Special report: Does corporate America kowtow to China?
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By Nick Carey and James B. Kelleher

SHEBOYGAN, Wisc. (Reuters) - China's rise as a manufacturing power has benefited American factory owners in at least one way. The Middle Kingdom's insatiable appetite for second-hand machinery means that small U.S. businesses can make a quick buck by selling old equipment there.

For some American manufacturers, however, the idea of shipping even used stuff with no book value to their chief overseas rival is anathema. Many of the machines at Bob Chesebro's factory in this Wisconsin city on the shores of Lake Michigan do something seemingly mundane: they sew the toes of the socks he makes closed. In China that is still often done by hand -- a labor-intensive task that other developing countries will eventually do more cheaply as Chinese wages rise.

Chesebro, chief executive and third-generation owner of Wigwam Mills Inc, one of America's few remaining sock makers, refuses to surrender his edge. His equipment ends its days as scrap metal in a dumpster behind his plant.

"We have taken the view that if we sell these machines we're just going to put them in the hands of people who will compete against us," he said.

In several ways, Wigwam defies the conventional wisdom of today's global market. It has managed to succeed making a relatively high-volume, low-cost commodity product, employing hundreds of workers right here in the United States. It has done so by boosting its productivity and developing niche products like hiking and medical socks in-house.

Given the savage nature of the competition you might expect Chesebro to vent mainly against Chinese-style capitalism. But like dozens of manufacturers and others across America interviewed for this story, his anger isn't directed at China, which he and others say is doing what it deems as necessary to boost its own people's prosperity. Instead, their ire is aimed at the U.S. government and American multinationals for not stepping up to the plate and defending long-term U.S. interests.

"I don't blame the Chinese, they're just pursuing their national interest," said Patrick Mulloy, a member of the Congressional U.S.-China Economic and Security Review Commission. "I blame us for not realizing what's happening to us and for doing nothing about it."

Prior to China's accession to the World Trade Organization almost a decade ago, free trade proponents argued that the move would create American jobs and eliminate the country's trade deficit. Neither prediction has proven accurate. The U.S. trade shortfall with China hit a record high $273 billion last year and government data shows some 40 percent of factories with more than 250 employees closed down from 2001 to 2010.

While it can't all be laid at China's door, it is not a coincidence that after decades of more gradual decline, U.S. manufacturing took a nose dive after China's entry into the WTO.

Cheap labor is one huge advantage for China, of course. But numerous academics, former trade officials and labor union officials say predatory trade practices, subsidized exports and other controversial economic policies also make Chinese companies tough to compete against.

And they warn that unless the U.S. works out a way to bolster and promote the sector, future prosperity and America's superpower status will eventually be at risk. This is only underlined by the U.S. economy's fragile state, with the jobless rate at 8.8 percent, growth tepid, and a huge government budget deficit and debt burden.

Even China's rising production costs may present an increasing threat, they argue. It means that China will be less able to rely on being the cheap maker of textiles, toys, furniture and plastics to create jobs -- some of that production is increasingly going to go to places like Bangladesh and Vietnam.

Instead, Beijing is increasingly focused on moving up the chain to higher valued technology-based goods -- which puts it in direct competition with the remaining power base of the U.S. manufacturing sector. And the technology-transfer terms that many big American companies are agreeing to when they do deals in China, and the research centers they are opening up there, means they could in some cases be signing their own death warrants.

Peter Navarro, a professor of economics and public policy at the University of California, who correctly predicted the U.S. housing bust, predicts that the crash America faces if it neglects manufacturing for too long is "going to be far worse."

"Over time the problems Americans are seeing with their economy are only going to get worse as China rises," he said. "We're heading for a collision and the longer that collision is delayed the harder it's going to be."

CHINA INC VERSUS JAPAN INC
Still, free trade proponents have warned repeatedly that any protectionist measures would result in a costly trade war that neither side can win. They also argue that the United States has only itself to blame for its economic problems.

In an interview at the Hilton Chicago during Chinese President Hu Jintao's visit to the city earlier this year, Doug Oberhelman, CEO of heavy equipment maker Caterpillar Inc, which has 11 Caterpillar plants and R&D centers and some 15 percent of its workforce in China, acknowledged there would always be "frictions" between the two countries.

"But the fact is ... we need each other desperately," he said. "We need peace."

Local manufacturers, though, say the first shots have been fired, and they question whether the multinationals are wrongly pursuing a policy of appeasement.

