International Trade and U.S. Prosperity

Written Testimony of

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Chairman Casey, Vice Chairman Brady, and members of the committee, thank you for the opportunity to testify today on the importance of international trade to the well-being of America. The United States has a proud bipartisan tradition of leading the world in economic integration. The country has benefited enormously from the open rules-based trading system it has helped create.

In difficult economic times, the remaining shortcomings of the system can become particularly salient. There are countries who do not abide by the letter or spirit of global trade rules. There are important areas of commerce that remain uncovered by international agreements, where we have yet to set rules to govern fair play. And many countries retain significant barriers against U.S. goods and services, to their detriment and ours.

This just demonstrates that work remains to be done. U.S. leadership is more important than ever. A well-functioning open trading system is critical to America's future prosperity. The United States is uniquely positioned to build and sustain such a system. Reviving U.S. leadership in trade would not only lay the foundations for long-term U.S. economic well-being, it would also send a positive short-term signal to U.S. employers about an improved business climate and the prospect for new economic opportunities. These are the conditions in which investors in the U.S. economy, both foreign and domestic, will create new jobs.

I will organize my brief remarks into four parts. First, I will argue why the trade future is bright for the United States. Second, I will discuss some of the confounding factors that often cloud discussions of trade's impact on the United States. Third, I will draw out some of the trade policy implications. Finally, as an addendum, I will address some of the trade issues raised by the special – but important – case of China.

As members of this committee will be well aware, economic forecasts can be notoriously unreliable. They can be waylaid by unforeseen swings in consumer or business sentiment, or by significant shocks, either natural or man-made. For that reason, I will not even venture a guess about what we will see next year in terms of GDP, unemployment, or the current account balance.

There are other trends, however, that are much more predictable. I will rely on two. The first is demographic. While the U.S. population is aging, it is doing so much more slowly than populations in the major surplus countries of the world economy: Germany, Japan, and China. As a general rule, an aged population will consume more and produce less. As much as China may currently appear an unstoppable juggernaut, the size of its labor force is set to peak and then begin to decline in the near future. This is an instance in which extrapolating from recent experience can be highly misleading.

The second long-term tendency, related to the first, is that those who have made loans will ultimately wish to be repaid. The United States has run a current account deficit for decades. The value of goods and services that we have imported exceeded the value we sent back in exchange. The difference can be thought of as a loan. Whether in the form of a Treasury bond, a corporate loan, or currency holdings, the rest of the world has accumulated IOUs. These IOUs, ultimately, are claims on future production of U.S. goods and services. When aging populations around the world cash in their IOUs, they will be providing a new net demand for U.S. goods and services. In such a world, the

United States will rely heavily on the rules and sureties of a healthy global trading system.

The prospect of the United States as a surplus country is hardly the only reason to support an open trading system. There is a natural tendency to equate exporting with economic success, but this sort of mercantilism was discredited long ago. The country benefits from both imports and exports.[1] Nor is this the sort of lesson that we can afford to embrace only in good times, but must set aside in the harsh light of a downturn. In the recent financial crisis, we saw the U.S. current account deficit decline at the same time that unemployment rose.[2] The simple arithmetic whereby exports are proportional to jobs gained and imports proportional to jobs lost is both theoretically unsound and empirically unsupported.

Yet international trade remains suspect in the United States, frequently seen as an affliction more than an opportunity.[3] In part, this is due to reasons I've already described: the tendency to treat current account balances as a scorecard, rather than as an indicator of borrowing or lending; and the facile equation of exports with job gains and imports with job losses. I would like to suggest three additional sources of potential misunderstanding about trade's effects.

First, there is a popular tendency to cling to a very old-fashioned, textbook view of trade in finished products. In this conception, ripped from the pages of David Ricardo, one country produces wine, another makes cloth, and they swap goods back and forth on tall-masted sailing ships. There is some of that still today (not the sailing ships), but much of modern trade features globally integrated production. The modern car or large passenger aircraft consists of parts produced around the world. International trade often occurs between parent corporations and their overseas subsidiaries. Foreign production can thus be a complement to domestic production, rather than a substitute. We saw a small demonstration of this interconnectedness in the wake of Japan's terrible earthquake and tsunami earlier this year. Rather than advantaging U.S.-based factories by laying low a competitor, the effect was to threaten output from U.S. production lines, which faced the shortage of key parts produced in Japan. Similarly, when the furor over services outsourcing exploded in the middle of the last decade, most serious simulation studies of

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[1] A prominent Peterson Institute study in 2005 found that the U.S. economy was approximately $1 trillion richer annually because of past global liberalization, with the remaining potential to gain another $500 billion annually from future liberalization. Bradford, Scott C., Paul L. E. Grieco, and Gary Clyde Hufbauer, "The Payoff to America from Global Integration," In C. Fred Bergsten, ed., The United States and the World Economy: Foreign Economic Policy for the Next Decade, Institute for International Economics. Washington: Institute for International Economics, 2005.

