SPECIAL FX

BROWN BROTHERS HARRIMAN

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It's About Hu not Yuan

The Russian despot Vladimir Lenin was a big fan of Frederick Taylor. Taylor's time and motion studies revolutionized the work process by boosting output, albeit often at the cost of worker dehumanization. Taylorism is not about capitalism per se, it is about efficiency, and apparently good communists can respect that.

As Taylorism was adopted by the Soviet Union, so too does it appear that Fordism may be coming to China. Fordism refers to a type of a political economy which recognizes that, despite the great disparities in power, workers need to earn high enough wages to purchase the products that are being created in order to complete the circuit of production.

The financial impact of the euro's decline over the past six months have seen European officials dialing back their calls for Chinese yuan appreciation. While the U.S. Treasury appears to be embracing a multilateral effort (e.g. IMF, G20), many in the U.S. Congress are preparing to escalate their case, perhaps, if it is not too cynical, as the November mid-term elections approach.

The focus on bilateral exchange rates makes for poor economics and poor policy and investment strategy, even if it plays well in Peoria. The large U.S. trade deficit with China, and its larger trade deficit with the world, is not simply a function of exchange rates, but rather a result of investment, savings, consumption patterns, and corporate strategies.

Value-Added

Many pundits talk about China being the factory of the world. This is misleading. China might be more accurately thought of as the assembler of the world. While last year it was the world's biggest exporter, it was also one of the world's biggest importers. China does not simply import raw materials and commodities; it also imports parts and semi-finished goods which it then assembles.

The imported raw materials and commodities are largely invoiced in U.S. dollars. So are the parts and semi-finished goods. The cost of these inputs is estimated to be about 25% of the price of the finished good. The value-added in the assembly work can also be worth another quarter of the price of the finished good. This assembly work is the only part that is sensitive to the value of the yuan.

The other 50% of the price of the Chinese good is incurred locally in the U.S. for storage, shipping, and marketing. Of course, each of those middlemen also earns a profit. The fact that only a small part of the price of the Chinese made goods is impacted by the value of the yuan means that nearly any reasonable currency appreciation will simply be insufficient to balance the accounts.

Some U.S. Congressmen like to cite extreme estimates that the yuan is as much as 40% under-valued against the dollar. But there is an even more profound gap, and that is the discrepancy between U.S. and Chinese manufacturing wages. Chinese manufacturing wages are about 3% of manufacturing wages in the U.S.

The impact of a 40% appreciation of the yuan on the price of a Chinese good would be limited to the increased cost of the value-added component of that good, i.e. the wages of the Chinese manufacturing worker. Assuming all else being equal, it would raise the price of a Chinese made good by 10%. However Chinese manufacturing wages would still be only 4.2% of U.S. levels, and the imbalance would remain. A sharp appreciation of the yuan would also reduce import prices, and therefore likely offset the impact on wages.

China's Labor Unrest

News of wage increases in China has captured the imagination of the media, economists, and investors. There are two forces at work here. The first is the supply of workers has reportedly fallen by 20% from its peak. This is the older of the two forces. Four years ago Business Week ran a story "How Rising Wages are Changing the Game in China" that noted that in 2005 wages surged 40% to the equivalent of $160 a month largely as a function of this shortage.[1]

The second force pushing wages higher is labor unrest. A number of reports indicate Chinese officials prevent much media coverage of the strikes and protests. However, contrary to what it may appear, this is not a case of spontaneous worker revolts. To some extent, officials seem to be inviting them. Chinese officials have been commenting, and the media has been reporting, on the widening income gaps and the divergence between corporate profits and wage income.

In the U.S. and Europe we would recognize this as class warfare, but the "socialism with Chinese characteristics" requires, as Chinese President Hu Jintao stated, a "harmonious society". Li Keqiang, the deputy prime minister, and likely successor to Prime Minister Wen Jiabao, supported the calls for higher wages. And it is not just Beijing. Seven provinces reportedly hiked wages in the first quarter and more are coming.

