From T-shirts to T-bonds

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Global wages, prices, profits, interest rates and even house prices are increasingly "made in China"

"IF YOU want one year of prosperity, grow grain. If you want ten years of prosperity, grow trees. If you want 100 years of prosperity, grow people." This old Chinese proverb crudely sums up how the entry of China's massive labour force into the global economy may prove to be the most profound change for 50, and perhaps even for 100, years.

Until a couple of years ago nobody cared much that the Chinese yuan was pegged to the dollar. Recently, though, this link has become one of the hottest issues in international politics, widely blamed in America for its huge trade deficit. But in fact, China is not the main cause of the American trade deficit. As chart 1 shows, most of the increase in America's trade deficit has come from outside China. The main cause of America's trade deficit is a lack of domestic saving, not unfair Chinese competition. The deficit is thus made in America, not made in China. On the other hand, China is behind almost everything else going on in the world economy. For China is beginning to drive, in a new and pervasive way, economic trends that many countries assume to be domestically determined. Everyone knows that most TVs and T-shirts are "made in China". But so, in some ways, are developed countries' inflation rates, interest rates, wages, profits, oil prices and even house prices—or at least they are strongly influenced by what happens in China.

Of course, China is not the only fast-growing emerging economy that is making waves around the world. But China really does loom much larger: its contribution to global GDP growth since 2000 has been almost twice as large as that of the next three biggest emerging economies, India, Brazil and Russia, combined. Moreover, there is another crucial reason why China's integration into the world economy is today having a bigger global impact than other emerging economies, or than Japan did during its period of rapid growth from the mid-1950s onwards. Uniquely, China combines a vast supply of cheap labour with an economy that is (for its size) unusually open to the rest of the world, in terms of trade and foreign direct investment. The sum of its total exports and imports of goods and services amounts to around 75% of China's GDP; in Japan, India and Brazil the figure is 25-30% (see chart 2). As a result, the dragon's awakening is more traumatic for the rest of the world.

To view China's global impact mainly in terms of its exports and its trade surplus is to misunderstand, and to underestimate, the profound forces behind China's growing influence. China's growing influence stretches much deeper than its exports of cheap goods: it is revolutionising the relative prices of labour, capital, goods and assets in a way that has never happened so quickly before.

Doubling the world's workforce

Most analysis of China's growing importance focuses on its rising share of global output and exports. That, in turn, fuels fears that China is stealing production and jobs from the rest of the world. But this misses half the story. It is true that China's trade surplus has increased sharply this year—mainly because the government's efforts to cool fixed investment have cut back imports. But over the past decade, China's imports have risen at the same pace as its exports. So China is giving a big boost to both global supply and demand.

China's impact on the world economy can best be understood as a “positive supply-side shock”. Richard Freeman, an economist at Harvard University, reckons that the entry into the world economy of China, India and the former Soviet Union has, in effect, doubled the global labour force (China accounts for more than half of this increase). This has increased the world's potential growth rate, helped to hold down inflation and triggered changes in the relative prices of labour and capital.

The new entrants to the global economy brought with them little capital of economic value. So, with twice as many workers and little change in the size of the global capital stock, the ratio of global capital to labour has fallen by almost half in a matter of years: probably the biggest such shift in history. And, since this ratio determines the relative returns to labour and capital, it goes a long way to explain recent trends in wages and profits.

In America, Europe and Japan, the pace of growth in real wages has been unusually weak in recent years. Indeed, measured by the growth in income from employment, this is America's weakest recovery for decades. According to Stephen Roach, an economist at

Morgan Stanley, American private-sector workers' total compensation (wages plus benefits) has risen by only 11% in real terms since November 2001, the trough of the recession, compared with an average gain of 17% over the equivalent period of the five previous recoveries (see chart 3). In most developed countries, average real wages have lagged well behind productivity gains.

The entry of China's vast army of cheap workers into the international system of production and trade has reduced the bargaining power of workers in developed economies. Although the absolute number of jobs outsourced from developed countries to China remains small, the threat that firms could produce offshore helps to keep a lid on wages. In most developed countries, wages as a proportion of total national income are currently close to their lowest level for decades.

