Testimony of Business Professor Peter Navarro before the U.S.-China Economic and Security Review Commission, February 1, 2007

Mr. Chairman and members of the Commission. My name is Peter Navarro, and I want to extend my deepest thanks for providing me with this opportunity -- and high honor -- to speak before you today on the crucial issue of U.S.-China relations.

As a biographical note, I am a business professor at the University of California-Irvine and hold a PhD in economics from Harvard University. My research has appeared in academic journals ranging from the Journal of Economic Perspectives, the Journal of Business, and the Rand Journal to the Harvard Business Review and China Perspectives. I am also the author of a number of books on economics and public policy, including *The Coming China Wars: Where They Will Be Fought, How They Can Be Won* (Prentice Hall, 2006).

In my judgment, last week's State of the Union address represents a microcosm of everything wrong with the United States' China policy. During that address, America's President made reference to Iraq or the Iraqi people 35 times and the Middle East, oil, or Al Queda another 25 times. While Iran was mentioned five times and Syria twice, China was referenced only once – and only in a non-economic context.

The fact is: While American politicians, policymakers, and journalists remain dangerously preoccupied with events in the Middle East, China has emerged, largely unchallenged, as an economic superpower with an ever-growing ability to exert significant influence over U.S. economic, financial and political institutions. China's growing influence may be directly traced to a set of unfair, mercantilist trading practices that, as "weapons of mass production," are allowing China to conquer one new export market after another. The mercantilist foundations of China's global competitive advantage are revealed by an analysis of the eight major drivers of the so-called "China Price."

The Mercantilist Foundations Of China's Competitive Advantage

The China Price refers to the ability of Chinese manufacturers to undercut global competitors by as much as 50% or more or a wide range of manufactured goods. Today, as a result of the "China Price," China has captured over 70% of the world's market share for DVDs and toys, more than half of the share for bikes, cameras, shoes, and telephones; and more than a third for air conditioners, color TVs, computer monitors, luggage, and microwave ovens. It also has established dominant market positions in everything from furniture, refrigerators and washing machines to jeans and underwear.

Table 1 summarizes the findings of "The China Price Project," which was conducted with the help of a large team of MBA students at the University of California-Irvine. This table provides estimates of the relative importance of eight key drivers of Chinese competitive advantage.[1]

Table 1: Relative Contributions of the Eight China Price Drives

Wages	39.41%
Export Industry Subsidies & Preferences	16.71%
Industrial Network Clustering	16.02%
Undervalued Currency	11.44%
Counterfeiting & Piracy	8.63%
FDI	3.09%
Lax Health & Safety Regulations	2.44%
Lax Environmental Regulations	2.26%
TOTAL	100%

What is remarkable – and extremely troubling – about these results is that at least five of the eight major drivers of Chinese competitiveness may be traced to unfair trade practices. For example, a complex web of export subsides, tax preferences, and other related violations of the World Trade Organization agreement account for 17% of the advantage.

In this regard, energy and water remain heavily subsidized.[2] Many Chinese manufacturers likewise benefit from subsidized rent and/or cheap or free land and preferential access to land by local and regional governments. Despite alleged reforms, China's state-owned banks continue to hold a large portfolio of non-performing loans; these NPLs often have been issued without expectation of repayment, providing many Chinese enterprises with essentially free money. China also continues to use an extensive value-added tax rebate system for its export industries.[3]

As for the other four overtly mercantilist drivers of the China Price, an undervalued currency adds 11% to the China Price advantage (after adjusting for the high import content of Chinese exports) while counterfeiting and piracy contribute another 9%. Lax environmental and worker health and safety regulatory regimes add another 5%; and together, these five mercantilist drivers account for roughly 40% of the China Price advantage.

