THE FUTURE OF AMERICAN TRADE POLICY

Testimony to the Senate Committee on Finance

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Mr. Chairman, Mr. Ranking Member and Members of the Committee, thank you for this opportunity to discuss America's trade agenda.

The Finance Committee has a decades-old tradition of careful deliberation and bipartisan leadership on trade and the global economy. Today's event is a sterling example. Trade has rarely been so important – whether we speak of the long-run questions of America's future growth and economic position in the world; or the immediate environment, with exports America's only significant source of private-sector growth during a period of financial crisis and contraction. But public anxieties over globalization have rarely been so high, and reasonably so. Structural change in the global economy is creating new industries and overturning familiar old ones; outdating old domestic policies, social arrangements and elements of our trade regime; and, as China and India rise, raising questions about America's status as the world's economic leader.

This hearing, accordingly, is a remarkable opportunity to reflect and develop consensus on our response to a profound set of challenges. My first and most important point is that trade policy can be only one element in this response, and not the principal element. We should place national competitiveness at the center, examining our finances, our commitment to science and innovation, our high-tech and traditional infrastructure, our human resources policies in both education and immigration, and other matters. We should also restructure our domestic social contract, to remove powerful sources of anxiety, notably fear of the loss of health care, as well as to spread the benefits more equitably and mitigate the risks for individuals. Together with this, we need a battery of trade, financial and other global policies that allow us to draw maximum benefit from the global economy, tap new areas of growth, and support our goals in national security, development and poverty reduction, and environmental quality.

These basic points are the foundation of my testimony today. I will touch upon four areas:

- The backdrop for a trade agenda, in the dramatic acceleration of the phenomena we bring together as "globalization" and the resulting shifts in competitiveness;
- The policy context and the ways trade policy needs to mesh with policies in other areas;
- The appropriate goals for trade policy *per se*; and
- A trade agenda that better meets our needs.

BACKDROP: ACCELERATION OF GLOBALIZATION

The need for a robust set of policies today is intuitively clear to the country, and is especially striking when we look at the changes underway beyond our borders and outside the world of policy.

We often use terms like "never in history" and "unprecedented" to describe the modern global economy. We should employ them with care, because in most cases there are precedents. Exports and imports of goods were probably larger, relative to America's domestic economy, in the 1790s than they are today. Foreign investment peaked relative to GDP in the late 19th century. Immigration reached its highest point in the first decades of the 20th century. And alarm over low-wage competition from abroad was the basis of almost all American trade arguments from the 1820s until 1932; as early as 1791, Alexander Hamilton was pointing out that to match low-income European competition we would need to improve our use of technology and our productivity. More recently, concern with low-wage competition has characterized the debate over trade with the Asian tigers in the 1980s, Mexico in the 1990s, and many free trade agreements that have followed.

Ever since our first major trade agreement of the modern era, the GATT agreement of 1947, the growth of the world economy has been accelerating. The economic historian Angus Maddison suggests that the global economy grew about five-fold between the year 1 and the year 1800; then grew ten-fold to the year 1950; and grew again ten-fold between 1950 and 2000. And this decade has presented challenges that are unique in modern experience, and in some cases fundamentally new. The pace of change has again accelerated – and not only in terms of aggregate growth, but along other axes, with more players, new industries, and new patterns of industrial organization led by the multinational supply chain.

Most of these shifts have emerged from processes outside American policy, and sometimes outside the world of 'policy' completely. Despite many debates over specific agreements in this decade, our actual trade regime has been relatively static. The only significant liberalization of U.S. policy has been abolition of textile quotas (other than for China) three years ago. Even here, high tariffs remain. The drivers of globalization in this decade have instead been dominated by structural changes in technology, logistics and Asian geopolitics:

Information technology and telecommunications: International communications are easier and cheaper each year. The massive investment in IT infrastructure since 1998 – over 370,000 kilometers of submarine cable and the weekly launch of a new communications satellite – has driven down the cost and vastly improved the quality of communications. This in turn has improved productivity and reduced redundancy in goods industries, created dozens of new Internet-based services industries, and rapidly 'globalized' many existing services industries by enabling large-scale experimentation in global media, finance, entertainment and others. This includes heavily publicized back-office work, research and development, software design and other functions now done in India, the Philippines and other mid-income countries, in addition to the United States.

Logistical industries: The capacity and efficiency of the shipping and air-cargo industries grow annually. In 1997 UNCTAD's annual maritime-industry survey counted 2000 container ships, with an average capacity of 1600 twenty-foot equivalent containers (TEUs). By the 2007 report there were 4000 container ships, with an average capacity of 2400 TEUs. This is likely to continue as new container ships with upwards of 12,000 TEU capacity enter service. Advances in air cargo and express-delivery are less easy to quantify, but at least as rapid and profound. The combination, especially when linked to information technology, has facilitated the creation of elaborate international supply chains, and made international transport of manufactured goods and intermediate products much faster, cheaper and more precise.

