

U.S.-CHINA ECONOMIC CHALLENGES

HEARING
BEFORE THE
U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

ONE HUNDRED THIRTEENTH CONGRESS
SECOND SESSION

FRIDAY, FEBRUARY 21, 2014

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UNITED STATES-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

WASHINGTON: 2014

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

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The Commission was created on October 30, 2000 by the Floyd D. Spence National Defense Authorization Act for 2001 § 1238, Public Law No. 106-398, 114 STAT. 1654A-334 (2000) (codified at 22 U.S.C. § 7002 (2001), as amended by the Treasury and General Government Appropriations Act for 2002 § 645 (regarding employment status of staff) & § 648 (regarding changing annual report due date from March to June), Public Law No. 107-67, 115 STAT. 514 (Nov. 12, 2001); as amended by Division P of the “Consolidated Appropriations Resolution, 2003,” Pub L. No. 108-7 (Feb. 20, 2003) (regarding Commission name change, terms of Commissioners, and responsibilities of the Commission); as amended by Public Law No. 109-108 (H.R. 2862) (Nov. 22, 2005) (regarding responsibilities of Commission and applicability of FACA); as amended by Division J of the “Consolidated Appropriations Act, 2008,” Public Law No. 110-161 (December 26, 2007) (regarding responsibilities of the Commission, and changing the Annual Report due date from June to December).

The Commission’s full charter is available at www.uscc.gov.

April 14, 2014

The Honorable Patrick J. Leahy
President Pro Tempore of the Senate, Washington, D.C. 20510
The Honorable John A. Boehner
Speaker of the House of Representatives, Washington, D.C. 20515

DEAR SENATOR LEAHY AND SPEAKER BOEHNER:

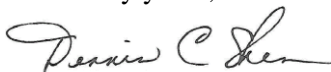
We are pleased to notify you of the Commission's February 21, 2014 public hearing on "U.S.-China Economic Challenges." The Floyd D. Spence National Defense Authorization Act (amended by Pub. L. No. 109-108, section 635(a)) provides the basis for this hearing.

At the hearing, the Commissioners received testimony from the following witnesses: Dr. Robert Scott, Director of Trade and Manufacturing Policy Research, Economic Policy Institute; Dr. Oded Shenkar, Ford Motor Company Chair in Global Business Management, Fisher School of Business, Ohio State University; Dr. Peter K. Schott, Professor of Economics, Yale University; Mr. Dan DiMicco, Chairman Emeritus, Nucor Corporation; Ms. Elizabeth Drake, Partner, Stewart and Stewart; Dr. Philip I. Levy, Senior Fellow, The Chicago Council on Global Affairs; Dr. Willy C. Shih, Robert and Jane Cizik Professor of Management Practice in Business Administration, Harvard Business School; Dr. Adam Hersh, Senior economist and China specialist, Center for American Progress; and Mr. Joel Backaler, Director, Frontier Strategy Group. This hearing examined challenges to the U.S. economy from Chinese competition in manufacturing and the role of state-owned enterprises. In addition, this hearing assessed the effectiveness of U.S. trade laws and trade enforcement in addressing these challenges.

We note that prepared statements for the hearing, the hearing transcript, and supporting documents submitted by the witnesses are available on the Commission's website at www.USCC.gov. Members and the staff of the Commission are available to provide more detailed briefings. We hope these materials will be helpful to the Congress as it continues its assessment of U.S.-China relations and their impact on U.S. security.

The Commission will examine in greater depth these issues, and the other issues enumerated in its statutory mandate, in its 2014 Annual Report that will be submitted to Congress in November 2014. Should you have any questions regarding this hearing or any other issue related to China, please do not hesitate to have your staff contact our Congressional Liaison, Reed Eckhold, at (202) 624-1496 or via email at reckhold@uscc.gov.

Sincerely yours,



Hon. Dennis C. Shea
Chairman



Hon. William A. Reinsch
Vice Chairman

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U.S.-CHINA ECONOMIC CHALLENGES

FRIDAY, FEBRUARY 21, 2014

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

Washington, D.C.

The Commission met in Room 608 of Dirksen Senate Office Building, Washington, DC at 9:00 a.m., Commissioners Daniel M. Slane and Michael R. Wessel (Hearing Co-Chairs), presiding.

OPENING STATEMENT OF COMMISSIONER MICHAEL R. WESSEL HEARING CO-CHAIR

HEARING CO-CHAIR WESSEL: Good morning, everyone. I want to thank our witnesses for being here today and for all the time they've put into their excellent written testimony and the time that they will spend with us today. We appreciate it.

Each of their written statements will be submitted for the record and will be available online at the Commission's Web site.

Today's hearing addresses three important topics: what impact has the U.S.-China relationship had on U.S. jobs; how should we assess U.S. trade law enforcement efforts with China; and, finally, what are the competitive challenges posed by Chinese state-owned enterprises and non-market economic forces?

Today's three panels raise many of the issues at the core of the U.S.-China economic relationship. Recently, the Commerce Department released data on the annual trade deficit with China, and, once again, the deficit reached a new annual high in 2013.

While U.S. exports to China are up, these exports are swamped by a flood of Chinese imports into the U.S. market. And China is not just exporting toys and textiles. China now ships more advanced technology products to us than we send to them. Last year, the U.S. bilateral deficit in these products reached almost \$117 billion.

This hearing also comes at an important time as our nation's trade agenda is more active than at any time in history. Negotiations for a Trans-Pacific Partnership, a Transatlantic Trade and Investment Partnership, a Bilateral Investment Treaty with China, an International Services Agreement, an Environmental Goods Agreement, and other negotiations are well underway.

The administration is actually expected to start agreements with Latin America and Africa as well.

Today's hearing also comes amid pervasive economic uncertainty. The unemployment rate has been coming down, but that's partly because so many discouraged job seekers have given up looking. Many people are wondering what Washington is going to do, if anything, and certainly some are hoping that Washington won't act at all.

Trade plays a role in all of this. No one is saying that trade is the only factor. Certainly technology, productivity, and other factors are important.

But we hope to have a discussion about what the impact of trade with China

has had on jobs here in the U.S. We also want to discuss what role trade enforcement may play in addressing some of the problems that have arisen, and what's working, what isn't, and what improvements, if any, can be made.

Finally, we will hear about the unique challenges posed by Chinese state-owned enterprises and the non-market economic forces from China. This topic is an important one as Chinese SOEs continue to consolidate and grow in economic power. They are becoming, year by year, more important players in the international economy.

The non-market economic forces have other implications beyond Chinese SOEs as well that need to be discussed. On their own, these topics are important. But as the administration is reportedly negotiating a chapter in the TPP to create new rules and disciplines on these SOEs, the rules that are set there will, presumably, be the template for how they intend to deal with China. What approach is in America's interest?

I want to thank our staff for all the work that went into preparing today's hearing, their work with the witnesses, and preparing our briefing books. And I'll now turn over to my Co-Chair Dan Slane.

**PREPARED STATEMENT OF COMMISSIONER MICHAEL R. WESSEL
HEARING CO-CHAIR**

OPENING COMMENTS

Commissioner Michael Wessel
Hearing on U.S.-China Economic Challenges
February 21, 2014

I want to thank our witnesses for being here today, and for the time they have put into their excellent written testimony, and for the time they will spend with us today. Each of their written statements will be submitted for the record and will be available online at the Commission's website.

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I want to thank our staff for the work that goes into preparing for these hearings.

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PANEL I INTRODUCTION BY COMMISSIONER DANIEL M. SLANE

HEARING CO-CHAIR SLANE: Thank you, Mike.

We'd also like to express our appreciation to Senator Patty Murray, who is Chairman of the Budget Committee, and the staff of the Budget Committee for helping us secure this room for our hearing.

I'd like to introduce our three panel members and ask that they keep their opening statements to seven minutes each so that we'll have enough time to ask questions.

Our first member is Dr. Scott of the Economic Policy Institute, and Dr. Scott's research areas include international economics, trade and manufacturing policies and their impacts on working people in the U.S. and elsewhere, the economic impacts of foreign investment, and the microeconomic effects of trade and capital flows.

He has published widely in academic journals and the press. Dr. Scott has testified previously before the Commission.

Dr. Shenkar has traveled here from the Ohio State University's Fisher College of Business--my alma mater--where he has served as the Ford Motor Company Chair in Global Business Management.

He is also a member of the Centers for Chinese Studies and for Near East Studies. Dr. Shenkar has been an advisor to firms, governments, international institutions and universities worldwide and has published more than 100 scholarly articles in leading academic journals, as well as several books, including his most recent book, *Copcats: How Smart Companies Use Imitation to Gain a Strategic Edge*.

Dr. Shenkar has also previously testified before the Commission.

Dr. Schott is a Professor of Economics at Yale University School of Management. Dr. Schott also serves as a Research Associate at the National Bureau of Economic Research and Special-Sworn-Status Researcher at the U.S. Census Bureau.

His research focuses on how countries, firms and workers react to globalization. Some of Dr. Schott's recent work examines the decline of U.S. manufacturing employment since China joined the WTO. His writing has appeared in various academic journals and in mainstream press.

Dr. Schott was kind enough to rearrange his busy schedule so he could travel to Washington and testify, and we very much appreciate that.

Gentlemen, thank you very much for coming, and we'll start with Dr. Scott.

**OPENING STATEMENT OF DR. ROBERT E. SCOTT
DIRECTOR OF TRADE AND MANUFACTURING POLICY RESEARCH
ECONOMIC POLICY INSTITUTE**

DR. SCOTT: Thank you, members of the Commission. I appreciate the opportunity to testify here today.

I'd like to make four points in my statement. First, I want to emphasize new research findings I'm about to release which shows that eliminating currency manipulation could create 2.3 to 5.8 million jobs in the United States.

I start by noting that the President has identified reducing inequality as the "defining challenge of our time." The best way to reduce inequality is to raise the wages of the middle class by creating more jobs and thereby reducing unemployment.

To do that, we need to increase the sales of goods and services made in the United States, which means expanding exports, reducing imports, and shrinking our trade deficit.

Currency manipulation by about 20 countries, mostly in Asia, is the single-most important cause of our trade deficit. These nations have been exploiting our markets and stealing our jobs for over a decade. Ending currency manipulation would reduce the U.S. trade deficits by \$200 to \$500 billion per year within three years, creating 2.3 to 5.8 million jobs, as I noted. This is shown in Table 1 in my prepared statement.

It would also increase U.S. GDP by 288 to \$720 billion. It would reduce U.S. budget deficits by stimulating growth and wages and tax revenues and reducing public spending on unemployment, and so on, reduce budget deficits by 107 billion to \$266 billion, and improve state budgets by 40 to \$101 billion.

China is by far the largest currency manipulator. It has increased its holdings of foreign exchange reserves by an average of \$360 billion a year over the last six years. Joe Gagnon from PIIE has shown that there is a nearly perfect one-to-one correlation between a country's purchases of foreign exchange reserves and its current account balances. Thus, and this is key, we don't have to estimate how much the Chinese yuan is undervalued; we simply need to note that China is buying up foreign exchange reserves and essentially buying continued large current account surpluses.

China has acquired over \$4 trillion in foreign exchange reserves and other foreign assets since 2000. Those purchases are strongly correlated with the growth of its trade and current account surpluses with the United States and the world.

The second point I want to make is that growing trade deficits with China have eliminated nearly three million U.S. jobs since China entered the World Trade Organization. Business and government officials frequently claim that export growth is delivering great benefits to the economy, but, as I note in my prepared statement, trade is a two-way street.

When most U.S. officials talk about the benefits of trade, they refuse to discuss imports or their effects on employment. Talking about trade and only talking about the growth of exports is like keeping score in a baseball game and only counting runs scored by the home team. It might make your team sound like it's doing well, but it won't tell you if they've won the game.

It's clear: exports support domestic jobs, but imports cost jobs or displace them. The best measure of the net impact of trade on the demand for labor and on overall

GDP in the United States is the change in the trade balance, measured in dollars.

The administration continues to tout the supposed benefits of rapid export growth to China and other countries. However, as shown in my Exhibits C through E, it's not the rate of growth that matters but the volume of growth in imports and exports that determines what happens to our trade balance and, thus, the employment impacts of trade with China.

Thus, rapidly growing trade deficits with China between 2001 and 2012--as I'll show in another new paper I'm finishing right now--have eliminated about 2.9 million jobs in the United States. More than three-fourths of the jobs lost, some 2.3 million of those jobs, more than three-quarters, were in manufacturing. Similar findings have been obtained by other authors, including a study authored by Professor Schott we're going to hear about in a moment.

The third point I want to make is that growing trade deficits/trade and trade deficits with China has lowered wages in the U.S. and that growing trade with low-wage countries explains 90 percent of the growth in the college/non-college wage gap over the past two decades.

And this is the product of two factors:

First, in direct effect of displacement of highly-paid manufacturing jobs, pushing workers out of manufacturing into lower-paid jobs in non-traded goods industries, and those losses, according to my estimates, added up to some \$37 billion a year in 2011, or \$13,500 per displaced worker for the 2.--at that time--7 million workers displaced through 2011.

Secondly, and this is a much broader effect, competition with imports from China has put all workers who look like manufacturing workers--that is essentially everyone who does not have a college degree--into competition with workers in China and other countries. This is the big part of the iceberg. This is what has really walloped the labor force.

Trade with low-wage countries, and especially China, has reduced wages for U.S. non-college educated workers by five-and-a-half percent, roughly \$1,800 per year, for full time full-year workers without a college degree.

There are 100 million such workers in the U.S. economy, about 70 percent of our labor force, and overall then these 100 million workers have lost about \$180 billion in income that's transferred from low-wage workers to high-wage workers. These are the results of my colleague Josh Bivens.

My formal statement's response to the other questions in the hearing prospectus--I just have a few seconds left to comment on a Bilateral Investment Treaty. I'll just summarize my notes and say my research shows that the effects of trade and trade agreements have been to encourage firms to invest abroad. That's a principal path that these agreements have through which they've increased trade deficits and led to job loss.

And my question is why would we want to invest more resources in negotiating agreements to expand foreign investment? And I have a lot of data on that question in my statement.

Happy to take your questions. Thank you.

**PREPARED STATEMENT OF DR. ROBERT E. SCOTT
DIRECTOR OF TRADE AND MANUFACTURING POLICY RESEARCH
ECONOMIC POLICY INSTITUTE**

Testimony before the U.S.-China Economic and Security Review Commission

Hearing on US-China Economic Challenges

Robert E. Scott

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**608 Dirksen Senate Office Building
9:00 a.m., January 21, 2014**

Question 1. Does the U.S.-China trade have an impact on U.S. jobs, wages and benefits? If so, how has this changed over the last 10 years?

Currency Manipulation, Trade, Jobs and Wages

The President has identified reducing inequality as the “defining challenge of our time.” While inequality is a complicated problem, it won’t be solved without raising wages of middle class Americans, creating more jobs, and reducing unemployment. To do that, we need to increase sales of goods and services made in the United States, which means expanding exports, reducing imports, and shrinking our trade deficit.

Currency manipulation, by about twenty countries (mostly in Asia), is the single most important cause of our trade deficit. These nations have been exploiting our markets and stealing U.S. jobs for over a decade. Ending currency manipulation would reduce U.S. trade deficits by \$200 to \$500 billion per year within three years, creating 2.3 to 5.8 million U.S. jobs (**Table 1**). It would also increase U.S. GDP by \$288 to \$720 billion (2.0 to 4.9 percent), reduce U.S. budget deficits by \$107 to \$266 billion (34.4 to 86.1 percent) and improve state budgets by \$40 to \$101 billion (2.0 to 4.9 percent of total state spending).

China is by far the largest currency manipulator, and it has increased its holdings of foreign exchange reserves by at least \$359 billion per year, on average, between 2006 and 2012 (see **Figure A**). Gagnon (2013) has shown that there is nearly a perfect, 1-to-1 correlation between a country’s official purchases of foreign exchange reserves and its current account balances. China acquired over \$4 trillion in foreign exchange reserves and other foreign assets since 2000. Those purchases are strongly correlated with the growth of China’s trade and current account surpluses with the United States, and the world.

Currency manipulators have increased their holding of official foreign assets by nearly \$1 trillion per year in recent years. Bergsten and Gagnon (2012) also estimate that the elimination of currency manipulation would result in 10 to 25 percent depreciation in the trade-weighted value of the dollar. The elimination of currency manipulation would result in a somewhat larger appreciation in the Chinese yuan and other manipulated currencies relative to the U.S. dollar.

Currency manipulation can be eliminated by passing new laws (such as H.R. 1276 and S.1114) and by confronting the perpetrators.¹ China is by far the most important currency manipulator. There are approximately 20 other significant currency manipulators, and many others who have been forced to engage in defensive devaluations to maintain their competitiveness with China and other large manipulators (Bergsten and

Gagnon 2012, 1). In this regard, it is important to note that official Chinese trade data, which are used by the IMF and other agencies to estimate China global trade surplus, substantially and consistently underestimate the overall Chinese trade surplus, as shown by comparison of Chinese trade statistics with comparable trading partner data on their trade with China (**Figure B**).

Turning to trade, jobs, and wages, the most important cause of growing inequality remains extremely high levels of unemployment, and low levels of labor force participation. The unemployment rate was 13.1 percent in January if missing workers are included. Sustained low unemployment would deliver much higher levels of wage growth to workers in the bottom and middle of the income distribution. When unemployment falls, wages rise much faster at the bottom and middle of the income distribution than at the top. Thus, reducing unemployment will directly improve income inequality. EPI research has also shown how the growth of trade with China and other low-wage nations has contributed directly to growing income inequality.

EPI research on the costs of China trade and the impacts of trade with low-wage countries

Business and government officials frequently claim that export growth is delivering great benefits to the economy. For example, the International Trade Administration (ITA) claimed last year that

Americans are selling more U.S. goods and services to the 95 percent of consumers who live outside of our borders. In 2012, U.S. exports hit an all-time record of \$2.2 trillion and supported 9.8 million jobs.²

Trade is a two way street. Exports support domestic jobs, but imports displace jobs that would be located in the United States. But when most U.S. officials talk about the benefits they refuse to discuss imports or their effects on employment. Talking about trade and only discussing the growth of exports and their implications for employment is like keeping score in a baseball game and only counting runs scored by the home team—it might make your team sound good, but it won't tell you if they've won the game (Scott 2013b).

Exports support jobs, but imports destroy them. The best measure of the net impact of trade on the demand for labor, and on overall GDP in the United States, is the change in the U.S. trade balance, measured in dollars.

The Administration continues to tout the supposed benefits of rapid export growth.³ However, the *rate* of growth of exports is not the only, or even the most important determinant of changes in the U.S. trade balance, as shown in the attached charts for U.S. trade with China. For example, **Figure C** shows that exports to China grew at a 10.3 percent annual rate in 2013, while imports increased only 3.5 percent. However, as shown in **Figure D**, the value of U.S. exports to China increased only \$11.4 billion in 2013, while the value of imports increased \$14.8 billion. Thus, the U.S. trade deficit with China increased \$3.4 billion last year (in 2013).

¹ H.R. 1276 and S.1114 would allow the Commerce Department to treat currency manipulation as a subsidy in Countervailing Duty trade cases (OpenCongress.org 2013b and 2013a).

² International Trade Administration. 2013. "National Export Initiative." <http://trade.gov/nei/>

³ International Trade Administration. 2012. "Powering Export Growth." http://trade.gov/cs/cs_annualreport12.pdf

The trade deficit increased, despite more rapid export *growth* because total value of imports exceeded that of exports by a factor of 3.6-to-1, (U.S.-China imports, exports and the trade balance for 2000-2013 are shown in **Figure E**). Thus, exports would have to grow 360% faster than imports just to keep the trade deficit from growing, and they did not. The U.S. trade deficit with China has increased rapidly since that country entered the World Trade Organizations (WTO) in 2001, as shown in Figure E.

The China Trade Toll: Growing Trade Deficits, Job Losses and Wage Suppression

Growing U.S. trade deficits with China between 2001 and 2012 eliminated 2.9 million U.S. jobs. More than three fourths of the jobs lost (2.3 million, 77.1 percent) were in the manufacturing sector (Scott 2014b, forthcoming). Similar findings have been obtained by Autor, Dorn and Hanson (2012) and Pierce and Schott (2013).⁴

Workers displaced by trade were pushed out of good jobs with excellent wages, primarily in manufacturing industries, into lower paying jobs in non-traded industries, or into unemployment. Growing trade deficits with China between 2001 and 2011 resulted in the net loss of at least \$13,505 per displaced worker in 2011 alone. For all displaced workers, using education group averages, net wages losses totaled \$37 billion (Scott 2013a).

Direct trade and wage losses are just the tip of the iceberg when it comes to the cost of China trade, and globalization more broadly, for American workers. Using standard models to benchmark the cost of globalization for American workers without a college degree Bivens (2013) has estimated that in 2011, trade with low wage countries lowered wages by 5.5 percent—roughly \$1,800 for all full time, full-year workers without a college degree.

There are approximately 100 million workers in the United States without a college degree. Overall, the growth of imports from low wage nations has resulted in a total transfer of \$180 billion per year from production to non-production workers, directly contributing to the observed rise in inequality. The growth of trade with low-wage countries explains 90 percent of the rise in college wage premium since 1995. Between 1995 and 2011, China alone was responsible for over half (51.6 percent) of the growth in the college/noncollege wage gap.

Questions 2. What secondary factors, such as indirect employment effects, or the impact of manufacturing job losses on the business services sector, have affected overall employment in the U.S. economy as a result of the trade imbalance?

The U.S. economy is entering the seventh year of the great recession. Nearly 8 million jobs are needed to absorb the excess workers in the economy and return to unemployment levels that prevailed before the start of the recession. The U.S. economy was operating 4.5 percent below potential output in 2013 (and output gap of \$797.5 billion).⁵

The elimination of currency manipulation would directly stimulate the creation of up to 2.3 million U.S. jobs (**Table 2**, high impact scenario). An additional 1.7 million jobs would be created in indirectly supported industries, including jobs in supplier industries (such as steel, glass and tires used as inputs to the auto industry), and service industries (such as accounting, scientific and technical and managerial services). Because the economy has un-used resources, the creation of up to 4 million (direct plus indirect jobs by the elimination of

⁴ Autor, Dorn and Hanson (2012) examine the period 1990-2007. Pierce and Schott examine data for March 2001 to March 2007.

⁵ Congressional Budget Office, Baseline Economic Forecast—February 2014 Baseline Projections.

currency manipulation will also result in the creation of additional responding jobs in the economy, as those initial workers spend the wages earned on goods and services. Since wages are high in manufacturing (which makes most traded goods), reducing trade deficits will have a large “multiplier” effect on employment. We estimate that the multiplier for such spending is 0.44. Thus, an additional 1.8 million jobs multiplier jobs would be created by eliminating currency manipulation in the high-impact scenario, as shown in Table 2.

Jobs supported by eliminating currency manipulation would be concentrated primarily in manufacturing and agricultural states in the Upper Midwest including Wisconsin, Indiana, Iowa, Minnesota, Michigan, Ohio, South Dakota, Nebraska, and also Idaho in the West. Growing trade deficits have devastated manufacturing production, which has had a ripple effect on state and local governments throughout these “rustbelt” regions of the country.

Question 3. How would our economic relationship with China need to change for it to produce more U.S. jobs and a better balance of trade?

China has built an export based economy on a foundation of illegal financial, trade and industrial policies. These include China’s currency manipulation, its many trade-distorting practices including extensive subsidies, illegal barriers to imports, restrictions on critical trade in critical materials (such as taxes and quotas on exports of rare earth minerals), dumping, and suppression of wages and labor rights and a race to the bottom in environmental, an health and product safety standards that have threatened consumers in the U.S., polluted our air and oceans and increased global warming.

At the same time, China has suppressed wages and neglected the development of its own domestic consumer markets. From a macroeconomic perspective, China has developed bloated manufacturing and trade goods sectors and suppressed domestic consumption. As a result the structure of China’s economy is distorted, imbalanced and unsustainable.

China needs to redevelop its economy by reducing its reliance on export-led growth and taking steps to increase domestic consumption. These could include measures to raise domestic wages by raiding minimum wages and by recognizing the rights of workers to independently organize and bargain collectively (e.g. form independent trade unions). China can also boost domestic demand by increasing investment in its social safety net and through expanded investments in domestic infrastructure.

Question 4. As China evolves from an economy that makes copies of things to an economy that also invents things, what does the U.S. need to do to ensure that our workers are prepared to compete?

There are a number of policies the United States can and should undertake to redevelopment its economy. All will contribute to rebuilding U.S. manufacturing. For example, underinvestment in infrastructure reduces the efficiency of the economy and the competitiveness of U.S. manufacturing. The United States needs \$3.6 trillion in infrastructure investment by 2020.⁶ Rebuilding U.S. infrastructure will create huge demands for domestic manufactured products such as steel, concrete, construction equipment, controls and instruments. It will also help rebuild overall demand in the domestic economy

Enacting policies to more effectively stimulate demand, including ending currency manipulation, rebuilding

⁶ American Society of Civil Engineers 2013. [Report Card for America’s Infrastructure.](#)

infrastructure, investing in clean and renewable technology industries, and eliminating unfair trade policies (such as dumping, subsidies, and other unfair trade barriers) are the most important steps needed to rebuild U.S. manufacturing.

New trade policies to respond to a dynamic and increasingly hostile international environment would move toward a restructuring of the world trading system so that it supports fair, balanced, and sustainable trade. And the massive public investments needed to rebuild U.S. infrastructure and develop new green and clean energy technologies will create domestic and foreign demand for new products that can help rebuild U.S. manufacturing, while increasing the competitiveness of the U.S. economy as a whole. Finally, reforms of health care and tax systems are also needed to increase competitiveness and rebalance public spending and revenues in the United States.

While policies that address the demand side of the equation are critical, supply-side assistance is also crucial; U.S. manufacturing suffers from reduced capacity, in both absolute terms and relative to our trading partners. The United States and its domestic manufacturers are operating in an environment where many other countries, including Germany, Japan, China, and Korea, operate comprehensive, supply-side programs to support their traded goods industries. The United States needs to create a world-class environment to support domestic manufacturing (Ezell and Atkinson 2011 and 2012). This should include greatly enhanced investments in technology development, and manufacturing “extension programs” such as the Manufacturing Extension Partnership, a program of the National Institute of Standards and Technology (NIST) that is vastly underfunded when compared with agriculture capacity-building programs of the USDA and with manufacturing capacity-building programs of other countries such as Canada, Germany and Japan.

The United States also needs an intermediary institution to provide working and investment capital to small and medium-sized manufacturers, which often lack access to U.S. bank and capital markets that give preference to large multinational companies for bank loans and long-term corporate bonds. This “Mannie Mae” would be modeled on the federal housing enterprises (i.e., Fannie Mae, Freddie Mac, and Ginnie Mae) that channel capital into the nation’s housing finance markets.

In addition, federal and state governments should work with schools, unions, and manufacturers to develop improved school-to-work training programs for non-college graduates, modeled on German and Danish labor force policies.

Finally, Japan has a Ministry of Economy, Trade, and Industry (METI), a powerful agency that works to ensure that foreign trade policy complements efforts to strengthen domestic manufacturing interests. China through its five-year plans also provides critical strategic support to manufacturing efforts. The U.S. government needs to expand its capacity to develop and implement national trade and competitiveness strategies to respond to, and compete with, Japan’s METI and China’s five-year plans.

Lessons on building strong support systems from the United States and other countries

The major elements of a more effective national trade and industrial policy were outlined in the previous section. A few examples will illustrate the scale of resources and commitments required to raise manufacturing support in the United States to a level on par with other countries.

In the debates about the future of manufacturing, comparisons are frequently drawn between the decline of employment in agriculture and that in manufacturing. However, agriculture has continued to be a major U.S.

exporter, and its contribution to the economy has been relatively constant in recent years despite the sharp decline in employment. Agricultural output has continued to grow (in real terms) despite falling employment.

One of the primary reasons for rising output in agriculture is the steady growth of productivity (output per acre). Among the foremost reasons for the large and steady rise in agricultural productivity has been the key role played by the federal government in supporting research and its dissemination and diffusion. Resources dedicated to this task include the U.S. Department of Agriculture and its Agricultural Research Service, the system of land-grant colleges that support a vast base of primary research into agricultural sciences, economics and technology diffusion, and the USDA's farm extension service, which has disseminated the latest research findings to farmers at the county and farm level.

There is simply no counterpart in manufacturing to the USDA/land-grant college system of agricultural research, development, innovation, and diffusion of new technologies. The entity that comes closest to performing a similar role in manufacturing may be the relatively obscure National Institute of Standards and Technology (NIST). The president's budget requested \$857 million for NIST in fiscal 2013 (NIST 2012).

In comparison, the USDA's overall 2013 budget request, including mandatory crop subsidy programs and all other research programs, was \$155 billion (USDA 2012). Some 72 percent of USDA expenditures are for nutrition assistance (the Women, Infants and Children program), which only indirectly benefits agriculture. Considering only non-nutrition assistance programs, which include farm and commodity programs, conservation and forestry, rural development, research, and other programs, the USDA's fiscal 2013 request is still \$43.4 billion, more than 50 times total spending on NIST programs. However, manufacturing generated 10 times as much output as did agriculture in 2011: \$1,731.5 billion of value added in manufacturing versus \$173.5 billion in agriculture (Bureau of Economic Analysis 2012). Thus, per dollar of economic output generated, the USDA spends more than 500 times as much to support agriculture and related activities as NIST spends on manufacturing research and related activities.

One of the most visible (and controversial) elements of NIST is the Hollings Manufacturing Extension Partnership (MEP), which was designated to receive \$128 million in fiscal 2013 (NIST 2012). Comparative research by Ezell and Atkinson (2011) has shown that U.S. expenditures for the MEP program represent only 0.0014 percent of U.S. GDP. As a share of GDP, Canada spends more than seven times as much as the United States on manufacturing extension and services programs, and Japan spends nearly 23 times more than the United States.

If U.S. spending on the MEP program were to rise to the Japanese level, it would require a budget allocation of approximately \$5 billion per year, not large in the context of the USDA budget, or of overall government spending, but a huge, roughly 40-fold increase of the program.

Germany's Fraunhofer-Gesellschaft, the country's largest organization for applied research, serves as a compelling model of what the MEP could become. It supports more than 80 research units and 60 Fraunhofer Institutes and in 2011 had a staff of 20,000, more than half of whom are scientists and engineers. It had an annual budget of €1.8 billion euros (\$2.4 billion). More than 70 percent of Fraunhofer's contract research is from contracts with industry and from publicly funded research projects. Almost 30 percent of its funding is provided by the German federal and state (lander) governments. (Fraunhofer 2012)

The U.S. GDP is approximately 4.2 times larger than Germany's (IMF 2012). If the U.S. MEP program were operated on the scale of the Fraunhofer-Gesellschaft, it would require total funding of \$10.1 billion, of which

\$3.0 billion would be required from federal and state contributions. Thus, both the German and Japanese examples suggest U.S. spending on the MEP program should be expanded 20- to 40-fold. Expanding to a program of this scale would require time and resources to ensure that the needed capacities were developed and the resources well invested.

But expanding the MEP program would by no means be sufficient to restore U.S. manufacturing competitiveness. The United States would also need to greatly expand its national R&D infrastructure, both through funding programs within federal agencies such as the National Science Foundation, the Department of Energy, the Environmental Protection Agency, and the National Institutes of Health, and by creating a national system of research universities dedicated to developing manufacturing technology and training manufacturing engineers. This training system would serve as the manufacturing equivalent of the USDA's system of land-grant colleges, but on a larger scale.

International comparisons also provide good models for labor/management relations, for financing small and medium-sized manufacturing firms and other exporting firms, and for training non-college-educated workers. German manufacturers practice "stakeholder capitalism" in which boards of directors include an equal number of representatives of managers and workers (Meyerson 2011). Germany also has an entire sector of banks devoted to financing small and medium-sized firms, which reduces such firms' need to rely on private capital markets and lessens the demand for maintaining short-term profits. Additionally, Germany has a highly developed school-to-work job-training system for non-college-educated workers, which is much more effective than U.S. job training and displaced-labor-assistance programs. As a result, over the past decade Germany has maintained a large and growing trade surplus even relative to low-wage countries outside the eurozone, despite having some of the highest manufacturing compensation rates in the world (BLS 2011). Furthermore, it has maintained its competitiveness in world export markets, and its exports are dominated by autos and other high-value, durable manufactured goods.

There are externalities that lead U.S. private firms to underinvest in training, R&D, and other activities that would be supported by supply-side policies previously suggested. There are also market imperfections in capital markets that need to be addressed with new public institutions, as suggested above. These market imperfections provide an economic justification for investing public resources in activities that would enhance U.S. manufacturing capacity.

While it is beyond the scope of this statement to detail a comprehensive program to develop a world-class environment to support U.S. manufacturing, it is clear that such programs are necessary and would greatly aid expansion of manufacturing and other traded industries, creating millions of additional jobs. Rebuilding manufacturing through rebalancing trade can help restructure the U.S. economy, close the output gap, and help return the U.S. economy to full employment. In the absence of such programs, the United States appears destined to suffer through a "lost decade" or more of excessive unemployment and output far below potential (Fieldhouse and Bivens 2012).

On the other hand, implementing more effective trade and industrial policies, coupled with massive investments in infrastructure, clean technologies, and renewable energy, could reduce or eliminate the U.S. trade deficit altogether. This would support millions of additional good jobs, add hundreds of billions of dollars to U.S. GDP, and reduce unemployment and federal budget deficits while greatly improving state and local finances. These policies would be win-win for the United States, its workers, U.S. communities, and manufacturing and other high-wage domestic industries such as construction and utilities.

Question 5. What is the U.S. doing to address worker readiness and education?

It is important to note that at this stage of the recovery, there is very strong evidence suggesting that a shortage of training or skills mismatches are not responsible for current high levels of unemployment. As a February 2014, there were still more than 2.5 unemployed workers for every available job opening in the county. There are between 1.3 and 8.2 times as many unemployed workers as job openings in every industry. In *no* industry does the number of job openings even come close to the number of people looking for work (Shierholz 2014).

There is some evidence that employer paid training in the U.S. has increased slightly in 2013. The American Society for Training and Development (ASTD) estimated that “organizations spent \$164.2 billion on training in 2012, up from \$156 billion in 2011.”⁷ An earlier study for the Employment and Training Administration of the U.S. Department of Labor and the ASTD found that in 2006 businesses spent \$46-\$54 million per year on training. However, only one fifth to one third of employees received training from their employer, and more educated workers were more likely to receive training.⁸ Thus, most workers did not receive job training from their employer.

Question 7. Why negotiate a Bilateral Investment Treaty (BIT) with China? Why seek an agreement that ensures U.S. companies are better able to move jobs to China?

This question illustrates the tension between policies that are good for U.S. companies, and those that benefit the United States as a location for jobs and production. The data on the economic impacts of foreign investment and “insourcing” are quite clear. Between 1990 and 2006, foreign multinational companies (MNCs) operating in the U.S. were responsible for the net loss of 4 million jobs in domestic firms taken over by those companies, due to layoffs, firms that spun off (and including net jobs created in startups owned by those firms) (Scott 2007).

One of the major motivations for negotiating a BIT is to encourage foreign multinationals to invest in the US. Public officials often take credit for the local jobs created or retained by such investments. Millions of dollars in public money are often offered as incentives to attract such investments, in what often becomes a race-to-the bottom among cities and states who engage in “smokestack chasing.” Less attention has been given to what happens after the initial investment takes place. Sometimes foreign MNCs make an initial job-creating investment and then change their mind. Swedish MNC Electrolux, for example, manufactured refrigerators for years in Greenville, Michigan but recently closed the plant and moved most of its 2,700 jobs to Mexico.

Insourcing is often deliberately designed to remove jobs from American industries. Foreign multinationals buy U.S. firms, hollow them out, and then outsource production to their home countries. For example, a few years ago the Indian firm GHLC acquired Dan River, a U.S. textile company. News reports confirm that “Indian firms are attracted in particular to companies whose brands enjoy considerable popularity in their home markets as those brands can be manufactured more cheaply in their Indian plants” (Business Wire 2007). A similar fate likely awaits Smithfield foods, which was recently purchased by China’s Shanghai.⁹

Stepping back from the plant-level view of insourcing, a **Figure F** provides data on total trade by U.S. and foreign MNCs for 1997 to 2011. Overall, these firms have been responsible for a growing share of the U.S.

⁷ Cook, Dan. 2014. “[Employers spending more on training](#)”

⁸ Nightingale, Demetra and Kelly Mikelson, “Estimating Public and Private Expenditures on Job Training in the U.S.”

⁹ Industry Week. “China’s Shuanghui Buys Meat Processor Smithfield Foods,” <http://www.industryweek.com/companies-and-executives/chinas-shuanghui-buys-meat-processor-smithfield-foods>

trade deficit. Foreign MNCs were responsible for nearly half (44.2 percent) of the U.S. goods trade deficit in 2011. It is, in general, true that foreign companies invest in the United States to gain access to this market.

In the 1990s and before, it was true that U.S. MNCs also invested abroad to gain market access. U.S. MNCs used to have a goods trade surplus until 2000. Since then, these firms have developed a large and growing trade deficit. The dominant mode of production for U.S. MNCs is now oriented largely towards outsourcing production of goods destined for sale in the United States. U.S. trade deficits with China and other countries have displaced millions of jobs in the United States. Overall, U.S. and foreign MNCs are responsible for nearly three quarters (71.1 percent) of the U.S. goods trade deficit in 2011, and shown in Figure F, and hence for most of the jobs displaced by trade in the United States. Thus, the globalization of finance, and the rapid growth of MNCs have hurt the US economy through the contributions of these firms to growing U.S. trade deficits and trade-related jobs losses. What is good for Wall Street is definitely not good for Main Street in America.

The United States would be better served by using the scarce resources devoted to negotiating new international trade agreements and investment treaties to improve the enforcement of U.S. fair trade laws. The risks associated with a new BIT, especially with China, greatly outweigh any potential benefits.

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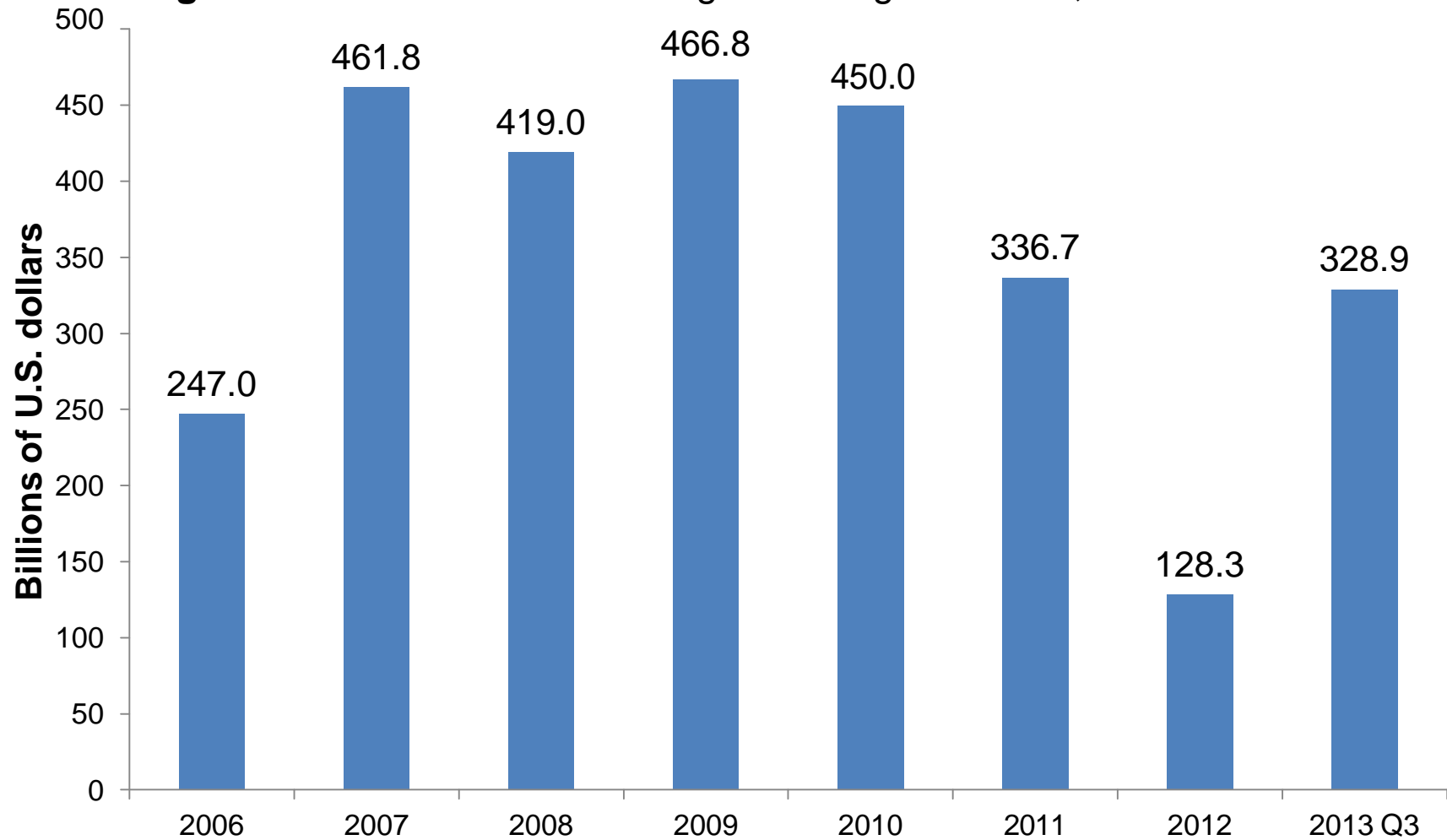
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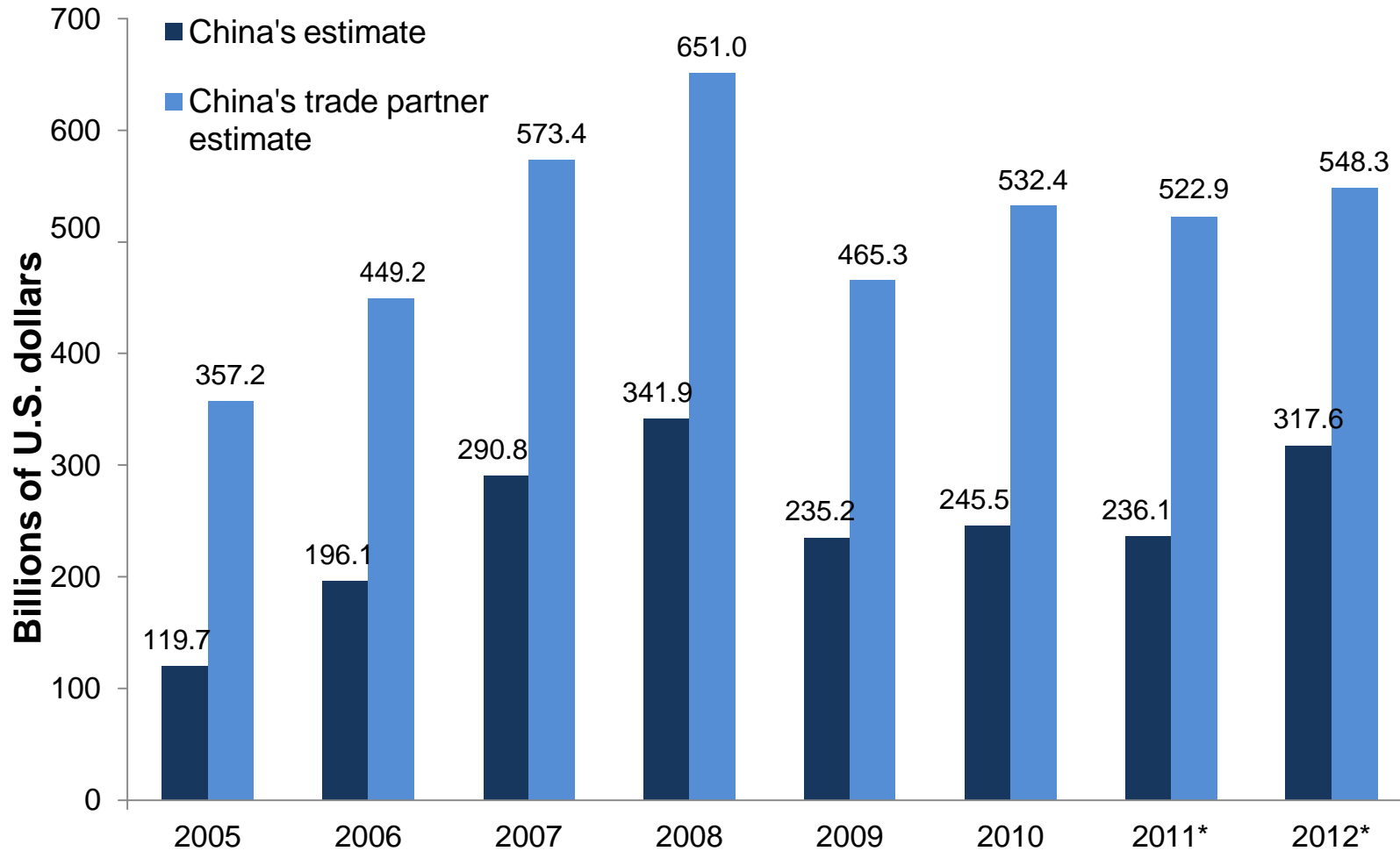
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Figure A Growth in China's foreign-exchange reserves, 2006–2013

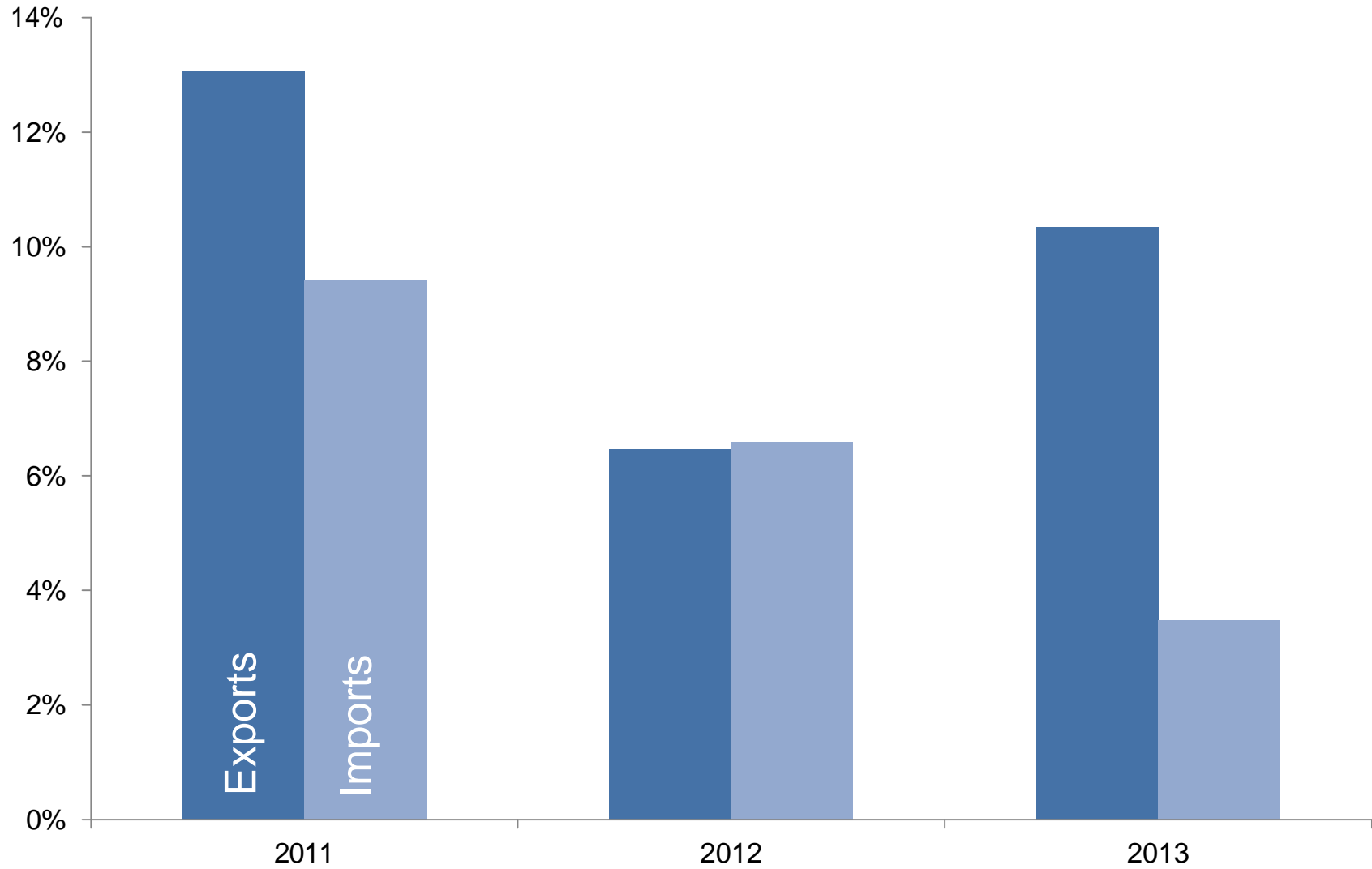
Note: Data for 2013 are of the third quarter, reported by Silk (2013).

