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The great fall of China

Revised GDP calculations show that Beijing isn't the giant we thought it was.
By Walter Russell Mead

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The most important story to come out of Washington recently had nothing to do with the endless presidential campaign. And although the media largely ignored it, the story changes the world.

The story's unlikely source was the staid World Bank, which published updated statistics on the economic output of 146 countries. China's economy, said the bank, is smaller than it thought.

About 40% smaller.

China, it turns out, isn't a $10-trillion economy on the brink of catching up with the United States. It is a $6-trillion economy, less than half our size. For the foreseeable future, China will have far less money to spend on its military and will face much deeper social and economic problems at home than experts previously believed.

What happened to $4 trillion in Chinese gross domestic product?

Statistics. When economists calculate a country's gross domestic product, they add up the prices of the goods and services its economy produces and get a total -- in dollars for the United States, euros for such countries as Germany and France and yuan for China. To compare countries' GDP, they typically convert each country's product into dollars.

The simplest way to do this is to use exchange rates. In 2006, the World Bank calculated that China produced 21 trillion yuan worth of goods and services. Using the market exchange rate of 7.8 yuan to the dollar, the bank pegged China's GDP at $2.7 trillion.

That number is too low. For one thing, like many countries, China artificially manipulates the value of its currency. For another, many goods in less developed economies such as China and Mexico are much cheaper than they are in countries such as the United States.

To take these factors into account, economists compare prices from one economy to another and compute an adjusted GDP figure based on "purchasing-power parity." The idea is that a country's GDP adjusted for purchasing-power parity provides a more realistic measure of relative economic strength and of living standards than the unadjusted GDP numbers.

Unfortunately, comparing hundreds and even thousands of prices in almost 150 economies all over the world is a difficult thing to do. Concerned that its purchasing-power-parity numbers were out of whack, the World Bank went back to the drawing board and, with help from such countries as India and China, reviewed the data behind its GDP adjustments.

It learned that there is less difference between China's domestic prices and those in such countries as the United States than previously thought. So the new purchasing-power-parity adjustment is smaller than the old one -- and $4 trillion in Chinese GDP melts into air.

The political consequences will be felt far and wide. To begin with, the U.S. will remain the world's largest economy well into the future. Given that fact, fears that China will challenge the U.S. for global political leadership seem overblown. Under the old figures, China was predicted to pass the United States as the world's largest economy in 2012. That isn't going to happen.

Also, the difference in U.S. and Chinese living standards is much larger than previously thought. Average income per Chinese is less than one-tenth the U.S. level. With its people this poor, China will have a hard time raising enough revenue for the vast military buildup needed to challenge the United States.

The balance of power in Asia looks more secure. Japan's economy was not affected by the World Bank revisions. China's economy has shrunk by 40% compared with Japan too. And although India's economy was downgraded by 40%, the United States, Japan and India will be more than capable of balancing China's military power in Asia for a very long time to come.

But don't pop the champagne corks. It is bad news that billions of people are significantly poorer than we thought. China and India are not the only countries whose GDP has been revised downward. The World Bank figures show sub-Saharan Africa's economy to be 25% smaller. One consequence is that the ambitious campaign to reduce world poverty by 2015 through the United Nations Millennium Development Goals will surely fail. We have underestimated the size of the world's poverty problem, and we have overestimated our progress in attacking it. This is not good.

There is more bad news. U.S. businesses and entrepreneurs hoping to crack the Chinese and Indian markets must come to terms with a middle class that is significantly smaller than thought. Investors in overseas stocks should take note. Companies with growth plans tied to the Indian and Chinese markets could face disappointing results, and the high prices of many emerging-market stocks depend on buzz and psychology. Investor sentiment on China and India may now be significantly more vulnerable to future bad news.

China's political stability may be more fragile than thought. The country faces huge domestic challenges -- an aging population lacking any form of social security, wholesale problems in the financial system that dwarf those revealed in the U.S. sub-prime loan mess and the breakdown of its health system. These problems are as big as ever, but China has fewer resources to meet them than we thought.

And there is the environment. With poor air quality, acute water shortages, massive pollution in major watersheds and many other environmental problems, China needs to make enormous investments in the environment to avoid major disasters. Globally, it will be much harder to get China -- and India -- to make any sacrifices to address problems such as global warming.

For Americans, the new numbers from the World Bank bring good news and bad. On the plus side, U.S. leadership in the global system seems more secure and more likely to endure through the next generation. On the other hand, the world we are called on to lead is poorer and more troubled than we anticipated.

Maybe the old Chinese curse says it best: We seem to be headed for interesting times.

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