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Why a Floating Chinese Currency is Bad for Business

If you are following the Chinese currency issue, you know that members of Congress are pushing the Bush administration to pressure the Chinese government to float its currency, which would dramatically strengthen it against the U.S. dollar. Some analysts estimate that the yuan is undervalued by 30% to 40%, keeping the cost of Chinese goods artificially low. China's strategy thus far has been to gradually allow the yuan, which has been pegged to the dollar, to strengthen in very small increments. Those of us in the promotional products business can only hope that the Chinese continue this strategy. If Chinese currency were allowed to dramatically strengthen over the short term against the dollar it would have a dire effect on the margins of suppliers and distributors, and could even drive companies buying promotional products into other forms of advertising.

The Domino Effect

U.S. promotional products suppliers are already being asked to absorb high single-digit and, in some instances, double-digit price increases for parts and finished hard goods manufactured in China. Those increases are being driven largely by the costs of commodities such as oil, copper and steel. The higher commodity prices, and subsequent increase in the cost of finished goods from China, are already working their way through the promotional products distribution network in the form of price increases for mid-year 2006, and will certainly be reflected in January 2007 supplier catalogs. Increasing transportation costs due to the historically high price of oil also adds to the upward pressure on prices.

If the yuan were to dramatically strengthen against the dollar over a short time period, the promotional products distribution network could experience price increases in the neighborhood of 20% or higher. Attempting to keep price increases to the buyer within reason, suppliers and distributors would be forced to slash margins. Some large suppliers, with access to alternate manufacturing locations outside China, would better weather the storm. Smaller suppliers, if dependent on one or two key China sources, would suffer the most.

Imagine you are a small pen supplier importing from China, operating with gross margins of 45%, and the yuan strengthens by 30% against the dollar. Even if your Chinese supplier agrees to absorb half of the shock, your cost of goods sold would increase by at least 15% over the course of only a few months. How do you maintain a healthy bottom line under those circumstances? How do you cut operating expenses and still maintain the service levels required in today's marketplace? Where do you pare your already lean sales and marketing budget?

One might argue that since your competitors' costs would also be increasing, that you would all be in the same boat. Perhaps, but it would be a badly leaking boat, as both distributors and suppliers would find themselves losing still more high-volume orders to direct overseas purchases, as higher prices drive more clients to bypass the traditional distribution network. Some buyers could even be driven to other forms of advertising as the value

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proposition of targeted promotional products disintegrates due to the spike in prices.

The Upside of Window Dressing

Fortunately, the Bush administration, while paying lip service to Chinese currency revaluation for domestic political purposes, is focused on two China issues that are far more important: the enforcement of intellectual property rights in China and Chinese leverage over North Korea on nuclear weapons. Enforcement of intellectual property rights in China will provide far more long term benefits for U.S. companies than will a floating yuan. And we need Chinese pressure on North Korea if we are to resolve the deadlock over the nuclear weapons programs there.

A weak Chinese currency, albeit artificially weak, has helped to keep U.S. inflation low. Ominously, after signaling for weeks that interest rate increases were largely behind us, Fed Chairman Ben Bernanke, in early June, once again began talking up the threat of inflation and the potential for additional rate increases. This sent the stock market to its low for the year. If the inflationary pressures from a strengthened yuan were added to this equation, the U.S. economy would be on a steady diet of interest rate increases for the foreseeable future.

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As an industry, we are fortunate that, thus far, the Bush administration's pressure on China to let its currency float has been largely window-dressing. Let's hope the window-dressing isn't replaced by serious action the health of the industry depends on it.

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