

Box 1

ARE RECENT WAGE INCREASES IN CHINA PUTTING UPWARD PRESSURE ON EURO AREA IMPORT PRICES?

The prices of euro area manufacturing imports from China increased by 13% year on year in euro terms in the second half of 2010. This is almost double the pace of the overall rise in euro area manufacturing import prices. As a result, after many years of downward pressure on euro area import prices, Chinese exports to the euro area made a positive contribution – of 1 percentage point – to the 8% overall increase in euro area manufacturing import prices in the

second half of 2010. This box presents the factors behind the developments in the prices of euro area imports from China and discusses the prospects for the future.

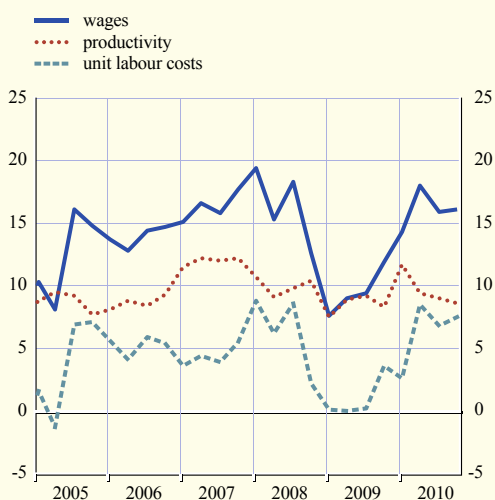
The recent increase in Chinese export prices occurred in parallel with an increase in labour costs for Chinese manufacturers. However, at this point in time, there is no compelling empirical evidence to suggest that Chinese real wages are set to increase well above productivity growth. While the growth rate of manufacturing unit labour costs picked up to around 8% by the end of 2010, this may reflect the stronger cyclical position of the economy. In addition, the current growth rate of unit labour costs is still in line with historical developments and is close to the pre-crisis level (see Chart A).

Historically, increases in Chinese manufacturing export prices in euro terms have been more strongly correlated with movements in the bilateral exchange rate of the euro vis-à-vis the renminbi than with unit labour costs (see Chart B). For instance, the rise in Chinese export prices in the first half of 2010 occurred in parallel with a 21% appreciation of the renminbi against the euro. This strong positive correlation between Chinese export prices and the EUR/RMB exchange rate may be due to the fact that the bulk of Chinese exports to the euro area are thought to be invoiced in US dollars, with prices being sticky in the short run owing to the periodical revision of contracts. Given that the movements in the EUR/RMB exchange rate are mainly a by-product of the movements in the exchange rate of the US dollar against the euro, Chinese export prices – while being unchanged in dollar terms – have fluctuated in euro terms.

Looking ahead, China is expected to remain a low-cost country for a prolonged period. While the supply of young workers, who are the most willing to migrate, is projected to decline in the coming years, the relaxation of existing obstacles to migration and the delocalisation of production towards inner provinces should help Chinese manufacturers to utilise cheap rural labour for a

Chart A China's manufacturing wages, productivity and unit labour costs

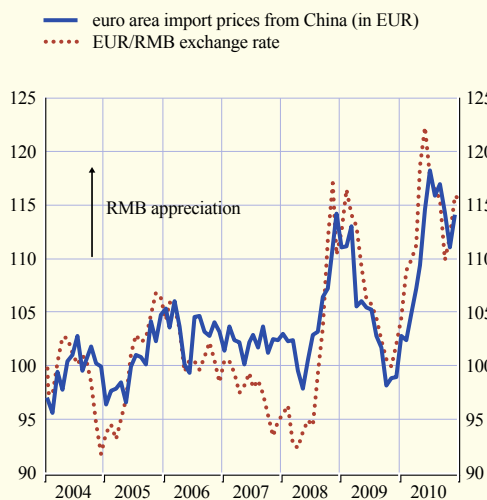
(year-on-year percentage changes)



Source: CEIC, ECB staff calculations.
Note: Latest observation refers to the fourth quarter of 2010.

