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August 9, 2007

Honorable John D. Dingell
Chairman
House Energy and Commerce Committee
2125 Rayburn House Office Building
Washington, D.C. 20515

Honorable Bart Stupak
Chairman
House Energy and Commerce
Subcommittee on Oversight and Investigations
2352 Rayburn House Office Building
Washington, D.C. 20515

Re: Tyson Foods, Inc.

Dear Chairmen Dingell and Stupak:

I am writing in response to your letter of June 26, 2007, to Tyson Foods, Inc. ("Tyson") relating to the review by the House Energy and Commerce Committee and the Subcommittee on Oversight and Investigations ("Committee") into the adequacy of efforts of the Food and Drug Administration ("FDA") and the U.S. Department of Agriculture's Food Safety and Inspection Service ("FSIS") to protect Americans from contaminated or otherwise unsafe foods.

The quality and safety of our fresh meat products is a high priority for Tyson. We combine this commitment of excellence toward food quality and safety with state-of-the-art facilities, programs, and processes. This "gold standard" approach enables us to protect consumer health as we remain a leader in the production of meat and meat protein based products.

Tyson's commitment to a "gold standard" means that we implement programs and processes to ensure the quality and safety of our fresh meat products. We have in place a best-in-class Hazard Analysis and Critical Control Point ("HACCP") program. We also have cutting-edge cold chain management programs from slaughter to packaging that include critical control points to ensure that products are safe and wholesome. For example, we carefully monitor and manage temperatures and the packaging, storage, and distribution of our products. We take great pride in these programs, as they represent our

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complete dedication to food safety and quality assurance. Complementing our efforts for safety are the USDA inspection personnel who carefully monitor our facilities to make sure that our programs are sufficient and properly implemented.

As you know, Tyson representatives have been working with Committee staff to more fully understand and address the Committee's concerns regarding the utilization of carbon monoxide ("CO") in fresh meat packages. Although, the use of CO is approved by FDA and USDA, Tyson has decided to discontinue the use of the barrier tray CO process approved by FDA in GRN 000143.

We estimate that it will take approximately five weeks to phase out the utilization of the barrier tray CO process. As part of this process, customer notification and new packaging should be finalized by August 24, 2007. Thus, we anticipate that by September 7, 2007, Tyson will no longer manufacture products in a CO barrier tray.

Tyson shares the Committee's desire to provide the American consumer with safe and wholesome food. As part of that commitment, Tyson will continue to work with the USDA, FDA, and the Committee to provide the highest quality beef, chicken, and pork products to the American consumer.

Thank you for your consideration.

Sincerely,

A handwritten signature in blue ink, appearing to read "Gary Sherman".

Gary Sherman

Vice President Business Operations
Fresh Meal Solutions

cc: w/ encl. Joe Barton, Ranking Minority Member
Committee on Energy and Commerce

w/o encl. Hon. Ed Whitfield, Ranking Member
Subcommittee on Oversight and Investigations



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August 13, 2007

COMMENTARY

Food Fights

By **JAMES M. RICE**

August 13, 2007

More and more people are worried about the safety of food coming from China, but what exactly does "safety" mean, anyway? It's no simple question, given that safety standards frequently vary from country to country, and for many reasons. Compounding the problem, "safety standards" aren't always about safety. Standards can become a back door to protectionism. The phenomenon even has a name: technical trade barriers.

Everyone plays this game. The European Union enforces safety regulations that lack support in international science; its standards on hormones prevent the import of U.S. beef, and rules on naturally occurring aflatoxin mold blocks all imports of corn and nut products from Africa. China enforces a zero-tolerance rule on salmonella and the feed-additive ractopamine in meat and animal-feed imports, although the U.S. and EU allow trace amounts, without any accompanying health problems. The U.S. blocked importation of Chinese Ya pears for two years (in 2005 and 2006) based on an alleged fungus that no scientist outside the U.S. Department of Agriculture could ever identify.


