

MR. LARDY: Yes. Thank you. I want to thank the Commission for inviting me to appear before you today.

What I'd like to do is simply go through some of the diagrams that I submitted to the Commission last week in my written statement, supplemented by some that were handed to you a few moments ago.

I would like to start with China's extraordinary trade performance over the last 20 or so years. The growth of China's trade over the period between '78 and '98 has been about four and a half times more rapid than that of the growth of the trade world.

No other country has increased its share of international trade so rapidly in so short a period of time. One of the questions obviously is: how was this accomplished?

I think part of the answer has to do with China's extraordinary openness to foreign direct investment, beginning very slowly in the late 1970s and then accelerating, particularly in the 1990s.

And in the second diagram, you can see the annual inflows of foreign direct investment, which reached a peak of about \$45 billion in both 1997 and 1998 before declining slightly to about \$40 billion last year.

More importantly, in Diagram 3, I'm showing you the stock of foreign direct investment. And here the key thing, of course, is the stock of foreign direct investment in China today is well over \$300 billion U.S. and accounts for almost a third of all foreign direct investment in developing countries. So you have one single country that has a third of all direct investment going to developing economies.

This huge stock of investment has begun to have very substantial impact on China's trade. As you can see in Diagram 4, beginning about in the mid-1980s, foreign investment companies began to play a perceptible role in exports. And by last year, they were responsible for almost 50 percent of China's exports. They were also responsible for about 50 percent of China's imports as well.

It's very difficult to find a large economy like China's in which foreign-invested firms; that is, joint ventures and wholly foreign-owned companies, play such a large role. You may find it in Singapore and a few very other special cases like that, but in a large continental economy, I think China is really unprecedented in the extent to which it has allowed foreign direct investment in and the extent to which

that, in turn, has shaped its trade. Basically, the pattern of China's imports and exports has increasingly reflected the decisions of foreign companies operating in China.

So, clearly, the first part of the answer to the question of why has China's trade grown so rapidly has to do with the very extensive role of foreign companies.

The second reason I think is that China has increasingly opened its economy, not only in terms of foreign direct investment, but also in terms of more traditional barriers to trade, in the form of tariffs and non-tariff barriers.

As you can see in Diagram 5, there are two lines. The top line is showing China's official tariff rates, which indeed were extremely high in the mid-80s and continuing, really, until the 1990s, in which period of time they have come down now to about 16 or 17 percent, which is roughly about half the level of tariffs in India and about equivalent to those in Brazil and Mexico.

Interestingly, if you look at the second line, the bottom line, which is showing us how much tariff revenue is actually collected relative to the

value of imports coming into China, you can see the peak levels were in the high teens in the mid-1980s.

But numbers have come down very substantially and for the period of 1993 through 1998 have averaged only about three percent of the value of imports. So this is an environment in which tariffs have been a declining impediment to the flow of goods.

Beyond that, the non-tariff barriers have also been shrinking pretty dramatically, particularly as a result of the agreement that one of your members, Carla Hills, negotiated in the early 1990s. The number of tariff lines today that are subject to licenses and quotas has been reduced by about 80 percent compared with the time that she negotiated that agreement. And these restrictions now apply to less than four percent of all import lines in China. So both the tariff barriers and the non-tariff barriers have come down pretty dramatically, particularly for both of them, in the 1990s.

What has the result been in terms of how well U.S. firms have done? This is shown in Diagram 6, where I'm looking at the growth of U.S. exports to our six largest export markets in the world. And China is now our sixth largest export market.

You can see for the period of the 1990s, the growth of exports to China is above that of any of our other large export markets. So certainly U.S. firms have benefited from the reductions in tariff and non-tariff barriers that have occurred in this market over time.

Obviously there is a paradox. Our exports to China are growing so rapidly they have tripled between 1990 and 1998. Why do we have such a large deficit? And I begin to explore that in the three additional diagrams that were handed out earlier this afternoon.

The first is simply an overlay of the trends in the role of foreign-funded enterprises and exporting in China and the U.S.-China bilateral trade deficit, one measured in percentage terms and one measured in billions of U.S. dollars.

If you can see, as foreign-funded firms became the significant exporters in China beginning in the mid-1980s, our deficit with China has gone steadily upward.

In other words, what we're witnessing, really, is a deficit that reflects the migration of labor-intensive manufacturing to China. China's

opening up in the 1980s coincided with rapidly rising wages in places like Hong Kong, Taiwan, and South Korea.

To remain competitive, those firms moved their manufacturing operations to China. That explains a large portion of the 300-plus billion dollars in foreign-direct investment there.

So Asian entrepreneurs moved a growing share of their labor-intensive manufacturing activities out of China. They were generating most of the exports coming out of China, and, as a result, since we are a large market for those products, our deficit went up.

In the final two diagrams, I simply look at two commodities that are the most important of our imports from China. The first is footwear, and the second one is toys and sporting goods.

I think the diagrams show an almost identical story. That is, if you go back to the mid-1980s, 50, 60, 70 percent of these products were coming, in the case of footwear from South Korea and Taiwan. Under one percent was coming from China. By 1999 we are getting 60 percent from China and about two percent from South Korea and Taiwan.

The same thing is true in toys and sporting goods. We used to buy these things predominantly from Hong Kong, South Korea, Taiwan. Now their share has declined dramatically to well under 10 percent while China's share has risen to slightly above 60 percent.

So the message I am leaving you with, quite frankly, is the deficit is a function of the fact that China has developed over time a very liberal foreign direct investment environment that has attracted record amounts of foreign direct investment.

Entrepreneurial firms elsewhere in Asia have moved their manufacturing there and the goods that we use to buy from those countries, particularly in the labor-intensive commodities that are the bulk of our imports from China, are now coming from China, rather than these alternative sources of supply.

My own view, thus, is it's likely that the deficit with China will continue to rise, for reasons that Harry alluded to, these underlying structural reasons that I'm talking about.

I think U.S. gains will be achieved as a result of the agreement, but I think they are likely to be in the services sector, where the current degree of

protection in China is substantially higher than it is in manufacturing.

So I would expect to see additional significant investment by U.S. firms in telecommunications, distribution, financial services, and so forth. And I would expect to see some improvements in the service sector account. But, of course, these are not going to be reflected in the merchandise trade account, which attracts so much attention in this part of Washington.

The improvements I would be looking for would be in the service sector. I don't see any reason to expect a dramatic improvement in the merchandise trade. And, indeed, I think, subject to some caveats, it's likely that the merchandise deficit will continue to rise.

Nonetheless, I come to the same conclusion that Gerrit and Harry do. And that is we should be encouraging China's entry into the World Trade Organization. We should be in favor of congressional approval of permanent normal trade relations because it will integrate China more fully into the international economy.

It will subject them to the disciplines of the WTO. It will give us opportunities for using the dispute settlement mechanism. It will give us opportunities to negotiate further with them in additional rounds of WTO arrangements.

Thank you very much.

VICE CHAIRMAN PAPADIMITRIOU: Thank you very, very much. Mr. Mastel?