Figure B China's global goods trade surplus, Chinese vs. trading partner-country reports, 2005–2012



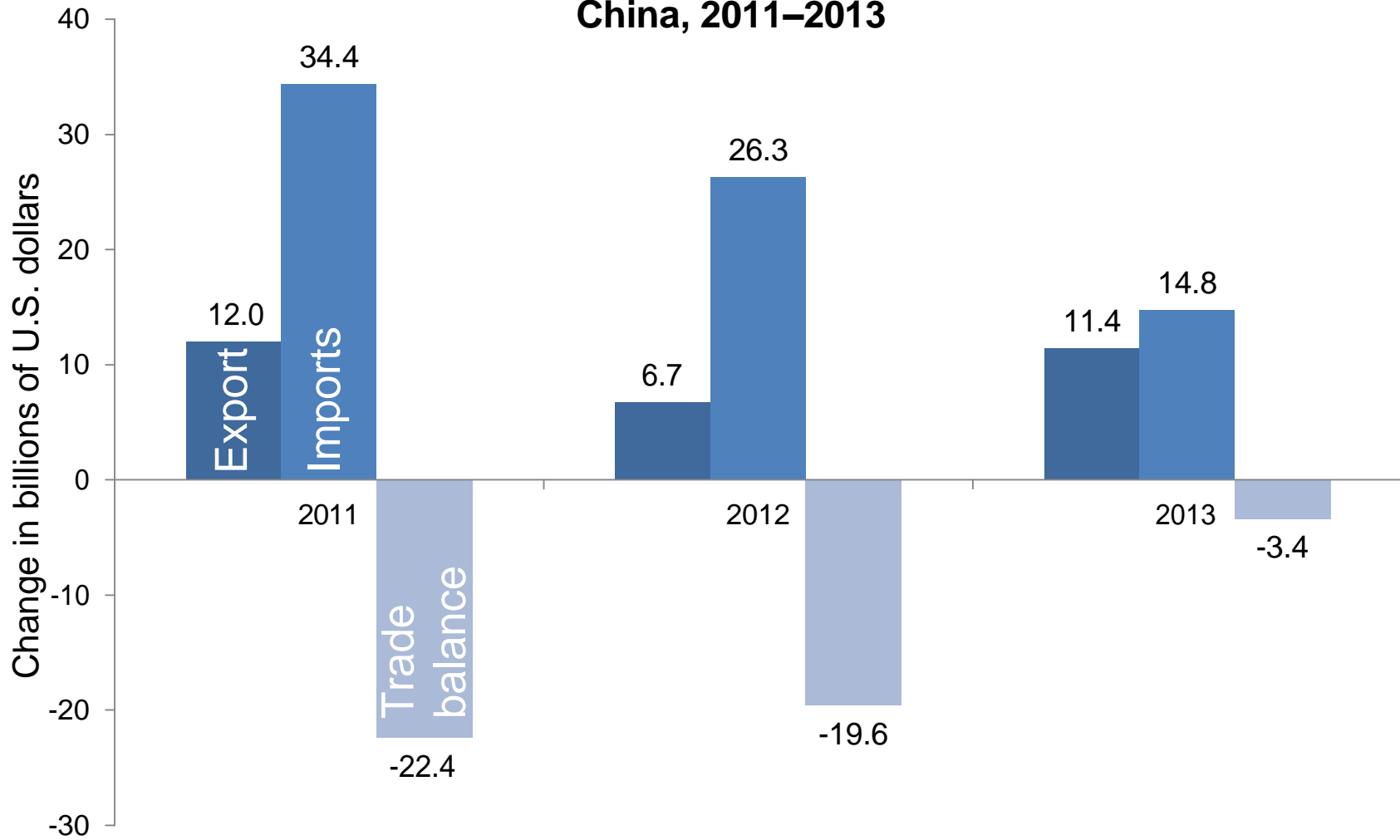
*Estimates for 2011 and 2012 are based on incomplete data, with fewer than 154 out of 171 countries reporting.

Source: Author's analysis of U.N. Comtrade (2013)

Figure C Growth in U.S. exports and imports with China, 2011–2013

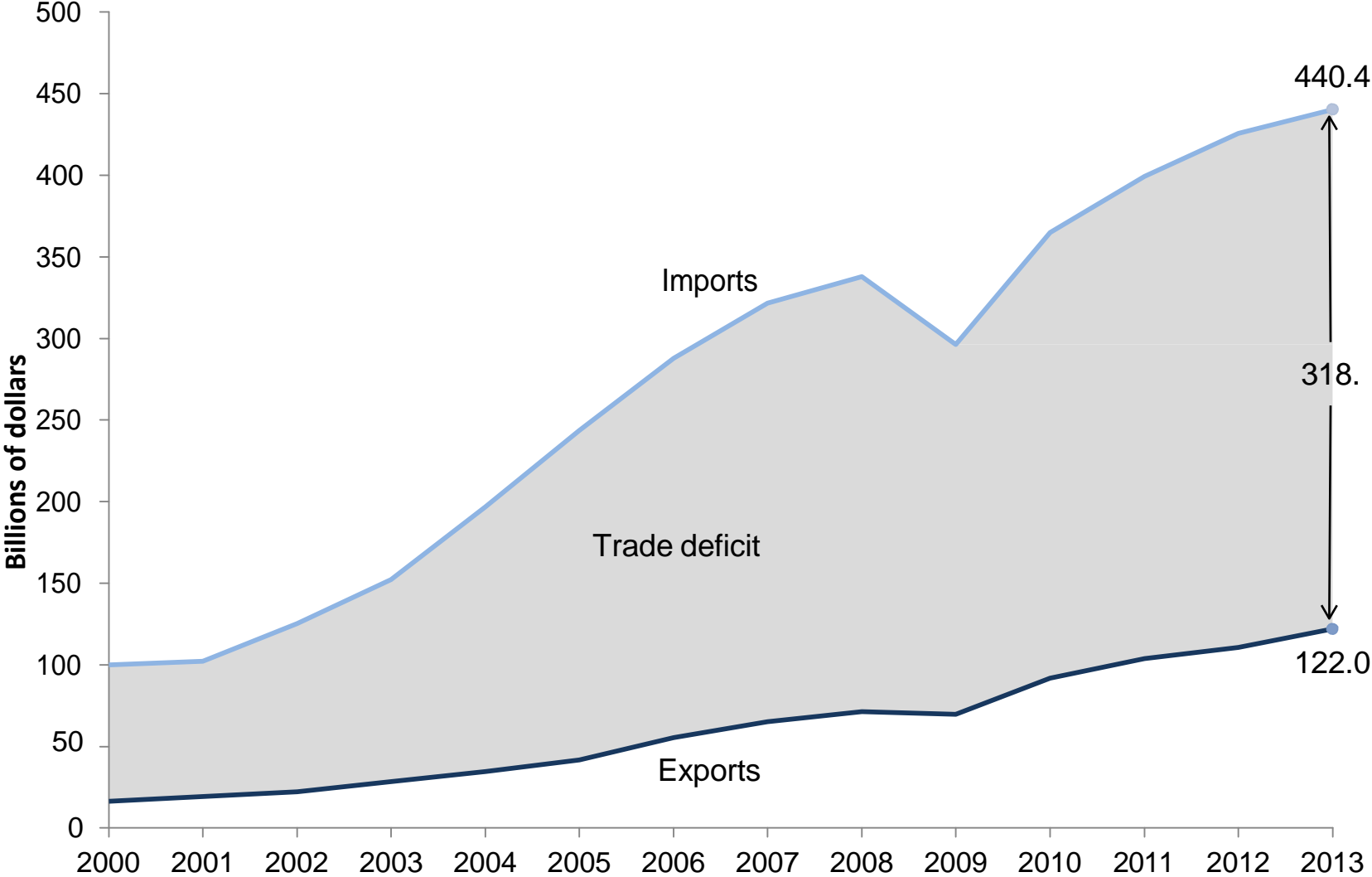
Source: U.S. International Trade Commission (USITC)

Figure D Change in U.S. exports, imports, and trade balance with China, 2011–2013



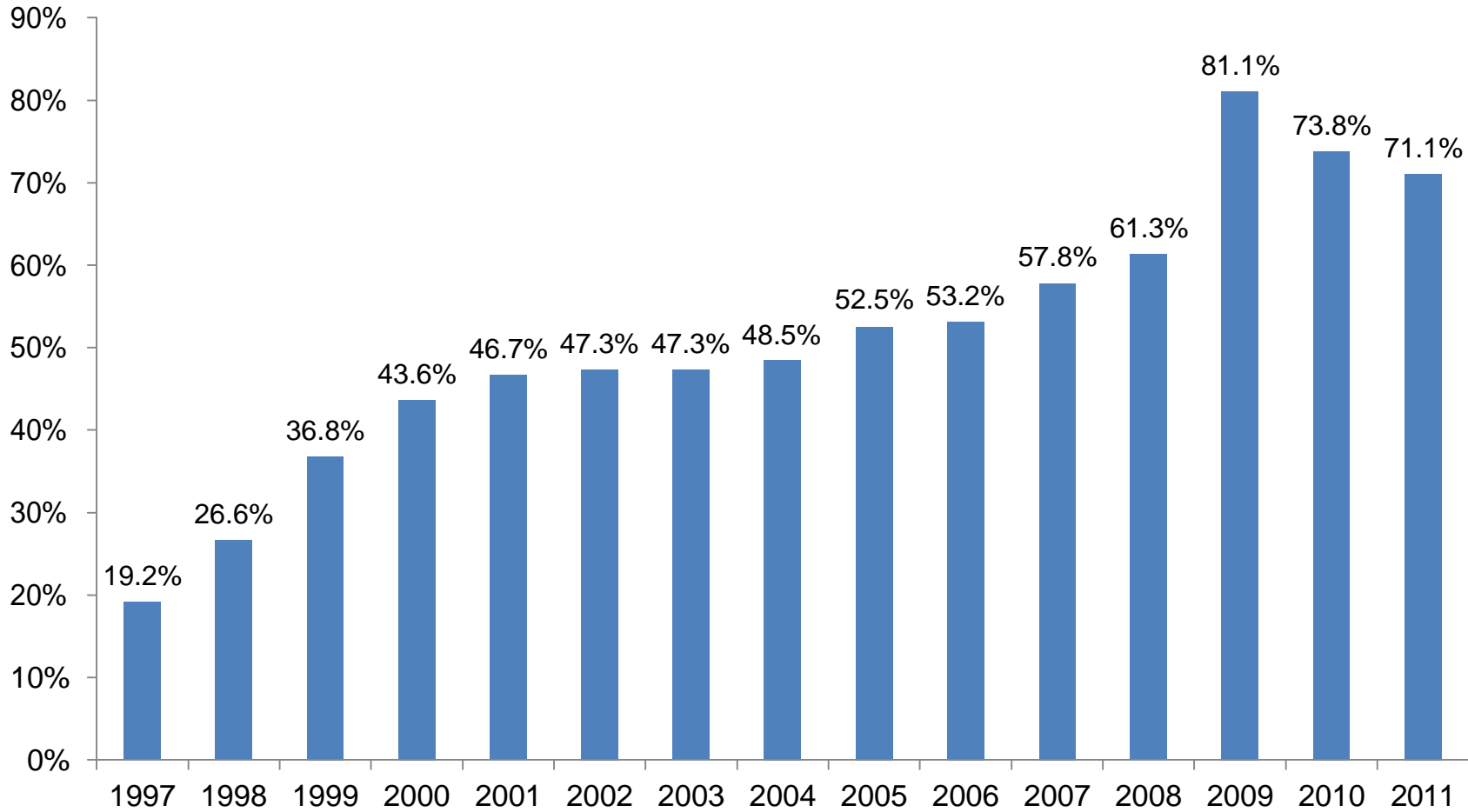
Source: U.S. International Trade Commission (USITC)

Figure E U.S. Trade with China, 2000–2013



Source: U.S. International Trade Commission (USITC)

Figure F Trade deficit of MNCs operating in the U.S. as a share of the total U.S. goods trade deficit, 1997–2011



*Multinational companies

Source: Bureau of Economic Analysis *National Income and Product Account* Table 1.1.5 and *Direct Investment and Multinational Companies* data

Table 1 Impact of ending currency manipulation, on U.S. economy and state spending, 2015		
Change in:	Scenario:	
	Low impact	High impact
Trade deficit (billions of dollars)	-200	-500
Gross domestic product		
in annual billions of dollars	288	720
as a share of projected GDP in 2015	2.0%	4.9%
Number of jobs	2,300,000	5,800,000
Federal budget deficit		
in annual billions of dollars	107	266
as a share of projected federal deficit in 2015	34.4%	86.1%
State budget funds		
in annual billions of dollars	40	101
as a share of state spending	2.0%	4.9%
as a share of state/local deficits in 2015	27.4%	68.4%
Note: Dollar calculations are in 2005 dollars.		
Source: Author's analysis of U.S. Census Bureau American Community Survey (2013), U.S. International Trade Commission (2013), Congressional Budget Office (2013a and 2013b), Bivens (2011), Bivens and Edwards (2010), Kondo and Svec (2009, 10), Bureau of Labor Statistics (2013), Bureau of Labor Statistics Office of Employment Projections (2011a and 2011b), and Zandi (2011). For a more detailed explanation of data sources and computations, see Scott (2014)		

Table 2 Impact of ending currency manipulation on U.S. jobs, 2015		
	Scenario:	
	Low impact	High impact
Direct jobs	1,112,700	2,280,800
Indirect jobs	487,300	1,719,200
Respending jobs	700,000	1,800,000
Total	2,300,000	5,800,000
<p>Source: Author's analysis of U.S. Census Bureau American Community Survey (2013), U.S. International Trade Commission (2013), Congressional Budget Office (2013a and 2013b), Bivens (2011), Bivens and Edwards (2010), Kondo and Svec (2009, 10), Bureau of Labor Statistics (2013), Bureau of Labor Statistics Office of Employment Projections (2011a and 2011b), and Zandi (2011). For a more detailed explanation of data sources and computations, see Scott (2014)</p>		

**OPENING STATEMENT OF DR. ODED SHENKAR
FORD MOTOR COMPANY CHAIR IN GLOBAL BUSINESS MANAGEMENT
FISHER SCHOOL OF BUSINESS, OHIO STATE UNIVERSITY**

DR. SHENKAR: Good morning to everyone.

Looking at the employment impact of China or, more specifically, the trade imbalance with China is a fairly complex enterprise. Let me start with a word about the conceptualization and measurement of the impact here.

It is impossible to understand that impact without looking not only at China but also at what is happening in the United States, for instance, you know, wage levels and the like, and without understanding what is happening more broadly in the global economy, which would also give us a hint as to what will happen if this trade deficit is reduced.

China in many ways when it comes to exports continues to be what I would term "pass-through assembly of imported inputs." You look at a study that looked at the iPhone, for instance, out of a cost of about \$200, about \$6.50 to \$8 in a newer model is accounted for by work. So that is one thing that we have to keep in mind, and that again means that it is impossible to grasp the impact here without looking also at exports. Some of the studies that I have seen looked merely at imports.

And, also, most importantly, without looking at the impact of FDI, foreign direct investment, in both directions. And I will talk a little bit about that later on.

Finally, I should say that Trade Adjustment Assistance has been

one of the very few direct measures of the impact of foreign competition on employment. The last time I checked, which admittedly was several years ago,--I tried to do a study on the topic--I discovered that there was not any systematic tally even of the source of the trade disruption, meaning that this one very useful direct measure, at least at that time, did not provide us the information that could have been helpful for our purposes.

Overall, if I'm talking about the impact of China trade imbalance on employment in the United States, it's a no-brainer that it has been negative and substantial, but one must remember again that it continues to vary quite dramatically by region and by industry.

There are region and industries--if you think, for instance, about commercial aircraft--that actually benefit from trade in China. There are those that get hit very badly if you think of about say a small town in Ohio that has lost its major, you know, single employer there. As China goes up the ladder, though, this is bound to change.

As far as inward FDI, and this is inward into China, most foreign plays right now are in China for China, meaning they are there to produce for the Chinese market, and that means that, yes, they are less likely to export certain inputs from the United States into China.

As far as Chinese outward investment, including into the United States, which is a wave that is about to hit us I think very soon--it is already here--one of the biggest problems has been that China has a tendency--Chinese enterprises have a tendency not to do greenfield investments but rather to do mergers and acquisition, typically taking over existing operations and, therefore, contribution to employment tends to be fairly minimal.

As China becomes more expensive, the situation will improve but only marginally. There are a few things that will come back into the United States. Some have already. But, by and large, if you're talking about labor-intensive operations, they will simply shift to other developing countries, and, more importantly, China is working very hard to climb up the ladder, which means that in the future, the imports that you will see into this country, and therefore the impact on employment, will not only be in labor-intensive goods, shoes, toys and the like, but we'll start seeing motor vehicles. We'll go in and start seeing commercial aircraft at some point, and that will be a fairly dramatic change.

You've asked me to look at innovation, and on that I hold a fairly contrarian perspective. I do not buy into all of the hoopla, at least about the beauty of innovation and that we're going to innovate our way out of it. The reality is when you look very, very closely at the evidence, is that very often it is the imitator who captures much of the economic value.

On that, the Chinese have done a tremendous job. They are great imitators. I don't think our companies take imitation seriously; it is considered almost a stigma to do it here. But I am worried about the combination. This to me can be a fairly winning combination in a global economy of those who can combine innovation and imitation.

Now, keep in mind the Chinese have a problem innovating, but they have absolutely no problem, and they increasingly do that, not only in the United States, but in many other countries, buying up the innovators, the small start-up companies that come up with new technologies. So we need to keep in mind that going forward, we will see innovative product coming out of Chinese companies.

We will also start to see services. Right now the Chinese do very well in services such as transportation, perhaps tourism. Down the road, they are working hard to improve in knowledge-based services, even things such as legal services, consulting and the like. So we're going to start impact on that. Mind you the United States has significant surplus in the export of services, and if this were to change, you will see an employment impact on a sector that we have not yet seen.

Finally, a word about localization. Localization can take very many forms: change in ownership, change in senior leadership, and the like. This, too, is going to have an impact directly on the employment of U.S. expatriates. Beyond that, on the broader workforce.

Thank you very much.

**PREPARED STATEMENT OF DR. ODED SHENKAR
FORD MOTOR COMPANY CHAIR IN GLOBAL BUSINESS MANAGEMENT
FISHER SCHOOL OF BUSINESS, OHIO STATE UNIVERSITY**

Hearing on "U.S.-China Economic Challenges"

February 21, 2014

Written Statement of Professor Oded Shenkar

1. What is the impact of US-China bilateral trade on U.S. jobs and worker wages and compensation?

Assessing the impact of trade on unemployment is a very complex endeavor, among other reasons because of the number of drivers at play, some of which have little to do with trade (e.g., new technologies, automation, productivity improvements), varying underlying domain definitions (e.g., merchandise versus service trade; official versus broader unemployment counts), and the like. Undoubtedly, these variations will produce different outcome estimates that are amenable to politicization (as expressed, for instance, in attitudes towards free trade agreements).

The last time I checked, the Trade Adjustment Assistance program did not systematically measure or tally the national source of foreign competition behind employee displacement (which would anyway cover only a portion of those affected by foreign trade), which would be one of the few direct measures of US job losses resulting from bilateral trade. I would also suggest that in today's global environment, an assessment of the impact of trade on employment should include bilateral foreign direct investment (FDI) as well rather than trade alone, since FDI influences both trade and employment patterns.

With these constraints in mind, let me make a number of general observations:

1. A lopsided trade gap such as the one the United States has with China is bound to have an overall adverse impact on US employment. In other words, the number of jobs generated by US exports to China, substantial as it may be, is unlikely to offset the number of US jobs lost to Chinese imports even when US FDI in China is taken to account (as I will notice later, such FDI has the potential to both increase and decrease US employment).
2. The job impact of any bilateral trade flow is bound to vary across regions and industries, meaning that some US states and regions likely benefit from US – China trade (think, for instance, Washington State, where most Boeing airliners are assembled) while others are likely to suffer (think, for instance, North Carolina with its textile mills). The same is true for various occupations and income groups: In the first phase of Chinese reforms, the US employees to be adversely affected were low-income, low-skill; however as China climbs up the ladder, those affected will increasingly be higher income employees and professionals. Chinese FDI into the US would have a similarly variable impact, as states and even cities increasingly compete for incoming FDI dollars.
3. US foreign direct investment (FDI) into China, while generating some employment for US citizens (e.g., re expatriate assignment) often serves as an import substitute in China as well as a catalyst for Chinese exports to the US – the majority of China’s global exports come from Foreign Invested Enterprises (FIEs), so indirectly such investment also harms US employment at home.
4. Chinese outward FDI into the US will, at times, preserve some jobs, but is unlikely to create many. This is because Chinese outward FDI tends to be concentrated in extractive industries and is typically done via the acquisition of existing operations rather than the creation of new ones. While it is true that an acquisition can at times salvage a company from bankruptcy and hence save jobs, the positive impact is likely to be limited and some employee retention may be temporary, since once the Chinese side masters key skills they may have a lower need for expert help.
5. Like other FDI into the United States, Chinese investment is often assisted by a myriad of incentives meted by US state and local governments. The argument may be made that these incentives come at the expense of domestic competitors and may be financed by a higher tax burden on individuals and businesses, thus stifling job creation potential in the US economy while benefiting a narrow constituency.
6. One domestic impact of Chinese (and other foreign) investment in the US is the shifting of employment from the high cost and unionized Eastern, West Coast and Midwest regions to the cheaper and nonunionized Southern part of the country. Recent estimates showing a deflection point where US becomes cost competitive against Chinese production circa 2015 use the Southern US cost basis for

comparison. The impact in some sectors of the US economy may therefore be increased employment but depressed wages.

7. As China becomes a more expensive place in which to do business, labor-intensive Chinese imports into the US will shift to other developing economies, such as Vietnam, Sri Lanka and Bangladesh, but this is unlikely to alter overall employment in the US, to which such production is unlikely to return. However, where higher US productivity, lower transportation costs, and the need to react quickly to the vagaries of the market are important, some production and hence employment might be repatriated.
8. US employment in services, e.g., consulting, banking, legal services, engineering, has benefited from US bilateral trade with China, and will continue to do so in the near to medium term future. In the long range, however, many of those jobs will be shifted to China.

3. How would our economic relationship with China need to change for it to produce more U.S. jobs and a better balance of trade?

To have a meaningful change, the trade imbalance will need to disappear, or, more realistically, substantially narrowed. Given the size of the imbalance, a meaningful change will require both that US exports to China increase while imports from China decline. For a number of reasons listed below, such a shift is unlikely to happen in the near future.

1. The Chinese currency is unlikely to revalue any time soon, owing to the importance of exports to the Chinese economy and the risks unemployment represents to Chinese social stability.
2. Chinese export subsidies are unlikely to disappear for the same reasons noted above.
3. China has become a (if not *the*) manufacturing hub consisting of world dominant industry clusters for multiple reasons of which low wages are only on factor, implying that even the farming out of labor intensive, polluting links in the value chain to other developing nations or to the Chinese hinterland is unlikely to derail the position of the hub itself and its supportive industries.
4. Many current US exports, such as passenger aircraft, will eventually come under pressure as China develops its technology and continues to implement import substitution policies when it comes to national security and related issues.
5. The gradual recovery of the US economy, while welcome, also increases the appetite for imported goods, and for many goods China remains the primary import source for the world.

6. Future trade barriers erected by China are more likely to be in the form of non-tariff barriers, which are more difficult to discern quickly and act upon.
 7. Many products lost to Chinese competition, e.g., shoes, are unlikely to come back to the US but rather migrate to other developing countries, such as Vietnam or India. Automation or 3D printing may make a dent in this trend, but not much more.
 8. Products such as motor vehicles are likely to be made close to market, and with the Chinese market already the largest market globally for such vehicles, exports from the US are not likely to grow much if at all. And if the Chinese market share of US firms decline, as is the intention of the Chinese government, the inputs that currently make a substantial portion of US exports to China will eventually be substituted for.
 9. As US companies strive to localize in China, the number of US expatriates working for US affiliates will decline; Chinese firm recruitment of US veterans will expand but is likely to be insufficient to offset this trend.
 10. US companies and their affiliates, the employer of choice for US expatriates, increasingly feel that they already are or about to be discriminated against in an effort to promote domestic players. This too will have a negative impact on expatriate recruitment as well as on exports from the US to China.
- 4. As China evolves from an economy that makes copies of things to an economy that also invents things, what does the U.S. need to do to ensure that our workers are prepared to compete? What is the U.S. doing to address worker readiness and education?**

I should mention upfront that I hold a contrarian view on the subject of innovation and imitation, and refer the reader to my book *"Copycats: How smart companies use imitation to gain a strategic edge"* (Harvard Business Press, 2010). The basic argument is that imitation is as valuable to business success as innovation and that we neglect it at our peril since economic benefit is as likely to be captured by an agile imitator than by the pioneer/innovator. In a US-China context, this implies that Chinese firms are doing well precisely because they are effective imitators, and that the combination of this capability with carefully selected and focused innovation is likely to produce highly competitive firms that will often do better than firms that are good on innovation alone. I believe US companies have been caught in a fever of innovation and have forgotten how to imitate, a serious deficiency that will come back to haunt them.

I should also note that historically, China has produced many inventions (e.g., the compass, gun powder) that have changed the world though it has been much less successful building the scientific structure that would let them to continue and build on those inventions. Still, there are many ways open to Chinese firms to overcome their current innovation deficiencies, including special measures taken by the

Chinese government to attract experienced scientists and scholars who have studied and worked in the innovative environment of other countries, especially the United States, the purchase of new technologies, and the acquisition of US innovating companies, especially but not only startups. The acquisition of IBM PC business and now low-end server is a case in point.

What should the US do to ensure that our workers are ready to compete?

The US is clearly not doing enough to address the yawning gap between what employers need and what employees have, with shortages ranging from advanced skills to basic work ethic.

1. Make sure that our employees have an even playing ground in which to compete: at this time, as the rest of this article suggests, they often do not; however there are many steps that can be taken to improve the capabilities of individuals and companies, as suggested below.
 2. Make sure people and companies learn to appreciate imitation, something that requires a cultural change as well as the development of specialized mechanisms. A corollary of the above is the recognition that innovation and imitation can come from anywhere on the globe, and that companies should develop the tools to monitor, assess, and implement what has been developed by others, where appropriate.
 3. Improve education: It is well known that the US consistently ranks low on comparative math, science and reading tests, whereas the jobs of the future requires all three. Given that the school system has not made enough of a progress preparing young people for positions in the economy of the future, it may be time to offer incentives for companies to provide employee development on their own.
 4. Improve global skills – despite the effort invested at the school and other levels, there is a vast number of US companies, typically small and mid-sized but sometimes large firms as well, that are not leveraging the opportunities in the global market place, including in China.
 5. Allow skilled immigration – skilled immigrants do not take away Americans' jobs – on the contrary, they create more of them. This is especially important given the deficiency noted in (3).
- 6. China has its own worker struggles, such as an aging workforce and a surplus of educated workers frustrated in their efforts to find skilled jobs. What do China's recent policy announcements portend in terms of its efforts to address these issues, and what new issues might these policy responses create for the U.S.?**

China has a number of serious workers' related issues, including the two you have mentioned, namely an aging workforce and a surplus of educated workers. Additional and related problems include the existence of a very large contingent of migrant workers who live away from their families as a result of the hukou system and other constraints, and who have no prospect of upward mobility; talent dislocation resulting from reliance on relationships and residence-based preferences, and the like.

The Third Plenum has tried to address some of those issues, primarily by way of relaxing the hukou system, paving a path to residency in urban centers (with the exception of first tier cities), and by way of relaxing the one child policy, permitting a second child where both parents are single children. Other steps include the creation of a rudimentary pension system and an attempt to reinforce the Confucian edict of caring for one's parents, which is hoped to reduce increasing pressure on the state to provide support for the elderly.

The overall impact of those issues and remedies on the US is not clear. There are a couple of possibilities. For instance, once the one child policy is relaxed, demographic pressure will subside, but the increase in the workforce will take decades to complete and by then wages will be significantly higher. So this will not stem the flow of labor-intensive flow out of China, but, again, not many of those jobs will be repatriated to the US. On the other hand, a reform in the hukou system, especially if it were to eventually expand as I forecast, will make the Chinese workforce more mobile, a net benefit for Chinese competitiveness because it will enable a better and faster match between economic needs on the one hand to talent and skills on the other hand.

The surplus of educated workers is unlikely to subside any time soon, and the response of the Chinese government has been so far a patchwork of temporary solutions, such as rural internships, which do not solve the basic mismatch between a vastly expanded system of higher education that does not equip many of its graduates with the skills desired by companies (ironically, somewhat similar to the US predicament). Here too the impact is difficult to assess: For instance, the surplus might cause extra pressure to maintain or bring employment into China, increasing the incentive to provide subsidies and the like at the expense of foreign competitors, or it may increase the number of Chinese students in the US, which essentially represents a US export to China and hence a generator of US employment.

7. Why a BIT? Why seek an agreement that ensures U.S. companies are better able to move jobs to China? How is China converting foreign-invested companies into Chinese companies?

The conversion of enterprises from an FIE to a Chinese company is a long-term process that means different things which can be achieved in a myriad of ways.

Meanings of localization:

1. An actual change in ownership and or governance from a foreign owned and or controlled enterprise to one owned and or controlled by Chinese interests
2. The replacement of foreigners by locals in senior positions in FIEs (at times foreign nationals of Chinese ancestry are considered local in this context)
3. A global or regional strategy being launched by a joint affiliate rather than US parent. SAIC / GM is a case in point.

Localization Drivers:

1. Discrimination against foreign players (e.g., variable regulatory enforcement) that makes it less beneficial to operate as a foreign entity.
2. Incentives provided to domestic players, including for “going out”.

Localization Vehicles

1. Merger/acquisition
2. EJV conversion
3. Asset transfer
4. Bankruptcy
5. Relisting
6. Regulatory change (e.g., closing down of polluting enterprises)
7. Sectorial reassignment (e.g., redefinition of a sector as strategic)

Overall, localization is likely to have a negative impact on US employment, for instance by making foreign products made in China less competitive with those of localized players. In theory, a US affiliate headed by Chinese nationals will have an easier time selling into the Chinese market, but it is not at all clear that such affiliates will be treated differently than other US subsidiaries/ ventures.

**OPENING STATEMENT OF DR. PETER K. SCHOTT
PROFESSOR OF ECONOMICS
YALE UNIVERSITY SCHOOL OF MANAGEMENT**

DR. SCHOTT: So thank you for having me here and the opportunity to talk about work that I've done with others.

So I would agree with the last comments in the sense that trying to understand the dynamics of this world trading system is incredibly difficult. It's incredibly complicated. And so one way into that is the study that I made, my formal remarks, and that study focuses on the very large loss in manufacturing employment that occurs after 2001.

So after 2001, between 2001 and 2007, the U.S. lost about 18

percent of its manufacturing employment, which was very large by historical standards if you look at the time series, a picture of which is in my remarks.

And what's surprising about that loss is that it happened during the 2001 recession, which was relatively mild, especially when we think about it compared to the 2007 recession. In fact, manufacturing employment fell more quickly and more steeply after 2001 than it did after 2007, and that's remarkable if you think about it.

So the question is why? What was going on? And what we find is a link between that sharp loss in manufacturing employment and a very specific change in U.S. trade policy, which was the granting of Permanent Normal Trade Relations to China as part of its run-up to the WTO.

And what's really interesting about that change in U.S. trade policy is it didn't work the way you're used to seeing, which is, you know, the U.S. might drop its tariffs on a trading partner and therefore you expect to see more imports. In fact, the U.S. assessments of tariffs on Chinese goods didn't change at all during this whole period.

What did change, right, is that the granting of PNTR and the associated movement of China into WTO reduced the uncertainty that tariffs on Chinese goods would rise, and reducing that uncertainty could have had large effects on both firms inside the U.S. and firms in China.

So a little bit of history here. Prior to that vote, prior to the granting of PNTR to China, China had already had access since the 1980s to the relatively low tariffs that the U.S. assesses to WTO members, and that comes out of a law from the 1970s that allows the President to grant a waiver to non-market economies to give them access to these lower tariffs.

The hitch is that that it required these annual votes by Congress where they had to go along with this vote, and those votes were very contentious, especially during the 1990s, especially after Tiananmen, but actually all the way up until PNTR was granted in the late 1990s.

So it turns out that the elimination of uncertainty effects were very different across industries. So the way it would have worked was imagine during that period when tariffs were temporarily low because of these annual votes on Chinese goods, during that period, if an annual--if Congress had balked and decided not to go along with the waiver, Chinese tariffs would have risen substantially, but a lot more in some industries than others, than other industries.

And it's exactly that variation, right, that different susceptibility of industries in the U.S. to this change in uncertainty, that shows up very strongly in the data. It shows up, as I'll say in a second, talk about in a second, in terms of manufacturing loss, but it also shows up in terms of other dimensions that are perhaps a bit surprising.

So before I get to that, let me say that if you just thought, you know, if you sat back and asked how might that change in uncertainty have affected firms, think about U.S. firms. U.S. firms are, in the 1990s, globalization is occurring; they're thinking of maybe finding a partner in China to produce something that they make themselves. Maybe they're

thinking of putting a plant in China. All of those things require large investments potentially, and you may be hesitant as a firm to engage in those investments if you thought that tariffs would jump because the Congress wouldn't go along with low rates.

So by eliminating that uncertainty, you now have some that have already decided to go to China--but you now have maybe a bigger chunk of firms that would decide to engage in those things and either go offshore themselves or use a foreign supplier, a Chinese supplier, instead of a domestic supplier.

The second effect could have been on firms in China. So you're a Chinese firm. You're thinking of entering or expanding in the U.S. market, but you are also worried because if that temporary vote, if the maintenance of the temporary status doesn't occur, you know, you'd make this big investment, and then all of sudden you'd face higher tariffs, and your market would go away.

And the third potential trigger or effect would be, again, think about U.S. firms and don't think about outsourcing now, just think about technology adoption, which is like the other major explanation for a lot of the trends that we're talking about, when you reduce the uncertainty about tariff hikes with China, U.S. firms now know they might face stiffer competition from firms in China, and they may now have incentives to adopt technologies like robotics that reduce labor in their factories in order to get down labor costs and compete more effectively, especially in the most labor-intensive goods.

All right. So all three of those reactions might lead you to expect that this change in trade policy that the U.S. voted on in late 2000 would both lead to a reduction in employment and a reduction in output in manufacturing. You might just see manufacturing go to zero, which is what some pundits talk about.

So what do we find? So what we find is, again, remember the treatment of this change in policy is differential across industries because some industries, tariffs would have jumped a lot, and some wouldn't have jumped as much. That was a feature of the way U.S. trade tariffs look.

It turns out that if you go back to that loss, that 18 percent loss, between 2001 and 2007, it's very closely tied. Losses in industries, manufacturing employment, is very closely tied to their exposure to that risk. So when you eliminate that uncertainty, employment falls the most in the industries where tariffs in the old regime would have risen the most.

Okay. The second thing you see is that those are also exactly the same industries where we see U.S. imports from China surging. So those two facts together let you think, well, you know maybe there is something going on here with this outsourcing story. U.S. firms either directly or indirectly are now using Chinese goods as inputs to their production and U.S. consumers likewise, and that's causing the trade growth that we see from China.

The third reaction is also quite interesting, which is that in

contrast to employment, if you look at the health of the manufacturing sector in terms of its output or value added, that keeps rising. So what's happening is that manufacturing value added is rising at more or less the historic--real value added is rising at more or less the historical rate, slightly slower after 2001 than before, while employment is falling.

That implies tremendous increases in labor productivity, and why would that occur? Why didn't manufacturing go away? Well, the likely explanation, but I think more research is needed, is that U.S. manufacturers both used technology that substituted away from workers to make the things that they were making before, but they also substituted out of labor-intensive manufacturing and into the higher-value-added worker stuff that you think the U.S. has a comparative advantage in, as is completely predicted by kind of most views of trade.

So digging more into those exact channels is the subject of current research. Thanks.

**PREPARED STATEMENT OF DR. PETER K. SCHOTT
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A complete version of Dr. Peter K. Schott's written testimony can be found on the U.S.-China Commission's website.

<http://www.uscc.gov/sites/default/files/Peter%20Schott%20written%20testimony.pdf>

PANEL I QUESTION AND ANSWER

HEARING CO-CHAIR SLANE: Thank you, Dr. Schott.

I'll start the questioning with Dr. Shenkar. We had earlier, I think last year, a hearing on innovation in China, and I think the conclusion was that for a variety of reasons, they have a lot of difficulty innovating, and it gave me a false sense of security after reading your book, and, in effect, your book indicates that it's a new type of innovation, if I can put it that way, or an innovation with Chinese characters.

Can you talk about that a little bit?

DR. SHENKAR: Absolutely. First of all, you know, I think everyone should be reminded that China has a fairly remarkable record of inventions. China is quite different than Japan and Korea in that respect. I mean if you go back, paper, the compass, you're talking about actually a very impressive record. The problem was establishing kind of a scientific infrastructure to take this forward.

China's opening to reform had throughout one very important objective, and actually I looked at the various policies of the Chinese government as far as foreign investment going back to '79, so you're looking at more than 30 years, there's only one item that has never changed.

Everything else is substituted by something else.

The only thing that has not changed was the emphasis on technology transfer, and China has been remarkably successful. Also in its form of enterprise, as far as forcing technology transfer as a condition for bidding, as a condition for investment.

I personally, when I looked at the WTO Agreement, I think that our government has made an error by agreeing, for instance, to limit foreign investment, say, in automotive, to a 50 percent stake. The joint venture in management is considered the most effective knowledge transfer mechanism. The Chinese have done a remarkable job of absorbing this technology, this knowledge, and they are now ready to take it to the next level.

As I noted before, they have done extremely well with imitation, and I think that one reason why people have been taken by surprise is that they do not accord imitation the respect that it is owed. There is the assumption that innovation would always allow you to capture the profit. Not only has this not been the case, but my own argument, also in that book, has been that we are entering an imitation age, meaning that it is easier to imitate, it is more beneficial to imitate, and I believe that this is one of the explanations for, you know, the rise of Chinese companies, and I think that we have not paid close attention to that as we should.

HEARING CO-CHAIR SLANE: Thank you, Doctor.

Vice Chairman Reinsch.

VICE CHAIRMAN REINSCH: Thank you.

Dr. Scott, Dr. Shenkar made reference to the value-added issue and cited the case involving iphones, which I'm sure you're familiar with. Did you base your calculations on the gross deficit or on value-added?

DR. SCOTT: Well, my calculations are based on net trade flows so it takes into account the exports that go from the United States to China and those that come back. Many of the products that we export to China are components, everything ranging from scrap steel and paper to plastic to semiconductors, that are used in China and reimported here.

So when you look at net trade flows, it takes into account both, you know, the job content of the exports as well as the jobs displaced by imports, and it does take into account those so-called "tourist exports."

VICE CHAIRMAN REINSCH: I guess I need to understand that a little bit more because it's not just a bilateral flow. The components that we're talking about more often than not have come from elsewhere in Asia, not from the United States.

DR. SCOTT: Well--

VICE CHAIRMAN REINSCH: The Chinese value is de minimis, yet the amount that's reflected in the deficit reflects the total value of the product, not just the Chinese value, and factoring out the U.S. value I don't think does the job.

DR. SCOTT: Well, the OECD published a study last year which looked at so-called "value-added measures of trade," and the headline from that study was it supposedly reduced, and I criticized this finding, the U.S.

trade deficit with China by 20 or 25 percent.

There's two problems with that estimate. One, value-added trade accounting simply redistributes trade balances from one country to another. It does not change the global U.S. trade balance, and it's the global U.S. trade balance is what, in the end, determines the overall number of jobs created or displaced by trade.