It doesn't need to be that way. Despite some safety or sanitary problems with Chinese exports, it's far better to settle these issues through technical discussions on standards rather than through political sparring. Ideally, the end result will be that both countries have the same technical standards for quality and food safety, which will mean products of the same high quality could be sold to consumers in both countries.

The alternative is a climate in which no one can be sure whether import bans are related to genuine safety concerns or politics. My own company, Tyson Foods, and others recently saw some of our processing plants banned from importing into China due to the presence of traces of salmonella that wouldn't survive proper cooking, and would have been acceptable at most other borders. The move followed what was effectively a U.S. ban on imports of several seafood types that may have resulted either from political pressure or concern over trace amount of antibiotics.

More than one year ago, there were some encouraging signs on this topic. The Joint Commission on Commerce and Trade agreed to discuss technical trade barriers. The JCCT is a forum for high-level dialogue on bilateral trade issues between the U.S. and China, and it's co-chaired by the U.S. Secretary of Commerce and China's Minister of Commerce. In their 2006 meeting, both countries agreed to start developing mutually accepted standards to avert disputes over safety regulations. The U.S. Department of Agriculture and China's Administration of Quality Supervision, Inspection and Quarantine (AQSIQ) even signed a memorandum of understanding on this principle.

Then, silence. A dialogue on the issue never materialized. Until, that is, today. Even as the U.S. Food

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and Drug Administration has effectively banned certain types of Chinese seafood and the Chinese have blocked certain meat imports from the U.S., the two sides are finally sitting down together to start discussing standards. Real negotiations about technical food safety and sanitary standards are happening this month in both Beijing and Washington, between the FDA, USDA and AQSIQ. Last week, China's State Food and Drug Administration agreed with the U.S. FDA to increase technical exchanges through seminars and training programs, a process that will certainly increase the technical and scientific skills of Chinese regulators.

As these talks progress, China and the U.S. could turn to world health authorities, who stand a better chance of operating above the fray of national politics. The World Organization for Animal Health (OIE) and the Codex Alimentarius, which literally means the food code, of the Food and Agriculture Organization of the United Nations, provide a base from which to start. Both organizations have standards and guidelines that a member country can adopt, protecting the health of consumers and fair trade practices in our industry.

There is certainly a role for national safety regulators, who can sometimes act more nimbly than a global institution to protect consumers from newly discovered safety threats. To name one example from the pharmaceuticals sphere, U.S. regulators never approved thalidomide for widespread use despite its acceptance elsewhere. But distinguishing between prudence and protectionism requires constant vigilance.

Tyson Foods, Inc. and our industry peers have long sought a set of equal standards for trade of our products between China and the U.S. Only the recent food safety issues inside China and the U.S. have brought both governments back into a discussion. Agreements on scientific quality standards for food will facilitate the trade of food products between producers and consumers, and have the added advantage of bringing universally accepted food standards, and safe food, to all individual consumers, everywhere.

Mr. Rice is Vice President and China country manager for Tyson Foods, Inc.

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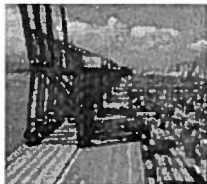
SPECIAL REPORT -- THE CHINA PRICE

"The China Price"

They are the three scariest words in U.S. industry. Cut your price at least 30% or lose your customers. Nearly every manufacturer is vulnerable -- from furniture to networking gear. The result: A massive shift in economic power is under way

From the rich walnut paneling and carved arches to the molded Italian Renaissance patterns on the ceiling, the circa 1925 council chamber room of Akron's municipal hall evokes a time when the America's manufacturing heartland was at the peak of its power. But when the U.S.-China Economic & Security Review Commission, a congressionally appointed panel, convened there on Sept. 23, it was not to discuss power but decline. One after another, economists, union officials, and small manufacturers took the microphone to describe the devastation Chinese competitors are inflicting on U.S. industries, from kitchenware and car tires to electronic circuit boards.