Asian economic integration: Asia has integrated its economies and become vastly more competitive. China's opening to the world, beginning in 1978 and continuing ever since, has catalyzed a rapid evolution of the entire Asian economy. The continent has integrated much as Europe has, but in one decade rather than six. This is best traced through FDI statistics. China has received on average $40-$50 billion in FDI from Hong Kong, Taiwan, Japan, Korea and Singapore annually. Early in the decade, China's Commerce Ministry reported that this investment – usually a larger figure than American direct investment in China, Mexico, India and all other developing countries combined – was putting up 10-15,000 mainland manufacturing facilities a year. The result has been to transform Asian manufacturing and trade patterns on a massive scale, fusing the technological and financial power of Japan, Korea, Taiwan, Hong Kong, and Singapore with the resource base of Southeast Asia and the large, relatively low-cost and educated workforce of China.

The consequence has been a sudden, dramatic broadening of the global economy, occurring simultaneously in several different dimensions:

- Trade in goods and services has accelerated. In 1980, America's trade in goods and services, combining exports and imports, amounted to 20.6 percent of GDP. By 2000 the ratio had risen to 26.2 percent of GDP. So far in 2008, the figure is 30.4 percent. For the world as a whole, goods and services exports rose from 21 to 24.8 percent between 1980 and 2000, and reached 31 percent by 2007.

- Financial flows have grown even faster than trade flows. Currency trading volumes have doubled from $1.5 to $3 trillion a day over the last decade, and FDI flows, though more volatile, are growing at comparable rates.

- The flow of information has accelerated still faster. To choose a very simple example, international phone calls have grown in volume - the FCC counted about 22 million international phone call minutes in 1994 and 42 million by 2004 – and have become vastly cheaper, with the price per minute dropping from about 70 cents to a dime per minute in the last decade. And information flows are of incomparably higher quality each year, as satellites and fiber-optic cable spread high-speed, high-bandwidth Internet connections around the world.

The combination has already made some policies visibly obsolete. The falling cost of trade, for example, has largely transmuted many light-industry tariffs from trade policies into excise taxes applied to goods barely made or not at all made in America. In fact, the highest manufacturing tariff in the U.S. Tariff schedules, a 48 percent tax on cheap sneakers, applies to a product not made here for decades. The effect abroad is similar, with the countries facing genuinely high barriers in the United States not industrial competitors but very low-income Asian, Arab and other majority Muslim countries. Last year, for example, the Customs service recorded a $523 million tariff penalty on $3 billion in Bangladeshi goods, a $419 million penalty on $2.4 billion worth of Cambodian goods – and simultaneously a $412 million penalty on $57 billion worth of British goods. The rapid development of multinational supply chains likewise has raised questions about the relevance of bilateral free trade agreements, with businesses more and more frequently choosing to maintain supply chains rather than meet rules of origin. One striking example is the falling share of imports from Canada and Mexico that come in under the NAFTA.

Looking ahead, we should expect many of the structural changes to accelerate further. Two large regions, Africa and the 'greater Middle East,' are still largely outside the world of integrated manufacturing, value-added agriculture and services. They, especially the Muslim Middle East, retain the policy characteristics of earlier times – reliance on natural resources, fragmented economies, and chaotic politics at times producing virulent regimes and political movements. Together they account for 1.5 billion people yet to enter the global economy in a meaningful way. Elsewhere, the IT revolution is certainly still in its infancy. Asian integration is continuing, now through deliberate trade, financial and infrastructure policies by China, Korea, Japan, India and ASEAN as well as by business investment. Logistical advance may slow a bit to accommodate higher fuel prices, but is likely to recover as businesses become more energy-efficient. So integration is coming at tremendous speed and in many different areas. Barring some calamitous event – a great-power war, or a massive disruption of energy supplies – it is likely to speed up rather than slow in the years ahead.

EFFECTS AND CHALLENGE TO U.S.

The pace of change – and, as I will note later, the slow response of domestic policy to it – has naturally aroused public anxiety. Again, though, we have past experience to draw upon. Similar waves of anxiety emerged in the early 1970s and the mid-1980s, coinciding like today's, with the rise of large new competitors, the growth of international imbalances, and domestic economic downturns. Each is a sign that we need to examine ourselves and our policies closely, and adapt to new circumstances.

We should begin, of course, by observing that globalization has many positive effects. With foreign markets more open to our farmers, factories and services providers than ever before, America's manufacturing exports have roughly doubled since 2002, from $560 billion to a likely $1.04 trillion this year. Services and farm exports have risen even faster, to likely records around $600 billion and $135 billion, respectively. This is important in the long run for our economic success – and it is essential today with exports our only significant source of private-sector growth during a period of financial crisis, falling consumer confidence, and recession. To be precise, since mid-2007 exporters have provided about 0.6 percent growth in GDP, while the rest of the private sector has been contracting by about -0.2 percent. And wages in export dependent jobs range between 13 and 18 percent higher than non-export related jobs.

