China Economic Update

by NAB Group Economics

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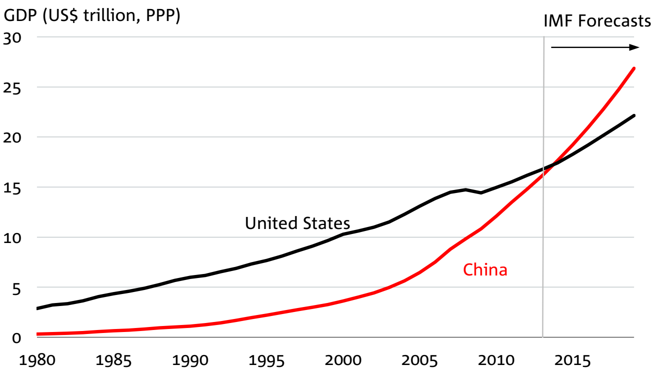
National Australia Bank

Is China already the world's largest economy, and does it even matter?

In October 2014, the International Monetary Fund (IMF) announced that China had overtaken the United States to become the world's largest economy, when GDP is compared on a purchasing power parity basis. According to the IMF estimates in the latest World Economic Outlook, the Chinese economy was valued at around US$17.6 trillion last year, compared with US$17.4 trillion for the US. This was the first time since 1872 (according to some estimates) that the United States was not considered the world's largest economy, when it overtook the United Kingdom.

IMF estimates put China ahead of the United States in 2014



Source: IMF, NAB Economics

The response from China's government has been relatively muted. The China Times printed comments from the Ministry of Finance's deputy director, Zhu Guangyao, that 'China is still a developing country.' State media outlet Xinhua highlighted that PPP figures could be misleading, indicating that Chinese authorities were not particularly eager to claim this position.

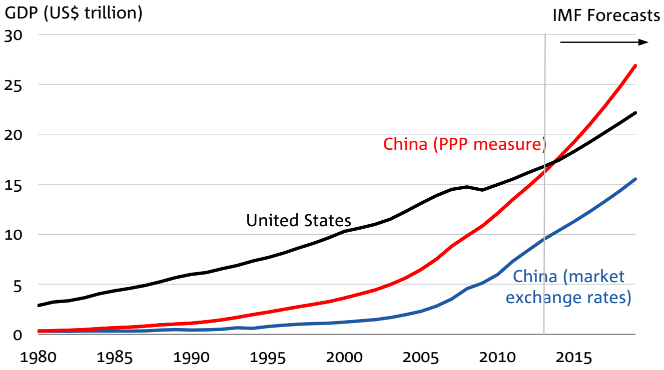
The IMF estimate came ahead of an official revision to China's 2013 nominal GDP in late December (as part of the Third National Economic Census). This revision increased the nominal GDP by 3.4% to RMB 58.8 trillion, from the previous estimate of RMB 56.9 trillion. This increase was only slightly smaller than the entire economy of Malaysia, according to World Bank statistics. At the time of writing, a revised historical series for China's nominal GDP had not been released, nor had a revised real GDP series – however both the first (2004) and second (2008) censuses led to significant upward revisions in the size of the economy (as previously unaccounted activity was included).

Is China the largest economy?

National accounting is a difficult task – attempting to measure economic activity across an entire country – particularly in a country the size of China. It is even more challenging to accurately compare the relative sizes of GDP across countries. For example, when compared at prevailing market exchange rates, the United States remains considerably larger than China – with China's economy only valued at US$10.4 trillion using this methodology, just under 60% of the United States.

However this simplistic methodology has some significant issues. First is that the Chinese currency is generally considered to be undervalued – meaning a direct conversion is unlikely to accurately represent the true scale of the economy. Second is the difference in prices between economies, particularly for non-traded goods and services, which is what purchasing power parity (PPP) attempts to address. The PPP approach scales up the value of these goods and services to make them more comparable between economies.

