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Asian Economic Perspectives

China's World-Deflation Role in Doubt as Export Prices Rise

China's ability to export deflation—perceived as a key contributor to the benign global inflation environment of the last 10 years—may be waning, judging by two emerging trends that have alarmed financial markets. In our view, the alarm may be premature, but the trends need to be watched. There is little doubt that China, having grown rapidly as the global centre of manufacturing exports, has helped deflate a range of finished-good prices around the world. There is also a broad consensus that its ability to export deflation is long-lasting and, indeed, should grow as the country expands its industrial capacity and becomes even more attractive to foreign manufacturers as a base for their global export operations. Evidence to the contrary potentially has important implications not only for China's development, but for the global economy too.

US Pays China More

The first of the two trends has surfaced in Chinese customs statistics, which show that the country's export unit value, in US dollar terms, has risen dramatically over the past year. Year-on-year, the rate of increase in China's export prices reached around 8% last month compared to a little under 1% in early 2006. This is not all. A bigger worry lies in the second trend: Chinese export prices have apparently begun to push up the US's imports bill. Data compiled by the US Department of Labor suggest that prices of imports from China were positive in May and June (up 0.1% and 0.6% year-on-year, respectively) following a three-year price decline (**Display 1**). On this evidence, China appears to have started exporting inflation to the world economy, rather than deflation.

It is not hard to find reasons for China's rising export prices. The renminbi (RMB) has appreciated against the US dollar—though at a slowing rate—by close to 10% cumulatively since the currency was revalued and unpegged from the US dollar in 2005. Many Chinese producers of finished goods have been operating at very thin profit margins (3% to 5%), which offer little to no scope to absorb the effect of adverse currency movements on their export prices. Hence, it is more than likely that rising export prices at least partly reflect the RMB's rise against the greenback.

Another reason behind rising export prices is that the Chinese government has significantly slashed VAT rebates for exports in many manufacturing sectors over the past year, favouring value-added industrial sectors at the expense of some lower-quality, environmentally harmful and resource-intensive industries. The rebates had played a key role in maintaining China's export price competitiveness; their reduction—and, in some cases, complete removal—represents an additional cost pressure for many Chinese exporters, although the effect is one-off.

Do High Prices Reflect Better Quality?

At this juncture, however, we hesitate to draw any conclusion from these developments. We do not know, for example, the extent to which improvements in product quality, or perhaps an increase in the share of industrial value-added in the total export mix, are contributing to the rise in export prices. If, for example, the higher prices are simply the result of better product quality, China may still be contributing deflation to the world economy, but doing so higher up the value chain.

This prompts a question: Has the standard of Chinese export products improved? Over the past year, China's exports of transport equipment and special-purpose machinery have expanded briskly and grown as a share of the export mix. Another encouraging sign has been the increase in foreign direct investment (FDI) in special-purpose equipment: China's share of FDI jumped to 4.7% in 2006 from only 2% in 2000. This is, admittedly, slim evidence of a general improvement in export-product quality. If such a trend exists, however, the government's latest effort to boost industrial value-added will only reinforce it in coming years.

Accelerating Wage Cost Is a Key Concern

Some observers point to rising industrial wages as a cause of rising export prices. Our own estimates suggest that the unit labour cost (ULC) in the industrial sector is no longer falling and has actually been increasing steadily since 2001. While labour productivity growth remained at an impressive level of around 12% in 2006, it failed to outpace the increase in nominal wages, which jumped to about 14.5% last year. The net effect is a rise in the ULC (nominal wage growth minus productivity growth) of about 2.5% (**Display 2**). The outlook for ULC depends on whether or not China will achieve one of its industry policy objectives—to shift lower-quality manufacturing production away from the crowded coastal regions and into the vast hinterland. Just this week, the government unexpectedly announced tax differentials to encourage low value-added export-processing industries to relocate west to capitalize on the labour and resources in the inner provinces. If successful, the policy should help curb wage growth and, at the same time, boost labour productivity.