On the other side of the ledger, an open market helps us remain competitive; and by lowering the price of consumer goods, helps American families shift spending from life necessities like clothes and food to education, health and other services. The Bureau of Labor Statistics suggests that Americans devoted 27 percent of family spending to food and clothing in 1973, and now only 17 percent. And attempts to ease anxiety through import limits have either simply failed, as the maintenance of shoe tariffs and textile quotas did; or made existing problems worse while creating new ones, as they did at the end of the 1920s.

But these benefits have often been poorly spread – wages and incomes in particular have risen rapidly for high-income Americans, but stagnated for middle-income families – and globalization also brings challenge. As individuals, Americans compete against a much wider range of consumers, businesses and workers. The IMF made an interesting observation on this point last year, noting that the number of 'globalized' workers – that is, people who work in businesses that export or compete against imports, people who are employed by transnational businesses, or people who work outside their home country – rose from 225 to 900 million between 1980 and 2005. Matched against the growth of the overall global workforce, this means 'globalized' workers accounted for about one in nine of the world's workers in 1980, and now make up one in four.

On a national scale, we have to ask questions about our own ability to remain the world's economic leader, with China likely to become the world's largest economy in absolute size during the next decade or so, and India is catching up fast as well. We can look to the past as a sign for what may lie ahead. Maddison points out that in 1820, China and India accounted for about 49 percent of global GDP. Their share then shrank as the Industrial Revolution took off in Europe, and reached a low of about 8 percent in the 1970s. They have now rebounded to roughly 20 percent of global GDP, which is still far below their historic place in the world economy. Should they continue to grow at this rate, as a country with a smaller population, we can retain our present leading role – but only by growing more competitive, more innovative, and more educated than we are today.

Even successful private-sector adaptation to challenge, as essential as it is, can increase public stress. One sees this in the services industries, where the Internet has helped high-value American exports boom, and our sectoral surplus has risen from $48 billion in 2004 to $119 billion last year and perhaps $140 billion this year. But this has not eased the uncertainty emerging from the Internet's reshaping and 'globalizing' of banking, accounting, journalism, research and development and other services industries. Adjustment in manufacturing has been still more painful, as we have had a massive rationalization of production, accompanied however by record-setting output in U.S. value-added manufactures, but a swift and rapid decline in employment. And at worst, business adjustment without better public policies can tear the business interest from the national interest: if we avoid the public-policy steps necessary to hold our attractiveness as a site for research, finance and production, businesses can and will simply move operations elsewhere.

RESPONSE IN ASIA, EUROPE AND THE UNITED STATES

The United States, of course, is not alone in facing these questions. All countries are grappling with them. But Asia, and Europe to a lesser degree, seem more successful in this decade than we.

Asia: Rapid Integration, Rising Competitiveness

Asian countries have devoted the last decade to integrating their economies, upgrading their national infrastructures, and raising their commitment to research and education. China, Korea, Taiwan, Malaysia, Singapore, Vietnam, Japan and India have all invested tens of billions of dollars in upgrading airports, container terminals, roads, bridges, telecommunications and broadband networks. The *Economist* reports that China will expand seaport capacity by 85 percent in the next decade, add 97 airports, and spend $200 billion on railroads between 2006 and 2010. India may spend $500 billion on infrastructure by 2012.

Each is also spending heavily on intellectual infrastructure, including public research and development and new schools at all levels. One result has been to sharply raise, especially in China and India, the rate of graduation in science and engineering. China appears to have recently surpassed the US in total science and engineering graduates. One can wonder about the quality of the graduates, of course. But the results appear, among other places, in the data published by the US Patent and Trademark Office each year that are not ambiguous – patenting by residents of India and China has grew nearly ten-fold in the first half of this decade, from 900 applications in the year 2000 to 6,000 in 2006.

At a slower but noticeable pace, highlighted in last month's Asian Development Bank report on 'Asian regionalism,' China, Japan, ASEAN and Korea, joined recently by India, have been designing trade, financial and infrastructure integration agreements among governments and coordinating policies through the East Asia Summits, ASEAN + 3 and other new venues. These are less ambitious than the agreements the United States has signed. But they are completed faster, include most of the major Asian economies rather than only smaller markets, and cover most of the manufacturing and new technology industries where trade is growing most rapidly. The U.S. is present in none of these agreements.

European Union: New Members, New Currency

Europe too has responded. Discussion here often dismisses the European Union as old, divided, slow in decision and likely to decline over time. Europe does have some significant challenges, including a greater sensitivity to immigration, a less mobile public, somewhat lower rates of spending on research, and a more rapidly aging population than ours. But their policy has been far more active and successful than one infers from debate.

