**Economic rebalancing**

# The end of surplus labor

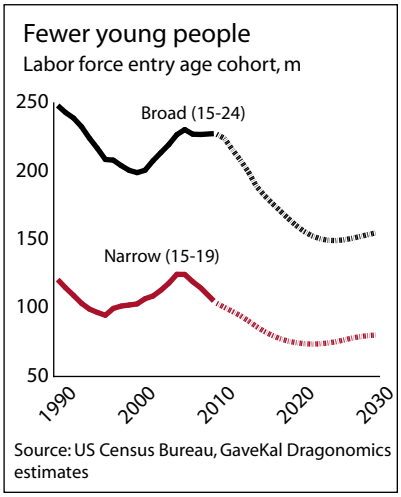
*by Arthur Kroeber*

*Editor's note:* This is the second installment in our three-part series on rebalancing China's growth model. The first part, in the December 2009 issue, dealt with the sources of excess saving. The third part, in the June 2010 issue, will address fiscal and financial market reform.

Discussions of China's economy generally, and of the need for "rebalancing" from an investment-led to a consumption-led growth model, tend to ignore the labor market. This omission arises partly on practical grounds: the inadequacies of Chinese data on employment and wages make robust analysis difficult. But it also comes about because of an implicit assumption that one crucial fact about the labor market will remain static for many years: an abundant supply of ultra-low cost workers.

That assumption is severely flawed. China's labor market is about to undergo a wrenching change as the supply of young workers entering the labor force drops by one-third over the next dozen years. This does not mean, contrary to some recent headlines, that China faces a labor "shortage." The working age population will continue to grow for a few years, and labor force participation rates will continue to rise. But the radically altered age structure of the labor force means that wages are almost certain to rise rather faster relative to productivity than they have over the past 20 years. This in turn means that a certain amount of economic rebalancing will occur naturally, as households will grab a bigger share of national income, increasing their consumption power. It also means that natural inflationary pressure will be stronger over the next decade than it was in the past one.

This natural rebalancing does not let policy makers off the hook. Construction of a social safety net is urgently required, as an older work force will need much more in the way of education, health care and ultimately pensions than the current young work force. Deregulation of service markets is essential in order to keep older workers productively employed for longer. Comprehensive fiscal and financial market reforms must occur to enable companies and local governments to respond flexibly to the changed structure of labor supply, and to the increasingly complex demands of a more mature urban citizenry. Finally, macroeconomic policy must adjust to recognize the fact that the days of inflation-free high growth are gone forever.




## I. A changing labor market

Three years ago China's leading labor economist, Cai Fang of the Institute of Population and Labor Economics of the China Academy of Social Sciences (CASS), published a controversial book arguing that China's economy was about to hit a crucial turning point: the supply of "surplus labor" from the countryside was on the verge of drying up. Cai built on the development theory of British economist Arthur Lewis, who showed

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## Will China's supply of surplus rural labor dry up soon?

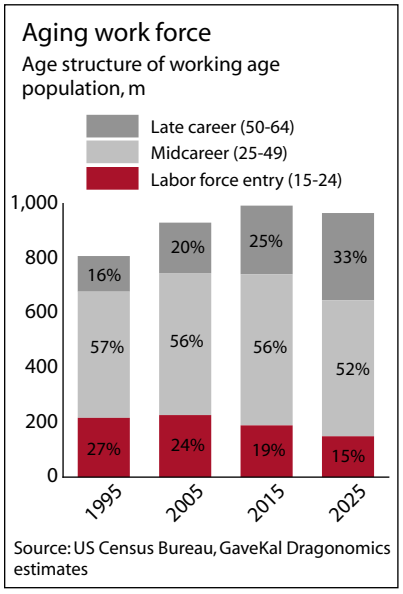
that early-stage industrial economies had two distinct sectors operating in parallel: a traditional agricultural sector with low productivity, and a modern capitalist sector with high productivity growth. In the early stage of industrialization, the impoverished traditional sector provides a large labor pool for the modern capitalist sector, which offers higher wages. This pool is at first effectively infinite, because the capitalist sector can continuously raise its demand for labor without raising real wages – or at any rate, raising wages well below the rate of productivity growth in the capitalist sector. But at some point – a moment dubbed the "Lewis turning point" – the pool of labor in the traditional sector becomes smaller than the demand for labor in the capitalist sector, and this changed supply-demand balance requires real wages to rise. In the first industrial revolution in the United Kingdom, real wages were static from the late 18th century until about 1840; after that they grew smartly. Japan hit its Lewis turning point around 1960 and experienced very rapid wage growth thereafter. Cai's book asserted that China was about to hit the same turning point.

