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CONVENTIONAL WISDOM OR (UN)INTENTIONAL IGNORANCE?

Concerns over China reveal the dangers in staying in the comfort of familiarity and acceptance

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JOHN Kenneth Galbraith, whom we can call the Shakespeare of economics, coined the phrase "conventional wisdom". In essence, he uses this term to describe the concepts that are more or less universally familiar and deemed acceptable; the views that one finds the most agreeable.

It is a close relative of what we tend to call the "consensus" in financial markets.

Mr Galbraith went on to say that "the conventional view serves to protect us from the painful job of thinking". Indeed, much of the current conventional wisdom regarding China does seem to involve a certain lack of that latter mental effort.

Growth rate

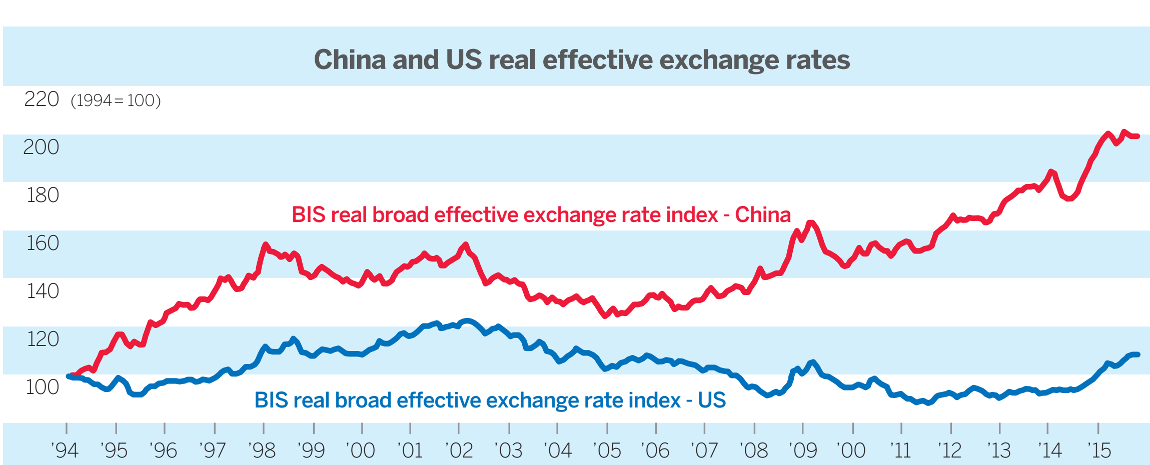
Firstly, the GDP (gross domestic product) growth rate. There is much anxiety about China's slowing growth rate. It is undeniably slowing, from close to 15 per cent in the early 1990s to around 7 per cent currently.

What is completely overlooked in most commentary on the topic is that in the interim, the Chinese economy has more than doubled in size. Hence, even with this lower GDP growth rate, China manages to increase its contribution to world GDP, to around 1.2 percentage points currently, up from close to one percentage point some 35 years ago when the growth rate peaked (in 1992).

It is surely by a strange logic that analysts focus on the falling growth rate instead of on the greater contribution to world GDP. The warped logic might partly be due to a failure to differentiate between absolute levels and relative concepts.

Let us look at this from the point of view of the country. To calculate the growth rate we divide the output produced in a given year by the total output level reached in the previous year. Assume, in a stylised example, that we divide one by two. The result is 0.5, or a 50 per cent growth rate. Then let us assume that some years later the division involves the same numerator, one, but the denominator is now four. The result drops to 0.25 or a 25 per cent growth rate.

Which would you rather be, if you're an economy? The 1/2 or the 1/4? Surely, the answer is the 1/4, in spite of the lower growth rate. This is the most desirable because in absolute terms the economy "4" is twice as large as the economy "2" although in relative terms the same output of "1" represents a smaller share of 4 than of 2.



China's renminbi

Secondly, the currency. The change to the exchange rate regime that China enacted during the summer happened to coincide with rather weak export numbers. The instant analysis was that China was engaging in a competitive devaluation, aimed at recuperating export competitiveness.

However, when one looks just a little bit closer one discovers that the Chinese yuan has appreciated almost continuously against its major trading partners over the whole 1994-2015 period, and that appreciation did not have much of a negative effect on Chinese exports.

In fact, the yuan has appreciated by 100 per cent since 1994, while the US dollar has appreciated by a mere 9.1 per cent over the same period (real effective exchange rates, see Chart). Hence, if either country should be accused of conducting a weak-currency policy in order to gain competitive advantage, it would be the US, not China.