During this decade, the European Union has almost doubled its membership from 15 to 27 countries – one in seven of the world's independent states. EU GDP has risen to $15 trillion, above the US level, and the combined population of its members has reached half a billion. The EU has also successfully launched the first common European currency in centuries, raising questions about whether the dollar will remain the world reserve currency. These are large accomplishments which we should not ignore or discount – especially given the state of our own policies.

U.S.: Policy Erodes, Debate Drifts

For our part, the challenge is clear. Competitors have improved their policies and are rising rapidly. We need to match them if we are to hold our leading position. But we have been very slow to accept this reality. Instead, all too often we have indulged ourselves in resentment of Asian success (or in old debates largely centered on trade with Mexico), and in hopes that assertive trade and currency policy can substitute for better performance at home. Meanwhile, few of our policies have improved and some have degraded, leaving us less able to meet our challenge. Let me cite three particularly disturbing facts:

- Finance: Our financial position has grown extraordinarily weak. We have essentially no private savings, and changes in government tax policies in this decade have shifted a $400 billion surplus into a $300 billion deficit. This leaves us highly dependent on foreign capital to finance government deficits and consumer spending. Together with currency mismatches and oil-price inflation, it has also created a very large national current-account deficit.

- Physical infrastructure: Some spectacular events highlight the aging of our bridges and roads. But anyone who travels to Asia – not only Korea and Japan but coastal China, Malaysia, Singapore and others – is immediately struck by how efficient and new their airports, seaports and roads are in comparison to ours. Likewise our use of broadband Internet remains well behind that of Japan and Korea, and also of Taiwan, parts of urban China and parts of Europe.

- Energy: Our economy is much less energy-efficient than Europe and Japan. According to the World Bank's most recent annual list, a kilogram of oil produces $4.60 in US GDP, but $6.50 in European or Japanese GDP and $4.80 in

> Australian. The consequences are visible in our trade accounts. Energy now accounts for 18 percent of America's merchandise imports and 2.5 percent of GDP – in both cases the highest figure since the Iranian crisis of 1979-1982 – and keeps our aggregate national trade deficit high despite rapidly falling manufacturing deficits and rising surpluses in agriculture and services.

In some other areas we fare better relative to foreign countries, but still less well than we should expect. In 'intellectual' infrastructure, we maintain an exceptional university system, but have notorious weakness in middle and high school. With fewer Americans choosing science and technology careers, we have historically compensated by attracting skilled foreign students and workers. Here we continue to do better than almost all other countries, with the likely exceptions of Australia and Canada. But immigration restriction since 9/11, and perhaps a broader perception of anti-immigrant sentiment, is eroding our attractiveness vis-à-vis competing schools in Britain, Canada, Australia, Japan and Hong Kong. And while our public investment in research in life sciences is strong, in hard-science fields such as physics, math, computer science and chemistry it is low. Here public spending has dropped from 0.33 percent of GDP in 1975 to 0.21 percent today. The Internet's ability to allow firms to conduct R & D anywhere in the world means investment will likely flow in the future to wherever companies believe the talent is best, so we cannot count on private-sector research to compensate.

Finally, we have weak adjustment policies that do little to ease public anxieties. Some European countries, especially Scandinavia and Netherlands, remain much more exposed to trade competition than are we, if one measures the ratio of imports to GDP. They, like Europe generally, are also transitioning as rapidly as we to low-employment manufacturing. But their publics seem more confident than ours. One evident reason is their national guarantees of health care, access to job training, and job placement systems overseen by businesses and unions as well as governments. Without appropriate support, change here has become more frightening. Public anxiety is higher. And effective and honest response becomes more difficult.

Trade policy should be a part of this response. We need well-chosen trade agreements, measured not by the number completed but by the impact on our economy and enhancement of our strategic alliances. We need as well a strong policy to assert our rights and enforce trade agreements, and we need an effective financial and currency policy that removes sources of distortion in the flow of goods, services and investment. I will come to these in a moment. But we also need to be realistic and honest with ourselves.

Neither new trade enforcement measures, labor-rights policies nor currency measures will make China less efficient at manufacturing goods. Nor will they detach India's knowledge industries from the Internet. Nor are they likely to return labor-intensive manufacturing jobs to the United States. Manufacturing output in the United States has been steadily rising, with record output in 2005, 2006 and 2007. But factory employment, pressured by technological change as well as international specialization, has been falling relative to the total US labor force since the 1950s, and in absolute terms since the 1970s – and also in Europe, Japan, Korea, and even China.

Our goal instead must be a holistic agenda including 'trade policy' per se but resting upon a far broader foundation. This would examine and address our main competitive weaknesses; improve and in some cases rewrite the social compact for workers as the economy changes; reshape outdated institutions at home and abroad; and simultaneously use trade policy to ensure that we draw the maximum benefit from the world's growth, protect our rights, and help meet major challenges in security, development and climate change.

