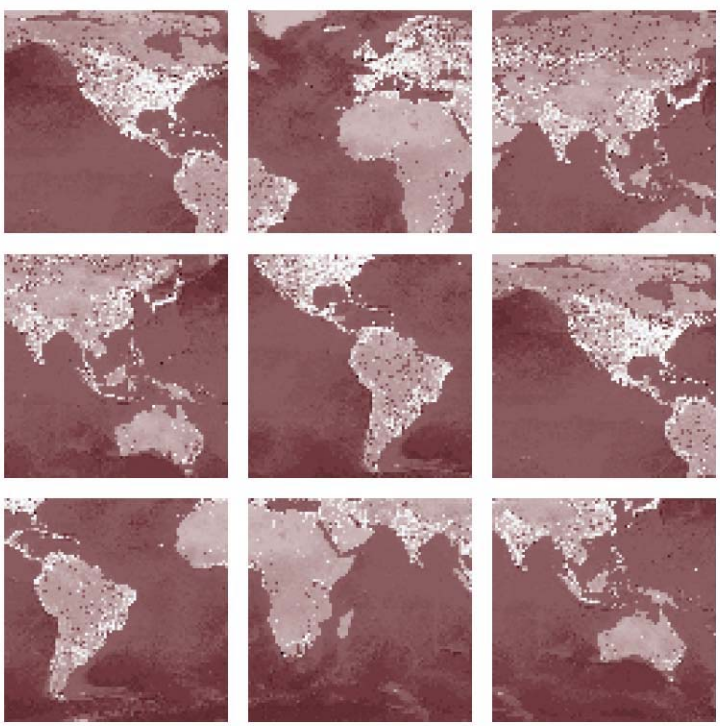
CHAPTER NINETEEN

GLOBALISATION AND DISINFLATION: CAN ANYONE ELSE 'DO A CHINA'?

October 2006



GLOBALISATION AND DISINFLATION: CAN ANYONE ELSE 'DO A CHINA'?

Inflation 'Discount' Thanks to China

After many years of positive surprises, inflation has crept higher in the US and globally over the past year, perhaps finally reflecting years of abundant global liquidity, a sharp increase in commodity prices and generally strong global growth. Until this year, inflation had remained lower than most traditional models had predicted, and consensus forecasts for inflation have been consistently higher than actual inflation over the past decade.

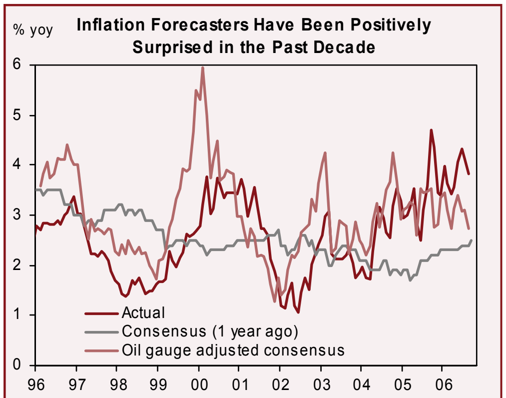
Is our luck running out? Indeed, why have we been so lucky? The happy coincidence of strong growth with low inflation that we have enjoyed until now was the result of a number of factors, including a move towards inflation targeting and the associated greater credibility of central banks across many countries.

But we believe other factors have contributed. We suspect that China has played a critical role in how globalisation has evolved economically, and that this could explain why inflation has, until recently, remained so tame. As a result of the strength of China's own economy, inflation is now rising there. If this cyclical tendency persists, it could reverse the global inflation 'discount' that China has helped create. The structural dynamics will probably allow China to continue to offer disinflationary benefits to the world, so long as the world can tolerate them.

We also think there is scope for the other BRICs and the 'Next 11' (N-11) to 'do a China' and generate another source of disinflationary pressure. Encouraged by China's success, some of these countries may take on a more active role in the global economy. India has the potential to do this, but the other BRICs and the N-11 could only duplicate the impact of China on a collective basis—not alone. Indeed, China itself may still have the best potential to give a repeat performance. In our view, the globalisation process is still in its early days, and it may help central banks in their efforts to keep inflation low and stable for a long time to come.

