CHINA AND THE FUTURE OF GLOBALIZATION

HEARINGS

BEFORE THE

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

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MAY 19 AND 20, 2005

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The Commission's Statutory Mandate begins on page 305.

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

SEPTEMBER 22, 2005

The Honorable TED STEVENS,
President Pro Tempore of the U.S. Senate, Washington, D.C. 20510
The Honorable J. DENNIS HASTERT,
Speaker of the House of Representatives, Washington, D.C. 20515

DEAR SENATOR STEVENS AND SPEAKER HASTERT:

On behalf of the U.S.-China Economic and Security Review Commission, we are pleased to provide the following assessments for the record of our hearing in New York City at the Council on Foreign Relations on May 19 and 20, 2005. The hearing on "*China and the Future of Globalization*" gave the Commission insights into China's role in global economic developments and how these "globalization" trends affect the American economy. A copy of the hearing record is available on the Commission's website at *www.uscc.gov*.

U.S.-China economic relations have become central to the development of global economic trends. As trade and investment between the two nations has expanded in importance and scope, the impact of this relationship on the U.S. economy—and the global economy—has grown to enormous proportions. In its 2004 Report to Congress, the Commission noted that "the U.S.-China economic relationship is of such large dimensions that the future trends of globalization will be influenced to a substantial degree by how the United States manages its economic relations with China" and that "[i]t is reasonable to believe that U.S.-China economic relations will help shape the rules of the road for broader global trade relations."

Understanding the assumptions and governing theories and models underlying globalization is essential because they shape the way policymakers view the trends and implications of global economic developments. These theories and models are deeply rooted and have driven U.S. economic policies for decades. For this reason the Commission felt it important to take stock of the underlying theories and models of globalization and China's role in these developments.

The New York hearing featured testimony from prominent economists, academicians, and business leaders. The topics discussed included the economic underpinnings of globalization, the impacts of globalization on national economies, China's role in the development of globalization, the interrelationship between globalization and the U.S. trade deficit, corporate globalization strategies, the rise of mass retailers and their influence on production location decisions, and the role of tax policy in driving trade and investment flows.

Among the key observations made by participants during this session were the following:

- While many U.S. firms have addressed their global competitiveness challenges through outsourcing and "off-shoring,"[1] these individual corporate decisions do not address, and in some cases may conflict with, efforts to maintain productive capacities in industries important to U.S. economic leadership and viability. This distinction between private and national interests is particularly pertinent with regard to the U.S. economic relationship with China.
- In today's global economy, factors of production, including capital and technology, flow freely across national borders, raising questions about the continuing usefulness of the traditional theory of comparative advantage, which assumes non-mobile factors of production, for understanding patterns of trade and production.
- In assessing the relevance of comparative advantage analysis to U.S.-China economic relations, it is important to recognize that a significant aspect of China's competitive advantage stems from a system where workers are often denied fundamental workers rights. Addressing this requires the inclusion of strong workers rights provisions in trade agreements.
- The opening of the Chinese, Indian, and former Soviet bloc economies has led to more than a doubling of the global work force and likely will put downward pressure on U.S. wages, at increasingly higher levels of the wage scale, for decades.
- China and other East Asian economies are pursuing export-led, mercantilist growth strategies that undermine the foundations of an open and balanced international trading system.
- While there is not a complete consensus regarding all the underlying causes of the U.S. trade deficit, the current trends are unsustainable and demand immediate attention, including addressing U.S. federal budget deficits and misaligned exchange rates.
- The rise of "big box" mass retailers has led to a shift of market power from manufacturers to retailers with profound implications for the organization of production. China has become the key source from which such retailers obtain manufactured consumer products and this has been a key driver of China's economic growth.
- The current structure of the U.S. international tax system is both inefficiently complex and generally favorable to offshore, as opposed to domestic, investment.

U.S. Economic Competitiveness

Ambassador Richard Haass, President of the Council on Foreign Relations, opened the hearing with perceptive observations on U.S. economic competitiveness. He noted that the arrows are pointing in the wrong direction with regard to long-term trends in U.S. competitiveness and that competitiveness is not something that can be established "overnight," but instead must be developed and nurtured over the long-term.

[1] "Off-shoring" encompasses both the outsourcing of work by a U.S. firm to a foreign firm producing abroad and a U.S. firm's relocation of production to a facility it owns and operates overseas.

Dr. Ralph Gomory, President of the Alfred P. Sloan Foundation, highlighted the differing competitiveness challenges faced by individual companies and the nation as a whole. He told the Commission that "[t]here is and can be fundamental conflict between the goals of the company and the goals of the country" since U.S. companies are required to make profits rather than consider the national effect of their decisions about where to produce goods or services. This distinction between "national" and "private" competitiveness raises profound public policy questions concerning the distinction between public and private interests. These questions are especially germane to our economic and security relationship with China, where the market may promote private actions that are at odds with the national interest.

Such concerns were also voiced by Mr. Ron Blackwell, Chief Economist of the AFL-CIO. Mr. Blackwell maintained that our nation faces its most serious competitive challenge in modern history. Like Ambassador Haass, he noted that the issue is not receiving adequate public debate and policy attention. With regard to the conflict between "national" and "private" competitiveness, Mr. Blackwell noted that many companies have solved or are attempting to solve their private competitiveness challenges through offshoring. But this leaves unresolved the national competitiveness problem regarding how the United States will pay its way in the global economy in the future and continue to create a broad base of well-paying jobs for American workers.

The United States' lack of attention to strategic competitiveness concerns was concretely brought home to the Commission by testimony from Mr. William Jones, Chairman of the Cummins-Allison Corporation. Cummins-Allison is a producer of specialty currency printing and verification equipment. Whereas other countries view protection of their currencies as a national and economic security concern warranting a domestic production champion, the United States has no such policy. The result has been the creation of an uneven playing field in which foreign competitors are significantly advantaged by the support of their governments. This has contributed to the decimation of the U.S. security printing industry. Cummins-Allison is the last remaining U.S. firm in this industry, and it is restricted to competing in niche markets owing to a lack of government support that would yield the economies of scale needed to support a full product base.

International Trade and Comparative Advantage

Support for international trade is traditionally justified by the theory of comparative advantage. That theory was developed by David Ricardo during the 19th Century based on the assumption that factors of production, including capital and technology, are immobile. In today's world, capital and technology flow freely across borders, raising questions about how useful comparative advantage theory is for understanding current patterns of trade and production.

The Commission heard from Dr. Gomory that, in the modern world, comparative advantage is not often fixed by nature. Instead, it can be changed rapidly by private sector actions and government policy. This directly connects with the issue of economic competi-

tiveness policy. In the 19th Century, when Ricardo developed his theory, natural and enduring factors meant that it was unlikely that production of either Portuguese wool or English wine would suddenly become more efficient. This is no longer the case for modern industries, and countries can more easily enter new business areas. According to Dr. Gomory, the important policy implication is that a country's gains from trade can be significantly reduced if a trading partner increases its productivity, a finding that is directly relevant to U.S.-China relations.

In written testimony submitted to the Commission, Dr. Paul Craig Roberts of the Institute for Political Economy emphasized that in a world of mobile factors of production, specialization according to comparative advantage no longer will prevail as capital flows to locations of absolute advantage. A significant implication is that "international mobility of capital and technology and the advent of production functions that operate the same regardless of location mean first world labor will be displaced in tradable goods and services until there is a global equalization of wages and living standards." This will result in tremendous downward pressure on the wages of U.S. workers.

Similarly, Dr. William Wolman, former Chief Economist for Business Week, told the Commission that mobility of capital and the resulting increase in global competition facing the U.S. workforce is leading to the "law of one price." He argues that, adjusting for transportation costs, products eventually will sell for the same price whether in Bangalore, India or Bangor, Maine. If costs of production are lowered in India, capital will flow there to increase the rate of return on that capital.

In contrast to the questions raised above about the comparative advantage model, Dr. Arvind Panagariya of Columbia University defended the current relevance of the model. While acknowledging that U.S. income declines may result from Chinese gains in productivity, he argued that the decline in U.S. incomes would be greater if the United States were to close its borders completely to trade and that comparative advantage theory postulates that the United States is better off trading rather than not trading with China in the presence as well as the absence of labor mobility.

In assessing the relevance of comparative advantage analysis to U.S.-China economic relations, it also is important to recognize that a significant aspect of China's competitive advantages stem from a system where workers often are denied basic human and labor rights. Mr. Blackwell told the Commission that "workers in China are systematically denied their fundamental human rights—the right to freedom of opinion and speech, the right of mobility within the country, freedom of association, but especially the freedom to form unions and bargain collectively." He suggested that the denial of fundamental worker rights is a key component of the Chinese government's competitiveness strategy. Addressing this, according to Mr. Blackwell, requires the inclusion of strong worker rights provisions in trade agreements in the same manner as such agreements include strong protections for intellectual property rights.

This analysis points to a vital need for U.S. policy to maintain the nation's competitiveness through investment in education, in-

frastructure, training, and knowledge production. It also requires that protections for fundamental worker rights be a priority in future trade agreements. If the United States stays ahead of the competition in these vital respects, it can secure gains from trade; if it falls behind it will experience reduced gains or potentially losses from trade.

Doubling of the Global Work Force

Professor Richard Freeman of Harvard University addressed the implications of the doubling of the global work force that has occurred with the opening of the Chinese, Indian, and former Soviet bloc economies. The net result has been a massive increase in global labor supply that he argues, similar to Dr. Roberts, will put downward pressure on U.S. wages.

Professor Freeman predicted that absorbing this increase in labor supply could exert downward pressure on wages for the next thirty to forty years. Wages need not necessarily go down in this period owing to productivity advances, but if they rise they will not rise as fast as would have been the case if these developing economies had not joined the global economy.

Downward wage pressures have been felt at the bottom of the wage distribution for some time. However, the United States now should expect those pressures to move up the wage distribution as skill and educational levels increase in China, India, and the former Soviet bloc countries. Globalization and the ability to trade previously un-tradable, knowledge-based services over the Internet promise to further increase these pressures.

Professor Freeman testified that reducing these adverse pressures calls for major public investments in education, science, and technology. The United States has a comparative advantage in knowledge creation, and it is critical that the nation invest wisely to maintain that comparative advantage. Further, in this new hyper-competitive environment the United States must remove self-imposed cost disadvantages such as the way we provide healthcare. We place a large portion of the expense for health care for workers and their families on our companies, which is especially injurious to the global competitiveness of U.S. manufacturing firms.

Export-Led Growth Strategies

The Commission heard testimony from Professor Robert Blecker of American University and Mr. Clyde Prestowitz, President of the Economic Strategy Institute, about China's economic development model. Whereas the United States has emphasized an economic model that gives primacy to consumers, China and other East Asian economies have adopted a model that emphasizes strategic accumulation of productive capacity. An important part of this strategy is "export-led growth" which constitutes a modern form of mercantilism.

Export-led growth is an economic strategy in which a country seeks to promote its industrial growth through a variety of policy devices that promote exports while strategically restricting imports to items needed for domestic growth and export production (such as technology and raw materials). These policy devices include

wage repression, industrial subsidies, government procurement policies, closed distribution systems, performance requirements on foreign investors, and an undervalued exchange rate. All these policies are evident in China, and they also are evident in other East Asian economies.

It is important for U.S. policy to recognize that such export-led mercantilist practices are fundamentally contrary to the spirit of an open and balanced international trading system. Such practices create imbalanced trade and frustrate the principles upon which the post-World War II open trading system is based. Longer-term, export-led mercantilism represents a strategic danger by generating artificial de-industrialization in those countries that play by the rules of our trading system.

Professor Oded Shenkar of Ohio State University cautioned the Commission about assumptions that China intends eventually to conform to the economic or political model of a democratic liberal country. Instead, China has a history of playing by its own rules, and of borrowing ideas and practices from outside and giving them Chinese characteristics. Export-led mercantilism is fully consistent with this history, and it is a dubious assumption that China aims to adopt the fundamentals of the democratic, liberal, multilateral, international economic order.

The Trade Deficit

The U.S. trade deficit with China has figured prominently in the elevation of concerns about the U.S.-China economic relationship, and is a major component of the massive and rapidly expanding U.S. global trade deficit. The Commission heard varied testimony on the causes of the deficit. While all witnesses agreed that the deficit is a significant problem that needs policy attention, they disagreed on the underlying causes of the deficit.

Dr. Catherine Mann of the Institute for International Economics echoed earlier comments about China's export-led growth, and characterized the U.S.-China trade relationship as one of co-dependence under which the United States gets cheap consumer goods and China gets jobs. She argued that this pattern is unsustainable and that both countries stand to be injured, leading to the need for urgent policy action. With regard to cause, Dr. Mann characterized the U.S. problem in terms of excessive consumption and inadequate saving, due in part to U.S. federal budget deficits driven in recent years by personal income tax cuts.

This diagnosis was partially challenged by Dr. Dean Baker of the Center for Economic Policy and Research, who argued that although the United States had a low savings rate, the real cause of the trade deficit was the over-valued dollar, which is a particular problem with regard to the Chinese and other East Asian currencies. In Dr. Baker's view, near-term action to correct exchange rate misalignments is badly needed.

Ambassador Richard McCormack of the Center for Strategic and International Studies expressed his concerns about the long-term implications of the U.S. current account and trade deficits. He explained that "America has an absolute requirement, over time, to buy less from abroad, sell more overseas, or some combination of the two. More and more of the fruits of our work and productivity

will otherwise go to our foreign creditors in interest payments and other financial transfers. This ultimately could impact living standards here, depending on the ultimate size of our accumulating external debts."

Role of "Big Box" Mass Retailers

Professor Gary Hamilton of the University of Washington provided testimony on the role of mass retailers in globalization and China's economic development. Over the last fifty years there has been a revolution in American retailing, the first stage of which was a shift from shopping on Main Street to shopping in malls. The second stage has involved "big box" discount retailers such as Wal-Mart and Home Depot displacing traditional general merchandise department stores such as Sears and J.C. Penney. This shift has had tectonic consequences for the organization of production and the nature of economic competition.

Professor Hamilton detailed how the emergence of big box discount retailers has led to an enormous increase in concentration in the retailing sector. With this increase in concentration there has been a shift of market power away from manufacturers to the retailers. Not only have these retailers acquired increased buying power relative to manufacturers, they also have driven a reorganization of the structure of manufacturing production. In particular, these retailers have become global buyers, scouring the globe for the lowest cost producers. The big box discount retailers thereby have served as a vehicle for putting countries—and workers in those countries—in competition with each other. In effect, big box retailers can be viewed as a critical mechanism of global labor arbitrage, one that may be even more important than the production decisions of multi-national corporations.

In addition to changing the nature of international competition, the rise of mass retailers also has enormous implications for the trade deficit. This is because they provide a ready-made distribution network for selling imported products on a national basis. In effect, they are the pipeline via which items move from the factories of China to the homes of Middle America. Professor Hamilton concludes that "the single most important driver of China's growth is that China has become the world's chief site for sourcing manufactured consumer products" and that "[t]he most important firms that source goods from China are the large retailers and brand-name merchandisers, which are mainly located in the United States."

These developments raise significant public policy concerns. Yet, there has been a general lack of awareness of and attention paid to the implications of this retail revolution.

International Tax Policies

The Commission heard testimony from prominent tax policy experts and practitioners concerning how U.S. tax policies, particularly those dealing with taxation of income earned by overseas subsidiaries of U.S. firms, affect trade and investment flows. The panelists discussed the principal elements of current U.S. tax law that apply to overseas investment by U.S. firms and offered proposals

for reforming current laws to better encourage domestic investment and production.

While the panelists offered different ideas for potential reforms, they were in agreement that the current structure of the U.S. international tax system is both inefficiently complex and favorable to offshore, as opposed to domestic, investment. They also emphasized that while China is growing in importance as a location for U.S. investment, it is necessary to look at U.S. tax policy toward international investment in general, not just its application to China, and to consider needed reforms on a broader scale rather than as a bilateral matter.

Deferral. Under current U.S. tax rules, when a U.S. firm conducts its foreign business through a foreign-chartered subsidiary corporation, the overseas earnings of the subsidiary are not subject to U.S. tax unless and until this income is repatriated to the U.S. parent corporation (though the subsidiary remains liable for tax in the local jurisdiction). There are exceptions for certain types of "tainted" income, such as passive investment income, which remains subject to U.S. taxation. The deferral rules were designed in part to keep U.S. firms competitive in their overseas operations with foreign firms that enjoy preferential tax treatment. Although the enactment of tainted income exceptions have limited the scope of deferral somewhat, the experts who testified before the Commission believe that by providing an exclusion from U.S. taxation the deferral rules result in more favorable tax treatment for offshore investment than for domestic investment and encourage U.S. firms to keep their foreign subsidiaries' earnings overseas rather than investing them in the United States.

Professor H. David Rosenbloom of New York University explained that the current rules fail to take into account the differing tax systems of countries that are recipients of U.S. investment. He argued that our tax policies should differentiate between countries with tax systems similar to that of the United States where investment is usually aimed at conducting active business operations and countries that attract investment as tax havens. He suggested that complete exemption from U.S. taxation could be allowed for the former, while full taxation might be the general rule for the latter. Countries such as China, that attract investment for active business but that also employ tax holidays and special tax regimes to attract such investment, could be addressed on an individual basis through the bilateral tax treaty process. He noted that other countries make such differentiations in their tax law and therefore it is feasible.

U.S. Corporate Tax Structure. Dr. Gary Hufbauer of the Institute for International Economics told the Commission that the U.S. corporate tax structure was more of a hindrance to U.S. domestic investment than the international tax rules. He explained that over the past two decades, the United States has become increasingly less "tax friendly" as other countries have significantly reduced their effective corporate tax rates. This has included both traditional low-tax and tax haven countries, and major industrial competitors such as France, the United Kingdom, China, Taiwan, Mexico, and Brazil.

A related concern is the World Trade Organization's (WTO's) disparate treatment of direct and indirect taxes. Pursuant to WTO rules, the United States is not permitted to levy its corporate income tax—a direct tax—on imports nor waive its corporate tax on exports. At the same time, WTO rules allow countries that have a value added tax (VAT) system—an indirect tax—to exempt this tax on exports while imposing it on imports. Dr. Hufbauer argued that this distinction in treatment between direct and indirect tax is not justified.

For these reasons, Dr. Hufbauer advocates replacing the current U.S. corporate income tax with a Corporate Activity Tax (CAT), a variant of the subtraction-method VAT, levied on the domestic sales of corporations. He argues that such a system would be more efficient and broader-based than the current U.S. corporate tax system, and as an indirect tax could be imposed on imports and exempted on exports, thereby removing a key disparity favoring offshore investment. Notably, EU nations, China, and most other industrial nations use a VAT system.

Sourcing Rules. One of the fundamental components of U.S. international tax rules is the determination of whether income is U.S. or foreign-sourced. Income derived by foreign business entities is generally taxed only if sourced in the United States, whereas U.S. firms receive credits for foreign taxes paid only to the extent of the U.S. tax liability on their foreign-source income. Mr. David Tillinghast of Baker & McKenzie explained that these rules were developed at a time when the U.S. economy and the economies of its major trading partners principally involved tangible property, and these rules are not readily workable with regard to global business operations and intangible property. For example, he noted the complexities of determining the source of income earned from licensing software or from services provided over the Internet.

Bilateral Tax Treaties. The United States has entered into bilateral income tax treaties with a number of countries, including China. One aim of these treaties is to avoid double taxation given differing national tax laws. In its treaties with developing countries like China, the United States generally has given these countries the right to tax royalty income earned by U.S. firms that is exempt from tax under the terms of its treaties with developed countries. This has led China and others to take an expansive view of royalty income, encompassing certain types of income that developed countries generally classify as "business profits" exempt from source-based taxation. Mr. Tillinghast argues that the tax treaty with China, which came into force in 1986, is ripe for renegotiation to deal with this and other concerns given the significant changes that have taken place in China over the past twenty years.

Going Forward

The Commission believes that current developments in U.S.-China trade and investment warrant a revisiting of the assumptions and models of globalization in order to more appropriately fashion economic and trade policies to address U.S. challenges in the global economy. Moreover, the Commission believes that a review of U.S. international tax policies should be an important component of a broader policy review in this area. Going forward, the

Commission plans to deepen its examination of these matters, which are central to informing our analysis as we continue to assess specific areas of U.S.-China economic relations and the implications for the U.S. economy and economic security.

Sincerely,

C. Richard D'Amato
Chairman

Roger W. Robinson, Jr.
Vice Chairman

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CHINA AND THE FUTURE OF GLOBALIZATION

THURSDAY, MAY 19, 2005

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION,
Washington, D.C.

The Commission met the Council on Foreign Relations, 58 East 68th Street, New York, N.Y. at 8:30 a.m., Chairman C. Richard D'Amato and Vice Chairman Roger W. Robinson, Jr. (Hearing Co-chairs), presiding.

OPENING REMARKS OF CHAIRMAN C. RICHARD D'AMATO

Chairman D'AMATO. The Commission will come to order. I am pleased to open the U.S.-China Economic and Security Review Commission's two-day hearing in New York City at the Council on Foreign Relations on a topic of great scope and importance: China and the Future of Globalization.

I welcome Richard Haass, President of the Council, and on behalf of the Commission, let me thank you for your hospitality and allowing us the rooms and courtesies of the Council for this hearing.

Richard Haass has been President of the Council almost two years now, a former Director of Policy and Planning at the State Department, and Director of Foreign Policy Studies at the Brookings Institution.

He is the author or editor of ten books on American foreign policy. His next book is called "The Opportunity." He may want to do some revisions to it based on the hearing today. I don't know. Maybe it's too late. It will be available shortly.

Richard Haass was confirmed by the U.S. Senate to hold the rank of Ambassador and has served as U.S. Coordinator for Policy Toward the Future of Afghanistan, and was the lead U.S. Government official in support of the Northern Ireland peace process. For his efforts, he received the State Department's Distinguished Honor Award.

In his past life, he was on the National Security Council in 1991 and began his political and diplomatic life as a legislative aide in the United States Senate where I am sure he learned his political and diplomatic skills. He also is a Rhodes scholar and has degrees from Oberlin College and Oxford University. We thank you very much for your hospitality, Mr. Haass.

[The statement follows:]

Prepared Statement of Chairman C. Richard D'Amato

I am pleased to open our two-day hearing in New York City at the Council on Foreign Relations on a topic of great scope and importance.

It is particularly fitting that we examine the nature and implications of global economic integration—what has come to be known as "globalization"—at this impor-

tant institution for American foreign policy, and in this city at the center of America's global economy. After all, the Commission was established to look at how our economic and strategic goals intersect in the context of China. We are indebted to Ambassador Haass and the Council for their hospitality and assistance in convening this event. I would also like to recognize the exceptional efforts of my colleague, Commissioner Patrick Mulloy, in helping to develop the agenda for this hearing.

In its 2004 Report to Congress, the Commission set the framework for our hearing by drawing a link between the development of U.S.-China economic relations and the development of globalization writ large. The Commission stated in the report:

> *[T]he U.S.-China economic relationship is of such large dimensions that the future trends of globalization will be influenced to a substantial degree by how the United States manages its economic relations with China. It is reasonable to believe that U.S.-China economic relations will help shape the rules of the road for broader global trade relations. If current failings are remedied and the relationship is developed so as to provide broad-based benefits for both sides, globalization will likely be affected in a positive manner on a worldwide scale. If not, the opposite will likely be true.*

This Commission has been detailing for the Congress on an ongoing basis the increasing breadth of U.S.-China economic relations. The level of trade and financial flows between the two countries has reached massive proportions. Two-way trade exceeded $230 billion in 2004, including a U.S. trade deficit of $162 billion. Yet China remains a developing, non-market economy. It is a truly unprecedented economic relationship between two economies at vastly different ends of the development spectrum. The Commission believes that understanding and addressing the costs and benefits of this relationship are vital to long-term U.S. economic health and to broader global trade relations.

Globalization is dealt with in formal economics under theories of trade, investment, and comparative advantage. We intend to explore the theoretical underpinnings of globalization with our distinguished panelists and assess how they comport with today's economic realities. A key question is whether traditional theories need to be modified or recast in the face of a dramatically changing world. For example, do traditional theories of comparative advantage still hold true where the factors of production—both labor and capital—are highly mobile?

Moreover, we will examine how the U.S. economy is faring in a global environment. Surely there will be specific winners and losers from globalization in the American economy, but we hope to understand what structural changes have taken place that will alter U.S. economic fundamentals in the future. For example, to what extent are U.S. retailers driving decisionmaking as opposed to U.S. manufacturers? What are the implications for the arrangements hammered out between labor and management in this country over decades of negotiations?

We will further examine the causes and consequences of the U.S. trade deficit, one of the most controversial and significant outgrowths of globalization for the U.S. economy. Some economists contend that the deficit is driven by global economic trends, while others view it primarily as the result of U.S. consumption and savings trends. It is vital to understand the true dynamics at work in order to fashion an appropriate national policy response.

Lastly, the Commission believes it is essential to understand the role that U.S. tax policies play in influencing U.S. firms' global business strategies. U.S. rules for taxing or exempting from tax the income of U.S. firms' foreign subsidiaries have been criticized by many tax analysts and practitioners for providing undue incentives for U.S. firms to relocate abroad. We need to understand whether the current U.S. tax regime strikes the right balance between maintaining the competitiveness of U.S. firms doing business abroad and removing unnecessary incentives for U.S. firms to move capital and production offshore.

In the context of this hearing, it is fair to ask if globalization, per se, is being used as a convenient marquee to justify corporate or governmental behavior that is in fact intended as simply self-serving, or to circumvent labor, environmental, or other standards erected in the most developed economies. If globalization is to be used as a "one size fits all" justification for such behavior, then it is being stripped as a concept of any lasting content.

We fully recognize that even a two-day hearing can only begin to scratch the surface of these far-reaching questions. But these are questions that must be examined and understood with the goal of reaching a national consensus on how best to meet the challenges and opportunities of globalization.

INTRODUCTORY REMARKS

STATEMENT OF AMBASSADOR RICHARD N. HAASS
PRESIDENT, COUNCIL ON FOREIGN RELATIONS
NEW YORK, NEW YORK

Ambassador HAASS. Thank you, Mr. Chairman, and let me just first of all welcome you all to the Council. And thank you for what you're doing, not just today, but more generally. I'll be honest, I didn't realize just how much of a commitment you've all made in time and effort, and I respect it and I thank you for it.

When I read the law that created you, you've clearly got an important charge: to assess the national security implications of the U.S.-China economic relationship and to make policy recommendations to the Congress. All this is close to what we do here at the Council; in two ways it resonates.

First of all, it seems to me you have got to come up with a blend of analysis and prescription. Essentially people are looking for what you think and what you recommend.

Secondly, you're looking at the relationship between, on the one hand, the security aspects of economic interactions, and, secondly, the economic implications of security interactions. And again, this is something that we are struggling with at the Council. Indeed, we have an entire center devoted to geo-economics, and what you are doing fits very squarely in what I think is an often under explored area of work, in part because so many experts are stovepiped. They are either area specialists or they're economists or they're political scientists and the sort of work that you're trying to do, this kind of integrative work, is both as necessary as it is rare.

So again I applaud what you're up to here. I looked at your schedule. You've got an extraordinary program for the next day and a half, an ambitious one. I'd almost call it a Chinese banquet of talent. It has got that good combination of breadth and depth, and my only personal regret is I'm hopping on a plane in about an hour to Los Angeles so I won't be here. But then since so much of what you do is publicly available, I will avail myself of it.

Let me just say a few things, since you were generous enough to offer me the opportunity, about globalization, about U.S.-China economic ties, and about the relationship more generally.

First, about globalization. It clearly forms part of the context for U.S.-China ties. It is not the entire context. Clearly, the post-9/11 world also formed part of that context. Everyone has got his or her own definition of globalization. Since I'm the President of the Council on Foreign Relations, and we are meeting here today, you get to hear mine. Globalization represents the increasing volume, velocity and importance of flows within and across borders of people, ideas, greenhouse gases, oil and gas, drugs, manufactured goods, dollars, euros, TV and radio signals, germs, e-mails, weapons and just about everything else.

And what is interesting to me about globalization is not simply what it is, but the fact that you can attach either a positive or negative sign to it. It is both and it is simultaneous. 9/11 in some ways was a perfect manifestation of it. One of the wonderful parts of globalization is the ability to travel. One of the awful aspects of globalization is that people hijacked airplanes and crashed them into buildings.

One way to think about the U.S.-China relationship is that we have the mutual challenge—I would call it a mutual opportunity given my new book—to help structure and regulate globalization. To put it more simply, we can try to stop or slow those aspects or those flows that constitute globalization that are clearly dangerous and destructive: terrorism, terrorist financing, technology related to weapons of mass destruction, drugs, greenhouse gases, what have you. Side-by-side we can promote or support those flows that are the positive side of globalization, such as goods, services, investment, energy, students, and tourism.

In order to do this, though, in order to get the United States and China to cooperate on managing or structuring globalization, there are many requirements, but let me simply focus on two.

One is that the United States and China and the leadership of the two countries figure out a way to structure what ought to be an area of cooperation and of mutual interest, namely their economic relationship, so that it is, in fact, judged to be positive by both sides.

From my point of view, this does not require that there be a balance of trade. But it does require on China's part that it abide by the WTO rules, that it respect copyrights and patents, that it offer market access, and that it doesn't maintain its currency at artificial levels that distort trade.

From the U.S. side, though, we must also act consistent with the WTO and that means not adopting unilateral or extra-WTO remedies in the trade area.

A second requirement for the United States and China to be able to cooperate to manage globalization is that the political/military issues that constitute our agenda not overwhelm the relationship.

Let me just mention two very briefly. One is Taiwan. You've all spent time working on this issue. If there is any single issue that has the potential to disrupt the potentially positive trajectory of U.S.-China relations, it's Taiwan.

And it's obviously important that the mainland not in any way be tempted to use force to unify China. The United States for its part needs to stand by the one China policy. It needs to stand by the Three Communiqués, but simultaneously, it needs to stand by its commitments to Taiwan and observe both the letter and the spirit of the Taiwan Relations Act. It's a delicate balancing act, but that said, it's a delicate balancing act that has worked for more than three decades, and there is no reason it can't work for as long as it takes. It is clearly in the interest of the United States that it does.

As for North Korea, I would suggest that what is needed is a package that spells out what is required of North Korea in the nuclear area, the benefits that would accrue to it if it met those requirements, and the penalties that will flow to it if it fails to meet those requirements.

If this is to happen, I believe the United States must put forward more in the way of incentives and these incentives must be packaged in a way that are sequenced in a realistic fashion.

But China also must do more, and in particular China needs to articulate or demonstrate its willingness to support meaningful sanctions against North Korea if it fails to live up to specified re-

quirements in the realm of weapons of mass destruction. I would simply say that it is hard to exaggerate what is at stake for the region, because an overtly nuclear North Korea would have all sorts of consequences for the nuclear programs of others and for the relationships of major countries in northeast Asia, which as it happens is a part of the world that is institution poor, unlike Europe, for example, which you might describe as institution rich.

But also it is hard to exaggerate the stakes for the world because a North Korea that has all sorts of nuclear material and nuclear weapons could be tempted to put them on the market, since it has put so much else on the market. Again, another form of globalization. It is also hard to exaggerate the consequences because of the tipping point effect, that an overtly nuclear North Korea could have consequences for the region, which could, in turn, could have consequences for other parts of the world.

There are other things that will affect the ability of the U.S. and China to cooperate in a global world including China's own political evolution. I don't want to take any more of your time, so let me just say that when I look at this relationship, it is important we get it right. Let me just end up with what I think that is.

More than any other bilateral relationship in the world, this relationship is going to determine the character of the 21st century. I actually believe it will go a long ways toward defining this era of international relations. It's interesting; we still call this the post-Cold War era, and it's now 15 years since the wall came down. We call it the post-Cold War era because we haven't figured out what to call it, and the reason we haven't figured out what to call it is because the character of the age is still unclear.

What I began with is true, you've got positives and negatives simultaneously at play, and neither has gained the upper hand. Again, I believe it is U.S.-Chinese relations that will help determine what the ultimate balance at this stage is.

Just to give you an idea, this could turn out to be a remarkable era of U.S.-Chinese cooperation, part of a larger pattern of great power cooperation, which would set a context for unprecedented stability and peace and prosperity and even human freedom. This is one end of the spectrum.

At the other end of the spectrum, you could have a total breakdown in not just U.S.-Chinese relations, but in part because of it, in relations among other major powers and even medium powers. This could turn out to be at worst a kind of modern Dark Ages in which the malign or dark side of globalization becomes the norm, in which failed states multiply, terrorists run rampant, weapons of mass destruction proliferate, and in which there is simply very little global cooperation out there to deal with things like global climate change to infectious disease.

So this could turn out to be a truly awful era of history. In between these two worlds is the possibility that what we are living in today could one day become known as the inter-Cold War period, and if U.S.-Chinese relations turn out wrong, I predict that historians will call this the inter-Cold War period, one existing between a U.S.-Soviet Cold War and a U.S.-Chinese Cold War.

The danger in that is twofold. It is not simply the risk that a U.S.-Chinese Cold War would bring inherently. It is also the dis-

traction of resources. There would be an enormous opportunity cost if the United States and China were to find themselves in a Cold War relationship, because by definition they would be focusing on one another rather than on the challenges of globalization.

What does this mean for us? The goal for U.S. foreign policy should not be to try to work to prevent China's rise, as if we could. Rather, the goal of U.S. foreign policy should be to try to shape China's behavior. To put it another way, we shouldn't regret or fear China's strength; rather, we should try to work with it to see that the strength is used in constructive ways or, to put it bluntly, to persuade the Chinese that it is in their interests to work with us to help tame globalization.

And this means integrating China in the world so that it benefits from economic ties to a degree that it will be reluctant to upset them, and so that it helps us manage the challenges of a global world that have the potential to overwhelm us both.

What this suggests to me is that economic ties can be a foundation for the U.S.-Chinese relationship more broadly or economic ties can be a source of friction that will help frustrate the overall relationship.

The jury is out, and as a result, the importance of your work is clear. So again let me thank you for the opportunity to meet with you today and more broadly thank you again for all the hours you're putting into this.

Introductory Remarks: Discussion, Questions and Answers

Chairman D'AMATO. Mr. President, thank you very much for those observations. I hope you will have a few moments to respond to some observations or questions from the panel.

Just two comments. The fact of the existence of this Commission is recognition that Congress understands this bilateral relationship is without a doubt our most important. This is the only permanent commission established by the Congress in the current era to look at a bilateral relationship. That in itself is recognition of the importance of this relationship.

The second thing is in connecting and creating the Commission, the Congress did what you mentioned for the first time, which you're doing here as well, and that's trying to connect the dots between economic, military and political realities.

Prior to the creation of this Commission, there was indeed, as you mentioned, a tendency to stovepipe the relationship. There are people who were experts on human rights, didn't know a thing about politics, economics and military, the same thing. There was no attempt to look at this in a holistic way to understand what the long-term trends would be for all of these national security and economic issues for us.

Commissioner Dreyer.

Commissioner TEUFEL DREYER. I guess I am one of the stovepiped people. I concentrate on China and that's one of the reasons this Commission has been so valuable to me, since I learn new things that are outside my specialty. I was interested in your comment that if China and the United States have a hostile relationships and we need to help China see the world the way we do, it seems to me from reading Chinese publications, that China already

regards us as the major enemy, and that they have ever since 1989 when the Soviet Union began to disintegrate.

Now, admittedly, I spend a lot of my time reading Chinese military publications, but the tenor of these and also other Chinese newspapers, which are written by Chinese for a Chinese audience, is that they don't want democracy; they see us thrusting them forward into a world they are not sure they want to participate in, and it seems to me that the hostile relationship has been there for a long time.

I was stupefied when Strobe Talbott said if we treat China like an enemy, it will surely become one. I wondered if he ever read any Chinese newspapers. Do you see this from your broader perspective in a different way?

Ambassador HAASS. I don't see that China sees us as an enemy nor do I believe it's inevitable that we will become enemies, which is not to say there are not voices in China that clearly see us as an enemy. There are enough voices there that one can find that as well as other things, whether it is in the academic writings or in government writings.

Just as the Chinese can cherrypick our writings and statements and find, say, expressions of what you might call realism, which talk about the inevitability of a U.S.-China Cold War, they can find other statements. I think it is even more mixed on their end.

Second of all, the one thing that does concern me more than anything else on the Chinese side is not so much where they are now, but where they could be given the rise of nationalism in China. The one thing that it's hard to find in China these days is a real Communist. And in this political/intellectual vacuum, I am concerned about the rise of nationalism.

On the more positive side, I do believe that China's leaders have 20/20 vision about one thing: they know that China is not yet a great power. They know that China needs a generation or longer focus on their economic evolution. If that happens, and I believe it's likely to, two things are likely to happen as well.

One is China will find itself ever more integrated in the world economically, which provides something of a bulwark against what you might call breakout, what Henry Kissinger wrote about in another setting of Germany becoming a revolutionary country.

Secondly, I believe as China continues to evolve economically, it will have to address its politics. You can only have so large of a gap between where a country is economically and where it is politically. China right now has a gap where it's far more open economically, as you know, than it is politically, even though it has politically evolved over the last, say, 15, 20 years. But I believe as it continues to become more integrated economically, the nature of political life in China will have to evolve also, or there will simply be too big of a gap between the two, and either China would have to bring up the political side or slow down the economic side. I do not believe they are prepared to slow down the economic side because they fear the domestic political consequences of that.

So I believe China will continue to evolve, which is another reason that I do not believe that a U.S.-China Cold War is inevitable. I'd go so far to say one of the principal diplomatic or strategic challenges to the United States is trying to avoid a Cold War, although

not at any price, because obviously, if China wants one or acts in ways that it is unavoidable, so be it.

But we should not want one and that means to me trying to again enlist China in efforts, whether it is to deal with North Korea's proliferation or trying to come up with new regional structures for northeast Asia, that shape Chinese behavior or get them to live up to WTO rules. In each area of international relations we should look for ways to integrate China in the emerging arrangements of this era.

If we do that, then I think we have a decent chance of having China, an ever-stronger China, also emerge as a responsible country. That at least ought to be the goal of American strategy.

Commissioner TEUFEL DREYER. Thank you.

Chairman D'AMATO. Thank you. I think Vice Chairman Robinson has a comment.

Vice Chairman ROBINSON. In that connection, as the Chairman was describing our mandate from the Congress, we're looking at the China relationship with an economic emphasis but through a decidedly security-minded lens. We're not necessarily part of the cheerleading crowd about all that's going well with the relationship. There are, of course, a number of positive indicators, but we are focused on what the downside risks to the relationship may be and inform the Congress accordingly.

As you may have noted in our 2004 report, which was unanimous on the part of the Commission, we saw that the preponderance of trends, both economic and security in the bilateral relationship, were negative. That is to say we weren't hopeless at all about thesituation with China. We simply said urgent course corrections in a number of areas are going to be required to get to the kind of positive evolution of the relationship that you're referring to, and I think that we all want.

At the same time, I think one of many value-added aspects of the Commission's work is that of a kind of early warning mechanism. Now, the Chinese don't view it that way. We're not the most popular Commission from their perspective and they're not embracing us trying to shape our views.

China is very sensitive about the kind of constructive critique that we offer. Nevertheless, I think that if wiser heads prevail there, they would understand that developing this kind of metric to measure the relationship on an annual basis in a number of different areas, particularly the early warning character of what we're about, is actually a big net positive for the Chinese. I mean we're actually trying to ensure that these problematic issues don't continue to fester and turn into mini or full-blown crises.

I would underscore again the downside risks of Chinese nationalism, which I think is moving in a potentially perilous direction for them and us. Moreover, the way it's being pursued is counterproductive of late anyway. Our Japanese friends can attest to this. But it's also, of course, the emotion that is associated with Cross-Strait relations. And the Chinese are going to have difficulty containing themselves despite the fact that there would be debilitating repercussions of any Cross-Strait conflict.

So I'm basically agreeing with your perspective on this. I just wanted to offer the view that although we may not be popular in

China, I think that the Commission is performing a valuable service to the bilateral relationship.

Chairman D'AMATO. Thank you, Vice Chairman Robinson. Commissioner Mulloy has a question.

Commissioner MULLOY. Mr. Ambassador, thank you for hosting us today and also for your service to our country in many different positions through the years.

Ambassador HAASS. Thank you.

Commissioner MULLOY. I agree with your point that economics can be a positive part of this relationship. I always tell my Chinese friends, if we don't get the economics right, we will poison the political relationship. I was also pleased in our earlier conversation today that you are talking about competitiveness here at the Council.

Earlier I spoke with Dr. Gomory who will testify later today. In our first report, I put in my additional views that I felt for too long, the United States has turned over its China policy to the business community, and that the elected representatives of the people have to play a larger role in this, or else it won't be sustained. So my strong view is there are things that we have to get our Chinese friends to do right, but there are also things that the United States has to do. I don't think we've fully comprehended what it means to be thrown into a globalized economy.

And this is a very important thing for our country and our political leaders to help our people understand. In our last report, we planted the seed that the United States should be thinking about a national competitiveness strategy and have an open debate on this. I welcome that the Council on Foreign Relations is going to be getting into this area.

Thank you.

Chairman D'AMATO. Thank you.

Ambassador HAASS. Well, thank you for that. At the risk of being shameless, there are two reasons that I think there is a tremendous opportunity for the United States and the world right now. One is that for the most part, what it is we seek to do in the world is not against the interest of others.

Our is not a narrowly pro-American agenda when it comes to what the United States is trying to do in resisting terror and stopping proliferation and trying to stop genocide or promote trade. These ought to be things that others can sign on to.

But the other reason that I believe there is an opportunity is that the United States is strong, and that it is not obviously in the interest of others or in their reach to successfully challenge the United States. And one of the things that worries me and one of the reasons that I think this opportunity is not necessarily a permanent one are some of the trends with U.S. strength. I worry about the consequences of a fiscal and a current account deficit of the scale we have. I worry about our energy dependence and I worry about our competitive position.

Ambassador HAASS. Competitiveness involves any number of things, from the nature of education to the number of students we're turning out in certain areas that are central to maintaining a competitive position in areas of information technology, say, to homeland security policies which have the unintended consequence

of reducing the ability of all sorts of talented people to get into the United States or stay here, to questions of trade where we lose control of intellectual material.

When it comes to the long-term trend in U.S. competitiveness, the arrows are pointing in the wrong direction, and sooner or later that has to have geopolitical consequences.

Commissioner MULLOY. Absolutely.

Ambassador HAASS. You can't separate it. To come back to stovepipes, the idea that all these things happen and it doesn't manifest itself geopolitically, shall we say is suspect. History suggests it will be otherwise, and it is the reason that we are going launch a major effort here at the Council on Foreign Relations to try to not simply identify but to be prescriptive about various aspects of a public policy in the United States that need to be addressed in order to shore up our competitive position. If we fail in this, I do not believe we will have in place the prerequisites of American strength that will discourage others from embarking on potentially adventurous or destabilizing paths.

So we have got to change some of our policies. At the risk of playing tennis here and hitting the compliment back in your court, what you're doing needs attention. And it's worrying to me that in our public debate, questions of relative competitiveness have not gotten anything like the attention they need. I'm worried about it, because by the time it becomes obvious it is too late.

There is a major lag. Competitiveness is not something you can change overnight. It is generational. There is a lag, and right now by what it is we're doing or not doing, we are sowing seeds that I fear will have adverse consequences.

Commissioner MULLOY. Yes, thank you.

Chairman D'AMATO. Mr. President, you're absolutely singing to the choir on that matter. As I mentioned to you earlier, the Commission was in Silicon Valley, had a hearing at Stanford University for two days, April 21–22, on the question of high technology, and of course the question of American competitiveness came up over and over and over again. We're going to have a report that we'll get to you within about two weeks making some recommendations on that matter, and we would be very interested in your comments on that.

Again, thank you very much for your hospitality. Mr. President, we don't want to detain you more. I don't know how fast you can get to the airport. You're going to LA today.

Ambassador HAASS. We're going to find out.

Chairman D'AMATO. We thank you very much. This completes our initial session.

Commissioner TEUFEL DREYER. Thank you.

Ambassador HAASS. Thank you.

Chairman D'AMATO. We'll take a five-minute break.

[Whereupon, a short break was taken.]

Chairman D'AMATO. I'm pleased to open our two-day hearing at the Council on a topic of great scope and importance.

It is particularly fitting that we examine the nature and implications of global economic integration—what has become known as "globalization"—at this important institution for American foreign policy and in a city at the center of America's global economy.

After all, the Commission was established to look at how our economic and strategic goals intersect in the context of China. We are indebted to Ambassador Haass and the Council for its hospitality and assistance in convening this event. At this point, I'd also like to recognize the exceptional efforts of my colleague, Commissioner Patrick Mulloy, to my right who worked very hard at developing the agenda for this hearing.

In its 2004 Report to the Congress, the Commission set the framework for our hearing by drawing a link between the development of U.S.-China economic relations and the development of globalization writ large. We stated in our report, quote:

"The U.S.-China economic relationship is of such large dimensions that the future trends of globalization will be influenced to a substantial degree by how the United States manages its economic relations with China. It is reasonable to believe that U.S.-China economic relations will help shape the rules of the road for broader global trade relations. If current failings are remedied and the relationship is developed so as to provide broad-based benefits for both sides, globalization will likely be affected in a positive manner on a worldwide basis. If not, the opposite will likely be true."

The Commission has been detailing for the Congress on an ongoing basis the increasing breadth of U.S.-China economic relations. The level of trade and financial flows between the two countries has reached massive proportions. Two-way trade exceeded $230 billion in 2004, which included a U.S. deficit of $162 billion.

Yet China remains clearly a developing non-market economy. It is a truly unprecedented economic relationship between two economies at vastly different ends of the development spectrum.

The Commission believes that understanding and addressing the costs and benefits of this relationship are vital to long-term U.S. economic health and to broader global trade relations.

We will further examine the causes and consequences of the U.S. trade deficit, one of the most controversial and significant outgrowths of globalization for the U.S. economy. We also intend to explore the theoretical underpinnings of globalization with our distinguished panelists and assess how they comport with today's economic realities in Panel I.

A key question is whether traditional theories need to be modified or recast in the face of a dramatically changing world. For example, do traditional theories of comparative advantage still hold true when the factors of production, as has been stated by various economists—both labor and capital—are highly mobile?

We will further examine how the U.S. economy is faring in a global environment. Surely, there will be specific winners and losers from globalization of the American economy, but we hope to understand what structural changes have taken place that will alter U.S. economic fundamentals in the future. For example, to what extent are U.S. retailers driving decisionmaking as opposed to U.S. manufacturers? There has been a sea change in the focus of power within the economy in the last ten years.

What are the implications for the arrangements hammered out between labor and management in this country over decades of negotiations?

In the context of this hearing, it is fair to ask if, quote, "'globalization' per se has or is being used as a convenient marquee to justify corporate or government behavior that is, in fact, intended as simply self-serving or to circumvent labor, environmental and other standards erected in the most developed societies in the world?"

If globalization is to be used as a, "one size fits all" justification for anything goes, then it will be stripped as an operational concept of any lasting content in the long run.

We fully recognize that even a two-day hearing can only begin to scratch the surface of these far-reaching questions, but these are questions that must be examined and understood with the goal of reaching a national consensus in the United States on how the United States can best approach the challenges and opportunities of globalization.

Vice Chairman Robinson.

OPENING REMARKS OF VICE CHAIRMAN ROGER W. ROBINSON, JR.

Vice Chairman ROBINSON. Thank you, Mr. Chairman. I'd like to first join the Chairman in expressing the Commission's sincere appreciation to Ambassador Haass and the Council on Foreign Relations for hosting this important event. I'd also like to join the Chairman in expressing my thanks to Commissioner Patrick Mulloy who was indispensable in helping pull together this hearing for the Commission.

When Congress established the Commission, it laid out several particular areas of investigation for the Commission to undertake in assessing how U.S.-China economic relations are affecting our broader economic and national security interests.

Over the years, we've held hearings on many dimensions of U.S.-China economic relations, ranging from China's adherence to its World Trade Organization obligations to Chinese firms' offerings in the U.S. capital markets to our series of field hearings across the country, examining how the bilateral relationship is impacting key U.S. industry sectors.

In many ways, the topic we'll be exploring here in New York represents the next step in our analysis of the economic implications of our relations with China. We're interested in gaining a more comprehensive understanding of the role that U.S.-China economic relations play in the broader context of what is commonly referred to as globalization.

As the Chairman explained and as stated in our 2004 Report to Congress, the Commission believes that the U.S.-China economic relationship is so large in scope and importance that it may well be setting precedents for the global economic order.

Globalization did not begin with China, but China's emergence as an economic power of such rapidly advancing proportions may well be changing the assumptions and theories that have to date governed our thinking about globalization. By all accounts, China has reaped substantial benefits from its rapidly expanding participation in the global economy.

Few could realistically have predicted two decades ago that China's economic integration into the world trading system would lead to the scale of developments that we're witnessing today. It's there-

fore useful to ask: Does the China factor change the dynamic of the global economy? Has China's emergence changed the paradigm of globalization compared to the earlier development of, say, Latin America and other Asian countries, or are the trends with China of a piece with the same progression?

We're fortunate to have with us over the next two days a number of prominent economists, academicians, business leaders, and tax practitioners to explore these important issues. We'll be examining the economic theories underpinning globalization, the impact of globalization on the U.S. economy, the interrelationship between globalization and the U.S. trade deficit and strategies that corporations employ to compete in the global economy, and finally the role of tax policy in driving trade and investment flows.

We hope to see this event or use it to stimulate a debate on what is, in fact, driving global economic flows, the impact of such flows on the U.S. economy, and the role that the U.S.-China trade and investment relationship is playing in creating the international framework for globalization that we're seeing unfold today. These proceedings likely will raise more questions than provide answers, but asking the right questions, as most of us know, is an essential first step in seeking prescriptions aimed at maintaining our nation's long-term economic and national security well-being.

With that, I'd like to turn the proceedings back over to our Chairman Dick D'Amato. Thank you.

[The statement follows:]

Prepared Statement of Vice Chairman Roger W. Robinson, Jr.

I would like to join the Chairman in expressing the Commission's sincere appreciation to Ambassador Haass and the Council on Foreign Relations for hosting this important event. I would also like at the outset to express my thanks to Commissioner Patrick Mulloy who was indispensable in helping pull together this important hearing for the Commission.

When Congress established the Commission, it laid out several particular areas of investigation for the Commission to undertake in assessing how U.S.-China economic relations are affecting our broader economic and national security interests. Over the years, we have held hearings on many dimensions of U.S.-China economic relations, ranging from China's adherence to its World Trade Organization (WTO) obligations to Chinese firms' offerings in the U.S. capital markets to our series of field hearings across the country examining how the bi-lateral relationship is impacting key U.S. industry sectors.

In many ways, the topic we will be exploring here in New York represents the next step in our analysis of the economic implications of our relations with China. We are interested in gaining a more comprehensive understanding of the role that U.S.-China economic relations play in the broader context of what is commonly referred to as "globalization." As the Chairman explained, and as stated in our 2004 Report to Congress, the Commission believes that the U.S.-China economic relationship is so large in scope and importance that it may well be setting precedents for the global economic order. Globalization did not begin with China, but China's emergence as an economic power of such rapidly advancing proportions may well be changing the assumptions and theories that have to date governed our thinking about globalization.

By all accounts, China has reaped substantial benefits from its rapidly expanding participation in the global economy. Few could realistically have predicted two decades ago that China's economic integration into the world trading system would lead to the scale of developments we are witnessing today. It is therefore useful to ask: Does the China factor change the dynamic of the global economy? Has China's emergence changed the paradigm of globalization compared to the earlier development of Latin America and other Asian countries, or are the trends with China of a piece with the same progression?

We are fortunate to have with us over the next two days a number of prominent economists, academicians, business leaders, and tax practitioners to explore these

important issues. We will be examining the economic theories underlying globalization, the impact of globalization on the U.S. economy, the interrelationship between globalization and the U.S. trade deficit, the strategies that corporations employ to compete in the global economy, and the role of tax policy in driving trade and investment flows.

We hope to use this event to stimulate a debate on what is driving global economic flows, the impact of such flows on the U.S. economy, and the role of U.S.-China trade and investment relations in creating the international framework for globalization. These proceedings likely will raise more questions than provide answers, but asking the right questions is an essential first step in seeking prescriptions aimed at maintaining our nation's long-term economic well being.

PANEL I: THE ECONOMIC UNDERPINNINGS OF GLOBALIZATION

Chairman D'AMATO. Thank you, Vice Chairman Robinson.

Our first panel will discuss the underlying economic theories and assumptions of globalization. Chief among these, of course, is the theory of comparative advantage, which lays out how nations benefit from trade.

Our panelists will discuss whether the increasing mobility of capital, labor and information in today's global economy comports with the traditional theories of trade. It will also consider whether the rapid integration of China, India, and the former Soviet states and other developing countries and economies into the global trading system has changed even temporarily how trade models translate into real-world economics.

We are pleased to be joined by Dr. Arvind Panagariya, who is Jagdish Bhagwati Professor of Indian Political Economy at Columbia University School of International and Public Affairs and a specialist in theory and policy of international trade and economic development, just recently from the University of Maryland, I believe.

On his left, Dr. Ralph Gomory, who has been President of the Alfred P. Sloan Foundation since 1989 and has also served in many capacities in academic, industrial, and governmental organizations, and co-authored the book, "Global Trade and Conflicting National Interests."

To his left, Professor Richard Freeman, Herbert Ascherman Chair in Economics at Harvard University, Director of the Labor Studies Program at the National Bureau of Economic Research.

We will also include in the record for this panel a statement, which was distributed to the panel by Dr. Paul Craig Roberts of the Hoover Institution and the Institute of Political Economy. He was planning to be on this panel, but for personal reasons had to withdraw at the last minute, but his testimony was developed.

The way we'll proceed is if each one of you would provide us with your oral remarks in seven to ten minutes, and then we will proceed after the three of you finish. Then we will proceed to questions and answers and we have a good session until 11:00 o'clock.

Dr. Panagariya.

STATEMENT OF ARVIND PANAGARIYA
PROFESSOR OF ECONOMICS AND
JAGDISH BHAGWATI PROFESSOR OF INDIAN POLITICAL ECONOMY
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Dr. PANAGARIYA. Thank you, Mr. Chairman, Vice Chairman and the Commissioners. I greatly appreciate this opportunity to testify

before you. It's terrific for an academic to be able to bring his ideas to the policy domain.

Since time is limited, I'll talk fast and also get to the point right away.

Commissioner TEUFEL DREYER. Very New York.

Dr. PANAGARIYA. The principle of comparative advantage as expounded by Ricardo almost 200 years ago has been under constant onslaught since it was first enunciated, and it has survived the test, and I have no doubt that it will survive the current onslaught as well.

What I would do is take three or four of the arguments that have been out there in the policy domain in the recent times, let's say about last decade or so, which kind of question the essential idea that trade is beneficial, and argue that none of these really actually survive to close examination.

The one that has been at the forefront very recently is the argument that the conventional case for free trade somehow doesn't apply to outsourcing. Now, I personally think that on this Gregory Mankiw was quite correct in asserting that outsourcing is really another form of trade. Innovations that lower transport costs turn some goods that were previously non-traded into traded ones, and innovations that likewise allow massive data to be transported internationally at low costs turn some of services that were previously non-traded at arm's length into traded ones.

Just as the opening to trade of non-traded goods generates the gains from trade, opening to trade of non-traded services brings gains as well. This is formally shown using three different models in a paper I did very recently in the Journal of Economic Perspective with Jagdish Bhagwati and T.N. Srinivasan.

In the discussion, we have heard only about outsourcing, but of course, there is also in-sourcing from the United States, and as these data begin to be transmitted on a massive scale at near zero cost, we also actually have in-sourcing happening from the United States of such services as the medical, legal, architectural, designing and educational services, and precisely in the way that outsourcing brings gains, because we are able to buy services at prices lower than our own cost of production. Likewise, in-sourcing allows us to sell them at prices higher than our production costs. On both ends, benefits do accrue.

Now, there is a caveat that has been out there, not just here, but within the context of theory of comparative advantage, and always stems from the terms of trade shifting. I discuss this at great length in my written testimony. I'll not discuss that in detail here, but simply note that this has been known to trade economists for at least half century, and the bottom line trade economists really draw is that this is not a reason to actually move away from free trade.

That actually gets illustrated in the next kind of argument that has appeared which I'll dissect right now, which is that the productivity gains abroad, say in China, in goods and services exported by us, the United States, undermine the case for free trade.

Now, this is the kind of argument that is attributed, I think, in a way wrongly to Paul Samuelson. His recent article in the Journal of Economic Perspectives argues that if our trading partners be-

come good at producing the goods that we export to them. That is going to reduce their demand for our goods and therefore lower the prices of our goods that we export. So there is this decline in our terms of trade that leads to losses.

Now, theoretically this is a correct argument. It was made by Harry Johnson actually in the 1950s when Europe and Japan were rising very rapidly and fears were expressed that their rise was going to somehow minimize or reduce the real incomes of the United States.

Now, as Avinash Dixit and Gene Grossman, both from Princeton University, have argued actually in the context of the Samuelson article, this really provides no case in terms of policy for turning away from free trade. It is true that our gains from trade are reduced if the Chinese get better at producing the aircraft that we export to them. It nevertheless leaves gains from trade being positive, and there is no reason for us to walk away from those gains just because the gains are now today smaller than they were yesterday.

So, again, there is a terms of trade issue. We can bring it in there, but the broad idea that trade remains beneficial in spite of the Chinese becoming good at the goods that we export to them or to the rest of the world remains intact.

The third argument against free trade is the more puzzling one, which says that the free flow of many factors internationally renders the principle of comparative advantage and the associated gains from trade invalid.

Now, this is stated very forcefully in a New York Times op-ed by Senator Schumer and Paul Craig Roberts, which has circulated widely. I should quote them to give you a sense of how this argued.

This is a quote from Schumer and Roberts:

"However, when Ricardo said that free trade would produce shared gains for all nations, he assumed that resources used to produce goods—what he called the 'factors of production'—would not be easily moved over international borders. Comparative advantage is undermined if the factors of production can relocate to wherever they are most productive: in today's case, to a relatively few countries with abundant cheap labor. In this situation, they are no longer shared gains—some countries win and others lose."

Now, that, of course, if it were true would indeed be a very serious indictment of Ricardo's principle. But I must say I find this argument very puzzling. Factor mobility had been present surely in the time of David Ricardo, and it became really pervasive during what I call "first globalization" that extended from 1870s to the First World War, and again during the current second globalization that began following the Second World War.

It is implausible to me that Ricardo failed to notice international factor mobility around him. It is even more implausible that trade economists since Ricardo have uniformly ignored the implications of factor mobility and gone about business as usual, teaching the principle of comparative advantage and the gains from trade, its contradiction by the fact of widespread international factor mobility notwithstanding.

More likely, if Ricardo did not model international factor mobility in his celebrated England-Portugal example of gains from trade, the answer is to be found in the presumption that like all great theorists, he was constructing the simplest example to demonstrate the gains from specialization under trade to all parties involved and to demolish the mercantilist case for protection.

In the same way, while trade economists since Ricardo have formally analyzed the implications of factor mobility in a variety of contexts including the gains from trade, they continue to use the simple England-Portugal example because it continues to be the most powerful tool of demolishing the fallacies arising out of the faulty thinking about international trade.

I address that issue more formally, more explicitly in the appendix to my testimony where I actually go through various examples demonstrating that no matter where you start, allowing factor mobility is not going to cause the gains from trade to disappear.

Certainly, nobody is going to lose from trade. The worst that can happen is that even in the presence of factor mobility, one of the sides has no positive gains, but that's the borderline case, and it certainly would not turn into a loss from trade for any of the parties.

Now, quite apart from this theoretical analysis, I think the empirical relevance of the assertion by Schumer and Roberts that all factors today want to move to the location with cheap labor must also be questioned.

In fact, my colleagues at Columbia University, Donald Davis and David Weinstein, have written a paper where they argue exactly the opposite, and I'll quote them here. They say that "The U.S. is the destination for a broad range of net factor inflows: unskilled labor, skilled labor and capital."

So it is not as though factors are flowing all to China or to India where labor is cheap. It's quite the contrary. In fact, that is the evidence that Donald Davis and David Weinstein marshal, that looking on a net basis, if you look at it, skilled labor, unskilled labor, as well as capital actually is flowing into the United States.

There is also the issue of economies of scale. In the Ricardian context, that is brought out in Dr. Gomory's testimony. Let me just point out that 25 years ago I wrote my Ph.D. thesis precisely on that subject—economies of scale, and the patterns of specialization and the gains from trade. So it is not that the trade economists have not looked at that. In fact, I have here something that I won't read, but is something that was written by Bertil Ohlin, who got the Nobel Prize in trade. In his very early thesis back in 1923 or 1922, he wrote a whole chapter on economies of scale, where he said that if factors move internationally, factor prices will equalize, and does that mean that there are no gains from trade to be had?

And then he said, no, in fact there is another reason why gains from trade could arise, which is from specialization according to economies of scale. It will not make sense for everybody to produce everything. Instead, you want to let countries in that situation specialize in products by economies or scale, so, you know, some regions would produce one set of products, another region would produce another set of products, and then they will trade, and

those gains will arise purely from the economies of scale rather than differences in factor endowments, which otherwise Bertil Ohlin had emphasized in the rest of his work.

Finally, if you allow me one more minute, Mr. Chairman, there is also this argument made that soon all jobs will get outsourced to China and India. The best example of it is perhaps in a number of presentations that the Intel Chief Craig Barrett had been giving where he was talking about 300 million Indians and Chinese coming to take all the jobs at all levels of skills, et cetera.

I think there is a big huge fallacy here if one thinks that all jobs can get outsourced to outside of the United States. About 70 percent of the jobs, in fact, according to one estimate, simply cannot move because you require actually the presence of the buyer and seller in a single place. These are things like retailing, catering, restaurants and hotels, tourism, personal care, et cetera, and you can't really outsource all the jobs in the first place.

Also, the theoretical error is that one is mixing up the absolute versus the comparative advantage, and that simply is not going to happen.

Let me just conclude by one example which all of us have heard about, which has given fuel to this kind of argument, which is the reading of the X-ray charts in Bangalore, India. This is a report that floated widely. Now, I must say that here our journalist friends didn't do their homework very well.

An MIT professor, Frank Levy, studied this case very carefully. It turns out that there is one facility in Bangalore where these charts are read and the doctors who had to read these charts actually had to be board certified in the United States and they had to be actually licensed in the state in which these charts originated.

Frank Levy's take was that there is really no difference between those doctors and the doctors here. They were simply living in slightly nicer places. So to think that the medical high skill jobs can move out of the United States in that way, I think is not having enough confidence in the U.S. economy. I personally think that as far as the top end is concerned, the U.S. has been the leader and will remain the leader.

U.S. universities are absolutely well ahead of any universities in the world and I just don't see that the universities outside either in India or China are about to catch up. This is not a reason to become complacent, but simply to emphasize the fact that leadership we do retain.

I think we can argue about the schooling level and all. I suppose there are more problems there. We do need reforms. But insofar as the leadership at the upper skill levels is concerned, I am confident that the U.S. economy will continue to generate higher level research, will continue to generate high skill jobs, and I see no reason for pessimism.

Thank you very much.

[The statement follows:]

Prepared Statement of Arvind Panagariya*
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Defending the Case for Free Trade

Several fallacious arguments against free trade were made in the debate on outsourcing that raged during the latest Presidential election. In my remarks, I will consider four of them: (i) the conventional case for free trade does not apply to outsourcing; (ii) productivity gains abroad in the goods exported by us undermine the case for free trade; (iii) the free flow of many factors internationally renders the principle of comparative advantage and the associated gains from trade invalid; and (iv) soon all jobs will be outsourced to China and India. In my brief remarks, I endeavor to demonstrate that these arguments do not stand up to closer scrutiny and the conventional case for free trade survives them without so much as a scratch.

Fallacy 1: The conventional case for free trade does not apply to outsourcing.

On this, Gregory Mankiw was correct in asserting that outsourcing is another form of trade. Innovations that lower the transport costs turn some goods that were previously non-traded into traded ones. Innovations that likewise allow massive data to be transported internationally at low costs turn some services that were previously non-traded at arms length into traded ones. Just as the opening to trade of non-traded goods generates the gains from trade, opening to trade of non-traded services brings gains. In my joint article with Jagdish Bhagwati and T.N. Srinivasan (Bhagwati, Panagariya and Srinivasan 2004), I demonstrate this point formally using three different models commonly used by trade economists.

Note that though only outsourcing has received attention in the press, the innovation that makes outsourcing possible also gives rise to in-sourcing from the United States. While moving the call centers and back office activities abroad, the telecommunications revolution has also given rise to the exports of medical, legal, architectural, designing and educational services by the United States. Like outsourcing, in-sourcing also generates gains: the former allows us to buy services at prices lower than our production costs and the latter allows us to sell them at prices higher than our production costs.

A *caveat* to this conclusion arises from the possibility of an adverse secondary effect of outsourcing (or in-sourcing) on the terms of trade in the market for goods that are already traded. For example, cheaper tech support through outsourcing may expand the supply of computers by the U.S. firms and, holding the demand for them constant, lower the prices received abroad for the latter. If the loss due to this induced decline in the price of the U.S. computers is larger than the initial benefit from the purchase of cheaper tech support services, a net loss is possible.

Of course, the terms of trade effect can as easily go the other way. The countries earning export revenues from outsourcing by the United States may increase their spending on the U.S. goods. For example, they may demand more of the U.S. computers and office furniture. This demand-driven effect would pull the U.S. terms of trade in the favorable direction.

The terms of trade caveat arises in the case of *every* innovations or policy change that alters a country's demand and supply of traded goods. For example, an innovation by the U.S. firms that lowers their production cost of computers or an efficiency enhancing policy change by the U.S. Government that lowers its demand for computers would normally result in an increase in the supply of the U.S. computers in the world markets. Such expansion of exports would lead to a harmful reduction in the price of the U.S. computers. If this decline in the price is sufficiently large, the net effect of the innovation or improved government efficiency may be a decline in the overall U.S. welfare.

While economists have long recognized this possible harmful effect due to the shift in the terms of trade when any policy change or innovation impacts trade flows, the appropriate policy response to it is not a withdrawal from trade. For while these changes may reduce the gains from trade, the latter remain positive. By walking away from those remaining gains, we would make matters only worse.

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Fallacy 2: Productivity gains abroad in goods and services exported by us undermine the case for free trade.

This is the argument (wrongly) attributed to Paul Samuelson (2004) in his recent article in the *Journal of Economic Perspectives*. All Samuelson argued was that productivity gains abroad in the goods exported by us would lower the prices of our exports and lower our initial incomes. For example, if the Chinese learn to produce the aircraft they currently import from us, their demand for our aircraft will decline and the price we receive for them in the world market would fall. Trade theorists have, of course, been aware of this possibility since the influential papers by Harry Johnson (1954, 1955) written at a time when fears were being raised that the growth and productivity gains in Europe and Japan might impact the United States adversely.

As Avinash Dixit and Gene Grossman (2004) have pointed out, this possibility does not offer a reason to deviate from the free-trade policy.[1] True, the U.S. incomes decline as a result of the Chinese gain in productivity but its incomes would decline even more were it to respond by closing its borders to trade. The fundamental message of Ricardo's theory of comparative advantage remains valid: given the new Chinese productivity, the United States is still better off trading than not trading with China.

Quite apart from the fact that the adverse terms-of-trade effect does not give one reason to turn to protectionism, the possibility of a loss on this account must itself be questioned. For example, we must ask if China and India were to turn into another Europe or Japan, will it be bad for the United States? There are at least two reasons why the answer is not so clear-cut. First, as these countries grow, they will not just produce more of many goods exported by the United States. They will also demand more of many goods exported by the United States. Second, as the two countries become richer, their trade, like the U.S.-Europe and U.S.-Japan trade, will turn product-differentiation based intra-industry type rather than the factor-endowment-difference based inter-industry type. Such trade is less likely to produce the terms of trade shift and is more likely to generate benefits resulting from increased variety.

Fallacy 3: The free flow of many factors internationally renders the principle of comparative advantage and the associated gains from trade invalid.

Charles Schumer and Paul Craig Roberts (2003) make this argument most forcefully in an influential *op-ed* in the New York Times. They argue that in the modern world with factor mobility, the principle of comparative advantage put forth by David Ricardo in the early 19th century no longer holds. The resulting trade somehow turns into a zero-sum activity with some countries gaining at the expense of the others. To quote them, "However, when Ricardo said that free trade would produce shared gains for all nations, he assumed that resources used to produce goods—what he called the 'factors of production'—would not be easily moved over international borders. Comparative advantage is undermined if the factors of production can relocate to wherever they are most productive: in today's case, to a relatively few countries with abundant cheap labor. In this situation, there are no longer shared gains—some countries win and others lose."

I must say that this is a very puzzling argument. Factor mobility had surely existed in the time of David Ricardo. And it became pervasive during the First Globalization extending from 1870 to the First World War and again during the current Second Globalization that began following the Second World War. It is implausible that Ricardo failed to notice international factor mobility around him. It is even more implausible that trade economists since Ricardo have uniformly ignored the implications of factor mobility and gone about business as usual teaching the principle of comparative advantage and the gains from trade, its contradiction by the fact of widespread international factor mobility notwithstanding.

More likely, if Ricardo did not model international factor mobility in his celebrated England-Portugal example of gains from trade, the answer is to be found in the presumption that like all great theorists, he was constructing the simplest example to demonstrate the gains from specialization under trade to all parties involved and to demolish the mercantilist case for protection. In the same vein, while trade economists since Ricardo have formally analyzed the implications of factor mobility in a variety of contexts including the gains from trade, they continue to use the simple England-Portugal example because it continues to be the most powerful tool of demolishing the fallacies arising out of faulty thinking about international trade.

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[1] Also see Panagariya (2004) in this context.

But to answer the Schumer-Roberts criticism explicitly, in Bhagwati, Panagariya and Srinivasan (June 30, 2004), we explain systematically how the Ricardian example extends to the case when labor is allowed to move internationally. I reproduce that extension in the appendix to this paper. Here let me just note that the free-trade equilibrium is always at least as good as the "no-trade" equilibrium for all parties involved in the presence as well as absence of labor mobility. This conclusion also remains valid when we allow for more than one factor as, for example, in the Hecksher-Ohlin model.

Quite apart from this theoretical analysis, the empirical relevance of the assertion by Schumer and Roberts that all factors today want to move to the location with cheap labor must itself be questioned. In a recent paper, my colleagues Donald Davis and David Weinstein (2002) have offered evidence that is just the opposite of this assertion. According to them, "The U.S. is the destination for a broad range of net factor inflows: unskilled labor, skilled labor, and capital." While I disagree with the manner in which they model migration, they do bring into question the notion that all factors are flowing towards the country with cheap labor today. Moreover, the evidence on gross, as opposed to net, investment flows demonstrates the presence of large volumes of cross investments among the developed countries. The operations of multinationals are concentrated far more within the developed rather than between developed and developing countries.

Fallacy 4: Soon all jobs will be outsourced to China and India.

This is not an argument directly about the gains from trade but it relates to the principle of comparative advantage in a fundamental way. If the contention here is that all or most service jobs will be outsourced to India and China, the statement involves both empirical and theoretical errors. The empirical error is that not all service jobs can be outsourced. About 70 percent of the jobs in the United States are in service industries such as retailing, catering, restaurants and hotels, tourism and personal care that require the consumer and producer to be present in the same place and, therefore, cannot be outsourced (Agrawal and Farrell, 2003). The theoretical error is that the possibility that all jobs, in both manufactures and services, will go to China and India, whether through outsourcing or other trade, because of low labor costs, comes perilously close to confusing absolute and comparative advantage.

One way to see why all jobs cannot shift abroad even if it were physically possible is that we cannot get the Chinese and Indians to work for free for the United States. If we are going to buy their services, we must pay them in some form. The obvious form of payment would be exports and, in that case, the more we import, the more we will have to export. The only alternatives to exports would be that China and India either accept IOUs from the United States in perpetuity or accept IOUs for now and cash them at some time in the future. In the former case, the United States cannot possibly lose since it gets to maintain its high living standard in perpetuity at the expense of China and India. In the latter case, we still continue to reap the gains from trade with trade having the additional inter-temporal dimension.

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Appendix: Factor Mobility and Comparative Advantage

It is also readily shown that the gains from trade do not depend on the absence of factor mobility. We can demonstrate this in the Ricardian model cited by Charles Schumer and Paul Craig Roberts. Thus, consider Table 1, which offers three possible examples assuming the familiar Ricardian structure of two goods (X and Y), two countries (A and B) and one factor of production (labor).

Table 1: Comparative Advantage and Factor Mobility

Output Per Person Year						
Country	**Example 1**		**Example 2**		**Example 3**	
	X	**Y**	**X**	**Y**	**X**	**Y**
A	8	4	4	2	4	2
B	2	2	2	4	2	1

In Example 1, A has an absolute advantage in both goods but comparative advantage in X. Denoting by FT and NT the level of welfare under free trade and no trade (autarky), respectively, we know from the conventional Ricardian theory that FT ≥ NT for each country with strict inequality applying to at least one country.[2] In the trading equilibrium, real wages are higher in A so that allowing labor to move internationally results in the workers migrating from B to A. If only a part of B's labor force is allowed to migrate, the inequality FT ≥ NT still holds for the nationals of both countries at the post-migration labor endowments.[3] If all labor in B moves to A, the gains-from-trade issue is of course rendered irrelevant.

In Example 2, A has an absolute advantage in X and B in Y. Consequently, A also has a comparative advantage in X and B in Y so that FT ≥ NT continues to apply. In this case, it is possible for trade to equalize real wages, eliminating the incentive to migrate. If the real wages remain different, however, labor mobility will still be partial and the gains from trade will characterize the trade equilibrium under international factor mobility.

In Example 3, A has an absolute advantage in both goods but comparative advantage in none. With the opportunity costs being the same in A and B, there is no scope for trade so that opening to trade is neither beneficial nor harmful: we then have FT = NT. The real wages being higher in A than B, however, labor in B has an incentive to migrate to A. If such migration is permitted, it benefits migrants without hurting the workers in A. But we continue to have FT = NT at the post-migration labor endowments.

The outcomes are not dramatically different in the Heckscher-Ohlin model, which in its conventional version assumes identical technologies across countries and allows for two factors whose relative endowments differ across the two trading nations. As long as the countries do not specialize completely in production, free trade in commodities (free movement of factors) with no movement of factors (commodities), by equalizing commodity (factor) prices, equalizes factor (commodity) prices, thus eliminating the incentive, that exist in autarky, for movements of factors (trade commodities).[4] By the same token any restrictions on commodity trade (factor move-

[2] The strict equality holds for one country if it is so large that the relative free-trade price settles at its autarky price, which equals its opportunity cost ratio. As long as the free-trade price lies strictly between the opportunity cost ratios of the two countries, we have FT > NT for each country.

[3] A different comparison can be done between the welfare levels enjoyed by a country at the free-trade equilibriums with and without labor mobility. If the country is small in the goods market so that the terms of trade effects of labor mobility are ruled out, opening to the latter cannot harm the national welfare. If the country is large, however, the ranking between free-trade equilibrium with and without factor mobility compares two sub-optimal equilibriums and can go either way. Our discussion below sheds more light on this question.

[4] This is the celebrated Factor Price Equalization theorem of Paul Samuelson.

ments), by preventing equalization of factor (commodity) prices, could prevent factor (commodity) price equalization, thus leaving positive incentive for factor (commodity) movement as under autarky.

If we allow for complete specialization by one country or for differences in technologies across countries, free trade fails to equalize factor prices. In this case, factors do have an incentive to move internationally even under free trade in goods. But such movement does not eliminate the benefits of trade. With resources having moved to new locations, the trade equilibrium will still be characterized by a superior outcome for the nationals of each country than under autarky, so that FT ≥ NT.

Chairman D'AMATO. Thank you, Dr. Panagariya. Let's go right on to Dr. Gomory. Go ahead; you may proceed.

STATEMENT OF RALPH E. GOMORY
PRESIDENT, ALFRED P. SLOAN FOUNDATION, NEW YORK, NEW YORK

Dr. GOMORY. I'm very pleased to have the opportunity to testify to this distinguished group, a group charged to address one of the most important issues of our time. So I'm very pleased to be here.

So let me start by saying that in the almost two centuries that have elapsed since David Ricardo developed his influential theories of international trade, technological progress has transformed that world of international trade. Technological progress has lowered and in some cases almost erased the effects of geographic distance, and this effect was first felt in manufacturing with the arrival of cheap seaborne goods in container ships, and today the effect of fiber-optic cables is to make the sending of bits around the world almost instantaneous and remarkably cheap. As our previous speaker pointed out, this has opened up totally new possibilities in competition in a wide range of services of which call centers are only one example.

Many of the services that now can be provided from overseas were until very recently regarded as inherently domestic goods. This new situation contrasts profoundly with the world that Ricardo knew. In Ricardo's world, production capabilities changed very slowly and were often determined by natural advantages. In the classical example still often taught to students, we describe a world where England is relatively good at wool, Portugal relatively good at wine, and they enter into a mutually beneficial trade with each other, with England specializing in wool and Portugal in wine.

In Ricardo's world, we did not have to consider that England would successfully enter grape production and then what would happen to Portugal because that simply was not going to happen. In the classical model, the economic outcomes for trading countries tend to be unique free market forces including free international competition, comparative advantage and the rest determine what goods are made where, and from this unique outcome also flows a fixed and theoretically predictable degree of prosperity for each country.

A country that ends up producing little of value will have little to consume at home and little to trade abroad and will have a low standard of living. It is one of the most remarkable results of economic theory that this unique outcome tends to be the best for consumer welfare and productive efficiency in each of the countries involved. In particular, it is always better than no trade at all.

But today, industrial advantage is more likely to be acquired than to be a gift of nature. Semiconductor plants or athletic shoe

assembly plants or help desks can be located almost anywhere independent of climate and consequently the outcomes of free trade are not predetermined. Many free trade outcomes become possible.

We should keep in mind, and in this I completely agree with our previous speaker, that all of these free trade outcomes are better than no trade, but they vary significantly from each other in their effect on the countries involved.

The actual result we experience depends on which of these many possible capabilities are actually developed. Any plant built abroad or for that matter more people getting better education in the U.S. results in a new and different free trade outcome. Therefore, in today's world, we're faced with a question that was far less significant in Ricardo's day: when are changes in capabilities abroad good and when are they bad for the home country?

With changes in capability happening all around us and in particular with the rise of Asia are these changes good or bad for the United States? What I'm trying to say is all these free trade outcomes, and as our previous speaker has pointed out, are better than cutting off all trade. We are in total agreement. That isn't, however, the issue that we face.

We're sitting here today and should be asking whether changes to a free trade outcome are good or bad? We should not be comparing it always with no trade. That, in my opinion, is a misleading comparison and that is a comparison that is often made.

What Will Baumol and I have done is to take the ordinary classical Ricardo model, long used by economists, and using new methods analyze the question of when is progress abroad good and when is it bad for the home country? All of this in a free trade environment. All the outcomes that we consider are free trade outcomes. All the outcomes that we consider satisfy comparative advantage because every economic equilibrium does.

Many believe, and this includes many but not all economists, that improved productivity abroad is automatically beneficial to the U.S. as a whole, setting aside the local effects of job displacement, damaged communities and so forth.

In fact, the argument over offshoring often takes the form of discussing the local pain versus the general gain. However, our work shows clearly that there are many situations where there is no general gain, only further general loss, to add to the local gain. And again, we are not comparing with no trade. We are comparing changing free trade outcomes, and it's possible for productivity abroad to change the current free trade outcome to a different one, and that change can be harmful to the country as a whole.

Economists incidentally have known this for a long time, but it is something to which Will and I have been able to contribute a great deal of new information.

If we are aware that many free trade outcomes are possible and some are better than others, and given where a country is at a given moment, how can we tell whether further productivity improvements abroad and further loss of industries is good or bad for that country, and the general result that we have is along the following lines:

If the wage differential between two trading countries is sufficiently large, the loss of industries to the low-wage underdeveloped

country may well benefit both countries at the national level. That's disregarding all the local problems.

However, as the underdeveloped country develops and starts to look more like the developed one, the balance turns around, and further loss of industries—that's changing again to a new free trade equilibrium—becomes harmful to the overall welfare of the more developed nation.

Our best guess is that with China and India, we are approaching that turning point, and we will be there in a few years if we're not there now.

What can be done to strengthen the U.S. in this situation? There is a long list of possibilities, many that have been used by other countries and by many U.S. states.

One approach used by foreign countries and U.S. states is to offer special incentives for firms to locate within their borders. These can be special tax treatments, access to markets, or a host of very other special provisions, which perhaps later in the time I can talk about.

The U.S. Federal Government has a long precedent of spending to encourage basic research and higher education, and this has helped our country to be in the start of new industries. It has helped less to retain them when they are bigger and more mature and to innovate in mass production and large-scale provision of services, but that, too, is important. It is important to retain industries as well as to be in at the start of industries.

It is important to realize that the problem of motivating companies is today a significant part of the problem. U.S. companies are required to make profits if they are to survive. That is what they are in business for. They are not in business to consider which country they make their goods in or where they make their services in any way other than its effect on their profitability.

And yet it is what we as a nation make in goods and services that we have available either to consume or to trade for the goods we consume.

Companies need profit. If a company will increase profit by moving part of its operations overseas, they will do it. And in many cases, they need to do it just to survive. But if we are at a point where further losses of producing goods and services is harmful to the country, that is not part of the company's calculation.

We are, I think, approaching a situation where there can be conflict between the fundamental motivation of companies and of their home countries, and we need to take this problem of motivation into account.

It is important for the U.S. to realize that increases in productivity can be harmful, which is not to say it doesn't still beat no trade. If we do that, if we come to that realization and are not lulled by the idea that somehow in some long-range sense productivity improvements abroad are always for the general good of the U.S., we will, if we look, find many things to affect the outcome.

It is, however, a vital first step to come to that realization. And as has been remarked, I think in the earlier discussion, it takes time to develop the ability to change these outcomes and so if we are looking to a situation several years ahead, we should start thinking now.

Thank you very much.
[The statement follows:]

Prepared Statement of Ralph E. Gomory
President, Alfred P. Sloan Foundation, New York, New York

Introduction

I am pleased to be able to contribute to the Commission's work as part of the panel on "The Underpinnings of Globalization."

Let me start by observing that much of our understanding about trade and its effects originated in a world very different from today's world of emerging globalization. It is remarkable how much of that thinking developed then is still valid today. However in view of the almost total transformation of the conditions of international trade, it is reasonable to expect some changes and additions to that understanding. I will touch on some of those aspects today reflecting the work that Professor Baumol and I have done in this area.

One of the things I hope to get across is that the effect of things like offshoring, one of today's most important topics, are not easily captured in a single phrase. It is not true for example that all offshoring is bad, nor is it true that all offshoring is good. Similarly it is not true that improvements in productivity abroad are always beneficial to this country. Nor is it true that they always are harmful. Reality is just one step more complex than that. Although this more realistic picture that I will paint does not make for simple slogans, it represents a reality that we will have to face sooner or later.

Changes in International Trade Since the Time of Ricardo

International trade has undergone enormous change in the almost 200 years that have elapsed since the time of the influential trade theorist David Ricardo. In Ricardo's time trade is estimated to have constituted about 1 percent of world GDP. Since then, despite exploding world output, the volume of trade *relative* to GDP has risen by more than thirteen fold.[1]

It is also clear that the nature of the goods entering into international trade has changed along with the quantities. Advantages based on natural resources still exist, but more dominant today are advantages that can be *acquired*. These can be the advantages conferred through being established in an industry and gaining thereby either specialized knowledge or economies of scale or scope. There is also the possibility, in industries, where knowledge is easily transferred, and where economies of scale are not significant, of dispersing production around the world to use cheap labor or other special advantages, and then to exploit the cheapness of modern transportation or wideband communication to deliver these goods or services to global markets.

One might conclude from all this that the location of economic activity today no longer matters. After all companies can repatriate their profits from whatever part of the globe houses their actual economic activities. However, in almost all cases, most of the economic benefit stays where the value is added. Most of that value added, wages, etc, remains local. It still matters to a country to be the site of an economic activity, whoever may own the company.

The Way It Was

In the classical Ricardo model the economic outcomes for trading countries tend to be unique. Free market forces, including free international competition, determine what goods are made where. From this unique outcome also flows a fixed and theoretically predictable degree of prosperity for each country. A country that ends up producing little of value will have little to consume at home and little to trade abroad, and will have a low standard of living.

A well-known and appropriately antique example, taught to generations of economics students, illustrates the point. If England and Portugal trade wine and cloth, Portugal, because of its natural advantages, will end up as producer of wine, and England with its wooly sheep, as producer of textiles. Matters will never go the other way around.

As this example illustrates, which country makes what product is generally uniquely determined in the classical economic model of trade.

It is one of the most remarkable results of economic theory that this unique outcome, tend to be best for consumer welfare and productive efficiency in each of the countries involved. In particular it is always better than no trade at all.

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[1] "Global Trade and Conflicting National Interests," Ralph E. Gomory and William J. Baumol. MIT Press, 2000.

But today's world of industry contrasts sharply with the wine-wool example that is so typical of the past. In the world of the classical trade model, with its emphasis on natural advantage derived from climate or natural resources, it was difficult, for example, for England to become a substantial presence in wine production. However, in the modern world it is possible for many countries to learn the skills involved in making a product, and then to practice those skills until they approach the capability of the world's productivity leaders.

Where We Are Today

The modern world is characterized by substantial and rapid technological and industrial change. Success in industry today is more likely to be acquired than natural. It is more likely to come from manufacturing skill or service know-how, low wages, or technical knowledge, or a workable combination of these, than from any gift of climate or of nature. The ability to produce and market some good or service depends less on the presence or absence of mineral deposits and more on a superiority of learned abilities or, more accurately, on a level of learned abilities that, coupled with its wage level, makes a country a competitor in a particular industry. Then cheap goods transport in the form of container ships, or cheap bit transport in the form of fiber optic cables, makes those goods or services available anywhere in the world. Indeed the technical improvements in bit transport by themselves have ushered in the most striking examples of offshoring: those where the service now being provided from abroad is one that was previously provided only domestically because of prohibitive transport costs.

While superiority based on natural advantage provides stability in the industries where such advantages exist, industries whose method of operation can be learned and that do not require huge entry costs are subject to rapid changes in their competitive positions as new countries acquire the know-how or as technology makes far off countries near neighbors.

We have seen this in Asia. While there has been success in high-tech industries, and Japan, in particular, has entered industries such as autos and semiconductors that are high-tech and have a high cost of entry, much of the Asian success has been based on much more mundane products. Clothing and athletic shoes are not hard to make. Television sets and many other electronic consumer products are not hard to assemble. And knowledge of assembly operations, for example, can be acquired. Call centers in do not call for skills that are hard to acquire provided the language skills are there. Often, multinationals, seeking low cost production sites, will create a plant and also train the workers. Once this know-how has been acquired, plants in many Asian countries become competitive because of their generally low labor costs.

You cannot create natural advantages. Climate will be what it will be. *But in today's world you can create industrial advantages.*

Countries today can change their circumstances and can acquire (or lose) industries through rapid change of their capabilities in industries or the rapid change in the capabilities of others, or through the rapid change in technologies that effectively bring countries closer together. Every such change leads to a new outcome in international trade. The possibility of such changes and such new outcomes means in a changing world the free trade outcome is constantly changing. It is no longer either fixed or slow changing as it was in the time of Ricardo. Any plant abroad, or for that matter more people getting better education in the U.S., or lower international rates for data transfer, results in a new free trade outcome.

Why Outcomes Matter and the Pattern of Outcomes

Why should we care about the existence of this very large number of possible free trade outcomes? We care because among these many outcomes, all of which are better than no trade at all, may have very different effects on the welfare of the different trading countries. There will be outcomes that are good for one trading country and bad for the other, and vice versa, some that are good for both, some that are bad and some indifferent.

In fact, though there is not time to discuss this in any depth today, these numerous possible outcomes are not random. They distribute themselves into a surprisingly simple and orderly pattern that makes visible their advantages and disadvantages to the countries involved. This pattern is spelled out in the book "Global Trade and Conflicting National Interests" by Professor Baumol and myself.

In its simplest form the pattern we see is this: if the wage differential between two trading countries is sufficiently large, the loss of industries from the higher wage developed country to the low wage underdeveloped country may well benefit both countries at the national level. However as the underdeveloped country develops and starts to look more like the developed one, we reach a turning point: further

loss of industries, becoming harmful to the overall welfare of the more developed nation, although it continues to benefit the developing one.

What We Know and What We Don't Know

While we can make this qualitative picture quite convincing, the location of that turning point depends on a host of factors including country size, the nature of the industries involved, and the fate of the displaced workers in the industries involved. Both present day theory and the availability of actual information leave us far from certain of the outcome in actual real world situations.

In the cases of India and China, which are rapidly evolving countries having vast underdeveloped areas and poorly educated populations as well as significant and growing sectors that are industrialized and productive, our best guess, based on very simple models is that they are approaching that turning point.

Multiple Outcomes—Increasing Productivity Abroad

The importance of multiple outcomes becomes most visible when we face changes at home that are the result of improvements in the productive efficiency and product quality of foreign industries. In these situations business and labor often hold opposing and emotional views as to what if anything should be done, and the views of the political parties or even successive Administrations often diverge. Often the discussion becomes far more than an abstract discussion about the effect of increased productivity abroad on the nation *as a whole*. With jobs and the fate of particular industries at stake, the concrete instances in which an industry is threatened by increasingly productive foreign competition become the focus of lobbying and intense political pressure.

Does an increase in the industrial abilities of a trading partner drive down our wages and impoverish our workers? Is it true that our consumers benefit when products that were once made at home become available more cheaply or in better quality from abroad? How do these conflicting consequences balance out? What is the net effect on our country's *overall* prosperity? These are obviously very real and very important issues. But we need to realize that our real ability to judge these outcomes is limited and that there is no simple overall rule that says a priori that these events are either beneficial or harmful when these effects all occur at once.

The Three Aspects of Each Outcome

We should also bear in mind that there are at least three different aspects of any of these economic outcomes. First there is the local aspect, if jobs in some industry move overseas what happens to the people who had those jobs? This is the aspect that is most concentrated, most visible, and most easily understood in human terms. The second aspect is the effect on the country as a whole. This may be in the form of cheaper goods, or, as the terms of trade change, more expensive goods. It can be a large effect, but it is diffuse and tends to be spread across the whole population. Finally there is the effect not on the national economy, but on the total world economy. It is here that one would take into account in the case of offshoring, not only the effect on the U.S. economy but its effect on India or China as well.

Different outcomes can score differently on these different outcomes. You can have an outcome that is bad locally and good for the nation. You can have outcomes from productivity improvements abroad that are bad locally and bad for the nation as a whole. You can have an outcome that is good for one nation and bad for the other at a national level. And so forth.

Economic models such as the standard Ricardo model tend to shed light on the national and international effects, but not on the local effect. The local effect, the effect on jobs, is too detailed and different in different cases to really appear in these models. This is one reason why the remarks of economists about long range or national benefits often clash with visible and local realities.

What Countries Do

Countries do act to get what they consider better free trade outcomes whether this is driven by the desire to protect existing industries or by a notion of general national development.

While the governments of some nations have successfully organized, cajoled, and even forced their home enterprises into entering existent high-tech industries, many such efforts have not succeeded. Those that have achieved their goals are countries with a strong tradition of powerful government and an unambiguous history of industrial policy, plus a skilled and prestigious bureaucracy, able to carry out that policy. This is not an easy path. Another approach used both by foreign countries and U.S. states is to offer special incentive to firms to locate within their borders. These can be special tax treatments, access to markets or a host of other special provisions.

The U.S. tradition runs a different direction: The U.S. has had no conscious industrial policy, and its government bureaucracy has, with some exceptions, never aspired to a close, cooperative relationship with industry outside of the arena of national defense. Even if it were desirable, which is not clear, a path of very active government guidance of and collaboration with industry is probably unworkable for the U.S.

The U.S. tends to have more of a history of invention, of being in at the start of things. Its early role in electric power and telephones, automobile mass production, and the development of radio enabled the U.S. to be in on the beginning of these industries and to grow with them as they matured into major industries. That approach of being there at the beginning continues today in biotechnology, computers, software, and the Internet.

And although the U.S. has avoided any explicit industrial policy, it has nevertheless benefited from its support of higher education and its consistent support of basic research, an ongoing commitment of government resources that has helped the U.S. launch some major modern industries and emerge with a commanding position in them. Recent examples are the biotechnology industry and, very recently, the vast array of electronic communications of the Internet. The U.S. may not have skilled and experienced government personnel charged to shape up an industry against an entrenched competitor, but it *does* have a long precedent of spending to encourage basic research and higher education, and this has helped the country to be in on the start of new industries.

These policies help less when the goal is to retain industries when they become larger, more mature and more important. Helpful as it is to be in at the birth of an industry and to grow up with it, continuation of that strong position is not automatic. Semiconductors, steel, and automobiles are all examples of industries in which the U.S. had a major role from their earliest days. Those positions, at later dates, were subjected to major challenges.

The theory described in our book indicates that government actions, if successful, and if justified by the position of the country in the pattern of possible trade outcomes, can do more than serve the interests of the industry in question. Our analysis suggests there can be circumstances where the development or preservation of a particular industry can be in the *national* interest.

In addition to industry-specific approaches, there are actions that improve general conditions and thereby can help many industries to succeed. Government outlays on infrastructure, such as roads, or an advanced educational system, are not aimed at particular industries, but benefit many. Education today can mean not only education during the early years of life but also ongoing education of members of the workforce. This has become possible because high quality on-line learning is now available and is compatible with continuing to work and earn.

While automation is often confused with offshoring or outsourcing because of its impact on jobs, it is in fact beneficial to the country as a whole and should be encouraged. While automation, like offshoring, can displace workers, its overall economic effect is totally different. Unlike offshoring, which can be either beneficial or harmful on a national scale, automation, or other capital improvements, add to the national wealth. The U.S. is a high wage country compared to many others because we dig trenches with backhoes while in many countries that work is done with shovels.

Country vs. Company

What is the effect of the activities of a multinational corporation on its home country? Suppose that one of an advanced nation's leading companies decides to build manufacturing capacity in a foreign country. It may do this for any of the reasons just mentioned: that country may offer lower wages with fairly high productivity, newly-built infrastructure, special governmental concessions to the company, good intellectual property protection, or access to new markets.

If that new capacity takes the form of a production facility, its establishment may send both knowledge and capital abroad. If the firm has chosen well and can produce cheaply and effectively abroad, the products made there may even end up returning as imports to the firm's own home country. This overseas investment decision may prove to be very good for that multinational firm. But there remains the question, is the decision good for its own country? The answer can in fact go either way depending on circumstances, but it is not always and automatically benign. There is and can be fundamental conflict between the goals of the company and the goals of the country.

It is important to realize that the problem of motivating companies is part of the problem. U.S. companies are required to make profits, that is what they are in business for, they are not in business to consider the national effect of their decisions

about where to make their goods or services. They are obliged to consider the effect on profitability. Yet it is what the U.S. as a nation makes in goods and services that we have available either to consume or to trade for the goods we consume. Companies need to be profitable. If moving part of its operations overseas will help profitability they will do it; in many cases they will need to do it just to survive. If the country is at a point where further losses in producing goods and services is harmful to the country, that is not part of the company's calculation. We need to take this problem of motivation into account.

Conclusion

There can be inherent conflict in the interests of nations trading in a free trade regime. What is good for one is not necessarily good for the other. There can also be conflicts between the interests of corporations and their home countries.

However there can also be benefits from improvements in productivity abroad and there can also be benefits to the home country from the foreign activities of their corporations. It is simply not a simple picture.

We need to understand that there is much we do not understand. Deeper and more detailed knowledge of actual situations will help us to judge when various actions are beneficial at the national level, and we should make the effort to develop this if we are to be realistic rather than slogan-bound about international trade.

However it is important for the U.S. to realize that increases in productivity abroad can be harmful. If we do that and are not lulled by the idea that somehow in some long range sense this is all for the general good of the U.S. we will find many things to affect and improve the outcome. It is however a vital first step to come to that realization.

Chairman D'AMATO. Thank you very much, Dr. Gomory. We'll move now to Dr. Freeman. Thank you.

STATEMENT OF RICHARD B. FREEMAN
PROFESSOR, HARVARD UNIVERSITY, CAMBRIDGE, MASSACHUSETTS

Dr. FREEMAN. I've presented this as a little PowerPoint. I'm going to focus not on the effects on the nation, but on the effects of the people in the nation, namely the workers, and that really does reflect this recognition that there may be differences between the companies that are owned by some of us and the vast majority of working people inside the country.

I think there is one big fact: everyone should understand what China and India have done and Russia less so. Basically, the global workforce, meaning the numbers of people involved in the global economy, has doubled roughly speaking. There are numbers there and I compare the 2.93 billion people who currently work in the global workforce versus the 1.46 if we took out China, India and the ex-Soviet when they were basically living in protected economies.

China is the biggest of these. I put the numbers at the bottom of what they've added. So the global economy is incredibly different than it was, let's say, in the 1980s when the Washington Consensus was being thought about. This is twice as many workers.

The global capital ratio has not gone up. These are estimates that I made. They're from the Penn World Tables. The Penn World Tables keeps telling us that they are going to provide official estimates. They haven't. There are a lot of assumptions you have to make, but this is the basic fact is that if you double the workforce and in this ten-year period that I've looked it, we can carry it to the present—15 years—capital has not increased as much.

So I think companies in that sense, if we think of the companies as being capital, they suddenly have more choices, more groups of workers that they can locate to, and we just want to see the cap-

ital/labor ratio obviously rise as quickly as we can towards what it was.

This .56 means that it's 56 percent global capital/labor ratio. What we did was we cumulated the capital across all the countries and what happened—the issue is that China comes in with very little capital, India comes in with very little capital, and the Soviets came in with capital, but it was useless to produce decent goods and services, and so essentially the bottom of the capital/labor ratio, the labor part, doubles, and this reduces it more or less by half.

And so you need a lot of savings and many years before this ratio will be back to what it was before these countries joined. I think there are big winners from this doubling, namely the workers in these new entrants. Entering the global economy has been wonderful for China, and it's been wonderful for India. It's not so wonderful, I think, for the Soviets, but that's because they've got all kinds of internal economic and other problems.

So we've seen the living standards of China and India rise, and if you take—you sort of stand there above the world—there is over two billion people in those countries, and if it were to be the case that some of the advanced countries had some losses in income standards, that wouldn't be so bad given that these were very poor people and they are moving up, and when we calculate global inequality in the world, we see that global inequality in the world actually has declined because these countries have moved up rapidly, even though there is a lot of inequality in China and India and the former Soviet Union.

There are great pressures being put on what I call the old LDCs—which is Brazil, Peru, Latin America, South Africa—simply because the million or so workers in China and India taken together are able to produce things and compete very well with the workers in these other countries, and that necessarily creates problems for them in terms of trade issues that were raised earlier.

What about us, the U.S.? We were told at one point that we got all the educated jobs and they, meaning the developing countries, would get all the less-educated jobs. I say here very sharply "no way." I think what we've learned over the last ten or 15 years has been that China and India in particular, in part just because they have so many people, can produce massive numbers of highly educated people who are as smart as we are and can do work either here or in Bangalore as pointed out.

I'll just give some figures here. At one point I think it was historical sort of happenstance, in the 1950s, the 1960s, the United States had something like 40 percent of the world's college students, and we're down now, as we should be going down because the rest of the world is catching up, to 15 percent. And I said approximately 12 percent could do your job. That's probably an excessive number because I've seen some more recent things from McKinsey that would reduce that, but there are a lot of people who can do your job.

And the U.S., in the great universities where we have a dominant position, our share of world Ph.D. production has now fallen very sharply. So our comparative advantage is weakening in things that we think are quite important.

The key here is China because India does not produce all that much in the way of Ph.D.s. There are a lot of engineers from the IITs. China has gone on a massive program so by 2010, they will be producing more science and engineering Ph.D.s than the United States, 26 percent more according to these numbers.

The quality is not going to be at U.S. standards, and of course I'm counting in the U.S. all the Chinese students and Indian students who are here, many of whom will stay here, et cetera. At the bottom I put the Chinese Diaspora for 2001, which showed that the Chinese figure in 2001 jumped from 32 percent of the American to 72 percent. If you think that our comparative advantage comes about because of these great universities and all these Ph.D.s and these great scientists and engineers doing things, that advantage is diminishing.

I think it has to diminish because these billions of people have joined the world and they're going to do this kind of work. So we do have, I think, a situation. Here I gave some figures, and unfortunately these are only through 2001, the global high technology. That's our production. It shows Japan really has a significant loss of their shares. Germany's shares going down. South Korea and China going up.

In terms of the trade, we have seen a significant shift that our share of high tech exports has fallen. Now part of this will be discussed I assume later in these meetings about the value of the dollar and we're running huge trade deficits in everything at this point.

But we no longer have this thing where high tech, the exports, greatly exceeded the imports as they did years ago. This is our importing of foreign-born scientists and engineers and the figure that I find the most interesting is that Ph.D.s less than 45, in the United States, 52 percent in 2000 were foreign born, and you can go to every university, and you will see this.

This is a sign that we have that we have a strong comparative advantage and we are importing people to help us maintain this advantage, and I think that's a critical thing that we keep doing this because there are going to be more and more bright people not in U.S. universities outside the country, and we want to bring them if we can, and that's what we have been doing.

If and when these numbers ever turn around, then I would be very frightened because that would mean the best, the brightest, highest educated people, have decided the U.S. is no longer an attractive place to be.

The bachelors are engineers. So 17 percent largely of our engineers now, bachelor degree engineers, are foreign born. So we are indeed living on this form of trade.

I agree with the statement that offshoring is just trade in another form—absolutely right. But I think it's very real and very significant, and I gave a quote—this is from a businessman—"it's digital, contestable, and will be offshored if possible because the wages are lower overseas."

Estimates, ten to 15 percent of the jobs. I agree. At least 70 percent are going to stay no matter what. But we can have great professors doing things through videoconferencing and my job may be gone.

And there will be coming out in the next couple of weeks a McKinsey study on offshoring that will be quite, I think, influential and important. It basically says, in a lot of areas this is a serious issue because they can do the work overseas cheaper.

This slide shows numbers of chemical abstracts. Chemical is a more of a technical area and is technologically closer to business in many ways, and you see these are English-speaking journals, and you see are falling. This just has to happen. We have to be losing some of our comparative advantage. This slide shows China rising up. Georgia Tech has an index of prowess in technology. We see China coming up here as well. I think it just has to be do as long as these countries run their show reasonably well. They're going to be educating people; they're going to be moving into these sectors; and that's the issue.

I quote actually Ralph here: "This can harm advanced countries." Now maybe some harm we should take because it's benefiting billions of people who have been very poor overseas, but nonetheless there is some harm to this. And the industries that we have had that have had the R&D and the new products, they have a certain monopoly. It's the newest thing you got, and you're the seller and it's good to be a monopolist.

We may be losing some of that monopoly power. I'll just say what I think China is possibly doing: it's the large LDC with lots of people and it can leapfrog in some sectors to technical dominance and that I think would be very harmful to the United States because we would lose our comparative advantage in the areas that we are specialized in. Those are high wage and good job areas.

There's a paper where someone says, well, if we lose everything to China, all of our things, it's not so bad because they'll produce them so cheaply that we'll be able to buy them at really low prices. That is a weird model.

I can vouch for you that such a model doesn't stand up to real world analysis because the assumptions are strange. Let me put it that way.

So I put a great stress on the job structure. When these contested sectors, ones that our acquired comparative advantage can keep or they can go to another country. If they have a lot of good jobs, that's bad for us. My view of the best thing for America, not the best for China certainly, would be if they use a lot of their smart people working on a trip to Mars. That will cost us nothing in jobs, and it's just ridiculous. I remember when the President announced that we were going to go to Mars, and I was at an NSF thing and people were just going, oh, my God, he doesn't really mean that because that would be the silliest thing we could do in terms of using our resources.

And so I think we have to choose sectors wisely. A lot of economists think the word "industrial policy" is some sort of an insane word by some mad planner. But our R&D and our education money, where we put these resources, are a form of policy. They're going to create the workforce and the ideas for the next generation of industry. So I think they are very important decisions that have to be made to maintain our comparative advantage.

As I think everyone else here said, this is a pro-free trade position. It's just we want to position ourselves so we are the guys who

produce really good things with really good jobs, and we don't want to be in some other situation.

And then I conclude with a couple of scenarios. The bad one is that China and India really take a lot of these very good sectors because their wages go up very slowly and they always have. Now that they have the ideas and they have the brainpower and they also have low wages, they will create trouble for us.

The global capital stock grows slowly. If it grows slowly, we just can't raise the position of people/workers that much. I think one of the worst things I think that could happen if we went into a new protectionism. Also, if the within country inequality, and here I do worry mostly about China, if it led to some sort of explosion, inside that country. These would be terrible things.

My good scenario is if we retain some of the leading sectors. We take advantage of the fact that there are all these smart people in China and India doing R&D, and our businesses are tuned up so we can grab some of those good ideas, produce the products in the U.S. because we're fast on our feet in innovation. The cost of these goods will go down and that may dominate the declining terms of trade. So they are definitely good things.

I strongly believe that the American university system because so many of the best people overseas are trained here. They are actually working in part for Americans. They're networked into our companies, to our things, and I think that really does help us. I also think we need social services and infrastructure to keep businesses here, to keep—I'm not so much in favor of these cost deals struck by different states with business things. I would rather have a great education system, a great university system, save cities, and then the businesses will come because that's where people really will be able to get good workers.

So I actually think we have lots of policy choices to make here at this time, and we are in a critical period just from the natural recovery from the disaster of communism in India. The disaster of government mandating things, a kind of socialism, if I can call it that. These guys are now in the game as capitalists, and that does create troubles and problems that we have to deal with. I don't think we can hide them.

Panel I: Discussion, Questions and Answers

Chairman D'AMATO. Thank you very much, Dr. Freeman. We'll move to questions. I'd like to start off with Dr. Panagariya about your calculus and your paper. It may not be your complete thinking, but there are two parts to it that I find missing, that I wanted to ask you about. One has to do about the assumptions about full employment and the other has to do with the question of manipulating currencies.

The discussion of trade is largely conducted in terms of the theory of comparative advantage. An assumption behind that comparative advantage is, I believe, that it assumes full employment, which is necessary to create the scarcity of resources that then justifies reorganizing global production along the lines of comparative advantage.

What happens if countries have persistent what we call Keynesian unemployment so that there is no scarcity of labor? Instead,

there is a scarcity of demand. Are we at full employment or what is your assumption in terms of your model on the question of full employment?

Dr. PANAGARIYA. Virtually all trade models assume full employment. That's a good assumption for the long-term analysis that is addressed by these models. When it comes to unemployment, we get back to the macro kind of issues, which pertains more to short-run issues.

Trade models typically are addressing the issue of efficiency, and you don't then want the rate of unemployment or rate of employment changing in the background every time you change something. If efficiency is what you're after, then that is right. Having full employment is the right assumption.

Chairman D'AMATO. Do you think the United States is at full employment?

Dr. PANAGARIYA. I think if you think in long-term, take a long-term view, U.S. has been I would say last 25 years on the natural rate of unemployment, which is equivalent to what I would call in trade models the full employment models.

Chairman D'AMATO. My second question is your model doesn't talk about exchange rates. We have what we believe to be a seriously rigged exchange rate, maybe as much as 40 to 50 percent some view, on the part of the Chinese.

Now if exchange rates are wrong, can't this undermine comparative advantage and even drive a country's industries out of business? And how do you view the current exchange rate situation? How does it fit into your model?

Dr. PANAGARIYA. Now here we get into a lot of macro issues, and again there is an intertemporal aspect of trade which gets in here that when we run current account deficits, which is what is happening with this exchange rate, in effect, that is reflecting the savings/investment imbalance that is out there within the domestic economy, that we are not saving as much as we are investing.

The U.S. economy happens to be highly productive so the private investment demand is much higher than the investible resources left over, after large deficits have substantially absorbed the domestic saving. So part of this trade gap that we're seeing is actually, in fact largely I would say, is reflecting the savings investment gap. Now, coming to the exchange rate issue, if you are going to fix both the factor prices and only the exchange rate, then it is a problem, but as long as the exchange rate is fixed—remember that from 1945 on till 1971, everybody was on a fixed exchange rate system, and we didn't then say that, gee, this fixed exchange rate system somehow kind of mucks up the comparative advantage.

So fixed exchange rates are completely compatible with comparative advantage. Now, will the fixed Chinese exchange rate be sustained? I don't think this will be sustained because in the end, nobody would want to run surpluses in the current account as the Chinese have done forever because then you are actually giving a gift to the United States so that the United States can consume more than what it produces in perpetuity.

If the Chinese want to give us that gift, I think I'll personally certainly gladly take it. But that's not going to happen. In the end, the Chinese will have to pay back, and so as far as the trade side

is concerned, I don't see the fixed Chinese exchange rate as the reason for us to turn protectionist.

Eventually this will not be sustained, and I think it is in the Chinese interest themselves. They are going to let go. The problem I think the Chinese are facing right now is where to time it in the way that, because they need to open the capital account. The Chinese capital account is still closed, and there is an issue, whether you let the exchange rate go now, then open the capital account or get to the open capital account gradually, and then let the exchange rate go. But that is the calculus that's going on there.