Moreover, the degree of impact of a few per cent of the exchange rate on the real economy pales in comparison with the evolution of the oil price. The oil price hit a high in June 2014 at US$114 per barrel. As at Nov 2, 2015, the price stands at US$49 per barrel, a 57 per cent drop from the 2014 high.

China is the world's largest net importer of crude oil and petroleum products, accounting for 43 per cent of the world's oil consumption growth in 2014, according to the EIA (US Energy Information Administration), and importing 6.1 million barrels per day. Compared to the boost that the lower oil price provides, the marginal gain from currency depreciation seems microscopic in comparison.

Instead, the true motive for the change in the exchange rate regime is the long-stated objective to make the yuan fully convertible. Earlier five-year plans cited 2015 as the year in which this should happen. Full convertibility is not possible this year as there are still restrictions on the capital account.

However, inclusion in the International Monetary Fund's (IMF) basket of reserve currencies (called the SDR, Special Drawing Rights), is possible. The IMF is likely to take this decision at the end of November. Disconnecting the yuan from the US dollar and minimising the spread between the onshore and offshore yuan are necessary moves for the IMF to be able to include the yuan in the basket. This, and only this, was the motive behind the new exchange rate regime.

Rebalancing debate

Thirdly, the rebalancing debate. Most commentators argue for the necessity for China to invest less, export less, and consume more. One can hardly disagree with the statement that China should consume more. As many as 152 million Chinese still live on less than US$1.90 per day (World Bank data) and the aim must clearly be to raise their level of consumption in particular.

However, what is little known is that consumption already contributes as much to China's GDP as investment. Concerning investment, it could certainly be more efficient. However, with the real capital stock per capita estimated at some 10 per cent of that of the US, one can hardly hold on to the idea that the country should invest less.

On the contrary, a phenomenal effort is still required before China can catch up with the West. Arguably, the most amazing fact in the rebalancing debate is that net exports contribute as little as 0.5 percentage points to China's GDP, in round figures, while investment and consumption contribute roughly 3-3.5 percentage points each.

How can China's large export sector make such a small contribution to GDP? After all, China generates some 12 per cent of world exports. The answer lies in the fact that much of China's export industry is of the low-value added assembly sort. China's exports need to climb the value-added ladder in order for the external sector to make a contribution to GDP commensurate with the heft of the export sector in the economy.

Economic data

Fourthly, the quality of Chinese economic data. It is a very popular conventional wisdom that no matter what numbers the Chinese publish, they are sure to be wrong and/or manipulated. On the one hand, one can agree, because all economic statistics are the result of surveys, assumptions, estimations, and choice of statistical methods. Unfortunately, it is simply not possible to observe economic phenomena directly, such as inflation or GDP. Instead, they have to be estimated. Every country faces the same challenges in this respect, although China does so more than most as a result of its formidable size.

It is possible, for instance, to know the automobile industry because a limited number of companies can be visited and measured directly. This is not so in the service sector, certainly in a country such as China where 20 million more persons were employed in the latest census including regions where nobody had been able to count the inhabitants before.

For sure, one could think that the result is that China's data is less reliable than other countries'.

However, this is not borne out by evidence in academic studies. Analysis of major countries' GDP data finds Chinese data as reliable (or as false) as US data.

Furthermore, the OECD (Organisation for Economic Co-operation and Development) finds that GDP statistics tend to be revised upwards, mostly as a result of the difficult-to-measure service sector whose data comes in last. We come to the conclusion that GDP data everywhere is probably under-estimated in absolute numbers. In terms of the growth rate, however, there need not be any major questions about reliability as an adjustment to the absolute level would likely leave the rate of change intact.

This article is not about telling you how ignorant you are. It is about showing the dangers involved in staying in the comfort of familiarity and acceptance. It allows our brains to go on holiday, and that can never be a good idea, unless we're truly on holiday.

Anecdotally, a post went viral on Facebook last summer. It suggested that since Obamacare cost US$360 million and the US has 317 million citizens, one could just give everybody one million. We can easily imagine the buzz that made thanks to the instant appeal of the idea of potentially receiving one million dollars. If one does not stop to think, one might even believe that to be possible. It takes at least a fraction of a second of painful thought to realise that each person can only receive US$1.14. Such are the perils of conventional wisdom.