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In China, U.S. producer haven, rumbles of trouble

By James B. Kelleher

In a global economy unsettled by the patchiness of the U.S. recovery and European financial turmoil, China would appear to be the one place in the world no one needs to worry about.

Appearances may be deceiving.

While China's efforts to rein in real-estate speculation have alleviated fears it might be overheating, experts say other issues -- from wage inflation to continued currency controls to a new "Buy China" push -- are turning the world's third-largest economy into another source of potential trouble for the foreign companies that do business there.

That could be especially bad news for U.S. manufacturers, which have not only moved a lot of production to China but come to rely on it in recent years to offset the weakness in many other markets, including the United States.

No one believes China, which is expected to post GDP growth of as much as 10 percent this year, is heading into a recession. In fact, government efforts to slow the economy by forcing some banks to increase reserves and by jawboning the property market with "anti-speculation housing rhetoric" (in the words of Don Straszheim, former chief economist at Merrill Lynch) worked so well that many observers believe Beijing has already taken its foot off the brake.

Jim Dugan, a spokesman at construction equipment giant Caterpillar Inc, says the company's flagship plant in Xuzhou, which makes hydraulic excavators, is back operating at full capacity. "If we could make more, we could sell them," he said.

But experts say several factors could turn those Chinese tailwinds into headwinds for some U.S. manufacturers.

The first is the issue of China's currency controls -- an old controversy with a new twist thanks to the problems in Europe, its primary overseas market.

"China depends a lot more on Europe than the U.S. does," said Cliff Waldman, global economist for the Manufacturers Alliance/MAPI and a China expert.

China has long sold its own currency, known as the yuan or renminbi, and bought foreign currencies. It defends the policy as a defense against so-called hot money --

speculative inflows of capital that can become massive, destabilizing outflows in a developing economy when sentiment flips.

But critics, including many U.S. manufacturers, say the controls amount to currency manipulation that undervalues the yuan by as much as 40 percent and essentially serves as a state subsidy to China's export sector -- and they have long urged the Chinese to abandon them and to allow the yuan to rise in value.

There has been growing hope in recent years that China would finally yield. But Straszheim says the financial turmoil in Europe means "that's not going to happen" any time soon. The crisis has sent the euro swooning nearly 20 percent against the dollar and the dollar-pegged Chinese yuan over the past six months. The last thing the Chinese government will want to do is to compound that by allowing the yuan to appreciate even further against the euro.

Ominous Issues

The second issue is Chinese wage inflation and the way it is upending the cost assumptions that drove the offshoring model. The recent strikes at several of Honda Motor Co's Chinese suppliers over pay demands have highlighted the fact that China's vast labor force is no longer willing to work for nothing.

While wages there are still well below the wages in Mexico and other developing countries, the true landed cost of Chinese-produced goods is in some cases higher once tariffs, transportation back to the United States and Europe and other costs are factored in.

As the higher wages squeeze profits, they are forcing many manufacturers that offshored factories in China to reconsider.

"Global multinationals are really keeping an eye on inflation in China," said Kevin Potts, an executive with Emptoris, a company that helps businesses like GlaxoSmithKlin, Vodafone, Motorola, and Owens Corning manage their supply chains.

Potts says that one customer, a life sciences company, had actually shifted some production back to the United States from China because they "found in some cases, ironically, the United States was becoming the low-cost country for their production" when all costs were tallied.

The third and potentially more ominous issue for U.S. manufacturers is the country's new proposed public procurement policy.

According to China Daily, the state-run paper that is widely regarded as the government's English language mouthpiece, Beijing is ordering local officials to adhere to a new "made in China" policy when buying anything.

"Under the draft regulation," the newspaper reported earlier this month, "the priority for government procurement would be on domestic products. If domestic products cannot meet the criteria for local content, purchasers should give priority to foreign products assembled in China."

China Daily estimates the Chinese government spent about 700 billion yuan (\$102.5 billion) last year on goods and services, a good chunk of it imported.

Washington considers the policy pure protectionism. The Chinese defend the move, Straszheim says, because "if there are foreign products that can compete, they'll be happy to buy them."

The trouble, he says, is demonstrating to the Chinese that the foreign-made product is as good as the domestically made items. "That's basically a prices-times-quantity measure," Straszheim said, "and that's a tough standard to meet up against."