TOWARDS A GLOBALIZATION AGENDA

In designing this holistic agenda, we should begin not with trade policy or international negotiations but at home.

The top priority must be competitiveness. We will need to restore a commitment to publicly funded basic research in hard sciences, and to both train and recruit from abroad the scientists and engineers necessary to keep the U.S. at the leading edge of innovation. We will need a major effort to upgrade our traditional and high-tech infrastructure, to put it back at par with those in Asia. Congress I believe is considering very interesting proposals to create an independent entity to evaluate and finance infrastructure proposals of national significance.

We will need at the same time to strengthen the government's fiscal position, and to promote private savings. The IMF reports show the United States with a gross national savings rate of about 13 percent. This is down from 18 percent at the turn of the century, driven by the return of structural government fiscal deficits as well as by a dearth of personal savings. By comparison, the world's savings rate is 23 percent, the European Union's 21 percent, Japan's 29 percent and developing Asia's 43 percent. Here is a basic contributor to our persistent current-account deficits. If we are to bring these down to a sustainable level – that is, setting aside fluctuations upward due to energy prices and downward from the present recessionary trend – currency policy is part of the solution, but more fundamentally we will need budgetary reform and savings incentives.

We will also need to reshape much of our social compact – helping workers upgrade their skills and take advantage of higher-paying jobs to broaden the benefits of globalization, designing better EITC and minimum-wage systems to support living standards for lower-wage families, while using public policies to mitigate the effects of competition on vulnerable individuals and communities and restore their confidence that career transition and industrial change are not synonyms for personal financial catastrophe. I am struck, for example, by the fact that Germany spends 3.1 percent of GDP on adjustment, while we spend only 0.5 percent of GDP. Here let me applaud the Committee's work to broaden and ease access to Trade Adjustment Assistance, in 2002 and again this year. As time passes, I would hope this can evolve into a universal system which offers guarantees of health care, pension portability and perhaps other social-insurance measures to all workers dislocated for no fault of their own.

With these two points as the foundation, we need to reshape our trade debate and our trade policy priorities. To date, most argument over globalization has taken the form of defense or criticism of NAFTA. These both miss the point. The relationships with Canada and Mexico are large, and the agreement is important. But before the agreement, Mexico was our third-largest trading partner and Canada our first. Mexico is still our third-largest trading partner, and Canada still our first, albeit at vastly higher absolute levels of two-way trade. Their shares of US imports and exports, have however, declined in this decade – especially if total oil imports are excluded – and are only modestly above the levels of 1993. The fact is that NAFTA is not the source of technology-driven change in services, nor the source of logistics-driven decline in the cost of manufacturing trade, nor a factor in Asia's rising competitiveness. A trade debate focused upon it, therefore, misses the major structural changes underway in the world economy, and is not likely to lead to policies that directly respond to our problems today.

THE TRADE AGENDA

What then should be the aim of trade policy? We can begin with first principles:

- It should create economic opportunities by opening markets and establishing fair rules in the major overseas economies and industry sectors which are likely to grow fastest in the coming years.
- It should support national security in the areas where economics and foreign policy intersect – strengthening our strategic alliances, smoothing great-power relationships where we do not have alliances, and promoting the growth and development that ease political challenges in troubled regions.
- It should create an efficient, innovative domestic economy and boost living standards by maintaining open U.S. markets, while also providing the public with confidence that agreements are enforced and make sure competitors play by the rules.
- And it should mesh rather than clash with policy in other major areas, in particular poverty reduction, worker rights, response to climate change, preserving free flows of information.

The basic tools of trade policy remains appropriate for these goals. Since the Committee considered the first Reciprocal Trade Agreements Act in 1934, American presidents of both parties have used a combination of international trade agreements that lower barriers to trade, investment and information flows; enforcement at the WTO and through domestic law; tariff preferences for low-income regions; trade remedies; and consumer protection policies. This approach has been fundamentally consistent across 12 multilateral trade agreements at the GATT and WTO between 1947 and 1998; the 'accession' agreements of 130 countries to the trading system, led in recent years by China, Taiwan, Vietnam, Saudi Arabia and Ukraine, and more recently a spate of bilateral agreements and preference programs. It has adapted to address changes in geopolitics, and to take on new issues as economic structure and technology change. And now it is time to adapt again.

I would urge the Committee to adopt a trade policy that addresses the genuinely major challenges. These can be divided roughly into three baskets, two dealing with trade policy issues and the third looking at institutional arrangements –

- *Economic expansion*: The economic integration and phenomenal growth of Asia; the secondary but still major development of the European Union; the technology-driven rise of new industries and acceleration of global integration;
- *Security and development*: The marginalization of many of the world's large Muslim countries, especially in and around the Middle East; the tilt of trade regimes in the United States and elsewhere against the poor; and the drift towards authoritarian populism in Latin America.
- *21st-Century Bretton Woods*: The need for a renewal and modernization of the international institutional arrangements launched at the Bretton Woods Conference in 1945, with particular focus on the fading of the international financial institutions; the absence or inadequacy of environmental institutions; and the challenge a climate-change agreement will pose in its own right and for trade policies in particular.