These aren't stories of mundane sunset industries equipped with antiquated technology. David W. Johnson, CEO of 92-year-old Summitville Tiles Inc. in Summitville, Ohio, described how imports forced him to shut a state-of-the-art, \$120 million tilemaking plant four football fields long, sending Summitville into Chapter 11 bankruptcy protection. Now, a tenfold surge in high-quality Chinese imports at "below our manufacturing costs" threatens to polish Summitville off. Makers of precision machine tools and plastic molds -- essential supports of America's industrial architecture -- told how their business has shrunk as home-appliance makers have shifted manufacturing from Ohio to China. Despite buying the best computer-controlled gear, Douglas S. Bartlett reported that at his Cary (Ill.)-based Bartlett Manufacturing Co., a maker of high-end circuit boards for aerospace and automotive customers, sales are half the late-1990s level and the workforce is one-third smaller. He waved a board Bartlett makes for a U.S. Navy submarine-detection device. His buyer says he can get the same board overseas for 40% less. "From experience I can only assume this is the Chinese price," Bartlett said. "We have faced competition in the past. What is dramatically different about China is that they are about half the price."



SLIDE SHOW: CHINA PRICES

Where the Jobs Went

"The China price." They are the three scariest words in U.S. industry. In general, it means 30% to 50% less than what you can possibly make something for in the U.S. In the worst cases, it means below your cost of materials. Makers of apparel, footwear, electric appliances, and plastics products, which have been shutting U.S. factories for decades, know well the futility of trying to match the China price. It has been a big factor in the loss of 2.7 million manufacturing jobs since 2000. Meanwhile, America's deficit with China keeps soaring to new records. It is likely to pass \$150 billion this year.

Now, manufacturers and workers who never thought they had to worry about the China price are confronting the new math of the mainland. These companies had once held their own against imports mostly because their businesses required advanced skills, heavy investment, and proximity to customers. Many of these companies are in the small-to-midsize sector, which makes up 37% of U.S. manufacturing. The China price is even being felt in high tech. Chinese exports of advanced networking gear, still at a low level, are already affecting prices. And there's talk by some that China could eventually become a major car exporter.

Multinationals have accelerated the mainland's industrialization by shifting production there, and midsize companies that can are following suit. The alternative is to stay at home and fight -- and probably lose. Ohio State University business professor Oded Shenkar, author of the new book *The Chinese Century*, hears many war stories from local companies. He gives it to them straight: "If you still make anything labor intensive, get out now rather than bleed to death. Shaving 5% here and there won't work." Chinese producers can make the same adjustments. "You need an entirely new business model to compete."

America has survived import waves before, from Japan, South Korea, and Mexico. And it has lived with China for two decades. But something very different is happening. The assumption has long been that the U.S. and other industrialized nations will keep leading in knowledge-intensive industries while developing nations focus on lower-skill sectors. That's now open to debate. "What is stunning about China is that for the first time we have a huge, poor country that can compete both with very low wages and in high tech," says Harvard University economist Richard B. Freeman. "Combine the two, and America has a problem."

How much of a problem? That's in fierce dispute. On one side, the benefits of the relationship with China are enormous. After years of struggling to crack the mainland market, U.S. multinationals from General Motors (**GM**) to Procter & Gamble (**PG**) and Motorola (**MOT**) are finally reaping rich profits. They're making cell phones, shampoo, autos, and PCs in China and selling them to its middle class of some 100 million people, a group that should more than double in size by 2010. "Our commercial success in China is important to our competitiveness worldwide," says Motorola China Chairman Gene Delaney.

By outsourcing components and hardware from China, U.S. companies have sharply boosted their return on capital. China's trade barriers continue to come down, part of its agreement to enter the World Trade Organization in 2001. Big new opportunities will emerge for U.S. insurers, banks, and retailers. China's surging demand for raw materials and commodities has driven prices up worldwide, creating a windfall for U.S. steelmakers, miners, and lumber companies. The cheap cost of Chinese goods has kept inflation low in the U.S. and fueled a consumer boom that helped America weather a recession and kept global growth on track.

