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China's Incredible Shrinking Economy

by Eswar Prasad

ITHACA, NY -- The World Bank recently announced that the Chinese and Indian economies are 40% smaller than previously estimated. Since these are the fastest-growing large economies, the Bank's revision has clipped half a percentage point off world growth over the last five years, according to the IMF.

The new numbers set off a firestorm of debate, and have brought conspiracy theorists out in force. But when the dust settles, the new data may be less revolutionary than some people believe. They may also have the unintended benefit of shifting a key policy debate in a more productive direction.

The new data are based on improved estimates of purchasing power parity (PPP). The basic idea is that, when comparing incomes across countries, variations in purchasing power should be taken into account. Market exchange rates are not a good indicator of these differences, because they can fluctuate for other reasons.

The World Bank and some other organizations have, collectively, gathered a massive amount of data – covering 1,000 similar products in 146 countries – to construct comparable international prices. Price levels in China and India, among other developing countries, turn out to be much higher than previously estimated. Hence, their real per capita incomes are lower relative to other countries.

Despite this massive shrinkage, the reality on the ground is unchanged. Indeed, people in Beijing and Delhi are showing more equanimity than most would if their incomes were cut by 40%. The bottom line is that China and India are still large economies, growing rapidly, and consuming massive amounts of resources. All that has changed is that both countries have been downgraded to smaller roles on the world stage.

But size is not all that matters. The new PPP data also have implications for evaluating the extent of poverty and the level of a currency's exchange rate. This is where the conspiracy theories come in.

The reduction in income levels at international prices means that many more people in China and India are now classified as poor – an automatic boon for the World Bank, whose primary business is to end poverty. And the fact that China's market exchange rate was far lower (i.e., more yuan per dollar) than the earlier PPP exchange rate had been interpreted as evidence of huge undervaluation. The new data, by contrast, show that the exchange rate of the renminbi relative to the dollar is about right.

The calculations can be tweaked, but it is difficult to generate anything close to the dramatic figures of 40-50% undervaluation that had been bandied about by some researchers. This has fomented accusations that China apologists have cooked the new numbers.

But the conspiracy theories are off the mark. The World Bank has engaged in a good faith effort to make progress on a hugely complicated matter. Of course, there remain gaping holes in the data. For example, the data for China are based on surveys in just 11 cities. Prices for rural areas – where two-thirds of China's population still resides – are based on extrapolations from these data. There is guesswork involved, but at least it's been done in a systematic way. In any case, earlier calculations depended on an even greater amount of guesswork.

Whatever one makes of the data, the number of people leading lives of quiet desperation in these countries is unconscionably large. As for the exchange rate, PPP is only one of many ways to calculate its equilibrium level. Given China's massive current account surplus (12% of GDP), the renminbi is still undervalued.

But the degree of undervaluation is not the point. What China needs is a more flexible exchange rate that can respond freely to market forces. Otherwise, China's central bank must focus on keeping the exchange rate stable and doesn't have a truly independent monetary policy.

More flexibility would help attain more balanced and sustainable growth. It would allow the central bank to raise interest rates aggressively to control runaway credit and investment growth, and keep inflation in check. Raising interest rates on bank deposits, which are now negative in real terms, would reduce incentives for individuals to pour money into equity markets or real estate, mitigating the risk of asset market bubbles and boom-bust cycles in the economy.

Trying to determine the "right" level of the renminbi, by contrast, is a fool's game, and the proposal of a step revaluation to get to that level has become a polemical distraction. Perhaps the new data will cool the heated rhetoric about undervaluation and currency manipulation, and instead generate a substantive discussion about exchange-rate flexibility and its benefits for China and the world.

Eswar Prasad, a professor of trade policy at Cornell University, is the former head of the IMF's China Division.