Economic expansion: Fundamentally, trade policy should turn from bilateral agreements with relatively small partners toward the fast-growing industries and major economies that we can tap for growth. Among these industries are services generally, energy and environmental technologies, infrastructure-linked industries where Asian countries in particular are large buyers, and medical and health industries. Our goal should be to ensure that American-based service providers and manufacturers can supply the goods and services where demand is greatest. Major targets should include the EU and Japan, China, India, Brazil, ASEAN, the Persian Gulf and similar large developing-country markets.

A quick conclusion of the Doha Round would be a good start here, though not at all sufficient. Whether Doha succeeds or fails, we should move quickly to a new approach, based on the negotiation of plurilateral sectoral agreements among the main economies. These would seek broad liberalization of large and rapidly growing industries: energy and environmental industries perhaps first, also selected medical and health industries, based on agreement among the major players rather than requiring participation of each one of the WTO's 153 members. The model would be the Information Technology Agreement of 1996, and the WTO's later agreements on financial services and basic telecommunications. Here is where we will tap rapidly growing markets, and ensure that America remains a leading player in the industries that will lead the 2010s and 2020s. These agreements have the further advantage of being sectoral in nature, not country-specific, and are therefore based upon MFN policies that work with rather than against supply chains and other business trends.

Joined with this we should take up two large regional initiatives. One would be an effort toward regulatory policy coordination with Europe and Japan. This should not aim principally at revising current regulatory policies, but at averting conflicts in new regulatory fields. Our experience with regulatory dialogues like the Transatlantic

Economic Partnership and various US-Japan initiatives shows that dealing with current regulations is exceptionally difficult, successful only in very narrow fields, and ought to be limited to areas of genuine dispute. A better approach would be to seek early consensus on regulation of rapidly emerging technologies like nanotechnology, energy and environmental technology, IT, and some medical industries. These are fields which are likely to grow extremely rapidly in the future, and where regulatory coordination among the developed countries will probably set the pattern for the world.

The other would be a restoration of the U.S.' place in East Asian trade and financial arrangements. This is the fastest-growing part of the world, and one in which the US is at risk of marginalization. It is natural that a revival of India and China will reshape Asian trade patterns, and that in some relative sense our share of Asian imports and exports will fall. But it is not natural or inevitable that initiatives like the East Asian Summits, free trade areas linking India, China and Japan with Southeast Asia, and financial coordination accelerate while the United States remains outside. Should this continue, we will lose opportunities in fast-growing markets and in industries crucial to our technological and economic leadership.

Here we should begin by passing the Korea-US free trade agreement. We need to significantly raise our level of dialogue, including agreements, with ASEAN and with India, which is rising very rapidly as a manufacturing-trade partner as well as a services trade partner. But two-thirds of our Asian trade is with China and Japan, and most immediately, direct engagement with both – not skirmishing and positioning in smaller markets – needs to be the heart of Asian policy. With Japan we should consider a comprehensive agreement similar to KORUS, or at minimum a comprehensive services agreement. And we need a well-honed agenda with China. The focus of U.S. China trade talks should initially center on the negotiation of a bilateral investment treaty and accelerated WTO government procurement agreement, in addition to further trade liberalization and compliance. The broader economic agenda should revolve around macroeconomic policy and climate change. Strategically, China must also come to accept a larger role on a range of issues, in helping manage global finance, macroeconomics and currency policies; contributing to the effort to slow climate change and develop a more energy-efficient global economy; managing the trading system; and other issues as well.

Security and Development: Here we need to think about reform of our own trade regime, to make it less punitive toward the poor at home and abroad and more likely to support rather than clash with our goals in the Muslim world.

The acceleration of globalization has left much of our trade regime antiquated. Light-industry tariffs in particular are exceptionally high and obsolete, and in need of unilateral reform. Tariffs on clothes, shoes, household linens, luggage, watches, silverware and a few other light goods raise half of our $26 billion in tariff revenue, on about five percent of imports. They protect few if any jobs, but do noticeable damage to hopes for poverty reduction in the United States and overseas. And they tilt noticeably not only against very poor Asian states, but against Afghanistan, Pakistan, Bangladesh, Turkey, and a number of other large majority-Muslim countries central to the campaign against radicalism and fundamentalism.