VICE CHAIRMAN REINSCH: Right.

DR. SCOTT: Number one. Number one.

VICE CHAIRMAN REINSCH: Could--

DR. SCOTT: If I can finish my point.

VICE CHAIRMAN REINSCH: All right.

DR. SCOTT: The second problem is that the OECD distorted U.S. trade statistics. They used much lower estimate of the U.S. trade balance with China than the U.S. reports.

Thank you.

VICE CHAIRMAN REINSCH: I couldn't agree more that it's the aggregate deficit that's the issue, and obviously if one goes down, others will go up because the total remains the same.

This particular panel, though, is more about assigning blame, if you will, than anything else. If we're going to blame the Chinese, I think we want to make sure that we're blaming them accurately, and maybe we should be blaming somebody else or we should be apportioning blame differently. That was the point of the question.

The other question I had about your methodology was the basis, which I don't think you reflected in your written testimony, for your assumption about job losses. Are you assuming in your work that if the imports from China stopped for whatever reason that the jobs that were embodied in those imports would be recreated in the United States?

DR. SCOTT: First, let me respond to your earlier comment about the source of the imports, whether it's from China or elsewhere. Ultimately, China facilitates the growth of the U.S. trade deficit both directly through its trade and also by creating a global work station to assemble products for export to the United States.

My models are explained in the reports which I've referenced in my reference section of my prepared statement. My models look at the labor content of U.S. exports and the labor content of U.S. imports. So it's basically a standard macroeconomic model of trade. We've learned over the last business cycle that these macroeconomic models are, in fact, very accurate descriptors of the way in which the economy works.

Growth of exports stimulates demand for goods produced in the U.S. Growth of imports displaces U.S. demand. Those are two major components of aggregate income accounting. Those are the assumptions used in my model. So that is the basis for the estimates that I prepared.

VICE CHAIRMAN REINSCH: So was that a yes or a no for my question?

DR. SCOTT: I didn't understand you wanted a yes or a no. I

thought you wanted an explanation. Could you restate your question?

VICE CHAIRMAN REINSCH: Yes, but I didn't understand it. So I'm going--

DR. SCOTT: Could you restate your question?

VICE CHAIRMAN REINSCH: Are you assuming that the jobs lost by Chinese trade, if the trade were to stop, would be recreated in the form of American jobs?

DR. SCOTT: That's not the assumption I made, no. The assumption I made is that if the U.S. trade balance with China changed, then we would have more people working in manufacturing and other supporting industries. That's the assumption I made.

VICE CHAIRMAN REINSCH: Okay. My time is up. Can you put me down for another round?

HEARING CO-CHAIR SLANE: Commissioner Wessel.

HEARING CO-CHAIR WESSEL: Your time is up.

[Laughter.]

HEARING CO-CHAIR WESSEL: Note laughter, Vicki, please.

[Laughter.]

VICE CHAIRMAN REINSCH: Note that I was laughing, too.

HEARING CO-CHAIR WESSEL: Good.

[Laughter.]

HEARING CO-CHAIR WESSEL: Thank you. I don't think any of us would say that China is the only problem, and that addressing the China problem does not mean that our overall problems go away, that it won't shift to some others, but, Dr. Scott, I'd like to go back to your first comments about currency manipulation because it seems that we're on this path now with China and how we deal with China--how China is approaching the world economy and how we are approaching them in terms of trade enforcement, currency manipulation, is setting a tone overall.

You mentioned, I think, that there are 20 other nations that are engaged in currency manipulation. While this and previous administrations have resorted to dialogue as the principal tool to address currency manipulation, it seems that other countries--Japan, I think, is now coming on the radar--are engaging in this as well so that, the China problem is actually spreading. It's a contagion, if you will, to other countries who view our enforcement efforts--their economic prospects as being fueled by their export-led growth, as, it's increasing the threat.

Can you comment on what's happening with currency manipulation, not just in China, but elsewhere? Are others emulating what they're doing and what impact do you think that might have?

DR. SCOTT: There's no question that other countries have been forced to intervene in order to keep up with China. Those countries were also dependent on exports, and in order to maintain their competitiveness with China and with the rest of the world, they also engaged in competitive violations. And there are many countries not on that list of 20 who also intervened for the same reason. They engaged in what might be called

"defensive intervention" to keep their currencies competitive.

These are just the top 20 countries that maintain sustained trade balances over the past--trade surpluses over the past decade. So I think this is a problem, and it's a problem really that started perhaps as much with Japan as anyone else, going back a decade or two ago. Japan has been a consistent currency manipulator, especially in the 1990s and the early part of this decade. They've accumulated over a trillion dollars in foreign exchange reserves, the second-largest, historically, the second-largest currency manipulator if we view the foreign exchange reserves as the measure ultimately of currency manipulation.

So there are many other countries that have followed the China, and, in fact, in the case of Japan, established the model that China has been using so aggressively for the last 15 years.

I would just add that China slowed down its intervention in 2012. It did reduce its purchases of foreign exchange reserves, but they increased dramatically in 2013, especially in the last, the last quarter, the last four months of the year. I think they purchased over \$500 billion in total in 2013 alone, and their total foreign exchange reserves are now up to about, over \$3.8 trillion, and that doesn't include another 600 billion in holdings of China's sovereign wealth funds, and those also count.

HEARING CO-CHAIR WESSEL: Thank you.

Dr. Schott, I have to say I got lost in some of your formulas. I'm not an econometrician so help me if you can.

Is the displacement in the industries that you identified, the controlling for the, I guess, Schedule I and Schedule II rates, tier, however you want to put it, is the greatest impact in those that had the highest tariffs, those that quite frankly had high tariffs here because of the import sensitivity that had been attributed to them in U.S. law over such a long period of time?

DR. SCHOTT: Sorry, I tried to be clear. I'll try to be clear too here. If you go back to the basic story, the basic story is for a long time China had rates that we give to WTO members, and those were low. Like four percent, but they're slightly higher in the textiles, lower in other places.

Then there's these Schedule II tariffs, right, that are much higher.

HEARING CO-CHAIR WESSEL: Right.

DR. SCHOTT: And the gap between those two, right, how much they would have risen, that's what explains the job loss. And the story there is in the industries where the threat of tariff hikes was the biggest is where job loss would be most. Actually if you take the--

HEARING CO-CHAIR WESSEL: So where the gap was big-- again--

DR. SCHOTT: Yeah.

HEARING CO-CHAIR WESSEL: --formulaic, the gap, where the gap was biggest was the greatest job loss?

DR. SCHOTT: Yeah.

HEARING CO-CHAIR WESSEL: So pretty much one-for-one or-

DR. SCHOTT: Yeah, but the thing--

HEARING CO-CHAIR WESSEL: A strong correlation.

DR. SCHOTT: Yeah, and the thing to realize in your question was it's not, you know, if you think about industries in the U.S. that might have relatively high tariffs, the Schedule I tariffs, actually that's a smaller gap; right? Because then the ceilings are high; right?

HEARING CO-CHAIR WESSEL: Oh, that's a good point.

DR. SCHOTT: So it's really, it's not the fact--

HEARING CO-CHAIR WESSEL: So it's not footwear which has a high--

DR. SCHOTT: No.

HEARING CO-CHAIR WESSEL: --Schedule I and--

DR. SCHOTT: No.

HEARING CO-CHAIR WESSEL: Okay.

DR. SCHOTT: And, in fact, what we tried to do a lot, I mean again, I opened by saying it's really complicated, and what we try to do also is, you know, trade is not the only explanation obviously for employment loss in the U.S.

HEARING CO-CHAIR WESSEL: Uh-huh.

DR. SCHOTT: China agreed to many conditions when it joined the WTO. It dropped its own tariffs. It promised to get rid of subsidies. There's other explanations about the U.S.--you know, this was a tech bubble; there's unions; unionized sectors may be different than non-unionized sectors. So what we try to do as carefully as possible, think of all those other stories and try to collect information that would illuminate those stories and put all of that information into our model as well.

And so the punch line is that even if you control for every possible story you can try to think of and get data on, you still come up with this very strong relationship with this uncertainty explanation, and so that all helps you explain the job loss, and then the interesting thing is that the value added in manufacturing keeps rising.

HEARING CO-CHAIR WESSEL: Right. Okay. Thank you.

If there is another round, I'd like to have the opportunity.

HEARING CO-CHAIR SLANE: Commissioner Wortzel.

COMMISSIONER WORTZEL: First, more a comment than a question for Dr. Scott. I found broadly your argument very persuasive. I think it would be a stronger argument and more demonstrable for our purposes in an annual report if the macro data in Table 1 was kind of laid out in a more micro fashion because you're talking about 20 countries engaged in serious currency manipulation. I read that, your second paragraph. My first question is, okay, what 20; how much?

And if you showed or were able to show what countries those are and the estimated amount of currency manipulation in each country and the estimated effect on the United States of each of those, you sort of begin to

get a picture of where does it really matter with regard to China? Where do we face a global problem? What's the extent of the problem?

So I know that's probably a lot of work, but certainly as we write a report, with all due respect, Dr. Schott, most of the congressmen are not going to read your calculations. They would read that though.

Now, I do have a question for you, Dr. Schott. If I may, you make the point in the first part of your conclusion that it's really the uncertainty about tariffs that causes this loss. So I'd ask you if China attains market economy status, would that affect your conclusions at all?

DR. SCHOTT: Very good question. First, in defense of complicated formulas, so I agree, we don't expect congressmen to read the complicated formulas.

[Laughter.]

DR. SCHOTT: But I hope that, I think the serious point there is that this is really hard stuff, like you just can't conclude because two things happen together that that's an explanation unless you have somebody willing to kind of go down and dig into the formulas.

So what I'm trying to do, though, is push the idea as opposed to what the actual identification was.

So now quickly, what was the--sorry--I forgot the question.

COMMISSIONER WORTZEL: Market economies.

DR. SCHOTT: Oh, yeah, so--

COMMISSIONER WORTZEL: When they get market economy status--

DR. SCHOTT: Excellent question.

COMMISSIONER WORTZEL: --so how does it affect that big conclusion?

DR. SCHOTT: Yeah. So excellent question. So if you go back to what we tried to do, what we focused on is the change in U.S. policy which gave China PNTR; right? And, of course, that didn't happen in a vacuum. That happened because China joined WTO.

And, in fact, the data, you know, we don't have the data you would need in order to separately identify what was PNTR and what was joining WTO. Of course, why would joining WTO reduce uncertainty? Well, because now they're in the world trading system in a way they weren't before. That might make a lot of firms feel more comfortable.

Further movements along those lines might have a similar effect, but my guess, without studying it directly, my gut reaction is they would be smaller than what we did.

I mean eliminating that threat of very large tariff hikes--I mean these were tariffs that might have gone from four percent to more than 100 percent. I think that has a tremendous effect. Making China, you know, I think the biggest road bump we went over in terms of China becoming part of the world system, we've already gone through. I'm not sure that there would be this huge further reaction would be my intuition.

COMMISSIONER WORTZEL: Thank you.

HEARING CO-CHAIR SLANE: Commissioner Fiedler.

COMMISSIONER FIEDLER: I have a couple of questions. First, I want to comment on my colleague's thing. This value added discussion that we've had going on now a year-and-a-half, I'm not an economist, but commonsensically if China didn't add any value, it wouldn't seem to me they would accumulate so many dollars.

[Laughter.]

COMMISSIONER FIEDLER: I mean right? Am I missing something here? I mean if they have nearly \$4 trillion invested in the United States, they must have added some value somewhere to accumulate that amount of money.

DR. SCHOTT: You want me to respond to that?

COMMISSIONER FIEDLER: No.

VICE CHAIRMAN REINSCH: You don't want him to respond?

COMMISSIONER FIEDLER: I want him in his second round to come back. I have a couple questions, one on the 18 percent loss from 2001 to 2007. I actually understand, I think, not as dramatic a drop in this last recession if you had such a dramatic uncertainty factor; right?

The impact from 2007 till now, have you looked at that at all?

DR. SCHOTT: So, yeah--so that's a very big difference, of course. I mean there's a much larger recession. It's a global shock, huge credit crunch, you know, durable goods, manufactured. Okay. So all that excepted, we have looked at whether the effect that we identify for 2001 and 2007 continues. The data for doing that is still not completely available. The data we use only goes up to like 2010 right now.

COMMISSIONER FIEDLER: Right.

DR. SCHOTT: It doesn't look like that's persisting. So the drop in manufacturing that's occurring in the Great Recession is, I would argue, is probably much more related to things associated with the Great Recession.

COMMISSIONER FIEDLER: Great Recession.

Now, Dr. Scott, you talked about impact on wages. I want to understand if anybody has done any research, if you know of anyone who has done any research on the impact of wage stagnation on an increase in demand for imports?

I'll give you the example. I'm a worker working on an assembly line; I need a pair of work boots. I can buy one from Wolverine made in the United States still for \$75. It will last me three years. But I haven't got \$75 to spend on boots. So I go to Wal-Mart and I spend \$35 on a pair of boots that will last me a year, but in three years' time, I've now spent \$90 so the retail system and the import system has taken more money out of wage-stagnated people's pockets than it would have if they had been making slightly more money.

Have we seen any data on the impact of wage stagnation on increased import demand from China?

DR. SCOTT: I don't think we've seen any studies. I'm not aware of any studies that would look at that. I would just observe casually that

what we've seen over the last decade or decade and a half has been a growth in discount stores like Wal-Mart where you get goods that are--I mean, by the way, many of the goods we buy at Wal-Mart come from China, and I've done some studies on that. Wal-Mart is a big importer of Chinese goods.

And, you know, over the same period, we've seen some mid-range discounters, you know, Sears, for example, has struggled.

COMMISSIONER FIEDLER: Go out of business.

DR. SCOTT: So that's one indicator of what you're talking about.

COMMISSIONER FIEDLER: Do you agree that this is a pernicious thing?

DR. SCOTT: I think it is a pernicious thing, but principally because it's driving down the wages of working people. I think that's the big effect. You know, \$1,800 per worker per year for 100 million workers, that's the really big effect. I think the substitution that you're talking about is a second-order effect.

COMMISSIONER FIEDLER: Well, the second--I mean I would maintain that actually Sam Walton's genius was not distribution but how to make money off of poverty more than anyone else has ever dreamed of.

DR. SCHOTT: Can I?

COMMISSIONER FIEDLER: Yeah, please.

DR. SCHOTT: Well, I'm not aware of a study either on that direct question, but I'll give you another way to think about it.

COMMISSIONER FIEDLER: Okay.

DR. SCHOTT: So, you know, in order to figure out whether there is wage stagnation, we need to know what wages are and what the prices of the goods that the different segments of the labor force are buying, and there's evidence that the, let's say, overall growth of trade with China is disproportionately lowering the cost of the bundles purchased by lower-income households. So that's pushing in the other direction.

So nominal wages are falling. I agree there's income inequality. But this is complicated as well.

COMMISSIONER FIEDLER: But my problem with that is that you're correct in the first instance of the purchase.

DR. SCHOTT: I agree, and then there's a--

COMMISSIONER FIEDLER: You're not correct in the third instance of the purchase within a short period of time.

DR. SCHOTT: We're not sure whether I'm correct. I would say there's not a lot of evidence on that.

COMMISSIONER FIEDLER: Right.

DR. SCHOTT: I started by saying I'll give you another way to think about it, right, which is you need to not only--your effect would be the effect on overall demand of the kinds of forces we're talking about, but, you know, you have to think carefully that's a wage effect, and there's also a price effect. In order to even talk about things like income inequality we have to know what real wages are, right--

COMMISSIONER FIEDLER: Right. No, I understand.

DR. SCHOTT: --because we need to compare them over time. So that's just another way to think about this; right? And I think those studies are also quite difficult to perform because, again, the data demands are pretty strong; right? The best people usually do, they use like scanner data from retail stores, and they try to figure out whether if they have information about workers' levels of income, you know, how the purchasing bundles vary. I mean lots of very smart people work on this and try to figure this out.

But just to, again, since I'm the pusher of complexity here, I'll say let me--

COMMISSIONER FIEDLER: I actually believe it's complex.

DR. SHENKAR: If I could add something to that. There are certainly studies in marketing rather than economics that looked at that issue. Keep in mind that one should ask if this is what the customer wants, why is it that local companies do not provide it; right?

COMMISSIONER FIEDLER: It's not, the issue that I was describing is not what the customer wants. The customer wanted that Wolverine pair of boots for \$75, but he couldn't buy them because he didn't have the money, and he bought the \$35, and then he repeatedly buys that.

So none of this takes into account the quality of the product and the income of the person and the repetition with which they have to purchase.

DR. SHENKAR: No, no, of course. All I was saying is that there are studies in consumer behavior that will give you some indication as to when a person will opt to go for a cheaper product even though in the long run, he may be paying more.

Now, obviously, the Chinese are very well situated to provide those products because this is exactly what they do at home.

COMMISSIONER FIEDLER: Okay. Thank you.

HEARING CO-CHAIR SLANE: Commissioner Bartholomew.

COMMISSIONER BARTHOLOMEW: Thanks very much.

A couple comments. First, our Chairman has a predisposition to Ohio State, but, Dr. Shenkar, it's always a pleasure to see you, and it's always interesting to listen to you. I can always count when Dan is on a panel, that we're going to be having somebody from Ohio State.

And Larry, I'm just in awe of the fact that you asked a question about market economy status. It's just, you're expanding. You're expanding.

COMMISSIONER WORTZEL: Slowly.

[Laughter.]

HEARING CO-CHAIR WESSEL: 12 years, and we're getting it.

COMMISSIONER BARTHOLOMEW: Gentlemen, thank you for testifying today, and always your research is very interesting, and I know that economists focus on facts and data and where things are and where things have come from, but I'd like to tap into your intellectual heft and ask you to think forward a little bit because one of the things I'm always

interested in doing is trying to identify trends that we need to be concerned about.

So China has its own struggles going on. It's got an aging workforce. It's got a surplus of educated workers. And I'm just wondering-- obviously there are a lot of different variables, but 15 years from now if you were to be coming here and testifying, what do you think that you would be saying? Is it a continuation of the trends that we're seeing now?

Do you think that the employment situation here in the United States is just going to continue to deteriorate? What would you think would be your kind of statement 15 years from now about where things stand?

DR. SCOTT: Thank you.

I'll take a crack at that. I think it really depends on policy choices that are made here in the United States. I think that, to borrow the language of the economist, *ceteris paribus*, holding everything else constant. If we don't do anything, I think what we're going to see is that evidence of the last year indicates China is going to continue to lean on export-led growth just as long as it can.

They will continue to buy up 500, 600, \$700 billion a year of foreign exchange reserves, mostly dollars, to depress their currency, to keep churning out more and more exports until they have taken over most or all of U.S. manufacturing.

I think that is where we are headed unless we stop the practice by forcing them to eliminate currency manipulation. Then I think that's the direction we're headed. It's not a pretty picture. The founder of my institute, Jeff Faux, has written a book called *The Servant Economy*, in which he sees a future where we are primarily providing low-wage services, what I might call the "Disneyization" of the U.S. economy, or the "Jamaicanization." We become a tourist destination for the rest of the world, and the jobs associated in tourist industries are not very good. So it's not a pretty picture.

We get much concentration of wealth at the top. MBAs and people who run corporations engaged in trading international goods earn good, very good livings, and the rest of the population does not, and that's, I'm afraid, where we're going.

DR. SHENKAR: I think the theme of the hearing will be about the Chinese buying up America. I think that there is no question that one of the most important developments is the beginning, if you will, or amplification of a Chinese outward foreign investment, which already has been passing that of inward investment. There is no question that that will be one of the most important developments.

On the one hand, you will probably have a session on labor practices in Chinese-owned enterprises in the United States, and you'll have another session that I'm very concerned about as to what had happened to our knowledge based and what are the implications to our national security as well as economic competitiveness?

COMMISSIONER BARTHOLOMEW: Dr. Schott.

DR. SCHOTT: Okay. So I guess I'll give another, another way

to think about it. So if I want to know what's going to happen in 30 years, let's look back 30 years; right? So we've talked about Japan. We had many of the same issues, currency manipulation, jobs, hollowing out of manufacturing. After Japan, we had Mexico. Same--it's actually the great sucking sound, jobs lost, okay.

Now we have China; right? Where are we going to be in 15 years? We'll be talking about Bangladesh; right? It will be the next low-wage country that's relatively big that's taken the lowest manufacturing jobs away from the developed world.

So I guess I'm a bit more sanguine. I do agree that there will be, of course, a policy discussion. As Chinese wages rise, as Chinese multinationals, state-owned enterprises or not, start moving outside China to produce, there will be lots of discussions, again, like there was with Japan in terms of buying Rockefeller Center, buying this, buying that, so I expect to have those same debates.

My point would be that we've had these debates before. We're having them now with China. We'll have them. We'll keep having them. It's the nature of competition. Firms don't stand still.

So I think one problem in discussing these issues, sometimes we assume the U.S. will be the way the U.S. is now in 15 years, and that's not true. The U.S. the way it is now wasn't the U.S. we had 15 years ago. Many firms have survived competition with Japan, Mexico, China. These guys, the ones that survive, will figure things out, and they'll keep surviving, and, of course, there will be losers who don't survive. So I think that's what my prediction would be: we'll keep having the same debates.

COMMISSIONER BARTHOLOMEW: Thank you.

HEARING CO-CHAIR SLANE: I think what really concerns me more than anything else is the loss of our high-tech manufacturing industries to China as a result of various trade manipulations that are going on by the Chinese.

It seems like it's the lifeblood of our economy and the ability to increase our military innovation. Can the three of you talk about that and what your thoughts are, and if you share my opinion?

I'll start with Dr. Scott.

DR. SCOTT: Thank you.

China has rapidly moved up the food chain in terms of the quality of goods it's producing. We heard earlier about the size of our ATP product trade deficit with China. My research has shown that I think over 40 percent of the jobs displaced due to growing trade deficits with China are due to growing imports in high-tech industries, as defined by the Commerce Department, and so, especially just in electronics, just those industries in particular.

So I think that's a growing source of concern. Certainly, that also then limits our ability to compete in military goods.

I would also echo some of the concerns mentioned here about FDI. My research on FDI shows that foreign firms invest here in order to

gain access to U.S. technology, U.S. market share, and access for their imports, and that's what we can expect to see more of. So if we see Chinese firms buying up high-tech firms in the U.S., I think it will just be another vehicle for bringing imports in here. Overall, foreign multinationals are responsible for over half of the U.S. trade deficit, and that's a growing concern.

Thank you.

DR. SHENKAR: I certainly share the concern, and I have to say that with all respect to the currency issue, and this is obviously a very important issue, to me, long term, the issue of knowledge and technology is even more important, and does it have an impact on employment?

There is no question about it because if China, as an example, has forced GE to hand over all its blueprints of turbines, gas turbines, as a condition to win a large bid, this technology is already imbedded in Chinese products that are being exported around the world, and they are being exported instead of the United States exporting those.

One of the things that will happen, I believe, if you look--you asked about 15 years from now, relating to that, we are going to ask whose company is it anyway? It is already becoming more difficult to determine.

Again, as a reminder, well more than 50 percent of Chinese exports come from so-called foreign-invested enterprises. If you look at high-tech sector, this is much higher. It can reach 75 or 80 percent, and this is one of the arguments the Chinese make, is say what do you really want? I mean these are your companies that are doing that.

So the issue of whose company is it? Where does, you know, your loyalty lie, which we begin to hear right now, mostly in relationship to taxation and the like, is going to become much more serious, and we better start dealing with it because I believe that our infrastructure is not suited to the demand of the global economy, the kind that we already have today, and certainly the one we'll be having going forward.

DR. SCHOTT: So I guess I would start by questioning just the extent to which China actually is already exporting high technology as opposed to China's exporting high technology that came from Japan and is going out through China? So it's true you can look at this deficit in the advanced technology products, the ones defined by the Census Bureau, but those data alone don't tell you where the technology is coming from.

So I believe this is an issue. China's wages are rising, and China will certainly move up, but, you know, there are other countries in the world that are also quite good at technology innovation, like the EU, and we survive against them, and I'm not sure why we think that, you know, this is the way competition works.

I would take one further step and ask, you know, really what does it mean to be a manufacturer? I mean this is changing in a sense that you can have firms like Roku that never actually made anything. They do this design work so that's kind of what sits in Silicon Valley, and then the contract manufacturing stuff isn't all that high value added that gets shifted

offshore.

I think a really interesting question, but I don't know the answer to, but which you can hear debates on both sides--I haven't seen great evidence one way or the other--is the extent to which future innovation in tangible goods requires the innovation to take place in the same location as where it's being made as opposed to whether that can be fragmented; right?

If you're in a world where where the manufacturing takes place is where the innovation has to take place, and you're thinking about China moving up the chain, that's one way things could go.

If you're in a world where that gets divorced, you don't actually have to be next to it, the innovation can happen someplace else, then you can imagine this is just like any other splitting apart of the production process, and it goes by comparative advantage; right?

So the places where it's relatively cheaper to assemble, that gets done there, but the innovation gets done someplace else. Then it falls back on what kind of economy is the U.S. going to have in 15 years? What's our workforce going to look like in terms of skills relative to others?

Thanks.

HEARING CO-CHAIR SLANE: Thank you.

Commissioner Wortzel--I'm sorry--Wessel.

HEARING CO-CHAIR WESSEL: Thank you.

This has all been fascinating, and I want to thank all of you. If I can try and get shorter answers because I have a number of questions. Dr. Schott, I want to get your thoughts because you controlled for--the controlled research you did.

We've had a brief discussion of the Bilateral Investment Treaty here this morning. Can you, as I take your sort of let's call it Good Housekeeping seal of approval economic theory, if you will, the certainty, the ratification of the rules, if you will, I'd take that analysis and looking at a Bilateral Investment Treaty and assume we're going to see more U.S. companies investing in China.

The certainty about what rules China will apply to our investments there would get those who have not been investing to do more of it. Would you see that as a logical conclusion?

DR. SCHOTT: How short an answer do you want? Yes.

HEARING CO-CHAIR WESSEL: I'm sorry?

DR. SCHOTT: How short an answer do you want? I would say yes, I think that it would go in that direction.

HEARING CO-CHAIR WESSEL: That's fine.

DR. SCHOTT: The question would be what would be the magnitude; right?

HEARING CO-CHAIR WESSEL: Right.

DR. SCHOTT: And I think you're thinking about it exactly the right way. To the extent that whatever the parameters of the Bilateral Investment Treaty are reduce uncertainty about operating in China, you would expect to see--that's going for firms that already haven't done it or

firms that might be doing more of it, that might push them in that direction.

HEARING CO-CHAIR WESSEL: Okay.

DR. SCHOTT: So it would depend on the parameters of the treaty.

HEARING CO-CHAIR WESSEL: Okay.

DR. SCHOTT: And then you'd--

HEARING CO-CHAIR WESSEL: I'm sorry. Go ahead.

DR. SCHOTT: And then I would say the next round of things to think about is then how that, how moving some production, further production, offshore would affect the opportunities of firms that operations stay in the United States in terms of complementing production in the U.S., the same kinds of gains from trade that we would normally expect.

HEARING CO-CHAIR WESSEL: Okay. Second question, relating to your status over at Department of Commerce, and I assume that means you're able to see BPI data and just assess it for studies you're doing; is that right?

DR. SCHOTT: BPI?

HEARING CO-CHAIR WESSEL: Business Proprietary Data. That's the--you're a cleared advisor.

DR. SCHOTT: I can see all the economic census data at the level that it's collected.

HEARING CO-CHAIR WESSEL: Are you seeing it at the firm level?

DR. SCHOTT: Yeah, at the establishment level actually, yeah.

HEARING CO-CHAIR WESSEL: Okay. So based on that, without, of course, divulging anything, I had a discussion with a witness who's going to be on a panel later today, Dr. Willy Shih, and we have, as I understand it, roughly 700 Chinese enterprises that have been investing in the United States over many years.

We don't really have great case studies as to what they are doing. As I understand it, of those firms, the failure rate is there have been five firms that have actually failed. We're trying to find out what failed means? Is it bankruptcy or withdrawal from the market?

We're trying to find out how their capital structures, whether they are operating under Western approaches, if you will, whether they are receiving financial benefits or anything else? Is that the kind of information you would be able to get in your status that we should be asking the government for?

DR. SCHOTT: So data on capital structures is scant in the kinds of Census data that I look at. What I think you're talking about, what would be more helpful would be a merging of data that's at the Census in terms of being able to look at an establishment that's owned by the Chinese. Merging that with information about their tax records I think would probably give more information about their--

HEARING CO-CHAIR WESSEL: So the transfer pricing and all that information.

DR. SCHOTT: Well, transfer pricing is a different issue. Capital structure is one thing. Those data are kind of limited in the Census data sets that I have access to.

HEARING CO-CHAIR WESSEL: Okay.

DR. SCHOTT: Okay. The transfer pricing you can try to pick up by looking at the unit values of the goods that are traded. That you can see. I have a paper on transfer pricing. So you can try to tease that out, but you have limited information in those studies on the attributes of the foreign firm that would be sending the good to the U.S.

So you can tell whether they're related or arm's length, but you-- so that can be done.

HEARING CO-CHAIR WESSEL: Okay.

DR. SCHOTT: But there's limits, yeah.

HEARING CO-CHAIR WESSEL: Let us follow up because this is something I think we have a real interest in.

And following up finally with a discussion based on Commissioner Fiedler's line of questioning about the workers and the question of frozen wages, stagnant wages, et cetera, have any of you looked at Michael Mandel's research relating to the unit pricing of Chinese goods, and his view that our trade data does not, or the evaluation of trade data does not give a correct picture of what's happening?

So, for example, a product produced in the U.S. at a dollar, if there's a dollar of trade coming here, in a normal input-output model, you just do a one-for-one, but, in fact, the Chinese price may be 50 cents per unit versus the dollar per unit. So it actually may be displacing more U.S. manufacturing.

Have any of you looked at that? Rob, do you want to start?

DR. SCOTT: I do take this into account to some extent by using a fixed set of coefficients based on economic relationships in 2001, not the most recent, but in 2001 as a base period for evaluating U.S.-China trade. So that tends to increase the labor content of imports. I've been criticized for that, but there's a reason for it because of this--because of the lower price of Chinese inputs.

I think there's another point to Michael Mandel and Susan Houseman's work on this import pricing question, and it has to do with rapid growth of the value of output in computer and related products, which explains something like half of all growth in manufacturing production in the last decade, and I think that's a separate issue, and a lot of it is related to these low-priced imports.

I haven't gotten into that in any depth. I think it's a very important issue, though, for further work.

HEARING CO-CHAIR WESSEL: Other witnesses, any comment on that?

DR. SHENKAR: Not on that particular measure even though I've looked at it, but to your former question, I think it's remarkably important, we are indeed lacking in studies on Chinese FDI in the United States. There

are definitely quite a few cases that I'm familiar with from other countries, including from some African countries, Latin America, you know, Middle East and so forth, that show a remarkable set of problems and conflicts and issues.

And I think that at least some of that is going to show up in this country. It is just a matter of time. I know that in automotive, for instance, if you look at some of the big Chinese players, they already have a series of I would say fairly small acquisitions for now. In the first phase, they seem to retain, you know, the existing U.S. workforce. My own suspicion is that, you know, this is temporary.

It is critically important, I think, to initiate such studies. The Chinese usually are not enthusiastic about providing data and access, understandably. This has been my experience.

HEARING CO-CHAIR WESSEL: Understand. Dr. Schott, any comments?

DR. SCHOTT: So, unless--I don't remember the paper by Mandel specifically unless he's one of the authors with the Houseman work. I am familiar with the Houseman work and the broad issue of how you--you know, so, again, stepping back--how you measure price movements is incredibly important for many of the trends that we're talking about.

I don't remember it explaining half of the manufacturing growth. I remember it would shade it down a little bit in terms of value-added growth, but that's certainly an important issue, and if I could make a pitch for anything you guys could do to make data more available, the more data you make available, the more you give incentives and people on my side of the desk to study it, and then that leads to at least more data that we can discuss.

HEARING CO-CHAIR WESSEL: We would welcome a further discussion. Interestingly, and I'll stop in a moment, we had asked or recommended as a Commission that the issue of FDI be looked at. As a result, Chairman Wolf asked the Commerce Department to provide an assessment of Chinese FDI into the United States.

Their report to Congress indicated that in 2012, there was \$219 million of Chinese FDI in the United States, but they went on to say--thankfully--that the Rhodium Group, for example, had estimated it was between seven and nine billion. I'm glad that they indicated that the private sector actually probably had better data acquisition and results.

So working with you, we'd love to find out what's in the--since I'm not a cleared advisor, as you are--what's in those data sets, how should those be integrated, and what else should we be asking for, and see what potentially we as a Commission should be recommending?

DR. SCHOTT: Especially if you go back to the workers' side of the deflator issue for a second--

HEARING CO-CHAIR WESSEL: Right.

DR. SCHOTT: --you know, so we know the unemployment rate from 2001 to 2007 was relatively mild. So workers who were displaced from

manufacturing either got a job in a different sector or left the labor force, as mentioned earlier.

There are data sets that would allow you to track what happens to workers at the firm-worker level, but greater access to those data sets would make studying that question--we don't really know what happened to the workers; what goods they were buying; how that affected their wages. More access to those data would illuminate all of these questions much better.

HEARING CO-CHAIR WESSEL: And I've spent some time with the longitudinal data sets--

DR. SCHOTT: Yeah, the LEHD.

HEARING CO-CHAIR WESSEL: --and that's probably most helpful there. Thank you.

HEARING CO-CHAIR SLANE: Vice Chairman Reinsch.

VICE CHAIRMAN REINSCH: So do I get ten minutes like Mike? Is that the way it works?

[Laughter.]

VICE CHAIRMAN REINSCH: That would be good.

HEARING CO-CHAIR WESSEL: You're the Vice Chair. I'm the Co-Chair of the hearing.

COMMISSIONER FIEDLER: 30 seconds of it.

HEARING CO-CHAIR WESSEL: I thought you ceded that time.

[Laughter.]

VICE CHAIRMAN REINSCH: Nice try.

Just as an aside, I think Dr. Shenkar and Dr. Schott both made important points about the role of technology in this and the role of manufacturing. I've long had the view that if you don't make anything, eventually you won't invent anything, and that's the important issue here.

I do want to go back, though, to the topic we've been focusing on first with a couple questions. Dr. Schott, you focused your comments on what's happened since PNTR, and, Dr. Scott, you referred specifically to what's happened in the last decade, which is compelling, but we've been losing manufacturing jobs since the '70s; right? So whose fault was it before that?

COMMISSIONER FIEDLER: Somebody else?

VICE CHAIRMAN REINSCH: Well, Dr.--who wants to go first?

DR. SCHOTT: So the high point of U.S. manufacturing employment is 19.5 million in 1979, but for the decade before and after that, it was up and down. 2000--1980 recession, there was a partial recovery. The 1990 recession was the first time--

VICE CHAIRMAN REINSCH: But it's been straight down since '79.

DR. SCHOTT: No, it hasn't been straight down.

VICE CHAIRMAN REINSCH: No? It hasn't been?

DR. SCHOTT: It's been treading water since 1979. From 1979 till the 1990 recession was the first recession where manufacturing employment didn't stage a kind of recovery that it had in previous years.

VICE CHAIRMAN REINSCH: Okay.

DR. SCHOTT: So you have this beginning of the jobless recoveries that happened in 1990. That's true in manufacturing and non-manufacturing, by the way. It seems to be oriented towards workers that perform routine tasks, kind of the tasks that are most susceptible to kind of--

VICE CHAIRMAN REINSCH: Okay, but why?

DR. SCHOTT: Well, then you have 1990, there's a partial recovery. Then you get to 2001, and then it falls off a cliff. So I would stay it's straight down starting in 2001. That's the real puzzling thing. You're right. It's trending down. You're looking at me puzzled. So I could say, let me--I could paint the picture for you two ways. In absolute levels, manufacturing employment is kind of sideways until you get to about PNTR, and then it falls off a cliff.

As a share of U.S. employment, it's going down kind of more or less steadily over that whole period, and that's because, of course, the rest of the economy's sectors are growing much faster so it depends which picture you want to say it's going straight down; right? Not in levels, but it's true in shares.

VICE CHAIRMAN REINSCH: Dr. Scott.

DR. SCOTT: I generally agree with that. Roughly speaking, manufacturing employment in numbers, absolute number was roughly, was relatively constant, between 16.5 and 19.5 million between '79 and roughly '97. '97 was actually sort of the inflection point. It started to go--and '97, it's critical because '97 was the date of the Asian financial crisis. So things start to unwind at that point, and then they really fall apart in 2001 with the recession and China's entry into the WTO. Those all came together.

VICE CHAIRMAN REINSCH: So for any of you, there was a reference earlier to productivity improvements, labor productivity going up during the same period. Can you each sort out the relative importance of that versus the relative importance of currency manipulation in terms of what happened?

DR. SCOTT: I'd like to address that. I've looked at this. I didn't include the new graphs in my testimony, but historically, we had relatively rapid productivity growth in manufacturing for a long time, for decades. In the past, say particularly in the 1990s, we had high productivity growth. We also had high relative growth in demand for manufactured goods. And so the two canceled each other out.

For example, between 19--I think--I have the data, the exact dates--but roughly 1989 to 2000, we had about 4.1 percent growth in manufacturing value added, and similar, 4.2 percent growth in productivity. So essentially very little change in employment.

After 2000, the rate of growth of manufacturing output did slow and did slow substantially. And it slowed to, I think, about two-and-a-half to three percent depending on what end points you use, and yet you still had high productivity growth. So it's a chicken-egg problem. Did technology cause the job loss or is it slow demand growth?

And what explains the slow demand growth is less growth for domestic demand for goods produced in the United States. When you include imported goods coming from China and elsewhere, but largely from China, and when you recognize those goods are coming at a much lower price, as we discussed earlier, that explains in large part the decline in the rate of growth of demand for overall manufactured goods.

And so, in my view, the cause of job loss is a decline in growth in demand for domestic-manufactured goods, and that is explained by trade.

VICE CHAIRMAN REINSCH: Okay. Dr. Shenkar and Dr. Schott, do you agree with that?

DR. SHENKAR: There is no question that this is kind of a multivariate explanation, that automation, other productivity increases, currency rate all explain eventual decline in employment.

However, I'm trying to look at the overall trend, and people have mentioned Japan here before so I would like to remind everyone that in the early '80s, everyone was convinced that currency manipulation was the single and almost only variable explaining Japanese success. We had the Plaza Accord. We looked at what happened later, and this seems to have been a fairly partial explanation.

But I am much more concerned about long-term trend because following this event, as some people want to look at it as being done because the Japanese economy has been stagnating now for a very long time, the U.S. automotive industry has never been the same. It never returned to the same status. Japan has never opened its market to U.S.-made automobiles. It went from there to basically take over many of the global markets.

So it is these long-term that I must say I'm very worried about, and people who say, well, we've had Japan, we have others, we're going to go on and be successful, I would have a problem with that because I believe the case of China is fundamentally different. It is also fundamentally different from that certainly of Vietnam or Bangladesh and so forth.

This is a competition for, let me put it in blunt terms, for global leadership. It's nothing less than that. Thank you.

VICE CHAIRMAN REINSCH: Dr. Schott, you want to weigh in in conclusion?

DR. SCHOTT: If I understood the question, it was whether currency manipulation might be behind the trends in value added work--

VICE CHAIRMAN REINSCH: To weigh that versus productivity improvements.

DR. SCHOTT: Yeah. So I guess the way I think about that, and what, to the extent I know the evidence says, something like currency manipulation could give China an advantage in certain products. Which products? The ones that are more labor intensive because that's the kind of economy at least they started with.

They're moving up, but that's where they start so that's going to draw off what it's going to draw off, sectors in the United States that are relatively labor intensive. So when you take those sectors out of the U.S.

mix, the most labor-intensive toys, T-shirts, et cetera, those go away. Of course, the U.S. economy will tilt towards being higher value added for worker. So, in that sense, I can see a connection.

But I think what's important to realize there is that's the result of firms trying to figure out how to make profits in this changing regime. So I think currency manipulation isn't the major part of the story. But PNTR I think maybe was a much bigger one. So there's a connection there.

But don't forget there's a much broader trend outside of manufacturing that's been going on since the '90s that we've talked about where technology is substituting for workers, and to really make it complicated, you could ask, how are the incentives for coming up with technology that substitutes away from labor affected by international trade so trade-induced technical change.

VICE CHAIRMAN REINSCH: A good question. And I want to come back to PNTR, but I'll have to do that in yet another round if we have time.

COMMISSIONER FIEDLER: A third round.

VICE CHAIRMAN REINSCH: Thanks.

HEARING CO-CHAIR SLANE: Commissioner Shea.

CHAIRMAN SHEA: Thank you.

Sorry I was late for your testimony, but I did read it in our briefing book, and, Dr. Schott, I want to scold you for all the deltas and epsilons and squiggly lines.

[Laughter.]

DR. SCHOTT: I've already been scolded. Scold me again.

[Laughter.]

CHAIRMAN SHEA: Oh, you have. All right.

DR. SCHOTT: But you shouldn't scold it though.

CHAIRMAN SHEA: I know.

DR. SCHOTT: I mean this is where the answers to the questions that you guys are asking come from. It's not like I picked that out of thin air.

CHAIRMAN SHEA: I know. I stand scolded. I am scolded so--

COMMISSIONER WORTZEL: You are scolded.

COMMISSIONER FIEDLER: That's right. The Harvard-Yale--

[Laughter.]

CHAIRMAN SHEA: Dr. Scott, when I read your material, it seems you have a very binary view: exports are good/they create jobs; imports are bad/they result in the loss of jobs. But don't imports also create jobs at the port, through the sales retail system? So why don't you respond to that?

DR. SCOTT: Sure. Thanks very much for the question.

My view is based on basic macroeconomic accounting, as I said earlier, and standard textbook macroeconomics output, or "y" is equal to consumption plus investments, plus government spending, plus exports minus imports, and really that's the engine that drives my little model.

In terms of the jobs at the ports and so on, if those goods were produced domestically, they would also support jobs, not just in shipping, but also in advertising and wholesale trade and retail trade. So where we source the goods is less important for those secondary industries than for the primary industries. The primary industries, manufacturing, in particular, are where most of the jobs are gained and lost, and that's what my model shows.

But if we produce those goods in Detroit, the shipping jobs would be in Detroit. Now we import them from Japan. The shipping jobs are at the port. But they have to be shipped one way or the other to the final destination.

CHAIRMAN SHEA: Does anybody want to respond or? Well, Dr. Shenkar, you have a very interesting term, "imovators." Are there any U.S. companies that you think are imovators today?

DR. SHENKAR: I believe so, though they will not admit it because the "i word" has such a stigma in our society, but if I'm looking at it, and I've interviewed people extensively at P&G, for instance, I think P&G has been quite successful doing that.

CHAIRMAN SHEA: Procter and Gamble; is that?

DR. SHENKAR: That is correct. Procter and Gamble.

CHAIRMAN SHEA: Okay.

DR. SHENKAR: And the reason is that we call them imovators because they continue to innovate, but they also imitate even though they call it open innovation. It's a more appealing name, but also, and this is a very important point, I found in my interviews that these so-called "imovators" were very good at defending their knowledge and technology. They were very good at protecting it.

And in the current global environment where everyone out there is there to copy what you already have and come up maybe with a cheaper substitute or a better substitute, for that matter, this is very critical. I did not find too many companies that were willing, for instance, to pay a price in more complex logistics, in higher production costs, et cetera, in order to better defend the product or service.

Actually, I believe that most U.S. companies are doing a fairly lousy job at defending what they have. There are different reasons for that, but that's the overall conclusion.

CHAIRMAN SHEA: Thank you. I have 50 seconds here. You say in your testimony that U.S. employment in services, consulting, banking, legal, engineering, has benefited from bilateral U.S. trade with China and will continue to do so in the near to medium-term, but in the long range those jobs, too, will be shifted to China.

Could you flesh that out for us a little bit?

DR. SHENKAR: Right. China is very, very clear, explicit and policy driven in its desire to climb up the ladder. It is already happening. So we still have to see whether this new Chinese, for instance, large commercial aircraft, there's already a regional produced in a JV, whether it will happen, but the Chinese have gone a very long road.

I want to remind everyone that in the 1950s, the Chinese copied the Boeing 707. There was only one little problem: it didn't really fly. Nowadays, they have built tremendous capacity. In today's environment, you can source many of the inputs, including from U.S. makers of avionics and other components, and that means that in a number of years, they will be competing for us, and the model will be the same.

