

US-China Economic Security and Review Commission

June 23, 2005

Remarks Of

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Committee on Small Business

U.S. House of Representatives

“MANUFACTURING DRAGON:

CHINA’S EMERGING ROLE AS A GLOBAL FACTORY

AND ITS IMPLICATIONS FOR AMERICAN

INNOVATION”

Chairman D’Amato, distinguished Commissioners and ladies and gentlemen, thank you for this opportunity to discuss the emergence of China as a global manufacturing superpower and its impact upon America’s ability to innovate.

This inquiry is extremely timely and critical for policy leaders here in Washington, as the rise of China directly impacts the current health and future vitality of the U.S. industrial base upon which we all depend for our security, our livelihood and our future.

We all know that the ascent of Chinese exports continues to grow. In particular, China’s merchandise trade surplus with the US now far exceeds Japan’s, and the torrid rate of growth has continued into 2005.

This unprecedented growth in exports is a direct reflection of the rise of China as the world leader in manufacturing. We can debate whether this rise in manufacturing muscle is due primarily to low wages, unfair trading practices (such as the current government’s policy of

undervaluing its currency and appropriating intellectual property), or the 22.4 percent structural cost disadvantage that American manufacturing must endure to do business in the US.

In fact I believe that all of these issues have directly supported China's rise as a manufacturing superpower. But what cannot be debated is the fact that China has become a manufacturing superpower. What does this mean for American manufacturing and those few policymakers in Congress that care about American manufacturing?

As one of the few Members of Congress deeply interested in American manufacturing, I have criss-crossed this country and visited hundreds of factories. As Chairman of the House Small Business Committee, I have held over 60 hearings addressing these concerns. I want to share with you today some of my thoughts and my findings about the relationship between manufacturing and innovation. The purpose of my talk is to spark a dialogue about our national strength.

At the end of World War II, General George C. Marshall said, "We are now concerned with the peace of the entire world, and the peace can only be maintained by the strong."

Here are some questions we need to ask ourselves:

- What does it mean for Americans if we lose our ability to innovate in this country?
- Can strength be defined within the limits of financial prowess or does the ability to make things matter?
- How important is it to maintain manufacturing in this country?
- Do we really need to build anything anymore here in America to maintain our innovation capacity?

The defense industrial base, which is a subset of our overall industrial base, is an element of our national power – the sum total of our country's ability to use our power to shape world events, and ultimately, implement our National Security Strategy. In past years, DoD was a major driver of technological advances within manufacturing. Today, they have become mere purchasers of whatever comes off the shelf; pawns of a commercial industry that's driven by the bottom line as opposed to national security.

So often we hear about the need to maintain broad, free trade principles and an unconstrained global engagement, and I certainly count myself as a free trader. In fact, I will put my free trade credentials up against any Member of Congress. Some people think I am against free trade, but as the President has said on numerous occasions, trade must be both free and fair.

This is why there is such a sour mood regarding trade in the Congress right now. Congress has become deeply concerned, some would say fixated, on trade issues with China and the lack of meaningful progress to resolve the issues of currency manipulation, intellectual property rights and other free trade barriers enacted by the Chinese. Right now there are many bills and resolutions pending in Congress that address some, or all of these issues. Mr. English wants to

treat China as if it were a market economy for purposes of imposing countervailing duties. And some in the Senate have called for a 27.5 percent blanket tariff upon Chinese imports.

All this activity squarely reflects the growing frustration and sense of unease about China's emergence. It is no wonder that many here in Congress believe that discussion of further free trade agreements, such as DR-CAFTA, are premature and should be put on hold until the Administration gets tough with China.

Clearly, here at home we have some fundamental problems to deal with, such as overhauling the tax code, ending lawsuit abuse, enacting sound energy policies, and lowering the cost of healthcare by allowing small companies to band together and purchase medical care at a lower insurance cost.

But this is not enough. Consider the following:

- Growth in U.S. manufacturing activity slowed in May for the sixth consecutive month, while factory employment failed to improve for the first time in 18 months, according to data from the Institute for Supply management. Survey released June 1.
- The rate of increase in new orders continued to decelerate, with only 11 of 20 industries reporting gains in new orders in May.
- Growth in exports has also continued to erode since at least February.

PRODUCTIVITY

Whenever there is a discussion over the erosion of manufacturing, inevitably productivity is mentioned as a major reason for the loss of jobs. Theoretically, higher productivity means it costs less to make the same unit today than it did yesterday. We tend to attribute that to greater use of technology. In reality, what's reported quarterly as sectoral output productivity doesn't capture the cost of business inputs. So the fact that your unit costs are lower, doesn't mean you're more productive because of capital equipment or improved business process. It simply means you've found a cheaper way to get that work done. More often than not, it's by offshoring the work, including high-end work.