Chairman D'AMATO. Well, I'm not sure I understood all that, but savings and investment decisions are private decisions, individual decisions. The exchange rate is a government decision, is a protectionist matter. You talk about protectionist, it seems to me that setting up an exchange rate which protects 40 percent of the value of your economy is the ultimate in protectionism.

So responding to that, the question is how you respond to that and not be protectionist. But the initial problem, it seems to me, is essentially protectionist. I don't know how you can get around that.

Commissioner Wortzel has a question.

Commissioner WORTZEL. We've now managed to hear a range of views on this whole problem of globalization and of shifts in employment. I want to lay out for you what I think elected officials and lawmakers face today. Some of you alluded to solutions to this. I want to pose a couple of dilemmas and see if I can get you to come up with specific policy recommendations or courses of action.

Now it seems to me that the major concern with trade and jobs flowing or going is labor dislocation. What is it doing to people? The pain of retraining, and some people may be incapable of it. The pain of people relocating or having to relocate their families to new places, sometimes to service jobs. Seventy percent of the jobs are service jobs. Service jobs don't pay an individual what they might make in manufacturing. So there's also that impact of what happens to wages.

Who ought to bear the burden of those shifts? Dr. Freeman seems to imply that it's the government. It's a social responsibility. We turn into sort of a social welfare state, more like Eastern Europe than the entrepreneurial spirit we have here in the United States. And we all give up a little so these poor people overseas can have a better income.

Dr. Gomory emphasizes entrepreneurship and real policy changes it seems to me, such as encouraging in-sourcing, changing tax incentives, more the capitalist spirit, more the American spirit.

And folks are going to lose. So I guess what I'd like to hear, if I could, if you're facing a worker out in Akron, Ohio, or in the mountains of North Carolina that's in the manufacturing, what's your policy response? What's your policy recommendation to a lawmaker either for legislation or for some way to reexamine our trade agreements?

Dr. PANAGARIYA. Thank you, Commissioner. I would agree—actually there are two issues I see here in the question. One relates to the adjustment and the other to the wage loss, that even when you

move to a second job, it may pay a lot less than what the previous job was paying, and that's painful.

So, on both counts, I would certainly go along with Professor Freeman that we ought to have very strong social safety nets and adjustment assistance. I think adjustment assistance, as has existed in the U.S. for several decades now, should be strengthened. It does not exist for workers in service industries. It is only for manufacturing, and I would certainly support having that adjustment assistance, trade adjustment assistance, extended also to services industries. I think there have been proposals made, most notably by Bob Litan at Brookings Institution, that we might consider possibility of wage compensation, at least for "x" number of years, maybe three, four, five years.

Some of this was built into the Trade Promotion Authority to the President, I think up to $5,000 per year, some limit because again, it's a matter of balancing out how much taxes you can raise and how much transfers you can make.

But I certainly would go along with that prescription.

Commissioner WORTZEL. And is it also a corporate responsibility?

Dr. PANAGARIYA. And it's also corporate responsibility.

Dr. GOMORY. Well, I think we have to divide the question that you're asking I think into two parts. One is when there are changes people are hurt. What do we do about those people? And I think we need to devise a mechanism to spread that pain over the entire nation.

And that means we will have to pay taxes in order to help these people, whether it is through reeducation, I don't know. Or it may be some form of compensation. Because I think a lot of the retraining programs are somewhat illusory. You just can't do it.

So I definitely think that the country should try and spread that pain, but I also think that we should try and not have it happen. And I don't think we can do that unless we tackle the incentives of the corporation. There are some traditional ways, but I think we ought to wake up and start thinking of non-traditional ways, and this is a vague notion, but let me explain.

What is it we want companies to do? What is it a company really does for a country? Let me emphasize one thing. In the modern world individuals cannot really earn a living. An individual cannot make a car. An individual cannot make a computer. So individuals, if they are to earn their bread, have to be part of an organization that can make a car or make a computer or make steel.

So the existence of corporations quite aside from their individual goals serves the nation by allowing people to earn a living. In some sense that's the social role they play, and our system of raising money and profitability is a way to incent them to compete and do this role efficiently.

But if they disappear, you have not got a way to earn a living. We need the companies. But if we want the companies and we want them to be there and enable people to create wealth in this world in which you can't do it alone anymore, then we should incent them to do that. I won't even call it a half-baked but a three-percent-baked idea, which is there is such a thing in Europe as a value added tax. This shows that you can compute the value added by a company.

In other words, how much does Wal-Mart add to the U.S. economy? You take the value of everything they sell and you subtract from it the value of everything they import and the rest is the value they add. Okay. That's their value added. If you divided that by the number of people they employ, I think you'll get a rather low per capita figure. In other words, their domestic value added per employee is probably on the low side.

We should consider, and I toss this out not because it's right or wrong, but just to stimulate thought, why don't we consider a tax or—it would be a positive tax—it would be an incentive—to reward companies that have a high domestic value added per capita. All right. So one way they can make a profit is by having high value added per American.

So we'll translate that, add that on to the profit motive. I think we should start thinking in those ways. Thank you.

Commissioner WORTZEL. Thank you.

Chairman D'AMATO. Thank you. Go ahead, Dr. Freeman.

Dr. FREEMAN. I wouldn't privilege workers who let's say suffered from trade. I could lose my job either because it gets offshored or because they have a new robot and a new computer that does a better job of doing what I do.

I don't think the safety net should be only for people whose jobs certifiably got lost through trade. I think there is one screaming policy that I think all kinds of economists and analysts would agree because we are the only advanced country that doesn't have some form of universal health care. It's an expense put on to our companies, particularly the manufacturing companies.

In any social safety net, the first thing you would imagine would be that your health is protected. You then could go down a list of some other things that we would say these are the things you should have as a citizen. We guarantee you this. And there could be some monetary compensation for job losses or so on and so forth. Some countries do have severance pay that generally the companies pay the severance pay, but you could have it jointly paid, you know, in some fashion the state kicks in part of it.

I'm less favorable to that. I think there is a very basic safety net for everybody, and if you provide that and maybe you would have some mortgage reinsurance of some form. The United Kingdom they have that. You will not lose your house or your flat if you lose your job. You know you won't be homeless and your health is covered.

Beyond some things like that, I would not go. I think that's about what a safety net means.

Commissioner WORTZEL. Thank you very much.

Chairman D'AMATO. Thank you. Commissioner Mulloy has a question.

Commissioner MULLOY. I want to ask a couple very quick questions to Dr. Panagariya and then throw out a larger question for all three of you. Tom Palley, who is the Chief Economist for the Commission, is always bringing up a book by John Maynard Keynes, and he points out that Keynes says that ideas matter. And so I take these economic ideas very seriously because I teach international trade law and my students have all been educated in this system, and they're always voicing these ideas, very similar to ones

you put forth, Dr. Panagariya. And that's why I think it's important that we discuss these ideas.

On page four of your prepared testimony, you take on Senator Schumer and Dr. Paul Craig Roberts, both of whom have testified before this Commission in prior hearings. You contend that the classical theorists must have assumed mobile factors of production. At least you discredit their argument that the classical theorists assumed non-mobile factors of production, so I want to ask you a couple of things. Do you know Professor John Jackson and do you think he's reputable?

Dr. PANAGARIYA. Yes.

Commissioner MULLOY. Do you know Dr. Charles Kindleberger and do you think he's reputable?

Dr. PANAGARIYA. Yes. I know of them.

Commissioner MULLOY. Let me read you from-

Chairman D'AMATO. That was a set-up.

Commissioner TEUFEL DREYER. Sounds like he's setting a trap.

Dr. PANAGARIYA. That's fine.

Commissioner MULLOY. Professor John Jackson's case book on international trade law, and he has an article by Dr. Charles Kindleberger from his international economics textbook, 1973, quote:

"Classical economists"—of whom I believe Ricardo was one—"thought that the labor theory of value, valid in trade within a country, cannot be applied between nations since factors of production are immobile internationally."

So if I read that, I think he's agreeing that these classical economists did, as Schumer and Roberts claim, factor in non-mobile factors of production.

Now, the important thing is if we now have mobile factors of production, should that cause us to at least rethink some of these theories? I think you're telling us, no, that everything works out fine, and I just want to ask is that correct? And then I would like to hear what the others say about that particular point because I think it's of enormous importance to this debate.

Dr. PANAGARIYA. Let me first say that actually the 1973 text of Charles Kindleberger was the first international trade text that I read as a student in India actually.

Commissioner MULLOY. You should have paid attention to that.

Dr. PANAGARIYA. So I know where this is. Yes. First, I do not say in my submitted formal write-up that Ricardo did not assume factor immobility. He did assume factor immobility. What I say is that it is unlikely that Ricardo was unaware that factors are mobile because factor mobility existed in his time.

So the reason he made the assumption was simply to make the point in the simplest possible way, as all of us who do theory do. Now, the critical question is the last one that you stated, Commissioner, which is does the factor mobility invalidate the gains from trade? And in particular, in the quote that I gave from Senator Schumer and Mr. Roberts, that quote answered saying that well some countries will lose and some countries will gain once you allow for labor mobility, or factor mobility, whichever you want to think.

That is simply not true. The worst that can happen is that one country will gain and the other will not gain, but it's not going to lose.

Commissioner MULLOY. Dr. Gomory? Dr. Freeman?

Dr. GOMORY. Well, I don't think I can comment on what Ricardo had in mind. But I do want to make a point that I think is relevant to this. For example, in the Schumer op-ed article implicit was the assumption that if you use the classical model, you could not get these bad results, and I just want to make clear, if I didn't before, that's just not correct. The work that Will and I have done and earlier economists to a lesser extent shows that within the classical model, unchanged, with comparative advantage, all that stuff, improvements abroad can be harmful. They can never—and this is what Professor Panagariya keeps telling you—they can't be worse than no trade, but that comparison is not what you feel.

What you feel is here we are today. There's a change. Now we're worse off. It's very consoling to learn that we would have been even worse off if we cut off all trade, and it's good to know that so you won't be tempted to do it. But the real issue is, you know, when we go from one equilibrium to another, are we going up or down?

And both are possible within this absolutely standard model that has been used. You don't need to invalidate that model to get that result.

Chairman D'AMATO. Dr. Freeman.

Dr. FREEMAN. It's a very interesting issue how trade and capital/labor mobility work together. And in analyses that say, let's say, we have the best technology in the world, we will likely as not draw in very able immigrants labor mobility coming in, and likely as not we'll draw in a lot of capital coming into the country—I guess the point of the Davis and Weinstein arguments.

In that case, we may be getting a lot of capital from other countries and we're getting their smartest people. Now think of the other countries. You've just lost some of your capital and some of your smart people. They're not going to be better off—the average people in those countries.

And I think an extremely important point I would stress very strongly, all trade and factor mobility, some people benefit and some people lose. So if more professors come pouring into the United States from different countries, the pay of professors in this country is going to suffer and we are the losers.

Chairman D'AMATO. Yes.

Dr. FREEMAN. And everyone else in the country will benefit because you've got now bright professors doing work, et cetera. But the two of us at least would be losers, you and Ralph. And I think an important issue is if all the trade things are saying is our whole economy benefits, but they're not saying which of us benefit and which of us may lose, I keep thinking of say we had a trade or technology/some change that made Bill Gates tomorrow $50 billion wealthier and made the poorest Americans $40 billion poorer, that's a gain of GDP. These models are telling you that's a good thing.

I think most of us, including Bill Gates, would sit there and say no, that's not a good thing, and that's because trade and globalization also bring with them some redistributions from some

people to other people, and you get at some clues as to those redistributions by actually seeing and what resources are coming to the country and which are not coming to the country as well.

Commissioner MULLOY. Yes. Dr. Gomory, I'm not trying to discredit that theory. I just want to understand the theories on which it was based.

Dr. GOMORY. Yes.

Commissioner MULLOY. And Dr. Panagariya, from what I heard you say is that the theory was based on non-mobile factors of production, and we do have mobile factors of production now, capital in particular. Thank you.

Chairman D'AMATO. We're wondering if sheep were actually snuck into Portugal? The Portuguese really had some sheep? Commissioner Donnelly, do you have a question?

Commissioner DONNELLY. Thanks. I guess I don't necessarily know that I have a question, but going back to Ambassador Haass' presentation, I'm struck very much by the discussion of globalization as a sort of self-creating and self-perpetuating phenomenon driven entirely by its own internal economic logic without much reference to the political and security framework, which I would suggest underlies it, which is certainly in the modern era an American dominated international order, which suggests apropos of the panels to come and as we try to transfer this discussion from globalization per se to China's role, and I would invite the panel to comment on this. Everything you talked about sort of assumes that the international political order will stay as it is. Again, you didn't say it explicitly so I may be making a leap of faith here.

Dr. Gomory, in your analogy to earlier eras of rapidly increasing trade you talk about technological process. Certainly seaborne trade was a product of a particular political order and wielding, particularly by Great Britain, of a certain form of military power with great success. And, you know, your point that changes could be either good or bad, again, I think there's an underlying assumption.

I wonder whether they would be possible even if this international political order, in particular the stability dominated by the United States, were to be called into question. Whether that would offend it, as with the first era of globalization was brought to a close by Germany in World War I. Whether there's a similar land mine lurking out there for the future of globalization?

And finally apropos of Dr. Freeman's great doubling metaphor, one of the things that also possibly has doubled is the responsibility of the United States to secure efficient and effective international trade flows to ensure that products produced in East Asia or in India can be brought to market in an effective way.

I would like to hear your comments on globalization as a political phenomenon. In particular, how you believe changes in geopolitics could sort of undermine the scenarios that you lay out or how it is necessary to maintain political stability, and particularly an American-led international order, if the process of globalization is to produce the benefits that you all, with asterisks and tweaks, anticipate?

So I'd just toss that out there for comment. I suggest to my fellow Commissioners that as we understand China's role in all this, that

underlying the purely economic competition is a larger geopolitical context. Ambassador Haass's predilection for the theory of geo-economics makes me nervous.

Dr. GOMORY. I can make one comment. I certainly don't feel that I'm an authority on that. The only advantage I have is I've been alive for a long time and I can remember some things, and if we take the Second World War, I think it is fair to say that the advantage that the United States brought into it, which had an economic dimension, was our unbelievable ability to mass produce.

We brought to the battlefield unbelievable numbers of ships. We started that war with a few aircraft carriers. We ended, if you count auxiliary aircraft carriers I think with 40 odd. No one anticipated that ability. We filled the air with bombers. They were not the best and neither were the fighters most of the time, but, boy, were they numerous, and we made them in places where we had, of course, never built aircraft before. So the economic strength of the United States, its ability to make what was needed, made an enormous difference.

On top of that was grafted a newly emerging capability in advanced science. In the '20s and '30s, the United States in science was nowhere. But largely with imported people, we managed to put together the atomic bomb and radar, which were very, very important in the war. But the underlying strength of the country was its ability to mass-produce.

Now, I think we have to ask whether in the future, what are the things that underlie our military or security side, which in that war related directly to our internal economic strengths. And I think our ability to produce, not just invent, very advanced technologies, would certainly be one of the things that we'd have to consider. So I think that you need a very strong economy just to maintain the armed services. Look what happened to the Soviet armed services when their economy collapsed.

So I do think that the security issues are very tightly tied to what you can produce in your country. I hope that's a helpful remark.

Dr. FREEMAN. This will be a very different comment. I'm going to focus on China, and I'm sure you know every week there are riots in different Chinese cities. There is a large number of disgruntled Chinese peasants and elderly and so on and so forth. So I think the greatest danger to the sensible global political order would be if we had major instability that got organized through China because the nationalism of which was spoken earlier would potentially explode. There is no other developing country that one has to worry about in that respect. Maybe one can worry about Russia this way. You certainly don't worry about democratic India going off on some weird tangent.

I know that various parts of the Chinese government are deeply worried about the possibility that there would be those instabilities. I don't know how we influence that. On way we can help avoid instabilities of a more significant kind, is to democratize things as opposed to some sort of a nationalist military rule.

Dr. PANAGARIYA. It's not a subject I write on, but just a couple of observations really. In my thinking, I take the optimistic view that globalization, especially through free trade, goes hand in hand

with generally improved security. The best example is France and Germany which fought the Second World War and then against each other and then they came together in the European Economic Community and we know that they are not going to go to war again.

Also, insofar as open markets go hand-in-hand with democracy, and certainly if you are going to maintain economic prosperity, I don't see ultimately how you can do it without democracy. You can kick off prosperity under more authoritarian regimes for a while and succeed, but eventually I think, you know, democracy is a necessary part of overall stability over a very long period of time. Also democracies are known not to go to war generally speaking. So that, again, goes in the direction of the two being complementary rather than in conflict.

And I would just stay this—this is the part that disturbs me—is that the French and Germans think that they invented their peace by themselves without having the United States and Russia defeat the Nazis. So, again, I would say I see an underlying political order that permits peace, prosperity, you know, economic, you know, globalization.

Chairman D'AMATO. Thank you very much. I would just make one comment. You three are all economists and you're one of the two big dots we're supposed to connect, but that doesn't absolve you of understanding what the national security implications are of the economic flows. This Commission was created by Congress to report and make recommendations to the Congress on national security implications of the bilateral trade and economic relationship. Connect those two dots, but prior to that it was a series of stovepipes. You didn't have to worry about military things. You're an economist, you're fine, or you're a military guy, you're fine. No, now you have to be responsible for both.

So, in a sense, the creation of this Commission was an attempt to establish a new paradigm analyzing this relationship, that everything economic so big has a national security implication for this country. How to assess that.

Just one other comment—you mentioned democracy. When Congress passed the PNTR legislation and endorsed access of China to the WTO, the underlying assumption which was repeated many, many times over on the floors of both chambers, was that if China became a market economy, it would lead to political reform and democratization.

That was an assumption that was made. I believe if that assumption had been contradicted and we didn't believe it, that legislation would not have been passed. So that was ingrained in passage of PNTR. Of course, the China government, we think, is making every effort to prove that assumption wrong, to have a market economy and also run a command political system.

So we're watching, and there's a question as to whether they're going to be able to defeat that proposition or not. I think the jury is out on that.

Commissioner Reinsch.

Commissioner REINSCH. Thank you. These questions are primarily for Dr. Gomory and Dr. Freeman. I infer from both of your comments that one of the most useful things the United States can

do is to adopt policies that will maintain its role as an innovation leader. Is that a fair statement?

It seems to me, and this goes back to something Richard Haass said in the beginning, I'll be less tactful than he was because I'm not in his position, that we're in the process in some fundamental ways of encouraging the movement of our innovation base overseas if you look at what we're doing on restrictions on certain kinds of bioscience, R&D, what we're doing on students and engineers and foreign-born engineer students coming here, what we're doing on reductions in funding of both basic R&D and the smaller amount of applied R&D the government funds.

It seems to me we're accelerating the trend that you, Dr. Freeman, in particular, have already demonstrated is occurring anyway. Do you think that's right or am I off base?

Dr. GOMORY. Do you think that what is right?

Commissioner REINSCH. Do you think that what I said is correct, that some of the government's current policies are accelerating the trend of moving innovation leadership offshore?

Dr. GOMORY. Well, Richard, you should address this. I would like to make a remark after Richard because I think he's better for that particular point.

Dr. FREEMAN. Yes, I think there are policies that we've done, and there's an interesting conflict, I think, between some of the national security policies and the economic strength policies on the innovation front. I think the State Department has been very good in dealing with the visa issues that at least some academics fear. Some universities fear we're going to reduce the supply of these very smart people coming to our country.

We do have some strange things, though. If you're a Chinese or Indian or whatever, and you want to come to the U.S. to study, you have to swear you have no intention of ever working here, when our national interest is the exact opposite: we want you to stay and work, maybe not building another nuclear bomb but doing useful things.

Also, something in the R&D expenditure, you mentioned the biology experiment, the bio-shield program, and I'm not favoring one or the other—it's a very difficult thing—if you put a lot of resources into trying to protect us from some strange pathogens that some mad terrorist kind of person will release in the subways of New York, you are pulling resources out of some other areas that would probably directly benefit our economy.

And the Defense Department has been, as you know, in their expenditures in DARPA, they've been narrowing the focus of their research activities. That may improve our security. So there's a tension. But it will not help us in the long run in our economy. I recognize it's difficult how you're going to judge where to be on these things. But they certainly don't, I think, bode well for the future economic strength of the country. And as you also probably know, the R&D budget has not been increasing. There was a promise to double NSF (National Science Foundation) that I think President Bush made early—I don't know how many years ago—and that has not occurred. And it's not conceivable that it's going to occur, in the way we did NIH (National Institute of Health), which pushed a lot

of resources into the health and biology, potentially at the expense of the physical science, chemistry, physics, engineering things.

So these decisions actually do have effects, and I think some of them, let's face it, could be questioned as to whether they're the right ones.

Commissioner REINSCH. Thank you. Dr. Gomory.

Dr. GOMORY. Well, I hope you will be patient with me because I'm going to try to make a point which is a little less familiar, I think, than many, which is I appreciate the stress in the question of the leading intellects and the scientific and technical leadership and all that. But I want to stress that I personally believe the Commission could consider a wider view of innovation.

Let me try and explain what I mean. When I first became the Director of Research of IBM, I inherited the views of most researchers, which is that research is really what starts everything. But as part of my job, I had to move stuff, you know, into real product, so I really got to appreciate the R&D community. Those are the guys who designed the next products.

And at that time, I thought we had a very good R&D group making disk drives. By the way, IBM no longer makes disk drives. They've moved to Asia. And I was going through the disk production facility one day, guided by a production guy, and I remarked to him—I thought I was making an innocent remark—I think you've got a pretty good development team, right, and he looked at me and said, Ralph, anybody can make one of anything.

And I came to learn that the production folks have their own set of problems, which is to make stuff in numbers and cheaply and with quality, and it's a different world and it's a world full of invention and full of ideas, many of them from the people who have their hands in it.

Beyond that, I one day learned that even marketers invent. But each world thinks it's it. I just want to say that by and large, commissions like yours or any other tend to hear from the research and the R&D community because that's who you call on.

Let us remember that the country became great on innovation of every sort, in particular innovation in manufacturing. I think that the strength of America is that people feel free to think new thoughts and invent in whatever area they are in, and that we do need high tech and all of that. We shouldn't let it get away from us and it's an edge in military and many thing. We should also encourage invention in everything, and that has been the American tradition and we shouldn't abandon that with an overemphasis on the very high-end things.

And that's one of the reasons why when I suggest activities helpful things, that we should reward companies that produce a high contribution to the domestic product per capita regardless of whether they're high tech or low tech because we will encourage invention in everything. I think it's important to think in those terms as well.

Thank you.

Commissioner REINSCH. I'm glad you said that because it actually addressed another question I was going to ask which deals indirectly with the role of current manufacturing and facilitating fur-

ther development, further R&D, and I'm glad you went in that direction.

Let me ask one other quick one if I may, Dr. Gomory. I was very struck, both in your oral comments and your written statement, about the frequent conflict between corporate objectives and government objectives.

Dr. GOMORY. Yes.

Commissioner REINSCH. I recall I first thought about this in the late '80s when I read this fascinating little monograph that the National Academy of Sciences had produced that examined every then-existing joint venture in semiconductors between Japan and the United States and concluded that each one of them taken individually was in the interest of the participants, but taken collectively they were not in the U.S. national interest for a variety of reasons.

And you in your testimony have made some comments similar to that. What is the government's obligation when it finds itself in that situation?

Dr. GOMORY. In the situation? In the moment, I don't think the government has one, does it?

Commissioner REINSCH. Well, should it do anything?

Dr. GOMORY. I do think we need to provide incentives to change that. Let me just take, and I hope I'm addressing your point, two experiences that I had, and sometimes these concrete things are more helpful. I'm a director of a company that makes inkjet printers.

A few years ago, we as directors voted to do a printer assembly in China and more recently we as directors voted to expand our R&D facilities in the Philippines. Now, what should the government do about that? At the present time, the government has no relation to that. What I'm suggesting is, if it had a policy, what should it be? The government is starting to think because one of the things that government has is this act, whatever it is, about repatriating your overseas profits. We're repatriating them.

So I don't know whether that thing is a good thing or not, but I was pleased that's the first time in my life as a director that I ever saw the government do anything. It may or may not be a good idea, but it shows there's life.

So I do think basically incentives to a company to add value, high value per capita in the U.S. is something to think about. It's a very acute problem, and again let's not take comfort in the high tech. I'm also the director of a very tiny start-up, which has an innovation that if it works on a large scale, and I've learned that small scale is different from large scale, will make a difference in the semiconductor industry.

But we're looking for a partner with whom to work, a large-scale producer. It's just a conflict for us between Singapore and Shanghai. That's all. So the new ideas are going to migrate to where the production is. So let us not separate too much the high tech and the rest of the economy.

Commissioner REINSCH. Thank you.

Chairman D'AMATO. Thank you very much. Commissioner Dreyer.

Commissioner TEUFEL DREYER. I was struck by Dr. Gomory's move beyond the wine/wool analogy, wherein you said that in the modern world it's possible for countries to learn the skills involved in making a product and then practice those skills until they approach the capability of the world's productivity leaders.

It struck me in particular during our hearings in Palo Alto two weeks ago that the United States seems to be losing its comparative advantage. The example that was given was this computational contest that is held every year; and it seems that the only time that an American university won, it was Harvey Mudd College, ten years ago. This is something for us to be concerned with and, of course, Dr. Freeman did mention the comparative advantage educationally.

We have a situation where more and more foreign-born Ph.D.s teach in American universities. This is, on the one hand, very good because they are smart, competent and hardworking. Psychologically, however, it seems to have a discouraging effect on American students. We have at my university an engineering school where there is one American-born professor—one.

The others represent 70 percent one country, and 20-something percent another country. The problem we have is that American born students who therefore feel they are not wanted psychologically—since no one has told them this. So they are not studying in the engineering school. Meanwhile the foreign born Ph.D.s who are teaching there are vigorously importing people from their countries. Is there some bright side to this? Is this some comparative advantage in this? Or do we need to rethink what we are doing. I was at Harvard last week; it's my alma mater and I was addressing the Formosan Students Association. These are Taiwanese, and they are fantastic, and I was really, really impressed. They are bright kids doing wonderful things. But do I see any Americans there? No.

Dr. FREEMAN. Hopefully your non-U.S. born have become citizens in the country and that's the first thing. This country has always done this, having people from overseas born elsewhere come here.

But I have actually just completed a study for the National Science Foundation on what we could do to attract more American students into these fields. The National Science Foundation's Graduate Research Fellowships are only for American citizens or permanent residents, what they call alien residents. Every country has fellowships only for their own students.

What we found is that in the last four years or five years, since 1999 through 2004, the NSF awards went from $15,000 to $30,000. They doubled. It was a massive increase in the size of the awards. The number of American students who applied to get these awards literally doubled as well, went up huge numbers. We got many more women, underrepresented minorities, and we actually have the records of these people on the GRE exams and a whole bunch of things.

And it's fine. They're very good people meaning that there are a lot of people out there in this country who look at these fields and they may say, well, gee, there are a lot of foreigners coming in, and the economic opportunities are not going to be so good, or I don't feel so good.

But the economist in me and this evidence from what happened when the NSF did this says that you put some money in front of the faces of the U.S. young people, there's a doubling, there's a huge increase.

Universities were complaining bitterly about this. They're very upset that the NSF did not increase the number of awards a little bit. We've actually calculated, if they had given three, four, 500 more, they give about a thousand now a year, they could raise easily to 1,500, and that would affect the flows of this very top group and without any measurable decline in the quality because there are just a lot of very good people who are there.

So I would want to deal with these kind of problems would be through very positive incentives to young Americans. We're not going to discriminate in the labor market for Americans, and no company is going to want to do this at all, you know, gee, I'm an American guy instead of a Taiwanese, and if the Taiwanese is better, I'm not going to hire him. That goes against everything that our country is about.

But putting the money there, when you win one of these National Sciences fellowships, you feel you have been chosen by the country as one of the best science and engineering people in the country, so it's more than the money. The money had a huge effect on number of applicants. People don't reject these awards. So I think that's the solution.

Commissioner TEUFEL DREYER. Thank you. Dr. Gomory.

Dr. GOMORY. Of course Richard is really an authority on these matters. I want to add a couple of points. There is wide misunderstanding—people choose their careers for a mixture of motives. It's partly money and it's partly interest and it varies a lot with the individual.

What isn't as widely understood as I think it ought to be is that we, in fact, have more Americans entering universities with the intent to major in engineering or science than we could ever use in spite of the K through 12. This is a fact and I think Richard would agree with it.

But then we do things to them, and we do two things to them in particular. One is that in the first couple of years of engineering or some of the sciences as well, we almost deliberately weed them out. That's a residue. If you talk to some engineering professors, it's somewhat shocking. They feel it's their job to separate the ones who quote "can't cut it." But what is it they're teaching them?

They're teaching them calculus, mathematical things. These folks want to be engineers. We are inflicting in the early years of college a tremendous and unnecessary attrition through the way we teach. We are not necessarily weeding out the good people because we did a study a number of years ago, we in this case means the Sloan Foundation, of comparing the ones who remained in and the ones who came out. The ones who came out were just as good on their entering college scores, but they just didn't like what they were being given.

So there are many things. I think the things Richard said about fellowships are correct. But an untouched lever is how we teach the early years of college. The second thing, of course, is a globalization

effect which is as jobs in these areas increasingly go overseas, the career prospects become more daunting, and that's a deterrent to.

But I do think this notion that either K through 12 has rendered our children unfit or that American science is too tough for Americans, I couldn't disagree with that more. Much of that wound is self-inflicted.

Commissioner TEUFEL DREYER. If I could just add a personal note to that.

Dr. GOMORY. Yes.

Commissioner TEUFEL DREYER. My son attended Georgia Tech, and had really scored well on the mathematics portion of the SATs. But he could not understand his differential calculus professor, and dropped the course and majored in something else, not engineering, and this is somebody who managed to get a 780 on the math SAT.

Dr. GOMORY. Yes.

Commissioner TEUFEL DREYER. So that is another disadvantage.

Dr. GOMORY. We have American professors who are also unintelligible for other reasons.

Chairman D'AMATO. We have a couple more questions left. Commissioner Becker.

Commissioner BECKER. This has been a very interesting discussion and as much as I like theory, I'd like to get the discussion a bit closer to the ground. We're moving away from bilateral agreements and into global trade. This is just an opinion on your part. I have two questions.

With the movement of business investments on a global basis and outsourcing or offshoring services the same as regular trade, (which economists estimate two-thirds of the total economic activity in the United States is in services), what effect do you believe this kind of movement is going to have on workers, on their jobs and their wages in the United States?

Dr. FREEMAN. Well, I think the ability of capital in the companies that do global sourcing, they don't refer to it as outsourcing, because it's just globally deciding where you can do the best, where you can get the best price, I think that does put a damper on the wages and wage increases that are possible for American workers.

It doesn't mean the wages have to go down because we have productivity advance ongoing but wages would go up more if companies didn't have the option of locating offshore. If you couldn't have located in Singapore or Shanghai, they probably would have figured some way to build it in the U.S. at a higher price for all of us, but there would be more job creation. I agree that unemployment is not really the long run issue. It's the wages that people would get. I would put the great stress on that.

And I just think for the next 30 or 40 years until China and India and some of the other countries get their wages up so they no longer are competing with us on wage dimension, it's going to be difficult on American workers.

Commissioner BECKER. The next how many years?

Dr. FREEMAN. 30 to 40 years.

Commissioner BECKER. 30 or 40?

Dr. FREEMAN. Yes, I think that's right.

Commissioner BECKER. I don't think workers can wait that long, do you?

Dr. FREEMAN. Well, wages have to go down and there is this technological progress things and cheaper goods coming in from overseas, but it's just not going to be a great period. If the capital/labor ratio is half of what it was, it is going to be a difficult situation for workers until that goes back up.

Commissioner BECKER. Earlier you were talking about people choosing their careers. Most workers in the United States do not choose their careers. They're looking for a job and they're wanting the ability to support a family. They don't have the opportunity to go into the levels that you were talking about.

Do you have any comment on this?

Dr. GOMORY. First of all, I agree with Richard that this tremendous explosion of available labor is going to have a depressing effect. But I do think that with the proper incentives, we can to some extent offset it. And what I'm going to say is going to sound very bad at the beginning, but I'm going to make a point which is why America has been a rich country compared to the Asian countries.

And I would put it this way. For many years, we dug ditches with backhoes; they dug them with shovels. And we can afford to pay someone who is driving a backhoe because they produce a lot. I think we have to make every effort to do that in our country. Now, today, the equivalent of the backhoe or the automated factory or the semi-automated factory is often computer support.

What I'm saying sounds mixed up perhaps because I'm saying we can do the jobs with less people but higher paid people. So what happens, we're creating unemployment in another way. If you trace that out, that has a better effect on the economy than shipping those jobs overseas.

So I don't see any way that we can stay ahead of the general depression of wages around the world except by equipping our people with more machinery, more productive machinery than anyone else has, and that will take some incentives because even in cases where you can do a job either with a lot of people or with a few and more machinery it's easier to do it the way you're doing it and add more people. That is to say to do it overseas because you can do it that way overseas.

To change into more advanced things, say more advanced things with the computer, is harder and riskier. But we should incent that because that keeps the jobs in this country.

Dr. PANAGARIYA. I want to speak a bit more optimistically here. I think Ralph was probably in the middle. But since 1985, let's say, we have had lots of opening up of the U.S. economy, a lot of investment going in and out. We had lots of innovations that were labor-saving innovations or you could call job-reducing innovations, but during that period, the number of jobs, the number of people employed in the United States has gone up by about 20 million.

U.S. economy has been very flexible in this respect as opposed to the European economy. And it has generated more and new jobs. Now, the distributional effects have happened, and that's where I think Richard has pointed out. But overall, I think, Richard, would it be fair to say that the level of real wages has continued to rise. At least if you look at the household income, certainly they have gone up. But that is the effect of two-income households for sure.

Dr. FREEMAN. That's right. That's right.

Dr. PANAGARIYA. But on the whole, it is not as though—and remember there is a huge impact of this technology, which is basically what economists will call pro-skilled labor intensive technology. That technological change has moved the economy closer and closer toward demanding more and more skilled labor as opposed to unskilled labor and that has had a detrimental effect on the wages of the unskilled.

And that's where the big problem I see is at that level that for the unskilled workers or low-skilled workers, perhaps the wages have not done well, and that's where maybe the policy ought to focus, but I think on the rest of it, the U.S. economy has done well and I personally think that it will continue to do well.

Chairman D'AMATO. Thank you. Commissioner Bartholomew.

Commissioner BARTHOLOMEW. George had another comment?

Chairman D'AMATO. Go ahead, George.

Commissioner BECKER. I have a second question. Does it matter what the comparative advantage a country has actually is? How it's derived? Does it matter? Does this weigh into the calculations?

The discussions we're having today are about developing nations. We're not talking about problems with trade and free trade with Europe, or the UK, or Canada. We're talking about the developing countries. And that's where comparative advantage comes in. For example, does it matter if a country's comparative advantage comes from repressed labor?

Or that the country is trafficking in women and children? Or that there is no freedom of association amongst the workers so they can't share in the wealth they help create? Does this matter to you gentlemen? Should we even have a free trade agreement with countries that are using that as a source of comparative advantage?

Dr. FREEMAN. I suppose I've written about those things. And obviously we don't want to be trading right now with Burma, which is the country I assume you refer, which has, you know, literally slave labor and the military orders people to build things.

I personally think that by having some of these bad practices publicized and through corporate shareholders who don't want their companies involved in this kind of thing, threats to consumer products and so on, we actually have been reasonably successful in getting our major corporations to try to take steps to improve the labor standards and conditions overseas.

We understand Burma is a very peculiar case. It got brought up before the ILO, the only time the ILO ever managed to at least speak harshly towards a country, to apply their weak penalties.

The big one is China. And there I think our companies—you can look at Reebok has been doing and I don't know if Reebok is American or British company at this point, but it's a western company—they have taken steps to try to improve, freedom of association, and I just think we have got to keep pushing on the Chinese to do this, for them to understand it's in their own interest in the long run, that they won't have instability, and they won't have more inequality if they move towards more democratic freedoms.

Commissioner BECKER. Our own State Department says that in China the human rights violations and all the factors that I referred to have increased in China year after year since PNTR. I don't know if we're going in the right direction.

Dr. GOMORY. Well, I can only give you a personal opinion. Because I have no expertise on the question you ask, but I think that underlying the notion that trade, free trade is good, and when you lose there is some benefit to the world, even if you may not, is undermined if it isn't symmetrical. If one group is slaves, the other is free. I think that undermines the rationale of free trade.

Chairman D'AMATO. Dr. Panagariya.

Dr. PANAGARIYA. The labor standards issue is a whole big debate out there, and what are the aspirations versus what is realistically feasible. I mean there's a whole set of issues. On some there is agreement that you don't want forced labor, you don't want slave labor. Now child labor, there is I think aspiration is that everybody would like to get rid of child labor. I don't think there are parents out there who like their children to go out and work rather than have a decent education and decent childhood.

But can we do it as one goal and do we use trade as an instrument to actually achieve it? There I disagree. We all need to work on raising standards everywhere. There is some pressure that can be brought in. But to suspend trade is not going to overnight improve the standards. We have this example from the early 1990s when the fears that the Bangladesh's might actually lose their preferences in the market in the U.S. and European Union because they had individuals below 16 years of age working in the factories.

So for the Bangladeshis actually, apparel exports are really more than half of the export earnings. They got very worried and quickly laid off all the children that were employed in these factories. But in the end, it turned out many of them ended up in destitution and prostitution and UNICEF had to be brought in. So the point is one needs a bit more architectural work there. You've got to have means developed meaning educational alternatives developed so that as you take them out of the labor force, you then take children into educational institutions.

Many of these countries really don't have enough educational institutions out there so that if you took the children out of employment, they will probably end up being worse off than they are working. So while immediately one can work on ensuring that there is no slave labor and no forced labor, bonded labor, that sort of thing, also there is general agreement on employment of children in unsafe occupations, and most, actually 170 countries have signed this new convention in the ILO—it was Convention 182 and they are working towards abiding by that.

But it appears as though in the debates that there is general agreement on all the core labor standards, et cetera, but that is at the aspiration level, and yet, you know, it will take awhile, and certainly what most you can do, if trade is suspended you might get children out of the traded goods activities, but they will end up in something else that is non-traded.

So, in the end, you would not have accomplished the objective. I think it can be pushed up and it can be speeded up but through instrumentalities other than trade.

That's one. And two, the process will be slower than what we might like because ultimately growth is what is going to do it. Living standards as they rise, parents will pull the children out of employment.

Chairman D'AMATO. Thank you very much. Commissioner Bartholomew.

Commissioner BARTHOLOMEW. Thank you, Mr. Chairman. Thank you to our witnesses. It's particularly interesting—I want to commend you all for working to relate theory to the realities of what's going on in the world, and I'm very encouraged to see you grappling with the complexities that human motivations bring to everything.

I think, like Commissioner Donnelly, I have in some ways two comments more than questions, but would be interested in your thoughts on it, and they'll circle us back to where we started. It seems to me that there are at least two other significant challenges to applying classical trade policy to the economic world that we are in today.

One, of course, is that it really was predicated on the movement of goods, not so much the movement of services and intellectual property as our economic basis has been declining; our manufacturing base in this country has been declining. We've all been told all along for the past 15 to 20 years that America's future is our intellectual property, and all that that entails.

I'd note particularly, as you were saying, Doctor, that there were a number of jobs that half to stay in this country. I think it was The Washington Post several weeks ago had an article about an outsourcing firm based in Washington, D.C. whose receptionist is working via plasma TV from South Asia. She is, of course, having to work very skewed hours, but literally people come in the door, they have a camera, they deal with her, but she is thousands of miles away, she can order the sandwiches for everybody in the office from the deli around the corner, so it is forcing us to rethink just what it is.

Of course if you want somebody to carry your bags in a hotel, it's different than 4,000 miles away, but how many of these jobs can be moved is a very interesting challenge. So that to me seems to be one of the challenges: intellectual property and the nature of what is being traded.

And the second one is it seems that classical trade theory was really based on good faith actions on the part of the trading partners. It was not a world where the Portuguese would be stealing English wool and selling it, for example, to Spain, possibly as a Portuguese product or even just technology transfers, forced technology transfers, intellectual property rights theft, counterfeiting. All of these things are actions that do not seem to fit into a good faith interpretation; it is taking the world trading rules, either ignoring them or distinctly trying to get around them.

So to me as I look at the reality of the world that we are living in, as people try to model these things, I find those as challenges, and would just welcome your comments on them.

Dr. GOMORY. I would say on the bit, I think the models are just about as good for the service outsourcing as for goods, and in fact there are some—it's a more difficult thing to deal with from the point of view of the home country because with goods, there's a delay. If you order shirts from China, and you're a retailer and through a wholesaler, and you're running out of a certain color and

certain size, it takes a long time to come from China, so a certain amount of local production can be sustained on the fact it's nearby.

When it's bits, it doesn't make any difference. It's instantaneous. That receptionist was just as good, though halfway around the world. So I think the theory as far as I can see would remain unchanged, but I would expect that it may be even more efficient to outsource in services than it has been in manufacturing.

Commissioner BARTHOLOMEW. And the issues of cheating?

Dr. GOMORY. I'd say that's just part of the general problem. There is one—I may be wedging this in here, but I did have one thought I came in with, and I haven't succeeded in wedging it so far. So if you don't mind, I will now.

Commissioner TEUFEL DREYER. Please.

Dr. GOMORY. And it relates to something that Professor Panagariya said, and to a various remarks relating to the unskilled portion of our labor force, which is most likely to be further disadvantaged by these developments, and also to the notion of equipping our people with the best technology, whether that be machines or computers, or education.

And I think the possibility has opened up in the last decade to equip every American who wants to learn with whatever it is they want to learn. And they can go on working at the same time because during the last ten years, the ability to teach over the internet, and I mean teach—I do not mean just posting textbook information. A professor interacting with students and the students interact with each other. Online learning works, and it works as well as classroom.

And pretty well that is an important statement and it is pretty widely accepted. This is something that I've had enormous experience with and as we sit here today there are probably 2.5 million Americans online taking for credit courses from certified schools, ranging from Stanford University down to St. Leo—no one has ever heard of.

Commissioner TEUFEL DREYER. It's in North Florida.

Dr. GOMORY. And it has a lot of students and the University College of the University of Maryland, which is basically there—I don't know what you call it—like their night school, but it isn't at night—has I think 100,000 people taking a course. This stuff works, and I think it opens up the possibility because we tend too much to think of education as something you go to school, you get educated, you go to work.

First of all, that's getting very hard for Americans to afford in some cases. This opens the possibility of learning while you're working. You can work. You don't have to be in the classroom or at worst you have to be there, you know, once every ten meetings or something or not at all.

And we should realize that this stuff works and I wanted to bring it up because there are legal obstacles coming from an earlier period so that the usual government subsidies to students don't apply to this kind of school which was a very good idea ten or 15 years ago because a lot of these schools were diploma mills. Not true now.

And I think one thing that we could consider would be a national effort to make training available to every American who wants to

learn, and it can be done. We ought to think in that direction and at least remove the obstacles.

Thank you.

Chairman D'AMATO. Thank you very much.

Dr. FREEMAN. May I quickly address the cheating issue?

Commissioner BARTHOLOMEW. Yes.

Dr. FREEMAN. Cheating can be good. I have very mixed feelings about cheating. I have a drug that can cure lots of people. He steals it from me and he saves lots of people's lives, because we know that is a problem in developing countries. They can't afford drugs and if it requires some form of, quote, "cheating" or breaking international property rights, we can understand that under some circumstances, that can be good.

I'm not going to endorse all cheating of course. But we've got to be very careful about how we think about this. The government passes a law and that means somebody loses their job. And they decide to cheat, work off the books with the company, and it saves the job, and the company is better off and the worker is better off, and this law is broken.

That also can be a case where cheating is not so terrible. Now, so I think the whole economics of cheating when it is a good thing—when you go to Hong Kong and you buy some sort of special kind of Gucci watch in the street for $5, that's not really even cheating. Everyone knows that that's just a peculiar transaction that your—even my eight-year-old son—or he was eight-years-old, and we were in China and he bought some of these things. Even he knew he was not getting the real product, but maybe it didn't matter.

So I just think the cheating thing has got to be treated very gingerly, and the way of phrasing it, it would be how much money would you be willing to spend to stop certain forms of cheating and how much you say that's not that harmful or maybe it's even good. So I would just be more even-handed towards this nasty word.

Dr. PANAGARIYA. I agree with what Professor Freeman has just said also, but starting January 1, 2005, now we have in full operation the Trade Related Intellectual Property Rights Agreement in the WTO, so now actually countries must abide by a uniform patent law and uniform copyright law and what not, so now an intellectual property rights regime across the world is quite strong. The exception is given to the least developed countries, which are mostly the poorest of the countries in sub-Saharan Africa.

Countries such as India, China, et cetera, now have to abide by patent laws and copyright laws that are very close to the U.S. laws. Now, you are saying are they going to enforce? Of course. That's what WTO is about, that in the end if they don't enforce, they are going to face trade sanctions from the United States, European Union or whoever's copyrights they violate or whoever's patent rights they violate.

So I think we are not seeing the effect yet because the enforcement machinery has not started operating because in a large number of the developing countries, the deadline to implement this was January 1, 2005.

But as far as the legal regime is concerned, it is in place. India was one of the last ones to implement it. It has done it.

Commissioner BARTHOLOMEW. And the only comment I would make there is that there is a distinction of course between the signing of these agreements and actually going ahead and implementing them.

Dr. PANAGARIYA. WTO is a body that's an enforcement body. It has a very strong dispute settlement process and countries have been challenged, and implementation has happened. Pre-WTO, the GATT dispute settlement system was very weak, no doubt, and you could get away with murder there, but not in the current one.

Commissioner BARTHOLOMEW. Mr. Chairman, our witnesses raised so many more issues. I think one more comment on my end, and that is I think the verdict remains to be seen whether China's entry into the WTO changes China or changes the WTO. And only time will tell us on that.

Thank you.

Chairman D'AMATO. Thank you very much. I would just make one comment. This Commission has already recommended that the United States take China to the WTO on IPR since they're not enforcing any of it, and we think that would be a good use of the WTO. We've got to use the WTO or we shouldn't be in it.

So anyway, I want to thank the panel for their extensive commentary and interesting testimony. Thank you very much. We'll take a five-minute break and begin our next panel.

[Whereupon, a short break was taken.]

PANEL II: THE IMPACTS OF GLOBALIZATION ON THE U.S. ECONOMY

Chairman D'AMATO. The Commission will come to order. This panel is entitled "The Impacts of Globalization on the United States Economy." Our second panel will investigate how global economic trends are affecting the U.S. economy and national economic decisionmaking. Areas of consideration will include how exchange rates, the trade deficit investment flows, the sustainability of the trade deficit, the impact of global labor arbitrage on wages, U.S. indebtedness to China and other foreign holders of U.S. notes, and the impact of offshore transfers of manufacturing R&D activities and services.

For this discussion, we have with us, left to right, Professor Richard Cooper, the Maurits C. Boas Professor of International Economics at Harvard University. Dr. Cooper is an expert in the field of international macroeconomics. He served as Undersecretary of State for Economic Affairs during the Carter Administration, and specializes in the area of exchange rates, trade deficits and international financial capital movements.

On Professor Cooper's left is Dr. Clyde Prestowitz, President and Founder of the Economic Strategy Institute. He has previously served as counselor to the Secretary of Commerce in the Reagan Administration, has also worked as a senior executive in the private sector. His writings have focused on strategic trade policy.

Next to him Ambassador Richard McCormack, Senior Advisor in the International Security Program at CSIS in Washington, previously Undersecretary of State for Economic Affairs during the first Bush Administration, and has been a high level advisor to political leaders and senior government officials since then.

We welcome the panel. We'll proceed, from left to right, Dr. Cooper first, and if you could confine your remarks to seven or eight minutes and then all three of you go ahead and make your remarks, and then we'll go for questions and answers after. So thank you very much for coming. Dr. Cooper, you may proceed.

STATEMENT OF RICHARD N. COOPER
MAURITS C. BOAS PROFESSOR OF INTERNATIONAL ECONOMICS
HARVARD UNIVERSITY, CAMBRIDGE, MASSACHUSETTS

Dr. COOPER. Thank you very much, Mr. Chairman, for inviting me to this panel. Increased economic interdependence with the rest of the world has many dimensions, and I want to focus today mainly on financial interdependence (although, as we shall see, it also has important implications for trade).

World exports of goods and services now amount to around $8 trillion a year. The foreign exchange markets clear around $1.2 trillion per day. Hence, most transactions across currency markets are purely financial and these transactions determine the value of floating exchange rates in the short and even medium run.

The rich world, especially Europe and Japan, is aging, both because of increased longevity and because of declining birth rates. The latter imply eventually declining labor forces (unless offset by immigration) and declines in new household formation.

The demand for housing, a large user of capital in all economies, will remain low in these aging societies, especially in Japan and Germany, the second and third-largest national economies after the United States.

A decline in the labor force also implies less need for capital investment to equip new workers. Some capital-for-labor substitution will occur, but that will push returns to capital even lower than they are now.

The excess of savings over investment in these countries helps to explain the low long-term interest rates around the world today. Some of the excess savings is absorbed in government deficits, which are relatively high both in Japan and Germany, but much of it goes into investment abroad, resulting in large current account surpluses of these two countries, that together amounted to nearly $300 billion in 2004. This is, in fact, a sensible disposition of savings if people want to save for their retirement when returns to domestic investment are low. Much of the excess savings in the rest of the world comes to the United States. It exceeds investment abroad by Americans and supports the large current account deficit of the United States, now running over five percent of GDP.

Why does the savings come to the United States rather than going to emerging markets where returns might be expected to be higher? The answer is complex. Some of it, in fact, does go to emerging markets, but those countries at present as a group also have an excess of savings. Since the financial crises of the 1990s, risk averse investors, especially in Japan and Europe, have been reluctant to invest significantly in emerging markets, other than those in Central Europe which have largely joined the European Union.

Returns in emerging markets are not only volatile but on the basis of recent experience in Russia and Argentina may be insecure from political or legal action as well. Also, some emerging markets,

notably China, have high domestic savings rates themselves, more than enough to cover their requirements for domestic investment.

The U.S., in contrast, has investment opportunities that produce higher yields than Japan and Europe and they are more secure and more reliable than investments in most emerging markets. Moreover, the U.S. economy is large, accounting for a quarter to a third of the world economy and has especially well-developed financial markets accounting for half of the world's marketable securities. It is not surprising then that funds from all around the world are invested in the United States. When private foreign investment declines, as it did after somewhat after 2001, foreign official investment often takes up the slack. There has been a large build-up of foreign exchange reserves in the last two years, especially in East Asia, but also elsewhere such as India and Russia, a byproduct of exchange rate or macroeconomic policy in those countries.

Budget deficits have reached practical limits in Japan and are constrained by the Stability Pact in the core of Europe, which has exceeded three percent of GDP for several years.

China is overheated and requires some fiscal tightening despite large continuing infrastructure needs. That would tend to increase China's already high national savings and modest current account surplus, not reduce it.

Private savers in Japan are highly risk averse. The Bank of Japan in effect is providing foreign exchange cover for private sector savings, which from households continue to go heavily into the low yield postal saving system.

In China, residents cannot legally invest abroad without specific authorization. Again, official investment abroad through the People's Bank of China occurs when private investment cannot take place. But the latent demand among China's newly well-to-do citizens for overseas investment, especially in the United States, is undoubtedly high.

These are all consequences of financial globalization. The flows into the U.S. economy are often said to be "financing" the U.S. current account deficit, which reached $666 billion last year. That is true only in an accounting sense. The motivation certainly for the private flows, more controversially for the official flows, is investment in the United States. Americans have accommodated this excess saving abroad by importing much more than they export. Although eventually the savings in Japan and Europe will probably fall, as those societies increasingly age, the current configuration can endure for many years. Mr. Chairman, I've submitted a separate paper to your staff on the sustainability of the U.S. current account deficit.

Chairman D'AMATO. Thank you. We'll include that in the record.

Dr. COOPER. These flows are mutually beneficial so long as the United States generates productive assets for sales to foreigners in financial forms that yield less than the underlying investment yields.

The main problem at present, in my view, is that the United States is producing in abundance financial claims in the form of U.S. Treasury securities that are attractive to foreign institutions but that do not support an increase in productive assets in the United States. Thus, they represent a claim on the unaugmented

future income of Americans. We want to reduce these claims, increase national savings, and encourage greater and private investment. We need to take serious steps to reduce the Federal budget deficit. In summary, the United States has a revealed comparative advantage in today's increasingly globalized world in producing highly desired financial claims to the mutual benefits of foreigners and Americans alike so long as Americans invest the proceeds productively.

Thank you, Mr. Chairman.

[The statement follows:]

Prepared Statement of Richard N. Cooper
Maurits C. Boas Professor of International Economics
Harvard University, Cambridge, Massachusetts

Globalization and the U.S. Economy

Increased economic interdependence with the rest of the world has many dimensions. I will focus today mainly on financial interdependence, although as we shall see that also has important implications for trade. World exports of goods and services now amount to around $8 trillion a year. The foreign exchange markets clear around $1.2 trillion *per day*. Hence most transactions across currency markets are purely financial, and these transactions determine the value of floating exchange rates in the short and even medium run.

The rich world—especially Europe and Japan—is aging, both because of increased longevity and because of declining birth rates. The latter imply eventually declining labor forces, unless offset by immigration, and declines in new household formation. The demand for housing, a large user of capital in all economies, will remain low in these aging societies, especially in Japan and Germany, the second and third largest national economies after the United States. A decline in the labor force also implies less need for capital investment to equip new workers; some capital for labor substitution will occur, but that will push returns to capital even lower than they are now. The excess of savings over investment in these countries helps to explain the low real long-term interest rates around the world. Some of the excess savings is absorbed in government deficits, which are relatively high in both Japan and Germany, but much of it goes into investment abroad, resulting in the large current account surpluses of these two countries, which together amounted to nearly $300 billion in 2004. This is in fact a sensible disposition of savings if people want to save for their retirement when returns to domestic investment are low.

Much of this excess saving in the rest of the world comes to the United States; it exceeds investment abroad by Americans, and accounts for the large current account deficit of the United States, now running at over five percent of GDP. Why does this saving come to the United States rather than going to emerging markets, where returns should be expected to be higher? The answer is complex. Some of it does go to emerging markets, but those countries at present, as a group, also have excess saving. Since the financial crises of the 1990s, risk-averse investors, especially in Japan and Europe, have been reluctant to invest significantly in emerging markets outside central Europe, which has largely joined the European Union. Returns in emerging markets are not only volatile, but on the basis of recent experience in Russia and Argentina, may be insecure from political or legal action as well. Also, some emerging markets, notably China, have high domestic savings rates themselves, more than enough to cover their requirements for domestic investment.

The United States in contrast has investment opportunities that produce higher yields than Japan and Europe, and that are more secure and reliable than investments in many emerging markets. Moreover, the U.S. economy is large, accounting for a quarter to a third of the world economy (depending on the exchange rate used for adding up GDPs in national currencies around the world), and has especially well developed financial markets, accounting for half of the world's marketable securities. It is not surprising, then, that funds from all around the world are invested in the United States (although Australia, Britain, and Canada, while much smaller than the United States, share some of its other desirable characteristics, and are also destinations for much foreign capital).

When private foreign investment slackens, as it did after 2001, foreign official investment often takes up the slack. There has been a huge build-up of foreign exchange reserves in 2003–2004, especially in East Asia but also elsewhere, such as India and Russia, as a by-product of exchange rate policy or more generally of

macroeconomic policy in those countries. Budget deficits have reached practical limits in Japan, and are constrained by the Stability Pact in Germany (and France and Italy), which has exceeded its three percent of GDP limit for several years. China is over-heated, and requires some fiscal tightening, despite large infrastructure needs. That would tend to increase China's already high national savings and modest current account surplus, not reduce it. Private savers in Japan are highly risk averse. The Bank of Japan is in effect providing foreign exchange cover for private sector savings, which from households continue to go heavily into the low-yield postal savings system. In China, residents cannot legally invest abroad without specific authorization (which is increasingly given for foreign direct investments). Again, official investment abroad through the People's Bank of China occurs when private investment cannot take place. But the latent demand among China's newly well-to-do citizens for overseas investment, especially in the United States, is undoubtedly high.

These are consequences of financial globalization. These inflows into the U.S. economy are often said to be "financing" the U.S. current account deficit, which reached $666 billion (on preliminary figures) in 2004. That is true only in an accounting sense. The motivation, certainly for the private flows, more controversially for the official flows, is investment in the United States. Americans have accommodated this excess saving abroad by importing much more than they export. Although eventually the savings in Japan and Europe will probably fall, as those societies increasingly age, the current configuration can endure for many years (see my paper on the sustainability of the current account deficit). They are mutually beneficial so long as the United States generates productive assets for sale to foreigners, in financial forms that yield less than the underlying investment yields. The problem at present is that the United States is producing in abundance financial claims, in the form of U.S. Treasury securities, that are attractive to foreign institutions but that do not support an increase in the productive assets of the United States. They thus represent a claim on the unaugmented future income of Americans. If we want to reduce these claims, increase national savings, and encourage greater private investment, we need to take serious steps—more serious than simply proposing cuts in programs with strong Congressional and public support—to reduce the Federal budget deficit.

In summary, the United States has a revealed comparative advantage in today's increasingly globalized world in producing highly desired financial claims, to the mutual benefit of foreigners and Americans alike so long as Americans invest the proceeds in productive assets.

Chairman D'AMATO. Thank you, Dr. Cooper. Mr. Prestowitz.

STATEMENT OF CLYDE PRESTOWITZ
PRESIDENT, ECONOMIC STRATEGY INSTITUTE, WASHINGTON, D.C.

Mr. PRESTOWITZ. Thank you, Mr. Chairman. I think a way to visualize the current structure of the global economy and also the effect of that structure on the United States and on much of the rest of the world is to think of it a bit as a sliding board. That is to say we heard in the earlier session about a number of phenomena that have been developing over the recent years that are kind of smoothing the global system, taking the friction out.

So the internet, international air express delivery, global supply chain management, the fact that you can, as Dr. Gomory said, if you're working in bits, you can do the work as easily in Bangalore as you can in Silicon Valley. That's all taking the friction out of the system and smoothing it.

But the global structure is tilted and so it's tilted and smooth and the structure is such as to move investment and to move technology and to move wealth and jobs from west to east and particularly from the United States to the east. And the reason for that is because we still live in a bipolar world. We think we live in a unipolar world, but it's a bipolar world.

One block of countries is practicing what we might call dirty free trade. We talk about dirty floats in the currency markets, but think

of dirty free trade. The NAFTA countries, the EU, Chile, Australia, a few others would be in the dirty free trade bloc, which means that they're not pure free traders; they protect things like sugar. They impose emergency tariffs on steel or textiles. So they're not pure by any means, but they're by and large committed to the proposition of free trade. They are by and large democratic, rule of law. They believe in market forces. They have competition rules that are meaningful. Their currencies float freely in the currency markets generally speaking. And so this is the dirty free trade bloc.

The other bloc is the mercantilist bloc. And the mercantilist bloc includes most of the rest of the world but particularly Asia. Now, it's very important to understand what the mercantilists do and how they're thinking. For them, economic policy and international trade is not primarily driven by economic motivation. And it's not to say they don't want to increase the welfare of their people; they do. But they don't believe that the objective of economics is entirely more consumption.

They look upon it as catch-up. They look upon economic development as a matter of increasing natural strength, national power. It's geo-strategic or geo-economic as well as welfare driven. And there are a variety of forms of this. You have what I would call heavy mercantilism and mercantilism light, ranging from a Singapore to maybe South Korea, but the point is that all of them in one way or another suppress consumption. All of them in one way or another compel savings.

Think of Singapore. They take 40 percent of your salary out of your check before you get it and put it in the Provident Fund. 40 percent savings rate automatically. So they compel savings. They focus on investment production and export lead growth, and as a result of this, in the global structure, we have one country, the United States, which has built and focused its economic policies largely on increasing consumption. So there is one net consumer in the global economy. It's the United States, and the U.S. by focusing on consumption for the last 50 years has become a fantastic consumer. I mean the greatest consumer the world has ever seen, so much so that we consume $700 billion a year more than we produce.

The rest of the world, or the mercantilists, have focused on production and they're really good at production, and they have focused on exports and they're really good at it, and they export a lot more than they import and they produce more than they consume, and they need to get rid of that excess production, and so they ship it to the only open market that absorbs it, the United States market, and so hence we have this distorted global structure in which U.S. runs enormous current account deficits and much of the rest of the world, all the rest of the world is running current account surpluses.

As has been mentioned earlier, this is driven by many factors, but the big one is because these countries have very high savings rates and while the savings rates are sometimes attributed to their thrift or to Confucian values, the fact is, they compel savings. The savings rates in Asia have only been reached in the West during wartime, so you might think of these as wartime savings rates or think of them as strategic savings rates.

Now, in the econometric equations that are used to figure out what drives all this, it's commonly considered that Americans save too little and that the driver here is low U.S. savings/high consumption. But because it's an equation, mathematically it has to be the case that the drivers can be either way.

More recently there has been substantial economic analysis suggesting—Ben Bernanke at the Fed among them—that, in fact, it's the savings in Asia that kind of drives the low U.S. savings rate and that kind of drives the value of the dollar.

Now, that's a really important point because the U.S. gets away with its low savings rate and gets away with its current account deficit because it pays in dollars and a dollar is the world's money. So when we buy oil, we just print green pictures of Presidents and send them Saudi Arabia or Venezuela or Mexico and we get the oil.

Everybody else, of course, the Japanese, for example, have to build a Lexus, sell it to us, get dollars and then buy oil. The hegemony of the dollar relieves us of the necessity to be fiscally responsible. It also relieves the mercantilists of the necessity to be fiscally responsible because they manage the dollar. They intervene in the dollar markets.

Japan last year spent more intervening in dollar markets than we did in Iraq. So they managed the dollar to facilitate their exports by keeping the value of the dollar high in relation to their own currencies.

So the result of this is that we have a kind of a giant, you might think of it as a giant Ponzi scheme or a giant pyramid scheme in the global economy in which the whole growth in the global economy—I shouldn't say the whole—but a lot of the growth in the global economy depends on ever-rising U.S. consumption, but, of course, in order to continue increasing U.S. consumption, the U.S. has to borrow more and more, and the borrowing then comes from the vendors. We get vendor financing from Asia. They save, produce, export and lend us money so that we can buy more and more.

Now, this lending is really interesting because a lot of the lending from Asia comes from two sources: the Japanese Central Bank and the Chinese Central Bank. There is some private flow of capital in the U.S. and it's been during the U.S. technology bubble of the late 1990s, fell off, and has been relatively low actually in recent years, but the central banks jump in to pick up the slack.

Are the central banks investing in U.S. Treasuries because they think the U.S. economy is the place to put their bets or are they investing U.S. Treasuries because that's what keeps the dollar strong and that's what keeps the export machine going? I submit to you it's primarily the latter motivation.

The question is how long can this go on? And the answer is nobody knows, but the answer also is that there is great nervousness and fragility in this system. Recently, a minor official in the Bank of Korea used the word "diversification" suggesting that maybe the Central Bank of Korea might move a bit out of dollars. The Dow fell 200 points instantly. All of the world central bankers are watching each other like hawks because the last guy out really takes a beating.

And so nobody can predict when the next long-term credit management blow-up might occur. Nobody can predict when a small player in the system without a big stake in exports to the U.S. might decide that a better place to put their reserves is in Swiss francs or euros or something else and start a cascade effect.

But even if none of the dark scenarios occur, for sure what is occurring is a huge build up of claims abroad on U.S. assets and a long-term necessity of Americans to finance those claims and, as Dr. Cooper said, without necessarily the investment in the United States' capacity to produce the finest. So this looks to me like an unsustainable system. Thank you very much.

[The statement follows:]

Prepared Statement of Clyde Prestowitz
President, Economic Strategy Institute, Washington, D.C.

With the U.S. economy on life support lending from the central banks of China and Japan and the White House backtracking on open markets in textiles, steel, and agriculture while proving unable to conclude new free trade deals, it's time for American economists, CEOs, and political leaders to fess up. In its current form and mode of operation, globalization is ultimately unsustainable and is presently undermining long term U.S. welfare and power.

As usually presented in the press and quantified in economic models, globalization presumes a world of private enterprises engaging in free trade through open markets under conditions of transparency and rule of law. Nothing could be further from reality.

In fact, the global economy is bi-polar. One bloc of countries—the United States, the EU, Canada, Mexico, and a few others—run according to a kind of "dirty" free trade model. The others pursue a variety of forms of mercantilism. This reality is obfuscated by the fact that all pretend not only to be playing pure free trade, but that all the others are too.

The result is a world in which there is one net consumer—the United States. All others (even the "dirty" free trade EU) are net sellers, depending on exports directly or indirectly to the U.S. market for all or most of their growth. U.S. annual consumption is now $700 billion more than production. World growth depends entirely on growth in this consumption, which can only be maintained by borrowing from abroad, especially from the above noted banks. Thus the global economic role of the United States is to borrow ever more in order to consume ever more so that the rest of the world can export ever more.

In contrast, the mercantilists suppress consumption (by, for example, limiting consumer credit), compel high savings rates (in some cases by simply deducting from your paycheck), subsidize investment and exports, protect key markets, and manage the dollar exchange rate to keep their goods and services underpriced while those of America remain overpriced on world markets. Although it tends to transfer U.S. production, technology, and investment abroad, American leaders, Republican and Democrat alike, have long acquiesced to these practices because they keep prices and interest rates down while stimulating short term growth through, among other things, home equity financed consumption.

One result of all this is that the United States is now absorbing about 80 percent of all available global savings, a figure suggests the ultimate denouement. When the number hits 100 percent, the music will stop. And because U.S. and world growth depend on ever rising U.S. consumption and borrowing, the number is mathematically almost guaranteed to hit 100 percent. Thus the sustainability of the system has been in question for some time. Recent developments, however, have dramatically sharpened the question.

Three billion new participants from China, India, and the former Soviet bloc have suddenly entered the global economy in the past ten years. Standard international economic doctrine holds that people in developing countries typically have low skills and that their low wages are offset by low productivity because of lack of technology and capital investment. It is further assumed that they can't easily move abroad and that capital and technology can't easily move to them. Hence, their low wage production poses no threat to high wage developed country workers.

With the advent of the Internet and global air express a new wave of globalization has made most of these assumptions no longer valid. Capital moves instantly around the world at the click of a mouse. Technology goes where it finds smart peo-

ple and financial incentives. And people move quite easily and almost instantly in the virtual world of call centers and business processing offshore.

On top of this is a unique aspect of these three billion new participants. While on average they are poor and unskilled, because there are so many, a large number of them (perhaps equal to the population of the United States) have the unexpected combination of the highest skill levels with the lowest wages. The new globalization puts them all effectively in the next cubicle, and their ticket to the good life is to combine these low cost skills with the mobile technology, capital, and virtual workplace to produce more U.S. bound exports financed by more U.S. borrowing from China and Japan.

In theory, of course, as these new participants sell more, their wages will rise and they will consume more, including more U.S. made goods and services. So everyone will win. But that's where the problem is. It hasn't yet happened that way. Japan and the Asian tigers have not become net consumers as they have gotten rich. Just as the U.S. structure of consumption is hard wired so is the mercantilist structure of export led growth.

While necessary, dollar devaluation, Federal budget deficit reduction, and other conventional nostrums are insufficient solutions because they are based on invalid assumptions. Without dramatic commitment to fundamental change the global economy will go over the cliff. Before it does so we need to rethink our understanding and operation of globalization.

Today a third wave of globalization is washing over the world. Riding its crest, the two giants of Asia—China and India—are coming back into their own after six hundred years of impoverishment and servitude. The key elements of this new wave are the negation of time and distance and the rapid transfer of technology from advanced to developing countries. The already struggling machinery of the American-led globalization of the Cold War will be battered and strained further, perhaps beyond repair, by the impact of the 3 billion new capitalists. The new wave will dramatically change corporate strategy, the balance of power, and the everyday lives of billions of people, from the elite "masters of the universe" to ordinary citizens in America and abroad. It will empower individuals as never before and bring into action talents and players long ignored. One of its defining characteristics is that it will be less driven by countries or corporations and more driven by real people. It will unleash unprecedented creativity, advancement of knowledge, and economic development. But at the same time, it will tend to undermine safety net systems and penalize the unskilled. Nondiscriminatory and already less American and less first world, it will challenge the livelihoods of heretofore secure professionals in Europe, the United States, and Japan. Indeed, it will challenge all the conventional economic wisdom as it shifts wealth and power to Asia.

For example, take immigration. Historically America has attracted immigrants in search of opportunity and work. More recently this has also been true of Europe and even, to a lesser extent, of Japan. Now, however, the flow is going the other way. Some of the work is emigrating to seek the workers, and former immigrants are going home where opportunities now seem better. China has become the location of choice for global manufacturing, while India is becoming the destination for software development and services.

These new players are creating new markets and ways of doing business as well as substantial and badly needed centers of demand in the global economy. China has just displaced America as Japan's biggest trading partner and is supplying the demand for possible Japanese growth. Its enormous appetite for food and primary resources is also spurring development from Indonesia to Brazil. At the same time, the new wave is rapidly raising demand for scarce water, accelerating decertification, and poisoning both the water and the air with pollution. On top of that is the question of energy. The entire world will become more dependent than ever on Persian Gulf oil suppliers, even as the price of oil ratchets ever upward. Both energy and environmental issues will challenge not only the United States but also China and India and the rest of the world.

As these developments shift the basic structure of the global economy, they are calling into question assumptions that have long dominated global economic policies. Business executives, economists, and political leaders have resisted rethinking them even when they seemed seriously out of whack with realities. These issues remind me of the flaws in the Titanic, since the global system could founder on them, absent new thinking more compatible with the realities of the new wave of globalization:

- The U.S. trade deficit is now over $600 billion, or about 6 percent of GDP annually. As a result, the United States has swung from being a major creditor nation to having the biggest debt—now nearing $3 trillion. These unprecedented

amounts, however, have been dismissed as potential problems. They have even been called signs of strength by some who claim they just mean the U.S. economy is growing faster than others. This growth also supposedly makes it easy to finance them because foreigners will want to invest in the fast-growing U.S. economy. More recently, however, leaders like Federal Reserve Chairman Alan Greenspan and former Chairman Paul Volcker have begun to express concern that the deficits may be unsustainable, while the headlines included in the Prologue testify to the concern of foreign leaders. The United States now needs a fix of over $2 billion a day of foreign money coming in. Without new thinking, there may be a day when it doesn't come.

- Behind the trade deficit lies the zero savings of American households, the Federal budget deficit, and the excessive savings rates and mercantilism of a number of other countries. None of these phenomena are sustainable.
- Can, and should, the dollar last as the world's currency? Heretofore there have been no real alternatives; but with the advent of the euro and discussion of an Asian currency unit, that situation is changing. The special role of the dollar as the world's money removes all financial discipline from the United States and enables currency manipulation by other countries. This is the key Titanic-like flaw in the current system. It cannot last. But how and when to change are crucial questions not presently being addressed.
- Does manufacturing matter? In the United States, manufacturing has declined from 23 percent of GDP in the 1980s to 12.7 percent today. Europe and Japan have also seen a decline but smaller than in the United States. The conventional wisdom holds that the structure of an economy, what it makes, and the services it provides are not terribly important and should not be the subject of government policy. According to this view, linkages between industries and technologies are unimportant, and technology development is independent of manufacturing and production. This view also seems to be at odds with the realities of the third wave of globalization. Beyond that is the question of balancing the trade deficit, which is mostly in manufactured goods. But the United States does not have enough physical manufacturing capacity to export its way to anything approaching a trade balance even if the dollar goes to zero value. Services exports can surely rise, but it is unlikely they can completely fill in the gap. Without some development in manufacturing, therefore, the only way out of the trade deficit is a significant cut in consumption. Thus the question, does manufacturing matter?
- Economists have held it as an article of faith that high-tech manufacturing and services are done in advanced countries, while routine, low-value work is done in developing countries. But China has more semiconductor plants under construction or about to go into operation than America has. All mobile phone makers have moved most or much of their R&D to China. Nor does India limit itself to mundane software development; it also works at the cutting edge. As for services work, radiology, heart and joint replacement surgery, and pharmaceutical development are regularly outsourced to India. U.S. and European companies emphasize that they do a lot of high-tech work in China and India because they can't get it done as well at home.
- It has long been assumed that as manufacturing jobs disappeared, the service industries would provide secure, high-paying jobs to compensate for the loss of manufacturing. That view, however, is pre-Internet and pre-third wave. It may not be sustainable in the world of 3 billion new capitalists all online.
- The view that the uniquely inventive U.S. economy will always maintain economic leadership by doing the next new thing no longer necessarily holds. U.S. spending on research and development has declined in critical areas, and its technology infrastructure is deteriorating. Other countries are graduating more scientists and engineers, while America graduates fewer and fewer. Most important, the leading U.S. venture capitalists and technology firms are taking R&D and new start-up company development to Asia as fast as possible.
- The MBA and the American business model have had great influence on how business is done worldwide. The success of U.S. business has been largely attributed to its management and its focus on shareholders as opposed to stakeholders. Yet much of the U.S. business success has been due to government support and fortunate circumstances. The change in circumstances and the rise of strong non-American companies with different concepts of their purpose and objectives may require a whole new way of thinking about business.
- Although Western, particularly U.S., business leaders tend to disdain intervention in their affairs by their own governments, they frequently curry favor with authoritarian foreign governments. This practice may make them more subject to the policies of foreign governments than their own. Ironically this situation

has been fostered by Western government officials who disdain the whole notion of an economic strategy. None of this thinking may be sustainable in the wake of the third wave of globalization.

- The level playing field concept is much loved by Western political leaders who are quick to call Asian countries trade cheaters while insisting that Western workers can compete with any on "a level playing field." But the truth is they can't. Advanced country workers with the same skills as Chinese or Indian workers will not be able to compete unless they are willing to accept Indian or Chinese wages. Moreover, in a peculiar way, the playing field will tilt toward the two new giants of the global economy. The potential size of their markets, their endless supply of low-cost labor, the unique combination of many highly skilled but low-paid professionals, and the investment incentives offered by their governments will constitute an irresistible package that will attract investment away not only from the first world but from other developing countries as well. China, for example, could be a real problem for Mexico. The only sensible response is massive investment in education and up-skilling of the workforce. Only those who have capabilities no one else has or can work better than anyone else will be secure.
- Americans are likely to find themselves increasingly uncompetitive as individuals. They have never understood the extent to which their high standard of living has been the result of good luck rather than personal virtuosity. In the new world of no time and no distance where education will be at a premium, the poor quality of U.S. secondary education will be even more of a disadvantage than it is now. American students now rank near the bottom of all the comparative international tests. To have any chance of competing on a level playing field, the United States will have to find a way to reverse that situation.
- Unless China and India go totally off the rails, they will become the world's largest economies in the middle of this century. The European Union is already the world's largest economic unit and will remain larger than the United States indefinitely. Despite U.S. military might, the balance of international influence and power is already shifting. As the National Intelligence Council says, the international power situation is more fluid now than at any time in the past half century. The challenge for the United States will be to play its currently powerful cards to shape a new balance of power favorable to its interests in a future when it will be relatively much weaker. Will its pride allow it to recognize that reality?

But these are all subsets of a much larger question. Today's global economy is the most integrated and it offers greater potential opportunities than ever. Yet, in many respects it resembles the Titanic, a magnificent machine with serious and largely unrecognized internal flaws heading at full speed for icebergs, armed with knowledge and assumptions significantly at odds with reality.

At a recent conference in New Delhi concerning the future development of India and China, I was the only American on the program—or in the audience. Nevertheless, the economic discussion was couched in terms of dollars. Charts and tables relating to Indian or Chinese GDP growth rates, export and import volumes, foreign reserve holdings, and other variables were all denominated in dollars. Even when I had the bad luck to run short of Indian rupees in the middle of the conference, the coffee service gladly took my dollars. Nor was this surprising. Wherever I have traveled for the past forty years, people always and everywhere have readily accepted dollars. Few of the conference participants considered that the Indian and Chinese economic developments they were discussing could serve as catalysts for the end of the dollar era.

Yet that possibility was made clear to me on the return trip, when I stopped in Frankfurt for lunch with some German friends. The conversation turned to how inexpensive things are in the United States these days. When I mentioned the price of a new house in Washington, one of my friends became a bit confused and asked what that would be "in real money," by which he meant euros. It was a perfect reversal of the classic American tourist's question to anyone spouting prices in currency other than dollars. It was also a brutally insightful commentary on a developing financial shift of truly global proportions. Over the past four years, the chronic U.S. trade deficit has reached unprecedented levels, and the dollar has begun to weaken as a consequence. Of course, this has happened before and the dollar has not lost its global primacy despite a cumulative decline of 70 percent over the past fifty years. But this time it is different.

In today's global economy, one net consumer—the United States—is accumulating a huge trade deficit by buying more than it produces at an ever-accelerating rate. While it imported $600 billion more than it produced in 2004, it will import an ex-

cess of nearly $700 billion in 2005. The money to pay for this excess has to be borrowed from the rest of the world. So far that has been no problem because the rest of the world saves by consuming less than it produces, and then lends the savings to the United States so that we Americans can import the excess production of the other members of the global community. These U.S. imports create export-led growth for the rest of the world while adding to the growing U.S. trade deficit. Thus Americans borrow and buy more and more while the rest of the world saves and produces more and more. It then lends more and more to the Americans so they can spend more and more on imports from abroad.

This has been going on for a long time, and for a good reason. It suits all the players fine. The Americans get to live beyond their means, and they love it. The best part is that because individual Americans are not borrowing the money, they get to believe they are actually earning their high standard of living. The non-Americans also like it. The extra American demand enables them to invest more and grow faster than they otherwise could, particularly in what they consider key industries. It also allows them to earn a reserve of dollars that can cushion shocks and provide leverage in global financial negotiations. So everyone is happy. If the Americans could guarantee to buy more than they produce at an ever-accelerating pace indefinitely, while the rest of the world guaranteed to keep lending to America at the same pace, everyone would remain happy. Unfortunately, neither side can make those guarantees.

Here's why. American consumers have been buying so much on their credit cards and home equity lines that U.S. household debt is now at an all-time high of 120 percent of household income.[1] Once the credit cards and home equity lines are maxed out, the kids all have part-time jobs, and mom and dad both work full-time, it is just not possible to consume more unless earnings start rising more rapidly. But earnings can't rise. The lack of domestic savings is holding investment down, and the rapid move toward outsourcing and offshoring, along with technology-driven productivity gains, is restraining all but executive wages and salaries. And an aging population with lots of retirees means less consumption and less growth over time. Finally, the United States is already absorbing a large portion of the world's internationally available savings. At current rising debt rates, there simply may not be enough global savings to fund the American need.

There are also pressures on the other side of the equation. The great pools of world savings are in Asia, particularly China and Japan. But the aging of Japan's population has already cut savings rates from 15 percent to 6.4 percent.[2] In China, which is also aging, popular pressure to realize the fruits of economic growth through more consumption is also likely to cut savings rates. This is broadly true for the rest of East and Southeast Asia as well. More immediately, however, many foreigners are growing uneasy about the long-term value of the American IOUs they have been piling up. Foreigners effectively lend money to the United States in several ways. Private investors, for instance, might buy U.S. stocks and bonds or real estate or locate new factories and offices on U.S. territory. All of which brings foreign money flowing into the U.S. coffers. Foreign central banks also invest in the United States by acquiring Treasury bonds or buying the dollar in an effort to prop its value up when foreign exchange forces are tending to push it down. During the dot.com bubble of the late 1990s, the vast bulk of foreign money flowing into the United States belonged to private actors rushing to invest in the new El Dorado. In those years, however, the United States needed only $100 billion–$200 billion to balance its deficits.

Recently that amount has grown to nearly $700 billion annually, even as the crash of the U.S. stock markets and a recession have driven many private foreign investors out of the market. They were replaced by their countries' central banks, which are now sitting on enormous piles of U.S. Treasuries, dollars, and other assets. Twenty years ago, America was the world's biggest creditor. Now the world's central banks are choking on close to a net $1.5 trillion of American IOUs and increasingly wondering if Americans are really going to make good on them. They especially wonder this when they consider two developments. One is the rapid offshoring of U.S. manufacturing, software, and services, and the other is the likely continued decline of U.S. savings, as the Federal budget deficit widens under the

[1] Alan Greenspan, "The Mortgage Market and Consumer Debt," remarks before the annual convention of America's Community Bankers, Washington, D.C., October 19, 2004, http://www.federalreserve.gov/boarddocs/speeches/2004/20041019/default.htm.

[2] Teruhiko Mano, "Decline in Savings Rate a Warning to Reform-Resistant Politicians," *Japan Times Online,* June 28, 2004, http://www.202.221.217.59/print/business/nb06__2004/nb20040628a1.htm.

impact of rising social security and health insurance obligations. Both will make the current account deficit get much bigger before it gets smaller.

How did we get into this pickle? Of the many factors, primary have been America's misuse of the dollar, our falling savings rate, our soaring trade deficit, and the myth of free trade, along with the excessively high savings rates, production, and exports of other countries. Let's start with the abuse of America's privileged role as the issuer of the world's money—the dollar.

When President Nixon announced the end of the dollar's link to gold and created today's dollar standard, he effectively made the global financial system dependent on America's good behavior. With no necessity to make good on its obligations in a world with no alternative reserve currency, America was literally licensed to print international money. It could exchange green pieces of paper bearing pictures of Presidents for whatever it wished to buy. Do America's gas guzzlers need more oil? Print greenbacks and send 'em to the Saudis. Are American kids in love with everything made in Japan or China? Just run off some of those Presidential pictures and send them along. America could have anything it wanted without having to consider the value of what it was getting against the value of what it was giving because—except in a very abstract way and over a very long term—it wasn't giving anything of value.

With no potential discipline or real obligations involved, America's international trade accounts became accounting artifacts. When I was a student in the 1960s, the monthly trade and balance of payments statistics were prominently reported, and France's periodic demands for more gold from Fort Knox were hotly debated. After the Nixon shock, however, this all got relegated to page 42, and America stopped worrying about international trade. Other countries had to count their reserves and find ways to earn dollars in order to procure necessities from international suppliers. But not the Americans. They just ran their printing presses and bought whatever they wanted. If they happened to buy more than they produced, what difference did it make? In fact, it was actually good to buy more than you produced because the world needed an engine of growth, in view of the fact that the Asians saved too much and consumed too little.

America's emphasis—with the memory of the Great Depression still fresh—on consumption as the driver of economic growth after World War II has a twin—a declining national savings rate. From 1947 to 1973, America's national savings—the combination of household, corporate, and government budget surpluses and deficits—fluctuated between about 8 to 15 percent of GDP. Since 1980, however, everything has gone south. What lies behind this trend is both difficult and easy to explain.

The difficult part is personal savings. Over the past twenty-five years it has steadily declined, from nearly 10 percent of GDP in 1979 to almost nothing today. One factor, clearly, has been the heavy promotion of consumption. As a teenager in the late 1950s, I never received an unsolicited credit card in the mail. When my children were teenagers in the late 1980s, they were each getting two or three a month. In 1968 outstanding consumer credit (calculated in year 2000 dollars) was $119 billion. By June 2000 it had soared to nearly $1.5 trillion. In 1970 only 16 percent of households had a bank type of credit card. By 1998 that figure had climbed to nearly 70 percent.[3] So aggressive are the credit card companies that they use data-mining techniques to identify people with high debt balances on their present cards in order to ply them with additional card offers. I can remember when most retail stores were closed on Sundays. For my children, that is unimaginable.

This shop-till-you-drop mentality did not evolve unaided. For a long time, the interest on credit card debt was tax deductible because the government thought shop-till-you-drop was good for the economy. Even when the feds eliminated the deduction, they provided for tax deductibility on home equity loans, meaning you could keep shopping as long as you owned a house. And don't forget President Bush's stirring injunction to the nation following 9/11. After declaring "war on terrorism," he urged Americans to support the effort by shopping to keep the economy going. The same year, Alan Greenspan, Director of the Federal Reserve System and the nation's top economist, slashed interest rates virtually to zero after the collapse of the dot.com bubble in an effort to hold up consumer spending by encouraging home equity loan-based buying. Over the past fifty years, "saving" has almost become a bad word. Hardly anyone wants you to do it.

But the rise of consumerism only partly explains the decline of saving. There has also been a tightening squeeze on the average family's finances. After more than doubling from $21,201 to $43,219 (2003 dollars) between 1947 and 1973, median

[3] "Credit Cards: Use and Consumer Attitudes, 1970–2000," Federal Reserve Bulletin, September 2000, pp. 623–634.

family income went nowhere for the next twenty-two years, rising only to $48,679 in 1995.[4] It jumped to $54,191 in 2000 but then dropped back to $52,864 in 2002.[5] Had the 1947–1973 trajectory held, median family income would now be approaching $100,000. Even more revealing, over 80 percent of households in my youth in the early 1950s only had one earner. Today over 70 percent have two.[6] One could argue that the real per capita standard of living has declined. Of course, I must quickly acknowledge that today's houses are bigger than yesterday's, and families now drive two or three cars in place of one and shop online instead of driving to the mall on Saturday. Moreover, the imported clothing, toys, and PCs they buy are very inexpensive and have given families a kind of income boost through lower prices. Michael Cox, of the Dallas Federal Reserve Bank, has written that if you calculate retail costs not in the familiar constant dollars but in the amount of average-wage work time needed to earn something, most consumer goods have grown significantly cheaper over the past generation. Cox argues that the material possessions of Americans at the poverty line in 2000 roughly equaled those of middle-income Americans in 1971.[7] So perhaps "decline" is too strong a word. Still, the average American family has been under increasing pressure to find ways to pay for the average lifestyle. One way to do that has been to save less.

The part of the falling national savings rate that is easy to explain is the government portion. The Reagan tax cuts of the early 1980s did not generate enough economic growth to offset the revenue loss arising from lower tax rates. As a consequence, the Federal budget deficit soared to an unprecedented 6 percent of GDP and further accelerated the decline in the national savings rate arising from the fall in private saving.[8] America was spending far more than it was earning, and conventional analysts began to warn that government borrowing might soak up all the savings necessary to fund private investment, causing a spike in interest rates.

It never happened, because all that American buying included lots of imports that put billions of dollars in the hands of foreigners, especially of Japanese, who seemed to be making everything at the time. With global trade now denominated mainly in dollars decoupled from gold, the foreigners had no alternative but to accept and hold those green Presidential pictures in return for all the Hondas, Walkmans, and Airbuses they were selling us. But rather than just look at the handsome pictures, they used them to buy U.S. Treasury bonds. This funded the burgeoning budget deficit and kept interest rates under control. Americans could have their cake and eat it too. Deficits, whether fiscal or trade, didn't seem to matter for the United States. By implication, neither did savings because, in lieu of its own, America could soak up the savings of the rest of the world. How good could life get?

Actually there were a few clouds in this picture. Social Security was looking as if it would run out of money, and the Federal budget deficit projection was getting so big that all the savings in the world might not be enough to offset it. So Reagan eventually raised taxes, and Bush I and then Clinton raised them even more. That, along with the 1990s dot.com bubble that produced rising tax revenue, put the Federal budget in surplus and offset the continuing fall in private savings to keep total national savings at least in positive territory. Mind you, this was not enough to fund America's investment needs. The country was still borrowing like crazy, accepting those green pictures back in return for Treasury bonds or shares in U.S. companies and golf courses.

Then came the election of Bush II in 2000, and new tax cuts at the moment when private savings were collapsing completely. The budget deficit set new records in each following year, and America's national savings evaporated. In 2004 the Congressional Budget Office and several other public and private groups calculated a U.S. financial shortfall of $2.3 trillion over the next ten years. But official Washington was not worried. As Vice President Dick Cheney said, "Reagan proved deficits don't matter."

Cheney actually had a point. What's the big deal about national savings? So we consume more than we produce, run a trade deficit, and have no savings to fund further investment. But our economy grows and stimulates growth in the rest of the world. Saving is a virtue but not an end in itself. It simply provides investment cap-

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[4] Median family income includes all wages, salaries, and tips, income from self-employment, interest, rent, government cash assistance, dividends, and all other income.

[5] Lawrence Mishel, Jared Bernstein, and Sylvia Allegretto, *State of Working America, 2004/2005* (Washington, D.C.: Economic Policy Institute, 2005), Table 1.6, p. 48.

[6] Mishel, Bernstein, and Allegretto, *State of Working America*, Table 1.9, p. 56.

[7] W. Michael Cox and Richard Alms, "Defining Poverty Up," *Wall Street Journal*, November 2, 1999, A26.

[8] Office of Management and Budget, *Budget of the United States Government*, Fiscal Year 2005, Historical Tables, Table 1.3, http://www.whitehouse.gov/omb/budget/fy2005/sheets/hist01z3.xls.

ital for the real objective: growth and higher living standards. If you can get the capital without saving, that would seem pretty close to paradise. This is where American conservatives like Cheney think they are. They firmly believe that American democracy holds the secret to superior economic performance. Conservatives know that America's investment needs have long outstripped its now nonexistent savings. But they fully expect that foreigners will cover the gap indefinitely, both because they have no alternative to keeping their reserves in dollars and because they believe the U.S. economy will always yield the best return.

Recent history has seemed to justify this view. After raising concerns about declining competitiveness in the 1980s and recession in the early 1990s, the U.S. economy turned around to produce the longest boom in its history. It seemed to far outstrip the Japanese and European economies in both growth and productivity. On top of that, the Silicon Valley phenomenon, with its stock options, and the boiling NASDAQ market, were making everyone rich. Of course, foreign investors were putting their money in the United States. And who said Americans had no savings? Look at their capital gains in the stock market and at the skyrocketing equity in their homes. If you counted savings properly, it was argued by conservative economists, Americans were the world champions.

Then the market crashed, destroying $8 trillion of value. This is one reason market gains on paper don't count as savings. There were other flaws in the argument as well. Much of the growth was phony. The United States had experienced one of history's great investment bubbles, comparable to the South Seas bubble in the early eighteenth century, the Tulip bubble in the 1630s, and the Japanese bubble of the 1980s. The growth of such bubbles and their collapse are not usually considered signs of robust economic health.

Another apparent justification has been productivity growth. Productivity is the single most important thing in economics. It's the difference between a rich economy and a poor one. If I can produce twice as much as you in the same amount of time, I am going to be a lot richer than you. During the golden age of 1947–1973, productivity grew faster than it ever had, at about 2.8 percent annually. That's why real income more than doubled. For the next twenty years, however, productivity growth languished at about 1.5 percent and real income hardly moved. Then there was a huge jump to 2.5 percent annual productivity growth in the late 1990s, and everyone became euphoric about the new economy and its magnetism for foreign capital.

Still, it's not entirely clear that this jump was real. By creating huge excess investment, bubbles generate high rates of production, and factories running at 100 percent of capacity are always more productive than those limping along at 70 percent. The argument has been made that the huge infusion of IT equipment and processes that accompanied the bubble was a major factor in the jump in U.S. productivity, and it contains some truth. Although productivity growth fell off somewhat in the recession of 2001–2002, it has remained good over the past several years. U.S. analysts, comparing this to the approximately 1.5 percent rates of Europe and Japan, have not hesitated to attribute foreign capital flows to America to its apparently superior productivity.

Yet the way productivity is calculated and the effect of offshoring make it very hard to get an accurate accounting. For example, U.S. productivity calculations are done by a method known as hedonic scoring. Here's the deal. Last year you bought a laptop with a one-gigabit hard drive and a Pentium 3 microprocessor for $2,000. This year you got one for your wife, but it had a two-gigabit hard drive and a Pentium 5 chip, and it cost $1,000. Did computer production fall in the United States or did it double? Measured by price, it fell in half; but measured by computer power, it doubled. The U.S. Government, using hedonic scoring, says it doubled. (It's actually more complicated than that, but you get the idea.) For sure, it didn't fall by half, but is your wife really using all that extra power? Maybe it didn't double either. After all, when you buy your new Cadillac with 400 horsepower to replace an old one that only had 200, you don't consider that you got two cars in place of one. Anyway, the key is that other countries don't use hedonic scoring, so it's not entirely clear how our productivity compares to theirs.

Then there's the effect of offshoring. When companies close factories and move production offshore, they close the worst plants first. Remember that productivity is the amount produced per worker per hour. When the unproductive plant closes, output per worker rises. That's very good, but what of the workers from the plant that closed? Unless they get new jobs that pay as well as and with the same productivity as the old jobs, they become a drag on the economy.

Offshoring adds another complication as well. When my tax accountant moved his back office to Bangalore, it didn't mean he was doing more tax returns. Rather, as he explained to me, by laying off his back office staff and outsourcing the work to India, he would save a huge amount of money. How would this play out in U.S. pro-

ductivity accounting? Here's how it seems to work. Say my accountant sells $1,000 of tax returns. He pays nine back office employees a total of $500 to crunch the numbers and pockets $500 in profit for himself. Thus, before the switch to Bangalore, the U.S. economy gets to add $1,000 to GDP, and productivity is $100 per person employed. After the switch, the nine American back office workers have become fifteen Indian workers. The cost of doing the work in India is $100, which has to be deducted from the $1,000 gain to U.S. GDP. Thus the number of people required to do the work has increased, but as far as U.S. accounting is concerned, there is only one, my accountant. He is now making a profit of $900; and because he is now the only worker in the firm, productivity has gone to $900 per worker. U.S. GDP has decreased, and the number of people required to do the job has increased. But because most of those people are not in the United States, American productivity has taken an enormous jump. You see how slippery all this can become.

In truth, superior U.S. performance presently explains little of the foreign capital flow. The money now coming into the United States is largely not funding private investment. Rather, it is going into treasury bonds that fund budget deficits and excess U.S. consumption. When you borrow to invest, you expect to eventually pay off your loan and make a return. But when you borrow to throw a big party, you can expect only bigger credit card payments down the road, along with less money available for investment. That's where the United States is right now.

The fault, however, doesn't lie entirely with the Americans. In their efforts to achieve rapid economic growth, first Japan, then the Asian tigers like South Korea and Singapore, and now China have all contributed to the American problem. In *The Wealth of Nations*, Adam Smith argued that the objective of economic activity is consumption. While this may be true for the Asian economies in some long-term sense, their development models all involve the suppression of consumption, along with a heavy emphasis on saving, investment, and production. In Singapore, for example, the government mandates large contributions to a pension fund. In Japan, consumer credit is limited even today. Asian savings rates, at 30 percent to over 50 percent of GDP, are higher than Western rates have ever been except in wartime, which is perhaps not surprising given that industrial development is seen in Asia as a key element of national security and of avoidance of Western dominance. For similar reasons, savings have frequently been channeled not by the invisible hands of bureaucrats. They push investments in industries they think will grow faster and enjoy higher productivity gains than others or that will raise the general level of industrial technology and prevent undesirable strategic dependence. Whether the strategy is economic or geopolitical, it is not aimed at satisfying consumers today.

We have already seen a number of examples of this. The semiconductor industry has been a favorite, with Japan, Taiwan, South Korea, and now China all promoting its development through special financial incentives and regulatory policies. These countries are prepared, in effect, to buy semiconductor plants because those plants are seen as universities-cum-research centers that will bring quick technology transfer. Sometimes there is another factor. In capital-intensive industries with only a few competitors, dominant companies can become quasi-monopolies earning high profits and paying high wages. Sometimes policymakers aim to ensure that their country includes companies that dominate these industries.

Thus, while competition and market forces operate, they are subject to intervention. Nor are the Asians the only ones to use these techniques. Americans and Europeans invented them; RCA and Airbus are good examples. But in the past fifty years they have been used more extensively and consistently in Asia than elsewhere.

High productivity usually requires economies of scale that in turn require mass production. The high Asian savings rates and the drive for mass production mean these countries always produce more than they consume. Their high savings rates mean they cannot sustain their own production and would all go into recession or depression if they suddenly had to depend on their internal demand. In short, they save and produce too much.

There is a solution to this problem—exports. "Export-led growth model" is the phrase coined to describe the Asian approach to economic development. The model has a number of variations. For example, Singapore and China have welcomed foreign direct investment, while Japan, Taiwan, and South Korea have resisted it. But there is a common feature: if you are a country that produces more than it consumes and depends on exports for growth, you don't want a lot of imports. You might want to import raw materials or commodities you don't make, but imports of what you do make, or of products in industries you are trying to build, interfere with your growth. Thus there is a constant temptation to protect, particularly in "strategic" areas. In practice, this temptation has been yielded to in different ways.

The Japanese market has long been notoriously difficult to penetrate, while Hong Kong and Singapore are pretty easy, and China is surprisingly open. However, one characteristic common to all the key Asian economies except Hong Kong (which is essentially dollarized) is managed currencies. They are either pegged to the dollar, like China's yuan, or the object of frequent central bank intervention in the currency markets to conduct a "dirty float." Either way, they usually keep their currencies undervalued versus the dollar.

International economics employs a simple accounting equation to explain the causes and dynamics of the U.S. trade (more accurately, current account) deficit:

Exports − Imports (the trade balance) = Private Savings +
Government Budget Surplus (or deficit) − Domestic Investment

A trade surplus means the sum of private savings and government surpluses or deficits is greater than domestic investment. A trade deficit means the opposite. Over the past twenty-five years, nearly all the discussion of this equation has been based on the assumption that the action is from right to left. In other words, low private savings and government budget deficits have driven the American trade deficits.

Nonetheless, because the formula is an equation, the causality can run from left to right as well. An excess of imports over exports could be causing a reduction in private savings and/or an increase in the U.S. Government budget deficit. This is the effect of protectionism, pegged currencies, and "dirty floats." Companies producing in the United States sell less than they otherwise would, workers earn less, the government collects less in taxes. The result is a shortage of savings relative to investment and an ever larger trade deficit. Just as foreign governments suppress their domestic consumption, so they also help suppress U.S. savings. This is the elephant in the corner that is rarely discussed in polite company.

It is not discussed because to do so would be to challenge free trade policies that have formed the bedrock of the international economy for over half a century. The mismanagement of the global economy that worsened the Great Depression and helped bring on World War II taught postwar leaders an important lesson. Protectionism not only doesn't work; it can be dangerous. That lesson was the foundation of the postwar economic institutions, of the spread of the liberal trading regime, and of the whole second wave of globalization. The new system, built on free trade principles, succeeded because those principles are essentially sound, and there is great truth in the free trade analysis when its major assumptions are operative. But like generals fighting the last war, economists have too frequently fought the last depression while ignoring important new realities.

The impact of 3 billion new capitalists on the United States, along with America's abuse of the dollar and its soaring public and private debt, has made foreign central bankers and finance ministers very nervous. They are all in a global game of financial chicken. If foreigners dumped a large portion of their dollar holdings, the dollar would fall dramatically and cause a recession or even a depression in the United States. Because the rest of the world lives by selling to the Americans, a U.S. recession could be devastating to the rest of the world's economies. Dumping dollars could precipitate global stock and bond market crashes that would bring huge losses to, among others, those doing the dumping. From this perspective, Americans are holding the world's financiers hostage. On the other hand, should things fall apart, the first player who gets out of dollars will take the smallest loss. Thus any hint of significant dollar dumping is likely to cause a chain reaction—fast.

If you are a finance minister or central bank director, this possibility creates two worries. First, if it looks like things are beginning to fall apart and you don't move, you could wind up losing billions for your country, along with your reputation. Second, Americans owe so much that they are sure to be tempted to inflate the debt away. If they do that while you are steadfastly holding on, you will again lose gobs of money, and your epitaph will not be heroic. So all the players, or nearly all (about which more later), are damned if they do and damned if they don't. So far they haven't, but tomorrow is another day.

Recently everyone's nervousness has been reflected in some interesting moves. As private money abandoned the dollar over the past two years, the European Central Bank followed free market principles and refrained from any intervention in the currency markets. American officials said they wanted a strong dollar, but their body language said weak dollar. Consequently the euro, which had languished during the dot-com boom, gained over 35 percent against the dollar in a two-year period. The Bank of Japan, on the other hand, engaged in massive intervention, buying over 623 billion dollars in 2003 in a largely successful effort to prevent the

dollar from falling against the yen.[9] Because the Bank of China keeps the yuan pegged to the dollar by law, it doesn't intervene in the exchange markets as the Japanese do. But its trade surplus means that to hold the peg, the bank has to keep accumulating dollars. While doing so, however, the Chinese have quietly been buying lots of oil. They need the oil, and buying it now with strong dollars is a way to avoid investing in U.S. Treasuries, whose value could plummet in a crisis. The oil producers, in turn, have been taking the dollars from the Chinese and selling them for euros and euro bonds, putting more upward pressure on the euro. The Russians only added fuel to the euro fire when they announced the decision to reverse the dollar-euro ratio of their international reserve holdings. This activity has begun to price European goods out of international markets. As a result, the Europeans are now talking about "stabilizing" the dollar by organizing a joint buying operation with the Japanese. So far the system is still holding together, but it is increasingly shaky.

No one knows for certain what will happen, but clearly the global financial markets could implode very quickly. Former Federal Reserve Chairman Paul Volcker says there is a 75 percent chance of a dollar crash within the next five years. There is a market fundamentalist view that prevails in Washington and parts of Wall Street, that markets are self-correcting and best left alone—a dangerous siren song. Far from being self-correcting, markets tend to excess. They overshoot. Anyone with any experience of markets knows this. When markets are going down, all the weaknesses get concentrated, and you need intervention at the right time to stop things from getting out of control. If the dollar started to melt down, the results could be really nasty. A 1930s-style global depression is not out of the question.[10]

The lack of an alternative to the dollar is the only reason it hasn't taken a big fall already. But now those alternatives are emerging. The euro, though not a perfect substitute, is becoming more attractive. Besides the Russians, others are also sneaking into euros, which is why it has recently strengthened so much.[11] In Asia there is serious discussion of creating an Asian currency unit, or Acu, in imitation of the European Ecu, which preceded the euro.[12]

In the end, it is very simple: the global economy is highly distorted. Americans consume too much and save nothing and the rest of the world, especially Asia, consumes too little and saves too much. There are three ways for this situation to work itself out. Americans could consume less and save and invest more. The fastest way to do this would be to cut the Federal budget deficit. There are two problems. If Americans take all the adjustment, it would entail a big reduction of GDP. Since no political leader could survive that, it is not going to happen voluntarily. Nor is the Federal deficit likely to be cut. If anything, it will increase as the baby boomers retire and cause a dramatic rise in Social Security and Medicare payments. The second option would be for Asia and the rest of the world to cut saving and increase consumption. That will undoubtedly occur over the long run, but in the short run it would slow up the growth that is the raison d'être of these regimes, especially China's. Moreover, if it did occur, the reduction of the flow of Asian savings to U.S. financial markets would cause the dollar to fall.

That is, of course, the third and by far most likely event. When and how it might occur no one knows. Most analysts would like to see a smooth, gradual decline of 30–50 percent from present dollar values. How things develop will be significantly determined by China. To many Western economists China's policies seem foolishly mercantilist. But China's accumulation of dollar reserves has given it great negotiating leverage against the United States, and its policies induce rapid industrial development and technology transfer. So China might decide to prop the dollar up for a long time, as will, almost certainly, Japan. Europe might even join in to avoid the pain of the rising euro. But there is always the unexpected. Vladimir Putin is increasingly unhappy with the United States. Could he show his dissatisfaction by dumping dollars? What about OPEC? There are surely a number of members who have no love of the United States and might jump at an opportunity to dethrone the dollar. Remember also that before the Asian financial crisis of 1997, no one anticipated the damage hedge funds could cause. Recently a little bond market maneuver by Citibank caused a scary ripple in the European markets. There's no guar-

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[9] Japan, Ministry of Finance, *International Reserves/Foreign Currency Liquidity*, January 2005, http://www.mof.go.jp/1c006.htm.

[10] "Soros Warns of Dollar Plunge," BBC News, June 28, 2002, http://www.news.bbc.co.uk/1/hi/business/2072100.stm.

[11] Chris Giles and Steve Johnson, "Dollar Down as Moscow Trails Case for Euros," *Financial Times*, November 24, 2004, p. 17.

[12] Rebecca Buckman and Jason Singer, "Euro for Asia Gains in Allure: Regional or 'Trading' Currency Might Be Steadying Factor," *Wall Street Journal*, October 3, 2003, p. C16.

antee that something like that won't trigger a dramatic dollar crisis, and if it does, it won't just be another decline. It will be the end of the dollar's dominant role as the world's money.

Although America has not yet caught on, its relative economic superiority and power are rapidly slipping away. Far from leading the world on a global march to freedom, the United States could find itself hard pressed to maintain a reasonable standard of living and defend its vital interests. While America still has the best cards, it will have to hold on to them—and learn to play them a lot better. Unfortunately, the hand and the position of play have deteriorated since I first wrote about these issues nearly twenty years ago in *Trading Places: How We Allowed Japan to Take the Lead*. Maintaining a unipolar, hegemonic leadership is out of the question. It is no longer possible nor desirable for the long-term welfare of Americans. But there is much America can and should do to mitigate the impact of wage competition, maintain the promise of opportunity at the heart of the American Dream, provide for a continually rising standard of living more equally distributed, and continue to influence the course of global affairs.

The first step is to realize that there is a problem. America needs to recognize that many of the assumptions guiding its economic policy are at odds with the realities of today's global economy. Its performance in a broad range of areas—including saving, education, energy and water conservation, critical infrastructure, R&D investment, and workforce upskilling—is far below the standard of many other nations. America needs to understand that its refusal to have a broad competitiveness policy is, in fact, a policy. And it gives leading U.S. CEOs no choice but to play into the strategies of other countries. This policy, according to its proponents, leaves decisions to the unseen hand of the market. Actually, however, it leaves them to the highly visible hands of lobbyists and foreign policymakers. It is a policy that ultimately leads to impoverishment.

I have been involved in several efforts to identify principles of national competitiveness. The first one is always that a nation's industries cannot remain competitive internationally if the nation's overall economic environment is not competitive. It is impossible, for example, to have successful world-class competitors based in economies characterized by hyperinflation or lack of crucial infrastructure or low educational achievement. The first priority of American leaders—even more important than fighting terror or spreading liberty—should be to ensure long-term U.S. competitiveness. Without it, nothing else will make any difference. The President should establish an independent blue ribbon commission—headed by the Chairman of the Federal Reserve or another major figure and including leaders from government, private industry, academia, and the media—to assess and make recommendations for shoring up America's long-term competitive potential.

To preempt the gathering financial crisis and ensure a sounder basis for the third wave of globalization, the United States should take the lead in a global effort to reduce the role of the dollar. It must do so gradually and cautiously. Because the whole system now depends on U.S. consumption and the dirty floating of the dollar, any sudden or unilateral change could precipitate disaster. As a first step, the United States might convene a new Bretton Woods Conference of key global leaders to devise a plan. The U.S. Government might announce beforehand the measures it would take to begin balancing the Federal budget and creating more savings in the U.S. economy. It could then ask other major countries to come to the meeting with plans for raising consumption and stimulating their own economies. The initial objective of the conference would be to agree on joint implementation of these plans. It must be joint, since action by only one side would be worse than no action at all.

The second step could be to create an international planning commission, perhaps in the IMF, to develop a scheme for eventual adoption of a new international currency. This might involve interim steps like pricing oil and other key commodities in a basket of currencies including the yen, dollar, euro, and renminbi. Mechanisms for continued coordination of fiscal and monetary policy would also have to be developed.

An alternative reserve currency unit already exists in the form of IMF special drawing rights, or SDRs. These were originally created in 1969 to support the Bretton Woods fixed exchange rate system. Although the collapse of the Bretton Woods system in 1973 and the advent of the current floating exchange rate system obviated the original purpose of the SDRs, they are still used today as the IMF's unit of account, and some countries hold in their reserves SDRs that can be exchanged for IMF member country currencies, just like dollars or gold. The value of the SDR is presently based on a basket of currencies that includes the euro, the yen, the pound sterling, and the dollar, which provides a tie to present market values. Consequently it might provide a vehicle for moving away from today's largely

dollar-based system. Or perhaps some other vehicle would be preferable. The point is ultimately to get away from dollar hegemony.

Such a step away from the dollar as the world's money would be a big one for Americans, given our pride in our country and, by extension, the dollar. But in the long run, discretion is the better part of valor. The dollar's present role makes Americans feel good in the short term, but ultimately it will kill us. The way to maximize long-term welfare and power is to reduce the role of the dollar as fast as possible. I don't mean that the dollar should cease being prominent; only that it should not be the only player.

This leads to another vital issue, that of competitiveness. All microeconomic and international trade issues can be covered by the broad term "structural competitiveness," the area no one has charge of in the United States. We need to have someone constantly studying the building blocks of our economy, looking at how they fit together, and how they might be affected by all the regulatory, legislative, and trade and other factors at work. South Korea is far ahead of the United States in the application of Internet and broadband technology because that country's leaders approached regulatory issues from the perspective of how this technology could enhance economic growth and competitiveness. The United States dealt with the regulatory issues primarily as matters of fairness and competition. No one in the United States was charged with getting the most out of this new technology in terms of growth, productivity, and competitiveness. By the same token, no U.S. official is looking at the financial investment incentives being offered by foreign governments to entice U.S. firms or considering counteroffers to keep technology and those jobs in the United States. Nor is any U.S. official calculating the long-term damage to the U.S. economy of manipulated exchange rates or considering how to respond.

In seeking someone with real power to be in charge of this stuff, the Office of the Vice President might be a good place to lodge the overall responsibility. Below that, how about combining the Departments of Commerce, Energy, and Transportation, along with NASA, into one Department of International Industry and Commerce. The Vice President would chair a President's council on competitiveness that would include the Secretary of this new department, along with the Secretaries of Treasury, Defense, Justice, and State and the U.S. Trade Representative. Whatever we do, however we organize it, the main thing is to take the economic nuts and bolts.