Inflation lower than expected—until now

For much of the past decade, inflation has repeatedly come in below market expectations. While not a universal phenomenon, this has occurred in many important regions. China and Japan have frequently experienced mild deflation, while US policymakers also feared the risk of deflation in 2001-2002. In Europe, flirtation with lower-than-expected inflation has been an issue for the likes of Norway, Sweden and Switzerland, although not yet for the Eurozone. Forecasters have also been surprised by recurring instances of lower-than-expected inflation.



Source: Consensus Economics, Haver, GS calculations

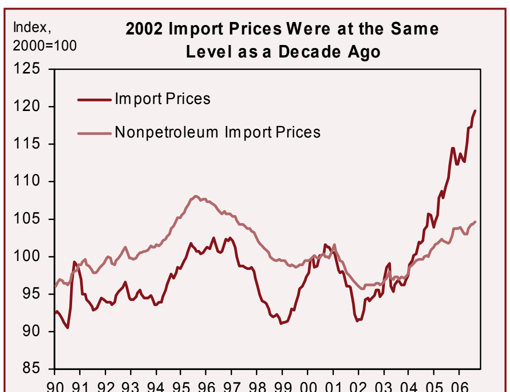
While it is difficult to obtain a history of consensus forecasts for core inflation, there is some evidence that forecasters have been positively surprised. We estimate that, adjusted for oil prices (which have in recent years repeatedly surprised on the upside), core CPI was around 0.5% (on average) below consensus forecasts in the past decade. We derived this conclusion by adjusting forecast CPI outcomes by the ‘surprise’ in oil price forecasts, i.e., the difference between oil price outcomes and the oil price ‘forward’ curve in the markets.

Why has inflation been so low? Most studies have concluded that, at its root, the key has been successful monetary policy under credible inflation-targeting regimes or broader, credible inflation-fighting central banks. Studies by the IMF and the OECD have failed to detect any major evidence that globalisation has been critical to the level of inflation, although the BIS says that the theoretical case for the influence of globalisation should ‘not be underestimated’.

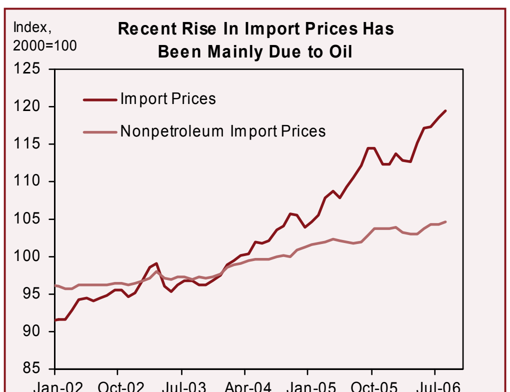
Much recent research understandably examines the trends in import prices in developed countries as the primary means of measuring the impact of globalisation, and it is here that many fail to find significant evidence of a dramatic impact. This seems a little surprising given trends in import prices. Consider the US, for example: in 2002, import prices overall were at the same level as a decade before. Since 2002, import prices have risen (possibly in line with Asian export prices, as we will discuss later), but the increase is very modest, and in the main due to oil prices. Non-oil import prices are today only 9% above where they were in 2002, despite a notable decline in the trade-weighted value of the Dollar and rising commodity prices. US import prices from China remain remarkably subdued. A generally similar pattern to that of the US experience can be seen in most other developed economies.

One of the reasons why inflation has been lower than expected may lie beyond the behaviour of import prices, and this could explain why many researchers have found no material sign of the impact of globalisation from this source. Federal Reserve Deputy Chairman Don Kohn has laid out three potential channels for the possible impact of globalisation on inflation: import prices, labour competition and productivity.

In both the US and Eurozone, simple econometric models (used to explain the rate of wage inflation) have recently under-predicted the level of wage inflation. Competition from overseas, and from China in particular, was quite likely responsible, as we shall discuss. BIS research cites evidence that relative wages have declined the most in industries that have shifted more of their production overseas from the advanced economies. This makes sense.