Perhaps not surprisingly, lower labor costs account for another 39% of the China Price advantage and clearly represent a dominant driver. On the surface, this suggests that more than a third of China's competitive edge is driven by a "fair" advantage in a "free trade" environment, i.e., China's comparative advantage in labor resources. Even this labor advantage is not without its mercantilist elements, however. As noted in a petition by the U.S. AFL-CIO to the Office of the U.S. Trade Representative, "workers in China frequently are paid less than the country's minimum wage, denied overtime pay, denied collective bargaining rights and often subjected to abusive treatment"[4] while lax health and safety standards make China one of the most dangerous work environments in any major country.

The two remaining drivers, so-called "industrial network clustering" and very high levels of foreign direct investment (FDI), add another 16% and 3%, respectively, to the China Price advantage. Both likewise suffer from a mercantilist taint, however, particularly FDI.

Among developing nations, China has become the world's leading FDI destination. Since 1983, FDI has grown from less than $1 billion a year to over $60 billion while 72% of China's FDI targets manufacturing.

China's catalytic FDI provides a variety of competitive benefits. It finances the transfer of the most technologically advanced production and process technologies. It brings with it best managerial practices. FDI is also often tied to the improvement of both marketing and distribution networks and skills. When all of these attributes are tied to one of the least expensive labor forces in the world, FDI becomes a powerful competitive driver.

While major FDI participants include the U.S., Japan, Korea, and Taiwan, it has been estimated that 20% to 30% of China's FDI is of domestic origin. This type of mercantilist FDI is the result of the "round tripping" of mainland Chinese capital, primarily through Hong Kong (and also the Virgin Islands). This round tripping is driven by the special preferences awarded to FDI in the form of lower tax rates, land use rights and subsidies, administrative support, and other subsidies (most of which represent violations of the WTO) as well as by a desire to evade foreign exchange controls.[5]

In addition, while the availability of cheap labor and the allure of China's large consumer market certainly play a role in attracting FDI, lax environmental and health and safety regulatory regimes synergistically factor into the FDI decision as countries ranging from Japan and South Korea to the U.S. export their pollution to a mercantilist China. China's grossly undervalued currency likewise provides considerable FDI synergy as an undervalued yuan makes Chinese assets appear relatively cheap to foreign investors.

The last major China Price driver, industrial network clustering, refers to the practice of locating all or most of the key enterprises in an industry's supply chain in close physical proximity to one another. Examples of such clustering include Detroit as the “motor city” hub for auto and auto parts manufacturing and New York as a financial center. What is so very different about industrial network clustering in China is not just its large scale and broad scope. It is the emergence of a myriad of “supply chain cities” that focus on a single product or set of products and serve as the focal points for highly localized supply chains.[6]

For example, in the Pearl River Delta area of China, the city of Huizou has emerged as the world’s largest producer of laser diodes and a leading DVD producer. Foshan and Shunde are major hubs for appliances like washing machines, microwave ovens, and refrigerators, and so on.[7]

As network clustering has evolved in China, it has come to represent one of the most efficient forms of supply chain management and production ever witnessed. It generates significant production and distribution benefits as it speeds both physical and information flows and extends “just in time” principles to the entire supply chain. However, even this driver is tainted with the mercantilist brush. This is because much of China’s industrial network clustering has been fueled by catalytic FDI, which, as noted above, is being driven at least in part by mercantilist elements.

It should be clear from this analysis that China’s competitive advantages in world markets rest largely on a mercantilist foundation of unfair trade practices. These practices, which have gone largely unchallenged by both the U.S. and Europe, have been designed to stimulate China’s export-driven economy and thereby provide job growth for the world’s most populous country

The view from the American corporate bridge is quite different. As a result of the China Price, American and other non-Chinese enterprises have been confronted with a classic “fight or flight” decision. The “flight” option involves what many foreign corporations have been doing, offshoring and outsourcing much of their manufacturing production to China.

