

Has China **ALREADY** Surpassed the U.S. as the World's Largest Economy?

By [Washington's Blog](#)

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Report: China Surpassed U.S. in 2010

While the IMF [forecasts](#) that China will surpass America as the world's top economy in 2016, it may have already become dog top.

As Arvind Subramanian – former assistant director in the Research Department of the International Monetary Fund, and now senior fellow jointly at the Peterson Institute for International Economics – [noted](#) in January:

Some time in 2010, the Chinese economy overtook that of the United States. My calculations of GDP for ... are based on new estimates of GDP that will soon be published by the Penn World Tables (PWT) under the guidance of Professor Alan Heston at the University of Pennsylvania.

According to the IMF's latest estimates for 2010, the value of total US GDP was \$14.6 trillion while that of China was \$5.7 trillion.

But it has long been recognized by many economists that using the market exchange rate to value goods and services is misleading about the real costs of living in two countries. Such goods and services as medical services, retail and constructions services, and haircuts—which are not traded across borders—are cheaper in poorer countries because labor is abundant. Using the market exchange rate to compare living standards across countries understates the benefits that citizens in poor countries enjoy from having access to these goods and services.

Purchasing power parity (PPP) estimates—which take account of these differing costs—are an alternative and, in some respects, more revealing way of computing and comparing standards of living and economic size across countries.

The size of the Chinese economy in 2010 was about \$14.8 trillion dollars—surpassing that of the United States.

A second correction relates to [the fact that when] a currency appreciates, the movement is akin to an increase in the average cost of living.

These two adjustments increase China's GDP from the current estimate of \$10.1 trillion to \$14.8 trillion (an increase of 47 percent, of which 27 percent is due to the revision in the 2005 estimate, and the rest due to smaller-than-assumed increases in the cost of living between 2005 and 2010). This \$14.8 trillion figure exceeds US GDP of \$14.6 trillion.

The GDP per capita (the average standard of living) is now about 4.3 times greater in the US than in China compared with a multiple of 6.3 without my corrections (and compared with a multiple of 11 if GDP is computed using market exchange rates).

[One] explanation of China's behavior [in failing to provide more accurate estimates] has to do with exchange rate politics. Had all prices been collected, China's average price level (cost of living) would have been substantially lower. And this would have resulted in estimates of undervaluation of the Chinese currency of close to 40 percent against the dollar (see Subramanian 2010 for the connection between China's price level and the implications for estimating whether currencies are under or overvalued). China's trading partners would have had additional technical ammunition to deploy against its highly sensitive but demonstrably beggar-thy-neighbor exchange rate policy.

Economist Simon Taylor – finance professor and director of the finance program at Cambridge (and former JPMorgan and Citigroup alum) – [writes](#):

The forecast [from the] Peterson Institute of International Economics [argues] that Chinese economic output already matched that of the US in 2010 (at purchasing power parity – more of that below). And, more dramatically, that the renminbi could overtake the dollar far more quickly than generally expected

If the new report is even roughly accurate, China's real economic output overtook that of the US several years ago. Even if it's still somewhat inaccurate, the timing of when China is number one is now imminent, not some next-decade event.

But leading Chinese economic analyst Michael Pettis is [not impressed](#):

China's economy is already bigger than the US economy according to PPP. I am not disputing Subramanian's numbers, but comparisons between two such disparate economies on a PPP basis of course have no meaningful content at all. The fact that it is much cheaper to get a haircut or massage in China ... tells us very little about the two countries that we wouldn't have already known.

This whole exercise is pretty meaningless, and not only for the reason you might think – that economic growth is not a horse race between countries. It is

meaningless for a far more fundamental reason, and this is because the comparable official GDP numbers for China (and PPP numbers start with the official numbers and then adjust for local prices) are wrong.

GDP may be higher

I am not just saying this because, according to Wikileaks, Li Keqiang doesn't take the official GDP numbers too seriously. This was widely reported, but isn't really news. None of us take the official GDP numbers too seriously, especially since it is almost impossible to produce good data in a large economy that is transforming itself so rapidly. I am saying that the GDP numbers are wrong for a more fundamental reason.

GDP is supposed to measure the total value of goods and services produced in China, but there are several problems with the official numbers. There are problems with all GDP numbers, but the biases, especially in the developed countries, are fairly consistent, which makes cross-country comparisons more or less meaningful. But in China there are additional problems, which make cross-country comparisons very complicated.

First of all we know that a lot of Chinese income – more than in most other major countries – is hidden, for whatever reasons, and this tends to pull down reported GDP numbers. One plausible recent estimate is that roughly 10% of total income is hidden beyond the NBS surveys, and so this suggests that GDP might really be substantially higher.

Second, when you compare the US and China (or any two countries), you have to think carefully about the exchange rate you're using.

What if you believe that the RMB is undervalued by 20% and held there only because of PBoC intervention? Doesn't that mean that if the PBoC were to stop intervening China's GDP would automatically be 20% larger relative to the US?

Yes, it should be larger, but not by 20%. The difference should be less than 20%, but how much less depends on how much of China's GDP growth can be explained by the undervalued currency.

If part of the country's high growth rate is a consequence of the undervalued exchange rate, and certainly Beijing seems to believe it is, then raising the value of the RMB would automatically cause a slowdown in Chinese growth. That is why analysts should consider the relationship between the two when they make projections, and by the way they are implicitly (if not very accurately) doing so when they calculate PPP numbers.

GDP may also be lower

But there is more. So far nearly all the adjustments and predictions about Chinese growth that we have seen in the press suggest that the "real" size of China's economy requires upward revisions of official GDP numbers, but that might reflect China hype more than a judicious approach might justify. What if China's GDP numbers seriously overstate the true value of China's economy?

