



IMPACT ANALYSIS

Issues Impacting Global Business

A Publication Serving the State of Delaware

September-October 2008



Dear Friends:

In this issue of Impact Analysis, we look at the factors causing prices in China to rise. But more importantly, we analyze what U.S. companies producing or sourcing goods there are doing about it (pages 1-2).

No country better represents the Olympic motto "faster, higher, stronger" than China. During the last 30 years it has made enormous gains. It would be foolish to focus only on China's flaws without recognizing its progress (pages 3-4).

Although these are difficult times for many businesses, it may even be worse for your workforce. Why? Because you may not be providing enough information. Learn how to improve labor relations (Pages 5-6).

I hope you find this issue informative and, as always, we welcome your comments.

Sincerely,

Rebecca C. Faber
Executive Director
World Trade Center Delaware

The 'China Price' Is Rising

American companies are adapting — some are implementing a dual strategy with much success

By John Manzella

In 2009, China is predicted to overtake the United States as the world's largest producer of manufactured goods, according to Global Insights, a U.S. economic consultancy. However, as this occurs a seemingly opposite trend appears to be taking shape.

China Is Losing its Low-Cost Edge

Due to rising prices, "The era of China as a low-cost, manufacturing-for-export market has come to an end," says the management consulting firm of Booz & Company. How does this square?

As costs rise, China is moving up the value chain, producing more higher-technology goods and fewer low-tech goods. In fact, the Chinese government is using incentives to encourage local companies to innovate, while discouraging low-end manu-

facturers from operating in southern China, *The New York Times* reports.

Many factors are responsible for rising costs. For example, from July 21, 2005—when the Chinese government unpegged its currency from the U.S. dollar and allowed it to float based on a managed basket of currencies—through August 27, 2008, the renminbi, also known as the yuan, rose by 21 percent against the dollar.

Chinese labor rates for blue-collar workers and managerial staff alike, according to various sources, have risen about 5 to 15 percent per year. And tougher labor and environmental standards, as well as the termination of tax breaks for thousands of Chinese factories, have boosted costs.

Foreign firms are not the only ones affected. A Pew Research Center survey of Chinese citizens released in July indicates "96 percent describe

WORLD TRADE CENTER
DELAWARE



For more information on World Trade Center Delaware services and events, please contact our office at 302-656-7905 or visit our website at www.wtcd.com

rising prices as a big problem for the country, and 72 percent say they are a very big problem.”

Lower Cost Locations Are Sought

For U.S. manufacturers who have viewed China solely as a source of low cost production, rising costs have cut into their margins. In turn, a growing number are moving production and supply sources to lower cost countries, like Vietnam, Indonesia, India, Thailand, Malaysia, Bangladesh and Brazil.

In fact, a survey of 66 manufacturers among the members of AmCham Shanghai’s Manufacturing Business Council found that “Nearly one in five (17 percent) of these companies already has made the decision to move at least some China-based operations to other low-cost countries in Asia and elsewhere.”

Other factors pulling manufacturers away from China include attractive tax benefits, the competitive landscape, intellectual property protection, and utility costs, the survey explains. Plus, some countries are selling themselves more effectively.

For example, “Vietnamese officials have aggressively marketed their country as a lower cost alternative to manufacturing in China and have

persuaded some U.S. customers to switch their outsourcing from China to Vietnam. In turn, an increasing number of companies are looking south to Vietnam to manufacture labor-intensive articles, such as toys and wood furniture,” says Ralph Watkins, Senior International Trade Analyst at the U.S. International Trade Commission in Washington, D.C.

Even though China is losing its competitive edge to other low-cost countries, Booz Allen Hamilton, a consultancy previously associated with Booz & Company and author of the AmCham survey, says the



Middle Kingdom is still very much in the game. That’s why 83 percent of survey respondents have no plans to move capacity away from China. The biggest reason to remain there, the study says, is to access China’s vast domestic market.

A Dual Strategy Is Adopted

For U.S. producers heavily invested in China and for those who prefer not to move elsewhere, a dual strategy may be in order.

Companies that pursue China for lower-cost labor and a source of supply, as well as a growth market for sales, and integrate these operationally, perform considerably better.