All the orders that have been placed for this new aircraft that's still being developed are from Chinese airliners. Those do not make a business decision. There is one government entity that makes all airplane purchases, and it is very clear that they're going to build and displace as the largest aviation market going forward, to displace us in our own domestic market and in other export markets.

I think it is coming, and I think we have to ask ourselves how are we preparing for that because we don't want to do just postmortem. Of course we want to gain better understanding of what happened in the past. This is very illuminating, but at the end of the day, we have to come up with questions and responses and be ready for what is coming. I don't have any question in my mind that it is coming.

CHAIRMAN SHEA: Thank you.

If there's another round, I'll ask you about those epsilons, Dr. Schott.

HEARING CO-CHAIR SLANE: Commissioner Fiedler.

COMMISSIONER FIEDLER: I want to pursue uncertainty a little more, but in a slightly different way. In the PNTR debate, the business community was largely unified. Today, the business community is all divided into their self-interests and the way the Chinese are treating them.

So there's an increasing amount of uncertainty in doing business inside China--whether you confiscate the joint venture; whether you force this; the rules are opaque. We're seeing that in testimony from the business community.

Now we're about to negotiate a bilateral investment agreement, which I would maintain, by the way, that your PNTR was, and you provided the evidence for it, partially an investment agreement because some substantial amount of manufacturing moved to China.

In intellectual property, if American companies were certain that their technology would not be stolen, would they stay or go?

DR. SCHOTT: In China?

COMMISSIONER FIEDLER: No, to China. In the United States.

DR. SCHOTT: So excellent question, and I think this also echoes back to some of the comments we just heard. Look, I talk to CEOs all the time. I mean not like I hang out with them all the time, but they come through Yale now and then, and a lot of them say exactly what's been said here, that the most sensitive technologies they have, they keep in the U.S.; right. And their view, it's not hard to find people who have had experiences where technology all of a sudden showed up at a Chinese competitor.

COMMISSIONER FIEDLER: Right.

DR. SCHOTT: If there were much stronger protection of intellectual property rights inside China, I think that would also reduce uncertainty about investing in China. A firm might be on the border of wanting to invest in China or not. It doesn't want to take its most sensitive technology for an environmentally great engine, for example, and produce it there even though that would make much more sense because they want to service the Chinese market and shipping engines is expensive.

You reduce that uncertainty. That moves in the same direction, I would agree, but I would challenge the first part of your question, which is I think uncertainty--I'm not sure uncertainty in China is increasing. I think over the long haul, it's been going down. This could reduce it further, I would say.

COMMISSIONER FIEDLER: Well, I mean just anecdotally with all the companies that come before us--

DR. SCHOTT: Yeah, but you get a selective--

COMMISSIONER FIEDLER: No, no, no, no, no, no.

DR. SCHOTT: You get a select version of people who come in front of you potentially so it's hard to measure that sentiment.

COMMISSIONER FIEDLER: Yeah, I mean--no, I think it varies.

DR. SCHOTT: Yeah.

COMMISSIONER FIEDLER: To be sure.

DR. SCHOTT: But I don't know the data about how much it's more or less.

COMMISSIONER FIEDLER: I mean you see it in the politics of the Hill, that companies who are getting gored, if you will, are screaming.

DR. SCHOTT: Sure.

COMMISSIONER FIEDLER: And they didn't scream before. They were saying let's go, let's go, let's go. The certainty question is a real one, but what you're just saying to me is that the next cliff could well be if they don't steal intellectual property, more manufacturing is going to go.

DR. SCHOTT: So I would say what I said in response to the question before, which is I would agree with you on the direction. What the magnitude would be we don't know; right. But I'd agree with you that it would move in that direction. Whether it would be off a cliff or it would be continued moderate declines--

COMMISSIONER FIEDLER: Well, I mean we're talking a small cliff or a large cliff.

DR. SCHOTT: Yeah. Or a bump or, you know, it depends. We don't know, but I agree with you on the direction.

COMMISSIONER FIEDLER: Actually you don't think that there's a lot of sensitive technology we're pro--

DR. SCHOTT: No, I would like to see the data. I'm a data kind of guy; right?

COMMISSIONER FIEDLER: Yeah. I mean how do you get it?

DR. SCHOTT: That data you're not going to get. What you want

is to go to all the firms in the world, for example, and say what's the technology right now that you're not moving into China, and what would you move into China according to your optimal business plans; right?

COMMISSIONER FIEDLER: Couldn't we do that through patent information?

DR. SCHOTT: No, because firms could have patents and then they--

COMMISSIONER FIEDLER: But they don't explain--

DR. SCHOTT: Yeah, maybe--I mean firms can have patents and they decide where to locate production differently.

DR. SHENKAR: One not very precise source, is the Census data that I rely on and actually have done some work with them on that is from the U.S. Chamber of Commerce in Shanghai. There is a separate one, amazingly, in Beijing that collects its own data. But I have looked at the data on that, and this provides you a yearly survey of at least those companies that are there which shows chose a continuous increase or at least flat concern vis-a-vis protection of intellectual property rights.

You don't see much improvement over time. Now, the textbooks used to say that if you have a country with lack of protection of IPR, a lot of corruption and opaque regulation, that particular country will not be able to attract foreign investment; right? So, welcome to China.

However, again, I should emphasize, you know, we make this crude distinction between so-called explicit, or codified, knowledge and tacit knowledge. Really to be a successful global player, you also need a lot of tacit knowledge.

COMMISSIONER FIEDLER: No, I understand.

DR. SHENKAR: Right? And that knowledge is being transferred, for instance, again, by this continuous forcing of a joint venture and other alliances, and actually patent regime forces you to disclose, and many times this will be transferred directly to a competitor, which goes, again, to my earlier point, that the company must do a better job of defending that knowledge, and simply saying okay, I--

COMMISSIONER FIEDLER: It actually goes to your earlier point of who they are loyal to?

DR. SHENKAR: The U.S. companies are not doing a good job as far as protecting their know-how, and simply saying, well, I leave the most sensitive stuff at home is not a very good answer. The reality is that the R&D intensity of U.S. subsidiaries in China is about the magnitude of three times that of U.S. subsidiaries in other parts of the world.

So, yes, they try to limit it in a myriad of ways, but it is not always very successful. Look at Ford. I mean Ford sold Volvo to Geely supposedly with a written agreement that Geely cannot take the knowledge from Volvo into its own vehicles. I believe you've got to be extremely naive to believe this is not going to happen.

Thank you.

COMMISSIONER FIEDLER: Thank you.

HEARING CO-CHAIR SLANE: Commissioner Wessel.

HEARING CO-CHAIR WESSEL: Thank you.

Let me ask two questions. First, several years ago I think it was Dr. Lester Thurow who had done some work on vector price analysis regarding exports and imports and the changing nature of imports into the United States, changing nature of exports.

He believed or I think his analysis was that the old adage that export jobs pay more is simply not holding up as much, if you will, that we are now exporting more commodity-based items. The number one by volume--I'm not saying by dollar-- export out of the west coast, at Portland or Seattle, is scrap paper and scrap metal. We have an ATP deficit, et cetera.

Have any of you done or are you aware of any vector price analysis or other research to get to the epsilons and deltas that may help us understand whether, Rob, it's not just a question of the number of jobs but the quality of those jobs related to exports and imports and how that's changing? Anyone, comments on that?

Please, Rob.

DR. SCOTT: The paper that I referred to in my statement on the effect of China trade on wages does look at just this question. What I found is that actually the jobs displaced by imports paid about \$100 a week more than the jobs gained through exports.

Now, both of those are dominated by manufacturing. They both pay more than jobs in non-traded good industries. So the hierarchy was that I think jobs in export industries paid on average about \$100 a week more than jobs in non-traded industries. Jobs in import competing industries paid about \$200 more.

So there was net loss on the substitution of export jobs for import jobs. In other words, the supposed gains from trade, at least from the point of view of workers, disappeared. When we traded one import job for one export job, we suffered a net loss in wage, total wage compensation.

HEARING CO-CHAIR WESSEL: Has there been an update, referring to one of the longitudinal studies I talked about earlier? There was one, I believe it was Trade Adjustment Assistance, and that workers who had been displaced by trade on average had two-thirds the income that they did prior to the displacement.

DR. SCOTT: It's not quite that bad.

HEARING CO-CHAIR WESSEL: Okay. What is the--

DR. SCOTT: The TA--the latest data from the Department of Labor is for the period 2009 to 2011.

HEARING CO-CHAIR WESSEL: Okay. Mine is old data. Yeah.

DR. SCOTT: I'm just remembering off the top of my head, I think a third of the workers suffered a wage loss of more than 20 percent.

HEARING CO-CHAIR WESSEL: Okay.

DR. SCOTT: But there was a substantial share of the workers who remained unemployed. It was on the order of 30 to 40 percent, and this

is two years after the separation.

HEARING CO-CHAIR WESSEL: Okay.

DR. SCOTT: So those were very substantial effects. So labor force dropouts, the biggest losses of all in terms of potential earnings. That's income foregone forever if those workers don't come back in the labor force, and that's been what we've seen overall in the current recession, in the Great Recession.

HEARING CO-CHAIR WESSEL: Other panelists? Any comments? Please.

DR. SCHOTT: I think all the studies show exporters pay more, but let's think about that a bit more carefully. Almost all trade goes through, I think it was mentioned someplace, the very largest firms. Those very large firms both export and import. Those are the most productive firms. That's how they got to be very large. So they have wage premium relative to other parts of the sector.

But I guess I would push back a little bit on this analysis of the gains from trade being viewed through the lens of the import job and the export job. The logic of gains from trade is the economy as a whole is gaining. And the simplest trade models to the more complicated ones tell you you make everybody whole by redistributing.

I know that's a tough word in this city, but that's the logic of these models. So you have to think, connecting that, this question, and the one right before, about what happens when the U.S. starts importing more from China? It's possible that those import opportunities give rise to whole new things that wouldn't have existed before which create whole new industries, which when you try to do the math is going to be hard to reconcile given the data.

You know, would we have the same iPhone we have now if it weren't possible for Apple to manufacture or assemble the device in China? That, again, is a very--I mean I defer on innovation. That's not really the focus of my study, but capturing those kinds of forces is very hard. Quantifying those kinds of things is very hard.

HEARING CO-CHAIR WESSEL: I think you're asking to exceed Washington's bandwidth to have a complex debate that's not black or white. But I certainly agree with you, it's a much more complex issue.

Dr. Shenkar, did you have a comment?

DR. SHENKAR: Yeah, yeah. Following that, again, looking at the Apple example, here is one thing that concerns me. It is, again, the value of Chinese work is a very small fraction in overall costs, but I did look at where the smart components come from. The Chinese assemble them. And I came up with these rough dollar figures. Components that come from Japan are about \$60. Components that come from Korea are about \$25. Components that come from Germany are about \$30. Components that come from the U.S. are about \$10. So I think the numbers speak for themselves.

Now Apple came up recently with a beautiful analysis as if they are contributing to more than 500,000. I'm sure you've all seen that.

But to me, this is a red light. The fact that the smart components do come from outside China, again, then you see that they come from a lot of places and not necessarily from this country.

HEARING CO-CHAIR WESSEL: Understand.

DR. SCOTT: Can I have a two-hander on this? We've heard several times about these studies of the iPhone. They're everywhere. It's a ubiquitous sort of urban legend almost now. I would just point out that they are controversial.

Dr. Charles McMillion, who has done some work for the Commission, has written a report a couple of years ago looking at this iPhone cost breakdown and has found a lot of holes in the data that they used. It was basically one firm that did a fairly limited survey, and they challenged it. They changed the numbers after some of the challenges came out.

So be careful which iteration of this study that you're looking at. And McMillion has got all of it broken out.

Thank you.

HEARING CO-CHAIR SLANE: Vice Chairman Reinsch.

VICE CHAIRMAN REINSCH: I think the last comment is well-taken. I've given speeches where I've pointed out some of the flaws in those studies. At the same time, Dr. Scott, you referenced the OECD work or the OECD WTO work which came to similar conclusions, which I think is more general but also solid.

We'll see if they can come up with a better way of counting. That's kind of a long-term thing. I don't know what the result of that will be.

Dr. Schott, I've been thinking about the uncertainty principle, if you will, that you've articulated, and I'm trying to decide whether I believe it or not, and this is not a data-oriented comment because you are way ahead of me in looking at numbers.

But it just seems to me that from a company standpoint, and I represent companies in my real job so I end up talking to them a lot, tariffs alone are de minimis as an issue. There are some sectors where that is not true, but, in general, they're not significant. Plus if I were thinking about exporting to China, I wouldn't care about whether U.S. tariffs were becoming more certain or not because it's a question of exporting, not importing.

If I were importing from China, or thinking about importing from China, then I'd be interested in the tariff implications, but it seems to me that if I were going to import, I have other options to import. I can import from Malaysia. I can import from Taiwan. I can import from any number of low-wage countries where there is no tariff uncertainty because they're WTO members.

So why am I suddenly going to be persuaded by the passage of PNTR and the adoption of tariff certainty to take all the steps that you've described?

DR. SCHOTT: That's an excellent question. Actually, I got that

exact question yesterday at Yale and given this to the macroeconomists.

VICE CHAIRMAN REINSCH: So you've practiced your answer already?

DR. SCHOTT: No, I'd say I'm going to give you the way I think about it, and I would like to find out the answer. So it's an excellent question. If I can restate it, just to make sure we're on the same page, how could this possibly have such a big effect? Either, you know, firms could import relatively easy from China anyway and so why this make a big deal? I think the answer--and so I agree, it's a surprising result.

I think another way --and we would like to know more--to get to know whether this is actually surprising, I need to know about what firms are doing, and that's what we're looking at right now. It's like trying to figure out what actually these firms are doing during this process, which is beyond what was in the paper so far but would be in another paper.

I think one way to think--the way we're starting to get our head around it, and this is behind a lot of the comments here-- trade is global. Firms, especially the biggest firms that do most of the trading have global supply chains; right? Nowadays, these things move with the efficiencies of Swiss watches and making changes to those supply chains is difficult and expensive, and so it may be the case that the uncertainty was enough to keep firms from pulling the trigger.

China, if it gets resolved, China is much more low cost, much bigger home market than other low-wage countries so it has that added attraction. This policy change has a big effect because now firms start to move their global supply chains around, and that is the data we're trying to figure out. You know, it involves operations of U.S. multinationals or German multinationals all around the world and where they're operating.

So there's big costs. If there's big costs, then, you know, there's lots of work in other areas of economics where uncertainty can keep you from investing when there is big costs, some costs on the line.

VICE CHAIRMAN REINSCH: Yet Dr. Shenkar is focused on the uncertainty of the investment conditions in China, yet also made the comment that that hasn't seemed to have stopped anybody.

DR. SCHOTT: Well, be careful there. Be careful. Just because something has happened doesn't mean that it would have been different if the conditions had been different.

You might have seen much, much more investment much earlier on in China had temporary NTR not been in place and then it gets resolved. You know, you have the big reaction when it does get in place because now the cost differentials are just enough to have firms do it.

It's true there's been investment in China. People have been importing from China.

VICE CHAIRMAN REINSCH: My hypothesis just parenthetically is much less sophisticated than that. My sense of a lot of the companies is the classic example of the lemming effect. Their friends went and so they're all going, and I don't know how many of them did the kind of

analysis that they should have done in order to make an informed economic judgment before they decided to go.

Once there, then they have a stake, and it's hard to--

DR. SCHOTT: It's an interesting comment on business decisions, I think.

VICE CHAIRMAN REINSCH: Well, I know. Maybe I'll lose my day job, but I'm old, and it doesn't matter.

[Laughter.]

VICE CHAIRMAN REINSCH: So Dr. Shenkar.

DR. SHENKAR: No, you are absolutely right. Piggybacking definitely has been studied and confirmed in many studies in business, and indeed one of the problems with the data, since we talked a lot about data problems here, is the data for what we call survival bias. I mean obviously the companies that get surveyed, for instance, by the different Chambers, are those that have survived and stayed in China and not the others.

But I should also add that what we see even from among those companies, from all the surveys, increasingly, the concern is not about or less about tariffs.

It is about what we call non-tariff barriers, and there not only don't we see an improvement, in many ways, it is getting considerably worse, anything from indigenous innovation to various corruption, and there is no question that U.S. companies, for instance, are at a disadvantage because of the Foreign Corrupt Practices Act.

It's not that I support repealing it, but it is a reality, and I have to say that I have looked at the numbers of enforcements because, you know, the OECD member adopted one version or another, and you will find some countries where there is almost zero enforcement of that.

So these are the issues when we talk, and I do talk very often to business executives and advisors or a researcher, these are the real concerns, and one of the problems is that these are variable that are very difficult to capture. They are very difficult to measure. But they are there. They are there everyday.

VICE CHAIRMAN REINSCH: On the NTBs, I think that's something where we all agree with you, and we've had many hearings on that subject, and I think we'll probably have some more.

Thank you, Mr. Chairman.

HEARING CO-CHAIR SLANE: Well, our time has expired. You've all been terrific. It's been enormously helpful, and on behalf of the Commission, we really want to thank you for your time.

We'll stand adjourned until 11:00 o'clock.

PANEL II INTRODUCTION BY COMMISSIONER MICHAEL R. WESSEL

HEARING CO-CHAIR WESSEL: We thank our panelists. We'll get started. Our second panel today will discuss U.S. trade law enforcement efforts as

they relate to China.

Joining us for the discussion are Ms. Elizabeth Drake, Dr. Philip Levy, and unfortunately Dan DiMicco was unable to be with us this morning, and the Senior Director and Counsel to the firm, Eileen Bradner, will be sitting in for him, and we appreciate her willingness on a short notice to do so. Five minutes. Five minutes short notice.

And I apologize, Eileen, I do not have your full bio so we will add that later for the record.

MS. BRADNER: For the record, I excelled in kindergarten.

HEARING CO-CHAIR WESSEL: Okay. Well, that's a great start then for us.

VICE CHAIRMAN REINSCH: That puts you ahead of most of us, I think. But it's fine.

[Laughter.]

HEARING CO-CHAIR WESSEL: Well, I won't touch that.

Ms. Drake is a partner in the law firm of Stewart and Stewart where she has worked on a broad array of international trade matters, including antidumping and countervailing duty proceedings, Section 301 petitions, China-specific safeguards, and bilateral trade agreements among others.

Prior to joining Stewart and Stewart in 2005, Ms. Drake served for six years as an international policy analyst at the American Federation of Labor-Congress of Industrial Organizations--we all know it as AFL-CIO--where she advocated on behalf of the American labor movement on trade and international economic policies.

Ms. Drake has previously testified before the Commission and welcome back.

Dr. Levy is a Senior Fellow at the Chicago Council on Global Affairs. He was previously an Associate Professor of Business Administration at the University of Virginia's Darden School of Business, a resident scholar at the American Enterprise Institute, instructor at Columbia University's School of International and Public Affairs, and economics faculty member at Yale University.

From 2003 to 2006, Dr. Levy served as Senior International Economist in the Bush administration. He has previously testified, as well, before the Commission, and we appreciate his being here.

We will put all of your written statements into the record. The normal rules are please confine yourselves to seven minutes for oral comments, and then we will take a round of questioning.

There is some crossover potentially in this panel. Dr. Levy may have comments on some of the studies discussed in the earlier panel, and we have asked Dr. Robert Scott to stay over should there be a need to have a discussion about that to make sure that Commissioners have appropriate levels of information.

Ms. Drake, why don't we start with you?

**OPENING STATEMENT OF MS. ELIZABETH J. DRAKE
PARTNER, STEWART AND STEWART**

MS. DRAKE: Thank you.

Good morning, Chairmen Wessel and Slane and members of the Commission. My name is Elizabeth Drake. I'm a partner at Stewart and Stewart, and I'm very pleased to be with you today.

Ensuring that China abides by its international commitments and that our trade laws are effectively enforced are absolutely essential to our nation's economic security and competitiveness.

This administration has made important strides in enforcement. It was the first and only administration to enforce the China specific-safeguard, stemming a damaging surge in tire imports, saving American jobs, and incentivizing investment here in the U.S.

This administration also accepted a Section 301 petition on China's policies in the green technology sector, leading to a range of enforcement actions on behalf of this vital and strategic industry.

The administration has filed eight requests for WTO consultations with China on issues ranging from export restraints to misuse of trade remedies to electronic payment services. The administration also filed the first counter-notification on China's subsidies at the WTO, and the administration has used bilateral consultations to secure numerous commitments from China to comply with WTO rules.

Despite these efforts, violations continue and our trade relationship grows more lopsided each year. USTR's most recent report on China's WTO compliance identifies problems such as WTO-illegal and trade-distorting subsidies, discrimination against U.S. goods, services and technologies, localization requirements, inadequate protections for intellectual property, and more.

Additional major distortions to our trade relationship stem from China's persistent undervaluation of its currency and its refusal to conform its massive export credits to international rules.

While additional enforcement resources would undoubtedly be helpful in addressing these problems, I would like to focus on five additional ways in which enforcement could be improved.

First, the U.S. should use all tools at its disposal to address Chinese currency manipulation. The Commerce Department refuses to use its existing authority to treat currency undervaluation as a countervailable subsidy, and Congress should pass legislation to correct this problem.

The administration should also explore challenging China's currency practices at the WTO, and it should insist on strong currency disciplines in any Trans-Pacific Partnership agreement. This will send a signal to China that these practices will not be tolerated in a 21st century trade relationship.

Second, the U.S. should ensure its trade remedy laws are accessible and effective. In some cases where relief is needed, bringing a

petition may be difficult or impossible due to industry fragmentation or divided interests among large players. In such instances, the administration should make full use of its authority to self-initiate trade remedy cases.

In addition, Congress should explore giving standing to bring trade cases to other domestic entities with an interest in fair trade enforcement such as states and localities. Congress should also ensure that China continues to be treated as a non-market economy as long as its economy meets that definition.

Third, if a trade remedy case is successful, it should actually deliver the relief that is promised. Unfortunately, problems such as circumvention, transshipment and duty evasion are all too common in cases on Chinese goods.

Customs' current enforcement regime suffers from a lack of transparency, access and accountability, severely hampering the ability of domestic industries to ensure the orders they have fought for are being effectively enforced. Proposals such as those in the ENFORCE Act would help address some of these problems.

Fourth, in some politically sensitive cases, the U.S. chooses dialogue over a WTO dispute with China. Currency manipulation and export credit subsidies appear to be two such areas, in my view.

If these and other issues are of concern to Congress, they should find a way to assert their role in the enforcement process. One way would be to create an independent congressional trade office, an idea that's been discussed for many years, which could gather its own factual information and conduct its own legal analysis of trade issues, giving members of Congress the support they need to push for more aggressive action where merited.

Fifth, and finally, we must find a way to overcome the twin challenges of China's lack of transparency and the hesitancy of some of our companies to share information on problems they face in China, sometimes out of fear of retaliation.

This makes it extremely difficult for USTR to pursue more fact-intensive cases on important issues such as trade distorting subsidies, discrimination by state-owned enterprises, localization and technology transfer requirements, and more.

To address these problems, policymakers may want to consider disclosure requirements for companies, perhaps through SEC rules, subpoena authority for USTR, and stronger confidentiality protections for companies.

Ultimately, we should also consider whether the current WTO compliance apparatus itself needs to be strengthened. The WTO system is based on the premise that members' legal systems are transparent, that rule of law prevails, and that members will endeavor to bring themselves into compliance in good faith. Far too often, these premises don't hold in the case of China.

Policymakers should therefore consider enhanced enforcement mechanisms at the international level that would be more suited to China's unique economic and legal system, which may include independent third-

party compliance monitoring or audits, more automatic penalties for noncompliance, and quantitative targets and triggers where appropriate.

Together, these tools could help our trade relationship mature into one that is more balanced and more beneficial to American industries, workers and communities.

Thank you, and I look forward to your questions.

**PREPARED STATEMENT OF MS. ELIZABETH J. DRAKE
PARTNER, STEWART AND STEWART**

U.S.-China Economic Challenges:

Assessment of U.S. Trade Law Enforcement Effort with China

Testimony before the U.S.-China Economic and Security Review Commission

Elizabeth J. Drake, Partner, Law Offices of Stewart and Stewart¹⁰

February 21, 2014

I. Introduction

Since China joined the WTO twelve years ago, it has become the world's number one exporter and the most important U.S. trading partner. But the growth in trade between the U.S. and China has been far from balanced. While annual U.S. exports to China grew by \$101 billion from 2001 to 2013, annual U.S. imports from China rose by nearly \$337 billion, more than three times as much.¹¹ As a result, our trade deficit with China has nearly quadrupled since 2001. Even though China accounted for less than eight percent of our exports to the world in 2013, it accounted for 19 percent of our imports and half of our trade deficit.¹² Our imbalanced trading relationship with China is thus one of the leading drivers of our growing overall trade deficit, which reached \$637 billion last year.¹³

As imports continue to outpace exports, American jobs are eliminated, our manufacturing sector weakens, critical technologies and know-how are lost, and communities across the nation suffer. Correcting this large and growing trade imbalance should be a top priority for policy makers, and addressing our trade deficit with China is a critical element of any such strategy. Ensuring that China abides by its international commitments and that our trade laws are effectively enforced are absolutely essential to addressing this growing threat to our economy and security.

II. Assessment of Enforcement Efforts

The Obama Administration has taken numerous important steps to try to address our trade imbalance by enforcing our trade remedy laws as well as the rules that China agreed to when it joined the WTO. The Administration enforced the China-specific safeguard mechanism

¹⁰ This testimony is submitted in the author's personal capacity and not on behalf of the firm or its clients.

¹¹ Import and export statistics are from USITC Dataweb. Imports are general imports; exports are total exports.

¹² *Id.*

¹³ *Id.*

for the first time in order to stem a surge in imports of passenger car tires from China. It also accepted a section 301 petition challenging China's trade and investment policies in the green technology sector, leading to a range of enforcement actions on behalf of the sector. The Administration has also filed eight requests for consultations with China at the WTO since 2009, covering issues ranging from export restraints on critical raw materials, prohibited subsidies to wind power equipment manufacturers and auto parts producers, the misuse of trade remedies, and restrictions on electronic payment services. The Administration has also pressed China on its lack of transparency at the WTO, and, in 2011, filed a counter-notification at the WTO subsidy committee to prod China into more timely and comprehensive disclosure of its subsidy programs.

The Administration has also secured numerous commitments from China to open its trade and investment regime and bring it into compliance with WTO rules through bilateral consultations. According to the GAO, since 2009 the U.S. has secured 75 trade and investment commitments from China through the U.S.-China Strategic and Economic Dialogue (S&ED) and 92 such commitments through the U.S.-China Joint Commission on Commerce and Trade (JCCT) (these totals include reiterations of prior commitments).¹⁴ Though these commitments are valuable steps towards removing distortions in our trading relationship, most of them do not include timeframes for completion, and there is no single system across the U.S. government for tracking China's compliance with these commitments.¹⁵

Despite these efforts, violations continue and our trade relationship grows more lopsided each year. In its most recent report on China's compliance with its WTO commitments, the U.S. Trade Representative (USTR) identified a wide range of areas in which China's compliance with WTO rules is lacking, including WTO-illegal and trade-distorting subsidies, discrimination against U.S. goods, services, and technologies, localization requirements, and inadequate protections for intellectual property rights. In many cases, effective action to address these violations is stymied by a continued lack of transparency in the Chinese legal system and, in some cases, an unwillingness of private actors to come forward with information for fear of retaliation. Combined with tight enforcement resources, these obstacles make it particularly difficult to bring enforcement actions against violations that involve complex factual situations on the ground in China. As a result, many of the WTO challenges the U.S. has brought are based on facial violations of WTO rules. While these violations certainly need to be addressed, mere repeal of a facially prohibited law or regulation is often not enough to ensure that U.S. companies and workers can compete on a level playing field in fact.

In other cases, the Administration has opted to pursue bilateral dialogue to resolve problems that could arguably be the subject of successful WTO challenges. This may be because the violation at issue would be complex to prosecute or is politically sensitive. For example, China provides tens of billions of dollars in export credits that do not appear to comply with global rules. U.S. ExIm Bank estimates China's export credits may near \$100 billion – triple the amount provided by the U.S. – and it has concluded that China's export financing does not

¹⁴ United States Government Accountability Office, U.S. China Trade: United States Has Secured Commitments in Key Bilateral Dialogues, but U.S. Agency Reporting on Status Should Be Improved, GAO-14-102 (Feb. 2014).

¹⁵ *Id.*

comply in practice with the terms of the *OECD Arrangement on Export Credits*.¹⁶ Export credits that do not comply with the terms countries agreed to in the *OECD Arrangement* are prohibited subsidies under WTO rules.¹⁷

Rather than challenging China's export credits at the WTO, however, the U.S. is negotiating with China to agree to "international guidelines" for official export credits that, while "consistent with international best practices," also "tak[e] into account varying national interests and situations."¹⁸ While the negotiations were originally intended to result in agreement by 2014, no final agreement has been announced to date. Moreover, the most recent public statements regarding the negotiations suggest that any agreement may now be limited to certain sectoral guidelines for ships and medical equipment.¹⁹

Similarly, the current Administration, like those before it, has opted to address China's continued manipulation of its currency through dialogue and consultation rather than enforcement action. Currency manipulation allows China to export goods at artificially low prices and artificially inflate the price of the goods it imports, putting U.S. workers and companies at a profound disadvantage. The U.S. could challenge these practices at the WTO, claiming that the undervaluation of China's currency: (1) constitutes a prohibited export subsidy within the meaning of various GATT articles and WTO Agreements; (2) violates GATT Article XV:4; (3) violates GATT Article II:3; and (4) nullifies and impairs benefits accruing to the United States. The WTO and IMF were designed to operate as a coherent, rules-based system to prevent and redress exactly the type of trade-distorting currency practices that China is currently engaged in, and the U.S. should use those rules to the furthest extent possible.

In addition, the Administration has refused to take action against currency undervaluation in countervailing duty investigations, even though American industries harmed by Chinese imports have shown that the practice meets the statutory criteria for a countervailable subsidy. While the Administration has the authority to countervail currency undervaluation under the current law, Congress should enact the Currency Exchange Rate Oversight Reform Act of 2013 to clarify that fact and ensure that industries and workers that continue to be harmed by this unfair trade practice can obtain relief. The Administration has also not taken advantage of provisions in the law which allow it to self-initiate antidumping and countervailing duty investigations; self-initiation can be a valuable tool where domestic industries and workers are fragmented or otherwise lack the ability to petition for trade relief.

Finally, there are areas where the current rules are simply inadequate to allow the U.S. to take action to address issues that distort our trade with China. One such substantive issue is the unequal treatment of direct and indirect taxes under WTO rules. This unequal treatment allows China to rebate its Value Added Tax (VAT) on its exports, even those to a country that does not use a VAT system, the most important of which is the United States. In addition, even though the U.S. does not rebate taxes on goods we export, those goods are subject to China's VAT tax

¹⁶ Export-Import Bank of the United States, *Report to the U.S. Congress on Export Credit Competition and the Export-Import Bank of the United States* (June 2013) at 18.

¹⁷ Agreement on Subsidies and Countervailing Measures, Annex I, item (k).

¹⁸ U.S. Department of the Treasury, "Joint U.S.-China Economic Track Fact Sheet - Fourth Meeting of the U.S. China Strategic and Economic Dialogue (S&ED)," (May 4, 2012).

¹⁹ U.S. Department of the Treasury, "Joint U.S.-China Economic Track Fact Sheet – Fifth Meeting of the U.S.-China Strategic and Economic Dialogue" (July 12, 2013).

when they enter China. Based on 2013 imports and exports and a standard China VAT rate of 17%, this differential tax treatment conferred a nearly \$75 billion benefit on Chinese exports to the U.S., while imposing more than \$20 billion in taxes on U.S. exports, resulting in a total distortion to our trade relationship of \$95 billion in the past year alone.

Where current rules perhaps fall farthest short, however, is in the procedures that exist for monitoring and enforcing compliance. The WTO compliance apparatus, even if it were invoked as vigorously and consistently as possible, is simply not adequate to effectively address the scale and complexity of the known and unknown violations that continue in China. The WTO system is based on the premise that Member's legal systems are transparent, that rule of law prevails, and that Members will endeavor to bring themselves into compliance or endure retaliation once it is clear that a violation has occurred. The Chinese system, however, is far from transparent and the rule of law is far from prevalent. The Chinese government, moreover, appears willing to engage in blatant violations of WTO rules for as long as possible if those violations are of strategic and economic importance to China, regardless of whether or not such violations undermine the rules-based system. In addition, even where the current system is adequate to reveal and redress violations, it often takes years to do so, years in which our trade deficit continues to balloon, American jobs continue to be lost, and our industries continue to grapple with unfair competition.

Policymakers should therefore consider whether the U.S. should try to pursue the creation of enhanced enforcement mechanisms that are more suited to China's unique economic and legal system. While China would have to agree, through negotiations, to be subject to such procedures, their adoption could help the U.S. reap much more of the benefits we bargained for when China joined the WTO in 2001. Additional enforcement mechanisms may include independent monitoring and assessment of compliance in some areas, particularly technical areas, on a more rapid and consistent basis than can currently be achieved in WTO committees and dispute proceedings. It may also include more automatic penalties for violations in order to create stronger incentives to come into compliance. Another possible option would be to agree to quantitative targets that would demonstrate progress towards a more balanced trade relationship, perhaps based on independent empirical studies regarding the trade flows that would be expected in an environment of full compliance. Such objective, quantitative targets should be easier to monitor and enforce than existing commitments, and their achievement could provide very tangible benefits to U.S. industries and workers.

III. Conclusion

China is our largest trading partner, and continued violations by China distort trade and investment, contribute to our growing trade deficit, harm U.S. producers and workers, and undermine innovation. The Administration has made significant strides in its China enforcement efforts in recent years, and those efforts are paying off in successful WTO dispute settlement outcomes and negotiated commitments obtained bilaterally from China. As China's role in the world trading system continues to grow, however, its responsible compliance with the rules of the road remains sorely lacking.

There are a number of steps the U.S. could take to improve enforcement on its own, such as countervailing currency undervaluation, improving tracking of JCCT and S&ED commitments, devoting the resources to mount more fact-intensive and complex WTO challenges, and self-initiating trade remedy cases where fragmented domestic industries are unable to do so. However, over the long term, the effectiveness of even the most aggressive

enforcement efforts is hampered by the current structure of the WTO's monitoring and dispute settlement apparatus. The U.S. should consider ways in which these enforcement tools can be strengthened to address the unique challenges posed by China's system.

**OPENING STATEMENT OF DR. PHILIP I. LEVY
SENIOR FELLOW
THE CHICAGO COUNCIL ON GLOBAL AFFAIRS**

DR. LEVY: Thank you very much, Mr. Chairman, Vice Chairman, members of the Commission.

I appreciate the opportunity to appear before you today and to discuss the economic challenges between the United States and China. It is an exceedingly important topic, and one that I think provides fertile ground for careful economic reasoning.

In my written testimony, I address both the effects of the U.S.-China economic relationship on jobs and some questions of enforcement. Given time constraints, I'll confine my remarks now to enforcement and negotiation strategy, but, of course, I'd be glad to answer questions on any aspect that should interest you.

On enforcement and the rules of trade, and how we set these rules between the United States and China, even if trade with China has on balance been beneficial for the U.S. economy, there are ample sources of concern about certain Chinese behaviors. The United States can be harmed by Chinese trade barriers, by the theft of intellectual property, or by predatory pricing practices.

This naturally raises questions about how the United States can pursue its interests in negotiations and enforcement actions.

I'll focus on two broad approaches and try to contrast them: a unilateral approach in which the United States attempts to influence Chinese behavior through its domestic laws and bilateral talks and a more multilateral approach in which rules are set among multiple participants.

A unilateral approach has the great virtue that it allows U.S. negotiators to pursue whatever set of objectives they choose. There is no need to compromise and build a consensus with other participating countries.

This is the approach the United States has pursued through a series of bilateral dialogues with China, including the JCCT, the Strategic Economic Dialogue, and its successor, the S&ED.

In a recent study, the GAO identified 298 trade and investment commitments made by China through these dialogues since 2004. While interesting, it's difficult to tell what that tally signifies. To make a meaningful statement, one would have to have a measure of the scope of each commitment--commitments could have widely varying economic impacts--and an assessment of whether the promises had been fulfilled. The GAO study had particular difficulty on the latter part and called for better tracking.

One reason this particular approach may not have yielded all that

we might have hoped is that China's incentive to comply is significantly less than it would be in the multilateral setting.

Prior to 2008, there was, to some extent, a dynamic by which China might accede to U.S. demands as a student might accept instruction from a more accomplished teacher. Subsequent to the global financial crisis, this dynamic was lost. That left a more straightforward bargaining environment between the two countries. In such an environment, the United States could induce China to change either by offering concessions in turn or by threatening retaliation for failure to accommodate U.S. concerns.

In terms of concessions, the United States has been relatively reluctant to yield on issues such as permitting the export of high technology products, relaxing security constraints on Chinese FDI into the United States, or granting China market economy status.

With little to offer, it is hardly surprising that the United States should receive polite but modest concessions in return. This does leave the option of pursuing U.S. interests with China through threats of retaliation. It is an option that received heightened interest amid accusations of currency manipulation and suppression of global demand.

There are at least two serious downsides to such a course of action. First, this approach likely misreads Chinese politics. On issues such as the undervaluation of Chinese currency, there have been vigorous debates within China. There are strong arguments it would be in China's own interest to appreciate the renminbi, which I believe to be true. Whatever the merits of this policy choice, however, if it is perceived as succumbing to U.S. intimidation, it will garner new opposition from Chinese nationalists.

The optimal U.S. strategy should be one that understands political dynamics and furthers our national interests, not one that bolsters the opposition.

Second, the danger is that without the structure and impartiality of the World Trade Organization, such a conflict could escalate into a damaging trade war. Some advocates suggested the United States could win such a war. After all, if we value exports over imports, does the bilateral trade deficit not suggest that China has more to lose than the United States?

This reasoning fundamentally misunderstands modern international trade. Modern manufacturers distribute production through global value chains. Breakdowns in those production chains damage not just the consumers of final goods but producers as well.

We saw a demonstration of this when the Japanese earthquake and the Fukushima nuclear disaster resulted in the closure of key parts factories. The result was not a shift in demand to U.S. producers; it was serious trouble and closure for U.S. factories missing key parts. A strategy that would inflict serious damage on U.S. consumers and producers should have very limited appeal.

An alternative approach is to work through multilateral institutions. The WTO offers the advantage of a well-developed dispute settlement mechanism. The United States has used this system 15 times to

press cases against China. That number certainly understates the benefits the United States has derived from the system since the threat of a WTO case can suffice to resolve a concern.

The system also has the virtues of legitimacy and impartiality. The rules are agreed by consensus and dispute decisions are made by panels of experts from third countries. This dramatically reduces the likelihood that a charged bilateral political relationship will inflame a dispute.

Further along these lines, the WTO dispute settlement approach prevents disputes from escalating by specifying a set level of retaliation should an offending party prove unwilling to bring its practices into line with its WTO commitments. If we consider China's incentives to make concessions and to comply with decisions in the WTO system, they are relatively high. The benefits to China of being a member in good standing of the WTO extends throughout its global trading relationships.

The downside of addressing U.S. concerns through a multilateral approach is that it has proven exceedingly difficult to reach a consensus on new agreements. The Doha Development Agenda was launched in 2001 with the goal of wrapping up within a few years. It has yet to conclude.

The Obama administration is to be commended for concluding a deal in Bali in December 2013, but that agreement covered a small fraction of the issues that were on the initial agenda and an even smaller fraction of the issues that would be on an agenda if it were to be created anew in 2014.

When the United States pushes to address concerns in multilateral settings, be it the WTO or the TPP, it must necessarily reach compromises with other countries who perceive their interests differently.

In sum, a multilateral approach requires accommodation of partner country interests and patient effort but substantially greater rewards. A unilateral approach frees the United States to make whatever demands it pleases but offers distinctly limited prospects of success.

To conclude, the United States faces some important choices as it constructs the agenda for this diplomacy. I would suggest that a multilateral approach, while fraught with difficulties, is more likely to be successful in achieving U.S. aims. This does not mean that the bilateral dialogues are worthless. Communication is valuable, and there have been some results--just that we should be realistic in our expectations and our strategy.

As we pursue bilateral talks, we need to be judicious in the prioritization of our requests and match asks with commensurate offers. Wherever possible, we should make the case that the changes under discussion are beneficial for both the United States and for China.

Thank you.

**PREPARED STATEMENT OF DR. PHILIP I. LEVY
SENIOR FELLOW
THE CHICAGO COUNCIL ON GLOBAL AFFAIRS**

February 21, 2014

Philip I. Levy, Ph.D.

Senior Fellow on the Global Economy, The Chicago Council on Global Affairs

Testimony before the U.S.-China Economic and Security Review Commission

Hearing on “U.S.-China Economic Challenges”

Chairman Shea, Vice Chairman Reinsch, and members of the Commission, thank you for the opportunity to appear before you today and discuss the economic challenges between the United States and China. It is an exceedingly important relationship. The vigorous public debate it has inspired provides fertile ground for careful economic reasoning.

With your indulgence, I would like to divide my remarks into two parts. First, I would like to take on some of the questions surrounding the effects of China trade on the number and composition of U.S. jobs. Second, I would like to address the ways the United States has pursued its interests in economic negotiations with China over trade rules.

China Trade and Jobs

It is hard to think of an economic policy question more pressing than the quality and quantity of jobs. The United States is suffering from a tepid economic recovery and the unemployment rate remains at an elevated level. The jobs picture looks even worse when one considers alternative measures, such as the labor force participation rate. Further, even among the employed, there have been steady shifts away from the sort of manufacturing jobs that have traditionally offered workers a stable middle class income.

If we had a firm grasp of the forces driving these changes, we might be in a better position to take remedial action. Unfortunately, such a firm grasp requires some very difficult disentangling. There are long term trends and short-term shocks that interweave to determine labor market outcomes. In an imaginary world of omnipotent economists – scary, I know – we could isolate the effects of individual changes by running history through both with and without. Thus, we could compare the experience of the last two decades with an alternate world in which Deng Xiaoping had never experimented with openness and China had remained largely closed to trade. In this alternate history, we could imagine that many things would be different. China would not have played the major role that it did in key industries such as electronics, or textiles and apparel. That could have meant that U.S. businesses in those sectors would have flourished. Or perhaps it would have meant that Mexican or Korean firms would have flourished and U.S. businesses would have been no better off. In this alternative history, U.S. consumers would have faced higher prices and thus enjoyed lower real incomes. U.S. inventors and entrepreneurs would have found it more costly to turn their visions into products. We could look and see what all that

would have meant for the U.S. economy and employment.

I raise this scenario not just because of an excessive exposure to science fiction in my youth. Instead, it holds out an ideal for what a pure analysis might look like. We cannot possibly conduct such an analysis, but the idea can highlight the pitfalls of some of the shortcuts that have become popular.

The most popular – and deeply flawed – shortcut is to equate a given value of trade with jobs. It is understandably tempting. Not only do we have ample data on trade flows, but we have often had that data broken down by trade partner and commodity. If we could only construct a simple multiplier, we could jump right from this abundant data to predictions about jobs gained (exports) or lost (imports). Here one sees numbers such as that put forward by the U.S. Department of Commerce: \$1 billion dollars of exports associated with 6,000 jobs.²⁰

There is some sophistication behind the generation of these numbers. Both the Commerce Department (2010) and Scott (2012) use input-output matrices.²¹ Rather than simply assuming that automobiles and t-shirt manufacturing use workers the same way, such a matrix allows each sector to employ workers at its own distinct rate. It is still averaging, but a collection of averages, rather than a single crude one.

There are at least two major pitfalls to this approach to estimation. The Department of Commerce is careful to describe the number of jobs “associated” with exports. This is a way to address the key challenge of *marginal vs. average*. The numbers provided are averages, but for policy, people generally want to know marginal effects. Policymakers are more likely to ask: if the U.S. imported \$1bn less, how many more jobs would the country have? The answer need have nothing to do with averages. To see this, just think of a factory operating below full capacity. For that factory, we might calculate that every \$1 million of orders is associated with 6 employees. But an additional \$1 million of output would not necessarily require the hiring of 6 more workers. Even if the firm needed to increase the hiring of assembly line workers proportionally, it would not necessarily need to hire additional accountants, janitors, or human resources staff (though those workers would have shown up in the averages).