They complain that Chinese companies benefit from a raft of subsidies -- from what they see as an undervalued yuan currency, to artificially cheap or even free land in some cases, low-interest loans and even subsidized energy bills -- and the U.S. government and major companies say or do little in response.

"We're in the middle of an economic war with China," said Milton Magnus, president of Leeds, Alabama-based M&B Hangers, America's last maker of metal coat hangers, who also destroys his old machines, which are designed and built in-house. "The Chinese want what we have and we're just sitting back and giving it to them."

But it isn't just a war over cheaper products like coat hangers and socks.

Mounting evidence also suggests China is appropriating proprietary technology from Western firms and then using it to compete directly in ever more advanced fields.

The Chinese government has also been accused by foreign businessmen of changing the rules at home to favor local manufacturers for government contracts over foreign competitors.

Small manufacturers say they have increased productivity to compete. Wigwam's Chesebro says he has not replaced staff who retired or moved on over the years, reducing headcount to about 260 from 500 over the past two decades and his machines are now far more efficient. But small manufacturers insist labor costs are not relevant when in many cases heavily-subsidized goods from China have been sold in America for below what the local manufacturers pay for raw materials.

"Labor costs have nothing to do with it," said Bill Upton, president of Pelham, Alabama-based Vulcan Threaded Products Inc. "Vulcan makes steel bars and rods for everything from air conditioning units to sprinkler systems, is the last American firm of its kind, and won a trade case against Chinese competitors in 2008."

"We have a lean, efficient operation and we can compete against anyone in the world on a level playing field. But there's no way we can compete against finished goods that cost less than the raw materials," Upton said.

Even when American manufacturers do successfully pursue cases alleging unfair competition they may not come out on top. A case can cost around $1 million in legal fees, and often takes more than a year plus a lot of management time that could be spent more productively. And they claim even after penalties have been imposed, Chinese competitors often merely circumvent customs regulations.

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Yet a key difference between "Japan Inc" in the 1980s and "China Inc" is that Japan discouraged foreign investment, whereas China has embraced it.

Back then, some key U.S. multinationals made a great deal of noise in public, and in the U.S. Congress, about unfair Japanese trading practices. Their interests were aligned with the smaller domestic manufacturers.

But today, multinationals profit hugely from China and have less incentive to rock the boat. Only last week, Yum Brands Inc, the owner of the KFC, Pizza Hut and Taco Bell fast food restaurants, reported its operating profit was 75 percent greater in China than in the U.S. in the first quarter.

"The big difference is that no one made any money off Japan Inc," said Diane Swonk, chief economist at Mesirow Financial. "But some people are making a lot of money off China Inc."

SILENCE OF THE CEOs

Big American companies with investments in China are afraid to criticize Beijing because of the controls it has over just about any access to the Chinese market. They fear too strident a stance could mean they will lose contracts or even be ostracized as Google Inc was after a dispute with China over censorship and hacking.

"The Chinese government controls all the levers of the economy, from import and export licenses on up," said Victor Shih, an assistant professor of politics at Northwestern University. "There are so many ways for the Chinese government to retaliate it is no surprise businesses are so reluctant to criticize it."

But multinationals and their CEOs have a great deal of influence on debate in Washington and more widely in the country. They have often lobbied aggressively against any measures they deem protectionist, so their relative silence is seen by many smaller manufacturers and others as weakening the U.S. in its trade relationship with China.

"The issue today is that the firms hurting the most are not as politically connected as the firms that are benefiting the most," Mesirow's Swonk said.

There are no easy answers to America's predicament, for either the administration of U.S. President Barack Obama or the businesses that have bet heavily on China.

The WTO, for instance, ruled on March 11 that the United States could not levy extra duties on Chinese goods that the American government had described as subsidized and unfairly priced.

But such difficulties are not a reason for multinationals to roll over easily in the face of Chinese demands, say critics of their behavior.

Critics and academics warn that multinationals trading technology for market access have frequently found themselves a few years later losing out in export markets to Chinese competitors who were formerly their partners.

"The companies that hand over proprietary technology do so in the hope that they'll be the ones to get the better end of the
A growing number of Western firms who thought they were getting a good deal by trading technology for access to China's market
have also belatedly found out that they were mistaken.

In 2004 and 2005, China set up partnerships with Kawasaki Heavy Industries, France's Alstom, Germany's Siemens and Canada's Bombardier to build high-speed trains for China.

At first Kawasaki exported finished trains, then the group of foreign companies subcontracted the production of basic components to Chinese train manufacturer Sifang and then assembled them in China.