According to the AmCham study, companies that pursue China for lower-cost labor and a source of supply, as well as a growth market for sales, and integrate these operationally, perform considerably better.

In fact, these companies “report an average profitability rate two-thirds higher than those focused on just one of those objectives (29.6 percent compared with 17.8 percent). Despite the returns that this approach can generate, only one out of four companies is able to combine a strong in-country market growth effort with its manufacturing and sourcing operations.”

Some Production Is Moving to the U.S.

Oil prices well above \$100 a barrel have forced the cost of shipping a 40-foot container from China to the United States through the roof. This, plus rising Chinese prices, are causing some American producers to relocate their facilities from China back to the United States.

“Escalating transportation costs have taken their toll on Chinese exporters of articles with a high ratio of weight to value. At least one Chinese producer of

Asian-style wood furniture has contracted with a manufacturer in Mississippi to produce furniture for distribution in the North American market,”

Watkins tells *Impact Analysis*.

How much U.S. production in China is likely to return to the United States? “Expecting the U.S. to recapture industries that have already gone to China may not be realistic. But the new cost equation likely will influence many decisions about where to locate production in the future,” says *China Economic Review*. ■

John Manzella, president of Manzella Trade Communications (ManzellaTrade.com), is a frequent speaker on China, international trade and policy, and the author of Grasping Globalization.

China Grows 'Faster, Higher, Stronger'

It would be foolish to focus only on China's flaws without recognizing its progress

By James A. Dorn

From an economic perspective, no country better represents the Olympic motto—"faster, higher, stronger"—than China. During the last 30 years of its opening to the outside world and economic liberalization, China has grown to be the world's third-largest trading nation and fourth-largest economy.

More important, the increase in economic freedom has widened the range of personal choices and given millions of people the opportunity to leave the state sector and "jump into the sea of private enterprise."

Progress Continues

During the Cultural Revolution, central planning dominated, capitalism was a crime, and Mao Zedong called upon people to "strike hard against the slightest sign of private ownership." Today most prices are set by market demand and supply, capitalists can join the Chinese Communist Party, and the PRC constitution proclaims, "The lawful private property of citizens is inviolable."

The Property Law, enacted in 2007, gives further protection to the private sector and to individual property rights. That legislation reflects the political influence of the growing middle class and private entrepreneurs who have a large stake in continued economic liberalization, which has allowed them a lifestyle few would have dreamed of just a short time ago. Millions of people now



enjoy the privacy of their own homes and cars, the freedom to travel, and the enormous benefits of cell phones and the Internet.

Seeing the Big Picture

It would be foolish to focus only on China's flaws without recognizing the progress made in improving people's lives—progress due to the removal of restrictions on economic and personal choices, rather than

It would be foolish to focus only on China's flaws without recognizing the progress made in improving people's lives—progress due to the removal of restrictions on economic and personal choices, rather than to central planning.

While China would win an Olympic gold medal for its economic performance since 1978, it would clearly not be a medalist in the quest for personal freedom. But China also would not be in last place.

In 1995, Chinese journalist Jianying Zha wrote in her book *China Pop*, "The economic reforms have created new opportunities, new dreams and to some extent a new atmosphere and new mindsets. . . . There is a growing sense of increased space for personal freedom." Many would agree.

to central planning. In particular, globalization and the information revolution have played crucial roles in China's development. Without the benefits of trade, China would still be poor.

Protectionism Is a Poor Tool

The slow pace of political reform and the violation of human rights should be of serious concern, but using trade sanctions against China to promote human rights would do the opposite. Unlike trade, protectionism denies individuals the freedom



to expand their effective alternatives, thus limiting their choices. Sanctions would fuel the flames of economic nationalism, harm U.S. consumers, and embolden hardliners in Beijing.

It makes no sense to use such a blunt instrument in an attempt to “advance” human rights in China when trade itself is an important human right. Instead, the United States can best help the Chinese people by continuing its policy of engagement and avoiding destructive protectionism.

Trade Has Had a Positive Effect

Trade increases the wealth of nations and reduces the risk of conflict. Hong Kong, the world’s freest economy, learned long ago the benefits of international trade and the rule of law. Its development strategy—“small government, big market”—has clearly influenced the Mainland, and the “freedom virus” is spreading.

