



# Deconstructing the China Price

PETER NAVARRO

**O**n February 2, 2007, the United States filed its third complaint in five years against China before the World Trade Organization (WTO).

This action makes it especially timely to ask how China has become the world's "factory floor" in just a few short decades. *Business Week* has even coined the term "China Price" for the low prices Chinese manufacturers offer—which typically undercut world prices by 50% or more.

Why can Chinese companies offer such dramatically lower prices? Is it because of a superior resource advantage, such as cheap labor, and/or a more highly evolved supply chain

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*Peter Navarro is a professor at the Paul Merage School of Business at the University of California, Irvine.*

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management and production process? Or, is it because "China, Inc." has engaged in a set of mercantilist practices that, in violating international norms and rules of trade, provide a significant cost advantage?

U.S. trade negotiators and litigators now are making it a priority to seek to reduce China's record-breaking trade surplus with the U.S. Knowing why that surplus exists is plainly key to solving it. Yet surprisingly, the economics profession has provided little in the way of studies to rigorously address the key questions about the true reason for China's ability to provide prices so far below those others can offer.

Of course, it is well-known that factors such as low wages on the free trade side of the ledger, and currency manipulation on the mercantilist side, are important. But no analysis to date has rigorously examined the many drivers of China's

tremendous cost advantage and their relative contributions. The China Price Project at the University of California, Irvine, was thus created to address this analytical lacuna.

The stakes are high: waiting in the wings, should the Bush Administration fail to bring a thus-far-intransigent China into the reform fold, is a U.S. Congress intent on unilaterally passing tough protectionist measures—and possibly sparking a global trade war. It would be a great shame if measures to supposedly solve the "China Price" problem were undertaken, without an accurate examination of why the "China Price" exists in the first place.

## THE CHINA PRICE PROJECT'S METHOD, AND ITS FINDINGS

**T**he China Price Project was conducted by a team of almost 100 MBA students, including

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a large number of native Chinese citizens, from both the PRC and Taiwan. The Project's goal was to identify the major economic drivers of the China Price, and their relative contributions to China's competitive advantage. Our approach was to compare the cost structures of U.S. versus Chinese manufacturers.

Two of the eight drivers identified—low wages and “network clustering”—clearly reflect China's comparative advantage and relatively greater efficiency in manufacturing. These two factors alone contribute 55% of the China Price advantage.

China's wage advantage comes not just from sheer numbers, but also from the quality of what is a remarkably well-disciplined and well-educated workforce. This advantage is likely to persist for decades, as the Chinese government plans to move 300 to 500 million of its peasant farmers into its factories. These new workers alone are roughly equal to the size of the current workforces of the United States and Euro Zone countries combined.

Another factor is “industrial network clustering.” This term refers to the practice of locating all or most of the key enterprises in an industry's

supply chain in close physical proximity to one another. U.S. examples of clustering include Detroit, the “motor city” hub, and New York as a financial center.

#### CHINA'S UNIQUE FORM OF INDUSTRIAL NETWORK CLUSTERING, AND ITS ADVANTAGES

What is different about industrial network clustering in China, however, is not just its large scale and broad scope. It is also the emergence of a myriad of “supply chain cities” that focus on a single product or set of products, and serve as the focal points for highly localized supply chains.

For example, in the Pearl River Delta area of China, the city of Huizhou has emerged as the world's largest producer of laser diodes and as a leading DVD producer as well. Foshan and Shunde are major hubs for appliances such as washing machines, microwave ovens, and refrigerators. Hongmei focuses on textile- and leather-related products, Leilu on bicycles, and so on.

China's unique form of clustering significantly cuts transportation costs. Moreover, this highly evolved supply chain management

technique also reduces search costs, and generates considerable positive information externalities.

#### THE MERCANTILIST DRIVERS OF THE CHINA PRICE: SUBSIDIES, UNDERVALUED CURRENCY, COUNTERFEITING, AND PIRACY

While a little more than half of the China Price may be attributed to fair trade factors, at least five of the eight remaining drivers are clearly mercantilist. The biggest of these, at 17%, is the complex web of export subsidies that the Chinese government provides. These range from heavily-subsidized energy, water, financial capital, and land costs, to tax subsidies, such as China's VAT tax rebate on most exports.

The second and third most important mercantilist drivers are two which have been frequently noted in the political discussion—an undervalued currency (11%) and counterfeiting and piracy (9%). Analytically, it is useful to note here that the currency effect is much less than popular perception would suggest, once the high import content of Chinese export is netted out. As for the piracy effect, this derives from factors such as the lower R&D costs and smaller

marketing budgets of enterprises which specialize in counterfeit and pirated goods.

The most surprising result of the China Price Project was arguably the small contributions that lax environmental and health and safety standards make. Given that China has emerged as the most polluted (large) nation in the global community and also features one of the most dangerous work environments, this is good news, in the sense that the benefits of reforms in these areas likely should far outweigh costs. Pollution is not importantly benefiting China's economy, nor is putting workers at risk, so any arguments against eliminating on these grounds have little, if any, force.

Lastly, there is matter of Foreign Direct Investment. China's massive FDI, amounting to well over \$60 billion a year, provides Chinese manufacturers with the most advanced capital equipment and, very often, foreign managerial resources that bring to China state-of-the-art management techniques.

Such FDI has one foot in the fair trade camp, because much of it is streaming into China, allowing China to leverage its cheap labor and clustering advantages. However, on the

mercantilist side, many foreign corporations are also moving to China in response to the subsidy environment, and as a way to evade tighter regulatory strictures at home. For example, China's policy of offering free land use to multinationals has been particularly effective in attracting foreign direct investment.

#### THE BOTTOM LINE: CHINA'S TRUE FAIR TRADE SITUATION

The picture that emerges from the China Price Project is a classic "glass half empty or half full" portrait. On one hand, Chinese manufacturers are beating the competition because of both an important labor resource advantage, and the development of a highly evolved form of industrial network clustering. Would-be competitors might do well to learn from the clustering example, as well as to develop capital-intensive strategies to cope with China's labor advantage.

On the other hand, it is abundantly clear that the fair trade glass is half empty because of numerous mercantilist practices of the Chinese government to promote the country's export-driven model. Any truly comprehensive policy response should focus on each of these

practices, rather than any single one, such as currency reform.

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