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'Misunderestimating' Living Standards

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In a recent report, the British economic consulting firm Oxford Economics predicted that in 2008 the gross domestic product (GDP) per person in the United Kingdom will exceed that of the United States. If correct, the Oxford Economics notes, 2008 would be the first time since the 19th Century that the United Kingdom surpassed the United States with respect to this fundamental measure of the national standard of living.

The Oxford Economics forecast, however, is completely misleading, and relies on a basic misunderstanding of widely accepted methods of comparing international standards of living. Using the appropriate economic method, in 2008, the GDP per capita of the United States will exceed that of the United Kingdom by almost 19 percent.[1]

Any comparison of income across countries must address the issue of how to compare incomes in one country in one currency (say, British pounds) with incomes earned in a second country in a second currency (say, US dollars).

Economists have two approaches to making the comparisons. The first uses "market exchange rates" --exchange rates recorded daily in international financial markets. Market exchange rates make sense in some circumstances. If a British financial corporation looking to expand, for example, is trying to decide between acquiring a US bank or a British bank, the British financial corporation will use market exchange rates to put the cost of the two banks on a comparable basis.

Economists call the second approach to making international exchange-rate comparisons "purchasing power parity" (PPP) exchange rates. PPP rates, which take into account differences in national prices, are the correct way to make international comparisons of the standard of living.

The Oxford Economics report incorrectly uses market exchange rates, which ignore differences in national prices and are subject to wide fluctuations, instead of PPP exchange rates. This methodological error is the only reason that the Oxford Economics report can conclude that GDP per capita in the United Kingdom is on target to surpass GDP per capita in the United States this year.

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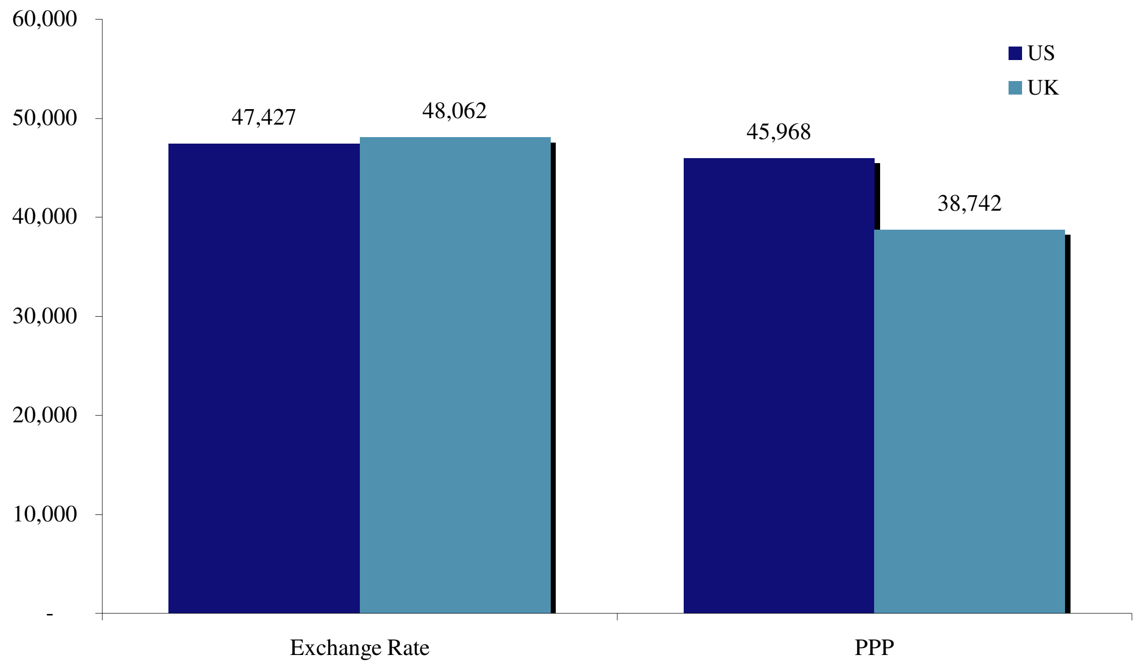
1 Estimate based on International Monetary Fund projections using purchasing-power-parity exchange rates; see International Monetary Fund, *World Economic Outlook*, October 2007, (World Economic Outlook online database).

FIGURE 1
Forecasted Measures of Per-Capita GDP in the US and UK, 2008 (US Dollars)



Sources: Oxford Economics (market exchange rate) and IMF, World Economic Outlook, October 2007 (PPP exchange rate).

A simple example makes the point to anyone familiar with the United States. Imagine that a US worker is considering two job offers. One job is based in Ottumwa, Iowa, and pays $50,000 per year; an otherwise identical job is based in New York City and pays $55,000 per year. If the worker uses the "market exchange rate" for New York City dollars to Ottumwa dollars to evaluate which job pays better, the worker would take the New York City job. The market exchange rate for New York City dollars to Ottumwa dollars is one: one dollar earned in New York City buys one dollar in Iowa. Therefore, using the market exchange rate the worker would have an additional $5,000 a year and a commensurately higher standard of living after taking the job in New York City.

Of course, prices are much different and generally much higher in New York City. What the worker considering the two job offers really needs is a PPP exchange rate for New York City to Ottumwa dollars. This PPP would take into consideration that corn may be cheaper in Iowa than it is in New York City, but housing is also much more expensive in New York City than it is in Ottumwa. While formal New York City to Ottumwa PPPs are not available, few US workers would make the same mistake that the Oxford Economics consulting firm has made and conclude --based on market exchange rates-- that the New York City job will offer them a higher standard of living.

Figure 1 illustrates the difference in the estimated 2008 GDP per capita for the United Kingdom and the United States using Oxford Economics misleading market exchange rate calculation, on the one hand, and similar forecasts from the International Monetary Fund using the correct PPP exchange rate methodology. Using Oxford Economics incorrect market exchange rate methodology, the GDP per person in 2008 will be slightly higher in the United Kingdom ($48,062) than it will be in the United States ($47,427). Using the correct PPP methodology, however, the IMF estimates 2008 GDP per capita in the United States ($45,968) will be almost 19 percent higher than it is in the United Kingdom ($38,742).[2]

2 A small portion of the difference in the two sets of forecasts for 2008 is due to the differences between Oxford Economics and the IMF with respect to estimated underlying growth rates in the two countries. The vast majority of the large difference in the two sets of forecasts, however, is due to the different exchange-rate methodology.