In the rules for national competitiveness, the key point is infrastructure, or an ecosystem of competitiveness. Far from being a few venture capital companies or semiconductor producers, Silicon Valley is a densely interwoven network of universities, law firms, venture capitalists, R&D centers, local government officials, major companies, and small start-ups. In some measure, all depend on each other. Being competitive, therefore, requires just as much attention to the key interrelationships as to the single elements themselves. From this perspective, what happens to important end-use markets or to key intellectual property rights or to university research can be critical to the viability of the whole ecosystem and, ultimately, to the nation's ability to remain competitive. The operation of the system is not necessarily linear. In other words, the disappearance of important companies might have as much impact on the number of students enrolled in the university engineering courses as the decline in that number might have on the ability of the companies to remain competitive.

Moreover, the development of these ecosystems is evolutionary, not revolutionary. The full impact of today's developments might not be felt for a decade or more. The fact that this view (initially an intuitive one that sprang from our experience in high-tech industries and international trade) has since been confirmed mathematically should demonstrate both the legitimacy and the absolute necessity of the government's concerning itself with these developments. Rather than being protectionist or even tending toward picking winners and losers, such concern is their antithesis and would aim to prevent the protectionism and mercantilism that so frequently distort these competitive ecosystems.

In this context, the United States must respond to interventions in foreign currency markets that distort trade and investment decisions by acting as indirect subsidies. Because such currency policies can nullify and impair the concessions made in WTO agreements and may therefore be in violation of those agreements, the U.S. Government must challenge possible violations. The WTO must be persuaded to deal with currency policies that undermine that organization's entire basis.

In the same way, the U.S. Government should actively review the investment incentives other governments are offering to attract major installations from U.S. companies. It is one thing for a factory or an R&D center to be located in a particular place owing to market considerations, but entirely another if the place has been chosen mainly because of tax holidays and other subsidies. The United States should not sit benignly by as perfectly competitive operations are moved overseas in re-

sponse to such subsidies. We should counter with our own incentives. Some state governments try to do this, but their resources are obviously more limited than those of the Federal Government. The U.S. Government ought to know at least as much about the investment thinking of its companies as the Chinese, Singaporese, and other governments routinely do. Just as foreign economic development boards actively work to promote investment in their jurisdictions, so the U.S. Government ought to be working to promote investment in the United States.

A final issue that is of huge importance but little discussed is infrastructure, both physical and institutional. Why are many foreign companies doing their initial public offerings in the United States? Because the U.S. financial markets and corporate governance rules are the most transparent and the best. Still, there is room for improvement, as Enron and other scandals clearly demonstrated. But they are an essential part of what makes New York the financial capital of the world. To be competitive, America needs to keep improving its financial infrastructure while upgrading institutions like the Centers for Disease Control, the National Institutes of Health, and research universities around the country.

The U.S. Government also needs to take a hard look at the country's physical infrastructure. People who travel abroad often have a slight feeling of returning to a developing country. While most foreign cities have a fast rail connection from the airport to downtown, most U.S. cities do not. The whole U.S. air traffic system, from the airlines to air traffic control technology, is obviously under stress. In Europe and Japan, rail is fast, comfortable, convenient, and efficient. U.S. rail travel is torture. Among international travelers, the U.S. telephone system has become a bit of a joke. My mobile phone works better in Bombay than in Washington, D.C. Many of our municipal water systems are getting close to one hundred years old, and the blackout of 2003 showed the weaknesses in our electric grid. We cannot be competitive with a second-rate infrastructure. The U.S. Government needs to make improvement a top priority.

Although its relative power and influence is in decline, the United States at this moment remains overwhelmingly the most important country on the globe. The unusually fluid international alignments present a once-in-a-lifetime opportunity for the United States to use its still vast power to reset the global table in ways that will favor its interests for a long time to come. Five specific initiatives should be pursued in respect to NAFTA, Japan, the European Union, India, and China.

NAFTA should be turned into an economic and, eventually, a political union along the lines of the EU. It is critically important to all of North America that Mexico succeed. This will require greater integration with Canada and the United States than is possible or likely under NAFTA. Steps should be taken toward the full integration of the three economies and the adoption of the dollar as the official currency in both Mexico and Canada—in order to relieve both of the costs of dollar fluctuations while also creating a more efficient market for all.

The NAFTA countries should invite Japan to join, and Japan should also be invited to adopt the dollar as its currency. Here what may seem like madness has a method. Japan, as we know, holds a lot of dollar assets and worries about their long-term value. Its economy is already highly integrated with the U.S. economy, and it has strong links to Canada and Mexico, with which it recently concluded a free trade agreement. It suffers a heavy cost burden as the result of dollar/yen fluctuations and is under constant uncertainty about the possibility of a protectionist backlash in the U.S. Congress. All these uncertainties and costs could be eliminated if it joined NAFTA and dollarized. In addition, dollarization would enable Japan to negotiate a conversion value for its dollar assets that would guarantee their long-term worth. For the United States, this deal would marry Japan's surpluses with U.S. deficits and create a dollar zone in trade balance with the rest of the world. It would also serve to keep Japan in the U.S. orbit and prevent it from slipping into China's.

Far from trying to divide the EU, the United States should do its best to unite it and encourage its expansion, along with the broad adoption of the euro as an international currency. For example, the United States might encourage the EU to incorporate not only Turkey but Russia as well. A bigger, stronger EU means a partner with somewhat similar values to share global burdens. A widely used euro means a necessary discipline on U.S. finances but also a more widely engaged EU likely to want to cooperate with Washington on global problems. Every effort should be made to develop NATO into a truly bilateral military force that can enable joint power projection on a global basis. Russia in the EU would guarantee Moscow's future democratic development and eliminate it as a potential threat while also relieving EU dependence on Middle Eastern oil. The EU is a natural partner for the United States: we need to promote that partnership and thereby enhance our influence.

India is special to the United States for several reasons. It is the largest democratic country, and the success of its democracy is important to democracy globally. Its business leaders are already well acclimated to U.S. values and practices. Both economies are based on English common law and can integrate quite easily. Done properly, economic integration can help both countries solve enormous problems. For America, the rising costs of health care and aging might be ameliorated. For India, access to critical technology and know-how could be enhanced. In view of India's positive demographics and likely eventual emergence as the world's biggest economy, development of a close relationship with India could extend and enhance American influence and welfare. The United States should foster a special relationship with India by negotiating a free trade agreement and perhaps eventually inviting India into NAFTA as well.

Right now, however, the most important bilateral relationship in the world is that between the United States and China. It will be a difficult and complex relationship for a long time. It is in America's interest for China to succeed. The most dangerous thing for the world of the future would be a failing China. Imagine a China with hundreds of millions of people desperate to escape upheaval and catastrophe, or a rogue China resembling North Korea. To avoid such scenarios, we must work for China's success. But we must do so with our eyes wide open, recognizing the element of competition between the two countries and keeping U.S. interests clearly in mind. It is of particular importance that China cope successfully with its pollution, energy, and water scarcity problems. Here there is great potential for joint R&D and the application of U.S. technologies and techniques. The U.S. Government should propose a couple of major joint projects along these lines.

Long ago as a Swarthmore College student, I listened to Scott Paper Company Chairman and Swarthmore benefactor Thomas B. McCabe tell the winners of his scholarship that the purpose of elite institutions of higher learning is to train leaders. Leadership, he emphasized, is what it's all about. I have pondered that statement many times in the intervening forty-five years as I have met a number of world leaders and have asked myself what exactly is leadership. It is good to have intelligent leaders, but intelligence is not leadership. Leaders may be in a position of high office, but all those who obtain these positions are not leaders. Just think of the high officials of 1914, blindly plunging the young men of Europe into the blood bath of World War I. Eloquence is a wonderful gift for a leader, but those who eloquently mouth the conventional wisdom are not leaders.

Essentially, a true leader strives to discover the facts, connect the dots, follow where they lead, and determine how best to face the problem they present, and then shape events and persuade people to embrace the results. Six centuries ago, Portugal's Prince Henry (the Navigator) was bold enough to connect certain dots, to think outside the box and so lead our forebears to the Far East and the New World. We too must think outside the box. The fact that we are now riding a new wave of globalization with 3 billion new surfers presents a unique opportunity for a still powerful America to turn from illusions of empire and exercise the ingenious entrepreneurial leadership that has long characterized it. To do so, we must be mindful of Shakespeare's lines in *Julius Caesar*:

> There is a tide in the affairs of men, which taken at the flood leads on to fortune; omitted, all the voyage of their life is bound in shallows and miseries. On such a full sea are we now afloat, and we must take the current when it serves, or lose our ventures.

Chairman D'AMATO. Thank you, Mr. Prestowitz. Ambassador McCormack.

STATEMENT OF AMBASSADOR RICHARD MCCORMACK
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WASHINGTON, D.C.

Ambassador MCCORMACK. As our earlier speakers have noted, the U.S. current accounts deficit this year exceeded $600 billion with more than $160 billion of it coming from our exports from and through China. By the end of this decade, if the current trend continues this debt will accumulate at the rate of $1 trillion a year, nearly 10 percent of our GDP.

These are some statistics from the Financial Times and from various other econometric sources. This trend obviously cannot continue indefinitely, and as Herb Stein, my old friend, noted long ago, it won't. But the present and projected current accounts deficits and the economic conditions needed to service and sustain these pose problems and potential longer-term dangers to the American economy, the Chinese economy and the broader global economy.

U.S. external debts generated largely by trade deficits now amount to more than $3 trillion. These debts obviously entail interest and other service charges. Growing nervousness about the magnitude of this debt and the current account deficits is likely to lead to higher future interest rates.

It is also likely to put ever-increasing pressure on the dollar itself which will add to the risk premiums that some investors will want to demand from us.

America has an absolute requirement over time to buy less from abroad, sell more overseas or some combination of the two. More and more of the fruits of our work and productivity will otherwise go to foreign creditors and interest payments. This ultimately could impact living standards depending upon the ultimate size of our external debts.

Competitive conditions on global markets, including existing currency ratios, will make it difficult to convince investors to create capacity in the United States to generate more tradeable goods and services on the scale we need to work our way back to a healthier current account balance.

The longer we delay this process, the greater the debt accumulation and the long-term service charges will be. It also means more painful adjustments overseas when the American market is no longer as available to exports as has been the case under current competitive conditions.

A significant and sudden depreciation of the dollar is only one of several possible factors that could limit the U.S. markets. This will generate problems in Asia that could eventually spread to the financial systems of some of these countries. Again, the longer we delay this adjustment, the more painful it ultimately will be to all involved.

The great value of market economics is that price signals encourage gradual adjustments, adjustments that carry with them the least negative political and economic consequences to impacted societies.

Large-scale intervention in the markets by governments that blunt and delay the impact of the normal function of the markets in currencies and other factors often create unsustainable conditions subject to sudden crises.

Today we have in effect the recycling of the U.S. trade deficit with Asian central banks buying U.S. Government bonds and other dollar instruments. This process poses some of the same potential dangers that the earlier recycling of petrodollars inflicted on the global economy. It creates the illusion that the current consumption and investment patterns are more sustainable than, in fact, is the case.

It results in the creating of more manufacturing and export facilities in Asia than the longer-term U.S. economy can absorb. Just

as the commodities boom of the 1970 turned into the commodities bust of the 1980s because of overinvestment and overproduction, so too today's overinvestment is likely to result in a deflationary situation in China and in certain global markets later in this decade.

Consider the Japanese bubble economy of the 1980s with excess monetary growth and production capacity. It ended dramatically in 1990 followed by a disastrous sustained deflation in economic stagnation that has lasted 15 years and we have not see the end of it yet. There are many instructive lessons to be learned by examining the causes and consequences of the Japanese boom, bubble and bust.

For those of you who are interested, I have brought with me a paper written on this subject in 1992 with a diagnosis of this and a projection, and it has stood the test of time.

We could easily witness another such bust in Asia in the years immediately ahead if weakness in the Chinese banking system and persistent signs of overcapacity in production in real estate are any indications.

Let me give you an example of what is happening in the banking system of China. Since 2002, there have been $22 billion worth of auto loans given to consumers in China. Of those $22 billion in auto loans, more than half of them have defaulted by the official statistics of the Chinese government itself. Now, consider the implications of this. Consider the loans that were made to people who were not able to afford these expensive cars. And this default rate did not suddenly happen.

The Chinese could see this was happening, but it created the artificial impression that there was a larger consumer base than, in fact, was the case. This encouraged more people to build automobile factories in China to service this market, which is ephemeral, but the factories are there in China, the technology is there, the workers have been trained, the engineers have been trained. We have in effect created the basis for what will soon be a major auto export industry coming from China added on top of strains and stresses from the global economic imbalances that are becoming more and more apparent. Within the past few months, there have been threats, as the previous speaker noted, by some central banks to diversify reserves out of the dollar and into the euro. Malaysia and Singapore have both acted to reduce dollar exposure. China and Japan have not done so, but have accumulated reserves of $600 and $900 billion respectively.

The danger of these accumulating reserves is that they leave the U.S. vulnerable to economic and political pressures from abroad. In particular, China's decisions on how to allocate their vast and growing reserves will increasingly impact global financial markets, including interest rates and currency ratios.

In today's massive derivative market, sudden unwelcome changes in reserve allocations away from the dollar could be highly disruptive, even dangerous, in certain unlikely but possible scenarios. Any disruptive action by China has potential harm for China in terms of the market value of its assets and in terms of the longer relationships with its largest market, the U.S. Thus, I consider the likelihood of disruptive Chinese deployment of dollar assets to be unlikely.

But it is not impossible. Consider what happened in 1956 concerning the element of vulnerability of Nasser. He was considered unstable—they weren't sure whether he could manage the Suez Canal and what rates he would charge. So Britain and France attacked. As the invasion unfolded, the American Government was upset about the deception of British and French intentions and threatened to withdraw all support for the vulnerable British pound, bringing the operation to a complete and humiliating collapse, forcing the resignation of the Prime Minister of Great Britain and no one ever again referred to Britain and France as great powers.

We cannot allow our dollar to become vulnerable as was the case of the British pound, which if you extend what is happening with our current accounts out to annual accumulation of a trillion dollars a year is exactly, in fact, happening. The greater this potential leverage occurs, the greater the temptation is going to be to exploit it.

We also need to be mindful of former Secretary Kissinger's recent warnings about allowing our manufacturing capacity to deteriorate dangerously.

Some of the current trends are problematic for the long-term health of the American economy. Current conditions are also problematic for the health of the Chinese economy. Current global economic conditions are also dangerous for the world. These explosive increases in Chinese exports which are happening in some respects because they've put their thumb through currency manipulations and intellectual property thefts on the scales of global commerce. This is creating the impression that there is an unfair process underway which is undermining the political support for the current global trading system.

When we have the next recession, which will happen sometime no doubt within the latter part of this Administration, these pressures are going to increase. So China is unlikely to allow a major appreciation of its currency without pressure. This pressure comes from Congress and it comes from people like yourselves. But it is not likely to happen without continued and sustained pressure.

We, however, also need to be mindful of the fact that China is in some respects xenophobic because of the history of the last 200 years where they have been repeatedly invaded and exploited by foreigners. Many of their strategists believe at this particular point that it is time for China to gradually assert its rightful role in the global stage.

This combination of ambition and xenophobia is potentially dangerous. So as we move to deal with the currency problems and the intellectual problems, we also need to be mindful that we do have a long-term stake in the goodwill of the Chinese people and we need to operate intelligently as we effectively accomplish our objectives.

Thank you very much.

[The statement follows:]

Prepared Statement of Ambassador Richard McCormack
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Washington, D.C.

This morning I have been asked by the Commission to touch briefly on some of the implications of the U.S. current account deficit, including that part of the deficit

generated by our present and prospective trade with China, and note some of the related potential U.S. vulnerabilities.

This year, America's current account deficit exceeded 600 billion dollars, of which more than 160 billion comes from our exports from and through China. By end of this decade, if the current trend lines continue, this debt will accumulate at a rate of more than a trillion dollars per year, nearly ten percent of our GDP. (See attachment 1.)

There are three relevant issues that need to be addressed: Each one of these issues deserves deeper analysis than is possible in this brief summary today.

1. Are current accounts deficits on present and prospective levels a problem for the United States?
2. If so, how can these issues be addressed with least possible damage to the American and global economy?
3. What are the economic and security implications for the United States of our growing interaction with China?

Present and projected U.S. current account deficits cannot continue indefinitely; and as my old friend Herb Stein noted long ago, they won't. But the present and projected current account deficits, and the economic measures needed to service and sustain them, pose problems and potential mid-term dangers to the American economy, the Chinese economy, and the broader global economy.

U.S. external debts generated largely by trade deficits now amount to more than three trillion dollars. These debts obviously entail substantial interest and other service charges. At a 5% nominal interest rate long term, each trillion dollars of this foreign debt and other service charges will require 50 billion dollars annually, on top of our future import costs.

The short-term consequences of recycling of part of our trade deficit through Asian central banks and back into the U.S. bond market, undoubtedly helps keep current bond rates lower than otherwise would be the case.

The longer-term consequences of this vast trade deficit, however, are likely to be very different. Accumulating foreign debt and ever-expanding current account deficits are likely to result in higher future U.S. interest rates. It is also likely to put ever increasing pressure on the dollar itself, which will add to the risk premiums that some investors will demand from us.

We are already finding it difficult to attract the necessary two billion dollars a day from the private sector to sustain our current account management, and are growing more and more dependent upon Asian central banks for this purpose. This entails potential political as well as economic vulnerabilities, which will expand as the U.S. dependence on Asian central banks rises.

America has an absolute requirement, over time, to buy less from abroad, sell more overseas, or some combination of the two. More and more of the fruits of our work and productivity will otherwise go to our foreign creditors in interest payments and other financial transfers. This ultimately could impact living standards here, depending on the ultimate size of our accumulating external debts. Our current account deficits deeply trouble many people, including the nation's premier long-term investor, Warren Buffett, who famously sold the dollar short two years ago, and profited from it.

Present global competitive conditions, including existing currency ratios, will make it difficult to convince investors to create the capacity to generate and market more tradable goods and services on the scale the U.S. needs. This will limit our ability to work our way back to a healthier current account balance. We need to improve these competitive conditions with a multifaceted macro- and microeconomic program that also includes changes in the existing relative currency ratios between the dollar and a number of Asian currencies, including China's.

The longer we delay addressing this problem, the greater the debt accumulation and the long term service charges will be.

It also means more painful adjustment overseas when the American market is no longer as available to exporters as has been the case under current competitive conditions. A significant and sudden depreciation of the dollar, triggered possibly by a major shock to financial markets, or loss of market confidence in U.S. macroeconomic management, is only one of several possible factors that could limit future access to the U.S. market. This will generate massive excess capacity problems in Asia and elsewhere that could eventually spread to local, regional, and global financial systems.

Again, the longer we delay this adjustment, the more painful it is eventually likely to be for all involved. The eventual deflationary impact in Asia and Europe of the excess capacity will also be greater, as well as the eventual financial consequences from more bankruptcies.

The great value of market economics is that price signals encourage rational allocation of capital and labor. It also facilitates gradual adjustments that carry with them the least negative political and economic consequences for impacted societies. Large scale intervention in the markets by governments blunt and delay the impact of the normal functioning of the market. Interventions in currency markets, directed concessionary loans by state run banks to state owned enterprises, gross disparities in purchasing power parity of the currency, and similar market distorting practices can create unsustainable conditions, subject to sudden crisis.

Today, unsustainable conditions have created a vast global economic imbalance in trade and payments. To keep this game going in the face of vast and growing U.S. payments deficits, the U.S. increasingly relies on the recycling of the U.S. trade deficit with Asian central banks buying U.S. Government bonds and other dollar instruments. Cash rich commercial entities subject to official administrative guidance supplement this process. This poses some of the same potential dangers that the 1970s recycling of petrodollars inflicted on the global economy. It creates the illusion that current consumption and investment patterns are more sustainable than in fact is the case.

It also results in the creation of more manufacturing and export facilities in Asia than the U.S. economy can accommodate in the mid term.

Just as the commodities boom of the 1970s turned into the commodities bust of the 1980s because of overinvestment, over production, monetary policy errors, stagflation and eventual recession, so too is today's overinvestment likely to result in a deflationary situation in China and in certain global markets later in this decade. Consider the 40% decline in semiconductor prices in the past year alone, far beyond the earlier secular trend, as an example of what may well happen in other sectors of the trading system later in the decade.

Consider the Japanese bubble economy in the 1980s, driven by excessive monetary growth, asset inflation, and investment in production capacity. It ended dramatically in 1990, followed by a disastrous sustained deflation and economic stagnation that included the loss of literally tens of trillions of dollars in vanished land and stock wealth. This trend has lasted fifteen years, and there is as yet no certain end in sight to Japan's economic problems. Japan has also accumulated a vast public debt well in excess of the OECD's estimate of 170% of GDP, when vast contingent liabilities are also factored in. This large debt is today manageable because Japanese interest rates are themselves unsustainably low, about 1 percent in nominal terms. Still, debt service charges already consume about 20% of Japan's annual government budget. Consider the staggering future burden when interest rate charges inevitably rise in the years ahead.

There are many instructive lessons to be learned by examining the causes and consequences of the Japanese boom, bubble, and bust. For those of you who are interested, I have brought with me a paper on this subject I published in 1992, with a diagnosis and projection. It has stood the test of time. (See attachment 2.)

We could easily witness another such bust in Asia in the years immediately ahead. Weakness in the Chinese banking system and persistent signs of overcapacity in production and real estate are clear warning signals. Look, for example, at the default rate on loans to Chinese auto purchasers. Of the 22 billion dollars of auto loans to Chinese consumers since 2002, more than 50% have already defaulted. I emphasize that these are official Chinese statistics, which are unlikely to overstate the actual size of the default rate.

A huge auto industry, mainly built by foreign capital and technology, was thus created to serve this apparently vast domestic consumer market. Undoubtedly an increasing part of the production of China's car industry will soon be directed to the already saturated global export market. It is a typical example of the way that state banks have directed loans to stimulate targeted sectors of the economy, with little apparent thought for the accumulating banking losses.

We need to study carefully the lessons of Japan's bubble and banking debacle as we consider the future in China. No two economic bubbles are exactly the same, but there are enough similarities here to warrant concerned attention.

OTHER POTENTIAL DANGERS

Strains and stresses from the growing global economic imbalances are becoming ever more apparent. The IMF's 2005 World Economic Outlook recently devoted a large section to this worrisome set of problems. I commend this analysis to all of you.

Within the past few months, there have been threats by some central banks to diversify reserves out of the dollar and into the euro. Malaysia and Singapore have

both acted to reduce dollar exposure. China and Japan have not yet done so, and have accumulated reserves of 600 and 900 billion dollars respectively.

You have asked me to address possible contingencies related to these growing current accounts vulnerabilities, increasing dependence on Asian central banks and cooperating national entities to recycle them, and broader issues relating to China's political economy.

The issue of how China's state owned enterprises and powerful bureaucracy deploy their growing market and investment power for political and strategic purposes on the regional and global stage is a subject beyond the scope of this paper. The gradual diplomatic isolation of Taiwan, however, was advanced by just such an exercise. There are other less well-known examples. More of this can be expected in the future. China has shown in the past that it is capable of long term economic planning to achieve strategic and political objectives outside of China's borders. This also includes activities in the Western Hemisphere and the Middle East. How America should react to these trends and potential long-term challenges goes beyond the scope of this paper. It is a subject for collective analysis by our best strategic minds. Our response should not, however, be driven by paranoia, naivete, or short-term commercial interests. It needs to be formulated by top professionals who understand both economics and broader national security considerations and who have full access to classified information.

On a microlevel, the U.S. could become vulnerable to economic and political pressures from abroad as currency reserves continue to accumulate in China and elsewhere in Asia. In particular, China's decisions as to how to allocate their vast and growing reserves will increasingly impact global financial markets, including currencies and interest rates. In today's massive derivative markets, sudden unwelcome changes in reserve allocations away from the dollar could be highly disruptive, in certain unlikely but possible scenarios. Think, for example, of the short-term economic turmoil that could occur in the months prior to a Presidential election, if China wanted to influence the result of that election. No official announcement of reserve reallocation would be necessary. I raise this, not because I think it is likely to happen, but because it is one possible problem.

Think also of the consequences for Europe's export competitiveness in the dollar zone as reserves are shifted from dollars into public and private assets denominated in the euro. Think of the leverage the private threat to do this could later have on European freedom of action. Of course, there are countermeasures that European leaders could take, but they would not be cost free.

Should there be tension between China and the United States in the decade ahead over Taiwan or any number of other potential flashpoints, disruptive changes in the way China manages its huge financial reserves could be an additional stress point at a very unwelcome moment. To be sure, such disruptive activity on the part of China would be very costly to it, both in terms of the market value of its assets and in its longer-term relationships with its largest market, the U.S. If we were once bitten, we would undoubtedly take measures to reduce future vulnerabilities. Thus, I consider the likelihood of disruptive Chinese deployment of its dollar assets to be unlikely. But it is not impossible.

Consider what happened in 1956 between America and its closest ally, Great Britain.

You will recall from your history that in 1956 the British and the French invaded Egypt to prevent President Nasser from seizing Europe's vital trade lifeline to Asia, the Suez Canal. Their powerful armies quickly cut through the Egyptian military defenses.

Unfortunately, our allies lied to the American Government about their intentions, and when the invasion began unexpectedly, President Eisenhower was furious.

The President picked up the telephone, called the British Prime Minister, Anthony Eden, and informed him that if the military operations against Egypt did not cease forthwith, all American support for the vulnerable British pound would terminate immediately.

This caused a humiliating collapse of the whole military operation, and forced the resignation of the British Prime Minster. Never again did the world refer to Britain and France as Great Powers.

Remember, the United States threatened to use its leverage against the vulnerable currency of its closest ally, Great Britain. Will China be more restrained when the chips are down in the middle of a possible major confrontation ten years from now? One cannot be sure.

We also have no idea what will happen politically in China over the next quarter of a century. It is possible that the current system will continue in place or gradually evolve in a more democratic direction. That system, however, is now under pressure, with riots in many parts of China every year against local abuses. What will

happen to that system during a major financial crisis, if unemployment rises and many banks are unable to meet depositors' demands for cash? Presumably China's vast foreign exchange reserves could be deployed to meet a banking crisis, but the frequent concerns expressed about the banking system's weakness suggest that it remains a troubling issue for China's top planners. (Any sudden drawdown of China's U.S. bond holdings to address an internal financial crisis would also, of course, impact U.S. interest rates and currency markets.)

The long history of China tells us that there are periodic struggles among the various power centers: between the court in Beijing, the bureaucracy both in the capital and in various provincial centers, the rich merchant classes of the coastal provinces, the peasantry, and the military. Over the course of each century, no complete or permanent victory by any of the contending classes ever occurs. Relative power constantly shifts due to incompetence, corruption, invasions, extortionate taxation, etc. that create grievances or opportunities. The mandate of heaven is not a permanent possession of any emperor or dynasty.

Thus, none of us have the faintest idea who or what kind of system will govern China in the decades immediately ahead. One assumes that self interest will produce rational decisions. But the cultural revolution was hardly an act of enlightened national interest. It did serve the power interests of a leader who perceived that his grip was slipping. The idea that foreigners are going to manage China's political transition may be a mere hopeful conceit. Even assuming reasonable prudence in avoiding needless provocation on our part, the ability of foreign actors to influence the internal political dynamic in a nation of 1.3 billion people is limited.

In many parts of the world, when the power relationships shift, whether in a joint commercial venture or on a contested border, pressures can develop for a change in the status quo.

If we wish to preserve our current global role, we need to make sure that we also keep a sharp eye on the essential power factors. The military equation is, of course, central. We also need, however, to make sure that the American economy remains an element of national strength, not the weak link in our armor, as was the case with Britain in 1956.

We also need to be mindful of former Secretary of State Kissinger's recent warnings about allowing our manufacturing capacity to deteriorate dangerously. People may disagree with the former Secretary of State, but nobody ever called Henry Kissinger an alarmist or a fool.

If we are wise, we will begin now to consider measures to allow a gradual turnaround in our current account deficits, and begin to create the necessary conditions for the production of more U.S. tradable goods and services for domestic and export use. Current trends are problematic for the long-term health of the American economy.

Ironically, current conditions are also problematic for the mid-term health of the Chinese economy. Buying up surplus dollars by the People's Bank of China is causing an excessive growth in the money supply, which in turn, is causing overheating and overinvestment.

The Achilles heel of the Asian development model, an export led process accomplished in part by various forms of state capitalism, has always been overleveraging of finance. This eventually produces banking and financial crises. China is unlikely to be the exception to this rule.

The current global imbalances and the conditions that produce them are also dangerous for the world. The sustained and explosive annual increase in exports from and through China, running at a 30–40 percent annual compound rate, is helping create a backlash of protectionism in America, Europe, and elsewhere. In the U.S. there have been three million manufacturing jobs lost since 2000. The politics of this alone pose a threat to the global trading system as it now exists.

During the next global recession, these pressures working through democracies, will undoubtedly intensify.

There is also a broader danger to the world. China has suffered enormously in the past two centuries from foreign intrusions and exploitation. There is a sense of historic grievance in China that spills out into period outbursts. The recent demonstrations against Japanese interests in China are only the latest manifestation of this. Many Chinese strategists yearn for China to reassert what they believe to be China's rightful role in Asia and the world. This combination of xenophobia and strategic ambition is potentially volatile.

Thus, as we consider the imbalances growing in the global economy, and the role of China in this development, we also need to be mindful of the need to manage the adjustment with due regard for political and diplomatic considerations.

This is not going to be easy.

China, for example, is unlikely to allow more than a token currency appreciation without significant and real pressure from abroad. Pressure in democracies is generated by the speeches of elected officials, if private persuasion by the executive branch of government fails. The longer the Chinese delay, the louder and more pointed will be the speeches from an alarmed Congress. This will play into the press in China in a way not likely to improve U.S. China relations.

We need to make clear to China that we in fact welcome its modernizing economy, but urge them to pace their export emphasis in such a way that it does not kill the goose that lays the golden eggs either in China or in the world at large. The political and economic support base behind the current global trading system is today imperiled. There is a sense that exchange rate manipulations, directed loans to exporters that will never be repaid, and intellectual property violations are an unfair thumb on the scales of global commerce.

Engineering the necessary gradual reduction in present global economic imbalances is going to require careful planning by the world's major trading powers, including China and the United States. We need to minimize prospects that the dynamics of the adjustment could fatally poison the important relationship between the Chinese and American peoples.

That is going to be a major challenge for global statesmanship.

Equally importantly, the United States needs to develop a macro- and microeconomic strategy involving both medium- and long-term measures to address its own competitiveness problems. Nobody is going to do this job for us. We must organize it and carry it out ourselves.

It is important to recognize that while there is a macroeconomic element in the current global economic imbalance, there is also an even more important microeconomic set of problems that need to be addressed by the United States. This includes currency problems involving several major Asian countries that make us less competitive in local and global markets. It includes large-scale violations of WTO agreements on intellectual property issues that deprive us of a return on our investments in research and development. It includes revamping the U.S. educational system as we did in the post Sputnik era to generate American scientists and engineers in large numbers. It includes avoiding self-inflicted wounds, which is how many view the Airbus agreement in 1992 that failed to block subsidized and virtually risk free development capital to Boeing's largest competitor. The list of other microeconomic obstacles to U.S. competitiveness is extensive.

Taken individually, the impact of microeconomic obstacles to U.S. competitiveness is often modest, but when added up, they constitute a massive barrier to the resolution of our unsustainable and growing current account problem.

Finally, remember the U.S. current accounts problem is not likely to solve itself unless there is a market related train wreck that forces sudden global adjustment. The current account problem was, in part, caused by policy decisions and it can best be corrected by policy decisions. There are two alternatives to addressing the current account imbalance by corrective policy measures. One is to wait until the train wreck occurs. The other is to reconcile ourselves to a lower living standard in the United States, and a reduced security related role for us in the world at large. Unless this latter process occurs on a very gradual basis, it is hard to imagine the American electorate supporting such results.

The Baker/Reagan reforms of 1985, supported by the first Clinton Administration, kept U.S. current accounts deficits under two percent of our GDP for a full decade. It was only the onset of the 1997 Asian financial crisis, and the policy responses to it here and abroad, that gradually undermined the current account correction that President Reagan launched.

The world today is different than that of 1985. In the first place, the U.S. current accounts problem is now twice as large a percentage of our GNP as was the case when President Reagan and Secretary Baker became alarmed and moved to correct it. Secondly, in retrospect, not all of the measures taken after 1985 were effective. Their collective success, however, is undeniable. They turned the U.S. balance of payments trends around and sustained them for a decade. Today, however, our balance payments deficits are out of control.

The OECD has recently issued an alarm about the dangers of the growing global economic imbalances. Five percent of Gross Domestic Product (GDP) is the International Monetary Fund's benchmark for a current account problem that is unsustainable. The United States current account deficit is now at 6% of our GDP and most projections predict a rate approaching 10% by the end of the decade. This is a recipe for an American and global disaster.

The longer we delay in finding a gradual solution to the global economic imbalance problem centered around the U.S. trade deficit, the more painful the eventual adjustment is likely to be for all concerned. The China related issues are only a part

of a much larger macro- and microeconomic problem that the U.S., its G–7 counterparts, and the other major exporting economies, must address on an urgent basis.

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Attachment

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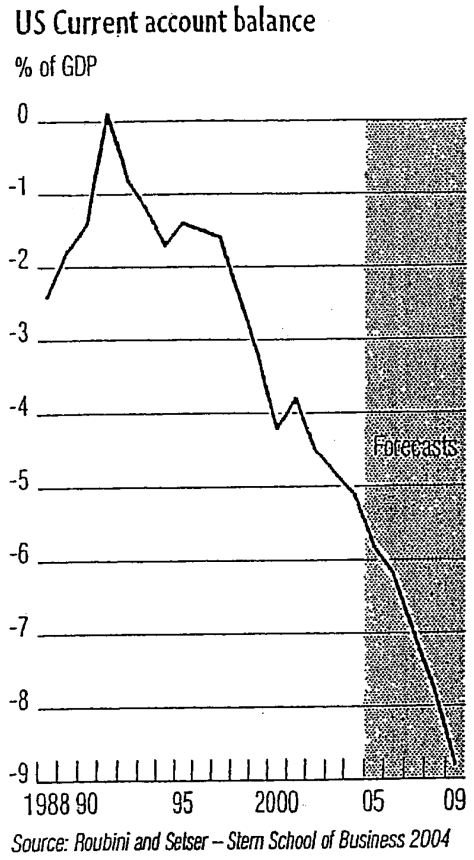

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Panel II: Discussion, Questions and Answers

Chairman D'AMATO. Thank you very much, Ambassador McCormack. I have a quick question for Mr. Prestowitz. Anyone else can join in. I think what you're saying in terms of the two, the bifurcated world, I think you're saying that the Chinese are acting as a mercantilist power; is that correct?

Mr. PRESTOWITZ. Yes, but I'm not limiting that to the Chinese. I think that all of the Asian, the major Asian economies are mercantilist to one extent or another. Japan is a good example. We've been concerned here and talking here, if I understand your Commission on China, we've been talking about the Chinese currency, but Japan is a much bigger player in the currency market than China, and Japan is a much bigger economy than China, and Japan intervenes massively in the currency markets, and it frankly puzzles me as to why nobody is talking about Japanese currency manipulation.

Chairman D'AMATO. I don't know why either. Maybe because the Japanese are more of an ally of the United States in terms of other matters, on Korea, for example. But isn't it true, don't you think, Japan aside for a second, if the United States were able to resolve this currency manipulation with the Chinese, that most of the rest of Asia would probably have to follow suit and that we would then be able to say that most of the currencies in Asia were not being manipulated or else they're being pegged at a more appropriate rate?

Mr. PRESTOWITZ. I have to say that I'm a little skeptical. It's not to say that I wouldn't like to see a revaluation of the Chinese currency, but we've seen this management of currency by other Asian countries before the Chinese became a factor, and while it's probably true that some of the current behavior of other Asian countries is key to the fact that they need to try to remain competitive vis-à-vis China, so from that perspective, if China moved, maybe that would allow a move by some of the others.

But I think there's a factor here that is not being adequately considered, and that is I want to go back to this issue of the structure of the global economy and particularly the structures of mercantilism and the structures of consumerism. What tends to happen as part of the mercantilist program, as was well described earlier by the earlier panel, is a focus on attempting to, you know, an offer of incentives. I mean if you're a high tech foreign company, and you want to build a four or $5 billion plant, you can get that plant almost free in many parts of the world.

Various governments will give you tax holidays and capital grants and so on and so forth. Now once the plant is there, as Ambassador McCormack was trying to make the point earlier, once the plant is there, you know, $5 billion and it produces a lot of stuff.

And you don't close it down because the currency fluctuates by ten or 20 percent. And we have seen our current account deficit; we've seen these imbalances very resistant to currency devaluations. I mean I came into the Reagan Administration when the yen was 270 to the dollar. I can remember during the discussion of the Plaza Agreement, I can agree some of the country's leading economists saying if we could just get it to 220, you know, that would be great. Then it went to 220, and then the leading economist said, well, 180. It went to 180, and we went all the way down to—or all the way up—eventually the yen topped at 79 yen to the dollar. We still have a very large current account deficit with Japan.

Now, you know, I understand that bilateral current account deficits are not supposed to be so significant, but the point is that

we've had a current account deficit for a very long time, very resistant to currency movements because—why—because, because we have structured our economy to consume and we constantly had others tell us we need to save more, and we do need to save more, but it turns out that it's really hard to save more because all of the interest groups and all of the politics are organized around consumption in the United States.

Look at the difficulty we have in dealing with a relatively minor problem like social security. Forget about Medicare and Medicaid and those kinds of things. My son who has just graduated from college and doesn't have a job gets three credit card solicitations a day. This doesn't happen in China or Japan or Singapore.

So it's very hard for us for really to change this structure of consumerism. They're hardwired in mercantilism. All the incentives in China or Korea or Japan or Singapore, Taiwan or Hong Kong, are built into save and to export. That's what they do. And it's very hard to change those structures. So those structures are going to stay there unless you have a massive change in the currency, a ten, 20, 30 percent change in the currency, I don't believe it. It's not going to change these structures.

Ambassador MCCORMACK. May I just add one brief point to this comment?

Chairman D'AMATO. Yes, go ahead.

Ambassador MCCORMACK. As your Vice Chairman will recall, we had a smaller but still worrisome current account problem in the Reagan Administrations. Secretary Baker and President Reagan were concerned about the implications of it and they organized a whole series of measures to correct it, beginning with the Plaza Agreement. The record shows that these policies succeeded in turning around the U.S. current account deficit, which remained less than 2 percent of our GNP for ten years. It shows that if you change policies, you can correct a current account problem. This is also true today. But if you ignore the current account problem, let the trade deficits generate $3 or $4 trillion worth of external debt that requires servicing, the problem will remain and grow. This will over time lower American standards of living, and generate other vulnerabilities.

So we need to intelligently consider how to gradually turn this thing around in such a way that we don't burn down the global economy in the process. A currency appreciation in China and more broadly in Asia is absolutely central to this process.

Chairman D'AMATO. Yes, thank you. Do you agree with that, Dr. Cooper?

Dr. COOPER. I could not disagree more. If we want to create a financial crisis, we do it exactly what we're doing, now which is to put pressure on China to appreciate its currency. The word that's being used officially is to float the currency, but they cannot float at the present time.

Chairman D'AMATO. No, re-peg.

Dr. COOPER. They could revalue at any time. Now, there are two possibilities if they're going to elect revaluation. One is a modest one. That's been the history of revaluation. We have not had so many revaluations in the last 50 years. And they're typically under ten percent. France did 11 percent in 1969.

If they did a modest one, which I think the Chinese would be tempted to do—seven percent is mentioned in the press as a figure—that would be sufficiently small not to persuade anyone, I think, and would nonetheless break the pattern of their current policy and therefore invoke a large flow of financial capital, which is already taking place, into China. Even more, it would provoke a huge movement of capital into other east and Southeast Asian countries. They would then have to cope with it one way or another.

It would be a crisis of capital inflow to those countries, not capital outflow, as in 1997–98, but it would create a very large management problem for those countries. If the Chinese were to bite the bullet seriously and go for revaluation, IIE is talking about 15 to 25 percent—there's a disagreement apparently between the two advocates—but let's say 20 percent.

Chairman D'AMATO. The Schumer bill is basically saying 27 percent.

Dr. COOPER. Yes. Then I think there is a serious risk of bringing the Chinese economy to a halt, not forever, but for several years, and for converting a lot of the performing loans—we make a lot of the nonperforming loans and there are already a lot of them—converting a lot of the performing loans into nonperforming loans in China. These are loans in RMB to exporting firms and a large revaluation would essentially cast into doubt the viability of at least some of the exporting firms.

So my own view is that this is an extremely risky game that we're playing. Financial capital moves readily around the world now, and we run the serious risk of provoking a financial crisis which all of our monetary and financial officials say, of course, is something they don't want.

If I imagine myself in Beijing, I don't see any reason to move except for pressure from the United States. And if I were sitting, to come to your question to Clyde Prestowitz, if I were sitting in Jakarta, Indonesia, and the Chinese did move by even as much as 20 percent, I would argue to myself that relieves some of the competitive pressure on me and I certainly don't want to take it away. I think I'll stay where I am.

So the presumption that China's move will lead to a pattern in which other countries sensibly appreciate their currencies is highly doubtful without a crisis of capital flows that essentially forces their hand. Thus, it is an extremely risky game that U.S. officials and Congress have initiated.

Chairman D'AMATO. That's right.

Dr. COOPER. Not the Asian countries.

Mr. PRESTOWITZ. Can I just add a comment?

Chairman D'AMATO. Let me just ask you one question, Mr. Cooper, because I think this is central to our inquiry here. The assumption is I think that we understand those who are making the case that China is acting as a mercantilist power. In a sense, it's producing highly driven export-led growth. It's keeping its currency at a pegged level. AmCham, the American Chamber, visited us, said one of the major problems is the Chinese are not allowing us into their distribution systems. Their middlemen are clogging up their systems. Our people cannot get into the Chinese distribution

system. Their unwillingness to go down the road at all on IPR. All of these things together mean that the Chinese are basically attempting/building a major nation state, national power, through quasi-mercantilist procedures.

Now, do you agree with that assessment? Is that what we're facing with the Chinese? And if that's true, don't you think we need to do something to help move them back into abiding by the global rules of the game?

Dr. COOPER. Well, I have a resistance to portmanteau labels like "mercantilist." There are no doubt mercantilist pressures in every society including the United States. That is to say, people who want to prevent competition from foreigners. No doubt such people exist in China. Just look at their auto sector. They welcome foreign investment, but they don't welcome auto imports into China.

Chairman D'AMATO. Yes.

Dr. COOPER. So they have a protectionist policy in that regard. I think it's a mistake to lump countries together. Clyde lumped all the Asian countries together. Japan and Korea followed a very different strategy from the one that China is following. They were both relatively closed to foreign investment and they resisted imports. China's imports have been growing extremely rapidly, more rapidly than GDP. Now many of the imports are intermediate products.

Chairman D'AMATO. Right.

Dr. COOPER. But that's worth keeping in mind. Their exports are also products in which the value added in China is modest compared with, say, U.S. exports or German exports. It's a processing country, not exclusively, but heavily a processing country. But imports for final consumption have also grown rapidly into China, and of course they welcome foreign direct investment, encourage it, marking a very different strategy from that followed by Japan and Korea some 30 and 40 years ago.

I don't find it satisfactory to lump both categories of countries together Under the term "mercantilist." Now, do they pursue a policy of export-led growth? That is correct. I actually think it is sensible policy for all developing countries to pursue a policy of export-led growth, if they seek growth.

The ones that tried a policy of import substitution typically failed after a few years. We have many examples of alternative strategies and none of them worked well in developing countries. So the question is, can they pursue a policy of export-led growth? If you like, we can go into the reasons why that's a sensible strategy. China is not a closed economy, and as long as they play by the rules of the game, I don't see anything wrong with that.

I also resist the use of the term "manipulation" for something that's been fixed for a decade. It abuses the English language to call something that has been constant for a decade "manipulation."

Chairman D'AMATO. We have to intervene massively in the currency markets to make sure that fixed stays.

Dr. COOPER. They have done that during the past few years, but remember China still maintains, I think for good pragmatic reasons, tight exchange control on resident capital outflow. They aspire to a convertible currency. They actually had a deadline at one

time, the year 2000, but postponed it after the Asian financial crisis and did not set a new deadline.

They cannot do that until they clean up the financial system and that's not a process that can be done overnight. But if you take, say, a five-year horizon, it's not at all clear to me that the Chinese currency is undervalued. In a free market floating exchange rate system with convertible currency and no controls on resident capital market flows, it is not at all clear to me that the RMB would appreciate rather than depreciate. I am not talking about next month, but in five to ten years. Under those circumstances, it's not clear that it's sensible for China or anyone else to have a big appreciation of the currency now if they face a depreciation of roughly comparable magnitude some time within the next decade.

That would lead to big reallocation of resources within the country and within their trading partners. Not especially in the U.S., because the main shifting would be between China and other low-skilled, low-wage countries. It's not clear to me that that is in anyone's interest. So I am not at all sympathetic with the current course whereby the U.S. Government is pushing China to revalue its currency.

Mr. PRESTOWITZ. I just wanted to add a comment if I could. One, I agree with Dick that this is a dangerous game, and I also agree that the Chinese can't float, and I also agree that any move by China is likely to be a relatively small move, and I also agree that it's not necessarily going to be followed by similar moves by other Asian countries, which brings me back to—and there is, however, one player out there who is a big player, who could take a substantial, who could float, who should be floating. That's Japan.

In the earlier discussion, there was this one point that talked about how developing countries gradually become richer and then they should become consuming countries. And we've been waiting for Japan to become an engine of growth for a very long time. Japan is a rich developed country, and it is committed in principle to floating its currency, but it doesn't.

A move by Japan would have much more impact and would be much easier for the Japanese economy to absorb than the kind of thing we're talking about in China.

Chairman D'AMATO. That's an interesting point. Mr. Cooper.

Dr. COOPER. I'd like to comment on that. Again, I agree with the general characterization. I think, though, there is a problem. First, as I understand it, the yen has been floating for the last year. If we believe press reports, the Bank of Japan has been out of the market since March 2004, a year ago. I don't know if that's literally true, but the yen has recently been floating. It's a concern of Japanese economists, and it's a concern of foreign economists who pay close attention to the Japanese economy—is that the already weak and fragile Japanese economy, and they've been fragile for the last 15 years, would be sent into a serious recession if the yen were allowed to go to say 85 yen to the dollar, where it was briefly in '95, but the Japanese responded very strongly to that, with U.S. help, by the way. There was a joint intervention when the yen did appreciate to that extent that the Japanese situation may be regrettable. What's striking about Japan is how high savings are, in spite of the fact that it's the most rapidly aging society in the world, and the

labor force is actually declining. Savings have come down significantly from their highs of 20 to 25 years ago, but nonetheless Japan remains for age-corrected, a high savings society, with very low returns to domestic investment in Japan. The scope for additional productive is very limited. If these savings are what economists call precautionary savings because of the Japanese uncertainty about their own future, it makes sense for them to invest it abroad.

It does not make sense for them to invest in U.S. Treasury bills, although even that's better than investing in Japanese Treasury bills. But it does make sense for them to invest abroad. I'll take the occasion here, because Clyde mentioned in his opening remarks that foreign private investment had fallen significantly in the U.S., to say that last year, foreign private parties invested over a trillion dollars in the U.S.—over a trillion dollars to purchase U.S. assets. Some of that, about $300 billion, is bank claims. If you take those out, it's still a number that exceeds the total U.S. current account deficit—foreign private investment in the United States. So what we're observing is an extraordinary process whereby even with all of the talk about the need for further depreciation of the dollar and so unsustainability of the U.S. deficit, foreigners around the world—leave aside the central banks now—foreigners around the world are putting lots of money into United States.

Chairman D'AMATO. Thank you very much. Vice Chairman Robinson.

Vice Chairman ROBINSON. Dr. Cooper, you presumably know a number of officials in the executive branch today. Do you think that the dministration is largely driven by congressional pressures on the matter of having China repeg at a more market-oriented level, the Schumer legislation being one such pressure point. It appears that some of the senior political figures in the Administration, of the Karl Rove variety, have stepped into this debate at this stage, believing that the currency issue has become sufficiently prominent and problematic. In your view, might this be the case?

And that the executive branch, the Treasury, Secretary Snow and others, have perhaps a better sense of this complex issue than some on Capitol Hill. That is to say that the fix is-with Beijing for something more like a 7 percent devaluation than something more radical like 20 to 25 percent. I mean is that your instinct of the dynamic that's at play here and the likely outcome?

Dr. COOPER. You are probably better informed than I am about the dynamic in Washington these days. I would just make the general observation that I think for Congress to set exchange rate courts disaster.

Vice Chairman ROBINSON. I would like to ask another question—you mentioned that the U.S. has half of the world's marketable securities.

Dr. COOPER. Stocks and bonds, marketable stocks and bonds.

Vice Chairman ROBINSON. And that's not the same as saying investable capital?

Dr. COOPER. That's marketable securities. That is to say paper, claims, which you can trade. That figure includes all of the securities of companies that have any securities traded, and yet we know, for example, in Japan and in China today, there are some traded

companies where only a fraction—say 15 percent—of the equities can actually be traded. The others are firmly held. So if you make allowance for that, it's probably well over half of the marketable stocks and bonds are in the United States.

Vice Chairman ROBINSON. It would be half of the tradable securities in the global capital markets?

Dr. COOPER. Of the tradable?

Vice Chairman ROBINSON. Tradable.

Dr. COOPER. Tradable papers, tradable fixed interest and equities, yes.

Vice Chairman ROBINSON. The Chinese savings rate is very high, more than enough to provide domestic liquidity. On the other hand, we have the foreign exchange side of the equation. They have very large reserves, much of them in T-bills which is rising to about the $300 billion level.

Dr. COOPER. $660 billion.

Vice Chairman ROBINSON. Not China's overall reserves. I'm just talking about U.S. T-bills.

Dr. COOPER. Oh, sorry.

Vice Chairman ROBINSON. $660 overall, but some $300 in our Treasury market. As part of our charge as a Commission, we're looking at the Chinese presence in the U.S. capital markets, but also we're interested in their presence in other major exchanges around the world such as those of Japan and Europe. I don't know precisely what the Chinese exposure is in our markets, but I would make a rough guess that it's in the neighborhood of $80 to $100 billion.

China may have a similar amount of exposure in Japan. We're told that as many as a thousand Chinese enterprises that are in the queue to come to our markets for funding. This typically takes the form of state-owned enterprises selling 10 to 15 percent of their equity for billions of dollars a pop and with very little disclosure or corporate governance.

So I'm trying to get a sense from you as to the true role of the vast U.S. capital markets, particularly when viewed in combination with those of Japan in China's national funding strategy. Where does this piece fit in your view?

Dr. COOPER. You're talking about issues on international markets of equity by Chinese companies.

Vice Chairman ROBINSON. Or bonds.

Dr. COOPER. Or bonds. Some of the members of the panel are probably better informed than I am on this issue because we're guessing now about Chinese motivations, but I think they have several motivations, the least of which is probably to raise capital, although that probably is a motivation for some particular firms to raise capital.

But I think that they want alternative sources of capital to the Chinese banking system, which is their main source of internal capital. They want the reputational value of being traded in Hong Kong, even in New York or London. I suspect, but this is conjecture on my part, that on the part of management, they actually value the increased independence they would get from the Chinese authorities if they were able to say, look, I've got an international constituency I have to worry about, and that gives more scope for

business judgment and less interference by the Party Committee in the enterprise in question.

And let us not forget because we've seen it in this country in spades—Hank Greenberg up on the wall behind you——

Vice Chairman ROBINSON. Right.

Dr. COOPER. CEOs have big egos. They often do things essentially which do not make good business sense, but they do increase CEO compensation. They increase CEO stature within the business community. This is even more conjectural than what I've said up to now, but I find it hard to believe that there aren't Chinese who aren't like Americans in this regard.

Vice Chairman ROBINSON. I'll buy that. So the capital markets fund-raising element as a source of Chinese hard-currency liquidity isn't a big part of their overall funding strategy from your perspective?

Dr. COOPER. On the whole, I would say not. It may be in the case of particular firms.

Vice Chairman ROBINSON. I see.

Dr. COOPER. It may be in the case of particular firms, they really are constrained for one reason or another. The banking system does not work like a normal banking system. Despite the best efforts by PBOC to instruct the bankers otherwise, guanxi is still an important element in Chinese banking. There was an interesting article a week or so ago. You may have seen it. The new chairman of the board of the Construction Bank of China complained that the Party Committee in his bank was effectively the loan committee and it had to stop. This is actually an extraordinary statement coming from a senior Chinese business leader.

Vice Chairman ROBINSON. And a final quick question—I apologize to the chair for extending my time a bit—but Ambassador McCormack, you made the, I think, valid point that the Chinese are all too willing to use economic leverage to advance geopolitical goals in one form or another.

They are accumulating U.S. T-bills at a brisk rate. They're probably purchasing as much as 12 percent on average at Treasury auctions. That's a big number I'm told. Leave it to say that as that number rises, although it may be a low percentage concern, if we get into a Taiwan conflict scenario, it's likely possible that we could have some disruptive things occur. For example, let's say that the Chinese ramp up their U.S. capital markets exposure went from $100 billion to four or $500 billion over the next few years. I think that's a plausible projection given the size of the Chinese queue and their appetite to come to our markets and those of Japan.

You would have scores of millions of Americans holding Chinese paper, seeking to redeem Chinese bonds for retirement purposes, trying to ensure that their equity values don't fall. Isn't there a kind of China lobby in the making there that could ultimately seek to discourage U.S. policymakers from pursuing economic sanctions in a future Taiwan conflict scenario or for proliferation-related abuses? Does that strike you as plausible?

Ambassador MCCORMACK. Well, I would put it in a somewhat different way, more along the lines of what our friend, Mr. Prestowitz, earlier said. Recent statements made by the Chinese and by the Koreans and several others that they were thinking of

dumping their dollars, had a significiant market impact for a period of time.

The markets recovered when the Japanese then announced that they were going to keep their reserves in dollars and other reassuring comments were made elsewhere. But this is an indication of potential problems ahead of us to the degree that we continue to generate these huge external foreign dollar holdings by central banks.

President Eisenhower's phone call to Anthony Eden was not a public threat, but it had a dramatic impact. Imagine if three weeks before a future American election during an Asian crisis, if an American President were to receive a phone call like this threatening to dump dollar assets in a big way if America did not modify its stance. I'm not saying this is likely to happen, I'm just giving you the kind of potential scenarios that could happen, and that we need to be mindful of. Yes, the Federal Reserve can do things to cushion the impact of problems like this, but it would not be cost free. Whenever you begin to accumulate foreign debt on the scale of recent years, your potential vulnerabilities mount.

I want to make one final comment. I agree that when Asian currencies, not just China's, finally appreciate against the dollar, which I believe needs to happen, there will be some strain in a number of the regional economies—including China's.

But if China says that it cannot handle a resulting banking problem that would flow from a currency appreciation while possessing $600 billion in reserves, then the banking problem is either dramatically larger than we think it is, or China is using that as an excuse for not moving forward.

I am absolutely convinced that the problem the global economy would have after a currency appreciation in Asia would be small by comparison with the size of the adjustment problems that will unfold if we sweep the current imbalance problem too much dry tinder in the forest. We also cannot simply sit by with the status quo, because even more dry tinder will be created.

Vice Chairman ROBINSON. Dr. Cooper, do you have something to add?

Dr. COOPER. I'd like to separate your question into the two parts. With increased economic interdependence, there is always an element of joint "hostage-taking" and to the extent that American pensioners held Chinese bonds or securities, you would no doubt create a voice in this country—you have lots and lots of voices in this country—for moderation with respect to China. That's just the way the American political system works.

Clyde earlier mentioned the dominance, the prominence these days of retailers in lobbying, which was not the case 50 years ago to this same extent. So I have no doubt that that process would occur as Chinese securities became more widely traded.

My own advice to anyone would be not to buy any Chinese securities at the present time. I think the Chinese stock market is a mechanism for insiders to fleece outsiders, which by the way is not a comment limited to China. It's a comment on the history of stock markets. The continental Europeans were there only 20 years ago, and the Italian stock market was a scandal, but anyway, that's private financial advice.

On the question of U.S. Government securities, I believe the U.S. holds all the high cards. People talk about dumping these treasuries. But you cannot dump securities on a huge scale. You have to think about what they're going to sell them for.

They have two options. One is to sell them for RMB. That involves tremendous contraction in the money supply of China, all other things being equal, that could offset it in other ways, and it means abandoning their exchange rate policy. In effect, that's what we're asking them to do. To stop buying U.S. Treasuries. Selling them would go further, although we don't put it that way.

They would incur all of the costs of a sharp appreciation in the RMB value if they were to sell them for RMB. The alternative is to sell them for some other foreign exchange, not to sell them for RMB, which would involve a change in exchange rate policy.

Vice Chairman ROBINSON. Euros?

Dr. COOPER. But to sell them for euros. And there you have to look at the technical aspects. The market for securities in euros is still developing, and it's developing nicely, but it is still a relatively small illiquid market compared to the United States. So while they could move tens of billions into euros, they cannot move hundreds of billions into euros just from a technical point of view. And you can't buy euros. You have to buy euro-denominated some things, and the question is which euro-denominated something? Central banks tend to like to hold short-term paper, although I understand some of the Asian central banks are now moving out into the longer end.

The predominant euro-denominated something at the short-end is Italian government paper. So the People's Bank of China has to ask—or their politburo, if this is a political decision—do we really want to exchange U.S. Treasuries for Mr. Berlusconi's debt?

These are very practical questions. If I were the Chinese—I don't know what they're actually doing—if I were the Chinese, I'd be experimenting now with the euro market just to find out how it works and how liquid it is and how much I can move. I assume they're doing that because that would be the sensible thing to do. But the fact is they've got so much money that they can't move it without shooting themselves in the foot one way or another.

Ambassador MCCORMACK. But no one would be limited to buying dodgy Italian bonds. Those seeking to diversity out of the dollar could purchase any asset public or private denominated in euros. Some of them are much more attractive than others.

Chairman D'AMATO. Thank you very much. Commissioner Mulloy.

Commissioner MULLOY. Thank you, Mr. Chairman. I just want to make a quick comment. Dr. Cooper, you talked about all the money flowing into this country. I look at us as kind of the wealthy family on the hill, no longer earning our—I think Warren Buffett talks about this as well—we're no longer earning our way in the world so we're selling off part of the patrimony in order to earn a standard of living we're no longer earning.

So I think that's a different way of looking at the point you made. But anyway——

Dr. COOPER. That would be true if our stock of physical assets were fixed, but it's not fixed. We invested 19 percent of GDP last year.

Commissioner MULLOY. I just wanted to put a different framework of looking at that, and that's one Warren Buffett shares. I don't think he's anybody's fool from what I can see.

I want to salute Clyde Prestowitz and his new book, "Three Billion New Capitalists." Clyde and I both entered the Foreign Service 40 years ago this year. We've been around this game a long time, and I salute him for his new book.

I just want to go back in history to after World War II. We wanted to avoid some of the calamities in the international trade and other things that led to that, and we put in structure the UN, the political. We tried to put in an ITO to deal with trade and we didn't quite get it, so we used the GATT. Then we did put in an IMF to deal with exchange rates because we saw currency manipulation had been a problem in the 1920s and 1930s.

That system fell apart in the early 1970s, and that's when people began to put their finger on the scales and get to the system that Clyde talks about in his testimony, that you have strategies in place by countries to use exchange rates to achieve competitive advantages in trade.

Now, I was shocked the other day when the Chinese said this is our sovereign decision, and the reason I'm shocked is because if you look at Article XV of the GATT and you look at Article IV of the IMF, you're not supposed to be manipulating currencies to gain competitive advantages in trade. So there's a legal framework of it. These aren't just policy decisions. There's a legal framework governing this.

We have people in this country whose jobs and families are being sacrificed. I'm concerned about China, but I'm concerned about our people as well, and what's going on in this country and the impact on Americans and the impact on our political system.

I think Dr. McCormack and Mr. Prestowitz have laid out a problem that is of enormous proportions in this country. I'm asking, do you think this should be moved right to the front of the queue in terms of national problems, and do you think this is a bipartisan issue that we can try and get some comprehensive recommendations on what we ought to do.

Dr. Cooper, I don't think you think it's a problem. But if we accept it's a problem, and I think it is, what do we do, where do we go?

Dr. Gomory, who testified earlier, thinks it's a problem, and he thinks we ought to be doing something, and that's what we need some help in thinking through. So Clyde and then Ambassador McCormack.

Mr. PRESTOWITZ. Two things. One, let me just respond quickly to something that Dick said earlier about the private capital inflow into the U.S. I'm not disputing Dick's number. There is a large private capital inflow into the U.S. You have to remember there's also a large U.S. private capital flow out of the U.S. U.S. companies invest a lot abroad.

The U.S. current account is being balanced and financed by central banks. They're making up the difference, and that's a very important point in this discussion.

Dr. COOPER. U.S. investment abroad was being financed by central banks is what President de Gaulle thought.

Mr. PRESTOWITZ. Well, that was in a very different context. But to your direct question, Pat, I think there are a lot of recommendations that can be made and that have been made. I think in terms of the big fix and the little fix that the big fix in my view is I'd love to see a grand deal in the G8 in which the U.S. makes some credible commitment to reducing the Federal budget deficit and the rest of the G8 and China make some—I say "and China"—and some of the other Asian countries that are not in the G8 make credible commitment to increasing—to stimulating their economies and increasing consumption.

If you just save more in the U.S. and take U.S. demand out of the global economy, everything goes kerplunk, so it's got to be a deal. And I would also like to see the beginning of some move toward actually over the long term reducing the hegemony of the dollar. Maybe you begin thinking about pricing oil in a basket of currencies.

But eventually I'd like to get to a place where there is fiscal discipline on all the players in the system so that you can't have excess savings or excess consumption in the unbalanced manner that we have now. So that's what I think of as the big fix.

The small fix is I think addressing some of the issues that Dr. Gomory and the panel this morning talked about where you look at these more microeconomic issues and you look at the trade negotiation issues from a somewhat different perspective.

I thought that the comment that Dr. Gomory made about innovation and the notion that most people have that innovation kind of proceeds literally from basic research and lab to development, and his point being, no, it doesn't work that way; it's an interactive process and a lot of it may take place on the factory floor, but if you don't have the factory floor, it can't take place. I think that that was a very important statement and some U.S. attention to that kind of thing is very important.

But to get there, and here's the main point, to get there, what I think is really needed is a change in mind-set in the United States. Let me give you an example of what I mean. IBM recently sold their personal computer division to China's Lenovo, and after they did that, IBM's CEO had an interview in The New York Times, and in it, he noted that before doing the deal, he had traveled to China about a year and a half or two years ahead, and he had gone to China, not to meet with the executives of Lenovo, but to meet with the top leaders of China and to talk to them about their plans and how IBM might fit into that, and whether if IBM were to make this kind of a deal, that would be compatible with the plans of China's leadership in their overall economic development, and apparently China's leaders said, yes, siree, that's just what we want.

And then he did the deal with Lenovo, and the deal was announced. Now, it was interesting that when the deal was announced, it was a surprise in Washington because the consultations that had taken place at the top level with the Chinese government had apparently not taken place at the top level in the U.S. Government, and in The New York Times interview, the CEO of IBM made the statement that IBM wants to be part of China's strategy.

Now, that raises an interesting question: does anybody want to be part of America's strategy? And the answer is nobody can answer that question because America doesn't have a strategy. So when U.S. companies are considering investment, for example, and there are a number of important U.S. companies right now who are considering major investments in new plants, big plants, four or $5 billion investments, these companies receive regular visits from the Economic Development Board of Singapore, the Economic Development Board of Ireland. France has an ambassador for foreign investment. All the—China has this. I mean many countries.

And these economic development boards come in and they're aware of the planning of the company. It's not just U.S. companies. They go to Europe and Japan and elsewhere as well. And they're aware of the planning and they're saying how can we help you locate in our country? Would you like a capital grant or how about a tax holiday or what have you?

These companies never receive a visit from the Secretary of the Treasury or the Secretary of Commerce or any high-ranking U.S. official. The high-ranking U.S. officials are not aware of their plans. Now, the governors are. And governors do this kind of thing in the U.S., but they have relative peanuts to offer, and so there's a mind-set imbalance here.

These, the CEOs of these major companies easily meet with the heads of government of most of the rest of the countries in the world to discuss their investment plan. They don't easily meet with the heads of the U.S. Government to discuss their investment planning because there's a mind-set in the U.S. that that's not, you know, kind of what top U.S. Government officials do.

There is a way of thinking here that, you know, we're kind of used to being the leader, used to being on top and kind of we don't need to do that, and I really think that in view of the comments and the work that Ralph Gomory has done and Bill Baumol and our experience now over a long period of time in the competitiveness arena and the trade arena that it's time for the U.S. to start thinking seriously not about protectionism, not about, you know, draconian measures to change the global trading system.

I think it's important to understand that globalization has on net had a very positive impact. But it's time to be serious about how does the U.S. maintain its ability to continue to innovate, to continue to be competitive, and to get to a point where these imbalances get adjusted without some major crisis.

Ambassador MCCORMACK. Responding to your question about what to do: I thought the suggestions of your earlier panel pointed to some promising opportunities. Various measures to improve our national competitiveness are very much worth looking into. About a year ago, I began looking at the current accounts problem, what to do about it, and I pulled together some former Treasury Department personnel who had worked on this problem successfully during the second Reagan Administration to try to learn from their successes and their mistakes.

As we were moving forward with our analysis about the causes of our present current account imbalance, and we realized that, yes, there was a U.S. macro problem, but that that was not the biggest problem. The biggest contributor to our current account dif-

ficulty, beyond the overarching global savings/investment imbalance proved to be a whole series of microeconomic obstacles to U.S. competitiveness. Many of these, such as the l992 airbus agreement, were comparatively small contributors to the problem; but when you added the consequences of all the microeconomic obstacles to U.S. competitiveness, they assume strategic proportions.

What are some of the other major microeconomic problems? The currency issue is the big one. Relative currency ratios have replaced tariffs as the means by which nations and economic groups seek to manipulate the terms of trade. Look at the huge dispute in Italy now about the euro as a case in point. Earlier the Italians simply devalued the lira to fuel Europe's once second largest economy. Now this game is played in Asia.

How do you compete when somebody else's currency puts you at such an enormous disadvantage? A powerful second microeconomic dimension is U.S. education. As was pointed out earlier, Wernher von Braun and others were the ones who developed some of our missile programs early on, but then we the American post-Sputnik efforts produced a whole generation of other Americans who were providing the cutting-edge analysis on rocketry and science and all the rest of it. There were huge spillovers into all sorts of other areas.

We need to go back and think about how did we do this once before: how we turned all those little league baseball players and boy scouts into world-class rocket scientists. We had a national policy. We energized people. We provided targeted incentives.

We have to exercise care in our trade negotiations, and use a much sharper pencil than we did when we negotiated the l992 airbus agreement that legitimized subsidized, risk free development capital to Boeing's largest competitor. Otherwise, we're just shooting ourselves in the foot and making our current account problem worse.

Until recently we have not effectively challenged China at the WTO on lack of enforcement of its commitments. I heard Secretary Snow say to the Economic Club of New York last fall that China has the most wonderful laws in the world, but they're simply not enforcing their WTO agreements, particularly regarding the wholesale theft of intellectual property. Crushing a pile of pirated CDs on the streets of some provincial city for benefit of assembled cameras isn't enforcement—it's just a charade and a fraud.

Chairman D'AMATO. Can you go ahead and summarize?

Ambassador MCCORMACK. We have to look at these individual microeconomic issues and fix them. It will take a decade to turn young American baseball players into world-class scientists again, but we can do it with national leadership, a targeted education program, and the right incentives.

Chairman D'AMATO. Thank you. Commissioner Becker.

Commissioner BECKER. Very quickly, at the very end, you reminded me of something, you know, when you talk about subsidies. China has $600 billion, more than, in non-performing loans that have been made to industry, they are non-collectable. I submit that amounts to a subsidy and that's something that somebody should be taking some positions on.

But here's my question particularly on what Mr. Cooper, Dr. Cooper, raised in the beginning about crisis. I've been in a crisis mode I guess half my life. There was a crisis after World War II, which everything they felt was going to collapse here in the United States. The United States had a crisis for the savings and loan debacle of half a dozen years ago or eight years ago. And the government jumped in and bailed them out.

The United States had a crisis with the "Hedge Funds." Now you're getting into the big bucks. You're getting into the big people and in the dark of night, the Federal Reserve of the U.S. Treasury jumped into that crisis to help bail these people out—Goldman Sachs and others. I can't even comprehend the kind of money that was at risk to these investors. These were crises that apparently we've pulled through.

But now Dr. Cooper, you raised the question that if we pressure the Chinese to change the exchange rate, that this could precipitate a crisis. I wish you would tell me just what kind of a crisis we're talking about. I wonder if we've got an accurate picture of this. What do you visualize as the crisis by us pressuring them to raise the exchange rate?

Dr. COOPER. I mentioned two possible crises depending on how the Chinese respond. One is that the Chinese respond modestly in which case financial investors around the world will see that the pattern has been broken and it's only a question of the amounts involved, and so they will try to move more money into China. That's been happening anyway, by the way. There's been a lot of money moving into China, mostly resident capital returning to China.

But the view has been expressed today and on the Hill and by think tanks, that a movement of the Chinese currency by itself will not make a significant difference on the U.S. deficit. What's necessary is a movement of other currencies. A movement by the Chinese would then be an invitation for tens of billions of dollars to move into other currencies that unlike China don't have exchange controls, don't have limits on what foreigners can invest.

So we would see very large inflows of funds into Japan. The exchange rate would respond by rising and the Bank of Japan would have to decide what to do. The Japanese are used to that kind of thing, although it might precipitate another recession, thus reducing, not increasing, Japan's demand for U.S. imports. But it's the other developing countries of east and Southeast Asia that I think would experience very large inflows of funds and these would be very disruptive of these economies.

They do not have the depth of markets and the sophistication of, for example, the Federal Reserve to be able to control the impact on the money supply.

Commissioner BECKER. Let me clarify my concern just a bit I think we are facing a crisis in this country. I think we are facing a crisis with the trade deficit that keeps rising, which encourages transfers of industry out of this country into places like China where companies can produce cheaper and still export back into the U.S. So view all this in mind with the crisis that we have going here.

Dr. COOPER. Well, with respect, we've been facing that crisis now for 20 years, and it's gone on and on. This may be a semantic question whether you can call something that continues for 20 years a crisis or a condition, a question of taste I suppose. People started identifying the U.S. current account deficit as of crisis proportions in 1983. It was over 20 years ago. McCormack pointed out that we had a surplus. But that was only in one year, 1991, and that's because we sold the Gulf War to our allies. Actually we've been in continuous deficit apart from the remittances we got from our allies on the Gulf War. It's gone up and down, but we've been in significant deficit.

On U.S. manufacturing, it's noteworthy—leaving the recessions that we had in 1982, in 1991, and in 2001–2002—U.S. manufacturing production has gone up and up. What has gone down is employment in manufacturing. Whether you call that a crisis or not, again, is a question of taste. I come from a farming background and I see manufacturing going the same way as farming. That is to say, declines in employment and increases in output, the difference, of course, being productivity growth. Productivity has gone up fabulously in manufacturing since 1995, so employment has gone down. It basically stayed the same, but as a share of total employment, it's gone down. That has consequences, and I don't want to minimize that. I see it not as a crisis but as a secular trend. It has been going on for three decades. I see it going on for the next three decades. Again, I see an analogy to agriculture, where we have huge agricultural output with a very small number of farmers, of whom my cousin is still one.

I do not think that's all that bad. Change creates hardship for individuals. We need a system to look after that. Of course, if it comes abruptly in one fell swoop, it creates a lot of hardship. But this is not abrupt. This is a continuous process.

China's contribution to this process has been negligible. The main contribution of China has been to create jobs that already moved out of the United States ten and twenty years ago to Korea, Taiwan and Southeast Asia. That may create strains on those countries.

Commissioner TEUFEL DREYER. Mexico.

Dr. COOPER. Mexico is the latest example. Now we have a new situation in the expiration of the MFA. That is putting new pressure on the U.S. apparel industry. It shouldn't be a surprise to anyone because it was a deal that was made ten years ago, so people have had a lot of chance to prepare for it. But you know how human beings often tend to procrastinate. Some of that pressure is coming from China. But it would be a fallacy of concreteness to hold China responsible for that change.

The change is the expiration of the MFA, and that production was going to move someplace once the quota system was dismantled. It was going to move someplace. It happens to be China at the moment, but if, for example, we and the Europeans put restrictions on China, it will be Bangladesh or Indonesia or wherever. So, to repeat, I think it is a fallacy of concreteness to hold China responsible for that particular change in policy and the consequences that flow from it.

Chairman D'AMATO. Thank you very much. We're running a little bit late. We have one more question before we have lunch, and that's Commissioner Dreyer.

Commissioner TEUFEL DREYER. I was intrigued by Ambassador McCormack's story of Eisenhower and Eden, and I am wondering, do we have recourse? In other words, if Eden were to have said just try it and see what happens. There is a difference between the British and the United States economy in '56 and the Chinese economy and the U.S. economy as we approach 2006.

One of them is that I think, without really knowing, that the U.S. economy was really strong in 1956. As I look at the Chinese economy, it looks to me like an icy lake as spring approaches. There are a lot of non-performing loans. There is a Gini-coefficient that is probably .52 at this point and getting higher, meaning a greater degree of income inequality. The unemployment rate is going up. The population increases every year. Jobs have to be found for these people. You have There are regional income disparity problems, especially east versus west China. There is corruption. There is environmental deterioration. Of course, you were not speaking for yourself when you mentioned this; you were speaking about other people's views.

You said China must assume its rightful role on the world stage. What the dickens is China's rightful role on the world stage and who has decided what that is? The world is littered with former empires that we don't say this about—the Roman Empire, the Greek Empire, the Persian Empire, the Japanese Empire.

Ambassador MCCORMACK. Yes, many Chinese strategists believe that China should assume its rightful role on the Asian and world stage. I said that in the context of the humiliation that the Chinese people felt they have been subjected for two centuries by Europeans, Japanese, and others.

When Mao took power, and when he stood in front of the assembled people and said "China has stood up" there was this tremendous resonance to that statement throughout China for a very long time. They do feel genuinely that they were exploited, invaded and abused for centuries because of their weakness and they're determined to change that. That is also how l9th century German nationalists reacted as they grew stronger. This led to wars.

Commissioner TEUFEL DREYER. I realize you weren't speaking of your own view. You made that very clear. But it is a view that is out there.

Ambassador MCCORMACK. When you talk to some of China's strategists, you hear their short-term view that the U.S. should remain in Asia because we're now seen as a stabilizing force. But looking ahead, and they say quite candidly, that they expect us to gradually recede from Asia and make room for their own increasing power and presence as the regional hegemon.

I was sent to China in 1983 by the President as part of a mission to make some changes in technology transfer. They told me at that time that they intended to take Taiwan by encouraging the Taiwanese to invest in China—making money in those enclaves. They predicted that after 30 or 40 years of this accumulated Taiwanese investment in China, this hostage investment would allow the absorption by China of Taiwan. This strategy is right on track. The

point I want to make is that China does take a longer-term view. They do use economic leverage to accomplish long-term political goals, and we need to be mindful of that.

One final comment. It is true that in 1990 during the Gulf War, the U.S. Government twisted arms to ensure equitable burden sharing. This was part of a strategy to turn our current accounts around—and it worked. But it did many other things as well. The first Clinton Administration followed up with similar measures. For ten years, the U.S. current account was held under 2 percent of our GDP.

That result was a consequence of policies put in place by the second Reagan Administration. Then came the l997 Asian financial crisis and new demands generating U.S. priorities to deal with the crisis became a permanent fixture. Asia also reacted to the l997 crisis by accumulating titanic financial reserves, worsening the global savings investment imbalance. Between the accommodative monetary policies and the Asian propensity to save and invest and export caused a disastrous U.S. current account problem that continues, ever worsening, to this day. Turning all this around needs to be a priority for America in the years immediately ahead.

It remains to be seen if this can be accomplished by well thought out and coordinated policy moves in the United States and more broadly in other parts of the trading system. If it is not done this way, the adjustment will eventually be driven by financial markets in the midst of crisis. It may not be a pretty sight.

Commissioner TEUFEL DREYER. Well, I would say in closing that there are a lot of cracks in the Chinese economy, and to your statement that it's a long-term strategy they have, in the long term we're all dead.

Ambassador MCCORMACK. Yes, monetary, banking, and investment trends in China flowing from the current situation are also dangerous to them. Overleveraging in finance has been the Achilles heel of the Asian development model—you have only to think of the earlier Japanese bubble. China is not likely to be an exception to this rule.

Chairman D'AMATO. Well, with that, we'll conclude this morning's hearing, and we're going to convene for lunch. We'll reconvene back here at this afternoon's hearing at 2:30.

[Whereupon, at 1:15 p.m., the hearing recessed, to reconvene at 2:35 p.m., this same day.]

AFTERNOON SESSION, 2:35 P.M.
THURSDAY, MAY 19, 2005

PANEL III: CHINA'S ROLE IN THE DEVELOPMENT OF GLOBALIZATION

Vice Chairman ROBINSON. We'll convene the afternoon session with our third panel of the day. This is going to be a panel on China's Role in the Development of Globalization, and as we explored this morning, China's been a major beneficiary of globalization thus far, and it's relied extensively on foreign direct investment and export-led growth in its development.

Nobody today disputes the leading role that China plays as a locus of production in the global economy.

Our third panel will assess the role of China in global economic trends and whether and how China's rapid economic rise is changing the traditional paradigm of international trade and investment.

Joining in this discussion will be Professor Oded Shenkar, Ford Motor Company Chair and Global Business Management Professor at Ohio State University. He's published numerous books on China-related topics. His latest book is entitled The Chinese Century: The Rising Chinese Economy and Its Impact on the Global Economy, the Balance of Power and Your Job.

Professor Robert Blecker, Professor of Economics at American University. His research has covered international trade and finance, macroeconomics, economic development and U.S. trade policy.

And Dr. William Overholt, Chair in Asia Policy Research at the RAND Corporation. He is the author of numerous books including The Rise of China. As far as ground rules, we're typically trying to keep remarks to seven to eight minutes, although we're trying to show some flexibility on that, and we'll hear from all of our panelists first prior to Commissioners' questions.

So Dr. Shenkar, we'd like to start with you. Thank you.

STATEMENT OF ODED SHENKAR
FORD MOTOR CHAIR, FISHER COLLEGE OF BUSINESS
OHIO STATE UNIVERSITY, COLUMBUS, OHIO

Dr. SHENKAR. Thank you very much and thanks for having me here. I think it's an important Commission on an important topic. Let me start by saying that to me the rise of China is a monumental event. I tend to equate it with the rise of the United States in the 1870s and the second part of the 19th century to become a global prominent power.

There is a lot of discussion as to when, if and when China will overtake the United States as the world's number one economy. There has been a prediction by Goldman Sachs that this will happen around 2042. There have been some more optimistic predictions.

Commissioner TEUFEL DREYER. Yes, on Tuesday.

Dr. SHENKAR. My own prediction is that this even will take place between 2020 and 2025, of course, adjusted for purchasing power parity, and some people will ask does it really matter? It's kind of a line in the sand, and I would say that it does matter. It is at least a symbolic event because, if and when it happens, this will be the end of 150 years in which the United States was the number one economic power in the world. So this is not an event without significance even though China's per capita GDP and income will remain way below those of the United States for many years to come.

China rejoined the family of nations in late 1978 when it began the process of reform. It is, of course, a very meaningful event for globalization when a county that now has 1.3 billion people becomes part of the world trading system, becomes number one foreign investment target, but I think it would be a fundamental error to assume that globalization equates with standardization, with similarity. And, therefore, the assumption that just give the Chinese more time and they will be more like us is a flawed assumption.

It is also a dangerous assumption. The Chinese, and I'm going back here to the late 19th century, early 20th century, always thought to find a solution with Chinese characteristics. It was always a unique solution, and already more than 100 years ago, they had a movement that came up with the idea that they want foreign technology without foreign values.

We want to make this separation. I think this is exactly what the Chinese are trying to do today. So the assumption that you cannot have a free market without a democratic system has already proven wrong.

Vice Chairman ROBINSON. Yes.

Dr. SHENKAR. The assumption that it is just a matter of time until the Chinese adopt, say a democratic system I think is also wrong or may well prove wrong. I see a number of scenarios, none of which sees a full-fledged democracy any time soon. I see a shift in that direction, but something that's going to look very, very different than our own system.

The Chinese already are showing us that they play by their own rules. Case in point. I understand that it was the subject of Commission meeting last month to which I submitted the written testimony: intellectual property rights. And by the way, I believe that the issue of intellectual property rights is an extremely important one, possibly the most important topic. Today, I actually believe that we, our government, seems, at least to outside onlookers, as being almost obsessed with the exchange rate issue to the exclusion of others.

This country has one tremendous competitive advantage, and that is know-how and the ability to innovate. Anything that happens as part of globalization that will mean that we are either not compensated for that know-how or that somebody is using our know-how to advance themselves in what we would call an improper way is dangerous to the long-term interests of this country.

I do not believe that it is only a matter of time till the Chinese reform their ways and become IPR compliant. I got a reminder of that just last month when I was informed that my book will be published next month in a Chinese translation but minus one chapter.

That particular chapter is indeed the chapter on intellectual property rights. So that is a reminder that the Chinese do think this is a very important one. So I even see the possibility of kind of a frightening scenario where the world divides into two parts: one that is IPR compliant, one that is not, rather than this seemingly unstoppable flow toward, you know, respecting those rights that globalization may imply.

There is also no question that the rise of China is already and will affect geopolitics. I think the Chinese are very clear about it. They talk about U.S. hegemony. This is something that they continue to use. They used it in 1950s and '60s, and this is one term that they continue to use today. Despite all the changes and all the reforms, they see themselves, in my mind, replacing the Soviet Union as the counterbalance to United States influence.

It is easy to see the amount of money and the percentage of money that is going towards a military build-up. The Chinese are

not increasing their investment in R&D because they can borrow it for free, but they are increasing the difference capabilities.

Finally, I was asked to talk about trade deficit. Let me say just one word about it even though it was not, you know, the initial definition of the charter of this panel. I have argued already awhile ago that the trade deficit is a ticking timebomb, that it is unsustainable, and I've explained it to people in China, too. It is unsustainable, not only on an economic level; it is unsustainable politically. It is unsustainable socially. It is very difficult to say where the tipping point is or will be.

I think we'll get fairly close to that. I do not see any dramatic change in the level, for instance, of U.S. exports to China that could balance very rapid increase in imports, and I see many of the measures that are being taken today such as temporary restraint on textile import and so forth as very temporary solution, and my hope only is that such temporary solution will not distract that from a long-term strategic view.

Thank you very much.

[The statement follows:]

Prepared Statement of Oded Shenkar
Ford Motor Chair, Fisher College of Business
Ohio State University, Columbus, Ohio

Honorable Members of the Commission:

The following are my very brief observations regarding China's influence on globalization as well as the impact it is having, and is likely to have in the future, on other nations, their economies and their geo-political standing. In my remarks, I will make specific references to the impact a rising China will have on the United States, its economy and geo-political situation. More detailed information can be found in my book, *The Chinese Century*, as well as in previous written testimony to the Commission on IPR violations by China.

Introduction

My starting point is that the rise of China is an event of enormous proportions that has much in common with the rise of the United States to become an economic and political power in the latter part of the nineteenth century. When the United States rose to prominence, the initial response from the United Kingdom and the rest of the world has been a mixture of disbelief and complacency, a sentiment that was soon replaced with a feeling of vulnerability and threat. Only years later came the realization that the competitive landscape has been changed for good, and that nations and companies had to adjust their policies and strategies in accordance with the new realities. Today, the world may be facing a similar situation, presenting opportunities as well as risks.

Of course, there are also remarkable differences between the rise of the United States and that of China. At the time of its ascent, the United States was a relatively new nation and a new force to reckon with, while China is an ancient civilization that during many centuries was the leading world's economy and is seeking to restore that status. The United States is a democracy which brought to the world ideals and institutions supportive of freedom and open markets, while China is ruled by an unelected Party dictatorship which shows no signs of letting go of its powers. These differences and China's many remaining obstacles on its way up notwithstanding, the analogy between the rise of China and that of the United States is plausible and we would be ignoring it at our peril.

China and Globalization

Once one of the most open civilizations on its cosmopolitan cities and adventurous seafarers, China has become under Communist rule an isolationist and xenophobic nation that feared foreign influences and sought self sufficiency at almost any cost. The launch of China's reforms in late 1978 signaled the return of China to the family of nations, its borders slowly opening to foreign tourists, trade and investment. Today, China is the largest recipient of foreign investment in the world, having displaced the United States. It is increasingly integrated into the global economy, its share of global trade and investment rising rapidly. In this respect, China today is

already more global than Japan or South Korea, two nations it is often compared with but two that have embraced a different path to progress.

Through over a century, the Chinese ideal remained that of "foreign technology without foreign values." The idea was to learn from the foreigners who have shown their technological superiority in the battlefield as well as on the factory floor, yet avoiding the absorption of foreign, especially Western ideas in politics, society and culture. Judging by the current combination of a political dictatorship coupled with a relatively free market—a combination most Western economists thought to be implausible—the Chinese have been successful in defending this ideal. This is not to say that China's increasingly permeable borders during a period of unprecedented globalization do not yield a slew of foreign influences. Western ideas are coming into the country via foreign movies (pirated as they may be), foreign invested enterprises, foreign visitors, and returning students and business people, to name a few. However so far China has resisted the political and social ramifications of Western style modernization, and it is my belief that solutions "with Chinese characteristics" will be sought in those realms as an alternative to those available from the West.

China has already defied the prediction of most observers that it was impossible to have a free market system without a democratic regime, and my own forecast is that China will not evolve into a democracy in the foreseeable future. Instead, I see two possible scenarios. The first, a gradual evolution into a Singapore style system, democratic in name but patriarchal in nature, where elections are held but their result is never in doubt. This will imply selective permission for alternative minor political parties that will be kept under close watch and starved of substantial resources and massive membership. The second possible scenario is the development of limited democracy at the local level (something the Chinese have already been experimenting with), with the center continuing to retain a monopoly of power on all major national issues as well as on key legislative and judicial matters. I call this "the Imperial model" because it is similar in many ways to the traditional system under the Chinese empire where the court and the bureaucracy yielded local power to kinship based clans.

At the same time, from a global perspective, the integration of the most populous country into economic, social and geo-political webs is likely to accelerate the process of globalization as we know it. This means greater and more rapid movement of people, goods and services across national boundaries and a broader flow of ideas. I should caution however that it is a serious error, in my mind, to equate globalization with increased similarity of values, norms, institutions and practices across borders. The superficial replication of the golden arches and other global corporate symbols in foreign locations masks fundamental differences in culture and institutions across the planet. China, with its combination of huge scale and marked differences with the West, will prove this point beyond doubt. Thus, expecting globalization to bring about a Western-style advance in thinking and systems in China and beyond is, by and large, wishful thinking.

China's Economic Impact

China's economic impact if already felt; it will be felt much more in the coming years. As with the rise of the United States more than a century ago, the economies affected will be both in the developing and developed world. Developing economies will find themselves hard pressed to compete with an economy that matches their wages but offers substantially higher productivity and superior infrastructure and capabilities. These economies compete with China not only for export markets but also for foreign investment, an area where China now garners more dollars than all other developing economies *combined*. Economies competing on labor costs, e.g., Bangladesh and Lesotho, where garment manufacturing is the dominant export, will be hard hit as China is capturing market share at lightning speed. These countries will have a problem generating the foreign exchange needed for the importation of basic necessities and will have to depend much more on the generosity of others, from developed country governments to international organizations. This will bring, in turn, an increase in illegal migration from countries such as Honduras, and it is not at all clear that current initiatives such as CAFTA will be sufficient to mitigate the problem. Thus, it is important to consider not only China's direct, bilateral impacts, but also secondary and tertiary impacts that will flow from its ascent.

Developed economies, in the meantime, will find themselves competing with a new phenomenon—an economy that is rapidly climbing the technological ladder but without concomitant respect for intellectual property rights, one that moves aggressively into capital intensive sectors but without relinquishing the labor intensive segments on which its initial economic launch has rested. In a previously written statement to the Commission, I have noted that the United States is the nation most adversely affected by the rampant Chinese violations of intellectual property

rights (IPR) because it is the world's largest producer and exporter of IPR. In the short to medium term I do not foresee an improvement in IPR infringement by China; on the contrary, I see the problem spreading across the globe. IPR infringing goods are now exported from China to many parts of the world, especially, but not only, to developing markets where compliance is either not feasible or not viewed as desirable by local authorities. In a worst case scenario, we may see the development of a world divided into two parts, one IPR-compliant, the other not. Such a development will have ominous consequences not only for the global trading system but also for the global economy as we know it and for the process of innovation which underlies economic growth and improvement in the standard of living. This again suggests the possibility that a China-driven globalization may differentiate rather than harmonize national economies.

China-Related Opportunities

The opening of China creates numerous opportunities for U.S. manufacturers and service providers. China is the fastest growing market for many U.S. manufacturers (e.g., Boeing), and is likely to become the fastest growing service market as well, which is of considerable importance to the United States, whose competitive advantage today lies more in the service than in the manufacturing sector. For example, thanks to its one child policy, China has a huge demographic problem of an aging society that will have to be supported by a rapidly shrinking workforce. Given the lack of a funded safety net, opportunities in the savings and insurance realms will be substantial.

One key opportunity is the growth of tourism from China. Tourism is a major industry in the United States, but one wonders if the proper preparations are being made in anticipation of this influx. Such preparations should include not only visa issues (which since 9/11 have become a major stumbling block), but also other measures. Being located in the Midwest, my impression is that this opportunity does not yet register on the screens of most states in the region. I believe that incoming Chinese tourists will have major interest in observing the U.S. hinterland, providing an economic boost to precisely those areas which have been adversely affected by the advent of Chinese manufacturing exports.

Opportunities will also continue in the realm of higher education, though here too visa and other problems may slow down the influx of Chinese students. Chinese students, especially in science and engineering, have made a major contribution to the U.S. economy, but their repatriation rate has started to go up and is likely to continue to climb rapidly. Should current trends continue, I expect the repatriation rate for Chinese students to reach 50% by the end of the decade (up from less than 20% at present).

All in all, I must say that I do not see the changes that will permit U.S. exports to China to grow at the level one would need in order to compensate for China's growing exports into the United States. It is beyond the scope of this testimony to explain why this is the case. Suffice it to say that I do not believe that the modest revaluation I predict will fundamentally alter the pattern of a growing U.S. trade deficit with China, a deficit I believe is politically unsustainable. It is hence my humble recommendation that the Commission, if it had not done so already, will consider discussing this topic in one of its future meetings.

Geo-Political Ramifications

On a geo-political level, China sees itself as a counterbalance to what it sees as U.S. hegemony, and will leverage its growing economic clout to score geo-political points, from military buildup to the targeting of developing nations all over the world for trade, investment and other assistance. The Chinese are only beginning to flex their geo-political muscle, which is likely to grow in tandem with their economic clout. While their short-term interest is in gaining a foothold in energy producing regions such as Venezuela and Canada, China is already showing signs of active involvement in the developing regions of the world, e.g., Africa, where they provide assistance in building infrastructure among other forms of support.

A return to a bipolar world where China replaces the Soviet Union is not impossible, even if it is not highly probable in the short term. Rising levels of military expenditure and the growing economic base with which to fund them suggest that China is serious about establishing itself as a geo-political power. While the country currently lacks the technological know-how necessary for cutting-edge weapon systems, there is no reason to believe that it cannot replicate in the military domain what it did in the manufacturing realm—a combination of technology transfer via imports, foreign investment, indigenous development and knocking off others' technology.

Vice Chairman ROBINSON. Thank you. I must say I personally subscribe to many of your views, and I think that they are reflective of several Commission findings and recommendations of the past, and I'm very appreciative of your remarks.

We'd like to move to Professor Blecker, please.

STATEMENT OF ROBERT A. BLECKER, PH.D.
PROFESSOR OF ECONOMICS, AMERICAN UNIVERSITY
WASHINGTON, D.C.

Dr. BLECKER. Thank you, Mr. Vice Chairman, Mr. Chairman, and Members of the Commission, I very much appreciate the opportunity to testify at this important hearing. In my oral remarks, since so much ground has already been covered today, I will just highlight four points relative to the topic of this panel: China's Role in the Development of Globalization.

For more details, I refer you to my written statement. First, as you can see, I am with Clyde Prestowitz on point number one. I believe that it is accurate to characterize China's overall economic strategy as a mercantilist one. I use the phrase "the new mercantilism" which was coined by the British economist and follower of Keynes, Joan Robinson, back in the 1930s.

This is an economic strategy in which a country seeks to promote the growth of its own industries through the use of a variety of policy devices, both explicit and implicit, that have the effect of promoting exports while strategically restricting imports except for items needed for the promotion of domestic growth such as technology and raw materials.

It was commented on earlier that China does import a lot and they do, but they are careful about what.

The policy devices include wage repression, industrial subsidies, procurement policies, closed distribution systems, performance requirements on foreign investors, strategic bargaining with foreign companies, and in this case, especially, an undervalued exchange rate.

These policies have contributed positively to the remarkable growth of the Chinese economy. But they've also had a negative impact on other countries, by making Chinese products artificially competitive. Although China has been admitted to the global trading system as a member of the WTO and has been given PNTR status in the United States, I believe that its mercantilist practices are contrary to the spirit of an open and balanced international trading system.

At the same time, we must recognize China's potential to contribute to positive sum trade in the global economy. Chinese demand for capital goods and raw materials has bolstered the economies of countries that export these products. And strong Chinese demand has been a significant factor in the rise of global commodity prices and industrial prices in the last few years.

The challenge for U.S. policy is to induce China to abandon its mercantilist practices while encouraging it to grow and prosper as a more cooperative member of the international community of nations. China has many domestic strengths including its high savings rate, abundant labor supply, strong educational system, high technological capacity, and a capable public sector.

As a result, China should be able to reorient its growth more toward the provision of a rising standard of living at home without such excessive reliance on export markets abroad.

Second, I believe that China has become the leading cause in the world economy today of the problem of a fallacy of composition, which is affecting the large number of developing nations that are trying to grow their economies through export-led growth focused on manufactured exports.

The fallacy of composition is the proposition that all of these countries cannot achieve their goals for rapid export growth simultaneously, when instead of providing reciprocal demand for each other's exports—as was assumed in the classical theory of trade, going back not only to Ricardo but even earlier to Adam Smith—instead of buying each other's products, they are primarily depending on the limited export markets of the United States and the other industrialized nations.

For this reason, I would respectfully disagree with my former teacher, Professor Cooper, who said this morning that the export-led growth model is one that all the developing countries can succeed in the following under present circumstances.

Since the 1960s, a series of countries, starting with Japan, then the East Asian Four Tigers, and various others including especially China, have succeeded at such rapid export expansion. Initially, they did so largely by taking away market share from domestic producers in the United States and other industrialized countries. But as our domestic industries have shrunk, the exporting nations are increasingly thrust into cutthroat competition with each other, so that the success of some comes increasingly at the expense of the failure of others.

This has been documented now in voluminous academic research, which is summarized (and the references are given) in my written statement. Interestingly, China is a special factor in this case, not only because of its size, but because it competes in both ends of the market, both for the low technology, unskilled, labor intensive products and assembly operations, but also for more and more high technology and advanced products.

Third, I would like to briefly discuss U.S.-Mexican trade as an example of China's impact that should be of particular concern for Americans given our relationship with Mexico in the North American Free Trade Agreement. NAFTA promised Mexico a privileged position in the U.S. market. It also promised to give U.S. producers an edge in exports to Mexico.

Within the last five years, both Mexico's exports to the United States and U.S. exports to Mexico have been depressed by a flood of imports from China and other Asian countries into North America.

As Figure 1 shows, U.S. imports from China nearly doubled from 2000 to 2004, while imports from Mexico were almost flat. Imports from Mexico grew rapidly between 1994 and 2000 in the first six years of NAFTA, but since 2000, they've been virtually flat while the Chinese imports doubled, and in the process, China displaced Mexico as the second-largest source of U.S. imports, the largest, of course, being Canada.

As a result of this, there have now been job losses in Mexican manufacturing. Employment in the Mexican maquiladoras has actually shrunk since 2001. Meanwhile, the U.S. share of Mexico's imports has fallen dramatically from a peak of 75 percent in the late 1990s to barely 56 percent last year, and the largest reason for that is in the increasing share of China.

Thus, our effort to create a prosperous trading zone in North America is foundering even as we seek to extend free trade agreements to other neighboring countries, and I know this is of a lot of concern to our Latin American neighbors. On the train on the way up, I was reading a recent publication by the Inter-American Development Bank and they have a longer report, which documents this in great detail.

Fourth, and finally, and this, of course, has been commented on extensively already, there's the issue of China's currency manipulation, which has reached extraordinary proportions in the last few years. In spite of the fact that China now accounts for the largest part of the U.S. trade deficit, the yuan-dollar exchange rate has remained fixed, while the dollar has fallen an average of 14 percent globally and as much as 33 percent versus the euro since its peak in February 2002. The percentage declines in the dollar versus the various currencies are shown in Figure 2.

China's fixed exchange rate has been maintained only through massive intervention in foreign exchange markets that has averaged nearly $12 billion per month and which has tripled its foreign exchange reserves over the past three years.

This undervalued yuan has contributed to the emergence of a truly extraordinary trade imbalance in which we buy nearly $6 of Chinese imports for every one dollar of exports that we sell to China. Also, apropos of the theoretical conversation we had earlier this morning, I believe that in the case of the U.S. and China, we're not trading according to comparative advantage. We're trading according to absolute advantage, and that is because the adjustments that are necessary to shift from absolute advantage to comparative advantage are not taking place. I could discuss that more in response to questions.

But in addition to the impact on the United States, China's currency manipulation has other global impacts. First, because the yuan has been fixed relative to the dollar, and the dollar has depreciated, China has effectively depreciated its currency relative to other currencies and that is impacting China's trade balance with the rest of the world.

Secondly, I think it is true that the undervaluation of the yuan has kept pressure on other nations, particularly in Asia, to intervene and resist pressures for their currencies to rise. As this figure shows, several other key Asian currencies have either remained fixed or appreciated relatively little in the past three years.

In my own research, I have documented the damage to the U.S. domestic manufacturing sector caused by the dollar's overvaluation. My estimates show a loss of between $52 billion and $69 billion annually in investment spending in the domestic manufacturing sector as a result of the dollar's rise from 1995 to 2002.

This loss of investment is a key reason both for the loss of manufacturing jobs and for the slow response of the trade deficit since the dollar started falling three years ago.

Today, China has become the leading obstacle to a much-needed realignment of global currency values, which would help to revive manufacturing production and jobs, both in the United States and in many of our other trading partners.

I recognize that a currency realignment will not solve all of our problems, but I believe it is a necessary first step for reviving our manufacturing sector and rectifying our trade deficit. Therefore, I would urge us to focus on getting China to revalue its exchange rate and not to mix up this issue with the more difficult questions of China adopting a floating exchange rate system and liberalizing its financial markets, which are more long-term propositions.

I would just add that, in response to the news from this week, I think it is not necessary to wait for more months or years for any additional evidence to come in to conclude that China already meets the statutory standards for conducting currency manipulation.

Thank you.

[The statement follows:]

Prepared Statement of Robert A. Blecker, Ph.D.
Professor of Economics, American University, Washington, D.C.

Introduction

China plays a unique and important role in the evolving global economy of the early twenty-first century. Following the export-led growth model of other East Asian countries, such as Japan and South Korea, but also building on its own domestic strengths, China has been by far the most successful late-industrializing nation to emerge from among the low-income developing countries and transition economies since the 1980s. China's domestic strengths include its high saving rate, abundant labor supply, and strong educational system, which provide the nation with enormous advantages in terms of the accumulation of both physical and human capital. China's one-party, authoritarian political system, although legitimately criticized on human rights grounds, nevertheless gives its government significant advantages in its ability both to pursue an activist, state-led development strategy at home and to bargain effectively with foreign businesses and governments. But in many respects, the secret of China's success has been its pursuit of what the British economist Joan Robinson (1965) called "the new mercantilism" in its policies toward international trade, foreign investment, and exchange rates.

The new mercantilism is a policy that seeks trade surpluses as a way to boost a country's industrial growth and employment at the expense of its trading partners. It is an updated version of the original "beggar-my-neighbour" mercantilist policies so thoroughly criticized by Adam Smith (1776) more than two centuries ago (see Blecker, 1997, 2005a). Through a strategic combination of (either explicit or implicit) exchange rate manipulation, wage repression, export subsidies, import barriers, and performance requirements on foreign investment, a country like China can promote a form of rapid, hot-house industrial development that succeeds to a significant degree by capturing industrial production that would otherwise be located in other nations. In today's world, the other nations that lose out in this zero-sum approach to industrial development include other developing nations as well as richer, industrialized nations like the United States.

In fairness, China's role in the global economy is more complex than a simple mercantilist strategy. Until the last few years, China had trade deficits with other nations that outweighed its surplus with the United States. Essentially, China has taken advantage of the relatively open U.S. consumer market and the voracious U.S. appetite for consumer goods to sell its exports, while importing raw materials, capital goods, and intermediate products mostly from other nations. In the last few years, Chinese demand for raw materials and intermediate products has been so strong that it has significantly boosted many commodity and industrial prices throughout the global economy. In 2004, strong Chinese demand contributed to a remarkable recovery of the global steel market after many years of chronic excess

supplies and weak prices (which in turn led to certain well-known trade tensions—see Blecker, 2005c). China's role as a significant contributor to global demand shows that it has the potential to contribute to positive-sum trade in the international economy. Nevertheless, China still maintains a particularly lopsided trade relationship with the United States, with which China's bilateral exports exceed its imports by a factor of about 6:1, and its remarkable export growth has notably eroded the export growth of other developing nations. The challenge for U.S. policymakers today is how to induce China to abandon the mercantilist aspects of its foreign economic policies while still allowing China to achieve the growth and development that it needs to raise the living standards of its people.

The Fallacy of Composition in China's Export-led Growth Strategy

The classical liberal vision of free trade (Smith, 1776) assumes that all countries provide sufficient reciprocal demand for each other's exports so that no country need face a demand constraint on the growth of its exports. Based on this vision, economists for many years have tried to deny the existence of a "fallacy of composition" in the export-led growth efforts of the East Asian countries and other developing nations (see, for example, Balassa, 1987). However, the reality of the contemporary global economy is very far from the sort of balanced expansion of international trade that is contemplated in the classical liberal vision.

Starting with Japan in the 1960s–70s, and continuing with the Four Tigers (Hong Kong, Singapore, South Korea, and Taiwan) in the 1970s–80s and other countries (including Thailand, Malaysia, and Vietnam) more recently, a large and growing number of East Asian countries have relied heavily on export markets to propel their industrial development and overall growth. China thus follows in a well-trod path in this respect. Moreover, many developing countries and transition economies in other regions of the world, from Latin America to the Middle East, Africa, South Asia, and Eastern Europe, have sought (with varying degrees of success) to emulate the East Asian model. Today, so many countries are trying to grow by promoting exports of similar types of manufactured products to the United States and other industrialized countries that the problem of an "adding-up constraint," or fallacy of composition, can no longer be denied.

A fundamental weakness in this model of export-led growth is that the countries that are trying to expand their exports at a very rapid rate are not providing the demand for each other's goods that would be required to purchase those exports. Instead, these nations are relying on the demand of other countries, principally the United States and also other industrialized nations (for example, Canada and the European Union) to provide markets for their exports. The target rates of export growth from the nations pursuing export-led growth dramatically exceed the average growth rates of consumer markets in the United States and other industrialized countries. Hence, the more successful exporting nations must achieve their targeted growth rates in either (or both) of two ways: (1) by taking market share away from domestic producers in the United States and other industrialized countries; or (2) by crowding out other developing nations from succeeding in exporting to the same target markets (that is, by forcing these other nations to accept lower export growth rates than they would like to achieve). Rapid growth of export supplies from a large group of nations, in excess of the growth of demand, can also lead to falling prices for manufactured commodities. If this occurs, the exporting nations may succeed more in terms of their quantitative targets, but fail to receive the expected income gains due to a decline in their terms of trade.

Historically, the East Asian countries initially succeeded largely through mechanism (1), which generated serious trade frictions with the United States and western European nations in the 1970s and 1980s. This occurred because Japan and the original Four Tigers had few competitors among the developing nations at that time. But the more other developing countries and transition economies try to follow in the footsteps of the original East Asian exporters, the more that all these countries are forced to compete against each other for the same export markets, which continue to grow at limited rates. Although "South-South" trade among developing countries has grown, especially in Asia, on the whole the developing countries that export manufactures are still seeking to sell exports far in excess of the amount that they demand from each other, and hence they cannot avoid a certain amount of zero-sum competition in the U.S. market and other industrialized country markets. Moreover, to the extent that domestic production of these types of manufactured products (for example, textiles, apparel, and electronic components) has declined in the United States and other industrialized nations, the opportunity to take advantage of channel (1) for promoting exports has correspondingly diminished, and therefore developing country exporters are forced to rely more on option (2) in their efforts to achieve export-led growth.

Developing country exporters can escape this dilemma to some extent by moving up the "technological ladder" to produce more advanced types of manufactures, such as computers, automobiles, and electronics, rather than apparel, footwear, and other simple assembled goods. Japan and subsequently South Korea and Taiwan have had much success in this respect, although their export-led economies have sometimes faltered for other reasons such as financial crises. This leaves the exporters of less technologically sophisticated products, from Bangladesh to the Dominican Republic, to compete over the crumbs of stagnant markets for low-tech exports with diminishing prices (see Kaplinsky, 1993, 1999). This results in what has come to be known as the "flying geese formation," in which the leading developing nations move ahead into new product lines while poorer nations replace them in the simpler products (Erturk, 2001–02). China, however, is in the unique position of being able to export significant volumes of manufactured goods along a wide range of the "rungs" on the technological ladder, and hence competes with both groups of exporters (see Razmi and Blecker, 2005). Thus, China is simultaneously crowding out both low-income countries that seek to export low-tech apparel and other assembled goods, as well as middle-income countries that seek to export higher-tech electronics and other more sophisticated products. Metaphorically, one could say that China is able to compete with both leading and lagging birds in the flying geese formation.

Economic research on the fallacy of composition is finally catching up with the realities of global trade (for surveys see Mayer, 2002; Blecker, 2003a; and Razmi, 2004). Long ago, William R. Cline (1982) observed that it was not feasible for most developing nations to achieve the phenomenal rates of export growth that were achieved by the original Four Tigers in the 1970s. Riccardo Faini, Fernando Clavijo, and Abdel Senhadji-Semlale (1992) showed that developing country exports of manufactures face significant demand constraints in terms of low income elasticities, as well as high price elasticities with respect to other developing countries. The latter finding was later confirmed by Vito Antonio Muscatelli, Andrew A. Stevenson, and Catia Montagna (1994) for a group of five Asian countries. Thomas W. Walmsley and Terrie Hertel (2000) constructed a global trade model in which, even though China's accession to the WTO benefits global welfare via consumer gains, competitor nations in South Asia suffer losses in income and welfare. The present author (Blecker, 2003a) showed that rapidly growing U.S. imports from Japan and the Four Tigers displaced U.S. imports from other nations in the 1980s, while rapidly growing U.S. imports from China and Mexico in the 1990s in turn displaced U.S. imports from Japan and the Four Tigers at that time. Thomas I. Palley (2003) found statistical evidence for a negative correlation between the growth of U.S. imports from China and the Four Tigers throughout the period 1978–99, as well as between imports from Mexico and Japan in 1989–99. Rupa Duttagupta and Antonio Spilimbergo (2004) have found that, for a sample of East Asian countries, the elasticity of substitution is higher with competing exports from other East Asian countries than with goods produced in the rest of the world. They also found that competitive devaluations contributed to the slow recovery of exports following the Asian financial crisis of 1997–98. Barry Eichengreen, Yeongseop Rhee, and Hui Tong (2004) report evidence that China's impact on world trade generates positive effects for nations that export capital goods but negative effects for countries that compete with Chinese exports of consumer goods. Arslan Razmi and Robert A. Blecker (2005) have shown that the problem of a high degree of substitutability of developing country exports of manufactures is significant for a larger sample of countries extending beyond East Asia. Razmi and Blecker also show that this problem is more acute for the countries that produce less technologically advanced exports, and also that these countries have a lower income elasticity of export demand than countries that export more technologically advanced products. In short, the evidence is now overwhelming that the fallacy of composition is a genuine problem, and that China's success in export promotion—while very beneficial to China itself and to those countries where China sources its own imports—is significantly hindering the efforts of many other developing nations to export their way out of poverty.

