SRI LANKA IN THE WORLD ECONOMY

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INTRODUCTION

A few months ago several international economic organisations, including the Organisation for Economic Cooperation and Development (OECD), the International Monetary Fund (IMF) and the World Bank (IBRD), as well as several governments of the richest countries were confidently forecasting that the current recession in many developed and developing countries had run its course and that the world economy could look forward to a renewed period of prosperity. It is now abundantly clear that the recession is not only far from over but that it is becoming increasing global in scope, engulfing more and more countries and regions of the world. The earlier optimism has now given way to a certain amount of realism. Forecasts of growth rates of most countries have been revised markedly downwards. The consensus forecast of output growth in the United States economy in the current year, for example, has been revised downwards by some 50% in the space of just three months.

Global economic developments, especially the recent developments, are or should be of concern for Sri Lanka in view of the increasing outward orientation of the economy. In practice, however, they are ignored. Recent economic forecasts of the performance of the Sri Lankan economy over the short and medium term pay little heed to the developing global economic crisis. Policies measures are drawn up and pursued seemingly oblivious of the gravity of the external environment and the shock waves headed in Sri Lanka's direction.

TRENDS IN THE WORLD ECONOMY

World Output

The world economy began to slow down in 1989 after several years of rapid expansion. The growth rate in world output fell from 4.1% in 1988 to 3.0% in 1989, and world trade from 9.1% in 1988 to 7.3% in 1989 (see table 1). The roots of the slowdown are traceable to a moderation in the growth of certain industrialised countries (ICs) and the collapse in output in Eastern Europe and the former Soviet Union. The outbreak of hostilities in the Gulf region in August of 1989 and the resulting disruption of world trade and financial flows most certainly contributed to the deterioration in performance of the world economy, but was not the source of the latter. The decline had actually set in much earlier.

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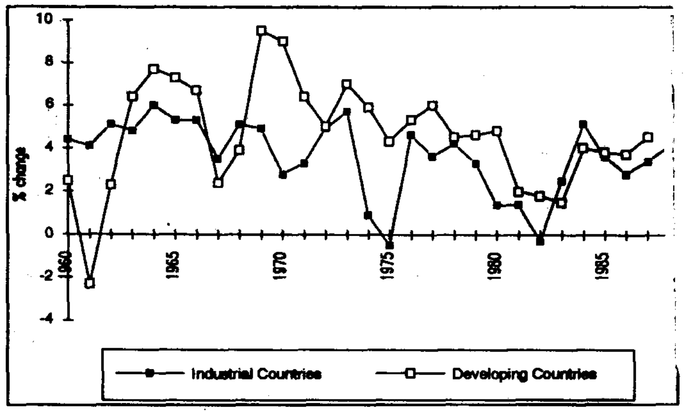

Figure 1

Real GDP Growth Rates of Industrialised and Developing Countries, 1960-88

By the latter part of 1990 recession had griped many ICs, most notably the U.S., U.K., and Canada. The growth rate for the so-called group of five ICs declined from 3.3% in 1989 to 2.7% in 1990, while that of the U.S. fell from 2.5% in 1989 to 1.0% in 1990. ICs as a whole only grew by 2.5% in 1990. As a consequence growth in world output fell to an annual rate of 2.5%. This rate was sustained by a 5.6% and 4.5% growth in the Japanese and German economies, respectively.

Table 1

World Trade and Output - Recent Trends (percentage change)

Output	1988	1989	1990
World	4.1%	3.0%	2.2%
Industrialised Countries	4.4%	3.4%	2.5%
Developing Countries	4.2%	3.0%	2.2%
World Trade	8.5%	7.0%	5.0%

Sources: ***World Economic Outlook***, October 1990 and 1991, International Monetary Fund

Judging by current indications, the end-of-year figures are likely to show a further weakening of the economy in 1991. The first nine months of the year has seen growth rates in all the major industrialised economies, including Japan and Germany, slumping. The US is now expected to contract by 0.4% in the current year, the UK by 2.1% and Canada by 1.0%. Japan is expected to grow at around 4% and Germany, because of the massive and rising cost of reunification, at 3.3%. Growth in output of

