By David A. Schwerin

Expensive Discounts

Cheap goods from China come at a high environmental and social cost.

THROUGHOUT 2007, China was widely condemned for manufacturing a flood of faulty, dangerous products, as well as for generating widespread air and water pollution. The cause of these problems is not as obvious as many commentators claim, and the implications for investors and consumers reach farther than most suspect.

I was privileged recently to give the keynote speech at an ethics conference in Dalian, China. One of the other speakers at the conference was a representative of the U.S.-China Business Council, whose members are among the largest U.S. companies doing business in China. In his excellent presentation, the speaker devoted considerable time to the problems these companies have monitoring the safety and environmental records of their Chinese suppliers. Supply-chain relationships are complex, and there are often many layers of subsuppliers the Western customer may not be aware of. His point was that U.S. companies want to sell safe products from environmentally friendly factories, but that it is very difficult to monitor and police all those involved.

Yet Western companies do, in fact, deserve their share of the blame. Inflation has pushed the price of almost all products higher over the past dozen years. However, because of the buying power of large retail chains and the cheaper labor in developing countries, prices of clothing imported into the United States have been in an almost continuous decline.

How can prices keep dropping? From corners being cut. For example, according to a recent *Wall Street Journal* article headlined "Ravaged Rivers," dumping waste directly into rivers has been a deliberate policy of many Chinese companies in order to avoid the cost of treating contaminated water. Who can blame them when, according to an executive director of Hong Kong–based Pacific Textiles Holdings, the first thing the discount-store executives say when they meet with their Chinese suppliers is, "How much discount do I get from last year?"

This cutthroat approach mirrors what U.S. CEOs have reported to me about their experiences dealing with multinational retail stores. "They will squeeze you until you are limp" is how one CEO described his dealings with one of the world's largest retailers.

PAINFUL OBLIGATIONS

Both consumers and investors have the power to improve a situation that places children's health at risk and creates a degraded global environment. From a consumer standpoint, we can take a principled stand by boycotting companies that follow irresponsible business practices and patronizing only those businesses that act responsibly. Doing the latter may cost more in the short run, but, as we have seen, dangerous products and filthy air and water inevitably result in much steeper prices.

Individuals of wealth have a special obligation to pay more for products made by manufacturers who protect the environment and ensure that their products are of the highest quality and safety. If those who can afford to pay more shirk their responsibility, they have no one else to blame.

The implications of China's evolving low-cost strategy are every bit as significant for Wall Street as for Main Street. Investors have benefited from a low inflation, low interest rate environment for many years. Leverage has been easy to obtain and profitable to employ. Investors, mortgage lenders and credit card borrowers have learned to enjoy living beyond their means. China's surpluses have been invested primarily in U.S. Treasurys, facilitating our borrow-and-spend addiction. World economic growth has been robust, but our current codependent relationship is unsustainable. Adjustments such as cradle-to-grave pricing, which reflects all transportation, resource depletion and disposal expenses, are necessary if we are to make the best decisions.

The bottom line is that consumer costs are certain to rise as China's product quality is improved, its workforce better paid and its environmental safeguards enforced. This means that inflation and interest rates will be higher. And as consumers are forced to rein in their debt, spending will return to more sustainable levels. Add it all up, and today's historically high profit margins are likely to decline. Investments that look reasonably priced today may be more reasonably priced tomorrow. As a professional money manager for more than 35 years, I know that predicting future trends is perilous. I also know that markets are constantly changing, and China's shifting priorities will offer both opportunities and risks for the thoughtful investor.

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