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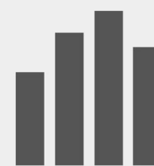

Verité Research provides strategic analysis and advice to governments and the private sector in Asia.

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93.5
PERCENT
GDP growth in nominal USD (2004-2009)

27.4
PERCENT
GDP growth in real LKR (2004-2009)

2027
YEAR
When real LKR will approach x4 increase from 2004

Image courtesy: Hugh Ferriss

Explaining the Mirage of GDP Growth Optimism

The government estimates that by 2015 per capita GDP will quadruple from what it was in 2004. But this is a mirage: real incomes will not even double in that period. The mirage is created by counting in US dollars and effectively presenting nominal growth in GDP (increased prices) as real GDP growth (increased incomes).

The underlying story at the Ceylon Chamber of Commerce's economic summit in early August 2014 was Sri Lanka experiencing tremendous GDP growth. The running refrain was that Sri Lanka which had doubled its GDP from USD 1,000 per capita to 2,000 between 2004-9, would once again double per capita GDP from USD 2,000 to 4,000 by 2015; and from thereon, go on to increase it to USD 7,000 per capita by 2020.

These statistics are impressive and underwrites this story of a tremendous rate of GDP growth. Yet, this story of GDP growth is also misleading. It is a mirage. An explanation of how the counting works, with a simple introduction to two important economic terms, can serve to expose the mirage and enable understanding of the real state of GDP growth.

THE DIFFERENCE BETWEEN NOMINAL AND REAL

When economists report growth, they make a distinction between nominal and real growth. Nominal GDP growth means the total counted increase in the value of goods and services produced in Sri Lanka at current prices. But this means an economy can register GDP growth for two reasons: (1) because of an actual increase in the goods and services produced (2) because of a rise in the prices of goods and services. Clearly it is important to distinguish between these two reasons. That is where the **nominal** and **real** distinction comes

into play. Nominal growth measures the *combination* of increased production and increased price, whereas real growth measures *only* the *increase in production.*

The distinction is important because only *real* growth measures the actual improvement in economic welfare. Nominal growth without real growth is no growth at all – it just means that prices went up. GDP growth rates reported for countries are always reported in real terms.

But by using a sleight of hand switch to US dollar terms, the media and policy discourse in Sri Lanka is routinely reporting a nominal growth measure as if it were a real measure of growth.

Government economists calculate a number called the GDP deflator, which estimates the increase in prices of all goods and services produced in the economy. The extent of the difference between the nominal and the real GDP growth is given by the size of the deflator. The larger the deflator the larger the difference between nominal and real growth. The GDP deflator is like a measure of consumer price inflation, except that inflation averages the price increase of a typical consumption basket, whereas the deflator averages the price increase of everything that is produced in the economy.

THE MIRAGE OF GROWTH CONCEALS IMPORTANT FACTS

The mirage that is set up by the misleading GDP growth story conceals three important facts, and they can be explained quite simply.

1) It conceals that the real GDP growth in Sri Lankan rupees per capita is in fact much lower than the growth advertised in US dollars. The real rupee growth rate is as little as one-third to one-half of the nominal dollar rate. For those consuming in Sri Lanka it is the real growth in rupee terms that is relevant – pricing and purchasing in Sri Lanka is not done in US dollars.

2) It conceals the fact that the nominal US dollar has been reducing in buying power. That is, like any other currency, the US dollar also depreciates in real value due to inflation. Therefore, a USD in 2004 does not have the same buying power as a US dollar in 2014, and comparing growth in nominal US dollar terms results in overstating growth, even in US dollar terms.

***Nominal* growth measures the combination of increased production and increased price, whereas *real* growth measures only the increase in production...Nominal growth without real growth is no growth at all – it just means that prices went up.**

3) It conceals that these US dollar based growth claims are highly fragile. They can change in an instant with a change in the exchange rate between the rupee and the US dollar; and Sri Lanka policy makers have a long history of making regular surprise downward adjustments to its currency. See Exhibit 1.

ILLUSION: 2004 TO 2009 GDP GROWTH DOUBLED; REALITY: IT INCREASED BY ABOUT 25%

In 2010 it was widely touted that in the 5 years between 2004 and 2009 Sri Lanka's per capita GDP doubled. In US dollar terms it almost did, increasing by 93.5% to USD 2,057 (see Exhibit 2). But in real rupee terms GDP growth did not even remotely approach a doubling. The precise increase was 27.4% (less than one third of the USD denominated presentation). Therefore the story of doubling from 2004 to 2009 is in effect an illusion.