The second great pitfall is the assumption that everything else holds constant. That rarely happens. In 1900, farmers made up 30.7% of the U.S. labor force. In 2000, farmers made up 2.4% of the labor force.²² If there were no other adjustments, this alone would seem to imply an unemployment rate of roughly 40 percent. Yet the actual unemployment rate was 4.0%. Clearly there were other important shifts going on. These kinds of shifts occur not only over the broad sweep of history, but in the short term as well. Countries have “balance of payments” constraints, in which financial transactions have to offset trade in goods and services. If there were to be a

²⁰ This is the number that emerges from U.S. Department of Commerce, “Exports Support American Jobs,” International Trade Research Report No. 1, May 2010. <http://trade.gov/publications/ita-newsletter/0510/exports-play-vital-role-in-supporting-us-employment-0510.asp>

²¹ Scott, Robert (2012), “The China Toll,” EPI Briefing Paper #345, August 23, 2012. <http://www.epi.org/publication/bp345-china-growing-trade-deficit-cost/>.

²² Carter, Susan B. (2005), “Labor Force,” in Susan B. Carter, Scott S. Gartner, Michael Haines, Alan Olmstead, Richard Sutch, and Gavin Wright, eds., *Historical Statistics of the United States, Millennial Edition*. New York: Cambridge University Press, 2005. <http://economics.ucr.edu/papers/papers04/04-03.pdf>

large decrease in the value of U.S. imports from China, it would have to be offset either by an increase in imports from elsewhere, a decrease in U.S. exports, or a decrease in the amount that the United States borrows from abroad. Any of these shifts would have repercussions.

Scott (2012) effectively assumes away all such adjustment. Thus, any imports that do not come from China are assumed to be replaced with U.S. production. How realistic is this? It flies in the face of recent experience. From 1999 to 2012, China's share of U.S. imports of goods and services increased from 7.4% to 17.4%. Over that same time period, the Asia-Pacific's share of U.S. imports of goods and services stayed essentially constant (an increase from 35.9% to 36.0%).²³ Thus, China's rise as an exporter to the U.S. was achieved substantially by displacing its Asian neighbors. Presumably, any thought experiment that removes China from this experience should think very carefully about what would happen with those same displaced neighbors.

This is particularly true because we know that bilateral trade data contains an important distortion – it does not measure *value-added*, just the *final value* of goods. Thus, if a good were made entirely in Malaysia in 1999, it would have entered U.S. import statistics as a Malaysian good. If, a few years later, 90 percent of the value of that good was still produced in Malaysia, but the final 10 percent of the value was added in China, it would have entered U.S. import statistics as a Chinese good. This would have dramatically overstated the impact of trade with China. Nor is this just a theoretical possibility – the ability to take on bite-sized pieces of production was an important means by which China developed its export prowess. Kee and Tang (2013) find that from 2000 to 2006, the domestic value added ratio of China's processing exports rose from 49% to 58%.²⁴

More careful analyses try to account for at least some of these secondary effects using econometric analysis. They also move from exogenous changes in levels of trade to a more practical linkage to actual policy measures.²⁵ Ray Fair, of Yale University, uses a macroeconomic model to consider the likely impact of an appreciation in China's currency on U.S. employment. His findings demonstrate the importance of secondary effects:

“The results show that a yuan appreciation has little effect on U.S. output. The main positive effect is that U.S. imports fall—mostly imports from China. But there are two negative effects that roughly offset this positive effect. The first is that the yuan appreciation leads to a decrease in Chinese output, which has a negative effect on Chinese imports, some of which are from the United States. The second is that the rise in U.S. import prices (from the rise in Chinese export prices) leads to an increase in U.S.

²³ Author's calculations from Bureau of Economic Analysis data. <http://bea.gov/international/index.htm>. The Asia-Pacific region, of course, includes China.

²⁴ Kee, Hiau Looi, and Heiwai Tang, “Domestic Value Added in Chinese Exports: Firm-level Evidence,” mimeo, April 2013.

²⁵ The work of Pierce and Schott (2014) seems to fall in between these categories. They associate actual changed employment in the United States with a hypothetical (but highly unlikely) increase in U.S. tariffs against China – the tariffs that would have applied had the United States not granted China Permanent Normal Trade Relations *and* had it not just rolled over existing Normal Trade Relations as it had done for more than a decade. It is not clear how to interpret this correlation. Pierce, Justin R.; Schott, Peter K. (2014), “The Surprisingly Swift Decline of U.S. Manufacturing Employment,” CESifo Working Paper, No. 4563. <http://hdl.handle.net/10419/89626>

domestic prices. The increase in U.S. domestic prices results in a decrease in real wealth and real wages, which have, other things being equal, a negative effect on U.S. aggregate demand and output.” Fair (2014, p. 23)²⁶

When discussing manufacturing job loss, it is particularly important to consider other potential explanations. It is true that China’s burgeoning share of U.S. imports coincided with a sharp drop in U.S. manufacturing employment as a percent of total, from 14.4% in 2000 to 10.1% in 2010.²⁷ This might seem to indicate a causal relationship. Yet consider the broader context: U.S. manufacturing employment share had been 24.8% in 1973 – the vast bulk of the drop occurred before China’s rise. Nor was this solely a U.S. phenomenon. The United States fall in manufacturing employment share from 1973-2010 was 14.7 percent, while the average fall across 9 advanced economies was 14.3 percent. Lawrence and Edwards (2013) conclude:

“We do not claim that international factors do not affect manufacturing... Over the long run, however, absent new product innovations, or a shift in consumer preferences, the basic forces leading to the declining share of manufacturing in overall employment are unlikely to abate. Just as rapid farm productivity growth combined with a limited demand for food has led to ever smaller shares of employment in agriculture, the combination of relatively rapid productivity growth and limited demand growth for goods will mean that more of the jobs in the future will be in services.” (p. 3)

Forces such as productivity growth are much more difficult to control than tariff levels or exchange rates. For practical purposes, the most fruitful approach is to focus analysis on the policy levers available to the United States and to China. My initial, alternative-history scenario was one in which China never opened itself up to trade. That was one policy option open to the Chinese, albeit an extreme one. Useful policy analyses of the U.S.-China economic relationship should be based on policies that China might plausibly adopt. Even if one strongly believes that a major Chinese currency appreciation would raise the well-being of U.S. workers, there is the essential question of how one can reap those benefits. How quickly could China actually boost the RMB without triggering counterproductive economic turmoil?²⁸

Enforcement and Rules

Even if trade with China has, on balance, been beneficial for the U.S. economy, there are ample sources for concern about certain Chinese behaviors. The United States can be harmed by Chinese trade barriers, by the theft of intellectual property, or by predatory pricing practices. This naturally raises questions about how the United States can pursue its interests in negotiations and enforcement actions. As a way to shed light on the issue, this section offers some distinctions that can separate productive approaches from ineffectual ones. The section

²⁶ Fair, Ray (2014), “Reflections on Macroeconometric Modeling,” January 2014.

<http://fairmodel.econ.yale.edu/rayfair/pdf/2013a.pdf>

²⁷ Figures are from Robert Z. Lawrence and Lawrence Edwards (2013), “U.S. Employment Deindustrialization: Insights from History and the International Experience,” Peterson Institute for International Economics Policy Brief Number PB13-27, October 2013. Table 1, p. 9. <http://www.iie.com/publications/pb/pb13-27.pdf>

²⁸ I developed this argument in Levy, Philip I. (2010), “[U.S. Policy Options in Response to Chinese Currency Practices](#),” House Committee on Ways and Means, March 24, 2010.

concludes with a consideration of China's record in accommodating U.S. economic concerns.

Distinction #1: Actual vs. Aspirational Rules

When China acceded to the World Trade Organization in 2001, it agreed to an extensive range of commitments that had been negotiated over the previous 15 years. China committed to drop barriers, permit investments, and adopt global rules across a range of sectors. As extensive as these commitments were, they did not cover every economic concern that trading partners might have. This incompleteness reflected the incompleteness of the WTO agreements to which China was acceding. In some cases this incompleteness reflected unfinished work by global negotiators; in other cases it reflected serious disagreements between countries that precluded strong rules. Two examples –in areas of actual controversy – can illustrate the point.

Currency.

GATT Article XV addresses “Exchange Arrangements.”²⁹ Paragraph 4 says: “Contracting parties shall not, by exchange action, frustrate the intent of the provisions of this Agreement...” This would seem to forbid the manipulation of exchange rates to counteract trade liberalization commitments. But the clause is exceedingly vague and refers all questions to the International Monetary Fund. It is the economic equivalent of a law that says “Don’t misbehave.” It is either unenforceable or it is a grant of enormous discretion to a judicial process to fill in the blanks. Chinese currency practices may deviate from those the United States would favor, but it is very difficult to point to clear agreed-upon rules that they contravene.

Subsidies.

The World Trade Organization puts some limits on the use of subsidies, but the determination of which subsidies are prohibited and which are permitted can be frustratingly complex.³⁰ There are clear examples of prohibited measures – subsidies directly linked to export performance. Then there are principles that help determine whether a subsidy is problematic. Most importantly, the agreement covers “specific” subsidies – those that apply only to a particular industry or group. This restriction would seem to exempt broad subsidies, such as general macroeconomic policies, public education, or infrastructure. The United States may have legitimate concerns about Chinese subsidy practices that are general rather than specific, but these are not covered by the existing agreement on subsidies.

The point of the distinction is that existing trade law does not forbid every trade practice that may harm U.S. interests. In considering the efficacy of the current system, enforcement questions should be posed only about objectives clearly covered by existing agreements. For concerns not covered by agreed-upon rules, the appropriate questions concern effective negotiating strategies.

Distinction #2: Unilateral vs. Multilateral Approaches

The United States has pursued its economic objectives with China through multiple approaches. The United States was a leader in establishing the multilateral trading system under the WTO

²⁹ http://www.wto.org/english/docs_e/legal_e/gatt47_01_e.htm - articleXV

³⁰ http://www.wto.org/english/tratop_e/scm_e/scm_e.htm

and in negotiating China's accession to that body.³¹ The United States is currently engaged in discussions among 12 trading nations across the Asia-Pacific to establish a Trans-Pacific Partnership (TPP) that would set new standards on topics like the treatment of State-Owned Enterprises. While China is not a party to those talks, the successful implementation of new standards would have an inevitable influence on the evolution of future rules.³²

In parallel, the United States has pursued a series of bilateral dialogues with China, including the Joint Commission on Commerce and Trade (JCCT), the Strategic Economic Dialogue (SED), and its successor the Strategic & Economic Dialogue (S&ED). In a recent study, the General Accounting Office identified 298 trade and investment commitments made by China since through these dialogues since 2004.³³ While interesting, it is difficult to tell what that tally signifies. To make a meaningful statement, one would have to have a measure of the scope of each commitment – commitments can have widely varying economic impacts – and an assessment of whether the promises had been fulfilled. The GAO study had particular difficulty on the latter point and called for better tracking.

Each approach to negotiation offers its own costs and benefits. The WTO offers the advantage of a well-developed dispute settlement mechanism. The United States has used this system 15 times to press cases against China.³⁴ That number certainly understates the benefits the United States has derived from the system, since the threat of a WTO case can suffice to resolve a concern. The system also has the virtue of legitimacy and impartiality – the rules are agreed by consensus and dispute decisions are made by panels of trade experts from third countries. This dramatically reduces the likelihood that a charged bilateral political relationship will inflame a dispute. Further, along these lines, the WTO dispute settlement approach prevents disputes from escalating by specifying a set level of retaliation, should an offending party prove unwilling to bring its practices into line with its WTO commitments. If we consider China's incentives to make concessions and to comply with decisions in the WTO system, they are relatively high. The benefits to China of being a member in good standing of the WTO extend throughout its global trading relationships.

The downside of addressing U.S. concerns through a multilateral approach is that it has proven exceedingly difficult to reach a consensus on new agreements. The Doha Development Agenda was launched in 2001 with the goal of wrapping up within a few years. It has yet to conclude. The Obama administration is to be commended for concluding a deal in Bali in December, 2013, but that agreement covered a small fraction of the issues that were on the initial agenda – and an even smaller fraction of the issues that would be on an agenda if it were to be created anew in 2014. When the United States pushes to address concerns in multilateral settings, be it the WTO or the TPP, it must necessarily reach compromises with other countries who perceive their

³¹ Note that many of the measures that are unilateral in implementation, such as Anti-Dumping and Countervailing Duty procedures, are shaped by WTO agreements governing their use.

³² This idea is developed in Levy, Philip I. (2013) "Bargains among Behemoths: TPP and TTIP Implications for Developing Countries," October 4. SSRN Working Paper *forthcoming*.

³³ General Accounting Office (2014), "U.S.-China Trade: United States Has Secured Commitments in Key Bilateral Dialogues, but U.S. Agency Reporting on Status Should Be Improved," GAO-14-102, February 2014. <http://www.gao.gov/assets/670/660824.pdf>

³⁴ United States Trade Representative (2013), "2013 Report to Congress on China's WTO Compliance," December. <http://www.ustr.gov/sites/default/files/2013-Report-to-Congress-China-WTO-Compliance.pdf>

interests differently.³⁵

In contrast, a unilateral approach allows U.S. negotiators to pursue an unfiltered set of objectives. However, China's incentive to comply is significantly less than it would be in the multilateral setting. Prior to 2008, there was, to some extent, a dynamic by which China might accede to U.S. demands as a student might accept instruction from a more accomplished teacher. Subsequent to the global financial crisis, this dynamic was lost. That left a more straightforward bargaining environment between the two countries. In such an environment, the United States could induce China to change either by offering concessions in turn, or by threatening retaliation for failure to accommodate U.S. concerns. In terms of concessions, the United States has been relatively reluctant to concede on issues such as permitting the export of high technology products, relaxing security constraints on Chinese FDI into the United States, or granting China "market economy" status. With little to offer, it is hardly surprising that the United States should receive polite but modest concessions in return.

This does leave the option of pursuing U.S. interests with China through threats of retaliation. It is an option that received heightened interests amidst accusations of currency manipulation and suppression of global demand. There are at least two serious downsides to such a course of action.

First, this approach likely misreads Chinese politics. On issues such as the undervaluation of the Chinese currency, there have been vigorous debates within China. There are strong arguments that it would be in China's own interest to appreciate the RMB. Whatever the merits of this policy choice, if it is perceived as succumbing to U.S. intimidation, it will garner new opposition from Chinese nationalists. The optimal U.S. strategy should be one that understands political dynamics and furthers our national interests, not one that bolsters the opposition.

Second, the danger is that without the structure and impartiality of the WTO, such a conflict could escalate into a damaging trade war. Some advocates suggested that the United States could win such a war – after all, if we value exports over imports, does the bilateral trade deficit not suggest that China has more to lose than the United States? This reasoning fundamentally misunderstands modern international trade. Modern manufacturers distribute production throughout global value chains. Breakdowns in those production chains damage not just the consumers of final goods, but producers. We saw a demonstration of this when the Fukushima nuclear disaster in Japan resulted in the closure of a key parts factories. The result was not a shift in demand to U.S. producers – it was serious trouble and closure for U.S. factories missing the key parts.³⁶ A strategy that would inflict serious damage on U.S. consumers and producers should have limited appeal.

In sum, a multilateral approach requires accommodation of partner country interests and patient

³⁵ As one example, the U.S. push to include enforceable currency measures in trade agreements was rejected by Canada, normally a staunch ally. See Carmichael, Kevin (2013), "Leave Currency Manipulation out of Trade Talks, Ed Fast Urges," *The Globe and Mail*, September 27, 2013. <http://www.theglobeandmail.com/report-on-business/economy/leave-currency-manipulation-out-of-trade-talks-ed-fast-urges/article14563787/>

³⁶ Clark, Don and Yoshio Takahashi (2011), "Quake Disrupts Key Supply Chains," *Wall Street Journal*, March 12, 2011.

effort, but substantially greater rewards. A unilateral approach frees the United States to make whatever demands it pleases, but offers distinctly limited prospects of success.

Distinction #3: Trade-Specific vs. Economy-Wide Concerns

The discussion above treated negotiating objectives generically. In fact, the likelihood of success in pursuing U.S. objectives with China can vary greatly with the nature of the request. The list of U.S. concerns can easily encompass both some very specific requests (e.g. permission to open a financial services operation in a particular sector or province) and some very general ones (e.g. broad shifts in macroeconomic, SOE, and exchange rate policies). In some cases, it can be difficult to tell the difference. The United States has repeatedly expressed concerns about China's unwillingness to enforce intellectual property rights and has even pressed a case at the WTO. While the Chinese government may be making objectionable decisions in individual IPR cases, this problem also involves a much larger economy-wide issue about the rule of law in China.

There is no reason to prevent United States negotiators from pursuing economy-wide concerns, but as a strategy we must be cognizant that these will be substantially larger "asks." To be effective, they must be coupled either with an explanation why the change would be in China's interest (true in the case of currency) or with a commensurate offer of U.S. policy shifts in exchange.

To conclude, rather than offering any definitive verdict on the effectiveness of U.S. enforcement actions against China, the three preceding distinctions are meant to suggest reasons why some approaches have been more effective than others in the past and are likely to be so in the future.

Conclusion

The United States has a broad range of economic interests in its relationship with the People's Republic of China. Over the last 15 years, China has emerged as a major trading power and it has been a major goal of U.S. foreign economic policy to shape China's role as a constructive member of the international economic community – a responsible stakeholder. This period has also witnessed a continued decline in the share of U.S. employment in manufacturing. While China's emergence as a trading power has played some role, it is important to put it in the context of shifts in manufacturing productivity and the development of other emerging markets.

The assessment of China's effect on the U.S. jobs market plays directly into concerns about the enforcement of trade rules. If we believe that Chinese economic malfeasance is the primary cause of American economic woes,³⁷ then it is natural to look for enforcement remedies. If, however, Chinese practices are a secondary or tertiary cause of low wages or lost jobs, then there is a dual risk to a focus on enforcement. First, it risks distracting from the more important task of creating a well-trained and flexible labor force. Second, it risks provoking economically

³⁷ See, e.g., the "China Cheats" campaign by the Alliance for American Manufacturing. Walker, Charlie (2012), "US: China's Cheating on Trade Rules Undercuts American Manufacturing," *Manufacturing Weekly*, September 18. <http://www.manufacturingweekly.com/us-chinas-cheating-on-trade-rules-undercuts-american-manufacturing/>

damaging disputes that could still leave the initial concerns unaddressed.

Even with the effects of U.S.-China trade put in proper perspective, there will certainly remain a range of concerns that need to be addressed. The United States faces some important choices as it constructs the agenda for this diplomacy. I would suggest that a multilateral approach, while fraught with difficulties, is more likely to be successful in achieving U.S. aims than a unilateral or bilateral approach. This does not mean that the bilateral dialogues are worthless – communication is valuable and there have been some results – just that we should be realistic in our expectations and our strategy. As we pursue bilateral talks, we need to be judicious in the prioritization of our requests and match asks with commensurate offers. Wherever possible, we should make the case that the changes under discussion are beneficial for both the United States and China.

**OPENING STATEMENT OF MR. DAN DIMICCO
CHAIRMAN EMERITUS
NUCOR CORPORATION
AS READ BY MS. EILEEN P. BRADNER
SENIOR DIRECTOR AND COUNSEL
FEDERAL GOVERNMENT AFFAIRS
NUCOR PUBLIC AFFAIRS, INC.**

MS. BRADNER: Thank you, Chairman Wessel, Co-Chair Slane, and members of the Commission.

I'm Eileen Bradner, Senior Director and Counsel for Federal Government Affairs for Nucor Corporation, appearing today for Dan DiMicco, our Chairman Emeritus and former CEO, who was taken ill. Nucor is the largest steel producer and recycler in the U.S.

China's disregard for trade rules is doing significant damage to our economy. The evidence is clear. We lost three million manufacturing jobs over the last decade. Our trade deficit with China last year was 318 billion, the highest ever with a single country.

I'll be blunt. If we do the necessary things to better balance this bilateral relationship, our economy and job creation will change significantly for the better. If we do not, our country will continue to experience economic malaise and anemic growth.

The steel industry provides an excellent example of all the tools China uses to unfairly advantage its companies. Since 2000, China's steelmaking capacity has grown almost tenfold to nearly a billion tons, moving from a net steel importer to the largest exporter in a few short years.

China accomplished this by manipulating its currency in order to drive exports of all manufactured goods and by providing massive subsidies to its industrial companies, many of which are state-owned enterprises.

The government support China's steel companies receive has created a glut of steelmaking capacity. Our open markets make the U.S. the destination of first and last resort for excess steel. As imports surge into our

market, U.S. steelmakers are faced with depressed prices and lost sales.

From an economic perspective, this surge makes no sense. U.S. steel producers are among the lowest-cost in the world. We enjoy clear advantages in almost every aspect of steelmaking, but willful disregard of the rules by China wipes these advantages out.

We know China breaks the rules, yet we have not done enough about it. Our economy and millions of American workers have paid a steep price for our failure to be more aggressive. My recommendation is straightforward: hold China accountable for the commitments it made when it joined the WTO.

Right now, we have few tools at our disposal: mainly, the antidumping and countervailing duty laws. These laws are essential in combating unfair trade, but they are expensive to use and woefully slow. By the time a case can finally be filed, the damage is already done, and even when you do win, there is often rampant cheating that undermines the remedy.

Just look at what China is doing on oil country tubular goods. After they were found guilty of dumping, they shifted minor finishing operations to third-party countries, such as Indonesia, to evade the remedy. This small tweak allowed China to resume pipe and tube shipments to the United States free of duties.

Last week, at the request of the U.S. industry, the Commerce Department made a ruling to close this loophole. Commerce got it right this time, but it took 18 months. We have to do better, and if I know Dan, he would pause here and repeat that again--Commerce got it right, but it took 18 months; we have to do better.

When our own government agencies have discretion, they should be aggressive in enforcing the laws, and our courts have to be there to back them up. These schemes are not limited to steel. They're also doing it in solar panels, forcing the U.S. industry to go to the expense of filing another case when China exploited a loophole that was left in the first remedy.

The reality is our trade laws remain under attack at every turn. China and other countries are continuing to challenge the core of our trade laws, and our federal courts are weakening our ability to discipline the unfair trade. For example, recent court rulings have weakened the Commerce Department's long-time ability to penalize foreign producers if they stiff the Department by failing to participate in an investigation or when they commit outright fraud. This behavior should not be tolerated.

We must be more proactive. The Administration deserves credit for bringing more cases at the WTO to defend U.S. rights and winning them convincingly, but challenges remain. When China joined the WTO, it committed to only operate its SOEs according to commercial considerations and to eliminate export duties on many of its products.

But more than ten years later, we are still waiting for them to comply. We have to be relentless in ensuring these commitments are met.

We also need Congress to act. It should pass the bipartisan

currency legislation empowering U.S. industries to fight back by treating currency manipulation for what it is--an illegal export subsidy.

They should also pass the ENFORCE Act to shut down the use of illegal evasion schemes that are used to avoid lawfully owed duties. From bedsprings to honey, China is cheating and getting away with it.

Part of the reason our trade laws work is because they properly treat China as a non-market, government-run economy. That should not change until China itself changes. So be wary of what some are claiming. There is nothing in the law that requires us to treat China differently after some magic date in 2016.

Talk is cheap. In the 13 years since China joined the WTO, diplomacy has failed to result in significant change in China's behavior. We can no longer afford to be afraid of enforcing the rules of trade for fear of losing access to China's market. It's a one-way street right now. We can continue to be played for fools or we can fight back.

Thank you.

**PREPARED STATEMENT OF MR. DAN DIMICCO
CHAIRMAN EMERITUS
NUCOR CORPORATION**

Testimony before the U.S.-China Economic and Security Review Commission
“U.S.-China Economic Challenges”

Dan DiMicco, Chairman Emeritus & Former CEO, Nucor Corporation
February 21, 2014

Thank you Chairman Wessel, Co-Chair Slane, and members of the Commission for the opportunity to testify before you today on the state of trade enforcement with China. I am Dan DiMicco, Chairman Emeritus and former CEO of Nucor Corporation. Nucor is the largest steel producer and recycler in the U.S. I am also currently on the boards of Duke Energy and the Coalition for a Prosperous America. From 2008 through 2011, I was a member of the U.S. Manufacturing Council.

For more than ten years, I have been warning that China's disregard for trade rules is doing significant damage to our economy. The evidence is clear. We lost 3 million manufacturing jobs over the last decade. Our trade deficit with China last year was \$318 billion, the highest ever with a single country. I'll be blunt: if we do the necessary things to better balance this bilateral trading relationship, our economy and job creation will change significantly for the better. If we don't, our country will continue to experience economic malaise and anemic growth.

The steel industry provides an excellent example of all the tools China uses to unfairly advantage its companies. In 2000, China had roughly the same annual steelmaking capacity as the U.S. – 100 million tons. Today, China's steelmaking capacity is nearly 1 billion tons! They went from a net steel importer to the largest exporter in a matter of years. China accomplished this by

manipulating its currency in order to drive exports of all its manufactured goods, including steel, and by providing massive subsidies to its industrial companies, most of which are state-owned enterprises.

The government support China's steel companies receive has created a glut of steelmaking capacity. Our open markets make the U.S. the destination of first and last resort for excess steel, and as imports surge into our market, U.S. steelmakers are faced with depressed prices and lost sales. From an economic perspective, the steel import surge makes no sense. U.S. steel producers are among the lowest cost producers in the world. We enjoy clear advantages in practically every aspect of steelmaking, but willful disregard of trade rules by China wipes these advantages out.

We know China breaks the rules of global trade, yet we have not done enough about it. Our economy and millions of American workers have paid a steep price for our failure to be more aggressive. My recommendation is straightforward: hold China accountable for the commitments it made when it joined the WTO.

Right now domestic industries have few tools at their disposal, mainly antidumping and countervailing duty laws. Trade cases are expensive to bring and woefully slow. By the time a case can finally be filed, the damage is already done. And even when you win, there is often rampant cheating that undermines the remedy.

Just look at what China is doing on oil country tubular goods. After they were found guilty of dumping, they shifted minor finishing operations to third-party countries such as Indonesia to evade the dumping order. This small tweak allowed China to resume pipe and tube shipments to the United States free of antidumping duties. Last week, at the request of the U.S. industry, the Commerce Department made a ruling that would close this loophole. Commerce got it right this time, but it took 18 months! We have to do better. When our own government agencies have discretion, they should be aggressive in enforcing the law, and our courts should back them up. And these schemes are not limited to steel – they're also doing it in solar panels, forcing the U.S. industry to go to the expense of bringing a second case when China exploited a loophole left in the first remedy.

The reality is our trade laws remain under attack at every turn. China and other countries are continuing to challenge the core of our trade laws in the WTO, and our federal courts are also weakening our ability to discipline unfair trade. For example, several court rulings have weakened the Commerce Department's longstanding ability to penalize Chinese producers when they stiff the Department by failing to participate in an investigation, or when they commit outright fraud. This behavior should not be tolerated!

We must be more proactive. The Administration deserves credit for bringing more cases at the WTO to defend U.S. rights, and winning them convincingly, but challenges remain. When China joined the WTO it committed to only operate its SOEs according to commercial considerations and eliminate export duties on the vast majority of products. More than ten years later, we are still waiting for them to comply. We must be relentless in ensuring these commitments are met.

We also need Congress to act. It should pass the bipartisan currency legislation that empowers U.S. industries to fight back by treating currency manipulation for what it is – an illegal export subsidy! And strong and enforceable provisions addressing currency manipulation should be included in new trade agreements.

Congress should also pass the “ENFORCE” Act, which would shut down the use of illegal evasion schemes foreign producers use to avoid lawfully-owed duties. Allowing evasion schemes to go unchecked is a license to cheat, signed by the U.S. Government. From bedsprings to honey, China is cheating and getting away with it.

Part of the reason our trade laws work is because they properly treat China as a government-run, non-market economy. And that shouldn’t change – until China itself changes. So be wary of what some are claiming -- there is nothing in the law that requires us to treat China differently after 2016.

What I have learned working on trade disputes is that talk is cheap. In the 13 years since China joined the WTO, diplomacy has failed to result in significant change in China’s behavior. We can no longer afford to be afraid of enforcing the rules of trade for fear of losing access to China’s market. No American company has the same access to China’s market that it has to ours. It’s a one-way street. We can continue to be played for fools, or we can fight back.

We would be wise to remember the words of President Reagan who said, “We will vigorously pursue our policy of promoting free and open markets in this country and around the world. We will insist that all nations face up to their responsibilities of preserving and enhancing free trade everywhere. But let no one mistake our resolve to oppose any and all unfair trading practices.”

Thank you.

PANEL II QUESTION AND ANSWER

HEARING CO-CHAIR WESSEL: Thank you and thank you for stepping in for Mr. DiMicco and you were down to perfect timing.

Dr. Wortzel.

COMMISSIONER WORTZEL: Ms. Bradner, thank you very much for stepping in there. As you closed, you said there's nothing in the law that requires us to change the way we treat China and that you apparently feel we should continue to treat them as a non-market economy.

MS. BRADNER: Well, what I mean is they don't automatically become a market economy after 2016.

COMMISSIONER WORTZEL: No, I know they won't, but I thought that somewhere in the WTO Accession Agreement, we had already said that that's going to change in 2016. What alternatives would you suggest so that we can continue to treat the People's Republic of China as a state-run, non-market economy as long as it is that?

MS. BRADNER: Well, I believe that the Accession Agreement does not require us to change the treatment. What it says is that there are criteria for evaluating whether an economy is market or not, and we have to, at that point in time, look at all the indicia of market economy and decide whether their economy meets that criteria, but it's not automatic. The Agreement preserves the non-market economy option.

COMMISSIONER WORTZEL: Thank you.

HEARING CO-CHAIR WESSEL: Thank you.

Let me ask a couple of questions, and, Dr. Levy, it will not surprise you that I disagree with some of what you've said but actually agree with one of the points you made and underlined it: that the appropriate questions concern effective negotiating strategies.

And I think the point you made here, which I think frustrates all of us, and I'll let your other panelists as well as you respond to this, is that we seem to think that other nations have this view of trade rules and what the end point is of the economies that quite frankly differs than others.

So, for example, we argue with the fact that we're not allowed to own more of Chinese companies even though those rules were agreed to as part of the bilateral accession agreement, the multilateral accession agreement. We criticize China for not opening its market to U.S. films, but our negotiators agreed to a cap on U.S. films going into China.

One of the big issues that we have now is the question of what kind of discipline should there be on SOEs, and the TPP is expected to be the first trade agreement with a chapter and disciplines on SOEs, and, presumably since the U.S. has sort of a time-honored tradition of taking their approaches and airdropping them on other negotiations, what we do in the TPP is going to affect the China BIT, our multilateral approach, everything else.

What do you each of you think has to be in a SOE chapter to make it effective? If you as a litigator, Ms. Drake, want to be able to address certain market distorting practices of an SOE, what are you able to prove? What should you have to prove?

And to each of the other participants, those questions. PNTR is already done. You know we got to live with that, and we got to hope that we can do a more effective job through multilateral negotiations. We have a real opportunity now to get it right on SOEs in the TPP and then bring that forward. What should it be?

Dr. Levy, do you want to start since I used your name first?

DR. LEVY: Sure. I'm afraid I won't be able to give you a complete answer of what an SOE policy should be. It's a challenging issue. I would personally and professionally be very much in favor of something that pushed that sort of limited state involvement and pushed for commercial behaviors.

I think the challenge in these negotiations has been we very quickly realize there are defensive interests. We start these discussions owning a fair chunk of General Motors.

HEARING CO-CHAIR WESSEL: Which we no longer--

DR. LEVY: Which we no longer own--but we now realize that every now and then we might, or at least some think that that was strongly in our interests. So does one want to forbid that kind of action? I wouldn't mind doing that myself, but I think these are some of the challenges that come up. That's not a very thorough answer to your question. It is a hard thing to try and say exactly what pure market behavior is.

We have concerns. The U.S. government has expressed concerns about companies like Huawei, even when there is not an explicit ownership relationship, but they work closely or there was a historical relationship. Drawing those bright lines is very difficult. It's important, but I don't envy the negotiators the task.

HEARING CO-CHAIR WESSEL: Well, you criticize in your testimony those who are so concerned with Chinese activities. As I read it, and please correct me if I'm wrong, you think they're in compliance in a lot of ways or they're good at compliance. And I don't argue in many areas where there's been a WTO decision that they have complied with that, whereas, at the same time, there is 99 percent where they haven't complied.

The question is how do we address these negotiating deficiencies and give injured parties sitting on either side of you the ability to make you happy, that when they pursue something, they're right to do it?

DR. LEVY: If I could, I would just distinguish between several points. So I would not say that they've been perfect in compliance by any means, and I hope my testimony didn't come off that way.

HEARING CO-CHAIR WESSEL: No, no, I took it when the WTO acted against them is how I read your comment.

DR. LEVY: So I think that you've got several different categories of things. Two of those are where we actually have established rules that they are violating and this happens.

We do address some of these. We bring WTO cases, and they have been reasonably good, I think, about complying with those. The concerns that were addressed about the difficulty of getting companies to come forward, I think those are very real. So you have another set of instances where there might be an actual problem, but it is very hard to press a case. I think those are real concerns.

I think there is also a very broad area where we would like for there to be rules that govern behavior, but we don't have those rules exactly right now. This is where I think we are on currency. They are doing things that we don't like, and we are upset about that, but we have not yet agreed upon those rules. So that was what I was discussing as negotiating strategy: how do we move to a position where we have rules that we're comfortable with?

HEARING CO-CHAIR WESSEL: Okay. Ms. Drake? Ms. Bradner?

MS. DRAKE: Just quickly, we actually did have fairly strong SOE disciplines that were included in China's Accession Agreement--that

they operate on a commercial basis; that they not discriminate.

HEARING CO-CHAIR WESSEL: Yes.

MS. DRAKE: Unfortunately, those have never been enforced for a variety of reasons. Obviously, TPP provides a great opportunity for us to build on those disciplines. We shouldn't just be recreating what we already haven't enforced. And we should be addressing, especially in the context of an eventual BIT, SOE investment by Chinese SOEs here in the U.S., any anticompetitive or problematic impacts that that may have, but I think as important as the substance of the disciplines themselves is how they are enforced.

There is a lack of transparency so let's require semi-annual reports by independent auditors. Who are the SOEs? What is the ownership structure? What is the basis of their contracts? We can see from limited SEC disclosures that state-owned enterprises like Sinovel in their contracts say: I'm going to buy from you, American company, for now, but under this contract, in ten years you're going to produce everything here if you want me to keep buying from you. That should be disclosed for every SOE.

So we need to set up a better enforcement structure that allows us to bring these cases that are so hard to bring now, both on the existing substantive disciplines we have and on additional disciplines that we need to negotiate.

HEARING CO-CHAIR WESSEL: Would there be anything in U.S. law that would restrict the SEC from requiring that as far as you know? It may need more research, but shouldn't all agencies of government be doing the best within their current authorities?

MS. DRAKE: I think there's a real question about whether more could be done under the materiality standard. I'm a shareholder; I would be interested in knowing if the company I'm investing in is agreeing to requirements like that that are against the commercial interests of the company as a normal commercial investor would see it. That would be material to me.

We only know about examples for small companies where that's a huge part of their business and they disclose the terms of the contracts. But you don't see that disclosure from GE, from General Motors, from others, that from what we can tell from what information is out there likely are agreeing to similar terms that investors should be concerned about and regulators should be concerned about.

HEARING CO-CHAIR WESSEL: Okay. Ms. Bradner, any comments?

MS. BRADNER: Yes. Chairman Wessel, this issue is one that keeps us up at night. The emergence of SOEs and China's go-abroad policy, where they have told their steel industry it's not enough to have built up capacity at home, but we want you to go abroad and build mills in other countries, and they are doing that here in America.

We have invested. This recovery has been quite tepid, very gradual. And, it's slowly improving. We have invested \$7 billion in our

company in America since the beginning of the recession. It's tough to put that kind of money into your company when the recovery has been so weak, but we did it because we're betting on the future.

We want to be ready when this economy takes off to better serve our customers and make new products, but it really is a major worry that these state-owned enterprises are coming here. We can compete with anyone if it's fair, but if you're competing with a government that does not have to cover its costs, does not have to show a profit to its shareholders or its board of directors, it's a big concern.

And so I agree with Elizabeth. We need some kind of an enforceable mechanism that forces these entities to behave on commercial terms, and I think the key is that we can't be required to wait until we show injury before some kind of enforcement mechanism kicks in because that would be a mistake.

HEARING CO-CHAIR WESSEL: Thank you.

Commissioner Reinsch.

VICE CHAIRMAN REINSCH: Thank you.

I'm delighted to hear Commissioner Wessel's enthusiasm for at least one part of the TPP. Maybe if they get that right, you'll support the whole thing. That would be welcomed.

HEARING CO-CHAIR WESSEL: If they get TPP right, yes.

VICE CHAIRMAN REINSCH: I was hoping we would have a lower standard than that, but anyway.

Ms. Drake, you referenced in your comments the idea of potentially beefing up WTO enforcement procedures.

MS. DRAKE: Uh-huh.

VICE CHAIRMAN REINSCH: Which is a noble idea. How likely do you think that is to happen?

MS. DRAKE: Thank you, Commissioner Reinsch.

Obviously, to do it within the WTO itself would require multilateral consensus among all of the WTO members.

VICE CHAIRMAN REINSCH: Right.

MS. DRAKE: And it would be extremely difficult since even trade facilitation was pulling teeth. So I included the recommendation because I think it's a worthwhile one. I think it's probably least likely to happen at the WTO itself, but in any other forum where we are engaged in negotiations with China where we are making concessions we should consider: can we get something on the enforcement side here that applies not only to the obligations in the new agreement, whether a BIT, an eventual FTA, what have you, but also applies to other obligations that China has already undertaken.

So there may be opportunities to have a conversation with China in the context of other negotiations that say we don't feel we've gotten what we already bargained for, and if we're going to bargain for anything else, we're going to change the way that we handle enforcement so that we have more confidence in any new concessions that are made.

VICE CHAIRMAN REINSCH: And so the relevant case would be the BIT negotiation, I presume--

MS. DRAKE: At this point.

VICE CHAIRMAN REINSCH: --where you'd like to have them. Okay. That's very helpful. Thank you.

Dr. Levy, since you're here and since we asked Mr. Scott to stick around, I want to take advantage of the fact that he's done so, which is great, and the fact that you're here and ask if you would like to make a few comments on the thesis that he propounded in the previous panel? Whether you agree with it or not?

DR. LEVY: I would respectfully disagree with many of the major assertions about job loss. As I describe in my written testimony, I think it's a very challenging task because you have to say what are we asking if we sort of ran history over again with China not opening to the world, what would we have? I think you -- in your earlier questioning -- got at some of the key problems.

What we saw, and I referenced these numbers in my written testimony, the share of U.S. imports coming from Asia has held largely constant over a very long period of time. You've seen China's share of U.S. imports go up dramatically. What that suggests is this was not an additional thing, that it involved a degree of substitution. We know from studies that there is a great deal of value-added work. That doesn't necessarily mean that China did nothing. They did, of course, and they accumulated substantial foreign exchange reserves in the process.

But if we want to then try to do careful correlations and say if you took China out of this particular sector, how many U.S. jobs would it create... If China originally took those jobs from Malaysia and we take China out, do we think the jobs would then go to Ohio or to Malaysia? So it's a very difficult task, and I think the use of input-output matrices without considering them in a global context can be highly misleading.

VICE CHAIRMAN REINSCH: Okay. That's very helpful. Thank you. I thought it would be useful to get a contrary view on the record.

Eileen, thank you for being the designated victim on short notice. We appreciate that. We've had these discussions before. As you know, I ran the Senate steel caucus for 17 years. I fought a lot of these battles, some successfully, some not. What I learned then and what I've concluded since is that while the industry has done, I think, an exceptionally good job over a long period of time of making two compelling cases. First, that they're important. We're not talking about clothespins. We're talking about a fundamental element of a manufacturing economy, with all due respect to the clothespin industry. I'm sure somebody is going to tweet me about that.

And, second, that they've been a victim of unfair trade practices as defined not just by us, but by multilateral rules; and not just by China, but virtually everybody if you go back far enough.

They've made that compelling case, and Congress has responded, various administrations have responded in many ways, not always doing what you wanted, but sometimes doing what you've wanted. Yet the record of the industry continues a long-term trend of erosion, I guess would be the best way to put it, certainly in terms of jobs, maybe not in terms of productivity or cost effectiveness, as you pointed out in your own testimony.

That has left me with the conclusion that there are larger macroeconomic forces here that are determining the course of events, and that what we're talking about in this panel, while important-- and I don't yield to anybody in my enthusiasm for enforcing unfair trade practices laws. I had something to do with writing some of these during the Tokyo Round. We're still operating at the margin, or am I wrong about that?

MS. BRADNER: I don't think I would put it that way, and I did enjoy working with you in the Senate many decades ago.

VICE CHAIRMAN REINSCH: Not that many, please.

MS. BRADNER: Okay. Okay.

[Laughter.]

MS. BRADNER: We're only 30; right? But I would say what we're facing right now is global overcapacity in steel, and we have seen this before. But not the United States industry, but some of the foreign countries have overbuilt their steel industries -- many of them with the aid of the government-- and it has created a glut situation, and then combined with a weak recovery and a recession in some areas. The excess steel has to go somewhere, and because we do have free markets here-- we have zero tariffs on many steel products--it comes into the United States.

Some other countries have put up trade barriers. Brazil has doubled their tariffs on steel, just to keep it out during this recovery period, but that's not the American way. We're not going to do that, and so we feel strongly that you have to fight back with what you have, and right now those are the tools we have: the antidumping and countervailing duty statutes.

We've asked the administration to think outside the box about what else can be done to address this problem and to be proactive so that we address it before it's too late.

VICE CHAIRMAN REINSCH: How did the Brazilians get away with that? I mean were they not bound tariffs or was--

MS. BRADNER: Correct. They did not agree to bind their tariffs at a lower rate.

VICE CHAIRMAN REINSCH: Thank you.

HEARING CO-CHAIR WESSEL: Commissioner Fiedler.

COMMISSIONER FIEDLER: Why has no administration, Republican or Democrat, declared China a currency manipulator? All of you? Any of you?

DR. LEVY: Perhaps I can take a stab at it. I think it's because they have each looked at this and decided that it wouldn't be in the U.S. national interests. I think--

COMMISSIONER FIEDLER: But that's not sufficient. Explain

what--

DR. LEVY: I was going to give you a more detailed example.

COMMISSIONER FIEDLER: Okay.

DR. LEVY: Which is that we actually--the current administration--I had some involvement in the 2008 campaign--was very vocal about how they would, in fact. I believe they signed pledges about how they would find China to be a currency manipulator. That was not the campaign I was involved with. We argued that you will find when you get there, should you get there, that this will be counterproductive, that to name someone a currency manipulator, the punishment that ensues is you engage in talks. You're already engaged in talks except now you'd be engaged in talks with an offended, recalcitrant counterpart that looks to be counterproductive.

I think one way you can look at the story of China's currency practices is prior to around 2003, what we were excited about in the United States were bilateral imbalances. But they weren't really matched by global imbalances.

In 2003, China really started running significant global imbalances. They had held to a currency level through the Asian financial crisis when people were actually pushing them in the opposite direction, saying you need to depreciate. They didn't. This is not a novel school of thought, that a developing country should use a currency as an anchor.

What you saw with China was that in 2003 they started thinking they should probably do something about this, but they had a series of concerns. They had an export industry. They didn't have things like forward currency markets. So you had the Bush administration engage in discussions with them, how do you set up forward currency markets so that exporters have some protection against large swings in currencies?

In 2005, they actually did start to appreciate the renminbi. That continued until the global financial crisis. At that point, they got scared, and they froze. They resumed in 2010, and they've been appreciating ever since. We can ask: should they appreciate more quickly? Maybe. But I don't think the U.S. would benefit from say a 25 percent overnight appreciation of the renminbi. That would cause economic turmoil in China and shake world markets very badly.

So it's not entirely clear in this whole discussion what is this alternative approach that we're pushing for if you take the baseline that we're getting steady nominal appreciation of the renminbi and then even faster real appreciation.

COMMISSIONER FIEDLER: Okay.

MS. BRADNER: I'm not going to presume to know why a president decides not to name them a currency manipulator. I know that the current President when he was in the Senate did support the currency legislation that we support.

But I think the point, even if we put it as a principal negotiating objective in trade promotion authority legislation, that there be currency disciplines, it's only as good as whether it's enforced. And so that's why we

at Nucor and many other U.S. industries favor empowering domestic industries and workers to fight back by being able to bring a case under the subsidy law treating currency manipulation as an export subsidy. So take it out of the White House, take that discretion away, and let the private sector fight back.