Source: BLS



Source: BLS

The story of Wal-Mart is a typical example and its role as a major importer of consumer goods to the US from China serves to emphasise the point.

As Kohn suggested, a third channel could perhaps be seen in improved productivity in developed economies. Interestingly, we have seen signs of enhanced productivity in recent years in each of the three largest economies. In the US, Japan and Germany, domestic factors persuaded us to become more optimistic, but the cause may have been global and, in some industries (and national cases), the 'threat of China' might have been a specific driver.

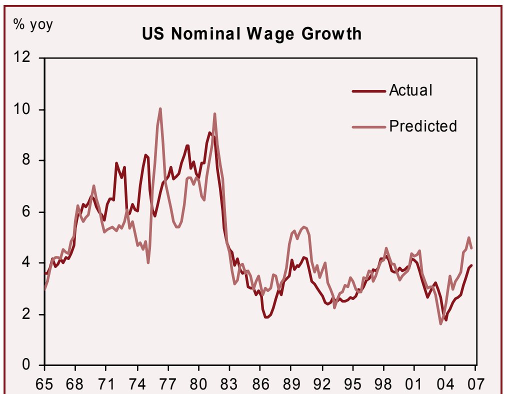
Globalisation and China Have Improved the Inflation and Growth Trade-Off

We think Don Kohn and the BIS are right. Sound theoretical reasons can explain why globalisation reduces global inflation (and at the same time raises the global trend real GDP growth rate). As Kohn argues, the transmission mechanism may involve import prices, wage competition and productivity.

The simple diagram on the next page can explain the globalisation impact on wages. We estimate that in 2000 the pan-Asian (ex-India) 'global' labour force was around 275mn (perhaps equivalent to curve S1). As discussed in the next section, by 2005 urbanisation in China had boosted the part of its labour force in the 'global' market by 100mn, or more than 25%. This increase in 'the global labour force' shifted the supply curve from S1 to S2. As a result, the price of wages fell and output rose, consistent with much evidence for both heavy industrialised wage behaviour and global output.

There are many examples of this. In the past eight years, the level of US GDP has expanded by more than a quarter, yet median wages have fallen by 4%. In Korea, there was evidence of a secular rise in wages from the 1980s onwards, but this appears to have stopped. Not surprisingly, Korea is one of the countries whose trade share with China has risen most rapidly. In Japan, despite the economic recovery, wage growth remains surprisingly tepid. Interestingly, and contrary to the gloomy instincts of those who oppose globalisation in developed countries, full-time employment in Japan is now rising sharply.

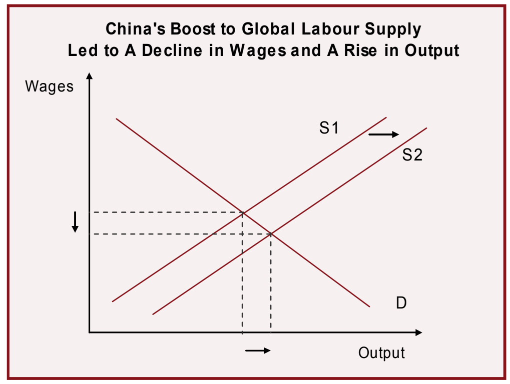
In line with weak wage growth, the profit share of GDP has risen in many developed countries. One of the consequences is that companies are more likely to invest. We can observe evidence of this today in some of the 'older' economies, such as Germany and Japan.



Source: Department of Labor, GS calculations

Source: Eurostat, GS estimates

Improving capex intentions and optimism in business surveys are more pronounced than they have been in either nation for much of the last decade, and the improved efficiency of capital (i.e., higher profits) is at the heart of why we have become more optimistic about the long-term real growth trend in both nations.



If employees in industries can be encouraged to accept compensation schemes linked to productivity growth, it is not necessarily the case that their earnings will be persistently diminished by globalisation—only their wage rates, or fixed compensation.