The macroeconomic consequences of the Lewis turning point are large. Before the turning point, the capitalist economy grows mainly through an accumulation of factors – labor and capital. The efficiency with which those factors are used – in economists' jargon, "total factor productivity" or TFP – is secondary. After the turning point, sheer factor accumulation slows down, and efficiency or TFP gains must become the main driver of economic growth. Because of these implications, Chinese policy makers intensively discussed Cai's theory. But in the end they concluded that he was wrong, or at least premature: the biggest immediate policy problem, they decided, was still creating enough jobs to absorb China's rural masses. We believe it is time for a re-think.

**Fewer young 'uns**

When we first tried to look at these issues two years ago, we found the data intractable. China's employment figures are notoriously sketchy. Official statistics carefully count jobs in the shrinking state sector, but miss a lot in the growing private sector. Detailed employment and wage data for the nation's huge migrant labor force – which totals between 100m-150m depending on definition – are scarcely available. The number of non-agricultural jobs in rural areas, in so-called "township and village enterprises" was probably over-counted in the early 1990s, but undercounted in the last decade. And the quarterly wage survey leaves out the vast majority of the private sector, meaning among other things that official data overstate the level of Chinese wages.

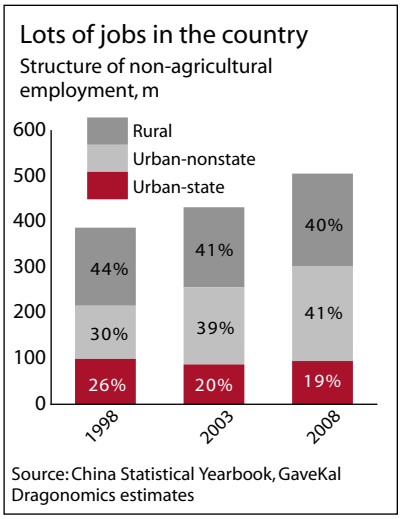
The labor data are still sketchy. But new and better demographic estimates clearly show that China has already begun to enter its Lewis turning point. Rather than try to construct an estimate of "surplus labor" in the agricultural sector, which with current data is a fruitless task, we start with the age structure of the work force. China's marginal wage is set by two factors: the supply of people willing to leave the farm for urban



Source: US Census Bureau, GaveKal Dragonomics estimates

employment, and the supply of young people entering the labor market (both relative to the demand for labor). Since surveys show that people's willingness to migrate long distances for work decreases sharply after age 30, the supply of willing migrants is to a large extent a function of the supply of young people. And the supply of young people is heading down, fast.

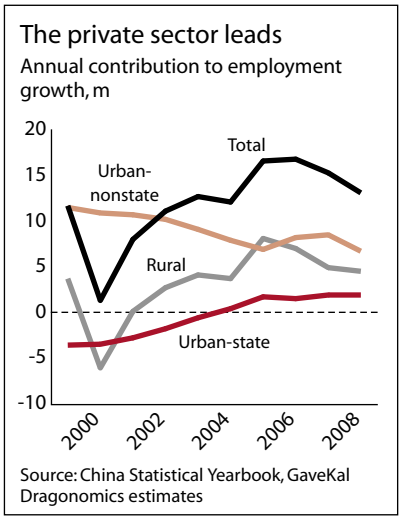
Until recently, getting a grip on the age structure of the Chinese work force was difficult because the two main data sources – the 2000 population census and the 2005 "mini-census" based on a 1% sample survey – showed contradictory trends. But in December 2009, the international division of the US Census Bureau, which has closely studied China's demographic data for years, published a revised estimate of China's age structure that tries to reconcile the contradictions in the underlying data. This estimate shows that the labor force entry population, which we define as people between the ages of 15 and 24, ranged from 200m-230m from 1994 onwards, with a sharp increase in 2000-05. But it has now peaked, and will fall from 227m in 2010 to 150m in 2024 – a drop of 34% in 14 years. A narrower labor-force entry age group, those between 15-19 years old, peaked in 2005 at 125m and will bottom out at 74m in 2021, a fall of over 40%.*




**Older and costlier**

This is a momentous change: for years, businesses have simply assumed that China has an unlimited supply of young people who can be had for modest wages and replaced at will. Over the next 15 years this will cease to be the case: businesses will have to pay more for entry level workers, and then work harder to retain them for longer, because they will not be so easy to replace.