MS. DRAKE: Just briefly, I think that also has the advantage of if an administration for political, diplomatic, whatever reasons doesn't want to take action, they say, well, I'm sorry, our hands are tied. Congress says that Commerce needs to treat it as a countervailable subsidy, and all of the factors are certainly there. Commerce could do it now but hasn't done it I think for these political reasons.

So take the political decision out of their hands and at least get limited relief for those industries that are able to take advantage of self-help.

COMMISSIONER FIEDLER: Thank you.

Just one sort of both comment and a question. You, Dr. Levy, sort of did this analogy or compared General Motors bailout with Chinese state ownership, which I think is like unequal in the extreme.

What I'm interested in understanding, and I can't understand this for the life of me, is why raving capitalists, some of whom are laissez-faire capitalists, are so uninterested in curbing state enterprises or actually go to embrace state enterprises? Is it simple greed because they have the money and we don't want to change the world, we just want their money?

And who yet at the same time will fight tooth and nail about a temporary bailout of a major United States company.

DR. LEVY: Well, I don't approve of either one. I'm not endorsing state-owned enterprises, and I agree--

COMMISSIONER FIEDLER: I wasn't saying you were.

DR. LEVY: And I agree that there is an apples and oranges element to talking about GM versus state-owned enterprises, but we can have a discussion of fruit. So there can be important differences between the two, but this is part of what one is concerned with. If you make rules that say that you will never have any government involvement of this sort, and every enterprise will run and rise and fall on its own commercial merits, you have to be careful to think is that what you actually believe in.

I'm not going to be the one who gives you a strong case for why we still need to have interventions because I'm one of these raving capitalists that you are mentioning.

COMMISSIONER FIEDLER: Who will deal with any state enterprise whether they're Russian, Chinese, Libyan--

DR. LEVY: Well, no, I actually, I do think we need to have these kinds of restrictions, but it's a challenging task, and I'd be glad to sort of sit down for a week and write something purist on exactly how I would like to have government stay out of these businesses. The question is will anyone accept that or is that a pure waste of time?

COMMISSIONER FIEDLER: The reason I think it's important is

that the Chinese represent a different form of capitalism or hybrid capitalism than we have ever seen on the scale that we have never seen, and therefore it becomes important.

It's not as important talking about Saudi state-owned companies as it is about Chinese state-owned companies. Okay. And I'm worried about the infection, the sort of ideological infection, of that into the United States. Okay. And so we tolerate certain kinds of things, but then we look the other way on others.

It's a very serious down-the-road problem on what form of capitalism we want to encourage the world to have, and it just so happens still that as you can see by the \$4 trillion roughly of foreign exchange that they invest in the United States that they want to come here and they don't want to put it anywhere else because it's not as safe. Okay.

So I don't think anybody here wants to make the United States the safety valve for Chinese state capitalism.

DR. LEVY: Yeah. I am not trying to argue for the virtues of China's approach to state-owned enterprises. The question is what rules can we agree upon that will constrain these? We're going to have issues on this within the TPP. I don't think Vietnam will put up the same fight that China will, which I think is one reason why we're doing things this way.

I do think that this is a legitimate objective. We would like to have an economy made up of enterprises that are working on commercial interests, way on the low end of government involvement. I won't say no government involvement, but in rare circumstances. The question is can you get that agreed and how do you set those rules? Is this something that we write and we just impose on everyone else?

That was what I was referring to in this distinction between the unilateral approach and the multilateral approach. We can try that. We'll see where it gets us.

COMMISSIONER FIEDLER: But there's no--I don't want to take any more time except to say that there is no other major economy that has a larger percentage of state ownership than the Chinese do.

DR. LEVY: I agree, but you will have other economies that say we have some defensive interests here.

HEARING CO-CHAIR WESSEL: Co-Chairman Slane.

HEARING CO-CHAIR SLANE: Thank you. Thank you all for coming.

Would the panel support Congress granting to American domestic corporations the private right to file suit in federal court to enforce the trade laws where they have been harmed?

MS. BRADNER: I'll start. We would certainly support that. We used to have a private right of action. It was the 1916 Antidumping Act. Before I worked at Nucor, I was at a law firm and represented a U.S. company in the printing press area that brought a successful case under that law.

However, the WTO ruled the law was contrary to the

Antidumping Agreement. As a result, the United States complied with the WTO and repealed a domestic statute that had been on the books for a long time. So it's gone for right now, but certainly, I mean I haven't thought about it too much recently, but we would support that.

MS. DRAKE: I think it's an idea that has a lot of potential. There's a lot of challenges too, in terms of even if you get a judgment in federal court that China is violating commitments, how do you get that judgment enforced? How do you get jurisdiction, et cetera?

There also is an important principle when we implement our international trade commitments. In many ways on purpose, Congress does not make them enforceable in federal court by individuals because there are concerns that it could override important parts of U.S. law that Congress didn't mean to change when it implemented the trade agreement.

So it's an idea with a lot of potential, but also possibly some pitfalls. So it would have to be carefully crafted to make sure that it's serving the ends that I believe the Commissioner is interested in, which is making sure that our industries can get more effective relief.

HEARING CO-CHAIR SLANE: If I can just respond to that. I mean in my opinion the system is not working for American companies, and something dramatic has to happen here. I understand there are challenges.

And as to the enforcement, Elizabeth, you know, what we're starting to see is a lot of Chinese companies interested in coming into the United States. So at least in the steel industry and maybe other industries, they would have some recourse.

Dr. Levy, do you have anything?

DR. LEVY: Well, I'm an economist, not a lawyer, so when we start talking about who has right to sue and over what things, I have about the same reaction that some of you do to the deltas and the epsilons in the earlier stuff.

But I would note that when you say the system is not working for American companies, I think the purpose of the system should be to work for the entire American population, of whom the companies are one significant component. But consumers are a component as well, and there's balances that need to be struck, and I think Ms. Drake actually raised some of the questions. You have to worry about imbalances that might emerge.

MS. DRAKE: I do certainly agree with the Commissioner that in the case of Chinese companies invested in the U.S., if there are anticompetitive effects of that, there certainly should be a private right of action and a private remedy for companies, workers, others that may be harmed by that anticompetitive behavior.

Internationally, it might also be worth looking at something that would be analogous to what currently exists in investor-state disputes where investors can seek compensation from governments if their investments are expropriated or what have you. Those current kinds of disciplines being discussed in the BIT wouldn't be sufficient to address all the kinds of harm that industries and workers face when they are competing with China.

But that's a different kind of model that does allow for private enforcement when there are violations.

HEARING CO-CHAIR SLANE: And just let me add, I know--I'd like to hear your comments--one of the things that we struggle with here is how does an American company or an American industry compete with an SOE that opens up a factory in the United States and has little or no cost of capital and innumerable huge subsidies?

It's one mechanism, I think, to level the playing field, and if what we're starting to see where these SOEs are now looking at coming into the U.S. market, how do we compete when we're talking about two different systems here? What American companies are really doing is competing against the Chinese government.

MS. BRADNER: Correct. This is why I said it keeps us up at night, and I would just like to emphasize on that printing press case, I want to emphasize how aggressive some of our trading partners are in protecting their own companies. In that case, the American company won a jury judgment in United States federal court for wrongdoing, and within 90 or 100 days the Japanese Diet retaliated by passing a law that declared that U.S. judgment null and void and allowed their Japanese company to go after the U.S. company, the plaintiff.

They had a plant in Japan because they couldn't sell into Japan without building a plant there, and that retaliatory Japanese law said you can go after that American company's plant in Japan and shut it down and seize it. That's what the Japanese government did for their company that had been found guilty of dumping in our market, and so that's why we say we're not aggressive enough here in America. We need to do more.

HEARING CO-CHAIR SLANE: Thank you.

HEARING CO-CHAIR WESSEL: We have two more questions in the first round, and then, Dr. Scott, I'm going to ask you to come up. I know that you'd like to make one comment.

Chairman Shea.

CHAIRMAN SHEA: Thank you all for being here.

There was a misstatement up here. The Romney administration did declare China a currency manipulator, just, oh, that didn't happen.

HEARING CO-CHAIR WESSEL: No, he said he'd do it on day one. Day one. He didn't have day one.

[Laughter.]

COMMISSIONER FIEDLER: Zero day.

CHAIRMAN SHEA: Dr. Levy, tell me I heard you right. You said that we shouldn't be as forceful in challenging China's currency manipulation because it might strengthen nationalist elements in China; is that fair? Did I fairly--

DR. LEVY: Yes. What I was arguing is that there's a camp that has been pushing hard for appreciation of the renminbi and then others who have been pushing against it. The nationalists are the ones who are going to react most adversely to anything that looks like succumbing to U.S. pressure

so it undermines some of those who have been taking the same position that we would advocate.

CHAIRMAN SHEA: When I heard you--okay, thank you. When I heard you say that, it just reminded me of Premier Wen when he, in a moment of candor, said that we cannot appreciate the currency significantly because there would be riots in the street. So the thought occurred to me that taking more of a laissez-faire approach to this issue is basically supporting, protecting the position of the Communist Party in China.

But that's the thought that came to mind. Are you aware of the Chinese ever taking U.S. domestic politics into account when they make their own trade policy and economic decision-making?

DR. LEVY: I think they try to figure out what the U.S. is doing. I've had conversations. I don't know that they do it terribly effectively, but they do try to figure it out, and it's where you get degrees of nuance between things that are deliberate government actions versus automatic.

So, for example, antidumping that we're talking about, these are not decisions by the administration that says we were going to go ahead with this antidumping suit. I think that's been a difficult concept for the Chinese to grasp, that they have struggled with, that each of these cases may look like, ah, President Obama just decided to do this.

CHAIRMAN SHEA: Right.

DR. LEVY: As we know, that's not how it works.

CHAIRMAN SHEA: You're an economist. I've heard some economists, friends, make the point that, let's take steel. They want to give it to the United States for free. Forget about subsidies. Just give it to the United States for free. That's good for the United States. They're giving us a huge gift for free.

And that enhances our consumer welfare. That promotes the U.S. economy. Okay. Some people in the U.S., domestic producers, will get hurt, but they will need to reposition themselves to do other things that are more productive. If the Chinese exploit a monopoly position as a result of their giving us this steel for free, then the company could reconstitute itself, and if the Chinese company raises its prices as a result of its monopoly position, then the U.S. company could reconstitute itself and hire competitive, and sell at a competitive price.

Do you subscribe to that view? It seems like that's sort of a view that says we don't need the antidumping or countervailing duty laws. And I was just wondering—the reaction of the whole panel to that?

DR. LEVY: I can start. I think it's a question of how we define unfair competition and what we worry about. I do worry about predatory pricing, which I think is what you described.

CHAIRMAN SHEA: Uh-huh.

DR. LEVY: Which is an instance where somebody does it, it's seemingly a gift, they wipe out an industry, and then say "ah-ha," now I have a monopoly position.

CHAIRMAN SHEA: Right.

DR. LEVY: That can be a difficult thing to execute. So there are some instances where you can quickly reconstitute the industry, but others where you just simply cannot. And I think we saw in rare earths fairly recently where it actually took a matter of years to get U.S. mines up and going again. So you have to balance out what are the costs and benefits of that.

I think this is the kind of analysis that we perform when we, the Justice Department, for example, or the FTC looking at antitrust matters. I think that's a very appropriate level, way to look at this. I'm not certain that that's the way our antidumping laws are currently constructed. I would favor moving in that direction.

CHAIRMAN SHEA: Dr. Drake.

MS. DRAKE: Just to add on that last point, clearly if a foreign producer is able to gain market share through unfair trade practices, that's not only bad for the domestic industry that may be harmed, but what you're actually doing is you may be getting rid of producers that are more productive, more efficient, more innovative in favor of producers who are not simply because they're propped up by a state.

And I think even the most free-market economists would agree that that's not an optimal result.

In terms of the predatory pricing issue, one of the problems with the current U.S. antitrust regime is that we assume that market actors act on a market basis and are rational and seek to maximize their returns. Therefore, we don't treat a pricing practice as predatory unless the company engaged in it could expect to make up what it lost once it gains that monopoly position.

A state-owned enterprise from China, for example, may never need to make up what it lost through predatory pricing because it continues to be supported by the government. So you could have the same harm in terms of an economic sense but no remedy in terms of a legal sense because our antitrust laws are built on the assumption that actors operate on a market basis, and that assumption just doesn't necessarily hold in the case of China.

MS. BRADNER: I'd like to answer as a non-economist. It's certainly true that after repeated dumping over a long period, some producers will be driven out of business. And it's not just the producers, but it's also the upstream. You know, we buy scrap all over America, all of that industry. And then the downstream, you know, the truckers, the rail, all of the downstream as well, is affected.

And even if the foreign producer then corrects itself and stops the dumping once they get the market share, it's not at all clear that the domestic industry would be able to reconstitute itself because some of those players will be gone and won't be able to come back.

I also think right now we really have a manufacturing resurgence because of the energy revolution going on in America, and that gives us an advantage over our global competitors, including, some of them who have cheated for decades. We suddenly have something working in our favor, and

I think that makes it even more essential that we enforce the rules of free trade to make sure that we can take advantage of that energy revolution.

CHAIRMAN SHEA: Thank you.

HEARING CO-CHAIR WESSEL: Commissioner Bartholomew.

COMMISSIONER BARTHOLOMEW: Thank you, and thank you to all of our panelists.

It's an interesting discussion, and I keep sitting here thinking of what our former colleague, George Becker, the president of the Steelworkers, said. He just used to say if you do what you always did, you'll get what you always got. And it kind of feels that way as we look through this.

Dr. Levy, I sort of admire your faith and trust in the ability of negotiations and the ability of the trade regime to resolve these issues. But I don't see that happening. At least not resolve them in a way that's actually leveling the playing field, which, of course, China's accession to the WTO was sold as. This was going to be something that was going to help level the playing field.

All of that said, I'm curious, particularly, Dr. Levy, about what you would call China's economy? We've had this discussion up here before. What is it?

DR. LEVY: Well, first, I'm not sure that my point was that we should just have faith and trust. I think I was talking about how each path was fraught with difficulties, and that we should compare different paths and see which gets us closer to our goals. We've seen instances like the Section 421 tire tariffs where I don't think it actually accomplished any of our goals, but we did use that path.

As to characterizing China's economy, a decidedly mixed economy with heavy government intervention. It's not a technical term, but that's how I might describe it.

COMMISSIONER BARTHOLOMEW: So one of the issues, and I think we're obviously facing this and going to have to face this more--I mean I would go further than you and call it a state capitalism with authoritarianism--and it is concern about the export of that model. Jeff was talking about tolerance, but really, I mean in a lot of places, in Africa, for example, that kind of model is really picking up traction. To me as I look down the future, that's not a world that is the idea that this country is based on and what we believe in.

But as we grapple with this issue of Chinese investment in the United States, again, Dr. Levy particularly, do you support unfettered investment by the Chinese companies into the United States? And if so, how do you reconcile that with this model of state-controlled capitalism?

DR. LEVY: So, first, it's important to recognize there are different sectors of the Chinese economy. I think the parts that have been most successful are those where you've had the least government involvement.

Now, other countries will draw whatever lessons they will from this, and I think you're quite right, that you have had some who say, 'hey,

this is great, the state can be fully involved, and we'll have tremendous results.' I don't think that's the lesson that we see from Chinese growth.

As to can the U.S. benefit from Chinese investment? Yes. But we should take it on its merits. It shouldn't be because we think that there is no state involvement, and there may well be. We need to look at each particular case. You say unfettered; I wouldn't go that far. I think it's perfectly legitimate to have security reviews.

On the other hand, I think we also need to be relatively transparent and relatively clear about what our security interests are, and whether they extend to ham is a real question.

COMMISSIONER BARTHOLOMEW: All right. I'm going to switch gears a little bit and ask all of you, the ways that Chinese companies are getting around duties -- or I'm going to use the word "sanctions" because I'm not a trade lawyer -- but duties, are you seeing any examples where Chinese companies are purchasing U.S. companies as a way to try to get around AD/CVD, for example?

MS. DRAKE: I mean there were concerns with an investment, Chinese investment, here in the U.S. that had the potential to facilitate circumvention, that the U.S. operation could just do minor alterations instead of in Malaysia, in Texas or Georgia or where have you and circumvent the AD order in that way.

There are current provisions in U.S. law that are designed to address that, but they are very limited, they have very stringent standards, and so I do think it is worth revisiting those provisions to see if they are sufficient to address the threat of that kind of activity here in the U.S.

Another concern in terms of Chinese investment in the U.S. and what it might mean for the integrity of our trade laws is when a domestic industry brings a case, it needs to show a certain threshold of support among domestic producers. Those producers that are related to foreign producers or are themselves importing, if they oppose the petition, that won't stop the petition, but there is no provision that if they are owned by the government that the petition is against, that their opposition will be discounted. That's something else that we should look at to make sure our trade laws remain effective and enforceable as investment increases in the U.S.

COMMISSIONER BARTHOLOMEW: Do I have time for just one more question, which is are you concerned that as states and localities are working to draw investment in, that sort of a conflict between our bigger trade laws and economic development taking place at state and local levels?

MS. BRADNER: Yes.

COMMISSIONER BARTHOLOMEW: Do you have a solution for it?

MS. BRADNER: Well, I think that our elected officials at all levels have to scrutinize who they're working with and ask the right questions. Is this company getting financing from Wall Street or where is it coming from? I mean there are tough questions they need to ask. Who are you dealing with? Who's really behind it?

COMMISSIONER BARTHOLOMEW: This will be a good segue into our final panel. Thank you.

HEARING CO-CHAIR WESSEL: Dr. Scott, do you want to pull up a chair quickly and maybe share Ms. Bradner's microphone for a moment?

DR. SCOTT: Yes, thank you.

Should I just respond?

HEARING CO-CHAIR WESSEL: Please.

DR. SCOTT: I just wanted to respond since Dr. Levy had commented on my models and some of the results that I've had. I just wanted to give a two-handed response. He characterizes my research with, -- a response to an earlier question -- as setting up an alternative history in which China never opened itself up for trade, and that's really a straw man. That's not what I do.

Models that I use in my research have been widely used, not just by myself. They were used by the Federal Reserve in a study they did on the effects of trade in the economy. He mentioned himself the Commerce Department's export multipliers. They don't do the import multipliers, but other economists have.

Lawrence and Bailey did this. I cite several such studies in my paper, "The China Trade Toll," which is listed in my references in my prepared testimony.

But I want to shift from that to the question of currency manipulation, which is one of the major ways in which China has accumulated its large trade surplus.

Now, going back just for a second to this statement that I am proposing alternative history in which or a scenario in which China never opened itself up to trade, I have no problem with China opening itself up to trade. The problem is with how they opened up, the fact that they opened up in a way that led to growing trade deficits for the United States, growing trade surpluses for China, not just with the U.S. but with the world, current account surpluses that in the late 2000s reached six to \$700 billion a year or more.

And the way in which they achieved those surpluses was through currency manipulation, in part. It was the biggest factor, and to assert that by ending currency manipulation, those surpluses would not go away is, in a sense, to assert that exchange rates don't matter, exchange rates on the most fundamental prices in international trade.

If China were to revalue its currency by 30 or 40 percent, that would raise the price of all of its exports by 30 or 40 percent. It would reduce the cost of U.S. exports to China by that amount and to the rest of the world relative to China. It clearly is going to have an impact on our trade, on both sides, on both imports and exports, and that's, in essence, what my model does.

It estimates the labor content of that trade surplus that China has accumulated, and I would just conclude by noting that the number I cite on the effect of currency manipulation on trade is not my own. It comes from

Fred Bergsten and Joe Gagnon of the Peterson Institute, two of the most widely respected economists in the international economic scene.

Thank you.

HEARING CO-CHAIR WESSEL: Dr. Levy.

DR. LEVY: Thank you.

I like this interactive format in which we can have a debate. I would say, first, the idea of an alternative history was not a criticism leveled at your model. This was saying in some ways all models do this. They say we have a construction. We're trying to figure out a counterfactual. What would have happened if something were different? Models are neither good nor bad in and of themselves. So simply to say there was a model, we can ask what are the assumptions that are underpinning the model? That was what I was criticizing, is which assumptions were underpinning them?

On questions of currency manipulation, I think it's really a question--we can delve more deeply into this--but how one defines it and how one holds the cause. The counterfactuals that emerge from this model, though, if you ask what is the labor that's embodied in the surplus, and if you get this? There's nothing, per se, objectionable about using input/output measures. These are just what conclusions you want to draw.

If you are saying that we have this much trade absent this, we can figure out how much labor was embodied in that, and that's labor that would have accrued to the United States, you are making some very particular assumptions about where that labor would have gone.

It gets back to Vice Chairman Reinsch's question earlier, that, yes, there may well be labor embodied, although, again, we get to questions of marginal versus average, which I raise in the paper, but that may have gone somewhere else as well. If you don't allow for that in the model, you are making some strong assumptions that color the results. That was the gist of my criticism.

HEARING CO-CHAIR WESSEL: I'll have a question, but Mr. Shea, you want to go ahead? Commissioner Shea.

CHAIRMAN SHEA: Yeah. No, stay. You mentioned, Dr. Scott, you mentioned the Bergsten-Gagnon study on currency manipulation, which says, as I recall, the employment impact of currency manipulation by all global players on the United States is a loss of jobs between one million and five million jobs.

Now, that's okay. But one to five, that seems like a very broad range, which makes me a little suspicious. So if you could respond maybe, too, Dr. Levy? I don't know if you're familiar with that study.

DR. SCOTT: They used a variety of approaches. On the one hand, they used a Commerce Department multiplier, which I think gave them the lowball number, and I think they used the \$200 million trade balance. Remember, they have a range of trade impacts from 200 to 500 billion dollars. So combining the Commerce Department multiplier and the small trade impact got them a million jobs.

Using a model from the Federal Reserve, which they got the

Federal Reserve to actually run their macro model and evaluate the impacts of a ten percent depreciation of the dollar against all currencies, the Federal Reserve came up with a figure that was more on the order of I think two to two-and-a-half, I guess about two million jobs for the \$200 billion impact, and so they scaled that up to about five million jobs for the \$500 billion impact. So that's how you got that wide range.

In the study I'm going to be publishing next week--we'll be releasing it on the 26th--we take into account, we use a CBO-based model, and we take into account full multipliers, that is respending of the wages earned and so on, and come up with this somewhat larger number that I mentioned, the 2.3 to 5.8 million jobs if you take full multipliers into account. So that's how our study is different.

DR. LEVY: I guess I would commend you on taking a caution from the fact that you've seen wide ranges. You get out of these models what you put in in terms of assumptions. If you are accurately depicting the way the world works, you can get very good results. If you have a great degree of uncertainty in terms of what you ought to say, we've seen then you're going to get a great range of results, great in the sense of large as opposed to good.

At one point in the discussion, it's been a moving target as China's currency has appreciated, but estimates of undervaluation range from, say, 15 to 40 percent. That's a pretty big range. It actually goes right to the question of do we actually know what we mean by currency manipulation? What is this alternate history? And I'm not using it in any pejorative sense, but if we got what we wanted, what would that be?

And so if you think somewhere 15 to 40, that's a big difference. Let's take 40 for a second. I can write a model where you do a 40 percent appreciation of the Chinese currency, and the Chinese economy continues to function just fine. They just shift their external demand and everything works really smoothly. I don't think that would be a very good model.

I think in reality if they appreciated by 40 percent overnight, you would have turmoil in the Chinese economy. How you get there actually matters. Maybe over a decade or two, they'd sort it all out, and we'd get to the long run steady state. That's often what these models assume, that you're going to have sort of a hassle-free transition. Those can be bad assumptions. So that's my urging of caution here. It's why in my written testimony I was describing we need to think about how this would actually work. I have 2009 testimony for Ways and Means where I go further into that as well.

CHAIRMAN SHEA: Thank you.

HEARING CO-CHAIR WESSEL: I'd take a million jobs.
Commissioner Reinsch.

VICE CHAIRMAN REINSCH: I just had--well, you can have them.

HEARING CO-CHAIR WESSEL: I have three of them now.

VICE CHAIRMAN REINSCH: As long as there's one left over for me, it will be fine.

I want to pursue one element of this. I attended a session with Joe Gagnon a couple weeks ago which was actually quite enlightening because this is an issue where I don't have the background or skill of either of our two economists here. So I learned a lot, and I thought he did a good job of defending his thesis.

There were, as you might imagine, a number of critics, and I don't want to run through all of them, but the one criticism that I thought was interesting, to which I think he didn't have a very good response, was, the fiscal policy versus monetary policy response. Well, if they stop doing this and let the currency float, they'll accomplish the same thing with some variation of quantitative easing. And there really isn't any way to solve the problem. They can pursue the same policy through different means.

So why are we spending all of our time focusing on currency? How do either of you want to respond to that?

DR. SCOTT: Actually, I think it's fairly straightforward. We have seen quantitative easing in Japan. It has had some impact on the value of the yen although I frankly think that there's more to that than just pure quantitative easing. But the distinction between the two is that quantitative easing involves buying up more of your own assets, and that's what Japan has done.

They've increased their domestic money supply. That's driven down interest rates in Japan. The primary effect has been to boost demand in Japan, which has happened. They're growing faster and it has boosted inflation.

The effect on this exchange rate is secondary, and so if China tried to do that, China already has a rampant inflation problem. If they tried to achieve devaluation or suppression of their currency through quantitative easing, they would just totally, totally destabilize the pricing in their economy.

So I think the key point to understand about currency manipulation is that the best indicator for manipulation is the degree of intervention in exchange markets. China is spending roughly \$500 billion a year. If they stop doing that, it will reduce China's trade deficit by anywhere between--China's trade surplus by anywhere between 300 and \$500 billion, and that's a very strong correlation. It comes right out of Joe's research, his 2013 working paper.

DR. LEVY: I think you hit on a very key point, which is trying to think is there an equivalence of policies. I think actually there's serious concern that if China were to float its exchange rate, that it would go in the other direction, that you could have people who have been very successful in China try to take money abroad.

You can make a distinction. It's one that's very important in international financial circles for decorum about whether or not you're sort of flooding the domestic market or your foreign exchange market with money, but to the extent that we think that these markets interconnect, it's not that important a distinction, and we've seen that in the United States. As

we do aggressive quantitative easing, you saw money went searching for yield and went around the world searching for yield.

So even though the U.S. was not purchasing foreign currencies, it did have that effect, and so I think it's a very legitimate concern.

VICE CHAIRMAN REINSCH: Thank you.

HEARING CO-CHAIR WESSEL: I'll be with you in one moment. Dr.--not Dr.--well, you probably are a Dr. Drake. You got a J.D.

Let me ask you a question about the ability to assist USTR because they have limited resources. Correct me if I'm wrong, but at the WTO and in some other international fora, as I understand it, other delegations, other countries are supported by the private bar, and can you tell me is that true and to what extent are you able to assist our own government officials to have a good either offense or defense?

MS. DRAKE: Thank you, Commissioner Wessel.

It's a big concern for the bar that represents domestic interests here in the U.S. USTR does not allow private attorneys into the room during dispute settlement panel proceedings, and because in the vast majority of those cases, those proceedings are not otherwise open for public observation, it puts us at a profound disadvantage because we're not able to provide the assistance to immediately pick up on the panelists' questions to bolster USTR's arguments, to get them the factual information or the legal analysis they need to make the best case possible.

China, by contrast, does bring private lawyers into the room, and they are pretty much all from D.C.. We recognize them as we file into the WTO, and we--on behalf of the domestic interests sit and drink coffee, and they on behalf of the Chinese interests go into the room with the Chinese delegation, argue on behalf of the Chinese delegation and are right there generally attacking U.S. trade laws for the Chinese at the WTO.

So it's a huge concern. I understand that USTR wants to, from its perspective, protect the integrity of the system. They in certain cases are going to have long-term interests that may be different than our short-term interests in any particular case in terms of litigation strategy. But, the domestic side is eager to do more to help USTR, and so this is a very, very frustrating dynamic for us.

At a minimum, one of the things that could potentially ease the imbalance is to do more to make the WTO dispute settlement system more transparent. I actually just got back from Geneva yesterday at a panel that did not involve China, and the other parties agreed to open it up to public observation so I could at least see what was going on and try to help USTR on behalf of U.S. interests.

Again, the Mexican delegation also had U.S. attorneys in the room with them so they could hand them a note. I couldn't. But it was a little bit better than the massive imbalance that you see in our disputes with China at the WTO.

HEARING CO-CHAIR WESSEL: Thank you.

Commissioner Bartholomew.

COMMISSIONER BARTHOLOMEW: Thank you.

Just I think my last closing comment. Dr. Levy, again, to you, which is that I certainly respect the difference in our world views on some of these issues, but I have to say that I'm really perplexed by the caution, and this is not just directed at you, but by a number of people with whom I have different world views, but their caution when it comes to encouraging changes in Chinese practices.

And honestly, I just keep finding myself wondering if he had been so cautious, would Ronald Reagan have ever stood up and said, "Mr. Gorbachev, tear down this wall"?

So it's trying to grapple both with the implications, but just this sense that somehow the Chinese government is this delicate entity that we need to protect and give the benefit of the doubt over and over again. Really it's just a comment. You're welcome to comment back.

DR. LEVY: Thank you. I will.

It's not so much that they're delicate. I think it's simply a matter of being realistic and pragmatic, that we can ask if we take different approaches, what are the results likely to be? I think we ask that too infrequently. Instead we say what would we like, and we proceed from there. I think it's a good thing to ask what we would like, and then we ask, well, what is the most likely means to achieve that goal?

I think if you don't consider what your counterparty is likely to do, you're missing a key step of the analysis.

COMMISSIONER BARTHOLOMEW: Thank you.

HEARING CO-CHAIR WESSEL: I thank the panelists, especially Ms. Bradner for stepping in on short notice, and I want to also note the bipartisan support for Republicans on trade, Mitt Romney, Ronald Reagan.

[Laughter.]

HEARING CO-CHAIR WESSEL: It shows you why this Commission works so well together. We will break until 1:30 for our next panel. Thank you.

PANEL III INTRODUCTION BY COMMISSIONER MICHAEL R. WESSEL

HEARING CO-CHAIR WESSEL: Good afternoon. Let's start this afternoon's panel. Our final panel today will assess the competitive challenges presented by Chinese state-owned enterprises.

Joining us for this discussion are Dr. Willy Shih, Dr. Adam Hersh, and Mr. Joel Backaler. Am I pronouncing that correctly?

MR. BACKALER: That's correct.

HEARING CO-CHAIR WESSEL: Correct. Good. Dr. Shih is the Robert and Jane Cizik Professor of Management Practice and Business Administration at the Harvard School of Business, where he serves on the Technology and Operations Management Unit and teaches in the MBA and Executive Education programs.

Dr. Shih has written or co-authored more than 125 cases and teaching materials on manufacturing and product development. His most recent book is *Producing Prosperity--Why America Needs a Manufacturing Renaissance*. Prior to his work at the Harvard School of Business, Dr. Shih spent 28 years in industry at IBM, Digital Equipment, Eastman Kodak, Silicon Graphics, and Thomas SA.

Dr. Shih has previously testified before the Commission. Appreciate your being back here with us.

Dr. Hersh is a Senior Economist and China Specialist at the Center for American Progress. His research focuses on economic growth and inequality in the United States, China, and the global economy.

Mr. Hersh co-authored the report "The American Middle Class, Income Inequality, and the Strength of our Economy: New Evidence in Economics."

Before joining the Center for American Progress, he taught macroeconomics and monetary and financial economics and worked with the Asian Development Bank, the Political Economy Research Institute, the Center for Economic and Policy Research, and the Economic Policy Institute.

And, again, a previous witness here before the Commission. We're glad you're back.

Our final witness is the Director of the Frontier Strategy Group, Forbes Magazine business columnist, and member of the National Committee on United States-China Relations. He is also the author of the forthcoming book, *China Goes West: Everything You Need to Know about Chinese Companies Going Global*. His book will be coming out in May 2014--is that right?

MR. BACKALER: That's correct.

HEARING CO-CHAIR WESSEL: Look forward to reading it. He is the author of *TheChinaObserver.com*, an award-winning China Business blog.

Our normal rules are seven minutes for oral testimony. Your written comments will be submitted and available in the record, and then we'll follow up with questions.

Dr. Shih, if you can start.

**OPENING STATEMENT OF DR. WILLY C. SHIH
ROBERT AND JANE CIZIK PROFESSOR OF MANAGEMENT PRACTICE IN
BUSINESS ADMINISTRATION
HARVARD BUSINESS SCHOOL**

DR. SHIH: Good afternoon and thank you for the invitation to speak with you today.

The role that state-owned enterprises play in the Chinese economy is a complex one, and I have to admit that my whole thinking on this question is constantly evolving.

State-directed capitalism is not a new idea. Many economies

have used it at particular stages of their economic development. We saw it in Japan, Taiwan, South Korea, and Singapore, to name a few. Most emerging economies give a larger role to the state than developed economies. The Economist Magazine pointed out that two-thirds of emerging market firms that made it on to the Fortune 500 list are, in fact, state-owned.

During the decades following World War II and the Korean War, I think we turned a blind eye towards the deleterious effects of state-sponsored competition on American industry, I think, for geopolitical reasons.

Not until 1980s Japan, did we start to fear the competitive threat to American firms, but I think China is different both because of its size and the timing.

Now, among the questions before the Commission are statements issued by the Third Plenum last November on the future role of SOEs in the Chinese economy. On the one hand, the Plenum reserved a strong and continuing role for SOEs, while also vowing to subject the SOEs to a competitive Chinese private economy.

Now, what's that about? I believe we are witnessing the evolution of a hybrid form of capitalism, what my colleague at HBS Aldo Musacchio describes as "state support disciplined by the market." This is not the traditional flavor of state capitalism because these firms are not government departments, and they have to compete in the marketplace. But they are advantaged because they have access to low cost and patient capital, they can benefit from the structuring of Chinese domestic markets. And most importantly, they can invest for the long term.

The other form we see is support of private Chinese firms by state-controlled banks, enabling them to do things that would otherwise be out of reach.

A colleague of mine, a young Chinese manager on assignment to the United States, had a great description of how China works. She said that the Chinese "renovate ideas" to make them fit their own needs. "Just look at Buddhism," she told me. I think they are, "renovating Western capitalism to fit their needs."

Now what role will SOEs have in Chinese industrial policy? I think at the highest level, China wants to control its own destiny. So in sectors where China is or will become the world's largest market, I think the Chinese government feels entitled to use that market power to set global standards, much as the U.S. has done historically, albeit not quite so deliberately.

Let me give you an example. China Mobile is an SOE with the largest subscriber base in the world. Its investment in TD-LTE, one of the two variants of the 4G LTE standard, as directed by the government, will favor firms like Huawei and ZTE. It will also benefit Spreadtrum Communications, a Shanghai-based and formerly U.S.-listed mobile chip supplier, which was recently acquired by Tsinghua Holdings, a state-owned company funded by Tsinghua University.

Now China is the world's largest market for mobile and smartphones, and it is where most of the handsets in the world are assembled. So the Chinese government tried to set a new global standard with the TD-CDMA standard several years ago, but they were too late with that one because GSM was already very well established.

I think they'll be far more successful with TD-LTE. They have the largest market to practice in and remember that U.S. and Europe are by and large using FD-LTE. I think it's a safe assumption that there is no way China wants to be dependent on U.S. firms like Qualcomm or Cisco for core technology over the long term, especially post-Mr. Snowden, or that will certainly be one of their justifications.

What other industries does China chafe under foreign dominance? Well, commercial aerospace, for sure. Asia is already the world's largest air travel market, and if you look at Boeing and Airbus' market growth projections, that is where a lot of the action globally will be. That's why Comac, another SOE, is building the C919 to compete in the narrow-body market. Will it take them awhile? For sure. Do they have the capital, the patience, the investment horizon to do this? There is no doubt in my mind.

Another set of circumstances I mention that drive SOEs like CNOOC or Sinopec is the desire to establish secure bases of supply in a volatile market. So if you look at CNOOC's attempted purchase of Unocal in 2005 or their more recent acquisition of Nexen in Canada, if I were sitting in the Chinese government office, trust me, I'd be thinking this way.

And then there is the acquisition of technology, which was mentioned this morning. Chinese firms realize that they need to acquire technology to build up their capabilities. I look at Sany Heavy Industries who acquired Putzmeister in Germany, a world leader in concrete pumping, or it was mentioned this morning, Zhejiang Geely acquiring Volvo or Wanxiang Group acquiring A123.

But it's hard to argue with these private company transactions. It's no different than when Cisco buys someone for its technology.

Are these are part of China's "going-out" strategy? Well, I would call it a responsible investment strategy. Will that mean more competition for U.S.-based multinationals? Well, some parts of the game they're playing by our rules, and some parts of the game, they have their own rulebook.

Do Chinese SOEs operating in world markets source locally or do they source from China as a matter of government policy? With all due respect, I think that's the wrong question. I can only comment based on what I've observed about companies like Huawei and Lenovo. Both have shown a strong propensity towards vertical integration, doing things themselves, and, frankly, it's served them very well.

What if China is granted market economy status within the WTO? China and we have very different definitions of what constitutes a market economy. I think this asymmetry in definition lies at the heart of our

uneasiness because I believe the spirit of the WTO rules are more aligned with our view. We can argue they need to play by our rules, but I don't think that's necessarily going to change their thinking, in my opinion.

My most urgent message is to U.S. multinationals. We need to learn from history and not delude ourselves into thinking that because they are not playing fair or because they are playing by a different set of rules that in the end fair play and justice will prevail.

For decades, for probably the first two decades of Airbus' existence, Boeing complained bitterly about state subsidies or believed that Airbus would collapse under the weight of competing national agendas. And certainly in the early days, it seemed that state subsidies and launch aid were all that kept them going.

But Airbus kept introducing innovative products, and constantly blaming state aid or discounting Airbus's capability growth, I think, got in the way of Boeing recognizing their own competitive shortcomings, something that they paid dearly for over subsequent years. So Cisco, take note.

We cannot let the Chinese form of state capitalism distract ourselves from leading the world in innovation, investing for the long term, and ensuring our own global competitiveness. I hope and pray that our leaders here in Washington can think carefully about the shackles and disadvantages we place on our firms in this high-stakes competition of economic systems.

Thank you very much.

**PREPARED STATEMENT OF DR. WILLY C. SHIH
ROBERT AND JANE CIZIK PROFESSOR OF MANAGEMENT PRACTICE IN
BUSINESS ADMINISTRATION**

Willy C. Shih
Robert & Jane Cizik Professor of Management Practice in Business Administration
Harvard Business School

Testimony before the U.S. - China Economic and Security Review Commission
February 21, 2014

Hearing on US-China Economic Challenges
U.S.-Chinese State-Owned Enterprises and Non-Market Economics – Competitive Challenges

Chairman Shea, hearing co-chairs Wessel and Slane, commission members, staff, and other distinguished guests, good afternoon, and thank you for the invitation to speak with you today. The role that state-owned enterprises (SOEs) play in the Chinese economy is a complex one, and I must admit my thinking on the whole question is constantly evolving.

State directed capitalism is not a new idea. Many economies have used it at particular stages of

their economic development. We saw it in Japan, Taiwan, South Korea, Singapore, to name a few. Most emerging economies give a larger role to the state than developed economies. *The Economist* pointed out that two-thirds of emerging market firms that made it onto the Fortune 500 list are state-owned.

During the decades following World War II and the Korean War, we turned a blind eye towards the deleterious effects of state-sponsored competition on American industry, I think for geopolitical reasons. Not until 1980s Japan did we start to fear the competitive threat to American firms. But China is different both because of its size and the timing. Here is a nation that is challenging the United States in market scale and scope, and its state-funded firms could have enormous global impact.

Among the questions before the commission are statements issued by the Third Plenum last November on the future role of SOEs in the Chinese economy. On the one hand the Plenum reserved a strong and continuing role for SOEs, while also vowing to subject the SOEs to a competitive Chinese private economy. What's that about?

I believe we are witnessing the evolution of a hybrid form of capitalism, what my colleague at HBS Aldo Musacchio describes as state support disciplined by the market. This is not the traditional flavor of state capitalism. These firms are not government departments, they have to compete in the marketplace. They are advantaged because they have access to low cost and patient capital, they can benefit from the structuring of Chinese domestic markets, and most importantly they can invest for the long term. The other form we see is support of private Chinese firms by state controlled banks, enabling them to do things that would otherwise be out of reach.

A colleague of mine, a young Chinese manager on assignment in the United States with a major multinational, had a great description of how China works. She said that the Chinese “renovate ideas” to make them fit their own needs. “Just look at Buddhism,” she told me. I think they are “renovating” Western capitalism to fit their needs.

What role will SOE's have in the implementation of Chinese industrial policy? At the highest level, I believe China wants to control its own destiny, as any country would. In sectors where China is or will become the world's largest market, I think the Chinese government feels entitled to use that market power to set global standards, much as the U.S. has done historically albeit not quite so deliberately. Let me give you an example. China Mobile is an SOE with the largest subscriber base in the world. Its investment in TD-LTE, one of the two variants of the 4G LTE standard, as directed by the government, will favor firms like Huawei and ZTE. It will also benefit Spreadtrum Communications, a Shanghai-based and formerly U.S.-listed mobile chip supplier recently acquired by Tsinghua Holdings, a state-owned company funded by Tsinghua University.

China is the world's largest market for mobile and smart phones, and it is where most of the handsets in the world are assembled. The Chinese government tried to set a new global standard with TD-CDMA but they were too late on that one, GSM was already well established. I think they will be far more successful with TD-LTE. They have the largest market to practice in.

Remember the U.S. and Europe are by and large using FD-LTE. I think it is a safe assumption that there is no way China wants to be dependent on U.S. firms like Qualcomm or Cisco for core technology over the long term. Especially post Mr. Snowden, or that will certainly be one of their justifications. Is Huawei a national champion? Yes. Are ZTE, Spreadtrum, and others far behind? They're coming. And many others.

In what other industries does China chafe under foreign dominance? Commercial aerospace, for example. Asia is already the world's largest air travel market, and if you look at China's investments in air transportation infrastructure, or Boeing and Airbus's market growth projections, that is where a lot of the action globally will be. That's why the Commercial Aircraft Corporation of China (Comac), another SOE, is building the C919 to compete in the narrowbody market. Will it take them a while? Sure. Do they have the capital, the patience, the investment horizon to do this? There is no doubt in my mind.

Another set of circumstances drive SOEs like China National Offshore Oil Corporation (CNOOC) or China Petroleum and Chemical Company (Sinopec) – a desire to establish secure bases of supply in a volatile world. Look at CNOOC's attempted purchase of Unocal in 2005, or their more recent acquisition of Nexen in Canada. If I were sitting in a Chinese government office, trust me, I would be thinking this way. It probably even spills over into the thinking of firms like Shuanghui Group when they acquired Smithfield Foods. Now Shuanghui is not an SOE, but they formerly were one. But that's what I think the mentality is – secure my supply base.

And then there is the acquisition of technology. Chinese SOEs as well as private firms realize that they need to acquire technology to build up their capabilities. Sany Heavy Industries Co. acquired Putzmeister, a German world leader in concrete pumping equipment. Zhejiang Geely Holding Group acquired Volvo for its capabilities as well. Wanxiang Group purchased a great bundle of technologies when it acquired A123. But it's hard to argue with these private company transactions. It's no different than when Cisco buys someone for its technology.

Four-fifths of the such acquisitions by dollar value are by SOEs, or financed by the state-controlled banking sector, according to the *New York Times*. With China holding \$3 trillion in assets, why wouldn't you buy all the critical technology you could get your hands on? If I were them, that's what I would do.

Are these all part of China's "go-out" strategy? I would call it a responsible investment strategy. Will that mean more competition for U.S. based multinationals? Yes, of course, it's competition to acquire the choicest assets. What makes this issue so difficult? Some parts of the game they are playing by our rules, some parts of the game they have their own rule book.

Do Chinese SOEs operating in world markets source locally or do they source from China as a matter of government policy? With all due respect, I think that's the wrong question. I can only comment based on what I have observed about Huawei and Lenovo. Both have shown a strong propensity towards vertical integration, doing things themselves. It has served them well. They obviously need to source the best raw materials and components from the best suppliers to stay competitive, but they have demonstrated both the will and the ability to do things internally, in

contrast to many American firms who favor vertical specialization and outsourcing.

