

2009: The Work is not all Coming Back

By Mary Ethridge

Not all the heavy lifting in China late this summer was going on in Olympic venues. The country's financial leaders found themselves facing something they hadn't expected — at least not so soon and in such dramatic fashion.

China's economy — which despite some scandal, seemed as healthy and unstoppable as an Olympic athlete a year earlier — was showing distinct and measurable signs of trouble. Many outside China were happy to chronicle the return of prodigal U.S. manufacturers, who'd found there's no place like home to manufacture.

"Globalization is reversible," analyst Jeff Rubin of CIBC in Toronto told the *Christian Science Monitor* in September. At least it seemed that way. Skyrocketing oil costs, which threatened to reach \$200 a barrel, a stronger Chinese currency, rising wages, fewer tax rebates for exporters and more tainted-product scandals were all signs pointing to

home — or at least someplace closer, like Mexico.

"Factories Bring Jobs Home Again," a headline in the *Wall Street Journal* read this summer. In September, the *Christian Science Monitor* predicted a boom in "reverse globalization."

Could we dare believe in the vision of a revived Rust Belt?

However, philosophers as far back as Confucius will tell you that things are never simple when it comes to China. The one established hallmark of the evolving global economy is rapid change, to which China has proven itself a swift adapter. In a matter of two to three months the landscape shifted again remarkably. As the reasons prodigal manufacturers gave for returning home evaporated (oil prices, for one), spinning heads ended the year trying to determine the next best step for U.S. companies.

“What do we do and where do we go now?” said Lisa Reisman, a metals specialist and managing director at Aptium Capital in Chicago.

China? Home? Someplace else? Where in the world is the best place for a U.S. manufacturer right now?

Before trying to answer that question, let’s look back to spring and summer. What could make even skeptical analysts believe that China, which has drawn thousands of U.S. manufacturers to set up operations there, was yesterday’s news? The evidence seemed compelling, especially for those who had been hoping for decades for a reversal of America’s manufacturing fortunes.

Crude oil prices were quickly on their way to reaching \$140 a barrel in July, and many were predicting prices of \$200 a barrel by fall. Few people were seeing an end to astronomical fuel costs, which raised the transportation costs when moving products between countries. More than half of China’s manufactured exports to the United States are what’s called “freight intensive.” At \$200 a barrel, shipping a 40-foot container from Shanghai to the East Coast would cost about \$15,000, experts estimated. In August, it was \$8,000, versus \$3,000 in 2000 when many U.S. manufacturers began moving operations to China.

China’s currency — officially the RMB, but called colloquially by its dollar-like denomination, the Yuan — was holding strong against U.S. currency. The U.S. government has often accused the Chinese of keeping their currency artificially low against the dollar to keep prices of Chinese-made products low — thus appealing to cost-conscious U.S. consumers. It got to the point that in April U.S. Senate Democrats introduced something called the China Currency Manipulation Act of 2008, which outlined punishments for the Chinese if they were found keeping the Yuan artificially low. It seemed China was getting the message. Since 2005, when China began pegging its currency to a “basket of currencies” instead of just the U.S. dollar, the Yuan had appreciated 20 percent to reach 6.88 against the U.S. dollar in July, and was predicted to appreciate more.

China had also started rapidly phasing out generous tax rebates offered to U.S. manufacturers that produced in China and then exported to sell in the U.S. and else-

where. Thousands of manufacturers have been adversely affected by the rebate cuts.

Chinese wages were on the rise. No reliable figures for average wages exist because the figures from the Chinese are notably unreliable. However, factory owners and labor experts said businesses were having a hard time finding good workers and were having to pay the workers they found more money. In January of last year, China began enforcing new laws mandating certain protections for workers and requiring the use of longer-term contracts, which some employers said locked them into high costs they couldn’t afford.

By late summer, word was beginning to leak out that Chinese-made baby formula had been watered down and tainted with poisonous melamine to fool inspectors. At least four babies died in September as a result. It followed a string of product-quality scandals for China that included toys contaminated with lead and the “date rape” drug GHB. Last February, a Maryland candy company pulled Pokemon-brand Valentine lollipops from store shelves after bits of metal were found in the

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sealed treats. Many top officials resigned or were fired, and several arrests were made in the wake of the tainting scandals. In response, the Chinese government took steps to improve quality control and safety, and tried to reassure the world that the vast majority of its products were fine.

