in 1960 to $14,849bn in 2010. The fully compensated figure fell marginally from $439.7bn in 1960 to $436.3bn in 2010,

So our theoretical proposition, that all the growth in GDP is entirely due to the growth in government spending, domestic monetary and credit inflation, and the falling purchasing power of the currency, is confirmed by the adjusted statistics. However, the compensated figures do have some volatility, though this is small compared to the adjustments made. The variables not taken into account, that might have some effect, are changes in levels of money-hoarding, changes in the level of black-market activity, and changes in the composition and methodology of calculating the consumer price index. Over the period there have been improvements in data collection and there is the changing relationship between M2 and other monetary factors, such as money in the shadow banking system, which are bound to affect any estimates. But taking these variations into account the relative constancy of the fully adjusted number over the last forty years is impressive. Our conclusion therefore stands as valid on this evidence.

So it turns out that GDP, this emperor among central planners' statistics, has no clothes. It is just a meaningless money quantity. It started as an invention of a US economist and Nobel laureate, Simon Kuznets, who was working for the National Bureau of Economic Research in the 1930s, and GDP was first applied in 1942 to complement estimates of national income and to facilitate war-time planning. Any caveats he might have put on its application have been ignored. The result was as if Congress had asked him to come up with a new statistic that would justify the future growth of government, making sure the losses to the economy were concealed[i]. And the fundamental basis of this statistic does not seem to have been seriously questioned since: after all, the ground-breaking work of a Nobel laureate, and all the statistical methodology of the best brains government can employ is regarded as authoritative.

Therefore the majority of published material on economics over the last seventy years is itself based on complete bunkum. Modern statistics are selected to support bad economic theories that seek to justify government intervention rather than the truth; and the further theories derived from the fundamental building-blocks of modern economics are themselves built on sand. According to the GDP statistic government spending does boost the economy, which is why Keynesians are convinced that government intervention is beneficial. But economists of the Austrian school know that government spending is detrimental to the economy. It is reliance on false statistics, such as GDP, that go a long way to explaining how the two camps can radically differ in their opinions. So familiar are we to the concept that GDP actually reflects economic activity that it is hard to accept that it is no more than a meaningless money number, but that is precisely what it is.

We shall now briefly look at the implications of this conclusion.

There are the obvious ones. For example, the more monetary inflation there is, the better GDP statistics will appear: this is an incitement for central banks to continue to expand money supply and encourage the growth of bank credit. No wonder we have ended up with a progression of higher and higher debt, the counterpart of bank credit, to the point where the debt bubble has finally become unstable. Secondly, the more government taxes and spends in an economy, the more it artificially inflates the GDP numbers: this gives socialism its veneer of success. No wonder government is encouraged to grow itself at the expense of the private sector, when this growth has statistical benefits, even though it is economically destructive. And finally, the more a government can manipulate CPI calculations to keep them artificially low, the more GDP appears to grow, reflecting actual changes in price levels: this is precisely what the US government has been doing in recent years, as recalculated inflation statistics from Shadowstats.com clearly demonstrate.

Governments use all these tricks, and have been successfully fooling themselves in the process since the GDP concept was invented and developed at their behest. So long as GDP is growing, we have tolerated the increasing burden of government and its management of our affairs. And the public now firmly believes from GDP statistics that increases in government spending, management and control over the economy are the road to salvation from the uncertainties of economic life.

Less obviously, at least to governments, we are now at the end of this social fallacy, with all the signs that the central planners have led us into a dead-end. Government debts in nearly all developed nations have now spiralled out of control, with even greater welfare costs in the pipeline. Governments are now no longer just fooling themselves with false statistics; they are fighting for their own economic survival, ensnared in a debt trap.

The fight will be lost, because governments are victims of their own statistical propaganda, wrongly believing that anything can be fixed with enough intervention, and not understanding why their flawed schemes are falling apart. Instead they blame the private sector for the economic ills that are actually the consequence of their own interventions. Their gut reaction is to inflate the components of GDP identified in this article even further: banks must lend more, governments must spend more, and the recent growth in the CPI must be ignored because a little inflation is good for GDP growth.

While these quack remedies are pursued in the vain hope that modern economies will recover given enough time, they are killing the prospects for any lasting recovery. The right balance of consumption and savings is needed, which can only be decided in the free market, and not by economic planners. Instead of permitting this to happen, accelerating levels of money and credit creation will take place, destroying savings entirely. And monetary inflation is no longer just puffing up GDP; it is being used to buy time to defer government bankruptcy and the unwinding of the associated malinvestments in the private sector.

For further proof that the GDP statistic is as far removed from actual measures of economic performance as stellar objects are from each other, consider this: if GDP had been calculated in the early 1920s, Germany would have been shown to be enjoying an unprecedented post-war boom, when the reality was hyper-inflation. And if you still cannot accept the proposition that GDP has no statistical value, come up with a convincing argument how the total money-value of all goods and services can actually change in a sound money environment.

Alasdair Macleod

3 September 2011

---

[i] See The Bureau of Economic Analysis 2000 survey of current business, "GDP: One of the Great Inventions of the 20th Century". The BEA is very proud of their role in the creation of GDP and its role in the US's national accounts.