Inflation: consumption's friend

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Main argument

1. Underlying inflation is rising in China because of a tighter labor market.
2. Inflation should be welcomed, not resisted because it reflects high labor productivity growth.
3. Setting macro policy around higher inflation will aid the transition from an investment-led to a consumption-led economy, because the cost of capital, and relative returns to labor, will both rise.
4. Rebalancing through moderate inflation is preferable to aggressive exchange-rate appreciation.
5. The experience of Japan and Korea suggests GDP growth of 8% and <u>non-acccelerating</u> inflation of 5% can be sustained for at least a decade.

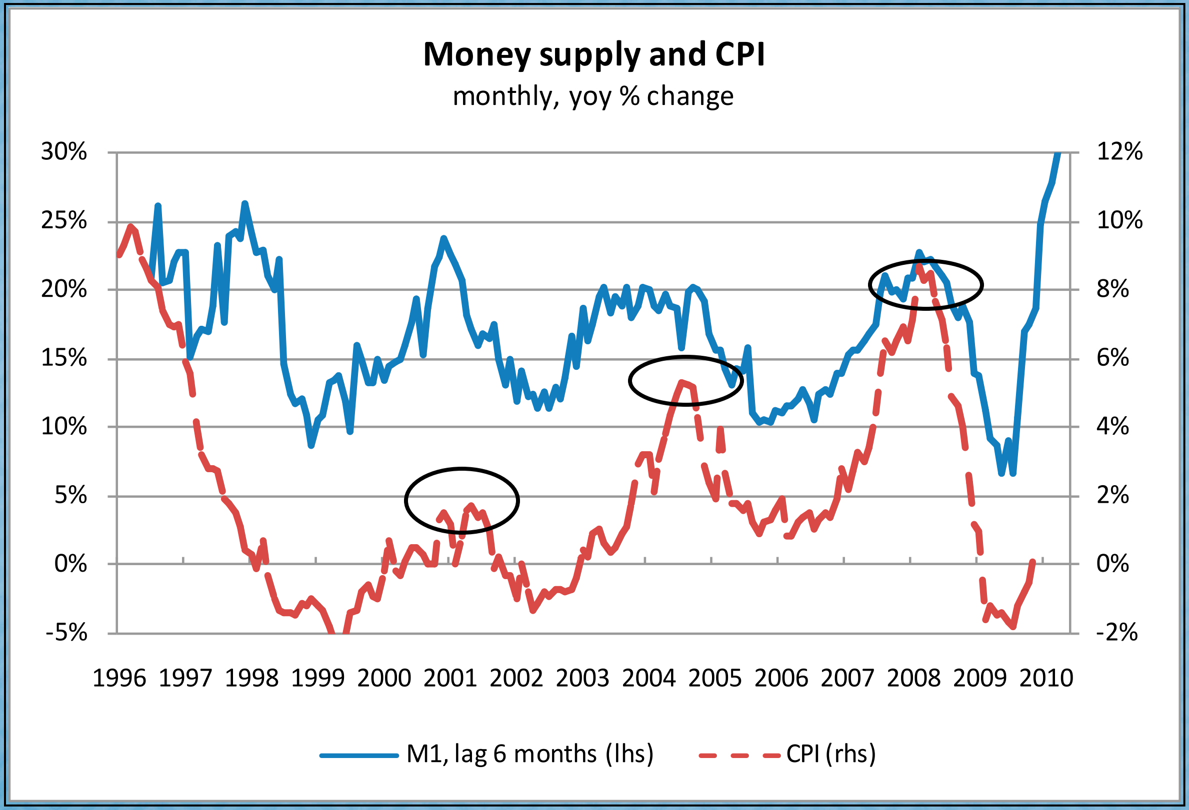
Deflation is gone

- The disinflationary economic structure of 1997-2006 is gone for good.

