Productivity Growth of the Non-Tradable Sectors in China

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Summary

Little is known about the total factor productivity (TFP) of the non-tradable sectors in China, not only due to the general technical difficulties in estimating TFP for services, but also because the data of output and employment for the non-tradable sectors is either problematic or not available at all. We estimate TFP growth of the non-tradable sectors by studying the relative price movements of the non-tradable sectors vis-à-vis the tradable sectors, i.e. changes in the internal real exchange rate. We find that prices of the non-tradable sectors have risen significantly faster than those of the tradable sectors, and China's internal real exchange rate has appreciated at a faster pace than the renminbi real effective exchange rate. We also find the non-tradable sectors have seen much lower TFP growth than the tradable sectors, and such productivity differentials are large when compared to other economies.

If TFP growth in the non-tradable sectors remains slow, China will likely see more difficulty in rebalancing its growth pattern and higher inflationary pressures in the medium term. Whether China can successfully rebalance its growth pattern depends in large part on the productivity of non-tradable sectors because productivity growth is the basis for improvement in real income. In the meantime, demographic changes point to wage increases and hence inflationary pressures in China, and higher growth of labour productivity in the service sector could help mitigate the impact of unit labour costs on inflation. As TFP growth is a component of labour productivity growth, higher TFP growth in the service sector points to lower inflationary pressures accordingly.

It is therefore important for the authorities to take policy actions to raise productivity growth in the non-tradable sectors. The findings of this paper provide empirical support for such policy actions.