Oil prices, a strong Yuan, few rebates, higher wages and product scandals — when adding those to existing concerns over pirated intellectual property, some U.S. manufacturers said it just didn't make sense to keep production in a country with such problems and fewer payouts. Desa LLC, a heating product manufacturer based in Bowling Green, Ky., moved its manufacturing from China back to its home state. It had held onto all the necessary equipment and machines to do the job, it said.

“What looked like an albatross 1.5 years ago, today looks like a pretty good asset,” Claude Hayes, the head of Desa's retail heating division told the *Wall Street Journal* in June.

In a survey of executives called the “Future of Manufacturing,” taken in August and September by the consulting and accounting firm Crowe Horwath for *IndustryWeek*, one executive of a steel furniture manufacturer summed up his industry's general feeling.

“In our industry, more and more production is being outsourced to China,” the executive said. “Should the cost differential change due to improved exchange rates, increased freight costs, higher wage rates in China, lower material costs, etc., then U.S. companies with manufacturing capacity should be able to make a comeback.”

U.S. newspapers were filled with stories of other happy homecomings. Thomasville Furniture, Excel Outdoors and Regal Cookware were just a few of the

American companies featured in stories about “reverse globalization.” Caterpillar reportedly expanded its U.S. plants in part because production in China was not as cost-effective as it had once been. The Wisconsin-based Coatings Excellence International (CEI), which makes poly-coated papers, said it was able to convince the printers who make Sweet ‘N’ Low packets to source from them instead of overseas by making some simple, cost-saving production changes. Lexmark of Lexington, Kentucky, which makes printer cartridges, didn't quite make it all the way home. It moved production out of China to Mexico. Still, North America's gain was China's loss.

Others said they were beginning to look back home. Mark Stephens, director of logistics for Faultless Starch/Bon Ami consumer products, said in September that his company was “actively” pursuing partners closer to the United States. St. Louis based Emerson, which makes electronics, moved some manufacturing home from China over the summer.

“It makes sense to produce where a product is sold,” Emerson Chief Executive Officer Edward Monser told the *Wall Street Journal* in June.

Mark Levinson, author of “The Box”, a history of the shipping container, summed up the attitude this way: “Many companies want to be in China anyway because of the Chinese market. But is it the best from which to serve the U.S.?” Numbers backed up the anecdotal stories about happy homecomings, but those numbers were anything but happy for the Chinese. Manufacturing in China is undergoing its sharpest contraction since the modern wave of outsourcing began. The Purchasing Managers Index, which is used as a measure of China's overall manufacturing health, began falling in August and kept falling through the end of the year — a sure sign of a faltering sector. By November, the World Bank

had cut its 2009 China economic growth forecast to 7.5 percent from the 9.2 percent it predicted in June. Beijing has long held that economic growth of at least eight percent is needed to provide the population the improvement of employment and income the ruling Communist Party rely on for popular support.

China's overall growth has slowed to its weakest pace in five years, with output expanding just nine percent in the third quarter from a year earlier, after gaining nearly 12 percent in 2007, if you believe their stats. When taken by itself, the number of exports fell 2.2 percent in November, the first drop in nearly eight years. And half of China's exports come from foreign-based companies manufacturing in China. Foreign direct investment in China fell 36.5 percent in November, according to China's commerce ministry. Chinese factories have been closing at an unprecedented rate, saying they can't keep up with the demand for higher wages and a shrinking demand for their services.

For those who'd been keeping very careful watch, the economic turn shouldn't have surprised the Chinese the way it did. In March last year, Dexter Roberts, bureau chief of China for *BusinessWeek*, was predicting problems for the Chinese economy, but said the government seemed not to notice.

"They don't realize the scale of it. At this point, they don't seem concerned," he told listeners of a March 8, 2008, podcast.

A survey in April by Iowa-based consulting firm RSM McGladrey, said the number of companies planning offshore production fell 20 percent from the same time in 2007.

Although they were a bit slow on the uptake, the Chinese were beginning to realize the scale of the problem by the time the Olympics closed up shop in late August. They also realized the U.S. economy was continuing to slump, which meant consumers would soon be shutting their wallets — even to deals at Wal-Mart. The Chinese cut interest rates four times between September and November to stimulate growth. In November, China unveiled an economic stimulus program it billed as totaling \$586 billion, aiming to bolster domestic demand and help avert a global recession.

