

Dr. Helmut Reisen

Thank you very much for the invitation to this wonderful conference. I am really honored, ladies and gentlemen, to speak after two marvelous speakers that we had. And when I was asked to give a presentation here at the conference of IIASA, I asked myself – what could I usefully say? Certainly I would not report on current research, which is, if you want to know, about the debt sustainability in Africa, post-debt relief in the presence of heavy Chinese lending to Africa, but I thought I'd take a more general subject which is linked to the fact that with China and with India, 2 billion people have integrated into the market economy recently and what does that mean to the poor and the rich. So I could speak about this issue for 180 minutes, but unfortunately the organizers took off the last zero so it will boil down to eighteen minutes hopefully.

OK, lets see how this works. Now, here you see [shows slides], but perhaps not very well, declining curves. These declining curves show for the major OECD regions a decline in wage share. The wage share has been a very important development in OECD countries; its decline of about 20 percentage points is quite remarkable, and to this day, unbroken. If we move to the next slide we see the investment of Asian surpluses into US government bonds and what that has done to interest rates. It has depressed interest rates and by depressing interest rates it has stimulated asset price inflation, for pictures, for classic cars, for stocks, you name it. Those who hold assets have been benefiting, while the wage share has been going down.

Now I do think that this is very much related to the cheap goods and the cheap savings that China, above all, has been delivering to the world until very recently, but my major thesis is that this time, that period that has lasted for the last 10–15 years really is coming to a close and is already changing, so that we will see very strong important developments arising from the labor markets. This is a picture that I took from Ed Leamer, from UCLA. It shows the populations on the X-axis and the income levels on the Y-axis, and if you imagine a glass of water where you have conversions within the glass of water, this would be a fairly frightening prospect for OECD countries and a very good prospect for the poorer countries. By the way I have 2 figures here, one is blue and one is green. The blue one is for 2000, the green is for 1980. What we see is that everybody except the middle income countries are better off in the twenty years from 1980 to 2000. And so we have some movement of wage and income convergence but not for these middle-income countries. The question, of course, that you always have to raise is what will happen to productivity? What will happen to our productivity and what will happen to the productivity of those countries that are integrating into the world economy?

I think the under-discussed aspect is really the shock to world labor markets that the integration of China, India, but also the former Soviet Republics, had given to the world economy to absorb within a very short time post 1990. What it meant to us that the capital–labor ratio in market economies was first halved. Now if you apply a very simple [?] production function, this factor shares one third for human capital, one third for capital, one third for labor. This would mean that this integration, first of all, has depressed equilibrium wages by 15%. Either it does so when wages are free to move or it

generates unemployment when there are minimum wages that do not allow wages to decline by the corresponding 15%. The good news though is that particularly China is adding very quickly to the existing capital stock and so refilling that capital-labor ratio because it has a tremendously high savings rate, which I think in this context is good.

Now the wonderful thing for us older economists about the integration of China and India is that it has revived some old theories that were written in the 40s or 50s and that we learned in our textbooks. One was Lewis's model of unlimited supply of labor which is shown in the graph. We had this situation in the rural hinterland of India and China where just the urban sectors, the developed former sectors, just offer a slight increase in wages and then they will move over. This means that we do not have a neo-classical situation in the labor market; we have a very Ricardo-like classic situation in the labor market until the rural surplus labor in the hinterland is absorbed. And that is exactly what we are witnessing since 2004.

Now if you look at the wage development in China you will see it strongly up in nominal terms, but in real terms actually the entry wages in the construction sector in China have been fairly flat. That is the result of the fact that there was a lot of movement into this sector, which again can be described by an older model, the Harris-Todaro. And until 2003 we have seen in China that the urban wages as a fraction of rural wages have been rising tremendously. So until 2003-4 there was really no indication that the surplus labor in China had been exhausted. This meant that China was able to export cheap goods, and if you look at the 1944 theory written by Samuelson, you will know that this means pressure on wages in our countries and this is exactly what we had. Now some people say they are super-competitive in everything; they have people, they have capital, they are smart; but I think this is very un-economic way of thinking about these things. Krugman has nicely shown, I think, even for the layman in an article in the Harvard Business Review that there is always a comparative advantage to the old established world. The question is where do the Chinas and the Indias compete with the OECD countries? It is probably in the intermediate-tech sectors, not in the low-tech, nor in the high-tech sectors. That's where the productivity relationship determines the wage relationship and let's assume in this picture in this diagram [shows slide], it is 5 to one, then it means that if we are only doubly productive in textiles, let's say, then we will not be competitive at these wage relationships but as long as we are super-productive 10 to 1 let's say in new pollution-fighting instruments, in handsets, phones that have lots of new features, like the Nokia phones for example, then this can very much absorb the higher wages being paid.