What are the implications for the United States if China is granted market economy status within the WTO? This is a definitional problem. China and we have different definitions of what constitutes a market economy. We think a free-market free of interventionist distortions. China has their model of state-directed capitalism. I think this asymmetry in definition lies at the heart of our uneasiness, because I believe the spirit of the WTO rules are more aligned with our view. We can argue that they need to play by our rules. When we were the world's "most attractive" market we could make the rules and try to enforce them through market access. That's not necessarily going to change their thinking, in my opinion.

Nonetheless, I see opportunity in the Trans-Pacific Partnership to set the bar for state intervention. We will have to be careful, as Singapore, one of the TPP's founding members, still engages in a lot of developmental subsidies. But to me this is an opportunity to establish some rules of the road prior to a possible entry by China some day.

My most urgent message is to U.S. multinationals faced with competing with Chinese SOEs or private firms with access to state aid or state-controlled bank capital. These firms are aggressive, they think globally, and they have long investment horizons.

We need to learn from history, and not delude ourselves into thinking that because they are not playing fair or because they are playing by a different set of rules, that in the end fair play and justice will prevail. For perhaps the first two decades of Airbus's existence, Boeing complained bitterly about state subsidies, or believed that Airbus would collapse under the weight of competing national agendas. Certainly in the early days of the A300 "white tails," it seemed that state subsidies and launch aid were all that kept them going, so I certainly understood Boeing's point of view. But Airbus kept introducing innovative products, like the NASA developed fly-by-wire and winglets on the A320, and they developed a low cost production system. Constantly blaming state aid or discounting Airbus's capability growth got in the way of Boeing recognizing their own competitive shortcomings, something that they paid dearly for over subsequent years. Cisco take note.

We cannot let the Chinese form of state capitalism distract ourselves from leading the world in innovation, investing for the long term, and ensuring our own global competitiveness. I hope and pray that our leaders here in Washington can think carefully about the shackles and disadvantages we place on *our* firms in this high stakes competition of economic systems.

**OPENING STATEMENT OF MR. JOEL BACKALER
DIRECTOR, FRONTIER STRATEGY GROUP**

MR. BACKALER: Mr. Chairman and members of the Commission, thank you for the opportunity to appear before you today. My name is Joel Backaler. I am a Director at Frontier Strategy Group, a Washington, D.C.-based advisory firm that supports American multinationals' entry and operation in emerging markets.

I am also author of the forthcoming book, *China Goes West*,

being published by Palgrave Macmillan. The book analyzes the drivers and implications of Chinese firms' global expansion with a particular focus on Chinese companies investing in the United States and other advanced economies.

I previously worked as a consultant for both private and state-owned Chinese companies on the ground in China.

My statement summarizes key findings from my research on Chinese state-owned and private firms and their overseas expansion.

Overall, the United States has much to gain from the global emergence of Chinese companies, including: employment generation, tax revenues, potential investors in domestic infrastructure, and new market access. However, there are important reasons to proceed with caution, including very legitimate concerns about national security, cybersecurity, and anti-competitiveness.

In my statement for the record, I offer a series of recommendations to maximize the benefits of Chinese ODI while mitigating risk. For example, we should do more to coordinate, track and report state and federal investment recruitment efforts. We could also improve "America's storefront" by establishing a 24-hour online presence that not only attracts and engages potential investors, but also provides valuable insight and information about these overseas investors.

In *China Goes West*, I expand on this list to include a complete set of recommendations across the government, corporate and social spheres of both the U.S. and China.

Transitioning to address some of the specific questions raised by today's panel, I believe the line between state-owned and private is blurred. The use of "state-owned enterprises" as a homogenous term in current policy discourse belies their variation and structural complexity. Central state-owned enterprises are managed by state ownership agency SASAC, which combines both ownership and regulatory functions.

Each central state-owned enterprise itself comprises a complex, multi-layered business group, the apex of which is a state holding corporation. Below the state holding corporation are myriad subsidiary firms, some of which may be publicly listed on stock exchanges in China and overseas.

SASAC has sought since its founding in 2003 to introduce modern corporate governance institutions such as boards of directors and supervisory boards. But while corporate governance institutions have been established in central state-owned enterprises, publicly listed subsidiaries, and an increasing number of state holding corporations, the fact that the newly created board chairman is also the Party Secretary in virtually all companies suggests this has not fundamentally changed existing authority structures.

It is important to note that government support of Chinese firms, both financial and political, is not limited exclusively to state-owned enterprises. For example, Haier, the Chinese consumer appliance maker,

positions itself as a collective firm. However, it relied on the municipal government of Qingdao for support ranging from loans and free land use early on in its development.

Moreover, Haier as an ostensibly private company is the only non-state-owned enterprise managed by Qingdao's SASAC. It is wrong to think that state-owned enterprises are the only firms with ties to the Chinese government and recipients of financial and political support from the state.

While the Third Plenum affirmed the enduring importance of state-owned enterprises, it emphasized the market's decisive role in resource allocation and expressed the new administration's intention to build a more even playing field between state-owned and private enterprises. Gradual economic reform achieved through increased market competition, rather than ownership change, has long characterized China's approach to economic reform.

Far-reaching reform to the state sector remains unlikely given the powerful interest groups and individuals within the Party who profit from the current status quo. Yet, the Third Plenum reforms have not unequivocally bolstered Chinese state-owned enterprises' position vis-a-vis private Chinese firms.

Consider the Third Plenum's reform aimed at introducing greater competition in non-strategic sectors. In fact, there are a significant number of SOEs operating in non-strategic sectors such as restaurants, retailing and low-end manufacturing. According to the Ministry of Finance data, over 90,000 individual enterprises with approximately 37 trillion renminbi--that's 6 trillion in U.S. dollars--operate in non-strategic sectors. Consider one of my former clients, a chemical state-owned enterprise that also happened to operate a series of noodle restaurants, or a steel producer that raises pigs.

Despite opposition from vested interests within the State and Party itself, Chinese leaders have important motivations to continue and deepen reform of the state-owned sector, including decreasing governmental liabilities, strengthening budget constraints, and improving the quality of state-owned companies' goods and services through greater market competition.

Chinese companies of varying ownership structures expand internationally due to both governmental and commercial motivations. By encouraging Chinese firms' international expansion, the government can secure the natural resources necessary to fuel China's economic growth while bolstering economic ties with friendly regimes. In addition, internationalization of the state-owned sector provides the Chinese government with a channel to invest its vast foreign exchange reserves while boosting long-term economic growth and increasing its soft power via national champions in strategic industries.

From a domestic perspective, the business case for Chinese companies to go out is very strong. The domestic market in China is fiercely competitive and Chinese firms require advanced technology and global management best practices to stay ahead of competitors back home.

Acquiring global brands through mergers and acquisitions help bridge the trust gap for Chinese companies seeking to connect with an international audience for the first time, as was the case for Pearl River Piano, or to rebrand their firm as a high-end alternative for the Chinese domestic market like automaker Geely.

Most importantly, international expansion opens up new markets to grow Chinese firms' businesses and become less reliant on a slowing Chinese economy.

Chinese ODI has been and continues to be dominated in terms of overall amount by state-owned enterprises. However, a trend in which the proportion of ODI constituted by private Chinese companies' investment has already appeared. In 2012, private Chinese firms accounted for 9.5 percent of China's ODI, representing a substantial increase from just four percent in 2010. Another important trend is the shift in the focus of Chinese firms' ODI beyond resources to industries as diverse as consumer goods, manufacturing, and even entertainment.

I'm happy to elaborate on any of these points during Q&A, but that concludes my opening statement.

**PREPARED STATEMENT OF MR. JOEL BACKALER
DIRECTOR, FRONTIER STRATEGY GROUP;
AUTHOR, CHINA GOES WEST: EVERYTHING YOU NEED TO KNOW ABOUT
CHINESE COMPANIES GOING GLOBAL**

Testimony before the U.S.-China Economic and Security Review Commission

Joel Backaler
Director, Frontier Strategy Group &
Author of *China Goes West* (Palgrave Macmillan, 2014)

Friday, February 21, 2014
1:30 PM

**Hearing on US-China Economic Challenges:
Panel III: Chinese State-Owned Enterprises and Non-Market Economics –
Competitive Challenges**

Mr. Chairman and members of the Commission, thank you for the opportunity to appear before you today. My name is Joel Backaler and I am a Director at Frontier Strategy Group, a Washington DC-based advisory firm that supports American multinationals' entry and operation in emerging markets. I am also author of the forthcoming book *China Goes West*, published by Palgrave Macmillan. The book analyzes the drivers and implications of Chinese firms' global expansion, with a particular focus on Chinese companies investing in the United States and other advanced economies. I previously worked as a consultant for both private and state-owned

Chinese companies on the ground in China.

This written statement summarizes key findings from my research on Chinese state-owned and private firms and their overseas expansion.

State vs. Private: A Blurred Line

The use of “Chinese state-owned enterprises” as a homogenous term in current policy discourse belies their variation and structural complexity. Central state-owned enterprises are managed by state ownership agency SASAC (State-owned Assets Supervision and Administration Commission), which combines both ownership and regulatory functions.³⁸ Each central state-owned enterprise itself comprises a complex, multi-layered ‘business group’, the apex of which is a state holding corporation.³⁹ Below the state holding corporation are myriad subsidiary firms, some of which may be publicly listed on stock exchanges in China and overseas. SASAC has sought since its founding in 2003 to introduce modern corporate governance institutions such as boards of directors and supervisory boards. But while corporate governance institutions have been established in central state-owned enterprises’ publicly listed subsidiaries and an increasing number of state holding corporations, the fact that the newly-created Board Chairman is also the Party Secretary in virtually all companies suggest this has not fundamentally changed existing authority structures.

It is important to note that government support of Chinese firms—both financial and political—is not limited exclusively to state-owned enterprises. This assumption can be misleading. For example, Haier, the Chinese consumer appliance maker positions itself as a ‘collective firm’; however, it relied on the municipal government of Qingdao for support ranging from loans, free land use, and even government-brokered acquisitions of failing Chinese SOEs in the consumer appliance industry.⁴⁰ Moreover, Haier—as an ostensibly private company—is the only non-state-owned enterprise managed by Qingdao’s SASAC.⁴¹ It is wrong to think that state-owned companies are the only firms with ties to the Chinese government and recipients of financial and political support from the state.

The Third Plenum & State Sector Reform in China

³⁸SASAC exercises state authority by its direct involvement in personnel appointment, setting annual performance targets, and conducting performance evaluation for the companies it manages. However, SASAC does not directly manage firm operations or decision-making about investments; firm leaders and companies retain significant autonomy in these areas.

³⁹ Industry-based analysis of business groups is complicated by the fact that subsidiaries frequently have investments outside of the holding company's core industry at home and overseas. For example according to the China Iron and Steel Association (CISA), non-steel business turnover of China’s seven largest steelmakers accounted for 23 per cent of their total revenues as of 2013.

⁴⁰ Caijing GuanCha. “Guoyouqiye haishi jiti qiye? Haier jituan chanquan xingzhi zhibian.” 7 July 2004. Web. [http://gb.cri.cn/7212/2004/12/07/1166@ 383635.htm].

⁴¹ From SASAC.gov.cn: “The relationship between SASAC and state-owned assets supervision and administration bodies at provincial and municipal (regional) levels is to fulfill the responsibilities of investors of state and local assets authorized by the State Council and the provincial and municipal (regional) governments respectively.”

In November 2013, The Third Plenum of the 18th Central Committee of the Chinese Communist Party (CCP) presented the Xi administration's agenda for the next stage of reform to China's state-owned sector. While affirming the enduring importance of state-owned enterprises, it emphasized the market's "decisive" role in resource allocation and expressed the new administration's intention to build a more even playing field between state-owned and private enterprises. Gradual economic reform achieved through increased market competition—rather than ownership change—has long characterized China's approach to economic reform. Far-reaching reform to the state-sector remains unlikely given the powerful interest groups and individuals within the Party who profit from the current status quo.⁴²

Yet the Third Plenum reforms have not unequivocally buttressed Chinese state-owned enterprises' position vis-a-vis private Chinese firms. One of the most important indicators of this is the intention expressed in the Third Plenum reforms to introduce greater competition in non-strategic sectors to break up monopolies and let SOEs face more competition from private Chinese companies. SOEs currently operating in "non-strategic" industries such as restaurants, retailing and low-end manufacturing are significant — according to Ministry of Finance data, over 90,000 individual enterprises with approximately 37 trillion *renminbi* (6 trillion USD) operate in "non-strategic" sectors.⁴³ Despite opposition from vested interests within the state and Party itself, Chinese leaders have important motivations to continue and deepen reform of the state-owned sector, including: decreasing government liabilities, strengthening budget constraints, and improving the quality of state-owned companies' goods and services through greater market competition.

Chinese Firms and Overseas Direct Investment

Chinese companies of varying ownership structures expand internationally due to both governmental and commercial motivations.⁴⁴ The "go out" policy, formally launched in 2000 during the 10th 5-year plan, remains the primary policy framework through which the government supports Chinese overseas investment. By encouraging Chinese firms' international expansion, the government can secure the natural resources necessary to fuel China's economic growth while bolstering economic ties with friendly regimes. In addition, internationalization of the state-owned sector provides the Chinese government with a channel to invest its vast foreign exchange reserves while boosting long-term economic growth. The development of national champions in strategic industries helps China expand its political as well as economic influence through soft power.

From a domestic perspective, the business case for Chinese companies to 'go out' is very strong. The domestic market in China is fiercely competitive and Chinese firms require advanced technology and global management best practices to stay ahead of competitors back home. Acquiring global brands through mergers and acquisitions help bridge the trust gap for Chinese companies seeking to connect with an international audience for the first time, or to rebrand their

⁴² Naughton, Barry. "The Narrow Road to Reform." 7 October, 2013.
[<http://media.hoover.org/sites/default/files/documents/CLM42BN.pdf>]

⁴³ Batson, Andrew. "Fixing China's State Sector." January 2014
[http://www.paulsoninstitute.org/media/117965/fixingchina_sstatesector_english.pdf]

⁴⁴ For a detailed overview of the motivations for Chinese firms to invest overseas – see Chapter 2 titled, *Fleeing the Great Game: Why Are Chinese Companies Going Global?* in *China Goes West* (Palgrave Macmillan, April 2014).

firm as a high-end alternative for the domestic Chinese market. Most importantly, international expansion opens new markets to grow Chinese firms' businesses and become less reliant on a slowing Chinese economy.

Chinese overseas direct investment (ODI) has been - and continues to be - dominated in terms of overall amount by state-owned enterprises. However, a trend in which the proportion of ODI constituted by private Chinese companies' investments comprising a greater proportion of total ODI flows has already appeared. In 2012, private Chinese firms accounted for 9.5% of China's ODI representing a substantial increase from just 4% in 2010.⁴⁵ If the reforms announced at the Third Plenum are implemented, this trend will only accelerate further. Another important trend is the shift in the focus of Chinese firms' ODI beyond resources to industries including consumer goods, manufacturing, and entertainment. The U.S. and EU's slow recovery from the global financial crisis has undoubtedly expedited the frequency and scale of Chinese companies' investments overseas.

However, what we know about Chinese SOEs' ODI in terms of data outside of developed markets remains limited for several reasons. First, China's Ministry of Commerce (MofCOM) statistics do not give firm-level investment data and includes only investments above \$10 million. Second, for the central SOEs that do have publicly listed subsidiaries, we only have reliable investment data for those subsidiaries and not their other subsidiaries with investments overseas or the overall holding companies. Third, even within these companies there is an information problem as corporate headquarters struggles to get accurate economic data from subsidiary firms. They attempt to control subsidiaries—but with various degrees of success—through methods including: executive personnel control; centralized information management systems; one-level-up decision-making; and budget controls.

Recommendations for the United States

The United States has much to gain from the global emergence of Chinese companies, including: employment generation, tax revenues, potential investors in domestic infrastructure, and new market access. However, there are important reasons why Chinese investments should not all be welcomed, such as: concerns about national security, cyber-security, and anti-competitiveness. Targeted efforts must be made to ensure that Chinese investment in the US is mutually beneficial at the government, corporate, and individual levels. Below I offer a series of recommendations⁴⁶ for the American government to maximize the benefits of Chinese ODI, while mitigating potential anti-competitive, cyber security or national security concerns.

i. Remove politics from investment review to the greatest possible extent

Last year, Chinese state-owned Shuanghui International acquired complete ownership of American pork producer Smithfield Foods in a \$4.7 billion deal. But before the Committee on Foreign Investment in the United States (CFIUS) scrutiny of the deal even began, politicians started to appear on major news networks expressing their “concerns” about food safety and

⁴⁵ “The expanding scale and scope of China's outward direct investment,” *The Economist* (Jan. 19, 2013).

⁴⁶ For a complete set of recommendations across the government, corporate and social spheres – both in China and the US – see Chapter 8 titled, *The Response: Maximizing Benefits, Minimizing Concerns in China Goes West* (Palgrave Macmillan, April 2014).

product quality, despite the fact that government oversight of the firm's products would not change. The ongoing politicization of high-profile Chinese investments perpetuates the myth that Chinese investment is not welcome in the U.S. In fact, the data shows that the vast majority of attempted Chinese investments are successfully completed without government interference. But if the US is seen by Chinese firms as “unwelcome to Chinese investment” as a result of unclear, inconsistently applied, or politically motivated regulatory procedures will miss a tremendous opportunity to benefit from Chinese investment.

ii. Consider political priorities, focus on economic factors

The U.S. should consider political priorities, but focus on economic factors and communicate from the senior government level down that Chinese investment is welcome. This message should begin with an official statement and be reinforced by trade dialogues, bilateral forums and on the Internet. Messaging needs to be targeted toward the relevant Chinese investors for a particular industry or location of investment. It should also be made as accessible as possible through multiple channels. For example, many Chinese businesspeople may feel more comfortable reviewing only FAQ's and chatting informally through one-on-one Internet messaging tools with SelectUSA⁴⁷'s representatives rather than attending a live Q&A session. It is critical that all communications are in Mandarin—leave no room for misinterpretation. Clear, consistent, and regularly repeated messaging will strengthen bilateral communication on investment issues. At the same time, these communications will help to provide a more objective economic context for any domestic voices that might focus solely on political factors.

iii. Remedy the disconnect between federal and state levels in the U.S.

In China, SelectUSA primarily fulfills its mission by traveling to various provinces and hosting events at which Chinese firms interested in investing in the U.S. can learn more about the American business environment. At the same time, a small group of U.S. state governors and city mayors visit China on trade missions to selectively recruit Chinese investment and introduce specific projects in their individual regions. State representatives may partner with one of 33 U.S. state trade offices in China.

This situation clearly illustrates the disconnect between federal and state efforts to promote Chinese investment. Through SelectUSA, the federal government cannot recommend particular industries or locations where Chinese companies should invest. Therefore, the only specific guidance Chinese investors receive is often from state government officials traveling to China for trade missions. Such state officials are incentivized to promote their own interests—seeking out job creation and tax dollars that will fuel their local economies.

The U.S. should bridge this federal-state gap by adopting a more systematic and coordinated approach to promoting investment from Chinese companies. With small trade offices in China,

⁴⁷ SelectUSA was established by Executive Order of the President and is housed within the U.S. Department of Commerce. SelectUSA is a U.S. government-wide effort to encourage, facilitate, and accelerate business investment in the United States by both domestic and foreign firms—a major engine of economic growth and job creation.

irregular governor visits from some states, and understaffed federal agencies, actors at the state and federal levels should be working together to attract investment and to consistently communicate information about investment regulations and procedures. Instead, in some cases levels are competing with each other, or providing inconsistent information to potential Chinese investors.

iv. Improve data accessibility

Chinese overseas investment can be clearly quantified if the U.S. government can adopt a more coordinated approach to data collection. For example, several state investment recruitment agencies create “Project Profiles” for proposed investments from China and other overseas investors. The project profile measures the potential net economic impact of an investment to their local economy by documenting expected job creation, land and building use, energy consumption, and a range of other factors. Successful investments are documented and tracked by local agencies. If such data were collected and reported in a consistent manner at the state level in the U.S. then a centralized federal dataset would paint a highly accurate picture of the nature and volume of Chinese investment in the US. The resulting data could help indirectly inform Chinese businesses about where they should consider investing based on the industry distribution of the already documented investment cases. Meanwhile, the dataset could serve as a valuable means to encourage greater cooperation among the various government stakeholders competing for Chinese investment in their respected regions.

v. Adopt a dual online-offline strategy

To supplement its live forums, SelectUSA would be wise to learn from Germany’s Trade & Invest, the economic development agency of Germany, and create a Chinese language website with a detailed Q&A section addressing common concerns. SelectUSA could also go a step further and use Chinese social media tools such as Weibo, WeChat, and QQ instant messenger to engage with Chinese businesspeople one-on-one to answer their individual questions. This would ensure that the US has a “24-hour storefront” in China. In addition, SelectUSA would gain valuable intelligence about Chinese investors, enabling it to identify common characteristics, concerns, and trends to improve its engagement strategy. A dual online-offline approach is best suited for the current stage where SelectUSA’s staffing capacity is simply not sufficient to meet potential Chinese demand across more than 30 provinces.

Appendix: Selected Tables & Figures from *China Goes West*

Chinese companies are young and learning.

“In many industries Western firms have had decades or even a century more of operating experience compared with their Chinese competitors. In contrast, Chinese firms’ rapid growth trajectory means that they are learning how to develop their business while transforming into global industry giants at the same time.” (p. 11)

Table 1.1 Comparison of Chinese vs Western firms by years of experience

Industry	Western company	Founded	Chinese company	Founded
<i>Home Appliances</i>	Electrolux	1910	Haier	1984
<i>Beverages</i>	The Coca Cola Company	1892	Jianlibao	1984
<i>Athletic Apparel</i>	Nike	1964	Li-Ning	1990
<i>Medical Devices</i>	Roche	1896	Mindray	1991
<i>Oil & Gas</i>	Chevron	1879	PetroChina	1999

Chinese state-owned enterprises may operate across different business areas.

Chinese state-owned chemical firm ChemChina operates a subsidiary under its BlueStar group called Malan Noodles. Malan Noodles is one of the largest fast food noodle restaurants in all of China. (p. 25)

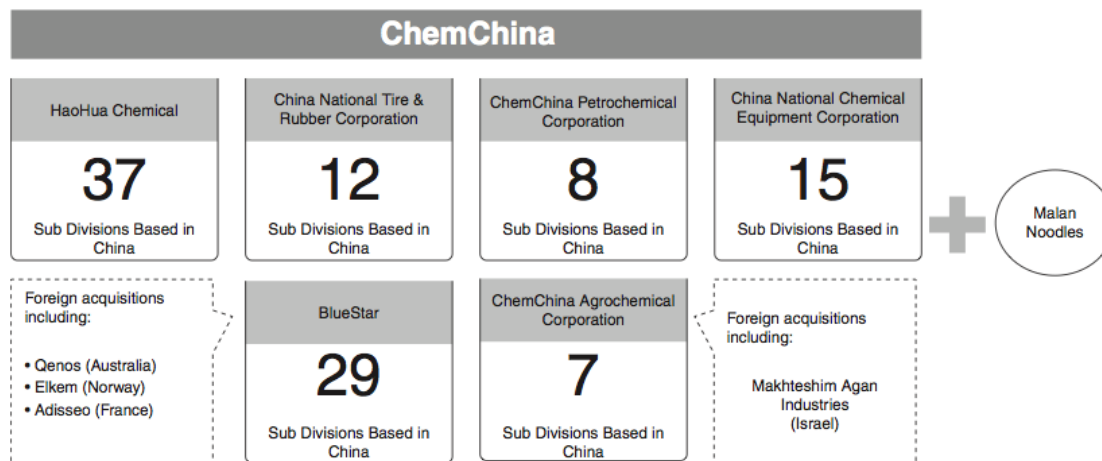


FIGURE 1.2 ChemChina domestic and overseas subsidiaries

Source: Author's own image, statistics from ChemChina.com.

**OPENING STATEMENT OF DR. ADAM HERSH
SENIOR ECONOMIST AND CHINA SPECIALIST
CENTER FOR AMERICAN PROGRESS**

DR. HERSH: Co-Chairs, members of the Commission, thank you for inviting me to testify on China's state-owned enterprises and non-market economics.

In order to fully understand how China's non-market economy works, it's important to distinguish between the Communist Party of China and the nation-state of the People's Republic of China. The Party rules with an unchecked monopoly on power while institutions of state administer this rule and provide a veil for Party control.

Even if governance institutions may change, the thread of Party influence will still run throughout China's economy as members continue occupying key positions in the Party, the government, and business hierarchies--often at the same time.

What matters from an economic perspective is not the name that we give this system but who holds control over China's economic resources, and what incentives and constraints they face in making economic decisions.

The answer to these questions, even if the Third Plenum agenda is fully implemented, are that the same people with the same policy levers facing the same set of incentives will continue to be in charge of productive and financial resources. This fact defines the fundamentally non-market nature on which China's economy operates.

To be sure, there are some significant changes proposed in the Third Plenum, and China has a growing number of private companies. But overtures to a decisive role of the market are just the latest effort to create the illusion of marketization. Private companies in China are still playing by the Party's game.

Today, I want to focus on three aspects of China's non-market economy, although there are many.

First, state ownership and Party control run much deeper than the 117 State Owned Enterprises administered by the State-owned Assets Supervision and Administration Commission. The majority of state ownership and the ability to deliver preferential treatment to businesses resides at the local government level where officials operate with broad independence from Beijing.

Both the extent of state ownership and the means to privilege favored businesses are becoming increasingly obscured as more enterprises are corporatized and registered in offshore tax havens. These assume the form of modern global businesses; however, they continue to operate on a non-market basis and through relational transactions.

Top managers and board members are chosen not by shareholders but through Party mechanisms, even in joint ventures with foreign companies. Individuals in these positions typically also hold roles in the government, the Party, and on boards of related enterprises. The interpersonal linkages help coordinate non-commercial dealings between

legally unrelated firms, and they are reinforced by Party personnel systems that rotate people between such posts.

Changsha Zoomlion Heavy Industries, the world's sixth largest heavy machinery manufacturer, is a representative case of how this works. Zoomlion is not a SASAC SOE. It was founded in 1992 as a spinoff from Hunan's provincial government. In 2006, Zoomlion created an offshore financial holding company and reorganized itself as a foreign-invested joint stock company.

Despite listing shares on the Shenzhen and Hong Kong stock markets, Zoomlion is still 60 percent owned by the Hunan government, 17 percent owned by SASAC, and nine percent by a state-backed private equity fund.

Its board is comprised of people connected to businesses upstream and downstream from Zoomlion. Board members connected to state-owned steel producers influence Zoomlion's sourcing decisions for inputs, and board members connected to downstream construction and mining businesses help Zoomlion secure market share for their products.

Chinese officials have also proven themselves willing to deliver preferential treatment to favored private businesses when it serves their interests. For example, private automaker Geely routinely received a range of tax breaks, land grants, subsidized utilities and preferential loans from state-owned banks throughout its growth.

Geely also received eager financial backing from local governments in Shanghai and Heilongjiang Province to acquire Volvo in 2010.

Second, extensive government ownership of financial and nonfinancial corporations creates structural barriers to the true marketization of China's financial system. These barriers are foundational and will not be overcome by relaxing controls on interest rates and international capital flows.

Capital raised in China's corporate bond markets flows almost exclusively to local government-owned enterprises and is supplied almost exclusively by state banks. This practice is supplanting bond debt for policy lending, not allowing markets to price capital.

China's stock markets also don't operate on market principles which would require providing a market for corporate control and allocating capital resources. Because in China only non-controlling minorities of shares are ever offered, it is not possible for the market to govern corporate control or price capital assets. Firm managers and boards of directors are appointed by Party systems and thus are insulated from the possibility that investors could threaten management position or state control of firms.

Stock market listings do achieve two things, however.

First, they inject substantial capital into SOEs without burdening state banks and budgets and without losing state control over the productive assets.

Second, they legitimize China's SOEs in the global economy by

vesting them with the credibility of international investment banks, consultancies, and accounting and law firms that help take them public.

Third, one of the most heralded aspects of the Third Plenum agenda really only gives the appearance of change from current policy restricting foreign investments. This is the pledge to shift from a positive list regime for foreign investment to a negative list with national treatment. This pledge is today being tested in the Shanghai Pilot Free Trade Zone, but so far it appears to be merely symbolic.

The negative list for the zone, in essence, simply recreates the positive list of the current and foreign investment catalogue, albeit in a different form. Investment in industries on the negative list within the zone will still need to apply for investment approval just like before and just like outside the zone.

This equivalence is not lost on foreign businesses, which have continued to invest strongly in Shanghai but mainly outside of the new pilot free trade zone.

It is worth noting that the reason discriminatory treatment of foreign investment has been such a big issue is because discrimination against foreign goods and services is so prevalent in China. This discrimination on imports is one reason motivating foreign businesses to invest directly in China in order to gain access to the world's fastest growing and soon-to-be largest market.

These are just three of the many aspects that define China's nonmarket economy. I look forward to further discussing these with you and thank you for the opportunity today.

**PREPARED STATEMENT OF DR. ADAM HERSH
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CENTER FOR AMERICAN PROGRESS**

Testimony before the U.S.-China Economic and Security Review Commission on “China’s State-Owned Enterprises and Non-Market Economics”

Dr. Adam S. Hersh
Senior Economist, Center for American Progress
February 21, 2014

Co-chairs, members of the Commission: thank you for inviting me to testify today on China’s state-owned enterprises (SOEs) and non-market economics.

My name is Adam Hersh and I am Senior Economist at the Center for American Progress, although the testimony today solely reflects my personal opinions.

In order to fully understand how China’s nonmarket economy works, it is important to distinguish between the Communist Party of China and the nation-state of the People’s Republic of China. The distinction is this: the Party rules over China’s economy and society with an

unchecked monopoly on power, while the institutions of state administer this rule. In China, the Party is fundamental while the artifice of state institutions is fungible. One can imagine multiple institutional configurations for governing China's economy consistent with preserving Party rule, of which the reform agenda envisioned in the 18th Party Congress's in the third 3rd Plenum "Decision" is but one.

To be clear, by invoking the Party I am not inciting a "Red Scare." The Party is "communist" in name only and does not espouse an imperial left-wing ideology, but rather a profound nationalism to justify its one-party authoritarian rule whose thread runs throughout the economy and society where members occupy key positions—often simultaneously—in Party, government, and business hierarchies.

What matters—from an economic perspective—is who holds agency over China's economic resources, and what incentives and constraints these people face in making economic decisions? The answer to these questions are—even if the 3rd Plenum reform agenda is fully implemented as envisioned by 2020—the same people, with most of the same policy levers, and facing the same set of incentives will still be occupy positions of controls over China's productive and financial resources and will be linked together through formal and informal networks that allow coordination of activities across discrete institutions.

This should not imply that the Party's foundational role provides a unified, monolithic force capable of issuing directives from the top of the pyramid in Beijing down to the lowest reaches of the governing apparatus. Rather, we should recognize this structure as one of "fragmented authoritarianism," in the words of political scientist Ken Lieberthal,⁴⁸ where authority and autonomy is highly decentralized throughout China's political system, particularly with respect to control over economic resources and economic choices: where and when to invest, how to implement strategies for economic growth. This bottom-up structure of state involvement is combined with top-down policies that create a favorable macroeconomic environment for development including through engineering an undervalued exchange rate, setting the price of capital and other inputs for production, coordinating relationships between firms, and restricting access to the domestic market for goods, services, and investments.

Overtures in the 3rd Plenum to a "decisive role of the market" are the just latest step in erecting a façade of a modern market economy. Party influence over the economy runs much deeper than mere state ownership and creates a structural barrier to China moving beyond its nonmarket economy foundations that cannot be separated from specific industries or firms within these industries.

I will make three points to illustrate this assessment.

1. Pervasive Government Influence Within and Across Firms

First, government ownership and Party control run much deeper than the 117 state-owned enterprises, or SOEs, designated by the State-owned Assets Supervision and Administration

⁴⁸ Kenneth Lieberthal and Michael Oksenberg. *Policy Making in China: Leaders, Structures, and Processes*. Princeton University Press: 1990.

http://books.google.com/books/about/Policy_Making_in_China.html?id=7kgIN9KJwSwC.

Commission, or SASAC. As I testified previously before this commission, much of the resources and authority to deliver preferential treatment to businesses reside at the local levels of China's government.⁴⁹ Local officials face incentives both for promotion through the Party personnel system—conditioned on maximizing economic output, technological accumulation, and social stability—as well as for personal enrichment. There is a competitive element for powerful local officials embedded in this system, but this competition is based on political advancement rather than market-based competition.

Both the extent of state ownership and the means for delivering preferential treatment to favored businesses are becoming increasingly obscured by policies that have transformed enterprises into corporate structures that assume many of the trappings of a modern global business, including often with publicly traded shares, and boards of directors with ostensibly independent external directors. But function does not necessarily follow form. In practice, these firms operate under quite different decision-making mechanisms than do comparable firms in the United States or other advanced economy countries.

Top managers and members of boards of directors of China's major and minor corporations are not selected by shareholders, but by the Party work groups established within state-owned and many private-owned firms.⁵⁰ Senior managers and directors often hold positions of power simultaneously in government institutions, within the Party, and on boards of related enterprises. What's more, scholars identify a system of “institutional bridging” through which the personnel department rotates individuals between industry, government, and Party posts as a mechanism for coordinating activities and strategy across discrete organizations.⁵¹ In one example in 2007, senior executives of China Mobile, China Telecom, China Netcom, and China Unicom all rotated positions between these firms.⁵²

Take the case of Changsha Zoomlion Heavy Industries, the world's 6th largest heavy machinery manufacturer. Zoomlion is not registered as a central SOE under SASAC control. The company was founded in 1992 as a spinoff from Hunan province's Ministry of Construction. The company's founder and chairman, Zhan Chunxin had been the Deputy Director of the provincial agency that preceded Zoomlion's reorganization, and has been a longtime representative to the National People's Congress as well as being the deputy chairman of the China Entrepreneurs Association since 2008.

In 1999, during the central government's SOE reform campaign to “grasp the large and let go the small,” Zoomlion absorbed a number of other smaller heavy equipment manufacturers from

⁴⁹ Adam Hersh, “Chinese State-Owned and State-Controlled Enterprises,” Testimony before the U.S.-China Economic and Security Review Commission. February 15, 2011. <http://www.americanprogressaction.org/issues/economy/report/2012/02/15/11069/chinese-state-owned-and-state-controlled-enterprises/>.

⁵⁰ Richard McGregor. *The Party: The Secret World of China's Communist Rulers*. Harper: 2012.

⁵¹ Li-Web Lin and Curtis J. Milhaupt, “We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China,” *Stanford Law Review*, Vol. 65, no. 697, pp. 697-760.

⁵² Nicholas Howson. “China's Restructured Commercial Banks: *Nomenklatura* Accountability Serving Corporate Governance Reform?” In Zhu Min, et al. (eds.) *China's Emerging Financial Markets: Challenges and Global Impact*. Wiley and Sons: 2009.

around the country,⁵³ which allowed SASAC to take a minority holding in the company of nearly 17 percent, while the Hunan provincial government retained 75 percent ownership and with the remaining 9 percent equity was distributed to investment holding companies in which Mr. Zhan and other senior managers in Zoomlion and the absorbed enterprises held ownership.⁵⁴ In other words, part of the public's assets was transferred directly to the private wealth of Party officials controlling the enterprise.

Then in 2006, Zoomlion created an offshore financial holding company and re-registered itself onshore as a foreign-invested joint stock limited company in preparation for an IPO on the Hong Kong stock exchange in December 2010. This share offering floated a minority stake of 18.5 percent of the company's equity—1.5 percent of which were deposited to China's National Council for Social Security Fund.⁵⁵

Through holding companies, the Hunan provincial government still controls 60 percent of Zoomlion, and its board of directors is comprised of individuals with linkages to enterprises in protected strategic industries both upstream and downstream from Zoomlion's core businesses, according to company reports. These relationships allow coordination between firms to procure key inputs for production—namely steel—and to secure steady demand for Zoomlion's outputs in the infrastructure construction and mineral extraction industries.⁵⁶

In 2012, the company report notes, Zoomlion received 212 million yuan in direct government grants and have used access to favorable credit from state-owned financial institutions to provide consumer credit in order to expand its market share.⁵⁷ Zoomlion has also used its state financial backing to “go out” into foreign markets through direct investment in global competitors, in 2008 purchasing a controlling 60 percent stake in the Italian company Compagnia Italiana Forme Acciaio, known as CIFA.⁵⁸

The case of Zoomlion is one example of the pervasive pattern of state ownership and privileged treatment masquerading as a private corporation. But state involvement to support business operations also extends to ostensibly private companies, such as automaker Geely of Zhejiang province, where support is consistent with local officials' incentives to maximize output,

⁵³ Unlike in a market system, inefficient capital assets in China are not recycled back into the market through bankruptcy for alternative, more productive uses. Rather, smaller and lower-performing state enterprises will be resorbed into their larger, more profitable big brothers.

⁵⁴ Zhang Boling and Yu Ning. “Dirty Clash of China's Heavy Equipment Heavies.” *Caixin (English)*. November 6, 2013. http://english.caixin.com/2013-11-06/100600019_1.html; <http://www.easecurities.com.hk/tc/Research/ipo/ipo01157.pdf>.

⁵⁵ BEA Securities. “Main Board H-share Listing Research: Changsha Zoomlion Heavy Industry Science & Technology Development Co., Ltd.” December 13, 2010. <http://www.easecurities.com.hk/tc/Research/ipo/ipo01157.pdf>.

⁵⁶ Zoomlion Heavy Industry Science and Technology Co., Ltd., “2012 Annual Report,” available at <http://zoomlionresource.icm.cn/attach/h000/h00/attach201304250855360.pdf> (accessed February 2014).

⁵⁷ Dinny McMahon, “China Machinery Makers' Gamble,” *The Wall Street Journal*, September 17, 2012, available at <http://online.wsj.com/news/articles/SB10000872396390443571904577630981616262896>.

⁵⁸ “PE Firm Hony Finds a Way to ‘Go Global,’” *Caijing Magazine*, October 28, 2008. <http://english.caijing.com.cn/2008-10-21/110029936.html>.

employment and other benchmarks for political promotion. Thus, though privately owned, Geely routinely received a range of tax breaks, land grants, subsidized utilities, and preferential loans from local government-controlled banks.⁵⁹ When private Geely sought to “go out” into the foreign marketplace by purchasing foreign automaker Volvo in 2010, it found a number of readily willing financial backers including financial holding companies controlled by the Shanghai city government, the Daqing city government (Heilongjiang province), and state-controlled banks.⁶⁰

2. Structural Barriers to a Marketized Financial System

Second, China’s status as a nonmarket economy is underscored by the structural barriers to marketization of its financial system posed by ongoing pervasive state-ownership of both financial institutions and nonfinancial corporations. Despite boasting many of the world’s largest banks and world record-breaking IPOs, China’s financial system is not poised to operate on market principles anytime soon, even with the marginal opening proposed for the Shanghai Pilot Free Trade Zone, or SFTZ. Relaxing controls on interest rates, international capital flows, trading of derivatives products, and the provision of financial services are insufficient conditions to overcome these barriers to market-based pricing and allocation of capital, and market-based control and governance of China’s corporate sector. Banks do not operate on market principles in their lending decisions and other asset positions. Firms also do not operate on market principles in their borrowing and investment decisions as they are neither accountable to lenders for repaying the loans (soft budget constraints), nor are they accountable to shareholders.

Consider first China’s financial institutions. China boasts a number of the world’s largest banks, measured by market capitalization, yet these banks are conspicuously absent from most of the world’s markets for financial services. This seeming anomaly is symptomatic of the non-market foundation for China’s financial system and hints at the real objective function of China’s mammoth financial institutions: serving the needs of national economic development. Unlike market-oriented U.S. banks, China’s banks appear to have little interest in expanding into new, foreign markets for financial services—except, perhaps, to provide financial services in support of SOEs that are “going out” with direct investment in overseas markets.

China’s efforts at financial liberalization are doing little more than erecting a façade of modern financial markets that supplants direct bank lending to favored companies with indirect lending through bond markets. But it is clear that corporate bond markets are serving the same borrowers that directed lending served, though without the problem of accumulating non-performing loans. As China’s corporate bond markets developed after 2005, the share of capital raised by local government-connected enterprises rose from a marginal share in January 2005 to more than 93 percent of the market by January 2014.⁶¹

Most of the corporate bond debt raised by local government entities flowed to areas typically

⁵⁹ Greg Anderson, *Designated Drivers: How China Plans to Dominate the Global Auto Industry*. Wiley and Sons: 2012.

⁶⁰ Liu Peng. “Where is Geely Getting the Money to Buy Volvo?” *The Economic Observer (English)*. April 20, 2010. <http://www.eeo.com.cn/ens/2010/0429/168910.shtml>; “Status Symbol,” *The Economist*. March 31, 2010. <http://www.economist.com/node/15825810>.

⁶¹ On an annualized basis. Author’s analysis of CEIC China database.

thought to be China's most commercially-advanced areas: Shanghai, Jiangsu, and Zhejiang accounted for 45 percent of all corporate bond borrowing by local governments in 2009; Beijing, Tianjin, and Guangdong accounted for another 21 percent.⁶² The shift from bank lending to debt issued in China's capital market helped banks avoid the embarrassing predicament of accumulating more non-performing loans from subsidized credit directed at favored firms and convey the impression of market-based mechanisms for assessing risk and pricing credit. However, while there new issues of bond debt have grown, trading volumes remain low and China's state-owned banks hold more than 70 percent of all bond issues.⁶³ Thus, China's bond markets are not working to price risk and interest rates. Only one percent of China's domestic debt obligations is held by non-state controlled entities.⁶⁴ This means that the Chinese state enjoys a monopoly in setting the domestic price of capital.

China's equity markets are also unable to operate on market principles due to widespread state ownership and control of nonfinancial corporations. To understand why, consider the role played by capital markets in shaping corporate business decisions and performance. In a market-based financial system, equity markets:

- price and allocate capital based on economic risk assessments,
- provide a price signal to guide firm managers,
- provide an opportunity to participate in control over the firm, including governance and ownership decisions, and
- provide a claim on the income (dividends) generated by the firm.

None of these conditions can be said to pertain to China's equity markets. Chinese laws and regulation constrain the control that shareholders can exercise over management, but because only non-controlling minorities of shares are ever in play in the market firm managers and boards of directors—appointed by Party systems—are insulated from the possibility that market investors could threaten state control of the firm, which remains squarely in the hands of those inside the system. What equity listings do achieve, however, is alleviating state budgets and state banks from the burden of financing SOEs without fundamentally changing the system of control over productive assets. In essence, the strategy of corporatization has infused Chinese firms with a new source of capital that comes with no strings attached.

For private investors, public offering of shares does provide a way for investors to claim a speculative slice of the pie of China's state capitalism. But these investors are merely along for the ride, with no prospect for management control or for exercising control through market mechanisms. Floating thin blocs of shares, rather than liberalizing control and governance of SOEs, strengthens the position of these entities inside the system of China's state capitalism.

It is also worth noting the role that major international investment banks, consultancies, and accounting law firms have played in assisting this strategy of corporatizing China's SOEs by

⁶² Carl Walter and Fraser Howie. *Red Capitalism: The fragile financial foundation of China's extraordinary rise*. Singapore: Wiley and Sons. 2011. Table 5.1.

⁶³ Carl Walter and Fraser Howie. *Red Capitalism: The fragile financial foundation of China's extraordinary rise*. Singapore: Wiley and Sons. 2011. P. 85.

⁶⁴ Carl Walter and Fraser Howie. *Red Capitalism: The fragile financial foundation of China's extraordinary rise*. Singapore: Wiley and Sons. 2011. P. 206.

providing the professional services to restructure the legal ownership forms, underwrite IPOs, and—perhaps most importantly—cloaked the restructured Chinese companies with credibility by championing the trading of their equities.

3. The 3rd Plenum's Non-reform Agenda

Third, business as usual in China's nonmarket economy is confirmed by the lack of foreign business enthusiasm for the most-heralded aspect of China's 3rd Plenum agenda: reforming the regime governing foreign investment. The 3rd Plenum calls for moving from a "positive" list defining permissible investment activities and a system of broad administrative discretion over investment approval to a "negative list" that specifies prohibited activities and promises to streamline investment approval.

This changes has long been a priority for U.S. officials and businesses investing in China that complain of discriminatory practices and that the investment approval regime facilitates technology transfer.⁶⁵ But it is also worth noting that one key impetus for inbound foreign direct investment in China is the restrictions on market access and discriminatory practices in business and government sourcing decisions that put foreign producers at competitive disadvantage. In order to access China's commercial market where businesses desire a share of the growth, foreign businesses are subject to accede to conditions for entry.