Then in 2009 the government began requiring that prospective bidders for Chinese high-speed rail projects form minority joint ventures with state-run manufacturers and hand over their latest designs and that 70 percent of the equipment had to be produced locally.

While aware of the flow of technology to the Chinese side, Kawasaki saw its joint venture as an opportunity to gain access to China, which was rapidly expanding its high-speed rail network. China has been by a long way the world's largest market for new rail lines in recent years.

Now, Chinese companies build faster, cheaper trains than their former mentors make and compete against them in global markets. Kawasaki has complained that trains built by Sifang are based on its own technology. Similarly, Siemens was elbowed aside by its erstwhile partner, the China National Railway Signal and Communication Corp, when it came to constructing the high-profile Beijing-Shanghai high-speed link.

Other times, technology is pilfered. Glen Tellock, CEO of crane maker Manitowoc, says that while American companies find intellectual property theft a major problem, "the answer from the Chinese is always 'what's the harm?'"

In "China vs the World," Hout and Ghemawat write that Chinese firms have "come to dominate the global silicon-wafer-panel business, aided by low-cost financing and inexpensive land sales."

Local governments provide companies with land cheaply or even free. Chinese firms are provided land grants in excess of what they need, so they build apartment buildings on the land, which then pays for research costs and offsets start-up losses. State-owned banks provide Chinese firms with loans at below prevailing interest rates and sometimes local governments pay the interest on their behalf.

Hout and Ghemawat also examine the solar panel industry, an area that the Obama administration has championed as a way to create "green" jobs for the future.

But Chinese competition pushed solar panel prices down 50 percent in 2010 from 2009, hurting Western manufacturers. China now exports most of its solar panels and Chinese firms control half of the German market and a third of the U.S. market.

China's Suntech Power Holdings Co Ltd is the world's largest solar panel maker. While Yingli Green Energy and JA Solar Holdings Co Ltd are also major competitors in the industry.

"NOT NAIVE OR STUPID"

In January, General Electric Co. announced a joint venture with Aviation Industry Corporation of China (AVIC) to develop electronics for the C919, a single-aisle commercial jetliner. That raised concerns that GE runs the risk of creating Chinese competitors through the proprietary technology it will provide as part of that joint venture.

"Multinationals are a little too optimistic about how much they can control the technology transfer process," the Brookings Institution's Prasad said. "The Chinese are very keen to build up their aviation industry and they've made it very clear what they want from GE to make that happen."

In a January 19 interview with Reuters, CEO Jeff Immelt, who also heads Obama's jobs council, insisted the company was "not naive or stupid" about doing business in China. "We really do think a lot about it," he said. "There is a multitude of ways to succeed in China. It's going to be the biggest economy in the world. The only question is when."

This tone differed markedly from comments Immelt made in July last year at a private dinner in Rome -- remarks that caused him no little trouble. "I really worry about China," he told a group of executives, as reported by the Financial Times. "I am not sure that in the end they want any of us to win, or any of us to be successful."

GE initially contested the FT report then changed tack when a spokesman said Immelt's remarks "do not represent our views."

Behind the scenes there does appear to be mounting worry among U.S. multinationals over Chinese policy. A report commissioned by the U.S. Chamber of Commerce ("China's Drive for 'Indigenous Innovation': A Web of Industrial Policies") examines a Chinese plan for science and technology from 2006 to 2020 that is "considered by many international technology companies to be a blueprint for technology theft on a scale the world has never seen before."

"Indigenous innovation" refers to a Chinese government policy designed, among other things, to favor Chinese firms for state contracts and require technology transfer if Western companies want to participate.

"With these indigenous innovation industrial policies, it is very clear that China has switched from defense to offense," the chamber report said.

During his state visit here in January, China's Hu said the country would ease up on the program. The U.S. government has since publicly stated China needs to make good on that promise, though so far it is not clear that anything has yet changed.

What has also not changed is how keen American multinationals are to get into China, even if there are long-term concerns over the conditions attached to doing business there. And their willingness to keep silent about things they do not like.

Ralph Gomory, a research professor at New York University's Stern School of Business who worked for IBM for three decades, said the problem for U.S. multinationals is that the focus on short-term profit easily outweighs long-term worries.

"The Chinese are exploiting our weaknesses," he said. "They see the strength of America as the strength of our corporations and that the driver is profit. So they have merely said bring your plant over here and we'll make sure you make a big profit."

It means that shareholders of the American multinationals like Caterpillar may be doing well in the short term -- after all its share price has doubled in less than a year largely on demand from China and other emerging markets. However, middle class Americans have not seen the benefits in terms of jobs created or wages increased.

