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China's Still Playing Catch-Up

Purchasing-power data do not reflect an economy's size or clout.

By ESWAR PRASAD

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The era of U.S. economic dominance would appear to be over. New calculations from the World Bank's International Comparison Program, based on adjustments for purchasing power, predict that China's GDP will surpass that of the U.S. later this year. And right on cue, here come the hand-wringing pundits who have long predicted doom for the U.S. economy.

This is one of those cases where you shouldn't believe the hype. While the World Bank's new figures do present a better picture of living standards, as with all purchasing power calculations they are less useful when comparing the sizes of entire economies.

The principle is simple and also applies domestically—goods and services that can't be traded over long distances (for example, apartments and haircuts) cost less in places with lower productivity. Even the prices of tradable goods are affected to some degree by local costs. So a family earning $100,000 annually can afford a materially more comfortable lifestyle in Topeka, Kansas, than they could in New York City.

However, we should be wary of drawing further conclusions based on these facts. For example, the family in Topeka is not necessarily richer, since there are other benefits that lead people to prefer living in New York. Using the prices of a comparable basket of goods is also misleading as consumption patterns might be quite different for the "average" household in Topeka compared to one in New York.

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These are some of the reasons why calculations based on purchasing power are less useful when measuring the sizes of economies. Market exchange rates are still a more robust and objective measure for cross-country comparisons. By this measure, China still has a long way to go to match the U.S.

Moreover, China will remain a middle-income country even when it does become the world's largest economy. There is still a gulf in terms of per capita income and other measures of development. Even by the most optimistic measures, China's per capita income is about one-fifth that of the U.S., and based on market exchange rates it is one-eighth.

Interestingly, Beijing is not keen to proclaim itself a leading economic power and has gone so far as to reject the new calculations. The government would prefer that China be viewed as a developing country as opposed to a leading one with all the obligations that come with it.

Beijing seems to want to have it both ways—demanding the prestige and respect due to a major economic power but none of the responsibilities. For instance, Chinese officials have long argued that they should not be expected to contribute as much to climate change mitigation as the advanced economies since their population still has a much lower standard of living.

Moreover, Beijing still sees its actions and policies from the narrow perspective of national self-interest rather than its role as a leader. Other Asian countries are keen to develop closer economic ties with China but they are wary of China's expansionist tendencies in areas such as the South China Sea. Even with its economic might, Beijing has few partners that trust it.

The Chinese yuan is becoming more important in international finance as China becomes more prominent in global trade. But there is little chance it will be seen as a safe haven currency, one that investors world-wide turn to for protection from global financial turmoil. For all the flaws in U.S. economic policies, the U.S. dollar's role as a safe-haven currency was actually strengthened by the financial crisis.

What accounts for this faith in the U.S.? In addition to its economic size and deep financial markets, the U.S. has a set of powerful institutions that inspire the trust of domestic and foreign investors—an open and transparent political framework with an institutionalized system of checks and balances, trusted public institutions, free press and an independent judiciary.

For China to be respected rather than feared, it will take more than just economic might. Beijing will also need to undertake a broader set of political, legal, and institutional reforms—reforms that its leaders have rejected since they threaten the Communist Party's grip on power.

The size of China's economy will likely exceed that of the U.S. not later this year, but at some point over the next decade. Yet the world will still look to the U.S. for leadership. Of course, American exceptionalism is by no means guaranteed and Washington's dithering on everything from Syria to Crimea hurts its standing in the world. The World Bank calculations may be misleading but they still ought to serve as a wake-up call to Washington.

Mr. Prasad is a professor at Cornell University, a senior fellow at the Brookings Institution and author of "The Dollar Trap" (Princeton, 2014).