

## Hu Xiaolian: The cooperative relation between adjustment of production factor price and reform of the exchange rate regime

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China faces a major challenge and the task of restructuring the economy and achieving sustainable and balanced growth. To realize these goals and to transform the growth pattern, the Chinese government has taken a series of decisive measures, especially in the field of the price reform of production factors, energy saving and emission reduction, e.g. promoting the resource tax and fee reform, increasing the cost of polluting the environment, raising the minimum wage of enterprise employees, and etc. The price of labor, resource and energy and environment cost are generally on the rise. In this context, further reform of the RMB exchange rate regime requires in-depth analysis on the relation between factor price adjustment and the reform of RMB exchange rate regime.

### **1. *It is necessary to adjust production factor prices as the economy develops.***

The benefits brought by economic development should be shared by the whole society and lead to higher wages. Significant demographic change is underway in China. In the first decade of the 21st century, the growth of working-age population moderated compared with the last two decades of the 20th century. Total working-age population may even decline in the next 5 to 10 years. With such a demographic change and continued and massive migration of surplus rural labor into the urban area, the Chinese economy is approaching the Lewis Turning Point, where labor surplus is expected to drain off and pressures for pay rise will mount. For years, wages for unskilled workers of export-oriented processing enterprises rose quite slowly, but migrant worker shortage frequently seen in recent years points to the fact that the wage for workers, especially that of the migrant workers, can no longer remain as low as previously was. Moreover, the Foxconn incident has drawn increased attention to the issue of low-income workers, pressing for substantial rise of minimum wages in many areas.

In the meantime, as the economy grows in size and consumes more energy and resources, bottlenecks will become more acute. With urbanization and industrialization rapidly progressing, the fast growing Chinese economy consumes massive amount of energy and resources and faces mounting pressures to protect the environment and address climate change. It is a general global trend that prices for non-renewable energy and resources and environment cost will be on a rise. From 2003 to 2009, the purchasing price index of raw materials, fuel and power rose by a total of 35.6 percent, partly due to price hike on the international market and partly as a result of manufacturing and export expansion domestically. As China's economic development enters a new stage, growing public awareness of resource scarcity and environment protection adds to the pressure of energy and resource price adjustment. In short, production factor price will have to be adjusted regardless of the Balance of Payments (BOP) status.

### **2. *The adjustment of production factor prices in a broad sense is an important component of China's economic system reform.***

The Chinese government has emphasized the need and made continued efforts to adjust the structure of income distribution, including raising the share of household income, promoting price reform of energy products such as petroleum, gas, water and electricity to have in place a more reasonable price system for basic products, raising pollution charge and fee standards for sewage and garbage treatment to deepen the reform of environment protection charges. In addition to direct price adjustments, measures have been adopted to reinforce law enforcement examination on environmental protection, keep market in order, forbid defaulting on wage payment to migrant workers, set a ceiling for maximum working hours

and etc. All these measures will lead to a rise in the production factor price in general. When adjusting factor prices, usually consideration will be given to how to handle the relations between reform and inflation on the one hand and between reform and primary income distribution and redistribution on the other hand, and whether to compensate those affected negatively by such adjustments. Therefore, the adjustment of production factor prices needs to be planned and designed as an integral part of the whole reform package.

**3. Adjustment of production factor prices and exchange rate movements can substitute and complement each other.** The Central Economic Work Conference outlined the goal of expanding domestic demand and lessening the reliance on net export in the pursuit of national economic development, restructuring and growth pattern upgrade. Further reform of the exchange rate regime and adjustment of production factor prices in a broad sense both contribute to the goals above. Rapid adjustment of production factor price help ease appreciation pressures and a floating RMB exchange rate regime alleviate upward pressures on production factor prices. The two substitute each other to a certain extent. A proper mix of the adjustment of production factor prices and exchange rate changes based on the economic circumstances will be more effective to serve policy goals than adopting merely one of both. For example, compared with a substantial pay rise without enhancing the flexibility of exchange rate regime, a two-pronged approach will be more effective to promote stability and help ensure that the improvement of productivity and efficiency of enterprises is kept abreast with the rise of wage level. This is particularly true under upward price pressures. If the wage and price levels are allowed to rise unchecked while exchange rate is fixed, inflationary expectations will be reinforced, heightening uncertainties in consumption and investment and exposing the working population to higher inflationary risks. Therefore, adjustment of production factor price and the floating of exchange rate complement each other.