It is important to understand precisely what this shift does and does not mean. It does *not* mean that China's total labor supply is shrinking or that China faces a labor "shortage." Quite the contrary: the total working age population (defined as people aged 15-64) will continue to rise until around 2015, when it will peak just shy of 1 bn. After that it will decline quite slowly; in 2025 the working-age population will be about as big as it is today. Moreover, the *labor force* (ie, people actually at work) can continue to rise even if the *working age population* is stagnant, because of greater labor-force participation. Scope for gains here is significant: according to a recent analysis by Cai and two colleagues, 69% of the population aged 45-54 is at work, but only 23% of those aged 55-64.**




What the shift *does* mean is that in future China's labor force will be older, less mobile and more costly (relative to productivity) than it is today. As recently as 2005 nearly a quarter of the working-age population was of entry-level age; by 2025 that share will fall to 15%. Conversely, the pro-

*Detailed data can be found at www.census.gov/ipc/www/idb/

**Albert Park, Cai Fang and Du Yang, "Can China meet her employment challenges?", Table 2. Available at www.economics.ox.ac.uk/members/albert.park/papers/employ.pdf

portion of late-career workers (aged 50 and above) will rise from 20% in 2005 to a full one-third of the working age population in 2025.

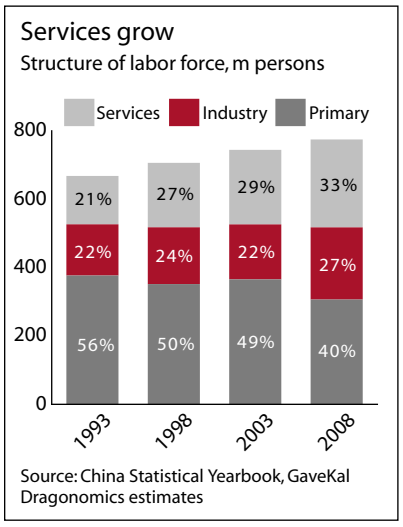
An older work force will be less mobile

An older work force will be less mobile, because young people are more willing to move. Cai and his colleagues found that rural people aged 17-20 had migration rates of over 20%, falling to 15% for people in their 20s. Over age 35 the average migration rate is less than 10%. And although we do not have the data to prove it, it seems likely that people in their teens and early 20s are more willing to move great distances and put up with cramped living conditions in company dormitories; older workers will move shorter distances, and demand more spacious housing to accommodate their families. In general, as the urban work force ages it will require a more comprehensive urban lifestyle, with better housing and access to a wider range of social services ranging from children's education, health care, leisure activities and ultimately pensions. This work force will be more costly to employers, who will have to pay a higher wage premium to get people to move (or to attract increasingly scarce young people), and who will have to work harder to retain workers. It will also be more costly to government, which will need to invest far more in affordable housing and social services for an older, more settled urban population than it needed to for the young, risk-taking migrants of the past two decades.

**Labor-hungry industry**

So the supply of new workers is likely to shrink. What about demand? Here we enter more speculative territory, thanks to data inadequacies. But we can reach some broad conclusions with fair confidence. First, the sources of labor demand became increasingly diversified in recent years. In the late 1990s, the urban private sector was virtually the only source of net labor demand, as state-owned enterprise restructuring saw the laying-off of millions of industrial workers, rural industry atrophied, and falling real agricultural prices forced many farmers off their land. But beginning in the early 2000s this picture changed. Demand for labor in rural industry strengthened, in part because of the emphasis placed by the Hu Jintao/Wen Jiabao administration on developing non-agricultural activities in rural areas. A related development was a big increase in farm incomes thanks to higher agricultural prices and pro-farmer policies such as the abolition of agricultural taxes. This rise in farm incomes probably adds to the wage premium urban employers must pay to encourage workers to migrate away from the farm. And by 2005 the urban state sector once again became a net contributor to employment demand, although the urban private sector still creates about three times as many new jobs each year as the state sector.

Second, for all the talk of China's under-developed service sector, services have in fact been the biggest and most consistent net job creator since the early 1990s: the service sector's share of total employment rose from 21% in 1993 to 33% in 2008. During the same period, industry's share of jobs rose from 22% to 27% (it fell during the restructuring of state-owned




*Park, Cai and Du, Table 5.

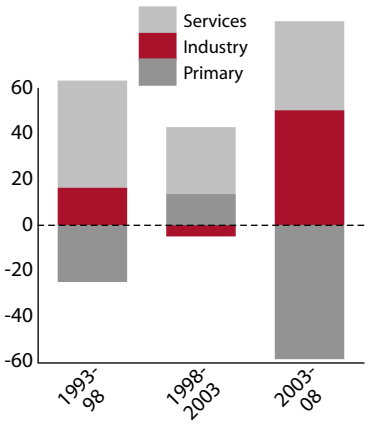
industry in the late 1990s, but then rose sharply in recent years). While this finding is almost certainly true in broad terms, it is subject to a couple of important qualifications.

For one thing, much of the increase in service sector employment was concentrated in very low productivity areas. Restaurants and retail shops with far more staff than customers are a common sight throughout China; and a large chunk of recent employment gains almost certainly occurred in state-owned oligopoly companies in banking, insurance and telecoms services. Employment gains of this type produce little economic growth and are not sustainable in the long run. The policy implication is that sustained employment growth in services is only likely if these state-dominated oligopoly sectors are deregulated. This will initially create some job losses, but – just as with the downsizing of the state-owned industrial sector in 1998-2003 – the subsequent labor demand from more efficient, competitive and dynamic private companies will likely outweigh those losses.