The alternative corporate option of “fight” would necessarily entail comprehensive and highly coordinated lobbying efforts across countries aimed at both domestic governments and international agencies. In this option, the goal would be to level the manufacturing playing field with China by pressuring China to adhere to international economic standards of free and fair trade and to abide by “social clauses” that tie trade to international standards for environmental protection and workers’ rights and safety. As I shall discuss further below, what is chilling here is that as more and more U.S. corporations locate to China, there is far less incentive for corporate America to embrace the fight option.

China’s March Up – And Across -- The Value Chain

It’s one thing for America to lose much of its blue collar manufacturing base to China. If the U.S. loses its white collar science and technology base too, it will be Americans living the peasant life rather than the Chinese. That is why it is crucial at this juncture to understand China’s ongoing mercantilist economic development not just in a static China Price framework but in a more dynamic “march up the value chain” framework context as well.

In this regard, in China’s first long march, Mao Zedong and his communist cadres trekked over 8,000 miles to evade annihilation. China’s newest and latest long march is stunningly different. One element of this long march involves a bold move <u>across</u> the value chain. This involves a movement from first assembly to production and eventually to design and research and development.

A second element involves an equally bold move <u>up</u> the value chain, moving first from tube socks and cheap electronics to heavy manufacturing and increasingly to high value-added products such as autos, aircraft, and, perhaps most surprisingly, biotechnology and pharmaceuticals.

With each move up and across the value chain, China is able to quite literally capture more valued added in the production process and thereby boost the incomes of its workers and profits of its entrepreneurs. Were there not substantial elements of a zero-sum global game in this progression and were this long march not being driven by substantial unfair trade practices, one might simply stand back and applause China for its rapid economic development. Instead, this next stage in China's development – its continued mercantilist long march to the top rungs of the economic value chain – should serve as a long overdue wakeup call to those American and European elites who arrogantly assume that China is capable of nothing more than backbreaking heavy industry.

Consider the auto industry – once the bedrock of America's prosperous blue collar middle class. Already, China – with the aid of billions of foreign investment from the likes of GM, Toyota, and Volkswagen – has put into place a manufacturing infrastructure that will soon start churning out millions of new cars and trucks for both domestic consumption and export to foreign markets. China is likewise moving up the economic ladder into sophisticated computer chip and software design – on the wings of billions from companies like HP, Intel, and Microsoft.

The case of biotechnology and pharmaceuticals may be the most instructive.[8] After all, the "biopharma" companies of theU.S. are shining examples of the success of American science. New drugs provide exceptional health benefits. The industry also employs over 500,000 Americans at very high wages and contributes scores of billions of dollars to the US economy.

Like all industries, biopharma is constantly seeking to reduce costs while increasing productivity. As a result, biopharma research is increasingly being offshored to China. The most obvious benefits of locating to China include low wages and less stringent environmental laws. Companies also don't have to worry about regulatory agencies such as the FDA slowing down new drug development -- or interfering with experiments on humans.

There are more subtle driving forces as well. The American President's veto of embryonic stem cell research coupled with China's far greater willingness – indeed, eagerness -- to explore this new field provides substantial advantages to biopharma companies locating to the PRC. Nor are the Chinese squeamish about the ethics of genetic engineering and cloning-related issues -- notably, a Chinese company (Shenzhen's SiBono GenTech) was first in the world to obtain a drug license for a recombinant gene therapy.

Finally, there is the not-so-invisible hand of Chinese industrial policy. Besides the plethora of unfair trade practices documented earlier, the Chinese government is spending billions on the creation of so-called "biotech clusters" in Beijing, Hong Kong, Shanghai, and Shenzhen. Today, these clusters are every bit the rivals of similar clusters initially funded privately by the likes of Amgen, Genentech, and others in Boston, San Diego, and San Francisco.