The challenge for China’s new generation of leaders is to continue on the path of “peaceful development” and not let politics get in the way of the market. If China is to

prosper and become the world’s largest economy, Beijing needs to allow market socialism to wither away and market liberalism to flourish. That transformation would require a transparent and just legal system that fully protects people’s rights to life, liberty and property.

Dialogue Is Key

To help China along that path,

Trade increases the wealth of nations and reduces the risk of conflict. Hong Kong, the world’s freest economy, learned long ago the benefits of international trade and the rule of law. Its development strategy has clearly influenced the Mainland.

the United States should continue the Strategic Economic Dialogue initiated by Presidents Bush and Hu Jintao. Two other positive steps would be to end the discrimination against China in antidumping cases by recognizing the PRC as a market economy, and admit China to the G-8 as a normal rising power.

Those acts of friendship would reassure Beijing that the United States welcomes China’s rise and does not view the Middle Kingdom as an inevitable enemy. At the same time, we should not ignore the human rights violations that do occur, and use diplomatic pressure to help move China toward a legitimate rule of law.

Determining the Direction

While tourists admire the compelling architecture in Beijing and other cities, they should not forget that what counts in the long run is not the physical infrastructure but the formal and informal institutions that limit government power and enhance freedom.

Ultimately, the Chinese people must determine the form of their government and other institutions, but the United States can help by upholding the same market-liberal principles it

wants China to adopt.

Finally, by adhering to a free-trade agenda, the U.S. government can show the Chinese people that Americans practice what they preach. ■

James A. Dorn is a China specialist at the Cato Institute, editor of the Cato Journal, and coeditor of China’s Future: Constructive Partner or Emerging Threat? (Cato Institute Press, 2000).

This article appeared in the Far Eastern Economic Review (www.feer.com) on August 11, 2008, and is reprinted with the permission of James Dorn and Far Eastern Economic Review.

Stop Avoiding Your Employees During Difficult Times

Open and honest communication benefits everyone

By Jim Kestenbaum, Ph.D.

These are tough economic times. As a business leader, you may feel engaged in a nearly impossible balancing act. Inflows and outflows. Customers and suppliers. Board members and employees. Nothing lines up!

Information Is Control

Although these are difficult economic times for many businesses, it is even worse for the workforce. Why? Because whatever decisions your business makes, you'll have a central role. And this will make you feel in control—in the good times, like the successful captain of your ship—as well as in bad times, because you have the power and opportunity to make things right.

Why do you feel this way? You have information, lots of information. And this is key. It guides your thinking and actions.

Being informed makes you feel you are in the game. Unfortunately, employees are often ill informed and as a result, rarely have a sense of control. This only makes matters worse.

Managing Sensitive Issues

Corporate executives are called upon to be the bearer of news. Sometimes it's good news, like communicating pay raises or company parties. And sometimes it's bad news—which is more typical during these economically challenging times.

In fact, you may have to inform your employees of no raises this year, a 10 percent increase in healthcare

costs or the need to begin furloughs—unpaid furloughs that result in lost income for employees.

In many cases, executives take too long to communicate bad news because they don't want to hurt their employees. So they stall, hoping a little bit more time will soften the blow. But it doesn't.

On the other hand, many executives do this to avoid their own pain—pain they'll feel when they see the disappointment in their employees' eyes and hear the disappointment in their voices.

Too often executives need to realize one fundamental thing: in tough times people don't want to be taken care of—they know this isn't possible. Instead, they want to be kept in the loop.

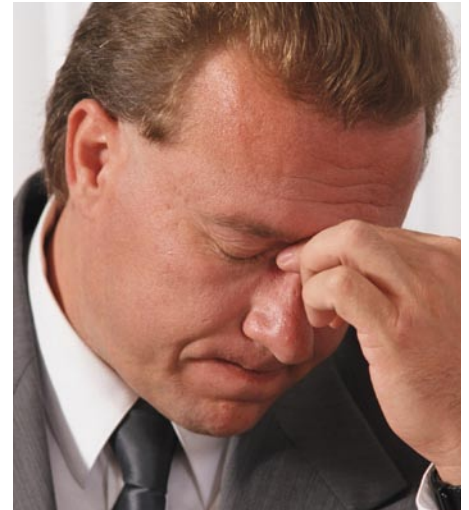
In many cases, executives take too long to communicate bad news because they don't want to hurt their employees. So they stall, hoping a little bit more time will soften the blow. But it doesn't.

