In our note ‘The Phillips curve — rumours of its death are greatly exaggerated’, we showed that the relationship between slack in the economy and price pressures is alive and kicking. However, expectations are more firmly anchored than before and a number of other factors have masked inflationary pressures. Of these various masks, one — globalisation — is about to slip, thanks to China. That is the focus of this note.

Cross-border integration in flows of trade, capital and people has deepened significantly during the past half-century. One metric of this trend, otherwise known as globalisation, is the sum of global exports and imports of goods as a share of global GDP. This rose from just 20% in 1970 to a record 52% by 2008. Basic economic theory concludes that globalisation has an unambiguously positive influence on the size of the global pie (world GDP), owing to exploitations of gains from comparative advantage boosting global productivity and reducing global inequality.

Globalisation
Merchandise trade as a share of global GDP, per cent

Source: Thomson Reuters Datastream / Fathom Consulting
The process of globalisation has seen a shift in economic power away from developed economies and towards emerging economies. Poor economies have industrialised, reaching middle-income status very rapidly — most notably China which has followed a growth model of high investment, focused on export-orientated sectors, for many years now. In 2016, its investment as a share of output stood close to 45%, compared to an advanced-economy average of just over 20%. Its admission to the World Trade Organisation in 2001, opened it up to international markets, enabling a substantial build-up of productive capital to be exported abroad. China’s trade relative to world GDP reached almost 1% in 2015.

Owing to China’s vast amounts of excess productive capacity, government subsidies to predominately state-owned export firms and relatively low labour costs, China has provided cheap goods to the rest of the world. The price of US imports from China is the same today as it was fourteen years ago. During the same timeframe, the price of imports from advanced countries has increased by around 20%.
As well as lowering the cost of imported goods, globalisation has put downward pressure on wages in developed economies. Reallocating labour from low-productivity agricultural sectors to higher-productivity manufacturing sectors in emerging economies, has released a pool of cheap labour on to the global market. By enabling firms to either import goods or locate production abroad, globalisation has reduced the wage bargaining power of the average worker. As the next chart shows, the share of the pie accruing to labour via wages, salaries, bonuses and benefits in developed economies has reduced as globalisation has risen.1

This goes some way towards explaining why populist parties advocating protectionist policies have gained so much support in developed economies during the last couple of years. The growing share of the electorate calling for the ‘end of globalisation’, has led to an increase in restrictive trade policies — the trade-weighted average global tariff rate has risen for three consecutive years since 2012, the longest streak since records began in 1988. The rise of globalisation has been stunted.

Not only has globalisation stalled, but the gap between unit labour costs in China and the US is closing — both factors will reduce the downward pressure on wages in advanced economies. Between 1992 and 2014, the average cost of labour per unit of output increased by 150% in China. During the same timeframe it rose by just 40% in US. We have focused on the relationship between the US and China for two reasons: China is the largest emerging and developing economy in the world; and no other emerging economy has the same capacity as China to influence prices. As relative unit labour costs come closer into line across emerging and advanced economies, the downward pull on wage settlements along with the gains from offshoring manufacturing should reduce.

1. Globalisation is just one of the five factors we believe are responsible for the sustained decline in the labour share. The other four (demographics, de-unionisation, labour-replacing technology, and the rise of the ‘gig’ economy) are discussed in detail in a note released last week: ‘The Phillips curve – rumours of its death are greatly exaggerated’.
When China’s labour market reaches the Lewis Turning Point (LTP) this should reduce relative unit labour costs even further. In an economy such as China’s, where there is an excess supply of labour in a low-productivity sector, wage increases in the fast-growing industrial sector are limited by wage levels in the agricultural sector, as labour flows from the farms to industry. The LTP, named after the Nobel laureate Sir Arthur Lewis, is the point at which the supply of cheap rural labour dries up, and first rural and then urban wages start to rise. China has not yet reached this point — real urban wage growth was 6.7% in 2016, the lowest reading for almost twenty years. Indeed, until significant reforms are made to China’s household registration system, hukou, which ties a Chinese citizen’s access to benefits and certain rights to the town in which they were born, labour mobility will remain restricted and therefore the LTP will not be reached. Evidence to date suggests reforms to the hukou are progressing extremely slowly — if at all. In 2016, only 38% of all migrant employees had signed a contract, giving them workers’ rights, a record low.

Using our global model, GESAM, we have simulated the impact of China reaching the LTP on both domestic and global inflation. We have assumed urban wage growth surges from 6% to around 20%. In the first instance this increases domestic inflation by around 250 percentage points. GDP growth is also positively impacted, with the significant boost to incomes leading to higher consumption growth. However, the impact on GDP growth then turns negative as China’s policymakers respond to increased inflationary pressures by hiking interest rates. Despite this, the upward pressure on wages from China leads to a permanent increase of around 0.6% to global inflation — quite a substantial increase from its current rate of 2.8%.
Evidence presented above suggests that globalisation will continue to put a downward pressure on global wages, but to a lesser extent. As we will discuss in future notes, we believe only two of the five factors which have led to a sustained decline in the labour share in developed economies still have further to run: labour-replacing technology and the rise of the ‘gig’ economy.

When China reaches the LTP it will lead to a significant boost in global inflation, ceteris paribus.