As a result of these disparate factors, Chinese biotech is growing faster than even the broader white hot Chinese economy. Today, there are more than 300 biotech companies in China, and nearly every major pharmaceutical company has built, or is building, a research center in China. It's not just big multinationals such as AstraZeneca, Eli Lilly, GSK, Novartis, Novo Nordisk, Roche, and Pfizer. It's also much smaller, cutting edge research companies like Canada's Dragon Pharmaceuticals and San Diego's Abgent, Ambit, and Kalypsys.

According to the *China Daily*, China's biopharma sector now has US$74B in total investment and fixed assets. China currently spends 1.2% of GDP on R&D and plans to increase this to 2% by 2010 and to 2.5% by 2020. In contrast, U.S. spending on biopharma R&D is 2.7% of GDP. By leveraging its multitude of cost and price advantages, however, output of Chinese research per dollar is higher than America's.

While the offshoring of U.S. manufacturing has been a body blow to the blue collar segments of Americana, this more recent and accelerating trend towards offshoring science-driven industries much higher up the value chain could well be a knockout punch to future American prosperity. Consider that, most broadly, all increases in per capita GDP—economic growth—occur as a result of scientific innovation. This is because fundamentally all new products are based on chemistry and physics.

This offshoring of biopharma to China has very important implications for U.S. education and economic development. As economics teaches us, students invest their time and efforts to study subjects they feel are not just interesting. They also have the expectation they will be able to earn a living for themselves and their future families. With biopharma and other jobs in the sciences shifting overseas at an accelerating rate, the economic impetus to pursue advanced degrees lessens. The result is that on a percentage basis, fewer and fewer American students are studying science, and America is losing to China the very innovation that has provided it with a comparative advantage and high standard of living

Most broadly, science is at the root of all innovation. Indeed, science clearly drives economic growth, and America's current comparative advantage in scientific innovation has afforded many of us the high standard of living we enjoy. If we lose that advantage to China – as is becoming more and more apparent – the effects on our economy will be far-reaching. This is precisely why China's latest "long march" up the economic value chain should be a wakeup call to any U.S. policymakers who still believe that China's economic dominance can be contained to highly polluting and relatively low value-added manufacturing industries.

China's Growing Strategic Projection Of Economic, Financial and Political Power

> *It is true and can be argued forcefully that the incentive for … China to dump treasury bills at a rapid rate is not very strong, given the consequences that it would have for their own econom[y]. That is a powerful argument, and it is a reason a prudent person would avoid immediate concern. But it surely cannot be prudent for us as a country to rely on a kind of balance of financial terror to hold back reserve sales that would threaten our stability.*
>
> **Former U.S. Secretary of the Treasury Lawrence Summers**[9]

As America's politicians, policymakers, and journalists have remained dangerously preoccupied with events in the Middle East, they have ignored the emergence of arguably the single greatest threat to U.S. economic, financial, and political independence in its history. This threat is now emerging in three clear stages and proceeding hand in glove with China's own emergence as an economic superpower.

Stage One is virtually complete as China is now America's de facto central banker. As it runs record trade surpluses with the U.S., China now largely funds the U.S. budget by recycling surplus greenbacks back into the U.S. bond market.

At least up until this point, China's financing of the U.S. budget deficit has been motivated by the need to maintain its fixed currency peg between the U.S. dollar and the Chinese yuan and thereby keep the yuan grossly undervalued. As noted in the discussion above, such currency manipulation is one of the major mercantilist policies that China has used to stimulate its export-driven economy.

Stage One of the projection of Chinese power poses, however, a very clear and present danger: With the U.S. so heavily dependent on China for its deficit financing, China now has the power to destabilize both U.S. financial markets and the broader U.S. economy by triggering a stagflation shock.

Consider that if China were to stop buying U.S. bonds, or even substantially reduce its purchases, this would drive up long term interest rates and mortgage rates and trigger a recessionary shock. At the same time, a "dump the greenback" Chinese strategy would drive down the value of the dollar and therefore drive up the rate of inflation as imports become more dear.