Another crucial point is that in the 2003-08 period, industry was by far the biggest engine of job growth, creating 50m net new positions compared to just 39m in services. True industrial job growth may have been even greater, because the scale of rural industry is probably understated in official employment statistics. This tremendous surge in industrial employment helps explain a crucial imbalance in China's economy: the decline in the labor share of national income, which led to a relative decline in the consumption power of households. So we now turn our attention to the vexed question of why China consumes so little, and saves so much.

Resurgent industry

Contribution to employment growth, m



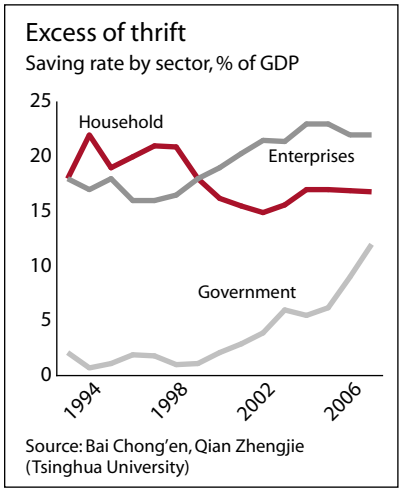

Source: China Statistical Yearbook, GaveKal Dragonomics estimates

## The cities keep growing

If the supply of young, migration-ready workers is about to plummet, must the rate of rural-to-urban migration also slow? The question is crucial: urbanization is often invoked as one of the main drivers of Chinese economic growth. If the pace of urbanization slows, then growth must also slow. But in reality, the supply of young labor and the rate of urbanization are independent variables. We do not believe that the decline in the labor force entry population will cause a serious slowdown in the urbanization rate. China's urban population will rise from about 50% of the national total today to near 70% in 2030. Only then will the urbanization rate slow substantially.

There are two main reasons for this prediction. First, the decline in the supply of potential migrants does not mean that the actual number of migrants each year will necessarily fall: it simply means that employers will need to pay more to get those migrants. If employers are truly incapable of paying higher wages, then there will be fewer migrants. But as we show in the next section, Chinese wages have grown far slower than labor productivity, and unit labor costs remain well below those in many other developing countries. Employers have plenty of scope to raise wages and remain profitable.

Second, the urbanization that has already occurred is only partial. Tens of millions of migrant workers live in factory dormitories and have virtually no access to urban social services. Eventually they will need to graduate from their second-class citizen status and move into proper flats and enjoy the full range of urban amenities. So the full economic impact of urbanization – in terms of demand for housing, infrastructure and social services – has not been fully realized. A final point is that urbanization occurs partly through migration, but also through the expansion of urban areas into previously rural communities. While this process will slow because of central government efforts to restrict local-government land grabs, it will remain a significant mechanism of urban growth.




**II. Consumption: it's all about income**

The central "imbalance" in China's economy is an excess of thrift. While it is important for a developing country to have a high national saving rate to finance large-scale investment in industry and infrastructure, China has taken this rule to an extreme: it saves and invests too much, and consumes too little of what it produces. In their intensive development eras, Japan, South Korea and Taiwan enjoyed peak national saving ratios of 35-38% of GDP. China maintained a similar saving rate in the 1990s and early 2000s, but after 2003 the saving rate soared, reaching 52% of GDP in 2009. This enabled China to finance investments totaling 47% of GDP, ten points higher than the peak ratios in earlier East Asian economies. We believe that these absolute numbers are exaggerated, thanks to the chronic inability of the Chinese statistical system accurately to count consumption of services. But the trend of rapidly rising national saving and investment, to levels that are almost certainly unsustainable, cannot be denied.

The question of why China saves so much has sparked much debate among economists. As reflected in our survey of this question in the December 2009 *CEQ* ("Saving debate," pp 25-38), some believe the rising saving rate reflects an increased tendency of households to save, because of an ever-more patchy social safety net, or for life-cycle reasons. Others argue that the main contributors to national saving have been ever more profitable companies and a parsimonious government.

Those readers who managed to stay awake through the saving debate article in the last issue know that the debate boils down to an argument about how to interpret the "flow of funds" data in the national accounts, which track the sources of income in the whole economy. These data are of questionable quality, frequently revised, and hard to square with other economic statistics. Happily, recent careful work by two economists at Tsinghua University, Bai Chong'en and Qian Zhengjie, resolves many of these difficulties and makes clear that virtually all of the increase in China's national saving since 2000 has been in the corporate and government sector. Bai and Qian reconciled national data with much more detailed provincial data, and found that the corporate saving rate rose from 16% of GDP in 1997 to 23% in 2004, after which it remained roughly constant. Government saving (much of which represents investments in infrastructure) exploded from 4% of GDP in 2002 to 12% in 2007. Household saving remained roughly constant at 15-17% of GDP during the whole 2000-07 period. And over that period, households tended to save a constant share of their income, a bit over one-quarter.