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The Shenzhen government intends to hike its minimum wage by 10% from the current CNY900-CNY1000 ($132-$146) level on 1 July. Jiangsu, an east coast province recently raised its minimum wage 66% from CNY420 a month. A survey by the People's Bank of China found that a quarter of the workers in nine provinces would receive at least a 10% wage increase this year.

Foreign Multinationals

China is more hospitable to multinational companies than many developing countries. The economic miracle of the past couple of decades is not only a reflection of the hard working Chinese people; it is also a function of the relatively open international trade regime (for merchandise). By some measures the affiliates of foreign multinationals account for around half of China's manufacturing exports.

This does not mean that China treats these affiliates the same as domestic companies. In fact, they often offer non Chinese companies tax breaks and other inducements. Even though most Chinese businesses and the government are not unionized, China has encouraged the unionization of some affiliates of U.S. companies.

The two big cases of labor unrest in China, and where wages are rising the fastest, is at affiliates of Japan's Honda and Taiwan's Hon Hai Precision Industry. Strikes against Honda have taken place in a number of factories and in different provinces with varied wage structures. Some settlements appear to have emboldened other Honda workers. In some of the plants, Honda appears to be doubling or nearly doubling wages.

Hon Hai's China-based affiliate is Foxconn Technology. It is the world's largest contract electronics assembler. It does work for well known companies, including Apple, Hewlett Packard, Dell, Motorola, and Sony. Reports suggest it employs around 800k Chinese workers in 20 locations. Following several suicides in its Shenzhen manufacturing complex, Foxconn appears to also be in the process of doubling wages.

Even if Chinese manufacturing wages throughout the Middle Kingdom were raised to CNY2000 a month, which they are not going to any time soon, the gap between China and other industrial countries would still be humongous. At CNY2000, Chinese manufacturing wages would be around 6% of what the Bureau of Labor Statistics estimates are U.S. manufacturing wages.

The BLS data suggests that in 2007, the most recent data for international comparisons, manufacturing wages in Norway were 1.8 times higher than the U.S. Canada , Australia, and 10 of 12 west European countries surveyed had higher manufacturing wages than the U.S.

Significance Explained

Higher Chinese wages can only be inflationary if they are a significant part of the price of the good, and they are passed on to the consumer. This does not seem to be very likely. For assembly work and most manufacturing, wages pale in comparison to the cost of the raw materials or parts and semi-finished goods.

The most significant impact will not be on the price of Chinese goods for foreign or domestic consumption. It will be on how the rewards of the economy are distributed between employers and workers. The share of the surplus that goes to workers may rise and the share of profits may fall, but it does not mean that overall profits will necessarily decline.

It is possible that some businesses may move from the eastern part of China into the interior to try to secure lower wage workers and resist this development. Others may move out of the country entirely. But most will stay. In fact, the higher pay may improve retention rates and increase efficiency. Foreign multinationals are attracted to China for reasons other than cheap labor. After all there are parts of India and sub-Saharan Africa that also have very low wages. China offers relatively better infrastructure and unique clusters of component suppliers, not to mention a rapidly growing market of consumers.

The combination of upward pressure on Chinese wages and the appreciation of the yuan on a trade weighted basis (more than 15% appreciation against the euro, the currency of its largest export market) is moving China in the desired direction of rebalancing its economy.

It will not be sufficient to satisfy many in the U.S. Congress, but then it is difficult to see what would. The last Asian country that received such focus by American politicians was Japan.

No matter how much currency appreciation Japanese officials allowed, it did not satisfy their demands. The yen has appreciated by 77% against the U.S. dollar in the last 20 years and yet it still has a trade surplus with the U.S. on par with that of the early 1990s. Japan is currently experiencing outright deflation. The stock market peaked 20 years ago and still some captains of industry and their political allies complain about the unfair weakness of the yen.

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[1] http://www.businessweek.com/magazine/content/06_13/b3977049.html