The ability of the Chinese to induce such a stagflation shock upon the U.S. represents a very real threat to America's political independence. It is a weapon that may be used by China simply as a threat to deter U.S. foreign policy or trade policy reforms. Alternatively, it is a weapon that China may use as an actual act of retaliation for any one of a number of U.S. actions, e.g., passage of a Congressional bill to impose protectionist tariffs on China. Accordingly, in Stage One of the projection of Chinese power, China is already able to exert a subtle but very powerful countervailing force against the efforts of U.S. policymakers to hold China to account for its various mercantilist trade practices. (This observation may help explain the abject failure of the most recent trade negotiations in Beijing last December. While Chinese negotiators rejected any suggestion of WTO violations or unfair trade practices, American negotiators returned home empty-handed.)

Stage Two in the projection of Chinese economic, financial, and political power is just now getting underway, and it involves what is likely to be a very aggressive move into U.S. equity markets. In this regard, a Bank of America analyst recently reported the expected formation of a new investment corporation in China that may be capitalized with as much as $200 billion, roughly one-fifth of China's foreign currency reserves.[10] The purpose of this corporation will be to invest some of China's reserves into equity holdings around the world, with much of the investment likely to be focused in the U.S.

On the surface, this seems like a good thing for the U.S. stock market as any infusion of capital into U.S. equity markets would be reflected in higher share prices. There are, however, several caution flags.

First, should China become as important a player in U.S. equity markets as it now is in the U.S. bond market, it would be able to destabilize not just the U.S. bond market but the equity markets as well. Second, China may begin to use its equity funds strategically to establish controlling interests in U.S. companies. In this way, China may effect decisions ranging from the offshoring of production or transfer of technology to China to lobbying against U.S. legislation designed to promote fair trade.

Third, there is no guarantee that China will always "go long" the U.S. market with its financial capital. Indeed, there may be times that China may want to short the broad U.S. market indices or major U.S. companies as a hedge against events it may either be anticipating – or, in the worst case, precipitate itself.

For example, if China knows it is going to shift it's currency policy to that of strengthening the yuan, this would likely be bearish for the U.S. stock market and a short position in advance of such a policy shift would be more profitable than a long position. Similarly, albeit far more unlikely, one can also imagine scenarios in which China shorts the U.S. market in anticipation of events such as a move on Taiwan – in much the same way Al Qaeda shorted the U.S. market in advance of the 9/11 attacks.

While there are inherent dangers in this second stage of the projection of China's economic, financial, and political power, as a practical matter, this second stage is more likely to be merely a bridge to Stage Three. This third stage involves the accelerated use of China's growing U.S. currency reserves to acquire U.S. companies.

In this regard, in a rare political misstep, China blundered badly in 2005 when it sought to acquire a major U.S. oil company. This proposed purchase sparked a sharp backlash in Washington in a time of rising oil and gasoline prices and concerns over U.S. energy security; and China was forced to effectively withdraw the bid. The result has been a much lower profile for Chinese acquisition activities. In 2007 and beyond, it is likely, however, that China will begin to significantly increase its acquisition activities in the U.S. This will be in part because of an irony embedded in yet another variation on the well-known law of unintended consequences.

In particular, the more the U.S. pressures China to engage in currency reform, the more likely it becomes that China will let its currency float upward. After all, as the analysis of the China Price drivers above has indicated, currency manipulation may be an important mercantilist driver of Chinese competitive advantage but it is hardly the only one -- or even most important.

In the Chinese power calculus, the time then may be coming quite soon when an upward valuation of the yuan will tie in quite nicely and strategically with its Stage Three acquisitions of U.S. companies. In this stage, China will move from the acquisition of <u>financial</u> assets in Stage One and Two to the acquisition of real assets in Stage Three. In this stage, a stronger yuan and a cheaper dollar will merely increase the purchasing power of China with respect to U.S. acquisitions.