The greater Middle East is probably the trading system's major failure. Its countries, roughly spanning the Maghreb through the Middle East per se to Central Asia, participate less than those of any other region in the global trading system. In contrast to Southeast Asia or Latin America, they have been unable to integrate with the world economy; instead their share of trade and investment has rapidly declined, with bouts of excessive oil wealth only serving to camouflage a deteriorating economic position. Though Egypt and Pakistan have shown some encouraging trade and investment growth in the last two years, as a whole the region remains dependent on resource trade, and lags far behind others in both regional integration and participation in manufacturing and services trade. Weak domestic economic policies and education join a dysfunctional trade environment to give the greater Middle East region the world's highest unemployment, the lowest level of regional trade, and the largest disparities of wealth – and the most serious security challenge.

Economic reform and recovery is not a solution per se to the political and security issues we confront in this region. But it is a step that can help lower the political temperature, reduce the appeal of radicalism, and ease the tasks of peacemaking and democratic reform. A major effort to integrate this region into the world economy, as was done with Japan and Germany post-World War II, Southeast Asia in the 1970s and 1980s and Central America in the 1980s and 1990s, should be a top priority for the next administration. Its foundation should be a broad tariff exemption that makes the GSP system permanent, and grants 100 percent duty-free treatment based on simple and easy rules of origin to the least-developed countries and to other low-income states – Pakistan, Sri Lanka, Iraq, Lebanon – with high national-security significance. Ideally, this would be part of a larger international effort done in concert with Europe, Japan, China and India, designed to exempt all least-developed countries from tariffs and quotas, including sub-Sahara Africa, and to make a special priority of promoting growth and economic diversification in the Muslim Middle East and Muslim South Asia. Accompanying this should be a sustained and targeted foreign aid commitment, designed to help improve education and governance in large and strategically crucial countries such as Pakistan, Afghanistan, Egypt and others.

Africa policy can be developed in perhaps four ways, building upon the work initiated by the African Growth and Opportunity Act. One would be to open entirely AGOA's product eligibility, and a second would be a much more ambitious technical assistance program, focused in particular on training African farmers to meet American sanitary and phytosanitary rules. Together with this, we should continue to broaden our foreign aid programs, in particular for the countries hit hardest by the HIV/AIDS pandemic. We should also begin a dialogue, joined by Europe and perhaps China, on the use of natural-resource wealth, where the surge in energy and metals prices has provided a sudden and very large source of income, and consequently an historic opportunity for Africa to reshape its infrastructure and become fundamentally more competitive than it is today.

Also under the security category, we need a fresh start with Latin America. In South America, and not only in Venezuela, we are at great risk of a drift toward authoritarian, anti-American populism backed by resource money. Meanwhile, American policy has fragmented since the abandonment of the FTAA several years ago, with the free-trade agreement program increasingly controversial and lacking obvious new partners. Looking ahead, I do think we should begin by passing the Colombia and Panama agreements. We should, I believe, shift toward a policy of dialogue and engagement rather than isolation with Cuba and Venezuela. This should include steps toward eliminating the embargo on Cuba, which does more to undermine than to enhance our ability to influence events there and promote our broader hemispheric interests. But in the next years, the centerpiece of policy needs to be an integration of our existing trade agreements, and a path toward meshing them with Mercosur. Here the key is closer and deeper work with Brazil, which is the largest western hemisphere economy.

21st-Century Bretton Woods – Third, trade negotiations and policy need to be complemented by institution-building in finance and the environment.

The international financial institutions, especially the G-8 and IMF, no longer accurately reflect the realities of the world economy and need to be reshaped. If they are to be effective vehicles for policy, they must give appropriate roles to China and India. These are countries with large capital reserves, influential currencies, high and growing shares of goods and services trade, growing roles as exporters of capital, and accordingly influences on the global economy. They need a role in the global institutions commensurate with their influence – or else the institutions will fade as effective venues for policy. The G-8 thus needs to add China and India, and subsequent consideration should be given to Korea and Brazil. The IMF in particular, but also the World Bank, should ask more contributions from these countries, while dropping antiquated requirements that their heads be American and European.

Genuinely effective environmental institutions, meanwhile, have yet to be built. The best approximation of a central environmental institution is a branch of the UN known as UNEP, which has no independent Director-General, relies on voluntary contributions rather than mandatory dues for funds, and does not oversee its set of 98 multilateral environmental agreements in any meaningful way. Instead the agreements are usually overseen by Secretariats scattered around the world, from Japan to Quebec, Tasmania, Geneva and Germany. UNEP itself is in Kenya. Countries participating in the agreements are free to sign some and ignore others, neither governments nor interested citizens can easily assess their obligations or their partners' compliance, and no institution effectively oversees implementation of agreements. These deficiencies will be vastly greater as we consider a potential climate change agreement, which will be the most complex international agreement ever concluded. What we need here is a new institution comparable to the WTO – a Global Environmental Organization or GEO – which will serve as the venue for negotiating agreements, avoiding any conflict between their rules and those of the WTO, assessing their success, and managing disputes over implementation.

