MarketWatch

Trump wants jobs coming back to the U.S. from China — but companies and consumers might disagree

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Ed Yardeni: Reshoring factories is costly and ways to pay for it are unpopular

Reuters

President Donald Trump and White House trade advisor Peter Navarro would like to see U.S. companies' manufacturing operations come back home. Navarro noted recently that the administration is working on a phase-four stimulus package of at least $2 trillion that would focus on strengthening American manufacturing and include incentives for U.S. companies to reshore operations. The goal reportedly is to push legislation through Congress before its August recess.

There are many benefits of reshoring to the U.S. economy. As Navarro noted: "Manufacturing jobs not only provide good wages but also create more jobs, both up- and downstream through multiplier effects." In addition, reshoring also ensures access to necessary drugs and other items related to national security

That said, those writing the legislation should take into account the many reasons why reshoring is difficult. It's expensive, it requires access to capital, and it may result in former Chinese partners becoming competitors. Most importantly, reshoring may force U.S. companies to raise prices, something American consumers are likely to resist. Let's look at the obstacles that need to be overcome before U.S. manufacturers return home.

1. Reshoring isn't easy: Manufacturing has grown increasingly complex; suppliers now specialize in specific products to remain on the cutting edge of technology and to produce at volume at the lowest cost possible. Companies may have suppliers that rely on suppliers, which in turn rely on their suppliers, and so on. This multi-tiered chain is difficult to fully understand, let alone replicate.

Medtronic MDT, -1.36% CEO Geoff Martha explained the complexity in a recent article published in The Irish Times: "Take our ventilators which we make in Galway, for example. The ventilator has around 1,600 parts that come from suppliers in 14 different countries. The minute the U.S. does that [reshores], the question is what does the EU do, what does Ireland do, and it can create a lot of challenges for the global economy." Medtronic, which moved to Ireland after acquiring Covidien in a tax-driven deal in 2015, will make contingency plans in case its forced to manufacture more in the U.S. market.

2. Reshoring may increase costs: Outsourcing allows companies to run their factories with high efficiency. Plants can run constantly and any surge capacity can be contracted out. The companies that provide surge capacity can pool numerous clients to maximize their operation and lower costs. Take away this model and companies will have to build larger, more costly, less-efficient factories to handle surge capacity manufacturing.

Both the U.S. government and U.S. manufacturers may also need to spend more on research and development related to manufacturing. Chinese total R&D spending "which at the turn of the millennium was only about $10 billion, had by 2018 hit nearly $300 billion (2.2% of GDP), second only to the U.S. itself," The Wall Street Journal reported. The article noted that "If "decoupling" proceeds, then much more federal funding for basic research — and for U.S. science and math education—may be needed to plug the gap." China also subsidizes the construction and equipping of new production facilities.

Who would pay for these increased costs? Consider three options: 1) The U.S. government provides subsidies to U.S. manufacturers; 2) U.S. companies assume the costs and their margins get squeezed, 3) companies try to pass along the costs to consumers, risking the loss of customers who typically prefer the least expensive product — regardless of where it's produced. There also is an optimistic fourth option: U.S. manufacturers deploy new technologies to lower their manufacturing costs and remain competitive with importers.

3. Looking beyond the U.S. and China: Companies looking to diversify away from China may not move their manufacturing operations to the U.S. A survey by Site Selectors Guild, an association of professional site selection consultants, predicted an uptick in onshoring to the U.S., but also to Canada and Mexico — particularly in the pharma and life sciences industries, according to an article in Pharmaceutical Technology. Countries in Central and Eastern Europe and in Asia outside of China are also seen as low-cost production sites.

"Canada is set to attract several projects as it enjoys a low-profile versus the U.S., because of the exchange rate, and because of the nationalized healthcare system, which lowers the corporate burden to provide healthcare for employees," John Boyd, founder of location consultancy Boyd Company, told Pharmaceutical Technology. "Our clients in the U.S. typically pay upwards of 40% of their payroll for fringe benefits, whereas the rate in Canada is half that, largely due to its single-payer healthcare system." The article concludes that to minimize the impact of a disruptive event, companies should consider "spreading facilities across a number of regions."

4. Chinese roadblocks: China might make leaving difficult and expensive for foreign manufacturers. Most employees have one- to two-year employment contracts that must be fully paid if a company leaves, said Rosemary Coates, executive director of the Reshoring Institute, in an article published in the Global Supply Chain Law blog.

In addition, China may not allow a company to take any of the machinery, tools, and molds in its manufacturing plants to another country even if the company has contractual ownership rights of the equipment, Coates explained.

Perhaps most importantly, companies exiting China are creating potential competitors. "You have taught your Chinese suppliers how to make your products, and they are not likely to stop just because you are no longer doing business there," Coates said. This is why she encourages companies not to produce their latest products in China.

5. Timing is everything: Before pushing hard for companies to leave China, the U.S. should consider how long the transition will take. Building new U.S. facilities could take five- to eight years, John Murphy, senior vice president for international policy at the Chamber of Commerce, noted in a recent Reuters article.

What did Mom say about cutting off your nose?