How will we solve the China conundrum?

This year China will become the world's biggest destination for inward investment. That's a big problem for the UK, says **Gerard Lyons**

EUGENE HOSHIKO/AP

Downtown Shanghai: the pace of change is 'breathtaking'

Shanghai is a futuristic, 21st century version of New York: there are extravagant new tower blocks as far as the eye can see.

Standing on the 88th floor of yet another luxurious hotel, I can survey the Flash Gordon landscape and the city's version of the M25, the Huangpu River. There are lanes and lanes of barges, boats and tugs racing downstream, all laden with goods.

The pace of change in China is breathtaking. And the impact on the rest of the world is profound. A few years ago China produced cheap, low-quality goods. Now, as more foreign companies invest in China, the quality has improved remarkably, but the selling prices are still very low.

This year, foreign direct investment into China will exceed £40bn, making it the number one destination for international investors, displacing the US. It is likely to remain the world's biggest consumer of overseas capital for many years.

And these trends are highly relevant to the UK, as Hiroshi Okuda, the chairman of Toyota, said in last week's *Sunday Telegraph*. They explain why the sums articulated by Gordon Brown in last week's pre-Budget report have been revised downwards.

The world economy is soft, as the US has slowed and no one else has replaced it as the locomotive of growth. One of the causes is that all major economies are facing intense cost pressures as they come to terms with the competitive threat from China.

This is forcing firms to cut costs and search for cheaper countries in which to invest. This pressure is most noticeable within manufacturing, and not just among the low-cost producers. The result is a severe squeeze on margins that is dragging down previously overvalued equity markets.

How can UK manufacturing compete with the likes of China's Pearl River Delta? Just outside Hong Kong, it is the most rapidly growing region of the world's most rapidly growing economy. With 40m people, the Pearl River Delta is a huge, bustling workshop, where manufacturing wages are typically £35 per month.

Wages in China have not risen much, but even as they do, the sheer size of the country means a succession of new manufacturing regions will come on stream, also with low costs.

Around Shanghai there is a surge of Japanese inward investment. Indeed, it is estimated that half of Japanese manufacturing could have "hollowed out" to China within five years. And much of the investment is in high-quality, high-skilled production.

In this environment, where will job creation in the UK come from? It is no coincidence that last week's UK data showed a slump in business investment. And not only is Chinese competition squeezing manufacturing and causing low inflation, it is also contributing to imbalances across the British economy.

As manufacturing prices have been squeezed, inflation has fallen, allowing the Bank of England and other central banks to cut interest rates. This has led to a binge in consumer borrowing, sparking inflation in house prices. But this is not the end of the process. In time, the eradication of inflation may prompt these borrowers to recognise that their ability to pay off their debts will not be aided by inflationary wage increases – and that, in turn, may suddenly and painfully cause consumers to cut their spending. The housing boom may turn to bust.

Yet don't panic. Although China is clearly a competitive threat, it is also a fantastic opportunity for international businesses. It is important for UK companies to position themselves sooner, not later, to take advantage of this. So far, only a few have risen to this challenge.

In the space of 20 years, there has been an eightfold increase in the size of China's economy. Last year China overtook America to become the world's largest mobile phone market. Today, it is the world's fourth largest car market.

The remarkable aspect of all this is that Chinese policymakers have managed to keep the economy on track. If you think of the regional disparities in the UK, imagine how much worse they are in China.

Some regions are suffering, particularly the industrial rust belt of north east China, as previously loss-making state owned enterprises have been allowed to go bust. In contrast, the parts of China that foreign tourists and businessmen visit are booming.

As China develops, it will be important for its leaders to maintain stability. As capitalist economies develop, financial shocks are always a big risk. And it is not just the Chinese authorities who need to be wary. So too should we.

● *Dr Gerard Lyons is chief economist at Standard Chartered*