The waning of China as a global disinflationary force

The reason for the current burst of inflation, and central banks' belated and ongoing efforts to rein it in, are well understood. Covid-related supply constraints, exacerbated by the war in Ukraine, massive monetary and fiscal easing and, more recently, tight labour markets and rampant wage growth, have all contributed to a period of sustained global inflation.

We have not seen this sort of inflation surge since the 1980s, or since inflation targeting was established as a key tenet of macroeconomic stability in the early 1990s.

Harder to discern are the various cyclical and structural forces at play that, while unnoticeable given the recent inflationary shocks, are nevertheless bubbling under the surface and will have an impact of the medium- and long-term outlook for inflation and monetary policy.

Two factors weigh heavily in that thinking: the demise of globalisation and the ageing of China's workforce.

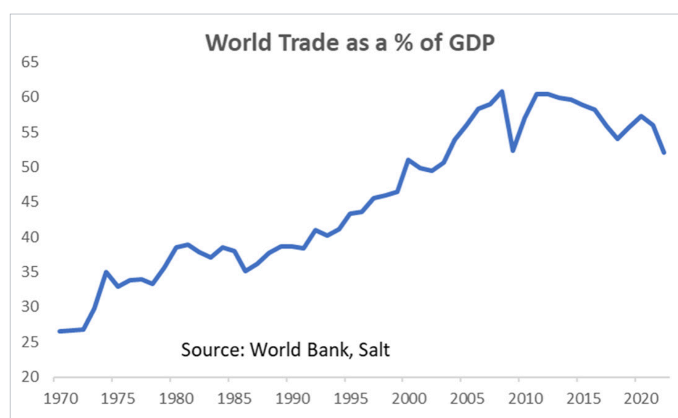
In the two decades prior to the Global Financial Crisis, globalisation was in its zenith and China was a key part of that development. Global trade was growing at twice the pace of overall GDP as liberalisation of both trade and investment allowed firms to shift production of final and intermediate goods to countries with lower costs of production, particularly the emerging economies.

China's low production costs and improving infrastructure, coupled with the encouragement of Foreign Direct Investment turned China into one of the largest recipients of FDI over that period, and enabled it to become the factory of the world.

Globalisation had a direct and significant disinflationary impact on advanced economies as cheap production from China and others was allowed to displace more expensive domestic production. At the same time, the bargaining power of developed economy workers was reduced, keeping wage growth suppressed.

Several developments over recent years have transpired to alter this dynamic.

Globalisation is in clear and obvious retreat as global trade as a percentage of global GDP is now on a downward trajectory. Critical to this development has been the political response to rising inequality, especially in the aftermath of the Global Financial Crisis.



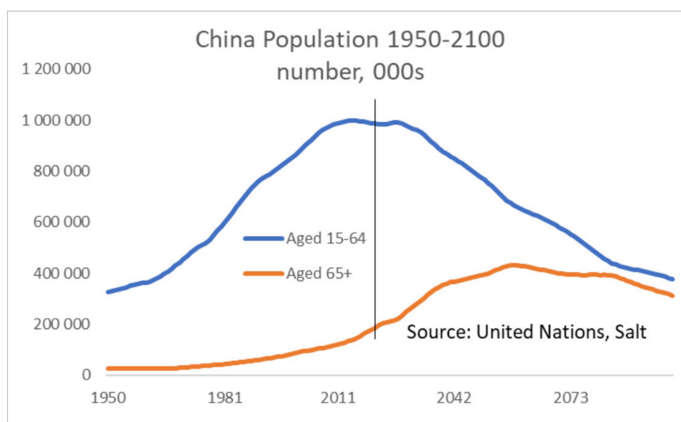
However, we need to clear about what inequality we are talking about. While globalisation has contributed to rising inequality within typically developed countries, it has made a massive contribution to reducing in equality between developed and emerging countries.

We would argue the political unease should be directed at developed economy's inability to deal with the consequences of globalisation rather than at globalisation per se. Regardless, globalisation has seen a significant political backlash, manifested most starkly in 2016 with Donald Trump's election to the US presidency on a mandate of making America great again, and the UK Brexit referendum.

Globalisation has been further derailed by Covid as many businesses now look to shore up what are now known to be fragile global supply chains, at least in the face of a global pandemic. Some are now looking to source final goods or inputs into production closer to home, even if that means they are more expensive.

Geo-political tensions are leading to a more fragmented world, which will have inevitably spill over into reduced trade flows and economic growth.

In China itself the population is ageing, and its working age population is now in decline. United Nations projections show this cohort peaked at 998 million in 2015 and is expected to decline to 767 million by 2050 and 378 million by 2100 with obvious implications for wage growth.



At the same time, China's new push for "common prosperity" and self-reliance will have further implications for wage growth and globalisation respectively.

Of course, higher wage growth is manageable if it is matched by productivity gains. Emerging markets find productivity gains easy to come by in the early stages of their development as they play catch up with the developed world.

China has been no exception, though we expect future productivity gains will be harder to come by. China's success as a technological innovator, as opposed to being a fast follower, is yet to be tested. Indeed, China may be hamstrung in its innovation drive by competitors' political responses such as the Biden Administration's recently announced and sweeping restrictions on the export of semiconductor and associated technologies from the US to China or into China-feeder technology pipelines. This move, dubbed "the most expansive export control action in decades" extends even to the provision of skilled advice by US nationals, and may be a harbinger of a new age of commercial-military restrictiveness.

In fact, China is facing into much the same challenge faced by many developed economies, declining working age populations and productivity challenges. Unfortunately for China, this has come before the country has become rich, raising questions about the fiscal sustainability of pension entitlements and health care as the country's dependency ratio rises.

More broadly it is widely assumed that the aging of populations is a disinflationary force. The argument goes that as people age, they save more, reducing demand for goods and services. Japan has long been held up as the poster child for this phenomenon.

However, Japan's ageing has coincided with the rise of China's role as the world's factory. With this role now in question, we believe ageing populations will prove inflationary, especially if productivity growth remains subdued.

China's role as a source of global disinflation is drawing to a close. Unless it can unlock the answer to higher productivity that has thus far eluded most more developed economies, China seems destined to become a new source of global inflation.

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