China's Impact on U.S.-Mexican Trade

Mexico is an interesting case of China's impact on other developing nations, and it is an important one for the United States because of the high degree of economic integration and close political cooperation that now exist within North America. As noted earlier, both China and Mexico increased their shares of the U.S. import market significantly in the 1990s at the expense of the Four Tigers and Japan. For Mexico, the rapid export growth of the late 1990s was its reward for having joined the North American Free Trade Agreement (NAFTA) with the United States and Canada in 1994—and helped to foster a relatively rapid recovery from the peso crisis of 1994–95. Mexico expected that, as a result of its preferential status in the U.S.

market under NAFTA, it could continue to rely on export-led growth focused primarily on its neighbor to the north (although, to hedge its bets, Mexico also signed free trade agreements with a number of other countries).

However, the value of Mexico's preferential market access in the United States was soon eroded by other factors. First, NAFTA was only one of the factors that boosted Mexican exports in the late 1990s; a devalued currency and the boom in the U.S. economy at the time also contributed to rapid Mexican export growth at the time (see Blecker, 2005b). When the peso appreciated again in the early 2000s, while the U.S. economy sank into a recession and slow recovery in 2001–03, Mexican exports stagnated and Mexican economic growth slowed to a virtual halt, in spite of Mexico's tariff preferences under NAFTA. Second, although it has not received much attention, Mexico's trade preferences under NAFTA are no longer as valuable as they originally appeared to be, partly because the 1995 WTO agreement reduced overall U.S. ("most-favored-nation") tariffs, and partly because the growing cost advantages of China and other much lower-wage countries are undermining Mexican competitiveness. (Parenthetically, this should be a warning to Central America and other regions contemplating free trade agreements with the United States: the likely gains may be much smaller than they anticipate—there is also a fallacy of composition in the proliferation of "preferential" trade agreements!)

The impact of China on Mexico in the early 2000s is difficult to exaggerate. In the 1990s, Mexico proudly displaced Japan as the second-largest U.S. trading partner. But since 2003, at least on the import side, Mexico has now been displaced by China as the second largest supplier of U.S. imports (after Canada, which remains the largest U.S. trading partner on both the export and import sides). Moreover, Mexican exports to the United States have been virtually flat since 2001, with only a slight recovery in 2004, while Chinese exports to the United States nearly doubled in value during those same three years (see Figure 1). Overall, the value of U.S. imports from Mexico increased by only 19 percent from 2001–04, while U.S. imports from China shot up by 92 percent over the same period (see Figure 1). Furthermore, Chinese competition has had a negative impact on Mexican employment. Although Americans have focused mainly on losses of manufacturing jobs to Mexico, the reality is that Mexico is now losing manufacturing jobs to China (and other lower-wage countries). For example, employment in the export-oriented Mexican maquiladoras peaked at 1.3 million in 2000, but then fell to 1.1 million in 2004, representing a loss of about 200,000 jobs (data from Banco de México, www.banxico.gob.mx).

Mexico's economic growth and prosperity are of vital importance to the United States for many reasons. The flood of Mexican immigrants into the United States, which is now causing a great deal of political controversy, will not abate unless and until Mexico can provide enough jobs for its people at wages closer to U.S. levels. No amount of border closures or enforcement of immigration restrictions can overturn the basic economic logic that drives migrants who are desperate for work and a decent standard of living. Moreover, Mexico is a test case for American promotion of free trade agreements. If Mexico does not get the anticipated gains from NAFTA on a persistent basis, other Latin American nations and nations in other developing regions are bound to notice. And most importantly, a stable and democratic neighbor on the United States' southern border is clearly in the national interest. Economic prosperity is vital to Mexico's stability and to the success of its recent conversion to a multi-party democracy.

In promoting NAFTA, both Presidents Bush and Clinton promised the U.S. people in the early 1990s that a prosperous Mexico would be a buoyant market for U.S. exports. Although U.S. exports to Mexico have grown more slowly than U.S. imports from Mexico since the adoption of NAFTA in 1994, resulting in rising U.S.-Mexican trade deficits, trade with Mexico remains relatively more of a two-way street than trade with most other countries—especially China. As of 2004, the ratio of U.S. imports to exports was only 1.4:1 with Mexico, compared with 5.7:1 with China (data from U.S. Department of Commerce, Bureau of Economic Analysis, www.bea.gov). U.S. imports from Mexico are more likely to be products assembled with relatively large amounts of U.S.-produced parts and components, as well as using U.S.-produced capital goods, while imports from China are more likely to be produced using inputs (parts, components, and capital equipment) either produced in China or imported from other Asian nations.

But just as Mexico's gains in the U.S. market have been eroding, so too have U.S. gains in the Mexican market. After NAFTA went into effect, the U.S. share of Mexican imports averaged about 74–75 percent during the late 1990s, but that share plummeted to only 56 percent by 2004—a loss that is primarily accounted for by a corresponding rise in the Asian share, which in turn is mostly due to imports from China (data from Banco de México, www.banxico.gob.mx). Thus, not only is China crowding Mexico out of U.S. markets for consumer goods and inhibiting the growth

of Mexican manufactured exports, but also China is displacing the United States as a source of Mexican imports. Of course, many U.S. firms are happily (and profitably) investing in Mexico, but some—such as the ever more present Wal-Mart—are stocking their Mexican shelves with Chinese imports rather than North American products. The result is that more and more manufacturing jobs are being created in China, not in Mexico or the United States.

The Impact of China's Currency Undervaluation

China's emergence as an export powerhouse owes much to its fundamental strengths, as discussed earlier. But a key element in its phenomenal export growth in the last several years has been the persistent undervaluation of the Chinese yuan and the extraordinary exchange rate manipulation required to maintain it. To put Chinese currency policy into perspective, one has to bear in mind that the United States has a large overall trade deficit, currently about 6 percent of GDP, that the largest bilateral trade deficit is with China (China accounted for 24 percent of the entire U.S. trade deficit in 2004), and that the dollar has been falling against most currencies since it peaked in February 2002—largely as a result of international investors' fears that the growing trade deficit is unsustainable. In this situation, China's maintenance of a fixed exchange rate with the dollar in the last few years, while the dollar has generally been sinking on global currency markets, has only been possible through the accumulation of enormous reserves of U.S. dollars (largely in the form of U.S. Treasury bills). China's official purchases of dollar assets artificially prop up the value of the dollar and correspondingly depress the value of the yuan, relative to a market equilibrium exchange rate. These purchases, which began to increase during the 1990s, have accelerated since 2002. In the three years since the dollar's peak (February 2002–February 2005), China has tripled its foreign exchange reserves (from $217.4 billion to $642.6 billion) by buying dollar reserves at an average rate of nearly $12 billion *per month* (data from International Monetary Fund, *International Financial Statistics*, on-line version).

China's ability to prevent a currency realignment with the dollar is all the more astounding given how much the dollar has fallen relative to other currencies (see Figure 2). While the dollar had virtually a zero change with the Chinese yuan from February 2002–April 2005, the dollar lost nearly one-third of its value compared to the euro, one-quarter of its value relative to the British pound, one-fifth of its value compared to the Japanese yen (in spite of massive currency market intervention by Japan, without which the dollar would have fallen even more relative to the yen), and similar amounts relative to most floating rate currencies (see Figure 2). This failure of the yuan to adjust along with other currencies has given China a substantial edge in the U.S. market as other currencies have appreciated, and has been a major factor in why the depreciation of the dollar has not made more of a dent in the U.S. trade deficit to date.

However, there are some implications of China's exchange rate manipulation that have not been as widely noticed. First, given that the yuan is pegged to the dollar and the dollar has been falling relative to so many other currencies, the yuan has depreciated substantially relative to those other currencies, which has contributed to improving China's trade balance with the rest of the world (i.e., non-U.S. countries). In other words, China has taken advantage of the dollar's decline to increase its competitive advantages in other global markets outside the United States. Second, China's role as a major competitor in export markets for manufactured products implies that its unwillingness to let its currency adjust puts strong pressure on competing developing nations not to let their currencies adjust either (or at least, not as much as the industrialized country currencies have adjusted). As Figure 2 shows, certain other East and Southeast Asian currencies have also remained fixed since February 2002 (the Hong Kong dollar and Malaysian ringgit), while several others (for example, the Singapore dollar, Thai baht, and Taiwanese dollar) have appreciated by much less than the major currencies of the industrialized nations (such as the euro, British pound, Canadian dollar, and Japanese yen).

The result is that, on a trade-weighted, inflation-adjusted basis, the average value of the dollar with all currencies has fallen by only 14 percent, not nearly enough to reverse the 34 percent appreciation that the dollar experienced overall between mid-1995 and early 2002 (see Blecker, 2003c). This in turn is another reason for the failure of the U.S. trade deficit to decline in response to the dollar's fall, since the dollar is falling more with countries (for example, European nations) where the deficit is smaller rather than with the Asian countries including China where the deficit is much larger, and the average depreciation is still relatively small.

In my own research, I have quantified the damage done to the U.S. manufacturing sector by the prolonged overvaluation of the dollar in the late 1990s and early 2000s (see Blecker 2004, which updates earlier estimates in Blecker 2003b).

Using two alternative models of profits and investment in the U.S. domestic manufacturing sector, I have obtained a range of estimates of how much this sector lost as a result of the dollar's appreciation between 1995 and 2002 (using annual data, which provides a more conservative picture compared with the monthly exchange rate data cited above). In the first set of estimates, I found that the net income of the U.S. manufacturing sector was reduced by $77.8 billion and investment spending was reduced by $51.7 billion (or 29.7 percent of its 2001 level), compared to what they would have been if the dollar had stayed at its 1995 value. In the alternative estimates, I found that the cashflow of domestic manufacturing corporations was reduced by $31.9 billion and investment spending was reduced by $68.5 billion (or 39.3 percent of its 2001 level), again compared to what they would have been if the dollar had not appreciated after 1995. I expect that these estimates will be increased when I am able to use newly released data for manufacturing sector investment in 2002 and 2003 from the Bureau of Economic Analysis to revise my econometric analysis (the present estimates were based on a sample period that ended in 2001 due to data limitations, but with the coefficient estimates applied to the actual increase in the value of the dollar from 1995–2002).

This systematic disinvestment in the U.S. manufacturing sector that was caused by the dollar's overvaluation was a major cause of the loss of nearly 3 million jobs in that sector since the late 1990s. Furthermore, this disinvestment has crippled the ability of U.S. manufacturing producers sector to respond to the current depreciation of the dollar by reviving domestic production in the short run. So much manufacturing capacity was shut down in the United States and relocated overseas during the prolonged period of dollar overvaluation in the late 1990s and early 2000s that the short-run benefits of the dollar's recent depreciation have been limited. In many lines of production, there is simply no longer adequate domestic capacity to replace goods that are now imported or "outsourced." As a result of the chronic overvaluation of the dollar since the late 1990s along with other global developments, the U.S. manufacturing sector has adjusted by becoming more and more dependent on imports of vital inputs—parts and components—as well as for entire product lines of finished consumer goods (see Campa and Goldberg, 1999). In the long run, a lower dollar should eventually encourage the restoration of domestic manufacturing capacity, most likely in new industries or products or with new technologies. But the dollar would have to move substantially lower and stay there for a significant period of time for that to happen, and it cannot happen if the country that accounts for the largest part of the U.S. trade deficit keeps its currency fixed.

China's exchange rate policy is not the only cause of these negative effects of the high dollar on U.S. manufacturing, but it is by far the largest single cause, and the one that is most resistant to making the adjustments that are necessary to restore more balanced and sustainable trade relations in the global economy. In particular, China's currency market intervention is by far the largest reason why the average value of the dollar relative to all currencies has fallen so little compared with the dollar's fall versus the major floating rate currencies, as shown in Figure 2.

Conclusions and Policy Recommendations

In this short space it is not possible to address the many complexities of the U.S.-Chinese relationship, which obviously includes many security and foreign policy concerns that go beyond the economic issues discussed here. Moreover, it is important to recognize that China is destined to become a great economic power, and we have neither the ability to prevent this nor an interest in doing so. In the economic domain, what we need to do is to convince the Chinese that we need more of a mutual partnership, rather than an antagonistic relationship based to a significant extent on the "new mercantilist" policy approach described earlier. Furthermore, it is vital to emphasize that the Chinese people will benefit more from their country's economic progress if they are able to increase their standard of living by capturing more of the gains from their rising productivity in the form of increased real wages and consumer well-being. Thus, a transition from low wages and an undervalued currency to higher wages, a more realistic exchange rate, and greater reliance on internal markets instead of export markets is in China's own interest. It is also in the United States' interest, if China is ever to become the large market for U.S. products that it potentially could be, but has not been up to the present time.

In the present situation, however, the most important economic issue on which to focus is China's exchange rate manipulation. Not only the United States, but also many other countries around the globe, near and far, would benefit from China allowing the yuan to appreciate. The Bush Administration has approached this issue largely by urging China to liberalize its financial markets and float the yuan. China has resisted, arguing (with considerable justification) that this cannot be done without long-term reform of its domestic financial system, and that to open up its finan-

cial markets prematurely would risk destabilizing capital inflows of the type that sparked the Asian financial crisis in the 1990s. But this is putting the cart before the horse. We need to separate the issue of the *value* of the yuan from the issue of whether it has a flexible or fixed exchange rate, as well as from the even thornier issues of opening up China's financial markets and reforming its domestic financial system. China can continue to peg its exchange rate if it wants to, but it must adjust the peg so as to substantially revalue the yuan. U.S. policymakers should be focused on coaxing China to make a significant revaluation of its currency, while leaving the method of doing so (i.e., adjusting the peg or floating the currency) up to Chinese policymakers. There is no reason to wait for long-run policy reforms that could take decades to enact before making a relatively simple adjustment that is vitally necessary for rectifying the current asymmetries in the global trading system.

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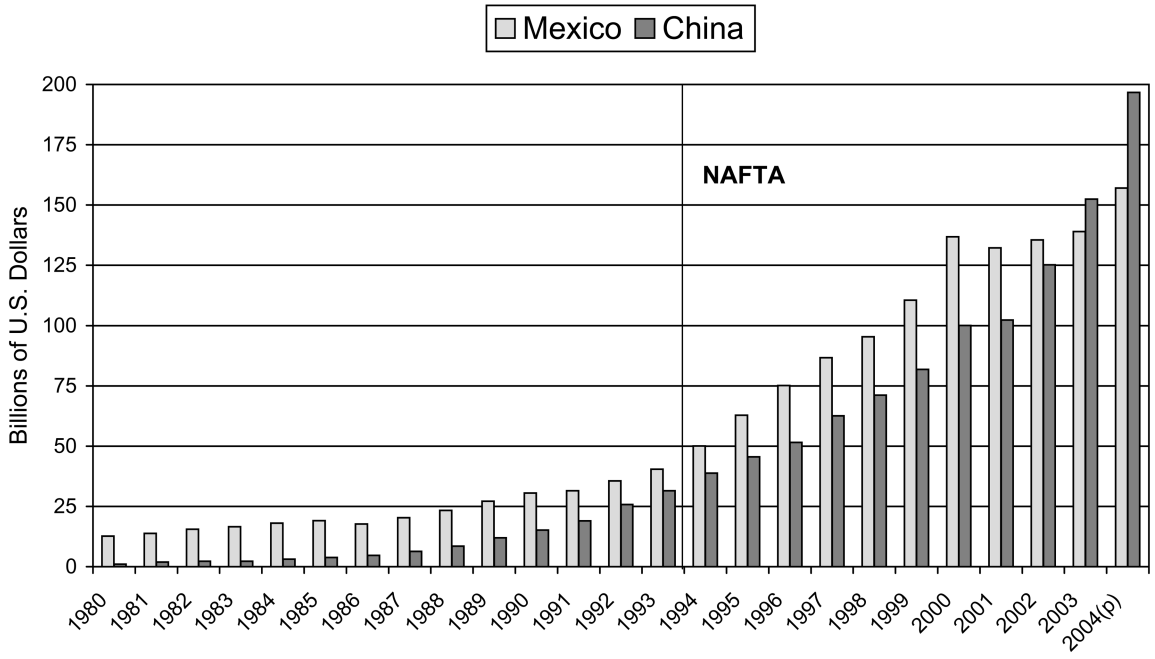
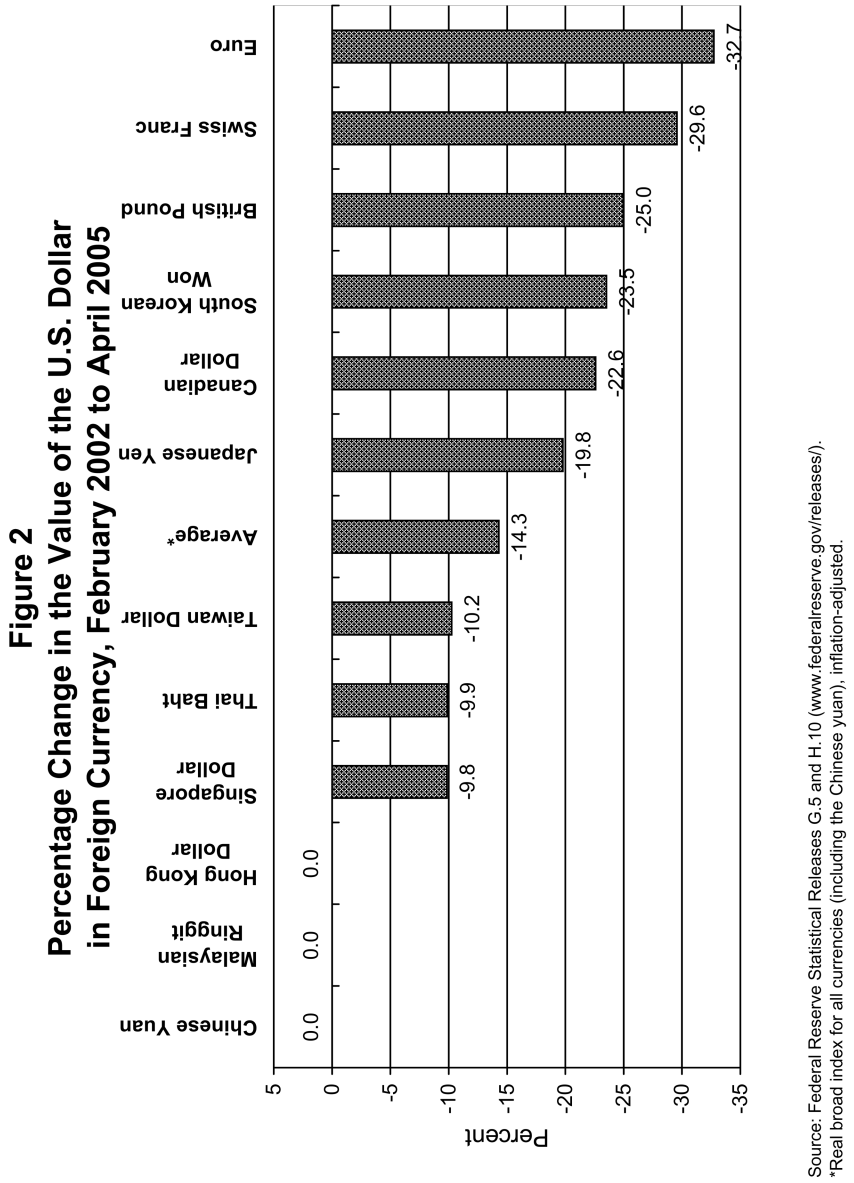
Figure 1
U.S. Imports of Goods from Mexico and China, 1980-2004(p)



Source: U.S. International Transactions data, release of March 16, 2005 <www.bea.gov>.
(p) Data for 2004 are preliminary.



Source: Federal Reserve Statistical Releases G.5 and H.10 (www.federalreserve.gov/releases/).
*Real broad index for all currencies (including the Chinese yuan), inflation-adjusted.

Vice Chairman ROBINSON. Thank you, Professor Blecker. We're intrigued that, in effect, you are predicting a bubble of a sort on export-led growth. If everybody is in that game, it's not sustainable for many of the reasons we've heard today. I think that your analysis on the U.S.-Mexico front is very illuminating and emblematic of many of the issues that we face. Obviously we have an abiding interest in the currency manipulation issue and I think you took that on very well.

Thank you. Dr. Overholt, please.

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Dr. OVERHOLT. Thank you very much. I'm honored to be invited to testify to you. Before I make my remarks, I'd just like to say I thought that in the first panel, the Commissioners asked very good questions, especially Commissioner Bartholomew, about factor mobility and cheating, and I thought the answers you got didn't address the issue or the facts of the situation adequately.

It would be nice if we could get back to those. If we can't, I may ask your permission to submit a one-page comment for the record.

On the impact of China on globalization, I'd like to address five issues. One, the degree of the turnaround that's happened in China. Two, the extent of globalization; the success of Chinese globalization from their point of view; the impact of globalization; and then I would like to tie the economics to the foreign policy implications for the United States, which you've been emphasizing as what your panel is all about.

First, the degree of turnaround. China was the greatest opponent of global stability, and of all the major institutions our country devoted itself to creating before and after World War II. It was destabilizing all of its neighbors, and subversion even extended into our own universities.

And this came about because of a situation where for two centuries China was weak and divided. This had two consequences. One was that were a giant geo-political vacuum that sucked in world conflicts. Had China been coherent, stable and prosperous in the 20th century, they would have been able to deter or defeat Japanese aggression. We would never have had Pearl Harbor or World War II.

We would have had European War II, and in many ways, we would have had European War I. Much of what made the 20th century, in terms of casualties, one of the most awful centuries in world history, and the great cost of that for us as a country came from China's weakness and division. If they had been then where they are today, we wouldn't have had those terrible costs.

Second, over a period of two centuries, China had tried everything to restore its old prosperity and unity. It tried empire and warlords and republic and various forms of capitalism and socialism. They even had some elections. Nothing worked.

Their frustration over this culminated in the cultural despair of the Cultural Revolution. This was a great civilization convinced that the deck was stacked against it. Nothing it could do, they believed, short of tearing down the world order, would provide a basis for restoring a decent life for their people.

All that changed after 1979. What we had coming without China's reforms was the equivalent of dozens of wars on terror. In fact, what China was already doing in the '60s and '70s was more disruptive than the war on terror has been around the world. And that all changed. It changed as a result of China's return of prosperity.

What is the extent of globalization? Well, China is now a much more open economy than Japan. Trade in China constitutes the equivalent of 70 percent of their economy, 24 percent of Japan's. Japan is suppressed even compared with us.

Foreign direct investment into China last year was $60 billion compared with $20 billion into a Japan that is a much bigger economy and is going through a phase of problems and consolidation that should attract completely disproportionate foreign investment. And I have to add that China abandoned export-led growth in the late '90s, and we've heard repeatedly that phrase misused.

Export-led growth means that growth is coming from an increase in net exports. Now, this year, they're having a little bit of that, but over the previous five years, exports, net exports, defined as exports minus imports, didn't grow significantly. Unlike Japan, which we started asking to make that shift in the late '70s, China made that shift.

The more important thing is institutional globalization. China has been doing what Japan did from the middle of the 19th century on. In that early Meiji era, Japan sent missions around the world looking for best practice, and they said we'll have a British Navy and we'll have a German education system, and so on, and that was the basis of the great takeoff of Japan.

Japan has forgotten how to do that. But China is doing it much more than Japan did. So we're seeing Western accounting systems, we're seeing Western corporate management systems, we're seeing securities laws drawn from the United States, the UK and Hong Kong. We're seeing China import Taiwan rules for foreign portfolio investment. They've got a central bank structure now that's modeled on the U.S. Federal Reserve. They've drawn their military procurement system from France. Much more fundamental are large concepts they've decided to borrow: the rule of law; the idea that competition is a good thing; the English language. Every Chinese student has to take seven years of English before graduating from college. They've sent their elite students all over the world in much the way that the Romans turned the education of their kids over to the Greeks. I think that's the only comparable time in history. But the Greeks had to come to the Romans. The Chinese go to Harvard. This has led to extraordinary success for China. Never in world history have workers' wages and working conditions risen so fast for so many people. There is nothing comparable anywhere in world history.

Just take one other example: Housing. At the beginning of the reform era, virtually no Chinese owned their own residences. Today, the home ownership is about the same as it is in our country. And this is why globalization has such strong support inside China. This is why they can go on with these extremely painful reforms. Let me emphasize just how much pain there has been associated with this change. The state enterprise employment ten years ago was 110 million people; now it's 66 million. That's a downward shift of 54 million. Manufacturing jobs have gone from over 54 million to under 30 million. China has lost 25 million jobs in the manufacturing sector. Even that doesn't express the full degree of social change. A couple years ago, they had 125 car companies. In a few years, they'll have between three and six.

The consolidation forced on them by WTO agreements has been something we couldn't even imagine happening in our country.

What has the impact of all this been on the world? Well, first, radical movements collapsed all over the world because of—the combination of the Soviet Union going down and what happened earlier—China's shift away from Maoist radicalism, which was more important in Latin America and Africa, because these insurgencies were Maoist insurgencies. They just disappeared all over the world when China changed.

There's been enormous emulation of China's successes, most notably in India. The combination of a 1991 foreign exchange squeeze and seeing how well the Chinese were doing with globalization is what motivated India to make the changes that have doubled India's growth rate: deregulation, competition, openness. One of the crucial things about the Chinese model is an openness to foreign direct investment that was never tolerated by Japan and South Korea or Latin American countries. With balanced equity and bank loans, which is what you have in China, as compared with just taking loans in Japan and Latin America, a lot of good things happen. It's more efficient, just like a company that relies on equity as well as debt. So everybody in the world has to compete with that balance, and that's opening up countries all over the world to foreign direct investment, heavily from us.

Those countries grow faster; those countries are going to have fewer financial crises. And our companies have more opportunities all over the world. A few years ago, it was assumed that Chinese success would suck away trade and investment from its neighbors. We now have the numbers. All of China's neighbors that have improved conditions for foreign direct investment have received an absolute explosion. China has benefited foreign direct investment to them—if you look at Japan, at Korea, at India. Same with trade. Trade has expanded dramatically, and in fact when the world had a downturn a few years ago, it was China that saved the neighbors, and this has had tremendous foreign policy consequences because they're grateful.

Above all, the Japanese recovery was a result of increased Chinese demand. Japan was right at the tipping point. It almost went down.It would have taken all of Asia and maybe the world down with it if it had gone down. And the Japanese were very conscious of that, and by the way, that's why they oppose our policy on Chinese currency revaluation.

A few comments about the geopolitical consequences. Unlike the former Soviet Union and unlike Maoist China, the Chinese are not trying to change the way we organize our lives or other countries do. And their success does not mean they're going to take over the world.

They have extraordinary problems. They have an equivalent of the population of the United States moving into their cities every generation. They have the worst banks in the world. They have the worst employment problems that the world has ever seen. And by 2020, we're not going to see China taking over the world. We're going to see the country in the world that has the worst ratio of workers to non-workers of any country in the world, worse than

Japan. It's going to be magical if they find a way to avoid just hitting a wall in a mere 15 years.

So, what are the big geopolitical consequences for us? Our foreign policy after World War II was to suck as many countries as possible into this network of institutions, IMF, World Bank, the GATT, WTO—as possible. This is a tremendous triumph for that policy.

We never imagined we would be that successful. We avoided the kind of vacuum that we had in the 20th century. The further Asian development that China is stimulating inhibits the kind of despair that we're seeing in the Middle East and that we saw earlier in places like Cambodia and Indonesia, and thereby averts spread of terrorism.

I'll just close with a note that China fever today reminds me of Japan fever 20 years ago. My first boss was Herman Kahn. The Japanese always used to come to him and say, when we get up to where you are, you're going to put us down; aren't you? And Herman would turn around and say, "You don't understand Americans. We won't attack you. We'll take credit for all your successes."

And I would argue that success for U.S.-China policy is turning China into a Japan. But expressing fright every time they make a technological advance is not the appropriate response. When they get richer, and it's going to take them a long, long time, it's going to turn into a division of labor like that between us and the Japanese. They're good at cars; we're good at software. There is no such thing as a country that has a comparative advantage in everything.

Thank you.

[The statement follows:]

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China and Globalization

Summary

China has transformed itself from the world's greatest opponent of globalization, and greatest disrupter of the global institutions we created, into a committed member of those institutions and advocate of globalization. It is now a far more open economy than Japan and it is globalizing its institutions to a degree not seen in a big country since Meiji Japan. Adoption of the rule of law, of commitment to competition, of widespread use of English, of foreign education, and of many foreign laws and institutions are not just updating Chinese institutions but transforming Chinese civilization.

All of China's economic successes are associated with liberalization and globalization, and each aspect of globalization has brought China further successes. Never in world history have so many workers improved their standards of living so rapidly. Thus popular support for globalization is greater than in Japan, where postwar recovery occurred in a highly managed economy, or with the former Soviet Union, where shock therapy traumatized society. In consequence, China has effectively be-

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come an ally of U.S. and Southeast Asian promotion of freer trade and investment than is acceptable to Japan, India and Brazil.

Nonetheless, rapid Chinese globalization has required stressful adjustments. State enterprise employment has declined by 44 million. China has lost 25 million manufacturing jobs. 125 car companies are expected to consolidate rapidly into 3 to 6.

China's globalization successes are profoundly influencing its neighbors. India has learned from China the advantages of a more open economy. Asians schooled in antipathy to foreign investment and Latin Americans with protectionist traditions are going to have to be more open to foreign investment and less dependent on loans in order to compete with China. This will transform third world strategies of development and create broader global opportunities for our companies.

Contrary to early fears, China's rise has stimulated neighbors' trade and foreign investment rather than depriving them. Indeed China's recent growth spurt revived Japan's economy and saved key neighbors from recession, possibly averting a dangerous global downturn.

Chinese growth has brought American companies new markets. The flow of profits from China to the U.S. is as disproportionate as the flow of goods. Inexpensive products have substantially improved the living standards of poorer Americans. Inexpensive Chinese goods and Chinese financing of our deficit have kept U.S. inflation and interest rates down and prolonged our economic booms. At the same time, it has caused trade deficits and social adjustments. Chinese misappropriation of intellectual property creates losses for many of our companies. A manic construction and transportation boom has raised global raw materials prices, to the great benefit of producers and a great cost to consumers.

China's success is one of the most important developments of modern history, but projecting from current growth to Chinese global dominance or threats to our way of life is just wrong. Unlike the old Soviet Union, reformist China does not seek to alter any other country's way of life. Its economy faces world history's most severe combination of banking, urbanization and employment challenges, and by 2020 a demographic squeeze that will have few workers supporting many dependents. The best outcome for us would be a China that is eventually like Japan, prosperous, winning in some sectors, losing in others. Signs that China is making rapid progress in that direction should be welcomed, not feared.

China and Globalization

Before reform, China was the world's most important opponent of globalization. It had an autarkic economy. It opposed the global economic order. It opposed the global political order and the major global institutions such as the IMF and the World Bank. It believed that global disorder was a good thing, and under Mao Zedong it actively promoted disorder throughout the world, including promotion of insurgencies in most of China's neighbors, in much of Africa and Latin America, and even in our universities.

Accompanying foreign policy disaffection was domestic cultural despair on a scale the world has seldom witnessed. In the Cultural Revolution, 1966–1976, China's students and others, under the guidance of Mao Zedong's peasant chiliasm, humiliated a majority of senior government and party leaders, attacked the country's major educational, social and political institutions, destroyed much of China's cultural heritage, and in general tried to smash the country's establishment.

For two centuries Chinese had tried a range of ways—socialism, capitalism, empire, republic, warlords, religious fundamentalism, and others. All failed. Alienation was so severe that, along with students, much of the country accepted that the world economic and political order, and the Chinese economic and political order, were so stacked against them that any path to success had to start with destruction of the existing order.

The Cultural Revolution was actually just one small episode in the problems that Chinese impoverishment and political division created for the world and specifically for us. Had China been prosperous and unified throughout the twentieth century, we would have had European War II rather than World War II and World War I would have been quite different. China would have been able to deter or defeat Japanese aggression. The cost of those conflicts to the U.S. would have been radically smaller because Pearl Harbor and much else would not have happened. We and the world, not to speak of a billion Chinese citizens, have paid a horrible price, over more than a century, for China's weakness. The world needs a healthy China.

Because of China's successful globalization we no longer have such problems. China is no longer a vacuum that sucks the world's great powers into gigantic conflicts. China no longer sponsors insurgencies in Southeast Asia and Africa and Latin America. China no longer seeks to undermine the global financial institutions. We obtain benefits from a China that supports stable capitalist democracy in Thailand

and the Philippines; that joins the IMF, World Bank, and WTO; and that counsels its neighbors about the benefits of political stability, free trade, and free investment.

From the beginning of the Cold War, it has been the central tenet of U.S. foreign policy that, if we could engage as much of the world as possible in successful economic growth, through domestic reform and what came later to be called globalization, we could stabilize Europe and Asia, win the Cold War, and create a stable global order. Our military protected this process, but from the Marshall Plan to our aid missions in Asia and Africa, the core long-run strategy of our country has been to engage the world and stabilize it by enmeshing other countries in a web of institutions and successful economic practices that constitute the kind of world we want.

This strategy has proved to be one of the most successful geopolitical strategies in human history, so much so that it has entangled our former enemies as well as our allies in the web we wove. Throughout, it has stimulated many controversies, and occasional waves of fear in this country. Key industries, including especially textiles and shoes, have successively opposed liberal trade with Japan, South Korea, Taiwan, Southeast Asia, China and Latin America. We had a wave of panic over whether Japan was going to take over all manufacturing and buy all our most important assets; after all, if they could triumph in steel, cars, and televisions, and buy Rockefeller Center, wasn't everything in our economy at risk? Elsewhere, weren't we sponsoring horrible dictatorships by encouraging the development of Taiwan and South Korea? Each time, our fears have proved excessive, and each time our strategy triumphed. The results have been good for our security, good for our prosperity, good for political liberalization overseas, and good for the people of our trading partners. Our concerns about China are the same.

China's Globalization

What we never expected from our strategy was that it would entice our former adversaries, including China, into our web of economic institutions and our commitment to geopolitical stability.

Although joining late, China has joined the globalized system much more enthusiastically than Japan. China's economy is much more open than Japan. China's trade in 2004 was equal to 70% of its GDP, Japan's to 24%. China received $60.6 billion of foreign direct investment in 2004, while Japan, with an economy several times larger and in a phase of restructuring that should have attracted disproportionate foreign investment, received only $20.1 billion.

China's globalization is not confined to opening the economy but more importantly to globalization of institutions. Here the development strategy of contemporary China bears a striking resemblance to that of early Meiji (mid-nineteenth century) Japan, when the Japanese government was sending missions around the world to choose for emulation the best foreign navy (Britain), the best foreign education system (Germany), and so forth. In the intervening century and a half, Japanese practice has become more inward-looking, while China has evolved from Qing defensiveness and Maoist peasant xenophobia to an assimilative cosmopolitanism.

Today China is the country that sends missions throughout the world seeking best practice. It adapts not just foreign technology and foreign corporate management techniques but also a wide variety of foreign institutions and practices: international accounting standards; British, U.S. and Hong Kong securities laws; French military acquisition systems; a central bank structure modeled on the U.S. Federal Reserve Bank; Taiwan-style regulations for foreign portfolio investment; an economic development strategy adapted from South Korea, Singapore and Taiwan; and many others. Among the most important of these changes are the decision to adopt the Western concept of rule of law; adoption of competition as a centrally important economic practice; and adoption of English language as virtually a second language for the educated Chinese population. Today I can lecture in Peking University and interview senior officials in Beijing and Shanghai without a translator. Perhaps most importantly, China has sent its elite youth abroad for education in an exercise of internationalism comparable to the Romans turning over their children to the Greeks.

Of course, such changes occur gradually; you can't instantly introduce Western accounting or Western law in a country that starts with no professional accountants or lawyers. But the changes are startlingly fast compared with what other countries do. More importantly, these are not technical adaptations in the manner of the old dynastic efforts to pursue "Western technology, Chinese culture." These are transformative processes that in cases like rule of law and promotion of competition repudiate core aspects of traditional Chinese civilization that go back for millennia.

China is also experiencing globalization of tastes. The exposure of the Chinese population to foreign brands has been incorporating them into global culture. To take one example, I spent many months studying the Chinese car industry. One of

the questions we were asked was whether China might develop indigenous car models in a closed-off market like that of South Korea in the 1970s and 1980s. What we discovered was that the Chinese people have been so much more exposed to global culture than South Koreans of a generation ago that no car could succeed in China unless it incorporated global designs and prestigious foreign technologies. Ten to thirty years ago, when South Korea was at a phase of car industry development more comparable to China today, one virtually never saw a European or American car on the road, and they are still very rare today. But in China the roads are packed with Volkswagens and Buicks.

China has come to believe in globalization more than most third world countries and many first world countries. China's successes have all coincided with "reform and opening," that is, with globalization. In contrast, Japan's and South Korea's successes occurred in an era when, although they were globalizing, they employed far stricter controls on trade, foreign investment, and domestic economic activity than today's China.

Globalization has required extremely painful adjustments by China. Employment in the state enterprises has declined from 110 million at the end of 1995 to 66 million in March 2005. Those who think there has been a simple transfer of U.S. manufacturing jobs to China will be surprised to know that manufacturing jobs in China have declined from over 54 million in 1994 to under 30 million today. Even these striking numbers understate the adjustments China has had to accept due to greater competition and lately from WTO membership. For instance, while employment in the car industry has remained relatively constant, the number of car manufacturers is expected to decline from 125 at the peak to somewhere between three and six. Meanwhile, foreign joint ventures have come to dominate much of the market.

It is hard to overstate the social adjustment Chinese are experiencing. But because China has been willing to accept such adjustments, no large country in human history has ever experienced such rapid improvements in living standards and working conditions. When reform began, workers in Shanghai all wore the same clothes, looked tired and listless, and seldom owned basic appliances like televisions or even watches. In the countryside malnutrition was widespread. Today Shanghai workers wear colorful clothes and look confident and energetic. Today the average Chinese family owns slightly more than one television. Malnutrition has vanished. As a result, Chinese overwhelmingly support further globalization.

China's Globalization and Other Countries

China's globalization has of course strongly influenced other countries too. The most important impact has been on India's economic policy and performance. Since independence India's economy had been hobbled by extremely protectionist trade policies, an antagonistic stance toward foreign direct investment, and a remarkable network of domestic socialist economic controls called the license raj, combined with strong foreign economic and political ties to the old Soviet Union. A 1991 foreign exchange squeeze and neighboring China's success shocked India and also showed that abandoning the old hostility to globalization could lead to prosperity. While India started later than China and moved more slowly, India's economic growth rates have doubled. The number of people in absolute poverty has declined sharply. Exports have boomed and foreign exchange reserves are ample for the first time in modern history. Visit India today, as I did last month, and you find the kind of hope and confidence and energy that once seemed confined to East Asia.

As happened earlier with China, India's newfound economic dynamism has shifted the balance of leaders' priorities from conflictful geopolitical goals to mutual economic interests. India's relations with its neighbors, sometimes including even Pakistan, and most notably with both China and ourselves, are much better than previously. Indeed, Indian-Chinese relations are better than at any time since the conflicts of the 1960s, and India's business community has shifted from terror about competition with China to confidence in India's competitive advantages and even some celebration of India's recent trade surplus with China.

China's influence on India's economic policies is just one example of a much wider phenomenon that is probably just beginning. Until recently, most of the third world plus Japan has taken a relatively hostile attitude toward foreign direct investment. Difficult licensing requirements, high taxes, unfair judicial treatment and a negative opinion climate have faced direct investors from Japan and South Korea to the Philippines and Thailand to India, not to mention most of Latin America. Instead of accepting foreign ownership, countries typically relied on foreign loans (South Korea, Southeast Asia, Latin America) or domestic loans (Japan), frequently creating an excessive burden of debt. Thailand imposed very high taxes and then reduced them for selected foreign investors; Indian groups attacked Kentucky Fried Chicken with distorted hygiene allegations. Now such tactics are waning.

The success of China at balancing debt with equity, building upon the previous successes of Hong Kong, Taiwan and Singapore, is gradually changing the way much of the world manages economic development. This Chinese influence is going to be transformative, particularly in Asia. The old pattern has been to avoid dependence on foreign investment by taking domestic and foreign bank loans. Governments then controlled the development of industry by channeling the bank loans. This made companies and countries overly dependent on banks, leading to periodic financial crises. It gave governments too much control over industries, encouraging mismanagement and corruption. It gave unfair advantages to large, politically favored companies over smaller companies and foreign companies. Importantly for us, it limited the opportunities for our own companies. Now competition with China will force most companies to open themselves to foreign investment. American companies will benefit not just in China but throughout the world.

At the beginning of this decade, there were widespread fears that China's success would suck the trade and investment away from its Asian neighbors, impoverishing them. In the event, the opposite has happened. Wherever rules have been changed to welcome foreign direct investment, as in India, South Korea, and Japan, such investment has boomed. China has taught others to attract foreign investment, and in response the total pool of foreign investment has greatly expanded.

Amid the global slowdown following the tech bust, countries like South Korea and the Philippines found themselves saved from recession by Chinese demand. Most importantly, Chinese demand provided the stimulus that lifted Japan out of recession. It is difficult to overstate the risk the world economy faced from the Japanese situation, where mountainous debt created the risk of a domino-like collapse inside Japan and subsequent rippling collapses around the world. That risk seems to have passed, helped by a critical margin of stimulus from China. Few books are written about global depressions that never happened, but it is quite possible that China's globalization saved us from beginning the new century with a drastic global economic squeeze.

Many other peoples have benefited from Chinese demand that rose just as the world economy was slowing. Raw materials producers had become inured to terms of trade that deteriorated inexorably year after year. Suddenly our ally Australia found that its terms of trade have improved to the best in its entire history, largely because of Chinese demand. Many of the world's poorest countries, including Laos, Papua New Guinea, and much of Africa, benefited just when they needed it most. No aid programs, no IMF gold sales could have come close to providing the improved livelihoods that resulted from increasing, sustained demand for their products.

In short, the most important results of China's rise are the same as the results for the world of America's rise or of the recoveries of Japan and Europe: you are always better off with a rich neighbor than with a denizen of the slums.

Benefits and Costs for the U.S.

China's globalization has had numerous impacts on the U.S. Most obviously, China has become a vast market for U.S. goods. Arguments that this is a mythic "China Dream" have proved false. Coca Cola has long since surpassed the fabled goal of selling a billion Cokes. General Motors, once ridiculed by the China Dream theory, sells many Buicks in China, and, despite a current cyclical pause, profits from China have been a critical margin for GM during a difficult time. We gain from billions of dollars of profits remitted back to our country and from the improved health of our most successful companies as they compete against other foreign companies.

Lower prices for basic goods have contributed significantly to American standards of living, particularly for our less prosperous citizens. While we do not yet have definitive studies, indications are that lower-income Americans achieve improvements in their standards of living of perhaps 5% to 10% as a result of being able to buy lower-priced imports from China. That impact is undoubtedly expanded by the fact that competition from China drives other countries to produce less expensive goods for our consumption.

Inexpensive Chinese goods have kept down our inflation rates and enabled us to prolong the upswings of our business cycles because the Fed doesn't have to raise interest rates so quickly in order to slow inflation. Similarly, Chinese purchases of U.S. Treasury bonds have helped to finance our budget deficits. Without those Chinese purchases we would either have to raise interest rates, slowing our growth, or we would have to run comparable trade deficits with other countries so that they could buy our bonds.

We are just beginning to see another layer of benefits. The Chinese are beginning to invest here. Haier is now manufacturing refrigerators in this country. When China's Lenovo bought IBM's personal computer business, it saved jobs in a moribund

division, freed IBM to move up into higher-tech markets, and helped finance that IBM move up. So far, this trend is small, but it will grow quickly. China's goal for this year is to spend $30–40 billion buying resource and distribution companies.

We also benefit indirectly from China's boost to foreign economies like Japan and Australia. Having a prosperous partner is invaluable to the U.S. economy. We spent the 1980s fretting about Japan taking over the world, but we spent the 1990s worrying that Japan wasn't doing its share to boost global growth. Those who worry about China's success would have far more to worry about if China's growth slowed drastically.

Adjustment Problems

China's globalization and growth also cause stresses for us. Some of these are politically eternal but economically and strategically tired. As countries get rich, the manufacture of textiles, and shoes, furniture and basic consumer electronics mostly migrates elsewhere. The manufacture of socks migrated from here to Japan, from Japan to South Korea and Taiwan, and thence to Southeast Asia and now China. That adjustment will continue. It has been gradual over many decades. We have had ten years to get ready for the current round of textile adjustments. We knew what was coming and we agreed to it, in return for China so stressful that they are virtually beyond Americans' imagination. Our own adjustments are smaller than those of virtually any other country.

These adjustments are smaller than we tend to believe, because China gets blamed for much that it does not cause. Virtually all of our job loss has been caused by productivity improvements. In fact, productivity gains have been sufficiently large that we should have experienced more job losses than we have. It is conceivable that our job losses have been smaller than they "should" have been because China has helped us adapt. We don't know, because no lobby has been interested in paying for the research to find out how many jobs have been saved by partial moves to China decreasing the costs of endangered companies. And China is, of course, just part of a global readjustment caused by China, India, and the former Soviet Union joining our economic system.

A more serious policy problem is hyper-competition created by cheap financing in China. The irrationalities of the Chinese financial system mean that in key sectors like steel China builds too many factories, and props up too many moribund companies, causing massive overcapacity. In recent years Chinese financial vagaries have led to excessive construction and huge demand for steel, aluminum, cement and others. For a while this has buoyed the global steel industry, including ours. But it has also led to construction of so many steel factories in China that soon China will have half of all world capacity. That means overproduction and eventually a steel price bust.

This cycle creates problems for our industry, just as our Internet mania and tech bubble created problems for much of the world. It is fair for us to complain about such problems. It is fair to pressure the Chinese to reform their financial practices. It may be fair in some cases to view Chinese bank lending practices as constituting an inappropriate subsidy. The tone of our complaints and the substance of our policies needs, however, to reflect three facts. First, the Chinese are trying to reform their banks and put them on a market basis. Second, our financial vagaries cause them problems too. Third, the biggest price for their financial mismanagement will eventually be paid by them, because inappropriate lending eventually makes troubled banks much more troubled. China making steel today looks like Japan buying Rockefeller Center two decades ago; if you project their excesses indefinitely into the future, first the Japanese and now the Chinese look as if they are about to take over everything in the world. But when you look at their underlying finances, you see a black hole. The Japanese spent the 1990s in their black hole and are still trying to climb out. China will feel the pain of its recent spree for many years. Having said these things, some excesses may require a policy response by us.

Chinese theft of intellectual property has become a major issue. The IPR problems presented by China are similar to those presented by other developing countries. In the 1930s, Japan built cars that were half Ford parts and half GM parts, with DeSoto styling. In the early days of Japan's postwar takeoff, a high proportion of its electronics exports infringed Texas Instruments' patents. I, like numerous others, accumulated a library of knockoff books from Taiwan in the 1970s, and Taiwan still has the best knockoff watches. When I lived in Singapore in 1998, I could get knockoffs of most Hollywood movies at a six-story building within five minutes' walk of my office, and indeed well into the 1990s official U.S. Government briefings credited Singapore for some 70% of the knockoff computer software in Asia—at a time when China was getting most of the blame. China's IPR practices today are not very different from those of India and Russia. But the scale and efficiency of China, and

the extent of foreign direct investment in China, make the issue a larger one. Indeed, the IPR losses caused by Chinese practices are probably on a scale with those of other major emerging markets, like for instance American youth. It is appropriate for us to make very strong representations about IPR abuses. It is appropriate for us to implement policies that punish bad behavior and reward better behavior. It is also useful to maintain a certain historical perspective.

The other side of the benefits Australia, Africa, Latin America, and other resource providers (including part of our own economy) have received from Chinese demand is a rise in prices for consumers, and we are more consumer than producer of raw materials. For many key materials, the biggest part of recent price rises has been cyclical. The Chinese mania for steel, aluminum and cement has peaked. In the case of petroleum, the cumulative increase in demand caused by China, India, Russia, and other developing countries may soon push against long-run supply constraints. This may compel us to make new, potentially urgent decisions about conservation, the kind of energy we use and the degree to which we compete or collaborate with the other major users. This would have happened eventually even without the rise of China, but China is certainly accelerating the issue.

Finally, the rise of China raises questions about whether we face a major challenge to our role in the world or to our way of life. One part of this is easy. We do not face a challenge to our way of life. Unlike the Soviet Union, and unlike China under Mao Zedong, reformist China does not seek to change the way we organize ourselves or the world, but rather to join the world system we have created.

Geopolitical competition raises more complicated issues. Like South Korea, as China grows it gets stronger. Its military becomes more modern. In one particular area, the Taiwan Straits, maintaining our dominance will become increasingly difficult. That is a serious and difficult and legitimate challenge for our military to cope with. But theories that China is going to take over the world suffer from the same flaws as theories two decades ago that Japan was going to take over the world. The Chinese military has to defend 11,000 miles of not-always-friendly borders, and its growing military is far from excessive for the tasks it faces. Economically, China is not going to manufacture everything in the world; no country can have a comparative advantage in everything.

In the medium term China faces daunting challenges. Its banks are the worst in the world that we know about. In each generation a population about the size of the United States will move from China's countryside to its cities. Each year 12–13 million new workers join the workforce. The impact of productivity on employment in manufacturing is much more severe than in our country. All these people need jobs. For a considerable period China's high growth can be sustained, but only through heroic reform measures by China's leaders. If somehow China powers through these problems, by 2020 its aging population will have the worst ratio of workers to non-workers of any population in the world, including Japan's. That is to say, without some miraculous new policies the Chinese economy may well hit a wall in that period. In 2020, they will still be a very poor country by our standards. Even if their success continues until then, they will not be taking over the world.

The emergence of China as a principal advocate of globalization and stability creates a complex geopolitical situation for us. On issues of free trade and investment, and on a variety of economic issues like GMO crops, China is our principal ally. On North Korea, despite differences over tactics, we share the same goal and China is our only effective partner. On terrorism and crime, China is our principal Asian ally. We are now in a novel situation where Japan is our military ally and partial ideological soulmate, but China is effectively our ally on the important political and economic issues, with Japan either ineffectual or in opposition to us. This is a novel historical situation.

Where Chinese influence has increased greatly at our expense, other than the unique situation in the Taiwan Straits, it has been because we and our traditional allies created a vacuum, not because China has aggressively asserted power. But there have been important shifts, and we need to be very conscious of them. On the dangerous North Korean issue, we have been divided at home, and our allies, most notably South Korea, have disagreed with our tactics. We have demanded that China play the central role, and China was hesitant to accept the invitation. In Southeast Asia, we have traditionally earned loyal support by organizing our policies around a core value of economic growth through liberalization and globalization. Today we are perceived as having abandoned that priority in favor of a more military focus on the war on terror, while China is seen having abandoned its Maoist geopolitical priorities in favor of a priority for mutual economic development through multilateral liberalization. Within our economic policies we are seen as having abandoned multilateral liberalization in favor of highly politicized bilateral free trade agreements, while China has become the principal supporter of multilateral-

ism. China carefully joined ASEAN on trade, rather than asserting its own vision. Without exception, Southeast Asian (and many other Asian) elites see the 2003 APEC summit as a watershed that marked the U.S. and Chinese reversal of roles. The result of these Korean and Southeast Asian developments is a sea change in Asian geopolitics, but we are the ones who made the changes, not China, and we still can take the initiative if we wish to do so.

We Americans must be very clear about the difference between success and failure. When our system of institutions and relationships pulls the unstable China of 1870 and the destructive China of 1970 into coherence, prosperity and support of the major global institutions that we have created, it is success for us, not failure. In fact, it is one of the great successes of history. When we have a prosperous economic partner, at the cost of historically minor adjustments, that is success for us, not failure. Of course, our successes to date provide no absolute assurance that China will always be friendly or supportive of our institutions. But if we welcome China's prosperity, we maximize the chances of an auspicious outcome. If we reject it, we ensure the worst outcome.

The best outcome for our relationship with a globalized China is that China becomes like Japan, a prosperous competitor with whom we have a mutually beneficial division of labor. Hopefully China will absorb useful political lessons from its Asian neighbors, and hopefully Japan and South Korea will learn the economic lessons of China's superior openness to our investments. China's turn to globalization has been one of the greatest foreign policy triumphs of American history.

My first boss was Herman Kahn, who wrote a book called "The Emerging Japanese Superstate." Japanese experts constantly worried that, if their economy really succeeded, we would intervene to put them down. Herman Kahn invariably replied, "You don't understand Americans. We won't attack you. We'll take credit for everything you achieve." Herman Kahn was a great American strategist and a great American patriot.

Panel III: Discussion, Questions and Answers

Vice Chairman ROBINSON. Well, I must say it's a breathtaking spectrum of views.

Really. I mean you've presented us with a very provocative set of issues. Dr. Shenkar, I agree with much of what you've said. We have seen, regrettably, that globalization doesn't equate to similarity and that China has been able to insulate its political system from economic development to a large degree, much more successfully than I think many proponents of engagement had in mind.

And, of course, we've heard from Dr. Cooper and others, and hopefully he's right, that the bilateral relationship is still on track. But when you think of 30,000 Chinese dedicated to media control alone, and ensuring that the Internet does not permit a free flow of information, it's just one of a myriad of illustrations of how dedicated the Chinese are to making sure that the Internet firewall is effectively maintained.

The rise of Chinese nationalism is a huge topic. When one considers that China is a country with rigid systemic bottlenecks and challenges, it has a vast amount of overhead, a very weak financial system and the list goes on. I don't think one can miss the fact that nationalism is increasingly serving as a substitute for Communist ideology. Dare we call it national socialism, which in the period of World War II had another name—fascism.

It could well be that China, at least in my view, may well be headed in that direction. Although China has been an engine for growth in Asia, as Dr. Overholt just pointed out, and possibly catapulted Japan from continued stagnation to modest growthand that China is participating in the globalization movement, some would say on balance positively, there are somedark clouds forming. One of them is a highly emotional challenge represented by Cross-Strait relations. Combine this with rising Chinese nationalism and it may

not be a pretty picture ahead. It's likely that this huge symbolic threshold, I agree with you, will be passed by China in terms of U.S. purchasing power equivalency.

So I'm really just looking for any of your observations about the rise of Chinese nationalism, perhaps in response to their own domestic shortcomings and bottlenecks., Can China get beyond its traditional view that the U.S. as a hegemon in the region that must be replaced. In short, there are lots of serious bumps along the trail in our bilateral relationship in the not too distant, say between 2007 and 2012. I'm wondering how you see the evolution of the rise of Chinese nationalism and some of these serious threats to a happy ending for China's integration into the world's trading and financial systems.

Dr. SHENKAR. Throughout thousands of years of history, the legitimacy of the ruler in China relied on an established share ideology, on a sacred text, starting with Confucian intellects, moving on the Three Principles of the People on Sun Yat-sen, on to Mao Zedong's writings. This doesn't exist today.

I believe that the legitimacy of this unelected government nowadays rests solely on two things. One of them is nationalism, and I think these orchestrated attacks on some Japanese targets recently were a good demonstration of that.

Vice Chairman ROBINSON. Right.

Dr. SHENKAR. The other thing, and this is something that worries me more, is that of economic prosperity. In other words, there is no more legitimate ideology to support the regime. Students still take classes in Marxism but nobody takes them seriously anymore if they did back then. What the Chinese subscribe to is something that the Chinese official mentioned, I think, very wisely in the early 1980s when somebody asked him what you are doing now is not really that consistent with your ideology, the answer was we are experimenting with everything now. Whatever works, we'll call it socialism.

So, here is my fear. My fear is that right now we have a lot that is riding on economic prosperity. In imperial days, this used to be called the Mandate of Heaven. That is if the emperor does not perform, then the people can put him out. My fear is that if indeed one of the negative scenarios occurs, if indeed there is a sudden deterioration in the economy, one of the things that might happen, for instance, is the initiation of trouble in the Taiwan Straits. In other words, it's not going to take necessarily a declaration of independence. It may simply take a deterioration of economic situation for the whole planet to plunge into a serious problem.

Vice Chairman ROBINSON. Thank you. Dr. Overholt.

Dr. OVERHOLT. I agree completely that Chinese legitimacy rides on economic performance, on improvement in living standards today, and ideology is gone. We've seen this in South Korea. We've seen it in Taiwan. The Asian miracles typically take place over the body of whatever ideology was there before. They create an ideological vacuum. That ideological vacuum was initially filled by Sun Myung Moon in South Korea, Falun Gong in China, and by more established religions, and later in all the other cases by democracy.

And Park Chung-Hee was a lot wiser in the way he played Sun Myung Moon; he let him create a chaebol and let the chaebol go

bust, than Jiang Zemin in the way he's played Falun Gong, but the processes are identical. Now, if it goes wrong—it didn't go wrong in Korea, it didn't go wrong in Taiwan—if it goes wrong, you could get nasty nationalism of the kind we saw in the '30s in other places. But what we need to emphasize is that the way fascism arose in Japan and Germany was horrible, horrible economic and social traumas.

People were on the verge of starvation in Japan. The Germans, whether or not they deserved it, went through terrible traumas too. What's happening in China is the exact opposite of that, and the only historical models we have for how that evolves are Taiwan and South Korea.

So, yes, there are circumstances under which nationalism could get out of control in China, but we're not into a Japanese or Germany 1930s model at this point.

Vice Chairman ROBINSON. Professor Blecker, anything to add?

Dr. BLECKER. I seem to be the only economist on this panel, and this is outside my area of expertise.

Vice Chairman ROBINSON. Okay. Very good. Well, Commissioner Wortzel—over to you.

Commissioner WORTZEL. Really a schizophrenic range of options that you gentlemen are presenting. It could turn nationalist and that nationalism could manifest itself in fascism and expansion like Nazi Germany or Japan. Or a rise like the rise of the United States in the 19th century, which means a very strong country. But, it also meant a war with Spain over hegemony in the hemisphere and maybe more than the hemisphere.

So what does that sort of rise that you described, Dr. Shenkar, this great power rising mean? This is a rising China that takes the route of the 19th century form of military, political and economic expansion. What does that mean for U.S. security interests? What does that mean for peace and stability in the Pacific? Does that mean that there is going to be inevitable conflict between China and the United States if that's the way the thing goes?

The Mandate to Heaven—you're absolutely correct to suggest that the failure on the part of any dynastic or political leadership in China to provide for basic livelihood and wealth for the population led to some sort of revolution or turmoil. Of course, when that happened, China was the weakest in history, but it did not rise up like Germany after the Weimar Republic, create a Nazi party and take over or attempt to take over at least an entire hemisphere of the world.

It collapsed on itself and the Chinese fought each other. China was a threat to nobody except all kinds of poor Chinese that got killed, starved and murdered in these internal wars.

So I guess I have to say you all don't have to come up with a single option, but at least for yourselves or for us, it can't be both ways. If you lose the Mandate to Heaven, then you're not reaching out and taking over a region; you're probably not even worried about Taiwan. You're worried about maintaining power yourselves and things are falling apart or, alternatively, if it's a Weimar Republic case, what does that mean for U.S. security? Whichever? Go ahead.

Dr. BLECKER. Well, I might just be an amateur historian for a moment. I think China's starting point today is very different than 100 or 150 years ago when the Europeans came over there and they had their various revolutions and collapses. Through what we've been hearing about today and I'm sure you've heard about at your other hearings, there is a modern, technologically advanced, scientifically sophisticated China emerging, and it has serious military muscle and potential.

So the reaction today could be very different than what it was in 1910 or some earlier time period.

Dr. SHENKAR. I would like to add something about China's history. I mean the good news, if you will, is that China traditionally has not been an expansionist country. This is possibly the only power in ancient times that didn't take advantage of its power to actually take over territories that it could take over militarily at that time, and this is——

Commissioner WORTZEL. I've got to dispute you on that.

Dr. SHENKAR. Okay. Please.

Commissioner WORTZEL. I think the Vietnamese all the way down through the majority of what is today South Vietnam might call the Chinese expansionist, and the Koreans might call the Chinese expansionists.

Dr. SHENKAR. Right.

Commissioner WORTZEL. And the Japanese might, who had to sort of eat them away at least once might call them expansionist.

Commissioner TEUFEL DREYER. I think this is canard spread by the Chinese, and I don't think you ought to swallow it. Iain Johnston has written an entire book on this.

Dr. SHENKAR. Yes. My reference point is a similar power such as the Roman Empire. I fully agree with you vis-à-vis Chinese forays into near territory, you know, in Vietnam, in Taiwan, which traditionally indeed has not been Chinese territory. But China did not translate its military and economic power at that time into such global ambition as to—and this is to me the most comparable case—you know, that of the Roman power.

Commissioner TEUFEL DREYER. We can argue about that sometime later.

Dr. SHENKAR. Absolutely. However, I would make the point that if we ask about the global implication, today, we have a global economy. We are intertwined. Whatever is happening in China, unlike in ancient times, will directly impact what happens in the rest of the world. Just think of a scenario where there is a dramatic slowdown in economic activity, and the Chinese dump product in world markets, and the trade deficit that you see today would look tame by comparison to what might be coming. You're going to end up with protectionism and so forth.

I do have to say, and this is going back to the schizophrenia, how do I end up with a fairly optimistic prediction on China's Rise. In my estimation, and this is based on 25 years of reform, the Chinese have been successful in tackling most of their problems. Again, in historical terms, the imperial system survived for about 2,000 years with different dynasties.

It is not impossible that this dynasty will fall. It does not necessarily mean that you're going to get a republic instead. You may get a new dynasty.

Vice Chairman ROBINSON. Anyone else?

Dr. BLECKER. I don't know if this is exactly related to the question, but I would say that I don't fear China becoming a rich and prosperous country or having a gross domestic product larger than ours. That's not necessarily something we should fear. It is something we should welcome. We don't want a poor, unstable China. But the question is what kind of responsibility will China take as a leading economic power once it is one and it is already becoming one?

And there are key elements here, and it does relate to the macroeconomic questions we've been discussing all day: will China instead of just hoarding currency reserves spend some of that and reinfuse liquidity into the global financial system? Will it create enough demand to help boost global markets or will it be restrictive?

We have been the main motor of global demand growth for the last 15 or 20 years, but as we've discussed, for various reasons that's not sustainable long-term if we keep going the way we're going. Will China step up to the plate and assume a different role there?

So these are the kinds of questions we need to ask. I don't think we need to fear them being big. But I think we need to look at what their role will be and convince them that it's in their long-term interest to make some of these adjustments.

Vice Chairman ROBINSON. If you look on the other side of our Commission's mandate, the security side, we need to ask if we want to see a strong and prosperous China that's building an evermore formidable ICBM capability targeting American cities, a blue water navy and submarine force that occasionally makes incursions into Japan's sea lanes, and the deployment of some 700 or more missiles targeting Taiwan today that's increasing by 75 to 100 a year. The long and short of it is that these and other major security concerns accompany a prosperous Chinaand we need to be mindful of that.

Commissioner Mulloy.

Commissioner MULLOY. Thank you, Mr. Chairman. Two of three witnesses have asked us to come back to the economic, so I want to do that. In our first annual report in my additional views, I said I'm not out to demonize China because this is a country with whom we're going to have to work. But I do think China has policies in place to spur its own strength and growth that may not serve our interests and we ought to try and understand that and figure out what we can do to prevent that from happening at our expense. That's my game, and that's what I'm trying to understand.

Let me tell you why the structure of these economic questions are so important. The GATT structure and the WTO now is one in which if I give you a two percent tariff. You don't need to give me a two percent tariff, you can give me a 20 percent tariff, and if I take it, that's the structure we're in.

I'll give you an example. We ship a car to China, 25 percent tariff on China's part. They ship a car here, 2.5 percent tariff. That's a

structure. We agreed to it. It's in place. When GATT was first put together, you did not have mobile capital. We all had capital controls after the war. When GATT was put together, you didn't have technologies that can move jobs so readily and transportation.

So this whole question that Senator Schumer and Paul Craig Roberts have thrown up of does this system of comparative advantage depend upon having non-mobile factors of production, capital and now technology.

But now we do have mobile capital and technology. When you've got a framework in which these kinds of tariff discrepancies can be put in place, and you have such different standards of living, pensions and health care and other costs that our people face and that they don't, is this an unsound system for our country if we want to maintain a standard of living that we've built for our people over 200 years? That's the question.

So I'd like to know did this economic theory on which we're all now taught through our educational system, comparative advantage, like a theology, is this really workable in today's world? And I want to throw that open. I'll ask Mr. Blecker, then Mr. Overholt and Dr. Shenkar.

Dr. BLECKER. That's a big question. Let me back up to where we left off this morning with my colleagues, the economists. It is absolutely true that when the theory of comparative advantage was invented by Ricardo and later refined by Heckscher and Ohlin and Samuelson and many others, it always assumed immobility of factors. Yes, they were all aware that factors could move, but they deliberately assumed it away, and for the reason that it can, in fact—it doesn't necessarily, but it can invalidate—the theory or at least change the nature of trade.

So as not to take up too much time with the history of economic thought, you can put the analysis in the following way. Suppose you start out with a situation where one country has got all the absolute advantages. They're cheaper at everything or almost everything, and that might be like China relative to the U.S. in our bilateral trade today, where it's a six to one ratio.

What is supposed to move you from there to comparative advantage? Comparative advantage means balanced trade. By the way, that's another key assumption of comparative advantage is that the trade is balanced. What's supposed to happen is there's supposed to be an adjustment: either the currency adjusts or the wages adjust in the various countries or the price levels adjust. There are all kinds of theories of international adjustment that have been proposed for 200 years going back to Ricardo.

If the adjustments take place, then that country that was highly competitive will get less competitive and in some sectors it will switch over to being an importer and we eventually get comparative advantage trade and it's balanced.

What I think is going on in today's world, and where the capital mobility and the movements of technology come in, is that these are accelerating the rate at which countries can become more competitive very quickly in new products like China coming on so quickly in recent years, and at the same time we have situations where the adjustments are not taking place or are not taking place

fast enough to balance things out and bring us back to comparative advantage trade.

So I would characterize our trade with China today as based on absolute competitive advantage. It could be comparative advantage trade if we made those adjustments, or we or they together, but we are not. That's one reason why the currency issue, I think, is important because it helps to prevent that kind of adjustment. Now, the adjustment can take place, as I think Professor Panagariya said it can take place in another variable like wages. Wages have gone up substantially, but not enough to eliminate the competitive advantage.

If the currency was to change, then the wage expressed in dollars would be higher. That would help in that direction. But if you have mobile capital and technology, you can relocate production somewhere and if the wages don't adjust fast enough, then you can get an absolute competitive advantage and it's a question of whether those adjustments take place. I don't think they're as automatic or as easy as they are assumed to be in the textbooks where the model shows you're already in an equilibrium with comparative advantage trade.

I hope that helps.

Dr. OVERHOLT. There are so many misunderstandings here. Let me just basically address one. The argument that Ricardo assumed factor immobility because he thought factors were immobile or that he thought that was key to his system is just absolutely 100 percent indisputably wrong.

When Ricardo wrote his book on political economy in 1817, they were in the midst of the biggest explosion of factor mobility in world history. It involved an enormous transfer of labor, capital and technology to a very large country with very low wages and extremely cheap land. That country was called the United States.

Everybody in the world was conscious of it. There hadn't been anything like this in world history. It was at the forefront of the mind of every economist like Ricardo. Why did he assume factor immobility? For the same reason Isaac Newton wrote the equations of gravity excluding atmospheric friction—because it just makes the math so complicated.

Nobody discussing this kind of issue in Ricardo's era had the complex versions of calculus that would be necessary to introduce those factor mobility issues into the equation. Nothing that has happened has changed the basic argument that he made. Today, the key factors that drive international comparative advantage are things like transparency, capital markets, education, democratic adjustments, and if we think those things don't matter, then we're throwing out everything we believe in. Those are the reasons why capital and the most educated labor in the world flows toward us.

Second, the theory of comparative advantage doesn't say that if all of our wages are higher than all the Chinese wages, then they have an absolute advantage. The whole theory is built on ratio of whether wine costs five times as much to make in this country as wool, and only two times as much in China. So the whole discussion, the whole discussion of absolute advantage just doesn't take into account what we all studied in EC–1.

Our adjustment is now occurring. If you look at the explosion of certain sectors in China, you see the forces of adjustment. No, they're not instantaneous, but they're just as effective there as they are anywhere else in the world. And most of the adjustments through most of our modern history were in the context of fixed exchange rates. Up until five years ago, all the Europeans were demanding that we get back to fixed exchange rates, and thinking that our floating rate system was awful.

So we need to be very careful about the intellectual basis of our discourse. Well, I'll stop.

Dr. BLECKER. Well, first of all, I don't know that much about Chinese history, but I know some American economic history. It is not true that we were a low wage country in the 19th century. If it was, millions of our ancestors would not have come over here from Europe and other places. We were a low land cost country. Yes, we had cheap land. But we were a high wage country, and that's exactly what attracted millions of people to come here and still does today.

Secondly, on the issue about capital mobility and comparative advantage, I hate to get academic, but it has nothing to do with algebra, calculus, or what kind of math you use. It's basic economic intuition, but if you want a reference, your staff can look this up.

The Journal of International Economics, a respected peer-reviewed academic journal, 1985, had a marvelous article by a British economist, Anthony Brewer, which summarizes this issue, actually using plain old algebra, no calculus, and he shows very clearly that if you take a simple Ricardian trade model and you allow for capital mobility, you get comparative advantage trade if and only if the wages are flexible but you get absolute advantage trade if the wages are not flexible.

So it's a matter of the degree of flexibility of the wages in combination with the mobility of the capital. And I'll stop right there.

Dr. SHENKAR. I take a bit of a different view on that, but keep in mind the production factors of time, including, for instance, land or arable land was a huge resource, and obviously its proportion now in GDP is so much lower.

We used to say that the country with no transparency, very high level of corruption, little respect for intellectual property rights, will not draw foreign direct investment, and yet China is number one recipient of foreign investment in the world. It ranks, if you look at the Transparency International, for instance, number two I believe on the so-called "bribe payers index."

Commissioner TEUFEL DREYER. The what index?

Dr. SHENKAR. Bribe payer's index.

Commissioner TEUFEL DREYER. Bribe payers.

Dr. SHENKAR. Okay. By the way, that creates a special problem for U.S. companies because of Foreign Corrupt Practices Act and the fact that many other countries have ratified the new OECD convention, but I have yet to see any enforcements. So we typically talk about China not enforcing laws; apparently this is not only in China. It puts U.S. companies at very serious disadvantage.

The reality is that China has defied those predictions. The reality is that foreign-invested enterprise accounts for more than half of China's exports. There are very limited parallels to that. You can

find small parallels in such countries as Ireland, but remember China is a huge example. If you are a huge example, you're not only an example; you can change the rules of the game.

China is so attractive as a huge potential market that investors are willing to disregard. Otherwise, explain to me how is it possible that in this country with very little protection for IPR, actually rampant abuse of IPR, the intensity of R&D investment of U.S. affiliates is three times what it is in U.S. affiliates in other countries.

So there are a lot of paradoxes here that we have to be very careful about. In the 1980s when Japanese trade surplus did not act the way economists predicted it would act, some economists in despair said Japan doesn't fit the model. Well, maybe China doesn't fit the model either because of its size. And because we are in a global economy can change the model, can change the rules of the game. I think that this is something that is possible. And I think that we will do a disservice if we do not take that possibility, at least, into account. I'm not saying it is a sure thing, but it is definitely a possibility.

Dr. OVERHOLT. Could I just add one sentence or comment please to Professor Blecker's point?

Vice Chairman ROBINSON. Please.

Dr. OVERHOLT. Chinese wages have been rising very fast and show signs of accelerating and rising even faster.

Vice Chairman ROBINSON. Yes. I would just say to Dr. Shenkar that I think that's an important insight. I regret to say I don't think it's just a possibility. I mean I think that we're seeing it unfold before our eyes. I mean this particular paradox.

With that, I'd like to turn to Commissioner Dreyer.

Commissioner TEUFEL DREYER. I am surprised by Dr. Overholt's historical analogy and you say—I'm quoting from your written testimony here—"had China been prosperous and unified," it would have been able to deter or defeat Japanese aggression and Pearl Harbor wouldn't have happened. And therefore what we need is a healthy China.

Now, no problem with the conclusion. Almost nobody in the world wants an unhealthy country, whatever the name of that country is. But let me just say that I think that what happened to China was a result of what was wrong in Japan rather than the cause of what you say it was.

Japan had some real problems in the 1920s and '30s. It had a population explosion partly due to the import of Western foodstuffs. It had nowhere to go. Poverty was getting worse. Japan then produces enormous amounts of goods which the Western powers froze out of their markets because they were afraid of putting their own workers out of jobs.

Western powers also froze Japan out of the Western power equation, and inadvertently I think gave it the signal that it would be acceptable for Japan to do what it wanted to in Asia. Do you see what I mean? And meanwhile Republican China was very nationalistic. So if you had had a stronger China, you might have had a very different historical situation, but it would not necessarily have meant peace and stability in Asia. It would have been a different situation but not necessarily a better one.

Now, here's my question. I invite your perusal or your conjecture on the statement that the same type of systemic problems that kept China from being strong and healthy in the late 19th century and early 20th century may be what will keep China from being a strong and healthy power in 2050.

In other words, the Chinese government likes to dwell on the "century of humiliation" without ever thinking what is China responsible for, and the fact that it allowed itself to be humiliated. I believe that the Beijing government may be using this "century of humiliation" for its own purposes.

Let me put forth another statement for conjecture. By the early 20th century, Confucianism was dead. There was, however, a problem with what was going to take its place. Now, Marxism is dead. There's a question of what's going to take its place. It could be nationalism. It could be a millennial movement such as Falun Gong. Then you had population pressures. Now, you have population pressures.

We all agree that the one child policy has reduced the population growth, but it hasn't solved the population problem because almost nobody has one child except in the cities, and most people don't live in the cities.

Corruption was a problem a century ago. There was a broad agreement that corruption was getting out of control. Now corruption is also perceived as getting out of control. There was a growing inequality then; there is growing inequality now.

What I am asking you to speculate on is whether you think that this kind of thing can go on. I'm amused at the habit of economists in general, to tend to extrapolate things into outer space. If you continue their calculations, pretty soon China is going to own 300 percent of the universe or get 300 percent of the available FDI. It can't go on. Do you not see this as being a factor?

Feel free to chime in as well. It was mainly prompted by the historical example that Dr. Overholt gave.

Dr. OVERHOLT. I think the analogies you provided in most cases apply to pretty much any third world country. I used to have arguments in the mid-1970s about South Korea. And I used to get told that I was a right-wing militarist because I argued that things were getting better in South Korea and we should be patient. And I didn't think it was a good idea for us to pull our troops out as a kind of misguided human rights lesson for Park Chung-Hee. That's the issue that got me out of politics.

On corruption: There's corruption and there's corruption. There is corruption that's increasing, and there's corruption that's decreasing. In South Korea in the late 1970s and in China today it's decreasing. There's corruption where the leadership seeks to become President in order to make a lot of money like the Marcos Philippines and Suharto's Indonesia and there's corruption where everybody has his hand out, but Deng Xiaoping and Zhu Rongji and their comparable leaders are looking at the history books, and they're not in the job to make money. They're in the job to become the fathers of their country.

Commissioner TEUFEL DREYER. Li Peng and his family and the power mafia? Jiang Mianhong going into computer business. Deng Xiaoping's children profiting.

Dr. OVERHOLT. The children of leaders and the wives of leaders virtually always make money. It's not unknown in our country.

Commissioner TEUFEL DREYER. That doesn't answer the question though.

Dr. OVERHOLT. It does because the values of Deng Xiaoping and Zhu Rongji are how can I fix my country? Marcos never thought about how can I fix my country. He thought about how can I get more power and make more money? And if you look at the Marcos Philippines or the Suharto Indonesia, they give more and more monopolies to all their family and their friends, whereas if you look at what's happening in China, they're creating more and more competition, whether it's in telephones or in steel or in anything you can name, and they're getting the army out of business so that corruption goes down. This is why these analogies break down.

The fundamental difference is that conditions were deteriorating in the first half of the 20th century in China, and they went up and down, but got pretty awful under Mao, but now they've been uniformly getting better. If we have a banking collapse and an economic collapse, and chaos, yes, we will get back to where we were in the early 20th century.

Commissioner TEUFEL DREYER. But most Chinese would not agree with you that corruption is getting better.

Dr. OVERHOLT. When I give a talk on that subject in China, and they hear it, they agree. Students going back from here, Chinese students going back, are absolutely shocked when they get back that they can't do any kind of business without being corrupt. Corruption in the sense of, give me something for doing my job, is everywhere. But the difference is you're not allowed to destroy national policy.

National policy is set and within that who gets the deal is dependent on who pays the most, but the nature of the deal is not dependent on who pays, and that's the difference from the Philippines and Indonesia and most of Latin America. It's a difference that's shared by Park Chung-Hee South Korea, Lee Kuan Yew Singapore, Chiang Ching-kuo's Taiwan.

One of the secrets of their success is the value of the leaders. They want to go down in the history books.

Vice Chairman ROBINSON. This might require further debate in the corridor.

Commissioner TEUFEL DREYER. Yes.

Vice Chairman ROBINSON. Leave it to say——

Commissioner TEUFEL DREYER. Does Dr. Shenkar want to comment?

Vice Chairman ROBINSON. Sorry.

Dr. SHENKAR. Yes. I don't want to refer to particular individual leaders. But you see the essence of the Chinese system is that—I don't want to say everyone, but almost everyone breaks the law or doesn't obey a regulation or so forth. It is within the power of the regime to decide who will be sacrificed, who will be made a scapegoat. Will it be a mayor of a mid-size town because we don't want to show that there is a corruption higher up, but we want to show that we're doing something about it.

The reality is that despite the existence of a lot of laws in Chinese books, the fundamental principle of what we equate with

democratic free market system such as separation of powers simply does not exist in China, and therein, I go back to my comment as to where globalization, you know, is taking us.

It definitely has not taken China in that direction. There is no independent judiciary to speak of. The decision to go after someone will be made in the higher echelons.

Vice Chairman ROBINSON. Agreed. I regret to say that time is getting a little bit tight. We have three more Commissioners with questions, and I'd like to move through and go to Commissioner Donnelly.

Commissioner DONNELLY. I appreciate that, Mr. Chairman, so I'll try to be brief, but given the level of historical analogizing, I intend to be as promiscuous as everybody else.

Vice Chairman ROBINSON. You have that right.

Commissioner DONNELLY. Well, I intend to abuse it. I do have one question particularly to begin with, and I hope particularly Dr. Shenkar will address this. You seem to hold out the prospect of what I would describe as a bifurcated economic order in the future describing the fault line as over intellectual property rights. I think your term was non-IPR world versus an IPR world.

I kind of don't see how that remains a globalized economy and how there aren't really very serious geopolitical consequences if that actually does come to pass. So after I'm through sorting out the history of mankind from 1800 onward, I wish you would return to that.

To get right to that, one thing that you all seem to agree on is that on balance, a stronger China is a better thing for all of us. But it does seem to me that is confusing the question of economic strength with political health. Again, a lot of analogies have been made. It's sort of like saying that from the perspective of post-Napoleonic Europe, that the weakness of the central European states and of the German world, in particular, is something that can only be solved by unifying and strengthening the German world.

That ends up, in fact, leading to the Kaiser and ultimately to Hitler. Germany is only weak in 1920, and its underlying previous century of development leaves it, it seems to me, fundamentally strong. So if you marry an unhealthy political culture with rising economic strength, the historical analogies are a little bit more problematic than optimistic, and particularly if our goal is to turn China into Japan, Japan being, it seems to me, essentially a geopolitically weak but rich country, or Korea or Taiwan, all those things have happened within the context of the exercise of American power.

They have been essentially client states of the United States. It's very difficult for me to see how a future China can, again, without a lot of, you know, heartburn and heartbreak make that transformation, and it doesn't seem to me that the Chinese themselves particularly want to become client states of us.

So with that really sketchy summary of my reading of the historical analogies, I would like a response. It's too much to go through too rapidly.

Well, okay, I'm trying to be brief. What can I say?

Vice Chairman ROBINSON. You did this on purpose.

Dr. OVERHOLT. Let me just comment on two parts of that. The IPR world versus the non-IPR world. That's not what we're heading toward.

Commissioner DONNELLY. So you reject the analysis.

Dr. OVERHOLT. Poor countries are always non-IPR countries. The history of cheating started when one tribe noticed that the other tribe had fire and they tried it too. When you go through the period of our development, the first century of our infrastructure was paid for entirely, 100 percent, by our basically stealing what the British invested.

Japan in 1934–35 started its car industry with a car that was half Chevrolet parts, half Ford parts, and a DeSoto design. After World War II, they had to start over again. Almost all their consumer electronics stole Motorola IPR. What we've got with China, India and the third world is a bunch of countries that didn't accept our IPR standards, but one of the first to totally accept the idea intellectually was China because they have so much IPR of their own.

India and Thailand came much later. They haven't implemented it. The Chinese have got a lot of confusion, but they buy the concept because they've got a huge IPR rip-off problem at home. All those Chinese medicines, famous mountain waters, local beers, they're all getting ripped off.

Their own studies show that the only way their electronics industry/their software industry can survive is if they start rigorously enforcing IPR standards within the Chinese government. So this is a question of development. They will get there.

The Indians were totally opposed to this idea. IPR was the common heritage of mankind until outsourcing and some other things started in the last ten years in India. Now, they buy it. So this will come if they're successful.

Finally, on the client state, they don't have to become a client state. They just have to join the system. The Japanese do not intend to be our client state in 20 years. They want to be part of the system, but they are absolutely determined not to be our client state. So it's not necessary for any emerging country to become a client state in order to have a peaceful world.

Commissioner DONNELLY. Okay. Any other?

Dr. SHENKAR. If I may add to that, it is certainly true and maybe we should apologize in the name of the American people to Charles Dickens, for instance, whose American publisher refused his royalties at the time. But again analogies are limited. At the time, there was very little you could copyright. In this country, copyright industries are the fastest growing segment of the economy. They happen to be exactly where America's competitive advantage lies.

Any infringement of that system puts us, our economy and our future in jeopardy. It is true that perhaps the Chinese over time will reform, but when I grew up, we had a saying in the long run we'll all be dead. If it's going to take 20 years

If I'm a company, that may be too long for me to stay in business. The Chinese will try to start to protect IPR when they have more innovation at some point. That will happen. By then, many competitors will be out of business and nobody assures you that this is not going to be selective enforcement.

Actually, this is precisely the scenario that I see. We'll protect some. We will not protect others. Again, I encourage you to think at least of that possibility.

Vice Chairman ROBINSON. Commissioner Becker followed by Commissioner Bartholomew.

Commissioner BECKER. Thank you, Mr. Chairman. I was listening carefully, Dr. Overholt, when you were marveling how things have changed and how rapidly the Chinese have been able to move from a very low level, just within a period of couple decades, up high. And I agree with you on that.

I was in China shortly after Nixon, and I couldn't believe even more what I saw then, but when I went back a couple of years ago, I couldn't believe what I saw then. I mean the change was astronomical and defied anything that I could think of. But I want to point one thing, and I don't think we should lose track of this in any of the things that we're doing.

China is a Communist government. The people do not elect their own leaders. Absolute power is directed from the top. They traffic in women and children. The leaders all are inalterably opposed to the freedom of religion. I could go on and on. I've heard figures that their annual rate executions run in the neighborhood of a thousand or more, I think considerably more every year.

Many of them are summary executions, no trial, nothing. They just take them out, stand them up and shoot them. And it's over. The U.S. State Department itself judges China as a human rights violator in almost every category and each year, the report comes back condemning them even more than the previous year.

Nothing is decreasing. It's going up. It's increasing. Absolute power. In my previous life, I was the international president of the steel workers union and they used to kid me, maybe not kidding, that I had absolute power, and I could just direct things to be done. Not quite that simple, but I understand the rationale.

You don't have to go to an election in China. You don't have to ask other people. You don't have to get bond issues passed. You don't have to convince people to go your way. Just say do it. Hu's predecessor went to Europe and he saw a Mag-lev operate, I guess it was in Germany; he said I want one. Now, we've been struggling in the United States to build a Mag-lev, going through the political shenanigans to get approval for 20, 30 years. The Chinese leader went back, told them this is what I want. They went to work, and within a year and a half they had it operating. No fuss; no muss. Absolute power. That means an awful lot.

China has a trade policy. They direct the policy. They make a decision on what company they want, require them to give the technology, they make a decision on where they want them to build. They make sure it's in the vicinity where it's favorable to the other related industries. They cluster them. Mergers are directed. A little over a year ago, in one of the major industries, they directed that of the five similar companies in China, each CEO move to another plant, another facility, another company, that they never even worked for in order to share innovation and technology.

Absolute power. You can direct that. You can keep wages where you want them. You don't have to let it move. You can control an awful lot of things. And, it's not a stable government. I go back just

a short term in history, Tiananmen Square, the massacres that took place, the EP3 incident that for a while people thought this was going to take us to the brink of an altercation with China. Totally irresponsible on their part, but it happened.

The fuse wasn't lit. But Japan right now is reeling a little bit, maybe a lot from the demonstrations in China against Japanese industry and government. Things don't happen spontaneously in China. Everybody knows that was directed. It just does not happen. People die. They kill them. Just like at Tiananmen Square.

We went through a phase with Russia in the Cold War. This was containment. And it went on for a long time and finally it brought down the Soviet regime from the inside and, the Soviet bloc countries in Eastern Europe. It brought them down with no war and no sacrifice. It was hailed as a great victory by the Reagan Administration at that time.

But then we immediately flip and we go into a program of engagement with China. It's still a Communist country and we fought a terrible war with them back in the '50s. I remember that. We had somewhere in the neighborhood of 50,000 American boys that was killed over there, men that were killed in that war. That was a Chinese war.

They even talk about it within China as a Chinese war defeating the Americans. North Korea is a client state of China. China could shut them down tomorrow. All the power comes from China, the food, the oil. China could exercise that power if they want to.

Somewhere along the line here I ought to have a question.

I would like your comments on any and all of that, but I don't need them. I just wanted to have a different perspective out there. If you want to make any comments on it, that's fine. If you don't, that's okay, too, but I just don't think we should let that slide by without comment. This is not the rose garden that we think it is. When I was a kid we used to talk about dancing with the devil. We may be doing just that.

Vice Chairman ROBINSON. We need to watch our time. I want you to react to Commissioner Becker's point. One way to proceed here might be for Commissioner Bartholomew, if she would, to ask her question and then if you'd like to also comment on Commissioner Becker's point, that would be helpful.

Thank you. Commissioner Bartholomew.

Commissioner BARTHOLOMEW. Thank you, Mr. Chairman, and thank you to our panelists. For people who might have wondered whether we provided the opportunity for a full range of views during our hearings, I think that this panel alone would give lie to any concern that we don't. In some ways I have to say that it's a little mind-boggling to me to think about the spectrum of views that we've had here, and it reminds me of what my former boss used to say about China: it's a huge country, and you can see what you want to see. And of course, in terms of any analysis, we all are blinded by the views that we carry into something.

Dr. Overholt, I have to say it might be the first time that somebody has said that I've had important questions, and then chosen to decide that they were important because he completely disagreed with me on both of them. So that's an interesting experience.

I guess in some ways I would only return the favor in the sense that I find that some of the points that you make in your written testimony, I find myself really fundamentally disagreeing with, including, for example, that China has made the decision to adopt the Western concept of rule of law. I don't think that they've adopted the concept of the rule of law, either the way we do it, or the rule of law that pertains to the rights of the individual.

I also would say that I'm surprised to hear that on issues of free trade and investment that China is our principal ally. I don't agree that on North Korea we share necessarily the same goal. But I think there's a key to one of the words that you use, and I don't know if you picked it on purpose, but you say that China "adapts" not just foreign technology and foreign corporate management techniques, but also British, U.S. and Hong Kong securities laws. And I wonder if part of the difference of opinion is the difference between adopting other standards, even international standards, adopting the principles of the WTO, and adapting the principles of the WTO. Which gets me to one of the things that I mentioned earlier that we still haven't seen, which is does China change, or does China change these international institutions and the way they do business? I'd like a comment on that, but I also want to make a point. I think that what Dr. Shenkar said in terms of IPR enforcement is really important.

Dr. Overholt, a number of people who share your views, when we started talking about IPR ten, 15 years ago, essentially said, well, the Chinese cannot enforce. They don't have the power to enforce. This is happening by individual companies. They can't do this kind of enforcement. We still hear this kind of argument.

But I would note that when we were in Palo Alto a couple of weeks ago, the people representing the Motion Picture Association and Warner Brothers actually talked about how Chinese movies are not being counterfeited, whereas, of course, you can buy knockoffs of U.S. releases literally the day that they hit the screens here and sometimes before.

So it's an interesting thing to me to hear you talk about IPR protections, but one of the questions really is, is it only going to become protection of Chinese intellectual property?

So like George, I'm afraid I put a lot of issues on the table, but any closing comments you have would be good. I think we should start with Dr. Overholt since we asked him so many questions.

Dr. OVERHOLT. Well, let me start with the baseline, which is that everything Commissioner Becker says is right. Human rights are abused. People are summarily executed. Religious people are thrown in jail because of their religion. Trade unions are ruthlessly suppressed.

What you say about rule of law and IPR, basically correct too, and one of the problems we have is the half-full/half-empty problem with China, and in this case, 20 percent full, 80 percent empty. When I compare what's going on in China with what was going on in South Korea in 1979 and what was going on in Taiwan in the early 1980s, it's much better.

It was 1984 when the leading Taiwan dissident was assassinated in the streets of San Francisco, and the authority——

Commissioner TEUFEL DREYER. He wasn't the leading Taiwan dissident.

Dr. OVERHOLT. Well, a leading Taiwan dissident. The same folks who ordered that execution were the great liberalizers of Taiwan a few years later. You have to try to look at what's changing, and, you know, in Taiwan, the political change started with elections at the village level, and that's where it started in China, but they're several decades behind.

The idea of accountability has been spreading, and they've been trying all sorts of experiments. One city I happen to know a lot about is Nanjing where they're trying to make the heads of government departments accountable. They designate an electorate of 10,000 educated people and hold fairly frequent elections, and the two that get the lowest votes each time have to resign.

It's not the way our system works. It's not democracy. It's still a bad dictatorship. But everywhere they're struggling, and they're reinventing ideas that we've taken for granted for centuries, but they, like South Korea and Taiwan, have to figure it out themselves. They're not going to get it from foreign lectures.

And the degree of change is extraordinary. I was in 1998 giving a centennial lecture at Beijing University and the kids stood up and said your book The Rise of China and Gordon Chang's book The Coming Collapse of China were both assigned to our class. And, he said, Gordon Chang says the economy is changing but the politics is not. That means collapse. What do you think of that, Dr. Overholt?

I said the fact that you could stand up in a public forum and ask that question is the answer. He would have gone to jail for the rest of his life for asking that question 15 years earlier. Does that mean it's a free society? No, it's a dictatorship. Does that mean there's freedom of speech? No. But the change is a transformation. And if they don't do more transformation, they will fail.

On intellectual property and rule of law, it's the same thing. They may be at the five percent level there, but they mean it. If you talked to a Chinese professor, a typical expert, five years ago, about basic principles of intellectual property, he bought it all. If you talked to the typical Indian professor, he didn't buy it. Common heritage of mankind. You get that everywhere in the third world.

China has been moving faster than the others, but they're in a situation where change can only be gradual. I remember when they decided to introduce international accounting standards. They held a meeting. And they said we want these new accounting standards, but, by the way, the number of accountants we have trained in these things is less than the number of people in the room, which was 50.

When you have 1.3 billion people, and you introduce a whole new concept, whether it's accounting or rule of law, it takes a lot of time to implement. We can't judge that they have failed because they've only multiplied the number of accountants by 100. That's a big achievement, but it's going to take a long, long time. And there's no assurance they'll get there, but we need to encourage it.

Vice Chairman ROBINSON. Professor Blecker or Dr. Shenkar, anything on that?

Dr. SHENKAR. Just as a closing statement, I think that, yes, China today is much more open than it was five, ten, 20 years ago. Society continues to evolve, but again I would like to warn against an assumption that the endgame is a Western American style of government. I do not believe it is. I think that what we are seeing is evolution of a Chinese system that may well and probably will look quite different than the one that we have. And going back to issue of globalization, Commissioner Becker has referred to the temptation, this advantage China seems to have by making a decision and implementing it the next day. They don't have to worry about hearings, they don't have to worry about opposition, they don't have to get anything approved. Here is my fear, that this will become a fairly tempting model for many developing nations.

They will say look at the Chinese, what they have done; why bother to go and do things the Western way? This is an alternative model. You get things done. Look at the economic indicators. And that can change the very nature of globalization as we know it.

Vice Chairman ROBINSON. Well, thank you very much, gentlemen. This has been a provocative and illuminating session to say the least, and we're very grateful to you.

We're going to move on to the fourth panel shortly, Globalization and the Trade Deficit. If I might ask that we have a very disciplined five- minute break, we will gavel in precisely at that time. Thank you.

[Whereupon, a short break was taken.]

PANEL IV: GLOBALIZATION AND THE TRADE DEFICIT

Vice Chairman ROBINSON. If you wouldn't mind, let's be seated and we'll reconvene. I'd like to begin our last panel for the day, Panel 4, which is Globalization and the Trade Deficit. Our final panel of the day will examine the causes and consequences of the U.S. trade deficit. We hope to gain a better understanding of what's driving the growth of our massive U.S. global trade deficit and the bilateral deficit with China.

We'll also hope to explore to what extent the drivers related to global economic trends relate to U.S. savings and consumption trends. We'll also discuss the sustainability of the current deficit levels and the potential policy options for addressing this growing challenge.

Our fourth panel will consist of Dr. Dean Baker, Co-Director of the Center for Economic and Policy Research. Dr. Baker is the author of regular economic-oriented commentaries on jobs and unemployment, prices, inflation and GDP growth.

Dr. Baker will be followed by Professor James Galbraith, the Lloyd M. Bentsen Chair of Government at the Lyndon B. Johnson School of Public Affairs at the University of Texas. Professor Galbraith spent four years as Chief Technical Advisor to the State Planning Commission of the People's Republic of China on a macroeconomic reform project. He has also served in the U.S. Government as Executive Director of the Joint Economic Committee of the U.S. Congress.

Finally, Dr. Catherine Mann, a Senior Fellow at the Institute for International Economics. She specializes in U.S. economic policy, international finance and technology. Her current work is on issues

of global information, communications and technology and their impact on the U.S. economy.

We're very grateful you could join us today, and I'd like to start with Dr. Baker. As you may know from previous panels, we're looking at about seven to eight minutes for your opening remarks. We'll go through all of the panelists' presentations prior to questions from Commissioners. With that, I'd like to turn it over to you, Dr. Baker.

STATEMENT OF DEAN BAKER
CO-DIRECTOR, CENTER FOR ECONOMIC AND POLICY RESEARCH
WASHINGTON, D.C.

Dr. BAKER. Thank you very much. I wanted to make comments that I recognize will be very elementary, but I guess I'm beating up not on people here—you all know better—but what I see in the New York Times when we see discussions of the trade deficit. The basic point I want to make is that our trade deficit is first and foremost a function of the overvalued dollar, and we often see this posed. On the one hand, we have people say it's a function of overvalued dollar, and then the alternative, no, the problem is lack of savings, too little private savings, too large a budget deficit. The point I want to make here is that those are not alternative theories, that insofar as there really is an issue that we have too little savings, which I think is a big problem that only can affect the trade deficit by having an overvalued dollar. There is no alternative mechanism. Those are one and the same view.

So that's a point I want to make, a simple point, but just to go through the basic logic. This is all kind of Economics 101. Our imports are going to be on the one hand a function of GDP growth, our GDP, and secondly, relative prices, how expensive are imports relative to domestically produced goods—fairly straightforward. Exports, on the other hand, are a function of foreign GDP, foreign GDP growth, and again, our price, the price of our exports relative to goods produced elsewhere in the world.

If we think about those two for a moment, the import side, I don't think any of us are advocating slower growth, so that means for the most part we want to focus on the import prices, relative prices. On the export side, we might like to see more rapid growth elsewhere in the world, but not too much we can do about it. At least in the case of China, I don't think any of us would be audacious enough to insist they should have more rapid growth than they've been experiencing.

So what I want to focus on is the relative prices, which does get, first and foremost, to the dollar. Obviously, the price of foreign goods relative to U.S. goods is determined primarily by the value of the dollar. Those prices are fixed whether it's Chinese, Korean, Japanese, European, whatever it might be. They are fixed by domestic conditions in those countries by their wages, their markups.

We have relatively little impact on that. What those goods sell for in the United States is determined by the value of their currencies relative to the dollar. The higher the dollar is, the cheaper those goods are for the people in the United States. That's very straightforward. Again, the point that follows from that very sim-

ply is when the dollar rises, those goods are cheaper; we buy more imports.

The opposite side, how expensive are our exports for people living in the other countries? Again, prices here are determined by domestic conditions, wages, mark-ups, et cetera. How expensive our goods are for people living in Europe, in China, wherever it might be, it's determined by the value of the dollar relative to their currencies. The more expensive the dollar, the more expensive our exports are, the less likely they will be to buy them-that about as simple as you can get.

Now, we have this argument, this accounting identity that is repeated endlessly, that if we have insufficient supply of savings in the United States, our investment exceeds our savings, and that has to be made up by a trade deficit. Exactly right. That's an accounting identity.

What's the mechanism? You hear people talk about this. You almost think that someone is sitting there in Wal-Mart and they're trying to decide between a pair of shoes that were made in China or a pair of shoes made in the United States, and they're about to grab the shoes made in the United States, and they go, wait a second, we have a big budget deficit, and get the shoes in China.

I don't know anyone, anywhere, even if they mean to buy American, they don't do it for those reasons. So it just doesn't make any sense. Why do they buy the goods produced in China, Korea, wherever it might be? They do that because it's cheaper. It's that simple. And why is it cheaper? It's because the dollar is very high.

Now, can you tell a story that that's due to inadequate savings, of course. We have a very large budget deficit, hardly a secret. We have very little private savings. At least a big problem in my mind, private savings are almost zero, as a share of disposable income, near record lows.

It's a very big problem. I can go on about the housing bubble and what drives that. You don't want to hear that today, but clearly the point is we have very low savings. Now, how would that lead to a high dollar? Well, the classic story. We have low savings. Large budget deficit. It drives up interest rates. I'm not sure how true that is today. If you look at the ten year Treasury rate, it's a little over four. It's hard to say that's very high.

But let's for the moment assume that that's been driven up by the budget deficit and lack of savings. How does that push up the dollar? The story runs because we have high interest rates in the United States, foreign investors, who are deciding where to put their money opt to put it in dollar denominated notes to take advantage of the high returns here.

Is that happening? Well, it happens to some extent, but as we know, much of the financial assets being purchased today are not by foreign investors. It's by foreign central banks. Largely, the East Asian central banks, but central banks throughout the world. That explains a lot of the purchases of financial assets, and that's being done, obviously quite deliberately to keep up the value of their currencies against the U.S. dollar. That's not secret information. That's quite open. So the long and short of the story, we can tell a story that we have a high value of the dollar, that we have a

large budget deficit, inadequate savings. It's not very hard to tell how the budget deficit and the trade deficit are linked.

Just to make that point clearly, let's imagine tomorrow, we snap our fingers and balance the budget. What would happen? Would we expect interest rates to fall? Maybe. I wouldn't necessarily bet on that, but let's for the moment say interest rates fall, what then would happen? Would the dollar fall? Maybe or maybe not. That would depend on the decision of foreign central banks. It may well be the case that foreign central banks would simply make up for whatever loss of private investment, private foreign investment we see, and keep the dollar exactly where it is.

But even if that were to happen, again, the most important point here is the mechanism is still through the value of the dollar. Our decision to reduce the budget deficit or increased private savings in and of itself does nothing to correct the trade deficit unless it's associated with the decline in the dollar against other currencies.

It's about as simple as it could be. Now, my colleagues here will quickly jump on me and say I didn't give you the whole story. That's right. I didn't give you the whole story because you can tell a story that we could have an increase in savings, we could have a decline in the budget deficit, which could reduce imports through the other mechanism.

We could get a recession. We could have a big falloff in demand. We could get a recession. That would reduce imports. That will help the trade deficit. That's exactly right.

On the other hand, I think that very few of the people who are saying that the problem is a lack of savings, a large budget deficit, I think very few of those people are really saying that we want to have a recession in order to correct the trade deficit.

They, of course, will correct me if that's true, but I don't think that's the policy any of us here would advocate. So its long and short, what I'd say is if you think through the logic, it's very straightforward that whether we say we have a problem with savings or not, and I agree, we do have a problem with savings, but that doesn't change the fact that the immediate cause of our trade deficit is an overvalued dollar and whatever we do to correct the trade deficit short of having a severe recession will require a large reduction in the value of the dollar.

If that coincides with an increase in private savings, a reduction of the budget deficit, great. But the point is the decline in the value of the dollar is an essential part. There is no alternative to that in the mechanism.

So I'll stop there.

[The statement follows:]

Prepared Statement of Dean Baker
Co-Director, Center for Economic and Policy Research
Washington, D.C.

The Trade Deficit and the Over-Valued Dollar

In my statement, I will make one simple but important point: the United States has a large and unsustainable trade deficit *because* of the overvaluation of the dollar. There can be differences over the factors that have led the dollar to be overvalued, but the debate over the cause of the overvaluation does not change the fact that the mechanism that has driven the rapid run-up in the trade deficit is the overvaluation of the dollar. This overvaluation has made U.S. goods and services uncom-

petitive in international markets and has allowed imported goods and services to undermine domestically produced items in the U.S. market. I lay out this argument in more detail below.

The large and growing trade deficit is widely recognized as a serious problem. In the first quarter of 2005, the Commerce Department estimated the trade deficit as $717.6 billion, just under 6.0 percent of GDP. This deficit is far larger than any trade deficit the United States ever ran in the past. The run-up in the dollar in the early eighties led to a rising trade deficit that eventually peaked at just over 3.0 percent of GDP, slightly more than half the share reached in the first quarter of 2005.

While a country as big as the United States can run a deficit of this size for two or three years, it cannot sustain a deficit of this magnitude for long. If the trade deficit were to remain at 6 percent of GDP (it is still increasing according to the most recent data) then the net indebtedness of the United States would be more than 90 percent of the value of the stock market by the end of 2015. (These calculations assume that the nominal interest rate on foreign owned assets in the United States averages 5.0 percent. They also assume that nominal GDP grows at a 5.0 percent annual rate, approximately the rate projected by the Congressional Budget Office.)

This means that the total amount of U.S. assets held by foreigners would exceed the value of foreign assets held by people living in the United States by an amount equal to 90 percent of the size of the stock market. Net indebtedness would be more than 1.5 times the value of the stock market by the end of 2025. In other words, the only way that the United States can finance this trade deficit is by selling off the country's capital stock, and before too long it will run out of capital stock to sell. This is why virtually all economists would agree that a trade deficit of the current magnitude is unsustainable.

In spite of the agreement on the unsustainability of the trade deficit, there is some confusion on the cause of the deficit. While many economists argue that the trade deficit is attributable to an overvalued currency, there are some analysts who claim that the real problem is a lack of domestic savings. By definition, the trade deficit is equal to the gap between domestic savings and domestic investment. Many have inferred from this relationship that the key to getting the trade deficit down to a manageable level is therefore to increase domestic savings. However, this view is not an alternative to the argument that the dollar is overvalued. In fact, it is the same argument.

To see this point, it is important to understand the mechanism through which a lack of savings can lead to a larger trade deficit. In the conventional story, a lack of national savings (in this case due to large government budget deficits, coupled with low private sector savings), leads to upward pressure on interest rates. Higher interest rates in the United States make it a more attractive location for foreign investors, since they will be able to get a higher return on funds invested in bank deposits, government bonds, or private bonds. This means that high interest rates in the United States will increase foreign demand for U.S. bank deposits, bonds, and other interest paying financial assets. In order to buy these U.S. financial assets, foreign investors must first acquire dollars. The effect of foreign investors buying more dollars is to raise the value of the dollar in international financial markets. In this way, less savings in the United States can lead to a rise in the value of the dollar.

The higher dollar has the effect of raising the price of U.S. exports to consumers in other countries. U.S. goods and services are priced in dollars. This means that if the value of the dollars rises, so that it takes more yen, euros, or pounds to buy a dollar, then the price of U.S. made goods and services will be more expensive to people seeking to buy them with foreign currencies. (This discussion assumes that the price of goods and services produced in the United States do not fall in response to a reduced demand for exports. It also assumes that prices of goods and services imported into the United States do not rise [measured in the currency of the exporting country] as demand for imports increases. While this is not strictly true, it is a reasonable first approximation. The basic analysis does not change in any substantive way if the changes in prices are allowed.)

The higher price of U.S. exports in turn leads to reduced demand, and therefore a fall in U.S. exports, at least compared to a situation in which the dollar did not rise. (Exports may still rise even if a higher dollar is making them less competitive, they just would be increasing more slowly than would otherwise be the case. It is also important to recognize that exports and imports are often directly linked. For example, if car parts are shipped from the United States, to be assembled in Mexico, and the finished car is eventually sold in the United States, an increase in the num-

ber of cars that the U.S. imports from Mexico would be associated with an increase in the export of car parts to Mexico.)

The rise in the value of the dollar leads to the opposite outcome in the case of imports. If the price of producing goods or services in Japan, Germany, or England is held fixed, and the dollar rises relative to the price of the currencies of these countries, then the price of these goods and services will become cheaper for people in the United States. For example, if it costs 20,000 euros to build a car in Germany, this car would cost $20,000 in the United States (ignoring shipping costs), if the value of the euro and the value of the dollar were equal, so that one dollar traded for one euro. However, if the dollar rises in value so that a dollar is equal to the value of two euros, then the same car would sell for just $10,000 in the United States. In this way, a rise in the value of the dollar makes imports cheaper for people living in the United States, leading the United States to purchase more imported goods.

The two effects of the higher dollar both lead to a rise in the trade deficit. On the one hand, the higher dollar makes U.S. exports to other countries more expensive, causing them to buy fewer goods and services from the United States. At the same time it makes foreign goods and services cheaper for consumers in the United States, thereby causing imports to rise. Fewer exports and more imports means that the country will have a larger trade deficit.

In this story, even though inadequate national savings is the ultimate cause of the trade deficit, the immediate cause of the deficit is the overvalued dollar. It is essential to recognize this fact. People in the United States make the decision to buy more imported goods and services because the higher dollar has reduced the price of imported goods and services relative to domestically produced goods and services, not because of inadequate savings in the United States.

This point can be easily demonstrated by describing the counterfactual. Imagine that savings increased by a large amount in the United States, but the value of the dollar remained unchanged. In this situation, there is no reason to believe that people who opted for foreign made cars, computers, clothes, etc. will now choose to buy the same products from U.S. producers. In fact, it is almost inconceivable that any U.S. consumer thinks about the domestic savings rate or the budget deficit, when he or she makes a decision on whether to buy a foreign or domestic produced shirt or pair of shoes. Consumers base their purchasing decision on a variety of factors, which may include concerns about domestic workers or national prosperity, in addition to considerations of price and quality, but they almost certainly do not base their buying decision on their assessment of the size of the national savings rate.

In short, inadequate savings in the United States can lead to a large trade deficit precisely because it leads to an overvalued dollar, it is not an alternative explanation. Those who believe that higher savings and/or lower budget deficits are essential to reducing the size of the U.S. trade deficit, must also believe that it is necessary to reduce the value of the dollar.

There is one alternative way in which higher savings can lead to a reduced trade deficit, without a decline in the value of the dollar, although presumably not one advocated by proponents of increased national savings. In addition to being affected by the price of the dollar relative to foreign currencies, imports also fluctuate in step with the U.S. economy. Other things equal, imports in the United States increase as GDP increases. The basic reason is very simple: as the economy grows, we buy more of everything, including more cars, clothes, etc. that are produced abroad. In addition to the high value of the dollar, one of the factors that has helped to increase the trade deficit in the years since the recession has been the relatively good growth performance of the United States.

Of course, this process works in reverses as well. If the United States economy grows more slowly, or even contracts, then import growth will slow, or in the extreme case, imports could even fall. A sudden rise in savings could bring about this result. For example, if consumption spending were to fall sharply as a result of a collapse of the housing market, then this would correspond to a large increase in savings in the national income accounts. At least in the short-term, this fall in consumption would almost certainly be associated with a large downturn in the economy, since there would be no obvious source of new demand that could quickly offset a plunge in consumption.

This economic downturn would lead to reduced imports, since the United States would be buying less of everything, including imported goods and services. However, if the downturn in the United States had no major effect on the rest of the world (a clearly implausible assumption), then demand for U.S. exports would not be affected. If U.S. imports fell, but U.S. exports remained on the same growth path, then the U.S. trade deficit would shrink. If the U.S. economy sank far enough, then imports could decline enough to bring the trade deficit into balance, or at least down

to a sustainable level. In this way a rise in savings could lead to a reduction in the U.S. trade deficit, without any necessary change in the value of the dollar.

While it is possible to describe a path that gets from higher savings to a lower trade deficit without a decline in the value of the dollar, it seems unlikely that anyone in a policy position would really advocate this course of action. Effectively, it amounts to correcting the U.S. trade deficit by throwing the economy into a severe recession or even depression. Presumably, those who argue that increased national savings are necessary to reduce the trade deficit are not really advocating a recession/depression.

If we rule out correcting the trade deficit through recession, then the only real path available for reducing the trade deficit is by lowering the value of the dollar. A higher savings rate may help in this process, but a higher savings rate does not act as an alternative to reducing the value of the dollar, it is one possible mechanism for bringing about this result.

Furthermore, in the current international financial situation, it is questionable how much impact higher savings in the United States will have on the value of the dollar. This is due both to the fact that it is not clear how much impact savings will have on interest rates, and how much impact interest rates will have on the value of the dollar.