The gap between PPP and market rate conversions highlights the uncertainty of global comparisons



Source: IMF, NAB Economics

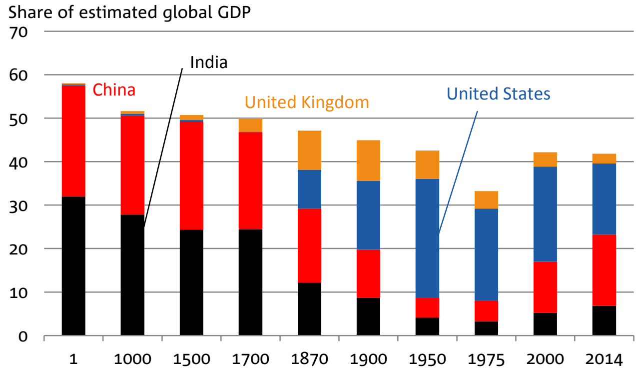
However, there is considerable uncertainty around PPP assessments. Given the narrow gap between the GDP estimates for the US and China, the US economy could still be larger than China's. That said, if it isn't already, it is only a matter of time before China overtakes it. Even with China's economic growth slowing over the next few years, the rate of growth far exceeds that of the advanced economies.

Changing methodology for calculating national accounts could also increase the relative scale of China's economy. China's current system is built on the 1993 global standard – however most advanced economies have already transitioned to a revised 2008 standard. In 2015, China will also adopt this standard, which is likely to result in an upward revision to historical results, largely driven by increased measured output from the services sector.

China's sheer size makes this the natural order

Whether or not it has already happened, it is inevitable that China will become the world's largest economy – due to the scale of its population. In 2013, China's population was over four times that of the United States, and for the majority of human history, population size has been the major determinant of GDP. In this respect, the rise of China is a return to the natural order, as highlighted by the research of the late Angus Maddison.

China's recent growth could be the re-emergence of its natural place in the global economy



Source: Maddison database, IMF, NAB Economics

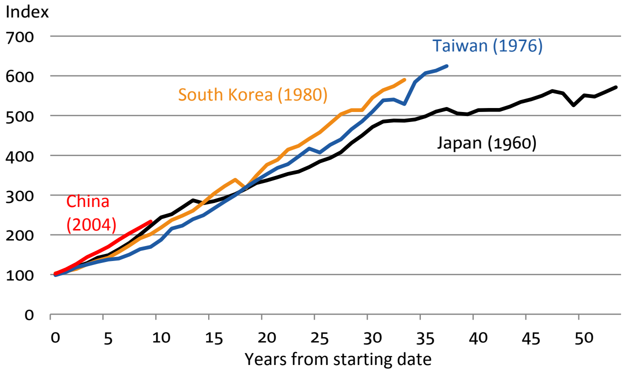
Prior to the industrial revolution, economic activity was limited by the capacity of physical labour, therefore estimates of historical GDP are largely related to population at these times. Maddison's research, which estimated GDP back to 1 AD, placed India and China at the heart of the global economy until the 1800s. It took the industrial revolution, and the asymmetric nature of global industrialisation, to change the pattern of the global economy. China's rapid industrialisation over the past decade has started to normalise the pattern.

Does it really matter?

There is only limited significance in the change in global ranking – aside from some wounded national pride (as exhibited by the response of some media following the IMF release). A major reason for this is the continued disparity in terms of GDP per capita – where China continues to lag advanced economies by a considerable margin. In per capita terms, China remains a 'middle income' economy – with its economy less than a quarter of the size of the United States (on a PPP basis).

In per capita terms, it is clear to see that China is only part way along its development path – if it continues to follow the progress of near neighbours like Japan, South Korea and Taiwan.

China still only a short way along the development path followed by its near neighbours



Source: The Conference Board database, NAB Economics

That said, this continued progress is far from guaranteed. As we have previously outlined, China's shrinking working age population increases the risk that the economy will be caught in the 'middle income trap' – where producers lose competitiveness to low cost rivals and fail to eliminate constraints that restrict income growth to advanced economy levels.

According to the Asian Development Bank, China can escape the middle income trap if it focuses on private sector development and innovation (in particular shifting to higher value production to offset higher labour costs), rebalancing the economy towards consumption and reducing inequality – which has increased sharply in recent years. The bank also notes the importance of reform to State Owned Enterprises and the finance sector, to improve the allocation of financial resources within the economy.

Conclusion

Revised estimates of China's GDP – particularly post the transition to current international standards – increases the likelihood that China is the world's largest economy on a PPP basis. However, this should not be allowed to distract China's policy makers from the reforms necessary to continue China's economic development, given the challenges in escaping the 'middle income trap'.

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