POWER AND PERIL
America's Supremacy and Its Limits
Second in a Series

Frank Lin

As China Surges, It Also Proves A Buttress to American Strength

Beijing Feeds a Giant Appetite In U.S. for Low-Cost Goods And Borrowed Capital

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DONGGUAN, China -- Frank Lin joined fellow Chinese furniture makers at a hotel here last summer to discuss some alarming news from America: U.S. furniture companies were asking Washington to investigate "illegal" Chinese trade practices and restrict Chinese sales to the U.S. Among the petitioners was one of Mr. Lin's longtime customers, Virginia-based **Hooker Furniture** Corp.

Mr. Lin's dismay turned to confusion days later when he received an e-mail from Hooker's chief executive. Hooker looked forward to an "exciting future" doing business with China, said the message, and wanted to "continue the extraordinary growth we have had in the last few years with Asian imports."

Indeed, thanks largely to the imports, Hooker has boomed. It closed a factory in North Carolina last summer but has boosted profits and dazzled investors with a stock that more than quadrupled in two years.

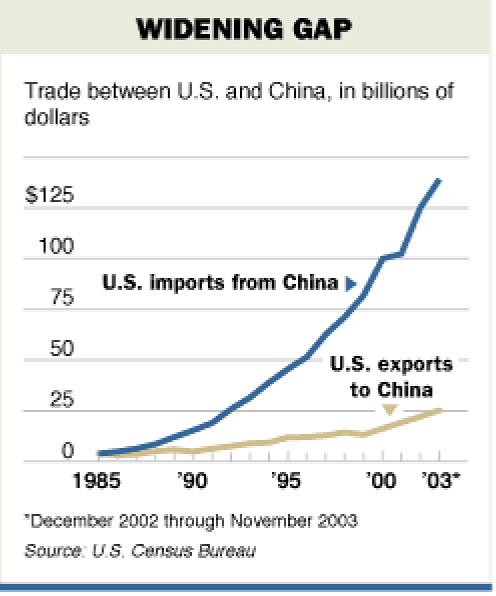
"I just don't understand what they are doing. It makes no sense," Mr. Lin said after receiving the e-mail in August. On his desk lay designs sent from America. Lining the wall, newly crafted chairs stood ready for inspection by U.S. buyers. "If they don't import, they die. They need us. So why do they want to hurt us?" Mr. Lin wondered.

His bewilderment flows from a much bigger tension besetting U.S. economic relations with China -- and the economic forces that underpin America's global hegemony. China's rise both supports the American superpower and embodies some of its self-generated vulnerabilities.

Burgeoning business ties with China have become treacherous terrain. Anxious to calm workers' worries about jobs, and fearful of appearing unpatriotic, even some U.S. companies that rely on China are joining industry coalitions clamoring to curb the "China threat."

But there's another side to China's dynamism. China is slotting itself into the global economic order that America dominates and largely created. As a critical link in this capitalist chain, nominally communist China helps enrich companies such as Hooker. At the same time, it supports a central feature of America's superpower status: its gargantuan appetite for foreign goods and capital.

Though America is sometimes loosely called an empire, it defies the imperial economic script described by Lenin (who called imperialism "the highest form of capitalism"). The U.S. doesn't seek vassal states as outlets for surplus capital. In an anomaly for such a



powerful nation, America sucks in money from abroad. With its large national debt and trade deficits, the U.S. binds not by lending but by borrowing and by importing.

Its status as a "hyper-debtor" makes this "hyper-power" oddly reliant on weaker partners, says Niall Ferguson, a professor at New York University and scholar of imperial history. "If you are dependent on the willingness of others to hold your assets, there is a limit to how unilaterally you can act."