The first question arises because interest rates in the United States are already extremely low, in spite of the low domestic savings rate. The real interest rate on 10-year government bonds is currently around 1.0 percent, compared to an average of more than 3.0 percent over the last three decades. (This is based on a nominal interest rate of 4.2 percent and an inflation rate (measured by the CPI) over the last year of 3.2 percent [March 2004–March 2005]). It is difficult to believe that the interest rate in the United States would decline to any significant degree, if the budget deficit were cut substantially or private savings rose.

The workings of the second link in this chain seem even more questionable. Foreign investors are not currently buying up large amounts of U.S. financial assets in order to take advantage of high domestic interest rates. Rather, a large percentage of the foreign purchases of U.S. financial assets are currently made by foreign central banks, primarily the central banks of the East Asian countries. These banks are buying up U.S. assets in a conscious effort to maintain the high value of the dollar relative to their currencies, they don't care much about the interest rates they earn on their dollar holdings. Therefore, they would not cut back their purchases of U.S. Government bonds just because the interest rate fell by 0.5 percentage points, or even a larger amount.

In other words, the extent to which higher savings in the United States could lead to a lower dollar is being severely limited by the intervention of foreign central banks who are consciously trying to prevent the dollar from declining in value relative to their currencies. As long as this situation persists, the trade deficit will not be substantially reduced even if there were a large reduction in the budget deficit or increase in private savings.

(Other U.S. trading partners, most notably Canada and the European countries, have allowed their currency to float more freely against the dollar. While it may be possible to bring about a further decline in the dollar relative to the currencies of these countries, even if the dollar value of the East Asian currencies remains relatively fixed, it is unlikely that their central banks will allow too much dollar depreciation against their currencies. It is important to remember, that if the dollar declines against the euro and other currencies, and the East Asian currencies remain fixed relative to the dollar, then the East Asian currencies have also declined relative to these currencies. This will have the effect of not only making U.S. exports more competitive in these markets, but also the exports of the East Asian countries. For this reason, other central banks are likely to limit the extent to which they will let their currencies rise relative to the dollar, unless the currencies of the East Asian countries also rise relative to the dollar.)

In sum, there really is only one way in which to reduce the U.S. trade deficit: reducing the value of the dollar. A lower budget deficit and higher private savings rate are desirable and may help to contribute to a reduction in the value of the dollar, but they are not substitutes for a lower dollar. Furthermore, in the current international financial environment, where many countries are fixing their currencies against the dollar, it is not clear that even sharp reductions in the budget deficit and increases in the private savings rate will have much impact on the value of the dollar.

Vice Chairman ROBINSON. Thank you, Dr. Baker. Dr. Galbraith.

STATEMENT OF JAMES K. GALBRAITH
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Dr. GALBRAITH. Thank you and thank you for inviting me. As you probably know by now, investment in America exceeds the sum of public and private savings with the balance being funded by foreign accumulation of U.S. financial assets. This is not itself an extremely interesting fact, but it does raise some interesting economic questions.

I'll address three of them in the time I have. First, can policies to raise national savings reduce deficits while promoting growth?

Second, does an inadequate supply of saving constrain investment here in the United States?

And third, does that accumulation of U.S. financial assets abroad pose unacceptable risks?

Former Secretary of the Treasury Robert Rubin expressed the anxieties underlying these questions—speaking of things you read in The New York Times—in The New York Times on May 13, writing: "If markets here and abroad begin to fear long-term fiscal disarray and our related trade imbalances, those markets could then demand sharply higher interest rates for providing long-term debt capital, and could put abrupt and sharp downward pressure on the dollar."

Clearly, these issues deserve careful scrutiny. So first let's ask, is there a national savings shortage? Many argue that the trade and current account deficits are a product of domestic macroeconomic imbalance. This is the thesis of a national savings shortage.

Rubin, therefore, writes: "The first priority should be to tackle the ten-year fiscal imbalances which would also be the best way to promote economic growth and minimize the risks I have outlined."

Unfortunately, it's just not true that cutting deficits will promote growth. Consumption spending is a direct component of GDP. Efforts to raise national savings at the expense of consumption per se depress profits, investment, incomes and GDP. For this reason, policies aimed, for instance, at budget surpluses were and are unsustainable.

They generate fiscal drag, which eventually brings economic expansion to an end. This is something that the experience of the late 1990s proved. Trade models that focus on savings investment balance in the very long run simply assume away the influence of the issue of demand and its effect on employment. It's totally impractical to do so. For this reason, we have to be very careful about wishing away our deficit problem on the assumption that the changes that we would like to see could be made to occur without adversely affecting output and employment.

On the other hand, there are policies, which some advocate, which attempt to encourage private savings with incentives, particularly tax cuts. But the problem here is that these do not raise total national savings. Many such policies have been put in place in the United States since the late 1970s, usually justified with

their supposed price incentive effects, but today's household savings rate, which is minute, proves that they are futile.

There is, in fact, only one totally reliable way to increase private savings relative to investment without hurting growth. And that is to push up private incomes and profits, for instance, with public expenditure and employment programs while at the same time blocking the channel of leakage to imports.

There is a long history of this going back in the United States to World War II, post-war European reconstruction, Japanese and Korean reconstruction, and China in the last 30 years. With free trade, however, this option isn't available, even if it were desirable under present conditions, which it is not.

Fortunately, none of this matters very much. Our problem is not a shortage of savings. We can productively turn our attention to the next questions. Is there a shortage of investment? Though many feel instinctively that more capital investment would be better, there is no real evidence that the United States is short of capital investment.

The share of private fixed business investment in GDP, presently close to 17 percent, is almost a full percentage point above its long-run historical trend of 16 percent since 1947 in quarterly data. It's true the investment share was higher in the late 1990s, and that this was associated with good things, full employment, non-inflationary economy, operating at the peak of optimism and enthusiasm and a booming stock market.

I'd love to get back to that, if I could, but it is clear that that boom cannot be reproduced by a mechanical policy aimed at increasing savings. There is also no evidence that public deficits at the present time are pushing up long-term interest rates. Remarkably, long-term interest rates remain well below levels of five years ago when budgets were in surplus.

So far, efforts to find the effects of deficits on interest rates in the econometric record have been wholly unsuccessful. All of the talk really is about the effect that deficits might have on interest rates, sometime in the future. That's certainly the tone of Secretary Rubin's editorial. The problem here is that we've known about the deficits. They've been on the record for four years and so you might as well ask—you might well ask what are the markets waiting for?

Let's go on to the third question, which is does the trade deficit threaten the dollar? Now, as Professor Cooper remarked earlier today, the United States has been in trade deficit almost continuously for 30 years. Since 1979, China has become one of our larger trading partners and then in the 1990s, the relative position of most other third-world countries has eroded. China and Japan now hold large reserves, and their actions can potentially determine the dollar's value.

Of course, the actions of other players including Russia, India, the European Central Bank, also could have important effects. But large creditors are constrained by creditor's risk. If they were to sell dollars aggressively, the value of the remainder of their portfolio would plummet and they would inflict large financial losses on themselves. This would especially undermine the basis of modern Chinese prosperity, which is the growth of export industries for the American market and stable purchasing power over food and fuel.

In some ways, you might say that China has recreated for itself the essential conditions of the old Bretton Woods systems: stable trading relationships, economic expansion, and a strong financial position built on access, essentially to unlimited reserves which protects it from speculative attack.

China could choose to wreck this system, but there's no compelling reason at present why it would choose to do so. A rise in the Chinese exchange rate, I should say parenthetically, is no real solution for our trade woes. The effects could be offset with difficulty by a fall of money wages inside China. But even if that did not happen the benefits in terms of U.S. market share would simply go to other developing countries, as I believe Professor Blecker pointed out in the earlier panel. The effect of Chinese expansion is much more on the market share of Mexico than it is on direct job losses from the United States.

So what is the main risk for the dollar? It is that of a panic, a rush to the exits, a run from the dollar toward the euro, analogous to an old-fashioned run on the Bank. As with old-fashioned bank runs, that involves irrationality and timing is impossible to predict. There is some degree of risk. It's a fact of a system, an artifact of the larger instability of world monetary arrangements, which in the past several centuries have rarely endured in any stable form for more than about 30 years.

But what can be done now by U.S. policy to allay that risk? Absent a major reconstruction of world financial architecture, I think the answer is virtually nothing. Reducing the budget deficit cannot save the dollar. Steps to reduce the trade deficit as such by discouraging imports would not save the dollar. If a panic got going, moreover higher risk interests wouldn't stop it either.

But how big is the risk? We don't know. My own view is that the risk of an arbitrary malicious or irrational collapse of world currency markets in trading relationships is not very large. Rather the ultimate dollar crisis will probably wait until a political crisis sets it off.

Measures that promote and stabilize trans-Pacific relations reduce that risk. And assuredly policies that interject instability and distrust in those relationships will increase it. Here is something which really does touch on the mission of this Commission to bring economic and security issues together.

It seems to me that economists would be well served by focusing less on trade and budget deficits and more on the dangers of policies affecting Korea, Iran, Taiwan, all of which touch vital Chinese and Japanese security interests as well as our own. A collapse of the non-proliferation regime is in my judgment far more likely than the budget deficit to lead to the collapse of world financial arrangements. As the bumper stickers say, just a one nuclear bomb can ruin your day.

I have addressed numerous additional issues in my prepared remarks including other sources of interest rate risks. I would be happy to discuss them in response to questions. Thank you very much.

[The statement follows:]

Prepared Statement of James K. Galbraith
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It is a fact that investment in America exceeds the sum of private and public saving, with the balance being funded by foreign accumulation of U.S. financial assets. With total investment at about 17 percent of GDP, private savings of 14 percent of GDP, and a budget deficit (negative public saving) around 3 percent of GDP, a current account deficit of 6 percent of GDP is unavoidable. This is fact. But it is not an intrinsically interesting fact.

Three economic questions are posed by this fact.

First, would policies to raise "national saving" reduce the current account deficit and reduce or eliminate reliance on foreign creditors, and would such measures be desirable if they were available?

Second, does an inadequate "supply of saving" constrain investment, either directly or through the interest rate, and would a higher rate of investment be desirable if it could be obtained?

Third, does the accumulation of U.S. financial assets abroad pose unacceptable risks to the performance or the security of the American economy, and if so what is the nature of those risks and what might be done to reduce them?

Former Secretary of the Treasury Robert Rubin expressed the anxieties underlying these questions in the *New York Times* on May 13, writing:

> "Virtually all mainstream economists agree that, over time, sustained deficits crowd out private investment, increase interest rates, and reduce productivity and economic growth. But, far more dangerously, if markets here and abroad begin to fear long-term fiscal disarray and our related trade imbalances, those markets could then demand sharply higher interest rates for providing long-term debt capital and could put abrupt and sharp downward pressure on the dollar. These market effects, plus the adverse impact of continuing fiscal imbalances on business and consumer confidence, could seriously undermine our economy."

Clearly, the issues posed by Secretary Rubin deserve careful and systematic scrutiny.

Is There a National Savings Shortage?

Many argue that the trade and current account deficits are a product of domestic macroeconomic imbalance. This is the thesis of a "national savings shortage." A direct implication is that national saving can, *in principle*, be raised to match investment, especially by reducing the budget deficit. Those making this argument invariably assume that deficits can be cut without harm to total income, output and employment. Rubin makes this case explicitly:

> "The *first priority* should be to tackle the 10-year fiscal imbalances, which would also *be the best way to promote economic growth* and minimize the risks I have outlined." (Emphasis added)

Unfortunately, it is not true that cutting deficits will promote growth. Consumption spending is a direct component of GDP. The growth of consumption is a direct element of economic growth. Efforts to raise "national savings" at the expense of consumption *per se* depress profits, investment, incomes and GDP. Thus policies aimed at budget surpluses—as in the late 1990s—were and are unsustainable. They generate "fiscal drag" which brings economic expansion to an end. The drag may be masked for a time by *reduced private saving*—the borrowing against home equity and stock appreciation that was the central feature of the late 1990s and that I have elsewhere called the "Keynesian Devolution" (Galbraith 2003). But such an effect is intrinsically unstable and temporary. This the late 1990s also demonstrated.

On the other hand, policies which attempt to encourage *private savings* with incentives such as tax cuts, do not raise total national saving. Many such policies have been put in place in the United States since the late 1970s, usually justified with supposed price-incentive effects. Today's minute *household* savings rate proves their futility. (So, for that matter, do our trade deficits.) In any event, some of any pro-savings tax cut inevitably leaks into consumption, and so the fall in public savings always exceeds the rise in private savings. Such policies may have slight positive effects on activity and therefore investment, but this is only because they *depress* rates of national saving, not because they increase them.

There is only one totally reliable way to increase private savings relative to investment without hurting growth. That is to push up private incomes, for instance with public expenditure and employment programs, *while blocking the channel of leakage to imports*. This is a tried and proven method in many parts of the world, including the United States during World War II, much of Europe during early post-war reconstruction, and Japan and Korea in more recent times. Today a country with capital controls (China) easily finances gross investment over 35 percent of GDP with internal savings! It's very simple to do so—so long as Chinese nationals have little capacity to import freely and run up a current account deficit. With free trade, however, this option isn't available, even if it were desirable, which it is not.

We can conclude four things. First, there is no way to reduce trade deficits by reducing budget deficits alone, without also slowing, not increasing, economic growth. Second, there is no known way to raise national savings with tax incentives. Third, the one reliable way to suppress the trade deficit—protectionism—is for the moment not under systematic consideration. Fourth, none of this matters very much. The important issue is not whether there exists, in some semantic sense, a shortage of domestic savings. There does, but as this fact leads to no useful policy, it is, practically speaking, unimportant. The important issues are instead, as according to Secretary Rubin "virtually all mainstream economists" believe, whether overall levels of investment have been limited, or will soon be limited, by reliance on external finance. And second, whether our trade deficits pose unacceptable risks of instability in the short and medium term. We next turn to these issues.

Is There a Shortage of Investment?

Does the United States need more investment? There is no *definitive* answer to this question. But there is also no evidence that the United States is short of capital investment.

The share of private fixed business investment in GDP, presently 16.9 percent, is almost a full percentage point above its long-run historical trend of 16.0 percent since 1947, in quarterly data. It is more than two percentage points above the corresponding figure for the 1950s (14.8 percent). If the 1950s were a Golden Age of American economic superiority—as in some respects they were—the difference between conditions then and conditions now has nothing to do with any fall-off in the propensity of private business to invest. Moreover, as a share of GDP U.S. investment does not compare unfavorably to the comparable share in Europe, and particularly not when consumers' durables purchases—notably for automobiles—are counted as investments, as they should be.

It is true that the investment share of GDP was higher in the late 1990s, reaching over a full percentage point higher at the peak in early 2000. This was associated with good things—a full employment, non-inflationary economy operating at a peak of optimism and enthusiasm, and a booming stock market. It was associated, also, with a remarkable degree of fantasy over technological possibilities, followed inevitably by a remarkable disillusion. It is this that prevents an early return to the boom, not any shortage of savings to be borrowed. It is therefore clear that the boom cannot be reproduced by any mechanical pro-savings policy.

The volume of business investment can be affected, of course, by the rate of interest. However, there is no evidence that public deficits are pushing up long-term interest rates in the United States at the present time. Remarkably, long-term interest rates remain well below levels of five years ago, when budgets were in surplus. Short-term interest rates are set by the Federal Reserve; long-term interest rates reflect the interaction of current short-term interest rates and market psychology, dominated by expectations of what the Federal Reserve will do in the future.

The pressure of demand for investment finance plays very little discernible role in this affair, and that of government funding plays almost none at all. Despite the claim made by Secretary Rubin, efforts to find the effect of deficits on interest rates in the econometric record have been spectacularly unsuccessful so far. Gale and Orszag 2004 provide an impeccably mainstream example. An interpretation of their remarkable failure to find important effects of deficits on interest rates is given in Galbraith, 2005.

In general, the theory of investment can only be a theory of business motivation, which begins and ends with the quest for profit. In the real world, every surge of private business investment is motivated by a boom psychology, which suffuses business enterprise with confidence in the potential for profitable expansion of productive capacity. With confidence, any amount of new investment can be financed. Without it, little will be undertaken. This and little else explains the prosperity of the 1990s and the slump that followed. Should a new boom return—an improbable development that Secretary Rubin fears but that I would welcome—either public

deficits would shrink or private savings would rise. In neither case would we run into "crowding out."

The serious set of questions, plainly, has to do with the external economic environment facing the United States and the risks of the global financial system to the current privileged and predominant position of the U.S. dollar.

Does the Trade Deficit Threaten the Dollar?

The United States current account has been in deficit continuously for 30 years. The last sustained surpluses were in 1975. Why did the United States start falling into chronic current deficit at that time? The answer at first was surely the oil shock of 1974, which itself followed the devaluation of the dollar in 1971 (effectively devaluing oil, which was priced in dollars), and the collapse of the Bretton Woods system in 1973. The result after 1974 was a vast recycling of "petrodollars" through the commercial banking system, and the creation of the modern world of a dollar-reserve system of global finance, mediated mainly by private financial markets.

From 1982 onward, the new dollar system was consolidated under a regime of high interest rates and, after 1986, low oil prices. High real interest rates and domestic recession in the early 1980s destroyed vast sectors of traditional American manufacturing strength, particularly in the machinery and metalworking industries of the upper Midwest. U.S. trade deficits deepened thereafter. By the 1990s, the U.S. had become a strongly dual economy, with a high-technology sector that supplied much of our non-agricultural exports, and a vast but relatively low-paid services sector which undergirded household consumption and whose workers depended in turn on access to low-cost imported goods. Trade deficits had become structural.

The benefits of this system worldwide were very uneven. The debt crisis that started in Latin America spread around the world, inflicting vast losses on populations in Africa, and leading to profound political change in Central Europe and to the collapse, political and economic of the Soviet Union. After 1988 even Japan fell into a prolonged economic slump, although Japan's vast industrial power and first-world currency permitted it to avoid hardship in the absolute sense. South Asia and Korea prospered before the crisis of 1997, but fell into depression thereafter (though Korea has since recovered). Only China and India—with forty percent of the world's population between them—both of which were largely isolated from the new system by their long traditions of capital control, managed to grow continuously during this period.

Since 1979, China has become one of our larger trading partners, while the relative position of most other Third World countries has eroded. The concentration of our manufactures trade on China and Japan now means that those two countries now hold large reserves, and their actions can potentially determine the dollar's value. However, the actions or potential actions of other players, including Russia, India and the European Central Bank, can also have important effects.

However, having power and using it are two different things. China and Japan are constrained in their behavior by creditor's risk. If they were to sell dollars aggressively, the value of the remainder of their portfolio would plummet and they would inflict large financial losses on themselves. This consideration prompts caution. Many commentators have sought to create scenarios in which China makes aggressive use of its portfolio to inflict damage or to change American behavior—say with respect to Taiwan. But such scenarios remain implausible, since they would undermine the basis of modern Chinese prosperity, which is the growth of export industries for the American market and stable purchasing power over food and fuel. In effect, China has recreated, for itself alone, the essential conditions of the Bretton Woods system: stable trading relationships, economic expansion, and a strong financial position built upon access to essentially unlimited reserves. India, Korea and a few others are auxiliary players in this system. None of these countries have an interest in unsettling matters. Barring a political crisis in the region—an attack on North Korea, a war over Taiwan, a disruption of world oil supplies following an attack on Iran—it remains unlikely that any of them will.

China is a success story of global development. As such it is far less, not more, of a threat than it was when in the grip of revolutionary ideologies forty years ago. It follows that the tragedy of the world financial order is not there. It lies, rather, in the countries and regions, notably Africa, Russia, Latin America and Southeast Asia, that have been left out. They must find ways forward in the face of crushing debt burdens and uncontrolled capital flight.

Apocalypse Considered

The main risk for the dollar is that of a panic, a rush to the exits, a run from the dollar and toward, say, the euro. If one major player gets wind that others may dump, then the urge to join in becomes hard to resist. This is exactly analogous to

an old-fashioned run on the bank. And as with old-fashioned bank runs, timing is impossible to predict.

Some fear that we may be close to the precipice. Recently we've heard rumors of Russia trading dollars for euro, of India diversifying its reserves, of China contemplating the same. The reaction in parts of Wall Street has been a trifle unnerved. In comments relayed furiously across the Internet, Morgan Stanley economist Steven Roach apparently told clients to gird for an "economic Armageddon." At Frankfurt a few weeks ago, Chairman Greenspan appeared to signal that he shared some of these concerns.

There is, plainly, a degree of risk. But it stems from thirty years of accumulated deficits and our resulting position at the base of the world financial system. It is a fact of the system. It is an artifact of the larger instability of world monetary arrangements, which have rarely endured in any stable form for more than thirty years in the past several centuries. The instability of the system is the instability of the dollar, and vice versa. The dollar's dilemma lies, precisely, in the difficulty of stabilizing world finance in the same way that the FDIC stabilized the domestic banks in the early years of the New Deal.

What can be done now, by U.S. policy acting alone, to allay this risk? Absent a major reconstruction of world financial architecture, the answer is: almost nothing. Specifically, reducing the budget deficit cannot save the dollar. Steps to reduce the trade deficit *per se*, by discouraging imports—cannot save the dollar. A bank, hit by a panic, cannot save itself by cutting its advertising budget, raising its fees or firing its staff. If a panic gets going, moreover, higher interest rates won't stop it either.

Small interest rate hikes do normally affect exchange rates, attracting traders to currencies with an interest rate edge. But, when a player has the kind of extreme market weight now enjoyed by China and Japan, the game changes, and becomes one largely of bluff and threat. It may be that short-term interest rate increases earlier this year were aimed, mainly, at deterring the Japanese and Chinese from dumping dollars. If so, was it necessary? That is an open question; in any event the crisis some may have feared did not occur. It might not have occurred had the Fed done nothing. And if one does occur later on, interest rates raised even to ten, twenty or thirty percent could only intensify the panic. These matters are, in short, imponderable. They are largely outside what can be safely predicted by an economist.

In general terms, however, the horses are already out of the barn. The risk now is not the trade deficit, nor the budget deficit, nor a failure to move interest rates just so. It is a panic by the holders of assets that already exist, in gigantic quantities, and that cannot be made to go away.

But how big is that risk? My view is that it is probably not very large. There are too many dollars in the theater of the world economy, too few exits. No one gains an advantage from panicking. And indeed there are only a few players who matter, and they are sluggish and obese, sitting almost alone in the front seats. Given the start of a panic, they would not move fast. Before they got through the exits, they might well be discouraged from leaving by the smoke in the lobby—the soaring price of the euro and perhaps the yen. The run might then fizzle out and the audience return to the show. And the show would go on.

For this reason, unless events are driven by some ulterior motive—for instance, war—there is no compelling case why the declining dollar should become a panic any time soon. It might be prudent to take collaborative and multilateral steps to insure against this possibility. But even if such steps are not taken, the immediate dangers are not as great as some fear and assume. Once again, the final dollar crisis will probably wait until a political crisis sets it off. Measures that promote and stabilize trans-Pacific relationships reduce the risk. Assuredly, policies that interject instability and distrust in that relationship will increase it. Economists should perhaps focus less on trade and budget deficits and more on dangerous policies affecting Korea, Iran and Taiwan—all of which, incidentally, touch vital Chinese security interests as well as our own. The collapse of the non-proliferation regime is, in my judgment, far more likely than the trade deficit to lead to the collapse of world financial arrangements. As the bumper stickers say, one nuclear bomb can ruin your day.

Apart from *that* risk, however, in my view it is reasonable to discount the risk of financial apocalypse for the time being. Having done so, one may prudently consider less dire risks posed by the instability of the dollar system.

Other Risks, Mainly of Rising Interest Rates

Secretary Rubin expresses the fear of "sharply higher interest rates" simply on account of the sliding dollar and price inflation. But these fears, which express the "leverage" of foreign creditors over domestic interest rates, are not well-founded.

For an *inflation premium* to be built into the long-term interest rate, there needs to be higher expected inflation *on a continuing basis*. But actual inflation can rise for a long time before expectations do, and the inflation adjustment, coming (let us say) primarily through a rising dollar oil price, could come and go rather quickly. It need not get built into a spiral of wages and prices. It's also worth observing that an *inflation premium* has no consequences for real activity. It merely involves a compensation to lenders for the effects of anticipated inflation. It is not a deterrent to new capital investment.

A *risk premium* is another matter. Were a risk premium to be added to the long-term interest rate, then presumably there would be effects on real investment. But this too presupposes power that foreign asset holders do not have. To be sure, they could sell bonds for cash, in which case bond prices will fall and long-term interest rates will rise. But why would a foreigner concerned about the dollar forego the interest available from a government bond and yet hold on to dollars in cash? Such behavior makes no sense. If, on the other hand, foreigners sell their bonds for assets in other currencies, the effect is on the exchange rate and not on the price of bonds.

So far, there is no evidence of either an inflation premium or a risk premium having been added to U.S. long-term interest rates. So far, despite a substantial dollar decline, long-term interest rates have hardly budged. All of the talk about the risk of the deficits to interest rates remains prospective, not actual. One cannot exclude the possibility that bad things will happen in the future. But deficits have been around for four years—and they haven't happened yet. One is surely entitled to ask what the markets are waiting for.

One serious risk to the international position of the United States would be a change in European policy. Should Europe shift toward a high-growth, full employment Keynesianism, that could bring a decisive shift in the world balance of economic power. Such a shift would create profits in Europe, where there presently are few. It would open up a European current account deficit, where there is presently a surplus. Soon the euro would not be a scarce currency any longer, but an international unit of account with a liquid market outside of Europe. At that point, the reduction of the dollar's reserve status could truly get underway, the situation might resemble the decline of the sterling region in the interwar years. But European policymakers don't see—and won't seize—this opportunity, and we may therefore discount it as a risk for the United States, just now.

A final possibility is that Alan Greenspan could simply take matters into his own hands, raise interest rates as Paul Volcker did in 1979, and inflict on us all a monumental "defense of the dollar." Morgan's Roach worries about this with some good reason; I've worried about it too. While sharply rising short-term interest rates could cure both inflation and the weak dollar—as they did in the early 1980s—they would soon invert the yield curve. The resulting slump might be even more disastrous than it was twenty-five years ago, because private debt levels are higher now than they were.

Such a folly is surely the most dangerous of the interest rate risks. But for now I don't expect it. It seems more likely that the Federal Reserve will continue to move cautiously while oil and some other import prices drive upward—raising short term rates gradually but by not so much as to invert the yield curve. Given the alternatives, and the nebulous nature of all the external risks about which so many make so much heavy weather, caution is probably well-advised. If there is a worldwide portfolio adjustment underway, the dollar will therefore slide until it stops sliding—or perhaps until European intervention decisively props it up. For all we know, for that matter, the dollar's slide may already have reached its limit for the time being.

What Should Be Done?

The above does not mean that the affairs of the country are in good order. It merely means that fixing a shortage of savings, manifested by budget and trade deficits, is the wrong way to approach the issues. The reality is that budget deficits cannot be controlled until the trade deficit is reduced. And the trade deficit cannot be reduced, at full employment, except by strategic measures over the medium to long run.

What should be done? It's a long-term project, but it's not difficult to assemble the conceptual start of a real program. Oil companies are likely to earn high profits in the turbulence ahead. Let's tax them (and other windfalls), perhaps with a variable import fee. Let's plough the proceeds back to state and local governments, so they can maintain services and vital investments. Let's allow the Bush tax cuts for the wealthy to expire—especially the repeal of the estate tax which serves no economic purpose—and instead cut payroll taxes for now, to help working people cope.

Let's start our next technology-based expansion, focused on new energy sources and reduction in per-unit GDP consumption of oil.

On the international side, fixing exchange rates between Europe, Japan, the UK and the U.S. is unnecessary: OECD members accept each other's currency and debt instruments and will continue to do so. But the larger experiment of worldwide floating exchange rates and open capital markets, inaugurated by global monetarists in 1971, has clearly failed. The developing world was better off under the old system. Recognizing this, parts of it have gone back to that system in effect. Such is the underlying meaning of the much-maligned Chinese dollar-pegging, combined with their capital controls and large dollar reserves. One can expect similar behavior from other countries that seek to insulate themselves from financial market risk; indeed one may observe it now in India and Russia, to name two. The problem for such countries is reserve accumulation for this purpose is a waste of valuable and scarce resources, which a poor country can ill afford.

A new system on the Bretton Woods model would help developing countries, by sharply curtailing the destabilizing role of currency markets, thereby freeing up reserves for real uses. This would probably require a new network of regional regulatory agents for the financial system, empowered to enforce capital controls and to take responsibility for successful development strategies among their members. Ultimately, we should work toward a new global financial network oriented toward the support of development and growth, which is to say with creditor adjustment, an effective lender of last resort, and policy supervision. That would also help us, by creating stronger and more stable markets for our exports, though there would be an inevitable financial adjustment. Obviously, this is no small challenge.

For such a policy to succeed, America must also change, in ways that do not often make themselves heard in economic discussions, but that are important to the role of a security commission. Our security role is important. But it is sustainable only to the degree that the rest of the world sees us as operating in their interest, as most of the world did, in fact, through the Cold War. Our present over-reliance on the unilateral application of armed force and financial power appears, on the other hand, to much of the world to be fueled by visions of dominance. For these, the rest of the world has diminishing reserves of patience and it will not agree to pay indefinitely.

We need, therefore, to combine a sustainable security strategy with an industrial strategy based on technological leadership, collective security, and smart use of the world's resources. Successful grand strategy surely requires reducing exposure to the real risks to American living standards—and not merely a program of gestures aimed at the balance sheets.

I do not judge the political realism of such a program. But in the medium term it seems to me that there is no viable alternative to action along these or similar lines. Absent an articulated strategy for financial stabilization, for energy security, and for international development, the attempt to move forward with slogans about savings, or about balancing budgets or trade, is an economic dead end. We can do better, and we should.

Thank you very much.

Appendix: Notes on the Nomenclature

The nomenclature on which arguments that the United States faces a "savings shortage" which is then supplied from foreign sources appears to rest on the following definitions:

(1) Investment = National Saving plus Net Foreign Saving
(2) National Saving = Private Saving + Government Budget Surplus
(3) Net Foreign Saving = Current Account Deficit = "Capital Inflow"

From these definitions, it would follow that:

(4) Investment = Private Saving + Government Budget Surplus + "Capital Inflow"

So far, all is merely accounting. But the interpretations attached to this way of expressing the accounting tend to be highly misleading. Thus:

—Equation (1) is often read as implying that a higher rate of national saving would generate a higher rate of investment. But in fact businesses make investment decisions without reference to the supply of savings, either national or foreign. If after-the-fact national savings are not sufficient to "fund" investment, an offsetting trade deficit is inevitable.

—Equation (2) places private saving and government budget surpluses on an equivalent footing. This might be reasonable as a way of making that point that

both activities depress economic activity are therefore to be discouraged! (But of course that is not the point on offer.) Yet in another sense, private savings and public surpluses are not similar activities. The private sector has reasons to save because it has risks and uncertainties to allay. A government surplus serves no comparable purpose and is not "saving" in any comparable sense.

—Equation (3) is often thought to represent "flows of capital," but it simply applies alternative names to the current account deficit. Capital does not "flow" from overseas to finance American business investment. Rather, foreigners sell us goods and are paid in dollars. Once that has happened, the "loan" has been made. The mere failure immediately to purchase an offsetting value of American-made goods prolongs it. Dollar holders do then typically convert those dollars into a reserve asset, such as a bond. In this way they acquire a claim to an income stream, but conversion of cash earnings to debt or equity is not a new loan.

—Equation (4) is therefore not a formula for increasing the national rate of investment. To confuse it with a theory of investment is a crude though common error. To repeat, the "supply of savings" has nothing to do with the decision to invest. (It also has nothing to do with the determination of the rate of interest, though that is another story.)

More useful equations for thinking about trade deficits, budget deficits and the financial balances of U.S. households are spelled out by Godley (2002, 2003, 2004) and derived in a very simple way from the fundamentals of national income accounting.

(5) National Income = Consumption + Investment + Government + Exports − Imports
(6) National Income = Consumption + Saving + Taxes
(7) Budget Deficit = Government − Taxes
(8) Trade Surplus = Exports − Imports
(9) Private Saving − Investment = Budget Deficit + Trade Surplus

Equation (9) restates Equation (4) in familiar Keynesian form, as the fundamental equation of internal and external balance. An easy way to note its practical significance is to observe that the private sector, as a whole, can only go out of approximate Savings-Investment balance for brief periods of time—historically, a few years. In the postwar period, savings have typically exceeded investment by large amounts—say three percent of GDP or more—only during recessions. Investment exceeded *private* savings by a large amount—say, five percent of GDP or more—only during the unprecedented bubble of the late 1990s. A fair rule of thumb is that a *large* deviation of the left hand side from zero is likely to be reversed in a short time. Therefore, the Budget Deficit and the Trade Surplus must, normally, offset each other within a few percentage points, so that the Budget Deficit and the Trade Deficit will be twins, except during the peaks and troughs of the cycle.

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Vice Chairman ROBINSON. Thank you, Dr. Galbraith. Dr. Mann.

STATEMENT OF CATHERINE L. MANN
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Dr. MANN. Thank you very much. I appreciate the opportunity to come before the Commission and discuss the issues of the trade deficit. There are a number of things that have already been said

throughout the course of this day and by the other speakers. I don't know if I'm last in line, batting clean-up or something like that, but what I will emphasize is that there are two countries in the title of your Commission name—United States and China—and my remarks will address both.

That is, the trade deficit has foreign policy sources, some of which originate in China. It also has policy sources that come from the United States. What I'd like to do is talk about how we've ended up in a situation where the United States and the rest of the world are in a co-dependent trading relationship. Notice that I did not use the word "symbiosis," which some people have suggested I should. Symbiosis is, of course, defined as a situation where the two parties are both better off for having been together.

I use the word "co-dependent relationship" in a specific way. The United States and other countries around the world are individually on economic and policy trajectories that are not sustainable. They prop each other up. They make us feel good, each of the trajectories that we have, but they are not sustainable and therefore something will go wrong in the future.

What can we do as policymakers to try to rectify it, both here in the short-term as well as the longer-term structural issues. In addition, what we ought to be focusing on is the breakdown of the co-dependent relationship when it ultimately does happen. My guess is it's better off to be the one to walk away as opposed to be the one that's left standing——

Commissioner DONNELLY. Left standing at the altar.

Dr. MANN. Yes. Left standing at the altar or however you want to describe it.

I would argue that there are things that the United States can do and should do that puts it in a stronger position to walk away from the co-dependent trajectory not walk away from global engagement, by any means, because global engagement is a positive relationship. It is just not a sustainable balance at this time. It is not balanced, not just because other countries are doing something nasty to us, but because we are aiding and abetting in generating the imbalance in global trade.

So let's talk a little bit about the sources of the external imbalance. Now, we know for a long time that the U.S. economy has tended to trade in the global environment. We tend to import more when we grow than compared to what we export when the rest of the world grows. That's something that has been a feature of the data since the Second World War, so there's nothing new about that overall relationship.

The macroeconomics of that relationship starts to look very different when you disaggregate our trading patterns. Chart 1 is a disaggregation of the overall trade balance into large categories of goods and services. Consumer goods are in the blue. Autos are in the yellow. Oil and agriculture is in the green. The little imbalances, the red and the blue bars, I want to talk about those for just a minute. They show balanced trade in capital goods and industrial supplies and materials.

We've been hearing a lot about the difficulties of the manufacturing sector and how we're losing our competitiveness in international markets. Actually, capital goods represents 40 percent of

what the United States exports to the rest of the world, up from 34 percent in 1980. So we have actually ended up doing better in manufacturing exports in the global marketplace than most people think.

So if that's not the source of the difficulties in the U.S. external balance, what is? Well, you can see it pretty well right there. The Chart runs from 1991 to 2004 and the rising imbalance in the consumer goods and automobiles sectors is the source of the overall trade imbalance. (Oil is also a very big issue right now, but I don't want to focus on oil as much because that's obviously a topic for another panel, and that has less to do, essentially very less to do with China, although they're related.)

So, about two-thirds of the deterioration in the U.S. external balance of trade with the rest of the world is in the area of consumer goods and autos. Is this because the U.S. inherently is unable to produce these goods inside the United States? I find that hard to believe, given the extent to which our manufacturing capability has been very, very successful in reaching global markets.

So it can't be about our inability to produce consumer goods and autos in the United States. So how might it be related to something about internal policy in the United States? Chart 2 describes internal policies and structure as revealed in the disaggregated national income and product accounts. Our two previous speakers and some others this morning have talked about national savings and household savings.

There is in the data a relationship between the trend deterioration in household savings—the blue bars—which has been trending down throughout the entire 1990s to 2004. A trend deterioration in household savings, of course, means that there is a lot of consumption spending out there. We're consuming a lot of things.

In addition, however, and linked to the issue of short-term policy, is the nature of the fiscal budget, which is in deficit (shown in red) except for a couple of years that are above zero, that is, in surplus.

The specific nature of the budget deficit over this time period, in the last four years, has added a dramatic additional component to the capacity of the U.S. consumer to go out and spend. The deterioration in the budget deficit that you see there from 2000 to 2004 represents a shift in the share of GDP of the fiscal deficit of six percent. Of the six percent of GDP deterioration in fiscal balance, 45 percent comes from the tax cuts, the personal income tax cuts.

That represents about $30 billion worth of additional consumption in 2001, about $101 billion in additional personal disposable income in 2003. If we take the projections from the CBO March 2005, what we find is that an additional $700 billion in potential consumption spending is going to be going into the U.S. economy and raise the budget deficit at the same time.

I've already shown you how much leakage of consumer spending goes to imported products. So you can pretty much see what's going to happen to the U.S. trade deficit going forward. So by virtue of the policies that we are pursuing in Washington with respect to the tax cuts, we are adding to the trade deficit—we are not walking away from the global co-dependency.

Now, what about the foreign sources? Well, just about every country is responsible for the U.S. trade deficit. It's pretty widely

distributed around the world. Chart 3 shows a wide range of bilateral trade balances and China, which is negative, the largest negative in 2004. But the bilateral imbalance with Europe actually accounts for about the same dollar value of deterioration in the trade deficit over this 1991 to 2004 period.

So we could dump on the Europeans just as much as could dump on the Chinese. And then we have the rest of Asia without China and Japan also in deficit to the U.S. The point is, the deterioration in the U.S. trade deficit is widely distributed across all of our trading partners, not just China.

There are a number of factors underpinning the widespread bilateral deficits. The dollar is one of them but it is not the most important one because, of course, the dollar rose and fell over the 1991 to 2004 period and we had a deterioration in external balance throughout the entire period. What really is going on abroad is that there is a lack of spending on a consistent basis throughout the world. The current account balances, as a share of GDP, is one way of measuring the extent to which economies in the rest of the world do not consume as much as they produce. It is the counterpart of our current account deficit.

Table 1 shows that on this basis throughout the world there has been a contraction of the spending power around the world and a focus on savings.

But in several respects the Asian region is different. If we take China as the centerpiece of the global trading system and ask where are they sending their stuff and are they globally balanced, of course, the answer is no. (Chart 4.)

They are a production platform for the rest of the world as exhibited by the fact that the pink line and the green line and the black line are all Asian trading partners who are sending their goods to China, their intermediate products to China, which then are exported to the United States (blue line), and Europe (red line).

So how does this (trading pattern get maintained? It is a structural policy of exchange rates that should have, as a manner of course, been appreciating over the reform period of the Asian economies. Chart 5 describes the pattern of exchange rates in the Asian region—for several different groups of countries—from the time they started a reform process. (The specific exchange rate index varies differently depending on the different countries).

Systematically their currencies have depreciated in real effective exchange rate terms. So their side of the co-dependent relationship is the inability to absorb real appreciation and restructure their domestic economies to rebalance their growth and enhance standards of living in their own countries.

So to conclude, the co-dependent relationship means that there are policies that need to be undertaken in the short term and the long term on both sides of the trading equation. We get to control policies on our side of the trading equation. We get to control our policies of fiscal spending. I think there are some ways to enhance household savings. We can talk about those. We get to control that.

We can discuss and evaluate with our trading partners that they are keeping their exchange rates undervalued, and as a consequence causing a deterioration in the standards of living in their own countries. But we can do more on our own policies in compari-

son to our ability to change their policies. We have the ability to control whether we walk away from co-dependency. The question is will we use that ability?

Thank you.

[The statement follows:]

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Globalization and the U.S. Trade Deficit: Domestic Sources, Foreign Sources, and Policy Challenges

The U.S. trade deficit is composed of cross-border flows of goods and services, which are determined by U.S. and foreign income growth, along with relative prices. Over the last 30 years, the U.S. trade deficit has narrowed and widened influenced largely by the degree to which the U.S. and foreign economic cycles are in or out of sync, and as augmented or dampened by movements in the dollar.

Since 1991, however, global imbalances, measured on the one hand by the U.S. trade deficit or current account and on the other by the current account surpluses of our trading partners, have widened nearly without pause. The U.S. trade deficit reached $670 billion in 2004—an unprecedented excess of domestic spending over production for any large industrial country. On the counterpart side, all our trading partners are running trade surpluses with the U.S.—growth in the rest of the world has come to be dependent on U.S. demand patterns.

Regardless of the exact point when economic forces push back hard, few suggest that the trajectory for the U.S. imbalance is sustainable. By construction, neither is the collective path for the rest-of-the-world. Moreover, that no other individual country faces as significant a quantitative change to their trade balance as the United States should not imply ease of adjustment. In fact, just the opposite could be the case: Each country (including the United States) facing the policy choices and structural challenges to reorienting demand and production could argue that someone else should "go first."

The co-dependency of global imbalance has taken many years to develop, and cannot be unwound in short-order. Nor should interdependence be seen as negative; rather that sustained global growth must be better balanced. Policymakers here and abroad have important structural issues to address. However, there are some near-term challenges where the timing of policy decisions is more urgent. Finally, coordinated policy action may be needed to put the global economy on a less vulnerable footing.

Domestic Sources of the U.S. Trade Deficit

U.S. trade evidences the empirical regularity that U.S. imports grow relatively faster when U.S. GDP grows as compared to how much U.S. exports grow when foreign GDP grows. This empirical finding has several potential foundations ranging from relatively richer and sophisticated U.S. consumers and business who demand variety and can fragment production, to trade protection abroad particularly in services. As the U.S. has grown robustly in terms of domestic demand since the 1990s, the result is a U.S. trade deficit of unprecedented magnitude, both in dollar terms and as a share of GDP.

This macroeconomic story of the U.S. trade deficit masks important features of the disaggregated data. In particular, a very large structural imbalance in the consumer categories of trade is likely a reflection of domestic imbalances in the United States, which point to key domestic sources of the U.S. trade deficit, both structural and amenable to short-term policy attention.

What does the disaggregated picture of U.S. trade show (Chart 1)? The largest category on both sides of the U.S. trade equation is capital goods and industrial supplies and materials excluding energy, which accounted for 45 percent of exports and 32 percent of imports (2004). Up until 1997, net trade cycled through larger and smaller surpluses depending in large part on the U.S. and global business cycles. Since about that time, however, the trade balance in this category has not recovered even as global growth has revived. From a surplus of about $50 billion in 1997, this balance is now in deficit some $50 billion. This change likely reflects a number of factors: the partial and slow pass-through of the recent dollar depreciation into trade prices; relatively slow growth of investment in U.S. exporters' markets abroad;

* Many thanks to Katharina Plück for preparing the charts.

a shift in the international supply chain for production of capital goods to center on China; and persistent effects of the Asian financial crises on policies there.

On the other hand, U.S. "other private services" such as education, finance, and business and professional services continue to reveal international competitiveness of U.S. firms. The balance on trade in this category of trade (which now accounts for 6 percent of total imports and 13 percent of total exports) is positive and has continued to rise despite slow growth and relatively closed markets abroad. This is particularly impressive given that empirical analysis of the income elasticity of trade in services indicates that sluggish growth abroad disproportionately tends to hold down exports of these services.

What is most notable about the U.S. trade deficit, however, is that the biggest component of the non-oil/non-agriculture trade deficit is in consumer goods, which accounts for 21 percent of imports and 8 percent of exports. When added to the net deficit in autos, nearly three-quarters of the increase in the non-oil/non-agriculture trade deficit since 1997 can be accounted for by these two categories of personal consumption expenditures. Only outright recession (in 1991 and 2001) stemmed the widening in these components of net trade.

How might the trade deficit in consumer goods be related to domestic structural trends and policies? Chart 2 shows the savings-investment decomposition of the national income and product accounts (NIPA). Net investment is always in excess of net national savings. Fiscal balance, a part of national savings, is negative for most of the period, albeit briefly in surplus at the end of the 1990s. The most notable feature of the savings-investment balance is the trend decline in the household savings rate. A low savings rate implies strong consumption spending out of wage and salary income, which has been bolstered by periods of high stock market valuation, enjoyed during the period of fiscal discipline, and now home equity wealth, coming from the current mix of fiscal and monetary policies.

Decomposing the fiscal deficit reveals an important link between fiscal policy choices and the trade deficit. According to the Congressional Research Service Report for Congress (March 2, 2005) 45 percent of the decline in the Federal budget balance between FY2000 and FY2004 (from a surplus of 2.4 percent of GDP to a deficit of 3.6 percent of GDP) was on account of tax cuts. The tax cuts in 2001 added about $30 billion in the second half of that year and the tax cuts of 2003 added another $101 billion to disposable personal income (Macroeconomic Advisors September 17, 2002 and September 19, 2003). The March 2005 projections for the fiscal deficit from the Congressional Budget Office indicates what might be in store for consumption spending based on legislation to extend the expiring tax provisions—some additional $700 billion in potential consumption spending. All these tax cuts translate into a lot of actual and potential consumption, which is clearly falling, at least in part, on imports.

Are there consequences of persistent spending in excess of earnings? The U.S. received a $1.8 trillion inflow of capital in 2004 from the rest of the world, well in excess of what was "needed" to finance the trade and current account deficit. Even so, the decades long and accelerating excess of spending over production yields a buildup of net financial obligations to the rest of the world. The net international investment position (NIIP) turned negative in 1986, and has since swelled from $0.8 trillion (about 7 percent of U.S. GDP) in 1997 to $2.4 trillion (about 23 percent of GDP) in 2003 (latest data). Perhaps more important, there is a rising share of interest-bearing financial instruments in the foreign purchases of U.S. assets, in particular, of official and private purchases of U.S. Treasury securities, which is the manner in which the fiscal deficit is financed.

In sum, domestic sources of the U.S. trade deficit center on extraordinarily robust domestic consumption underpinned by the structural trend decline in household savings in the United States, and further supported at various times by stock-market and housing equity wealth, and through deficit spending on the government account, particularly and disproportionately in recent years caused by the policy choice of personal income tax cuts. While foreign capital inflows remain robust to finance this spending, the rising share of interest-bearing instruments in these flows translates into a potentially more vulnerable financial position, both domestically and in international markets, should interest rates rise.

Foreign Sources of the U.S. Trade Deficit

The counterpart to the widening U.S. trade deficit of the 1990s is the geographically widespread and in most cases increasing trade surpluses vis-à-vis the U.S. (Chart 3). The widening U.S. trade imbalance is not just due to imports from China or Japan or Mexico, but is broad-based across all trading partners. Indeed, the worsening of the bilateral U.S. trade balance vis-à-vis Western Europe in recent years is about the same dollar magnitude as with China.

Just because a country has a bilateral trade surplus with the U.S. does not necessarily imply domestic savings-investment imbalance within the country—a country can have a bilateral trade surplus with the U.S. and a bilateral trade deficit with another country leaving the country in balance overall between domestic demand and production. A country's global current account position is one way to measure this domestic balance. During the 1990s, almost all countries moved toward current account surplus, in some cases dramatically so (Table 1). Persistent global current account surpluses reflect a systematic dependence on exports for GDP growth. In conjunction with bilateral trade surpluses vis-à-vis the United States it reveals a particular dependence on the exports to the U.S. market.

An alternative presentation of trade data puts China at the center of global trade (Chart 4). China's rapidly rising bilateral trade surplus with the industrial countries of the U.S. and, to a lesser extent, Western Europe is in stark contrast to its bilateral trade deficits distributed around the Asian region, including Japan. These patterns of trade for China, in conjunction with the pattern of U.S. bilateral trade with other Asian economies including Japan (Chart 3), are consistent with China being a value-added production-platform for goods ultimately destined for the United States and to a lesser extent Western Europe. So, the explosion in intra-regional trade in Asia is not so much from "home grown" demand, and the region's growth success remains dependent on the exporting outside the region, particularly to the United States. This dependence the U.S. has willingly abetted, what with its more rapid domestic demand.

The domestic growth strategy focused on exports and regional development, now centered on China, is consistent with the observed systematic evolution of real effective exchange-rates in the region (Chart 5). From the time of initial economic reforms, which commenced at different times for different countries in the Asian region, there has been a drifting lower of real effective exchange rates in the Asian region. This exchange-rate strategy has yielded high growth and rapid development, which would tend to put revaluation pressure on the currencies. However, following the financial crises of 1997, the currencies depreciated and the associated accumulation of international reserves could be viewed as an insurance policy should private finance once again roil markets. However, the policy choice to systematically limit currency appreciation dampens the economic signals that promote a balanced domestic-demand oriented growth strategy, which also yields higher domestic standards of living. Moreover, excessive accumulation of international reserves carries risks, for example, of capital loss when currencies do move. So, the export approach to growth and the associated exchange-rate and international-reserves strategy have downsides, which should be appropriately weighted in the policy calculus.

Exchange rate stability in the region over the years has been associated with periods of systematic purchases of U.S. Treasury securities. Important foreign official purchases appeared in 1986–1989 and again in the mid 1990s, times when the dollar was experiencing depreciation pressures. However, official purchases accelerated during 2003 and 2004, and are unprecedented in terms of dollar value and as a share of total financial inflow. These foreign official purchases are concentrated by holder, with the estimated share of Japanese official holdings in total estimated official holdings rising from 28 to 37 percent between 2000 and 2004 and the estimated share of holdings by China and Hong Kong, SAR rising from 16 to 20 percent of total estimated official holdings.

The real effective exchange rate of the renminbi stands out. Based on real effective exchange rates, it would appear that the Chinese exchange rate regime has maintained its currency valuation well beyond the time when at least some appreciation is consistent with continued economic reforms. Such reforms would yield more balanced GDP growth, raise standards of living, and limit real and potential negative consequences of excessive accumulation of international reserves (see Nicholas Lardy and Morris Goldstein for more details).

To the extent that China is now at the center of regional production, its exchange rate regime influences policy choices in the region. Other economies in the region may wish to maintain exchange rate stability as part of the regional production relationships and thus arrest their currency appreciation by buying U.S. Treasury securities. As a consequence, they may be accumulating a financial vulnerability as well as delaying needed structural changes in the sources of growth.

Policy Challenges

With the U.S. current account beyond all historical precedent and with the build-up of U.S. assets in the portfolios of private and official actors, the dollar should be under significant depreciation pressure and indeed it has depreciated from its trade-weighted 2002 peak. However, dollar adjustment alone is unlikely to close the

U.S. side of the global imbalance due to the size of the initial imbalance, the lopsided role of U.S. consumption, and slackness in demand abroad.

Policy choices are important. In the context of rising fiscal deficits, the U.S. is vulnerable to a negative feedback loop between the fiscal deficit and the current account deficit. As the share of U.S. Treasury securities held abroad increases (that share already has more than doubled in the last ten years to over 50 percent), the interest paid on U.S. Government debt increasingly will be paid to foreign holders of that debt. Interest payments will worsen the fiscal deficit and augment the current account directly as well. Our long-term policy challenge is to address the structural deterioration in household savings. Of more urgent policy consideration is the additional impetus for future consumption spending and the associated decline in national savings generated by a permanent cut in personal taxes.

On the other side, long-term structural reforms in Europe oriented toward more domestic growth will aid in balanced GDP growth there. The European economies are already absorbing price signals through the exchange rate to motivate further structural reforms. Prompt consideration of monetary policy would further assist in the reorienting of demand toward domestic consumption and investment.

In Asia, to the extent that policymakers have inhibited an appreciation of their currencies against the dollar, they are delaying, and likely making even more difficult, their own structural reforms to reorient demand in their own economies. In addition, for the countries that have not absorbed any depreciation vis-à-vis the dollar, future dollar depreciation will reduce the value of their stock of U.S. assets; hence a further buildup makes it increasingly difficult to alter the exchange-rate regime. Finally, if the U.S. succeeds in its domestic reforms, countries may experience slowed export growth. These risks to exports and to value of invested capital could be most acute in Asia where there has been the tendency to limit both currency change and structural reorienting of demand. Realigning exchange rates would address both the structural policy challenge to reorient demand and the more urgent objective of minimizing future capital losses on the existing portfolio of dollar assets.

Achieving more balanced growth paths and realistic exchange rates are difficult to orchestrate both domestically and internationally. It is in every policymaker's interest to pursue actively their own structural reforms, as well as engage collaboratively in the process of strengthening and sustaining global growth. Rising global imbalances and downward pressure on the dollar suggest that policymakers face some pressing short-term decisions: On the U.S. side, addressing the near-term impetus to consumption spending; and on the Asian side addressing the regional exchange rate relationships. A failure of the policy process—both short-term and structural—increases the vulnerability of both home and global economic activity.

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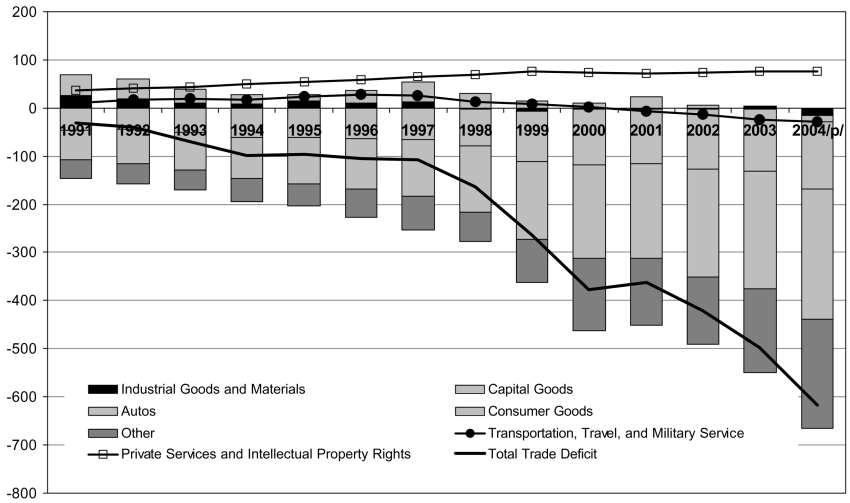
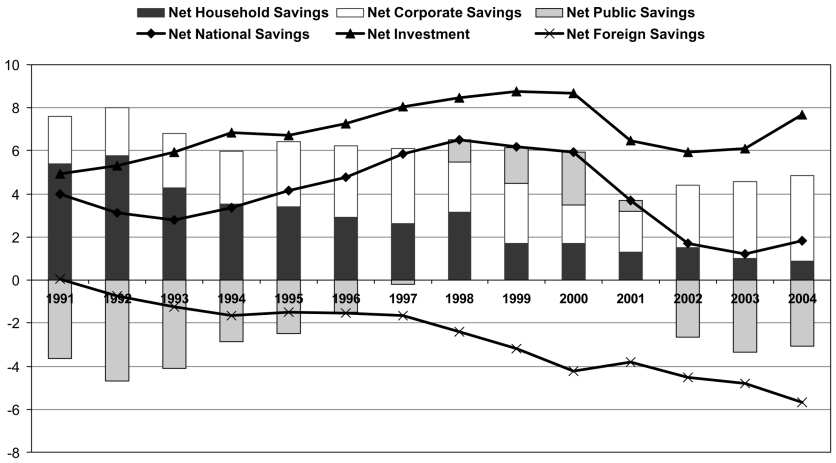
Chart 1 : Disaggregated Trade, 1980-2004 ($billions)



Source: Bureau of Economic Analysis, International Transactions Accounts Tables.

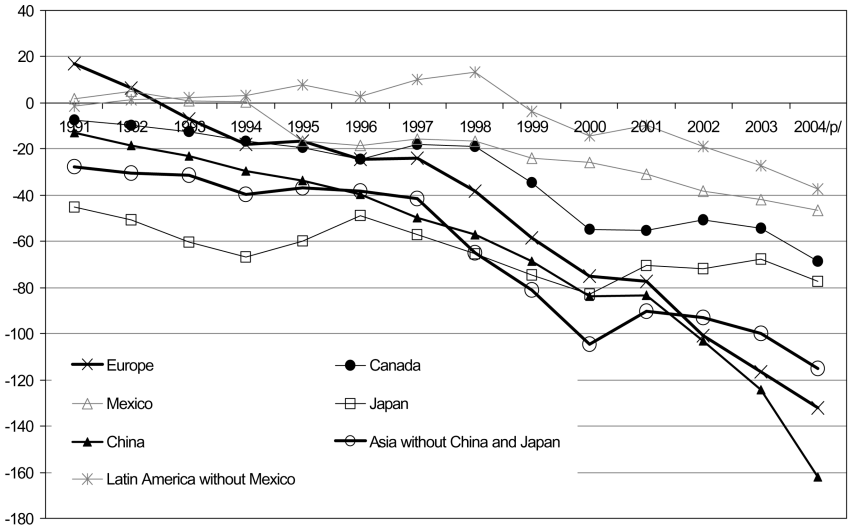
Chart 2: The NIPA in Disaggregate

US Savings and Investment as Percent of GDP, 1980-2004



Source: Bureau of Economic Analysis, National Income and Product Accounts; International Transactions Accounts; Catherine Mann.

Chart 3: US Goods Balance with Selected Trading Partners ($billions)



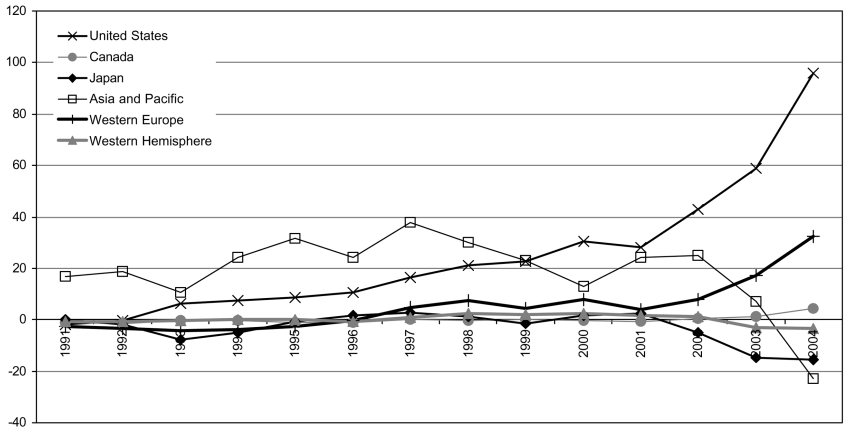
Source: BEA, International Transactions.

Table 1: Current Account Balances as Percent of GDP

	1990	1995	1998	2003	2004	2005p
China	3.1	0.2	3.3	3.2	4.2	4.1
Japan	1.4	2.1	3.0	3.2	3.7	3.3
Asia/Pacific	-0.6	-1.8	4.5	4.9	4.5	3.6
Latin America/ Caribbean	-0.1	-2.2	-4.5	0.4	0.8	0.2
Western Europe	-0.3	0.8	1.0	0.9	0.8	0.8

Source: IMF WEO, April 2005.

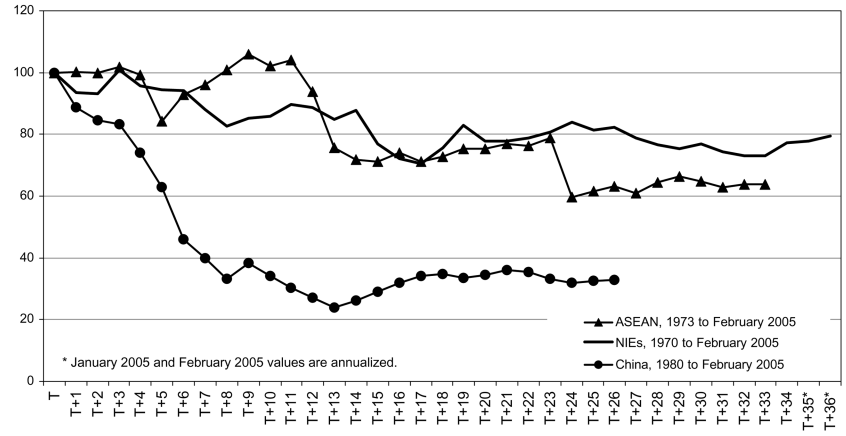
Chart 4: China's Goods Balance with Selected Trading Partners (billions USD)



Source: UN COMTRADE Database.

Chart 5: Real Effective Exchange Rates,

Time T (beginning year of economic integration) = 100



Source: JP Morgan Real Effective Exchange Rate Indices;
Time T from IMF WEO April 2004, chapter 2, p. 85.

Panel IV: Discussion, Questions and Answers

Vice Chairman ROBINSON. Thank you very much, Dr. Mann. Thank you all for your fine testimonies. I'd like to turn to Commissioner Reinsch.

Commissioner REINSCH. Thank you. Well, it's always nice to see a consensus amongst economists. A special thanks to Dr. Mann for laying out the Administration's tax policy for what it is. You did a good job. Saved me some trouble. Dr. Baker, I want to pursue one thing that you said. As Dr. Galbraith pointed out, well, as everybody pointed out, we've had a deficit for more than 30 years. Your argument, I assume, is not that the entire 30 years is due to the dollar being overvalued?

Dr. BAKER. Well, I would distinguish between different deficits.

Commissioner REINSCH. Ah.

Dr. BAKER. Well, no, I'll try to be careful on this. I wasn't terribly concerned about the deficits we were running in the mid-1990s when we had a deficit of one to two percent of GDP. We could do that literally forever.

Commissioner REINSCH. So there is some level of deficit that you think is sustainable and not necessarily undesirable?

Dr. BAKER. Exactly. When you have a deficit of six or seven percent of GDP that we're looking at today, we're definitely in the unsustainable/undesirable level. It's the exact same story with the budget deficit. If we have a budget deficit of one, two percent GDP, we could do that forever.

Commissioner REINSCH. And your line is around the two percent level of GDP?

Dr. BAKER. Somewhere around that, yes. I'll try and pick a number for you.

Commissioner REINSCH. Well, I'm just curious. All right. So your argument really is based on, say, the last eight to ten years, more than——

Dr. BAKER. That's right.

Commissioner REINSCH. Now I was struck by one of Dr. Mann's graphs which showed our trade balance with the EU, which continues to get worse apparently, according to her chart, despite what I think is a substantial appreciation of the euro. Why is that?

Dr. BAKER. I'd actually have to look at that more carefully. There is a lag between changes in currency values and trade patterns. So part of that story could be that it's lagging—the drop in the euro is fairly recent, so you know, where we are in a year or two might be very different from where we are today, but I'd have to look at it more closely.

Commissioner REINSCH. I think Dr. Mann has a comment.

Dr. MANN. Yes. Thank you very much. About a week and a half ago, I had an op-ed with my research assistant in The New York Times on exactly this question about why it is that we haven't seen much of a change in the value of the bilateral trade balance vis-à-vis Europe, and moreover why we haven't seen much of an increase in U.S. inflation in the United States given that the dollar has been depreciating for two years now.

The answer to the story is twofold. One: Why we don't see a lot of change in the value of the dollar passing through to the United States is that, 30 percent of our trade is with countries where the dollar really hasn't moved very much.

But second, even against European trade, only about 25 percent of the exchange rate against the euro has actually passed through to import prices.

When the Europeans look at the U.S. market, they don't want to lose their market share. So they absorb the exchange rate change into their profit margins and they can do this for some period of time.

The potential squeeze to profit margins appears to be longer than it used to be. In addition, retailer margins in the United States are also very elastic. And over the last 20 years, it's been researched by a number of authors, including Linda Goldberg, who is at the New York Fed here, showing that the retailer margin is playing a much bigger role in how much exchange rates show up in the prices of things that are on the store shelf.

Now, that's all about the import side—why imports haven't fallen very much. But another story is why exports haven't risen very much? After all, we've had this really big change against the Euro. Why aren't they buying our capital goods?

Europe is a very big market for our capital goods. The answer is we can have incredibly attractive prices of our capital good products, but if they're not undertaking any investment over there, they're not going to buy our capital goods. The price is right, but they don't buy because they're not undertaking investment. This is a growth story, not a price story. And that is why we're not seeing a big increase in the exports of our capital goods or any other things to Europe.

Commissioner REINSCH. Let me suggest another argument and then ask all of you to respond. But first just a comment on that last point. What I infer from what you just said is that perhaps currency revaluation or appreciation, whatever term you want to use, is not necessarily as useful a policy tool as we might think it is for some of the reasons that you suggested.

But before you comment on that, let me go back because it's not unrelated, particularly to what you last said—Dr. Galbraith alluded in his statement to the dual economy, and that started me thinking a about the extent to which some of this problem may be due at least in consumer goods which is a particularly good example, to the erosion of our manufacturing capabilities which makes it difficult for us to, if you will, ramp back up in the short run.

In other words, our exports may not be growing because we don't have as much stuff to sell. Or at least in the short run, we don't have as much to sell. Obviously, if you look out over the long term, if economic conditions change, it becomes profitable to start making things that we've stopped making.

But if, in fact, we've stopped making them, we can't, I assume, in the space of six months simply start making them again and become viable competitors or am I completely off-base? Anybody?

Dr. MANN. Okay. Let me just talk about a currency revaluation and then make a comment, a short one about consumer goods. My last chart showed all of the Asian currencies essentially have a real effective depreciation over about 25 years of the reform process, when for most countries by now there would have been some real appreciation (those curves would have started to move upward). I would argue that currency revaluation, particularly in Asia, is incredibly important for them. Currency revaluation is incredibly important for them as a way to restructure their economies toward more balanced domestic growth. Currency revaluation is not going

to solve our trade deficit problem. It's not completely irrelevant, but our problem is consumption. We have a MasterCard problem. And until we cut up the cards, you know, we have a spending problem.

With regard to why the deficit is in on consumer goods, other people can make comments, but let me tell you a story. For ten years, I flew down every other weekend to teach an executive MBA class in Nashville at the Owen School at Vanderbilt. That was between 1991 and 2001, during which as. You can see from that chart, the trade deficit in consumer goods was widening throughout this entire period. The students' companies produce a lot of stuff down in the Nashville area: white goods and cars, guitars and bibles, etc.

Many of those companies are global, and I asked these executives every year, why don't you ever produce much in the way of consumer goods? Are consumer goods too labor intensive? Are there no margins there? Tell me.

I never got an answer in ten years of asking that question to corporate middle managers.

Dr. BAKER. If I could——

Commissioner REINSCH. Sure. Make a comment and then I'll stop.

Dr. BAKER. Dr. Mann jogged my memory on the dollar/euro relationship. I think an important thing to understand here is the plunge of the dollar against the euro was very short term. If you recall, when the euro came into existence, it was $1.17 to a euro. Then it plummeted to 82, 82 cents. We never adjusted to that pattern. We didn't see this huge trade deficit result from that big run-up in the dollar because it was a very short period.

So when we compare the fall in the dollar, a lot of investors took a beating holding dollars against the euro. But the trade patterns never adjusted to a euro being worth 82 cents.

A couple other points: Inflation actually has risen a lot. I did a look at this. Every single measure of inflation has risen a lot in the last two years, and in fact there's been more acceleration now than there was in the '94–95 period when Alan Greenspan raised the Federal funds rate to six percent. So if he'll respond in the same way to inflation today as he did in the mid-1990s, we will be looking at Federal funds rates of 6 percent of more.

Commissioner REINSCH. Dr. Galbraith?

Dr. GALBRAITH. As I've said before, I do not see any virtue in a measure to improve U.S. balance sheet by cutting the consumption of working American households. It seems to me that is an extremely difficult way to go, and one which is likely in the course of implementation to depress profits and investments in GDP, leaving you no further forward than you were before.

We do have, and I think Catherine Mann's charts show this very clearly, an advantage in world markets in advanced capital goods. Our exports are therefore really dependent upon the amount of investment that is going on or the pace of development and growth in much of the rest of the world.

Over a strategic time horizon, the way to reduce the trade deficit is surely to put together an architecture that permits much of the rest of the world to grow more rapidly than it has been doing, and

this is not China, but all the other places—Latin America, Africa, other parts of Asia, which have not prospered in the era of globalization. Secondly, to reeducate the Europeans who are wasting ten percent of their manpower completely unnecessarily in the pursuit of rather mindless dogma about economic stability, which is a great shame for them and also a drag on our export markets.

We also need to address the issue of energy dependence. That is a major ongoing factor as her data clearly showed. We could do that in a way that over the long term increases our living standards and reduces our vulnerability to energy disruption. And then finally we could create an environment in which countries do not feel the urge to stockpile essentially financial reserves to quite the same extent that they have been doing. So if they would simply spend them, then our trade balance would improve.

Commissioner REINSCH. Thank you.

Vice Chairman ROBINSON. Commissioner Mulloy.

Commissioner MULLOY. Thank you, Mr. Chairman. Catherine, I recommend that you read the testimony from one of our witnesses tomorrow showing the role of the retail, Wal-Mart, box stores in all of this, which will help you, I think get a better, at least some idea of how the consumer goods thing works and why we're running such massive trade deficits in consumer goods.

If you haven't seen the program that Hedrick Smith put together for Frontline on Public Broadcasting, it's worth looking at. It helped me get a better understanding of the role of the retailers in all of this.

What I wanted to start out with is I was at your Institute, Catherine, when Secretary Rubin spoke on February 15, and I just want to give people out there some sense of what he said. And listen to this:

A deeply troubling fact of American life, American economic life is that over the past 25 years, median real wages in the United States have been roughly stagnant. And median real incomes up a small fraction of real growth with the exception of approximately five years in the 1990s, despite substantial economic growth.

Thus, a large number of our citizens did not have wages or incomes that benefited much if at all from the great economic success of our country during this period.

I think you have to understand that if you hope to understand what's going on politically with regard to the trade issue in Washington. This is now coming home to roost, I think.

Dr. Baker, you're saying the exchange rate is the problem. Dr. Galbraith I don't think agrees with that, but it isn't quite clear to me why. I think you both say that the savings argument for the reason for the trade deficit doesn't hold water, but exchange rates can't be the whole answer because we haven't ramped up production exports to Europe even though the euro has increased.

Dr. Blecker made a point before that. He said so much manufacturing capacity was shut down in the United States and relocated overseas during the prolonged period of dollar overvaluation is that the short-run benefits of the dollar's recent depreciation have been limited because we don't have the capacity to ramp up and take advantage of now export markets.

But it would help me to understand do you all agree—I keep reading in The New York Times, Washington Post, it's all our fault because we're not saving enough. Do we all agree—do you agree across the board that that is a red herring and that there are other things going on here. Help me just clearly tell me what would you say is the magic bullet or is there no magic bullet and it's a series of things?

Dr. BAKER. Just so I can be clear on what I was saying. I'd say the exchange rate is the mechanism. Now, are there are problems with our economy? We should be saving more. We have a lot of people who think they have a fortune in their house and they're going to be surprised to find out they have a lot less money there than they thought when they go to retire in three or four or five years, and that's going to be really big problem for them; it's going to be a really big problem for the economy.

Commissioner TEUFEL DREYER. Don't say that.

Vice Chairman ROBINSON. Is there a housing bubble?

Dr. BAKER. Yes, there is a housing bubble, and it's very serious, and that does affect the savings rate. There's a lot of good research on this, much of it done by the Fed, so if we want to see why we are not saving enough, the housing bubble is a good place to start. Alan Greenspan has really missed the boat in not doing anything about that.

Again, you don't want to hear me talk about that. But with this exchange rate point, people don't buy imports rather than domestically produced goods because we're not saving enough. They buy imports because they're cheaper and that's because of the dollar. I appreciate Catherine Mann making this point about the euro, and just to be very careful here, we go back to when the euro was created, which was about six years ago now. It was $1.17 to a euro. The euro then plummeted. We never adjusted to that. We didn't have this huge inflow of goods from Europe. It was a very short period of time where the euro was just at 82 cents.

We never really adjusted to that, so today I think if we look in the paper, it's about a 1.25. A euro is worth about $1.25, not very different from what it was when it was first created six or seven years ago.

So we have the euro falling sharply and then rising sharply, it is basically back to where it was. So we never adjusted to having a very low euro. We're pretty much back where we were. Now, does it get harder through time? Dr. Blecker's point—does it get harder through time as we have this deficit and we lose more capacity, does it get harder through time to adjust to a change in currency? Absolutely. Which is again one of the reasons why I'd like to see us do it sooner rather than later.

I agree with Jamie. I'm not anxious to see everyone take a big hit. But the alternative is I don't know a way around that and for me the best way for them to take the hit is to have the dollar fall against other currencies and recognize the different relevant prices, higher imported good prices, that we're going to see anyhow. The only question is the date.

So just like with the housing bubble, it will collapse. We just don't know when.

Commissioner MULLOY. Dr. Galbraith.

Dr. GALBRAITH. The question for me is a pragmatic one. What policies are available to us that can move us toward an improvement in the situation without inflicting unacceptable pain?

Policies that drive at increasing saving, first and foremost, are doomed to fail in that respect because they depress the economy before they do anything else. I also believe that with all respect to Dean Baker that a policy of depreciation of the U.S. dollar is likely to generate more instability, more difficulties international financial arrangements, and to do that before it gives us conditions under which our structural trade imbalance will improve.

In a much less politically correct time, my father wrote to President Kennedy in 1961 that—probably I shouldn't say this, but I will anyway—that depreciation is to certain economists like alcohol to the Iroquois.

Vice Chairman ROBINSON. You could do that in the '60s.

Dr. GALBRAITH. And I think there is something to that in today's world as well. We really need to think about a strategic time horizon in which we take steps that improve employment and real wages and our trade position and that is going to be a complicated problem, but there is no simple solution to it.

I would just want to say on your point about Secretary Rubin's comment about stagnation of real wages. That is very largely an internal distributional question in the United States. We've had growth, we've had productivity growth. But a large part of American workforce has not shared in that. That is because our distribution of income has gotten dramatically worse over this period.

Commissioner MULLOY. I tie that a little bit to globalization because globalization tends to give the more skilled people higher incomes and then they have increased leverage over the political system, to make it harder to correct the distribution problems we have at home.

Dr. GALBRAITH. Yes, the leverage over the political system is an essential point, because we could correct this problem technically if we chose to do so.

Commissioner MULLOY. But it makes it harder because of the globalization. All right. Thank you. Catherine.

Dr. MANN. With regard to savings, it is not that I'm a puritan where nobody should spend any money. But to the extent that everybody has maxed out their credit card—although as a nation—we're not there yet. But, we will get to the point where the interest bearing component of what we owe to the rest of the world starts to cut into our ability to consume as a nation.

As a nation, that is equivalent to using one credit card to make the payment on the other credit card that's full, and you have to make the minimum payment on the first. We don't want to get to that point, and to the extent that as a nation we're headed in that direction, we can make decisions now that are in our own interest even if that means each of us doesn't get to buy a plasma TV.

You have to do without it. With regard to the choice of spending within the fiscal system, we have a big budget deficit. As I said, a lot of it has to do with tax cuts. There's nothing wrong with having a budget deficit per se. The question is what are you spending your money on?

Different choices mean that some of these distributional issues could be addressed. If we didn't have a tax cut, for example, we could spend more on the earned income tax credit. We could spend more on R&D, as we heard about this morning. We could spend more on human capital investment tax credits for the medium skilled people who are incumbent workers and who are already being de-skilled out of the labor force as technological change alters what it is that they need to do.

So it's a matter of what we're choosing to spend our money on as opposed to the actual size of the budget deficit itself.

Commissioner MULLOY. I just want Dr. Galbraith to know I ran into Commissioner Donnelly last night and he was reading a book called The Iroquois Nation, and now it's clear to me why he was reading that.

Vice Chairman ROBINSON. Turning to Commissioner Donnelly.

Commissioner DONNELLY. Thanks for setting me up. Actually, the actual title of the book was The Ambiguous Iroquois Empire. The title alone was enough to make me buy it. And there are lessons for the United States in the fate of the Iroquois.

However, revealing my economic ignorance, I have a political question and appreciating also the essential truism that that which can't go on forever will eventually stop, what's puzzling to me at least is the degree of indulgence that the rest of the world seems to have for our plasma TV fetishes and our credit card ways.

The question I'd like to ask is, is it possible to attribute some of that simply to the fact that what we bring to the table is in part our military strength and our securing of the economic regime that's led to international prosperity? In other words, it's essentially the tribute that wealth pays to strength in some degree, and again without trying to suggest that this is a reason to continue to consume, or anything like that, but to try to simply explain the phenomenon, which seems to be always over the next hill from an economic perspective. You have to take a larger view in order to explain why the rest of the world simply continues to finance our consumptive ways.

Dr. BAKER. To my mind, I would explain it largely by economic failures on the part of most of these other countries in creating adequate demand, and I think, agreeing strongly with Jamie here, that Europe stands out here front and center, that they actually see it as a threat that their currency is getting too high. They're in fact buying up dollars trying to keep the euro down because they don't know how else to create demand.

Again, we learned this 60 years ago with Keynes. They should know how to create demand, but they don't. So their only way to create demand is by creating an export market in the U.S. which means keeping their currency or limiting the rise in their currency and we're seeing that to a large extent with other countries as well.

So I don't think that they're doing it out of a need to feeling gratitude for the military support. I think it's fairly directly an economic interest.

Dr. GALBRAITH. I'm more sympathetic to the implication of your question. I think that during the Cold War, we supplied Japan in particular with a security umbrella and I think it's fair to say that

in partial exchange for that, Japan sold more to us than it bought from us or from the rest of the world.

I think it's fair to say that we supplied, to some extent we supply security for Chinese trade, although it would also be reasonable to argue that China values the food and the fuel that it can purchase more than it values the labor that goes into the production of plasma TVs. So that from their point of view, this is not bad deal that they're getting.

I think, however, that the provision of security is a delicate business in the world. We had a strong position during the Cold War and that position is much more fragile now. And if the rest of the world comes to view our deployment of our military power as essentially self-interested rather than being in the service of the larger security of the world community, we may well find down the road that the financing of our trade deficit becomes much more problematic than it is up till now.

I would be very worried about that in terms of some of the way the world is looking at some of the initiatives that we've taken in the security and military area in recent years.

Commissioner DONNELLY. I was just hoping that Dr. Mann would kibitz or comment.

Dr. MANN. The only comment that I would add to that is that I also would not use the term "indulgence of the rest of the world." Their behavior is in their short term interests. They are the other side of the co-dependency. Just as we find it hard to live within our means, their economic structures have become rigidified in a particular pattern of production-for-export that does not achieve their maximum standard of living; but these policies and patterns are hard to adjust.

I wouldn't go quite so far as to describe the world as Clyde Prestowitz did this morning, but for a first approximation, he's not too bad on his description of the world into spenders and savers.

On the military side of things, another attack on this question is to note that over a number of years at various times, the United States has expended a large fraction of its R&D budget and private spending—government and private R&D on military or other kind of quasi-military objectives; today's flavor of the day is homeland security.

There are budget constraints out there someplace and money spent on the quasi-military objectives, although they do have spin-offs over various time frames into the private sector, are not the same as direct private sector spending or government spending on, say, industrial process, industrial design and other productivity-enhancing things.

Hence, this is another take on what they get from our military spending that is not positive for us.

Commissioner DONNELLY. Well, it would also be true that relative slice of GDP that we spend on military endeavors including homeland security is less than it was ten years ago and a couple points below the Cold War average. But again what I was trying to get at is essentially the suggestion that there is built into economic figures a kind of premium that's paid to have more effective and more efficient flows of trade and flows of capital that rests in

part upon a security structure that in turn is essentially guaranteed by the United States.

If there is a co-dependent economic relationship between the United States and exporting countries, there's an equally distorted security relationship, and then it also extends to China which has really no way to secure actually quite a large number of its material interests including things like the free flow of oil.

So I can't begin to imagine a methodology for quantifying that or to connect the security dots to the particular trade deficit dots. I wish people would address that problem or try to wrestle with that problem in some sense.

Dr. BAKER. Just to flip over, agreeing with you and Jamie on this now, without saying that the money is necessarily going to the U.S. as a quid pro quo, I would just say that obviously the cooperation in the economic sphere will follow to a large extent insofar as people feel that we're acting in a security realm in a way that's consistent with their interests.

If they feel we're acting unilaterally pursuing our own national interests, then we can anticipate we'll get less cooperation across the board in the economic sphere as well.

Commissioner DONNELLY. Presumably that would also be reflected in their levels of military spending as well.

Dr. BAKER. Yes.

Commissioner DONNELLY. If they were unhappy with the way we were running the world, there would be some reflection of which there is none as of this point.

Vice Chairman ROBINSON. We have two remaining questioners. Chairman D'Amato.

Chairman D'AMATO. Thank you, Mr. Vice Chairman. Ms. Mann, there is one area that I want to agree with you on and one area that I don't agree with you. You're actually batting 500 there, but the one area I agree with you on is I actually think, as well as you do, that this currency issue is extremely important to the Chinese. I'm not sure of all the reasons for it, but I think it's immensely important to them.

Unfortunately it's becoming more and more difficult for them to get off it because it's now becoming a political issue of great importance and within the regime who knows what the debate is on politics. But economically, as well, I think they think that they're going to be disadvantaged greatly if they move the peg to a point where it represents the value. I'm not sure why I think that, but from all the things that I've heard from them. It may not be that we will buy our goods instead of theirs, but it may well be that we'll buy far more of other nations' goods than theirs that become—and that I think is a very great worry for them. I don't think they know how that's going to work out.

And they're so dependent on this trade relationship, it's just too big a threat to them. I think they don't know how it's going to turn out. I don't agree with Dr. Cooper that it's going to go the other way and the currency will actually become, you know, more valuable rather than less valuable.

The other thing I think that's important about it is if they give it up, they will give up a habit that they have gotten into about the way of rigging things their way. They rig everything their way,

and if they can't rig it, they bully it. They do that in the WTO. They do that on IPR. They do that on proliferation of exports, which we have great familiarity with in this Commission. They do that on the WTO obligations. They do that on the question of standards, and so if they were then to move away from that currency thing, I think it would be a psychological change in a way they do business. I think it would be very, very good, but I think it's going to be very, very difficult for them to do it because of that.

The second thing where I don't agree with you is on the question of I think you saw that band on your chart on cars, and you said why isn't it that Americans should be buying more of our produced cars. Well, I know why we don't buy our own produced cars. We make lousy cars. I think that particular question, you might want to revisit the reasoning for that band. I think that American car industry just hasn't done the job in meeting consumer tastes in design. That band might be a lot smaller if it were to do that.

Thank you.

Vice Chairman ROBINSON. Commissioner Becker.

Commissioner BECKER. Thank you, Mr. Chairman. I want to make light on something first. Several Members of the Commission here today served on the Deficit Commission some five or six years ago. We didn't solve the problems then either. As a matter of fact, it's got a hell of a lot worse.

But I remember those long hearings, and that's all that the Commission was dealing with week after week, hearing after hearing, was the deficit. And I got sick of it myself. But here I am right back at it again.

Commissioner DONNELLY. You went shopping and made yourself feel better.

Commissioner BECKER. As long as I've got you laughing, let me say one other thing. Somebody suggested to me that Dr. Mann has a real hit here for the name of a country and western song, "Walking Away from Co-Dependence"—First copyright it. And sell it.

Dr. MANN. My son plays guitar. I have no idea.

Commissioner BECKER. The auto industry figures prominently within the deficit that the U.S. is running. Perhaps we are at fault in a way. Ford and General Motors and Chrysler-Daimler and all of the major auto parts suppliers have transferred the technology to China, showed them how to build the plants, showed them how to make the cars, allowed them how to steal it perhaps and make their own kind of knockoffs.

Industrially, we've allowed this to happen. And I guess my question probably first goes to Dr. Galbraith. There are strong feelings that China is poised to just inundate us with automobile imports into the United States. There are all kinds of predictions on when it's going to start that keeps moving up closer and closer.

They're equipped to do that. And whether it's because the cars are better or cheaper—I think buyers are driven mostly by cost. I guess my question goes along the line to the extent that could shed some light on this, if you have thoughts on this? It's been said that some 40 percent of manufacturing in the United States is geared directly or indirectly to the automobile industry.

That's the tooling, that's the machine tooling, that's the mining of the ore, making of steel, making of aluminum, textiles for the

fabrics, plastics. Those are all produced here in the United States, and if they as well as the cars are produced in China, it's going to have a hell of an impact on us—if that figure is right—40 percent—give or take some.

Do you have any thoughts on that?

Dr. GALBRAITH. My instinct on the matter is that a major Chinese presence in the world automobile market is probably a ways off. In the middle 1990s at a time when they had—I don't know how many they have now—but at that time, they had over 100 automobile producers. And they produced at low volumes, very low quality and at very high cost behind very high protectionist barriers.

My sense is that part of the WTO transition which involved reduction of trade barriers was to rationalize that and to bring a more modern production technique, get better cars produced for the Chinese market.

It will be awhile before those cars are able to compete with let's say Korean cars or other cars that are established in the U.S. market. We may see it, but my sense is, is that that's not as soon as some are saying.

Commissioner BECKER. Would you just hazard a guess?

Dr. GALBRAITH. Oh, I'll avoid that.

Commissioner BECKER. Five years, two years?

Dr. GALBRAITH. No, I wouldn't say two, but better authorities might be found on that point.

Commissioner MULLOY. Dr. Galbraith, I just want to comment. One area that they did not make a big tariff concession was on automobiles. 25 percent tariff, WTO legal 25 percent.

Dr. GALBRAITH. But it was much higher before.

I think the tariffs were in the order of 100 percent before, so they were reducing them, but as a means mainly of rationalizing their domestic production. That gets rid of a lot of very high cost low volume producers.

Commissioner MULLOY. I saw it mainly as an effort to get the automobile market in China to get the foreign investment in there.

Dr. GALBRAITH. Yes.

Commissioner MULLOY. And then to also even maybe use people who come in as foreign investors, like GM, then having a market mechanism when they do begin to make cars there to ship them back here to a ready-made market mechanism.

Dr. GALBRAITH. No, there may be some of that, but my understanding is that the main initiative here was to rationalize what was a very irrational domestic production system.

Commissioner MULLOY. Thank you.

Vice Chairman ROBINSON. Thank you very much. If there are no more questions, we will conclude today's session with our gratitude. It was a high quality panel and we profited greatly. We will be reconvening in this room tomorrow morning at 10 a.m. Many thanks.

[Whereupon, at 5:40 p.m., the hearing was recessed, to reconvene at 10:00 a.m., Friday, May 20, 2005.]

CHINA AND THE FUTURE OF GLOBALIZATION

FRIDAY, MAY 20, 2005

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION,
Washington, D.C.

The Commission met the Council on Foreign Relations, 58 East 68th Street, New York, N.Y. at 10:00 a.m., Chairman C. Richard D'Amato and Vice Chairman Roger W. Robinson, Jr. (Hearing Co-chairs), presiding.

OPENING REMARKS OF CHAIRMAN C. RICHARD D'AMATO

Chairman D'AMATO. The Commission will come to order. Yesterday, the Commission had a comprehensive and fruitful discussion of the dynamics at play in the global economy and the role of China in these trends. We examined the underlying theories of globalization and free trade and how they comport with today's realities and the impact and implications of global trade and investment flows for the U.S. economy.

We also delved into the complex issue of the causes and consequences of the U.S. global trade deficit and our massive bilateral trade deficit with China.

Today, in two separate panels, we go to a more concrete discussion of how U.S. corporations are competing in the global economy and the role of U.S. tax policies in affecting U.S. firms' global business decisions.

Panel I, Corporate Global Strategies, our first panel of the day, will look at the challenges and opportunities faced by companies competing in a global environment. It will examine which corporate sectors are the drivers of the global economy and whether there has been a shift in negotiating and price setting power from the manufacturing to the retail sector.

The panel will also look at the implications of global business decisions on the U.S. labor market and labor standards.

We are pleased to be joined by our panelists. On the left, Mr. William Jones, Chairman of Cummins-Allison Corporation and Chairman of the U.S. Business and Industry Council. Cummins-Allison is a privately held U.S. manufacturer of coin and currency scanning, sorting and processing equipment along with other office products such as paper shredders.

The U.S. Business and Industry Council is a Washington, D.C. based group that advocates on behalf of U.S. family owned and closely held firms.

To Mr. Jones' left, Mr. Ron Blackwell, Chief Economist of the AFL–CIO. Mr. Blackwell coordinates the economic agenda of the AFL–CIO. Before coming to the AFL–CIO, Mr. Blackwell was As-

sistant to the President of the Amalgamated Clothing and Textile Workers Union and Chief Economist of UNITE. We've heard a lot about those organizations in the last few days.

And to his left, Professor Gary Hamilton, who teaches at the University of Washington, Department of Sociology and its Jackson School of International Studies. He specializes in historical comparative sociology, economic sociology and organizational sociology with a particular focus on Asian societies.

We welcome the panel to this great venue here in New York City, and the way we proceed, we go from Mr. Jones right on down. If you would go ahead and make your remarks, confine them to seven to ten minutes. We will put your full statement in the record and it will be in a report that we will be delivering to the Congress.

So we'll go right down the line and each of you give your statements and then we'll open it for questions and answers. Mr. Jones, you may proceed.

PANEL I: CORPORATE GLOBALIZATION STRATEGIES

STATEMENT OF WILLIAM J. JONES, CHAIRMAN CUMMINS-ALLISON CORPORATION, MT. PROSPECT, ILLINOIS, AND CHAIRMAN, UNITED STATES BUSINESS AND INDUSTRY COUNCIL WASHINGTON, D.C.

Mr. JONES. Good morning. You gave a little background on our company so I won't cover that except to say that all our design, engineering and manufacturing takes place in Chicago, Philadelphia and San Diego. About 85 percent of what we produce is consumed in the United States and the rest is for export.

I was asked to speak about corporate globalization strategies today and I believe that the U.S. Government lacks a global strategy relative to U.S. industry. China, Europe and Japan and the other major industrial powers are pursuing coordinated industrial strategies to sustain their industries in the new global environment. Because foreign manufacturers receive strategic and financial support from their governments, U.S. manufacturers are now under siege in our domestic market.

American owned manufacturers are using all of our energy simply to survive in our home market, and given the significant barriers to entry in the Chinese market as well as other foreign markets, it is difficult for medium and small-sized U.S. manufacturers to achieve much success in the export business.

The U.S. Government is unable to respond to help medium and small manufacturers. The ITC does not understand the difference between yearly profitability and long-term health. USTR lacks resources and is under resourced and does not understand how to help the small and medium-sized manufacturers. There is rampant intellectual property theft and reverse engineering of our and other companies' products.

Put another way, Cummins-Allison would be far better off if we were a European company receiving the support and advocacy of European governments. In fact, we'd probably be ten times as large with their strategic support. Because instead of operating in niche markets, we would be able to profitably offer a larger and more complete product line. Then Cummins could be a global player and a global leader.

As an illustration of what I mean relative to lack of U.S. strategy I cite Cummins own industry, which is the protection of the integrity of U.S. currency. We make equipment to validate currency, and our equipment is used around the world, primarily to process U.S. currency.

Twenty years ago, there were five U.S. manufacturers in the United States providing this essential technology, from the central bank—that being the Federal Reserve—down to very small mom and pop stores and everything in between.

This domestic industry enabled the United States to maintain the critical technology to support the integrity of the dollar. Today, all but one of those U.S. companies are gone. Only Cummins survives. All of the other U.S. manufacturing facilities as well as R&D has been discontinued and shuttered.

During the same time frame, the European, Japanese and Chinese firms have increased their market penetration here to 70 percent. How did this happen? Well, the Chinese, Japanese, and European governments believed that currency processing and authentication is a national security issue and as such they've supported their domestic industries.

Their domestic industries were aware of that. They made all the profit they needed to make in their home market and as such dumped their products here in the U.S. over a 20-year period at one-half to one-third of their home market prices. This drove all the domestic U.S. industry out of the business. Cummins-Allison saw that the deck was stacked against us and we made a strategic decision to just move into niche markets that could be protected by comprehensive patents and that's the only reason we've been able to survive.

China, of course, is worse than all the others. Permit me to summarize some examples of our experiences in China. Even after entering into the WTO, China assesses a 40 percent tariff on our products imported into China. Their reasoning is they want to develop their own industry and they've explained it's a national security issue for them.

China has a stated goal to enter into our market and I cite a specific article written in the Chinese equivalent of The Wall Street Journal two years ago, which is attached as an exhibit to my testimony. The article states, for example, "the U.S. Cummins Corporation produces a complete product line. The equipment can be used at the counter or at the vault. This is probably the most advanced money processing equipment that exists today."

The article goes on to say "we, China, should learn the merits from importing money processing equipment and overcoming their drawbacks shall be our winning factor. We will move forward at full speed and enrich ourselves with technology and productivity, hoping one day we can replace imports (that being Cummins) and then begin exporting money processing equipment bearing Chinese brand names."

Furthermore, in China, there's no protection for intellectual property or our patents. There is no way to defend our intellectual property because the United States government failed to negotiate adequate remedies as a part of China's entry into the WTO. We also have reason to believe that the Chinese military is involved in the

production of currency handling equipment through tours I've had in those manufacturing facilities located in China.

More recently China introduced what's known as the CCC requirement, which they tell us is like UL. However, for us to receive CCC requires Cummins to agree to let Chinese government officials visit our facilities in the United States and Cummins must pay for all of their travel and other expenses. Furthermore, they're required to come and visit us on an annual basis. We have to agree to provide them with all of our engineering drawings, schematics, and let them tour anywhere in our facility that they wish. Somehow it seems to me that is contrary to national interests of the United States to let the Chinese government tour a facility where we are making technology to protect the integrity of U.S. currency.

There is no rule of law in China. There is no remedy for pirating of our technology, which takes place daily. So what is the end result of all of these barriers that China has implemented and their stated goal to move into our industry? Well, our export business to China over the last five years has declined from over $5 million a year to zero.

They've achieved their first stated goal which, of course, was to get rid of the imports and we now see them ramping up to export their products into the United States and other parts of the world.

It's also important to understand that Cummins technology is important to the integrity of currency. We spend a tremendous amount of money in R&D. We have two engineers, for instance, for every production person in our facility, and it's a moving game with counterfeiters. One of the technologies we developed in the last ten years is a new more cost effective scanning technology. Scanners used to cost anywhere from 25,000 to a million dollars each. Banks could only utilize currency scanners in their central vaults due to the high cost of the products.

Then Cummins introduced to scanning the equivalent of what a PC did for computers. Our new technology scanners cost $2,500 and banks could afford to move scanning and finding counterfeits to the teller line where currency comes into banks. And foreign banks use these Cummins scanners extensively on the U.S. dollar, and they have informed us if our technology was not available, they would no longer accept bulk deposits of U.S. currency overseas because of some of the excellent counterfeits which are in circulation.

Now, for years, we tried to encourage the United States Treasury Department to work with Cummins because we see flows of counterfeits around the world. Sometimes I think in certain regions outside the United States, we get this counterfeit feedback from banks before the Secret Service does. But much to our surprise, the Treasury Department does not have any interest in meeting or working with us in a collaborative environment.

It's a little like being a field commander in a war, and when you report back to the Pentagon, the staff says we just don't need your input. An illustration of this Treasury position is a recent Congressional hearing, and Tim, if you could show this to the panel.

In July 2003, the U.S. Congress Small Business Committee in combination with Congressman Duncan Hunter (Armed Services Chair) was looking at Federal procurement as it relates to national security and defense, and I was asked to sit on a panel. They were curious about Treasury and what were they procuring. So I thought this would finally lead to a collaborative effort with the Treasury Department. But I found out from some Members on the Hill that actually the Treasury Department was preparing for the Congressional hearing with the foreign manufacturers.

On the day of the Congressional hearing when I arrived, Treasury arrived with the lobbyists for the foreign manufacturers. One of the Treasury officials approached me and asked me for my written testimony, which as a gentleman I gave them. They (Treasury and lobbyists for the foreign manufacturer) then huddled around my testimony and made notes prior to the beginning of the hearing.

The hearing became rather animated and when the Congressman kept pressing the Treasury for the answer, which is how much of the technology that's used in the Federal Reserve and at the Bureau of Engraving and Printing is supplied by foreign manufacturers, the Treasury didn't want to answer that question. But I can tell you the answer—substantially all of it is foreign supplied.

Cummins theory at the 2003 hearing, given the currency, which I'm circulating here in the room today, is that these foreign manufacturers supplying the U.S. Treasury may be selling the same technology to governments which may be adversarial to the United States. However, the Treasury assured the Congressman during the 2003 hearing that we do not have a national security problem around the U.S. currency.

Fast forward two years. It's now out. The Korean press is reporting the fact that the North Korean government is printing excellent U.S. counterfeits. Now, where we, Cummins, see these counterfeits flowing around the world is in countries adjacent to China and into the Middle East.

What concerns Cummins the most based upon the feedback we get from the Middle East is the fact that terrorists, because many of their other methods of payment have been cut off may be using these excellent U.S. counterfeits. Terrorists may be involved in laundering U.S. counterfeits in order to acquire armaments and other things to make trouble for us and many other people in the world.

So it's a real serious problem. And as a result, we really continue to try to engage with the U.S. Treasury with the goal of developing a more coordinated program to attack this very significant problem. Another example of problems, with the lack of coordinated industrial programs within the United States government is the ITC.

As I mentioned, we stay in niche markets where we have patents. Four or five years ago, we decided to try to move into a nonniche market and enter what we call the note counter business. The Chinese and the Koreans immediately began to drop their prices aggressively, so we went to the ITC, and the ITC made a very interesting ruling. They said, well, while you're getting clobbered in that particular market, you're making lots of money in

your niche patented market, and therefore we don't see harm to the industry.

But the ITC missed the point. We cannot offer a full and complete product line if every time we try to enter a new market we get clobbered like that. As one of the foreign manufacturers from Europe told me, we should really sell our business to foreign manufacturers because everyone knows they dump here in the U.S. And the price offered by the foreign manufacturers keeps going up for the purchase of our business, by the way.

Then after failure with the Treasury and the ITC, we went to visit the United States Trade Representative, and these are great, well-trained people at the civil servant level, and they were very concerned. USTR staff believed we had a great case for the WTO, particularly with China. USTR staff goes to the higher-ups and, understandably, there's limited resources. It's very expensive to pursue something at WTO, and USTR decided to take a pass. They usually take a pass on the medium size and small manufacturers, that's another problem.

USTR suggested that we call on the Chinese Embassy, maybe we could work something out with them. After failing with the Treasury, the ITC, and USTR, we went to the Commerce Department and met with some very high level people in the Commerce Department. They also were very upset about the problems Cummins faced. We talked about remedies. But all the remedies you used to be able to use at Commerce under GATT have been banned under WTO. So it became very apparent, though they wanted to help us, there is nothing Commerce can do.

In conclusion, I want to leave you with three points. First, the U.S. lacks a complete coordinated currency protection policy, which should be an important component of our national security. I encourage the Congress and the Executive Branch to develop a coordinated and substantive U.S. currency protection program. In short, European and Asian governments do much to coordinate their currency protection policies with their domestic commercial banks, currency equipment manufacturers, academicians and others. America should do the same.

Second, I encourage the U.S.-China Commission to report to Congress that small and medium-sized U.S. manufacturers cannot have an effective globalization strategy given the current well intentioned but ineffective U.S. Government policies and support.

Manufacturing and good manufacturing jobs are rapidly declining in America, and particularly where I come from in Chicago. The United States needs to respond to this rapid economic erosion before it is too late.

The third and last point: American manufacturing and its corresponding jobs will not survive without improved government programs and a concentrated effort to fully enforce existing trade laws.

Our trade policies are not working and small and medium-sized American manufacturers are paying the price as well as their laborers. We can survive, but not without a level playing field here and at home in the export markets.

Thank you for providing me with this opportunity to speak with you today.

[The statement follows:]

Prepared Statement of William J. Jones, Chairman Cummins-Allison Corporation, Mt. Prospect, Illinois, and Chairman, United States Business and Industry Council Washington, D.C.

Testimony Given as Chair of the United States Business and Industry Council

Good morning, Mr. Chairman and Members of the Commission. My name is William Jones. I am President and CEO of Cummins-Allison, an American manufacturer of sophisticated machinery that counts, sorts and verifies the authenticity of American currency. I am also Chairman of the United States Business and Industry Council (USBIC), a national business organization whose roughly 1,000 members are principally small- and medium-sized privately held manufacturing companies.

I am very grateful for the opportunity to appear before you today, and will divide my written remarks into two main parts. First, I will discuss the challenges presented by Chinese competition to the types of companies represented by USBIC. Second, I will discuss the more specific challenges presented by China to my own company, Cummins-Allison.

As you will see from my discussion, it is very difficult for a company like mine to have a "globalization strategy," i.e. a game plan to take on all global competition and succeed both in the U.S. market and in multiple foreign markets at the same time. Market opportunities abroad are severely limited for many American companies, and the smaller a company is, the more difficult it is to muster the resources necessary to break through significant foreign barriers to market entry.

In addition, most American domestic manufacturers are under attack here in their home market. Rather than having the time to develop forward- and outward-looking "globalization strategies" to succeed abroad, most of our efforts are focused on surviving the very real, and well formulated "globalization strategies" of foreign companies, most often backed by their governments. These companies seek to put us out of business in our home market, often operating from the sanctuaries of closed markets in their home countries.

So the very notion of a global market is a misnomer. What we are actually dealing with is a global assault on the American market by foreign firms, which have the strong support of their governments, while foreign markets remain closed or difficult to penetrate for American firms, which receive little or no useful help from the U.S. Government.

Let me turn for a minute to the types of firms that USBIC represents and the type of firm that my own Cummins-Allison is. The growing number of USBIC member companies come from a wide variety of capital-intensive manufacturing sectors. They make few products that the typical American family would recognize. Like most small- and medium-sized manufacturing companies, they make parts and components and other inputs for much larger companies, often multinational companies. In other words, they are mainly members of the supply chains of these larger companies, although some do make finished, consumer-ready products.

Since all USBIC members are family-owned or closely-held, and many have been in existence for several generations, as a group, they have demonstrated remarkable staying power. Many of these firms survived the Great Depression. Many more survived the Japanese export wave that first emerged in the 1970s and 1980s (and which has by no means stopped). They survived NAFTA. They survived the creation of the World Trade Organization. And they survived the initial years of the great 1990s expansion of U.S. economy's ties with China.

Our members have survived—and often flourished—mainly by out-innovating and out-managing the competition. In recent years, however, their circumstances have changed dramatically. Thanks not only to China's indigenous industrial and technological development, but also to the almost indiscriminate transfer of technology and management know-how to China by multinational companies, the quality and sophistication of Chinese products has improved markedly. At the same time, a wide variety of predatory Chinese trade and other economic policies have kept the prices of these products artificially low. These practices include not only the Chinese exchange-rate manipulation that has attracted so much recent attention in Washington, but also subsidies for land, buildings, water, and fuel, and for exporting as well.

The bottom line is that a growing number of U.S. domestic manufacturers across the industrial spectrum find themselves competing against finished goods that cost less than the costs of the U.S. firms' raw materials. All the technological and management wizardry in the world cannot overcome these advantages. As a result, America's do-nothing China trade policy is forcing U.S. domestic manufacturers to compete with China and other third world subsidizers on the basis of cost. This kind

of competition is not only a no-win proposition for the companies and industries directly concerned. It is a no-win proposition for a nation ostensibly committed to raising its people's living standards—which is after all the main ultimate purpose of economic policy.

Because Washington has encouraged expanded trade with China while refusing to respond effectively to Chinese trade predation, the multinationals—whose supply chains have been comprised of companies like USBIC members—have been steadily switching their suppliers to Chinese firms and others in the third world. This upheaval most certainly has contributed to the technology and management skills transfers that have done so much to bring Chinese suppliers up to American quality and performance standards.

This export of industrial and innovative capacity to China has done grievous damage to the U.S. economy. When U.S. companies lose business to Chinese rivals, or need to cut costs to the bone even as their margins shrink, jobs can be displaced, wages can fall, taxable income can vanish, and resources for new investment in R&D and new plant and equipment can dry up. The communities where these companies have been located—and whose economies they often anchor—lose major sources of employment, income, and tax revenue. The flip side of this coin is that these communities are hit by rising demand for social services—welfare, Medicaid, job training, food stamps, etc. Nationally, the migration of supply chains depresses exports, boosts imports, worsens the trade deficit, increases America's cumulative foreign debt, and puts further downward pressure on the dollar.

The national security effects of the shriveling of (or complete loss of) supply chains is even more worrisome. As the Defense Department has begun to recognize, small- and medium-sized businesses are a leading engine of innovation for the economy, and for the military in particular. The health of this sector is essential for ensuring that America's armed forces are equipped with the world's most technologically advanced weapons and other military systems. With China, of course, a double-whammy emerges. The United States loses industrial capability critical to maintaining military strength, and it loses this capability to one of the few foreign powers capable of and interested in threatening our national security and our international interests.

Small- and medium-sized companies like USBIC members are often reminded by the U.S. Government that means are available to help them deal with predatory Chinese competition. Unfortunately, most of these means are available more in theory than in practice. Specifically, the U.S. trade law system designed to help U.S. companies combat unfair foreign trade practices suffers structural flaws that have rendered it almost useless. The slow, unworkable system suffers from a process that is both unresponsive and extremely expensive to engage.

So far, of course, currency manipulation is not even actionable under the system. Anti-subsidy laws can't be applied to non-market economies such as China's. And many trade cases cannot be brought because the industries whose consensus is needed to bring suit are dominated by multinational companies that actually benefit from the trade law violations of the countries where they have built factories.

Even when cases can be legally brought, companies routinely face sky-high legal bills plus long waits as cases wind their way through the Commerce Department and the International Trade Commission. More often than not, smaller companies simply can't afford to wait this long. Their problems are too pressing, and they lack the financial reserves of much larger firms. Just as important, the bureaucratically controlled political systems of many of our chief trading partners can put into effect new trade barriers much faster than U.S. officials and businessmen can even identify them, much less fashion responses and withstand the sluggish process.

And of course, at the end of the day, the President can ignore the mountains of evidence and months of work behind a successful case, and reject the remedies. Even more frustrating, it should be clear to all by now that the majority of countries comprising the World Trade Organization stand ready to strike down even U.S. trade law rulings that advance or defend internationally recognized U.S. rights. The reason, of course, is that the WTO is primarily a political institution with a legal veneer, not a legal institution, and most of its members have overriding interests in keeping the U.S. market open to their goods and denying U.S. producers reciprocal access.

Small- and medium-sized companies are also frequently advised to explore more vigorously opportunities to export to and invest in China. The market is enormous today and has even greater potential, we are repeatedly told; U.S. Government export and investment promotion programs stand ready to assist you. Yet the obstacles facing smaller firms thinking of entering the China market are formidable enough to render the advice practically meaningless as well.

In the first place, the Chinese consumer market is much smaller than commonly portrayed. Wages remain abysmally low, of course, but less widely recognized is China's extraordinarily high savings rate—some 40 percent of national income. China's workers are doing what Americans should be doing more and would be doing more—if U.S. economic policy did not penalize savings so heavily relative to consumption, and if real U.S. wages over the last 30 years had continued to rise at pre-1970 rates. Chinese workers are saving for a rainy day. It's easy to see why, given China's turbulent recent history, the uncertainties created for the individual Chinese by ongoing economic reforms and privatizations, and the absence of a social safety net. Nonetheless, these high savings rates put a real damper on Chinese consumption levels.

Unquestionably, much new wealth is being created in China, as a consuming class that is huge by any reasonable standards emerges in the cities. But the problem for the U.S. economy, and for small- and medium-sized manufacturers in particular, is that China's production and exporting potential will, for so many decades, vastly exceed its importing and consuming potential. Even in the last decade, robust Chinese growth has not been adequate to reduce the country's towering unemployment rates. In order to keep the lid on this threat to the regime's survival, Beijing has been forced to promote the overproduction of most of the goods made in China and the concomitant export of this job-creating surplus production.

This is why, according to economist Stephen Roach of Morgan Stanley, the export share of China's GDP has shot up from 20 percent in 1999 to 35 percent in 2004—and not surprisingly, private household consumption has fallen to a record low of 42 percent of China's GDP.

So although individual U.S. companies and even industries will no doubt be able to formulate "globalization strategies" to take advantage of the significant absolute growth in Chinese consumption, the immense structural trade surplus China has created with the United States means that, on an economy-wide basis, exporting to China is no panacea for our industries. In fact, this structural surplus means that the vast majority of U.S. industries will face continued, mounting levels of predatory Chinese competition for shares of the U.S. market, given the Chinese national globalization strategy.

Finally, the microeconomic obstacles to doing business successfully in China are far greater than small- and medium-sized companies can cope with. Just one indication of these obstacles—the China chapter in this year's annual report on foreign trade barriers from the U.S. Trade Representative's office totals 58 pages—the longest single chapter in the report. (Japan's chapter is the next longest, at 45 pages.)

The substance of these 58 pages is even more intimidating. Rather than repeat USTR's list of Chinese barriers, permit me to make this overarching point. The Chinese system of government is especially user-unfriendly to non-Chinese. There is no reliable, impartial legal system. There is not even the pretense of a reliable legal system. Many laws and regulations are never written down; they exist only in the minds or the confidential records of bureaucrats. The same applies to the changes that can be made in these laws and regulations with a simple phone call.

This is the concrete reality behind the common though all-too-abstract-sounding observation that the Chinese system is not transparent. Foreign actors for the most part literally are incapable of finding out what's going on. As for laws and regulations that are written down, they tend to be vague and interpretation tends to be arbitrary.