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developing countries (DCs) as a whole is likely to be under 1%, with many DCs experiencing significant negative rates. Disruption and economic dislocation in the former Eastern Bloc countries is on the increase. A recent survey article in the *Economist* (September, 1991) suggested that output in the countries comprising what was formerly the Soviet Union would fall in the current year by as high a rate as 17%. Bright spots undoubtedly also exist. For instance, both Latin America and Asia are expected to grow by around 5%, along with the group of so-called Newly Industrialising Countries (NICs) set to grow at 6.8% - only slightly less than the rate they achieved in 1990. However, these regions do not have adequate economic weight to lead a world recovery. Tentative projections are that world output growth will be in the order of 1% for 1991. The latest estimate by the International Monetary Fund (IMF) puts the figure at 0.9%.[1]

Several international organisations including the IMF, the World Bank and the OECD recently expressed optimism concerning the outlook for the world economy based on an expected turnaround in the U.S., U.K., and Canadian economies in the near future and a surge in output growth in DCs. The consensus view of these bodies is that the world economy is likely to grow by 2.5 - 3% next year.[2] According to the forthcoming IMFs *World Economic Outlook* the US should grow by 3% in 1992, the UK by 2.3%, Canada by 3.7%, France by 2.4% Italy by 2.5%, and the DCs as a whole by a remarkable 5%. Added to this, the recession in the Eastern bloc countries is expected to bottom out by the end of 1991 and a modest 2% growth to be registered in 1992. Other commentators are, however, more hesitant about world economic prospects. Their feeling is that the revival of the US and UK economies is faltering, while the Japanese and German economies are weakening rapidly. At the same time there is a strong belief that the turnaround in the former Soviet Union and Eastern bloc countries is unlikely to be so swift in view of the enormity and structural nature of their economic problems. This more pessimistic view suggests that growth of the world economy is likely to be under 2% in 1992, with the possibility of another downturn in 1993. Some economists are now going so far as to predict a growth rate of the world economy in 1992 in the order of 1%, and quite possibly even less.

Global Inflationary Pressures

Global inflationary pressures which were building up earlier, reached their height during the Gulf conflict when oil prices soared to around US $ 40 per barrel in September of 1989 The world inflation rate which stood at 12.9% in 1988 rose steeply in 1989, to 16.7%, and then again in 1990, when it reached 21.4%. As with world output, the major determinant of the world inflation rate is the inflation rate in the ICs (see table 2). The rate of inflation in the ICs rose from 3.3% in 1988, to 4.5% in 1989, and to 5.0% in 1990. The rise in inflation in ICs over this period is fundamentally the product of cyclical factors; the overheating of IC economies. Once again, the Gulf conflict and developments in Eastern Europe only exacerbated these tendencies, although possibly more so than in the case of output. With an ending of the Gulf war in March (and a collapse in oil prices to an average of US$ 20/barrel) and the deepening of recession in the world economy during the year, it would appear that world inflationary pressures have begun to abate. Point-to-point rates of increase for the first six months of 1991 show inflation rates in all the major ICs falling sharply. Current forecasts based on these trends suggest that the year-end average rate of inflation in 1991 for the ICs will be just over 4%,[3] and for the world economy around 16%. Much, however, will depend on the depth of the recession and the price movements of a number of strategic commodities such as oil. Current supply and demand conditions in the oil market suggest that oil prices will remain relatively stable for the remainder of the year. Of particular importance in this respect is the recent agreement by OPEC to lift its production ceiling for all 13 members to 23.6 million barrels a day, up from 22.289 million barrels a day, in the October-December period.

