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Global economy: An inflated outlook

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Onlookers at a Foxconn press conference called following a spate of suicides at the electronics maker last year

The Chinese province of Guangxi might be almost 9,000km from Frankfurt, home of the European Central Bank. But in today's globalised economy, the two are much closer than they first appear.

Two months ago Zhu Xinzhi, head of a lighting manufacturers' association in the industrial city of Foshan in southern China, set off for Guangxi on a recruiting trip. Offering a monthly wage of Rmb1,600, he hoped to attract 500 workers; he got 10. Alternative opportunities, high inflation and a recent trend of rising wages made his jobs unattractive. "The workers felt the salary was relatively low and that it's better to stay home and run their own small business or go to cities with higher pay," he says. "The salary we offered has no advantage any more. It was a very unsatisfactory trip."

The reverberations from China's rising wages, alongside rapid economic growth there and in fellow emerging economies, were felt in far-off Frankfurt this week. That Mr Zhu might have to pay more to recruit workers will raise the price of light bulbs imported into Germany from China. If the process is replicated in the prices of other Chinese goods, inflation in Germany and other European nations will be permanently higher, requiring action by the ECB.

It appears the bank has already begun to take action. On Thursday, the ECB raised interest rates for the first time in three years – initially by only a quarter of a percentage point to 1.25 per cent. Jean-Claude Trichet, president, cited inflationary risks stemming in part from "strong economic growth in emerging markets", as well as "ample liquidity at the global level, [which] may further fuel commodity price rises".

It is not just the ECB that looks at China and sees a more inflationary future. This week the People's Bank of China, the central bank, raised rates for the fourth time since October, as well as taking other action against price rises. Others are expected to follow suit by the end of the year.

The International Monetary Fund expressed concern in the World Economic Outlook published this week that oil scarcity combined with rapid growth in oil-intensive emerging economies would continue pushing oil prices higher year after year. In February James Bullard, president of the St Louis Federal Reserve Bank, raised the question of whether inflationary pressures might mount in the US despite high unemployment because there was little or no slack in the global economy.

The potential worldwide consequences of local trends make it impossible for policymakers to ignore the Chinese labour market and its links to the global economy.

A new era began last summer after a spate of suicides by workers at the Shenzhen plant of contract electronics manufacturer Foxconn, just across the border from Hong Kong. In response the Taiwanese company, which supplies the likes of Apple and Dell, raised wages by about 20 per cent. This was followed by wild-cat strikes at the factories of Honda parts suppliers in the same province, leading salaries there to rise by a similar percentage.

Until that point, says Han Dongfang of workers' rights group China Labour Bulletin, Beijing through its federation of trade unions had always sided with employers, helping to keep wage increases in check. In a video clip widely circulated online, young white-uniformed workers at the Honda parts plant shouted at representatives of the official government union for beating them and taking the part of their Japanese bosses.

These strikes, says Mr Han, were a "turning point. It became clear [the government union] was channelling employee anger into anger against the government". This year, the government has signalled its determination to raise workers' incomes by lifting the benchmark minimum wage by about 20 per cent in Beijing (where it is now Rmb1,232 per month); Guangzhou, capital of the industrialised province next to Hong Kong (to Rmb1,030); and elsewhere.

One of the catalysts for the upward trend in wages is demographic, with a falling number of young Chinese entering the labour market. Although employers are shifting production west, where the supply of workers is higher and wages lower, the sudden rise in pay levels cannot be ignored.

Since China started to integrate into the global trading system in the 1980s, says William Fung, head of the Hong Kong-based $15.9bn global sourcing company Li & Fung, it has “added at least 20 per cent to the world’s workforce, if not more. China became the world’s factory.” Its low wage levels allowed the rest of the world to “enjoy a massive labour supply shock that helped keep inflation tame”, according to Eswar Prasad, a professor of economics at Cornell University.

But as China’s share of world merchandise exports has risen from 1.1 per cent in 1982 to above 10 per cent at the end of last year, the moderating effect of China on advanced economy inflation is waning. Now that Chinese products are so important, domestic inflation in advanced economies is no longer immune from events in China.

Policymakers now fret that the future for advanced economies might be one of persistently more expensive imports because rapid growth raises both wages and the price of commodities necessary for manufacturing goods. In such a world, higher imported inflation would have to be offset by lower domestic inflation – or governments have to accept an overall acceleration of price rises.

In a speech last month, Spencer Dale, Bank of England chief economist, noted with particular concern that inflationary pressures in China were unlikely to be offset by a corresponding depreciation in the value of its currency. “Where economies operate pegged exchange rate regimes, it is far from clear that this can be relied upon, at least in the near term,” he said.

That said, three factors mitigate the potential effect of China’s rising wages, according to some economists.

First, more pricey Chinese labour still represents only a fraction of the final price of goods sold in Europe and the US. Prof Prasad says the value of goods exported from China that is actually created in the country is just 10 to 15 per cent. “The low value-added share implies that even a significant rise in China’s labour costs won’t add much to the final costs of processed exports.”

Second, Chinese productivity levels are not standing still. They have soared in the past 20 years, allowing companies to increase pay rapidly without significantly raising final prices. Gavekal Dragonomics, an economic consultancy based in Beijing and Hong Kong, says China’s exporters have moved up the value chain, and its ports and highways are almost as sophisticated as those in the developed world, allowing exports to rise despite rapid wage increases.

Third, as Chinese wages rise, some production will shift to lower-wage economies, keeping the global price low. Li & Fung, for example, reported in late March that it had moved some of its clothing production to Bangladesh, Vietnam, Indonesia and India.

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But sourcing goods in lower-wage economies is not always easy. Michael Austin, chief financial officer of Top Form International, headquartered in Hong Kong, says the company is moving some of its mass-market bra-making to Thailand, but China still accounts for about half of its production. More expensive bras requiring detailed lace work must stay in China, he says, as worker productivity is much higher and "the learning time is so much less in China. In China, people work to live," he says.

Michael Enright of the University of Hong Kong says he was asked by a client considering sourcing manufacturing from Asia to compare Chinese and Indian transport, electricity and labour costs. "They would have had to pay a negative wage to manufacture [the product] in India. People don't understand how much ahead China is in infrastructure," he says.

The benefits to China of rising wage levels and productivity are clear. In a lane near a cluster of factories in Foshan last month, two 20-something women were reading flyers on a noticeboard advertising vacancies. Wangli, 27, and her friend, Xiaoye, 24, were unimpressed by an offer of work at a lightbulb maker seeking workers with a "serious attitude who could eat bitterness" (which loosely translated, means the ability to make sacrifices).

Instead, they glanced at another advertisement. A stainless steel factory was offering salaries of about $250-$370 a month for "female packaging workers" to as much as $700 for experienced machine operators. The inducements did not stop at higher salaries. "We have a brand new dormitory building with air conditioning and hot water ... We can organise birthday and bonfire parties and trips," the company promised.

The improved prospects for Wangli and Xiaoye are far from a disaster for advanced economies but it is likely that the days of ever cheaper imported labour-intensive low-wage Chinese goods are coming to an end.

If China is no longer exporting deflation, domestic prices in Europe and the US will have to be kept on a rather tighter rein in future.

Additional reporting by Lydia Guo