The flip side is that profits are grabbing a bigger slice of the cake (see chart 4). Last year, America's after-tax profits rose to their highest as a proportion of GDP for 75 years; the shares of profit in the euro area and Japan are also close to their highest for at least 25 years. This is exactly what economic theory would predict. China's emergence into the world economy has made labour relatively abundant and capital relatively scarce, and so the relative return to capital has risen. It is ironic that western capitalists can thank the world's biggest communist country for their good fortune.

China's main impact on the world economy is to change relative prices and incomes. Not only are the prices of the goods that China exports falling; the prices of the goods that it imports are rising, notably oil and other raw materials. China is already the world's biggest consumer of many commodities, such as aluminium, steel, copper and coal, and the second-biggest consumer of oil, so changes in Chinese demand have a big impact on world prices.

China has accounted for one-third of the increase in global oil demand since 2000 and so must bear some of the blame for higher oil prices. Likewise, if China's economy stumbles, then so will oil prices. However, with China's oil consumption per person still only one-fifteenth of that in America, it is inevitable that China's energy demands will grow over the years in step with its income.

There is currently only one car for every 70 people in China, against one car for every two Americans. That implies a huge increase in oil demand, which could keep prices high for the foreseeable future, because of scarce global spare capacity. China's consumption per person of raw materials, such as copper and aluminium, is also still low, so rising demand will continue to support commodity prices.

Cheap money

Overall, the upward pressure that Chinese imports of raw materials have put on the prices of oil and other commodities has been more than offset by the downward pressure of Chinese manufactured exports. As a result, another important aspect of the China effect is low inflation.

Central bankers like to take all the credit for the defeat of inflation, but China has given them a big helping hand in recent years. China's ability to produce more cheaply has pushed down the prices of many goods worldwide, as well as restraining wage pressures in developed economies. For instance, the average prices of shoes and clothing in America have fallen by 10% over the past ten years—a drop of 35% in real terms.

A study by Dresdner Kleinwort Wasserstein reckons that China has knocked almost a full percentage-point off America's inflation rate in recent years. The 2% revaluation of the yuan last July was probably absorbed by Chinese manufacturers trimming their profit margins, rather than passed on into export prices. But Americans calling for a 25-30% revaluation may come to regret it: the result would almost certainly be faster inflation.

As it is, China's reduction of inflationary pressures has allowed central banks to hold interest rates lower than they otherwise would be. Four years into its recovery, America's real short-term interest rates are only just positive, almost full two percentage-points below their average at the equivalent stage in previous recoveries since 1960. This is good news for borrowers, but some economists worry that the entry of China and other emerging countries into the global economy may have affected monetary policy in ways that central banks do not fully understand.

In its latest annual report, the Bank for International Settlements (BIS) asks whether it is really desirable to maintain positive inflation rates when China is boosting the world's productive potential so dramatically and thus reducing the prices of so many goods. In other words, are central banks targeting too high a rate of inflation now that China has joined the global market economy?

During the late 19th-century era of rapid globalisation, falling average prices were quite common. This “good deflation”, which was accompanied by robust growth, is very different to the bad deflation experienced in the 1930s depression. Today, we would again have had “good deflation”—but central banks have instead held interest rates low in order to meet their inflation targets. The BIS frets that this has encouraged excessive credit growth.

This echoes a fierce debate in the 1920s. At that time, a similar jump in the world's productive potential (then caused by technology-driven productivity growth) was reducing manufacturing costs. Some economists suggested that, in such circumstances, overall price stability might be the wrong policy goal. Instead, they argued, average prices should be allowed to fall to pass the productivity gains on to workers and consumers as higher real incomes. But just like today, monetary policy prevented prices from falling. And an overly loose policy then inflated the late-1920s stockmarket bubble.

The Austrian school of economics offers perhaps the best framework to understand what is going on. The entry of China's army of cheap labour into the global economy has increased the worldwide return on capital. That, in turn, should imply an increase in the equilibrium level of real interest rates. But, instead, central banks are holding real rates at historically low levels. The result is a misallocation of capital, most obviously displayed at present in the shape of excessive mortgage borrowing and housing investment. If this analysis is correct, central banks, not China, are to blame for the excesses, but China's emergence has indirectly caused the problem.

