

Economics focus | Learning to like inflation

Higher inflation could help to rebalance China's economy

CHINA'S inflation rate has become one of the world's most closely watched numbers. This week's release showed that inflation rose to 4.9% in January, up from 1.5% a year earlier. The increase was smaller than expected, but has not quelled fears that as inflation creeps up the government will need to slam on the economic brakes. Some economists, however, believe that China should welcome higher inflation as a more effective way to rebalance its economy than a currency appreciation.

The recent surge in Chinese inflation has been driven mainly by food prices, but non-food inflation has also risen to 2.6%, its highest rate since the series began in 2001. Wages are increasing at a faster rate. For many years China's large pool of surplus labour held average pay rises below the rate of productivity growth. But as fewer young people enter the workforce, wages are now rising faster than productivity. Arthur Kroeber of Dragonomics, a Beijing-based research firm, argues that if higher inflation reflects faster wage growth, this will help China, not hurt it.

Economists brought up to believe inflation is always a bad thing will choke on the idea of welcoming more of it, but the truth is that China's average inflation rate of 2% over the past ten years has been unusually low for a developing country (see left-hand chart). The optimal inflation rate in an emerging economy is often higher than in the developed world because of something called the "Balassa-Samuelson effect". As low-income countries catch up with richer ones, faster productivity growth in the tradable-goods sector pushes up wages. Since labour is mobile, this in turn leads to higher wages in the non-tradable sector, where productivity growth is slower, so prices rise faster than in rich countries. Moreover, some of the ways in which inflation is thought to be harmful to growth, such as discouraging saving and investment, hardly matter in China, where both look excessive.

Indeed, a bit more inflation could help to rebalance China's lopsided economy. Its biggest imbalance is too little consumption, largely because wages have fallen as a share of national income. When wages rise more slowly than productivity, an economy produces more than it can consume, resulting in a current-account surplus. If wages now outpace productivity, workers' share of the cake will rise, boosting consumption and helping to reduce China's external surplus.

Wage-driven inflation would also help to narrow China's

trade surplus by pushing up the price of its exports. Conventional wisdom says that a stronger yuan would reduce China's current-account surplus. Yet the empirical support for this is weak. In a paper published in 2009, Menzie Chinn of the University of Wisconsin and Shang-Jin Wei of Columbia University examined more than 170 countries over the period 1971-2005*, and found little evidence that countries with flexible exchange rates reduced their current-account imbalances more quickly than countries with more rigid regimes.

In adjusting current accounts, what matters is the real exchange rate (which takes account of relative inflation rates at home and abroad). Movements in nominal exchange rates often do not achieve the desired adjustment in real rates because they may be offset by changing domestic prices. For example, the yen's trade-weighted value is around 150% stronger than it was in 1985. Yet Japan's current-account surplus remains big because that appreciation has been largely offset by a fall in domestic Japanese wholesale prices, so exporters remain competitive.

An alternative way to lift a real exchange rate is through higher inflation than abroad. To an American buyer, a 5% increase in the yuan price of Chinese exports is the same as a 5% appreciation of the yuan against the dollar. Mr Kroeber argues that rebalancing the economy by running an inflation rate of 4-6% would be preferable to either a sharp increase in the yuan, which could cause big job losses in export firms, or a gradual appreciation which attracted large speculative capital inflows, as happened in 2005-08. Inflation is already playing the bigger role. The yuan has risen by only 4% against the dollar since early 2009, yet, according to calculations by *The Economist*, the yuan's real exchange rate against the dollar (measured using unit labour costs in industry) has strengthened by 17% (see right-hand chart), because costs in China are rising much faster than in America.

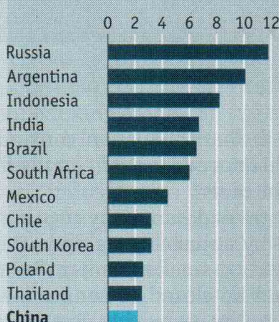
The runaway risk

What about the risk that inflation could get out of control, as in Latin America in the 1980s and 1990s or in China itself in 1989, when an inflation rate of over 25% triggered unrest? Runaway inflation is usually the result of fiscal excess, financed by printing money, or rigid labour markets, which produce a wage-price spiral that the central bank fails to stop. Unlike Latin America in the past, China has a record of fiscal prudence and trade unions are docile. Its labour market is much more flexible than in the late 1980s, when most workers were in the state sector.

China is more like Japan and South Korea during their eras of rapid growth than any Latin American country. Over 15-year periods ending in Japan in 1972 and South Korea in 1996, GDP growth averaged around 9% a year and inflation averaged 5-6% without it accelerating out of control. China's government cannot be complacent about rising prices. It should anchor expectations by setting an explicit inflation target. Interest rates on bank deposits need to be raised in line with inflation to encourage households to keep their money in the bank rather than speculate in property or shares. Otherwise negative real interest rates will inflate asset bubbles. That implies China still needs a more flexible exchange rate so it can lift interest rates while those in America remain low. But a bit more inflation would be welcome as well. ■

The case for heresy

Average annual inflation rate
2000-10, %



Sources: IMF; *The Economist*; Bureau of Labour Statistics; CEIC; Thomson Reuters

China's yuan-dollar exchange rates
Q1 2005=100



*Using relative unit labour costs in industry

* "A Faith-based Initiative Meets the Evidence: Does a Flexible Exchange Rate Regime Really Facilitate Current Account Adjustment?", by Menzie Chinn and Shang-Jin Wei. www.ssc.wisc.edu/~mchinn/chinn_wei_ca.pdf