The stimulus plan, although focused primarily on domestic growth, was designed to build up the failing confidence of Chinese businesses and consumers, as well as impress the United States and other foreign governments. The plan was accompanied by other outward-looking measures, such as a reinstatement of many of the export tax rebates the government had phased out.

And then, curiously, in early December, the Yuan, which had been steadily appreciating against the U.S. dollar, began to lose value. But not much — and there were caps in place to keep it from depreciating and appreciating too much in any day or week. However, it was enough to revive the old cry of currency manipulation from the United States.

"I think it's a just-under-panic mindset among the Chinese these days," said Reisman of Aptium Capital. "They know they have so many mouths to feed, and when the economy's growth rate goes under the double digits, they're going to take action," said Reisman. "The environment, politics, everything else is going to take a back seat while they fix things."

Some things have seemed to work out themselves for the Chinese. After peaking in July at nearly \$150 a barrel, crude oil nosedived to about \$40 a barrel by November. Prices at the U.S. gas pump fell from just over \$4 a gallon to under \$1.70. Within a matter of weeks, the primary factor U.S. manufacturers cited as their reason for leaving China, was gone.

"They're saying, 'Now what?'" So much for reversing globalization," said Tompkins of Tompkins Associates in Raleigh.

Tompkins said a few companies made the decision to abandon manufacturing in China and bring it home in light of fuel prices and other issues, but he stressed they were relatively few in number and in no way represent any sort of lasting trend. Barring some sort of monumental occurrence, outsourcing will remain a way of life for U.S. manufacturers.

"It's still about TDC — total deliverable cost. And companies are always going to go where that's lowest," he said. Fuel costs represent only about five percent of an average product's TDC, Tompkins said. And companies still need to pay shipping across the United States,

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which includes fuel surcharges at the height of gas prices. Boats are more fuel-efficient than planes, trains or trucks, he said. Fuel costs aren't that much of an issue for outsourcers, at least not in light of the challenges of moving a manufacturing operation back to the United States from abroad, he said.

“In most cases, there's no ‘back’ to come home to. The equipment is gone, the building sold. The basic infrastructure needed has dwindled or is gone,” said Tompkins.

Desa was lucky it still had its machinery in place for production, he said, because many outsourcers don't.

“And then once you bring it back here, where are the suppliers? They're gone too. And who are you going to have work there? The people needed to fill those jobs have moved on to other things.” The capital to rebuild operations and retrain workers isn't there, he said.

Tompkins predicts the Chinese will continue making rapid moves to keep U.S. businesses manufacturing there and will create new enticements.

“They have a one-party system. They may take awhile to see what needs to be done, but when they do, they just do it,” said Tompkins. “They have an ability to move very quickly.”

Offshore outsourcing is by no means an out-of-date notion, but it is a rapidly evolving one, said Mark Sarros, Chicago-based executive in charge of manufacturing and distribution segments at consulting firm Crowe Horwath. (Sarros helped design the “Future of Manufacturing” survey for *IndustryWeek*). He believes what we're seeing is a move toward “regional globalization.” Smart companies are beginning to figure out that it makes sense to manufacture as close to the selling point as possible — as long as the country has the educated workforce, security and infrastructure to support manu-

facturing.

We have only “temporary relief” from high gas prices, he said. They'll rise if supply is cut, which seems likely, and the outsourcing landscape will change again. Companies need to assess their manufacturing locations more frequently than ever. (Sarros believes fuel prices will fluctuate for a while and then level off at about \$2.75 to \$3 a gallon.)

Sarros said the survey found that smaller companies (\$25 million or less) feel more of a sense of control over corporate culture than larger ones and feel better able to drive a cost-efficient mindset among workers — and thus stay put.

“These are the people who are going to be investing in U.S. plants three to five years out,” said Sarros. “For the big ones, it sometimes seems easier to move and start over. It makes shareholders think they're taking action whether it makes sense or not. It could be a good idea, but that's not always the case. You have to assess the situation frequently.”

As for China? While the outlook for the country's once-booming economy has rapidly dimmed, China remains relatively well-placed to deal with any kind of slowdown. The boom years have been good ones for China. It has plenty of muscle — including a budget surplus — to shore up the economy while the global economy evolves.

For U.S. manufacturers, it seems, the heavy lifting has just begun.