**4. Adjustment of production factor price and greater exchange rate flexibility are different in frequency, flexibility, working mechanism and scope of influence.** First, factor price adjustment measures aimed to establish a market-based pricing mechanism will intensify inflationary pressures and have distributional effect, and need to be supported by other policies. Thus frequent price adjustment is neither practical nor plausible. Under a managed floating exchange rate regime, the RMB exchange rate moves in both directions to reflect changes in economic circumstances and BOP.

Second, the two differs in terms of flexibility. In a managed floating exchange rate regime, the exchange rate is more flexible and moves in two directions, whereas the price of production factors is somewhat rigid. As resources and energy are becoming increasingly scarce, prices will go up in general; once introduced, environmental protection fee will always be levied and have little chance of being revoked; the efforts of reducing emission of carbon dioxide and other greenhouse gas will be strengthened; Labor compensation is also rigid as its long term adjustment tends to be one way except the occasional downward movement caused by crisis and major technological breakthrough. Exchange rate, on the other hand, will move in both directions to respond to market supply and demand when the current account is in surplus or deficit.

Third, the two reforms impact resource allocation in different ways. Exchange rate floating affect prices of imported goods and the general price level fairly quickly and alter the relative price between tradables and non-tradables. Exchange rate appreciation will move resources from tradable sectors to non-tradable sectors, and promote the development of services and other tertiary sectors and economic restructuring. Production factor price adjustment affects relative price of various categories of prices and is usually designed to enable prices to play a fundamental role in resource allocation.

Fourth, the two reforms affect different enterprises. In the case of exchange rate reform, a stronger yuan is likely to affect the price competitiveness of exporters, but is a favorable change to enterprises that import large quantity of raw materials and semi-finished goods to

meet domestic demand. In the case of production factor price adjustment, higher labour and resources price and environmental protection cost will affect the corporate sector as a whole. Although enterprises are able to reduce the burden through technical innovation and higher resource utilization efficiency, the overall impact of such adjustment will be extensive and transmitted through a longer chain.

Fifth, the two reforms have different impacts on inflation. Production factor price adjustment will directly increase inflation pressure. If the RMB exchange rate appreciates in response to market demand and supply, that will directly reduce the domestic currency denominated price of imported goods, and reduce inflation pressure through changes towards a more balanced BOP account and the subsequent reduction of passive base money supply.

**5. *The production factor price adjustment and exchange rate regime reform can work together to achieve the intended outcome.*** On the one hand, a more flexible RMB exchange rate will create a low-inflation environment for the reform of production factor price, and will not stand in the way of such reform. Past experience has shown that the major consideration of production factor price adjustment is the concern for its impact on inflation and income distribution. For example, gasoline surcharge to tax reform has been in deliberation for more than a decade, and much debate is on the necessary conditions, timing, and distribution effect of such reform. The major concern is whether the price reform of production factor will cause inflation and have a big impact on income distribution. Exchange rate reform can mitigate the impact and promote production factor price reform. Moreover, when formulating the inflation range for monetary operations, consideration has been given to such reform.

On the other hand, the adjustment of production factor prices helps alter the cost-ineffective pattern of economic and trade growth both directly and indirectly. Such adjustment promotes the upgrade of export-oriented industries and makes enterprises more adaptive and resilient to volatility of market prices. It also helps ease the expectation of RMB appreciation, reduce short-term capital inflows, lessen pressures from the international community and thus provides a facilitating environment for further reform of RMB exchange rate regime. Therefore, the reform of exchange rate regime and adjustment of production factor prices complement rather than working against each other. Effective coordination of the two policy tools is essential to stable macroeconomic development.

To sum up, adjustment of production factor prices and further reform of exchange rate regime both contribute to realize the goals for macroeconomic management, as they help optimize resource allocation, incentivize enterprises to improve management and speed up technological innovation, reduce consumption of resources and energy, and promote the restructuring and sustainable development of the economy. Reform of the exchange rate regime and adjustment of production factor prices substitute and complement each other. They can be implemented in parallel. Unwavering efforts should be made to further reform the exchange rate regime and the pricing mechanism of production factors to consolidate the foundation for a balanced and sustainable economic development.