An increase in productivity growth may also contribute significantly to containing inflation. This could occur in two ways:

- Higher productivity growth initially leads to lower inflation as real wages lag behind increases in productivity.
- Higher productivity may also exert disinflationary pressure by lowering the natural rate of unemployment, i.e., NAIRU.

If real wage gains are proportionate to the tightness of the labour market, then higher productivity should allow an economy to operate at a lower unemployment rate without generating inflation pressure. This second channel will persist as long as the central bank keeps the actual unemployment rate above the now-lowered NAIRU.

The China shock and globalisation

The way in which China has evolved in line with globalisation, and the duration of this process, will be important in determining whether the disinflationary impulse from globalisation is likely to persist, or whether it is nearing an end.

As we discussed earlier, we think there are compelling reasons to believe that the positive surprise of lower-than-expected inflation since the early 1990s is linked to the rapid integration of China into the global trading system. Owing to the sheer size of its population and economy, structural changes in China have taken on 'mega-trend' proportions. As such, their impact has rippled beyond China's borders, far beyond any comparable advances in urbanisation and industrialisation in the past.

In particular, the emergence of China has had a greater impact on the world economy than the industrialisation of Japan after World War II and the Asian Tigers after the 1960s. Japan's role in the world grew dramatically from the 1950s—its share of global exports more than doubled to around 8.5%. This is impressive. But in just the last 10 years, China has almost fully matched the entire increase in exports that we saw over 30 years in Japan! In addition, China's share of global GDP is set to grow significantly faster than Japan's did during its heyday.

The Asian Tigers come closer to matching China's startling export performance, but nonetheless were slower in expanding export share than China over the last decade, and remain far smaller in terms of GDP.

Three 'mega-trends' in China

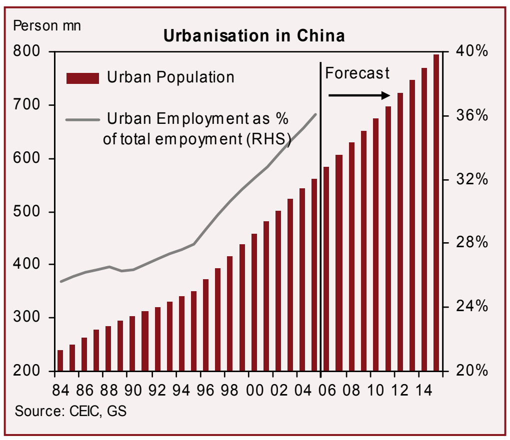
- **Urbanisation.** Urbanisation in China has picked up pace since the mid-1990s as the enforcement of restrictions on internal migration has been relaxed. In the past five years alone, the urban population cumulatively has risen by some 100mn, putting the urbanisation rate just above 40%. It is important to realise that this is still relatively low compared with other Asian countries at comparable levels of development. The government's strategy to spur the development of 'second-tier' cities suggests that urbanisation will remain a powerful trend. We estimate that over the next 10 years, China's urban population will rise approximately another 230mn, bringing the urbanisation rate to 57%.

- **Industrialisation.** As with its forerunners elsewhere in the world, urbanisation has helped fuel China's industrialisation. China's development is helped by the transition from a centrally-planned to a market-based economy, which has reduced the importance of the state-owned sector in the economy. The combination of urbanisation, industrialisation and economic reform has pushed China's cumulative per capita GDP growth since the onset of economic reform in 1978 above that of Japan and other Asian Tigers during the heyday of their own industrialisation processes.

- **Greater openness to trade and capital flows.** The impact of urbanisation and industrialisation has been more keenly felt as China has opened its door wider to the world. The share of exports in China's GDP rose from less than 10% in the mid-1980s to 34% in 2005. The export share in GDP grew by some 15 percentage points over just the last five years, which coincided with China's accession to WTO and the huge rise in FDI inflows. Exports have risen threefold since 2000 to $762bn. By 2004, China had displaced Japan—an economy twice as large at current market exchange rates—as the third-largest trading nation in the world, after Germany and the US.