**Wages rise, but not fast enough**

From 2000 to 2008, household consumption's share of GDP dropped from 46% to 35%

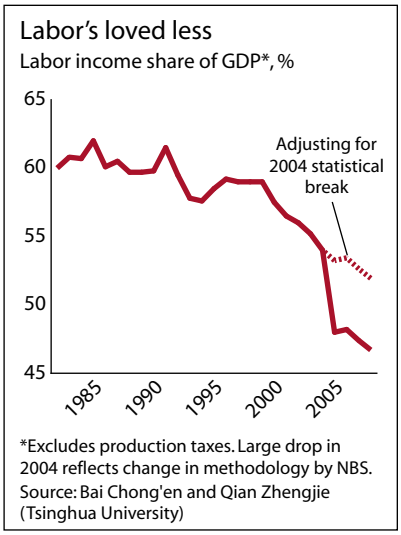
So household saving was roughly constant both as a share of GDP and of household income. But household *consumption* plummeted, from 46% of GDP in 2000 to 35% in 2008. If household saving is constant, but the household consumption share of GDP is falling, the only possible explanation is that household *income*'s share of GDP is falling. And this is precisely what Bai and Qian found: by analyzing national and provincial data they

estimate that the labor income share of GDP fell by 7 percentage points from 1997 to 2007. Households' non-wage income also stagnated during that period, since for most families the main source of outside income is interest on bank deposits. With interest rates at rock-bottom levels for most of that period, families earned little from their financial assets.

Again, it is important to be clear about what these findings do and do not mean. They do *not* mean that Chinese wages are falling. Chinese wages grew rapidly – but not as rapidly as GDP. Official wage data clearly overstate the level and growth rates in wages, but the drop in labor income share found by Bai and Qian is consistent with annual real wage growth of 8% from 1997 to 2007, compared to average real GDP growth of nearly 10%. This rate of wage growth is roughly corroborated by detailed studies of Chinese manufacturing wages.

So the picture is clear: since the mid 1990s, Chinese wages have grown fast, but not as fast as GDP. As a result, household incomes – which are mainly a function of wages – grew slower than GDP. Consequently, household consumption's share of GDP also fell, even though households were not saving any more of their income. So if the government wants to boost the consumption share of the economy, it must try to boost the *labor income share* of GDP. In order to do so it must first understand why the labor income share fell so sharply in the first place.

Bai and Qian's answer to that question is straightforward. About two-thirds of the drop in the labor income share can be explained by the economy's structural shift from agriculture, where the labor income share is around 90%, to industry, where the labor income share is typically less than 50%. This is borne out by our analysis in the previous section, which showed that industry was by far the biggest contributor to employment growth in 2003-08. Most of the remaining fall in the labor income share can be explained by a fall in the labor share *within industry*, mainly thanks to the restructuring of the state-owned enterprise sector in 1997-2003, which resulted in the layoffs of many workers, large new capital investments, and the setting of wage rates more in line with productivity growth. Moreover, the consolidation of state-owned oligopolies in many industrial sectors meant that monopoly rents increased – and virtually all the reward of such rents goes to the owners of capital, not to labor.

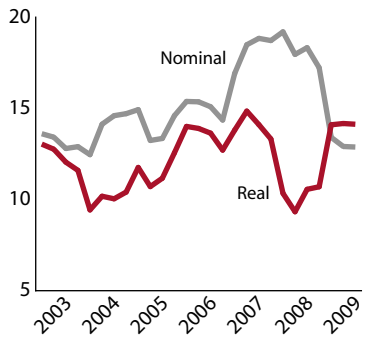



**Bust the trusts**

The policy implications of Bai and Qian's research are clear. To increase labor income's share of GDP, and household incomes more generally, they recommend vigorous development of service industries, in which the labor income share is typically 50%-60% – higher than in industry. Deregulation in both service and industrial sectors aimed at breaking down state-owned monopoly or oligopoly positions will reduce the rents that accrue to the owners of capital, increase labor demand, and boost the share of GDP that flows into household bank accounts. Bai and Qian also found that the labor income share is higher in provinces that are more open to foreign trade – probably because labor demand is stronger, and fiercer

To increase labor income's share of GDP, service industries must be boosted vigorously

Good paydays
Urban wages, % yoy change




Source: CEIC, GaveKal Dragonomics estimates

competition diminishes monopoly rents. So efforts to increase trade and foreign investment, especially in interior provinces, will also help.

