CNBC "On The Money" -- May 9, 2006

Zhejiang Province

DYLAN RATIGAN (anchor):
Manufacturing clothing is one of China's specialties. You know this. But it's also a window into one of China's biggest problems – inefficiency. We're on China watch once again tonight on ON THE MONEY. Mike Hegedus, fresh back from China, is here to explain what we can learn about their economy from buttonholes.

MIKE HEGEDUS (reporting):
It's an interesting way to begin, Dylan, because so far China has made the most out of what it has. Its economic growth in large measure thanks to its incredible supply of land, resources and people, and its willingness to use them all to the max. But nothing lasts forever, not even the Ming Dynasty, without figuring out what to do next. That's what the Chinese are trying to do now, one buttonhole at a time.

It is her job. Mark the location of buttonholes on a shirt and then it's the job of the 9,000 other people at the factory to make them. This is the Youngor Group manufacturing facility in Ningbo, a port city south of Shanghai along the China coast.

All told, a company that employs 20,000 is listed on the Chinese stock market and makes clothes, shirts, suits, pants. It is a facility that from the outside has a bit of a Colossus of Roads effect. It can't really be that big, can it? Sure it can.

DAVID SMITH (Visiting professor):
China has all the facets: land, labor, capital. They've got everything and they're putting it together well. I think they're hard-working. Very--the Chinese are very hard-working people, and I think that's beginning to pay off for them.

HEGEDUS:
It has certainly paid off for Youngor. A little over $2 billion in total revenue in 2005 with $795 million in exports. A net profit of about $127 million. Though it does some private label work to the likes of Tommy Hilfiger and Nike, it sells nothing under its brand name in the US--yet. Its dominant market, 40 percent of sales, is at home--China.

It has 2,000 retail partners and a chain of 400 upscale company-owned stores. But Youngor is running head-long into what potentially could put the brakes on a lot of Chinese economy: there just isn't enough of almost everything, including labor. In some places jobs go unfilled.

LEIMING ZHONG (Youngor Group chief supervisor):
(through translator) Yes, there is a different kind of pressure. One is the restricted, limited amount of production resources like water and electricity. The other is that there are other companies moving in that do the same thing. So we're trying to find new technology to increase the productivity and lower the costs.

HEGEDUS:
It's an interesting place to go to look for the future of the Chinese economy: Xiao Xing, the textile city. It is here you can find one of the oldest streets in the country, dating back 7,000 years. A 3,000-year-old Buddha, atop which sits a 1,000 tree.

But here in the China Light and Textile industry city market, the largest in China, where they do business the way they always have and buyers come from around the world to buy raw materials, face to face.

WU (China Light and Textile Manager):
All over the world. All over the world. From America, from the United States.

HEGEDUS:
There is something new--brand new. Showrooms where buyers come and look but then go to the Internet to place their orders or perhaps never come at all and do all the business on the Web. It is technology Mr. Wu, who runs the market, is keen to talk about, and something David Smith, a visiting marketing professor from Canada, thinks the Chinese economy needs.

SMITH:
The more they bring in and can adapt technology-wise the better they're going to be. I think they're going to be very strong.

HEGEDUS:
Which takes us back to the woman and her pencil and those buttonholes. In a sense she's the reason David Smith is in China. Invited by the government, one of the number of professors of different business disciplines who are in the country to teach the next generation of Chinese businessman how to be more efficient, produce more, better and cost-efficient goods of their own, not someone else's.

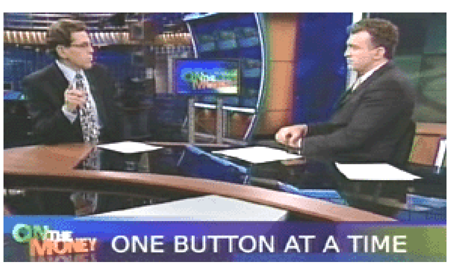
SMITH:
They do things very inefficiently in my mind from my perspective, and I think if they're doing so well and being so inefficient at the same time, imagine--I think the frontier of where they can go is so quite a ways out.

HEGEDUS:
Yeah, just imagine the Youngor brand coming to a store near you.

Does he want me to be able to be wearing Youngor brand if I want to buy it in Tucson, Arizona? Is that the goal?

ZHONG:
You being able to buy a Youngor shirt in Tucson is part of our dream.

HEGEDUS:
A dream that's getting closer all the time. Dylan, when you walk through these giant plants like the Youngor Group's textile factory in Ningbo, it's striking how far away from being totally automated they are. But they know about it and they're moving faster to try and step in that direction. But there are limitations from so many companies trying to tap into their limited natural resources. Limited in a Chinese sense, of course.



