IMPACT ANALYSIS

Opportunities and Risks Impacting International Business

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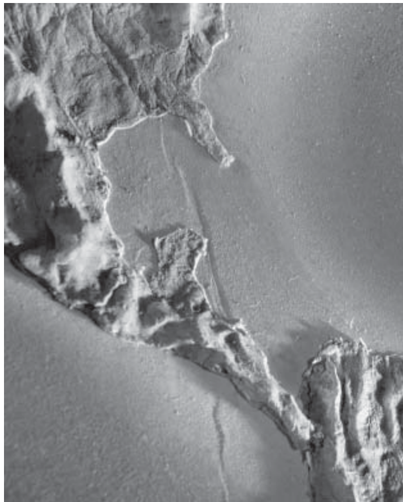

Dear Friends:

On June 30, DR-CAFTA was passed in the U.S. Senate by a vote of 54 to 45. Now the agreement goes to the House. On pages 1-3, Daniella Markheim debunks some of the myths.

On pages 4-5, Carl Chang reveals the likely impact of the newly announced China-India strategic partnership.

And, on page 6, John Manzella and Kirk Harrington consider the possible consequences of unpegging the Chinese yuan from the dollar.

I hope you find this issue informative, and as always, we welcome your comments.

Sincerely,

Barbara Travis
Executive Director
Mississippi World Trade Center

Just the Facts: Debunking Some Myths about DR-CAFTA

By Daniella Markheim

The debate on the potential costs and benefits of the proposed Dominican Republic–Central American Free Trade Agreement (DR–CAFTA) continue. Often contentious, it has played out between those who fear the effects of freer trade on their own narrow interests and those who embrace the economic and strategic benefits the agreement will bring.

On June 30, DR-CAFTA passed in the Senate by a 54-45 vote. The House of Representatives is expected to take up the measure in mid-July. In doing so, it is essential that lawmakers separate myth from fact. The following are some common misconceptions about freeing trade between the United States and the countries of Central America.

MYTH: DR–CAFTA, like NAFTA (the North American Free Trade Agreement with Canada and Mexico), will be a disaster for the American economy.

FACT: Since the implementation of NAFTA, the U.S. economy has grown rapidly, millions of new jobs have been created, and investment has expanded.

Between 1993 and 2003, the U.S. economy added almost 18 million new jobs, grew by 38 percent, and increased exports to Mexico and Canada from $134.3 billion to $250.6 billion. And, U.S. manufacturing output rose 41 percent. Today, the U.S. economy continues to exhibit strong growth and enjoys a historically low rate of unemployment. Clearly, NAFTA did not hurt the U.S. economy.

Freer trade stimulates growth, improves investment and job opportunities, and leads to higher living standards. Under DR–CAFTA, farmers, manufacturers, banks, and other service providers will become more competitive, have access to new markets, and benefit from stronger protection of property rights.

DR–CAFTA also will help the Central American countries to develop and modernize their economies. This,

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in turn, will generate greater demand for U.S. goods and services. For example, Costa Rica will be seeking to renovate its telecommunications systems and financial services, creating opportunities for U.S. firms. Freeing trade generates benefits in America today by making U.S. goods more competitive and tomorrow as Central American countries develop into larger markets.

MYTH: DR–CAFTA will result in U.S. job losses.

FACT: DR–CAFTA will encourage stronger growth and new, higher-quality jobs in the United States.

As illustrated in the *2005 Index of Economic Freedom*, countries adopting freer trade policies experienced higher average growth (2.8 percent) between 1995 and 2003 than countries that did nothing (2.4 percent) or that reduced their openness to trade (1.4 percent).

Since 1983, under the Caribbean Basin Initiative (CBI), the Dominican Republic and Central America have been receiving preferential trade access for most of their goods entering the U.S. Thus, any job loss associated with lowering tariffs on products from Central America already has occurred.

The agreement is actually a way to protect American jobs. For example, apparel manufacturers in Central America are required under the CBI to use U.S. fabric and yarn in their products in order to qualify for duty-free access to the U.S. market. By strengthening the relationship between U.S. textile producers and Central American apparel firms, DR–CAFTA will make the region, as a whole, better able to compete with Asia, thereby supporting continued U.S. textile exports and jobs.

