

COMMENTARY  
**Asiaphoria Meets Regression to the Mean**

Robert C. Feenstra

The question this session raises is whether Asia will be a growth engine for the United States and world economy. This topic is very much in the news lately, and here is a typical quote:

*... the continuing strength of China's economy in a difficult global situation present[s] opportunities for Asia to keep its economic engines strong. China will continue to become increasingly important in shaping the world's development in the years to come.*

Does that sound familiar? Well, I have actually changed a few words, and have also not been truthful in describing this as a *recent* quote. The original version is:

*... the continuing strength of China's economy in a difficult global situation present[s] opportunities for Asia to keep its economic engines strong. China will continue to become increasingly important in shaping the region's development in the years to come. [emphasis added]*

—Report of the World Economic Forum,  
*East Asia Economic Summit, Hong Kong, 2001*

In fact, in the years just after 2001, the policy discussion in Hong Kong was whether tourists from the mainland would be able to prop up the local economy. I recall being in Hong Kong at that time, and admit that I was quite skeptical as to whether that high-income economy could count on the boost coming from what I perceived to be low-income Chinese tourists. I could not have been more wrong, and in the years after 2001 there was a huge inflow of tourists from China. Among the 18 million people who visited Hong Kong in 2004, for example, 12 million were tourists from China, and they brought in US\$7 billion of business in that year.<sup>1</sup> In a short 10 years since that time, we have gone from asking whether China can prop up the Hong Kong economy to now asking whether China can prop up the *world* economy.

I am sympathetic to the views expressed in this paper that we should be very cautious about making predictions about future growth in China based on

its strong past performance: Very few economies have ever kept up the growth performance that China has maintained in the past decade. But I know how wrong I have been in the past, so I will avoid making predictions about future growth in China. Instead, I would like to list a number of pro and con factors for why we might expect China to keep up its current growth rates (about 7.5 to 8 percent per annum) for some time, or not.

Let me begin by listing three reasons to be skeptical that China can keep up its current growth rate. The first reason is that a large portion of China's aggregate demand comes from investment, and it seems doubtful that China can keep this up. We are all familiar, for example, with the so-called ghost cities that have been built in China but are mostly unoccupied. These types of wasteful investment can stimulate growth in the short term, but cannot be expected to provide sustainable growth over the long term.

Second, the pension system in China is ad hoc and does not provide the long-term benefits that the population can rely on. In the absence of economic security in their old age, the population will save more when it is young and middle-aged, so that it is difficult to increase the share of consumption in GDP.

Third, an argument has been made recently that the state-owned enterprises that are dominant in the upstream sectors of the Chinese economy extract rents from the downstream firms, and therefore from the workers employed in those firms (Li, Liu, and Wang 2012). According to this argument, the low share of labor in overall gross domestic product is explained at least in part by this rent extraction. That low labor share also acts to limit consumption in the Chinese economy. Together with the difficulty of keeping up investment over the long term, this means that both potential sources of growth cannot be relied upon.

But there are also some reasons to think that growth in China may be maintained at its current rate or close to it for some time into the future. One reason is that, while pollution is high, it is also the case that pollution *abatement* is a luxury good whose share in spending grows as a country becomes wealthier. There is every reason to expect that to be the case for China. To be sure, the pollution levels at present are unacceptably high, not just to observers from abroad but to the local population. For that reason we can expect spending on green technologies to increase and be maintained at a high level for the foreseeable future.

The final factor I would like to stress is that prices in China are high—surprisingly high, in fact—which suggests that China can become an important market for goods made in the United States and elsewhere, providing some boost to global growth. The high prices found in China have led to a substantial reduction in estimates of real GDP per capita. This can be seen by considering

estimates from the World Bank *World Development Indicators*, which in turn relies on prices collected by the International Comparison Program (ICP). The ICP first included China in 2005, so earlier estimates of real GDP in that country were based on extrapolations of prices from other countries. For China, the 2005 benchmark estimates from the World Bank show that real GDP per capita for China was 40 percent smaller in 2005 than real GDP for the same year based on extrapolations. As Deaton and Heston (2010, p. 3) report, “the 2007 version of the World Development Indicators (WDI) . . . lists 2005 per capita GDP for China as \$6,757 and for India as \$3,452, both in current international dollars. The 2008 version . . . which includes the new [2005] ICP data, gives, for the same year, and the same concept \$4,088 for China and \$2,222 for India. For comparison, GDP per capita at market exchange rates is \$1,721 for China and \$797 for India.”

The fact that the ICP prices for China in 2005 were higher than expected led to the reduction in real GDP for that country. The ICP sample for China has been criticized for being too heavily weighted towards urban areas, with higher prices. For that reason, when constructing the Penn World Table (PWT) version 7, Alan Heston has reduced the ICP prices of consumption and investment goods for that country by 20 percent in 2005, leading to an increase in the estimates of real GDP. This “20 percent solution” is also adopted by PWT version 8, which has now been taken over by the University of California, Davis, and the University of Groningen.<sup>2</sup>

The high prices paid in China suggest that this economy can become a purchaser of goods from the United States over the long run. A prime example of this comes from the number of students from China, some 200,000 currently, who are able to afford an education in the United States. It is remarkable that in a country whose real GDP per capita was only \$4,088 in 2005, citizens who are described as middle class can afford to send their children to the United States at full tuition. This represents a tremendous sacrifice for them. Surely, these people do not literally come from the middle of the income distribution but are among the more affluent wage earners. As wages in the rest of the country rise, we can expect that the large mass of population *below* that income level will also aspire to buy goods and services at the prices prevailing elsewhere in the global economy. If quality in China remains low and safety standards poorly enforced, that will lead to demand for foreign goods (of which demand for a university education is a prime example). For these reasons, we should not be surprised to find that Chinese consumers will indeed provide some boost to global demand and growth.

## REFERENCES

- Deaton, Angus, and Alan Heston. 2010. "Understanding PPPs and PPP-based National Accounts." *American Economic Journal: Macroeconomics* 2(4), pp. 1–35.
- Li, Xi, Xuewen Liu, and Yong Wang. 2012. "A Model of China's State Capitalism." Hong Kong University of Science and Technology Working Paper. [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2061521](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2061521)

## NOTES

- 1 "How Chinese Tourists Changed the Retailers in Hong Kong," *United Daily News*, May 30, 2005.
- 2 See <http://www.rug.nl/research/ggdc/data/penn-world-table>.