But there's a huge cost to the China relationship, too. Foremost is the question of America's huge trade deficit, of which China is the largest and fastest-growing part. While U.S. consumers binge on Chinese-made goods, the U.S. balance-of-payments deficit is nearing a record 6% of gross domestic product. The trade shortfall -- coupled with the U.S. budget deficit -- is driving the dollar ever downward, raising fears that cracks will appear in the global financial system. And by keeping its currency pegged to the greenback at a level analysts see as undervalued, China amplifies the problem.

America's Eroding Base

The deficit with China will keep widening under most projections. That raises the issue: Will America's industrial base erode to a dangerous level? So far the hardest-hit industries have been those that were destined to migrate to low-cost nations anyway. But China is ramping up rapidly in more advanced industries where America remains competitive, adding state-of-the-art capacity in cars, specialty steel, petrochemicals, and microchips. These plants are aimed at meeting insatiable demand in China. But the danger is that if China's growth stalls, the resulting glut will turn into another export wave and disrupt whole new strata of American industry. "As producers in China end up with significant unused capacity, they will try to be much more creative in how they deploy it," says Jim Hemerling, a senior vice-president at Boston Consulting Group's Shanghai office.

That's why China is an even thornier trade issue for the U.S. than Japan was in the 1980s. It's clear some Chinese exporters cheat, from intellectual-property theft and dumping to securing unfair subsidies. Washington can get much more aggressive in fighting violations of trade law. But broader protectionism is a nonstarter. On a practical level the U.S. is now so dependent on Chinese suppliers that resurrecting trade barriers would just raise costs and diminish the real benefits that China trade confers. Also, unlike Japan 20 years ago, China is a much more open economy. It continues to lower tariffs and even runs a slight trade deficit with the whole world -- which makes the U.S.'s deficit with China all the more glaring. Hiking the value of the yuan 30% might help. But that's unlikely. For one thing, Beijing fears what such a shift would do to jobs -- and the value of its \$515 billion in foreign reserves. The real solution is for the U.S. to reduce its twin deficits on its own -- but that's more America's issue than China's.

Meanwhile, U.S. companies are no longer investing in much new capacity at home, and the ranks of U.S. engineers are thinning. In contrast, China is emerging as the most competitive manufacturing platform ever. Chief among its formidable assets is its cheap labor, from \$120-a-month production workers to \$2,000-a-month chip designers. Even in sophisticated electronics industries, where direct labor is less than 10% of costs, China's low wages are reflected in the entire supply chain -- components, office workers, cargo handling -- you name it.

China is also propelled by an enormous domestic market that brings economies of scale, feverish local rivalry that keeps prices low, an army of engineers that is growing by 350,000 annually, young workers and managers willing to put in 12-hour days and work weekends, an unparalleled component and material base in electronics and light industry, and an entrepreneurial zeal to do whatever it takes to please big retailers such as Wal-Mart Stores (**WMT**), Target (**TGT**), Best Buy (**BBY**), and J.C. Penney (**JCP**). "The reason practically all home furnishings are now made in China factories is that they simply are better suppliers," says Janet E. Fox, vice-president for international procurement at J.C. Penney Co. "American manufacturers aren't even in the same game."

Fox's point is important. China's competitive advantages are built on much more than unfair trade practices. Some 70% of exports now come from private companies and foreign ventures mainly owned by Taiwanese, Hong Kong, Japanese, and U.S. companies that have brought access to foreign markets, advanced technology, and managerial knowhow. Aside from cheap land and tax breaks in some areas, private Chinese manufacturers get minimal government help. "The Chinese government cannot afford to offer financial support to the export economy," says business professor Gu Kejian of People's University in Beijing. And as capital floods in and modern plants are built in China, efficiencies improve dramatically. The productivity of private industry in China has grown an astounding 17% annually for five years, according to the U.S. Conference Board.