For any system so determined to keep its workings mysterious, only one explanation suffices: Creating a level playing field for all commercial actors is the furthest thing from the minds of Chinese leaders and officials. Rather, the exclusive aim is to promote the interests of Chinese producers. Consequently, it is impossible for small- and mid-sized firms to develop a "globalization strategy" when dealing with the unknown, the arbitrary, and the denial of "national treatment" by Chinese authorities.

As even the largest U.S. multinational companies will acknowledge, navigating this system is a struggle even with the deep pockets needed to make and maintain the right connections and relationships. Success, moreover, is anything but guaranteed. Look at the fight General Motors faces in the Chinese courts in its effort to prevent a Chinese rival from ripping off a vehicle design.

If doing business in China can be tortuous for companies such as these—with long experience operating in difficult foreign environments and the resources needed to make huge front-end economic and political investments and to wait the years it often takes to see profits materialize—how much more difficult will doing business in China be for smaller firms lacking these assets?

For it is now an open secret that the United States has long done a terrible job monitoring and enforcing the trade agreements it has signed, and China has been

the greatest failure. At the same time, the practical difficulties of enforcement in such an enormous country as China create suspicion and doubt. In all, as I see it, a company like mine has little confidence that the U.S. Government will provide enough meaningful support over a long enough period of time to give me a reasonable chance of making money in China—which is all any investor can ask.

Thank you for your attention and your concern.

Testimony Given as Chair of Cummins-Allison Corporation

I. History and Background of Cummins-Allison Corporation

My name is William Jones and I serve as Chairman of Cummins-Allison Corporation, which is a privately-held manufacturing company based in the Chicago area. Our company was founded in 1887 by the Cummins and Allison families, who were prominent leaders in the industrialization of the United States. As a matter of fact, one of the Cummins' brothers, Albert, served as the Governor of Iowa from 1902 to 1908, and subsequently was a United States Senator for approximately 18 years, from 1908 to 1926. The Allison family of Indianapolis was instrumental in founding Allison engineering, and you are probably familiar with today's Allison transmission and other Allison power generation related products and components.

A key product line manufactured by Cummins-Allison is equipment used to scan, sort, denominate, and authenticate U.S. currency, as well as other currencies of the world. Cummins' currency processing products are utilized by banks, retailers, governments, armored carriers, casinos, and others. All of Cummins-Allison Corp. design and engineering takes place at our research facilities located in Chicago, Philadelphia, and San Diego. 90% of the products Cummins sells around the world are manufactured and produced at our factories in the Chicago area. 80% of our production is consumed in the United States, while the balance of our production is sold in other markets around the world.

Cummins-Allison Corp. is a "main street" company heavily invested in our local community with the desire to sustain our production in the United States and continue to provide jobs and opportunities to our local Chicago community. Cummins-Allison Corp. directly employs 800 Americans, and additionally another 15,000 Americans are employed at our 300+ U.S. suppliers throughout the United States.

II. Why Domestic U.S. Manufacturers Generally Do Not Have Globalization Strategies

I have been asked to speak about our company's corporate globalization strategy. Sadly, it is difficult for Cummins-Allison Corp. to develop an effective globalization strategy because the United States Government lacks a global strategy relative to the U.S. manufacturing industry. The United States simply has not recognized the importance of sustaining the American manufacturing industry in a global economy. The lack of an effective government strategy is particularly harmful to medium- and small-sized U.S. manufacturers.

China, Europe, and Japan, inter alia, are all pursuing coordinated industrial strategies to sustain their domestic industries within this new global environment. The lack of a U.S. Government industrial strategy endangers the future of our industrial base, our economy, and the quality of life for millions of people who are employed by manufacturers.

Equally important to understand is that the lack of U.S. Government strategy makes it difficult for individual companies such as Cummins-Allison Corp. to pursue a successful business strategy not only for U.S. production, but for survival in the new global environment. Because foreign manufacturers receive strategic and financial support from their governments, U.S. manufacturers are now under siege in our own domestic U.S. market. American-owned manufacturers are using all of our energy simply to survive in our home market and, given the significant barriers to entry in the Chinese market, as well as other foreign markets, it is difficult for medium and small U.S. manufacturers to achieve much success in the export market.

Put another way, Cummins-Allison Corp. would be far better off if the company was a European or Japanese manufacturer, where we could enjoy the benefit of government's strategic initiatives and advocacy. If Cummins-Allison Corp. was a European-based manufacturer, we would probably be 10 times the size we are as a U.S. company. Cummins would be 10 times as large because strategic and other governmental support would enable Cummins to offer a larger and more complete product line. Instead, we are forced to concentrate on narrow niche markets, where we currently reside and attempt to survive. But understand, we are only playing on the margins of the industry and will be unable to take a leading role in a global economy until and unless our government policies change to support and promote U.S. industrial production.

III. An Illustration of the Demise of the Critical U.S. Currency Processing and Authentication Industry

Twenty years ago, five U.S.-owned manufacturers provided approximately 90% of the domestic requirements for technology adapted to automatically sort, denominate, and authenticate U.S. coin and currency. U.S. manufacturers dominated many sectors of the industry worldwide, ranging from the manufacture of large sophisticated equipment for use by Central Banks, down to the desktop equipment used in branches of commercial banks. This vibrant U.S. industry also exported significant amounts of equipment around the world. Furthermore, U.S. industry printed and produced bank notes for use by many foreign countries around the world. These domestic industries enabled the United States to maintain the critical technology to support the integrity of the U.S. dollar.

Today, all but one of the U.S.-owned manufacturers, Cummins-Allison Corp., have been eliminated. Over the last 20 years, most of the U.S. manufacturing facilities and U.S.-based R&D has been discontinued or shuttered. During the same timeframe, all of the European and Japanese, as well as Chinese, firms have survived and increased their market presence in the United States to about 70% of the total market. The sole U.S. manufacturer's (Cummins) share of the U.S. market is down to 30%. The large majority of the previous American export business has been lost.

How did this happen? The Chinese, Japanese, and European governments believe that currency processing and authentication is a national security issue. For example, the Japanese government will purchase currency processing equipment only from Japanese manufacturers. When releasing new currency, the Japanese Central Bank only shares this information in advance with the domestic Japanese producers. There are many other barriers in Japan, which time does not permit me to cover today, but which are known to American firms trying to penetrate the Japanese market. As a consequence of unfair Japanese trade practices, there are no foreign suppliers of currency handling equipment within the Japanese market.

The European approach is to control trade and market access through the setting of standards. The close government cooperation with industry can be illustrated by looking at standard setting and the introduction of the euro. Five years prior to the release of the euro, the European Central Bank established a committee to design the new euro and invited the domestic European currency processing equipment industry to participate. Our European competitors were permitted to participate on this committee. When Cummins-Allison Corp., an American manufacturer, learned about the existence of this committee, we specifically asked to be included and contacted the appropriate authorities at the European Central Bank. In addition, the U.S. Bureau of Engraving and Printing wrote a letter of recommendation to the European Central Bank suggesting that Cummins-Allison Corp. should be included in these deliberations. We received correspondence from the European Central Bank declining our request. This correspondence is attached as Exhibit 1 to my testimony.

As a result of being denied entry into the exclusive European club of manufacturers capable of handling the euro currency, when asked by European commercial banks about Cummins-Allison Corp. ability to handle the euro, we had to be honest and tell the banks we had not seen the euro as of that time. European banks expressed their surprise and indicated that the European manufacturers had received early access. Consequently, when the euro was introduced, Cummins-Allison Corp. was shut out of the market and obtained absolutely no business for the handling of the new euro and lost, potentially, hundreds of millions of dollars in sales.

Another illustration of European government policy promoting European manufacturers is illustrated by the fact that the European Central Bank contracts with our European based competitors for the printing of the euro. This would be the equivalent of the U.S. Government providing Cummins-Allison Corp. with a lucrative contract to design and produce approximately half of the U.S. currency in circulation. Our European competitors also enjoy hefty profit margins and cashflow from the government contracts to print the euro.

Similar to Japan and Europe, China too maintains that its currency processing equipment is a component of "national security." As a result of China's protected market, Chinese manufacturers are able to make substantial profits in their domestic markets. In addition, over the last 20 years they have used the advantage of home market protections to dump their products in the United States at prices that are only one-half to one-third of their home market prices. As a result, as stated above, all of the U.S. manufacturers in our industry, with the exception of Cummins-Allison Corp., have been eliminated.

Cummins-Allison Corp. has only been able to survive because we recognized that the deck was stacked against us and elected to operate only in smaller niche markets offering products that are protected by comprehensive patents. If Cummins did not have patent protection, we too would have been driven out of business. It is im-

portant to note that at some point Cummins' patents will expire and at that point the United States may be faced with the loss of its only currency processing equipment manufacturer.

IV. Additional China Issues

The government of China has also declared that currency is a national security issue. Therefore, even after entry into the WTO, tariffs of 38% to 40% continue to be assessed by the Chinese government upon Cummins-Allison products exported to China. A recent tender issued by commercial banks in China for 10,000 machines was lucrative and promising to Cummins. However, the Chinese government stepped in and informed the Chinese commercial banks through "administrative guidance" that the banks could not source these machines from a foreign supplier, and particularly could not source them from Cummins-Allison.

The Chinese government, however, does recognize that Cummins-Allison Corp. is the world leader relative to technology for processing currency at high speeds and low costs. I cite a specific article written in the Chinese equivalent of the Wall Street Journal. (Attached as Exhibit 2.) I quote, "For example, the U.S. Cummins Corporation produces a complete product line. ... This equipment can be used at the counter or in the vault. ... This is probably the most advanced money processing equipment that exists today." The article goes on to say, "We (China) should learn the merits from the importing money processing equipment and overcoming their drawbacks shall be our winning factor. We will move forward at full speed and enrich ourselves with technology and productivity hoping one day we can replace imports (that being Cummins) and then begin exporting money processing equipment bearing Chinese brand names."

Compounding the problem, Cummins has no practical means to protect our patents or intellectual property rights in China because our own U.S. Government failed to negotiate adequate protection of such rights as a condition of China's entry into the WTO. So China's industry can and does copy Cummins' technology with impunity.

Furthermore, we believe that the Chinese military is involved in the production of currency handling equipment within China. I have visited several factories and given their organization and personnel, it appears that the Chinese military may oversee this important industry. The Chinese military involvement in this industry would make some sense. Military history clearly teaches that counterfeiting is frequently used as an instrument of war and, as such, the Chinese military might maintain involvement in the currency processing industry in order to provide the military with strategic underpinning for counterfeiting capabilities.

Another trade barrier recently introduced by the Chinese government is the new CCC "safety" certification. China claims that CCC is their version of our UL requirement. However, to receive CCC certification, Cummins would have to agree to let Chinese government officials visit our facilities here in the United States and pay for all of their travel expenses. Chinese officials are to be given full access to our engineering drawings, schematics, etc., relative to the design and production of our equipment. Somehow, it does not seem to be in the best interests of our national security to provide Chinese government officials with access to Cummins' product design and production documents, when the technologies we have developed are intended to protect the integrity of U.S. currency and identify sophisticated counterfeits.

As a result of all the trade and entry barriers, Cummins has basically withdrawn from the Chinese market. Given the high tariffs, the government intervention, and the new so-called "safety" requirements, it is not practical or profitable for Cummins to export to that market and risk compromising or losing our intellectual property.

V. Cummins Technology is the Frontline in Fighting Counterfeit U.S. Currency

Approximately 10 years ago, through extensive research and development, Cummins introduced new patented scanning and authentication (counterfeit detection) technology to process bulk deposits of U.S. currency. Prior to the introduction of Cummins technologies, such machines cost anywhere from $25,000 to $1 million each. However, with the introduction of the new Cummins technologies, banks and other users were able to purchase Cummins' superior equipment to process U.S. currency at a cost of $2,500 per unit. This savings enabled banks and other users to move automated processing and authentication of U.S. currency from the central vault to the frontline bank branches, where deposits first enter the bank. As a result, the banks could identify counterfeits and match the counterfeit directly to the customer making the deposit.

This advance has proven to be very important as U.S. counterfeits have become more sophisticated and their circulation, particularly outside the U.S., has increased. In fact, foreign banks have told Cummins that they would no longer accept bulk deposits of U.S. currency if Cummins' technology to authenticate the currency was not available. Despite the increased prevalence and sophistication of currency counterfeiting, Cummins receives no support from the U.S. Government. For more than 4 years, Cummins has repeatedly contacted various Federal Government agencies to underscore the importance of protecting the dollar, our industry, and our national security, but we are continually rebuffed. Meanwhile, the Treasury Department routinely maintains before Congress that counterfeiting is not a problem.

As an analogy, if Cummins was a frontline field commander in wartime and reported its intelligence back to the Pentagon, the Pentagon would respond by saying that they do not really need to hear from the field commander, nor do they care to know what the situation is at the frontline. There are many government agencies and interests that have some type of enforcement or policy responsibility for currency counterfeiting. It is our experience that they do not adequately coordinate their work or communicate with one another. In addition, unlike their foreign counterparts, they do almost nothing to communicate with Cummins and no one within government appears to be coordinating the common battle.

VI. The Congressional Hearing of July 2003 Before the House Committee on Small Business Illustrates the Lack of a Coordinated American Policy

In the summer of 2003, some of our Congressional leaders held hearings to investigate domestic U.S. content as it related to defense and other strategic areas of Federal procurement. Because Cummins is involved in the security and integrity of the U.S. currency, Congressional leaders asked Cummins to testify on one of the panels relative to Treasury procurement. I thought that this would finally enable Cummins to engage in constructive discussions with the Treasury. We anticipated hearing from the Treasury Department in preparation of the hearing. Unfortunately, and much to my surprise, I learned from Members of the U.S. Congress that, in preparation for the hearing, the Treasury Department instead was working collaboratively with the foreign manufacturers who supply the Federal Reserve.

When I arrived at the hearing that day in July 2003, the Treasury Department arrived with lobbyists for the foreign manufacturer who exclusively provides equipment to the Federal Reserve Bank. Shortly before the hearing started, a Treasury official approached me and asked for a copy of my printed testimony. The foreign manufacturers' lobbyists, together with the Treasury Department officials, then huddled and scrutinized my testimony prior to the start of the hearing.

My point at the hearing was to warn Congress that Cummins had learned about new, excellent counterfeits of U.S. currency through our customers overseas. It was also my intention to point out that the Federal Reserve and the Treasury Department had become dependent upon foreign manufacturers, and they were purchasing, almost exclusively, foreign-manufactured products for their currency processing requirements. I thought Congress needed to know that foreign-manufactured currency authentication technology was being made available to other governments, some adversarial to the United States, by these same foreign manufacturers.

The hearing became rather animated because the Committee Members wanted to know how much of the Treasury procurement was from foreign sources. The Treasury took the position there were no problems relative to the security of U.S. currency. They chose not to explain that a very large percentage of Treasury and Federal Reserve currency processing equipment is, in fact, produced by foreign manufacturers, nor to discuss the implications for national security.

VII. Adversarial Governments Are Now Producing Excellent U.S. Currency Counterfeits

While the Department of the Treasury has assured Congress that there were no serious problems with U.S. counterfeits during the hearing, we now know that the North Korean government is printing counterfeit U.S. currency and other governments may be doing the same. If China is not assisting with the circulation of the North Korean counterfeits, they are at least ambivalent. This knowledge fits in with the observations that Cummins has made and is consistent with feedback we have received from our international distributors and commercial bank customers around the world.

For some time we have seen excellent counterfeits of American currency coming out of North Korea, circulating around China and into South America and the Middle East. It is indeed a national security issue for the United States when foreign governments collaborate to produce and circulate excellent counterfeit U.S. currency.

America, in fact, has a serious problem that the U.S. Government is neglecting. A recent story published in the *Korea Times* quotes a Congressional Research Service employee as saying that North Korea's government may be subsidizing itself through the annual circulation of $20 million in counterfeits. We also know that the North Korean counterfeiters are using the same model printing presses as those used by the Bureau of Engraving and Printing. (Please see Exhibit 3, which is attached to this testimony, for additional information.)

In counterfeiting, additional security risks are potentially generated by terrorist activities. As terrorist funding sources are eradicated, there is an increased likelihood that terrorists will turn to counterfeiting as a means to purchase technologies and armaments to further their objectives. Drying up the financial resources available to terrorists and concomitantly preventing the circulation of high-quality American counterfeit currency are two key means to cripple terrorist activities—in some ways more effective, and certainly much less costly, than military action.

Of perhaps greatest concern is that a terrorist or other criminal organization or an adversarial government has already produced a large stockpile of excellent U.S. counterfeits. At a moment deemed appropriate, these could be used to flood the consumer, commercial, and financial markets throughout the world and generate economic instability. The integrity of the dollar could be gravely damaged and its role as the world's reserve currency could be lost. We at Cummins strongly encourage Congress and the Executive Branch to more thoroughly investigate international currency counterfeiting and to coordinate policies to prevent its proliferation. We hope that a recommendation along these lines by the U.S.-China Economic and Security Review Commission will emerge from this hearing.

VIII. Cummins Experience at the U.S. International Trade Commission (ITC) Illustrates Again the Lack of U.S. Strategic Thinking Relative to Manufacturing and Trade Policy

In the summer of 2000, Cummins filed a petition before the International Trade Commission (ITC) regarding the dumping of desktop note counters and scanners from China and Korea. Our primary concern was, of course, China. As I mentioned, Cummins survives by producing niche products covered by comprehensive patents. In the late 1990s, we decided to try to diversify into other product lines that lack the comprehensive patent protection. Specifically, we began to sell desktop note counters. Shortly thereafter, foreign manufacturers began to drop their prices very substantially.

Despite the harm to the domestic industry for note counter production, the ITC would not even enter the investigative stage for dumping. The ITC reasoned that Cummins was profitable in selling our patented currency scanners product line, so our claims did not justify an investigation. The ITC, however, missed the point. As a result of foreign dumping, it is impossible for Cummins to expand its business and offer a complete product line of currency handling equipment from very large machines for government central banks to very small machines for mom and pop stores. When Cummins attempts to enter a product line where we do not have patent protection, the foreign manufactures simply drop their prices in the U.S. market to a point where it is not possible for Cummins to continue offering the product. As our patents expire, our market support will expire and it will be difficult for Cummins to sustain itself in the currency handling industry.

IX. Cummins Experience With the "Coalition Authority" in Iraq

In 2003, our London, U.K. office learned that the Coalition Authority in Iraq had released a request for quotation (RFQ) for the purchase of currency processing equipment. This equipment was needed as a result of the large amounts of American currency discovered there. Cummins produced the equipment as described in the RFQ and submitted a proposal to the coalition authority.

Shortly after submitting the quote, we received a call from the Coalition Authority in Baghdad at our home office near Chicago. We were informed that, as a U.S. manufacturer, Cummins would receive absolutely no preferential treatment from the government when awarding the contract. Several days later the contract was awarded to a European company that sub-contracted the production to a Chinese company. We lost the contract even though the Cummins bid was at a lower price than the European competitor/Chinese manufacturer who won the award.

Later the Chinese manufactured equipment was delivered to Iraq. The Coalition Authority had the intention of using the machines to process the Iraqi currency, as well as the U.S. dollars that were in circulation in Iraq. Several months after Iraq received delivery of the Chinese manufactured equipment, our Jordanian and Turkish export business increased. We researched why our sales had increased in that area of the world, and our Jordanian and Turkish dealers informed us that they

were selling Cummins currency processing equipment into Iraq because the Chinese equipment, purchased by the coalition authority, could not adequately authenticate and identify counterfeit U.S. currency in circulation within Iraq.

Because of a lack of a coordinated policy that supports American manufacturers, therefore, the U.S. Government purchased equipment from a Chinese manufacturer that could not authenticate U.S. currency. This equipment was produced in a factory where people are typically paid $2 per day. In contrast, our employees are paid living wages, which the Federal and state governments tax. The resulting revenues are used in part to help pay for U.S. defense efforts, including those in Iraq.

Cummins has employees who are in the Army Reserve and are stationed in Iraq. We keep the Reservist jobs open for them until they return from active duty. We comply with all U.S. labor laws for wages, benefits, collective bargaining, and environmental quality. Cummins jobs help to support and maintain strong American communities. Yet, Cummins received absolutely no recognition from our Federal Government in the purchase of currency processing equipment by the Coalition Authority.

X. Foreign Manufacturers' Reverse Engineering and Sale of Cummins Inventions and Patented Technology to Adversarial Governments

Cummins has frequently received inquiries from the Syrian government to purchase our equipment for the processing of U.S. currency. Because Syria is under a trade embargo, we refuse to sell this technology to Syria. However, one of our competitors from Japan, who has repeatedly infringed Cummins patents here in the United States, has perfected and copied our technology and equipment. Currently, this same company is selling its equipment, containing our technology, to the Syrian government. It is difficult to understand why the U.S. Government stands idly by while foreign manufacturers replicate U.S. technology and perfect that technology in the U.S. market, in effect permitting the foreign manufacturers to sell the technology to our adversaries in other parts of the world.

Foreign manufacturers who market and sell in the United States should be banned from our markets when they sell to embargoed or adversarial governments. Foreign manufacturers can either sell to the U.S. market or our adversaries but should not be permitted to have their cake and eat it too.

XI. Cummins Discussions With USTR Illustrate Lack of Strategic Thinking About Domestic Manufacturing and U.S. Trade Policy

In 2001, after the ITC failed to rule in Cummins favor and further investigate dumping claims, we initiated meetings with the U.S. Trade Representative (USTR). A number of meetings were held with the appropriate USTR personnel responsible for trade with China, and we reviewed the problems Cummins had encountered with China. USTR personnel agreed Cummins had a case that would merit advocacy from USTR.

Later that year, the USTR informed Cummins that other priorities prevented them from taking any action with China on our behalf. They explained that USTR needed to focus on establishing additional trade agreements with other countries, and most importantly, on the WTO Doha round of trade talks. In essence, we were informed by USTR staff that personnel and other resources were not available to advocate in behalf of Cummins' issues with China. Our suspicion is that Cummins' problems were simply not big enough or important enough in the eyes of USTR. The USTR routinely goes to bat for larger corporations such as Boeing, Motorola and others. But small- and medium-sized manufacturers appear to lack the clout necessary to tap into the same USTR advocacy resources that are available to the large manufacturers.

XII. Cummins and the U.S. Department of Commerce

After our lack of success at USTR, meetings were arranged with some high level officials at the U.S. Commerce Department. They were very professional and clearly concerned about the problems in the U.S. currency processing industry. However, as we began to discuss potential remedies with them, we learned that WTO rules severely limit the type of support Commerce can provide industry. While Commerce could utilize a variety of trade remedies under the old GATT agreement, these avenues were closed when the U.S. agreed to the new rules of the WTO. Needless to say, I was shocked to learn that the Commerce Department has few, if any, effective remedies available to support U.S. industry in matters involving trade disputes.

XIII. Conclusion

There are central three points I would like to leave you with today:

Point One: The U.S. lacks a complete, coordinated currency protection policy—a policy that should be an important component of our national security. I encourage the Congress and the Executive Branch to develop and coordinate a substantive U.S. currency protection program. In short, European and Asian governments do much to coordinate currency protection policies with their commercial banks, currency equipment manufacturers, academicians and others. America should do the same.

Point Two: I encourage the U.S.-China Commission to report to Congress that small- and medium-sized U.S. manufacturers cannot have effective globalization strategies given the current lack of meaningful government policies and support. Manufacturing and its attendant good jobs are rapidly declining in America. The United States needs to respond to this rapid economic erosion with coordinated policies before it is too late.

Point Three: American manufacturing and its corresponding jobs will not survive without improved government programs and a concerted effort to fully enforce existing trade laws. Our trade policies are not working, and small- and medium-sized American manufacturers are paying the price. We can survive, but not without a level playing field here at home and in export markets abroad. The current fixation on concluding more of the same free trade agreements will not solve the problems faced by domestic manufacturers, but will exacerbate them. We are pursuing a clearly failed model when a new strategy must be formulated.

Thank you for providing me with an opportunity to speak with you today.

EXHIBIT 1

MAILED
6/11/98

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June 9, 1998

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FIN-00101 Helsinki

Subject: Release of the Euro currency including security features

Dear Mr. Heinonen:

Cummins- Allison is a manufacturer of high speed currency scanning and currency counting equipment. We are a U.S. based company founded over 100 years ago. Today our currency handling products are sold to commercial banks in Europe, North America, Latin America, and Asia. For your reference, product literature and a brief company history are attached.

As an essential part of processing currency, Cummins- Allison has developed various currency authentication sensing devices to identify security features within currency to separate counterfeit notes from legitimate notes issued by central banks. The ability to scan, denominate, and authenticate currency at a high speed on Cummins equipment is extremely important to our commercial bank customers.

During a visit in March, 1998 to the Deutsch Bundesbank Mr. Jurgen Bartholomaus suggested that we contact you relative to the planned release of the Euro currency.

To develop and implement excellent sensing devices to deal with security features on the Euro currency shall requires a significant amount of time and research and development for our company.

As an example, with the release of the new series U.S. currency, Cummins- Allison has worked closely with the United States Treasury for over five years beginning at least 2½ to 3 years prior to the release of the new $100. This enabled Cummins to adapt the thousands of Cummins currency handling machines already installed and used by commercial banks throughout the United States.

We now face a similar challenge with the release of the Euro currency. Cummins is requesting your cooperation to insure we have enough lead time to adapt our currency scanning and counting equipment to handle the new Euro currency. Our equipment must

EXHIBIT 2

Newspaper Clipping

Source: China Financial Times, June 26, 2001, Tuesday
Financial news / Advertisement Section

Title: Further development + Overcome our shortcomings = Success
- production of our own money processing equipments
by Wang Zhi Ying

Nowadays, all our (the Chinese) commercial banks are still mainly using domestic manufactured money processing equipments such as note counter, detector, counters with counterfeit detection, and strapping machines; imported equipments such as USD detector, note sorter for different currencies and purposes, deposit machines, exchanging machines, and ATMs complete the automated banking picture. Our Renmenbi (RMB) are mostly processed by local machines, meanwhile, foreign currencies primarily USD are done by imported detector and sorter. Cash currency is indeed the most important means of our economy, and we have a humongous volume of RMB currency flow. As our country is slowly opening up, our foreign currency cash volume, especially USD, will increase and hence creating a large demand for money processing equipments will increase also. We cannot rely on imported equipments, and must rely on ourselves to develop hi-tech money processing equipments to satisfy our unique market requirements. Therefore, domestic production of such equipment is inevitable.

Imported machines can be seen at headquarters or large branches where volumes of cash are high, especially sorters and detectors to handle USD. Imported equipments have the following advantages and merits:

1. Machines are hi-tech, stable, reliable, multiple features, high speed, and have small number of errors. For example, there is a digital spectrum analyzer, utilizing the latest electronics and optics technology to analyze and verify the USD paper material content and ratio, as well as paper thickness, and its unique tint. Not only can the detector function as a counterfeit finder, but also a sorter for different denominations.
2. Offers a multiple models for a complete solution. For example, the US Cummins Corp. produces a complete product line including the 4022 USD counterfeit counter, 4028 multi-currency counterfeit counter (USD, JPY, HKD, GBP, EUR...), 4065 USD Scanner (petite sorter), as well as the 4095 USD Scanner (sorter). These equipments can be used at the counter or in the vault. They can sort different series, denominations, facing, at the same time, catch counterfeits of each series, sort out the dirty notes, and tally the total amounts of different denominations. This is probably the most technically advanced money processing equipment that exists today. (to be continued)

However, there are also drawbacks and disadvantages of imports: EXHIBIT 2

1. High prices. Import equipments can be several times or even ten times more expensive than the domestic equipments. An USD sorter can cost more than RMB100,000.
2. Some distributing companies cannot provide spares parts or maintenance. Several years ago, some distributing companies for the British De La Rue and some other Japanese note counter manufacturers could not repair their equipments. Machines were scrapped as soon as they started to fail. Some detectors could not handle the 1996 or later series of USD, and ended up being put aside and large amount of purchasing money was wasted.

We should learn the merits from the imported money processing equipments, and overcoming their drawbacks shall be our winning factor. As a matter of fact, we should concentrate our resources to develop more sophisticated technology to fill in the foreign currency detector void in the domestic manufacturing market. Recently, a local manufacturer has successfully developed an USD detector for all denominations, all series, usual counterfeits, as well as "Super Dollars". By utilizing "intelligent detection", results are almost as stable and reliable as imported equipments, and selling price is only 1/3 of the imported. This is great news for us. We shall move forward in full speed and enrich ourselves with technology and productivity, hoping one day, we can replace imports and then begin exporting money processing equipments bearing a Chinese brand name.

EXHIBIT 2

FINANCIAL NEWS
投资理财广告
星期二 2001.6.26

扬长补短 才有可为

从进口现金处理设备看国产化

机具国产化

目前，我国各商业银行主要还是使用国产现金处理设备，包括点钞机、验钞机、鉴伪点钞机、捆钞机等；部分是进口机具，主要是美元验钞机、各种类型的纸币清分机及自动存款机、外币兑换机、自动柜员机等。人民币处理一般都是用国产机具，而外币尤其是美元鉴伪，部分大多是用进口机具。我国是一个现钞大国，人民币的现钞量很大；随着我国改革开放的进一步发展，外币现钞量，尤其美钞量也在增大，对各种现金处理设备的需求也会越来越多，市场很大。我国不能依靠进口设备，必须依靠自己的力量，研制出符合我国国情的高科技的现钞处理设备。因此，机具国产化势在必行。

进口机具，在业务量较大的商业银行总行和有分行级能见到，尤其美元的清分机和验钞机购进得很多。进口机具的主要优点是：

一、大多技术含量较高，技术性能较稳定，功能多，速度快，误差小。比如美元验钞机，有一种电子数码光谱分析仪，利用最先进的电子技术和光学分析作用来测试美钞纸质材料的组成及配比，钞纸的质量，钞纸的特殊颜色，不仅能分辨真伪，还能起到清分的作用。

二、机器品种多，有的已形成系列产品。比如美国康明斯(CUMMINS)公司生产的系列产品，有4022型美钞鉴伪点钞机、4023型多种货币鉴伪点钞机(美元、日元、海币、英镑、欧元等)、4065型美钞扫描仪（美元小型清分机）、4095型美钞扫描仪（美元大型清分机）。这些机具有的是三班专门使用，有的是三班兼使用，对美元有按清分不同版面、不同面值、正反面，同时，识别美元各年版的伪钞，也能报出数据；在点数方面，能分别面值计数，又能汇总计数，是当前世界上较先进的现钞处理设备。

Note!

进口机具也有些问题，主要是：

一、价格太高，在国际比较，产品每台几万至三十几万。如一台美元大型清分机，其价格过10万元。

二、有的代理公司不能维修，还有零部件，比如前几年美国德利兵公司，目前一些厂家生产的点钞机，代理商不能修理，维修费用，不了元能修理，只能报废，一台美元验钞机只能鉴别1996年以前各版美钞的真伪，1996年新发行的美钞不能鉴别，花了很多钱购买一大件仪器，只能鉴别1996年版型号美钞，只好摆置一边等买新的。

进口现金处理设备的优点值得我们借鉴，其不足之处正是我国机具生产企业开拓市场的"突破口"。其实，只要加大研发力度，我国企业还会可以大有作为。外币现钞鉴别仪长期以来在我国是一个空白，最近得知国内某公司已研制出美元鉴别仪，可检测各种面额（包括1996年以后发行的新版美钞）假币伪钞、残损伪钞（残缺版），应用高科技智能鉴别，它能比较稳定，不亚于进口的先进设备，而价格仅相当于进口设备的1/3。这是一个可喜的开始。我国机具生产企业应发奋图强，进一步开展研究，生产出各种技术含量高的现金处理设备，逐步在国内市场取代外国厂商的产品，并努力开拓国际市场，争取创立中国现金处理设备的名牌。

文/王之英

EXHIBIT THREE

THE KOREA TIMES

NK Earns $20 Million a Year From Counterfeiting: Expert

SEOUL (Yonhap) - Using state-of-the-art technology, North Korea earns $20 million each year by trading high-quality counterfeit dollar bills dubbed ``supernotes,'' an American expert said on Friday.

Raphael Perl, an analyst at the U.S. Congressional Research Service, said that counterfeit currency and the arms trade represent the two biggest sources of income for the cash-strapped communist regime.

``The estimates that we have are between $15 and $20 million, and we assume the trade is growing as North Korea's need for hard currency is growing,'' he said in an interview with Radio Free Asia.

He argued that Pyongyang is increasingly dependent on counterfeiting to offset the reduction in its income from the narcotics trade, with countries ever vigilant to its drug smuggling activities.

Perl's claim comes amid widespread suspicion that North Korea operates a state-sponsored program to counterfeit U.S. dollars, an illicit cash cow that also serves to destabilize the U.S. economy.

Pyongyang is suspected of churning out the supernotes and circulating them through diplomats and high-ranking officials who make overseas trips.

A North Korean defector who used to work as a senior official at Pyongyang's intelligence agency said that the regime has manufactured counterfeit bills since the early 1990s and circulates them via nearby areas, such as China, Taiwan and Macau.

Perl described North Korea as a global superpower in terms of its counterfeiting technology.

``For example, you can buy Viagra manufactured in North Korea that looks like U.S.-manufactured Viagra. One cannot tell the difference,'' he said.

05-13-2005 18:12

Chairman D'AMATO. Thank you for that riveting testimony. We'll move to Mr. Blackwell.

STATEMENT OF RON BLACKWELL
CHIEF ECONOMIST, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL UNIONS (AFL–CIO), WASHINGTON, D.C.

Mr. BLACKWELL. Thank you and thanks to all the Commissioners for the opportunity to be here and discuss this very important question. I'll use my time here to highlight some of the points in my written testimony. The basic argument that I want to stress is that the growing symbiosis between the authoritarian government of China and increasing sectors of multinational business including American business, is fundamentally changing the dynamics of the global economy with enormous implications, not just for China and the international economy, but also for the American economy and especially for American workers.

The first point that I want to make is that we need to view globalization as being driven by corporate strategies. There have been enormous accelerations of the flow of goods and people and capital across borders before in our history, especially in the early 20th century, but what distinguishes this period of time is the internationalization of production of multinational companies that allows them to source from multiple companies in the world into any single market they choose to select, not least, the enormous market in the United States.

This is the unique characteristic of contemporary globalization, and this characteristic, the capacity to internationalize production, forces a disjunction between the economic space in which companies operate, which is increasingly international, and the political and regulatory space in which public authorities operate, which is still national or regional rendering public regulatory efforts weak, nonexistent or even perverse in trying to regulate the economic space is still their responsibility.

The exit threat that is constituted by the internationalization of production is enormously effective in shifting the balance of power between public authorities and private companies to the advantage of the private companies, and it shifts the balance of power between employees and workers for these companies in any place in the world and those same employers.

So we're creating a distended and inappropriate power in the private sector that is forming the private side of the symbiosis with an authoritarian government in China.

The second point I want to make is that one of the really historic changes that we're facing is that with the entry of China, India and the countries of the former Soviet Union into the global economy, we're effectively doubling the size of the international workforce in a very short period of time and at standards of work and pay and conditions of work far below anything that's experienced by workers here in this country.

Whatever we think of the law of comparative advantage, the law of one price is real and it can be brutal, especially for a high standard country and the workers in a high standard country now dealing with this international workplace.

Now, these two factors, the internationalization of production and in a world where you're increasing the labor force, at the bot-

tom in these proportions and at this pace, is forcing a change in the structure of companies and the strategies they adopt. The classic multidivisional corporation is transformed.

Companies are focusing sharply on their core competencies. They're outsourcing everything else that they do to their business partners in the United States or abroad. And to lower costs they are offshoring the goods that are outsourcing to the developing world and at an increasing pace. In the case of manufacturers, offshoring is very much focused on China.

In the process, companies are creating a whole industry which you're going to hear more about, I think, in this hearing, of contract manufacturers, who can do all the manufacturing operations for the company that remains domiciled in the United States. It's just a turnkey opportunity for companies, even small and medium-sized companies, in an increasing array of manufacturing industries. These changes in corporate structure and strategy began with a few pioneering companies, Motorola and Nike come to my mind. For them, it was a pure opportunity to increase their profit margins by taking advantage of advanced technology combined with very cheap labor. But as these practices spread across companies and across sectors, it's become a competitive necessity for more and more companies because the conditions in product markets, as Mr. Jones has just mentioned, have become extremely competitive.

You either hit the "China price" or you join the outsourcing or you go out of business. This is a tremendous imperative, and this imperative is enforced by our capital markets that insist on the largest return in the shortest period of time regardless of how the return comes.

So the intense competition for business in product markets enforced by the capital market pressure is really forcing the spread of outsourcing and offshoring to contract manufacturers that you will hear about in a moment.

The third point I want to make is the challenge these changes represent for U.S. competitiveness. I'm old enough to remember the competitiveness challenge of the late 1980s. There were many commissions formed and institutions founded and many discussions like this about the challenge to our nation from loss of market share to foreign producers, especially Japanese producers.

But when you look back from where we are now, the challenge is much more serious than it was in the 1980s because much of corporate America, or at least the multinational part of corporate America, has solved its competitiveness problem. It's outsourced and sending its work offshore and lowering its cost and defending its market share and profits are very strong as a result.

But the country has not solved its competitive problems. We're borrowing $2 billion a day to pay for the things that we consume that we can't produce as a country. And we're borrowing that money and we're not investing it, we're borrowing it and we're consuming it. The countries that are investing very handsomely like China must be laughing at us. The Chinese save enormous portions of their income. They invest the money they save. They get U.S. business to invest in their country, and they get us to buy what they produce, borrowing money from them, and then we consume it.

This may work for the companies, and even for China's development strategy, but it is not a formula for U.S. national competitive success. The second thing I notice is different between the competitive challenge today and in the 1980s is that back then we were competing with Japanese companies operating out of Japan. In the case of China today, we're competing with multinational companies, many of them American companies, competing out of China.

And the companies competing out of China are active in our political life and advising our elected leaders on how they should conduct their affairs with respect to China. That represents a very different problem than what we had in the late 1980s, but the main thing I want to point here is we have a national competitiveness crisis, and our country is not addressing that crisis and our government is not addressing that crisis. And as Mr. Jones mentioned, there is no strategy, national competitive strategy, for dealing with the situation.

We've got one group of people in power that simply say enact new free trade agreements, cut taxes, especially for the wealthy and hope for the best. We've got another group of people who say enact new free trade agreements, balance the budget, and hope for the best. I'd like to suggest to you that neither one of these is a formula for the success of the United States in this global economy.

This growing symbiosis, between the authoritarian government of a major U.S. trading partner and an increasing segment of U.S. business, is unprecedented in history. The businesses that Mr. Jones represents are struggling in this kind of environment to sustain their own operations here in the United States. They're dedicated to building successful companies in the United States, and in that way benefiting American workers and helping strengthen our national economy.

Finally, it is important to note that China, India and the former Soviet Union are all low wage countries, as I have already observed. However, one feature of China that distinguishes it from these other low wage countries is that the Chinese government operates the most oppressive labor regime in the world.

The Chinese government boasts the largest labor movement in the world—134 million people. But those unions have no capacity to act on behalf of Chinese workers. By law, Chinese unions are dominated by the Chinese government and the Chinese Communist Party, and they are expected to play their part in helping the authoritarian government in China maintain its rule by building its strength through exploiting its working class, one of the great historical ironies for People's Republic, in order to establish their military power in the world and to maintain their rule.

China's oppressive labor regime has enormous implications for China's development and stability, for international economic balance and for American competitiveness and living standards. Will it work for China? I'm not enough of a Sinologist to know whether this works or not. It seems to me, however, that the Chinese government is riding a tiger. Because they are privatizing all these publicly owned enterprises—they are throwing millions of people out of work. At the same time, they're counting on being able to build a private sector with foreign help to hire enough of these people to maintain social stability. There are mass protests everyday

in China from Chinese workers. So I don't know whether this is going to work for them.

To finish, I don't know if this growing symbiosis is compatible it's going to work for the international economy. One of the most signal conditions threatening the stability of the international economy is the imbalance in the Chinese currency. This system implies that the Chinese government will continue indefinitely to buy U.S. dominated assets and not allow their currency to rise to its proper level, and this is one of the signal threats to the stability of the international economy.

Finally, what I know most about and what I'm concerned most about, is that this is a mortal threat to the competitive success of the U.S. national economy on which so many of our American workers depend. Thank you.

[The statement follows:]

Prepared Statement of Ron Blackwell
Chief Economist, American Federation of Labor and Congress of Industrial Unions (AFL–CIO), Washington, D.C.

Corporations are the principle drivers of globalization. In rapidly internationalizing their operations, corporations are fundamentally altering their structure and strategies and posing critical challenges to public authorities at all levels whose responsibility it remains to govern an increasingly global economy. Among these challenges, perhaps the most serious is posed by the integration of China, India and Eastern Europe into the global economy.

As a matter of public policy, we delegate to companies the responsibility to create the many goods and services our society needs. Companies are organized and operate to make a profit. Aligning the legitimate private interest of companies to earn a profit with the public purpose of companies to create the wealth our society needs does not happen naturally. It requires effective law and regulation and competitive markets for products, capital and labor. When companies are properly regulated and effectively governed, the private interests of companies are consistent with their public purpose. However, when regulation is lacking or inappropriate, or when corporate governance is weak or conflicted, a wedge is driven between the private interests of business and the needs of society. The purpose of public policy is to provide the law and regulation, and assure the strong governance, necessary for business to fulfill its public mission.

Only government can assure the rule of law, the protection of property and the enforceability of contract that is fundamental for the conduct of responsible business. Only government can provide the regulations necessary to protect investors, consumers, labor and the environment and assure that the creative energies of business leaders are focused only on those ways of making a profit consistent with the creation of wealth. Corporations must be free to organize their organizational function and form their own business and competitive strategies, but only government can assure the internal governance mechanisms of companies are effective and free from conflicts of interest. Only government can provide the public goods so essential for individual companies to succeed. Finding the right balance between the responsibilities of government and those of business is essential if the needs of our society are to be met, but they are also exceedingly complex, particularly in a rapidly changing global environment.

Our country has developed, through its unique institutions and sometimes under very difficult circumstances, the most powerful economy the world has ever known and, in doing so, has provided the American people with the possibility of enjoying one of the world's highest standards of living. Today, we have an economic potential that even our grandparents could not have imagined. At the same time, it is important to recognize that our unprecedented income and wealth is more unequally distributed among the population than any other developed country in the world. Income, and especially wealth, are distributed more unequally today than at any time in our history since the 1920's.

Globalization provides new opportunities to not only enhance American economic strength and security, but also to extend the many benefits of our prosperity to the billions of people mired in poverty and desperation in the developing world. However, unless properly managed, globalization also threatens to weaken our national

economy, aggravate our already unacceptable social and economic inequality and undermine American living standards. The question is not, as is commonly posed, "Is globalization good or bad." The question is what policies we need to assure, in radically altered and rapidly changing circumstances, the proper alignment between the private interest of corporations and the public purpose they must continue to serve. To answer that question, we must better understand globalization and its effects on the structure and strategies of companies.

In some ways there is nothing new about globalization. As is often noted, there have been many other periods of history, which witnessed accelerated movements of goods, capital and people across national boundaries and in which national economies thereby became more integrated. The levels of investment, trade and immigration between the U.S. and the rest of the world were all higher relative to national income in the early 20th century than they are in the early 21st century. What distinguishes this period of globalization from others, however, is the internationalization of production. Today, improving information and communications technologies make it possible for firms to source their markets from anywhere in the world. Multinational companies, establishing worldwide production networks are the drivers of the current phase of globalization, not the information, communications and organizational technologies they employ. Both the structures and the strategies of corporations are undergoing fundamental changes as they establish complex global sourcing strategies. The magnitude and direction of international trade, investment and even immigration are increasingly determined by changing structures and strategies of multinational corporations.

Globalization, as the internationalization of production, forces a disjunction between the economic spaces in which individual corporations operate and the territorial and political space in which public authorities is still confined. Laws and regulations effective and appropriate in a relatively closed economy are weakened or even rendered perverse, as the operations of the corporations they regulate are increasingly international. The balance of power between governments and companies is shifting dramatically because companies with international production capabilities can shift their operations in search of more accommodating public authorities. And, because countries, particularly developing and transition countries, rely on the capital, technology and organizational knowledge which multinational companies can bring for their development, the governments of those countries are tempted to shape their laws and regulations to attract foreign investment. The result is international regulatory arbitrage in which multinational companies shop for the most convenient venue in which to organize their production.

Modern, public traded, multidivisional companies have been operating internationally for decades, of course, but it was only over the past twenty years or so that multinational companies began to seriously organize their production processes internationally into globally integrated sourcing strategies and begin turning their attention to the developing and transitional economies.

One of the most fundamental challenges to maintaining the appropriate balance between government and increasingly multinational corporations is the fact that, with the entrance of China, India and the countries of the former Soviet bloc into the global economy, the global labor force will effectively double in size in a very short period of time. Not only will the effective global labor force double, but also the estimated 1.5 billion new workers from China, India and the former Soviet bloc will be working at wages and under standards and conditions that are far below those of workers in the more developed world.

Whatever one thinks about the law of comparative advantage, the law of one price is real, and it can be brutal. Millions of jobs that would exist, or be created, in the developed world, will now be created in the international operations of multinational corporations or their business partners in the developing and transition economies. Just as serious, the exit threat which multinational companies hold will shift the balance of power dramatically away from workers in the developed world. Workers desperate for employment in slack labor markets in the global North will attempt, as they are now doing, to bid down the wages and benefits they demand, offer to work longer hours and endure harsher conditions in the effort to remain competitive with the new workers in developing and transition countries.

American workers are among the most productive workers in the world, but their advantage due to higher productivity is swamped by the wage differentials with workers in the developing and transition countries. And even the productivity advantage of American workers is disappearing, as companies are able to find ample supplies of highly educated and skilled workers abroad. Combined with the most advanced technology and organization, these workers are approaching, or even exceeding, U.S. productivity levels.

The shift in bargaining power from employees to their employers is already well underway in the U.S. and is driving our country's growing economic and social inequality. From 1949–73, real wages rose steadily along with productivity. This was the period in which the American middle class was built. Throughout this period income inequality and poverty were reduced. Since 1973, however, productivity has continued to advance—and recently even accelerate—but real wages have been stagnant.

The result is the current unacceptable level of inequality. The Congressional Budget Office estimates that from 1979–2001 the incomes of America's richest one percent of families increased by 139 percent to more than $700,000, while the incomes of the middle 20 percent rose only 17 percent to less than $44,000. In the current recovery from the 2001 recession, productivity has surged but an overwhelming proportion of increased income has gone to profits, not wages.

Since employment peaked in manufacturing in the U.S. in 1998, the American economy has lost 3.3 million manufacturing jobs. Studies conducted by the Federal Reserve Bank in New York have estimated that 89 percent of the jobs lost in the last recession, many of them manufacturing jobs, were lost for structural reasons, meaning that they will not come back as the economy recovers.

The offshoring of jobs in the service sector is more recent, but it promises to escalate rapidly. In manufacturing, at the end of the day, companies must move a box, a thing, from wherever it is produced to the customer however developed is the information and transportation technologies involved. In information services, however, communication is transportation. Any activity that can be digitalized can be done anywhere in the world in today's integrated world. Estimates vary, but we must believe that there are millions of American jobs that once seemed secure that could easily move to the developing world. It is not too much of an exaggeration to imagine that more and more of what we consume will be manufactured in China and serviced from India.

Already, as a nation, Americans are borrowing more than two billion dollars a day to pay for the things that we consume that we do not produce. As a result, our external account is currently running a deficit of nearly six percent of GDP and growing. These deficits, which have transformed the U.S. from one of the world's largest creditor nation's into the world's largest debtors, represent one of the most serious imbalances in the global economy. As I am sure you are aware, increasing amounts of these debts are held in central banks, especially in Japan and increasingly China. As you also know, there is much speculation, in the U.S. and abroad, about how much longer these banks can continue to buy this debt and what will happen if they decide to diversify their holdings.

Just as serious are the implications for the U.S. economy. If we cannot indefinitely rely on loans from the rest of the world to support our nation's consumption, one of two things must happen: either we find some way to produce more, or we will be forced, one way or another, to consume less. Consuming less is not, or should not be, an option. We still have too much unmet needs for too many of our citizens and the security of our country rests on the strength of our economy. Producing more of what we consume will be difficult, however. Currently we are not investing enough of the money we borrow abroad in the national economy, we are consuming it.

The current recovery is still quite weak by the standards of other recoveries since World War II, but at least the economy is growing, unlike the economies of Europe and Japan. However, it is consumer spending that is powering U.S. economic growth, supported more by rising housing prices than by rising incomes. Profits have surged in the recovery, but business spending has lagged and most of the business spending is to upgrade information services, not to build new productive capacity, at least not in the U.S. Meanwhile, in the absence of the investment, both public and private, we need to build a more competitive national economy, we are losing our capacity to produce. It is surely true that we do not presently have the capacity to increase exports enough to come close to closing the deficit in our external accounts.

There was a time in the late 1980's when competitiveness was a national concern, prompted then by the increasing loss of market share to foreign producers in a wide range of industries, especially from companies in Japan. Many studies were conducted, commissions formed and even institutions created to help the nation regain its competitive strength. The debate abated with the surge of growth in the 1990s and was eclipsed by visions of a "new economy." With the bursting of the Internet bubble in 2000 and the recession and weak recovery that have followed it may again be possible to focus on our nation's competitive challenges.

Much, however, has changed from that earlier competitive challenge. Most important, companies, at least those that have survived, have met their competitive chal-

lenge. The national economy has not met its competitiveness challenge. The boundaries of companies has been redrawn as companies strategically identified their core competence, the capabilities they feel are fundamental to their competitive success, and outsource other activities to their business partners. To lower their costs, particularly their labor costs but also their taxes and regulatory burden, they contract with business partners overseas, particularly in the developing countries. In doing so, they have created an enormous market for manufacturing and service contractors from both the developed and developing countries which capture increasing economies of scope and scale by consolidating their own capabilities in providing these manufacturing and service functions. In a sense, the companies have solved their competitive advantage, or made enormous progress from the 1980s, but have left the U.S. economy behind.

Although chartered in the U.S., these multinational corporations increasingly view themselves as "global companies," scouring the world in search of the most advanced technologies, the best trained managers and engineers, the least expensive capital, the most hospitable tax and regulatory environment and the cheapest workers. This may work well, at least in the short term, for the companies, its shareholders and especially their CEOs and senior managers, but it does nothing for the competitive strength or prosperity of the country. Worse still, U.S. companies and their trade associations lobby American politicians to assist them in their competitive strategies by reducing their taxes, relaxing our environmental standards and negotiating international trade and investment agreements all aimed at assisting the companies' competitive position. The result is less revenue for the U.S. Government to educate and train the American workforce and provide the infrastructure and support for companies committed to building their future in the U.S.

The contemporary phase of the globalization of American business began with individual pioneers—Nike, Motorola, GE come immediately to mind—who sought to enhance their competitiveness by combining the most advanced technologies and organizational initiatives, with the virtually endless supply of low wage workers in the developing and transition economies. As more and more companies followed, outsourcing and offshoring fundamentally altered product market competition. The mere opportunity to raise profit margins by offshoring increasingly became a competitive necessity if profit margins were to be protected in a widening range of industries. The insistent demands of capital markets for the highest short-term returns are also reinforcing the pressures from product markets for firms to outsource operations.

Indeed, today, outsourcing and offshoring production has become a management fad supported by an army of management consultants arguing to management that offshore outsourcing is essential to maintain competitiveness and providing their services to help their clients chart the unfamiliar waters.

As a result, the product market pressure on millions of domestic American companies determined to operate in the U.S. has become intense. Profit margins are squeezed and in many industries, companies operating in the U.S. are under tremendous pressure and too many are being forced to choose between offshoring themselves, or going out of business altogether.

While our government should be taking steps to assure that companies operating internationally do not escape their responsibilities to their employees, taxpayers and the American public, it should also be helping make it easier to build world-class companies operating in the U.S. Unfortunately, the current Administration's policy for dealing with the challenge to our national competitiveness is to negotiate as many free trade agreements as possible, cut taxes, particularly for our wealthiest citizens and hope for the best. Instead we need a national industrial strategy focused on assuring that companies operating internationally do not escape their responsibilities to the American people and undermine the companies that are struggling to build successful companies operating in the United States.

China represents a particularly serious challenge for the competitiveness of the American economy. China's entry into the global economy represents an additional 760 million workers at an average wage of 10 percent or less of U.S. wages, or 52 percent of the new additions to the global labor force. What really distinguishes China, however, are the unique labor market institutions of that country. Unlike workers in India or Eastern Europe, each unique in their own way, the workers in China are systematically denied their fundamental human rights—the right of freedom of opinion and speech, the right of mobility within the country, freedom of association, but especially the freedom to form unions and bargain collectively.

The Chinese government—the Peoples Republic of China, ironically—boasts the largest labor movement in the world, an estimated 134 million workers. Unlike workers in India and Eastern Europe, and the rest of the world, however, Chinese workers are not allowed to form unions independent of the All China Federation of

Trade Unions (ACFTU) and the Chinese government and the Chinese Communist Party control the ACFTU. The ACFTU is an organ of the Chinese government and party, not a federation of autonomous worker organizations.

Moreover, unlike any other labor movement in the world, no action can be taken by any firm level labor organization without the approval of the local labor organization, which cannot be approved without the approval of the regional organization, and so on up to the chain of command to the national ACFTU which is accountable to the Chinese Communist Party and the Chinese government. It is one of the ironies of modern history that the Peoples Republic of China operates one of the most repressive labor regimes in history. Unions in Russia and Eastern Europe have been transformed into autonomous workers organizations as a part of their transition from authoritarian domination. India has maintained, throughout its modern history, a tradition of free and independent unions. But today, the Chinese government stands alone in operating the most oppressive labor regime in the world.

Moreover, the systematic oppression of China's workers is a key component of that government's competitive strategy. The authoritarian Chinese government has obviously decided that in order to maintain power in a post-Communist world, they must build a strong economy and provide jobs for China's enormous population. Though China's national savings rate is quite high, particularly in relation to that of the U.S., they are rapidly liberalizing their economy in order to attract private foreign investment and the organizational and technological sophistication only available from companies in the more developed world. The resulting products are not for domestic consumption, but are targeted on the vast markets of the developed world, and particularly those in the U.S.

There is a growing symbiosis between the Chinese government's development strategy and the changing structures and strategies of U.S. companies. One might be tempted to say that it is almost something of a joint partnership. China offers a virtually endless supply of extremely inexpensive labor, in exchange for the most advanced technology and organization and access to a vast market for Chinese product.

To this point, the Chinese government's strategy has been wildly successful. China recently passed the U.S. as a recipient of private foreign investment, the rate of investment overall is over 50 percent of GDP and a double-digit rate of growth of production and exports. Finally, by investing their trade surplus with the U.S. in dollar-denominated assets, instead of allowing their currency to appreciate against the dollar, China has built their dollar reserves to a level second only to Japan.

Whether this strategy is sustainable in China, and for the world, is a very complex question the answers to which I do not have the time here or the expertise to answer. What is easier to see, is that this strategy is unsustainable for the U.S. Some U.S. companies may be becoming more competitive, at least in the short term, but U.S. national competitiveness is seriously undermined by the Chinese government's development strategy. Further the social and economic inequality fostered in the U.S. by China's development strategy, will surely provoke increasing reaction against China and against globalization as a whole.

I do not have the time here to explore the national strategy, which the U.S. Government might pursue to restore American industrial competitiveness. Nor do I have the time to pursue the complementary set of policies that need to be implemented at the global level to assure that the developing and transition economies can grow and be integrated into the global level without undermining the economic strength and the relatively high social and economic standards still found in the more developed world. But, because this is the U.S.-China Commission, I wanted to briefly sketch a particular policy to address the problem of the systematic oppression of hundreds of millions of Chinese workers: international workers rights as a component of international trade and investment agreements.

While the trade and investment agreements negotiated to date have provided elaborate, if somewhat less than effective, protection for intellectual property, they are uniformly, and by design, silent on human and worker rights. This is a crucial weakness in these agreements that makes it possible for the Chinese government to become a party to these agreements and that way gain access to global markets, while continuing to oppress their workers.

Human and workers rights—freedom of opinion and expression, freedom of association and the right to organize autonomous unions—are at least as important as intellectual property rights, and no more difficult to protect. The protection of human and worker rights is not intended, and would not have the result, of excluding Chinese goods from global markets. The protection of human and worker rights is intended rather to take oppression out of international competition, just as protec-

tion of intellectual property in these agreements is intended to take piracy out of competition.

By enforcing worker rights to be recognized in China, and allowing autonomous worker organizations to be formed, Chinese workers would have the protection, which the Chinese government denies. By forming their own unions and bargaining with their employers, Chinese workers could share in the benefits of Chinese development and help build a domestic Chinese market for Chinese products as well as the products of China's trading partners, including companies in the U.S. Just as important, Chinese unions would help build more democratic institutions in China as they have in so many other developing countries and allow China to develop its civil and political life as it develops its economy and integrates with the more developed countries in the global economy.

Enforceable human and worker rights would also remove the asymmetry in international trade and investment agreements between the protection of intellectual property and human rights. It would also help repair the currently perverse incentives such agreements provide companies in deciding between high- and low-road competitive strategies and whether to offshore their activities or produce in the American economy.

In conclusion, one thing is clear: the interaction between the Chinese government's development strategy and the changing business strategies of American business is providing a powerful force which is weakening the American economy and contributing to our country's already unacceptable levels of social and economic inequality. Individual companies may be succeeding in this relationship along with their shareholders and senior executives, but the American economy and our country's workers and communities as well as many of America's domestic companies are being left behind. It is the responsibility of government, a responsibility only government can bear, to create the laws and regulations necessary to respond to the many challenges of a rapidly changing global economy and help restore the strength of the American economy as well as its fairness.

Chairman D'AMATO. Thank you very much, Mr. Blackwell. I'm sure there will be a number of questions fleshing out your testimony.

Professor Hamilton.

STATEMENT OF GARY G. HAMILTON
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SEATTLE, WASHINGTON

Dr. HAMILTON. I want to thank the Commission for inviting me. I was here yesterday and have heard the entire hearing, and I congratulate you on a very high level of presentations and very penetrating questions. I look forward to more of the same now.

I want to follow on from Ron Blackwell. I think he raises some very interesting points, and I think I can give a little flesh to those bones in some areas.

Let me say first that my presentation draws from a book that is co-authored by Robert Feenstra that will be out later this year.

Let me start by quickly going over why the Chinese economy has grown so fast in the last decade. I'm not going to go through the figures. You know the figures. There are a lot of answers to this question. The one most often given is cheap labor, Chinese cheap labor; a second one is the aggressive policies of the Chinese state. We just heard Ron Blackwell talk about, these state policies. We also hear how entrepreneurial the Chinese people are. Although these are all important answers, they're really insufficient to explain why this rapid growth has occurred.

I think three other factors are more important, and I'll talk about each of these three in turn. One is direct foreign investment. The second is an emergent Asian division of labor. All of China's Asian neighbors are now focusing their economic efforts on China and are

using China, and this is the third point, as a platform for manufacturing consumer goods for the world.

Let me discuss each of these three factors. First of all, direct foreign investment is very high. Most of this direct foreign investment, over 60 percent of it, comes from Asia from Taiwan, Hong Kong, Japan, and South Korea. Only ten percent comes from the United States.

We can see that the Asian countries are investing very heavily into China and almost all that investment is for manufacturing. They are moving their manufacturing facilities from Taiwan, Hong Kong, South Korea, and Japan, and are creating new manufacturing facilities in China. This has caused China to grow very quickly because once you site your factories there, you also get a lot of add-ons from others in the local economy.

A triangle manufacturing system is emerging. It is a system in which Japan, South Korea, Hong Kong and Taiwan send a great quantity of their intermediate exports to China. These countries all run a trade surplus with China. For instance, these intermediate goods include plastics from Formosa Plastics in Taiwan for the shoes that the Taiwanese manufacturers make in China. Such intermediate goods go into China from Asian countries, and out of China to the United States and Europe come finished consumer goods. The U.S. runs a huge trade deficit with China from Americans buying these goods.

There is an emergent division of labor among Asian countries in the production of consumer goods. If we isolate the single-most important driver of China's growth, it is the fact that China has become the world's main site for sourcing manufactured consumer goods.

Now what accounts for these trends? I'm going to argue here, and I have entered a paper for your consideration, that documents this more firmly than I could do here, that what accounts for this is the increasingly tight linkages between the U.S. retailers and Asian manufacturers.

Let me go back and just jog your memory about some of the things that have happened in the post-World War II retail revolution. 1965 is the dividing line. Before that time, U.S. manufacturing sector was quite vibrant and was concentrated in each manufacturing sector. Within each sector, such as automobiles, chemicals, steel, and so forth, there were only a few very large firms. But the retail sector was much less concentrated. There were a few big players, such as Sears, J.C. Penney's, and A&P (Atlantic and Pacific) in groceries, but by and large, the retail sector featured small regionally dispersed retail stores.

In the decade before 1965, however, some things changed. First of all, there was a change in the tax codes under Eisenhower in 1955, which allowed business construction to be written off, and this led to a building boom across the county in shopping centers. At the same time, Congress authorized building the interstate highway system, and as the first stages of this system of highways were completed, suburbanization got started.

In 1954, there were only 500 shopping centers across the country. Remember, most people in those days shopped "downtown." You went "downtown" to shop. Only ten years later, in 1964, there

were 7,600 shopping centers, and these accounted for 30 percent of all retail sales in the U.S. By the 1960s, people began to go to shopping centers to shop, and of course since the 1960s mall shopping has become ubiquitous.

From 1929 to 1965 was the low point in U.S. imports of foreign goods. All these shopping centers and downtown stores sold goods made by U.S. manufacturers. If we take a look at the trade in relation to gross national product, we see that 1929 to 1965 is the historic low period of imports, but after 1965, imports began to rise very, very quickly.

Now let's look at the trends in retailers after 1965. First of all, chain stores become increasingly dominant. Some segments of this retail become concentrated in only a very few stores: major department stores and the major discounters. If we look behind these figures, we see that those retail firms that are now the largest retailers mainly began operation after 1960. In 1962 alone, Wal-Mart, Kmart, Target and Kohl's started discount operations. Specialty discounters—Toys R Us, The Gap, The Limited started about the same time. Factory-less manufacturers, such as Nike and Reebok, began large-scale operations in the 1970s. If you survey the stores in most malls today, you will find that most of the stores were not in existence in 1960. Here is the punch line: they all depend on global sourcing, and many of them did from the very beginning.

The consolidation in the retail sector between 1963 and 1992 increases markedly. Retail sales are more concentrated in fewer and fewer stores. Some segments of retailing, such as department stores, grocery stores, shoes, become very concentrated.

After 1965 we see a very rapid rise in the import penetration in consumer goods. Before 1965, ten percent or less of total U.S. consumption of consumer goods came from outside the United States. But after '65, we see a very rapid rise, and if we went to 2000, the level of foreign imports in total consumption would be even higher. A major portion of these goods have always come from East Asia. If we look at this chart here, even in '75 we see that most of the goods came from Asia. The blue areas indicate exports to the U.S. from the Chinese areas, the purple from Japan and South Korean areas. I should note that in 1975 and 1985, the products from the blue areas are from Taiwan and Hong Kong. China was not a prominent exporter then. China only became a prominent play in the 1990. Let me just skip this here. I can talk about this during questions and answer portion.

Chairman D'AMATO. Don't rush.

Dr. HAMILTON. Don't rush?

Chairman D'AMATO. No.

Dr. HAMILTON. Are you sure?

Commissioner MULLOY. Yes, that's great.

Commissioner TEUFEL DREYER. Yes, we want to hear this.

Dr. HAMILTON. Okay. After 1965, Japan and Hong Kong were the first ones that that began exporting consumer goods to the U.S. Then in the late 1960s Taiwanese and the South Korean imports jumped up very suddenly. From the American perspective, the imports were very small portion of total consumption, but from an Asian perspective, these exports to the U.S. represented a huge

portion of the total economic growth. They accounted for a large portion of the overall increases in these economies.

From disaggregated trade data (seven digit U.S. Customs data), we can see a very rapid rise in the number of items being exported into the U.S. from Taiwan and South Korea. Footwear and garments do not constitute the bulk of these exports. Most of the items come from other sectors. You will notice that Taiwan always has more exports to the United States than South Korea the entire period, and that trend has continued until the last couple of years.

Despite the thousands of different items being exported, almost all the value is accounted for in only the top ten categories of goods. These exports are very concentrated. What we are seeing here is the operation of retailers' ordering systems. Retailers order huge batches of different items, and these items change over time. Most of the value of all of the exports is accounted—in the entire period—by only the top ten items. In Korea in 1972, 50 percent of all exports are accounted for by the top 10 categories. In 2001, the figure is 40 percent.

I'll skip a detailed description of what is being exported. The important thing to recognize after 1975 is that the countries begin to diverge in what they export to the U.S. This divergence is also the result of retailers' ordering systems. Nike, for instance, orders very large runs of the same type of shoes from Korea, but the batches of specialty shoes they order from Taiwan. The modestly large firms in Korea get larger and more vertically integrated as the owners expand production to fill the orders. At the same time, the Taiwanese firms become more adept at organizing small and medium-sized production systems. Okay. Now we can see this divergence. Footwear, this is Korean footwear. Almost of it is in one or two kinds. Taiwan is quite diverse, but all quite different from what is produced in South Korea. A symbiosis develops between American retailer and brand-name merchandisers, on the one hand, and Asian manufacturers on the other hand: Each economy begins to specialize in a production system in response to retailer orders.

Here is another example, this one rubber and plastic products. Looking at aggregated data, both Korea and Taiwan export large amounts of goods in this sector, but in the disaggregated data we see that Korea export tires: tires for cars, tires for trucks. But from Taiwan, the exports include everything else—Christmas tree ornaments, wearing apparel, hoses, you name it. Small and medium sized firms in one place export goods that such firms are good at making; big firms in another place do the same thing, and the result is industrial divergence.

Here is another example: From Korea, microwaves, and from Taiwan hair dryers, curlers, and an array of small household appliances.

In 1985, the U.S. and the leading Asian exporting countries sign the Plaza Accord. This Accord led to an upward evaluation of a number of Asian currency relative to the U.S. dollar. This is what we're arguing about for China now. Around the same time the Plaza Accord is signed, lean retailing techniques become widely adopted. Retailers begin to adopt scanning systems that rationalize their supply lines.

In just a few years, investments divergence throughout Asia. The Japanese manufacturers could no longer make their price points. Their goods are no longer competitive in the United States. They begin to move their production sites to Southeast Asia and to the United States. The Taiwanese and Hong Kong manufacturers go into China. South Korean manufacturers go to Southeast Asia and other developing countries around the world.

Quickly the effects of this foreign direct investment become apparent. This chart shows apparel imports into the U.S. Before 1985, Taiwan, Hong Kong, and South Korea predominate, but with the Plaza Accord and the Multi-Fiber Agreement suddenly many countries begin to export to the U.S. Now for the important point: The same Taiwanese, Hong Kong, and South Korean manufacturers keep the orders; they simply move their factories. Among many other places, the Taiwan garment makers go to South Africa. The South Korean garment makers to Southeast Asia and Central America. They still have the orders. But they go someplace else.

Here is a chart showing footwear imports into the U.S. Although the Taiwanese still have the orders for shoes, they relocate to China. China's share in overall shoe production just shoots up, and Taiwanese share goes down to very little. The Koreans goes down as well. Most of their shoe production goes to Indonesia, but the Koreas also lose market share to the Taiwanese manufacturers now in China. There are many other examples that show the same trends.

In 1997, this division of labor changes again. 1997 is the year of the Asia financial crisis. Southeast Asia economies collapse. Their domestic markets for goods collapse as well. South Korea, too, is caught up in the swirl. The Chinese economy, however, barely ebbs. Many firms begin to shift their investment to China, following the Taiwanese and Hong Kong manufacturers who went there earlier in the decade.

It is this convergence of Asian manufacturers in China that fuels the rise of the Chinese economy. This chart shows the rising consolidation of consumer goods manufacturing in China; it is now substantial. All these categories of consumer goods exports go down for Taiwan, except for computer and electronic equipment. The OEM manufactures make Dell computers in Taiwan, but some of that too is now going to China.

What's driving China's growth today? The large retailers. The central message here is that the large retailers are able to organize their supply lines, and in organizing their supply lines, they organize backward to production and they're able to rationalize that production. So as retailers get larger, the manufacturers become more concentrated as well.

And here we have Wal-Mart buying in China $15 billion in purchases. That's fairly low in terms of Wal-Mart's total purchases, but it's now going to go up considerably because Wal-Mart is now putting hundreds of stores in China as retail outlets.

Let me stop here. The core idea is that the market makers for the global economy, both for consumers and for suppliers, are now the major retailers. Thank you.

[The statement follows:]

Prepared Statement of Gary G. Hamilton
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Remaking the Global Economy:
U.S. Retailers and Asian Manufacturers*

Please note: Having just been added to the agenda, I will not have time to prepare a formal statement. I am, however, submitting a longer paper, under the same title, to the Commission for its reference. All the comments made in this presentation are documented in that paper. This summary statement will consist of selected excerpts from that paper.

The principal thesis of my presentation is that the single most important driver of China's growth is that China has become the world's chief site for sourcing manufactured consumer products. The most important firms that source goods from China are the large retailers and brand-name merchandisers, which are mainly located in the United States. Among the most important manufacturers in China making export consumer goods are firms owned by businesspeople from Taiwan, Hong Kong, South Korea, and Japan, most of whom have relocated their firms to China in the last fifteen years. My presentation will demonstrate and explain these underlying trends. The first step in the explanation is to outline the transformation of retailing in the United States that begins after World War II.

The National Organization of U.S. Retailing Between 1945 and 1965

The consolidation and concentration in retailing in the United States occurred at different times and for different reasons than had occurred in manufacturing. In the decades before World War II, the manufacturing sectors of the American economy had already gone through several periods of mergers and massive consolidations that not only resulted in vertical and horizontal control over processes of production, but, by virtue of the economic power of manufacturing firms, also allowed them to control the distribution and retailing of their products as well. For instance, the automobile manufacturers developed franchised retail outlets, as did some consumer appliances makers (e.g., RCA and GE). More often, manufacturers dealt directly with wholesalers that in turn distributed products to many small retail stores, most of which were independently owned.

The Globalization of Supplier Markets for U.S. Retailers After 1965

In 1965, the United States ran its first postwar trade deficit with Japan. The deficit was rather small, $334 million, and did not represent a major cause for concern, especially in comparison with the massive $6.3 billion trade surplus with the rest of the world. In retrospect, however, the beginning of the U.S. trade deficit with Japan could easily be interpreted as a telling, even if only symbolic, indicator of the new era in the evolution of the U.S. economy, characterized by persistent trade deficits with Asian economies and the flooding of domestic markets by foreign manufactures. In sharp contrast with the previous period, the structure and dynamics of the post-1965 U.S. economy have been profoundly impacted by its rapidly developing links with the global economy. In 1965, the ratio of total U.S. international trade (imports and exports) to its GDP stood at a relatively modest 10 percent, a little bit over half of what it was at its all time high in 1919 and still lower than in the years before the Great Depression. Fifteen years later, in 1980, it reached 24 percent. In the same period, the U.S. economy turned from a net exporter, the position it held since the 1870s, to a net importer, with trade deficit in 1980 approaching $20 billion.

Trade figures from 1965 on show that imports in most major categories of manufactured goods constituted a growing percentage of U.S. consumption. In 1965, imports accounted for less than ten percent of total U.S. consumption in all major categories of manufactured consumer goods, but import penetration in all categories of consumer (non-grocery) goods rose rapidly after that. Where did these imports come from? The answer is that East Asian countries (i.e., Japan, South Korea, Taiwan, Hong Kong, and China) accounted for over 50 percent in almost all categories of imports from 1975 on.

We will now disaggregate these trends decade by decade to show the dramatic shifts that occurred from 1965 to present time.

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*This presentation draws from chapters 6, 7, and 8 of Robert Feenstra and Gary Hamilton's forthcoming book: *Emergent Economies, Divergent Paths: Economic Organization and International Trade in South Korea and Taiwan* (Cambridge University Press.)

1965–1975: Creating Asian Suppliers for American Retailers

Beginning around 1965, U.S. imports of foreign goods from Asia begin abruptly to rise. If we examine the detailed data from U.S. Customs, some clear trends begin to emerge. First, Taiwan and South Korea joined Japan and Hong Kong as the principal Asian economies exporting to the U.S., with Singapore coming somewhat later and providing smaller quantities of a narrower range of U.S. imports than the other Asian NICs. In 1965, imports from Taiwan and South Korea were almost non-existent, but starting around 1968 for Taiwan and 1970 for South Korea, the exports jumped suddenly.

Second, from a U.S. perspective, during the first decade (1965–1975), these countries contributed only a very small percentage of total U.S. consumption, even in the fastest growing categories. But from the perspective of the exporting economies, these goods exported to the U.S. accounted for a very large percentage of the total growth of these economies. This was especially true for Hong Kong, Taiwan, and South Korea, all of which maintained low levels of domestic consumption during the first several decades of industrialization.

The third trend is a very rapid increase in the number of categories of items being exported. Assuming that the pattern of U.S. imports in 1972 reflects emerging trends that started a few years earlier, we see a very rapid increase in the number of seven-digit custom classifications for items exported from South Korea and Taiwan between 1972 and 1988. Already by 1972, Taiwan exported to the U.S. over 2,000, and Korea over 1,000, categories of goods. These totals rapidly rise and peak in 1985 and 1986 at levels approaching 6,000 categories for Taiwan and 5,000 for South Korea.

The fourth trend shows that throughout the period, despite the wide variety of exported goods, a very high percentage of their total value was concentrated in only a very few product categories. The highest concentration for both countries occurs in the earliest period, with nearly 50% of the value of Korea's exports to the United States and 25% of the value of Taiwan's exports contained in only 10 categories of seven-digit categories. Indeed, in 1972, nearly 90 percent of the value of Korean exports, and nearly 80 percent of the value of Taiwan's exports was in the top 100 categories.

For the period before 1975, what explains these five emergent trends? Instead of the usual inchoate supply-side stories used to explain the Asian Miracle, most often in terms of developmental states, smart and trusting entrepreneurs, and free trade regimes, we should see that these particular trends are the direct results of the emergence of global intermediaries and their abilities to create supplier markets, often including suppliers themselves, for retail products to be sold in the United States. Therefore, rather than simply asking what comparative advantages these few Asian economies had in this period, we should ask instead why did most of the major U.S. retailers begin to source products in East Asia between 1965 and 1975?

First of all, we know that most of the major retailers did begin to source during this period. They developed networks of buying offices (or contracted with major sourcing firms) in Hong Kong, Taiwan, and South Korea in the late 1960s and early 1970s, and they quickly ramped up their orders from these countries in the following years. For example, Sears established its buying office in Taiwan in 1967, Kmart and J.C. Penney in 1971, and Associated Merchandising Corporation (which bought for Dayton-Hudson, Federated Department Stores, and Target, among many others) and Mast Industries (a wholly owned subsidiary of The Limited) in 1973. At about the same time, most of these U.S. retailers opened offices in South Korea.

The reason they came to Asia in the first place was due to their rapid expansion and intense competition in the United States in the late 1960s and early 1970s. In response to Fair Trade Laws, many of the largest department stores began to develop private labels clothing that they could use to undercut their brand name competitors. The department stores first bought their private label clothing from American based manufacturing companies located in the South, but when orders rapidly expanded, these Southern manufacturers began to arrange for a portion of their manufacturing to be done in Asia. Their ability to source goods in Asia was facilitated by Japanese trading companies, especially Mitsui, that served as intermediaries between American firms that ordered the goods and the Asian firms that manufactured them.

With the initial success of Japanese trading companies in creating competent suppliers, it soon became apparent to all concerned, however, that neither the Japanese trading companies nor other types of go-betweens were needed any longer to match U.S. retailers to non-Japanese Asian manufacturers. The general department stores and, more importantly, the new generation of discount and specialty retailers, especially those specializing in fashion apparels and footwear, eliminated the middlemen and began directly to arrange their own contracting relationships in Asia. They were

helped in this matchmaking effort by local firms and business groups that established their own trading companies to represent local manufacturers and to negotiate with U.S. retailers.

By 1975, Asian supplier markets had been created, partly by Japanese multinationals and partly by local efforts, and a model of how to do contract manufacturing in Asia (and elsewhere) was in the process of being developed and institutionalized. From the beginning, contract manufacturing spawned a relationship between retailers and manufacturers that did not exist in the United States: Beginning on a small scale in the early 1960's, but then accelerating rapidly after that, retailers started to directly source batches of differentiated goods specially ordered for sale in niche markets. The standard reason given for the early contract manufacturing in East Asia is the cheap labor, which of course was a factor. But even more important was that American-based retailers, engaged in hot competition in their home markets, began to develop and organize manufacturing directly without owning factories and without the corporate and labor negotiations that would be involved in subcontracting with American-based firms. This model of brand name merchandising blurred the distinction between retailing and manufacturing, so much so that many manufacturing firms, such as The Gap, The Limited, Nike, and later Dell Computers, began to appear that did not actually manufacture anything, but rather focused almost entirely on building and assessing consumer demand, designing products for consumer niches, merchandising those products to the targeted markets, and building relationships to Asian manufacturers that would supply their goods.

During this same decade when the American retail sector was beginning its transformation, the East Asian countries were developing the capacity to respond quickly to the needs of intermediary buyers for reliable infrastructures for international trade. The East Asian NICs founded extensive trade and manufacturing associations and built world trade centers, all to facilitate the matching process between buyers and potential manufacturers. At the same time, these countries began rapidly to establish the physical and financial infrastructure that would facilitate international trade (e.g., ports, shipping, containerization, fast freight forwarding, railways, highways, as well as banking, credit markets, and stock markets, corporate insurance). These infrastructure projects and market institutions allowed global intermediaries to develop the industries and to create competitive supplier markets throughout East Asia and allowed Asian manufacturers to become increasingly more responsive to big buyer demands.

1975–1985: Diversification of Supplier Markets for U.S. Retailers

The rapid expansion and growing diversity of retailing in the United States and the equally rapid expansion of Asian manufacturing during the period from 1965 to 1985 are two aspects of the same economic phenomenon. After the first ten years, by 1975, the retailers, the various sets of intermediaries (trading companies), and the Asian manufacturers had, provisionally, worked out the basic method of contract manufacturing. Moreover, the governments and industrialists in the key areas (i.e., Japan, Hong Kong, Taiwan, South Korea, and Singapore) had built sufficient economic infrastructures to facilitate this type of long-distance manufacturing.

At exactly this moment, around 1975, the United States slipped into a severe recession. The Vietnam War had ended precipitously and the first oil shock had occurred, and then a few years later, in 1980, a second oil shock happened. The traditional retailing sector and U.S. manufacturers both declined rapidly during the period. As occurs in most economic downturns, in this recession, many American consumers saved money by shopping where they could find the lowest prices. It was in this period that competition between the new discount and specialty retailers, on the one hand, and the older, more traditional retailers, on the other hand, came to a head, and set off a wave of mergers and acquisitions, resulting in even greater consolidation within the U.S. retail sector. The number of mass discounters reduced from over ten to four major chains. Moreover, the major department stores, such as Macy's and the Bon Marche, curtailed their in-store brands and began to build mini-boutiques within their stores, featuring such brand name apparel manufacturers as Polo and Anne Klein. In addition, many of the same brand name manufacturers began to open factory outlet stores in scattered locations around the United States and elsewhere.

The rise of the new retailers stocked with many items manufactured in Asia contributed to a reorganization of U.S. manufacturing that occurred in the late 1970s and early 1980s. Many analysts of the period began to worry that American firms were no longer competitive. Many older and well-established manufacturing firms were forced into bankruptcy and many survivors had to restructure, including IBM, among many others. The Upper Midwest, formerly renowned as the industrial

heartland of America, became widely known as the "Rustbelt." An important cause of this crisis in American manufacturing was that many of the traditional retailers had maintained their American-based supply lines and stocked their shelves with more traditional types of products, but as these retailers lost customers, because of their competitors' low prices and the availability of new products carried by other retailers, the orders with American manufacturers declined even as the imports of foreign products surged.

The need to cut costs and to restructure led once powerful manufacturers to join the ranks of the factory-less brand name merchandisers. Beginning in the late 1970s and continuing through the 1990s, such firms as Schwinn (bicycles), Eddie Bauer (specialty outdoor clothing), General Electric and Westinghouse (household appliances), and Compaq (computers) closed all or most of their consumer product factories in the United States and began to contract all or a large part of their products overseas, mostly in East Asia. In making the move to Asia, many American firms actually invested in and helped to organize the Asian production of their branded goods. Others played a more passive role, letting the Asian manufacturers perform the primary entrepreneurial functions. In both regards, these businesses simply followed in the footsteps of the earlier firms, copying the first-comers' techniques of contract manufacturing and direct sourcing of component parts and finished goods. What started in textiles had by 1985 spread to almost every category of consumer goods, including a full range of high-technology products, most of which were never mass produced in the United States. In fact, the Asian supply lines for high-technology products had been sufficiently developed by the early 1980s that Dell Computer Corporation and Gateway, two companies that owe their successes entirely to contract manufacturing, much of which is centered in Taiwan; started their businesses, respectively, in 1984 and 1985.

From 1975 on, the general trend has been for these Asian economies to specialize, and therefore to diverge in what they produce. The reason for this divergence results from the system of production that emerges in each economy in response to repeat orders from big retail buyers that, in turn, reinforces what was ordered there. South Korea, for example, started the industrialization process in the late 1960s with a few large and competitive business groups, and as the orders began to come in, these large groups, known locally as octopi, gobbled up most of the opportunities presented by foreign buyers. The result was that the big business groups, the *chaebol*, controlled the flow of orders and vertically integrated to prevent other *chaebol* from obtaining the orders. By contrast, in Taiwan, which began the industrialization process with many small firms competing for the early orders and no major players that could monopolize the opportunities, the Taiwanese businesspeople began from the outset to specialize in products that small firms, interlinked in small networks, could profitably produce. As the orders began to flow, the Taiwanese small- and medium-sized manufacturers became experts at producing a wide variety of products in batches, and the largest private-sector enterprises, usually family owned business groups became suppliers of intermediate goods (e.g., plastics, synthetic yarn, textiles, chemicals) and business services (e.g., shipping, insurance).

The big buyers in those locations quickly became sophisticated in sourcing their products with those entrepreneurs who could best produce them. For instance, Nike ordered very large runs of low-end standardized running shoes in Korea, and their high-end and more specialized shoes from Taiwan. In the industrializing countries of East Asia, the ordering system reinforced the competitive dynamics that drove the divergence in the industrial structure of each country, quite apart from anything that government of that country did. By 1985, the basic organizational trajectories of these economies were firmly in place and dependent on their continuing linkages with U.S. retailers and merchandisers.

1985–1997: Rationalization of Global Supply Lines

Two developments occurred in the middle 1980s that would forever restructure the organization of Asian economies. The first was the Plaza Accords signed in 1985 and the second was the global implementation of "lean retailing," a development that started in the previous decade but was only gradually implemented in Asia in the late 1980s and 1990s.

On September 22, 1985, at the Plaza Hotel in New York City, after years of running trade deficits with South Korea, Japan, and Taiwan, the United States completed negotiations on a currency reform measure that all parties signed. The Plaza Accord, as this currency reform became known, removed the pegged trading range of East Asian currencies with the U.S. dollar and allowed the Asian currencies to appreciate by as much as 40 percent.

The second development was a comprehensive reorganization of global supply lines that resulted from the U.S. retailers' implementation of which is known as

"lean retailing." Barcodes, scanners, and more generally "electronic data interchange" (EDI) became the medium to continue the trend towards the globalization of supply lines that was already well begun in the late 1960s and 1970s. A core principle of value merchandising—for discount retailers, brand-name merchandisers, and specialty retailers—is to match as closely as possible the number and types of goods on hand to the number and types of goods that consumers will actually buy. This involves a precise calculation of consumer demand. In the 1960s and 1970s, however, value merchandisers and department stores could only anticipate consumer demand, and to hedge their risks they would buy limited quantities of a limited range of each type of differentiated good.

The development of high powered mainframe computers and database software suitable for inventory control, both of which did not become widely available until the early 1980s, quickly made barcodes and scanners the preferred instruments of assessing consumer choice at the place and time of purchase. By the late 1980s, these innovations allowed retailers' and merchandisers' to rationalize their supply chains.

The innovations first designed for grocery stores were, in the 1980s, commandeered by other types of retailers. At first, however, the adoption of UPC codes was uneven. Many of the older retail firms, such as Sears, not only had predominantly American supply-lines, but also had already made large capital investments in developing proprietary, automated inventory systems, and were reluctant to make additional and even larger investments to adopt universal product codes and standardized scanning devices. But after Kmart and Wal-Mart both adopted the technology in the early 1980s and required their vendors to do so as well. Most other retailers had to follow suit.

This push into lean retailing occurred at the very time currencies in the leading export economies in Asia were being reevaluated upwards relative to the U.S. dollar (except for Hong Kong, which remained pegged to the U.S. dollar). In the span of just a few years, the Japanese, Taiwan, and, to a lesser degree, South Korean economies went through a momentary period of jubilation, a period when everyone felt much richer and many began to make extravagant purchases at home and abroad. The period of jubilation ended quickly, however, when domestic manufacturers realized that they could no longer meet the price points that the U.S. retailers and merchandisers required.

The currency revaluation stopped the Japanese economy in its tracks, but not its main exporting firms. By the late 1980s, Japanese industries were major OEM suppliers in only just a few products (e.g., microwaves, computers). Instead, many of the largest Japanese business groups had gone to considerable effort to build their own globally recognized brand names (e.g., Sony, Panasonic, Toyota) or to use their technology to develop upstream products, such as Toshiba's LCD panels and Shimano's bicycle gears, that they then could sell to all makers of the respective products. In order to remain competitive in terms of price and quality, the many major Japanese companies transferred their final assembly sites, along with some production, to other countries. The effect of these foreign direct investments on the domestic economy was widely reported in Japan as the "hollowing out" of the Japanese economy.

Unlike Japan, South Korea and Taiwan were able to escape severe recessions, and they even were able to increase their exports, but they did so in quite different ways. By 1985, the four largest South Korean chaebol (i.e., Hyundai, Samsung, Lucky Goldstar, and Daewoo) dwarfed all the other business groups in South Korea in size and sales, and virtually monopolized exports from South Korea. After the currency evaluations, these behemoths began to follow the precedent set by the largest Japanese business groups, establishing global brand names and developing higher quality, up-market products.

In the wake of the Plaza Accords, many of Taiwan's export manufacturers faced a serious dilemma. They had OEM contracts for goods that they needed to deliver to U.S. retailers, but they could not produce those goods profitably. If they failed to honor their contracts, the retailers and brand name merchandisers would easily find other manufacturers to make the products. If they stayed in Taiwan and honored their contracts, they would likely go bankrupt, and lose the contract anyway. After several years of hesitation, those small- and medium-sized firms making garments, bicycles, footwear, and other types of similar consumer goods moved their manufacturing operations to China. The move occurred suddenly, like a stampede, in a matter of just a couple of years.

The period between 1985 and 1997 was characterized, then, by further divergence of national development strategies, initiated in response to the reorganization of the U.S. demand for consumer goods. At the same time, however, the whole region was rapidly becoming more integrated, was beginning to show an increasingly elaborate

pattern of intra-regional trade, investment, and production. By the mid-1990s, any attempt to classify national economies in East Asia as to the level of their industrial development would be of little use. While Japan may still be a clear leader in advanced consumer electronics, as well as in the automotive sector, sizable portions of its production and assembly are organized outside of its borders. South Korea and Taiwan both managed to reshape their economies after the Plaza Accords, although in very different ways.

1997 to the Present Day: Convergence in China

By the middle 1990s, many of the Japanese, South Korean, Hong Kong, and Taiwanese manufacturers had reestablished their labor-intensive export businesses in new locations. At home, new businesses had been started, often manufacturing products that had been unknown only a few years earlier and rarely manufactured in the U.S.: cell phones, digital cameras, laptop computers, DVD players. Although many Asian firms continued to hold contracts with U.S. retailers and brand name merchandisers, they also worked diligently to obtain new orders from retailers and merchandisers in Europe, Latin America, as well as all across Asia. The U.S. share of total exports declines throughout the period, although the absolute values of exports continue to rise. Also by the mid-1990s, U.S. big box retailers no longer simply purchased goods in Asia; they began actively to integrate Asian manufacturers into their supply chains. Again, American manufacturers continued their long, gradual decline, driven in large part by the eagerness of American retailers to unify and simplify their supply lines around the least cost producers, mostly Asian ones in all areas of consumer goods except for food and cosmetics. What seemed, momentarily, like an endless expansion, like a Pacific Century dawning, came to an abrupt halt in 1997. Starting in Thailand in the summer of 1997, the financial underpinnings of economies all across Asia crumbled. The financial and property markets in Indonesia, Malaysia, Singapore, the Philippines, Hong Kong, and South Korea were all deeply shaken, each for slightly different reasons; all of these countries also suffered sudden and serious declines in exports and domestic production.

When the financial crisis occurred in Asia, the U.S. was in the buoyant years of the dot.com boom and the run-up to the Y2K scare, which led computer owners to upgrade their computers for fear that their internal clocks would be unable to register the new millennium. These were the years that high-technology merchandisers, such as Dell, Gateway, and Hewlett Packard, cemented their ties with Taiwanese manufacturers, and that the Taiwanese manufacturers began to relocate their low-end PC production to China. These were also the years that Wal-Mart and Target began establishing superstores across the U.S. and that Wal-Mart was beginning its global expansion. U.S. demand for the full range of consumer goods was at an all-time high, and outside of those areas most affected by the crisis, global demand was also picking up, especially in China.

First the Asian financial crisis and then the 2001 bursting of the dot.com bubble in the U.S. led businesses worldwide to reconsider their Asian strategies. In 2001, U.S. demand for high technology consumer goods suddenly and precipitously declined, which also led to an economic slowdown in Taiwan. But China's economy continued to grow. Encouraged by the Chinese government and by China's membership in the World Trade Organization, businesses around the world began to look to China as both its manufacturing platform and its next big market. The largest investors in China were its closest neighbors: Hong Kong and Taiwan continued their large scale investments in the Mainland, but now they were joined by large investments from Japan, South Korea; the four countries together account for 70% of the total direct foreign investment in China. The convergence of Asian firms developing manufacturing sites in China prompted retailers to establish buying offices there as well. As one Wal-Mart buyer explained, retailers followed their Taiwanese suppliers: "The only reason [manufacturing] moved from Taiwan was China's low level of wages. 'We didn't have any trouble in China, because the Taiwanese went into China and built their factories. We were dealing with the same people.'"

Recognizing the potential of China as the single best low-cost provider of goods, and as representing a huge domestic market in its own right, Wal-Mart executives established in 2001 their direct buying office (that later turned into Wal-Mart's global sourcing headquarters) in Shenzhen, China, just across the border from Hong Kong, and in 2003 another buying office in Tianjin. In 2004, Wal-Mart exported over $18 billion of goods purchased in China, which amounts to 10% of all U.S. exports from China. Wal-Mart alone accounts for 30% of all foreign buying in China. Besides exporting from China, Wal-Mart is also in the midst of a huge expansion of retail stores in China where they will be opening dozens of stores in the next few years. Wal-Mart is not the only major retailer to combine foreign buying with a domestic presence in China. The giant French firm, Carrefour, the second largest re-

tailer in the world, is the largest foreign retailer in China and is well ahead of Wal-Mart. Not far behind the front runner are German retail chains Metro and Ahold.

China is now emerging as the world's premier manufacturing platform for a large range of consumer goods. It is also one of the world's largest consumer markets. Some large U.S. manufacturers, such as General Motors, are making large investments in joint ventures producing for China's domestic market. But the largest U.S. investments in China are likely to be made by America's largest companies, the retailers and in particular Wal-Mart, a firm that has now become one of the few truly global marketmakers.

Conclusion

Along with many other firms, Wal-Mart has invested in China's manufacturing capacity, and based on this investment, Wal-Mart has consolidated its global chain, reducing the number of principal suppliers and forming a global alliance with the top 50. These investments having been made, will Wal-Mart and other retailers and merchandisers soon or easily abandon China for some other location, such as India or Southeast Asia? Even if China's prices rise, perhaps through an upward reevaluation of China's currency, will China's manufacturing platform become less important than it is today? Of course, these questions are for the future to answer. But one thing should be clear from the above narrative: both the comparative advantage of locations in global markets and the competitive advantage of nations in international trade are not decided by the impersonal workings of costless markets. Real firms, creating and maintaining real markets, competitively determine both comparative and competitive advantage in the global economy today. As the global retail sector consolidates, as it has been doing for the past 50 years, there is every reason to conclude that a relatively small number of very large retailers will become the hub of the global economy, will become the makers of both consumer and suppliers throughout the world.

There is much yet to understand about the role of retailers in the global economy. We, therefore, conclude with three propositions that we hope will fuel future research. First, we conclude that markets do not emerge spontaneously, in order to ensure the match between global demand and global supply, but are rather created and shaped by real economic players, and the most prominent players making markets in the global economy today are retailers and trade name merchandisers.

This leads us to our second major proposition. Global markets cannot be reduced to the operation of an abstract, costless price mechanism. Instead, they consist of a rich, increasingly complex patchwork of institutions that shapes and enables international trade. Market mechanisms are made and reproduced by large business firms, which typically dedicate a substantial amount of their organizational resources to such "marketmaking" activities, not for the universal benefit of all or to approximate the economist's model of perfect competition, but rather to maximize their own trading opportunities.

Finally, we propose that global markets do not, and should not be expected to, balance firms, regions, and nations in a state of productive equilibrium. How economies actually develop depend on many factors, not the least of which are the accumulated results of many choices that result in increasing returns in some locations and decreasing returns in other locations. Although institutionalized markets do generate a fair amount of stability and predictability, that fact alone does not necessarily ensure optimal, efficient or, universally beneficial outcomes. However, rather than viewing such outcomes as examples of market failure, as distortions from the ideal form of competitive market, we should understand these outcomes as the result of many knowledgeable actors making successive choices about how to position themselves in global markets. Increasingly such choices involve working with one or more of the global marketmakers or finding a niche where one can grow one's own business apart from their influence, and increasingly those niches are becoming harder and harder to find.

Panel I: Discussion, Questions and Answers

Chairman D'AMATO. Thank you and thank the three of you for very important testimony. We're the middlemen. We're going and try to retail this through to the Congress to make sure they get the full scope of your testimony.

Vice Chairman Robinson.

Vice Chairman ROBINSON. Thank you, Mr. Chairman. Well, Mr. Jones, you told a chilling tale from my perspective. It's a case study in predatory behavior at some level. We've heard this kind of testi-

mony before, I regret to say, and it just makes it clear the scale of the challenge we face. So I just wanted you to know at the outset that we are taking your experience seriously because there are so many firms like your own that have had a similar fate or are in the process of that kind of dissembling now.

Mr. Blackwell, I had the good fortune to be chatting with you a bit last night. You talked about how the performance in the capital markets is an incentive for the profitability of companies to be as quick and as high as possible.

I certainly concur with that. At the same time, China is using its large state-owned enterprises to come to our capital markets. Some of those enterprises are well known for abusing labor rights, and some even human rights more broadly.

I recall that the AFL–CIO was particularly active in opposing the PetroChina initial public offering in the year 2000, which was scheduled to come to market for $10 billion. When organized labor and a number of other like-minded organizations from across the political spectrum organizations joined together, the scale of that PetroChina IPO was knocked down by over 70 percent to only $2.89 billion. You even recruited some of the largest institutional investors in the country to publicize their unwillingness to purchase PetroChina stock even before it was made available on the New York Stock Exchange.

Would you characterize that campaign from the AFL–CIO's point of view as a success? Would you be similarly inclined in the future to challenge certain Chinese enterprises that are known to be abusers of labor rights and are seeking to list on our exchanges?

Mr. BLACKWELL. Thank you for that question. The American labor movement represents workers as employees of companies, but we also through our beneficial funds for retirement and for health care, we represent these individuals as shareholders. Workers' capital, we call it, totals over $6 trillion. It's the largest source of investable capital in the country. There's $13 trillion of worker capital internationally, and we are, in this way, an enormous player in equity markets.

26 percent of all publicly traded companies are owned funds that are there to support retirement security. Now, these are funds that ought to have very long-run time horizons because it's easy to predict retirements and the liabilities on those funds, but these funds are managed by people who are looking for the quickest buck and are competing with each other for quarter to quarter earning spikes, and their whole philosophy is put their money where you can get the quickest bounce immediately, and that can be in a fad like an emerging market and China represents just that kind of fad.

The PetroChina thing was a very interesting case because not only was there the abridgment of human rights in Tibet and the abridgment of worker rights in China, but they were asking people to buy into a black box. No one knew what they were actually buying. Only 15 percent of that company was going to be sold; the rest of it was being controlled by the People's Liberation Army of China. What kind of asset is that? How is that governed?

What kind of risks are those funds bearing because of their involvement in this? This is an enormous concern. We were able to

assemble a trillion dollars that stood aside from that transaction. That was one of the initial transactions, as you will recall, and we worked with you on that. It did give pause to the Chinese government about the plan to reach into the U.S. capital markets the way they're reaching into our product markets and to use our savings to finance their development.

We have a continuing interest in this kind of thing and would be very open to finding opportunities where with similar propositions we could take some action in these markets. We are among the most active shareholder components in the capital markets and we're very focused on IPOs in general, IPOs from emerging markets in particular, but China right now looms above them all.

So, yes, we have a continuing interest in representing the workers as the beneficiaries of those plans and protecting their long-run retirement security by making sure those funds are not invested in enterprises that do undermine the U.S. economy and perhaps foster much worse practices as well.

Vice Chairman ROBINSON. Thank you, sir.

Chairman D'AMATO. Thank you. In 1980, I guess, 25 years ago, I was Chief of Staff to a Senator who has since retired and is deceased named Abraham Ribicoff—some of you may remember Senator Ribicoff. He was Chairman of the Committee on Government Affairs in the Senate at that time.

One day he called me into his office and said, you know, we've got to figure out how we can make America competitive again. So we had a conference—some of you may remember this—at Harvard, sponsored by his Committee, the New York Stock Exchange, and Harvard University, to get at the question of how can America be competitive?

I'm not sure, and this is to all three of you, that we know now how to make America competitive given what you've described as this symbiosis between multinationals and the Chinese government. Do we know how to make America competitive given the situation today? That's the question I have to all of you, particularly Mr. Blackwell. You mentioned competitiveness.

Mr. BLACKWELL. The really important thing here is that we're no longer asking the question.

Chairman D'AMATO. I just asked it.

Mr. BLACKWELL. This was my point. In 1980s, we were asking that question.

Chairman D'AMATO. Yes.

Mr. BLACKWELL. People were running for President of the United States based on that question. That was not a question in the last Presidential election; that is not a matter that is really before the Congress. That's what is so important about this Commission is to make this clear that we're facing the most serious competitive challenge as a nation that we have met in modern history, and what we do now or don't do now will shape the future of our children and grandchildren.

We are a nation of large purposes, both internationally and domestically. We have to be, and we're the richest and most powerful country in the world. We have to lead, and I could say the dimensions of competitiveness are going to include an international level.

We have to level the playing field. We have to take intellectual piracy out of international competition.

We have to take oppression of workers out of competition, and we've got to make sure our tax policy supports, and does not undermine, the development of a domestic American economy. We've also got to work with other countries to assure that there's a level of demand in the world that can absorb some of the products that will meet the needs of the world's people that is now not being met.

Right now the only thing that's growing in the world is the U.S. economy, and we are consuming, we are the engine for the entire world economy. Europe and Japan are flat on their backs and China is basically growing based on the demand they're deriving from us.

The third element is going to be developing a productive capacity in the United States. We're at a critical point where we are losing—we're not just importing too much. We are losing our capacity to export. We could not now balance our external account by exporting. We don't have the capacity to do it.

We've got to invest certainly in the education of our people, in the infrastructure of our nation, but we've got to make sure that this gets commercialized by companies that are determined to build strong companies here in the United States. The American labor movement stands prepared to cooperate on all three of these dimensions of restoring American competitiveness.

Chairman D'AMATO. Yes. Mr. Jones, the story of your company, from what I get, is you have been rendered non-competitive in your main line of business, partly or mainly because American policies do not support your competitive reach. Is that right?

Mr. JONES. I think only a lunatic would go into manufacturing in this country today unless you had a niche, which we fortunately have through some patents. But when the patents run out——

Chairman D'AMATO. But you can't build a world power on niches.

Mr. JONES. No, you can't. That's why I said if we were in the automotive business, we're like Porsche. We're just a little niche manufacturer and we survive, but we can't supply the full product line.

Chairman D'AMATO. But if you had a government like China behind you——

Mr. JONES. We'd be huge.

Chairman D'AMATO. You'd be doing pretty good.

Mr. JONES. Look at the Japanese. Just as a contrast in thinking, on a recent trip to Japan I had breakfast with Governor Hayami, who was then the head of the Bank of Japan. The chairman of the Fuji Bank and Mitsubishi Trust were also at the breakfast, and we were talking, and you know they just think strategically about industry. It's fun to go to talk to them. They talk shop. And, Governor Hayami is an industrialist, not an economist.

So he's asking me all about our company, what do we do, and the technologies we use, where does Cummins get our machine tools, etc. I told Governor Hayami we had some custom built machine tools from Toyota, which is a Division of Toyota Motor Company because I can't get that machining center made in the United States anymore. Governor Hayami responded, "oh, send me pic-

tures, my friend, Mr. Toyota, would love to know about that." The Japanese leaders are thinking strategically about their industries.

But another problem we have, as you pointed out, is for me to compete with a country that pays people $2 a day. There were a lot of problems with the Industrial Revolution, but one thing is through the right to freedom of assembly under the Constitution labor in the old days could get together and get a piece of the pie through collective bargaining. Or people like Henry Ford recognized you must pay people. Ford was asked, "Why are you paying them these high wages?" Ford answered, "Well, so they will buy my cars." And it looks to me like we've got a situation in China where the elites are getting filthy rich, but everybody else—they have no leverage and spending power. So they're not creating enough of a domestic market in China. There's an imbalance in our trade agreements, and it's like we now have this bad marriage based upon co-dependency between two needy people between China and the United States. We've got to find a way to unravel this trade imbalance.

But as far as what kind of things could you do, as you said, and I agree with you, we couldn't balance our trade if we wanted to. Another business my family owns, and it's traditionally we were in this first, is banking. We have one of the largest banks in Illinois, and I can tell you we have watched the elimination of manufacturing in the United States amongst our customers and my father was on the Grainger Board years ago. Grainger is a supplier to industrial companies. Recently, my father and David Grainger got together and they said, can you believe what's happening?

Grainger said, 80 percent of my customers used to be manufacturers. They're leaving. Now, it's interesting. We'll have the Greenspan versus Buffett debate for a minute. Alan says we're going to get a soft landing, maybe we hope, as the dollar declines. And Warren Buffett, as we all know, has taken a big bet in currencies on the other side. And it's interesting, Warren Buffett also warned us about the stock bubble and it burst, just as Buffett predicted. We are being told by a lot of people in the government in those days not to worry because you have this great new economy.

I don't think the basics have changed. And I think we have to change from free trade to balanced trade and Buffett to his credit, he threw out an idea. He calls it import credits. With his plan you would have to force balanced trade. And he says you can all beat me up on the proposal. Maybe that's not the best idea, but he at least steps up with a vision, and I think he's right. In the long term you have to have balanced trade.

As far as tax policies, let me just give you an example. Our company pays an income tax and as I told you 20 years ago, there were five U.S. manufacturers and just for round numbers, let's say collectively we paid $100 million in income tax to the Federal Treasury. Now, the other four are gone; only Cummins is left. So let's say we, Cummins, pay $30 million to the Treasury every year.

Everything else is now imported. Imported from Europe and China and Japan. The foreign governments refund the VAT to their manufacturers when the product is exported to this country. So they don't have the cost of the foreign government on it. We track the earnings of our foreign competitors' subsidiaries in the

U.S. None of them pay corporate U.S. income tax. They transfer their product at a price where they pay no income tax.

So as manufacturing leaves the U.S., you lose money to the Federal Treasury. If you change to a VAT tax, at least when the foreign made product is imported, the Federal Government would collect some tax revenue on it. That helps level the playing field. You have to find ways to make it attractive to be in manufacturing in this country. It's not attractive. It just isn't.

Another is, Republican Donald Manzullo and Duncan Hunter and Democrats, Lipinski and Tim Ryan for instance, in the House who work very hard on changing Federal procurement to favor domestic production, particularly in defense, and domestic procurement legislation got through the House. And just to give you a couple illustrations. When it got through the House, there was a machining company in Rockford called Ingersoll that makes critical components for wings on fighter jets and so forth, and they were in bankruptcy. A group of us in Chicago were getting together to buy Ingersoll if the domestic procurement legislation passed the Senate.

But Senator Warner and Donald Rumsfeld killed it in the Senate, which was the requirement for 60 percent domestic content, and if the contract is more than $5 million in defense, you have to make them on domestic produced machine tools, and that's the clause we found very interesting. Now, we're entrepreneurial people. You set up the right environment; we'd have rushed in and bought Ingersoll. Instead, half of it has been sold to the Chinese.

I talked to the guy who ran that division for Ingersoll. He said it's scary what the Chinese bought and what they have. You know it's those kinds of things that we've got to think about more strategically.

And the last thing I would say is contrast Ronald Reagan and Jimmy Carter to today. Ronald Reagan and Jimmy Carter had an intuitive distrust for dictators. In trading with the Soviet Union, national security trumped free trade even in Ronald Reagan's mind. And he squeezed them and so did Jimmy Carter, and thank God they did.

I have an instinctive distrust for dictators. I question the wisdom of empowering a dictatorial power elite in a country where they pay, as you pointed out, their laborers almost nothing.

Chairman D'AMATO. Yes. Just for your information, the main squeezer for President Reagan is the man standing to my left. He did the squeezing. Did you hear that?

Mr. JONES. But they had a strategy and they did not want to share certain technologies with the Soviets for good reason.

Chairman D'AMATO. Right.

Vice Chairman ROBINSON. Not to mention that we deliberately went after the Soviet Union's hard currency cash flow.

Mr. JONES. Or Reagan, when there were imbalances—Harley Davidson—he stepped in. The automotive industry with the Japanese, at least he forced them to come over here and do final assembly. There's theory and then there's practical life, you know.

Chairman D'AMATO. Yes.

Mr. JONES. And we've just got to become more pragmatic.

Chairman D'AMATO. Something to add to that?

Dr. HAMILTON. Yes, I just want to add that you need to distinguish between U.S. firms and the U.S. economy. A lot of U.S. firms now are very competitive. Dell, Gap, they all adopt a retail model, and so—but their manufacturing is done elsewhere.

Chairman D'AMATO. Yes.

Dr. HAMILTON. So if you look at the Fortune 500 today, we have a huge number of retailers at the top, and the manufacturers have almost fallen off the chart. So the observations here are absolutely right. But American firms have the most successful, the most competitive American firms have, in fact, become global firms, and adopted these outsourcing contract manufacturing much to the detriment of the American economy.

Chairman D'AMATO. Yes. Commissioner Dreyer.

Commissioner TEUFEL DREYER. Yes. By the way, Mr. Jones, when this Commission held hearings in Akron, Ohio, we heard a very similar story to the Ingersoll story you mentioned. It involved directional components for submarines, again, something very, very scary that you do not want the Chinese to have. And the manufacturer fought it tooth and nail, but was given no encouragement by the U.S. Government. I imagine you know half dozen such stories.

Mr. JONES. We hear it all the time.

Commissioner TEUFEL DREYER. Yes; definitely national security-related. Now, we've heard a couple of horrible alternatives from you all. Either you meet the Chinese price or you outsource offshore or you got out of business or finally, but this isn't a real solution, you seek a niche market. And if you were to try to think—since our client is the Congress—of specific suggestions you would have for Congress to foster a more competitive environment, what would those suggestions be? We want to help.

Mr. BLACKWELL. Well, I really want to mention this because I don't know if it will be mentioned otherwise. But one of the things we've got to do is level the international playing field with regard to the rights of workers. As I mentioned, Chinese workers are not just poor, and we have to find a way for the poor workers of the world to be integrated in a developing world, but the problem with China is that they're not just poor; they're oppressed. They are denied their most fundamental rights of freedom of opinion, freedom of expression and freedom of association, and they are denied those rights not just because China is an autocratic government, but because that's the key to their competitive success. They want to hold down wages in order to be able to bludgeon our companies and attract as many companies as they can to help them develop and then punish the ones who refrain from taking advantage of that.

We have got to take that oppression out of competition. The labor movement in the United States together with the labor movement internationally has called for the establishment of fundamental worker rights as a condition of international trade agreements.

Intellectual property is carefully protected in our international trade and investment agreements not because we want to take intellectual piracy out of competition. I would suggest the same is true for fundamental rights. Worker rights, human rights, are just as important as intellectual property rights, and they are no more difficult to protect.

In protecting them, we're not opposing trade; we're just trying to take human oppression out of trade. So that the workers in China can exercise these rights, form their own organizations, bargain for some of the value added, create a domestic market in China, which can absorb some of the output of China, maybe even supply a market for the United States as they develop a middle class, and relieve some of the distended pressure on manufacturers and workers in the United States from oppression in international competition.