DEFENSE PROCUREMENT

You all know of my position on Buy America. I have found that many people simply don't understand the significance. The current law as applied to DoD allows the Secretary to bypass buying anything in the U.S. as long as a qualifying country can produce the item(s). The list of countries eligible for such status stands at 21, but there are other types of waivers through source of supply agreements and the balance of payments program that elevate that number to 45. That means that the Pentagon or one of its contractors can claim compliance with BAA without actually having to buy anything in the U.S.

In addition, while the Commerce Department continues to fight unfair subsidies around the world, like those in the Boeing v. Airbus debate, so that our companies can compete fairly, the Pentagon rushes to award contracts to foreign companies (or their American partner) that are subsidized or effectively controlled by their foreign governments. Take AgustaWestland, for example. That company is owned by the Italian government, has three of the board seats (with one of those being the treasurer of the country), and is controlled and subsidized by the government. The Pentagon sees no problem having our market-based companies compete against those that have the support of their government – all in the name of “best value.” Keep in mind that AgustaWestland is also helping the Chinese develop first-class helicopter technology.

ENGINEERS

We see the migration of our “innovation capital” in a number of disturbing trends.

An area not often thought of when discussing innovation is the challenge engineers are having. The unemployment rate continues to be at historical highs. Electrical engineers, for example, are seeing an unemployment rate of roughly 7 percent, three times the norm. Deans at respected engineering universities are finding fewer students entering this discipline. Why is this significant? According to a study published by the National Science Foundation, 46 percent of our engineers are employed in the manufacturing sector. As that sector shrinks, more engineers become unemployed. Students see this trend and decide to study something else with, hopefully, a longer future.

For example, don’t be fooled into thinking that all 25,000 jobs that will be eliminated over the next three years at GM are all factory floor people. GM has a nicely automated manufacturing plant in Shanghai with a 900-person state-of-the-art R&D center, with plans on designing, building, manufacturing, and exporting vehicles to North America by 2007. You can bet that while they are losing people in the U.S., GM is not losing capability.

Semiconductor industry

Another good example of the decline in our innovation capacity is reflected in the semiconductor industry. Semiconductor foundries are manufacturing facilities that produce semiconductors from designs provided by other companies. Most of these high tech foundries are now being located outside the U.S. -- Why?

Many governments view semiconductor foundries as a matter of critical national security—and intense national interest. Israel, Taiwan, Singapore—and most notably, China through its National Academy of Sciences - - have been extremely aggressive about providing massive government support -- and often out-right subsidies, to convince established companies and start-ups alike to build semiconductor foundries in their countries.

The latest ploy by the Chinese is to give “grants” of R&D money to Chinese semiconductor firms. They are not doing this to be charitable! They recognize **that having the manufacturing on their soil creates a “virtual cycle” of jobs, small business opportunity and innovation for their people.**

These are good, often great jobs for the locals; these governments understand that. They know that proximity accelerates tech transfer “from lab to fab.” The presence of fabrication facilities supports the research university base, and students’ benefit greatly from access to industry facilities. One prominent international trade expert who testified at one of my hearings last summer told us this:

The “foundries have enabled host countries to dramatically enhance competencies in semiconductor manufacturing, to build capability in integrated circuit design, to attract foreign investment and technology, and ultimately to draw in semiconductor infrastructural enterprises (makers of production equipment and materials, and providers of logistics and other services) as well as talented individuals.”

[Testimony of Thomas R. Howell, Dewey Ballentine, before the HSBC, 10/16/03].

What do these trend lines mean?

As we examine these trends and issues, I think we can only conclude one thing: America is at risk of losing its innovation lead in the world. These concerns were underscored by the National Association of Manufacturers, which concluded the following:

U.S. Manufacturing’s innovation process leads to investments in equipment and people, to productivity gains, to beneficial spillovers, and to new and improved products and processes. This intricate process generates economic growth and higher living standards superior to any other economic sector. But serious challenges threaten to undermine the critical mass of manufacturing necessary to maintain a dynamic innovation process.

If the U.S. Manufacturing base continues to shrink at its present rate and the critical mass is lost, the manufacturing innovation process will shift to other global centers. Once that happens, a decline in U.S. living standards in the future is virtually assured.

This is an excerpt from a white paper produced for the National Association of Manufacturers in Spring 2003.

In 2003, former Secretary of State Henry Kissinger told a crowd of technology professionals that “if outsourcing continues to strip the U.S. of its industrial base and the act of getting out (developing) its own technology, then we require a careful thought on national policy.”