These forces have all brought China into the global trading system in a dramatic way. Import prices have been generally soft in the major developed countries as a result of China's desire to export, as discussed earlier. Wages have been subdued as a result of the reduction in bargaining power of workers in developed countries, and in order for companies to thrive in this competitive world, productivity has risen. All of this suggests that China has played a key role in helping to contain inflation.

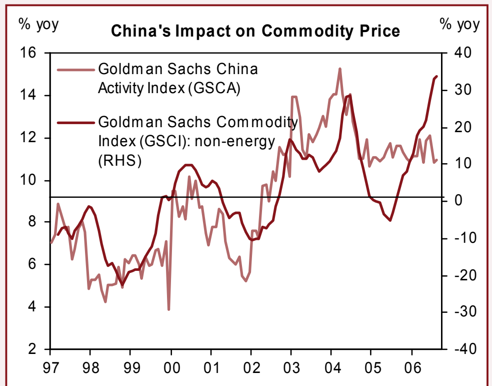
Source: CEIC, GS



Source: CEIC, GS

China and Global Commodity Prices

Although China is not a monopsonist in the commodities market, the country has emerged as an increasingly dominant consumer (and hence a source of marginal price shocks) in a widening array of commodities, from soybean and base metals to crude oil. Until recently, there has been a strikingly tight correlation in the past decade years between the Goldman Sachs China Activity Index—our preferred measure of China's economic growth—and the Goldman Sachs commodity price index, GSNE™.



Source: GS

The surge in global commodities prices since early 2002 coincides closely with the acceleration in China's economic growth. The policy tightening undertaken in early 2004 to combat overheating triggered an immediate and amplified downward drop in commodities prices. A strong recovery in commodities prices ensued, however, as growth in China stabilised at a lower, more sustainable pace. As can be seen in the chart, despite some leveling off in our GSCA estimate of current growth over the last year, commodity prices have continued to surge. In this light, perhaps the very recent decline in commodity prices is justifiable.

Cyclical versus structural forces

Since 2004, China's manufactured export prices have turned positive, as have non-oil import prices in the US, Japan and many other developed countries. The rise in Chinese manufactured prices follows the run-up in commodity prices, as well as the fact that China's unit labour costs have turned positive. Manufactured goods prices in China have also started to rise, as have broader consumer prices. With the economy operating with a positive output gap since 2003—i.e., GDP growth running above potential—manufacturers appear to have grown more comfortable passing on upstream cost pressure to final prices.

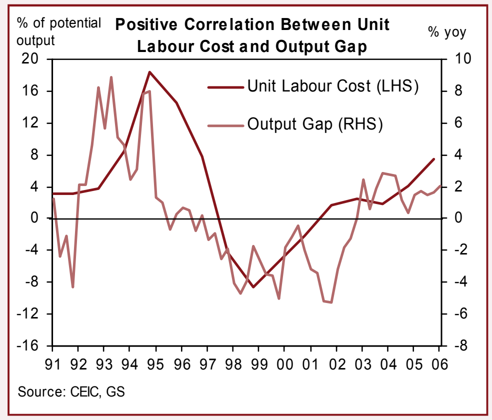
We expect the inflationary impulse in China to peak in late 2006 to early 2007 in response to a gradual tightening in financial conditions. As Chinese policymakers steer the economy back to a more sustainable, though still robust, 9%+ growth path, we expect both CPI and unit labour cost inflation to stabilise in 2007.

If this transpires, the underlying positive dynamics from China's 'mega-trends' may reassert themselves on global markets. If we are wrong and Chinese inflation continues to rise, the consequences for the rest of the world may be profound.

Can the Other BRICs and N-11 'Do a China'?

