

Tigers or Kittens ?

By Eswar Prasad

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The World Bank stunned the world recently when it announced that the economies of China and India are about 40 percent smaller than previous estimates.

How is it possible to shrink such large economies so much overnight, turning them from tigers into kittens? And what does it mean for people in those countries and the world at large?

The answer depends on whether you care more about reality or hype.

This debate's origin lies in an arcane-sounding concept called purchasing power parity.

Here's the logic: In comparing incomes earned by people in different places, what really matters is the standard of living those incomes can deliver.

This depends on local price levels. An annual income of \$100,000 is enough for a comfortable life in Des Moines but barely enough to get by in New York City.

The same logic applies to countries. One way to compare the incomes of various countries is to use the currency exchange rate to express their incomes in a common unit such as the dollar. But exchange rates are buffeted by various factors and may not capture true purchasing power. Ideally, we'd like to measure the cost of an identical bundle of goods in different countries - call it the international purchasing power of a dollar - and then adjust national incomes by those relative prices.

Clearly, this is a complex calculation. One needs to find comparable products in different countries, account for subtle differences in the quality of products, make adjustments for price variations within a country, and so on. Perhaps this is why the Economist magazine's BigMac index is appealing - BigMacs are a standardized product worldwide, so their local prices provide a good basis for comparing price levels across countries.

But even this is tricky - a BigMac is fast food in the United States but may be a rare treat and therefore priced as a premium product in a poor country. In any case, it is difficult to come up with more than a few other products - Starbucks coffee, Pizza Hut pies, The New York Times - that are similar across countries.

The World Bank has made a noble effort at constructing comparable international prices. Sure, there are big problems with the data. For instance, the data for China are based on surveys in just 11 cities. Prices for rural areas - where 60 percent of China's population still resides - are based on extrapolations from these data.

Before dismissing this as pure guesswork, consider how massive and difficult the exercise is when it covers 1,000 products in 146 countries. Moreover, it's a lot better than the greater amount of guesswork that went into earlier calculations.

Nevertheless, conspiracy theories abound. The new estimates imply that there are many more poor people in China and India, so the World Bank may be extending its own lease on life (one of its aims is to end poverty). But both countries now have less of a claim to a bigger stake in the World Bank and the International Monetary Fund, where economic might determines voting power.

There are also implications for the debate about whether China is manipulating its exchange rate to keep its currency undervalued and its exports cheaper in world markets. The new data imply that the degree of such undervaluation is far lower than some analysts had suggested, which ought to mute China-bashing.

The assertion that such large data revisions must be driven by a political agenda is a tall claim. Even the

United States revises its output and price data substantially every few years. Two years ago, China revised up its national GDP by 17 percent based on improved estimates of its services sector output. Nobody complained then.

Collecting national accounts data is an imprecise science - more of an art, really - and there are still huge gaps in these data, even in advanced industrial countries. Improvements in these data are to be welcomed. But the revisions should be treated with circumspection and not immediately result in a massive shift in world-view.

Even if one takes the new data seriously, the bottom line is that they do not change the reality on the ground. These two countries are still growing rapidly, consuming as many resources, and spewing out as much pollution as before.

It is still the case that in 2007 China will run a huge trade surplus, exporting at least \$250 billion worth of goods more than it imports. Together, China and India still hold nearly \$2 trillion of foreign exchange reserves.

What's changed is the perception that China will soon take over the world if it keeps growing at 10 percent a year. Or that China and India are the new engines for world growth, with the U.S. business cycle mattering a lot less. The people who bought into those overblown ideas are the ones most shaken by the new numbers.

The new World Bank data may change our perception of reality. But much of the reality is no different from what it was. The rest is just hype.

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