Table 2

International Rates of Inflation

Country Grouping	1988	1989	1990
World	12.9%	16.7%	21.4%
Industrialised countries	3.3%	4.5%	5.0%
Developing countries	56.6%	76.4%	104.8%

Source: ***International Financial Statistics, July 1991, International Monetary Fund***

Policy Responses to the Present Global Crisis

The duration and severity of the current global crisis will depend to a large extent on the economic policy responses of governments, particularly the governments of the richer nations. It is now clear that on this score there are major disagreements, most notably between the United States and Germany, each country pulling in the opposite direction. On the one side, the German Central Bank is clearly determined to push interest rates high enough to squeeze credit and force German unions to moderate their wage demands. This should help ease domestic inflation, which is running at a period high of 5% per annum, but at the cost of aggravating recessionary tendencies in the German economy as well as the economies of other European countries which are tied to it in a (formal and informal) monetary union. On the other side, the U.S. Federal Reserve recently pushed down interest rates to their lowest level since 1963[4] in what appears to be an attempt "to revive the ailing U.S. economy at almost any cost, undermining the dollar and thus making it even harder for European industry to compete with U.S. producers." (*International Herald Tribune*, 21/22 December, p1) The tendency of the U.S. political establishment to want to resolve what is widely regarded to be the most severe economic crisis since the Great Depression of the 1930s at the cost of other countries is also evidenced in the growing call for protection against cheap foreign imports and a moratorium on capital outflows to low-cost Latin American and

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Asian producers. Many candidates in the current campaign for the U.S. Presidency are adopting an explicitly anti-free trade platform. The Democrats in the U.S. legislature are threatening to impose trade sanctions against Japan unless the Japanese commit themselves to a substantial reduction of their enormous trade surplus with the United States. And there is growing opposition in trade union and political circles to a proposed free trade pact with Mexico, the signing of which now looks as if it will be postponed till at least 1993.

This beggar-thy-neighbour attitude will most certainly be intensifed in the coming months as politicians around the world come under increasing pressure from their electorates to provide a speedy remedy to the current economic malaise. Far from cushioning the impact of the present global crisis, the economic policies pursued by governments of the richest countries may actually contribute to its aggravation as each country adopts a progressively more self-centred economic strategy. Obviously, in such a situation the countries that will suffer the most are the poorest and the economically weakest.

The Kondratieff Wave

The slump in global commodity, financial and property markets has, as slumps always do, renewed interest in the study of business cycles. Several commentators have drawn attention to the work of Nicolai Kondratieff, a Russian economist, who postulated in a paper published in 1926 that (capitalist) economies move in broad swells or waves lasting between 50 and 54 years; roughly 20 years up, followed by a plateau period of 7-10 years, and then 20 years down (see figure 2).[5] The up-wave is usually associated with some major technological developments (e.g., canals in the 1820s and 1830s, railroads in the 1850s and 1860s, automobiles in the early twentieth century and electronics in the 1960s) and is characterised by a rise in profits, investment, output and prices. Credit is generally easy and interest rates are low. A common characteristic of the peak of each wave is a war. "Peak wars", as they are sometimes referred to, accentuate the distortions and ruptures that begin to appear in the system as it overheats, as technological and production capacities are reached. This is true of the peaks reached in the 1810s, 1860s, 1910s and 1960s. Because output reaches its capacity limits each peak war is associated with inflationary pressures. The plateau period is one of transition or adjustment during which inflation stabilises and credit becomes tighter. During this period there is usually a swing to the right politically as a result of the volatility and uncertainty of the terminal phase of the upswing. Consequently pressures build up to cut government spending and deficits. The impact of these is deflation. The downwave which follows is characterised by a secular contraction in profits, investment, output and prices. Credit becomes tighter and bankruptcies increase. The economy moves into recession. At the end of each downwave there is typically a war, a so-called trough war. Trough wars help restore the conditions for a new upwave by contributing to the destruction of worn out and obsolete capital, and, more importantly, inducing a massive increase in investment and output.