This is just a reminder because in the discussions they often get that wrong. This is a bit complicated; here we see that the products where China has been engaged, the prices of these products have been falling in real terms, so China's product terms of trade were declining until 2003 while our purchasing power was rising. This was especially beneficial to the typical consumer of let's say the Wal-Mart shops in the United States and their counterparts elsewhere because the content of China-produced or India-produced products is very high. On the other hand, we had an erosion of our purchasing power by the incremental demand deriving from India's and China's rise. Here you see

numbers for the oil price and raw-material price developments [shows slide]. They show that prices would have been 40% lower for oil if there were no integration of China into the world economy. So we wouldn't be paying \$90 a barrel but \$50 a barrel right now. And this of course had a negative effect on our purchasing power. I think very much benefiting from China these days are the raw material producers in Africa and Latin America. And it's not just higher prices, because especially China does give a big service to the world economy by not buying raw material prices on the spot markets—on the LME in London—but by extending the supply capacity in these countries by investing there. So there is a lot of investment in oil exploration, in copper exploration and so on, going on, which actually means a dampening of world prices compared to the situation were they only looking to get delivery from the spot markets. Now why don't they do this? They have seen that there was an Iraq war on oil; they have seen the Russia-Japan pipeline circumvented China; they have seen that Sinoc was not able to buy a counterpart in the United States so there is really no alternative for China to invest in those places, especially in Africa, that the West by the way had neglected for a while. Now we are seeing perhaps with development and with China is getting richer, that the two effects that are quite specific.

I will predict that iron ore prices that have benefited so far in the super-cycle from the fact that there was industrialization and heavy construction activities that this super cycle is not over yet but it will change its form. Price rises will be sustained for oil, simply for the reason also that cars are replacing bicycles, and agriculture prices are rising because of changing eating habits. So, for example, prices for soya are on the rise because the Chinese will eat more meat. I said at the beginning that we are at a watershed, it seems, and that is very much related to the one-child policy in China because those demographic cohorts that sit in the rural hinterlands and are fairly unproductive, these cohorts are really coming down quite considerably, so one should not look at the sheer numbers but really one should look at those specific cohorts that can make the move to the urban cities and these are coming down quite quickly. So we see now lots of complaints in China's manufacturing about rising wages, about shortages, we see out-movements, therefore, of low-skilled production to Bangladesh, to North Korea, to Vietnam. We see that the fundamental source of the decline in terms of trade, of the delivery of cheap goods to the world, is coming to an end. Here you have another picture which shows clearly that the average migrant rural wages have started to rise faster than before and that migrant workers saw a greater increase in the past 3 years than they did in the entire previous decade and that wages are now rising by more than 12%. Now this already shows up very much in export inflation. If you look at the fact China has been until 2003–2004 contributing to world deflation, I once wrote an article in the Financial Times – “With such a China, who needs central banks?” Central bankers were essentially jobless, they tried to avoid that impression, but they didn't have a great job to do until very recently. And this is coming to a change as well. You hear this already coming up in the press and I think again this is very much related to the graph that we are seeing in the left panel [slide]. We see that an annual drop in export prices of 3% until 2003 for on average has given rise to an average increase of 3% since then, and this of course means that the central bankers have to wake up because the inflationary pressures are coming back to the forefront.

Now, I wonder therefore whether we are at the start of a new era. We see for example, the desire of those Asian countries and, of course, the Middle East that are indirectly benefiting from China and India's rise as they have connected to the super-cycle that has sustained high oil prices. So we see that they stop investing in usual foreign exchange reserves, which means in US government bonds. We count these effects in a super-weak dollar, but we also see that interest rates have been rising because these assets formerly invested in foreign exchange reserves, are now being invested in real assets, or the SWF's, these Sovereign Wealth Funds that people discuss so much these days. This will mean that asset prices will be dampened because the underpinning depression of interest rates is coming to an end; but [it also means] that on the other end we will have goods and wage inflation and higher prices for skills and soft commodities. Low-skill goods and wages will rise as well, and we still will not be able to say that this should imply a rise in purchasing power for all wage earners because food prices to the extent that they are important are taking away, for example, much of the gain in purchasing power that comes with higher nominal wages.

So what are the policy consequences of change in the distributional impact of Asian giants? I think, first of all, it shows that it pays to be patient. It pays to be patient in terms of trade-openness because the beneficial effects are rather starting to show now more strongly for industrialized countries than they have in the past. In the past we had, of course, benefits, but we had a lot of friction and that friction is predicted to come down. Central banks I mentioned already, have to get back to their desks and be watchful of the inflation price development and, as far as OECD labor markets are concerned, we need permanent training as was prescribed by the OECD job study. We need a permanent upgrading of our skills. For IIASA, I think these developments mean that having the privilege of having both China and India as members, it might be an idea to explore this micro-macro link that I have touched on during these 18 minutes a bit more profoundly by going into the labor markets, watching very carefully what is going on in the labor markets in India and China, and then linking that up to events in the world economy. Thank you very much for your attention, I hope I kept within the time.