You may not hear that from everyone and I don't know what Mr. Jones would think about that proposal. But we think that rebalancing our trade agreements is one of the fundamental conditions for making the global economy work in a way in which we can rebuild American competitiveness.

Chairman D'AMATO. Let me make just one comment. One of the great farces of the current lexicon is that we're operating in a "free trade" environment. It's a "free trade" environment, only on one side of the street, free trade on our side. The Chinese side is rigged. Well, so I mean it's only just a marquee to call it free trade. Anything goes, but anything goes with the Chinese——

Mr. JONES. Well, yes, it goes——

Chairman D'AMATO. We're not moving from free trade. We're moving toward free trade if we go to balanced trade. Go ahead.

Mr. JONES. I mean I agree with him. We ought to be demanding reasonable wages for people in these trade agreements, which we don't. One of the things we have to recognize, however, is we can't make other countries do things. It's outside of our jurisdiction.

Chairman D'AMATO. Well, there is one thing we can do because they're so dependent on our market. We can hold our market hostage to their behavior.

Mr. JONES. Well, let's go back and have a history lesson. There's a great article written about the history of trade by a guy named Al Eckes—you may have heard of him—Professor Alfred E. Eckes (Foreign Affairs, Fall 1992, Vol. 71, No. 4 "Trading American Interests.")

He talks about the whole history, how we got in this mess. It's worth reading. Professor Eckes points out toward the end of the Second World War, there is a fellow named Cordell Hull who really was an advocate of free trade—changed all the rules. And I don't agree with Hull. I think we're in this mess because free trade has almost become like an absolute truth, and you have to understand it's like any theory; it's flawed.

Now, when I go to Japan and Germany, I tell you they're reading List—did you ever hear of List—you've heard of List. But most Americans don't know who he is. He has a counterview to free trade and Adam Smith.

You can learn from all theories and then you have to be practical. I tell you it makes me very uncomfortable that we have such a dependence upon a country like China run by dictators who pay people $2 a day. I think it's incompatible for us to trade so heavily with such a country without compromising this republic.

Mr. BLACKWELL. On this question of free trade, obviously you've heard from many economists, they're very devoted to this idea, but the actual agreements that we're negotiating have nothing to do

with what comes out of economic textbooks. It takes one page to write a free trade agreement.

These aren't one-page agreements. These are agreements that are carefully crafted to serve the interest of multinational business, not achieving the goals of free trade, so there is a mismatch between the arguments for free trade which come out of textbooks and the reality of the agreements that are being put together. Look, China is an enormous country. One out of every five people on the planet is a Chinese citizen. And they need to be in the global economy.

There is no question about that, and we can't dictate domestic policy to a sovereign country, but they're joining international commerce, and there are rules of international commerce, which we decide between countries. The United States is a very powerful country. It could, if it wanted to, represent that power and negotiate rules in those agreements that allow American companies to compete and allow American workers to hold on to their jobs. That has not been the negotiating objectives of the U.S. Government at this point. That's what we need to change.

Commissioner TEUFEL DREYER. Professor Hamilton.

Dr. HAMILTON. Yes. I don't have a good answer for you. I think the answers are very difficult. What I don't think works is to try to recapture policies that worked in a different age. And you have to recognize that the world's economy is, is the way it is, and it has an inertial force to it, and you're not going to stop that easily, but I do think Mr. Blackwell's point is correct; that you need to enforce worker rights, you need to enforce intellectual property, and you need to make sure that the companies that are infringing those rights are called to account. Maybe it's not the American merchandiser that's in violation, but another firm down their supply chain. Still, some consequence for violating rights should be felt up the supply chain.

I think there has to be some way to enforce standards that come with the WTO, for instance. Such standards are important. But beyond that, it's very difficult to develop policies that will in the long run harm the American economy. American firms, and indeed, the American economy is captured, if you will, by the global economy.

Commissioner TEUFEL DREYER. Thank you.

Chairman D'AMATO. Commissioner Mulloy.

Commissioner MULLOY. Professor Hamilton, I hope that the presentation you made and the charts that you used, can you leave those or can we have those submitted for the record?

Dr. HAMILTON. Those are the in the paper that I submitted.

Commissioner MULLOY. That would be very helpful. We watched the film put out by Frontline on "Wal-Mart: Is it Good for America?" After watching that, and being aware of what Mr. Jones said that the American standard of living is no longer increasing rapidly, at least for the vast bulk of the people. It's increasing rapidly for a group, but not for the vast bulk.

I was reminded of "It's a Wonderful Life," Jimmy Stewart; remember? I think this is what is going on. We are moving from a Bedford Falls economy where people benefited and we were taking care of our people, and they were taking care of themselves and

could raise families and improve the culture, we're moving towards Potterville, where he was the banker who was making all the——

Dr. HAMILTON. Oh, yes.

Commissioner MULLOY. And wealth was more and more concentrated, and the average person was losing out and being driven down both culturally and economically. I see that going on in this country right now.

This Commission has been really very helpful in helping me understand what's really going on. But I didn't quite understand the role of the Wal-Marts and the big box guys.

Dr. HAMILTON. Right.

Commissioner MULLOY. But it's so clear now as you put this together, and your testimony is very helpful, about how they don't pay their people a lot in these stores. Their people then go to emergency rooms and other places to get their medical care.

Mr. JONES. We're paying for that.

Commissioner MULLOY. Yes, exactly.

Mr. JONES. The Chief of Staff at Northwestern Hospital is a friend of ours, and he said, well, you know what happens? They don't have much coverage, so when they blow through it, we still take care of them. We roll that into overhead and you who are a good-paying customer—I mean we have good benefits for health care—we're subsidizing it.

Commissioner TEUFEL DREYER. Yes.

Mr. JONES. If you understand what I mean. General Motors is the canary in the mineshaft, if no one has noticed that we have a health crisis on our hands as well.

Chairman D'AMATO. The Maryland General Assembly, of which I was a member, passed legislation this year that didn't mention Wal-Mart, but the effect was to force Wal-Mart to pay its employees health care, and the Governor of Maryland just vetoed that bill. And that's going to be overridden by the General Assembly, in my opinion.

But that's where we're at, that government is trying now to force companies to do what they should have done in the first place.

Mr. BLACKWELL. It's not just governments that have to pay for it. It's also workers. Wal-Mart selects employees based on whether their spouse has health care coverage or not, so many of these people are covered by plans that are negotiated by our unions for their families and end up subsidizing the people that go to work for Wal-Mart, but this is an important point if you're looking for ideas for Congress. The fact that our manufacturers cover as much as health care costs as they do places them in enormous competitive disadvantage. I think it's over a thousand dollars in every American car that's produced is for the health care benefits of those workers and retirees.

We have 43 million people without any health care insurance. And the unions are definitely going to defend health care insurance for our members, but that is an enormous competitive problem that needs to be fixed at the national level. We spend more per capita in absolute dollars for health care than any nation on the face of the globe and we still have 45 million people with no health care coverage. We've got to fix this system as a part of our strategy for restoring U.S. competitiveness.

Commissioner MULLOY. Dr. Ralph Gomory was here yesterday and had some very interesting testimony. He's the President of the Sloan Foundation, and told us that we can't accuse the multinational CEOs and people like that and their allies of having the national interests in mind. They are being driven by other forces.

So he said you want to understand that. We've invited major CEOs to come to hearing, they don't want to come. So my worry is that this has to be changed or we're going in the wrong direction. But part of the people who are being driven out of business, the small manufacturers that care about the community, they're being driven out and there is a political force being weakened. Where is the political strength going to come from in order to change this downward spiral that the economy is in.

Now, Mr. Jones, you were asked international strategy or ideas. You don't have to submit those now, but over the next month, if you have people that you're working with that can give us some clear ones, we'll try and pull that together because that's what we're trying to do now is saying, well, this isn't just China. There are things that we have to fix here and should be fixed and that's what we're trying to spell out for ourselves now.

Professor Hamilton, you've done some very good work in helping a key piece of this puzzle become clear. So I thank you for it.

Dr. HAMILTON. Thank you.

Chairman D'AMATO. Yes. Vice Chairman Robinson, I think, had a follow-up.

Vice Chairman ROBINSON. Well, I must say that this may be the most downcast I've felt since arriving in New York, and I think that's a function of the candor and the vision that's on display in this panel. I don't think there is anywhere near an adequate recognition of the stakes that Mr. Blackwell has so vividly outlined for us. That is to say the scale of this predatory threat to our manufacturing base, our workers' well-being and the economic destiny of the United States. I think that it's only going to accelerate if it's not corrected.

I've had the good fortune to be a colleague of Commissioner Mulloy now for nearly four years, and I'll certainly remember his reference to Bedford Falls and Pottersville as one of his finest moments.

The fact is that we weren't going to WTO dispute settlement process until the Administration had its hand forced on semiconductors, and, as you know, we received a satisfactory outcome. But on intellectual property rights there is no excuse for non-action. Currency manipulation, also no excuse. Whether it's Wal-Mart, K-Mart, Goldman Sachs or Morgan Stanley, these and other firms that are prospering in China, for one reason or another have traditionally had an inordinate amount of stroke and influence with the executive branch, whichever party had the White House.

That's just the way it is. Throw in the war on terror and China's hoped for, but to date fatuous, cooperation on the North Korean nuclear crisis, and you witness punches being pulled in the trade and currency portfolios on a wholesale basis. The hope is presumably that we'll have some bigger geopolitical windfall realized from this grand strategy. That has not yet happened in the view of most

Commission Members on a bipartisan basis. I believe that these bilateral issues have to be dealt with on their individual merits.

We're trying these different strands of the bilateral relationship in this panel. I'm grateful for all of your testimony and the thoughtful answers to our questions. I can tell you that I'm more persuaded than ever that this exercise, for better or worse, will likely fall to the Congress, despite the limitations of Capitol Hill trying to micromanage trade and foreign policies. In short, the Executive Branch often needs to feel the heat in Congress before it takes appropriate, usually overdue, action. But, that said, the other policy players toward China that are only now taking the field are state governments, state legislatures, and universities. We see them getting more active in a number of areas, including divesting Chinese companies, notably PetroChina in their pension system or endowment portfolios that are doing business in Sudan and other terrorist-sponsoring states. It's akin to the South Africa apartheid days.

The point is that disciplining our relationship with China is going to require a sizeable grass-roots dimension. You may remember that in response to the Hainan incident, when China held our military personnel, average Americans spontaneously started to fill their Wal-Mart and other shopping carts goods made in China only to leave the entire shopping cart at the checkout counter with words to the effect that this is what I would have purchased had these items not been made in China, and walked out. Well, not surprisingly, that got the attention of the Chinese. As I recall, it was only a few days later after this Wal-Mart/K-Mart story made the front page of the New York Times, that our service men and women were released. Ironically, this case of retail activism may have had as great an impact on Beijing as our President and Secretary of State in resolving this serious incident. In any event, we are impressed with the urgency of these challenges and we believe that the stakes are as you have outlined them. We simply have to redouble our efforts because these issues are not going to wait another three to five years.

Chairman D'AMATO. Thank you, Vice Chairman Robinson. Let me just say many of us have had long experience in the Congress. Your hope is with the Congress. The lights are going on in the Congress, in my opinion. If you just look at the vote that occurred on very, very extreme measure, the Schumer bill on putting a 27.5 percent tariff on all Chinese goods as long as they don't fix their currency levels. That legislation got 68 votes. It wouldn't have gotten four votes three years ago.

So the lights are going on. The only question is whether or not we can manage the stampede as it starts. I have two quick questions. I know Commissioner Mulloy also wants to. When is your book coming out, Professor Hamilton?

Dr. HAMILTON. It should be out in November or December. If you want a manuscript, I can send it.

Chairman D'AMATO. Let me ask you, Mr. Jones, your Business Council, the Business and Industry Council——

Mr. JONES. Yes.

Chairman D'AMATO. Have you developed a series of recommendations?

Mr. JONES. Yes, we can send that to you.

Chairman D'AMATO. Yes, we'd like to do that. Has that gotten around to the Congress? Have you gotten that around to your Members?

Mr. JONES. Oh, sure. We've been talking to Members of Congress, Democrats and Republicans.

Chairman D'AMATO. Yes. We'd certainly like to see it.

Mr. JONES. The lights are going on.

Chairman D'AMATO. Yes.

Mr. JONES. They're far more receptive than they were four years ago. That's for certain.

Chairman D'AMATO. Yes.

Mr. JONES. And I'd encourage Mr. Robinson a little bit. There's an old saying in the scripture, "When there is no vision, the people perish."

Chairman D'AMATO. That's right.

Mr. JONES. But I think this is a great country and we'll get a vision, and as you said, it's difficult. These are difficult problems.

Chairman D'AMATO. Right.

Mr. JONES. But you think of examples of leadership in our history, you can take a Democrat FDR in a difficult time. Some of it is recognizing we have a problem and trying things. Some initiatives will fail, but I think you have to step up and try. Ronald Reagan is another example of that on the Republican side, and I think it's going to take the Congress in this case to start to lead and try some things.

Chairman D'AMATO. Yes.

Mr. JONES. That may be unconventional even or considered unconventional.

Chairman D'AMATO. Well, it's an unconventional situation we're in.

Mr. JONES. Yes, it is.

Chairman D'AMATO. Yes. Commissioner Mulloy.

Commissioner MULLOY. Professor Hamilton, in the program about Wal-Mart on Frontline, they pointed out that Wal-Mart has a very close relationship to China, and my understanding was not just to China but also to the Chinese government.

Dr. HAMILTON. Right.

Commissioner MULLOY. Do the Chinese see how this system is working and how it's benefiting them and do they nurture that? The reason I'm asking, Wal-Mart knows they have a problem politically. They've opened a new big Washington office now and are pumping money into lobbying, et cetera.

So it would be helpful for us to know, do you think the Chinese government has a very close relationship with that company? And who in that company?

Dr. HAMILTON. I have no firsthand information who they talk to in the Chinese government, but any big firm that takes a huge role in China has to have a close relationship with the government.

With Wal-Mart, the Chinese government knows exactly what is happening. They're allowing Wal-Mart to open up their domestic market. This is something I hoped that I would have a chance to talk about. Wal-Mart is playing both sides of the market. They're both organizing their supplier networks in China in a very big way,

but they're also opening up the domestic Chinese consumer market. The Chinese government has given them permission to do this; Wal-Mart has to have very high level contacts there.

The Chinese government has given them permission to spread Wal-Mart stores everyplace in China. They're opening dozens of stores a year. It will go up to hundreds of stores, and they're using the same strategy, the Greenfield strategy of opening stores in less developed markets, in out of the way cities, just the way they did in the United States. The problem with the Chinese domestic market is that the logistics system is very poor. Wal-Mart is going to create a logistical systems in the heart of China, in the Chinese domestic market, and when they do this other Chinese retailers will go in a well. I understand that Wal-Mart has agreed in principle to sell primarily Chinese goods in these stores.

Commissioner TEUFEL DREYER. Which it already does.

Dr. HAMILTON. Which it already does. But, in other words, they're going to be an engine of the Chinese economy to open up consumer markets and to continue the expansion of the Chinese economy. There is a danger to the U.S. economy in these actions. When the Chinese no longer need our domestic markets, our currency situation may become worse.

Commissioner MULLOY. Yes, thank you, Professor.

Chairman D'AMATO. Are there any other questions?

Commissioner TEUFEL DREYER. I'd just like to ask Mr. Jones to tell us which of the two bills was counterfeit.

Chairman D'AMATO. Yes.

Commissioner TEUFEL DREYER. Was it the one with the little red markings on the back?

Mr. JONES. No, that's a real note.

Commissioner TEUFEL DREYER. That's the real one. I could not tell.

Mr. JONES. This is the counterfeit. But what we do right now because of a lack of coordinated policy, when we get a call from a commercial bank overseas, they have to turn these into the Secret Service, which is a good thing. We support the policy. But because we don't have a coordinated program, we dispatch our engineers to that country to look at the counterfeits because they change from time to time, and you have to update the equipment.

So we have to go there on the spot, do it and then return home, and the next day the banks turn it in to the Secret Service. But if we had a coordinated policy, for instance, with the government, actually it would make sense that we would be authorized to take some of those counterfeit notes back to our facilities in Chicago, study them in greater detail, and then turn them into the Secret Service and also report to the government from time to time where we see counterfeits flowing.

For example, the European manufacturers are doing that with the European Central Bank. There is another thing. The European manufacturer that supplies the Fed with their sorting equipment also, when the euro was designed five years ago, the European manufacturers I compete with were put on a committee with the European Central Bank to design the euro. We found out about it and Tom Ferguson thankfully wrote a letter—he's the head of the Bureau of Engraving and Printing for the United States—let

Cummins participate. The European Central Bank said Cummins can't participate, national security issue.

A year before the euro comes out, the French banks, the German banks, make your bid for Cummins equipment, and by the way, can you do the euro? I said I can't. We were denied access to the committee. And they won't let us look at the euro till six months before it's released. The European Banks said, well, you got great stuff, but I'm not buying from Cummins because the European manufacturers can certify they can handle the euro, in fact, they helped design it.

Furthermore, my competitors in Europe got contracts from the European Central Bank to print the euros. It would be tantamount to the United States government giving Cummins a contract to print half the currency and design it.

This is the real world. This is how things work. So the European company supplying the Federal Reserve with their scanner/sorters at the 12 central banks is running around the rest of the world saying we have a better system with the euro. We have a coordinated program. We work with the European Central Bank. Don't forget the more euros that are printed and displace the dollar, the more money this European manufacturer will make. So the fox is in the henhouse at the Federal Reserve.

Now, 15 years ago, a company in Texas made all the equipment for the Federal Reserve. And the lobbyists that came with the Treasury to the testimony I gave to Small Business on domestic procurement work for this European manufacturer. Now, there's tension going on in the Treasury because you have, and I love economists, but the guys in charge of policy at the Treasury, they don't want to deal with this national security issue and they're driving policy. This drives the Secret Service people crazy.

The Secret Service came to visit our facility and they were like in Toyland; they can't believe some of the stuff we have that they'd like to be able to use. And they can see how what we have is a very effective technology, like if you're fighting a war, it's out there on the frontline. What the Fed has back in the 12 Reserve Banks in the United States does not do us much good with what's happening in the border countries of China and how the counterfeits are flowing from North Korea to the Middle East. This is not rocket science.

Chairman D'AMATO. One of the North Koreans main exports is counterfeit money, as I understand.

Mr. JONES. You have to understand that for six or seven years, we've been trying to tell the Treasury we see these counterfeit current flows.

Chairman D'AMATO. And you're saying that the lights aren't on in the Treasury about getting a handle on this problem.

Mr. JONES. The lights are not on in the policy area of the Treasury, the people that control policy. The lights are on in the Secret Service.

Chairman D'AMATO. Yes.

Vice Chairman ROBINSON. Are they printing dollars?

Mr. JONES. Who?

Vice Chairman ROBINSON. The North Koreans?

Chairman D'AMATO. Oh, yes.

Mr. JONES. Absolutely.

Vice Chairman ROBINSON. And the counterfeiting is high quality?

Mr. JONES. Absolutely. And in closed session I could tell you all sorts of things about it.

Chairman D'AMATO. We may do that.

Vice Chairman ROBINSON. Yes.

Commissioner TEUFEL DREYER. What is the provenance of the counterfeit bill that you have? Where does it come?

Mr. JONES. In a closed session, I could tell you exactly where this came from. I could tell you how we find this particular one. But I think to make it public helps the bad guys. Do you understand what I mean?

Chairman D'AMATO. Yes.

Commissioner TEUFEL DREYER. Okay. Fair enough.

Mr. JONES. Without being too specific.

Chairman D'AMATO. We can make an arrangement. We'd like to do that. If there are no more questions, this will conclude this panel and I want to give a special thanks to all of you for very, very important testimony.

Dr. HAMILTON. Thank you.

Chairman D'AMATO. Thank you. We'll take a five-minute break.

[Whereupon, a short break was taken.]

Chairman D'AMATO. The Commission will reconvene our last panel of this two-day hearing. Our concluding panel will focus on how U.S. tax policies, and this is the first time in four years this Commission has focused on tax policies, and we intend this to be the opening gun in a series of roundtables that we're going to have in Washington. I worked for Abe Ribicoff on the Finance Committee when Russell Long was Chairman, and if you want to see the way power is properly used in Washington, you might spend a couple days with Russell Long and you'll wonder what's going into that tax code, what's going on and why it's going in there.

In any case, we will be focusing on how U.S. tax policies affect trade and economic flows, particularly those policies dealing with taxation of income earned by overseas subsidiaries of U.S. firms. The panelists have been asked to discuss what elements of current U.S. tax law provide incentives or disincentives for corporate decisions regarding overseas production versus domestic production and how potential proposals for reforming current laws would affect this dynamic.

We have with us from left to right, Dr. Gary Clyde Hufbauer, Reginald Jones Senior Fellow at the Institute for International Economics. Dr. Hufbauer served as Deputy Assistant Secretary of the Treasury for International Trade and Investment Policy during the Carter Administration and has focused much of his work in recent years on international trade, investment and tax issues.

Next is Professor H. David Rosenbloom, Director of the International Tax Program at New York University Law School, and a practicing tax attorney with the firm of Caplin & Drysdale Chartered. Professor Rosenbloom previously served as International Tax Counsel, Director of the Office of International Tax Affairs at the U.S. Treasury Department.

And last, Mr. David Tillinghast is a Senior Partner in the New York office of the law firm Baker & McKenzie. His practice at the

firm focuses on representing U.S. and foreign businesses with cross-border transactions including tax planning, mergers and acquisitions, restructurings, joint ventures and financings. He is a leading lecturer and writer on international tax matters. We welcome all three of you.

The way we'll do this is go one after the other, seven or nine minutes or so of your oral testimony. Your written testimony will be in the record as you've prepared it, and then after the three of you have made your presentations, we'll go for questions and answers. So if you would proceed, Dr. Hufbauer.

PANEL II: TAX POLICY IMPLICATIONS

STATEMENT OF GARY CLYDE HUFBAUER
REGINALD JONES SENIOR FELLOW
INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, D.C.

Dr. HUFBAUER. Well, thank you very much. I can see this is the end of a very long two days for the Commission so we must have come to taxes to wind it up, and you are to be applauded for your endurance of two days of straight hearings which I know is just a portion of your very large agenda.

Chairman D'AMATO. We've saved the most exciting for the last.

Dr. HUFBAUER. Hard to believe. Well, tax competition matters. Firms shop their location decisions as you well know between states, provinces, and between countries. Estimated tax response coefficients are much higher today than they were 30 years ago. That reflects I think, both a higher actual response and better estimation techniques.

But today it's roughly estimated that a five percentage point difference in corporate tax rates may translate into a 15 percentage point change in the direct investment stock in a country after controlling for all other factors that one can control for.

Well, countries, provinces, states have responded to this reality by cutting their corporate tax rates. Twenty years ago, the United States was a low corporate tax country within the OECD. That was after the Reagan tax cuts, the 1981 tax cuts. Now, it is a relatively high tax country in terms of the marginal rates that shape business decisions. Meanwhile, if you take this 20-year period, new players, foremost China, have entered the international business arena.

Usually if one looks across the tax practices of the new players, they are very favorable in attracting business firms to locate there.

Now, 15 years ago or so, the way the United States taxed the foreign operations of U.S. multinationals was an important handicap and a colleague of mine and I wrote a book on this subject. It was an important handicap by comparison with British, Japanese, French and other practices within the OECD countries.

I don't think that's any longer the case and it's largely because of self-help. Multinationals have gotten very adept at reducing their tax burden on their overseas operations. The effective rate today is perhaps in the range of two to three percent U.S. tax on remitted income from repatriated income from foreign operations.

Now, the natural reaction to looking at this history might be to say, well, let's tax the rascals, especially if they're doing business in China, India or wherever. My view is that U.S. legislation that

would reverse the developments of the last 15 or 20 years or so by significantly raising U.S. taxes on the foreign operations of U.S.-based multinationals would do little to change the competitive picture that we as a country face.

And the reason is pretty straightforward. U.S. firms are less than a quarter of multinational production, and if you took total production including medium and smaller-sized firms, they are much less. So if we tax much heavier than we do, that doesn't mean we can't tax a little heavier, but if we tax much heavier than we do, other firms would rush in, and we heard some of that in the previous panel where there is a lot of talk about contract manufacturing.

And to zero in on China, the U.S. investment in China is under $20 billion, at least the statistics I've seen, and the total stock is around $200 billion. The U.S. is not a big investor in China—Taiwan and Hong Kong were mentioned—other countries, but we do a lot of contract manufacturing, various joint ventures and so forth, and if we were to tax more heavily our investors, the form would change but the competition would not significantly change.

So I would regard that as a possible response. I would put it in the category of a "feel good" tax policy and not what I would recommend. Before I conclude that point, let me just hasten to say that if we're only in the business of marginal changes, which is maybe all that this country is in the business of doing, then I am very sympathetic to the line of analysis that my colleagues on this panel, David Rosenbloom and David Tillinghast will be talking about later. They have very sensible approaches, but I would put them in the moderate or small change and not really addressing the big competitive challenge that we face today from China and in the future from India.

Now, the main U.S. burden, to recall Shakespeare, is not in our stars but in ourselves. We cannot do without business taxation in light of our fiscal problems, and our fiscal problems, as everyone knows, will be growing worse in the decade ahead because of our entitlement system.

We need business taxation to collect and remit funds to the Federal Government. But, of course, this could be done in a far less destructive manner than it is currently done, and when I say destructive, I'm not referring to the overseas part of the story. I'm referring to what we do here in the United States to our firms and, Mr. Jones of Cummins-Allison told the story briefly, and I fully subscribe to the sentiments he expressed.

So, in the written submission, which you have, you have seen or will see that we advocate a switch to a subtraction method, VAT. And I know that there is a lot of allergy to this. I've been in this tax business for nearly as long as my colleagues, though not full time the way they are. And I know all the allergies and objections, but consider this: we are the only major country in the world today without a VAT.

Chairman D'AMATO. Without?

Dr. HUFBAUER. Without a value added tax system.

Chairman D'AMATO. Yes.

Dr. HUFBAUER. As a principal revenue source. We're the only OECD country, but even if you take these emerging countries in-

cluding our two immediate neighbors, Mexico and Canada, they rely to a much greater extent on essentially broad-based consumption taxes than we do.

The basic idea, if we're going to focus in on China, of a value added tax approach is that in international competition with China or any other country is that Americans would pay the tax when they purchase goods or services from foreign suppliers, whether they be U.S., whether they are Wal-Mart goods that we were talking about earlier, or whether they were goods supplied by Unilever or whomever, including Chinese firms coming into the U.S. By the same token, U.S. firms that are producing in this country like Cummins-Allison and others, when they sell abroad, they would not be paying U.S. corporate tax on those, and the value added tax would be remitted.

So our basic proposal is to substitute the value-added type of tax for the current corporate tax, and I realize the time is not right here in the United States for that. But I believe this is the core of our tax problem in terms of our competitive position globally and specifically with respect to China. If we went in this direction, it would strengthen the level playing field both on the import side and the export side because U.S. firms would be paying the same tax as their foreign competitors and abroad. U.S. exports would be taxed as their local competitors are taxed.

Let me just add a point about efficiency which is always a dear subject to economists. The distinguished economist Dale Jorgenson together with Mr. Yun have done quite a detailed estimate and sophisticated econometric estimates of the efficiency burden that different kinds of taxes impose upon the economy. I get into it a little bit more in the summary and quite a bit more in the book that we are writing.

But here is a figure that I think is easy to carry away, and that is that the corporate tax as presently structured has an efficiency cost of 24 cents per dollar of revenue, 24 cents out the window because of all the waste that's created and the distortions that are created by it.

By comparison, a broad-based tax, and I would include retail sales taxes, value added taxes in various forms, their efficiency cost is about six cents a dollar of revenue. It's just much lower, and when you capitalize that difference over a period of time, the figure in present value terms is in excess of $800 billion. It's a major feature in terms of a drag on our economy.

Thank you very much.

[The statement follows:]

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Comprehensive Reform for U.S. Business Taxation [1]

Introduction: Globalization and Tax Competition

Political leaders have long accepted the proposition that investment location and business activity are, to some degree, motivated by tax considerations. As globalization has enhanced international competition, the United States has gotten more concerned about the contest for business investment—not because more investment abroad is bad for employment at home, but rather because more investment at home is good for raising productivity. While corporate taxes are certainly not the only consideration driving investment and location decisions, they are important.

In the 1980s, after the 1981 Reagan tax cuts, the U.S. corporate rate was lower than most of its industrial competitors—primarily Canada, Europe and Japan. Since then, many OECD countries have slashed their corporate tax rates and introduced new incentives, such as rapid depreciation. Moreover new industrial competitors have emerged—China, Korea, India, Mexico, Brazil, and others. While some of the new competitors have high statutory tax rates, their effective tax rates are often much lower—through tax holidays, special credits and deductions, and lenient enforcement.

By the late 1990s, the average effective foreign corporate tax rates actually paid by foreign affiliates of U.S.-based MNEs were considerably lower in a number of countries than the average effective (Federal plus state) corporate tax rate paid in the United States. This was true not only of traditional low-tax countries, such as Singapore, Hong Kong and Ireland, and tax-haven countries, such as Bermuda, Netherlands Antilles, and the Cayman Islands, but also of major industrial competitors, such as France, the United Kingdom, China, Taiwan, Mexico and Brazil.

The upshot, two decades after the Reagan revolution, is that the United States has become relatively less attractive from a tax standpoint. In his analysis of 59 countries, John Mutti found that, in the period 1984–92, some 20 countries had lower effective corporate rates than the United States, and 39 had higher rates. However, by the period 1992–96, 43 of the countries had lower effective rates than the United States, and only 16 had higher rates.[2] The trend continues to this day.

To meet the challenges of a more competitive international business environment, Federal business taxation within the United States should be fundamentally reconsidered. The mainstay of Federal business taxation, the U.S. corporate income tax, is riddled with distortions and inequities.[3] As a means of taxing the richest Americans—a popular goal—the corporate income tax is a hopeless failure. Many companies pay no corporate tax, and among those that do the burden is highly uneven.[4] Under pressure from business lobbies, Congress legislates deductions, exemptions and credits that twist the corporate tax base far from any plausible financial definition and distort the structure of effective rates. Faced with a tax terrain of mountains and ravines, corporations employ armies of lawyers and accountants to devise avoidance strategies.

Reviving the spirit of tax reform debates in the 1990s,[5] we propose to *replace* the corporate income tax with a tax that has a much broader base at a much lower rate: the Corporate Activity Tax (CAT), a variant of the subtraction-method value-added tax (VAT). The CAT will immediately broaden the corporate tax base, and reduce distortions between firms and industries. As a variant form of the VAT, the CAT would be adjustable at the border, and for this reason as well would improve U.S.

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[1] This proposal draws on the authors' forthcoming monograph *U.S. Taxation of Business in a Global Economy*, as well as a chapter of the forthcoming volume *U.S. Taxation of International Income*, by Gary Clyde Hufbauer and Arial Assa, both to be published by the Institute for International Economics.

[2] Mutti, John, *Foreign Direct Investment and Tax Competition* (Washington: Institute for International Economics, 2003), table 2.4.

[3] Among the many critics, see Pechman, A. Joesph, *Federal Tax Policy*, 4th ed. (Washington DC: Brookings Institution, 1987).

[4] See Government Accountability Office (GAO), Comparison of the Reported Tax Liabilities of Foreign- and U.S.-Controlled Corporations, 1996–2000, Report GAO–04–358, 2004.

[5] These debates are summarized in Hufbauer, Gary Clyde and Carol Gabyzon, Fundamental Tax Reform and Border Tax Adjustments, POLICY ANALYSES IN INTERNATIONAL ECONOMICS 43 (Washington: Institute for International Economics, 1996).

competitiveness in the global marketplace. To maintain the progressive character of the tax code, we include a companion measure to preserve the spending power of households at the lowest income levels.

Proposal: The Corporate Activity Tax (CAT)

The tension between fiscal demands and the competitive burden of corporate taxation requires a new workhorse for Federal business taxation. In fact, our recommendation goes further than simply adding a new tax. Instead, we suggest *replacing* the current corporate income tax—with its multiple loopholes and jagged profile—with a relatively flat business tax.[6]

Following the footsteps of Senator William Roth (R–DE) and Representative Richard Schulze (D–PA) in 1985, Representative Sam Gibbons (D–FL) in 1993, and Senators John Danforth (R–MO) and David Boren (D–OK) in 1994, we recommend a subtraction-method value-added tax (VAT) as an alternative template for U.S. business taxation.[7] Our proposal is a corporate activity tax (CAT) broadly structured to include labor, capital and technology income in the tax base.

CAT Collection

The CAT is designed to apply to medium and large corporations, those with annual receipts of about $10 million and more. The number of such firms in 2000 was around 131,000. To be conservative, we estimate that the number of firms subject to CAT liability—in other words, the number of tax collection points—would be around 200,000. This number is a small fraction of total taxpaying business entities (about 24 million). We propose to retain the distinction under current law between taxable firms (normal Subchapter C corporations) and pass-through firms (Subchapter S corporations, partnerships and proprietorships). Under current law, business entities that are organized as Subchapter S corporations, partnerships or proprietorships are not taxed on their business income. Instead their income (or loss) is attributed to their owners and taxed as individual income.[8]

CAT Tax Base

The CAT is a broad-based consumption tax assessed at the business level. The CAT tax base would be domestic sales of goods and services (with exceptions for capital and technology income noted below) minus purchases from other U.S. firms, *but only if the vendors are subject to the CAT tax*. Purchases of raw materials, utilities, components and inventory from U.S. firms subject to the CAT would all be eligible deductions. So would purchases of equipment and software—the functional equivalent (under the present corporate tax law) of immediate expensing.[9] However—and this is important—purchases from U.S. firms not subject to the CAT could *not* be deducted by firms subject to the CAT. In this way, the CAT would be indirectly collected on business-to-business sales from pass-through firms (mainly small firms) to large firms, because large firms would include such purchases in their CAT base.

Since the CAT is a value-added tax, it would be adjustable at the border: exports of goods and services would be exempt, while the tax would be collected on imports of goods and services. The employer's portion of Social Security taxes (currently 6.2 percent) and Medicare taxes (1.45 percent)—essentially business taxes on the use of labor inputs—would be credited against the CAT.[10] However, no refund would be permitted for excess credits. The rationale for the credit mechanism has three parts: first, not to disturb time-tested arrangements for financing Social Security and Medicare; second, not to discourage employment; third, to ensure that payroll taxes are collected on U.S. exports, even when no CAT is collected.

Table 1 illustrates the base to which the CAT would apply. By taxing only medium and large corporations—and therefore reducing the number of collection

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[6] Our proposal does not include changes to the individual income tax. It could be implemented either as a stand-alone plan or coupled with personal income tax simplification. In table 2 below we estimate a revenue neutral rate, as well as a revenue positive rate that could offset losses from reform of the individual income tax, such as reform of the alternative minimum tax (AMT).

[7] Charls E. Walker, a Deputy Secretary of the Treasury during the Nixon Administration, was the intellectual father of the business transfer tax (a version of the subtraction VAT), and largely responsible for sparking reform in the 1980s and early 1990s.

[8] Pass-through firms would calculate their profits and losses as under current law, but reformed (if possible) so that taxable income matched financial income under generally accepted accounting principles (GAAP). In 2000, there were 4.9 million corporations with receipts less than $10 million; in addition, there were 2.1 million partnerships and 17.9 million nonfarm proprietorships.

[9] Consequently, firms would not be able to deduct depreciation of equipment from the CAT base.

[10] The Social Security tax is assessed on each employee's compensation up to $90,000, while the Medicare tax is uncapped.

points—the CAT avoids many of the evasion and enforcement problems of other consumption taxes. Elements of the estimating process, spelled out in table 1, track the basic features laid out above.

CAT Tax Rate

The CAT would be assessed at a single rate. In table 2, we use the base summarized above to calculate rates required to meet two revenue goals (based on 2000 data): replacement of the Federal corporate income tax with the CAT, and raising business tax revenue by about $200 billion, to reach a total of $400 billion. According to these calculations, a revenue neutral rate would be 7.8 percent; the rate required to raise an additional $200 billion would be 11.6 percent. Our calculated rates make provision for the amounts required to alleviate the tax burden for all households up to the poverty line for household income (as described below). Corporations subject to the CAT would be allowed a tax credit to cover the employer share of Social Security and Medicare payroll taxes.

Impact of Proposal Relative to Current System

Domestic Efficiency

The more jagged the tax profile as between firms and industries, the greater the extent of economic distortion. One reason is that too few resources are committed to heavily taxed sectors (or firms), and too many resources are committed to lightly taxed sectors (or firms). Another reason is that executive and professional talent gets spent lobbying for and seeking out tax shelters. These forces ensure that the corporate tax burden differs greatly between firms and industries. Replacing the corporate income tax would immediately compress the variation of tax rates across industries and contribute to economic efficiency.

Jorgenson and Yun (JY, 2001, table 7.10) estimate that the *average* efficiency cost for the corporate income tax is 24.2 cents per dollar raised when compared to a "hypothetical, non-distorting" tax.[11] According to the estimates presented by JY, the average efficiency cost of a consumption tax with a rate of 15 percent is about 5.5 cents per dollar.[12] Based on these coefficients, replacing the corporate income tax with a consumption tax would save about 18.7 cents per average dollar of revenue collected (24.2 cents minus 5.5 cents). In 2000, the Federal corporate income tax collected $208 billion, so the efficiency gain of switching from corporate income tax to a less distorting consumption tax would be on the order of $39 billion annually. Capitalizing this annual efficiency savings over an infinite time horizon at a 4.45 percent discount rate (the rate used by JY) indicates that the present value of the switch is roughly $876 billion.

International Competitiveness

Unlike the corporate tax, which discourages inward foreign investment, the CAT would not penalize corporate activity within the United States both because the incidence of the CAT is expected to fall primarily on consumption, and because the CAT is adjustable at the border.[13]

Econometric estimates suggest that 5 percentage points of corporate taxation depress the inward foreign investment stock by about 15 percent. Estimates of this tax response (here three-to-one) have increased over past decades and are likely to increase further as global economic integration proceeds. Even at a three-to-one coefficient, the United States would attract a substantial amount of inward foreign di-

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[11] Jorgenson and Yun estimate that the *marginal* efficiency cost of the corporate income tax is 0.279. In other words, the final dollar of revenue collected via the corporate income tax places a burden of 27.9 cents on the economy above and beyond the dollar of collected revenue. As the amount of revenue rises, the marginal efficiency cost of the tax increases. Jorgenson, Dale W. and Kun-Young Yun, *Lifting the Burden: Tax Reform, the Cost of Capital and U.S. Economic Growth* (Cambridge, MA: MIT Press, 2001).

[12] One reason for using the 15 percent consumption tax figure is to incorporate state and local sales tax rates, which JY estimates to be 5.5 percent on average. Our rough estimate of efficiency cost is based on marginal rates of efficiency cost for a consumption tax simulation presented in JY (2001, table 8.12a).

[13] As the eminent scholar Arnold Harberger notes, in contrast to the corporate income tax, the tax wedge caused by a VAT works its way through the economic structure via prices paid by consumers. Harberger adds that this does not mean that a VAT has no effect on factor prices, but concludes that "the rise of the [factor] price is basically sufficient to cover the value added tax and what happens between wages and net returns to capital [as a result of imposition of a VAT] is a sort of a secondary story, not the primary story." (Harberger, Arnold, Corporate and Consumption Tax Incidence in an Open Economy. American Council for Capital Formation, 1994, http://www.accf.org/publications/reports/sr-corpconstax1994.html, accessed March 12, 2005).

rect investment by replacing the corporate income tax with a CAT. This should be seen as a very welcome development.

Repeal of the U.S. corporate tax would certainly be a bold step. However, it represents the end stage of the trend of tumbling corporate tax rates among OECD countries, a process that has now put U.S. firms at a competitive disadvantage vis-à-vis their foreign competitors. After the 1986 Tax Reform Act, the U.S. statutory rate remained approximately constant at 35 percent (40 percent including state corporate taxes), until the passage of the American Jobs Creation Act of 2004 (AJCA). The AJCA will eventually cut the Federal U.S. corporate tax rate, for qualified activities, to 32 percent. Meanwhile industrial countries abroad have cut their statutory rates, and emerging nations (such as China and India) often have special exemptions and lax enforcement.

By contrast with the corporate income tax, the CAT would be fully adjusted at the U.S. border, in compliance with WTO rules: the tax would be imposed on imports of goods and services and exempted on exports. By eliminating any tax advantage from producing overseas and then selling the goods and services in the U.S. market, the CAT would put an end to the debate over offshore outsourcing for tax reasons, whether blue-collar or white-collar. An important sub-theme of U.S. economic competition with China is the difference in corporate taxation. The best way to address this difference is not by expanding Subpart F to reach deferred profits lodged in Chinese subsidiaries, but by wholesale reform of U.S. taxation of business done in the United States. That way, whether goods and services are made in China or India or anyplace else, when sold to U.S. residents they will pay the same tax rates as U.S.-made goods and services.

Fairness

Progressivity is a political requirement of the U.S. tax system. While it is possible to create a progressive system of consumption-only taxation, it is easier to ensure that a hybrid system of consumption and income taxes will be progressive. Introduction of a broad-based Federal consumption tax as a substitute for *both* the corporate and individual income taxes would be widely characterized as regressive, since the share of income spent on consumption tends to fall as income rises. To the extent that shifting the tax burden from the rich to the poor is seen as unfair, so instituting a full replacement VAT or national sales tax will be politically difficult.[14] Under our hybrid proposal, we address the regressivity problem of consumption taxes by collecting sufficient revenue so as to rebate the tax on the initial dollars of household outlays; the rebates could be administered through the individual income tax system.[15] In table 2, we set aside enough annual CAT revenues to rebate CAT payments to all households for purchases up to the poverty line, thereby ensuring a progressive structure overall.

Simplicity

U.S. taxation of corporate earnings currently entails a complex two-tier system. Earnings are first taxed at the corporate level, and subsequently at the shareholder level, as shareholders receive income in the form of dividends and capital gains (on the sale of shares). In 2003, the Bush Administration reduced the tax rate on qualified dividend received prior to 2009—and extended the new lower rate of 15 percent to capital gains. These measures temporarily alleviated, but did not eliminate, the economic distortions associated with a two-tier system. By contrast, the CAT attacks the distortions at their root.

The CAT is designed as a response to deficiencies of the Federal corporate income tax, while focusing the collection burden on business firms rather than individual

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[14] In that respect, it should be noted that VAT systems in Europe, Canada, and other countries generally either exclude sales of food, housing and medical care from the tax base, usually by applying a zero rate of tax or by imposing a much lower rate of tax on sellers of these and other "necessities." Conventional wisdom is that such exclusions and preferences are necessary to offset the perceived "regressivity" of a VAT, based on the traditional view that the VAT's burden will always be passed forward to consumers (rather than workers or shareholders) in the form of higher prices. We reject the idea of special preferences for "necessities." When preferential rates apply to sellers of food, medical care and housing, zero or low rates apply to all sales. Consequently, a significant portion of the anti-regressivity benefit is wasted on middle- and upper-income households.

[15] While, in reality, it is the regressive or progressive nature of the tax system as a whole that should matter to taxpayers, politicians and advocates tend to fixate on the nature of specific taxes (e.g., the income tax, the CAT, the payroll tax, etc.). For this reason it would be politically imperative that a rebate be in some way visibly tied to the CAT (thereby making the CAT "package" progressive). The obvious examples of political connection are Social Security and Medicare benefits: these are visibly tied to payroll taxes (i.e., Social Security and Medicare taxes).

taxpayers. First, the CAT is designed to be broad-based, applying across-the-board to all sectors of the economy. For these reasons, it encourages more efficient allocation of resources than the corporate income tax.[16] Second, the CAT will eliminate the distortions associated with the two-tier income tax system, in which only corporate earnings are singled out for double taxation. Under the CAT, to the extent income is taxed at the individual level, no distinction would be made between wages, salaries, interest, rents and dividends.

Table 1. Illustrative Calculation of CAT Base, 2000

($ billions and percent)

Total private industry value added	8,607
Minus: Value added by partnerships and nonfarm proprietorships	(1,253)
Minus: Value added by corporations with receipts under $10 million	(1,178)
Plus: Repeal of depreciation allowances for large corporations [a]	516
Minus: Expenditures for equipment and software by large corporations	(659)
Plus: Imports of goods and services	1,445
Minus: Exports of goods and services	(1,070)
Equals: Tax base for CAT: Corporations with receipts of $10 million and over	6,408
Memorandum	
GDP in 2000	9,828
Corporate income tax revenue in 2000	208
as percent of GDP	2.1

a. A capital consumption adjustment is a negative component of private industry value added. Instead of allowing a depreciaiton deduction, the CAT will expense equipment and software in the year they are purchased.

Source: *Statistical Abstract of the United States: 2003*, U.S. Census Bureau; *National Income and Product Accounts*, Bureau of Economic Analysis; and authors' calculations.

Table 2. Possible CAT Rates

($ billions and percent)

	Replace Existing Corporate Income Tax	**Raise $400 Billion through Business Taxes**
Revenue goal	208	400
Plus payroll credit [a]	181	181
Total collected revenue	389	581
CAT rate (flat)	**6.1**	**9.1**
Plus revenue to finance progressivity [b]	108	161
Total revenue raised	497	745
CAT rate (progressive)	**7.8**	**11.6**
Memorandum		
CAT base	6,408	

a. Revenue amount required to meet revenue goal and allow $181 billion tax credit for payroll taxes to large corporations.

b. Amount of revenue required to rebate CAT rate to all households for purchases up to the poverty line. This effectively removes $1.4 trillion from the tax base.

Source: Authors' calculations.

[16] The Congressional Budget Office report "The Effects of Adopting a Value-Added Tax" (1992) simulated the effect of raising approximately $150 billion in annual revenue under two alternatives: raising income taxes as opposed to introducing a broad-based Federal level VAT. The conclusion of the study (p. 4) was that: "A broad-based VAT would allocate resources more efficiently than an income surtax, in part because it would not tax saving but for other reasons as well. First, the portion of the VAT's burden that falls on the value of existing capital, or wealth, would not distort the allocation of resources at all. Second, although a broad-based VAT would have few, if any, tax preferences to distort allocation of resources, *the current tax is replete with tax preferences, and a surtax would magnify the distortions resulting from these preferences*" (emphasis added). While the Congressional Budget Office's analysis relates to raising income tax in general, its conclusions are applicable to raising corporate income tax as well. In that regard, it should be noted that the Treasury Department estimated in a report entitled "Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once" (1992) that the increase in economic welfare from eliminating double taxation would range from 0.07 percent to 0.73 percent of annual national consumption.

Chairman D'AMATO. Thank you very much, Dr. Hufbauer. Professor Rosenbloom.

STATEMENT OF H. DAVID ROSENBLOOM
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Professor ROSENBLOOM. Thank you very much for giving me this opportunity to speak to the Commission on tax policy. Preliminarily let me say that I believe as Gary has just suggested, it is necessary to think about this subject on a broad scale before thinking about its application to China. In other words, it doesn't make sense to come at this just with respect to China as far as I'm concerned.

I'm going to start by explaining where I think we are because in discussing where we're going, it's usually a pretty good idea to know where you are. Our outbound tax policy has, broadly, two major components to it. And it's important that you understand this at some level in order to understand where I'm going with this.

On the one hand, we allow something called "deferral," and deferral has been with us forever. It's not really something that anyone sat down and decided to put in place. It's the logical implication of treating corporations as separate from their shareholders.

So if you have a U.S. shareholder, let's call it General Motors that owns stock of a foreign corporation—let's call it Opel in Germany—we do not tax currently in the United States the income of a foreign corporation. The foreign corporation is a separate entity, and if it's foreign, and it's not earning income in the United States, we will only tax that income when it's remitted as a dividend distribution to the United States unless it's paid out as a royalty to the United States. In any event, we won't tax the money until it comes back to the United States.

So deferral stands for the proposition that we do not tax controlled foreign corporations currently. That system has been with us since 1962. It came in with the Kennedy Administration, which wanted basically to end deferral and tax all controlled foreign corporations' income currently.

There was a compromise achieved in 1962 whereby we continued not to tax income currently except for certain classes of tainted income, and that's not a term in the statute. That's what people understand we designated income that we would tax currently and other income would go untaxed.

Over the years, Congress has tinkered with that system repeatedly. It has put things in. It has taken things out. The history of shipping, for example, has had more zigs and zags that I could even discuss in this testimony, just to take one example. Congress either favors or disfavors things, and the rules get very, very, very complicated. The statute is complicated. There are regulations. There's a variety of case law.

The result of deferral has been that our companies, U.S. controlled foreign companies, have accumulated large amounts of money abroad. Someone had the bright idea last year to induce those companies to bring that money home by passing what I think is popularly recognized to be an amnesty provision. They could bring the money home and it would be subject to tax at 5.25 percent instead of the normal 35 percent rate.

As I say in my testimony, Congress has sworn up and down on a stack of bibles that this is a one-time thing, but nobody I know believes that. Certainly, the multinationals don't believe that. So the net effect of the combination of deferral, plus the fact that we've started to emulate Italy in our tax policy, is that foreign income is favored over U.S. income and that is a simple fact.

The second component of our outbound policy is the foreign tax credit system, which in my own personal view is even worse than the deferral system because it is exceptionally complicated in what we give credits against U.S. tax for, imposts paid abroad. The complications are such that I think only the people who spend the money and take the time can really understand what's going on and so, as I have said, the advantages are all within the multinational community.

They understand these rules. Very few people in government do. Certainly very few people even in the Revenue Service do. And so the net effect is that the combination of these two elements, deferral and the foreign tax credit, produces a system that is just incredibly complicated, very favorable to foreign investment over U.S. investment. Without explaining it all to you, I'll just make the point that you can read the publications of the National Foreign Trade Council where they come out solidly against exemption for foreign business income.

What else do you need to know? I mean, the business community doesn't want to pay zero tax on foreign business income. That's telling you something. Okay. So what could you do? I've written on this and I've put this down in my testimony. I would allow exemption for active business income earned in our major trading partners. That would cover most of the developed world—almost all of Europe, large chunks of Asia, certainly Japan. I'd contemplate Korea. I'm not sure exactly about Korea, but a large part—probably 80 to 90 percent of our foreign investment would be covered.

But the flip side of that for me is I would propose taxing currently passive income and probably income in tax havens even if it was active. That's a debatable point. I would not try to separate out the active income in the havens and exempt it. I would go down this road no matter how many levels of corporate enterprise there are. Your know, everybody thinks about a corporation—lawyers in particular do this as though they're persons, but a corporation is just a piece of paper, and the difference between having one corporation and 1,000 corporations is basically a mouse click.

You can put in place 500 companies overnight if you want to. There are people throughout the Caribbean who will do this for you very easily, I assure you.

So I would have a pretty broad proposal, which would exempt a lot of business income, notwithstanding what the multinationals say, and would be pretty tough on passive income and probably on income in tax havens generally.

Anything along those lines, as broadly as I would go, I think is not worth debating. We're wasting our breath talking about things that ambitious in the current environment, insofar as taxes are concerned.

So I have proposed in my statement something that I think is more modest but that goes in that same direction and that I think

would be real helpful. That is to start separating out real jurisdictions from the havens, in particular. We are handicapped—we have our hands behind our back—if we approach taxation with this binary view where the United States is on the one hand and everybody else is on the other, so that we're lumping the Cayman Islands and Japan—we've got one rule for both of them.

To a layman, and certainly to me, that is a crazy way to go. Now, I will say before anybody agrees that that sounds sensible, that the OECD has tried doing this, and as in everything else in this country, lobby that would come in from the havens. You may or may not recall when Secretary O'Neill went up and testified about the harmful tax competition initiative of the OECD. I don't know whether this was on your radar screen.

But there was a lot of resistance in the name of some pretty oddball jurisdictions. And the United States criticized the OECD, and the OECD backed down because we are a big funder of the OECD. That's all history. From our parochial national interest, if we're going to do anything sensible here, we have to take the step of calling balls and strikes and basically try to separate jurisdictions where there is real activity going on for jurisdictions which are just trying to attract investment and not necessarily even active investment. A lot of multinationals succeed because of the foreign tax credit, because the credit is available to be used to shelter income, which isn't taxed abroad.

The multinationals are reasonably successful in earning a lot of income, which frankly on its own probably doesn't meet the test of competitiveness. The original Subpart F, the original anti-deferral regime, was concerned with identifying tainted income, separating out income where there was really a competitiveness concern from income where there was not.

But because of the foreign tax credit and because the rules are so complex, at this point in time I don't think the statute works very well. And we have a lot of modern techniques, what I call "international tax exotica," which the statute is not equipped to deal with. Wading into the congressional maelstrom and trying to get a rule that would adopt a purposive approach where we'd go back to 1962, I shudder to think of the fights that would go on on that issue.

But I do think that just the simple idea of trying to identify havens and separate them out from the big investment focuses makes sense, and other countries have done it.

One of the things that has happened out there is that a lot of other countries have anti-abuse legislation. Most of the developed world now does. I just have been working for example, on Australia's. They have a list of countries where, if you invest in that country, they'll tax you in Australia. This is my last point: Increasingly and somewhat surprisingly to me, in the area of international taxation, we are becoming people who learn from other countries' experience.

For years it was the other way around. But increasingly, these other countries are surpassing us in adopting intelligent policies. Thank you very much.

[The statement follows:]

Prepared Statement of H. David Rosenbloom
Director, International Tax Program
New York University School of Law, New York, New York

Mr. Chairman and Members of the Commission:

My name is H. David Rosenbloom. I am a member and Chairman of the law firm Caplin & Drysdale, Chartered, with offices in Washington, DC and New York, NY. I am also Director of the International Tax Program, a Master of Laws program at New York University School of Law.

Thank you for this opportunity to present my views on the role of tax policies in providing incentives and/or disincentives to offshore flows of trade and investment. According to the invitation I received, the Commission is interested in examining the economic theories and underpinning of the forces driving globalization and, in particular, exploring the implications of various proposals for reforming tax policies applicable to the global operations of U.S. firms.

I have worked for nearly 30 years in the field of international taxation, as a practicing attorney, a Treasury official, and an academic. The field comprises those aspects of the tax system that pertain to cross-border activities, transactions, and investment. Normally the subject breaks down into "inbound" matters and "outbound" matters—that is, transactions, activities, and investment coming into the country and transactions, activities, and investment leaving the country.

The Commission's interest is in the outbound aspects of international tax policy. Its initial focus is, as it should be, on outbound policy in general, and not as applied particularly to China. The United States has country-specific tax policies embodied in its tax treaty network but they represent recalibrations of general policies expressed in the Internal Revenue Code and operate at the margin insofar as offshore flows of trade and investment are concerned.

There is much to be said on the subject of outbound tax policy. Congress has returned to this area again and again over the past 40 years, with a view to effectuating "reform." The result has been rules of nearly impenetrable complexity studded with politically opportune rewards to specific interests of one sort or another. Few Americans, whether in Congress, the Executive Branch, or the public, have the slightest comprehension of what the rules mean, how they apply, or how much money rides on them. I do not believe the statute can withstand much more "reform" of the sort it has undergone to date.

Current law relating to outbound investment revolves around the concept of "deferral"—the lack of current taxation of foreign income earned by foreign corporations controlled by Americans. Deferral is, for all practical purposes, tantamount to exemption, since the holder of shares controlling a foreign corporation can choose if and when to repatriate earnings and subject them to U.S. tax. Prior to 2005 many U.S. controlled firms had foreign unrepatriated earnings in substantial amounts on which U.S. taxes had been "deferred" for 50 years or more.

Congress's recent decision in the American Jobs Creation Act to provide what amounts to an amnesty (in the form of a 5.25 percent tax) for these foreign earnings will doubtless produce a good deal of repatriation, but it can only reinforce the conclusion that foreign income is taxed more lightly than income earned in the United States. Congress has crossed its collective heart and sworn that it will never again do what it did in the AJCA but I do not believe them, and I do not know anyone who does. Thus, although the law has not gone so far as explicit exemption for income from foreign investment, there is clearly a strong and growing incentive favoring such investment over comparable U.S. investment.

The United States has accepted such favoritism in the name of the competitiveness of U.S. firms. We have hesitated to impose a current U.S. tax on foreign income of U.S. controlled businesses because competitors controlled in other countries may be free to earn similar income without current home country taxation. We are concerned that if we did impose U.S. taxation for the purpose of equating the burden on foreign and domestic investment we would subject our companies to disadvantage in the international marketplace. This is a real and justifiable concern.

It is therefore not surprising that U.S. laws pertaining to foreign income of U.S. firms have eschewed both full current taxation and outright exemption. Rather than making that choice we have attempted to subject certain classes of "tainted" income to current tax while leaving deferral as the rule for other income. For those not having a year or so to master the fine points, "tainted income" is income for which either the competitive case cannot be made or which is mobile enough that we cannot be sure.

The consequence of our understandable ambivalence about controlled foreign corporations has been a lack of clarity in the application of existing policy choices to many real-world situations, coupled with increasingly subtle and arbitrary defini-

tions of "tainted income." Since we find ourselves adrift between dichotomous policy choices, we are unclear how to respond to phenomena such as contract manufacturing, hybrid branches, and other international tax exotica, not to mention real but easily transportable business activities such as those carried on by banks, securities firms, insurance companies, and other financial institutions.

In addition to the rules pertaining to deferral, the outbound tax policy of the United States encompasses a foreign tax credit as a means of alleviating international double taxation. In much the same way as the rules on deferral, but in my view even worse, the foreign tax credit rules exhibit an intricacy that defies comprehension. In my experience these rules are applied by taxpayers and reviewed by tax administrators in an uneven, unpredictable, even haphazard manner. There is little doubt that the credit is used, in fact, to shelter large amounts of income that has not borne any foreign tax.

In the circumstances, intelligent debate about policy options is, to say the least, difficult. The well advised and well heeled have all the advantages. The U.S. multinational community is generally opposed to exemption for foreign business income. That should tell us something.

In my view, sound tax policy thinking does not involve increasing or decreasing incentives and disincentives for offshore trade and investments. Politicians have been using the tax system to attempt to influence trade and investment for decades and have not been especially successful at the game. The purpose of taxation is to raise revenue: policy thinking should proceed from that point. If we want a healthy tax system that allows for economically sensible trade and investment, we should make every effort to get out of the way. A simple, efficient system, one that is perceived as fair and can be administered effectively—that is the gold standard.

In a political vacuum, a small group of knowledgeable persons could develop a system of this nature that would serve the national interest. My own preference along these lines would be exemption for active foreign business income earned in the countries that are our major trading partners, and current taxation of other income. I would apply these rules regardless of how the income is earned and how many tiers of entities there may be between the U.S. taxpayer and the income. Corporations, partnerships, trusts—they are all just pieces of paper which, in my judgment, have been accorded far too much importance in our tax laws.

There is not a scintilla of political will to consider such radical change, or anything resembling it. Too many oxen are involved, and too many of them would be gored. Thinking large in this area is simply a recipe for frustration.

In more modest terms, what might make sense? An appropriate place to begin is the current view—unstated but pervasive in U.S. tax law—that all foreign jurisdictions are equal. We see the world in binary terms: There is the United States, and then there is everywhere else. From the standpoint of logic or common sense, this is odd—China and Monaco, the Cayman Islands and Japan, Germany and Nigeria are hardly the same except that they are all not the United States. The binary view is detrimental because it constrains policy choices. If we are going to make progress in this area, we need to start calling balls and strikes.

Suppose we took the view that, notwithstanding the multinationals' position on exemption, there can be no principled objection to zero tax on active business income earned through real investments in real countries outside the United States. I would be tempted to link that approach to a "white list" of jurisdictions but that may not be necessary; we could describe what is encompassed by the concepts of "active business income" and "real investments in real countries outside the United States" and leave the rest for interpretation, including interpretation in targeted tax treaties. Suffice it to say that most investments in Japan, Australia, New Zealand, Germany, France, the United Kingdom, Canada, Norway, Sweden, Finland, Spain, and Italy should qualify for exemption. There may be special rules in some of these jurisdictions that would need to be addressed with particularity, but it is usually business opportunities in them, not advantageous tax rules, that are attracting investment from the United States.

On the other hand, we might well adopt a different stance with respect to foreign income that does not qualify under the concepts spelled out above. A jaundiced view would be appropriate for both passive income earned by American firms abroad and foreign jurisdictions that use their existing or nonexisting tax systems as lures. In my view, good tax policy lies in distinguishing countries that receive most American trade and investment from tax havens—jurisdictions of convenience whose laws have attracted stashes of money earned elsewhere.

Identifying tax havens is not so difficult. Other countries have done it; the United States can as well. Naming the players at this end of the spectrum is no more challenging than naming the important developed countries where most U.S. investment goes and where real activity occurs.

The difficult questions relate to countries in the middle—developing countries that employ tax holidays and special tax regimes to attract real investment activity from the developed world and developed countries that have tax systems in some ways not unlike our own but that use their tax systems to siphon off profits earned elsewhere. China, among other countries, falls in the former category. The latter category would include Luxembourg, Ireland, Switzerland, possibly the Netherlands.

This is the hard part. Rules for these intermediate classes of countries are debatable. My own inclination would be to withhold from the statute both broad exemption and deferral, and to deal with these countries through the treaty process. Once again, a one-size-fits-all approach is not going to produce satisfactory results. If some general rule is absolutely necessary, one option would be current taxation and a narrowly circumscribed foreign tax credit.

Fortunately, it is not necessary to solve every problem, or agree on every solution, before doing anything. The proper starting point is weaning ourselves from the notion that we are discriminating or otherwise behaving inappropriately when we think about Bermuda differently from France. A distinction of this type is not just appropriate—it is compelling. If we can take the first step of beginning to develop different rules for different situations, we will be on the way toward a better set of outbound policies for the future.

Chairman D'AMATO. Thank you very much. I know there will be a number of questions on your testimony. Mr. Tillinghast.

STATEMENT OF DAVID R. TILLINGHAST
PARTNER, BAKER & MCKENZIE LLP, NEW YORK, NEW YORK

Mr. TILLINGHAST. Thank you, Mr. Chairman. I would like to start by saying that in the early '60s, I worked in the Treasury and I certainly had the pleasure of dealing with Senator Long as well as Mr. Wilbur Mills and others in the other House. It was a great experience, I assure you.

Chairman D'AMATO. Yes. Nobody really knew what they were doing. That's why they were the most powerful people in Washington.

Mr. TILLINGHAST. Well, there was one difference. I'll just digress for a second. When we had a problem in the House, we could go talk to Wilbur Mills and John Byrnes, and they'd tell us how it was going to come out and that was it.

I want to make three brief points today. The first is probably beating my head against a concrete wall, but I'll do it anyhow, and David has referred to the infinite complexity of the provisions that now govern the taxation of foreign income.

One of the points that I really want to drive home is that that is a self-inflicted wound. There is no way you're going to get a very simple system dealing with foreign income because we have a complex economy, you're dealing with countries all over the world and there are a lot of issues that have to be dealt with. But the complexity that exists is on the order of two or three times what it needs to be.

Now, the problem is that we don't fix it, and why don't we fix it? The answer to that is it's not an intellectual problem, it's not really probably even a policy problem; it's a political problem.

Chairman D'AMATO. Right.

Mr. TILLINGHAST. And that's a real problem. I'm not dismissing it as a problem, but when both the IRS and the multinationals complain about the truly enormous compliance costs they have in the foreign area, that's because we have inflicted that system on ourselves.

As I say, we'll never get it real simple, but we sure could get it a lot simpler than it is now. David's reference to an exemption system is a step in that direction, I think.

The second point I want to make is that we have a very large number of rules in the foreign provisions of our code that are, to put it frankly, just outdated. David was referring to the provisions that relate to controlled foreign corporations, the anti-deferral provisions. Those were enacted in 1962.

If you cast your mind back, in 1962, there were fixed exchange rates the UK had exchange controls; and more importantly than anything else, it was a brick and mortar economy. The rules that are in the code dealing with foreign income are largely rules that date from that period or before, and they are addressed to brick and mortar problems.

That presents some real issues, and we can talk about them in any detail you'd like, but cyberspace is not geography. The amount of income that is being earned off of intangible assets today as opposed to tangibles is just dramatically changed; and the rules don't work in some ways for this intangibles income. I'll give you just a couple of quick examples.

We have a rule in the code that says that royalty income has a U.S. or foreign source depending on where the right to use the intangible property is. If you have property that is licensed for use in Germany, that's foreign. If you have property that's licensed for use in the U.S., that's U.S. Sounds good.

It doesn't work. Let me give you an example. A software manufacturer licenses software to someone who uses it in a laptop. He travels to Europe. All of a sudden, licensing income that the software maker gets, now has a source or should have a source abroad rather than the U.S. How does he know that? He doesn't know that.

Another example. It's frequently the case that a multinational will enter into a package deal with a software provider, which gives the multinational the right to 500 uses of a software program. And that can be used anywhere in the world.

Furthermore, it is typical in such transactions for a large upfront payment to be made. In fact, the only payment may be an upfront payment. So the manufacturer says to the multinational: where are you going to use this? The response is: I don't know. Right now we're going to use it in Chicago, but, you know, we're thinking about outsourcing to India and of course, we will use the software there if we do outsource to India. What's the source of this payment that has been made? It just doesn't work.

I'm going to give you one more example, and then I'm going to go on. There are lots of kinds of income that are earned in the cyber-industries, which is characterized now under the code as income from the provision of services. If you give people access to a database, if you get income from advertising on your web site, that's income from services. Now, the code says that the source of income from services is where the services are performed.

If I'm a lawyer and I work in New York and then I work in Germany, then part of the work is in New York, and part of it is in Germany. But where is the source of the income that you get from this advertising? There's a server located somewhere, but that has

really nothing to do with the value added. That's a commodity function.

So where does that income arise? It arises out of the fact that the web site host has created an audience; that's what people pay for, for advertising. Or it's created a database, and that's what people pay for accessing it. Why does it matter where the database is? You can put it on a server anywhere. Does it matter where the advertising is generated? Anyhow, we have rules there that just don't work.

The third point I'm going to turn to has a little more to do with China. You know we have a very large number of bilateral income tax treaties that we enter into. As you know, there's a possibility of double taxation on any foreign income because of the source jurisdiction, where the income is sourced can tax and the U.S. can tax, if the corporation is resident here is incorporated here.

So there is a lot of double taxation. We have some unilateral rules for removing that, but sometimes they don't work so well. So we enter into treaties, and these treaties are designed to resolve problems that exist under the two domestic law systems.

We have some treaties with what are called developing countries, and in that category at the moment reside in both the People's Republic and India as well as some others.

The problem is that the so-called developing countries have revenue interests that are quite different from ours. The United States tends in entering into treaties to try to damp down source-based taxation, which is sometimes overzealously applied and is sometimes excessive.

On the other hand, the developing countries tend to rely very heavily on taxes they impose on the local sourced income of U.S. multinationals as well as others. So there is a real dramatic tension there between what the two sides want. That tension exists in other cases, too, but it's quite dramatic here.

One of the effects of that is that the United States has adopted a practice of giving something to developing countries in treaties that it doesn't give to developed countries, and that is often the right to impose a withholding tax on royalties that are generated in the jurisdiction. We don't do that with Germany and France, but we do it with developing countries.

The problem is that having made that concession, the United States is now finding, that countries like India and the People's Republic think a lot of things are royalties that we don't because they get to impose a tax on them whereas if they were services income or business income, they couldn't impose a tax unless there were a physical presence in the jurisdiction.

So there are a substantial number of disputes going on now—most of them at the moment centered in India, I must say, more than the PRC—about whether they have the right to tax payments that are made which to us and to the IRS and to the OECD they shouldn't be imposing a tax on.

Keep in mind that the tax I'm talking about is a withholding tax, which means it's based on the gross revenue payment that is made; and that can produce a very high rate of tax. If you have a 15 percent withholding tax, that's a very high rate of tax when you have

$80 of expense involved. And if you happen to be at a loss, in fact, it's an infinite rate.

So these are real thorns in the sides of U.S. multinationals, and it is a problem that has grown in dimension as U.S. companies have done more and more in countries like the People's Republic and India.

It isn't clear exactly now what we can do about this. There is in the tax world no dispute resolution mechanism built into the treaties although that's been proposed. There is a provision in the treaties, requiring the parties to consult on the subject, but consultation is consultation. It doesn't always work.

I think it's a moot issue at the moment whether the economies of countries like the PRC and India are so underdeveloped that they warrant preferential treatment that we wouldn't give to, say, South Korea or Taiwan. That's a policy question, but at the moment we're approaching that. Our treaties with both the PRC and India are rather old. The PRC treaty dates from 1986, and India from 1990, times when at least you can say the situation was quite different.

So I think there may be something to be looked at there. I think there. But I also think there is something to be looked at in terms of whether it's possible to bring some sort of influence to bear on what I think the IRS would certainly tell you is overzealous attempts to tax U.S. companies in some of those countries.

Thank you.

[The statement follows:]

Prepared Statement of David R. Tillinghast
Partner, Baker & McKenzie LLP, New York, New York

My name is David Tillinghast, and I am a partner in the law firm of Baker & McKenzie. Any views I express are personal and are not to be attributed to my firm or its clients.

As David Rosenbloom has stated, dramatic changes in international tax policy may be too difficult to achieve, but that does not mean that nothing can be done. I want to focus on three aspects of the U.S. international tax system about which I think something can be done.

David has alluded to the system's immense complexity. What needs emphasizing is that, although in the nature of things a degree—and perhaps a substantial degree—of complexity is unavoidable, a great deal of the complexity appears to me to be unnecessary. The technical details are not critical here,* but the principle is. Last year's legislation included two significant simplifying changes—the prospective reduction to two foreign tax credit limitation baskets and the repeal of the foreign personal holding company and foreign investment company rules (which were essentially duplicative of other provisions); but it added other provisions which contribute additional complexity. The net effect was, at best, a draw.

The reason that we do not simplify is simple: there is no political hay to be made by pushing simplicity. Some changes can be made with creating winners and losers, but others may adversely affect someone. Taxpayers want something, and it often turns out that, rather than reshape a provision, the Congress just tacks something else on to it. But the result is that both the IRS and American business is stuck in the quagmire, both heavily burdened by the amount of resources that compliance consumes. An income tax does not need to be as complex as what we have, and we would all be better off if we did something about it.

Many of the provisions of the Internal Revenue Code that relate to international income flows were written a long time ago. I may be one of the few people in the room that was in Washington in 1962, when the provisions of the Code relating to foreign controlled corporations were enacted. Provisions like these were drafted

*For those interested, many of the issues are discussed in Tillinghast, *International Tax Simplification*, *8 Am. J. Tax Policy* 187 (1990).

when international economic conditions were entirely different from those that exist today. Currency rates were fixed. The United Kingdom had exchange controls. But most importantly, the largest segments of the U.S. economy (and the economies of its trading partners) were brick-and-mortar businesses. Of course, there were banks, insurance companies and service operations; but since then we have witnessed not only the globalization of business generally but more significantly the dramatic decrease in the relative amount of income produced by tangible assets and the soaring amount of income attributable to intangible assets. Many concepts that are embedded in the Code were shaped by reference to tangible property and traditional business operations and simply do not work, or do not work right, when applied to globalized business operations and the cyberspace economy.

Let me give you a couple of examples. For a number of critical reasons, it is necessary under the Code to determine whether income derived by an enterprise is sourced in the United States or outside the United States. In general, we tax income derived by foreign business entities only if it is sourced in the United States. We allow U.S. entities credits for foreign taxes they pay only to the extent of the U.S. tax on their foreign-source income. The Code distinguishes U.S.-source income and foreign-source income according to the nature of the income.

One major problem arises because royalties derived from the licensing of intangible property are sourced where the intangible property is used. But in many cases this is difficult or impossible to ascertain, and in other cases it is changeable. A U.S. person that licenses an intangible for use on his or her laptop changes the source of royalty income whenever he or she uses the laptop abroad. The licensor, which must report the income, has no way of knowing where the use is or how much of it is abroad.

Software suppliers often enter into agreements with multinationals which permit use of the software in a specified number of computers but impose no geographical limits on where the use will be. Typically these are accompanied by up-front payments. Even the licensee may not know at the outset where the licensed rights will be used; if it outsources a function that uses the software to India, for example, the place of use will shift; but there is no mechanism for adjusting the source of the payment that has already been made.

An even bigger black hole exists with respect to certain payments which the Code characterizes as income from the provision of services. The applicable source rule states that the source is where the services are physically performed. But huge income streams that are thought to be properly characterized as income from the provision of services are generated without reference to geography—and any physical functions which can be identified are too unimportant to serve as rational indicators of source. The proprietor of a website may, for example, sell advertising on the site. Advertising income constitutes income from the provision of services. But where are the services performed? Where the server is located? The function of the server adds miniscule value and its location is easily changed. What the website proprietor is being paid for is delivering an audience. That audience has been created by a variety of activities carried on over a period of time, often in many different countries. And even the proprietor may not know where that audience (or major segments of it) is (are) located.

The upshot of this is that there are large segments of income derived from intangibles as to which there is no usable source rule. The existing rules rely on physical geography, but in the cyber-world physical geography is not important. Points of view will differ on how such income should be sourced, but it is clear that we need to go back to the drawing board and bring the Internal Revenue Code into the twenty-first century.

This point leads naturally to another one to which attention needs to be paid. An important dynamic at work in the international tax field is the increasing tension that exists between the United States (and other industrialized countries) and what have typically been defined as developing countries, a category that includes the People's Republic of China, India and several other countries for which the term may not be exactly appropriate. Income earned internationally by business enterprises may be subject to tax either on the basis of the residence of the entity involved (the U.S., for example, taxes the income of corporations organized in the U.S.) or on the basis of the source of the income which it derives (India and the Peoples' Republic, like other countries, tax income which they deem to arise in those countries). This obviously raises the prospect of double taxation, which would have a chilling effect on international trade and investment.

Many countries, including the U.S., have domestic law rules for eliminating the double tax (in the U.S. the foreign tax credit rules). But given the sometimes substantial differences in the laws of different countries, these unilateral rules often do not work well enough. As a result of this (and other considerations), the United

States has entered into bilateral income tax treaties with a large number of foreign countries, including some of the developing countries, the most important being the Peoples' Republic and India.

The United States and the developing country involved come to the negotiating table with very different objectives. From the U.S. point of view the treaty is designed to protect U.S. companies from over-zealous taxation on income which the other country may consider to arise within its borders. The developing countries are, on the other hand, hungry for revenue and depend much more heavily than does the United States on revenues derived from taxing income of foreign businesses. They also strongly believe that the advent of the digital economy is unfairly shrinking their tax base, because in many cases it dramatically reduces foreign companies' needs to have a physical presence in their territories. These differences in view unavoidably result in compromise, so that the United States cedes to developing countries the right to tax some items of income which in other treaties would be exempted from taxation at the source.

In particular, in treaties with developing countries the United States has given the treaty partner the right to impose withholding tax on items of income constituting royalties, whereas other types of business income owned by U.S. companies cannot be taxed. This has led to serious differences over what constitutes a royalty.

Both the Peoples' Republic and India have taken the position in certain cases that income of U.S. companies which the United States and virtually all other developed countries treat in a category of income called "business profits"—which are exempt from source-basis taxation under the treaties—do not fall in that category but must be treated as royalties which under the relevant treaties are subject to withholding tax. This not only gives rise to potential (and in many cases actual) double taxation, but of a particularly burdensome kind. The tax which is asserted is a withholding tax, one which is based on gross revenue and not on net income. A 15% withholding tax, for example, may represent a very high percentage of the company's net income—indeed, to a company at a loss, the rate is infinite. If a withholding tax is imposed on payments made to U.S. companies by residents of the treaty country, the effect is essentially indistinguishable from the imposition of a tariff.

Over some period of time, some form of an accommodation may be achieved. The problem would be solved, of course, if the U.S. treaties with these countries were renegotiated to provide (as do most of our treaties with other developed countries) that royalties are exempt from withholding tax. A new look may be justified because the existing treaties were concluded when the development of the Asian economies was far less advanced. (The treaty with the People's Republic came into force in 1986, and the treaty with India in 1990.) Such renegotiations would, however, be time-consuming and arduous. The treaty partners would undoubtedly resist any such change strenuously. It is not in the interest of the United States to terminate the treaties, since U.S. companies would then only be worse off. Some of the asserted taxes are being contested through litigation, and this may contribute to a solution. Possibly, two other things could be done. The United States could apply diplomatic or economic pressure on its treaty partners not to adopt unreasonable interpretations that do not conform to the international consensus. It could also explore the possibility of avoiding, in cases where the source country has a valid taxing claim, the tariff-like effect of the withholding taxes. Asking these countries to tax on a net income basis is probably not realistic; the administrative problem of determining the relevant net income, including allocating overall company expenses to that income, is just too difficult. But it might be possible to do rough justice by allowing a formulary deduction or, as Japan does in certain cases, simply imposing a withholding tax at a lowered rate as an indirect recognition that expenses are involved.

Panel II: Discussion, Questions and Answers

Chairman D'AMATO. Thank you very much. This is a very complicated subject, an interesting subject, and I think that we're proceeding the right way and that is to look at concepts first. And then as I recall from my days on the Finance Committee, we would get down to revenue impacts. I have the impression that a lot of these concepts involve huge revenue impacts. For example, your suggestion of limiting the number of countries that are allowed in this, that probably would have a very large revenue impact, I would guess.

Professor ROSENBLOOM. Positive.

Chairman D'AMATO. Have you ever tried to make that assessment?

Professor ROSENBLOOM. No, but there are people who have. I actually testified to the Senate Finance Committee about—it must be a year ago now—and I had some data at that time.

Chairman D'AMATO. The Joint Tax Committee can take of these concepts and fiddle with them in terms of revenue impacts. It's what they do.

Professor ROSENBLOOM. Well, the revenue impacts vary a lot, depending on precisely what——

Chairman D'AMATO. What you do?

Professor ROSENBLOOM. What you do. Yes. I do think that, by and large, I believe this is right, exempting active business income would pick up revenue. That would be a revenue gainer for the United States.

Chairman D'AMATO. Yes.

Professor ROSENBLOOM. If it was coupled with currently taxing passive income. I believe that is why the NFTC is against it.

Chairman D'AMATO. We have a representative from that organization who was not, unfortunately, able to attend today's hearing. He was here yesterday. We'll ask him about that. The other thing about the assessments is the question of elasticities. How much is enough to change behavior? Obviously, what we would want to do is change behavior.

Professor ROSENBLOOM. Right.

Chairman D'AMATO. In other words, the question is how do you give companies an incentive to stay in the United States, whereas it may be neutral now or it may be an incentive to go abroad, if they can defer all that income? There may be an incentive there.

How do you provide an incentive? The question is how much incentive do you need to provide to change behavior and elasticities of this behavior? That's another question that would be of great importance in trying to formulate a proposal that would change behavior.

I noticed about a month ago that an extraordinary press conference in Europe with President Chirac of France and Chancellor Schroeder of Germany. They stated in that press conference that enough is enough in this business about going abroad. You guys need to stay here.

The question I have is are the French and Germans doing something to give their companies these kinds of incentives? I don't know if any of you aware of this.

Professor ROSENBLOOM. You mean, to stay at home?

Chairman D'AMATO. To stay home, yes. It seems to me if you're going to put your money where you mouth is, they're going to start looking at the tax codes as incentives; right?

Professor ROSENBLOOM. There is a story that may be of some interest to you on this. In 1962 when we adopted a tax people call, Subpart F, which is the anti-deferral compromise that was done, and the Kennedy Administration wanted to terminate deferral, the companies came in and said no, no—from a competitiveness standpoint, we can't live with that. So they reached this compromise, which we still, have 45 years later.

We were alone in the world when we did that. And I think it would be fair to say that a lot of other countries thought we were a little nuts to do this, that we were hurting our companies and certainly the companies said that we were hurting the companies. Well, by the early 1980s, there were six other countries, I believe Canada was the second, and then a couple of other countries adopted anti-abuse legislation, not exactly like ours, but certainly modeled on ours.

Today, there are more than 30 countries that have done that, and most of the developed world has done it. France has certainly done it, and I think Germany has, although I'm not as familiar with it. I know Australia has something.

Chairman D'AMATO. Anti-deferral.

Professor ROSENBLOOM. Anti-deferral. Well, it's not what Kennedy proposed. It's not the complete end of deferral, but they have looked at our rules and they have said we are going to stop deferral in particular cases, and the direction they've gone really ties in with what I was saying in my statement. A lot of them have adopted either a blacklist or a whitelist. Australia will say, if you invest countries A—and they name names—if you invest in countries A, B, C, D, E or F, you're going to be taxed currently in Australia.

That's true in a surprisingly large number of countries. That whole area has grown enormously.

Dr. HUFBAUER. Can I inject just another perspective?

Chairman D'AMATO. Yes.

Dr. HUFBAUER. On that same point. You asked earlier about revenue impacts. I've looked at this in some detail on some issues, and the estimates are fairly wide between the Joint Tax Committee and the Treasury, but the current tax system that we have in terms of taxing income earned abroad including royalties, export earnings and so forth, raises something on the order of $10 billion a year.

Now that's not very much when you consider overall U.S. corporate taxation raises about $200 billion a year and so it's a small percentage of that, and by any standard it's fairly modest. So that's one point on revenue.

Chairman D'AMATO. What would be your estimate, or has anyone in Treasury or Joint Tax done an estimate as to what the remaining deferral excuse is in the way of taxation?

Dr. HUFBAUER. Right. Well, I did allude to that in my comments, in my written testimony. There are estimates, and we've done some of them. If you tax all overseas deferred income currently, the tax take on a one-time basis would be huge. Whether you could ever get that through Congress is questionable. The estimates of deferred income, again, there is some shakiness here, but they're in the 400 to $600 billion range.

Now, most of that is relatively lightly taxed because the heavier taxed foreign income tends to be repatriated. So a conservative estimate is that on that deferred income, you might be talking a 15 percent rate if it were all currently subject to a 15 percent U.S. tax take if it were currently subject to tax and the other 15 to 20 percent would correspond to the foreign tax credit abroad. So 15 percent on 600 billion would be 90 billion. That's a lot of money one time.

Chairman D'AMATO. Supplemental.

Dr. HUFBAUER. You could get up to a very large number.

Chairman D'AMATO. Supplemental.

Dr. HUFBAUER. But they're kind of out of the political realm. I wanted to just make a brief comment on the second part of your question. Well, let me just digress, go back a little bit. David is absolutely right. A pure exemption system according to the best estimates made would raise money, not a lot. I mean when I'm thinking money I'm thinking of the overall budget position and so forth.

So, it's a lot to a company, but it's in the $4 billion range. A pure exemption system would raise $4 billion. Obviously companies wouldn't like that. We're not talking about closing the fiscal deficit.

Now, turning to your other question as to what other countries have done, it has a flip side, which I tried to emphasize in my comments. France is a friendlier corporate tax country than the United States today and I know that's hard to believe, because we all have our images about France. Germany is friendlier.

Chairman D'AMATO. Friendlier?

Dr. HUFBAUER. In terms of domestic. Not as friendly as France, but it's friendlier than the United States in terms of new investment, and they're making it friendlier still. Schroeder, in one of his other statements, which he reversed himself 180 degrees, has proposed to lower further the corporate tax burden in Germany, and they have a very complicated tax system and so forth. If you look at what's happening abroad, they're going down on corporate taxes and what they're doing is doing revenue pickup on value added types of taxes. And that's the big global shift in which everybody is taking part in except possibly the U.S.

Chairman D'AMATO. Yes. And then the question, of course, we would be less interested in the revenue raised than in the change in behavior.

Dr. HUFBAUER. Right.

Chairman D'AMATO. All right. So what we then would assume is that in the German and French cases, companies would more than in the U.S. decide to stay at home rather than going abroad and that Schroeder wants to sweeten that pot further.

Dr. HUFBAUER. Right. Absolutely. That's his drive. He's concerned about German companies essentially going east to Poland and further east. And that is his big concern and that is the drive, to keep Volkswagen there to name a name. But there are a lot of other companies to try to change that behavior and make it friendly.

It's exactly what North Carolina has done, which is a very friendly tax state, and we have other states as well. And in Europe, the big success in that, of course, has been Ireland. When I was a student years ago in England, Ireland was a poor neighbor. Irish per capita income today is higher than Britain.

Chairman D'AMATO. Wow.

Dr. HUFBAUER. And you go to Ireland, it is booming, and there are a lot of components to that, but one component was just have a flat low rate tax system, and multinationals love Ireland.

Professor ROSENBLOOM. But that has been at our expense, a lot of that. That's our companies that are doing that in Ireland.

Chairman D'AMATO. Yes.

Professor ROSENBLOOM. That's subsidiaries of U.S. multinationals. The sums over there are just gigantic that people have put away. Ireland has got a ten percent across the board tax rate there.

Chairman D'AMATO. Flat tax?

Professor ROSENBLOOM. Ten percent tax rate.

Chairman D'AMATO. Flat tax?

Professor ROSENBLOOM. No, it's an income tax, but their maximum rate is ten percent.

Chairman D'AMATO. Oh.

Commissioner TEUFEL DREYER. Wow.

Chairman D'AMATO. Maximum.

Professor ROSENBLOOM. Well, the European Union may eventually have to do something about that because it's a thorn in their side even more than ours, but companies flock there. In terms of behavior, I think the three of us would agree that our current rules favor foreign investment over U.S. investment. I don't know if Gary has the same view? Would you agree with that proposition?

Dr. HUFBAUER. Oh, yes, but I guess my strong point would be that we should change the way we tax firms right here at home.

Professor ROSENBLOOM. Yes, I agree with that.

Dr. HUFBAUER. That's the big margin on which I think there could be a lot of movement.

Chairman D'AMATO. The domestic tax rate?

Dr. HUFBAUER. Pardon?

Chairman D'AMATO. The domestic tax rate?

Dr. HUFBAUER. The tax system.

Chairman D'AMATO. The tax system.

Dr. HUFBAUER. I'm advocating getting rid of the corporate income tax and replacing it with a——

Chairman D'AMATO. VAT.

Dr. HUFBAUER. —with a VAT.

Chairman D'AMATO. Yes.

Dr. HUFBAUER. That's the strong dose but going in that direction.

Chairman D'AMATO. So what I would assume, then, we all agree on at least a couple of things. First of all, it would be useful to take a look at seeing whether or not we can build better incentives to keep companies investing in the United States and not going abroad.

Secondly, to simplify the system and to rationalize it maybe along the way you're talking about. Have any of you taken a look at the PRC treaty?

Mr. TILLINGHAST. Sure.

Professor ROSENBLOOM. Yes.

Chairman D'AMATO. In your judgment, that's almost 20 years——

Professor ROSENBLOOM. Well, I agree with David. There is no question that it needs to be revised. It was put in place before they actually even had a tax system. I mean they didn't have a tax system when we negotiated that treaty. It was a pure political foreign policy document when we started. It was done to make a statement.

Chairman D'AMATO. Yes. So what would you say if you were to revise that treaty? Could you do it in a way that would encourage U.S. firms to invest in the United States as opposed to China?

Mr. TILLINGHAST. Well, I'm not sure that it would have the effect of encouraging them to invest in the United States, but what it would do would be to remove some frictions which arise when they do have either trade with or investment in the People's Republic. I don't want to make too much of it, but we have this concept which was in our minds 20 years ago that there was a country which, as David said, didn't even have a tax system.

Chairman D'AMATO. Right.

Mr. TILLINGHAST. So we had to——

Chairman D'AMATO. Come up with something.

Mr. TILLINGHAST. Yes. We had to be nice to them because they're poor people.

Chairman D'AMATO. Right.

Mr. TILLINGHAST. That isn't exactly where we are today.

Chairman D'AMATO. Do these treaties have sunsets, a lifetime, or do they just go in perpetuity?

Mr. TILLINGHAST. No, well, I think it's fair to say, that what happens is in our treaty relationships with our major partners, there is no time limit in the treaty. The treaty may be terminated on notice.

Chairman D'AMATO. Right.

Mr. TILLINGHAST. But no one ever does that. But they tend to get renegotiated every 20 years or so.

Chairman D'AMATO. So it's kind of pretty much time?

Mr. TILLINGHAST. Yes, I think it's pretty much time to have a look at it anyhow.

Chairman D'AMATO. I would think so. Commissioner Mulloy, do you have a question?

Commissioner MULLOY. Yes, I do. First, I want to say for the record, and this relates more to our last panel, that we did invite Wal-Mart to testify and they declined to do so. So I didn't want to say we were attacking Wal-Mart and not having the opportunity for them to be here.

Secondly, Professor Hamilton after that panel indicated that he had written an article about Wal-Mart and I asked permission of the Chairman to have his article inserted in the record.

Chairman D'AMATO. Certainly.

Commissioner MULLOY. The third is just a question for Mr. Tillinghast. These tax treaties, are they like a treaty that has to go through and get Senate approval?

Mr. TILLINGHAST. Yes, absolutely, yes.

Commissioner MULLOY. And do they go through the Senate Foreign Relations Committee?

Mr. TILLINGHAST. No, they go through the Senate Foreign Relations Committee.

Commissioner MULLOY. And there is no expertise there on tax issues.

Mr. TILLINGHAST. Well, what happens when a treaty is up for ratification is that the Finance Committee avails itself of the staff of the Joint Committee on Taxation.

Chairman D'AMATO. Yes, they have a joint jurisdiction.

Commissioner MULLOY. Oh, there will be a referral.

Mr. TILLINGHAST. The Treasury Department will normally prepare what it calls a technical explanation of the treaty. And then the Joint Committee staff will look at the treaty that's been negotiated, look at that technical explanation, then prepare its own report to the Foreign Relations Committee, which says here are ways in which this treaty may be different from other treaties. Here are issues you may want to consider in that kind of thing.

Commissioner MULLOY. Do they usually get through pretty quickly on these?

Mr. TILLINGHAST. It depends. I know that's a lawyer's answer, but many do. But we've had some treaties that were hung up for quite a long period of time for one reason or another.

Chairman D'AMATO. If someone is paying attention.

Mr. TILLINGHAST. Yes.

Chairman D'AMATO. Usually they go right on through.

Mr. TILLINGHAST. Yes.

Commissioner MULLOY. I have two issues I want to raise with this panel. I've given you a chart that shows the impact of the value added tax, the fact that China has a value added tax, so that when a good from China that costs $100, when that's exported to the United States, China rebates the value added tax, right? So it's $88.89.

We have a $100 item. When we sell it to China, we have to pay their value added tax when it goes into China. This is an important issue; and the same thing with the EU; right? Does this make sense? What should we be doing? Is this an important issue that people should be focusing on now that the U.S. is in a globalized economy?

Dr. HUFBAUER. Can I throw in a few comments on that?

Commissioner MULLOY. Yes, please. Dr. Hufbauer, you wrote an article in the Financial Times on this issue and I would hope that you can send that to us and we'll, Mr. Chairman, have it included in the record?

Chairman D'AMATO. Yes, that would be terrific.

Dr. HUFBAUER. Well, I've written an awful lot on this issue over the years because I was involved in the original FSC, predecessor to the FSE, predecessor to the ETI many years ago, so I followed the case both in the U.S. and in the WTO. At this point, suffice it to say that the strong WTO rulings in the FSC and ETI case, which I think were legally in error, but they are the rulings of the appellate body, make it very clear that there can be no relief from corporate income taxation when goods are exported, and of course there has never been any imposition of corporate income taxes on imported goods corresponding to the profits made on imported goods.

So there is no border adjustment as there is for the VAT in your picture. That disadvantages, in my view, the United States, but that is now the settled WTO jurisprudence on that, and it would be certainly be very difficult to reverse or reconsider those rules.

So I conclude, for this reason and some of the other reasons I sketched in the written testimony and summarized orally, that the United States should join the world by emphasizing a VAT type system for our revenues and get away from corporate income tax-

ation. And I would go all the way to 100 percent, though that's not going to be done overnight or any time quickly.

Now, let me briefly comment on the very substantial and respectable opposition amongst economists to the kinds of charts you have here and the kind of position that I have advocated in this hearing this morning. The economist's argument is that exchange rates will adjust and wipe out these differences that you're talking about.

Either exchange rates, or at a slightly higher level of sophistication, domestic price levels will adjust. And there's a long literature on this and I can give you more than you want to read on it, but in any event that is the strong position which has so far prevailed in the Treasury Department, prevailed when I was there, prevails to this day.

It raises eyebrows in light of some of our current currency disputes with China, but it is an article of faith. Even if exchange rates will adjust in the long run, and they may, when business firms look at the picture that you've drawn, it's very easy to decide if everything else is equal where you're going to locate your new facility. Businessmen, like Mr. Jones here, did he mention exchange rates when he talked about his tax burden? Absolutely not.

I've talked with hundreds of businessmen over the years. They either think it's an invention of the devil or, economists, about the same—this explanation of the exchange rate, or, it's just pure fantasy. And they look straight at the tax rate, and they say that's here and now. Exchange rates may adjust, tell me how soon and so forth and so on, very random on exchange rate movements. So the tax differences—and the econometric evidence is absolutely persuasive on this—make a very material difference in where firms decide to locate facilities.

Chairman D'AMATO. Do you have a question?

Commissioner MULLOY. Do either of you have a comment on this? I think there are two issues that we really have got to focus on when we're looking at this. When you look at tax, you can look at raising revenue, but that isn't the key focus here. It's the location of the activity that we're interested in.

Now, there are two ways of encouraging businesses to remain. One would be to lower taxes domestically. Or, to place a tax on the foreign activity; right? There are no WTO rules that would prevent us from placing a tax on the foreign activity of the company.

Professor ROSENBLOOM. Of U.S. controlled companies—correct.

Commissioner MULLOY. Of U.S. controlled companies. So is that the whole deferral issue?

Dr. HUFBAUER. That is, but if I could just insert again a point I briefly commented on. The U.S. companies are a modest part——

Commissioner MULLOY. Of the investment in China?

Dr. HUFBAUER. Of investment in China or investment worldwide. So whatever we do on our tax system is not going to affect how the British, the Dutch, the Japanese and so forth, how they do their—they are very unlikely to march in lock-step with us.

Commissioner MULLOY. All right. Now coming back to the value added tax, Gary, is that something that you think we ought to make a recommendation on and if so——

Dr. HUFBAUER. Well, I would hope to persuade you, and not that it's likely any time in this Administration, but I can certainly send

you a longer book. But you know, the revenue demands are just up there, the deficit is up there, and you ask where is the revenue going to come from? And every other country that has faced this problem has said, look, if we do it with the old tax structures, we will end up with distortion, which is very destructive economically.

Commissioner MULLOY. Could you send us the way you would recommend it? And the rationale for it?

Dr. HUFBAUER. Certainly.

Commissioner MULLOY. Thank you.

Professor ROSENBLOOM. I think you ought to also know some of the counterarguments.

Commissioner MULLOY. Yes.

Professor ROSENBLOOM. I'm probably not the person to make them most persuasively. I think Gary probably knows them better than I do, but two of them that are definitely out there are one, because of our Federal system, the states rely to a large extent on consumption taxes, and it's historically been sort of an unstated agreement that the area of consumption taxes would be left to the states. If you start imposing a VAT, which is a consumption tax—think of a sales tax at the Federal level—you run into serious federalism problems.

That may not be the end of the story, but it's a big component of this. The other area that I'm aware of, and there are probably others, is that with a recommendation of this kind you will get a very large amount of opposition from people who are adverse to taxes generally because the VAT is a money machine, a potential money machine. Just as Congress said they are never going to do an amnesty again, they can come in and swear on a stack on bibles that the VAT will never go above an eight or ten percent rate or whatever it is, but once it's there, raising it from ten percent to 20 or 30 is a pretty simple thing, and people feel very strongly about that.

Now, neither of those objections—and there may be more—make this a non-starter. I, for one, would certainly contemplate this as part of a sensible overall tax system, but you ought to know that those are two areas of stiff resistance.

Commissioner MULLOY. Okay. But you as an expert, you think the fact that we're in a globalized economy now, it's not beyond the pale to be thinking about this?

Professor ROSENBLOOM. I'm not a VAT expert, but thinking about a VAT seems to me to be a sensible thing to do. Gary is clearly right that most jurisdictions have had a VAT. Where I get off the bus is when we start thinking about consumption taxes as totally replacing income taxes because the three things you want in any tax system are efficiency, which is what Gary has described, you want simplicity, and you want fairness.

Ultimately, these consumption tax only systems, in my personal opinion, are not fair. I've had this argument with many people.

Commissioner MULLOY. I see.

Professor ROSENBLOOM. They tend to shift the burden down. If you go back through what Mr. Armey was proposing—I don't remember what the name of it was—fair tax or something—back several years ago. He's still proposing it, I think. Those are ideas to shift away from an income tax and like what Steve Forbes is pro-

posing, a consumption tax, and that's going to tax higher income people a lot less.

Commissioner MULLOY. Mr. Tillinghast?

Dr. HUFBAUER. Can I do 20 seconds?

Commissioner MULLOY. Mr. Tillinghast, do you have any comments?

Mr. TILLINGHAST. Yes. I just want to add that while there are a very large number of countries that have a value added tax, most of those countries also have a corporate income tax. It isn't a replacement for the corporate income tax, although it generates a lot more revenue.

Dr. HUFBAUER. David is absolutely right. Both Davids are right. The first David is right that he named the two leading objections. We deal with them in the larger manuscript. I think the money machine argument is particularly wrong as a factual statement though it is strongly believed, and I know there's a group of congressmen today who are forming an anti-VAT coalition or something like that on a money machine argument, which is closely related to a new tax is a bad tax argument.

So it has to be dealt with, but I don't think it has any factual basis in the experience of other countries.

Commissioner TEUFEL DREYER. I don't understand what's meant by a money machine.

Dr. HUFBAUER. The money machine is that you put the VAT in and it's so easy to raise the rates that the government just explodes.

Commissioner TEUFEL DREYER. Has too much to spend.

Dr. HUFBAUER. You get too much money and then you go for all these programs that shouldn't be there, so you don't want the money machine.

Commissioner TEUFEL DREYER. Gotcha.

Dr. HUFBAUER. This is a very strongly held argument. We have looked at it actually I think in a pretty non-ideological way. Ran some statistics. Looked at what the Europeans say. You cannot find evidence for it. But that doesn't mean people don't believe it.

Now, the other point that David Rosenbloom made—is quite right on total replacement of income taxes with value added taxes. My colleague and I, we are not in that group, and I do not believe in the widespread recommendation by some people to get rid of the personal income tax. I'm trying to reduce the role of the corporate income tax.

I know if you do a survey, you'll find that most people are under the illusion that the corporate income tax taxes the rich. It does not. It is very unsuccessful in taxing the rich, but personal income tax can be very successful in that goal.

And for that reason, I definitely do not want to get rid of the personal income tax. But he's right, a lot of people want to do everything, and what David Tillinghast said about most countries keeping both taxes is, in fact, correct. I think an important point is that many countries with both sets of taxes, the shift, the balance is clearly going the value added tax and away from the corporate tax, and they do their progressivity through the personal tax.

Commissioner MULLOY. Mr. Chairman, I ask permission that this be included in the record.

Chairman D'AMATO. Did you draw that?

Commissioner MULLOY. I didn't draw it, no.

Chairman D'AMATO. All right. That's fine. I have a question on the treaty. You mentioned in your testimony that you think that where we should be going with the Chinese is in revising this tax treaty. I believe you said that. My own inclination would be to withhold from the statute and deal with these countries through the treaty process.

I think I agree with that. It seems to me that the situation with China is so unique, the worries on the flow of investment into China, the whole retailer development that we've seen here with them dictating price to everybody, the range of considerations on China is so unique and I would think that the way to do it is to deal with it, and now is the time to take a look at that because it's been 20 years.

Professor ROSENBLOOM. I don't think you can change the behavior you're aiming at through the treaties alone. That's where I began. I think the treaties operate against the background of a statute, and as long as you've got deferral and foreign tax credit system, the treaty is important because there are these conflicts that David Tillinghast mentioned. The treaty is old, but where I think you're going, which you mentioned several times, Mr. Chairman, talking about behavior——

Chairman D'AMATO. Yes.

Professor ROSENBLOOM. —you're not going to change major behavior through the treaties as long as the statute remains where it is.

Chairman D'AMATO. You still have to go to the statute on deferral.

Professor ROSENBLOOM. Right.

Chairman D'AMATO. And the other things you mentioned. Okay. I think I can accept that. On the question of fairness, you mentioned fairness, I don't think anybody can say today whether the tax code is fair or even assess the level of fairness in the tax code because the tax code is so complicated that only the tax code itself knows what's in it.

So whether it's fair or not is just a complete mystery, but certainly we have piled on the tax code in such a way that we're going to have to start simplifying it, and this is one area where it seems to me that simplification is needed.

Do you have a question?

Commissioner TEUFEL DREYER. I am terribly impressed with all of these different factors you folks have mentioned. Do I take it that you are saying that other things being held equal, but of course there is no way to hold everything equal—the value added tax would help the deficit but not solve it; is that correct?

Commissioner MULLOY. Are you talking about the trade deficit?

Commissioner TEUFEL DREYER. Yes, the trade deficit.

Dr. HUFBAUER. The trade deficit. Right. We run through some numbers, which I didn't summarize here, but when I send the longer manuscript, they are there. And yes, I believe you would contribute to helping the trade deficit, but I don't want to say it would eliminate. We're running about $700 billion trade deficit this year. If we substituted a value added tax for the corporate tax and

raised about the same amount, $200 billion, I think at most, and that's revenue neutral, but we're adjusting it at the border now, you might expect 100, $200 billion at most improvement in the trade deficit over a period of time. I mean all this takes time to change, so there are a lot of other things would have to do.

Commissioner TEUFEL DREYER. And then also by changing the tax code, amending it in various ways, we are not sure exactly what would happen because an adjustment in one place might lead to the creation of loopholes in another?

Professor ROSENBLOOM. Well, in part that's clearly true because of the way the political process works. We don't have a parliamentary system and what goes into Congress inevitably comes out unrecognizable.

So it's easy to get a little cynical about the chances of achieving anything, but we have to do it sooner or later.

Chairman D'AMATO. Well, thank you very much. This panel has been very useful and it really is the beginning of a new era of understanding on the part of the Commission on where we should be going. This is a very important area.

This will conclude the last panel of the day, and before the Commission concludes the hearing, I would like to take a moment to thank our staff, David Ohrenstein, Tony Sutton and Tom Palley, for their great work in supporting this hearing, and putting together a superior product.

Thank you very much. This will conclude the hearing.

[Whereupon, at 1:00 p.m., the hearing was adjourned.]

Prepared Statement of William Wolman
Former Chief Economist, *Business Week Magazine*, New York, New York
Author of *The Judas Economy:*
The Triumph of Capital and the Betrayal of Work
Accompanied by Anne Colamosca, Co-Author

It is an honor to again be asked to testify before this distinguished Commission. We must begin, as we did in our June 14, 2001 testimony by saying that we do not come before you as experts on the Chinese economy. Rather, we speak as students of economic history and as economic journalists who have closely followed the evolution of the world economy in the wake of the fall of the Berlin Wall. We regard the end of the cold war as one of the few truly transforming events that have occurred in the world economy in the years for which a record of economic growth has been assembled thanks largely to the work of the great economic historian, Angus Maddison.

The years since the fall of the Berlin Wall have been characterized by "shock and awe" in the western world, responding to the emergence of some key Asian countries as huge economic success stories, particularly China and India. This is usually thought of as a remarkable change. But the truth of the matter is that the long-term growth records that have been carefully analyzed by Maddison show that between the beginning of the Christian era and the years that saw the industrial revolution in Europe, first of course in Great Britain, both India and China grew faster than did the Euro-centered countries.

Not that these countries grew very fast before the industrial revolution. Growth throughout the world was slow but was indeed faster in the east than in the west. And that more rapid growth, and the emergence of what Maddison believes were marginally higher standards of living lasted for almost 1800 years. These early statistics do not play a large part in this story. I cite them only to make the point that the Eurocentric west has hardly had a lock on world economic leadership. It was, on the contrary, the arriviste, emerging as the growth leader only with the discoveries, and, more importantly with the industrial revolution. I'm sure that our Chinese and Indian friends are well aware of these facts and it is good that we should know about them as well.

In May of 1997, Anne Colamosca and I published a book, "The Judas Economy: The Triumph of Capital and the Betrayal of Work." We testified on that book before the U.S.-China Economic and Security Review Commission, on June 14, 2001. That testimony stressed that because of the end of the Cold War and the spread of the market economy, the global labor force had become a New Leviathan, posing great challenges to those in the Eurocentric labor force that had dominated advanced production through the dark days of the Cold War and indeed the entire period of state socialism that had preceded it.

The serious nature of the decline in the demographic position of western workers was easy to grasp. In 1989, 248 million Americans were part of a select industrial world population of 900 million participating in a free global marketplace—some 23 percent of the world's population. Each American was, in effect, competing with 2.8 people in the industrial world. The end of the Cold War radically increased the number of workers involved in the competition. The year 1994 was the latest year for which we could get data, at the time we wrote our book. By that time, when the free market had penetrated all but the most remote and obdurately communist parts of the world, 260 million Americans faced potential competition from 5.6 billion people around the globe—essentially each American was competing with about 21 people, an enormous change.

In the book, we set about analyzing the impact of the quantitative leap in the labor force competition facing American workers by introducing two basic ideas: The first is the "law of one price," and that simply says that adjusting for transportation costs, products will sell for the same price everywhere in the world be it Bangalore, India or Bangor, Maine. The second is the common observation that capital is more mobile than labor. This, of course, is true for economic reasons, but it's also because capitalists have a way of smoothing the road for their product. "Judas" was essentially a 250-page analysis of the impact of this change and its conclusion that the Eurocentric labor force would have its troubles has obviously worked out both in extremely slow growth in per capita real worker income and in a general weakening in the ability of organized labor both to grow and achieve its goals. This has been true in both the United States and Europe.

One further point on "Judas"—I think it is fair to say that based on a reporting trip to India in early 1996 and a subsequent analysis of what was occurring in Bangalore, India, the book was early in delineating the challenge that globalization would pose to knowledge workers. The second idea that guided "Judas" was also a

simple one: capital is more mobile than labor. It is far easier for capital to move into zones where the returns are higher than at home than it is for labor to accomplish a similar feat. As the world opened up to the relatively free movement of capital, it was easy for American businessmen and American investors to move their capital into zones where rates of return were high. No such spectacular opportunity was available to those who earned their living from work in the United States. The effect, of course, was a weakening in the power of American labor. Wage growth began to stagnate, many high wage jobs disappeared and the American labor movement lost much of its power to bargain effectively for American workers. One effect was a shrinkage in the union movement.

The erosion of the position of those who earned their living from work represents a radical change in the entire atmosphere of the United States. Virtually anyone who has studied economics remembers the vivid celebration of the position of the American worker in the early days of the Republic. In "The Wealth of Nations," published in 1776, Adam Smith explained why the average worker was faring better in what was to become the United States than in Europe. He patiently showed that American workers were prospering simply because they were scarce, and small in number, relative to the quantity of resources, particularly land, that was available in the country. The consequence, of course, was that the return to labor was under constant upward pressure as compared to Europe where the supply of labor was abundant as compared to land and other resources.

Perhaps the biggest surprise that we experienced while working on "Judas" was what we found when we visited Bangalore. Why did we as reporters get to Bangalore so early? We asked the brilliant British historian, Eric Hobsbawm, in 1996, "If you wanted to know what was going to happen in the 21st century, how would you find out?" He answered. It's very simple. Go to Bangalore, India. With our journalistic connections, and a host of Indian friends, Bangalore opened up to us. We were lucky enough to spend a lot of time with N.R. Narayana Murthi, the then CEO of Infosys, a company he had founded. Listening and talking to Murthi was historically profound. It was not just about software for him by a longshot. It was about an overwhelming commitment to put India's young men and women on the world stage—to give them an historical platform and international respect of a kind they had not had for centuries. His aim was to dig deep into the untapped pools of knowledge workers who had emerged from the educational system that Nehru had set up in Bangalore. And in that sense, Bangalore's success is not just a triumph of enterprise but also a triumph of Nehru's social commitment in India. Murthi and his wife, both Brahmins, were dedicated to educating the poor and Mrs. Murthi did this as a computer science professor.

How has what has happened in India since surprised us? For one, we hadn't forecast American corporate problems with Y2K, the steep fall in the Nasdaq, and the subsequent deep cost-cutting that went on in corporate budgets afterwards. By demonstrating how capable and how inexpensive their services had been at a time of falling profits, the pace with which knowledge work migrated to India, was even faster than we had anticipated in "Judas."

We recognize that there have been many difficulties but it is nevertheless surprising that China and India have responded rationally to the opportunities that have opened up for their historically vibrant economies. In India, the remarkable spectacle has been the transformation of what was an imaginative socialist program to use education as a tool of economic advance for what is essentially a free market capitalist economic development. The rise of Manomahon Singh emphasizes the case in point. And in China, the evolution of a code of civil law that is fairly comfortable to Westerners including the great western corporations has been a massive stir to growth in the dynamic center and provinces of China. Most of what has happened in Asia is in accord with what we expected at the time that Judas was published.

It is the performance of the United States and indeed the Eurocentric economy generally that has been surprising. We would dearly have loved to be able to say that the United States has responded admirably to the twin challenges of the new world labor force demographics and the new technology that allows information to be analyzed and processed with great efficiency from virtually anywhere in the world. Unfortunately, almost the exact opposite is the case.

We have no wish to be partisan in our approach. But we must notice that the first Administration to take office after the end of the Cold War, that of President Clinton, was extremely careful in how it managed its deficits. It did, after all, raise taxes even though the military pressures had been reduced, and when it did fight its war on Kosovo, it did so in a limited way, with allies and relatively low expenditures. The United States had obviously become an empire, but the Clinton Administration basically chose to husband its resources to a major degree and was extremely careful in its foreign commitments.

