THE WALL STREET JOURNAL. ONLINE

September 11, 2006

THE OUTLOOK

Europeans' Appetite for Imports Benefits China at the Expense of the U.S.

By JOELLEN PERRY and MARCUS WALKER
September 11, 2006; Page A2

FRANKFURT -- After years of sluggish spending, Europeans are finally snapping up a range of imports -- including running shoes and construction cranes -- stepping in to prop up the global economy just as economists expect American consumers to start closing their wallets.

Europe's revival is good news for economies around the world that have long depended on selling more goods to the U.S. But the growth of the world's second-biggest market is likely to slow again next year, and it mightn't give the U.S. economy as much of a boost as economists had expected. That is because many of the additional imports Europeans are buying come from China.

The economy of the 12-nation euro zone, which has struggled to expand for the past five years, is expected to increase 2.7% in 2006, according to the Organization for Economic Cooperation and Development, almost doubling last year's growth rate. European consumers have started spending again, boosting the region's imports to $871 billion in the first half of this year, up 18.3% from a year earlier. That compares with import growth of 13.6% in the U.S. over the same period.

While higher energy prices account for some of Europe's rise in imports, more than three-quarters of it comes from a stronger hunger for foreign goods. "We expect that the euro zone will continue to add more to global growth in the near term than it has for a number of years," says Matthew Sharrat, economist with Bank of America in London.

Most forecasters say euro-zone growth will slow next year -- to around 2.1%, according to the OECD. That still would be a big improvement, however, from last year's 1.4%.

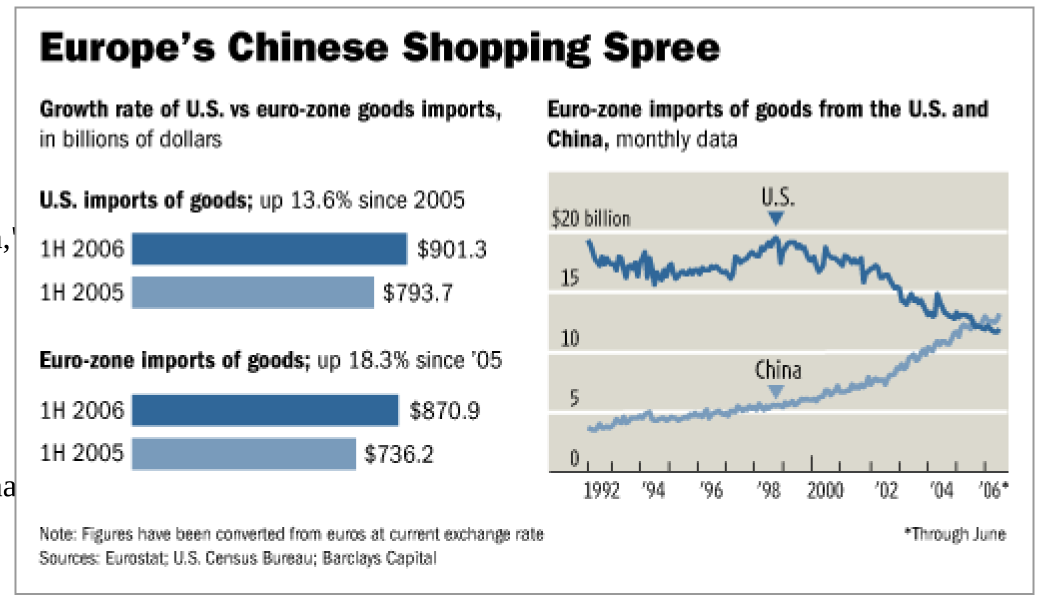
China has been the big winner in Europe's new shopping spree. In July 2005, China for the first time exported more goods to the euro zone than did the U.S. In the first five months of this year, China's exports to the region were $69 billion, up 26% from a year earlier. At almost $68 billion, U.S. exports of goods to the euro zone rose 8%, even though the dollar has weakened against the euro this year, making U.S. products cheaper for Europeans to buy.

"There's a sense that the U.S. has been a bit bypassed in terms of the trade flows," says Julian Callow, chief European economist at Barclays Capital in London.

That raises doubts about the hope many economists had for a rebalancing of trade flows in the global economy. Europe and Japan, by buying more U.S. goods as their economies picked up speed, were expected to help the U.S. reduce the difference between the amount it imports and exports. This year, the U.S. current-account deficit -- a measure of how much the U.S. borrows from overseas to pay for foreign goods and services -- is on track to surpass last year's record of nearly $717 billion.

The U.S. benefits from some of China's exports to Europe, because some of those exports are manufactured in Chinese factories run by American companies, which can send the profits home to the U.S. **Motorola** Inc. is one example. The bulk of the components for the mobile phones it sells in Europe are made in Asia. But the value of those profits to U.S. growth is less than that of exports manufactured in the U.S., where some local workers and suppliers benefit more directly.

As Chinese-made goods move up the value chain, the threat to U.S. exporters is growing. In the past, China specialized in simpler products, like apparel and low-tech assembly. But that is changing.



"China's on a real campaign to upgrade their production," says Frank Vargo, vice president for international economic affairs at the National Association of Manufacturers, which represents U.S. companies. He said Chinese companies are planning to produce sophisticated machinery, including aircraft. "As they move up the ladder, some of what they make will substitute for American products."

Trade data show U.S.-made goods already are losing market share in Europe. In 1998, they accounted for 15% of euro-zone imports. This year, the proportion has fallen below 10%, while China's share has increased.

China's ability to export high-value-added goods is a growing issue for European manufacturers, too. Though China's exports of shoes and clothing have attracted headlines -- as well as protectionist quotas -- machinery and transport equipment account for by far the largest chunk by value of its shipments to the euro zone. In May, China's sales of machinery to the region accounted for half of the $14.5 billion of its goods sold in the region.

China has become the world's No. 4 maker of machinery, behind the U.S., Japan and Germany, having overtaken Italy and Britain. "Until now, Chinese machinery production was strongly focused on supplying Chinese industry. Now it's competing for international markets, including in Europe," says Ralph Wiechers, chief economist at the German Engineering Federation.

MAN Takraf Fördertechnik GmbH, a Leipzig, Germany, engineering company that specializes in mining and materials-handling equipment, stopped making container cranes for ports a few years ago, after being undercut in its effort to supply the port of Hamburg by a Chinese bid. Now the German company aims to focus on making tailor-made engineering for specific industrial or mining sites, rather than mass-produced, standardized equipment.

"We have to accept that the Chinese will make more progress in high-volume products, and we will lose more market share here," says Rainer Kahrger, the company's chief executive.

If Chinese competition drives European industries further up the value chain, that could provide a boost for Europe's economic growth -- and imports. But businesses are calling on the European Union to tackle what they see as two of the drivers behind China's trade surplus with Europe: intervention in currency markets to keep the yuan and Chinese goods cheap, and domestic subsidies to Chinese exporters.

"We're calling for a much more resolute European position vis-à-vis China to deal with these issues," says Adrian van den Hoven, director of international relations at European business federation Unice.

Write to Joellen Perry at joellen.perry@wsj.com[1] and Marcus Walker at marcus.walker@wsj.com[2]

URL for this article:
http://online.wsj.com/article/SB115793038372758920.html

Hyperlinks in this Article:
(1) mailto:joellen.perry@wsj.com
(2) mailto:marcus.walker@wsj.com