China’s Questionable Economic Power

TOKYO – The World Bank recently announced that China’s economy will surpass that of the United States this year, measured according to purchasing power parity (PPP). But this is far from a holistic depiction of China’s global economic standing.

Though PPP can serve some purpose in comparing welfare across countries, it is affected significantly by population size. India, the world’s tenth largest economy measured according to the market exchange rate of the US dollar and the Indian rupee, is the third largest in PPP terms. Moreover, power resources, such as the cost of imported oil or an advanced fighter aircraft engine, are better judged according to the exchange rates of the currencies that must be used to pay for them.

To be sure, total size is an important aspect of economic power. China has an attractive market and is many countries’ largest trading partner – important sources of leverage that China’s leaders are not afraid to wield.

But, even if China’s overall GDP surpasses that of the US (by whatever measure), the two economies will maintain very different structures and levels of sophistication. And China’s per capita income – a more accurate measure of economic sophistication – amounts to only...
20% of America’s, and will take decades, at least, to catch up (if it ever does).

Moreover, as Chinese officials and researchers have acknowledged, though China surpassed Germany in 2009 as the world’s largest exporter by volume, it has yet to develop into a truly “strong” trading country, owing to lackluster trade in services and low value-added production. And China lacks the kind of strong international brands that trade powerhouses like the US and Germany boast; indeed, 17 of the top 25 global brands are American.

China’s lagging economic sophistication is also reflected in its financial markets, which are only one-eighth the size of America’s, with foreigners permitted to own only a tiny portion of Chinese debt. Though China has tried to increase its financial clout by encouraging the international use of its currency, renminbi-denominated trade still represents just 9% of the global total, compared to the dollar’s 81% share.

Not even China’s massive foreign-currency reserves – the world’s largest, at nearly $4 trillion – will be adequate to boost its financial leverage, unless the authorities create a deep and open bond market with liberalized interest rates and an easily convertible currency. These reserves do not give China much direct bargaining power over the US, either, given that interdependent relationships depend on asymmetries.

China holds dollars that it receives from its exports to America, while the US, by keeping its market open to Chinese products, helps to generate growth, employment, and stability in China. Yes, China could bring the US economy to its knees by dumping its dollars, but not without taking a serious hit itself.

The differences between China and the US in terms of economic sophistication extend to technology as well. Despite some important achievements, China relies on copying foreign inventions more than domestic innovation for its technological progress. Though China is issuing more patents than ever, few represent groundbreaking inventions. Chinese often complain that they produce iPhone jobs, but not Steve Jobs.

In the coming decades, China’s GDP growth will slow, as occurs in all economies once they reach a certain level of development – usually the per capita income level, in PPP terms, that China is approaching. After all, China cannot rely on imported technologies and cheap labor to support growth forever. The Harvard economists Lant Pritchett and Lawrence Summers have concluded that regression to the mean would place Chinese growth at 3.9% for the next two decades.
But this straightforward statistical estimate does not account for the serious problems that China must address in the coming years, such as rising inequality between rural and urban areas and between coastal and inland regions. Other major challenges include a bloated and inefficient state sector, environmental degradation, massive internal migration, an inadequate social safety net, corruption, and weak rule of law.

Moreover, China will face increasingly adverse demographic conditions. After enforcing a one-child policy for more than three decades, China’s labor force is set to peak in 2016, with elderly dependents outnumbering children by 2030. This has raised concerns that the population will grow old before it grows rich.

China’s authoritarian political system has demonstrated an impressive ability to meet specific targets, from the construction of high-speed railways to the creation of entire new cities. What China’s government is not yet prepared to do is respond effectively to increasingly loud demands for political participation – if not democracy – that tend to accompany rising per capita GDP. Will political change occur when per capita nominal GDP, now at roughly $7,000, approaches $10,000, as occurred in neighboring South Korea and Taiwan?

It remains to be seen whether China can develop a formula to manage an expanding urban middle class, regional inequality, and, in many places, restive ethnic minorities. Its lagging economic sophistication may complicate matters further. In any case, it means that aggregate GDP, however it is measured, is inadequate to determine when – and whether – China will overtake the US in economic power.


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