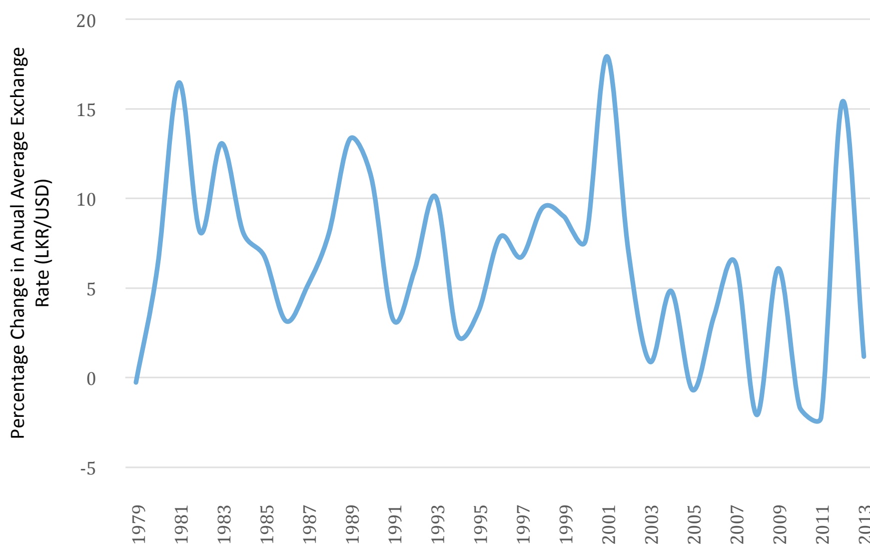
THE GROWTH STORY TOLD FOR 2015 WILL BECOME A REALITY ONLY AFTER 2027

In 2004, the GDP per capita was LKR 107,581. The average exchange rate that year was 101.19 LKR to a USD. Thus in dollar terms the per capita GDP was 1,063.

The story of shooting beyond USD 4,000 by 2015 is a story of doubling twice over -- almost quadrupling per capita GDP over the period (to be precise it means growing by a factor of 3.87 from 2004). But even on the very optimistic economic expectations real GDP per capita in LKR will increase by that quantum – a multiple of 3.87 in 2004 – only after 2027 (see Exhibit 2).

WHEN IS IT APPROPRIATE TO DENOMINATE GDP IN USD?

There are times when it is appropriate to report a country's GDP in US dollar terms. For instance for the purpose of cross country comparisons of economic activity (say to gauge trading potential). In such cases, it is important to convert the economic activity of all the countries to a single currency. The US dollar is the most commonly used currency for international comparisons. But this makes sense only for static cross country comparisons at a single point in time.



Even in such cross country comparisons, however, when the purpose is to compare potential living standards what is used not the nominal US dollar, but a measure called the purchasing price parity adjusted US dollar (PPP adjusted USD). This effectively adjusts for the differences in the inflation movements of the local currency and the US dollar and prevents the creation of an illusion.

FROM ILLUSION TO REALITY

No international organisation calculates the growth of a single economy overtime in terms of anything else other than the real increase in GDP in the local currency -- because it would be misleading as has been explained. Therefore, the tendency of the Sri Lankan policy discourse to use the nominal US dollar in evaluating the country's GDP growth over time is quite odd – and suggests a poor commitment to a sensible presentation of information.

Quadrupling per capita GDP from what it was in 2004 is desirable. But the claim that this will be achieved by 2015 is a mirage.

A mirage is an illusion that makes a traveller believe that a desired goal is much closer than it is. The story told of quadrupling per capita GDP by next year, from what it was in 2004 reflects a desirable goal. But the claim that this will be achieved by 2015 is a mirage.

This mirage is created by switching currencies and, through that, switching nominal and real measurements to a point of deception.■

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		Reality	*Illusion*
	Period	**Real LKR per capita GDP growth [in real 2004 LKR]**	**Nominal per capita USD growth**
2004 – 2009	5 years	27.4%	93.5%
	2004	LKR 107,581	USD 1,063
	2009	LKR 137,015	USD 2,057
2009 – 2015 (including projected)	6 years	49.6%	100.0%
	2009	LKR 137,015	USD 2,057
	2015	LKR 205,033	USD 4,114
To achieve real growth to 387% [~ quadrupling] of 2004	Per capita mark	LKR 403,428	LKR 4,114
	Year achieved	Beyond 2027	2015

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