[2] To illustrate, according to the Bureau of Economic Analysis, the U.S. current account deficit peaked at $800.6 billion in 2006, then fell to $376.6 billion in 2009. According to the Bureau of Labor Statistics, the mid-year national unemployment rate was 4.6 percent in 2006 and 9.5 percent in 2009.

[3] For a thorough discussion of public opinion trends on trade, see Bowman, Karlyn and Andrew Rugg, "Trade Winds: Which Way is Public Opinion Blowing?" AEI International Economic Outlook, March 2011.

the phenomenon found that the controversial practice would, on net, create jobs in the United States. This was because the international service transactions, such as data entry or customized programming, were generally inputs into other businesses and tended to drive down those businesses' costs and allow for the expansion of production.

A second, related source of confusion comes from trying to interpret bilateral trade balances in an integrated, multilateral world economy. In recent years, this has focused public attention on the U.S. trade relationship with the People's Republic of China. I will return to the policy questions surrounding that relationship later, but the large and persistent U.S. trade deficit with China has been held responsible for significant U.S. manufacturing job loss by organizations such as the Alliance for American Manufacturing and the Economic Policy Institute.[4] While there are certainly serious issues with China's economic policies, the bilateral trade balance can be a deeply misleading measure. It evokes a two-country world, in which any job not undertaken in China would be done in the United States.[5] In fact, one key to China's emergence as a global trading power was that it enmeshed itself in an East Asian trading network, often taking in nearly-finished goods and providing the final touches. What's more, just because China may be the low-cost producer of a particular good does not mean that the United States is the next lowest-cost producer. This misconception helped prompt the misguided U.S. Section 421 action against Chinese tires in 2009, which seems to have served mostly to reshuffle the sourcing of U.S. tire imports to other countries, while doing little or nothing to spur U.S. domestic tire production.[6]

A final, central misperception is that there is a fixed number of manufacturing jobs in the world. If a manufacturing job is lost in the United States, it must be found somewhere abroad, the reasoning goes – the "offshoring" of U.S. manufacturing jobs. The implication is usually that the U.S. manufacturing sector is declining right along with the manufacturing labor force. It is certainly true that there has been a marked decline in the share of the U.S. labor force working in the manufacturing sector. This decline is not new; it dates from 1979 when manufacturing employment was just under 20 percent of total employment. By 2007, manufacturing employment accounted for roughly 9 percent of the total. Yet, while manufacturing employment was falling in relative and absolute terms, manufacturing output was rising dramatically. Over the two decades leading up to the most recent recession, real value-added U.S. manufacturing almost doubled.[7] The difference in the employment and output trends is due to a dramatic increase in manufacturing productivity. The U.S. manufacturing sector is able to make more stuff with fewer workers. Nor is this phenomenon unique to the United States. As production technology has advanced, many countries have seen manufacturing shift to less labor-

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[4] For a discussion of China-induced job loss calculations, see Levy, Philip I., "Fair, Trade, and China Jobs," Enterprise Blog, April 2, 2010.

[5] This was the explicit assumption of at least one formal Section 301 petition objecting to China's hukou labor permit policies in 2004.

[6] See Progressive Economy, "Fewer tires from China, more from Korea, Taiwan & Southeast Asia," http://www.globalworksfoundation.org/Documents/fact485.rubber.tires_000.pdf, September 7, 2011.

[7] http://bea.gov/industry/gdpbyind_data.htm

intensive techniques.[8] Even China was shrinking its urban manufacturing employment throughout the 1990s, until the last decade, when manufacturing employment stabilized as Chinese output exploded.[9] For the U.S. manufacturing jobs that have been lost to technological change, no amount of misdirected railing against foreign trade will bring them back.

So far, I have argued that trade presents the United States with a significant economic opportunity and that many of the common popular objections to open trade are flawed. How, then, can the United States take advantage of this opportunity?

The country must reclaim its role as a leader in global trade liberalization. It can do so through multilateral bodies, such as the World Trade Organization, or through regional groupings, such as the Trans-Pacific Partnership. To have credibility in any of these fora, however, a prerequisite is the passage of the pending free trade agreements with South Korea, Colombia and Panama. Those agreements will benefit the U.S. economy directly by lowering barriers to U.S. exporters and stimulating economic activity.[10] Even more important, however, will be the reassurance to countries around the world that the United States is a credible economic partner. There was a good reason for global leaders in 2009 to prominently vow that they would bolster the global trading system as a means of restoring economic confidence and heading off a protectionist breakdown. That vow remains unfulfilled, but no less worthy. If the United States cannot meet aging promises to our patient FTA partners, we will have no credibility as we try to bargain for politically sensitive market access concessions from other countries around the globe.

