TEXT 1 China's economy

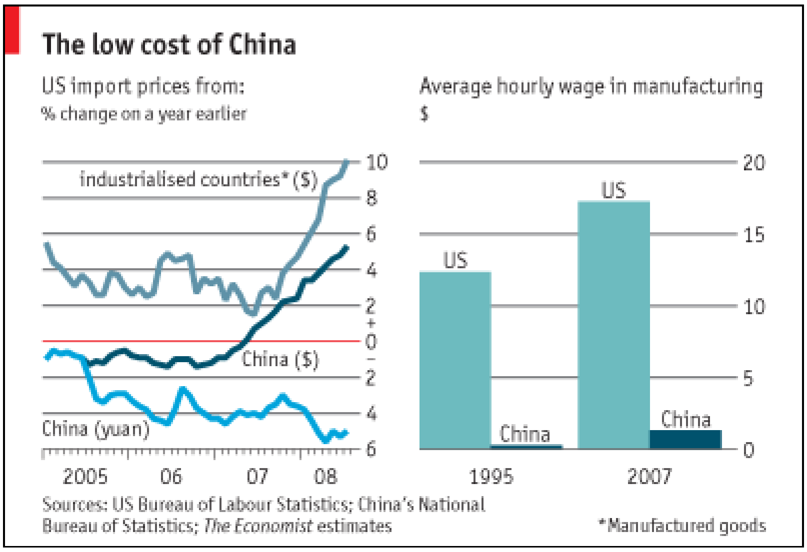
SOURCE: The Economist
http://www.economist.com/research/articlesbysubject/displaystory.cfm?subjectid=478048&story_id=11920640&CFID=22084348&CFTOKEN=65811792

Inflated claims

Aug 14th 2008
From *The Economist* print edition

Why China is not to blame for the surge in global inflation

MANY people in America and Europe think that the recent surge in inflation, like almost everything else these days, is "made in China". For a number of years, cheap Chinese goods helped to reduce prices in rich economies, but more recently wages and prices have surged in China. On top of this, the hungry dragon's insatiable appetite for food, energy and other raw materials has given cartoonists an emotive image for the surge in global commodity prices. As a result, it is claimed, China is no longer exporting deflation to the rich world, but inflation.



China's inflation rate did indeed hit almost 9% earlier this year (by July it had fallen to 6.3%). And after declining for several years, the prices of America's imports from China jumped by 5.3% in the year to July, pushing up the prices of goods in Wal-Mart, where many Americans shop. However, import prices from China are rising more slowly than the cost of goods from elsewhere: the average price of manufactured goods imported into America from industrialised countries rose by 10.1% over the past year (see left-hand chart). Moreover, all of the increase in the price of Chinese imports reflects the fall in the dollar against the yuan, not higher costs in China. In yuan terms, average Chinese export prices are still falling.

There is something to the claim that China's huge demand for food and energy is pushing up global commodity prices. China has accounted for a big slice of the growth in global consumption of oil and especially metals this decade, helping to drive prices higher. But its effect on global prices over the past year (when rich-world inflation took off) is easily overstated. The pace of growth in China's oil demand slowed to 4% last year. That is still relatively high, but not nearly as much as its annual rate of 12% in 2001-04, a period when the Fed was fretting about deflation, not inflation. And China's food production has grown faster than consumption over the past few years. As a small, but growing, net exporter of wheat, maize and rice, China has, if anything, helped to ease world grain prices.

A more nuanced argument, suggested in a recent speech by Donald Kohn, the Federal Reserve's vice-chairman, is that lax monetary policies have recently caused emerging economies such as

China to grow too fast, putting extra demand on resources. Mr Kohn concluded that central banks in emerging economies should tighten policy to restrain economic growth and so reduce global inflation. There are merits to this argument, but there is also a danger that Mr Kohn may be trying to pass the buck. After all, America's interest rates have been historically low for most of the past decade and thus it must share much of the responsibility for higher global inflation.

Mr Kohn used to argue that globalisation had a muted impact on American inflation. In 2006 he said that emerging economies were mildly disinflationary, because by running current-account surpluses they were adding more to global supply than to demand. China still has a large external surplus, so—using the same logic—how can it now be fuelling world inflation? Other inconsistencies abound. Some economists accuse China of overheating and exporting inflation, at the same time as they criticise it for overinvesting and creating excess capacity, which would imply downward pressure on prices. Last year it was fashionable to argue that China should boost its domestic demand to reduce its excess saving; now it is being told to tighten monetary policy, which would slow the growth in demand.

Cheap at twice the price

Some of this confusion reflects a widespread misunderstanding about how China's integration into the world economy affects prices in the rich world. A common mistake is to assume that falling export prices mean that China is exporting disinflation, whereas rising export prices imply it is exporting inflation. The truth is that the level of Chinese prices matters much more than their rate of increase. China helped to hold down inflation in developed economies not because its prices were falling, but because its goods were much cheaper.

In theory, global trade should cause prices in different countries to converge: the prices of low-cost producers should gradually increase as wages rise (ie, China's falling prices were a temporary anomaly), while the prices of high-cost producers should fall. Thus so long as China's wages and the prices of its goods remain well below those in rich countries (see right-hand chart, above), its increasing penetration of world markets will continue to depress prices for many years. For example, according to BCA Research, a firm of economic analysts, the prices of Chinese exports of electric motors and generators doubled over the past five years, yet because they remain much cheaper than American-produced products, their share of the American market has more than doubled, forcing local producers to cut prices. As China moves up the value chain, it will export cheaper products in new industries, such as cars. This will help to hold down global prices—although possibly by less than in the past.

Perhaps the best way to determine China's impact on world inflation is to gauge whether its net impact is to increase aggregate global demand or supply. China is boosting both, but so far its "positive supply shock" has been the more important. The integration of China and other emerging economies into the world trading system has, in effect, more than doubled the global labour force, and by curbing workers' bargaining power it has restrained pay demands in most developed economies in recent years. Despite higher consumer prices in America and the euro area, wage growth has remained subdued and real wages have fallen, which has prevented inflation from becoming entrenched.

Imagine if China did not trade with the rest of the world. Oil prices would be cheaper, whereas clothes, DVD players and computers would be dearer. China's biggest global impact is on relative prices. The net result, however, is still disinflationary. China is a handy scapegoat, but the real blame for the rise in inflation in the rich world may lie with monetary policy closer to home.