RATIGAN:
What does that mean?

HEGEDUS:
Well, it means that fellow that we talked to at the Youngor plant, he was willing to go and can go--he's got the people and the demand--to go seven days a week, three shifts a day. But the government won't let him because they're holding back electricity and water and natural gas to his facility. So they won't let him go as fast as he'd like to go.

RATIGAN:
And what are the pencils in the factory? Is it that antiquated everywhere? How prevalent is that?

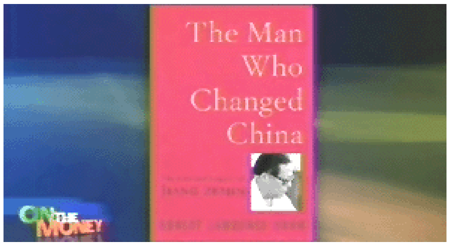
HEGEDUS:
Yeah, not really. I mean, it's kind of an object lesson or point being made. But there is that kind of stuff you find in a lot of different places. As an example, tracking inventory using a pencil and paper as opposed to even an adding machine or a computer.

RATIGAN:
Let alone the wireless things the UPS guy has--

HEGEDUS:
Uh, that's not happening. No, that's not happening.

RATIGAN:
All right, Mike, we'll see you tomorrow.

HEGEDUS:
You bet. Thanks, Dylan.



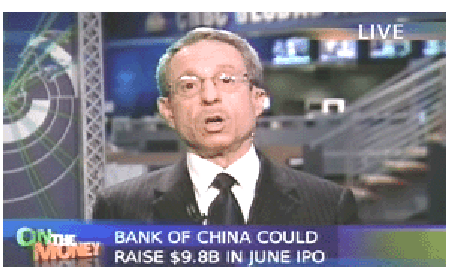
RATIGAN:
Indeed tomorrow night the Wild West atmosphere and China's economic boom. We're going to look specifically at the construction and architecture. It truly has become the new frontier of global business and global building. We'll get into that.

And now we look to China's future. Robert Lawrence Kuhn is senior advisor to Citigroup Investment Banking. He's also the author of "The Man Who Changed China: The Life and Legacy of Jiang Zemin." The book was the top seller in China in 2005. Robert, what will happen if China fails to solve some of the inefficiencies that Mike was just describing to us?

Dr. ROBERT LAWRENCE KUHN:
China's historic transformation was founded on it being the low-cost producer. That made certain sectors of society rich, which caused economic imbalances between sectors. President Hu Jintao wants to create a “Harmonious Society,” and to do that, you have to rebalance society.

When you rebalance society, salaries go up, and as a result China is no longer the low-cost producer. So China must innovate in order to maintain its growth. If China doesn't maintain its growth, its society will be in trouble, and if China is in trouble, the rest of us are too.

RATIGAN:
So, if we are to accept, though, that China at some point--literally as we speak--in some cases will no longer be the low-cost provider, what then becomes their competitive advantage?



KUHN:
They have to create it, and innovation is the key. President Hu is now focusing on innovation; universities are focusing on it. China must move up the value curve, producing higher value, higher margin goods, just like Japan did and South Korea did. They have to do this.

RATIGAN:
At the same time, will we see China emerge as the consumer market that has been so lusted for by American businesses for decades?

KUHN:
It has to happen. The key for China is that Chinese consumers have to save less and spend more -- just like American consumers have to do exactly the reverse: save more and spend less. This will get a big part of our trade problem solved. And the Chinese government is concerned about this: they're encouraging people to spend more.

How? By providing social services so people don't have to save in fear of having to pay hospital bills or to support their old-age retirement. So there are plans afoot. The domestic market is developing. There are problems, but that domestic market is real.

RATIGAN:
What's the health of the Chinese banking system? It has been long believed that the Chinese government was hiding all sorts of bad loans or encouraging the Chinese banks to do that. Today the *Wall Street Journal* is reporting we could see an IPO here from the Bank of China.

KUHN:
Let's look at what the major Chinese banks were – they were in essence subsidizing funnels into which the government poured money in order to subsidize state-owned enterprises, which were really moribund. That purpose began to change several years ago. The government took out the bad loans [putting them into special-purpose companies that hold and sell off bad loans]; they recapitalized the major banks with tens of billions of dollars.

They also brought into those major banks some foreign financial institutions to help change the bank's management style and structure and to create a credit culture in those banks (as opposed to what they were as "subsidizing funnels'). This transformation is in process, it is working, and the banks, because they are so strong, are very good plays on the entire Chinese economy.

RATIGAN:
Interesting stuff. We'll keep track of that if they offer it here in the US market. Robert, have a good night.