With signs of a pick-up in Chinese inflation, not surprisingly, markets seem anxious about whether the China effect is over. If China's disinflationary contribution comes to an end, who could assume its role? Could other large developing countries be capable of 'doing a China' in

Wage Pressures Have Risen



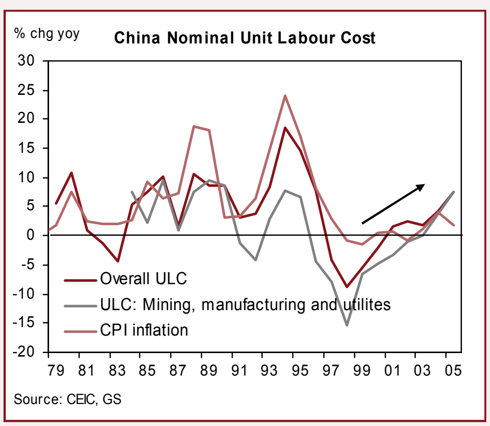
Source: CEIC, GS

With a population of 1.3bn, almost 60% of whom still live in rural areas, it is tempting to think that China has a virtually unlimited supply of labour. If this were the case, it would follow that China could not possibly face rising wage pressure or, more precisely, face rising unit labour costs, i.e., wages rising faster than productivity growth.

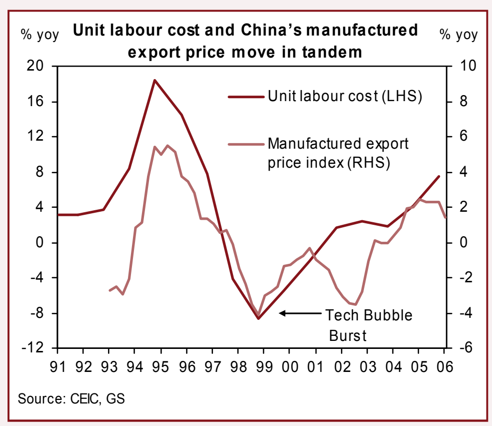
Just like any economy, China's has been subject to cyclical swings in inflation and unit labour costs—and large ones at that. As shown in the chart, unit labour costs have recently begun to rise. This is not the first time. In the late 1980s and the early 1990s, both CPI and labour costs rose. This was followed by a steep decline to outright deflation in the mid- to late-1990s. After a brief period of stability, unit labour costs have risen since 2003 and are now in positive territory compared with the early 1990s.

Our estimates of China's unit labour costs differ notably from others. It is plausible, given China's size, the variety of its labour force and the paucity of reliable data, that productivity is even stronger than we estimate, and that labour costs are not rising as quickly as we assume.

However, as can be seen, there is a close correlation between our estimates of China's output gap and unit labour costs. Our unit labour costs estimate also has a positive correlation with our estimate of China's manufactured export prices. In periods of declining unit labour costs, China's export price inflation has tended to fall (e.g., mid- to late-1990s). Recently, China's manufactured exports have begun to rise, after an extended period of deflation.



Source: CEIC, GS



Source: CEIC, GS

so far as they can open themselves up for FDI, boost trade, attract global industries as a result of any competitive advantage they may offer, and contribute to sustaining the last decade’s ‘golden era’ of rising trend growth and low inflation? Do others have the human capital, resources and ambition to do what China has done?

Among the BRICs, only India can match China on population

If you look at size alone, India is the only country that can match China. In fact, its far better demographics mean that population is likely to be bigger than China’s by 2030. Altogether, the populations of Brazil, Russia and India, as well as the N-11, amount to about 2.5bn, more than 1bn larger than China. In theory, if these countries all acted similarly at the same time, they could ‘do a China’. In reality, it is highly unlikely. Without India, Brazil and Russia, the combined population of the N-11 is slightly less than China’s, and they are a very diverse group geographically, culturally and socially.

In any case, as can be seen from their past growth performance and our GES scores, population is purely the foundation or minimum for high growth—not a guarantee.

Urbanisation and industrialisation: India’s potential is comparable to China’s

Probably of greater importance is the degree to which the population is urbanised and/or industrialised. In terms of future potential, arguably the bigger the population (and the lower the degree of urbanisation today), the better—because that means the potential is bigger.

Once again, India is the only country where the potential for urbanisation is anywhere near comparable to China. It is very difficult to find, in the future, an equivalent of the 200mn newly urbanised residents that China has seen over the past decade. Nor is it easy to find the 450mn that China might have produced looking back 20 years from 2016.

