Hearing on “U.S.-China Economic Challenges”
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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 us 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 if 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 Cost 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 or 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.