DR–CAFTA will open Central America and the Dominican Republic to U.S. goods and services. It is an opportunity to gain new markets for American products and services, make investing in the U.S. more attractive, and support better, higher-paying U.S. jobs.

MYTH: DR–CAFTA will be just another excuse for outsourcing by U.S. companies, resulting in further job losses.

The U.S. is not losing net jobs to other countries, and this trend should continue under DR–CAFTA. According to the Organization for International Investment, the number of manufacturing jobs insourced to the U.S. grew by 82 percent the past 15 years. During that same time period, the number of jobs lost as a result of outsourcing grew by only 23 percent.

FACT: The U.S. is not losing net jobs to other countries, and this trend should continue under DR–CAFTA.

According to the Organization for International Investment, the number of manufacturing jobs insourced to the U.S. grew by 82 percent the past 15 years. During that same time period, the number of jobs lost as a result of outsourcing grew by only 23 percent.

The size of the U.S. market, a highly skilled workforce, and relatively low international trade barriers combine to serve as a beacon for attracting foreign investment into the American economy and generating new, better-paying jobs.

Although South Carolina has lost some textile jobs as a result of technological advancement and trade adjustment, it has gained higher-paying jobs at new factories, such as BMW, Daimler–Chrysler, and China's leading electronics manufacturer.

The biggest reason for outsourcing is not free trade, but the tax and regulatory burdens faced by companies operating within the United States. If these burdens are reduced, firms in the U.S. will be more competitive and less likely to move their business elsewhere.

MYTH: DR–CAFTA will make the trade deficit bigger, hurting the U.S. economy.

FACT: A growing trade deficit is an indication of strong inflows of foreign investment and domestic economic growth, which results in

higher living standards for Americans.

Between 1980 and 2004, in those years where the current account deficit increased, the U.S. grew an average of 3.5 percent. The economy grew only 1.9 percent in years when the current account deficit shrank.

By definition, a trade deficit indicates an inflow of foreign capital. The U.S. trade deficit reflects too little domestic savings to satisfy all of the investment opportunities in this country. This shortfall is remedied by a net inflow of foreign investment.

As investment and the economy grow, new jobs are created and the demand for all goods, including imports, rises. A growing trade deficit is generally a sign of a healthy, expanding economy.

MYTH: DR–CAFTA leaves foreign workers unprotected.

FACT: DR–CAFTA will enable the Central American countries to enforce labor standards.

DR–CAFTA countries have adopted the core labor standards of the International Labor Organization. DR–CAFTA also requires effective enforcement of labor regulations. Failure to comply would lead to monetary fines and/or the loss of preferential trade benefits.

Programs have been designed to assist these countries in strengthening their institutional capacity to administer labor regulations effectively.

Data indicate that the more flexible a country's labor laws, the higher the level of a country's per capita GDP and the greater the benefit to each household. Thus, caution should be used when demanding that the Central American countries adopt additional regulations that may reduce the ability of their workforce to adjust to economic change.

Historically, as prosperity increases, the desire and ability to implement labor protections and expend resources on their enforcement become stronger. This natural evolution toward protecting workers has been demonstrated in the U.S., Britain, and other developed countries.

The facts are clear: DR–CAFTA will improve U.S. economic performance, support American jobs, improve regional competitiveness against China, and promote economic freedom and prosperity across the region.

MYTH: DR–CAFTA will encourage greater immigration from Central America to the United States.

FACT: New economic opportunities and growing living standards will work to stem the tide of immigration.

Recent studies show that areas in Mexico that benefited from NAFTA had higher wages and lower levels of emigration. Areas that did not experience increased economic activity as a result of NAFTA saw a decline in wages and remain the main source of immigration from Mexico into the U.S.

DR–CAFTA would help to generate the economic growth and stability that bring new opportunities, more jobs, and improved living standards to the people of Central America. With the agreement in place, the decision to emigrate to the United States would become one driven by choice rather than necessity.

Although the myths about DR–CAFTA might make for interesting media fodder, it is the facts that should rule the debate within Congress. Overall, the facts are clear: DR–CAFTA will improve U.S. economic performance, support American jobs, improve regional competitiveness against China, and promote economic freedom and prosperity across the region. ■

Daniella Markheim is a Senior Policy Analyst in the Center for International Trade and Economics at The Heritage Foundation.