Of course, China wants to acquire U.S. assets for any number of reasons. Most obviously, China gains control of our "bricks and mortar" plant and equipment. China also gains access to the latest management techniques as well as valuable marketing and distribution channels. More subtly, China can help determine the degree of offshoring and outsourcing of American production and services to China. In key industries, China also is able expropriate the latest technologies, including many that may be used in a non-commercial, more military context.

In this regard, as briefly mentioned earlier, one of the most dangerous effects of the offshoring and outsourcing of American jobs to China has been an increasing loss of political will within America to challenge China's unfair trade practices. In this sense, the difficulty of the U.S. political process adequately addressing the growing China problem goes far beyond America's current preoccupation with events in the Middle East.

Consider that when the hemorrhaging of manufacturing jobs to China first began in earnest at the turn of this century, there was a great hue and united cry from both business and labor interests. Increasingly, however, as more and more U.S. companies invest more and more in China, it becomes in the interests of corporate America to preserve the status quo in China. This has led to a clear schism within the American business community. While many loud voices against Chinese mercantilism remain, more and more of corporate America is becoming silent on the issue.

The broader point here is that in Stage Three of the projection of Chinese economic, financial, and political power, the problem of America's lack of political will to confront the Chinese on its unfair trading practices (and broader foreign policy issues) will only widen and deepen as China acquires more and more U.S. companies.

China's Growing Economy Feeds China's Growing Military Might

China's mercantilist trade policies have not just helped China gain increasing economic, financial, and political power over U.S. institutions. China's mercantilism has also been a primary catalyst for the rapid growth and modernization of Chinese military forces.

There is yet another dangerous irony here: By the U.S. spending far beyond its means, by the U.S. allowing the Chinese to finance its profligate ways, and by the U.S. refusing to crack down on China's unfair trade practices, America has been sowing the seeds of its own military decline and national security vulnerability.

Consider that while the Chinese economy has been growing at a white hot pace of 10% per year, its rate of military spending is growing almost twice as fast – fed as it were by the fruits of Chinese mercantilism. In this way, Chinese mercantilism and militarism go hand in hand.

In this relationship, it is increasingly clear China wants to do far more than protect its borders with its military modernization programs. With its budding deep water navy, China seeks to extend its military reach deep into traditional areas of American influence – from the oil rich Persian Gulf to the natural resource-rich countries of Africa and Latin America. With the world's largest standing army, China also seeks greater influence over both the Southeast Asian supply chain and the vast petroleum- and mineral-rich northern border countries of Central Asia. This latter vast area helps keep Europe energized and European factories humming.

Predictably, China denies any plans for world domination. It's official Party line is China's "defense policy…is purely defensive in nature." The most recent test shoot down of a satellite with a ballistic missile by China strongly suggests otherwise, however.

Consider that the international satellite grid is the lifeblood of the global economy and European and U.S. security and anti-terrorism efforts. Any country, particularly one with a nuclear capability like China, that can threaten the grid represents a serious threat. In fact, China has been working with both Cuba and Brazil for years to develop sophisticated satellite tracking technologies and electronic eavesdropping capabilities. The <u>only</u> application such technology can have is to knock U.S., European, Japanese, and/or Taiwanese satellites out of the sky in time of war.

It's not just that China might use this latest weapon itself. China has also established itself as the de facto arms dealer to rogue nations like Iran and North Korea that practice state-sanctioned terrorism. Imagine Tehran getting a crate of Chinese ballistic missiles capable of hitting not just Tel Aviv but the deep space eyes and ears of Israeli and U.S. defense forces.

Space is hardly the only frontier China seeks to conquer. With the help of Russian technology and advisors, Chinese deep water navy gambit involves running a string of aircraft carrier groups around the world capable of challenging the world's only other deep water navy. Why would China want to go gun to gun with the U.S. on the high seas?

There is the matter of Taiwan. U.S. naval forces have in the past helped rebuff Chinese moves on what the PRC views is a "renegade" province. Protecting Taiwan would be a lot more difficult for the U.S. – and a lot more dangerous for the world – if China had comparable warships as well as the ability to cripple the strategic U.S. satellite network.