Not only has China's disinflationary impact caused low short-term interest rates, but China is also partly responsible for the low level of long-term bond yields. To prevent its exchange rate rising against the dollar, China has been the biggest buyer of American Treasury bonds over the past year. In the 12 months to September, its foreign-exchange reserves increased by $250 billion, to $769 billion, of which about three-quarters are in dollars. This has also kept global capital costs artificially low.

Who calls the shots?

For many decades, global monetary policy has been set in Washington. When the Fed raised interest rates, global monetary conditions would tighten. Today, however, thanks in part to China's purchases of T-bonds, low long-term bond yields have offset the rise in American short-term interest rates over the past year. The yield on ten-year bonds is still lower than before the Fed started to lift interest rates in June 2004. America's sovereignty over its monetary policy has therefore been eroded, with a given rise in short-term rates producing much less monetary tightening than in the past. To that extent, global monetary policy is increasingly being set in Beijing as well as in Washington.

By helping to hold down interest rates in rich economies, China may have indirectly created a global liquidity bubble. Total global liquidity last year rose at its fastest pace in three decades after adjusting for inflation. This excess liquidity has not pushed up conventional inflation (thanks to cheap Chinese clothes and computers), but instead it has inflated a series of asset-price bubbles around the world. Thus, pushing this argument to its limit, it could be said that the global housing boom is indirectly “made in China”. Not only has China played a role in holding down short-term interest rates, but the People's Bank of China has also supported America's mortgage market by buying vast amounts of mortgage-backed securities.

What does the breaking of the yuan's peg to the dollar, announced in July, mean for bond yields? The revaluation of the yuan against the dollar has so far been trivial, but this might be the beginning of the end of what has been dubbed the “revived Bretton Woods” system of fixed exchange rates, under which China and other Asian countries have bought billions of dollars in foreign-exchange reserves to hold their currencies steady against the greenback. If the switch from a dollar peg to a currency basket causes China gradually to reduce its new purchases of dollar assets in favour of other currencies, then American bond yields will rise and badly hurt America's economy. Having played a hand in inflating America's housing bubble, could China now prick it by pushing up mortgage rates, which are closely tied to long-term bond yields? The fate of American house prices could thus be determined by unelected bureaucrats in Beijing rather than the unelected central bankers of the West.

This article has argued that global inflation, interest rates, bond yields, house prices, wages, profits and commodity prices are now being increasingly driven by decisions in China. Indeed, a recognition of China's profound and widespread impact on the world economy explains various current economic puzzles. Take, for instance, the oil price. Since the beginning of last year, oil prices have doubled, yet in contrast to previous oil shocks, inflation rates remain low and global growth robust. The answer to this riddle lies is China. To the extent that oil prices are driven up by strong Chinese demand rather than, as in the past, an interruption of supply, they are less likely to hurt global growth. And the impact of higher oil prices on inflation has been partly offset by falling prices of all sorts of goods from cameras and computers to microwaves and bicycles—thanks to China.

Another oddity is that, while the prices of most goods are falling, house prices are soaring in many countries. Again, enter the dragon. Cheaper goods from China have made it easier for central banks to achieve their inflation goals with much real interest rates than in the past. Cheap money has encouraged a borrowing binge, with the excess liquidity flowing into the prices of assets, such as homes, rather than into traditional inflation. And, last but not least, China is part of the answer to Alan Greenspan's conundrum of why American bond yields are so low despite robust growth and hefty government borrowing..

China's emergence could be the most profound economic change in the world for at least half a century. And its effect could last for another couple of decades. By some estimates, China has almost 200m underemployed workers in rural areas, and it could take at least two decades for them to be absorbed by industry. As this process takes place, it will continue to subdue wage growth and global inflation. Profit margins could also remain historically high for a period (though not for ever, as stockmarket valuations in many countries seem to imply).

China creates immense opportunities, but it also brings new risks. If it stumbles, or if it decides to buy fewer American T-bonds, pushing up yields, then America might really have something to complain about: the first global downturn made in China. How should the world's policymakers respond to China's growing economic clout? Trying to halt China's growth through protectionist measures, as many American congressmen would like to do, would be a disaster, for it would close off a powerful source of future global prosperity. A better way to deal with China's growing power would be to give the country a bigger stake in global economic stability. China should be a full member of international economic policy forums, such as the G7 and the OECD. Western policymakers would be wise to remember another Chinese proverb: "What you cannot avoid, welcome."