During each Kondratieff, wave there also emerge smaller waves of approximately 18 years, 9 years (the "Juglar cycle"), and 4 years (the "Kitchin cycle"). During each sub-cycle, profits, investment, output and prices fluctuate around their long-run secular trends (see figure 3). The reasons for these fluctuations are somewhat different from, although conditioned by, those underlying secular trends in the variables. The investment cycle of the Juglar, for example, has to do with the replacement of plant and equipment. The investment cycle of the Kitchin has to do with stock-building. In the upwave of a Kondratieff cycle the upswings of the smaller cycles tend to be strong and the downswings or recessions correspondingly mild. In the downwave of a Kondratieff cycle the reverse is true; the upswings of the smaller cycles are weak and the downswings increasingly strong.

Kondratieff wave theorists identify 1934 as the trough of the previous cycle and see the current wave, the fourth on record, as having begun in 1939 (see Figure 2). They identify the Vietnam war as the war at the peak of the current cycle and contend that it turned downwards around the middle of the 1970s. Accordingly, many Kondratieff adherents believe that a massive recession, marking the trough of the current Kondratieff cycle, is imminent. P.Q. Wall, the editor of a respected Wall Street newsletter, argues that the coming recession will be accompanied by a massive slump in stock and commodity prices, with the Dow Jones Industrial average, now at 3000, plummeting to 500 by 1993 and oil falling to a mere US$ 4 a barrel. W. Williams, President of American Business Econometrics Inc, a economic consultancy firm, expects the current downturn to last pretty much through the end of the decade and be as steep as anything seen in this century.

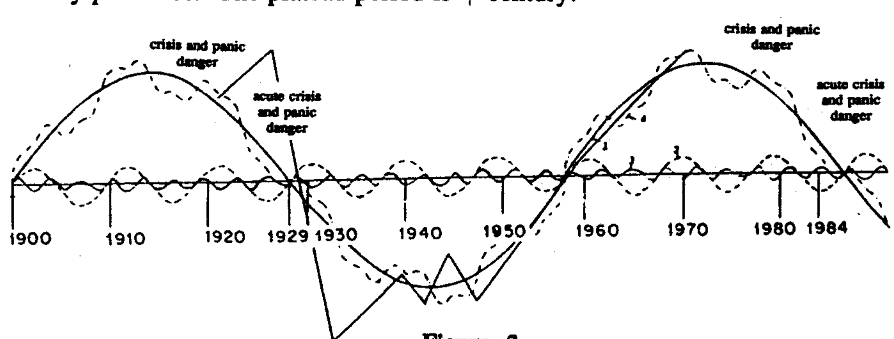

Figure 2

The twentieth-century business cycle and crisis points. Curve 1: Kondratieff; curve 2: Juglar; curve 3: Kitchin; curve 4: composite of curves 1 to 3. (*From* Business Cycles, by Josepb Schumpeter. Copyright © 1959 by McGraw-Hill. →