PROCEDURES: 'COMPREHENSIVE ROUNDS' AND FAST-TRACK

Finally, procedure. Here I think the frequent error of administrations is to put procedure before substance. Our main goal should be to create an agenda that is broadly viewed by Congress as meeting America's economic, security and other interests. If we do so, we will be able to find the policies best suited to negotiating and implementing it. Having said this, it is my personal view that two traditional procedural devices – the 'comprehensive round' concept used at the WTO, and the 'fast-track' procedure used to pass agreements here between 1974 and 2005 – have outlived their time and are now more obstacle than aid.

Rounds

The 'comprehensive round' is essentially a protracted negotiation involving all major issues and requiring assent by all WTO members. It worked reasonably well for the Kennedy Round in the 1960s and the Tokyo Round in the 1970s, spottily for the Uruguay Round in the 1980s and 1990s, and is now a hindrance.

The fast-growing future markets are fields like energy and environmental goods and services, medical and scientific technologies, and so on. Here the political obstacles to liberalization are in relative terms small. In the late 1990s, we were able to quite rapidly conclude very large agreements, with little domestic or international controversy, on information technology goods, financial services, basic telecommunications and duty-free cyberspace. These remain to this day the only multilateral agreements concluded since 1994. By contrast, a comprehensive round such as Doha, even when relatively limited compared to the Uruguay Round, covers difficult matters such as agricultural reform, movement of natural persons, trade remedies and other conflicted topics. Making very large potential agreements in fast-growing industries depend upon resolving these issues has been a recipe for slowing trade policy, and ultimately risks making the WTO irrelevant at least as a vehicle for new policy.

Thus if the Doha Round is completed – or in the regrettable event that it is abandoned – the WTO should drop the comprehensive-round concept. Its future is in integrated sectoral agreements in fast-growing industries, under WTO auspices, joining manufactured goods and services, which can be concluded among 'critical masses' of countries that cover most of the relevant trade depending on the sector involved. In the case of the ITA, this included eleven countries, expanding over time to a threshold level for the agreement to become effective. That number of countries would depend upon the aggregate percent of trade volume covered in the particular sector. Over time, as with the ITA, Financial Services and Basic Telecom, the number of participants expands rapidly, and each is now a condition of WTO entry.

Fast-Track

At home, I believe the focus on the fast-track procedure as the key to trade policy is likewise misplaced. The important thing is to get the agenda right – that is, identifying the key economic and strategically important countries, and the purpose of an agreement with each - and build a Congressional consensus for it. If that exists, procedures to pass it will follow. If not, procedures will be no substitute. As the recent case of Colombia shows, Congress can remove fast-track rules from an agreement where consensus has not yet emerged; as the Doha experience in 2005 proved, the value of fast-track for negotiators can be overstated. No country refused to negotiate last week because fast-track is not in force; nor did any country rush to close the Round three years ago in Hong Kong and Potsdam when fast-track neared expiration.

More recently, trade debates have consistently seen actual agreements get more support than the fast-track or TPA procedure itself. This indicates that a measure designed to ease consensus on and passage of trade agreements has become more of an obstacle to them – just as the Reciprocal Trade Agreements Act of the 1930s ran out its lifetime by the late 1960s. So my conclusion is that the procedure has become more of an obstacle to successful policy rather than a facilitator. The next administration and Congress should find a different approach.

CONCLUSION

In conclusion, Mr. Chairman, let me return to two points I made at the beginning, and add one more.

First, we face serious challenges – perhaps the most serious challenge to our position as the world's economic leader since the First World War – and we have not yet accepted their scale and seriousness. Complacency is a vast mistake. So is labeling the competitive pressure that comes from genuine advances in foreign countries as the consequence of 'unfair trade' or currency misalignments. We in fact need to remind ourselves that the United States does not own the position of world's economic leader; we need to earn it in each generation.

Second, more ambitious and focused trade policies are part of the solution. But on their own they are absolutely not enough. They need to be accompanied by an effort to improve our financial position, develop the public services that help create a more efficient and innovative economy, use energy more productively, and ease the transition for workers.

Third, if we accept the scale of the challenge and devote ourselves to meeting it, we should approach the task with some optimism. Because as much as I have stressed what I believe to be weaknesses and shortcoming, we have many strengths that should give the public confidence in the country's future. The United States is a vastly wealthy nation, with deep if depleted financial resources, a stable rule of law and democratic system, and a high quality of life. We attract the some of the world's most talented people each year, as students and as immigrants. And we remain very strong in some of the industries – IT, life sciences and medicine, media and entertainment, financial services, and perhaps if we are skilled and focused, clean energy and environmental technologies – that will define the economy of 2020 and 2030. Our aging challenge, though profound, is less dire than that of Europe or Japan, and perhaps China as well.

So if we are committed to leadership and willing to be straight with ourselves about our weaknesses, the foundation for success is there. I look forward to this debate, and I am grateful to the Committee for this opportunity to offer some thoughts as it begins.