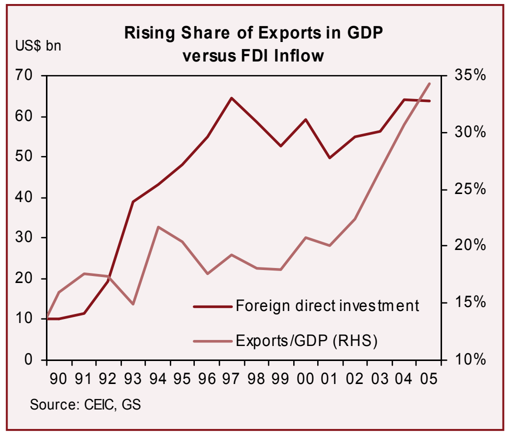
India alone could match China’s experience. It is currently less urbanised than China, at slightly less than 30%. If India’s urban population share were to reach 50% over the next 20 years, that would result in an additional 200mn people or more in cities. Given India’s strong demographics, India could probably match China within 30 years or so, if it chose to.

Urbanisation rates are already quite high in many of the N-11 countries. Only Bangladesh, Pakistan and Vietnam seem to have the scope for urban populations to rise significantly. These three, together with India, do have the potential to urbanise to a degree that would be ‘relevant’ in a Chinese economic context, and in theory therefore to replicate some of the remarkable developments that China has achieved. It is a tall order, though, especially given the complex and, in some cases diverse, nature of their societies.

BRICs and N-11 have scope to boost trade as a share of GDP

Conceptually, other countries could repeat China’s success in becoming a leading player in the global trading system. However, it is important to remember why China has had so much success in trade. This relates both to the speed of its urbanisation and its ability to attract large amounts of FDI.

Many of the other BRICs’ and N-11 countries’ share of global trade is so small compared with China’s that the scope for them to ‘do a China’ is insignificant. Of course, there is plenty for them to do in terms of boosting the share in global trade, but it is not clear that they have the leadership and policy inclination—nor whether the world has an 'appetite' for another China, given the rising strains in the developing world as it adapts to globalisation.



Hard to replicate China's success with FDI

Turning to FDI, the data yet again show what a remarkable job China has done. Replicating China's achievements would be very difficult. Attracting FDI usually involves giving up some domestic ownership of key companies and key industries. It is important for other BRIC and N-11 countries to embrace this attitude if they are to have any chance of 'doing a China'.

Brazil, Mexico and Russia are reasonably significant players already, in terms of global FDI flows. But India and the other N-11 are relatively insignificant. Even Korea, which scores so well in terms of our GES indicator, has had considerable difficulties embracing FDI. As with trade, India and many of the N-11 do have the scope to be significant players in attracting FDI, but the question arises as to whether their governments are prepared to enact the necessary policies.

The Importance of Policy Intentions in the BRICs and N-11

Of the other BRIC countries and the N-11, India alone is, conceptually, large enough to 'do a China' in terms of influencing the world, and is therefore critical to the general issues in this paper. To succeed in emulating China, India (and any other of the countries) would need to undertake strong reform measures.

Having witnessed China's remarkable achievements, India and a number of the other N-11 countries now appear more eager to embrace globalisation than in the past. If India especially, or any of the others, undertakes the necessary reforms to become attractive and competitive in the global market place—and if the rest of the world continues to support this process—then the disinflationary benefits to us all would be considerable for a long time to come.

Given the complexities that accompany global change (especially China's development and influence), protectionist forces remain a significant danger. Protectionism could lay the foundations for the reversal of the inflation discount of the past decade or longer. It would also limit the incentives for other countries to open their economies. In this regard, policies that help to foster further trade liberalisation, especially the WTO negotiations, are surely to be welcomed. The international community needs to support and encourage China, the other BRICs and the N-11. If this occurs, then we are all likely to benefit for a long time into the future from a repeat of the strong growth/low inflation environment experienced over the past decade.

Jim O'Neill, Sun Bae Kim and Mike Buchanan
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