For all their nation's power, many Americans feel an economic insecurity, for which China is a lightning rod. Its blitzkrieg thrust into U.S. markets over the past decade, many worry, reveals a soft economic core under the tough carapace of America's military might. From bed frames to circuit-boards, the industrial bedrock of American power is crumbling, say some politicians and pundits. At stake, warns the American Furniture Manufacturers Committee for Legal Trade, which filed the complaint that upset Mr. Lin, "is our way of life, our culture and the competitiveness of America in the world."

China's emergence as a major economic power is beyond doubt. Its $1.2 trillion economy, while far smaller than the $10.4 trillion economy of America and Japan's $4 trillion output, is on track to catch up with Japan inside of two decades. Already, China's growing economic weight, including a voracious consumption of crude oil, is giving Beijing commensurate influence in geopolitics -- another power center for America to contend with.

Also undeniable is a painful loss of U.S. manufacturing jobs to a country where the average plant worker earns around $80 a month, less than an American on minimum wage makes in two days. Cheap labor pushed China's trade surplus with the U.S. to $123 billion in a recent 12-month period, five times the gap a decade ago.

The figures, however, mask the many ways in which the world's two biggest continental economies complement each other. China's rests heavily on industry, with manufacturing, mining and related activities accounting for 51% of gross domestic product, by World Bank figures. America generates only a quarter of its GDP from industry and just 14% from manufacturing. Services contribute nearly three quarters.

Curbing Chinese imports through tariffs or a stronger yuan would only drive up imports from other countries, contends Stephen Roach, chief economist at Morgan Stanley. The only real alternative, he says, is for Americans to spend less and save more: "When Americans get frustrated with China, they should look in the mirror."

They could also look inside things they buy from China. Take the 20 million "made in China" computer mice shipped to the U.S. each year by **Logitech International** SA, a Swiss-American company with headquarters in California. The mice are put together in a six-floor building in Suzhou, a Chinese city once famous for its Confucian gardens but now better known as a frenetic manufacturing hub.

Mouse Called Wanda

Logitech's Suzhou parts warehouse is a microcosm of the global economy, and helps explain why China reinforces America's role as ringmaster. Piled to the ceiling on blue metal shelves are boxes marked with the logos of foreign companies, from big U.S. multinationals to a small Belgian billiard company that makes trackballs.

One of Logitech's big sellers is a wireless mouse called Wanda, which sells to American consumers for around $40. Of this, Logitech takes about $8, while distributors and retailers take $15. A further $14 goes to suppliers that provide Wanda's parts: A **Motorola** Inc. plant in Malaysia makes the mouse's chips, and America's **Agilent Technologies** Inc. supplies the optical sensor. Even the solder comes from a U.S. company, Cookson Electronics, which has a factory in China's Yunnan province next to Vietnam.

Marketing is led from Fremont, Calif., where a staff of 450 earns far more than 4,000 Chinese employed in Suzhou. China's take from each mouse comes to a meager $3, which covers wages, power, transport and other overhead costs. Other Chinese-made products rely less on U.S. components and use Japanese, Korean or Taiwanese parts instead. But, in many cases, the upshot for China is the same: Foreigners get the bulk of the money. They supply many of the parts, often own the plants in China that assemble them, and get a markup on sales abroad. Foreign companies account for more than three-quarters of China's high-tech exports. The Chinese Ministry of Commerce's ranking of "China's" top 10 exporters includes two American companies -- Motorola and hard-drive maker **Seagate Technology**. Logitech, like most tech, toy and textile companies with plants in China, employs mostly young women such as Wang Yan, an 18-year-old from the impoverished rural province of Anhui. She is paid $75 a month to sit all day at a conveyor belt plugging three tiny bits of metal into circuit boards. She does this 2,000 times a day. To earn extra money, she gets up at 6 a.m. to tidy the dormitory space she shares with a dozen fellow workers.

CHINA'S CHANGING PICTURE

The world confronting China, 25 years ago and today.

