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Shanghai surprise, as inflation dulls China's export edge Spikes in wages, production costs, eroding the country's appeal as a low-price manufacturing center

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The cost of Chinese products is going up on the world market. That's good news for U.S.-based manufacturers looking to compete with manufacturers in the People's Republic. Despite several interventions by the country's central bank—and with massive blizzards wiping out food supplies—the inflation rate in China came in at an annualized rate of nearly 8% in February. That's the highest rate in eleven years.

“People who think you'll never compete with China are wrong,” said Frank Vargo, vice president for international economic affairs at the National Association of Manufacturers. “We're going to see much more of a balance [in manufacturing for export], which is good news for manufacturing in the United States.”

Indeed, China isn't the bargain it used to be. All told, the inflation rate rose 7% last year, and manufacturing wages spiked 50% in some industries because of a lack of skilled foremen and workers to meet demand.

Production costs are rising too, as plants on the mainland deploy expensive pollution-control equipment and adopt more stringent worker-safety measures. In addition, the value-added tax rebate, which returns 14% of the cost of items to some industries, is being cut in half or eliminated for certain products this year.

Moreover, the Chinese currency, the yuan, is up 15% against the dollar over the last three years.

The looming shift in the manufacturing-for-export market was underscored by a recent report by Booz Allen Hamilton last week. In it, the consulting firm released the results of a survey of foreign manufacturers. More than half of the managers at foreign-owned or foreign-backed companies currently making products in China believe that the country is losing its competitive edge in manufacturing to other low-cost nations.

In fact, nearly 20% of the managers surveyed by Booz Allen (and the American Chamber of Commerce Shanghai) said their employers have definite plans to relocate their China operations—or set up new regional facilities—in other countries. The surveyed managers saw Vietnam and India as the best new options.

“China’s changing cost and currency structure have shifted, forcing companies to rethink how they structure their Chinese operations and how they perceive China in their overall global strategy,” said Booz Allen vice president Ronald Haddock.

Drew Greenblatt, president of the Wire Fabricators Association, which represents U.S. manufacturers of custom-engineered wire products, said in an interview with *Financial Week*, that several of his member companies that had established manufacturing operations in China were now pulling out due to rising costs and other economic considerations. “When you do the math, the numbers don’t add up anymore,” he said.

In a letter to the *Baltimore Sun* last week, Mr. Greenblatt, who is also president of Baltimore-based, Marlin Steel Wire Products, made the case that retooling by American manufacturers has made them much more competitive with China.

“Yes, the number and percentage of manufacturing jobs have declined as the U.S. economy has changed,” Mr. Greenblatt wrote. “But many manufacturers continue to thrive—and some companies, such as my own, have added jobs.”

Mr. Greenblatt said U.S. manufacturers could compete in industries where high quality and fast delivery are paramount. He noted that his company recently received its first orders from the United Kingdom, Belgium, Taiwan and Japan.

Granted, U.S. manufacturers of low-cost, high-volume products may have difficulties competing with Chinese rivals. Indeed, the Booz Allen study pointed out that China is still a desirable location to produce goods, particularly for companies that not only export from China but sell into the local market.

But companies that cleave to that strategy will still feel the pinch from runaway inflation. As NAM’s Mr. Vargo pointed out, Companies that make goods in China for export to other destinations “won’t necessarily have to shut their doors, but they’ll have to pass along those price increases to customers.”

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