China's *Secret* Ambition

BY K. PHILIPPA MALMGREN

To compete with America in America.

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
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China looks like a one-way bet. But the conventional view is that it is a one-way race to the bottom. In other words, global manufacturing jobs will shift to China and the downward pressure on wages will force down the standard of living in America and across the G7. It is a race to the bottom. That seems to be the overwhelming fact of the world economy today. But it is an incorrect assumption.

China is a one-way bet, but it represents a race to the top. On a recent visit to China, I was struck by the views of the Chinese authorities on the renminbi issue. They are completely unmoved by American political pressure. After all, they say, Bush and Kerry and other American politicians may complain about the cheap Chinese currency, but those comments are aimed at winning votes in the rust belt. It has little to do with China. In reality China must fix the currency peg for clear and overwhelming domestic reasons.

The Chinese authorities argue that they are already committed to becoming World Trade Organization-compliant. Nothing can protect even China from the wave of market forces in the world economy. They have to get ready. And so, the government believes they have to force the dumb lucky manufacturers to stop being so lazy. Now well accustomed to an artificially cheap and fixed exchange rate, these companies have no idea how to hedge against currency risk. They have no idea that currency risk matters. These firms must be, as one official put it to me, "forced to learn to swim" in the turbulent flows of the world economy. That requires exchange rate flexibility over time.

Plus, the Chinese leadership understands that the key to real success lies in value added. National incomes can only rise so far on the production of cheap, simple, thin-margin products like plastic flowers (which brought a fortune to one of the richest men in Hong Kong, Li Ka Shing, and helped put Hong Kong on the world econ-

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omy map). If you want the nation to get rich, you need somebody to make high-margin value-added products. You need the smartest and most entrepreneurial manufacturers to make a refrigerator that can compete with Maytag and a car that can compete with a Mercedes. And that is exactly what China is doing.

The brightest and most successful manufacturers in China are no longer content to make an incredible fortune by producing shoes for Nike at fifty cents a pair while Nike goes on to sell them to you for $120 a pair. They want to figure out how to build a brand name that lets them command a premium. Of course, that requires a huge amount of effort. These guys are already as rich as anyone can imagine. Why bother? They already own more Rolexes than a person can use, which they bought on a trip to London using their private jet, and they have already cleaned out the Rolls Royce dealership in Shenzhen. And with all that, they are still sitting on a huge pile of cash. Call it boredom. Or, call it a challenge. The smart Chinese manufacturers want to go global.

Consider China's premier white goods manufacturer, Haier (rhymes with higher). It acquired a manufacturing facility in Camden, North Carolina, in 1999. Haier went after a small niche—wine refrigerators. It now controls 50 percent of the U.S. wine refrigerator market. That is a good start. The CEO of Haier insists that all his senior managers must live in Camden to learn about their biggest consumer—America. That is the only way to build a brand—know your customer. The company's motto is "No mistakes, no excuses."

Of course, the Japanese model comes to mind. China will deal with mounting protectionism in the United States simply by hopping the border and producing inside the United States. Remember that Honda and Toyota revived the U.S. automotive industry by opening factories in the United States. Of course, the view in China is that if Japan can do it, China can.

Chery Motors, the largest automotive company in China, recently announced that it is opening its first overseas manufacturing plant—in Malaysia, the largest auto market in Asia.

This year there have been forty-four acquisitions of foreign firms by Chinese companies. That is the future. In a decade we will all be reading books about management "Chinese" style.

But why not just build this manufacturing machine right at home in China? Why go into the United States or Malaysia? Here lies China's dirty little secret. Foreigners are easily fooled by the glossy veneer of Shanghai and Beijing. But a little scratch to the surface reveals what the Chinese see—that China is still a third-world country. Worse, people in China tend to believe that everybody else's business is a scam. Their own business may well be a scam too, but it is

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China's Dirty Little Secret

Why not just build this manufacturing machine right at home in China? Why go into the United States or Malaysia? Here lies China's dirty little secret. Foreigners are easily fooled by the glossy veneer of Shanghai and Beijing. But a little scratch to the surface reveals what the Chinese see—that China is still a third-world country. Worse, people in China tend to believe that everybody else's business is a scam. Their own business may well be a scam too, but it is their own scam. There is little interest among the successful in deploying profits back into the Chinese economy. Plus, who wants the communist state of China, which it remains in spite of all optimism, to know where one's money is or how much one has? There is a growing industry in getting money out of China, often in suitcases. The property boom in Hong Kong is mainly driven by mainlanders who know that an apartment in Hong Kong is the key to a legal bank account at HSBC, and that is just one wire transfer away from financial freedom. A Chinese manufacturer recently took his top seven executives and their wives to Hong Kong for the first time on a business trip. Afterwards they joked that it had been an expensive trip. The wives had all bought apartments. This requires a degree of bureaucratic effort and forethought that should not be underestimated.

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—P. Malmgren

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adds to excess supply capacity, leading to final goods deflation. Each bust leads to deflation in both commodity and final goods prices. Overall, the inflationary impact of boom-bust growth is progressively outweighed by the deflationary impact.

Low Operating Rates; Low Profitability

A chronic excess of supply capacity—the result of regional governments competing with each other to attract foreign companies—causes operating rates to remain low in all but the most economically hyperactive periods. This makes it impossible for firms to make money except when the economy is overheating.

Political Strains

The stage is thus set for political conflict between local governors, bureaucrats, and businessmen, who wish local firms to be profitable, and the central government, which cannot allow inflation to go on accelerating and the trade balance to turn to deficit.

Financial Straits

When the central government moves to end a boom by tightening, bankruptcies of Chinese firms rise and bad loans increase. As a result, any progress by Chinese banks to shore up their balance sheets is erased.

Country Risk

For Japanese and U.S. companies and banks, the perceived risk of China-related investment grows. Particularly vulnerable are automakers and other companies that have targeted the Chinese domestic market through direct investment, firms that export their products to China (and have accounts receivable), and financial institutions that extend loans to China.

Capital Flight

As loans to China turn sour, and as foreign operations in China become unprofitable, capital flight from China begins. Foreign companies begin to withdraw. Chinese companies diversify overseas. Capital flight accelerates as people sense approaching social and political upheaval.

The End of Communism

Conflicts between regional and central government, popular unrest and financial instability associated with the deteriorating economy, and the historical trend towards democracy, combine to make one-party rule untenable.

While China Falters, Japan Recovers

The negative effects on Japan's economy of upheaval in China are far outweighed by the positive effects of deregulation and higher interest rates. Thus, Japan's long-delayed shift to a more services-oriented economy gathers speed. With a new breed of entrepreneurs discovering at last that the true potential for growth lies with new and small service-providing businesses, Japan returns to a sustainable growth path of 3 percent. It thus defies the conventional wisdom and rounds off Scenario Three—Japan turns the tables. ◆

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If you have a lot of money then a foreign acquisition is an easy way to move a large amount into a more attractive environment. In other words, given half a chance most of the smart business people in China would like to benefit from being inside the United States. Access to America's consumers, trustworthy corporate governance and legal standards, and the high standard of living are all attractions for the Chinese. How interesting that the political debate in America assumes that these things are under threat from China, when they are exactly what the Chinese are aspiring to.

The smart business people in China would like to benefit from being inside the United States.

So while the foreigners are piling in to China, the locals are trying to get out. And while the Americans are focused on the threat of imports from China, the Chinese are moving to America. America and China are not in a race to the bottom, they are in a race to the top. Arguably the latter may prove even more challenging than the former. ◆