Pathfinder Economic Alert

Dramatic Changes in the Global Economic Landscape
Next Generation of Reforms in Sri Lanka

The World Bank has just published the Report from its International Comparison Program (ICP). It confirms a number of aspects of the conventional wisdom regarding the trends that have emerged in recent years while challenging others.

'Dragonising' the World

The most eye-catching change is the likelihood that China would become the largest economy in the world, in Purchasing Power Parity (PPP) terms, by end 2014. The US has held this position since 1872. The ICP Report, based on 2011 data, estimated that China's economy was less than 14% smaller than the US in that year. In PPP terms the Chinese economy stood at \$13.5 trillion in 2011, whereas the US economy was estimated at \$15.5 trillion. Given that the Chinese economy has been growing more than 5 percentage points faster than the US, it should overtake the US this year. This is significantly earlier than what has been expected by analysts and forecasters. It will be the first time in history that the largest economy in the world ranks as low as China does in per capita terms: 99th out of the 179 countries covered by the ICP. One should also recognize that PPP is a measure that seeks to determine the comparative size of economies after adjusting for price differences and the local buying power of a currency. Instead, if one uses market determined exchange rate to compare the size of the two economies, the US GDP in nominal terms was \$16.2 trillion in 2012, while China was \$8.2 trillion. By this measure China will not overtake the US until well into the next decade, barring a collapse in the value of the US dollar against the Yuan.

In terms of methodology, the ICP report presents PPP – based estimates of real expenditures and relative price levels for the GDP as well as six aggregates related to consumption, investment and domestic absorption. These estimates are used to present analyses of the size of economies, measures of material well-being and price indices for the countries for which data was available.

China's rise is one example of a general trend which has seen rapid development of middle and low-income countries and their convergence with the advanced countries. Evidence of the convergence of social indicators, such as life expectancy and infant mortality, has been established for some time. The ICP makes clear that this is now happening with material living standards as well. The G7 countries, which accounted for half of global GDP in 2000, constituted less 1/3 by 2011. The whole of the OECD including new members such as South Korea, Mexico and a number of Eastern European countries, account for less than 1/2 of the global economy.

Emerging Economies

In regional terms, the pendulum has swung back to Asia, which dominated the global economy prior to the industrial revolution in Britain. The ICP data suggests that Asia alone is about ½ the global economy, broadly in line with its share of the world's population.

However, improvements have been recorded across all regions of the developing world. Only 8 of the 179 countries covered by the ICP report now have per capita real GDP of less than $1,000 a year (all are in Africa). Only 9 countries have had their real per capita GDP reduced by more than 10% from previous estimates. 84 countries have seen upward revisions of more than 10% (63 more than 20% and 25 more than 50%). The most startling findings are that Ghana and Indonesia are more than 80% richer than previously estimated. This means that the Indonesian economy could be as large as that of UK. Of course, one must remember that in per capita terms the picture continues to be significantly different.

Inequality Rising but Disparities Declining

While the ICP confirms the conventional wisdom regarding the progress that is being made in the developing world involving greater convergence with the advanced world, the narrative that has become increasingly strident regarding rising inequality needs to be viewed in a more nuanced fashion. While inequality is rising within many countries, the disparities across countries is declining because the poorest large countries are converging more rapidly with the rich countries than had been thought. The biggest adjustments found in the ICP Report are related to individual developing countries which are now perceived to be richer than previously considered. This can be attributed to significant downward revisions in the prices of goods and services in many developing countries. As a consequence, these economies have become larger when adjusted for purchasing power.

As one would expect from these trends, the middle class has been growing in the vast majority of countries. The ICP calculates the Actual Individual Consumption (AIC). This concept is derived by adding government expenditures consumed by individual households (e.g. health and education) to the expenditure incurred by those households. This provides a fuller measure of material well-being. The ICP Report defines as 'middle-class' households whose per capita consumption is between $10 - $100 per day in 2005 PPP terms. While recognizing that more work needs to be done to determine the size of the middle-class, the Report suggests that countries with average AIC levels of over $5,000 per year (2011 PPP terms) would have sizable middle-class populations. 2/3 of the 179 countries covered in the ICP Report belonged to this group.

