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Wage Increases: The Win-Win Answer on China Trade

High Chinese productivity will lead to higher pay and a reduced trade surplus—but not if Washington keeps pressuring Beijing to fiddle with the dollar exchange rate.

By RONALD MCKINNON

Recent Chinese labor strikes—particularly in the heartland of manufactured exports in Guangdong and the Pearl River Delta—have taken most observers by surprise. Labor shortages in and around Shanghai and Beijing are also widespread. Many local governments, especially on the developed eastern seaboard, have increased minimum wages by 15% to 20% this year.

A wage explosion fed by labor militancy is obviously disconcerting to Beijing. But in the long term China's wage increases should reflect its remarkably high productivity growth in manufacturing. Higher wage growth would have two great advantages for China and the rest of the world.

First, Chinese wages would become closer to those in the more mature industrial countries, thus reducing protectionist pressures. Second, higher wage settlements would reverse labor's declining share in China's national income. With a shift away from business profits—which have become exorbitantly high in recent years—to greater household disposable income, consumption would naturally rise and reduce China's trade surplus.

For wages to grow less erratically, what should China's long-term exchange-rate policy be? Much of the world, particularly Asia, is on a dollar standard. Most Chinese exports and imports are invoiced in dollars, as are international financial flows. China's net saving surplus is manifested mainly in a huge buildup of liquid dollar claims. In this dollar-based world, a fully credible fix of the yuan/dollar rate is the key to encouraging sustained high growth in Chinese wages that matches productivity growth.

In contrast, bashing China to appreciate its currency is counterproductive. If Chinese employers fear that the yuan will be higher in the future, then they become loath to grant large wage increases in the present. Producers of export products could be bankrupted if they granted high wage claims in yuan only to find out afterward that the yuan had also ratcheted upward, making the effective wage increases much larger in dollar terms.

In a world where competing goods from other countries (including the U.S.) are all invoiced in dollars, a safely fixed yuan/dollar rate allows a Chinese employer to estimate more precisely what wage increases

are commensurate with expected future growth in labor productivity. If any one employer offers less, others could well bid away his most prized workers.

The earlier experience of Japan shows the importance of the yen/dollar rate in determining wage growth. After the inflationary chaos and disorganization following World War II, in 1949 the Japanese government with American financial assistance unified the battered currency (got rid of multiple exchange rate and payments restrictions) and fixed the central rate at 360 yen per dollar.

With this dollar anchor, the postwar Japanese miracle unfolded: From the early 1950s to 1971, GDP and labor productivity in manufacturing began to grow by about 9% per year while growth in money wages was in excess of 10%, more than twice as high as in the U.S. With stable wholesale prices, trade was roughly balanced and so was international competitiveness.

But in August 1971, President Richard Nixon shocked the world by forcing the other industrial countries—Japan, Canada and those in Western Europe—to appreciate against the dollar. Nixon imposed a tariff on all industrial imports until the other industrial countries agreed to appreciate, which they all did by the following December. Japan appreciated by 17%. As early as 1970, the expectation of dollar depreciation caused huge hot money flows out of the U.S. Foreign central banks intervened heavily to buy dollars to prevent their currencies from appreciating more than what was agreed to with Nixon. The result was a world-wide loss of monetary control, great inflation, large business cycle fluctuations, and slow economic growth in the 1970s into the '80s.

Because Japan had by then emerged as America's foremost industrial competitor, the U.S. mistakenly began "bashing" Japan to force further yen appreciation. The yen rose to a high of 80 per dollar in April 1995 from 360 per dollar in August 1971. Hot money inflows first contributed to land- and stock-market bubbles in Japan in the late 1980s. But after these burst in 1990 and the overvalued yen rose even further, the economy was thrown into a deflationary slump from which it has yet to recover. By the end of the 1970s, money wage growth had slumped to less than in the U.S.—and Japanese wages are actually falling in 2010.

What is the lesson for China? Exchange rate appreciation and money wage growth are substitutes in the long term. But an erratically appreciating exchange rate with the associated hot money flows does long-term damage to the economy. Best to keep the exchange rate safely fixed near 6.83 yuan/dollar—as it had been for two years through mid June. Then gently explain to would-be China bashers that Beijing fully respects—and even encourages—workers to bargain in good faith for higher wages to match high productivity growth in manufacturing, which Chinese employers can more readily accept if they expect the yuan/dollar rate to remain stable.

Nevertheless, the U.S. Congress is again threatening to impose punitive tariffs on imports from China unless the yuan is appreciated. To contain the political risks from trade protectionism, the People's Bank of China bowed to this pressure on June 19 and depegged the yuan in favor of managed floating against an (unspecified) basket of foreign currencies. Whether this ambiguous "float" will succeed in defusing U.S. protectionist pressure remains to be seen.

But any systematic yuan appreciation—or threat thereof—will immediately restart the hot money inflows and, in the longer term, slow money wage growth. Moreover, a discrete sharp appreciation won't defuse the situation because it would be unlikely to reduce China's trade (i.e., net saving) surplus on which the Americans are so focused.

Behind this unnecessary political crisis is a widely held but false economic belief: that the exchange rate can be used to control any country's trade balance—the difference between its saving and investment. The imbalance actually arises from a large saving deficiency in the U.S.—with very large fiscal deficits and low personal saving—coupled with "surplus" saving in China from high business profits and buoyant government revenue.

The yuan/dollar debate that continues in Washington is more than a distraction. The threat of appreciation may well impede the natural process by which Chinese wages rise as fast as labor productivity in manufacturing, leading to greater unrest and perhaps even a Japan-like Chinese bubble.

Mr. McKinnon is a professor at Stanford University and a senior fellow at the Stanford Institution for Economic Policy Research.

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