	GDP	CPI
1997-2006	9.3	0.9
2007	13.0	3.9
2008	9.6	4.8

Money effects strengthen

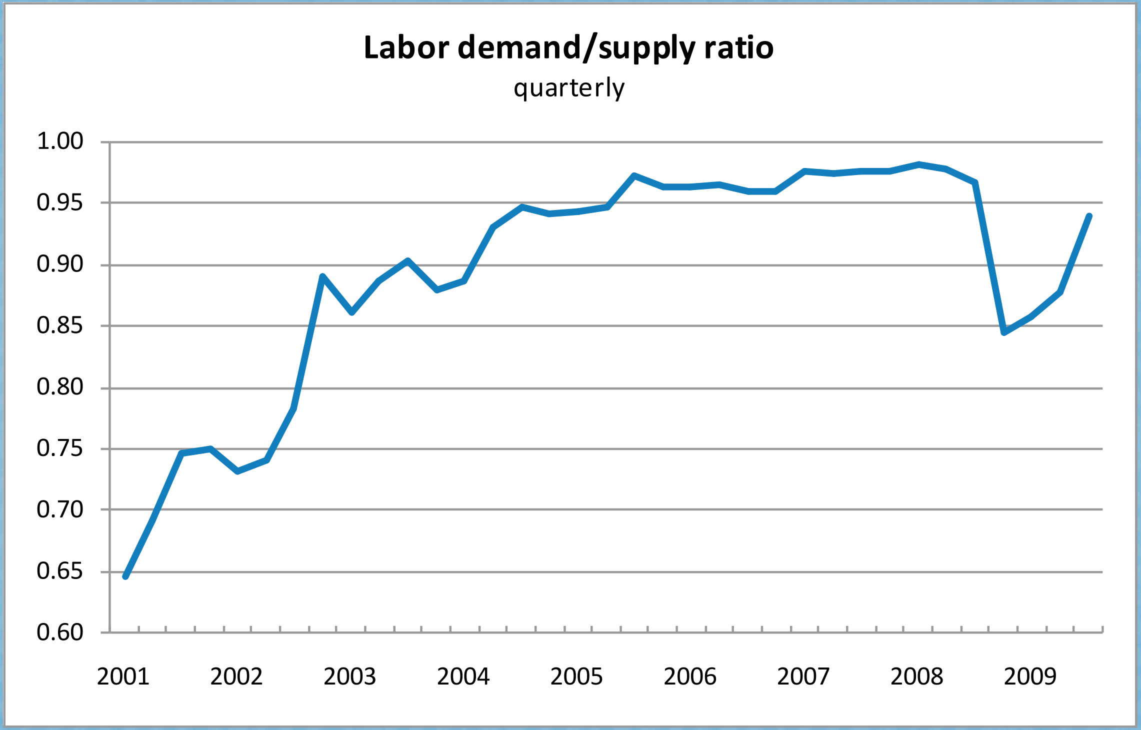
- The transmission of money growth into inflation is strengthening.



	Peak M1	Peak CPI
2001	23%	1.8%
2004	20%	5.8%
2008	23%	8.7%
2010	35%	**???**

A tighter labor market

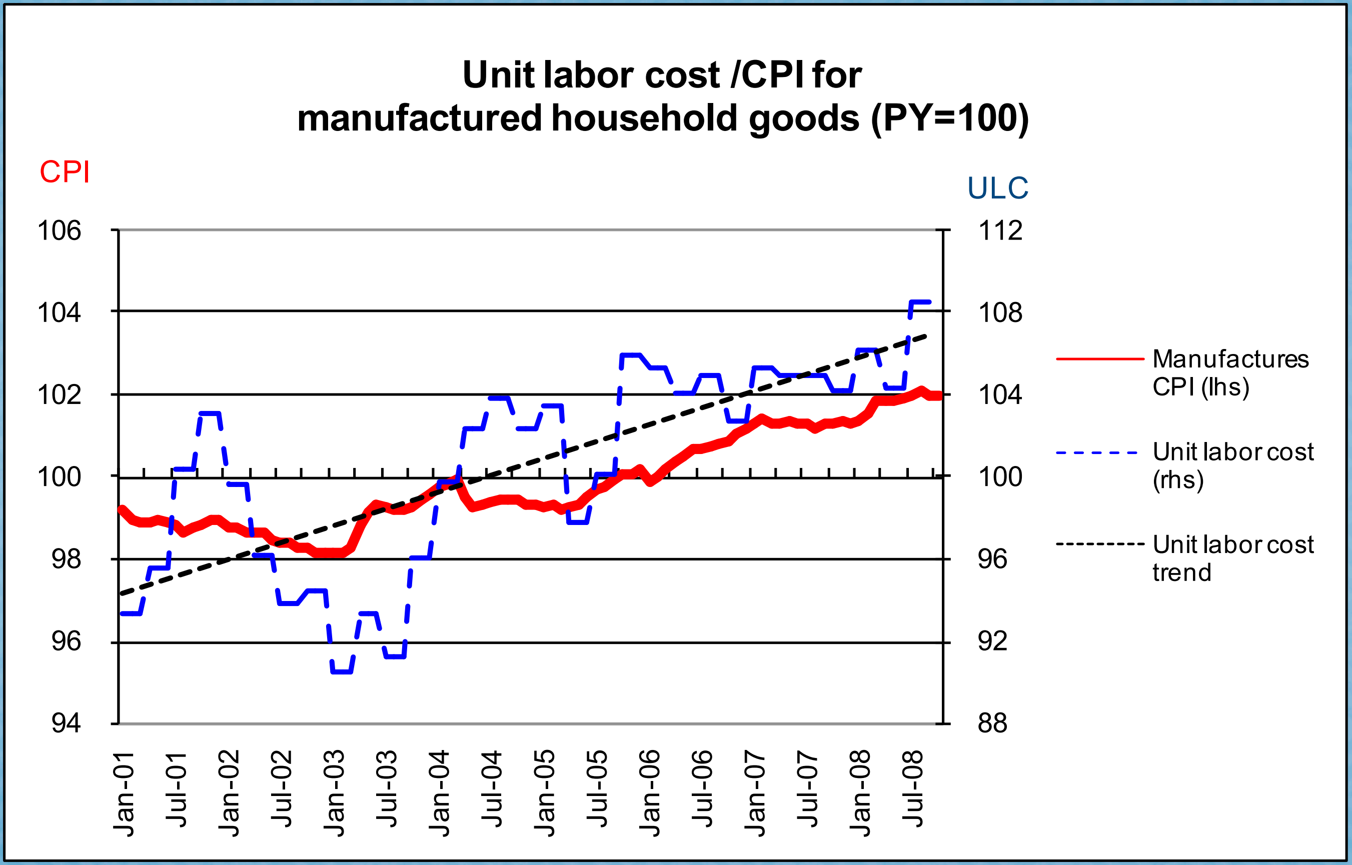
- The probable cause is that wage growth is rising faster compared to productivity, because of a tighter labor market.