He went on to say: “the question is whether America can remain a great or a dominant power if it becomes a [pure] service economy. I doubt it very much. I think that a country has to have a massive industrial base in order to play a significant role in the world.”

If we lose our manufacturing capability, America will still survive, but will we still be able to lead and, as Kissinger puts it, “play a significant role in the world?” I think this is the critical question. Does America want to remain the global superpower or are we satisfied with being a large financial center?

Can we defend ourselves if we no longer innovate?

Where I really think these issues become critically important is in respects of our ability to protect ourselves. Over the years, the Department of Defense has become much more reliant on the private sector. Recently President Bush noted in a major report that the defense industrial base is a key asset that has become vulnerable. His report states:

“Because of market competition and attrition, DoD now relies more and more on a single or very limited number of private-sector suppliers to fulfill some of its most essential needs.”Most often the procurement process is based on cost and efficiency. Such an approach may not always take into account the vendor’s critical infrastructure protection practices (e.g. Supplier base) and its ability to supply products and services and provide surge response during an emergency or exigent circumstance.”

Recently I was appointed to the Steering Committee for the National Innovation initiative. I want to commend such organizations as the Council on Competitiveness and IBM for driving this dialogue, and the good work that their report represents. This group is made up of a very distinguished group of scholars and leaders, and they concluded that America’s ability to innovate is being rapidly eroded by the ongoing and unparalleled loss of our manufacturing capacity. I commend their report, “Innovate America” for making some hard-hitting findings.

For example, they note “if U.S. production capabilities continue to shift to overseas locations, and our innovative design and R&D stages follow them offshore, the country will face a major national security problem. We need the most advanced technologies and best manufacturing facilities inside our borders”.

Manufacturing is, indeed, the core of our nation’s strength. With a strong manufacturing base comes engineering, R&D, and innovation. If we only look at the costs and determine that another country can do all those things cheaper, then we limit our strength and the speed of our innovation cycles to that of those nations. Do we really want a race to the bottom? At what point has so much technology and manufacturing skill left the U.S. that we become too reliant on foreign suppliers for the core components of our defense manufacturing capabilities?

So What Do We Do About It? – We Strengthen America!

I personally find these trend lines very disturbing. I think that policy makers in Washington need to start addressing a focused public policy response to them.

Here's what I am doing:

1. I propose that we "Strengthen America." As you know, the Government, and particularly the DoD, are among the biggest customers in the world. Using taxpayer money to support important public policy goals is a well-established doctrine in federal procurement law. We have guidelines to direct procurement dollars to assist small businesses, from woman-owned businesses and from native-American businesses. I think it's a good idea to use some of that taxpayer money to support innovation in this country.

In pursuit of strengthening our industrial capability, we should focus our procurement dollars to preserve American manufacturing innovation by using the taxpayer's money to support the growth and development of innovative new technologies through in the procurement process. No one has any interest in denying the war fighter the best technology at the best price to undertake their mission. This is, and never was the result or the intent behind Buy America.

Instead, we should refocus our purchasing priorities. If there are good value-based reasons to buy commodities and commercial end items on the open market, I am not too concerned about that (although I have to ask are we really prepared to buy all our bullets from the Chinese?)

2. We must reform our visa process, which is hurting our ability to sell our goods to foreign customers. They can't get into the country to inspect or buy our stuff. Our committee was instrumental in creating a one year, multi-entry visa with China. This allows Chinese business visitors to come meet with U.S. suppliers and inspect the goods before making a purchase. Without this, our suppliers were at a great disadvantage. We must do the same for those potential buyers Europe and India.

3. We must reform the CFIUS process to consider economic security as part of national security.

a. Expand the focus beyond narrow traditional national security concerns to encompass economic security. The reason is because the rise of China demonstrates that the loss of key manufacturing assets quickly devolves into a question of national security. If we no longer possess the capability to defend ourselves how can we maintain our role as the arsenal of democracy.

b. We must drive transparency and accountability into the CFIUS review mechanism. Currently, although, both the law and the implementing regulations require that the decision makers consult with Congress, that obligation is being ignored by the Treasury department. I base this conclusion upon my personal experience with Treasury officials during the course of our inquiry into the IBM/Lenovo acquisition.

c. Based on the above, I have to ask myself, if the Treasury department is still the appropriate place to handle CFIUS reviews. It seems to me that the Treasury Department has yet to see a foreign acquisition that it didn't like. I think it's time that the CFIUS process was administered by the Commerce department, which already looks at industrial security issues.

Thank you for the opportunity to testify here today on these important issues and I look forward to answering any questions you may have.