There are at least two very good reasons to believe that they might. The first is environmental degradation. To understand why, it is worth remembering that if an individual earns \$100, but in so doing destroys \$100 worth of his own assets, then a strict accounting would say that he earned nothing.

The same is true with the environment, which has a real economic value that can be adversely affected by certain kinds of economic activity. For example here is an article that came out four months ago on Bloomberg:

China, the world's worst polluter, needs to spend at least 2 percent of gross domestic product a year — 680 billion yuan at 2009 figures — to clean up 30 years of industrial waste, said He Ping, chairman of the Washington-based International Fund for China's Environment. Mun Sing Ho, a senior economist at Dale W. Jorgenson Associates and a visiting scholar at Harvard University in Cambridge, Massachusetts, put the range at 2 percent to 4 percent of GDP.

Failure to spend that much — equivalent to the annual GDP of Vietnam — may cost the Chinese economy half as much again in blighted crops, health costs and pollution-related expenses, He said: "The cleanup can't catch up with the speed of pollution" if spending is less.

This article suggests that a significant portion of Chinese growth came with a destruction of value that should have been deducted from that growth. After all, if you create net \$100 of chemicals, but in so doing you pollute a nearby river to the extent that future economic production associated with the river is reduced by \$100 (there will be less fishing, perhaps, or less agricultural production, or less usable water, or more health care costs), then the net value you created is 0, not \$100, although of course you as the polluter might earn \$100 today while the rest of the country loses \$100 over the future.

There is no objective way to figure out how much of Chinese GDP growth should be reversed because of environmental degradation (and in this China is simply an extreme case – most countries to a lesser extent have this problem), but there is no question that the number is big, and the result is that we overestimate China's GDP growth today and will underestimate GDP growth tomorrow. In other words environmental degradation simply causes us to take future growth and count it today.

And it is not just environmental degradation that may require a downward adjustment in GDP. What about misallocated investment?

Every country wastes investment, but China does it on a massive scale. I would argue that at least 1-2 percentage points of Chinese growth, perhaps even more, might consist of this kind of misallocated investment-driven growth.

When you add the impact of misallocated investment and environmental degradation, the necessary cumulative adjustment to Chinese GDP might be huge. For example, if the two adjustments combined range from 2 to 4 percentage points annually, over one decade China's "true" GDP (whatever that means), would be below the official numbers by anywhere from 16-31%. Over twenty years official GDP would be overstated by 31-52%. That means that we are massively overstating GDP today and will experience very low apparent GDP growth for many years in the future as the official number returns to some reasonable approximation of the real number.

These are big adjustments, both above and below the official GDP numbers. This is why I find the whole horserace to predict the earliest date by which China's economy will overtake the US to be so silly. What we are in effect doing is predicting the date by which an economy that is officially \$6 trillion, but in reality anywhere from \$3 trillion to \$15 trillion in size, will overtake another economy that is roughly around \$15 trillion in size.

And this is not the first time we have played this game. Look at Japan. Fifteen

to twenty years ago Japan's GDP was officially 17-18% of the world's GDP and it was rapidly catching up to the US. Today it is 8%, and there seems to be no chance of it every catching up.

But can this really be true? Or is it possible that Japan's official GDP growth was vastly inflated by misallocated investment before 1990, and vastly deflated by the repayment of that investment after 1990?

I think it's the latter. If you look at the growth in Japan's household consumption, you will find that household consumption grew much more slowly than GDP before 1990, and much more quickly after 1990. Household consumption might be at least as good an indicator of the real growth in wealth as production-side GDP numbers. So might it not be true that Japan's official GDP was too high before 1990, and it has been slowly adjusting since then? And if this could have happened in Japan, whose investment growth was high but way below China's, why can't it happen here?

Under these conditions what's the point of predicting when China's economy will officially overtake the US? We simply have no idea, and we cannot draw any conclusions from the numbers. Can the horserace generate headlines? Yes. Can it generate understanding? Not much.

Pettis naively assumes that the U.S. economic numbers aren't fudged, and that they adequately adjust for environmental degradation and misallocated capital. Given the widespread [environmental](#) and [economic](#) cover-ups – and [misallocation of capital](#) (and [see this](#)) – I'm not so confident.

Moreover, China's main credit rating agency – Dagong – [argues](#) that the U.S. economy is actually much closer to \$5 than \$15 trillion:

In the components of the U.S. GDP in 2009, the financial services sector accounted for 21.4% while the real economy sector accounted for 65%. The total output value of the U.S. financial services industry is composed of two major parts: one is the transferred production value, most of which comes from value distribution of participating in international production. Another part is the inflated value originated from credit innovation, which belongs to bubble value. In addition, due to the high economic financialization, more than half of the profits in the real economy come from the returns of financial activities. If we exclude the factor of virtual economy, the U.S. actual GDP is about 5 trillion U.S. dollars in 2009, per capita GDP about \$ 15,000. Meanwhile, the total domestic consumption was 10.0 trillion U.S. dollars and government expenditure was 4.5 trillion U.S. dollars. The production capacity of real value in the national economy is the material base to arrange social distribution and consumption. As the U.S. government arranges its budget according to the GDP including the virtual value, its revenue must fall short of its expenditure, so the socialization and normalization of debts will exacerbate the environment of economic development. It is predicted that the average real GDP per year of the United States will not reach 6 trillion U.S. dollar and per capita GDP will be less than 20,000 in the coming 3-5 years.

In any event, Pettis argues that any estimate of when China will (or did) pass the U.S. is meaningless.

It should be clear to everyone, however, that the U.S. is no longer the world's unchallenged economic superpower.

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