There is also growing regional tension between China and Japan. In 2004, China snuck a submerged submarine into Japanese waters. In a dispute over oil rights in the East China Sea, China has dispatched two high tech, Russian-built, warships armed with cruise ships to harass Japanese drilling teams. Japan now routinely scrambles its fighters to intercept suspected Chinese spy satellites. Just last October, a Chinese sub provocatively stalked, and then surfaced near, a Pacific fleet U..S. aircraft carrier battle group.

As concerns mount in Japan that China will eclipse Japan as an economic power and attempt to muscle Japan out of the way in its quest for both markets and energy, there is a growing view within Japan that it will have no other choice but to remilitarize and officially "go nuclear." The broader danger is a new arms race and nuclear proliferation, this time in Asia.

What Is To Be Done?

One may legitimately question whether there is a grand strategic design in China's rapid economic development, projection of power, and expansion of its military reach or whether the events now unfolding merely represent some accidental or perhaps evolutionary outgrowth of the industrialization of the world's most populous nation. Clearly, however, the emergence of China as an economic superpower poses a growing threat to the economic, financial, and political independence of the United States as well as U.S. national security.

Regrettably, ever since 9/11, both the Bush Administration and the U.S. Congress, as well as the American media, have been preoccupied by events in the Middle East. At the same time, Europe, for all practical purposes, has no foreign policy capabilities to address the emerging Chinese military threat. With the U.S. so distracted and European military and foreign policy capabilities so diffuse, China has been free to consolidate and expand not just its growing economic, financial, and political power but its military forces as well. The question we must ask ourselves at this critical juncture in history is what is to be done – and who is to do it?

In this policy deliberation process, there is no organization or entity more important than the U.S.-China Economic and Security Review Commission. Over the past six years, the USCC is the only organization which has consistently shone a bright, clear light on U.S.-China economic and military relationships and the dangers that may be embedded therein.

My concern in reviewing the U.S. policy landscape is not just that the U.S. is dangerously preoccupied with the Middle East. There also seems to be few voices in the American political pantheon clearly articulating the exact nature of the China problem much less any effective U.S. counterstrategy.

Consider this Congressional scenario in 2007. A bill jointly sponsored by Senators Charles Schumer (D-NY) and Lindsay Graham (R-SC) is likely to find strong support in both houses of Congress. In its last incarnation, this bill would impose stiff protectionist tariffs on China if it fails to fairly value its currency within 180 days.

In fact, this bill reveals a high level of ignorance about the scope of Chinese mercantilism even as it underestimates the ability of China to swiftly retaliate through the dumping of greenbacks on world markets. Consider that while the most credible estimates of the degree of undervaluation of the Chinese yuan range between 20% to 40%, a common error is to assign a “one-to-one” correspondence between the degree of undervaluation and the cost advantage to exporters. However, it is critical to also take into account the *import content* of exports.

Any benefits from selling exports with an undervalued currency will be at least partially offset by the need to buy from foreigners the raw materials, electronic components, and other imported inputs used in the manufacturing process with that same weak currency. In fact, the import content of most Chinese manufactured goods has been estimated to be quite high, which substantially mutes the currency effect. Lawrence Lau (2003)[11] and William Overholt (2003) suggest that this content is in the range of 75%.[12] Based on this estimate and an assumption of a currency undervaluation in the upper range of 40%, this would yield only a 10% improvement in the ability to compete against the China Price if the Schumer-Graham bill were to pass and China were to dutifully comply with its provisions. Clearly, then, currency reform alone is no magic bullet for the massive U.S.-China trade imbalance.

Of course, if Schumer-Graham were to pass, it is likely that China would not dutifully comply but rather retaliate with a concerted campaign to dump U.S. greenbacks to destabilize U.S. financial institutions and the economy. Moreover, the result would be a stronger yuan that would merely help China segue faster into Stage Three of its projection of power, which, as noted earlier, involves the accelerated acquisition of U.S. companies.