These policies are necessary and desirable; the big question is whether a government increasingly beholden to big state enterprises and crony-capitalist tycoons can muster the political resources to push them through. The good news, however, is that just as the labor market helped depress the labor income share of GDP over the past 15 years, it will probably boost the labor income share over the next 15 years.

There can be almost no doubt that the sheer abundance of labor in the past two decades, which made it impossible for workers to bargain for a wage that matched the huge productivity growth being generated in industry, played a crucial supporting role to the processes described by Bai and Qian. But as labor becomes more scarce, wages will have to be bid up until they match or exceed the rate of productivity growth. Once wages grow faster than productivity, the labor income share of GDP will start to grow, and household consumption will begin to assume its rightful place as the main motor of the Chinese economy. But the other consequence of wage growth in excess of productivity growth is more inflation. To manage the transition to a consumption-led economy, the government will need to get comfortable with a higher inflation rate than it has tolerated in the past.

## The wage conundrum

What are Chinese wages and how fast are they growing? The answer is that we do not know. The government publishes a quarterly series on urban wages, which shows that they grew at an average rate of 12% in inflation-adjusted terms from 2003 through 2009. The average urban wage for 2008 (the last year for which complete data are available) was a healthy Rmb29,400, or US$4,300 a year. But both the true wage level, and wage growth, are lower than official numbers indicate.

The basic problem with the wage survey is that it counts only a fraction of urban workers in China – 121m in 2008, only 40% of the reported urban work force of 302m. Coverage is disproportionately in the state sector, where wages tend to be higher than in the private sector. The National Bureau of Statistics (NBS) is aware of the problem and recently announced that from this year, its surveys will expand to cover much of the private sector, capturing around 190m workers. A baseline survey found that the average annual wage in the private sector in 2008 was Rmb17,100 – 42% lower than the published average wage for that year. NBS reckons that in its new coverage, the average urban wage will be about 15% lower than in the old series. But even this number is probably too high, because the survey still leaves out around 100m workers in the informal private sector, where wages are lowest.

It impossible to know for sure whether wages in the private sector have grown faster or slower than in the state sector. But a wealth of evidence suggests that wage growth has consistently lagged productivity. Several studies, notably by American research firm The Conference Board and the OECD, found that for much of the past decade productivity in Chinese manufacturing grew by 20% or more a year – well above the rate of reported growth for both real and nominal wages.

The most detailed study of Chinese labor cost* found that unit labor cost in Chinese manufacturing (inclusive of wages, social welfare contributions, housing and other benefits) rose from Rmb4.73 in 2002 to Rmb6.43 in 2006, for an average nominal growth rate of 8%. Labor cost in urban manufacturing units was more than twice as high as those in rural units to begin with, and grew almost twice as fast on average – 11% a year vs 6%. In US dollar terms, Chinese average unit labor cost was 81 US cents an hour in 2006, 3% of the US level of US$30 an hour, and well below the average for the Philippines and Mexico. Wages can grow rapidly for a long time before the competitiveness of Chinese manufacturers is harmed.

*Erin Lett and Judith Banister, "China's manufacturing employment and compensation costs, 2002-06," *Monthly Labor Review* (April 2009)

### III. Learning to live with inflation

Labor costs will rise much faster in this decade than the last one

The gist of our argument so far is that labor is about to become quite a bit scarcer, which means that wage costs will rise much faster in the next decade than they did in the last one. For the most part this is a good thing, because faster wage growth will push up household incomes and aid the rebalancing of the economy from investment-led to consumption-led growth. The fly in the ointment is that faster wage and consumption growth will almost certainly mean more inflation, of whose socially destabilizing consequences the government has long been skittish. It is right to be prudent on this score: sustained high inflation contributed to political unrest in China in the late 1980s, and in an earlier era severely damaged Latin American economies. But it is also important to recognize that the extremely low inflation rate in China since the mid-1990s was abnormal by the standards of successful developing countries in East Asia. If Beijing is serious about rebalancing its economy toward consumption, it must also learn to live with higher inflation.

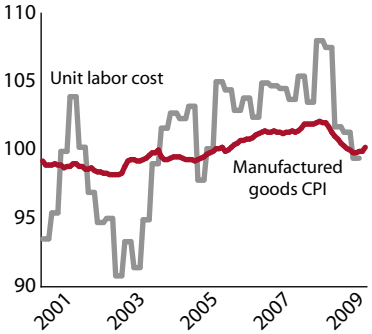
The dynamics of this higher inflation are straightforward. Since the mid-1990s, wages grew at a rate slower than productivity growth. The result was that the economy's ability to produce grew faster than its ability to consume, meaning that domestic inflationary pressure was virtually non-existent, and the excess production had to be exported – creating an ever-greater trade surplus. We expect that over the next decade, wages will start to grow faster than productivity. As a result, the economy's ability to consume will grow faster than its production capacity, and the consumption share of GDP will rise – along with inflation. In fact, evidence of this trend is already established.