The Strategic Significance of the New China-India Pact

By Dr. Carl Chang

In April 2005, China and India announced a strategic partnership to resolve their long-term border dispute and create the world's largest free trade zone. However, the impact of this has much broader implications.

Once this strategically significant Asian Union produces tangible results, other regional countries likely will seek membership. While this occurs, other benefits will accrue. As such, the West should welcome this emerging bloc and seek to maximize opportunities.

Why Now?

The announcement of this strategic partnership came shortly after the U.S. shifted its Indian foreign policy toward one of greater cooperation in arms manufacturing and nuclear programs. Recognized as a U.S. strategy to nurture India as a counter weight to China, China took what some analysts believe is a counterbalance. The China-India past also is seen as a natural development on the heels of NAFTA and the expansion of the European Union.

Playing Catch Up

China and India, with populations of 1.3 billion and 1.08 billion, respectively, are considerably larger than that of the United States' 296 million. Chinese and Indian gross domestic product, as compared to the United States, is small, but their annual growth rates are more than twice as high. And the annual industrial production growth rates of China, 30.4 percent, and India, 6.5 percent, are considerably higher, as the U.S. rate is 0.3 percent.

China's domestic savings rate, at 40 percent annually, is used to acquire technologies, and build infrastructure and factories. India's rate, at 20 percent annually, has been less successful in financing investment.

What does this mean? In short, China, moving at a faster pace than India, is catching up to the U.S.

Complementary Strengths

China and India complement each other in many ways. Both have inexpensive labor and plenty of scientists and engineers. Partly due to poor language skills and restricted information flows, China is weak in services. However, it has a sound infrastructure. On the other hand, India is superior in services but has poor infrastructure. Manufacturing is only 15 percent of the India's GDP.

India leads China in software development due to its high standards in the IT industry, governmental tax incentives, English proficiency and educational emphasis on mathematics and logical reasoning. As a result, India could help China in improving these capabilities.

For the last 25 years, China has moved 300 million people out of poverty and quadrupled its average per capita income. India has 250 universities and 11,549 colleges which educate 600,000 IT professionals and many other graduates.

At the end of 2004, China had a highway network that extended about 30,400 miles—only second to the United States. China plans to double this figure in 25 years. In these domains, China could assist India.

China and India are in need of industrial products to serve lower and middle market segments. The free trade zone created by the strategic partnership opens the door for Chinese and Indian entrepreneurs to develop low cost and acceptable quality products for these segments.

Serving Each Other's Markets

China and India are in need of industrial products to serve lower and middle market segments. The free trade zone created by the strategic partnership opens the door for Chinese and Indian entrepreneurs to develop low cost and acceptable quality products for these segments.

Currently, they remain unfulfilled since multinational enterprises (MNEs) in the West have been focused mostly on higher-end segments.

Particularly attractive to Chinese and Indian providers are new hardware and software systems based on India's creativity in product design and China's manufacturing savvy.

Higher Costs To Outsource?

Both China and India have difficult geographical topologies to navigate. This makes efficient distribution of products across each others' countries a challenge. An intensive collaboration between Chinese and Indian engineers could result in solutions designed to improve the distribution of products to rural and far away regions.

This re-engineering of the supply chain, as well as the adjustment to local marketing needs, are areas for potential joint ventures between Chinese and Indian firms. Should this occur, it is conceivable that each country's most qualified engineers could become preoccupied with these internal challenges—leaving fewer and less-qualified workers to serve the outsourcing needs of MNEs. In this scenario, the costs of doing business for multinational enterprises would increase, making them less competitive in global markets.

The China-India pact is likely to lay the foundation for an "Asian Union." As time progresses, many Asian nations will join the bloc, forming an economic union similar to that of NAFTA and the European Union. In time, the bloc will gain clout, and in turn, benefit the entire region.

New Standards, Greater Stabilization?

Based on existing capabilities in hardware and software, China and India likely will impact IT standards throughout Asia and greatly influence technology adoption globally. Thus, China's engineers may become more involved in setting the future standards for radio-frequency identification, encryption and other key technologies.

The China-India pact also could help stabilize the world economy in the same way China's robust growth helped the world escape recession after the U.S. stock market bubble burst in 2001. China further has enhanced world stability by its continued buying of U.S. Treasury bills that support heavy U.S. government borrowing. And lastly, the emerging economic China-India bloc could contribute more actively to the maintenance of world's security and peace.