To sum up, we think it is too early to fully gauge the implications of China's rising export prices. Some of the forces at play are one-off in nature and some are structural. So far, the pace of price increases has been gentle, but this is an important trend we need to monitor closely.

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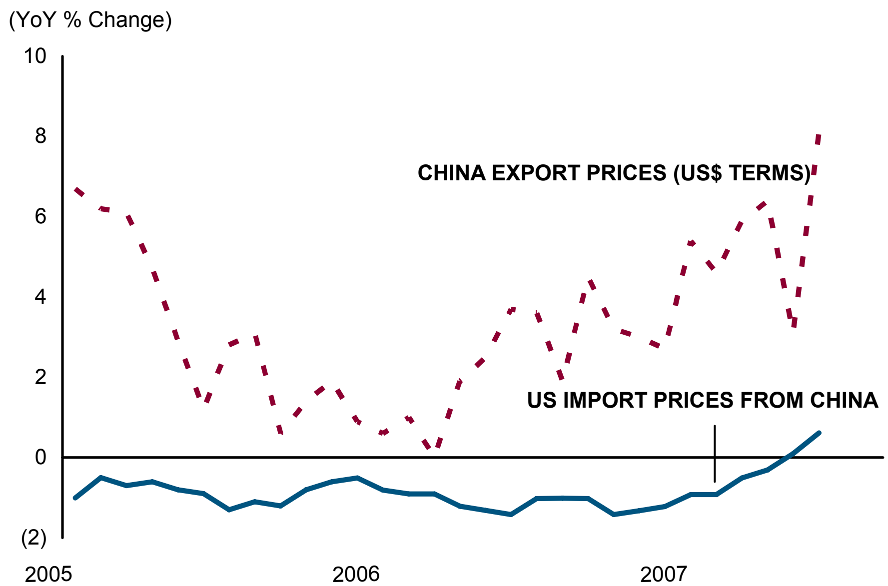
Display 1: Is China No Longer Exporting Deflation to the World?

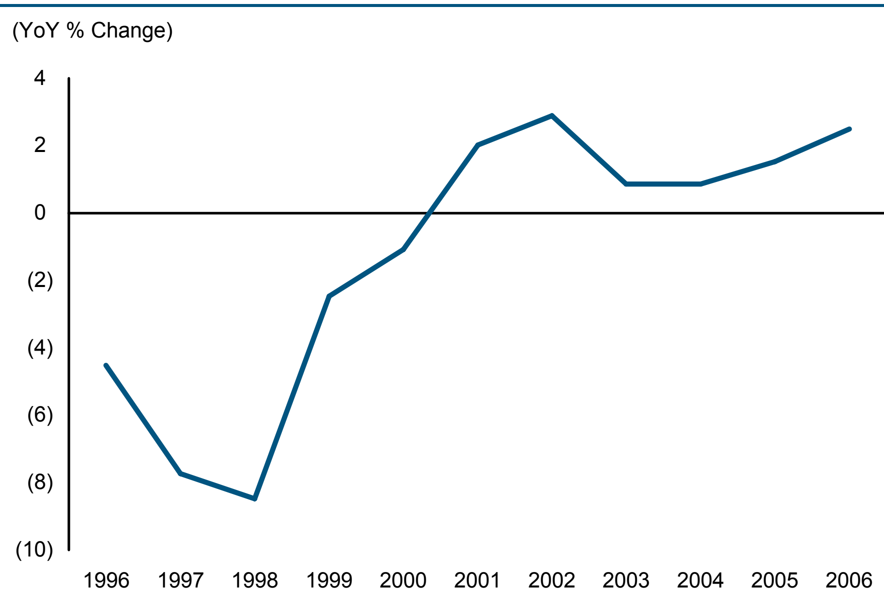
China Export Prices and US Import Prices of Chinese Products



Source: CEIC data and AllianceBernstein estimates

Display 2: Labour Costs Are on the Rise

Unit Labour Cost in China's Industrial Sector



Source: CEIC data and AllianceBernstein Fixed Income estimates