#### The start of cost-push

The first piece of evidence is the World Bank estimate of unit labor cost in manufacturing, which we correlate with our estimate of the consumer price index (CPI) for manufactured goods (see chart, "Pricier widgets"). The trend of the rather volatile unit labor cost series lines up reasonably well with an upward trend in the CPI for manufactured goods. The inflationary impact is not enormous. As annual growth in unit labor cost went from -4% in early 2003 to +8% in early 2008, manufactured-goods CPI rose from -2% to +2% in early 2008. This suggests two conclusions. First, less than half of the change in unit labor cost finds its way into final goods prices, meaning that Chinese manufacturers are adept at countering higher labor costs with efficiencies in other areas. The government therefore should resist claims by industry that higher wages will erode their competitiveness. As this survey makes clear, abundant evidence suggests that wages can rise a lot without fundamentally damaging the competitiveness of Chinese industry.

Pricier widgets

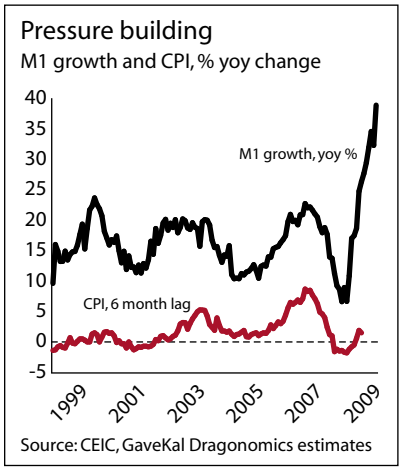
Unit labor cost and CPI for manufactured goods, py = 100




Source: World Bank, GaveKal Dragonomics estimates

Second, however, the four-point swing in manufactured-goods CPI between 2003 and 2008 indicates that the trend rate for overall CPI may well have risen from 1% or less in the early part of the decade to around 5% today. The immediate concern is that if trend or underlying inflation

is in the 4-5% range, the vast monetary infusion of 2009 (when credit grew by more than 30%) risks sparking a much more severe inflationary outbreak in 2010 than the 3-4% average rate that most government economists predict.




More evidence of increased underlying inflationary pressure comes from the correlation between growth in the M1 monetary aggregate and CPI, which tends to follow M1 with a six-month lag. Between 2001 and 2007 M1 growth experienced three peaks, each of about the same magnitude – 20-23%. Each M1 peak was followed by a CPI peak – but each CPI peak was higher than the one before. The CPI peaked at 2% in 2001, 5% in 2004 and nearly 9% in 2008. This strongly suggests that, before the global financial crisis intervened in late 2008, the inflationary impact of a given monetary impulse was gradually getting stronger. This lines up very well with the labor cost data, and it also suggests that the inflationary risk in 2010 is higher than the government is letting on. The short-term inflationary problem, if it occurs, can be solved by credit tightening. The bigger question is, should the government be scared of the trend towards higher underlying inflation?

**Getting the balance right**

We believe not. If inflation arises from incontinent monetary policy, reckless fiscal expansion and rigid labor markets that make it impossible for wages to fall during recessions, then it is indeed dangerous. But if inflation arises from rapid wage growth generated by big productivity gains in a flexible labor market, then it amounts to a perfectly normal and healthy adjustment of the real exchange rate. Abundant experience from the high-growth economies of East Asia suggests that non-accelerating inflation of this type is compatible with sustained and healthy economic growth over long periods of time. Both Japan and South Korea enjoyed stretches of around 15 years during which GDP growth averaged 8-9% and consumer price inflation averaged 5-6%. Inflation peaks were around 11-13% and did not last long.

China's inflation rate over the last 13 years has been abnormally low

The extraordinary thing is not moderate inflation in a fast-growing developing economy, it is China's ability to avoid inflation for so long. From 1997 to 2009, GDP growth averaged 9.6% but CPI inflation averaged just 1.3%. There is no reason for anxiety over the fact that China is becoming a normal developing East Asian country in which moderate inflation accompanies fast growth. The risk is that Chinese leaders may have deluded themselves into thinking that the extremely abnormal performance of the past 13 years is normal, and believe that policy should aim to maintain these strange conditions. This would be a sure recipe for overheating (because of a too-high growth target) or over-investment and artificial suppression of wages and consumption (because of a too-low inflation target).