The negative list and national treatment approach called for in the 3rd Plenum is now being pioneered in the Shanghai Pilot Free Trade Zone, or SFTZ. But this change thus far appears merely symbolic. The negative list promulgated in September 2013, covering nearly 200 activities, in essence replicates the restrictions of the positive list foreign investment catalogue. In other words, the negative list expresses the same restriction on foreign investment activities as the existing foreign investment catalogue, only in different terms. Investment in industries or activities on the negative list within the SFTZ will still need to apply for investment approval—just like before and just like outside the zone where the positive foreign investment list still governs.

While China's leaders have pledged annual review of the SFTZ's negative list, those closest to the issue, such as John Frisbie of the U.S.-China Business Council report suspect intentions that the economic reform agenda and its test implementation in the SFTZ make a break with past practice.⁶⁶ But the most telling indication of China's departure from existing policies is that little foreign investment has yet to flow into the zone, although Shanghai still remains an attractive destination for foreign direct investment.⁶⁷

⁶⁵ U.S. Chamber of Commerce. 2012. *China's Approval Process for Inbound Foreign Direct Investment*. https://www.uschamber.com/sites/default/files/legacy/reports/020021_China_InboundInvestment_Cvr.pdf; James McGregor. *China's Drive for Indigenous Innovation : A web of industrial policies*. https://www.uschamber.com/sites/default/files/legacy/reports/100728chinareport_0.pdf.

⁶⁶ "USCBC Head Sees ITA Collapse As Casting Doubt on Chinese Reforms." *Inside U.S. Trade*. February 14, 2014.

⁶⁷ Daniel Ren. "Foreign investors sideline Shanghai's free-trade zone in favour of manufacturing." *South China Morning Post*. January 27, 2014. <http://www.scmp.com/business/economy/article/1414449/foreign-investors-sideline-shanghai-free-trade-zone-favour>.

PANEL III QUESTION AND ANSWER

HEARING CO-CHAIR WESSEL: I want to thank each of you for the work that you've not only put into the testimony but your work on these issues over time. A lot of scholarship has gone in on these issues, and we appreciate it.

I want to make sure I understand the concept here, and, Mr. Backaler, you have, as you said, worked with a lot of Chinese SOEs, and, correct me if I'm wrong, I heard you say that the lines are often blurred, meaning between what one calls an entity and what one may call an entity in the next category.

And, Dr. Hersh, I think you said it's not the name; it's the impact that we should be concerned with.

As I heard your testimony, Dr. Hersh, which was I think the best single exposition of sort of the integration of the Party and the institutions and the companies that I've heard, probably seen, maybe the whole time I've been doing this, is there any entity that is truly operating under just straight market principles?

As I understand it, a quote-unquote, "private entity" is going to if it's a go-out strategy have to go through up to three approvals by the government to invest outside the country. So, no matter where you see an entity on the continuum, it seems the continuum never gets over to a market economy stage. It's a question of where else on the economy? Is it just being run straight by the Party or does it have the Party influence?

Can each of you comment on that? Start with Mr. Backaler.

MR. BACKALER: Yes. I think you make a very good point that the line between state-owned enterprises and private companies is very blurred. If you look at the regulatory approvals that Chinese firms have to go through in order to go overseas, it's extremely challenging for them because they must navigate across the Ministry of Commerce (MOFCOM), National Development and Reform Commission (NDRC), potentially State Administration of Foreign Exchange (SAFE) and other agencies, depending on the sector of investment.

It also is very difficult just to group companies and compare them to Western multinationals from Europe or the U.S. In particular, there are three areas that I was thinking about before this hearing that we could touch upon.

The first is Chinese companies are relatively young so as you look at Chinese companies compared to their competitors in the West, they tend to have decades, if not centuries, of less operating experience than their Western competitors. For example, look at the difference in operating experience between an Electrolux and a Haier.

The second relates to areas of business expansion. To Dr. Shih's point, there are a very few number of companies that are integrating vertically such as Lenovo or Huawei, but there's quite a bit of horizontal expansion - meaning expansion efforts that are not necessarily in a Chinese

company's core industry.

The example that I gave in my testimony around state-owned enterprises was a client that I had in the chemical industry. It was a company called Bluestar. They had a subsidiary called Malan Noodle, and they were, what I believe was the number one fast-food noodle restaurant in all of China. There was no real investment reason why Bluestar decided to invest in the noodle industry. The investment decision was made more so because the founder himself was from a province renowned for noodles, and he had always dreamed of doing this. His justification for the investment was if workers became redundant in the chemical factory, they could then go and become workers in the noodle restaurants.

And then the third area is the difference in terms of management culture - the kind of issues that a lot of people talk about in business context, such as "guanxi" and "mianzi," which translate to "face" and "relationships", but one of the most interesting areas where I saw this come up was in an interview I conducted with a consultant who was helping the integration between IBM's PC division and Lenovo during the post-merger integration period.

The consultant was a Chinese psychologist who received her degree at Harvard which gave her a really good understanding of both the American side as well as the Chinese side. When Bill Emelio, the CEO of Lenovo at the time, was trying to differentiate and determine whether the SVPs on his management team were really at global management levels, he had a very hard time because there were half that he felt really belonged on his management team, but then there was another half that he felt, should be demoted because they didn't have the skills.

So what--Dr. Wei was her name-- described to him was in order to make sure there was no 'loss of face' if they were demoted and that they understood that there was work to be done in order for them to get to become global managers they needed a creative solution. Dr. Wei and Emelio came up with a temporary strategy under which two levels of SVPs were created - SVP I and SVP II. Senior vice presidents who were labeled SVP I, were able to continue to operate as though they were global managers. The SVP IIs, realized there was work to do - so either they could 'up-skill' and become more advanced in their management capabilities or they could look for other jobs.

But the result of this and why this was creative was because externally both levels of SVPs had the ability to still say to their relatives and everybody that they are SVPs. There was no loss of face.

These are just three examples. I could list many others, but the companies themselves are very different internally even beyond just ownership structure itself.

HEARING CO-CHAIR WESSEL: It would be hard to see that a hedge fund investor here would accept loss of face as a market guiding principle, but--

MR. BACKALER: Exactly.

HEARING CO-CHAIR WESSEL: Dr. Hersh.

DR. HERSH: Thank you.

I think to understand whether there are companies that operate on market principles within China, I think it's important to look at the political structure as I've indicated because as political scientists describe, China's system is one of fragmented authoritarianism. We should not conclude that there is a monolithic party that is dictating from Beijing how actors throughout the economy should be behaving, but rather the power is dispersed throughout China's economy with officials at the local level retaining much autonomy and resources and able to guide economic development.

So we can look at the incentives that these people have to operate in the economy. Their incentive is to climb up the political ladder and to accumulate personal wealth for themselves. Climbing up the political ladder means doing what will be held in high regard by the Party above. This is maximizing GDP, maximizing technological accumulation and maintaining social stability, some combination of repressing dissent and providing employment and income growth.

These local officials are willing to entertain and use the tools at their disposal to achieve those things in whatever ways they sit fit, whether it be supporting the government-owned, government-involved enterprises under their jurisdiction or whether it be private enterprises in their jurisdiction.

And typically when a private enterprise develops and grows up, if it shows promise of success, that will be a magnet for the local official to come and start to open the door for the kinds of preferential treatment that can help that business become a local champion. So the ability to intervene in so many different facets of economic activity means that the Party will be cutting across all ownership sectors in the economy.

HEARING CO-CHAIR WESSEL: Dr. Shih, any comments?

DR. SHIH: Yes. Let me just add to what Mr. Backaler and Dr. Hersh have said. I think we have a tendency in this country to think of China as being very homogeneous. In fact, it is very heterogeneous, and you see this in all forms, not only in the differences among regions and cities, but also in various corporate forms.

I have been in a private company where the founder was also the local Party boss. I've been in a private research foundation where I walked down the hall and I saw the Chinese Communist Party office, and I'd been in SOEs where it's exactly as my colleagues have explained, that success is all about climbing the political ladder and you get rotated. They would talk about what would be this person's next assignment.

I also want to reinforce this notion of local influence which really plays towards this heterogeneity as well. There is this saying in Chinese, which is loosely translated as "the mountains are high and the emperor is far away," which is, those guys in Beijing are going to do what they're going to do, but we here in Wuhan, to pick a city, we want to become

a modern economy; therefore, we are going to do these things. And I think that's one of the reasons it's so difficult for us to get our arms around it.

HEARING CO-CHAIR WESSEL: Thank you.

Commissioner Slane.

HEARING CO-CHAIR SLANE: One of the things that I've been struggling with is how to deal with Chinese SOEs who want to come into the U.S. market? And I'm from Ohio, and the governor a few years ago was trying to recruit a major Chinese steel company to come into Ohio, and there were 2,000 direct jobs at stake, and several thousand more indirect jobs, and the issue came up about what about the domestic steel suppliers and how do they compete?

And my question to you is how do we level the playing field? I mean would you support amending the antitrust laws? Would you support amending CFIUS? Or do we just play it out?

MR. BACKALER: You raise a very good question, which is, as much as you want to allow all Chinese investment in because of the potential economic benefits, you have to be aware of very real concerns that are associated with it.

I think one of the things that the United States has at its advantage is the fact that we have very strong legal institutions. Let me give you the example of the Chinese shipping company, COSCO. It is a state-owned firm, and a few years ago they invested in Greece in one of their largest ports, and it was actually viewed by many as a really big mishap because they reportedly fired all of the local union laborers, and then they rehired them at extremely reduced rates.

I think some went from as much as 100,000 U.S. dollars per year to about \$20,000 per year. So socially it was a pretty big mishap. COSCO also came to the port of Boston over ten years ago. At that time a Danish shipping line was about to leave the port of Boston, and there were about 9,000 jobs on the line.

COSCO, the same firm that invested in Greece, came in, and not only did they save the 9,000 jobs, but they also added more. After ten years of investment, COSCO had added about 34,000 total jobs. I think the reason why COSCO's investment in Boston can be viewed as a more positive case is because here in the U.S. there are more stringent restrictions and regulatory processes.

Regulators in Boston did not allow COSCO, to have the same level of flexibility as the firm may have had in Greece, where regulatory institutions were much weaker. That said, I think it also is very difficult as you look at third-party markets, as you have Western companies or American companies that are trying to compete with Chinese firms, and the Chinese firms are not bound by regulations such as the Foreign Corrupt Practices Act and what not.

I think to our strength and to the best of our ability, we need to be looking at each deal on a case-by-case basis. I think CFIUS can definitely be improved, but at the same time, I think we're much better off

than a number of other economies around the world.

DR. SHIH: I think one of the reasons we have difficulty with this issue is because especially when we go into a negotiation on things like TPP, coming up, symmetry is a very important aspect of these things as well as consistency. It's hard to defend inconsistent positions.

So then, coming back to the Ohio example, how do we feel about state aid to Airbus over time? Ohio is the largest state in the U.S. in terms of contribution to Airbus' supply chain; right? And so now what we're doing is we're pitting local economic development with some of these longer-term strategic issues, and I think that's why we get into these types of difficulties.

We have built up a position through a series of actions and now maintaining consistency is very difficult.

DR. HERSH: So I think the answer to your question is that we should treat it very cautiously, by looking at what is the intention of the investment; what is the strategic role that it will play in the enterprise's business operations? Is the business acquiring a domestic distribution network in order to bring goods and services into this market that are produced on a non-market basis with market-distorting competitive advantages somewhere else?

And this is a very difficult thing to assess when we're sitting here, and so the proactive strategy maybe is to try to tackle this problem at its root, that is where the anticompetitive practices are happening, where state-owned enterprises are operating on a non-market basis.

The problem is not necessarily that these enterprises are owned by the state; it's that they are operating with preferential treatment that gives them unfair competitive advantages in the marketplace.

That said, we do have some tools at our disposal, though those have not been very well used at this point. China's accession to the WTO, China agreed to regular disclosure of state-owned enterprises and the subsidies that are delivered to them.

They have not lived up to this commitment, nor has the United States Trade Representative Office really held the Chinese government to account for failing to live up to this standard, and as we look forward, I think it's going to be critical with negotiations over the Trans-Pacific Partnership that we insist on extremely high standards and a precautionary principle when dealing with countries that have a strong presence of state-owned enterprises and delivering other non-market economic benefits to companies there.

This includes having a strong definition for what a state-owned enterprise is and having strong disciplines so that we're not just looking at state-owned enterprises at the central government level, but we are looking at all levels of ownership and all levels of a government that may be influencing and privileging the operations of businesses there.

HEARING CO-CHAIR WESSEL: Commissioner Shea.

CHAIRMAN SHEA: Thank you all for being here. Good to see Dr. Shih and Dr. Hersh who testified before and welcome, Mr. Backaler.

Dr. Shih, I think you mentioned this. You said China is different. You ventured into a comparison very briefly between the experience of the late '70s and '80s with Japanese companies investing in the United States and potential significant Chinese investment today.

Could you just compare what are the significant differences between the Japanese companies that invested in the United States in the '70s and '80s and Chinese companies today seeking to invest in the United States? How would you just in bullet form sort of highlight the differences? If there are any? If there are any significant ones?

DR. SHIH: Well, I think the most interesting example is the auto industry and the Japanese firms who invested in the U.S. under import restrictions on their products. Toyota came to Kentucky because they were faced with the import quotas or restrictions in the '80s, and they've actually done a good job in the U.S., particularly in Kentucky, Mississippi, Tennessee, that whole southern tier. In fact, some would say the U.S. auto industry is very healthy; it's just under different ownership now.

Now the question is do we like these investments? From an industrial development standpoint, if you look at the incentives the state of Alabama gave to Daimler to put the factory there or what states have done, it's hard to argue with the value of those investments.

Did they get to a more competitive market position through unfair means? I think what Toyota brought to the auto industry was actually a manufacturing revolution. If you think about Henry Ford having done the first implementation of mass production, and then this whole notion of lean production and the Toyota production system, so in some sense they had a better system, which gave them a huge competitive advantage.

CHAIRMAN SHEA: Right.

DR. SHIH: And I would argue that was another one of those things that maybe the world view of some of our Detroit automakers in the '80s failed to recognize until relatively lately.

CHAIRMAN SHEA: I was sort of jotting down in my own mind.

DR. SHIH: Yes.

CHAIRMAN SHEA: I think the Chinese SOEs are more agents of the state than the Japanese companies. They may have greater subsidization than the Japanese companies by the government. Their leadership of the large ones is chosen directly by the Organization Department of the Chinese Communist Party. As a U.S. policymaker, are there differences between these two entities because it's often said we overreacted to the Japanese investment in the United States and we shouldn't do so to the Chinese?

And I'm just trying to figure out are there significant differences between the two types of entities that are seeking to invest in the United States?

DR. SHIH: Some of the firms that I've gotten to know a little bit, like I look at Huawei. If you speak to Huawei management, and they're very controversial in the U.S., but if you speak to their management, they are

what I would describe as global thinkers. I mean at the very senior management level.

Now, I'm not sure if that's the Party necessarily telling them to do that but they recognize the global telecommunications market as their marketplace, and they are going to compete in it, and they are effective at recruiting management talent globally to try to build that position.

Okay. I don't think all Chinese companies are that way. I don't know how much state influence, per se, is in there. I think they are happy to use the advantage of the Chinese market being a large market, but they are global thinkers.

CHAIRMAN SHEA: Dr. Hersh or Mr. Backaler, do you have?

DR. HERSH: Well, I'm not going to comment on this. I'm not an expert on Japanese corporate governance systems. So I'll leave that to Dr. Shih.

CHAIRMAN SHEA: Okay.

MR. BACKALER: I'm the same.

CHAIRMAN SHEA: Okay. Thank you.

HEARING CO-CHAIR WESSEL: Could I just ask a related question because I've seen or heard of certain sourcing differences, meaning the Japanese when they came over, their auto plants, the just-in-time manufacturing, they brought over a lot of their suppliers so they could be close to the factory.

In an initial look at many of the Chinese companies, they are still sourcing from China. Do you have any experience in that, Dr. Shih?

DR. SHIH: One thing I observed about the Japanese companies, initially they brought over suppliers because that's what they were familiar with, but they also brought in American suppliers. I think about Toyota and Johnson Controls as a widely cited example.

I think the major difference in the approach they took is they took a very strategic approach in terms of their sourcing relationships, and they invested in not only bringing their Japanese suppliers to the U.S. but also in improving U.S. suppliers. So it's hard to argue with them not being a good citizen about that.

The Chinese suppliers, I commented that Huawei and Lenovo are very vertically integrated. I think that builds on the point that these other gentlemen have made about they're at a stage of development where they are much more aligned around vertical integration or horizontal conglomerate behavior that has been squeezed out in many U.S. firms.

HEARING CO-CHAIR WESSEL: Or maintaining the influence of the state so that they employ people at home and use the U.S., their corporate facilities here as output facilities.

Sinopec and a number of others.

DR. SHIH: Well, I'm not convinced of that actually.

HEARING CO-CHAIR WESSEL: Okay.

DR. SHIH: I think they're very focused on market leadership and cost and what it's going to take, and if that's a convenient way to do it, I

haven't necessarily seen that.

HEARING CO-CHAIR WESSEL: Okay. Thank you.
Commissioner Fiedler.

COMMISSIONER FIEDLER: A couple of--

COMMISSIONER FIEDLER: Yeah, go ahead.

MR. BACKALER: I'd add one more point on the topic of automotive investment in the U.S. I have seen some cases in the U.S. where we proactively sought it out. For example, the company Nexteer in Michigan is an automotive steering component business. I spoke to their CEO, and he had told me that during the difficulties the firm faced during the financial crisis in the 2008-2009 period, they were looking for new owners.

When I asked whether he was looking for American owners or European owners or private equity, he said they actually wanted to find a Chinese buyer, and the rationale he gave me was this.

COMMISSIONER FIEDLER: They would overpay.

MR. BACKALER: Yeah. It may have been one factor. But in terms of the private equity, he felt that if private equity investors were to invest in his firm, they would bring in a senior partner and he would lose control of the company. Meanwhile he thought that he fundamentally had a good business, just due to the crisis, economically the business was in bad shape; all he needed was a cash infusion.

So by going on road shows and identifying the right Chinese partners, he eventually got a Chinese company that's actually known for the aerospace industry, but it does have an automotive division. It's called AVIC Automotive. AVIC came in, and they took what he was hoping for, which was a relatively hands-off approach. So while they technically acquired Nexteer, they didn't actually integrate any back office functions. They didn't plant any Chinese management.

His entire management team remained in place. And they were able to continue to operate, not only with initial investment but with additional investment over the course of the years, which is if you look at the private equity perspective, they're looking for a one-time investment and then an exit.

So for him, and in that one case with Nexteer, again, I'm not saying this is for every case, but in this specific instance, the Chinese buyer was actually very beneficial for him and his firm.

COMMISSIONER FIEDLER: I'll make a comment first that I actually don't blame the Chinese for what they're doing because they have clearly defined this to be in their self-interest, and if you look at it geopolitically, from my point of view anyway, if survival of the Party in power is a paramount objective, then as much control as you could have over the economy and things related to it makes sense.

The issue is not so much the Chinese government, from my point of view, but from U.S. and Western governments, other governments around the world. The concept of reciprocity is not one that we seem to have embraced to our advantage in treatment. In other words a lot of people were

whining how terrible it was that the Chinese couldn't buy Unocal. Well, we can't buy Sinopec. So fairness doesn't seem to be a concept in that relationship.

What it seemed to be was, well, we can't undermine the purity of our free market by not allowing somebody to buy something because they won't let us buy their stuff. Okay. That's what I mean by it was perfectly in the Chinese interests but elements of our government were in favor of that actually.

Does reciprocity concern anybody here in dealing with state enterprises as they invest in the United States? Should that or should it not be a criteria for us to consider whether or not their money is placed here?

I have other questions so quick answers.

[Laughter.]

DR. SHIH: I would argue that's what negotiating strategy is all about when it comes to things like WTO accession or TPP or whatever. And the challenge is because of history, we have built up a complex set of precedents and assumptions and principles and that's what makes it difficult.

But I think reciprocity is important in any negotiation.

COMMISSIONER FIEDLER: Either of you guys?

DR. HERSH: Well, when you're talking about reciprocity and protecting the purity of our free markets, what comes to mind is that there are many segments of the American free market that have of their free will gone to engage with and buy into the system of economic governance that China has created. So many multinational businesses are there working hand-in-hand with these state-Party-controlled entities and that seems to be working out--

COMMISSIONER FIEDLER: Quite well for them.

DR. HERSH: --well for them.

COMMISSIONER FIEDLER: Yeah. It has. Reciprocity--I mean, in other words, certain elements of our economy have done well.

I would argue to you, and I don't want you to take this as cynical, that our government's policy is not dissimilar from the Communist Party's policy of stability, that we are, as a country, deeply concerned about the prospect of instability in China, and therefore tolerate a great deal of aberrational behavior, whether it's economic, slightly military, or otherwise, or diplomatic because we too are afraid of what would happen if the place was unstable.

That has a way of sacrificing ordinary people in the United States in the meantime, though, to that aberrational behavior. Am I off on this?

MR. BACKALER: I think you make a good point. One of the things that makes the U.S.-China relationship, especially when it comes to investments, is the fact that they are neither an enemy nor an ally, and so it's a very complex relationship that we have to handle. But, at the same time as you look at the specific issue of reciprocity, it becomes challenging as you look at the alternative markets that Chinese companies could potentially

invest in.

Because if we push very hard on reciprocity between the U.S. and China, then in reality there should be just as many options for China to invest in Europe, Australia, Canada, and that's not to say that we should do it just because that investment would go someplace else, but it is to say that it may be hard to just say, "if you're not going to open your markets in the exact same fashion to us, then you cannot do business here," it may not be that easy.

COMMISSIONER FIEDLER: So their bag of cash is too attractive; that's the point?

MR. BACKALER: Potentially.

DR. SHIH: Well, I think that's the difference, is they're already the world's largest market for certain products, and they're destined to be for many more. If you look back in history at some of the things that went on in Japan and Taiwan and Korea and Singapore in the '50s, '60s and '70s, one of the pieces I saw on Taiwan said one of the reasons we let them do these things is because they were an unsinkable aircraft carrier, and so I think those were tradeoffs that we made.

And I think the difference today is that China is so big, and the timing.

COMMISSIONER FIEDLER: No, no. But what you're saying is there's a tradeoff. I don't know what tradeoff you're talking about.

DR. SHIH: Well, I mean I look at Taiwan, right, I mean--

COMMISSIONER FIEDLER: No, no. Forget Taiwan. What's the tradeoff with China?

DR. SHIH: Well, the tradeoff with China is that our firms, U.S.-based firms, or multinationals want access to that world's largest market; right? And so it's a balancing act, and I think some of the points have been made they're not an ally or an enemy; it's a very complex relationship.

DR. HERSH: Certainly the concern about the stability of China is a valid foreign policy goal and one that needs to be weighed carefully with a multitude of considerations in the bilateral and multilateral relationships between the United States and China.

But we should recognize that the system that exists in place in China that we are now engaging with is actually a very unstable system in many respects and is building up serious fragilities that if we don't, if China doesn't change this non-market basis of its political economy, these fragilities are going to continue to mount and bring the risk of instability.

So this system is creating social instability by the inequality that is building up in the economy, especially as the leaders who sit at the tops of these enterprises are able to profit for themselves and for their family and friends from the privileged positions they hold within the political-economic structure. It's accumulating tremendous financial instabilities, and of course it's creating environmental instability.

So while we should be concerned about instability in China, this has many more dimensions than just preserving the one Party rule over the

Chinese state.

HEARING CO-CHAIR WESSEL: You lost me there for a minute, by the way, when you were talking about inequality and the elites and how the rich are doing so much better. I couldn't remember which country you were talking about.

COMMISSIONER BARTHOLOMEW: Thank you.

HEARING CO-CHAIR WESSEL: Commissioner Bartholomew.

COMMISSIONER BARTHOLOMEW: Thank you, and thank you, gentlemen. It's interesting. It raises just all sorts of interesting questions.

First, a comment. Mr. Backaler, when you said sort of reciprocity raises the possibility that they will invest someplace else, they already are. I mean they are investing in Europe. They are investing in Africa, and the reality is that they are investing here in certain things because they want technology; they want intellectual property. So I'm not sure that that displacement argument is quite as clear as that.

But it's also interesting just listening to this because we used to hear, I would say even up to about five years ago, that there was going to be a movement away from SOEs. Remember that? That was all part of the WTO accession, and China was going to move towards a free market economy, and SOEs were going to be diminished.

And as we talk, it's like that's the future. People aren't even saying anymore that there's going to be a transition or a movement away from SOEs, which is interesting and sad to me.

We also have heard over the years that exposure to U.S. business practices will help improve Chinese business practices. I'm not sure that we've seen that really happening, but as we are looking at, as we are facing Chinese investment in the United States, and particularly SOE investment in the United States, I wondered what your thoughts were on issues relating to corruption?

You know American companies dealing in China are facing Foreign Corrupt Practices Act investigations. Chinese activists, the new citizens movement, people who are trying to push for transparency, accountability and to government officials' corruption in China are being arrested, tried, thrown in jail, and I just wondered, as you look at this landscape we're facing in the next five years, the next ten years, and into the indefinite future, are you worried about sort of an export of Chinese business practices, including corruption, coming to the United States so that it becomes not just ODI but what I would think of as ODC, overseas direct corruption?

Is this an issue that you think we should be concerned about?

MR. BACKALER: I personally think there definitely could be an impact in that regard. I think the U.S. has already demonstrated-- if you look at the case last year with Sinovel-- a wind energy firm--that they were here and they were, in a sense, forced to divest, given those types of actions.

But I think what you do see is that as certain companies come here, and not just here, but essentially expand their global footprint, like

Lenovo, like a Huawei, a number of these firms right now are pretty much the minority. They're not the majority, but as you look at a company like Lenovo, they actually have become much more globally oriented and operate like a mature multinational company, and that's not necessarily because they're operating in those markets and because they're just getting exposure to those practices. It's also because they're infusing the senior-most level of their organizations with that talent.

So if you look at the management talent of a Lenovo, their entire management team, from their chief marketing officer to their head of strategy, you have people that are from some of the top multinational companies, such as an Apple, a Dell, et cetera, and these people are from all different parts of the world.

So I think by turning their organizations into organizations that are "less Chinese" at the senior-most level, that's when you start to see changes in behavior. It's not going to be those one-off investments that you see with a very small acquisition here in the United States.

COMMISSIONER BARTHOLOMEW: Do you think that Chinese SOEs are going to be satisfied with becoming sort of multinational, multicultural at the top?

MR. BACKALER: I think it depends. I mean I'd say probably it would be very unlikely at the central state-owned enterprises where there's obviously a much more stringent control on them and their operations, especially overseas, but I also think it's not just the state-owned enterprises themselves. I think it's also private companies in China as well.

I was speaking with a contact in Beijing two weeks ago, and she's now working at an organization called the China International Chamber of Commerce for the Private Sector. This organization was formed in 2011-- and what they're apparently doing is they operate as though they're just a Chamber of Commerce listening to interests of private Chinese companies that are looking to go global -- or I think it's also for domestic interests as well.

But the way she described it to me is there is a behind the scenes motive in which the government is using the Chamber as a way to obtain more investment data and more details into the operations of their private firms.

So, again, as we look at the blurred line between state-owned and private, I think that's a case where it's not going to naturally be a case of "if-they-invest-in-here-then-they-become-much-more-like-us".

COMMISSIONER BARTHOLOMEW: Something a little oxymoronic about a Chamber of Commerce for the Private Sector since one would think that that's what a Chamber of Commerce is. It's kind of like these Chinese, what people were calling GONGOs awhile ago, Government Organized Non-Governmental Organizations.

MR. BACKALER: Yeah.

COMMISSIONER BARTHOLOMEW: Dr. Hersh, do you have any comment on the corruption questions?

DR. HERSH: Just adding that it's not just good governance activists that are under pressure in China. As the Commission well knows, it's the large international accounting and auditing firms that are also facing pressure to conform to the interests of the state-owned enterprise sector in China.

And that is an issue for concern because as we invite investment into the United States, they will have to play by our rules at this time, and we have the rule of law, but that is incumbent upon having accurate financial and other disclosures for regulators and supervisors to be able to evaluate the performance of them.

And so this will be a challenging condition to take account of as we consider bringing more investment from China into the United States.

COMMISSIONER BARTHOLOMEW: Thanks.

Dr. Shih, anything to add?

DR. SHIH: I would just add as my opinion that I think Chinese leadership recognizes that corruption is one of the great threats to their system, and you can think about how that leads to a lot of market inefficiencies, especially vis-a-vis getting the right people into the right positions and so on.

So I think they recognize that, and some of the things that we're seeing are in some sense an effort to address that.

COMMISSIONER BARTHOLOMEW: Yes. I'll just take you to task on one piece of that, which is that certainly there's lip service paid to the need to deal with corruption and some measures to deal with Chinese corruption within China, but this crackdown, this particular crackdown on activists who are trying to promote good governance and stop corruption by government officials, the government has the ability to stop that kind of crackdown from taking place. So they're giving two very different messages as this goes forward.

DR. SHIH: Yes, I think it's--yes, I agree. There are mixed messages on that. But I think, looking at, as has been mentioned by my colleagues here, some of the firms who are thinking globally, I think they're well beyond that. You know they are trying to build globally competitive firms.

I think when you look at this notion of being able to, for example, buy a position in a firm, over time, that's a serious problem. I was talking to the head of the Hsinchu Science Park in Taiwan, and this was in March, several years ago, and he said --no, actually it was February--we were ten weeks, eight weeks into the year, and already he had hosted 55 visits from science parks in mainland China.

And they were all wondering, well, why was the Hsinchu Park so successful and why were the other ones not so successful, and I said so what's the secret, and he said, it's because all of our positions are awarded on peer review, and you can't buy them. Okay. So I think it's a potential flaw that's being masked by rapid growth right now. But I think that's an Achilles' heel for them.

COMMISSIONER BARTHOLOMEW: Thank you.

HEARING CO-CHAIR WESSEL: Thank you.

Commissioner Reinsch.

VICE CHAIRMAN REINSCH: Thank you.

This is for Mr. Backaler in particular, but if the rest want to respond as well, that's fine. It's kind of early in the game as far as Chinese investment here is concerned. I think the previous panel was talking about the impending wave, but you referred earlier, Mr. Backaler, to the COSCO case in Boston, and then you had some comments about Lenovo a few minutes ago.

Can you make some general comments about the behavior, for lack of a better term, of Chinese investors in the United States? Are the bulk of them following the lines of the two examples you gave or are there significant ones that are turning out to be problematic for this reason or that where they performed like COSCO did in Greece, for example? Just make a general overview.

MR. BACKALER: That's a very good question. I think as you look at the companies that have done well and have abided by our rules, I think they have had a similar path to COSCO in Boston; whereas, I think we have strong regulations in place where you see a Sinovel that pretty much is forced to divest and retreat to China.

The challenge is that as Chinese investment comes to the U.S., it becomes very difficult for Chinese firms to really understand our system because the system is very disjointed at the federal as well as state level.

At the federal level, we have the organization SelectUSA, and they are charged with promoting investment from not just China but all countries to come and invest here in the U.S., but really all they can say to a Chinese investor is come here, our market is open for investment, but they can't necessarily say what state or what project they can invest in because SelectUSA cannot favor one state over another.

Then at the state level, you have states essentially going out for their own self-interest and essentially making the case for why different companies want to come to their state and invest in different projects.

One example of this is I was speaking with the head of the Commerce Department in South Carolina, and he was telling me how he was initially speaking with Haier, let's say about five years ago when they were first thinking about investing in the U.S. The Chinese firm was debating between building a new factory in Florida or New York, and when he asked why, Haier essentially said that's just where they thought they should go.

Meanwhile, when my contact was speaking with them and providing them with context into the manufacturing sector in South Carolina and the potential resources that might bring them, it became very clear that it was a good investment location for them. But it's very hard for Chinese companies to understand where they should invest, who they should rely on for advice, and also who they should turn to navigate our processes.

So as you look, there may be an example like we saw two years

ago--- the Ralls case. In theory, regardless of what might have been found from a national security perspective, Ralls should have hired a third-party that would help them navigate through the CFIUS process and demonstrate whether or not this was a potential investment that could be harmful and would essentially be rejected by the committee.

So as you look at whether or not this investment is good for these different markets, it's really around the strength of our institutions, and I think the Chinese companies themselves are a little bit at a loss in terms of where they should be going to for advice about where to invest and how to do it.

VICE CHAIRMAN REINSCH: Dr. Shih, Dr. Hersh, do you want to comment on this one? Because I've got one more. Go ahead.

DR. HERSH: Well, I'll just say that while the wave may not have come yet, I think when we look at the Third Plenum reform agenda as well as what is happening now in the Shanghai Pilot Free Trade Zone, that leadership is communicating very clearly that this going-out strategy is about to get real.

The financial reforms proposed in the Free Trade Zone are really more about opening the exit door for capital in China's market than about opening the entrance door, and they're very explicit about setting up institutions and structures and streamlining approval processes for facilitating the outbound direct investment.

VICE CHAIRMAN REINSCH: Dr. Shih.

DR. SHIH: Only thing I would add is that I think for the size of the economy, China is really underrepresented in terms of global corporations, global leaders. You have a few--Huawei, Lenovo, Haier--and you have a lot of wannabes, and so I think it's consistent with everything my colleagues have said.

VICE CHAIRMAN REINSCH: Dr. Hersh, earlier you were talking about, I don't want to put words in your mouth, the unsustainability of the SOE model in the long term economically in China--I mean the discontinuities it creates. Or maybe you weren't, but that's what I heard.

Do you think that it is so clear that this is a model that ultimately is going to fail, and that we should just wait for that to happen or do we have to mobilize and do something about it short of that? That didn't come out very well, but maybe--

DR. HERSH: This is not a model that's going to fail in any economically meaningful timeline. The ability to deliver subsidies to keep these businesses, state-owned enterprises operating on a non-market basis can go on for quite some time given the political structure and the ability to extract incomes from individuals in China and from firms throughout the economic system.

So this is not something that we can just wait for, you know, the perestroika to collapse on itself. These are problems that we should be dealing with right now.

VICE CHAIRMAN REINSCH: So they're not going to run out of

money any time soon. Dr. Shih, do you agree with that?

DR. SHIH: Yes, I agree. I think they have the staying power, and they're intent on building some global champions.

VICE CHAIRMAN REINSCH: Mr. Backaler, do you want to add anything?

MR. BACKALER: Nothing to add.

VICE CHAIRMAN REINSCH: Okay. Thank you.

HEARING CO-CHAIR WESSEL: Let me follow up on a couple of questions, but the first one relating to Chinese investments in the United States, and, again, I think I mentioned earlier the U.S. government data versus the private sector data--I think it was on an earlier panel--219 million tracked by the Commerce Department; seven to nine billion by Rhodium with new numbers coming out soon, as I understand it.

We had a discussion of Nexteer, for example, and in some discussions I've had with people out in Detroit, their concern is that, yes, it has made Nexteer successful there, but rather than being able to export their products to China, the owners created facilities in China, and that's where they're sourcing from.

So what could have been an export success from the United States, they bought the company, they got the technology, they got the jobs. Same thing with Shuanghui and Smithfield Food. We tried for ten, 12 years to get our pork into China. As income rises, the consumption of protein rises. Pork is their favorite meat. Rather than just importing more pork from the United States, they buy our company. It's their right. They have the cash that we've given them.

But my real question is how do you know? Have any of you seen honest operating numbers from any of these Chinese companies? Have they let you into their board rooms and determine how decisions are made? Have you been able to determine what happens when they acquire technology and whether that is shifted around and capitalized in potentially inappropriate ways depending on patent, royalty, other issues?

Do you know whether they're getting state subsidized capital of any kind? I haven't talked to anyone who's been able to see those books or get that information.

So, I'm a skeptic. China is not doing this for us. We, Dr. Shih and I, had a conversation earlier today about the Japanese, and in the 1980s, I think it was James Fallows who wrote a book, I think it was called Just Like Us, that we have this view that everyone is just like us. Why on earth do we think the Chinese want to be just like us?

COMMISSIONER FIEDLER: They don't.

MR. BACKALER: I think you make a good point. I don't know if China necessarily does want to be like us. As you look at Chinese companies and their intentions to invest in the U.S., I think to Dr. Shih's point, I think it is still relatively early, and we can't look at one-off examples to determine what those conclusions are.

HEARING CO-CHAIR WESSEL: But are you able to get into the

examples to do what you as a researcher, Dr. Shih as a Harvard Business case study, do any of us actually know what's going on?

MR. BACKALER: I'd say you're able to get directional evidence. You're not able to get the concrete numbers I think we're all looking for. But I think you also raised another good point around data collection. I think it's very striking that we aren't doing a better job here in the United States, not just at the federal level, but also at the state and city level, about tracking Chinese investment here in the U.S.

For a number of the Western multinational companies that we work with, it seems like one of their primary concerns when operating in China is *can they trust the data* and where should they go to get data that's actually reliable to inform their decisions?

Whereas, I think when you look at Chinese companies coming here to invest, the story is a little different because we do have a much better understanding of what that impact is. We just need to do a better job of collecting it. So again looking at one of the state recruitment representatives that I spoke to, what they do in their state is they have what they call a project profile sheet. This is a relatively straightforward Excel document, and they look at the different levels of benefits that it would have on the local economy should that deal go through.

It looks at things such as job creation, electricity consumption, other kind of third-party industry impact, and then they can track that over time to see whether or not over the long term the benefits are realized.

The challenge is that's just what their one state does. I think we should create a concerted effort across the states to collect and synthesize that data in a more standard format - there's no reason why we shouldn't as a country have access to that information.

HEARING CO-CHAIR WESSEL: I agree that we should. I really question whether we're going to get it, and if you look at the opportunity costs broadly, what Alabama may look at, as you point out, is not a national picture. Canada, Australia, and others have a net economic benefit test, and I think we need to look at that.

Let me shift just a bit and follow up on a question that was asked by Commissioner Wortzel earlier today, which quite frankly I'm surprised the question has been asked, but it's being asked otherwise, so I'm going to ask it as well.

2016, we're under the terms of China's accession to the WTO. People say we lose the automatic right to treat them as a non-market economy. I have the statute here, which to me says, yes, we lose it under the WTO automatically, but here it says factors to be considered, and the last one was anything we want to consider, and the determination of those factors is not an issue.

Do any of you think that China is a market economy or will be any time soon? And that this question shouldn't be asked? Why are we asking it? Dr. Hersh, do you want to start with it?

DR. HERSH: As in my oral and written testimony, I argued that

China does not operate on the principles of a market economy nor does the agenda for reforms that have been announced last year seem to be putting China on the path to becoming a market economy. Unless there are substantial changes to the structure of China's political economy, this is even really not feasible for them to achieve the criteria that would make China operate as a market economy.

HEARING CO-CHAIR WESSEL: But to follow up on the discussion we just had, even if they change, I'm going to want to see all the data. I'm not going to take a risk with our underlying approach here without getting every single book and seeing everything and understanding it. I mean that would be stupid; wouldn't it?

COMMISSIONER FIEDLER: Call him stupid.

[Laughter.]

DR. HERSH: To skip back to your previous question, I've spent the better of six years trying to find that information that we're looking for about how China's economy really operates at the firm level, and I've worked with Chinese scholars on this as well, and the information is not available to us, but it is available to some people, and these are the people who are working in the investment banks, the legal firms, the accounting firms, that are helping Chinese state-owned enterprises restructure themselves in offshore tax havens and have record-breaking initial public offerings of stocks on international capital markets.

So they're seeing this information about how these firms actually operate, but I would be interested if one of them would come to this room to discuss with you.

HEARING CO-CHAIR WESSEL: Other witnesses, any comments?

MR. BACKALER: No comment.

HEARING CO-CHAIR WESSEL: Commissioner Fiedler.

COMMISSIONER FIEDLER: Anybody have any idea how much money U.S. investment banks have raised and earned in IPOs for Chinese state-owned enterprises in the last decade?

DR. HERSH: I don't have the aggregate figures on that, but typically from the cases that I've studied that investment banks will take one to 1.5 percent stake in the equity of a company when it is brought for IPO.

COMMISSIONER FIEDLER: Yeah. What's the overall number? Do we have any idea how much money has been raised on behalf of state enterprises by good U.S. capitalist investment bankers?

DR. HERSH: It's on the order of billions of dollars, but I don't--

COMMISSIONER FIEDLER: Tens or hundreds?

DR. HERSH: Yeah. I--

VICE CHAIRMAN REINSCH: Go ahead. Tell him the answer.

COMMISSIONER FIEDLER: I don't know the answer.

DR. HERSH: I would be happy to respond later--

COMMISSIONER FIEDLER: Okay. Please do.

DR. HERSH: --to the Commission on that.

COMMISSIONER FIEDLER: I think it's a big number. That's why I was--on Michael's question of non-market economy, is like private property a reasonable measure? Do you have a non-market economy? Is there any private property in China?

There isn't; right?

DR. HERSH: Well, there's increasing property rights, but those are not the same as what--

COMMISSIONER FIEDLER: 90-year rights, 99-year rights, you've got.

DR. HERSH: Yes.

COMMISSIONER FIEDLER: And so some of the richest people, private companies in China, are those who are property developers. The eighth richest man is a guy named Hui, who gambles a lot of money in Las Vegas. He's a private owner of property, a private developer of property.

Does anybody believe a private property developer in China hasn't paid off a significant amount of money to the land departments of the local province or city or the central government in order to get to where he is today?

DR. HERSH: It would be difficult to believe that they have not, and because the land rights are ultimately controlled by the local governments who hold jurisdiction over those areas, they control who has access to developing those pieces of property, and so it would be hard to imagine that there's not some relationship there.

COMMISSIONER FIEDLER: So would it be a good thing to have a private property developer who has paid off tens of millions of dollars to local politicians in China come down to develop undeveloped areas or blight areas in Philadelphia?

VICE CHAIRMAN REINSCH: He'd be right at home in Philadelphia.

[Laughter.]

COMMISSIONER BARTHOLOMEW: I think people don't really want to answer your question.

COMMISSIONER FIEDLER: I, you know, well, no, no, no. This gets to the question of private--

COMMISSIONER BARTHOLOMEW: Corruption.

COMMISSIONER FIEDLER: --corruption in the state, and this hybrid form of capitalism that we keep talking about. And whether or not only bullets and missiles are dangerous? Is money dangerous in the hands of certain kinds of people or not? And is it, if not dangerous, perhaps contrary to our interests, which gets to the issue of state enterprises to me is very fundamental.

It shows up our greed more than it has shown up--our willingness to accept and to do business with them just illustrates our greed and feeds the Chinese to say, oh, we don't have to change anything. We can continue to--because these are a bunch of greedy guys over here, and all they're interested in is the bag of cash that we're carrying, and the question becomes

also how much our government is succumbing to that pressure?

I articulated that by talking about reciprocity, which everybody seems to reject, not you guys, but everybody else.

I'm deeply concerned about the role of state enterprises in our democracy, not just our economy. And we haven't talked about that today, and, you know, I mean she did, but in terms of people who argue for transparency in the Chinese government are thrown in jail, and we sort of, okay, well, it's a couple of people are going to do 11 years; oh, well, they shouldn't have opened their mouths. And let's do business.

There's a danger level here that seems to be unrecognized in dealing with the state, dealing with a state on the scale that is likely to happen.

Thank you.

COMMISSIONER BARTHOLOMEW: Mr. Chairman.

HEARING CO-CHAIR WESSEL: Yes, please.

COMMISSIONER BARTHOLOMEW: I just want to reinforce one of the points that you made and tie it back into something that Dr. Hersh said when you were asking about the availability of data on Chinese companies.

Dr. Hersh, you made this reference to the Big Four, the Chinese branches of the Big Four accounting firms, and the reality is that even when there is data, people who need access to that data to determine what's going on can't get access to that, and I think that that's a point that both people who are facing the challenges of Chinese investment in the United States and American people who are buying stock in Chinese companies need to be very aware of that.

So I thank you for reminding us about what's going on with that.

HEARING CO-CHAIR WESSEL: Thank you.

You've all done wonderful research, and I mean that, and we are trying to understand specifically about how Chinese enterprises operate in the U.S. market. So Mr. Backaler with your upcoming book, Mr. Backaler, I look forward to reading it. Your ongoing work, Dr. Shih and Dr. Hersh, we appreciate all that you're doing, and please, let us know what you're up to and what information might assist us as we look at all these issues.

Others? If there are no further questions, we appreciate everyone's participation today. Thank you, and we stand adjourned.