China needs U.S. imports, though not as much as imagined when Beijing agreed to join the WTO. U.S. exports to China have risen 25% to 35% annually in the past two years. But China's exports still outstrip its imports from the U.S. by 5 to 1. The U.S. sells about \$2.4 billion worth of aircraft a year, and its semiconductor exports tripled in three years. Otherwise the U.S. looks like a developing nation. It runs surpluses in commodities such as oil seeds, grains, iron, wood pulp, and raw animal hides.

Meanwhile, the Chinese keep expanding their export base. Chinese competition arrives so fast that it's nearly impossible to adjust through the usual strategies, such as automating or squeezing suppliers. The Japanese, South Koreans, and Europeans often took "four or five years to develop their place in the market," says Robert B. Cassidy, a former U.S. Trade Representative official who helped negotiate China's entry into the WTO and now works for Washington law firm Collier Shannon Scott, which wages dumping cases on behalf of U.S. clients. "China overwhelms a market so quickly you don't see it coming."

"Shock and Awe"

Georgetown Steel Co. is a case in point. The Georgetown (S.C.) maker of wire rods used in everything from bridge cables to ball bearings had battled Asian and Mexican imports for years. But last year it shut its 600-worker plant, citing a tenfold leap in Chinese imports, to 252,000 tons, from 2001 to 2003. International Steel Group Inc. (**ISG**) has since bought the facility after U.S. anti-dumping duties on imports and a rise in global demand helped hike domestic prices. The Gardiner (Mass.) plant of Seaman Paper Co., a maker of crepe and decorative paper, is highly automated. Yet Chinese imports have grabbed a third of the market. It sells 81-foot streamers to big retailers for as little as 9 cents each. That's below Seaman's cost of materials. "We thought we could offset Chinese labor cost by automating, but we just couldn't," says Seaman President George Jones III.

In bedroom furniture, 59 U.S. plants employing 15,500 workers have closed since January, 2001, as Chinese imports have rocketed 221%, to \$1.4 billion -- half of the U.S. market. Prices have plunged 30%. Dumping certainly seems to be one factor: At its Galax (Va.) factory, Vaughan-Bassett Furniture Co. displays a Chinese knockoff of one of its dressers that wholesales for \$105 -- below the world market cost for the wood. But the main competition comes from Chinese megaplants that sell directly to U.S. retailers and can get a new design into mass production in two months. The new Chinese factories of suppliers such as Lacquer Craft Furniture, Markor, and Shing Mark, some of them Taiwanese-owned, employ thousands and are so big they seem meant to build Boeing 747s, making most U.S. factories look like cottage industries. "The first wave is shock and awe," says John D. Bassett III, CEO of Vaughan-Bassett, whose sales and workforce have shrunk even though it has boosted productivity fivefold at its 600-worker Galax plant since 1995 by investing in computer-controlled wood drying, cutting, and carving gear. "American industry has never encountered [such] competition."

As component industries and design work follow assembly lines to China, key elements of the U.S. industrial base are beginning to erode. American plastic-molding and machine-tool industries have shrunk dramatically in the past five years. Take Incoe Corp. in Troy, Mich., a maker of steel components for plastic-injection machines. "When the economy turned soft, we anticipated the business would come back," says Incoe CFO Robert Hoff. "But it didn't. We saw our customer base either close or migrate to China." The U.S. printed-circuit-board industry has seen sales go from \$11 billion to under \$5 billion since 2001. In that time, PCB exports from China have more than doubled, to a projected \$3.4 billion this year, says market researcher Global Sources Ltd. (**GSOL**) Most U.S. production of key electronics materials, such as copper-clad laminates, has fled, too. "The whole industry is hollowing out," says Joseph C. Fehsenfeld, CEO of Midwest Printed Circuit Services Inc. in Round Lake Beach, Ill.