Based on pure economics it is hard to justify what has happened since the 2000 election. The Bush Administration sought a growth surge in the U.S. economy using the well-worn formula of John F. Kennedy and Ronald Reagan, who both cut taxes and raised military spending. There was a burst in income growth for those who earned their living from capital, but incomes grew relatively slowly for those who earned their living from work. And with the invasion of Iraq, the Federal deficit ballooned, but rises in employment were limited by the new global labor market.

It's a loaded word, possibly with more than one meaning: imperialism. It is hard to escape the conclusion that with its military might, the great American republic has become an imperial power. One of the most penetrating analyses of imperialism is still the 1902 book "Imperialism" by the British economist, J.A. Hobson. Hobson believed, and demonstrated quite convincingly that the aim of British imperialism was to enhance the economic power of Britain relative to that of its rivals. Many British policies were designed to support British industry and Britain did succeed in generating large trade surpluses in order to finance what were its own attempts to secure world order. Yet Hobson clearly demonstrated that even in its imperial heyday, the economic returns for Britain were very low.

The economic returns to the current phase of American imperialism are even lower. The effect has been to produce astounding and persistent deficits in the U.S. balance of payments. Bush policies have resulted in a huge buildup in U.S. assets, particularly marketable stocks and debt in the hands of foreign countries.

The profligacy has turned the U.S. into what might be called a "Blanche Dubois economy." Like Tennessee Williams' great stage creation the United States has become like Blanche herself, "dependent on the kindness of strangers" to meet her financial needs. Given the size of our twin deficits, we are now dependent on other countries to keep the U.S. dollar not merely from falling, but from plunging. America's creditors obviously have a strong self interest in orderly movements in exchange rates, but the underlying fundamentals are sinister.

"Today's stewards of America's foreign policy could learn much from the wily and seductive (Benjamin) Franklin," Walter Isaacson wrote recently in The New York Times Book Review. "He was as adroit as a Richelieu or Metternich at the practice of balance of power realism . . . but he also wove in the idealism that was to make America's world view exceptional both then and now; he realized that the appeal of the value of democracy and an attention to winning hearts and minds through public diplomacy would be sources of the new nation's global influence as much as its military might."

What Isaacson could have added was that Franklin, America's first real diplomat and globalist, was also in close touch with the needs and problems of American labor. After decades of working in Europe, he was greeted by a huge band of printers and mechanics when he reached the shores of Philadelphia upon returning from Paris. Not only had Franklin continued to work on upgrading the printing press while living abroad (realizing that French printers and engravers were far superior to those in the newly formed United States) he continued to give money to manual workers so that they could be educated and continue to innovate and create new businesses. As we wrote in *The Judas Economy*: "Americans who earn their living from work have led the race to become competitive again, but they seem fated to be returning to the starting line again and again. They are looking from the outside at a prosperity in which they have no part and working in a job market in which they can find no peace."

Today's workers no longer enjoy the special advantages of those who worked during Benjamin Franklin's time. They are no longer demographically scarce, and no longer can command higher wages as a result of this scarcity. And there are no globalists around like Benjamin Franklin—except perhaps for N.R. Murthi—who deeply understand the needs of both globalization and labor. This may well be one of the country's most formidable challenge problems today.

Prepared Statement of Paul Craig Roberts

Offshore outsourcing is misunderstood by economists and policymakers. The phenomenon is misperceived as an extension of the mutual benefits of comparative advantage-based trade.

Comparative advantage has two necessary conditions, neither of which is met today. One condition is that capital is immobile internationally relative to traded goods. The other is that the trading countries have different opportunity costs of producing the traded goods. (The economic concept of opportunity cost is an in-kind measure; for example, the quantity of wine that is not produced in order to make a yard of cloth.)

The condition of capital immobility is required to insure that a country's capital seeks comparative advantage at home instead of absolute advantage abroad. Different internal cost ratios of producing one good in terms of another are necessary if low- and high-cost countries are to experience mutual gains from specializing and trading.

David Ricardo discovered comparative advantage when he investigated the question of why a country that could most cheaply produce all tradable goods would trade with a higher cost country.

Ricardo's answer is that the opportunity cost of producing one good in terms of the other was different in the two countries. He was able to show that total output would increase if each country specialized in the product in which it had relative advantage. He then showed that the increased output would be shared by the terms on which the countries would trade one product for the other.

In Ricardo's example, the different opportunity cost ratios of producing wine and cloth in the two countries are due to inherent differences in geography, climate and soil.

Modern production functions, however, are based on acquired knowledge. They operate the same in all countries. These production functions do not reflect country-specific inherent differences that result in different opportunity cost ratios on which comparative advantage depends.

When I point out that the conditions on which the case for free trade is based are no longer met in today's world, economists either evade the issue or drag red herrings across the path. They talk about shifts in the terms of trade, about productivity gains abroad, and about the pervasiveness of factor mobility even in Ricardo's time. They equate the rise of the high speed Internet and collapse of world socialism, which made vast quantities of cheap labor available to first world capital, with innovations such as lower transport costs that turned previously non-traded goods into traded goods.

None of these arguments engages the issue. Ricardo imposed the condition of relative capital immobility internationally in order that specialization according to comparative advantage could occur. Otherwise, a country's capital would flow to absolute advantage abroad. When U.S. firms substitute foreign labor for domestic labor in their production for domestic markets, capital is flowing to absolute advantage.

Factor mobility from Ricardo's time to the recent advent of offshore outsourcing was qualitatively different. Foreign investment was a way to evade tariffs, quotas, and high transport costs. Foreign investment was not geared toward offshore production for home markets. Ford and GM produced cars in Europe to sell to Europeans, not to export to America.

Economists assume that offshore production for home markets is trade because the goods count as imports when they enter the U.S. But what is being traded when a U.S. firm closes its American factory, lays off its American work force, moves its capital and technology offshore and uses foreign labor to produce the identical product for the same U.S. markets? This is not trade in the traditional sense with one country specializing in cloth, the other in wine, and sharing the gains.

The old free trade argument that U.S. labor has nothing to fear from cheap foreign labor, because U.S. labor works with more capital and better technology no longer holds when U.S. firms provide the same capital and technology to foreign labor. The international mobility of capital and technology and the advent of production functions that operate the same regardless of location mean first world labor will be displaced in tradable goods and services until there is a global equalization of wages and living standards.

Indeed, one reason the facts of offshore outsourcing are evaded by so many economists is that they look with favor on the international redistribution of income and wealth that is occurring.

As the BLS payroll jobs statistics make clear, the U.S. has ceased to create jobs in tradable goods and services. The higher productivity, higher value-added jobs

that provide upward mobility are missing from the data. Our most prestigious engineering schools report a marked decline in enrollments in computer and electrical engineering. Business Week magazine reports that U.S. firms are now outsourcing R&D, design and innovation.

As I report each month following the BLS release, so far in the 21st century the U.S. economy has been able to create jobs only in domestic nontradable services. Independent studies by economists at Northeastern University (reported in The Boston Globe by Charles Stein, Feb. 20, 2005) and by Edwin S. Rubenstein conclude that most of the new jobs in domestic services have gone to new legal and illegal immigrants. If these studies are correct, employment growth of native-born Americans has ceased in the 21st century.

In the 21st century, the U.S. labor force has been acquiring the complexion of a third world country, with new jobs available only in domestic services. In contrast, China and India are acquiring high tech manufacturing and professional service jobs, the mark of first world countries.

How does the U.S. gain from inability to create jobs in export and import-competitive goods and services?

How do Americans gain from the loss of the jobs, careers, and incomes associated with the production of the goods and services that they consume?

How do U.S. firms gain, beyond the short-run advantage of CEO bonuses and share prices based on quarterly performance, from becoming brand names with a sales force marketing foreign made goods?

How does America as a whole gain when the U.S. pays for the cheap foreign labor contained in the offshored goods and services (a major component of the rising trade deficit) a second time by handing over to foreigners more of its existing stock of assets? The "cheap Wal-Mart goods" are not cheap when properly measured.

How do U.S. universities gain when there are no payoffs to a university degree? The BLS estimates that the vast majority of the new jobs that the economy is expected to create during the next ten years require no university education.

Where is patriotism when politicians turn a blind eye to the decimation of opportunity for native-born citizens.

What is the state of economic education in the U.S. when economists cannot comprehend the reality that confronts them?

Economists are not even aware of the latest and most important work in international trade. In 2000 M.I.T. Press published *Global Trade and Conflicting National Interests* by Ralph E. Gomory and William J. Baumol. This important work, which does not directly address the offshore outsourcing issue, shows that the comparative advantage case for free trade is too unsophisticated to be correct even if its required conditions are met.

It will take economists a decade or longer to absorb this work. In the meantime, they are operating with a defective trade model that leads them to incorrect conclusions and disastrous policy advice.

UNITED STATES BUSINESS AND INDUSTRY COUNCIL

June 30, 2005

Mr. C. Richard D'Amato, Chairman
U.S.-China Economic and Security Review Commission
444 North Capitol Street, NW Suite 602
Washington, DC 20001

Dear Mr. D'Amato:

I want to thank you and the Commission for allowing me to participate in the hearing on "China and the Future of Globalization" held May 19-20 and to share with you in this letter the recommendations of the U.S. Business and Industry Council as to how to address the current dangerous imbalances in our international trade and financial positions.

Though it has only been a month since the hearing, the next phase of Beijing's globalization strategy has been revealed in the $18.5 billion bid by state-owned China National Offshore Oil Company (CNOOC) for U.S.-owned Unocal. Beijing's global quest for natural resources and manufacturing capability is based on its growing clout in world markets. It is China's massive trade surplus with the United States that both gives the regime the hard currency needed to finance its overseas ambitions and attracts additional foreign investment to further propel Beijing's rise to global power status.

Despite much talk about our inability to act because of the instability of China's banking system, that country appears flush with cash. Beijing is reported looking at acquisitions in a wide variety of fields, including automotive, consumer appliances, and telecommunications firms in addition to energy suppliers. China has long used mandated joint ventures and outright theft to acquire the intellectual property of foreign firms which have ventured into the country. Now it is reaching out to buy productive assets outside the country. The scope of the Chinese challenge is no longer confined to this or that particular American company or industry in the marketplace, but is a systemic assault on the global economy itself, in a bid to shift the balance of world power away from American preeminence.

The United States needs to adopt its own national globalization strategy to protect its position of world leadership, which rests on its manufacturing and technology base, in the very limited time that the wherewithal to do so remains. The United States is still the largest national economy, and if it reacts promptly to predatory foreign challenges, it can remain a predominant power with policy changes that are fairly straightforward in nature, but dramatic in their conceptual shift from current trade and economic policies, which have clearly failed.

First and foremost, the United States needs to limit imports from China and other predatory trading partners as part of an overall effort to bring the nation's trade back into balance. Over the last ten years (1994-2004), annual American imports have increased by over $800 billion while exports have increased by only

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about $300 billion. The trade deficit with China alone will likely reach $200 billion this year. It is simply unrealistic to believe that the trade deficit can be substantially reduced by increasing exports, even if the current level of imports were to be frozen.

With the U.S. trade deficit running over 5% of GDP, and the current account deficit running about 7% of GDP, the nation's international financial position has reached a danger level that could plunge the entire economy, and with it the global economy, into a deep recession. Every responsible economist and policymaker should know that the current U.S. imbalance is unsustainable.

The only options are whether to attempt to ameliorate the imbalance by conscious policy decisions, or to allow a "market-based solution," which may well bring crashing down what has become a house of cards with it. The collapse of the dollar and a downturn in the domestic economy would greatly weaken the United States in world affairs – and at a time when American leadership is most needed. Indeed it would hasten a "multipolar" world, which Chinese strategists have been proclaiming as the necessary next step in Beijing's continued rise to power.

The imbalance of trade and its impact on the current account deficit, the stability of the dollar, and the health of the American economy, require swift action. As the centerpiece of American action to slash the current account deficit and stabilize the dollar, the United States should impose as soon as possible a Trade Equalization Tariff, which would affect most seriously those countries running large, chronic trade surpluses with the United States. While the tariff would be non-discriminatory, China, of course, would be at the top of the list of affected countries.

Exceptions to the tariff should be granted for energy products and non-native commodities for which there are no available American substitutes. The tariff would be a temporary measure to bring the current account deficit down to under 1% of GDP, a level at which more normal trade remedies and market adjustments should be able to handle the problem. Article XII of GATT 1994 provides that a country may, "in order to safeguard its external financial position and its balance of payments, ... restrict the quantity or value of merchandise permitted to be imported." Thus a Trade Equalization Tariff would be WTO-compliant.

Several additional steps must be taken: U.S. trade laws need to be strengthened to stem the flood of imports that have undermined American manufacturing and threatened the nation's finances. Anti-dumping, countervailing duty, and safeguard cases must be easier to win. Remedies must be more promptly implemented. The applied protections must be extended up and down the production stream from the immediately affected companies/industries so that American firms can be united in a common defense rather than pitted against each other. Currency manipulation must be added to the list of unfair practices that are actionable under U.S. law. And the trade laws need to be expanded to protect against imports that are the result of the infringement of American intellectual property.

Communities and displaced workers should also be given a private right of action against foreign businesses that require U.S. manufacturers to close domestic operations in order to invest in foreign markets or that require a certain percentage of products produced overseas be exported back to United States. No provision of GATT 1994, TRIMs (Trade-Related Investment Measures), or any other agreement prohibits a private remedy against such private behavior.

As I mentioned in my submitted testimony, small and medium-sized companies find it difficult and costly to pursue legal action under the extremely bureaucratic and slow procedures currently in use by the Commerce Department and the International Trade Commission. In addition to streamlining the process for private firms, the government should self-initiate and drive forward actions in those sectors

that have shown the most chronic imbalances and threats to viable American industries. The so-called Super 301 provision should be reinstated immediately. This measure would require the U.S. Trade Representative to initiate a Section 301 investigation of any country identified as a priority foreign country with respect to anti-competitive practices.

The United States must take these actions on its own behalf and not place its trust in the World Trade Organization to solve its problems. As the Commission's Trade Lawyers' Advisory Group reported May 16, "U.S. manufacturers need strong and effective trade remedies to address the trade distortions caused by undervalued Chinese exports and state control in China and to prevent the loss of jobs and industries due to such distortions." The Advisory Group also raises serious questions about the WTO: (1) "The erosion, in the WTO dispute settlement process, of the right to use trade remedies, and attacks respecting U.S. trade remedy practices in particular;" and (2) "The ongoing Rules negotiations in the Doha Round, which are being used by many countries as an opportunity to attack and weaken trade remedies, in particular antidumping laws."

It was a critical error for the Bush Administration to abandon long-standing U.S. policy against including trade remedy laws in the WTO negotiating agenda for the Doha round. The Doha Round is explicitly dedicated to a global redistribution of wealth. According to its Ministerial Declaration, negotiations are to focus "on products of export interest to developing countries....The negotiations shall take fully into account the special needs and interests of developing and least-developed country participants, including through less than full reciprocity in [tariff] reduction commitments." The system is supposed to encourage "developing" countries to protect their home markets while boosting exports. The position of most countries, including China, is that they will take no new steps to open their markets.

The United States should put both WTO negotiations and the WTO dispute settlement system on hold until it gets its own trade situation in order. Washington cannot expect to obtain advantageous outcomes from a system currently stacked against it. We must bargain and negotiate from a position of strength.

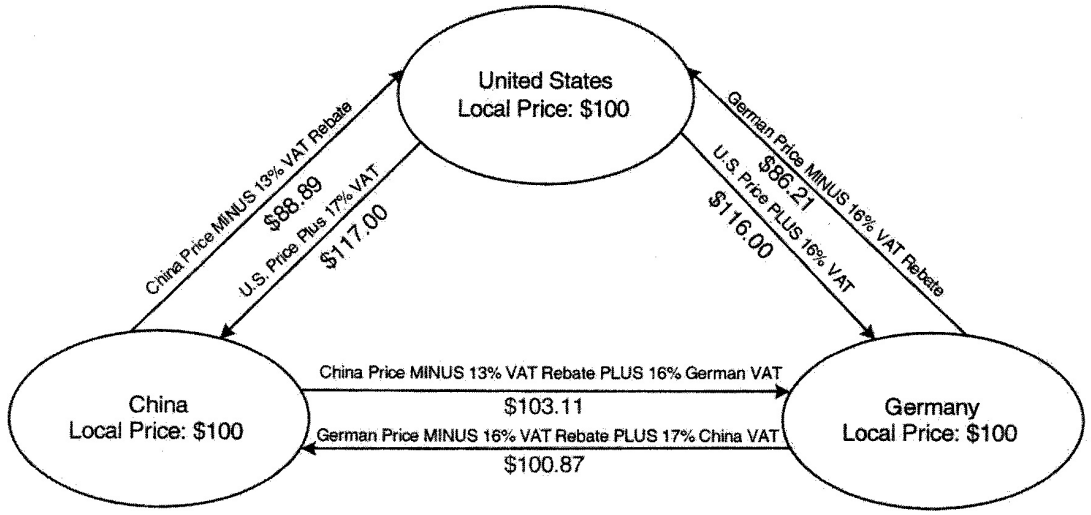
It is my hope that the Commission will take up these USBIC recommendations, especially the Trade Balancing Tariff, and press the Congress and the Executive to adopt them. A Trade Balancing Tariff is critical precisely because it is a comprehensive step that will bring down the trade deficit from its current dangerous levels in short order. It does not require endless negotiations or lengthy trade remedy cases, which are likely to remain both necessary and useful tools in the quest for a more stable trading order.

Again I thank for the opportunity to appear before the Commission and to submit these additional recommendations in writing. Please do not hesitate to contact me directly if you have any questions, or please feel free to contact USBIC's president, Kevin L. Kearns, in Washington for further information.

Sincerely,

William C. Jones
Immediate Past Chairman, USBIC
and
Chairman, Cummins-Allison Corp.

Example of How Current WTO Tax Rules Harm U.S. Manufacturing



Note: Data for Germany and China VAT from the U.S. Council for International Business. See http:\\www.uscib.org.

Financial Times (London, England)
April 21, 2005 Thursday

America badly needs a value added tax:

By PAUL GRIECO and GARY HUBFAUER

When Bill Thomas, Republican Congressman and Chairman of the House Ways and Means Committee, floated the idea of replacing the U.S. corporate income tax with a value added tax this year, he provoked a conservative howl of protest. Conservative-minded opponents of VAT place great weight on the "money machine" argument. They claim that VAT would raise so much money that it would provoke a splurge in Federal spending. That would be a powerful argument if true—but it is not.

We are waist-deep in the splurge, without any help from VAT. In 2004, George W. Bush, U.S. President, and a Republican Congress gave the country Medicare prescription benefits costing more than Dollars 1,000bn over 10 years. That comes on top of existing Medicare, Medicaid and veterans' benefits—all growing without limit. VAT played no role in these programmes. Yet the U.S. has already legislated entitlements that severely outrun the historical limit on Federal taxation, 20 percent of gross domestic product.

Since American experience can provide no support for the money machine argument, conservatives invoke the plight of Europe. They assert that VAT would consign the U.S. to the smothering embrace of a costly European welfare state. By this questionable logic, VAT might also prompt Americans to cultivate an unhealthy affection for Jerry Lewis.

VAT revenues have grown rapidly in Europe. But steep revenue increases are a feature across the European tax landscape, not a peculiarity of VAT systems. VAT did not encourage the growth of European government. Instead, European welfare programmes grew in response to popular demand and forced European leaders to find less distorting taxes with lower rates and broader bases. Doubling the tax rate will lead to about four times the distortion. Unlike the corporate income tax, levied at a Federal rate of 46 percent until the Reagan Administration, VAT rates tend to be about 15 percent.

Dale Jorgenson, the economist, estimates that distortions caused by the current corporate income tax (at 35 percent) already reduce U.S. income by an average of 24 cents for every dollar collected. If the U.S. tries to satisfy even one-third of future revenue needs with higher corporate tax rates, the result could be economic meltdown.

Another conservative charge is that VAT would add to existing Federal taxes, not contribute to tax reform. This allows critics to ignore the harsh fact that U.S. corporate income tax drives companies to other countries with lower rates. It also ignores the forceful personality of Mr. Thomas. He has no intention, in his last term as Chairman, of simply adding another tax to the existing mess.

Conservatives should instead focus on differences between the two main VAT systems. The credit-invoice method used in Europe assesses VAT on each transaction, but allows a credit for VAT paid by companies on their purchase of intermediate goods. This requires a chain of invoices and results in a system that looks similar to a sales or turnover tax. Under the subtraction method, used in Japan, companies pay VAT on their value added, calculated as the difference between final sales and purchases of intermediate goods. Administratively, this system closely resembles the corporate income tax—and is better suited to the U.S.

European countries implemented VAT to replace their archaic turnover taxes, so they applied the familiar credit-invoice system. There is no reason to create such a system at the Federal level in the U.S. It would overlap with state retail sales tax systems and impose accounting burdens on 25m small- and medium-sized companies.

By contrast, a subtraction-method VAT would inherit the administrative system of the corporate income tax. With proper design, no more than 200,000 large companies would file returns. Subtraction-method VAT is less susceptible to an array of differential (and distorting) rates than credit-invoice VAT and its adverse impact on low-income households can be offset by a complementary system of tax credits.

The conservative case against VAT is an argument that taxes should remain as painful and inefficient as possible, lest Americans grow to like them. Conservatives are right that public spending must be restrained, but wrong to think they can achieve restraint through perversions in the tax code. If fellow conservatives thwart Mr. Thomas, they will lay the groundwork for future corporate tax increases that will make them long for VAT.

The writers, who are associated with the Institute for International Economics, are preparing a monograph on U.S. Taxation of Business in a Global Economy.

MAKING GLOBAL MARKETS: WAL-MART AND ITS SUPPLIERS [1]

by

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and

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Forthcoming in *Wal-Mart: Template for 21st Century Capitalism,* edited by Nelson Lichtenstein. New York: The New Press.

INTRODUCTION: THE WAL-MART EFFECT

In the 1990s, as Wal-Mart became the biggest world retailer, its effect on the U.S. economy came under much scrutiny. At first, the "Wal-Mart effect" represented little more than the heightened competition between mass retailers, forcing many of them to merge, acquire other firms, declare bankruptcy, or overhaul their supply chains. But as Wal-Mart revenues grew from $33 billion in 1991 to $191 billion ten years later, some observers argued that the Wal-Mart effect had become an economy wide phenomenon, even one of global proportions.[2] Economists have pointed out that low retail prices help suppress inflation while saving American consumers billions of dollars. As the biggest private employer in the U.S., Wal-Mart creates more than a hundred thousand jobs a year, and as the leader in the implementation of information technology, it is responsible for a significant share of the economy's productivity growth. At the same time, numerous political activists, union leaders, and scholars have attacked Wal-Mart for holding down wages, driving small retailers out of business, and accelerating the shift of manufacturing jobs overseas. And the jobs it does create, they argue, merely cannibalize the jobs once offered by Wal-Mart's higher waged competitors.[3]

The net economic impact of any company, even one as big as Wal-Mart, is notoriously hard to measure, mainly due to the difficulties in specifying how the causal effects of corporate performance reverberate through the rest of the economy. Thus, we should not expect the arguments about the Wal-Mart effect to be resolved anytime soon. Moreover, even if Wal-Mart's overall impact could be calculated precisely, we would still be left with more difficult issues such as its impact on local communities, quality of life and the environment.

In this chapter, we examine the Wal-Mart effect from a different angle. Instead of focusing on standard measures of corporate performance, such as profits and sales, we emphasize Wal-Mart's ability to shape the institutional structure of the economy. More specifically, we explore Wal-Mart's relations with its suppliers, both domestic and foreign. While this topic has often been addressed in the business and popular press and recently even attracted some attention in the academic literature, what is typically missing from the current discussion is a description of various aspects of the retailer-supplier relation in terms of a broader framework of the creation and reproduction of market institutions. Thus, our main goal is to describe Wal-Mart's treatment of its suppliers—from negotiations about price to product development, and from arms-length transactions to long term partnerships—as an aspect of its *marketmaking* activities.

Market making, a concept that we describe in more detail in the following section, refers to all activities oriented toward creating and reproducing opportunities for trade, from pricing and contracting to finding and retaining trading partners, to getting the products into and through the market. Wal-Mart's ability to make markets—to define the shopping environment, the assortment of merchandise, and the "everyday low price" for its customers; to specify the rules of conduct and standards of performance for thousands of its global suppliers is the most profound of all Wal-Mart effects, revealing how the corporation has reshaped the global market for consumer goods during the last twenty years.

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[1] We wish to acknowledge that the research on the retail industry reported in this chapter has been supported by the Committee for Industry Studies at the Sloan Foundation. We also wish to thank Elif Andac and Deenesh Sohoni for their comments on an earlier draft.

[2] Most recent discussions of the Wal-Mart effect cite McKinsey & Company's 2001 study: The U.S. Productivity Growth, 1995–2000 (http://www.mckinsey.com/mgi/reports/pdfs/productivity/usprod.pdf) which attributes 12% of the economy-wide productivity gains to Wal-Mart's drive for efficiency.

[3] For a typical popular summary of such criticism see "Is Wal-Mart Too Powerful?," Business Week. (Oct 6, 2003), 3852, p.100.

At the same time, we should note that our present focus on Wal-Mart should not be taken to imply that this company's market making efforts are somehow unique or unprecedented. While its size and global influence may indeed be exceptional, Wal-Mart is just the most outstanding example of the new brand of retailers that have recently come to play a dominant role in creating and shaping global markets for consumer goods. Wal-Mart may have the starring role, but it is surrounded by a very talented cast that includes Carrefour, Aldi, Metro, Royal Ahold, Tesco, Ito-Yokado, Kingfisher, and Ikea, as well as Home Depot, Costco, and Best Buy. And these large retailers are joined by a supporting crew of brand name marketers and assemblers, such as Nike, Gap, VF Corporation, The Limited, Louis Vuitton, OttoVersand, Dell, Hewlett Packard, and many other similar firms.

Our analysis of Wal-Mart as a market maker should be seen as part of a larger historical narrative that brings together three trends in the global economy. The first is the shift in the balance of market power from manufacturers to retailers, a process that so far has developed to the greatest extent in the United States, but is also starting to accelerate elsewhere. The second trend refers to the rise of new global manufacturers, especially in East Asia, and the concomitant decline of international competitiveness of many American manufacturing firms. The third trend is the growing power of consumers in shaping marketing and production choices throughout the distribution channel. All three trends represent a shift in *market power relations,* and in all three large American retailers have played the crucial role. Since the late 1970s, they have provided market mechanisms by which the competitive advantages of foreign manufacturers have been translated into lost orders for American firms. At the same time, their access to consumer purchasing information and their control over marketing channels have not only increased retail power over their suppliers but also generated a greater sensitivity to consumer preferences, which is often somewhat misleadingly interpreted as the increase in "consumer power."[4]

MARKET MAKING AND RETAIL POWER: A CONCEPTUAL OVERVIEW

Since the late 1970's, an increasing number of industry observers have been describing the shift in market power from manufacturers to retailers. They have identified several causes of such a power shift, including the retailers' ability to use point-of-sale data to directly assess consumer preferences, the increase in retail concentration, the decrease in effectiveness of mass media as marketing channels, and the proliferation of store brands. Large retailers, they argued, are increasingly able to squeeze their suppliers and induce various forms of price concessions.[5]

However, empirical studies of the performance of retailers and their suppliers in this period show no clear evidence of systematic differences or a shift in their profitability. Moreover, manufacturers who sell only to large retailers that dominate particular markets do not necessarily have lower profit margins than those that do not, or even than those powerful retailers themselves.[6] Instead of trying to explain away such findings, we propose to sever the link between the notion of market power in the distribution channel and the profitability of retailers and their suppliers. Thus, we define vertical competition, and, by implication, the power distribution between retailers and manufacturers, in terms of their respective abilities to shape the conditions of trade. This cannot be reduced to mere bargaining about prices and quantities. Market negotiations also include issues such as how and when the product will be delivered, who will take the responsibility for packaging and presentation, advertising and warranty provisions, and even product character and composition. In other words, retailers and manufacturers compete not only to determine the out-

[4] Since we focus mostly on the making of supplier markets, we skip the discussion of the rise of "consumer power" and the concomitant changes in consumer markets. We should note, however, that the increase in consumer power, as defined by the increased sensitivity of both retailers and manufacturers to consumer demand, was brought about mainly by the changes in industrial structure and the general increase in competition, as well as by the development of more efficient tools for assessing consumer preferences, and not by changes in consumer behavior or bargaining power. The so-called increase in consumer power, in other words, simply describes the increased efficiency of consumer goods markets.

[5] For a good review of these arguments see: Kusum L. Ailawadi, "The retail power-performance conundrum: What have we learned?," Journal of Retailing, 77 (2001), 299–318.

[6] ibid., also: Paul N. Bloom, and Vanessa G. Perry, "Retailer power and supplier welfare: The case of Wal-Mart," Journal of Retailing 77 (2001) 379–396. Other indicators of the retail power have been proposed, such as the increase in slotting allowances and similar forms of trade promotion, as well as the increase in the share of store brands, but in absence of the profitability differential, it is not clear whether and how these indicators translate directly into market power.

comes of market negotiations, but also to set the rules and mechanisms by which these outcomes are typically determined.

THE EVOLUTION OF THE RETAIL POWER, 1960–1990

Before the late 1970s, there was little talk about the power of retailers over their suppliers. A few giant retailers, such as A&P and Sears have had an undeniable power over their vendors for the better part of the twentieth century, but they were treated as exceptions rather than indications of industry-wide trends. In the postwar era, the economic power of large American manufacturers seemed unassailable. They were seen as paragons of technological sophistication and organizational efficiency, in marked contrast with the labor intensive, low-tech retail sector still dominated by relatively small firms and segmented markets.

The relations between retailers and their suppliers started to change in the early 1970s as a result of three major factors: retailers' ability to deploy new information technologies to assess consumer demand; the increased concentration of the retail sector; and the increase in global competition in suppliers' industries. While the impact of these three was felt throughout the 1970s, it was not until the early 1980s that they converged to bring about a dramatic change in the retail power and enable the new generation of "big box" retailers to become a major driving force in shaping the American economy. For the first time since the 1920s, and perhaps since the emergence of the modern industrial enterprise, it was the merchant, not the manufacturer, who led the drive to rationalize market institutions. From the diffusion of bar codes and scanning devices, to electronic data interchange, direct store delivery, and quick replenishment, to integrated logistics solutions and vendor managed inventory, the rationalization initiatives and technological innovations flowed from large retailers to their suppliers.

Although less well recognized, the impact of the big U.S. retailers on their foreign suppliers and on the growth of their host economies was no less powerful. Retailers did not just buy products in developing countries; they also organized and rationalized global supply chains, established trade standards and logistics solutions, and even ventured into product development. The rapid growth of East Asian economies in the 1970s and 1980s would have been inconceivable without the strong U.S. demand for manufactured goods, and the paramount role of big retailers in organizing and channeling that demand.[7]

The retailers that emerged as industry leaders in the 1980s were not the same ones that dominated the top ranks of the industry between 1930s and 1970s. Instead of traditional department stores, national mass merchandisers (Sears, Montgomery Ward, and J.C. Penney), and grocery chain operators, the new industry leaders came from the ranks of full-line and specialty discounters. Wal-Mart, Kmart, and Target, the "big three" of the discount industry, all started their operations in 1962; Home Depot, Costco, Best Buy, Office Depot, Gap, Limited, and Nike are of an even more recent vintage. In order to understand the sources of the retail power in the 1980s, then, we first need to go back to the 1960s and the emergence of the discount retailing.

In its 1961 annual report, the Woolworth Company, then the seventh largest retailer and for several decades the largest variety chain operator in the United States, depicted a worldwide revolution in retailing which "reveals consumer willingness to dispense with certain services in exchange for cash savings and the shopping for all manner of goods under a single roof, with self-selection and checkout counters." Responding to this trend, the company announced that it would establish, beginning in the early 1962, "a chain of mass-merchandise, self-selection, low-margin, high quality Woolco Department Stores," in the United States and Canada.[8]

By the time Woolworth decided to join the ranks of discounters, the "discounting revolution" that had started only a couple of years earlier was in full swing. The success of the pioneer hard-good discounters of the 1950's, such as E. J. Korvette,

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[7] Gary Gereffi's concept of buyer-driven supply chains was one of the first steps toward recognizing the global development impact of American retailers and brand name merchandisers (see for example: Gary Gereffi, "The Organization of Buyer-Driven Global Commodity Chains: How U.S. Retailers Shape Overseas Production Networks." Pp. 95–122 in Gary Gereffi and Miguel Korzeniewicz (eds.), Commodity Chains and Global Capitalism, (Westport, Connecticut: Praeger, 1994). The linkages between the U.S. "retail revolution" and the Asian Miracle are explored in more detail in Robert C. Feenstra and Gary G. Hamilton, Emergent Economies, Divergent Paths: Economic Organization and International Trade in South Korea and Taiwan. (New York: Cambridge University Press, 2005).

[8] The first Woolco unit opened in June 1962 in Columbus, Ohio, an imposing 100,000 square feet store with a line of departments closely resembling the full service department store and carrying mostly nationally advertised merchandise. Godfrey Lebhar, Chain stores in America, 1859–1962, (New York, Chain Store Pub. Corp., 1963)

Vornado, Zayre, and Arlan's, revealed that massive inefficiencies could be squeezed out of traditional retailing. Apart from the grocery sector, where supermarkets had driven the rationalization trend since the 1940s, and the automotive and gasoline sectors, where distribution was tightly controlled by large manufacturers, other retailing firms enjoyed the benefits of the seller's market, with high gross margins, little direct price competition, and little incentive to innovate.[9] Thus, the first discounters were able to offer standard, mostly branded consumer goods at prices 10–25 percent less than what other stores were charging, simply by cutting their operating costs and accepting lower profit margins. By the late 1950s, discounting became sufficiently well established to attract the attention of large chain operators, mostly of variety and junior department stores, whose entrance into the field signified the beginning of the discount revolution. These included Dayton Hudson's Target stores, and Treasure Island stores operated by J.C. Penney as well as Woolworth's Woolco and Kresge's Jupiter and K-Mart stores. In 1962 alone, more than twenty retail chains, including Wal-Mart, started discount operations, prompting the *Fortune* to publish a comprehensive study of the new trend, spanning four issues of the magazine and titled "The Distribution Upheaval."

The buying power of these chains and their experience in managing large number of establishments pushed the discounting sector to a new level of competitive advantage. The merchandise assortment was not only expanded but also systematized, coming to resemble that of a department store. The associations with the hodgepodge assortment of cheap merchandise of many early discounters was repudiated and several operators decided to call their stores promotional rather than discount, while nonetheless upholding the principles of self-service and discount prices.

Woolworth's 1961 report mentioned above had captured the major elements of the format that, by the end of the decade, was to emerge as the discounting mainstream: the large, free-standing store that provided easy access and ample parking; the breadth of merchandise assortment that paralleled, although on a smaller scale, that of the department store, and thus allowed one-stop shopping; the replacement of the labor intensive model of "full" customer service with rationalized and automated forms, ranging from new ways of tracking and packaging goods to store designs that relied on shopping carts and electronic cash registers; and, of course, the emphasis on low prices. The format itself was hardly new; in fact, it represented little more than the application of the supermarket model, introduced in the late 1930s, to non-grocery retailing. What was new, however, and what perhaps is most deserving of being labeled a revolution, was how rapidly the discounting format was adopted in the general merchandise sector and also how rapidly, once the adoption reached a critical mass in the early 1970s, those new discounters emerged as the leaders in technological and market making innovation.

The favorable macroeconomic climate of the 1960s generated a lot of room for growth in the discounting sector, and the competition stayed relatively low with few bankruptcies and few mergers recorded before the mid-1970s recession. The full line, medium sized discount store, represented by Kmart, Woolco and Gibson stores, became the dominant format of the discount sector. The revenues of general merchandise discounters had surpassed those of department stores by 1970, but this was mostly the result of the rapid decline of the independent department store; at the same time, department store chains and mall-based specialty retailers, experienced strong growth.

Consolidation and intense competition characterized the 1970s. Many pioneer operators, including several top ten chains, such as Korvette and Vornado (Two Guys), folded during the decade. The recessions of 1980 and 1981 led to another wave of bankruptcies, including Fed-Mart, J.C. Penney's Treasure stores, and Woolco, the second biggest discount chain. At the same time, the second half of the 1970s saw a flurry of acquisition activity, led by Kmart, which by 1977 operated one thousand stores, had over ten-billion dollars in revenues, and had passed J.C. Penney to become the third biggest retailer in the United States. Wal-Mart and Target were among other major buyers of the period, and by 1982 they joined Kmart to form the Big Three of the discount world, controlling 35% of the sector's 70 billion in sales.[10]

The rapid consolidation, while certainly accelerated by the turbulent macroeconomic conditions, betrayed a more fundamental shift in the nature of dis-

[9] Barger's calculations show retail margins to be around 18 percent and declining for the supermarkets. See Harold Barger, Distribution's Place in the American Economy since 1869, (Princeton, NJ.: Princeton University Press, 1955)

[10] ibid.; Kmart by itself accounted for 25%. All three retailers combined were still smaller than Sears. Only ten years later, Wal-Mart will pass Sears to become the biggest retailer in the world (Fortune Magazine, Top 50 Retailers List).

counting. As large discounters expanded their merchandise assortment and achieved economies of scale in purchasing, their pursuit of operational efficiency shifted to more sophisticated strategies of rationalizing their internal operations. Kmart, Wal-Mart, Zayre, and Target emerged as industry leaders in adopting and further developing two major technological innovations of the period, the use of computers for inventory management and stock replenishment, and the automated distribution center. By the end of the 1970s, this small group of leading discounters managed to surpass all other retailers, even the supermarket chains, in technological and organizational integration.

The 1980s brought a rapid proliferation of discounting formats, including their penetration into specialty retailing. At the beginning of the decade, 19 out of 20 top discounters carried full lines of general merchandise; at its end this was true only for ten of them.[11] Warehouse clubs, off-price retailers, and specialty discounters in electronics, toys, office products, and "home improvement" merchandise all joined the ranks of industry leaders in the late 1980s. At the same time, mass merchandisers, such as Sears, and Montgomery Ward; department stores such as Dillard's, Ames, and Mervyn's; and apparel and footwear chains such as Melville Shoe, The Limited and The Gap, came to operate on the same principles as the discounters. By the late 1980s, the line between the discount industry and other retailers had blurred to the point that the very notion of discounting lost any distinctive meaning. This led to more competition and, hence, to a major wave of consolidation. Among top ten discounters of the 1980, only four—Wal-Mart, Kmart, Target, and failing Caldor—were still in operation in 1992. Of the 42 department stores chains operating in 1980, only 20 remained in the business a decade later. Fully 80 percent changed hands during that time.[12]

Even the big three discounters had their problems. Kmart debuted two off-price apparel chains, the upscale Designer Depot in 1983 and the more basic Designer Rack the following year. Target followed with its own version, Plums, the same year, but all three proved unsuccessful and folded by the late 1980s. Wal-Mart had its own share of failures with dot Discount Drugs (started in 1983, sold in 1990) and Helen's Arts and Crafts (1984–1988).

The strategies of the Big Three diverged in the mid-1980s. Kmart, still the biggest of the three, went aggressively into specialty retailing, acquiring Walden Books, Payless Drug, Builder's Square, The Sports Authority, Office Max, and Borders. At the same time, it pursued a private brand apparel strategy in its discount stores and expanded its national advertising presence. While K-Mart initially shunned the warehouse club and the combo grocery-discount formats, it entered this segment in 1987 with American Fare hypermarkets and followed shortly with Pace Membership Clubs and Kmart supercenters. This intense expansion and diversification strategy took its toll, however, in the 1990s, when, unable to complete a massive renovation of its discount stores, Kmart divested most of its specialty holdings and went through several waves of reorganization.

Target, the smallest of the Big Three, pursued a different strategy. Its parent, Dayton Hudson, acquired Mervyn's chain of junior department stores and the stores of the bankrupt Ayr-Way and Fed-Mart, but sold its B. Dalton bookstores as well as its controlling interest in nine regional shopping malls. Instead of diversifying, Target thereafter successfully focused on apparel and household furnishings, establishing an image of an upscale discounter.

While Kmart was emulating Sears's diversification strategy and Target aligned itself with Penney's and the department store chains, Wal-Mart, the most efficient and fastest growing of the three, led the development of warehouse and combination (grocery and general merchandise) formats. The first Sam's Wholesale Club opened in 1983, and by 1991 Wal-Mart became the leading warehouse operator (only to lose the first place to the newly merged Costco and Price Club in 1993); its first hypermarket—Hypermart USA—opened in Dallas at the end of 1987 and the first supercenter followed in 1989. But Wal-Mart's expansion strategy, in terms of market scope as well as merchandise assortment, remained extraordinarily cautious, especially for a company that averaged 40% growth a year in the late 1970s and the early 1980s. Most of its stores were still in small towns and even in 1990, when it surpassed Kmart and was one year away from passing Sears to become the

[11] "1982 to 1992: Clubs and category killers arrive on the scene," DSN Retailing Today, (New York: Aug 2002), Vol.41, Iss. 15.

[12] Allied, Federated, Carter Hawley Hale and Macy's all filed for bankruptcy in this period, as did many regional and specialty chains. At one point in the early 1990s more than one quarter of the total department store retail space was under Chapter 11 proceedings. James R Eckmann, "The Future of Retailing" pp. 32–34 in The Retail Industry edited by Charles Ingene (Charlottesville, VA: AIMR, 1993).

world's biggest retailer, it operated in only 28 states. David Glass, the CEO from 1988 to 2000, described the development of Sam's Club stores as a result of investors' pressure to diversify, adding that "[i]t complemented the Wal-Mart store: We can put them side by side; they get different customers. Sam's was also more of a metro strategy than what we were doing in Wal-Mart".[13] Similarly, the supercenter format was a direct extension of the idea of one-stop shopping and it required little more, at least from the consumer's perspective, than putting a supermarket and a discount store under the same roof.

Even before it became the largest U.S. retailer, Wal-Mart had established itself as the undisputed leader in defining the mainstream form of general merchandising. With Sears and Kmart aggressively pursuing diversification and struggling to define their core merchandising strategy, and Target and Penney's repositioning themselves as leaders in basic fashion and soft goods, Wal-Mart remained the only major general merchandiser to clearly emphasize the more traditional, full line discount approach. The proliferation of new products in the 1970s and 1980s made this strategy increasingly precarious. Compared to the Sears of the 1950s and 1960s, let alone to the early twentieth century department store and the Sears general catalog, the assortment of merchandise in the Wal-Mart discount store has always represented only a minuscule share of all goods available to the consumer. The rapid rise of specialty retailers in the 1980s seemed to indicate that consumers were looking for more choice and more depth in each merchandise category rather than the convenience of one-stop shopping for a wide variety of goods. Wal-Mart's subsequent performance demonstrated that the American retailing landscape still had a place, and indeed a sizeable one, for an enlarged version of the old variety store.

Information Technology and Lean Retailing

Discounters' implementation of information technologies (IT) in the 1980s was only the third wave of IT innovation in the retail trade, but the first one to have a substantial influence on the manufacturing sector as well.[14] Starting in the early 1960s, retail applications of IT were at first limited to a small number of financial and inventory management tasks, slowly expanding to incorporate other aspects of the business process. In the early 1970s, the main objectives of IT deployment became the integration of systems for reliable tagging and automatic identification of products, on the one hand, and the point-of-sale (POS) scanning and recording devices such as electronic cash registers, credit card, and check ("electronic fund transfer") readers, on the other. The development of the Universal Product Code (UPC) system by a number of major food manufacturers and grocery chains in the mid-1970s marks the first successful convergence of the two systems. This created an opportunity for efficient integration of the front-end, financial, and inventory management aspects of the business process.

The cost of implementing a new system of automated checkout counters equipped with barcode scanners was considerable, and the advantages of the new system could be realized only when a substantial proportion—estimated in the business literature at the time to be about seventy to eighty-five percent—of the products were coded. With a strong support from the food industry, this objective was reached in the supermarket sector as early as 1976, only two years after the first implementation of the system, creating a substantial advantage for the early adopters.[15] In the general merchandising sector, the development was slower, hampered by a much higher number of stock keeping units and by a greater diversity of suppliers. Moreover, the need for speed at the checkout was less pressing than in the grocery sector, since most purchases consisted of only a small number of items. Instead of bar codes, department stores and mass merchandisers used tickets with standardized type, usually generated in-house, and OCR devices ("wands") for scanning. The lack

[13] Hank Gilman, "The Most Underrated CEO Ever—An Interview With David Glass," Fortune, (New York: Apr 5, 2004), Vol. 149, 7, p. 242.

[14] In general, the use of computers in manufacturing predated their use in retailing by almost two decades. See James W. Cortada, The Digital Hand: How Computers Changed the Work of American Manufacturing, Transportation, and Retail Industries, (New York: Oxford University Press, 2004). However, as we will see shortly, the initiatives to use computers for developing inter-organizational links in the supply chain typically flowed from the retail industry to their suppliers. Moreover, the retail industry 49 Petrovic, Hamilton: Making Global Markets has, arguably, been transformed much more drastically by the implementation of IT than any other sector of the U.S. economy, with the possible exception of trucking.

[15] Frederick H Abernathy, John T. Dunlop, Janice H. Hammond, and David Weil, A Stitch in Time: Lean Retailing and the Transformation of Manufacturing—Lessons from the Apparel and Textile Industries. (New York: Oxford University Press, 1999); Cortada, Digital Hand; In 1978, only one percent of grocery stores nation-wide had barcode scanners installed, but these were the most progressive chain stores. In the 1981, the proportion went to ten percent, representing the majority of big supermarket chains.

of standardization meant that the innovation was more dispersed than in the grocery sector, and first adopters were often smaller department store chains such as Mervyn's and Dillard's. By the end of the 1970s, most major chains relied heavily on the use of wands, with Sears the sector's heaviest user.[16]

The situation changed dramatically during the 1980s, with momentous consequences for the retailing industry as well as for transportation and manufacturing. The supermarket industry ceased to be the innovation leader, and the big discounters, led by Wal-Mart and Kmart, emerged as the champions of the UPC, driving its diffusion along their supply chain. Supermarket chains had both less incentive and less opportunity to innovate outside their own industry. Unlike general merchandisers, they faced a small, highly concentrated group of large domestic suppliers, in the food, tobacco, and health care industries, that had no significant foreign competition. At the same time, the competition between supermarket chains was quite limited. The major "national" chains operated in segmented local markets, competing mainly against smaller chains and independents.[17]

In contrast, the discounters relied upon a more atomized set of supply industries, most of whom faced a significant degree of import penetration. Not only was their power to shape supplier markets much greater than in the grocery sector, but they also had more incentive to innovate, due to the intense competition in the general merchandise retailing sector. By 1980, therefore, leading discounters recognized that major promises of IT could be realized only by the reorganization of the entire supply chain. Kmart and Wal-Mart, as well as a group of leading apparel retailers such as Gap and The Limited, started pressuring their suppliers to tag all their products *before* the delivery, and to develop capabilities for rapid and efficient delivery to the retailer's highly automated distribution centers. By 1986, the practice was well established and the benefits became obvious enough to require more concerted action by the industry leaders.

Hence came the Voluntary Inter-Industry Communications Standards (VICS) initiative led by general discounters, department stores, and apparel retailers, but also including distributors and manufacturers. Despite its name, VICS demanded somewhat less-than-voluntary compliance with its suggested standards, the first of which was the general adoption of the UPC throughout the supply chain. The first marketing message that retailers sent to their suppliers about the UPC requirement was, in the words of the then Chief Information Officer of Wal-Mart, Bob Martin, "pretty positive."[18] It had the familiar picture of a barcode, accompanied by the message: "The fastest route between the two points is the straight line." The fine print read: "Universal Product Codes are required for all items BEFORE ORDERS WILL BE WRITTEN." "When companies did not comply," Martin continues, "a little bit stronger message, more than a marketing campaign but still polite, was needed." Using the same picture and the fine print statement, the main message now simply asserted: "If you don't draw the line, we do."[19]

The UPC requirement was the first VICS recommendation. There soon followed Electronic Data Interchange standards and codes for shipping containers and intermediate products. By year 2000, over ninety percent of the entire non-food consumer goods industry in the U.S. (in terms of volume), as well as a large number of global companies, were members of VICS and promulgated its standards. The result was a new, rationalized system of production and distribution. Frederick Abernathy and his associates have summarized the technological requirements of this new system, which they call "lean retailing," in terms of four building blocks: UPC, tags, and scanning devices; computerized inventory management; automated distribution centers; and adoption of communication standards throughout the supply chain.[20]

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[16] "Wanding: Slow, Steady Progress," Chain Store Age Executive with Shopping Center Age, (New York: June 1978), Vol. 54, 6, p. 33.

[17] The concentration in the grocery sector stayed low throughout the period—the revenue share of the top 20 chains increased from 35% to only 37% between 1972 and 1987. Major merger and consolidation attempts were rare before the 1990s, as most chains relied on debt financing through leveraged buyouts and recapitalization as core growth strategies. In terms of direct competition, "peripheral markets were sacrificed and what commentators described as the "geography of avoidance" or policies of competitive "forbearance" were practiced (. . .) Overlapping geographic areas between the three major competitors were profoundly circumscribed. Only in 6 of 54 Grocery Manufacturers of America areas did the three major players (Kroger, Safeway, and American Stores) choose to compete with each other." Andrew Seth and Geoffrey Randall. The Grocers: The Rise and Rise of the Supermarket Chains, (London: Kogan Page Ltd. 2001), p. 196.

[18] Bob L. Martin, "From Vision to Reality," Pp. 34–42 in Twenty-Five Years Behind Bars edited by Alan L. Haberman (Cambridge, MA.: Harvard University Press), p. 39.

[19] ibid.

[20] Abernathy et al, A Stitch in Time.

Through their adoption of lean retailing techniques, Wal-Mart and other large discounters were able to induce suppliers—trading companies, manufacturers, shippers, and fast-freight forwarders—to rationalize their own operations in accordance with the retailers' requirements. These measures created an awareness of the seminal importance of the supply chain itself. Before the 1980s, the links between manufacturers and retailers were conceptualized from the manufacturers' point of view, as distribution channels. With the advent of lean retailing, the perspective shifted to that of the retailers. As Philip Schary and Tage Skjott-Larsen put it, the supply chain now identifies "the complete process of providing goods and services to the final user," and conceptualizes "all parties and logistics operations from supplier to customer" to be part of a single system, a system that is evaluated in terms of the "performance of the chain as a whole." This system includes "procurement, production and distribution operations, ... extends across organizational boundaries, (and) is coordinated through an information system accessible to all members."[21]

Global Competition in Consumer Goods Industries

Since the early 1970s, a substantial share of the merchandise carried by discounters has been imported from East Asia. This started in the 1960s, with a flood of cheap house wares, consumer electronics, and small motorcycles imported from Japan and apparel from Hong Kong. In the 1970s Taiwan and South Korea joined the ranks of major exporters. By 1972, as Japan increasingly shifted toward exporting cars and other high technology goods, the imports from this group of Asian economies accounted for two-thirds of the value (and a substantially higher proportion of the quantity) of all U.S. imports of apparel and small electric appliances, 57 percent of kitchenware, and 80 percent of consumer electronics.

These already impressive numbers continued to increase during the 1970s, but they tell only one part of the story. Perhaps more importantly, the increasing share of imports from Asia was paralleled by the increasing share of the total imports in domestic consumption. As we can see in Figure 1, this increase was particularly dramatic between 1965 and 1975, with electronics, sporting goods, footwear, and leather products leading the way.

Cheap imports from Asia shifted the power balance between discounters and their domestic suppliers. Throughout much of the 1960s, discounters scrambled to fill their stores with quality merchandise, typically conceding to suppliers' terms. By the mid-1970s, however, they were not only able to demand quantity discounts and other concessions based on their control over a substantial share of the consumer market, but also threatened to circumvent uncooperative suppliers in favor of their foreign competitors.

An account of how they established linkages with Asian manufacturers is described at length in another location.[22] It is sufficient here to say that most Asian manufacturers had little to no access to the American market except through retailers and merchandisers, and therefore willingly adapted to the exchange requirements placed on them by specialty and discount retailers, as well as such brand name merchandisers as Nike. Because different Asian manufacturers had different production capabilities, American buyers quickly became quite sophisticated in where and with whom they would place their orders. For instance, orders of long runs of standardized massproduced items, such as microwave ovens and television sets, were placed with Korean and Japanese manufacturers, whereas short runs of batch-produced items, such as women's fashion apparels, were given to Taiwanese and Hong Kong manufacturers. Companies having a line of differentiated products, such as Nike or The Gap, would match their orders with the firms having capabilities to produce those products. Repeat orders of different kinds of products, as well as similar products targeted to different niche markets, helped to build diversified manufacturing capabilities across Asia, so that, by the late 1970s, buyers could order almost any type of consumer product from somewhere in Asia and have it made according to their specifications. As Asian manufacturers improved their ability to respond to buyers' demand, American manufacturers found themselves increasingly losing whatever leverage they may have had in earlier decades.

By the mid-1980s, the United States imports of consumer goods from Asia reached their peak, with over seventy percent of imported non-automotive consumer goods in those years coming from a select group of East Asian economies (i.e., Japan, Taiwan, South Korea, Hong Kong, and Singapore). A very large proportion of these goods, from apparel and footwear to consumer electronics to toys and sporting goods, were sold by the largest, most cost-conscious American retailers. Concerned that the

[21] Philip B. Schary and Tage Skjott-Larsen, Managing the Global Supply Chain, Copenhagen: Handelshojskolens Forlag, 1998, pp. 20–21.

[22] Feenstra and Hamilton, Emergent Economies.

trade deficit was too high and that U.S. manufacturing was losing its competitive edge, the U.S. Government negotiated with the East Asian governments of Japan, Taiwan, and South Korea to allow their currencies to float upwards by around 40% versus the U.S. dollar. The agreement, known as Plaza Accords (it was signed at the Plaza Hotel in New York City), was reached in September 1985 and led to a thorough reorganization of Asian manufacturing.

Faced with the sudden increase of the dollar value of their factor inputs, and eager to keep their prices low, and thus to maintain their contracts with American retailers, Asian businesses quickly began to diversify. Most of Taiwan's light industries (i.e., garments, footwear, low end consumer electronics) moved to locations where property and labor were much cheaper than in Taiwan, primarily to Mainland China, but also to Southeast Asia. Many of these firms established low-end mass-market production lines in China, and retained high-end niche market batch production in Taiwan.[23] Large segments of Japanese export-oriented industries moved to Southeast Asia.[24] In addition some firms, such as Toyota, Honda, and Sony, established portions of their business in the United States. South Korean business also moved labor-intensive operations to Southeast Asia, as well as to other developing countries in Latin America and Central Europe. In each place that they established their new businesses, low-price supplier networks began to form.

At the same time, businesses that remained at home either made core component parts for export to their overseas factories, upgraded their existing lines of products, or started manufacturing entirely new products. Fortuitously, from the late 1980s through the 1990s, high technology industries created completely new product worlds (e.g., personal computers, cell phones, compact disk and DVD players) based on components that Asian and not U.S. based firms manufactured from the beginning.[25] These new industries more than replaced the export volume of the older industries that had moved overseas. By the early 1990s, Asian firms were making both the high-end and low-end products in most categories of consumer goods.

Both in high technology industries at home and in light industries that had moved to other countries, Asian manufacturers began to implement supply chain techniques that American retailers and trade name merchandisers required. A consequence of this reorganization was that a smaller numbers of Asian firms began to produce larger quantities of goods destined to be sold in fewer chain stores in the U.S. and now increasingly around the world. Such companies as Dell, The Limited, and Nike worked through exclusive networks of producers, often selecting lead Asian firms to coordinate their supply lines, including, most importantly, production. Large American retailers also developed overseas buying offices that concentrated on buying particular products in particular places from particular firms. As a result, many of their Asian subcontractors and suppliers grew very large and began to adopt vertically integrated, economy-of-scale production systems to meet their orders.

The reorganization of supplier networks in Asia was not always smooth, but still created intense global competition in consumer goods industries that further reduced the competitiveness of the U.S. based suppliers. The latter increasingly found themselves unable to make existing low-end products at the price points required by American retailers, match the quality of high-end Asian manufactures, or enter into the new industries where Asian manufacturing firms had advantages from the outset.

WAL-MART AND ITS SUPPLIERS

Wal-Mart's growth in the 1990s

In the 1970s and 1980s, Wal-Mart was a rising power among other U.S. retail powers. But by the early 1990s, Wal-Mart outgrew the retailing context to become a major force in restructuring large sectors of the domestic, and increasingly, the global economy. Before the decade began, in 1987, Wal-Mart was still an upstart, an unusually successful regional retailer with strong presence in twenty states (and a few stores in another three), that dominated small town markets. Its technological savvy and its phenomenal growth rate, averaging over 30% a year in the 1980s attracted a lot of attention from the business press as well as competitors. Moreover, the Buy American campaign initiated in 1985 was hailed as a paragon of corporate patriotism, overshadowing protests of local merchants against opening of new Wal-

[23] Cheng-shu Kao and Gary G. Hamilton, "Reflexive Manufacturing: Taiwan's Integration in the Global Economy" International Studies Review 3,1 (June, 2000): 1–19.

[24] Yamamura, Kozo and Walter Hatch, Asia in Japan's Embrace : Building a Regional Production Alliance (New York: Cambridge University Press, 1996).

[25] This led to the emergence of U.S. based computer firms, such as Dell (1984) and Gateway (1985), that from the beginning relied exclusively on Asian manufacturing.

Mart stores in their communities.[26] Still, in 1987, with its 1,000 discount stores and 84 warehouse clubs, generating almost $16 billion in sales, Wal-Mart was only the fifth biggest retailer in the U.S., one third the size of Sears.

Only five years later, in 1992, Wal-Mart had already become the established leader of the industry, having surpassed Kmart in 1990 and Sears in 1991. Its 2000 discount stores (including new supercenters) and 256 Sam's clubs, now spread over 45 states, Puerto Rico, and, as the first international venture, Mexico, generated sales of over $50 billion. Its newly acquired wholesale distribution subsidiary, McLane Co., distributed groceries to over 30,000 convenience and independent stores (generating almost $3 billion in sales), and its trucking fleet and system of distribution centers were the biggest in the country.[27]

This, however, was only the beginning of the new phase of Wal-Mart's growth spanning the rest of 1990s, a phase represented by two trends that departed from Wal-Mart's previous strategies: its rapid expansion into grocery retailing, driven by its supercenter format, and its first efforts at global retailing.

Supercenters and the reorganization of American retailing

The supercenter format seemed a logical next step in the evolution of one-stop shopping, combining a supermarket sized grocery section with the standard assortment of discount merchandise. However, the earlier attempts to create such "combo" stores, including Wal-Mart's own experiment with Hypermart USA, were only moderately successful and the business press often dismissed them as lacking merchandising focus or being inappropriate to the American shopping culture. It was not until 1992 that Wal-Mart's management realized that the supercenter format could be the mainstay for the company's future growth. Unlike hypermarkets, which were located in metropolitan areas where they experienced intense competition from category killers and established supermarket operators, supercenters followed Wal-Mart's proven strategy of small town expansion and "geographic fortification,"[28] and were often based on existing discount stores, with their already established customer base. Supercenters were such an immediate success that even Wal-Mart's management was surprised. Discovering that adding grocery department to existing stores typically increased sales of non-food merchandise by 30%, Wal-Mart accelerated the conversion of discount stores into supercenters. In 1994, supercenters represented the majority of newly opened stores (see Table 1). At the end of 2004, there were more than 1600 supercenters in the U.S., the number that is likely to double in the next five years.

The ascendance of supercenters and warehouse clubs dramatically changed the nature of retail competition in the United States and led to the integration of general merchandise, specialty retailing, grocery, and drug store sectors. By 2003, this newly integrated sector accounted for $1.5 trillion in retail sales. Table 2 shows the relative performance of its main retail formats, both discount and non-discount ones. Wal-Mart supercenters, the most formidable retailing force of the last decade, capture around 7% of the total sector sales, and industry analysts predict this share to triple in the next six years.

The Wal-Mart supercenter defines the very core of this new field of integrated merchandising. Other giant retailers—Target and Costco, Kroger, Safeway, and Albertsons, Walgreen and CVS, the newly merged Sears and Kmart, and even Wal-Mart's own Sam's Club—increasingly position themselves in relation to supercenter retailing, some trying to emulate it, others emphasizing what they do better, or differently. Consolidation in each of the four major formats that compete directly with supercenters—warehouse clubs, supermarkets, drug stores, and discount department stores—left only a handful of major competitors with a lion's share of the market (see Table 3 for the list of biggest American retailers).

Further toward the periphery, yet still well within this field of competitive forces, are specialty apparel retailers such as Gap and The Limited, off-price apparel discounters such as TJX, and department stores, including J.C. Penney's, Kohl's and Dillard's. As their overall share of the soft goods market continues to shrink under the assault of big discounters, they are forced to pursue diversification strategies,

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[26] Wall Street Journal and New York Times ran several articles in the late 1980s, denouncing Wal-Mart's impact on small towns. The referendum in Steamboat Springs, Colorado, in 1989 was perhaps the first organized community action against opening a Wal-Mart store. More frequently in those days, however, the press and local communities lamented closing rather than opening of Wal-Mart stores. Sandra S. Vance, Roy V. Scott, Wal-Mart: A History of Sam Walton's Retail Phenomenon (New York: Twayne Publishers, 1994) p. 153.

[27] Wal-Mart Stores, Inc., Annual Report 1993.

[28] The expression was used by Stephen Kotvis, a retail consultant, in his research on Kmart and Wal-Mart location strategies in the early 1990s, quoted in Tibbett Speer, "Where Will Wal-Mart Strike Next?" American Demographics (Aug. 1994) 16, 8, p. 11.

competing on style, service, assortment depth, and the quality of merchandise. Specialty retailers in other categories, from Best Buy, Office Depot, and Staples to Toys R Us, Barnes and Noble, and Blockbuster, follow similar marketing strategies, in attempt to distinguish their merchandise assortment from the standard supercenter offering. Even those sectors that, until recently, had been impacted only marginally by the reorganization of general merchandising sector in the 1990s, such as home improvement centers, auto parts stores, and gasoline station/convenience store operators find themselves increasingly drawn into its boundaries. Finally, of course, we should also mention the possible revolution in general merchandising, the Internet-based retailing. While still of modest size compared to their brick-and-mortar counterparts, internet-only retailers are already making a big splash with their incredible market capitalization and innovative business models. Wal-Mart was among the first large retailers to join the e-commerce trend, in 1996, and has recently announced significant expansion plans for its internet retailing unit.

Global expansion

Wal-Mart's successful entry into grocery retailing was one major aspect of its 1990's expansion. The second, and somewhat slower to develop, was its international expansion. Since the 1970s, Wal-Mart has been selling imported goods sourced by U.S. brand name merchandisers and, to a lesser degree, directly by its purchasing agents in Hong Kong and Taiwan.[29] Estimates of the percentage of both type of imported goods sold in Wal-Mart range upward of 40 percent in the 1980s. Despite their extensive involvement with suppliers in Asia, Wal-Mart was cautious and always seemed to be one step behind its competitors. According to one retired Wal-Mart executive, "In going to Asia and then into China, department stores always beat us. A lot of people were there long before we were. But it was part of the strategy to let them go through the initial tortures. [Wal-Mart would] step in when all the groundwork had been laid."[30]

True to form, following the precedents of other firms, such as Royal Ahold and Carrefour, Wal-Mart in the early 1990's began to use its global supply chains to enter consumer markets outside the United States. The first Wal-Mart store to open abroad was its Club Aurrera (modeled on Sam's Club) warehouse in Mexico City, operated as a joint venture with Mexican retailer Cifra. In the following two years, more stores were added in Mexico and Puerto Rico, and Wal-Mart entered an agreement to supply Japanese retailers Ito-Yokado and Yaohan with its private label merchandise that the latter would market in Japan, Singapore, Hong Kong, Malaysia, Thailand, Indonesia and the Philippines. In 1994, the expansion accelerated with the acquisition of 122 Woolco stores in Canada and the opening of 3 Sam's Clubs in Hong Kong. Table 4 presents a chronology of Wal-Mart's international expansion.

Its early phase, which lasted until 1998, was characterized by focused expansion in North America and very cautious and generally not very successful steps elsewhere. From this early expansion, Wal-Mart managers found out that retailing in foreign markets, especially those that differ significantly from the U.S. domestic market, requires a considerable learning period and numerous adaptations of the merchandising model. It also became apparent that Wal-Mart's operational efficiency requires a considerable economy of scale and significant market share in order to be successfully replicated abroad.

Since 1999, however, Wal-Mart's global expansion steps became much bolder, marked by large acquisitions of the British retailer ASDA (1999), Interspar hypermarkets in Germany (1999), a stake in Japanese retailer Seiyu (2002), and Bompreco chain in Brazil (2004) as well as current negotiation over another major Japanese retailer, Daiei. At the same time, Wal-Mart began to open stores in China, following a "greenfield" strategy similar to its early U.S. expansion, and boosted by its already significant purchasing and distribution operations. As a result, Wal-Mart is currently not only the biggest global retailer, with almost $60 billion in sales outside the U.S. market, but also the biggest retailer in Canada and Mexico, the third largest in the UK and Brazil, and likely soon to claim a top spot in China and Japan. In all these countries, its entry triggered a substantial reorganization of the

[29] Wal-Mart was far from being a pioneer of direct buying from its foreign suppliers. As late as 1995, only 6 percent of its merchandise was bought directly from foreign suppliers, while likely more than 50 percent of merchandise on its shelves, and over 80 percent in apparel, toys, and similar categories, was not produced domestically. Even today, when the news of Wal-Mart buying $15 billion of merchandise in China frequently make headlines, we should keep in mind that this amount, however large in absolute terms, still represents well under 10 percent of its total merchandise purchases.

[30] Quoted by Sam Hornblower, "Wal-Mart and China: A Joint Venture." http://www.pbs.org/wgbh/pages/frontline/shows/walmart/secrets/wmchina.html.

domestic retail market, similar in scope and direction to the one that occurred in the U.S. market in the 1990s. Even its less successful entry in Germany led to the intense price war and consolidation of domestic market, and the sheer possibility of its entry into France provoked a merger between Carrefour and Promodes in 1999, thus creating the world's second biggest retailing firm.

Beside Wal-Mart, very few American big box retailers have ventured beyond the North American market, Costco, Staples, and Toys R Us being the major exceptions. Similarly, the presence of foreign retailers in the American market has been relatively limited and has decreased in the recent years. Thus, Wal-Mart's global competitors are mainly foreign firms, all of them with substantial experience in grocery retailing and with longer and more extensive international retailing experience; the battle for the share of the $4 billion general-merchandise-and-food global market is being waged outside of the Wal-Mart's home turf. At the same time, retail concentration in most developed countries, and even many developing ones, is significantly higher than in the American market and the development of big box specialty retailing considerably weaker, creating more intense competitive conditions.

Wal-Mart's transformation in the 1990s had a significant impact on its supply chain. Its entry into grocery retailing brought an increasing number of large manufacturers of packaged consumer goods into the orbit of its major suppliers. The effects were felt on both sides, as the manufacturers experienced a strong pressure to adapt to Wal-Mart's business model and increase their operational efficiency, and the retailer further rationalized its supplier base. The global expansion of Wal-Mart stores created a much bigger challenge of creating a new global sourcing infrastructure on the level of size and complexity well beyond what any multinational firm had attempted before. Wal-Mart now operates as a major exporter as well as importer in several large regional markets, shuffling tens of thousands of products around the world to meet the local demand in its 3,600 domestic and 1,600 international stores. While this creates a whole new set of opportunities for its major partners, which can now gain unprecedented access to global consumer markets, it also creates even more pressure to continuously shape and adapt their business models to Wal-Mart's strict demands.

Size matters

Wal-Mart, the business and popular press often asserts, has the power to "squeeze" its suppliers, reducing their profit margins, imposing cost-cutting measures, and, in the case of the U.S. firms, forcing them to turn to outsourcing. Such power is generally traced to its size or, more precisely, to its market share. Wal-Mart controls about 15% of the domestic sales of general merchandise and food, and in some categories such as household staples and basic apparel its share is closer to 30%. Even for the biggest manufacturers of packaged consumer goods, from Procter & Gamble to Clorox and Revlon and from Del Monte to Nabisco and Sara Lee, the amount of business with Wal-Mart—typically ranging between 15% and 30% of total shipments—creates a significant dependency on the retailer's demands. And such dependency can, of course, be much higher in the case of smaller firms among Wal-Mart's over 20,000 global suppliers, and in particular for those supplying the retailer with its private brand merchandise.

While Wal-Mart's market power is undeniable, and for many manufacturers unavoidable, becoming a Wal-Mart vendor is a highly sought prize because the retailer's size generates an opportunity to reach a majority of American, and an increasing number of global consumers. Wal-Mart stores are today, arguably, the biggest marketing channel for the consumer products in the world: the twenty million customers who shop at Wal-Mart on an average day represent a bigger market than could be reached by any traditional mass media promotion.[31]

Wal-Mart's size also implies that severing a relation with even major suppliers has little effect on the retailer's side.[32] And, in fact, most Wal-Mart's vendors re-

[31] In the U.S. this was partly a result of the segmentation of national mass media during the 1990s which made building brand awareness through national advertising a much more costly proposition. Thus, a recent study by Willard Bishop Consulting agency "found that in 1995 it took three TV commercials to reach 80% of 18- to 49-year-old women. In 2000, just five years later, it took 97 ads to reach the same group" (quoted in: Matthew Boyle, "Brand killers," Fortune, (Aug 11, 2003) Vol.148, Iss. 3, p. 89). At the 50 Petrovic, Hamilton: Making Global Markets global level, of course, even fewer manufacturers can afford to maintain brand awareness through direct advertising.

[32] For example, Wal-Mart recently warned major music labels that, unless they drastically lower the price of their CD albums, it will cut back on the amount of music it sells. On the retailer's side, such step would sacrifice less than two percent of its total revenues, but for the music industry it would mean losing nearly twenty percent of their sales. Warren Cohen, "Wal-

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ceive no guarantees that their business relationship with the retailer will be a long-lasting one. Wal-Mart's famous "Plus One" principle—that for each of the hundreds of thousands of products it handles either the price should be lowered or the quality improved every year—puts an intense pressure on its suppliers to stay ahead of their, increasingly global, competition. Partnering with Wal-Mart, thus, holds both the promise of reaching major global markets with minimal advertising and promotional outlays and the danger of adapting one's business model to the retailer's strict demands only to find out that the resulting lowered profit margins and the efficiency pressure are more than one's organizational capacities can bear.

The fact that more than 500 large vendors have established permanent sales offices near Wal-Mart's Bentonville headquarters, and that tens of thousands of global suppliers attend its global purchase fairs show that many manufacturers consider the prospect of becoming a Wal-Mart partner worth the gamble. From the retailer's side, the partner selection process is based on two main dimensions: the ability of a vendor to offer an everyday low supply price; and its operational and technological compatibility with Wal-Mart's own business process.[33]

The pursuit of everyday low supply price

Most accounts of Wal-Mart in the popular press tell of the retailer's relentless pursuit of the lowest purchase price. These accounts, however, give little information about how Wal-Mart's overall pricing model shapes the business strategies of Wal-Mart's suppliers. The "everyday low price" standard means that Wal-Mart's buyers are not bargain-hunters, trying to locate and close an extraordinary deal. Nor do they push for a discount on the prevailing market price.[34] Instead, they base their estimate of the purchasing price on the suppliers' cost structures and operational efficiency. Competitive bids may, of course, help to reveal the cost structure, but they are not the only means to do so. Wal-Mart often requires suppliers to open their books and submit to a rigorous cost analysis. Once a cost structure for a product is established, Wal-Mart requires the suppliers of that product to accept the retailer's own business strategy of low profit margins, rapid turnover, and high sales volume. Unlike other retailers, Wal-Mart demands of suppliers no elaborate trade promotions and no slotting allowances paid to the retailer in exchange for obtaining shelf space for products.[35] Instead, the cost of trade promotions and direct marketing campaigns is typically deducted from the wholesale price and the savings passed on to the consumer. For example, John Fitzgerald, a former vice president of Nabisco, remembers Wal-Mart's reaction to his company's plan to offer a 25-cent newspaper coupon for a large bag of Lifesavers in advance of Halloween. Wal-Mart told Nabisco to add up what it would spend on the promotion—for the newspaper ads, the coupons, and handling—and then just take that amount off the price instead. "That isn't necessarily good for the manufacturer," Fitzgerald says. "They need things that draw attention."[36]

For the manufacturer, consenting to Wal-Mart's everyday low supply price requirements holds the promise of gaining market share at the expense of the profit margin, the same outcome that it may also pursue through consumer and trade promotions. The main difference between these two strategies is that partnering with Wal-Mart entails losing a great deal of control over the pricing of one's products.

Mart Wants $10 CDs: Biggest U.S. Record Retailer Battles Record Labels Over Prices." Rolling Stone Magazine (Oct. 12, 2004).

[33] These dimensions correspond to two main advantages of working with Wal-Mart that the retailer's existing vendors typically list in business surveys: the transparency of its business strategy in creating relationships with its suppliers; and the relentless pressure for logistic and operational efficiency (see, for example, Cannondale Associates annual surveys of manufacturers).

[34] Commenting on the dispute with the music industry referred to in the previous note, Gary Severson, Wal-Mart's general merchandise manager in charge of the chain's entertainment section, specifies: "The labels price things based on what they believe they can get—a pricing philosophy a lot of industries have. (...) But we like to price things as cheaply as we possibly can, rather than charge as much as we can get. It's a big difference in philosophy, and we try to help other people see that" (Cohen, Rolling Stone).

[35] One element of contracting that is often emphasized by Wal-Mart in its dealing with large vendors of packaged consumer goods is the exclusivity clause in which certain new products would be made exclusively for Wal-Mart either permanently, or, more commonly, for a period of time, before they are sold to other retailers. Recently, however, a Wal-Mart spokesman announced that those deals will be reduced to fewer products and a maximum of a few months. Jack Neff, "Wal-Mart Weans Suppliers," Advertising Age. (Midwest region edition, Chicago, Dec. 1, 2003), Vol.74, Iss. 48, p. 1.

[36] Charles Fishman ,"The Wal-Mart You Don't Know." Fast Company Magazine, Issue 77, December 2003, Page 68.

Dealing with Wal-Mart, in other words, means accepting the structure of a highly rationalized market exchange with little space for strategic maneuvering.

Logistics and operational efficiency

Wal-Mart has developed a number of initiatives to help its suppliers deliver a quality product at a low cost and in a timely manner. Its Vendor Information Manual contains contracting instructions, specifies EDI requirements, and outlines the proper way to ship and deliver goods. The famous Retail Link gives vendors a direct insight into inventory levels of each product at each Wal-Mart store. Its data warehouse, which provides both internal operational data and serves as the backbone for the Retail Link, is by far the largest private collection of data in the world, perhaps second only to Pentagon's. Currently, it contains over 500 terabytes of data. It collects and organizes data from 140,000 POS systems around the world and records 20 million customer transactions each day. Several hundred thousands of data mining questions are sent to it every week. This elaborate infrastructure for product management is directly available to Wal-Mart's thousands of vendors, which can use it to reduce their own inventory management costs, enhance operational efficiency, and test the potential of new products in a way that is more precise and less costly than the standard product marketing tools. One such marketing strategy, often referred to as micromarketing, includes placing a new product in a small sample of Wal-Mart stores and assessing the demand for them dynamically. Market demand can be fully tested in as little as four weeks, a process that with traditional marketing campaigns often took six months or more.[37]

Vendors' ability to use this infrastructure requires that they conform to Wal-Mart's logistics requirements, which are among the most rigorous in the industry. Wal-Mart not only manages hundreds of millions of items in its 5,500 stores around the world, but also adjusts the inventory levels of all these products according to local demand forecasts. To manage these products Wal-Mart depends on the strict cooperation of its suppliers with the needs of its logistical system.[38] Delivery of the right amount of product at a right time—the window of delivery to the distribution center is generally around 15 minutes—is the key aspect of this process, but the additional product-related requirements can also be quite elaborate. For instance, Wal-Mart, and not the suppliers, specifies the features of floor-ready products, features that come as additions to basic labels, source codes, and other identifying elements.[39]

Behind the ever-evolving technological aspects of product management emerges a complex picture of negotiating over which side has the power to define the final product that consumers buy. Wal-Mart's efficiency in managing consumer markets implies that it is able to translate its competence in assessing the shape of consumer demand (what consumers want, at what price point, in what quantities, and at what time) into defining the shape of the product that will be produced and delivered by its vendors. This leads us beyond the two standard Wal-Mart's partner selection criteria that we just discussed—the cost structure and the operational efficiency— to two more ambiguous aspects of its buying "philosophy" that also have significant long-term impact on the structure of its supply base.

Buying Direct

The principle of buying direct from the manufacturer and thus reducing or eliminating the role of the middleman, i.e. the wholesaler, has been the driving force in the retailer's rationalization of consumer goods markets since the beginning of the modern retailing. As retailers grew in size, they recognized that either they or the manufacturers could more efficiently perform many of the "value-adding" functions typically done by wholesalers. These functions depended on the industry and the historical distribution regime, but the persistence of attempts to eliminate the middleman spurred many comments about the decline and ultimate disappearance of

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[37] Dawn Wilensky, "Ever-Shrinking Margins Unnerve some Wal-Mart Vendors." Discount Store News, (Dec. 5, 1994), Vol. 33, Iss. 23; p. 103.

[38] In a recent presentation, Linda Dillman, Wal-Mart's executive VP and CIO, specified that "inventory data is maintained on more than 693 million items, 335 million of which are reviewed every day to see if they need to be reordered." Dan Scheraga, "What Makes Wal-Mart Tick," Chain Store Age, (Mar. 2004) Vol. 80, Iss. 3, p. 49.

[39] For example, product packaging is many times adapted to shelf dimensions rather than vice versa. Packaging may also be required to include similar graphic solution on multiple sides so that errors in positioning the product on the shelf are minimized. Apparel items may need to be outfitted with hangers. In general, having "floor-ready merchandise" relates most directly to minimizing the operational complexity and cost of moving the merchandise from the back room to the shelf.

the wholesale sector.[40] Yet, far from being squeezed out of business by the joint assault of retailers and manufacturers, wholesalers managed to adapt and maintain a fairly stable share of income and corporate profits over the second half of the twentieth century. Rather than eliminating the role of wholesalers, the drive to rationalize consumer goods markets kept redefining which specialized wholesale functions add value to the supply chain, continually creating opportunities for the firms that establish a core competence in performing these functions.

The commitment to buying direct, then, should be seen in general, and even more so in Wal-Mart's case, as based on utilizing the economies of scale in buying and eliminating the operational inefficiency in the supply chain. Like most other large chain retailers, Wal-Mart has acquired a broad set of capabilities that resemble those of a typical wholesaler.[41] Thus, even an efficient wholesaler who is able to match Wal-Mart's low profit, high volume business philosophy and can provide useful intermediation services still puts itself in a more vulnerable position by partnering with Wal-Mart than it would with a manufacturer having corresponding qualities. Moreover, this vulnerability is not limited to traditional wholesalers, but can be experienced by all types of intermediaries, including many firms that are commonly recognized as manufacturers, but whose core competences have shifted to marketing and supply chain management. In order to become the vendors of such large retailers as Wal-Mart, these firms rely on developing their own capable, low cost suppliers; yet this puts them in danger of eventually being bypassed in favor of these suppliers. In short, the principle of buying direct generates a constant pressure on Wal-Mart's vendors to define their own core competencies as complementary, rather than competitive with those of the retailer, with wholesaling, marketing, transportation, and supply chain management being the most commonly contested areas.

Manufacturer Brands, Store Brands

The competitive pressure that Wal-Mart's strategy of buying direct puts on many of its vendors who are not manufacturers is somewhat similar to the pressure that Wal-Mart's private label brands puts on brand name manufacturers. The strong commitment to store brands is a relatively new development at Wal-Mart, closely related both to its entrance into grocery sector and to its global expansion. Since its 1960s beginnings, Wal-Mart has been known as a store that sells national brands of general merchandise; this merchandising strategy was crucial to building a reputation as a low price leader. As Wal-Mart's reputation grew in the 1980s, the discounter was able to add more prestigious national brands to its assortment, especially in apparel, while keeping its image as a low price retailer. However, after noticing Loblaw's success with the President's Choice brand, Wal-Mart accelerated its store brand program in 1991 by launching its own premium Sam's Choice brand and following two years later with an economy offering, Great Value. Today, Wal-Mart manages a portfolio of several hundred brands covering thousands of products and most merchandise categories and accounting for around 40 percent of its sales.[42]

These numbers, however, tell only a part of the story. Store brands have become a crucial part of Wal-Mart's global expansion strategy. Since few manufacturers' brands have a true global presence, and can afford to advertise globally, Wal-Mart stores and their price leadership image may prove to be the best marketing channel for building strong, value-priced, global brands. Wal-Mart's popular Great Value brand of packaged grocery items is already sold in most international Wal-Mart units, including those in Germany and China. Its George line of apparel, the leading clothing brand in the U.K., is now also offered in the U.S., Canada, and Germany. In the global context, Wal-Mart's brands have an advantage over manufacturer controlled and advertised brands for two reasons: first, although manufacturer brands may sell well in some regional markets, store brands can easily be established as their value-priced complements in all markets where Wal-Mart operates; second, Wal-Mart's shopping and consumption models redefine an increasing range of products as standardized cheap consumables for which the very concept of branding may become less significant.

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[40] An excellent discussion of these long-term historical trends could be found in: Louis P. Bucklin, Competition and Evolution in Distributive Trades, (Englewood Cliffs, NJ: Prentice Hall, 1972).

[41] When it moved full force into grocery retailing in the early 1990s, Wal-Mart also acquired a grocery wholesale business, the McLane Co., which sold to convenience stores and independent grocers. There is no doubt that Wal-Mart's own grocery buyers benefited significantly from the interaction with this experienced grocery wholesaler. The McLane was sold in 2003.

[42] In terms of the proportion of store brands, Wal-Mart isbehind Target (50% total, 80% in apparel) and Sears (55%, down from over 90% throughout most of the twentieth century) but ahead of major supermarket and drugstore chains.

For its suppliers, therefore, the impact of Wal-Mart's store brand strategy is ambivalent. On the one hand, the limited number of items in each product category in Wal-Mart stores, especially compared to other big box specialty retailers, clearly favors big national brands and store brands over smaller, second-tier brands. The national brands are needed to attract a broad range of consumers and to provide the basis for low price claims; the store brands attract price-sensitive shoppers, generate higher profit margins and create negotiating power over brand name manufacturers. Even if they are offered a chance, second-tier brands usually languish between dominant national brands, and the economy priced store ones. On the other hand, the growth of store brands at Wal-Mart can threaten even the best established national brands. From dog food and garden fertilizer to pain killers and vitamins, many Wal-Mart's store brands are now national sales leaders, surpassing their better recognized and more heavily advertised competitors.

Although the rise of store brands may not spell the demise of nationally advertised, manufacturer controlled brands, it may gradually transform them into niche, high-end, high-margin players. However, those manufacturers that want to avoid such a fate may have little choice but to follow Wal-Mart's lead in defining the shape and the dynamics of the global "product world," thus ceding a substantial amount of control over brand development and advertising. Although many manufacturers may try to preserve their best known brand names, it is likely that an increasing share of their productive capacity will go to supplying Wal-Mart with its own store branded goods.

The Evolution of Wal-Mart's Relations with its Suppliers

As we have seen in previous sections, Wal-Mart's market making power in supplier markets has several dimensions and cannot be reduced to the retailer's purchasing power or the pursuit of the lowest price. After discussing some general aspects of these dimensions, we are now in a position to broaden our historical perspective and put together a story of the evolution of Wal-Mart's relations with its suppliers.

In the 1960s and early 1970s, as a regional discounter with modest buying power, Wal-Mart bought mostly national brand merchandise, searching for lowest prices in the market, including closeout deals and similar bargains. As most other retailers at the time, it had to accept manufacturer's power in defining the terms of trade, that stretched from product development, branding, and advertising to logistics issues and, through resale price maintenance statutes, even to some aspects of retail pricing. Some major retailers, such as A&P, Safeway, and Sears, evaded manufacturers' power through maintaining a broad assortment of store brands, but the rapidly growing ranks of discounters typically accepted manufacturers' market making strategies, defining their own business model in terms of the efficient distribution of nationally advertised goods.

During the following period, from the mid-1970s to the mid-1980s, the balance of market making power shifted decidedly in favor of big discounters. Using their growing buying power, and the access to increasing supply of cheap foreign manufactures, they pitted their suppliers against each other in order to achieve the lowest purchase price. The consequent decline of domestic consumer goods industries was rapid, and the import penetration soared to unprecedented levels. Wal-Mart, Kmart, Target and a number of other big discounters were among the main beneficiaries of this process, using foreign sourcing both to maintain its low price appeal and to increase its leverage vis-à-vis its domestic suppliers. By the end of this period, almost half of all merchandise sold at Wal-Mart stores was imported and the retailer was able to force an increasing number of its domestic suppliers to accept its everyday low price business model.

In the mid-1980s, the transition to a new phase of retailer-supplier relationships occurred; adversarial relations and intense competition between retailers and their domestic suppliers gave way to the new climate of forging cooperative links and partnerships. As we have seen, the appreciation of major Asian currencies based on the Plaza Accords and the consequent rapid, albeit temporary, decline of the competitiveness of Asian manufacturers brought only a short-lived relief to the domestic suppliers. American suppliers benefited much more from the retailers' realization that the most effective way of using their market making power is through reorganizing their supply chains, rather than simply extracting concessions from them. Since these efforts were based on the diffusion of new information technologies, American suppliers were generally able to benefit from their proximity to the emerging national infrastructure of IT products and services.

Through its early adoption of the UPC code and EDI tools, development of automated distribution centers, and leadership in the VICS initiative, Wal-Mart emerged as the undisputed industry leader of supply chain rationalization. Even its

much hailed Buy American campaign, despite its symbolic overtones of economic patriotism, is best understood in the context of such rationalization efforts. The stories of domestic suppliers who benefited from the Buy American campaign typically reveal that Wal-Mart went beyond simply offering to buy their merchandise on favorable terms. The retailer also participated in product design and development, suggested improvement in the supplier's overall business process, and managed the logistics of distribution.

Wal-Mart's efforts to develop a new group of technologically capable suppliers that would adopt the retailer's own business model and standards of efficiency resulted in creation of stable relationships with several large manufacturers of packaged consumer goods. The leading example of such a relationship is Wal-Mart's much heralded partnership with Procter and Gamble, which started in 1988. In the 1990s, with the retailer's entry into grocery retailing, these partnership became commonplace. The minimal requirements for establishing such relationships included the transparency of pricing and contracting, and indeed of the whole business process, as well as a degree of technological sophistication and operational efficiency. During the 1990s, the relationships evolved to include the coordination of product development and vendor managed replenishment procedures (enabled by the Retail Link system), and many large suppliers established permanent offices in Bentonville with teams fully dedicated to furthering their partnership with Wal-Mart.

Doing business with Wal-Mart became the main organizational and operational mainstay for hundreds of medium-sized and even very large suppliers. The retailer's extraordinary growth in the 1990s, however, meant that it did not need to make equal commitments to its suppliers. Its growth, of course, generated extraordinary opportunities for its major partners; yet it also pushed them to adapt continuously to the retailer's demands for technological and logistical competence and to the rapidly changing dynamics of consumer markets it helped create. From the Retail Link to the newest drive for the adoption of RFID, Wal-Mart became the major driver of technologybased productivity gains in the American economy. At the same time, the success of its store brands generated an intense pressure on major manufacturers to improve their product lines and develop new ones. However, the potentially biggest challenge and biggest opportunity for its suppliers came from Wal-Mart's global expansion. Its expansion efforts in Japan and China, and the recent announcement by Wal-Mart CEO, Lee Scott, that it is considering growth opportunities in India and Russia, holds the promise of creating a completely new regime of retailer-supplier relationships, based on the model of integrated global sourcing for global markets.

CONCLUSION: THE COMING ERA OF GLOBAL PROCUREMENT?

Wal-Mart executives understand that in order to sustain the remarkable rates of growth expected by its shareholders, Wal-Mart must continue with aggressive international expansion. In the U.S., its same store sales growth has been sluggish in the last few years, both compared with its historical rates and with the growth of its international division. Of course, American market remains the world's largest, and even the most pessimistic prognoses allow that the number of Wal-Mart domestic supercenters may double before reaching the saturation point. In the international arena, Wal-Mart has already achieved the dominant position in Canada and Mexico and is still growing in the United Kingdom. Germany, where Wal-Mart has yet to turn a profit, and Japan, which is still dominated by small size stores, represent other main expansion opportunities. In the long run, however, it is the understored, virgin markets of developing countries such as China, India, and Russia, with their rapidly expanding consumer purchasing power and low levels of retail competition that hold the main promise for Wal-Mart's future growth.

The less well understood aspect of Wal-Mart's global expansion is how it will affect its suppliers. On the one hand, the retailer's expansion into new markets certainly represents a tremendous growth opportunity to those suppliers who can meet the global consumer demand. On the other hand, these suppliers will increasingly have to rely on Wal-Mart, and a small number of other global retailers, to assess, interpret, and shape global consumer demand and to translate it into specific product and service requirements in supplier markets. From the suppliers' perspective, the globalization of retailing poses the issue of retail power even more starkly than before. Increased retailers' control of global consumer markets may entail further decline of manufacturer control over product development, branding, and pricing, and a new wave of increased consolidation and competition in consumer goods industries, as occurred recently with the merger of Proctor and Gambles with Gillette.

Although it may be too early to describe this scenario of global economic transformation triggered by the globalization of retailers' making of consumer markets, we can look at some recent developments in Wal-Mart's global sourcing strategy for

a hint of its general outline. Since 1999, Wal-Mart's Global Sourcing group has been developing capabilities and mechanisms for helping Wal-Mart stores around the world with their buying tasks. The group does not buy merchandise. Instead, it refers to itself as "a service organization that aids in the procurement and execution of strategic initiatives developed by merchants."[43] It researches sources of supply, identifies new products, specifies import opportunities, and shares knowledge about merchandising practices within the Wal-Mart organization. Most of its recent successes involve introducing new private label (store brand) products, such as Alcott Ridge wines (made by Gallo) and George apparel, to all Wal-Mart's international markets. The globally standardized products go hand-in-hand with globally standardized sources of supply. From apparel and wine to copy paper and light bulbs, the number of private label suppliers has been reduced in order to "deliver consistent quality around the world."[44] In addition to promoting global sourcing initiatives, Wal-Mart has increasingly relied on its largest global suppliers for insight on how to handle its international expansion. These partnering efforts have recently evolved into the creation of an elite group of top fifty suppliers that serve as advisors for Wal-Mart's global venture, providing operating models on the basis of their own extensive international experience.

Perhaps an even better sign of the times to come is Wal-Mart renewed emphasis on sourcing products from China. While Wal-Mart has been buying in China since the early 1970's, first through American and Japanese importers and later through its purchasing partners from Hong Kong, it only recently established direct buying offices in Shenzhen (2001) and Tianjin (2003). The Shenzhen office was in the meantime promoted into Wal-Mart's global purchasing headquarters, clearly indicating the retailer's strategic orientation toward Chinese suppliers. While the current level of Wal-Mart's buying in China, at over $18 billion in 2004, is huge both in absolute terms and in terms of its share of the U.S. imports from China (10%) and of the total foreign buying in China (30%), it represents only 10% of the retailer's overall purchasing budget, a proportion significantly lower than that of many other major U.S. retailers. Thus, the main significance of Wal-Mart sourcing initiatives in China is not in its rationalization of the buying process, but rather in the fact that it has been buying relatively little from Chinese suppliers and that this amount is likely to increase substantially in the near future.

These recent developments in Wal-Mart's global strategy indicate not only a probable future trajectory of Wal-Mart's expansion, but also a model that other global retailers will likely adopt. So far, only a few other mass retailers have developed a major global presence and a strategy of integrated global procurement, most notably Carrefour, Metro, Ahold, and Tesco. None of these has yet approached the level of Wal-Mart's logistical and technological sophistication. However, as the share of the global retail market captured by Wal-Mart and a handful of other global retailers continues to increase, we can expect that in the next ten years a small group of these retailers will dominate the making of consumer markets in all major economies around the world.

This increase in the concentration of global retailing will certainly have a powerful impact on the shape of the global supplier markets. Will the power of retailers over their suppliers continue to increase? Although we cannot give a definitive answer to this question, we conclude that such a trend is quite likely, for at least two reasons. First, the concentration of global retailing is still at a very low level compared to most manufacturing industries, and thus we can expect leading retailers to continue to increase their market share and their buying power. The second, and perhaps more profound, reason is that our notion of the "natural balance of power" between retailers and manufacturers may have been distorted by the long period in which mass manufacturers enjoyed global economic prominence. For the better part of the twentieth century, the giants of steel, petrochemical, automotive, electronic, and packaged consumer goods industries dominated the corporate landscape of their national economies and captured the imagination of business observers, as well as the general public. They not only created new product worlds of standardized and affordable goods, but also pioneered new techniques of advertising, packaging, selling, and servicing these goods, thus assuming a large part of the responsibility for making modern consumer markets. Moreover, they represented the first crop of new "multinationals" that started the contemporary long wave of economic globalization.

In the broader historical context, however, the prominence of manufacturers is an anomaly. Until the end of the nineteenth century, the making of large-scale markets, including global ones, was predominantly the task of merchants, rather than

[43] DSN Retailing Today, "Vendor partnerships enhance produce quality and pipeline efficiency," (New York: Jun. 2001), Vol. 40, 11A, p. 14.
[44] ibid.

producers, and it was merchants, and not producers, who established the largest and most powerful businesses. In this sense, what we observed, in the second half of the twentieth century, as the shift of market making power from manufacturers to retailers, may represent less of a novelty than the restoration of the traditional division of labor between market makers and producers.

TABLES AND FIGURES

Table 1: Growth of Wal-Mart Stores in the 1990s

Year	Discount stores	Supercenters	Sam's Clubs	Neighborhood markets	International
1988	1259		105		
1989	1399	3	123		
1990	1568	5	148		
1991	1714	6	208		
1992	1850	30	256		10
1993	1950	72	417		24
1994	1985	147	426		226
1995	1995	239	433		276
1996	1960	344	436		314
1997	1921	441	443		589
1998	1869	564	451	4	703
1999	1801	721	463	7	991
2000	1736	888	475	19	1054
2001	1647	1066	500	31	1154
2002	1569	1258	525	49	1272
2003	1478	1471	538	64	1355
2004	1363	1672	550	76	1585

Source: Wal-Mart Corporation, Annual Reports, var. years

Table 2: Revenue share of various store formats, integrated general merchandise sector*, 1992–2003

Year	Warehouses and Supercenters	Discount Store	Department Stores	Grocery Stores	Specialty Stores**	Drug Stores	Wal-Mart Only***
1992	4.0	9.4	8.7	33.8	26.8	9.1	4.4
1993	4.5	9.9	8.5	32.8	27.2	9.0	5.3
1994	5.2	10.1	8.3	31.9	27.9	8.8	6.1
1995	5.7	10.3	8.0	31.1	28.2	8.9	7.2
1996	6.1	10.2	7.9	30.6	28.3	9.2	7.8
1997	6.6	10.3	7.8	30.0	28.1	9.6	8.4
1998	7.5	10.0	7.4	29.1	28.4	9.9	9.0
1999	8.5	9.6	7.1	28.5	28.5	10.2	9.8
2000	9.4	9.3	6.7	27.9	28.5	10.5	11.1
2001	10.7	9.1	6.1	28.2	27.5	10.9	12.4
2002	12.1	8.5	5.7	27.7	27.3	11.3	13.6
2003	13.1	7.8	5.3	27.5	27.1	11.6	14.7

*Integrated general merchandise sector is a combination of general merchandise, food and beverage, and beauty and health care stores (see text for more details)

**Includes apparel, furniture, home furnishings, electronics, appliance, sporting goods, books, jewelry and other specialty stores

***Wal-Mart stores revenues are also included in the "warehouses and supercenters" and "discount stores" categories

Source: U.S. Census Bureau, Current Business Reports, Series BR/03–A, *Annual Benchmark Report for Retail Trade and Food Services: January 1992 Through February 2004,* (Washington, DC, 2004)

Table 3: Top American Retailers*, Organized by their position in the Integrated General Merchandise Sector

Retail Category/Retailer/Rank**	Revenues 2003 ($ Bill.)	Stores 2003
Wal-Mart Supercenters (1)***	100	1471
Warehouse clubs		
Costco (5)	42.5	420
Sam's Club (1)	34.5	538
BJ's Wholesale Club (38)	6.7	150
Discounters and Mass Merchandisers		
Wal-Mart Discount Stores (1)***	74	1478
Target (4)	48.1	1553
Kmart (14)	23.4	1515
Sears (6)	41.1	1970
J.C. Penney (15)	17.8	1077
Grocery Chains and Drug Stores		
Kroger (3)	53.8	3774
Safeway (7)	35.5	1817
Albertsons (8)	35.4	2305
Walgreen (9)	32.5	4227
Ahold USA (11)	26.9	1489
CVS (12)	26.6	4179
Department Stores		
Federated Department Stores (20)	15.2	450
May Department Stores (21)	13.3	1124
Apparel Specialty		
Gap (18)	15.8	3022
TJX (22)	13.3	2062
Limited (34)	8.9	3911
Other Specialty		
Best Buy (13)	24.5	1767
Staples (23)	13.2	1559
Office Depot (24)	12.4	1099
Toys R Us (26)	11.6	1500
Home Improvement Centers		
Home Depot (2)	64.8	1707
Lowe's (10)	30.8	952

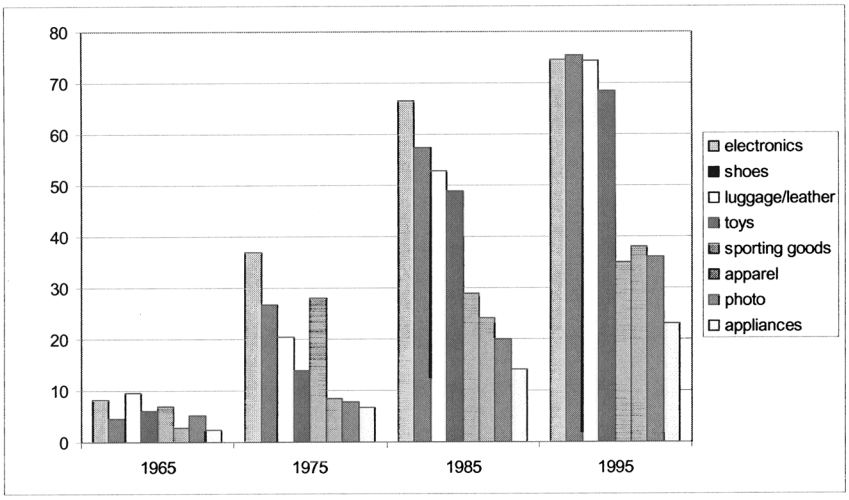
*Select retailers from the list of fifty largest retailers (by revenue), 2003
**Rank by revenue
***Estimated from total Wal-Mart stores revenue Source: Stores (www.stores.org), July 2004

Table 4: A Chronology of Wal-Mart's International Expansion

1991	Mexico City, Mexico (joint venture with Cifra).
1992	Puerto Rico
1993	Wal-Mart International division formed with Bobby Martin as president.
1994	Canada: acquisition of 122 Woolco stores; Hong Kong: 3 stores
1995	Argentina (3 units); Brazil (5)
1996	China (through a joint-venture agreement); Indonesia; exits Hong Kong
1997	Acquisition of dominant interest in Cifra (Mexico); Germany: acquisition of 21 Wertkauf stores
1998	South Korea (4 units, joint venture); Germany: acquisition of 74 Interspar stores
1999	United Kingdom: acquisition of 229 ASDA stores
2001	Wal-Mart moves its main global distribution center (global sourcing center) to Shenzhen, China
2002	Wal-Mart becomes world's most global retailer (measured by sales outside of the home market) Japan: minority stake in Seiyu
2003	Brazil: acquisition of 118 Bompreco stores

Source: Wal-Mart Corporation, Annual Reports, various years

Figure 1: Share of Imports in the Apparent U.S. Consumption, 1965-1995, select categories of consumer goods



Source: U.S. Department of Commerce, *U.S. Industrial Outlook*, various years.

STATUTORY MANDATE OF THE U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

Pursuant to Public Law 108–7, Division P, enacted February 20, 2003

RESPONSIBILITIES OF THE COMMISSION.—The United States-China Commission shall focus, in lieu of any other areas of work or study, on the following:

PROLIFERATION PRACTICES.—The Commission shall analyze and assess the Chinese role in the proliferation of weapons of mass destruction and other weapons (including dual use technologies) to terrorist-sponsoring states, and suggest possible steps which the United States might take, including economic sanctions, to encourage the Chinese to stop such practices.

ECONOMIC REFORMS AND UNITED STATES ECONOMIC TRANSFERS.—The Commission shall analyze and assess the qualitative and quantitative nature of the shift of United States production activities to China, including the relocation of high-technology, manufacturing, and R&D facilities; the impact of these transfers on United States national security, including political influence by the Chinese Government over American firms, dependence of the United States national security industrial base on Chinese imports, the adequacy of United States export control laws, and the effect of these transfers on United States economic security, employment, and the standard of living of the American people; analyze China's national budget and assess China's fiscal strength to address internal instability problems and assess the likelihood of externalization of such problems.

ENERGY.—The Commission shall evaluate and assess how China's large and growing economy will impact upon world energy supplies and the role the United States can play, including joint R&D efforts and technological assistance, in influencing China's energy policy.

UNITED STATES CAPITAL MARKETS.—The Commission shall evaluate the extent of Chinese access to, and use of United States capital markets, and whether the existing disclosure and transparency rules are adequate to identify Chinese companies which are active in United States markets and are also engaged in proliferation activities or other activities harmful to United States security interests.

CORPORATE REPORTING.—The Commission shall assess United States trade and investment relationship with China, including the need for corporate reporting on United States investments in China and incentives that China may be offering to United States corporations to relocate production and R&D to China.

REGIONAL ECONOMIC AND SECURITY IMPACTS.—The Commission shall assess the extent of China's "hollowing-out" of Asian manufacturing economies, and the impact on United States economic and security interests in the region; review the triangular economic and security relationship among the United States, Taipei and Beijing, including Beijing's military modernization and force deployments aimed at Taipei, and the adequacy of United States executive branch coordination and consultation with Congress on United States arms sales and defense relationship with Taipei.

UNITED STATES-CHINA BILATERAL PROGRAMS.—The Commission shall assess science and technology programs to evaluate if the United States is developing an adequate coordinating mechanism with appropriate review by the intelligence community with Congress; assess the degree of non-compliance by China and [with] United States-China agreements on prison labor imports and intellectual property rights; evaluate United States enforcement policies; and recommend what new measures the United States Government might take to strengthen our laws and enforcement activities and to encourage compliance by the Chinese.

WORLD TRADE ORGANIZATION COMPLIANCE.—The Commission shall review China's record of compliance to date with its accession agreement to the WTO, and explore what incentives and policy initiatives should be pursued to promote further compliance by China.

MEDIA CONTROL.—The Commission shall evaluate Chinese government efforts to influence and control perceptions of the United States and its policies through the internet, the Chinese print and electronic media, and Chinese internal propaganda.

FACT SHEET

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

ESTABLISHMENT:

The Commission was created in October 2000 by the Floyd D. Spence National Defense Authorization Act for 2001 δ 1238, Pub. L. No. 106-398, 114 STAT. 1654A–334 (2000) (codified at 22 U.S.C. δ 7002 (2001)), as amended, and the "Consolidated Appropriations Resolution of 2003," Pub. L. No. 108–7, dated February 20, 2003.

PURPOSE:

To monitor, investigate, and submit to congress an annual report on the national security implications of the bilateral trade and economic relationship between the United States and the People's Republic of China, and to provide recommendations, where appropriate, to Congress for legislative and administrative action.

Public Law 108–7 directs the Commission to focus its work and study on the following nine areas: proliferation practices, economic reforms and U.S. economic transfers, energy, U.S. capital markets, corporate reporting, regional economic and security impacts, U.S.-China bilateral programs, WTO compliance, and media control by the Chinese government.

COMPOSITION:

The Commission is composed of 12 members, three of whom are selected by each of the Majority and Minority Leaders of the Senate, and the Speaker and the Minority Leader of the House. The Commissioners serve two-year terms.

COMMISSIONERS:

Hon. C. Richard D'Amato, Chairman; Roger W. Robinson, Vice Chairman; Carolyn Bartholomew, George Becker, Stephen Bryen, Thomas Donnelly, June Teufel Dreyer, Hon. Patrick A. Mulloy, Hon. William A. Reinsch, Hon. Fred D. Thompson, Michael R. Wessel, and Larry M. Wortzel (brief bios are attached).

STAFF:

The Commissioners are supported by a professional substantive and administrative staff with extensive backgrounds in trade, economics, weapons proliferation, foreign policy, and U.S.-PRC relations. Some are fluent or proficient in Chinese (Mandarin), and most have significant prior working and traveling experience in China and Taiwan. The staff is headed by T. Scott Bunton, Commission Executive Director (brief bio is attached).

WEB SITE:

The Commission's web site provides the Commission's complete charter, hearing schedule, hearing transcripts, and selected research papers, and economic and trade data www.uscc.gov.

The Hon. C. Richard D'Amato (Chairman)

Maryland attorney; former delegate Maryland House of Delegates; former Counsel to Senator Robert C. Byrd (WV). Reappointed by Senate Democratic Leader Tom Daschle for a term expiring December 31, 2005. Served as Commission Chair and Vice-Chairman beginning in April 2001 and was unanimously approved as Chairman for report cycle 2004 to 2005.

Roger W. Robinson, Jr. (Vice Chairman)

President and CEO, Conflict Securities Advisory Group, Inc.; former Senior Director of International Economic Affairs at the National Security Council. Reappointed by Senate Majority Leader Bill Frist for a term expiring December 31, 2005. Served as the Commission Chair beginning October 2002 through July 2004 and was unanimously approved as Vice-Chairman for report cycle 2004–2005 on July 19, 2004.

Carolyn Bartholomew

Former Chief of Staff, Counsel, Legislative Director, and Foreign Policy Advisor to U.S. House of Representatives Democratic Leader Nancy Pelosi; former Professional Staff Member on the House Permanent Select Committee on Intelligence. Reappointed by House Democratic Leader Nancy Pelosi for a term expiring December 31, 2005

George Becker

Vice President, Executive Council, AFL–CIO; former International President, United Steelworkers of America. Reappointed by House Democratic Leader Nancy Pelosi for a term expiring December 31, 2005

Stephen D. Bryen

President of Finmeccanica, Inc.; former Deputy Under Secretary of Defense and founder and First Director of the Defense Technology Security Administration. Reappointed by House Speaker J. Dennis Hastert for a term expiring December 31, 2005.

Thomas Donnelly

Resident fellow in defense and security policy studies at the American Enterprise Institute; former policy group director of the House Armed Services Committee; former editor of Army Times and executive editor of the National Interest. Appointed by Senate Majority Leader Bill Frist for a two-year term expiring December 31, 2006.

June Teufel Dreyer

Professor of Political Science at the University of Miami; Senior Fellow of the Foreign Policy Research Institute. Reappointed by House Speaker J. Dennis Hastert for a term expiring on December 31, 2005.

The Hon. Patrick A. Mulloy

Adjunct Professor of International Trade Law at Catholic University and George Mason University law schools; former Assistant Secretary of Commerce for Market Access and Compliance; former General Counsel, U.S. Senate Banking Committee. Reappointed for a third two-year term upon the recommendation of the Senate Democratic Leader beginning January 1, 2005 and expiring December 31, 2006.

The Hon. William A. Reinsch

President, National Foreign Trade Council; former Undersecretary of Commerce for Export Administration; former legislative assistant to Senator John Heinz (PA) and Senator John D. Rockefeller, IV (WV). Reappointed by Senate Democratic Leader Tom Daschle for a term expiring December 31, 2005.

The Hon. Fred D. Thompson

Attorney and former United States Senator from Tennessee and member of the Senate Select Committee on Intelligence. Former Special Counsel to both the Senate Select Committee on Intelligence and Senate Committee on Foreign Relations. Appointed by Senate Majority Leader Bill Frist for a two-year term expiring December 31, 2006.

Michael R. Wessel

Senior Vice President, Downey McGrath Group; former Counsel to Congressman Richard A. Gephardt (MO). Reappointed by House Democratic Leader Nancy Pelosi for a term expiring December 31, 2006.

Larry M. Wortzel

Visiting Fellow at The Heritage Foundation; former Director of the Strategic Studies Institute of the U.S. Army War College; former Army Attache at the U.S. Embassy in China. Reappointed by House Speaker J. Dennis Hastert for a term expiring December 31, 2006.

T. Scott Bunton—Executive Director

Served from 1998 to 2002 as Deputy Under Secretary of Commerce for Export Administration and in 2002–2003 worked in the Transition Planning Office in the Executive Office of the President that was responsible for "standing up" the Department of Homeland Security when it was established by law. Previously served as national security advisor, policy director, and chief of staff to two U.S. Senators, staff director of a Senate leadership Committee, and staff designee to the Senate Committee on Intelligence.

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