Chart B Euro area import prices from China and the EUR/RMB exchange rate

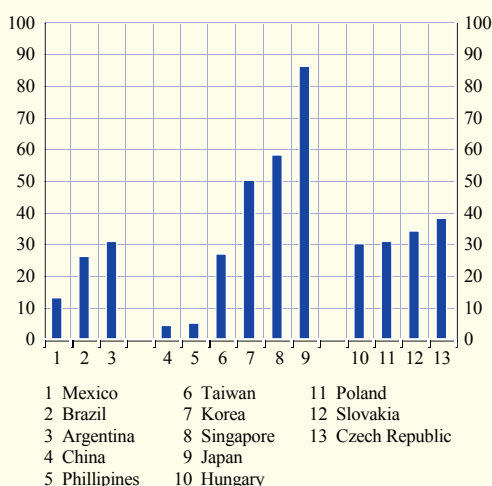
(2005 = 100)



Source: Eurostat.
Note: Latest observation refers to December 2010.

Chart C Relative wage level of China in 2008

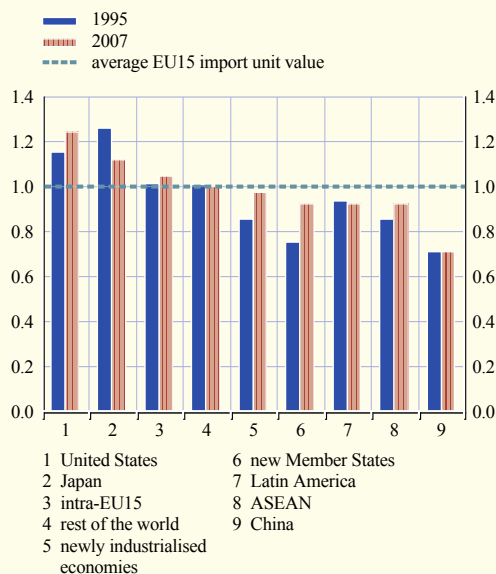
(manufacturing hourly compensation costs; United States=100)



Source: US Bureau of Labor Statistics.

Chart D The relative unit values of EU15 manufacturing imports by origin

(relative to the EU15's average import unit value)



Sources: Pula, G. and Santabárbara, D., "Is China climbing up the technology ladder?", *Working Paper Series*, No 1310, ECB, 2011. Note: The relative unit values are calculated at the CN8 digit product level and aggregated by country export weights. The relative unit value is calculated as the unit value of a given product from a given country divided by the average unit value of that product across all import origins.

longer period. Even more importantly, the share of Chinese workers in the agricultural sector is still very high at around 40%, suggesting that there may be further significant scope for labour restructuring and productivity gains in China.

Nonetheless, even if the labour market tightens and wage pressures increase, China's cost advantage is expected to decline only gradually. According to the most recent update of international labour cost statistics by the US Bureau of Labor Statistics, Chinese hourly compensation costs in the manufacturing sector are only 4% of the US level (see Chart C). China has the lowest wages among the 35 countries in the analysis, slightly below the level of the Philippines, one-third of Mexico's and one-eighth of Eastern Europe's wage level. While these figures partly reflect productivity differentials, they also suggest that Chinese manufacturing is highly price competitive. As a result, Chinese goods continue to be sold at a substantial discount on European markets in comparison with other competitors. ECB staff estimate the price advantage of Chinese export products to be around 30% (see Chart D). Given that Chinese goods are, on average, cheaper than those imported from other non-euro area countries, increases in the import share of China in euro area markets will have a downward impact on euro area import prices over time (referred to as the "share effect"). As a result, even if Chinese wages catch up to the level of more advanced economies at a faster speed, the impact on euro area import prices in the short to medium run may be limited, provided that China's share in euro area imports continues to grow.