The migration of electronics to China began when the Taiwanese shifted plants and suppliers across the Taiwan Strait in the late 1990s. As recently as four years ago, though, the U.S. exported \$45 billion in computer hardware. Since the tech crash, that number has slid to \$28 billion as the industry headed en masse for China, which is even more competitive than Taiwan. "All electronics hardware manufacturing is going to China," says Michael E. Marks, CEO of Flextronics Corp (**FLEX**), a contract manufacturer that employs 41,000 in China. Flextronics and other companies are hiring Chinese engineers to design the products assembled there. "There is a myth that the U.S. would remain the knowledge economy and China the sweatshop," says BCG's Hemerling. "Increasingly, this is no longer the case."

A visit to Flextronics' campus in the Pearl River Delta town of Doumen vividly illustrates Marks's point. The site employs 18,000 workers making cell phones, X-box game consoles, PCs, and other hardware in 13 factories sprawled over 149 acres. The bamboo scaffolding is about to come down on an additional 720,000-square-foot factory nearing completion. Almost every chemical, component, plastic, machine tool, and packing material Flextronics needs is available from thousands of suppliers within a two-hour drive of the site. That alone makes most components 20% cheaper in China than in the U.S., says campus General Manager Tim Dinwiddie. Plus, China will soon eliminate remaining tariffs on imported chips. In the past five years, electronic manufacturing-services companies such as Flextronics have cut their U.S. production from \$37 billion to \$27 billion while doubling their China output, to \$31 billion. That's likely to double again by 2007.

"Gravitational Pull"

China is even making its presence felt in the U.S. market for networking gear, a bastion of American comparative advantage. On Nov. 15, struggling 3Com Corp. (**COMS**) in Marlborough, Mass., launched a data-communications switching system for corporate networks of 10,000 users or more. It claims twice the performance of Cisco Systems Inc.'s (**CSCO**) comparable switch. At \$183,000, 3Com's list price is 25% less. Its secret? 3Com is settling for lower margins and taking advantage of a 1,200-engineer joint venture with China telecom giant Huawei Technologies Co. This is the first high-end piece of networking gear sold by a U.S. company that is designed and manufactured in China. For the price of one U.S. engineer, the joint venture can throw four engineers into the task of making customized products for a client. Even if 3Com does not succeed, similar tie-ups are expected, which could drive down prices of high-end gear sold in the U.S. Says 3Com President Bruce Claffin: "We want to change the pricing structure of this industry." 3Com hopes this is the start of a whole line of networking gear designed and made in China for the global market. Without referring to China, Cisco CEO John T. Chambers says "we are starting to see a stream of good, very price-competitive competitors, particular from Asia."

The next step for China is critical mass in core industries. Outside Beijing, Semiconductor Manufacturing International Corp. (**SMI**) has just opened a chip plant fabricating 12-inch silicon wafers that experts say is just two generations behind Intel Corp. (**INTC**) A foundry that makes chips on a contract basis, this plant won't compete directly with U.S. chipmakers. But with four more 12-inch wafer plants due by 2006 and many more fabs in the pipeline, the U.S. Semiconductor Industry Assn. warns that a "gravitational pull" could suck capital, people, and leading-edge research-and-development and design functions from the U.S.

Digital technologies aren't the only areas where the Chinese have huge ambitions. In the past decade, U.S. petrochemical makers have invested in little new capacity. But at a three-mile-long site in Nanjing, 12,000 workers are erecting a \$2.7 billion network of pipes and towers for China's Sinopec (**SNP**) and Germany's BASF (**BE**) that by next year will be among the world's biggest, most modern complexes for ethylene, the basic ingredient in plastics. An even bigger complex is going up in Shanghai. "The Chinese understand everything that scale means," says Fluor Corp. (**FLR**) Group President Robert McNamara, who lives part-time in Shanghai and whose company has design contracts at both complexes. "When they target an industry to dominate, they don't mitigate."