Accordingly, my suggested policy prescriptions run along two separate but synergistic tracks. On one track, there is the path to U.S. fiscal and monetary policy restraint and responsibility. To put it most simply, America must learn to leave within its means and that means balancing the Federal budget and pursuing an interest rate policy consistent with proper price signals. Together, these steps would significantly lessen America’s voracious appetite for Chinese imports and help bring the trade deficit back into balance. This, in turn, would mean that the U.S. would have far less need to rely on China as its central banker, and China would have far fewer surplus greenbacks with which to buy American assets with.

The second policy prescription track involves a comprehensive effort to ensure that all countries – not just China – abide by certain standards and norms of free trade. As a practical matter, this means that any Congressional bill seeking to address the problem of Chinese mercantilist must hit all major points of the compass. Thus, rather than focus merely on one dimension such as currency reform, any comprehensive bill must include provisions that pertain to all of the various mercantilist drivers of the China Price. As this testimony has revealed, these mercantilist drivers range from illegal export subsidies and flagrant violations of the WTO to rampant counterfeiting and piracy, lax environmental health and safety standards, and questionable practices relating to the attraction of FDI into China.

Only with such a comprehensive and far-ranging dual-track policy approach will the U.S. be able to begin to fight back against the growing Chinese threat to American economic, financial, political independence and U.S. national security. The very first step in this process must begin with the recognition – from Main Street and Wall Street to the White House and Capitol Hill -- that the rise of China poses a very serious threat to the U.S. and that, over the longer term, this threat is every bit as serious as the challenges now posed by the troubling events in the Middle East.

ENDNOTES

[1] The full report may be accessed at www.peternavarro.com. A version of this report appears in issue 68 of *China Perspectives* and in French translation in issue 97 of *Perspectives chinoises*. http://www.cefc.com.hk/uk/pc/dernier_numero.php

[2] China's policy of offering free land use to multinationals has been particularly effective in attracting foreign direct investment.

[3] It is well worth noting that the Chinese government has suspended the VAT tax rebate in a number of industries, including most prominently semiconductors. However, it did so only after threats from the U.S. of filing WTO complaints. See, for example, "China Encourages IC Research & Development." China Daily, September 8, 2004

[4] "Unions Urge Sanctions in China Labor Case," *The Wall Street Journal,* June 9, 2006.

[5] Numerous studies have examined this phenonmenon. See, for example, World Bank 2002. "Global Development Finance 2002," Washington, D.C. p. 41.

[6] See, for example, Kusterbeck, Staci. "China Appeals to U.S. Buyers with 'Supply Chain Cities'." Apparel Magazine, August 20, 2005.

[7] See Enright, Michael, Scott, Edith and Chang, Ka-Mun. Enright, Michael, Scott, Edith and Chang, Ka-Mun. "*The Greater Pearl River Delta and the Rise Of China."* John Wiley & Sons May 27, 2005, for analysis.

[8] The biopharma related elements of this testimony were prepared with the help of Professor Andrew Vaino of the University of Maine.

[9] Lawrence H. Summers. "The United States and the Global Adjustment Process," Speech at the Third Annual Stavros S. Niarchos Lecture. Institute for International Economics. Washington, D.C. March 23, 2004. (emphasis added)
http://www.iie.com/publications/papers/paper.cfm?researchid=200

[10] McManus, Thomas. "Mutual Fund Liquidity Trends." Bank of America Equity Research. January 22, 2007

[11] Statement of Lawrence J. Lau, "Is China Playing By the Rules?" Congressional-Executive Commission on China, September 24, 2003.
http://www.cecc.gov/pages/hearings/092403/index.php

[12] Overholt, William. "Exposing the Myths," South China Morning Post, November 17, 2003.