INDICATOR	THEN	NOW
Population	975 million	1.3 billion
Leader	Deng Xiaoping	Hu Jintao
Number of private sedans	0	3 million
Fashion icon	Jiang Qing	Gong Li
Oil imports	0	2 million barrels a day
Annual U.S.-China trade	$2.3 billion	$177 billion (a)
Trade balance	$1.1 billion surplus for U.S.	$123 billion deficit for U.S. (a)
Currency	Nonconvertible	Convertible in trade (b)
Stock trading	None	Two exchanges (c)
Unresolved territorial claims	Hong Kong, Macao, Taiwan, Soviet border region, South China Sea islands	Taiwan, South China Sea islands

(a) December 2002 through November 2003
(b) Beijing pegs yuan at 8.28 to a U.S. dollar
(c)Shanghai and Shenzhen, listing 1,287 stocks in all
Source: WSJ research

This is her second stint in a factory. Before coming to Suzhou, she skipped school to become an underage worker at an electronics plant not far from Mr. Lin's furniture company in Dongguan. She complains about her salary but isn't going back to her village. That would mean only "eating bitterness," she says.

China's pivotal role in the global supply chain buttresses a pillar of foreign policy dating all the way back to 1899, when the U.S. pushed for an Open Door Policy making China's ports available to all. In turn, China's trade opening to the world in the past two decades softened its once-antagonistic foreign policy. Last year, as the U.S. prepared to invade Iraq, Beijing stood aloof from the Paris-Berlin-Moscow axis of outspoken opposition. It has offered the U.S. some help trying to curb North Korea's nuclear ambitions.

China's explosive growth as an exporter, though distressing for many American plants, prods the U.S. in a direction it has been moving for decades. Hooker furniture, which now imports more than 40% of the furniture it sells, mirrors this shift, scaling back on domestic manufacturing but expanding in services such as design, distribution and marketing. Meanwhile, other American companies, such as **Intel** Corp., focus on making high-end products, many of which end up in goods sold in America as "made in China."

China also does well out of an arrangement that provides millions of jobs, lets China steadily increase military spending and has created the biggest foreign-currency reserves after Japan's. Because of the U.S. debt habit, the arrangement also leaves China with leverage over America.

Borrowing Habit

The U.S. has been a net capital importer since at least the 1980s. This is in stark contrast to Britain at the height of its imperium before World War I, when the British had net foreign assets valued at 150% of their own GDP. America, though often described as Britain's successor as the world's dominant power, does the opposite. Recent figures from the Commerce Department's Bureau of Economic Analysis show that foreign holdings of U.S. stocks, bonds and other assets exceeded America's foreign assets to the tune of $2.3 trillion -- or 22% of GDP -- at the end of 2002.

"America is certainly a hegemon and may be occupying Iraq but, economically at least, it does the opposite of what Lenin described as imperialism," says Angus Maddison, a British economist whose many books include a survey of the world economy over the last millennium.

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MILESTONES

1979: Deng steers post-Mao China on "capitalist road"
1981: China convicts "Gang of Four" radicals, including Mao's widow, Jiang Qing
1989: China crushes pro-democracy protest in Tiananmen Square
1990: Reopens Shanghai Stock Exchange, closed since '49 revolution (a)
1997: Deng dies; China regains Hong Kong from British
1999: Regains Macao, enclave Portugal had held since 16th century
1999: Protests as U.S. accidentally bombs Chinese embassy in Belgrade
2000: Cracks down on Falun Gong quasi-religious group
2001: Joins World Trade Organization
2001: Chinese jet collides with U.S. spy plane over South China Sea, prompting diplomatic standoff
2002: Communist Party says it will admit capitalists
2003: SARS outbreak (b)
2003: U.S., Japan urge China to float yuan; it declines (c)
2003: Mass march for democracy in Hong Kong
(a) Shanghai and Shenzhen, listing 1,287 stocks in all
(b) December 2002 through November 2003
(c) Beijing pegs yuan at 8.28 to a U.S. dollar
Source: WSJ research

Tax cuts, spending in Iraq and other factors have stirred alarm among some economists that America's debt is getting out of control. A recent International Monetary Fund report said America's net foreign obligations could rise in a few years to 40% of GDP, and warned of an "unprecedented level of external debt for a large industrial country."