No Sugar Coating Please

Since the layoffs of the late 1980's, the American workforce has become very familiar with the new employee-employer relationship. This was not always the case. Years ago, companies took a nearly parental role, caring for the hardworking employee from "womb to tomb," as the saying went.

Since the late 1980's, the American workforce has adjusted to its new relationship with management, which has shifted to a more mature relationship of peers.

As peers with an equal buy-in to the company's success, there needs to be one absolute that serves both



management and employees: the full and open sharing of information.

No sugar coating. No smoke and mirrors. Required is information that tells it like it is.

The American workforce has come of age. It doesn't need or want bedtime stories. Rather, the workforce is ready and willing to hear bad news so it can

begin to plan and chart its next career course. "Information ownership" gives employees the ability to take control of their lives—the same kind of control you value.

How Much Information Should Be Shared?

Information sharing needs to be carefully planned. For example, years ago I was contacted by an HR manager who stated up front that her institution was coming to an end. She said it was too late for consultants, advisors or last minute Herculean efforts. Instead, she wanted to know only one thing: how to manage her

workforce during this most difficult time.

My response was to the point: communicate with your people, I said. And do it a lot in a variety of ways.

The reason for my approach is premised on a basic psychological fact: people thrive on information and hate uncertainty. If you give employees information straight from the hip and deliver it with compassion and respect, you won't go wrong.

Still, people will be upset, and some might even cry. Depending on the news, wouldn't you?

Executives need the courage to stand in the face of employee sadness, understand the pain and demonstrate an understanding of what employees are going through. This is good old fashioned empathy.

How do you communicate bad news? Use daily company huddles. Talk during staff meetings. And remember: the president or CEO needs to get in front

of the workforce during these smaller team meetings, as well as in company-wide meetings. To help, make the

company newsletter into a real news organ.

Importantly, make sure you get the news out to employees as it occurs. Senior managers will surely have more credibility if they make communication a priority during difficult times.

Not All Communication Is Good

If you need to broach sensitive subjects with your workforce, you first need to be honest with yourself and acknowledge how emotionally difficult this also is for you.

Should you share your doubts or

your darkest fears with your staff? Whether you attempt a corporate turnaround or anticipate a total shut-down, you need to equip employees with the fortitude for both trips.

A great rule of thumb is to ask yourself two questions: is this the way I would like to get bad news? And, what am I trying to accomplish by sharing this information? Your answers will guide your actions.

Employees Provide Great Solutions

Your workforce represents the majority of your company's intellectual capital. When you shield them from important facts, they won't be able to fully and competently participate in the solutions. And, it is conceivable that they will see things you don't that could result in a turnaround, or at least get the company on the right path.

When a company is in trouble, it needs to have all hands on deck. And when people are kept in the loop,

People thrive on information and hate uncertainty. If you give employees information straight from the hip and deliver it with compassion and respect, you won't go wrong.

they feel part of the enterprise. They recall they used to be on a winning team and usually continue to feel loyalty.

If you get people involved, they will feel empowered and invited to contribute their efforts and ideas. And very importantly, they will feel valued.

When employees are left out of the process in order to "soften the blow," they feel progressively disengaged and often come to believe what they are thinking doesn't matter because nobody has asked what they think should be done. When people



don't feel valued they typically pull back.

Essential Points to Remember

1. Tough economic times are hard on everybody. People don't want to be taken care of—they want to be treated as adults.
2. Sensitive issues are more manageable for employees when they have the information to understand what's going on, and the opportunity to do something proactive—like assist the company to improve or even leave for another job.
3. Treat people as your partners in the business—in bad times as well as the good ones.
4. As you involve and support employees, they'll do the same for you—it's human nature. It doesn't have to be lonely at the top. ■

Dr. Jim Kestenbaum, a corporate psychologist, is founder of The Solutions Group (www.tsgdrjim.com).