Intra-Bloc Trade To Expand

Chinese-Indian trade currently is small, totaling about $3 billion annually. This is likely to change. The Chinese-Indian free trade zone is anticipated to significantly boost China-India trade. The result: trade between the China-India bloc and the West may become increasingly more specialized over time, as China and India continue to share their resources more fully between themselves.

A Rise in High-End Demand Likely

The China-India pact will encourage the rapid development of low cost and acceptable quality products for both low and middle market segments in China and India, as well as in other developing countries. As the needs of these customers become satisfied, demand for higher-end products will rise. This will benefit multinational enterprises. And in the long run, the India-China pact will raise living standards in many developing regions, while preparing these markets for the eventual acceptance of premium products from the West.

A Win-Win-Win

The China-India pact is likely to lay the foundation for an "Asian Union." As time progresses, many Asian nations will join the bloc, forming an economic union similar to that of NAFTA and the European Union. In time, the bloc will gain clout, and in turn, benefit the entire region. It also may provide a balancing force that will help maintain world peace and security. The West should welcome the emerging bloc's trade and investment policies and seek to maximize the mutual benefits derived from this new reality. ■

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Unpegging the Yuan from the Dollar: The Impact Is Uncertain

By John Manzella in association with Kirk Harrington

China's practice of pegging its currency, the yuan (also known as the renminbi), to the U.S. dollar has created much speculation in corporate board rooms and controversy among policymakers. Unpegging the yuan from the dollar, a solution advocated by many, may not be so easy. And, it may not achieve what it is intended to do. What's worse, it could have some unintended consequences.

Will It Rise or Fall?

Congressional sources have declared the yuan to be considerably undervalued, which in turn, make Chinese exports more attractive worldwide. In response, some U.S. politicians and various organizations suggest that China should allow the yuan to float freely, assuming it will rise to a higher level.

On the other hand, some economists believe that if this were to occur, the currency may become volatile due to China's weak financial sector, instability associated with the country's transition to a market economy and difficult economic adjustments associated with WTO-mandated reforms. In turn, a widely fluctuating yuan could have a destabilizing effect and fall well below current levels. In this less likely scenario, a falling yuan could lead to a financial crisis.

The Outcome Is Unclear

Regardless of these arguments, a revaluation of the yuan is likely to have little impact on the U.S. trade deficit. Why? If the yuan were to rise in value, U.S. companies would continue to seek low cost imports from other developing countries.

In his June 23, 2005 testimony before the U.S. Senate Committee on Finance, Federal Reserve Chairman Alan Greenspan said, "An increase in the exchange rate of the renminbi, relative to the dollar, would likely redirect trade within Asia, reversing to some extent the patterns that have emerged during the past half century. However, a revaluation of the renminbi would have limited consequences for overall U.S. imports, as well as for U.S. exports that compete with Chinese products for third markets."

If China were to revalue its currency, other Asian countries would become more comfortable in allowing their currencies to appreciate against the dollar, according to the Deloitte Research report, *China at a Crossroads: Seven Risks of Doing Business*. The result: the U.S. would ultimately experience an improvement in its current account balance. How much? Economists suggest it would be minimal.

The Other Impact on China

Although the full impact of a floating yuan is uncertain, many analysts agree it is increasingly likely that China will allow the yuan to appreciate against the dollar. They also agree that continued pegging of the yuan to the dollar negatively impacts China.

In a May 2005 report to Congress, the U.S. Treasury Department said the yuan's peg "blocks the transmission of critical price signals, impedes needed adjustment of international imbalances, attracts speculative capital flows and is a large and increasing risk to the Chinese economy."

It also is widely agreed that the pegging policy hurts low-cost global producers who compete with China for global market share.

Market Forces Should Dictate

The yuan-dollar pegging policy originally began when the dollar was strong and China was considered an economy in need of development aid. Now that China has become a strong international player, especially in the manufacturing sector, and one that is seeking higher technologies, many argue that China is ready to implement a more flexible exchange rate.

To play fair on the world stage, China should take steps to achieve currency convertibility based on market forces. When, not if, may be the more appropriate question. ■

John Manzella, president of Manzella Trade Communications, is a leading author, speaker and strategic communications consultant. Kirk Harrington is an economic and financial analyst.

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