Revision Note: The China Effect

*Events and developments in one country inevitably have spill-over effects onto others. Your economics revision should consider some of these inter-relationships wherever possible. It will certainly help your analysis and evaluation. In this revision note we look at China*

<table>
<thead>
<tr>
<th>Economic indicator</th>
<th>Unit</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008F</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP growth</td>
<td>% Year</td>
<td>10.1</td>
<td>10.2</td>
<td>11.1</td>
<td>11.4</td>
<td>11</td>
</tr>
<tr>
<td>Consumer spending</td>
<td>% Year</td>
<td>7.2</td>
<td>8.5</td>
<td>8.7</td>
<td>9</td>
<td>8.9</td>
</tr>
<tr>
<td>Capital investment</td>
<td>% Year</td>
<td>21.5</td>
<td>22.3</td>
<td>21.5</td>
<td>20.7</td>
<td>18.6</td>
</tr>
<tr>
<td>Exports</td>
<td>% Year</td>
<td>32</td>
<td>29</td>
<td>25</td>
<td>23.5</td>
<td>18</td>
</tr>
<tr>
<td>Inflation</td>
<td>% Year</td>
<td>3.9</td>
<td>1.8</td>
<td>1.5</td>
<td>4.8</td>
<td>4.1</td>
</tr>
<tr>
<td>Manufacturing wages</td>
<td>% Year</td>
<td>12.3</td>
<td>12.3</td>
<td>14.5</td>
<td>15</td>
<td>14</td>
</tr>
<tr>
<td>BoP Current Account</td>
<td>% of GDP</td>
<td>3.6</td>
<td>7.2</td>
<td>9.4</td>
<td>9.7</td>
<td>10</td>
</tr>
<tr>
<td>Official Interest Rates</td>
<td>per cent</td>
<td>1.7</td>
<td>1.7</td>
<td>1.7</td>
<td>2.6</td>
<td>3.6</td>
</tr>
</tbody>
</table>

*Data for 2008 is a forecast from HSBC*

Revision points from the table

1. Growth continues to exceed 10% per year – phenomenal trend growth rate
2. Consumer spending also rising strongly – though less quickly than GDP – but rising demand is having a huge effect on global demand for metals and foodstuffs
3. Notice the incredibly strong data for capital investment – some of linked to the 2008 Beijing Olympics – but also huge investment in transport and energy infrastructure
4. Export growth remains super-charged – one of the key questions is whether Chinese economic growth has become ‘de-coupled’ from the economic cycle of the USA – i.e. can China find new export markets if the USA suffers a deep recession?
5. Inflation is picking up – less than 2% in 2005-06 but now more than 4% - the highest inflation for a decade – signs of an over-heating economy
6. Look how quickly manufacturing wages are rising – higher wages boost real incomes and spending power, but they also add to supply costs if wages rise faster than productivity
7. The balance of payments surplus on the current account is enormous – forecast to be 10% of China’s GDP this year – leading to huge accumulations of foreign exchange – allowing the Chinese sovereign wealth funds to make major strategic stakes in overseas businesses. (China has established a company – the Chinese State Investment Bank - to invest the profits of its booming economy in foreign firms.)
8. Interest rates are being raised – but will this be enough to control inflation and engineer a softer-landing for the Chinese economy?

*China’s emergence as a superpower* has undoubtedly had some important demand and supply-side effects on the UK in recent years. This revision note considers some of those links.

Originally the “China Effect” was used to describe the deflationary effects on the price level in the UK and other countries that has come from China’s huge export-led growth. The seismic shift in manufacturing of shoes, clothing, iPods and household appliances to a lower labour cost country has helped to keep inflation down in the UK. And to this extent, mortgage payers in Britain have China to thank in part for their cheaper borrowing costs whilst consumers with a faulty kettle can simply pop down to Tesco to replace it rather than find the money for it to be repaired down the high street.
Professor Richard Freeman of Harvard University has estimated that the opening up of China and India, together with the collapse of the iron curtain in Europe, had resulted in a doubling of global labour supply – perhaps the biggest positive supply-side shock to the global economy in decades.

For the UK, the “China Effect” has until recently:

- Reduced the **real prices** of many staple household goods and appliances
- Put severe **competitive pressure** on UK manufacturing businesses struggling to compete with Chinese producers in international markets
- Caused a **widening trade deficit** with China – this has a **negative effect on AD** (C+I+G+X-M)
- Caused a fall in the price of many imports thereby **shifting out SRAS** to the right
- Lower import prices make incomes stretch further and help to **dampen down pay** claims.

The China effect has until recent times reduced both the **actual** and the **expected** rate of consumer price inflation in the UK

But in some ways the China Effect has and is proving to have inflationary consequences for the UK economy

- China’s rapid growth has been a key factor behind the **surge in global commodity prices** – there has been rampant price inflation in many hard and soft metals and also in **foodstuffs** such as wheat and rice.
- Part of the reason is that **China’s demand for meat** is increasing (the income elasticity of demand for meat is strongly positive) and this is driving up the demand for the grain used in producing cattle feed. **Food prices in China** are rising at more than 20% per year.
- China has contributed heavily to the **extra global demand for oil** and other sources of energy – driving crude oil prices high and delivering an **inflationary shock** to the world economy – China is engaged in a determined search to secure the supplies of essential fuels and other minerals it needs to keep her growth strong in the years ahead.
- China appears to be **growing too fast** for its own good, there is **demand-pull inflation** in the economy and the era of Chinese price deflation exported to advanced nations has come to an end.
- The **huge Chinese trade surplus** with the US is contributing to **dollar weakness** – this is driving sterling higher and making many of our export industries less competitive.
- Chinese deflation has kept **UK interest rates** lower than they might otherwise have been – and this helped to stoke the housing boom / bubble - now at an end following the credit crunch. Indeed one can argue that China’s contribution to globalisation has been a driving force behind the surge in global savings and the boom in credit and debt in advanced nations.

So what can we expect?

1. Much depends on what happens to
   - **The Chinese-US dollar exchange rate** – will the Chinese authorities allow the Yuan to appreciate and rebalance some of the trade between the two countries? A weaker US dollar will stimulate their economy but make our commodity imports (priced in dollars) more expensive.
   - There are signs that the Chinese currency is now appreciating at a faster rate against the dollar – in part to help control inflationary pressure in China
2. The China effect may be followed by an "African effect" or a "Bangladesh effect" – for as manufacturing in China becomes more expensive, production may start to relocate towards lower cost centres e.g. other emerging market countries such as Vietnam, Indonesia or Nigeria.

3. If the Chinese economy slows down (they have started to raise interest rates but with little or no effect thus far), then world commodity and energy prices may fall back, reducing some of the inflationary threat to the rest of the world economy.

Keep reading the business and economics pages of the newspapers right up to the exams!

UK, Exports to and Imports from China

£ billion per month, trade in goods and services

Growth Rates for selected Countries

Annual percentage change in real national output

Source: Reuters EcoWin