One of the most politically popular U.S. trade stances, in recent years, has been a pledge to focus on the enforcement of U.S. rights under existing trade agreements. Of course the United States should enforce its rights. But for such a stance to have the impact that its proponents envision, two prerequisites must be met: 1. The rules granting us the rights we desire must be in place; 2. The institutions overseeing those rights must be sufficiently sturdy to enforce them.

While the first point may seem obvious, in many cases that the U.S. deems important, international rules guaranteeing fair and equitable treatment have yet to be agreed. The last broad global trade agreement, the Uruguay Round, was concluded over 17 years ago. Global commerce has changed a great deal since then and new rules have yet to be put in place. Unless we contemplate unilateral imposition of new trading norms, we cannot enforce rules that do not exist. Where these rules are lacking, the push for enforcement should really be a push for negotiating progress.

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[8] See Lincicome, Scott, "Are Manufacturing Exports the Key to Recovery?", The Compass, November 18, 2009.

[9] See Banister, Judith, and George Cook, "China's employment and compensation costs in manufacturing through 2008," Monthly Labor Review Online, Bureau of Labor Statistics, Vol. 134, No. 3, March 2011.

[10] These benefits are partially quantified in mandated reports to Congress on each agreement by the U.S. International Trade Commission. The quantification is partial – providing a lower bound – because the modeling techniques are ill-suited to capturing the gains from measures other than the straightforward elimination of border barriers.

In the absence of new agreements, there is a temptation to seek satisfaction through the aggressive use of venues such as the WTO dispute settlement mechanism – litigation in lieu of negotiation. This poses a serious long-term threat to the viability of the WTO. It is not a legislative body and the United States government has generally objected when dispute settlement panels have taken an expansive view of their powers. The dispute settlement system is highly valuable as a means of settling factual disputes over the application settled agreements. If the dispute settlement mechanism is used to resolve fundamentally political or unsettled points, it will eventually lose credibility and countries will cease to abide by its decisions.

There is much more to a successful U.S. trade policy than passing the pending FTAs, but it is an indispensable first step. Then, serious work must be done to restore trade negotiating authority (TPA) to the executive branch. Once these two steps are accomplished, the United States will then be equipped to reclaim its position of global leadership on economic matters. In that position, it can work to shape global commercial rules and standards in a favorable way and ensure market access for the country's producers and employers.[11] This will work to the benefit of all sectors of the U.S. economy, certainly including manufacturing.

I would like to conclude with a brief discussion of U.S. economic policy toward China.[12] Following decades of remarkable economic growth, China has transformed itself into an economic heavyweight and a major trading power. While China undertook an impressive set of liberalizing obligations when it joined the WTO in 2001, the state sector retains a very large role in the economy and the country has contributed significantly to global economic imbalances. China's global imbalances, exemplified by its $3.2 trillion of foreign exchange reserves, derive from a combination of export-oriented policies, including an undervalued exchange rate, financial repression, and an emphasis on investment over consumption. Chinese actions, such as tying investment opportunities to technology transfer, violate the spirit, if not the letter, of global trade rules.

A first question is who is harmed by these policies. Ultimately, I believe they will prove harmful to Chinese hopes of developing a more sophisticated economy. Policies such as the rapid accumulation of foreign exchange reserves are clearly unsustainable and are already threatening to stoke inflation. Other policies, such as China's approach to indigenous innovation, will do damage more slowly. They will deter businesses from bringing their best products to the Chinese market and will fail to nurture an innovative domestic environment within China.

Just as China's array of policies will have differential impacts on China, they differ in the extent to which they will impact the United States. They also differ in the extent to which the United States can fruitfully press for change. The United States should choose

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[11] For a prominent recent bipartisan statement of the need for U.S. global involvement, see the Council on Foreign Relations Task Force Report on U.S. Trade and Investment Policy, September, 2011.

[12] This topic is addressed at greater length in Levy, Philip I., "The United States and China: Macroeconomic Imbalances and Economic Diplomacy," AEI Economic Policy Studies Working Paper 2011-04, June 28, 2011. http://www.aei.org/paper/100233

its policies to best further the national interest. That requires a compound calculation of both the gains available from a change in Chinese policy and the probability of U.S. initiatives effecting such a change. This calculation is complicated by the constraint that by pressing on too many points at once, the United States will dilute its bargaining power.

Such considerations lead me to think that a frontal assault on Chinese currency practices is less likely to advance U.S. interests than pressure on Chinese policies such as those that discriminate against foreign investors and those that work in favor of politically-connected Chinese industries.

Again, I thank the Committee for the opportunity to discuss these issues and look forward to responding to any questions you might have.