Beware wishes that could come true

The world wants China to revalue its currency, but that could have unpleasant consequences, writes Salil Tripathi

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The world, it seems, wants a dearer yuan. The assumption is that if the yuan strengthens, it would weaken China's unbeatable export competitiveness, narrow trade deficits, and preserve more jobs at home. Chinese goods would become more expensive, and consumers in Europe, the United States and elsewhere will start buying locally-made products again. If only.

On Monday, China did allow the yuan to strengthen, and the Chinese currency crossed the level of eight to the dollar. This excited currency speculators and traders, who saw this as further sign of weakening of the US dollar. Some manufacturers in the west may have even heaved a collective sigh of relief.

The pressure on China to revalue its currency has indeed been enormous, and it has been growing over the years. Last week, the US Treasury avoided the temptation of calling China a "currency manipulator", and some analysts believe the appreciation of yuan was China's way of saying thank you.

But the US Congress wants more. Two senators, Republican Lindsey Graham and Democrat Charles Schumer have crafted a law that would impose a 27.5% tariff on imports from China unless the yuan rises "substantially". The bill is unlikely to pass and whether it can be consistent with the US's WTO obligations is another matter.

Facing sustained criticism over what many economists believed was its artificially depressed currency, last year China did revalue the yuan by 2.1% and it has been slowly gaining value since then. The yuan problem does not affect the US alone. European trade ministers are also concerned, even though Europe exports more to China than America. But lately, Europe has been buying more Chinese products as well.

At $97bn, Europe's trade deficit with China is now nearly half of the US deficit of about $200bn a year. The group of industrialised nations known as the G7, as well as the World Bank, have both urged China to let the yuan rise. The central assumption behind the drive for the yuan's appreciation is the expectation that it would slow down China's export juggernaut. Jobs in the west would be preserved, if not recreated.

However, a dearer yuan will not necessarily help the west. In fact, it will hasten Chinese advances in higher value-added manufacturing. And if some labour-intensive industries do shift relocate from China, the beneficiaries will be factories in Vietnam, Bangladesh, and possibly India, Indonesia and Thailand. Those jobs will not fly back to Europe or America.

Moreover, exports account for one-third of China's economy, and China simply cannot afford trade to slow down. Its economy must grow rapidly, so that it can keep its people gainfully employed.

As state-owned factories fold, and as the countryside offers less, millions of Chinese workers have been moving around the country for better opportunities, and domestic pressures are rising.

China is therefore not about to oblige by restraining job generation. A marginal dip in the pace at which exports are rising from China is, in any case, inevitable.

Reports from southern China suggest that in the booming zones in the Pearl River Delta, there are now looming labour shortages.

That is a result of three trends: China's one child policy; workers choosing to remain in their own provinces, as opportunities increase at home in some areas; and young people choosing to pursue higher education to acquire qualifications that will equip them for better jobs than on assembly lines.

If international pressure continues on China to strengthen the yuan and it is forced to relent and continue to recalibrate the currency, its government will want to ensure that its manufacturers move to higher value-added industries.

Labour cost advantage works in your favour if you make footwear and toys. As labour becomes less significant as a component of total costs, other aspects such as quality and sophistication of manufacture start to matter more.

China will want to do that, meaning increased competitive pressure on Korea, Taiwan, Singapore and even Europe. Instead of bra or shoe wars, we will be hearing about auto parts and precision instruments conflicts.

To be sure, a dearer yuan will allow the Chinese to buy more heavy machinery and pay the sticker price of shrink-wrapped software, which is good for western economies. It will also make Chinese-made T-shirts, toys and footwear more expensive, which may not be good for some western consumers - particularly the poor.

As large buyers such as Wal-Mart have historically refused to accept market movement in currencies as justification for suppliers to increase their price, some Chinese factories will be squeezed out.

Smarter Chinese factories are already learning this game. They are investing in better machines to make higher-quality products. They will then unleash the power of lower cost of operations, due to sheer economies of scale, and lure even more investment in their direction.

China's car exports go to Africa; they have slowly started making inroads into western markets. Another consequence of a dearer yuan is that China will be able to spend more abroad as both tourists and investors.

How prepared is the world for 50m Chinese tourists by 2010? By comparison, 67m Americans travelled abroad in 2004. And more critically, how ready is the west to see its companies bought by Chinese investors?

The US is already concerned. While Lenovo managed to buy IBM's PC business, the state-owned oil company CNOOC could not snap up Unocal when it was on offer, and Haier's attempts to take over Maytag faltered.

Chinese companies will also start locking up supplies, as they are already doing, of strategic minerals and oil, which will only sharpen tensions with the west. Be sure what you want with China, because you just might get it.

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