Can China dominate everything? Of course not. America remains the world's biggest manufacturer, producing 75% of what it consumes, though that's down from 90% in the mid-'90s. Industries requiring huge R&D budgets and capital investment, such as aerospace, pharmaceuticals, and cars, still have strong bases in the U.S. "I don't see China becoming a major car exporter in the foreseeable future," says GM China (**GM**) Chairman Philip F. Murtaugh. "There is no economic rationale." Murtaugh cites high production costs and quality issues at Chinese car plants, as well as just-in-time delivery needs in the West, as impediments.

Burning Rubber

Don't tell that to Miao Wei, president of Dongfeng Motor Corp. On Nov. 7, Dongfeng and Honda Motor Co. (**HMC**) announced that their joint venture will invest \$340 million to boost output of Honda CR-Vs and Civics fivefold, to 120,000, by early 2006. The plant aims to achieve world standards by employing Honda's flexible manufacturing system. "Honda will sell some of the Chinese-built cars in Europe," says Miao. Nissan Motor Co. (**NSANY**) is also talking about exporting with Dongfeng.

China's carmakers are developing the suppliers that one day could sustain exports. Auto-parts maker Wanxiang Group in Hangzhou started as a tiny township-owned farm-machinery shop in 1969. Now it's a \$2.4 billion conglomerate that supplies the Chinese assembly plants of GM, Ford Motor (E), Volkswagen, and others and also exports 30% of its output. In two years, China will drop the rule that its auto plants buy at least 40% of parts locally. Wanxiang is getting ready: It is opening a \$42 million plant loaded with U.S. and European testing gear. And since 1995, Wanxiang has bought 10 U.S. auto-parts makers. "Our goal is to acquire technology, management, and most important, to get access to overseas markets," says Chairman Lu Guanqiu.

Some U.S. manufacturers hope China will run out of steam. This year, factories in Guangdong and Fujian faced serious labor shortages for the first time. Red-hot demand has meant skyrocketing costs for China's producers, most of which rely on imported goods such as steel, plastics, and components. Energy shortages have forced manufacturers to shut factories several times a week. In almost any industry one can think of, vicious price wars are biting into already razor-sharp margins. "There are so many small companies competing that they crowd out all profit," says Beijing University economist Zhang Weiying. Indeed, given the low emphasis on profits and the unsophisticated accounting of many Chinese companies, often their pricing isn't based on a full understanding of costs. Having gotten as far as they can on cheap production costs, Chinese manufacturers must develop their own technologies and innovative products to move ahead -- areas in which they've made slow progress so far.

The juggernaut will slow, but only slightly. While salaries for top Chinese designers are rising fast, they are still a fifth to a tenth of those in Silicon Valley. If China's wages rise 8% annually for the next five years, says a Boston Consulting Group study, the average factory hand will still earn just \$1.30 an hour by then. If China allowed the yuan to appreciate by around 10% in the next year, productivity gains would more than offset the higher costs, figures China expert Nicholas R. Lardy of the Institute for International Economics. "I don't think revaluation will have a significant impact," he says.

And Chinese producers are hardly standing still. In a recent survey of Chinese and U.S. manufacturers by *IndustryWeek* and Cleveland-based Manufacturing Performance Institute, 54% of Chinese companies cited innovation as one of their top objectives, while only 26% of U.S. respondents did. Chinese companies spend more on worker training and enterprise-management software. And 91% of U.S. plants are more than a decade old, vs. 54% in China. Shanghai-based TV maker SVA Group, for example, has opened China's first plant to make flat panels, a venture with Japan's NEC (NIPNY) Corp. That is enabling SVA to secure a U.S. beachhead by selling liquid-crystal display and plasma TV sets through channels such as the online sites of Costco Wholesale (COST) and Target. Starting price: \$1,600 -- 30% below similar models by Royal Philips Electronics (PHG) and Panasonic (MC).

More innovation. Better goods. Lower prices. Newer plants. America will surely continue to benefit from China's expansion. But unless it can deal with the industrial challenge, it will suffer a loss of economic power and influence. Can America afford the China price? It's the question U.S. workers, execs, and policymakers urgently need to ask.

By Pete Engardio and Dexter Roberts With Brian Bremner in Beijing and bureau reports

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