China didn't create this potentially unstable edifice, but it does, at least for the time being, help to keep it upright. China has loans outstanding to the U.S. government of more than $120 billion, in the form of Treasury debt that China owns. It holds probably that much again in Fannie Mae and other dollar-denominated debt securities.

Contrast that with what U.S. companies have invested in Chinese plants and equipment -- not a direct comparison, by any means, but revealing nonetheless. This "foreign direct investment" stood at $10.2 billion at the end of 2002, according to the Bureau of Economic Analysis, about one-twenty-fifth the level of China's U.S.-securities holdings. The Chinese government offers a much higher figure for U.S. investment in China but still far below the value of Chinese holdings of U.S. debt.

America's addiction to foreign money hands China and other potential adversaries a weapon, some influential voices warn. Among them is Aaron Friedberg of Princeton University, an authority on Britain's imperial decline who is now a national security adviser to Vice President Dick Cheney. Mr. Friedberg wrote in a 2000 article in Commentary that China could one day dump its dollar assets to "trigger a run on the dollar, an increase in U.S. interest rates and perhaps a stock-market crash."

But China has reasons of its own to buy dollar assets -- reasons that show how intricately the officially Marxist country fits into a U.S.-led world economic order. As China lends to the U.S. by buying U.S. government notes, it stows in a safe place the vast surplus cash its export economy generates.

Meanwhile, its buying of dollar assets buttresses another Chinese policy: keeping the yuan pegged at a low exchange rate against the greenback. Every time China buys a

Treasury note it sells yuan. This selling helps stop the yuan from rising. By keeping its currency cheap, China keeps its exports especially inexpensive abroad -- one of the trade policies the U.S. complains about.

The Chip Trade

What worries some Americans most isn't the loss of menial jobs to tens of millions of Chinese such as Ms. Wang but a migration of white-collar work as China moves up the economic ladder. A Godzilla role once played by Japan is now assigned to China, and sometimes India. "When you hear that Intel, IBM and Goldman Sachs plan to move high-end jobs to China and India, what's going to be left here -- restaurants?" asked Democratic Sen. Charles Schumer of New York at a Banking Committee hearing last year.

A study of the U.S. semiconductor industry's moves abroad, headed by Democratic Sen. Joseph Lieberman of Connecticut, said, "What is at stake here is our ability to be pre-eminent in the world of ideas."

Intel now produces more than 50 million chips a year in China. Most end up in computers and other goods for export.

Yet Intel's main facility, a $500 million plant in Shanghai, doesn't really make chips: It tests and assembles them from silicon wafers made in Intel plants abroad, mostly in the U.S. China adds less than 5% of the value. The U.S. generates the bulk of the value, and the profits.

Motorola, by contrast, does make chips in China, and has been far less successful. Its $1 billion plant in Tianjin has been plagued by problems. As part of a strategic rethink, Motorola has announced plans to transfer the facility to Semiconductor Manufacturing International Corp., a company based in China but partly owned by non-Chinese.

Attempts by domestic Chinese companies to make sophisticated semiconductors have a mixed record. Making high-end chips requires hugely expensive, imported equipment and does not play to China's natural strength in cheap labor. To try to overcome this, the government has been offering tax and other incentives in a big push reminiscent of an earlier drive to build up a large auto industry. This suggests the big competitive advantage China enjoys in labor-intensive manufacturing isn't easily transferred upward.

Whose Profits?

How much U.S. multinationals profit from their Chinese operations is hard to assess. Most book their earnings through Hong Kong or other offshore locations with low taxes. Bureau of Economic Analysis data, however, give a rough guide. American companies, after losing money in China in the 1980s and having minimal earnings for much of the 1990s, reported net income from their China affiliates of $755 million in 1999 and double that in the first three quarters of 2003. If income from Hong Kong affiliates is included, American corporate earnings from greater China totaled $5.16 billion in the first three quarters of 2003, about the same as earnings from Japan.

