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Panel III  
China's Role in the Development of Globalization

## 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-neighbor" 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. policy makers 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](http://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](http://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](http://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 WalMart--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 cash flow 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.

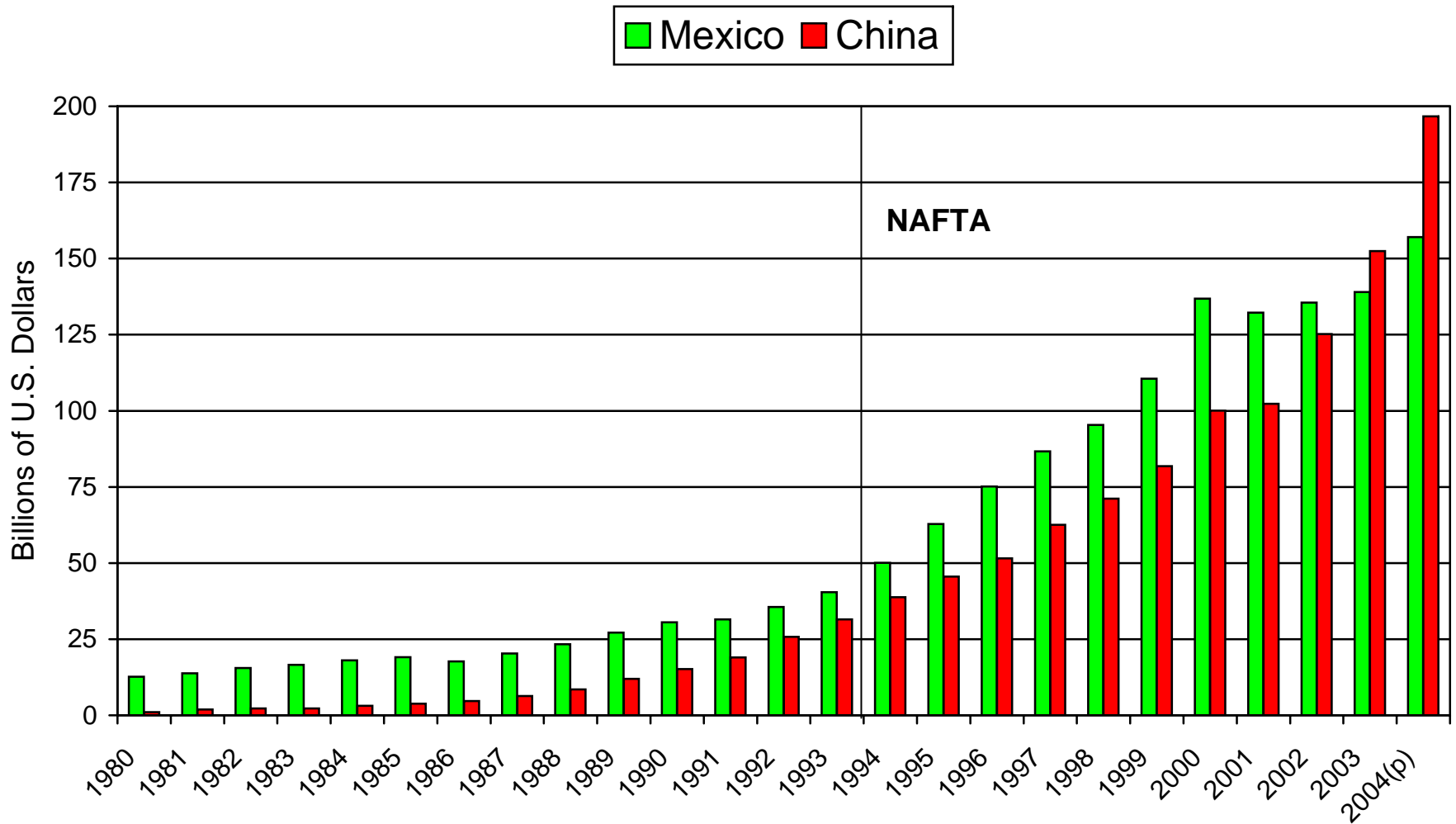
In the present situation, however, the most important economic issue on which to focus is China's exchange rate manipulation. Not only the United States, but also many other countries around the globe, near and far, would benefit from China allowing the yuan to appreciate. The Bush administration has 