Beijing therefore faces a two-fold task as it confronts the imminent reality of higher wage pressure resulting from a more constrained labor supply. First, it must re-adjust the main macroeconomic parameters, and accept

## China becomes normal

GDP growth and CPI in Asian economies, % yoy change

| | Japan 1960-72 | South Korea 1982-96 | China 1997-2009 | China 2010-20f |
|---|---|---|---|---|
| Avg GDP | 8.9 | 8.5 | 9.6 | 8.0 |
| Avg CPI | 5.6 | 5.2 | 1.3 | 4.5 |
| Max CPI | 13.1 | 11.1 | 4.8 | 10.0 |
| Min CPI | 3.6 | 2.3 | -1.5 | 2.0 |

Source: IMF, ADB, GaveKal Dragonomics estimates

a somewhat lower GDP growth rate, and a somewhat higher inflation rate, than in the past decade. This re-adjustment – particularly to a lower GDP growth target – will be painful. China can tolerate more inflation than its leaders now think, but probably less inflation than Japan and South Korea experienced in their high-growth eras. It is a bigger, more fractious country with a less secure social contract and greater income inequality, and its decentralization means monetary discipline is harder to maintain. Less inflation also means a bit less growth. Eight percent GDP growth—which the government now considers a floor—should be seen as a desirable *average*, meaning that authorities should not panic if it dips down to 6% or so for a year or two.

**What is to be done?**

Policies must be put in place to dampen inflationary expectations

The other task is to put in place policies to control inflationary expectations, so that moderate, healthy, productivity-driven wage inflation does not spiral out of control. One method (employed successfully in China in the early- to mid-1990s) is to index deposit interest rates to inflation. This will assure households that the real value of their savings will not be eroded, and encourage them to keep their money in the bank. Another set of measures relates to the property market. One reason why Chinese house prices are so high is that people use investments in housing as a store of wealth and inflation hedge. In other words, inflationary pressure is now expressed not so much in rising consumption and goods prices as in increased housing prices, which require a high rate of saving (since people need to fund down payments on ever more expensive properties). Consumption-driven goods inflation is far preferable to asset-price inflation, because ultimately consumption is a function of productivity-driven wage growth, whereas asset prices reflect not actual income growth but a bet on perceived scarcity value. A tax on property values, now under discussion, would increase holding costs for property investors, reduce speculative property investment, bring down housing prices and reduce the need for precautionary saving. Greater public investment in low-cost housing could aid this process.

Financial sector reform is also a must. If interest rates rise in response to inflation, capital will be more expensive; it is therefore necessary for investment to become more efficient and deliver a higher return per dollar invested. Simply raising the price of capital is not enough: one also needs institutional channels, notably bond and stock markets, that will direct capital to those who will use it most effectively. A related set of fis-

cal reform policies must also be enacted to reduce the incentives for local governments to invest wastefully in excess industrial capacity and over-the-top infrastructure. (The final installment of this series, in June, will examine the full range of necessary financial and fiscal reforms.)

### Exchange rate policy needs to become more flexible

Finally, a more flexible exchange rate needs to play a role, though just how big a role is open to question. Outside analysts tend to focus on the exchange rate as the solution to all of China's ills, particularly the high saving rate that leads to a big trade surplus. The problem is that the most thorough study of the historical record provides no evidence that a higher exchange rate, on its own, reduces current account surpluses.* In China's case, this makes perfect sense. As this survey has shown, the high national saving rate and low rate of household consumption result from a complex interaction of factors in the domestic economy. If none of the domestic imbalances is resolved, but the exchange rate appreciates, the main consequence is that Chinese industry will become less competitive. It is a pleasant fantasy, but a fantasy nonetheless, that exchange-rate appreciation will somehow cause all of the necessary domestic reforms to occur.

### Higher inflation may be scary, but it is China's best choice for the coming decade

Rebalancing of both the domestic and external sectors of the Chinese economy is more likely to occur if the government allows some wage-driven inflation to run through the economy, supports household incomes through more active social welfare spending, allows interest rates to rise, adjusts tax policy to discourage asset-price bubbles, reforms the financial sector to improve the efficiency of capital allocation, and accepts a slightly lower trend GDP growth rate. In the context of these policies, exchange rate appreciation can help, by increasing the incentive for investment in service industries whose competitiveness is not damaged by a rising exchange rate, and by acting as a pressure valve when inflation rises. But this is a supporting role, not a starring one. If China's prices need to rise – and they must – then it is probably better for them to rise through sensibly managed inflation than through a big exchange rate appreciation, which risks causing massive asset bubbles as in Japan in the late 1980s. Higher inflation is understandably a bit scary, but it is probably the best choice for China in the coming decade.

*Menzie Chinn and Shang-jin Wei, "A Faith-based initiative: does a flexible exchange rate really facilitate current account adjustment?" NBER Working Paper no. W14420 (October 2008). Available at www.ssc.wisc.edu/~mchinn/chinn_wei_ca.pdf