There is, therefore, a strongly upbeat message contained in the ICP Report. The world is a richer place than we thought. In 2014, total global expenditure is expected to exceed $100 trillion in PPP terms for the first time ever. Life seems to be improving for hundreds of millions of people living in emerging and developing economies. However, the report also throws up some sobering facts which leave no room for complacency. There are still 900 million people living in extreme poverty (less than $1.25 per day). In more than half of African countries, government spending on individual consumption items is less than $200/ per person/per year – the level considered the minimum to provide basic public services, such as education, health, safe water and sanitation. In OECD countries, the equivalent figure is about $5,000/per person/per year. In addition to its upside messages, the new data also reveals the challenge of millions of people continuing to face extreme poverty and massive inequalities.

Emerging Sri Lanka

On Sri Lanka specifically, the ICP sets out a positive picture. Per capita expenditure (in PPP terms) has increased from $ 3,481 in 2005 to $ 8,111 in 2011. Actual Individual Consumption rose from $ 2,735 to $ 6,393 in the same period. While this is commendable and encouraging, there is no scope for complacency for two reasons: international benchmarking; and the sustainability of the improvement recorded in recent years.

While Sri Lanka's per capita expenditure (in PPP terms) was $8,111 in 2011, Malaysia recorded $20,926 and Thailand $13,299. Sri Lanka's AIC was $6,393, while Malaysia's was $11,082 and Thailand $8,477. Given than Sri Lanka was second to Japan at the time of independence and ahead of South Korea and Singapore as late as the 1960s on most socioeconomic indicators, these are disappointing outcomes. In fact Singapore's per capita expenditure (in PPP terms) is $72,296 and the AIC is $24,725.

The Pathfinder Foundation (PF) has constantly highlighted that the current growth model, which is over-dependent on foreign commercial borrowing, is unsustainable. There needs to be a shift to FDI and exports to achieve the 8% sustained growth targeted by the authorities. The successful countries of East and South East Asia based their growth model on the following: undervalued currencies; FDI-led export growth; accumulation of EARNED/NOT BORROWED foreign reserves; and the development of local currency debt markets. This was supported by embracing economic orthodoxy in terms of tackling the twin fiscal and current account deficits.

In Sri Lanka, we have seen the authorities responding to the crisis that was looming in early 2012 by embarking upon fiscal consolidation; more prudent monetary policy; a more realistic exchange rate and a courageous adjustment of electricity and fuel prices. The authorities have made progress in stabilizing the economy. However, the structural reforms required to achieve sustained 8% growth have not been embarked upon. This is confirmed by the fact that the IMF recently estimated the potential growth rate of the economy at 6.8%.

The imperative for such reforms has been deflected by the favorable effects of the very accommodating monetary policy in major economies, including QE, which has seen money flooding into emerging markets in search of higher yields. Sri Lanka has successfully issued five sovereign bonds and attracted $3.6 billion into Rupee denominated Treasury instruments. In addition, banks and corporates are being encouraged to borrow abroad. These flows have helped to finance growth in the economy by assisting in the funding of government projects and supporting consumer credit.

However, the evolution in external debt dynamics is gradually undermining the sustainability of this model. Both Sri Lanka's debt to GDP (78.3%) and external debt to GDP (35.9%) ratios are about double those of its rating peers in the BB category. The external vulnerability index also remains in amber light territory. In addition, total debt service payments absorb all government revenue. Urgent priority needs to be attached to a shift from an over-reliance on foreign commercial borrowings and domestic demand to FDI and exports.

The government resorted to commercial and other borrowings to accomplish its development objectives soon after the ending of terrorism in Sri Lanka particularly as graduation to lower-middle-income country status resulted in a loss of eligibility to foreign aid and in the immediate aftermath of the defeat of the LTTE the country was faced with a barrage of anti-Sri Lanka propaganda which negatively impacted FDI promotion. In order to maintain or increase the current level of investment in infrastructure in the future it is necessary to introduce policy reforms.

Growth through Reforms, not stagnation through Dogma

The CBSL Annual Report 2013 sets out the challenges very well in its Overview Section, including the Box on diversification. The PF Economic Alert number 27 sets out some specific recommendations.

While Central Banks may recognize the need for reform, progress is often hamstrung by politics. The next generation of reforms requires both politicians and voters to recognize the need to relinquish some vested interests and obsolete ideologies. This is only feasible after the anticipated elections early next year. However, the time has now come to formulate the package of structural reforms to be implemented at the beginning of the next political cycle.

This is the Fifty-Eight Economic Alert published by the Pathfinder Foundation. Readers' comments are welcome at www.pathfinderfoundation.org