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 financial 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. policy makers 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 policy makers. 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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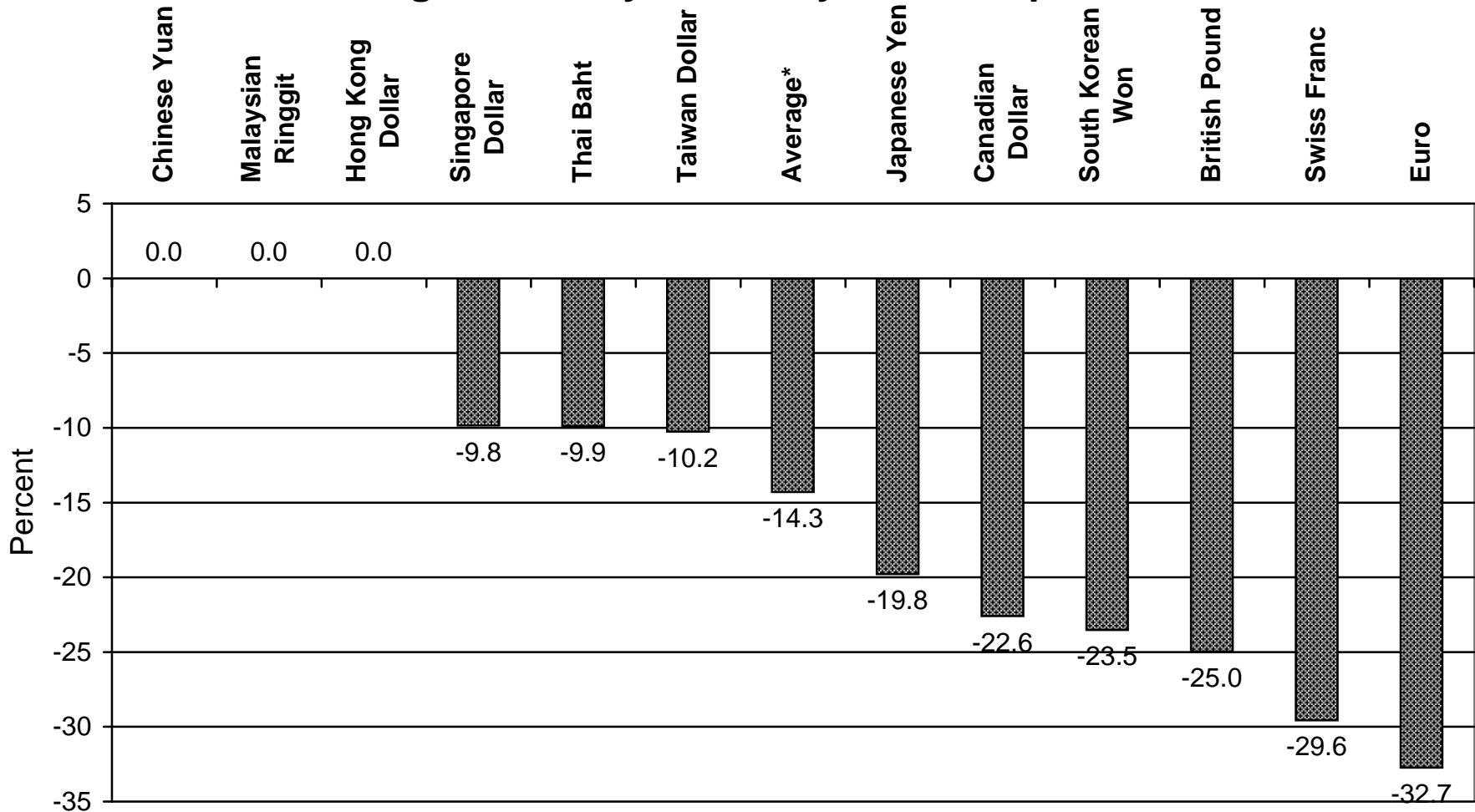
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**Figure 1**  
**U.S. Imports of Goods from Mexico and China, 1980-2004(p)**



Source: U.S. International Transactions data, release of March 16, 2005 <[www.bea.gov](http://www.bea.gov)>. (p) Data for 2004 are preliminary.

**Figure 2**  
**Percentage Change in the Value of the U.S. Dollar**  
**in Foreign Currency, February 2002 to April 2005**



Source: Federal Reserve Statistical Releases G.5 and H.10 ([www.federalreserve.gov/releases/](http://www.federalreserve.gov/releases/)).

\*Real broad index for all currencies (including the Chinese yuan), inflation-adjusted.