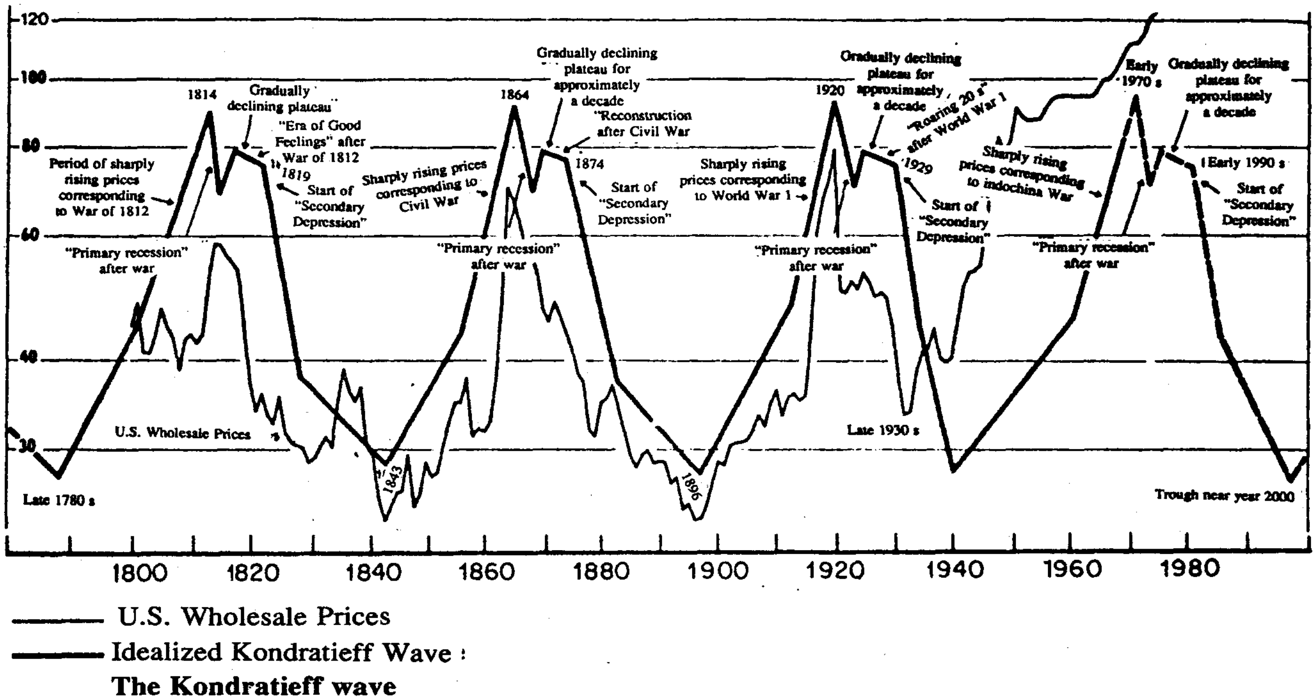

Figure 3

The Implications for Sri Lanka

Whatever the validity of the Kondratieff wave theory, and though it needs pointing out that a many economists reject it as unsound, it would appear that the world economy is currently in the grip of a severe recession, which in all probability still has some way to go.

The implications for Sri Lanka are twofold. Firstly, forecasts of 6%+ growth rates for 1991 and 1992 are not simply unrealistic but potentially damaging to the extent that they are signals for private sector behaviour and government policy. If, for example, the private sector accepted the optimistic growth forecasts it should consider expanding its capacity, possibly borrowing long-term at current high rates of interest - in the belief that interest rates are unlikely to come down in the near future and could well go up further because of sustained demand pressures. In a recessionary environment, however, such a strategy could prove fatal.

Secondly, and on the question of government policy, the implication is that the latter should presently be oriented towards damage control. A reduction in interest rates, a depreciation of the currency, and the expansion of public investment would all help. A reduction in interest rates (to around 10% for the prime lending rate) will assist businesses reduce costs and restore their liquidity positions in preparation for renewed expansion when the world economy eventually turns around. Although a further depreciation of the currency (say to around Rs47:1 US$) is unlikely to lead to a significant expansion of export volumes in the present climate, it may serve to bolster the flagging fortunes of exporters on whose shoulders the government has placed the burden of economic prosperity. One cost of such a depreciation may be the fueling of inflation. However, this should be bearable in a situation where world market prices are generally on the decline.

Lastly, an expansion of public investment in physical infrastructure as well as in human resource development will not only maintain the growth momentum at a time when the private sector is displaying an increasing nervousness, but also provide the necessary base for an accelerated growth process in the next upswing - which could possibly be the beginning of a new Kondratieff wave. ■

1. This figure is given in the forthcoming *World Economic Outlook*, October 1991.
2. In its recent *World Economic Outlook* (October 1991), the IMF estimates the world growth rate to be 2.75% in 1992 (see also "IMF Ties Growth to Deficit Cuts by Governments", International Herald Tribune, 10/10/1991, p. 9)
3. In its recent *World Economic Outlook* (October 1991), the IMF estimates the 1991 inflation rate for industrialised countries to be 4.6%.
4. The Federal Reserve Board cut its discount rate on Friday the 20th December to 3.5% from 4.5%.
5. Knondratieff died in a Siberian concentration camp for what were believed to be heretical and dangerous views of economic developments.