- Underemployment caused by the financial crisis was extremely short-lived.

Labor cost is rising

- Some of the higher labor cost can be offset by higher productivity, but not all.



Source for unit labor cost estimate: World Bank

Moderate inflation is good

- The crucial challenge in 2010-15 will <u>not</u> be generating employment. Private sector labor demand is strong.
- The main policy challenge will be managing higher inflation resulting from greater wage pressure.
- Inflation should not be feared – it should be welcomed.
- Inflation that results from productivity-driven wage growth is healthy.
- Japan and South Korea both sustained non-accelerating inflation during high growth periods.
- A refusal to accept inflation will make the transition to a consumption-oriented economy more difficult.

Inflation need not accelerate

	Japan 1960-72	Korea 1982-96	Hong Kong 1983-94
Average GDP % growth	8.9	8.5	6.6
Average CPI % change	5.6	5.2	8.2
Maximum CPI	13.1	11.1	13.4
Minimum CPI	3.6	2.3	3.6

Inflation can help consumption

- When productivity rises faster than wages, the economy produces more than it can consume.
- This creates excess savings and a trade surplus.
- The high saving rate depresses the cost of capital, making it cheap to invest in new capacity. The cycle of excess investment is self-reinforcing.
- When wages start rising faster than productivity the process reverses.
- Inflation rises, forcing up interest rates and the cost of capital – reducing incentives to build excess capacity, and making investment more efficient.
- Because wages are rising faster, and investment growth is slowed by higher capital cost, the investment share of GDP should fall and the consumption share should rise.

Policy implications

- The policy problem is how to prevent inflation expectations from creating price acceleration.
- One option is to index deposit rates to CPI, so that depositors know the real value of their savings will not erode.
- Another crucial step is to impose a tax on property value to prevent households from investing in property as an inflation hedge, which will create a property-market bubble.
- Finally, GDP growth expectations should be lowered. Targeting growth above 8% will create dangerous inflationary and asset-bubble pressures.

Exchange-rate implications

- In economic terms, higher inflation is equivalent to an exchange-rate appreciation – both create an increase in the real exchange rate.
- However, moderate inflation is probably preferable to a large exchange rate appreciation. An appreciating exchange rate will invite capital inflows. Moderate inflation will discourage capital inflows because foreign investors will tend to view the country as more risky.
- Exchange rate policy should be used to keep inflation in check, not as a rebalancing tool.

The next decade

Conclusion:

Policy parameters need to be adjusted, and the most important adjustment is <u>higher inflation tolerance.</u>

One possibility for new growth, inflation and exchange rate parameters:

	1997-2006	2010-2020
Average GDP growth	9.3	8.0
Average CPI inflation	0.9	4.0
Average Rmb appreciation	0.0	2.0

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