When asked about GE's recently announced Chinese avionics joint venture and how he would look at it if he held GE shares, the
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But there would be a downside as well as positive consequences for Corporate America.

Although American spending on R&D ($402 billion in 2010) is quadruple China's ($103 billion), Hout and Ghemawat estimate that at current growth levels China will catch up with U.S. spending by 2020. Factoring in what they estimate could be a 40 percent undervaluation for the yuan, they estimate that spending parity will come by 2016.

The real problem for America is that it has few easy alternatives when it comes to solving its Chinese puzzle and leveling that field. Pressuring the Chinese government to allow the yuan to revalue seems a straightforward solution, for example, and is one that U.S. administrations have been suggesting for some time. Economists say a substantial revaluation would make a sizable dent in the U.S. trade and current account deficits.

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The large number of U.S. multinationals producing goods in China for export means that any significant appreciation would hurt their profits, said Sunil Chopra, a professor at Northwestern University's Kellogg School of Management.

One politically sensitive consequence of an appreciation of the yuan could also come in the form of higher prices for consumers at retail stores, which would hurt poorer people hardest. "We get a major rise in import prices from China, who does it hurt the most?" Mesriow's Swonk asked. "People who shop at Walmart and Target." Hout said that although the Obama administration has been more vocal about problem issues with China than his predecessor George W. Bush, America needs to take far bolder action.

"The United States is so wedded to the multinational processes of the WTO, which take forever and provide only rifle shot results," he said. "We've got all this stuff flogging the United States and we've been very inactive when it comes to playing hardball."

"The obvious reaction would be to rely on reciprocity," he added. "If the Chinese insist that American firms have to form joint ventures in China and have to adhere to local content requirements, then the U.S. government should enact requirements for Chinese firms wishing to ship goods here that they must do likewise. But we've seen nothing from the U.S. government."

GETTING TOUGH

Others recommend getting tougher with China in the same way President Reagan got tough with Japan at times, by being willing to impose more customs duties or file more cases through bodies like the WTO.

Reagan, with the backing of his Commerce Secretary Malcolm Baldrige and a number of CEOs angry over Japanese trade policy, was unafraid to impose duties on Japanese goods. Reagan also brokered a semiconductor trade agreement with Japan that prevented the dumping of Japanese semiconductors on the U.S. market.

"They (Reagan and Baldrige) were the most activist leaders for a long time in defending U.S. manufacturing and took action necessary to do so," said Gil Kaplan, an international trade lawyer who worked in the Reagan administration. "They realized that..."
we need a manufacturing sector in the United States."
Kaplan said that although proponents of free trade fear a trade war with China would be inevitable if the U.S. government took a
tougher line on unfair subsidies, "we need to demonstrate that we are not afraid to take action."
"We do have to act now," he said. "At some point in time we're going to reach a tipping point where we won't be able to come back.
In some industries so much of the supply chain has gone that it's going to be difficult to come back."
Kaplan and others say the government's actions do not necessarily have to be limited to taking action against the Chinese, but
could take the form of greater support for American manufacturers.
A common practice in developed nations, for instance, is to have a Value Added Tax that provides manufacturers with tax rebates
as an added incentive to export goods.
"We don't just have to focus on the negative," said Tessera's Nothhaft. "We can find ways to support our own companies and make
the playing field a little more level."
For many local manufacturers, the lack of a real public debate is discouraging to say the least. They feel disenfranchised,
outgunned and outmaneuvered by the influential U.S. multinationals who argue for more free trade while small manufacturers want
fair trade as well.
"The politicians in Washington don't represent you and me, they represent the special interests who pay their bills," said Richard
Gill, president of Polyfab Corp, a plastic molding company in Sheboygan County, Wisconsin. "Our decline is not inevitable. We can
still turn this around. But things are going to get a lot worse if we don't do the right things to stop it."
Carleton College's Schier said "increased middle-class radicalism" shown by the power of the conservative Tea Party movement
will likely be followed by increased radicalism in general as more voters are hurt by the decline of manufacturing and the lack of
jobs more than two years after the height of the financial crisis.
"America's political elite would rather not give the debate much oxygen because they haven't come up with any real solutions,"
Schier said. "But the majority of the public has a sense there's something very wrong with our relations with China."
"It's a prescription for chronic instability," he said. "You can't build a long-term working majority in a situation like this. Voters are
going to zig and zag and we'll likely see backlash after backlash." (Additional reporting by Terril Jones in Beijing; Editing by Jim
Impoco, Martin Howell and Claudia Parsons)