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China's Gains in Manufacturing Stir Friction Across the Pacific

By TIMOTHY AEPPEL

China is on its way to surpassing the U.S. as the world's largest manufacturer far sooner than expected. The question is, does that matter?

In terms of actual size, the answer is, no. But if size is a proxy for relative health of each nation's sector, the answer is yes.

Anyone who walks the aisles of a U.S. retailer might think China already is the world's largest manufacturer. But, in fact, the U.S. retains that distinction by a wide margin. In 2007, the latest year for which data are available, the U.S. accounted for 20% of global manufacturing; China was 12%.

The gap, though, is closing rapidly. According to IHS/Global Insight, an economic-forecasting firm in Lexington, Mass., China will produce more in terms of real value-added by 2015. Using value-added as a measure avoids the problem of double-counting by tallying the value created at each step of an extended production process.

As recently as two years ago, Global Insight's estimate was that China would surpass the U.S. as the world's top manufacturer by 2020. Last year, it pulled the date forward to 2016 or 2017.

"The recent deep recession in U.S. manufacturing does mean that China's catch-up is occurring a few years earlier than would have been the case if there had been no recession," says Nariman Behravesh, the group's chief economist.

U.S. manufacturing is shrinking, shedding jobs and, in the wake of this deep recession, producing and exporting far fewer goods, while China's factories keep expanding. If manufacturers on both sides of the Pacific were thriving, there would be little reason to butt heads. But given the massive trade gap between the two nations and uncertainty in the U.S. over when and to what degree manufacturing will recover, China's ascent has become a point of growing friction.

Chinese manufacturing activity continued to tick up in July from the previous month, data from the China Federation of Logistics and Purchasing showed Saturday. The Purchasing Managers Index edged up to 53.3 in July, from 53.2 in June and 53.1 in May.

A separate CLSA China Purchasing Managers Index rose to a 12-month high of 52.8 in July from 51.8 in June, CLSA Asia-Pacific Markets said Monday. July was the fourth consecutive month the CLSA PMI was above 50 after hovering below the key level for eight months.

Many economists argue that the shrinking of U.S. manufacturing -- both in terms of jobs and share of gross domestic product -- is a normal economic evolution that started long before China emerged as a manufacturing powerhouse. From their point of view, the shrinking would happen regardless and is actually a sign of health that the sector doesn't need to be big to be productive and is shedding low-skill jobs and creating select higher-skill ones.

Global Insight's Mr. Behravesh is one of those who views China's rise as normal, even healthy. "In the natural course, countries go from agriculture to manufacturing to services," he says. "To subsidize manufacturing pushes [the U.S.] backwards down that curve."

But another school of thought -- one known by the somewhat backhanded label of "manufacturing fundamentalists" -- contends the U.S. decline isn't natural and must be reversed to retain America's economic power. From their perspective, that necessitates fighting Chinese policies that fuel low-cost exports, swamping a variety of industries from textiles to tires.

"The notion that we can be a nonmanufacturing society is folly," says Peter Morici, an economist at the University of Maryland. "It's pseudo-science that gives rise to the collapse of civilizations."

The Obama administration is stepping carefully through this minefield. At a two-day conference last week, the first meeting of a new forum designed to foster closer cooperation between the two countries, China's tightly managed currency policy was barely discussed even though it is a hot-button issue for many U.S.-based producers and organized labor. They argue that China undervalues its currency to gain a competitive advantage for its exports, which sell at a lower price in the U.S.

The U.S. Business and Industry Council, which represents U.S.-based manufacturers, accused the Obama administration of "panda-hugging." The administration earlier this year softened its stance on the issue when it declined to label China a currency manipulator.

John Engler, president of the National Association of Manufacturers, says he doesn't expect China to surpass the U.S. before 2020. "It may or may not continue to grow so rapidly," he says. "The importance of the China challenge to the U.S. depends on how we respond to it," such as implementing tax and investment policies that encourage domestic producers to expand.

Mr. Engler's group faces a delicate issue of its own regarding China: Many of its powerful members produce in China and are eager to avoid controversy on trade issues, while the group's large roster of smaller members are often outspoken critics of China.

Even in its weakened state, manufacturing remains a surprisingly large part of the U.S. economy. The sector generates more than 13% of the nation's GDP, making it a bigger contributor to the economy than retail trade, finance or the health-care industry. In China, manufacturing represents 34% of GDP.

Still, the concern remains that U.S. manufacturers now being hit by the economic downturn will never recover. J.B. Brown, president of Bremen Castings Inc., a family-owned foundry in Bremen, Ind., says the downturn has halted what had been a hopeful trend that emerged last year of work returning to the U.S. from China.

"I see a lot of people starting to look at going overseas again," he says, in part because costs are rising in the U.S. even in the depth of this recession. He notes, for instance, that Bremen's electricity rates jumped 17% this year -- and the company has been warned they could increase even more next year. Foundries like Bremen use large amounts of electricity to heat metal.

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