Why China Is Vulnerable — Part 2

For the first part of Perry's analysis, go here [1].

Reason #5: The Brain Drain
Many people in this country complain that the Chinese are sending their best and their brightest over here for their schooling, and that those kids then return home with the knowledge they've acquired in the U.S. and put it to work trying to out-innovate us.

The problem with that argument is that many of those U.S.-educated Chinese kids aren't actually going back. Many are staying here, lured by the freedoms, the quality of life and the entrepreneurial opportunities they've discover as undergrads.

In fact, the brain drain is getting so critical in China that two years ago the government initiated a sweeping initiative called the *Thousand Talents* program, which offered perks and other benefits to entrepreneurial-minded and research-savvy Chinese ex-pats, to try to lure them back home. While a handful of high level scientists and researchers at places like Princeton and Northwestern did eventually bite, *Newsweek* reported that as of late last year there were still only 600 of the 1,000 slots filled.

While it's true that China's brain drain will grow less acute as the country continues to develop its own institutes of higher learning, on the same token, the more educated the Chinese people become, the less tolerant they'll grow with government oppression, totalitarian mandates, and the systematic denial of human rights.

Reason #6: The Jasmine Revolution
Outside of, perhaps, the Statue of Liberty, there may be no more telling or more poignant symbol of a national mindset than the Great Wall of China. For years,

China was a mysterious world unto itself, self-contained and all-but-cut off from the rest of the world — and that way as a matter of choice.

But as the Chinese economy has thrown its arms around capitalism, and as its ties to the Western world have grown not only in number and size, but in sophistication and complexity, that large stone wall has grown less iconic and more ironic by the day.

And with that increased contact with the outside world, has come an increased awareness on the part of the Chinese people of the joys of freedom and liberty. That, combined with a growing middle class, a new-found appreciation of the benefits of higher learning, and a communications network that thumbs its nose at the idea of a single gatekeeper trying to shut it down, and what you have is recipe for revolution.

So called "Jasmine" revolutions have occurred in Tunisia [2], Egypt [3], Libya [4], Bahrain [5], Morocco [6], Gabon [7], Algeria [8] and Iran [9]. And one is now underway in China. But China's Jasmine Revolution promises to be two things those others were not: global and epic.

Because unlike those other countries, in China's case the entire world will be watching, particularly the global marketplace.

What's more, in this revolution China is not going to simply be dealing with a few thousands unarmed students in Tiananmen Square.

And this time the demands of billions of Chinese citizens will not be able to be quashed with tanks, no more than that Great Wall will be able to continue to keep ideas, dreams and innovation from flowing back and forth across China's borders.

Reason #7: Inflation

As China continues to industrialize, banks in the country have made money easier and easier to come by. After all, that's how banks makes money in boom times; by lending it.

But as Chinese banks have started to dip into their reserves to lend more and more money for such things as infrastructure and public housing projects — in addition, of course, to billions upon billions in large and small business loans — that stunning infusion of cash has started to trickle down to the country's millions of hourly workers, causing a steady increase in their cost of living.

What's even more frightening for some analysts (not to mention, those millions of Chinese workers and its 700 million rural poor people) is that China's inflation is manifesting itself most profoundly in a steady rise in the cost of one of the most precious commodities of all: food.

The Chinese government is doing its best to control the flow of money, and is saying all the right things publicly about inflation being under control, but the fact of the matter is they're trying to un-ring a bell that's been sounding for the better

part of a decade. Inflation in China rose to 4.9 percent, this past month, which is a rate that borders on the untenable. But hidden in that somewhat frightening 4.9 percent is the fact that the price of food rose 11 percent the same month, which was even higher than January's already scary 10.3 percent. In fact, it is now anticipated that Chinese laborers will spend half their 2011 income on food alone.

And while government officials have mandated the supply of food, particularly vegetables, be increased to slow down inflation and calm workers' fears, at some point the demand for food will outstrip the government's ability to supply it. And when that happens, and as the price of everything from shampoo to snow peas goes through the roof, it doesn't take a genius to determine what that at some point China might have bigger problems than back-orders on TV sets and video game players.

[10]Reason #8: The Price War Paradox
Remember the **Chrysler** K Car? Back in the 1970's auto manufacturers became downright obsessed with price; so much so, in fact, that quality almost became an afterthought.

Then came the ultra-affordable K Car, which was not only ugly, but seemed to be held together by some combination of glue, staples and baling wire. And with its release, Detroit's maniacal pursuit of offering car buyers the lowest possible price, regardless, officially crossed over from the ridiculous to the sublime.

The K Car was historically critical because it not only single-handedly brought Chrysler to the brink of extinction and triggered a controversial government bail-out, it also helped launch the modern Japanese auto industry. Japanese companies like **Nissan**, **Honda** and **Toyota** saw what was happening to the quality of the American-made automobile and launched a full-out assault on the hearts and minds of the American consumer — one that used as its sole point of differentiation the quality of Japanese vehicles.

Today, China finds itself in a position much like the pre-**Lee Iacocca** Chrysler of the **Jimmy Carter** era; an entity so utterly obsessed with price that it truly believes people will continue to buy anything as long as it's marketed correctly and the price is right. What's different about China, however, is that not only does not have any institutional marketplace experience to fall back on, but it is a hulking, even monolithic government entity — and a Communist one at that.

Those two facts do not bode well for China as the market dynamics continue to shift, as consumers grow increasingly frustrated with the quality of Chinese products, and as more and more deaths and disease occur around the world as Chinese manufacturers continue to cut corners at an accelerated rate, all in the interest of price.

Meanwhile, much like Japan once turned Detroit's obsession with price into an historic opportunity for growth, U.S. manufacturers who continue to provide superior quality products at a compelling price stand primed reap the benefits as consumers start buying ABC. Only this time it won't mean Anything But Chrysler.

It will mean Anything But *Chinese*.

With that, let me offer my own personal take on one of the age-old tenets of business: The second worst thing you can do in a price war is to enter it.

The worst is to actually win it.

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