"Americans are getting a great deal in China," says Huang Yasheng, a Massachusetts Institute of Technology professor and critic of a model he says benefits foreigners and state-owned Chinese concerns at the expense of Chinese entrepreneurs. China, he says, "produces zillions of low-value-added things, but this is a miracle of volume, not a miracle of value. ... Americans get cheap goods and then get to borrow money from China at pathetic rates."

America's China deal looks pretty good from Frank Lin's furniture factory in Dongguan, operated by Glory Oceanic Co., a Taiwanese-owned company of which he is president.

Mr. Lin makes low-cost, high-quality furniture that allows U.S. companies better margins than on their U.S.-made goods. He buys wood from America and coats it with lacquer from a Dongguan factory that is run by Americans, uses American chemicals and flies an American flag. (The lacquer factory, owned by Akzo Nobel of the Netherlands, briefly hoisted a Dutch flag at the start of the Iraq war.)

Also now benefiting is a group of Americans that Chinese furniture makers wish they didn't need: Washington trade lawyers. Mr. Lin and fellow factory bosses -- most from Taiwan -- have chipped in $2 million to defend their business against complaints of "dumping" -- selling for less than fair-market value. After preliminary hearings, the U.S. International Trade Commission ruled this month that domestic furniture makers have been hurt by imports. The Commerce Department must now decide whether this is due to illegal pricing by the Chinese, and whether to impose duties, theoretically as high as 440%.

A Show of Hands

To plan strategy, a "defense committee" set up by Chinese furniture makers has been holding meetings in the ballroom of Dongguan's Fu Ying Hotel. At one gathering last year, the chairman read a list of U.S. companies that initiated the antidumping complaint and asked plant bosses to raise their hands if they made goods for any of them. Mr. Lin raised his hand four times. Many other hands also popped up, revealing that more than half of the U.S. furniture companies claiming concern about Chinese imports were themselves importers.

U.S. buyers, Mr. Lin said, "come here and go chop, chop, chop on our asking price and then complain that we are selling too cheaply." His warehouse was stacked with boxes full of furniture ordered by Hooker and marked with Hooker's corporate insignia.

Hooker's chief executive, Paul Toms, says he joined the antidumping petition to be "fair to our employees," and notes that it targets only bedroom furniture. Hooker and other supporters of the petition make most of their bedroom furniture in the U.S. "The last thing we want is to have the Chinese believe we are against them," Mr. Toms says, because imports from Asia "have been responsible for all our growth and a lot of the profit over the last few years." China, he says, is "both a threat and a great opportunity."

Mr. Lin and his colleagues said they were considering withholding shipments to U.S. companies that signed the petition. Scrambling to avoid a disaster for their businesses, Hooker and other importers rushed executives to China to try to calm tempers. In his e-mail, Mr. Toms assured Mr. Lin that, despite Hooker's joining the claims of illegal trade by China, he didn't think Mr. Lin had done anything "illegal or unethical."

Caught in the middle are scores of Americans working in Dongguan's furniture factories, lacquer-mixing plants and related enterprises. Smeared with sweat and sawdust after a day of supervising quality at a factory here, Karen Lanning and Bill Ward, both veteran furniture makers from North Carolina, swapped theories on what lay behind the importers' anti-import campaign.

"The whole thing is so goofy it must be politics," said Mr. Ward, aged 52. "It's a perfect platform: Wave the flag and whip up the crowd." Ms. Lanning, 49, who moved to China when factories back home began to close, blamed a failure to face economic reality by American furniture companies. "It breaks my heart to see workers lose their jobs at home, but we all picked up in our late 40s and 50s and came over here," she said. "This is evolution. You can't stop it."

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