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Dear Friends:

As we enter 2012, caution, volatility and uncertainty are three key words we will continue to hear. Read what's ahead for the U.S. economy, American manufacturing, U.S.-China relations, and what's really behind Europe's problems (p1-2).

The North American Free Trade Agreement is about much more than trade. It's about managing a single economy. But what comes after NAFTA must be capable of overcoming political divisions that harm economic efforts (p3-4).

In December, Russia was admitted to the World Trade Organization. This can provide much opportunity for the United States. But the U.S. can't benefit unless it repeals an outdated policy rooted in the Cold War (p5-7).

I hope you find this issue informative and welcome your comments.

Sincerely,

Tim J. Nowak
Executive Director
World Trade Center Saint Louis

2012: What's Ahead

Slow growth, high unemployment, political gridlock, European fallout, Chinese tension, and a bright spot in manufacturing

By John Manzella

Caution, volatility and uncertainty are three key words we will continue to hear in 2012. Due to slow economic growth, which is projected to hover around 2 percent, the unemployment rate likely will continue to remain in the 8 to 9 percent range this year. Prior to the Great Recession, the United States had not experienced similar unemployment levels since 1983. When including those who have stopped looking for work or have reluctantly accepted part-time jobs, the rate could be as high as 16 percent, analysts say.

Several factors will continue to put a drag on growth. For example, some estimates indicate one in five homeowners owe more on their mortgages than their homes are worth. Until home values stabilize and consumers feel more confident about their future, consumer demand, which typically represents 70 percent of gross domestic product, will continue to lag.

In addition, declining U.S. federal and state government spending will depress U.S. growth in 2012. And with the presidential election this November, we can expect continued gridlock and an inability of our policymakers to come together to execute necessary reforms, restructure entitlement programs, increase investment in education, research and infrastructure, and improve immigration laws and the tax code.

Gerrymandering, the redrawing of congressional districts to assure dominance by one party over the other, shares some responsibility. It has enabled politicians to stake out extreme positions and no longer seek approval of the moderate-voting public. This makes compromise difficult.

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European Fallout

A major factor impacting U.S. growth this year will be the European debt crisis. Although this was a big story in 2011, its impact certainly will be felt in 2012.

On a cumulative basis, Europe is the source of 72 percent of foreign direct investment in the United States. It's also the destination of 22 percent of our exports. A disruption in U.S.-European trade and investment, as well as major European defaults, can have serious consequences on this side of the Atlantic.

The 27 members of the European Union (EU) have different economies, fiscal disciplines, democracies, histories, values, and languages. Holding together a group this diverse is difficult in the best of times. Now, due to its debt crisis, many are wondering if the eurozone, the 17 EU member countries using the euro, will survive.

An underlying problem with many EU members has been their inability to adapt to globalization. When a country recognizes the rules of the free market and globalization, and decides to abide by them, it puts on what author and *New York Times* columnist, Thomas Friedman, in 1999 called the "Golden Straitjacket." But to fit, Friedman said, countries must adhere to various policies to enhance national competitiveness.

The United States began squeezing into the Golden Straitjacket in the 1980s. However, one could argue that Greece, and perhaps Spain and Italy, haven't donned the straitjacket or, in some ways, adapted as well to globalization as the United States or several northern European countries like Germany, Austria and the Netherlands.

Stronger American Manufacturing

According to the Institute for Supply Chain Management, economic activity in the manufacturing sector expanded in December for the 29th consecutive month. Output will continue to rise as it has for decades. Surprising to many, American manufacturing value-added output has tripled since 1980, rising from $558 billion to $1.7 trillion in 2010.

However, due to new technologies and automation, fewer employees can produce much more in less time. Consequently, manufacturing employment has fallen from its high of 19.5 million in 1979 to 11.7 million last November. In December, Americans were reminded of this fact by President Obama, who said "Steel mills that needed 1,000 employees are now able to do the same work with 100 employees, so layoffs too often became permanent, not just a temporary part of the business cycle."
In turn, labor as a percentage of a product's total costs has decreased to approximately 10 to 30 percent, on average, analysts say. As the labor component continues to shrink, and Chinese labor rates, fuel costs and expenses related to long distance supply chain logistics continue to rise, it makes sense for some U.S. producers to "backshore" or return previously offshored manufacturing from China to the United States.

Rising U.S.-Chinese Tensions

Due to upcoming U.S. elections and the selection of new Chinese Central Committee members, including China's presidency, expect harsh rhetoric on both sides this year to escalate as political candidates pander to their constituents. Plus, difficult issues, including piracy of American intellectual property, the protection of certain Chinese strategic sectors, and the Chinese military buildup, will continue to fuel the fire. But the currency issue will continue to remain a primary irritant. Since July 2005, when the Chinese yuan, also known as the renminbi, was allowed to climb in value, it has risen from about 8.28 to nearly 6.36 per U.S. dollar. Nevertheless, most economists agree that it still is considerably undervalued giving Chinese exporters an unfair advantage that's boosting the U.S. trade deficit. But much of the tension here is caused by misinformation. Why? The true U.S. trade deficit with China is not accurately reflected in conventional trade statistics. Thus, Chinese value-added, as a component of Chinese exports to the United States, is about 50 percent, according to the U.S. International Trade Commission. Others put this figure much lower.

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Consider Apple's Ipod. When imported into the United States from China, the iPod's value is identified at approximately $150. Yet, only about $4 of this is Chinese value-added derived from Chinese labor and components, according to the University of California. The remaining $146 represents the value of components produced in the United States, Japan, Singapore, Taiwan, and Korea. Nevertheless, $150, not $4, is added to U.S. import statistics, artificially increasing the U.S.-China trade deficit.

Long-Term Optimism

Although our economy will remain weak this year, American optimism, free market capitalism, acceptance of immigrants and a brilliant Constitution will propel the United States forward for generations to come. ■

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NAFTA Really Isn't About Trade

It's about managing a single integrated economy

By Brian Lee Crowley

What is NAFTA really about? This might seem a silly question. NAFTA is about trade, right? It's the North American Free Trade Agreement after all.

But what if it's not really mainly about trade at all? Thinking chiefly in terms of trade might actually obscure the real point.

Unfortunately when many people think about trade, they think of it in old-fashioned terms. Each country has its own self-contained economy. And in each economy, that country's workers make goods and services. Those finished products are then sold to other countries, which make different goods and services in their own little self-contained economy. Japan makes cars. France makes wine. They trade wine for cars.

That is emphatically not what happens for the most part in North America. What we have is not three countries and three economies trading finished products with each other. We have a single economy shared by two countries, Canada and the United States (and increasingly a third, Mexico). We have a single economy awkwardly cross-cut by inefficient and obstructive national borders.

The implication of this one-economy-but-three-countries view is that NAFTA is not (despite its name) chiefly about trading finished goods between separate national economies. It is about managing a highly integrated continental economy in which Canadians and Americans work together to make things. NAFTA should really be called the North American Integrated Production Agreement (NAIPA).

Canadians and Americans do not trade with each other as the French and the Japanese do. We make things together and then sell them to each other and the rest of the world. That is why, for example, about two-fifths of the vast "trade" between our two countries takes place within individual companies. They move goods from one plant to another at different stages of production, and those plants are spread about in both Canada and the United States.

Let me make this eminently practical. I have in my hand a drawing of a rear wheel assembly used in North American auto production. In this drawing every part contained in the assembly has been flagged to show the country in which it was produced. Roughly half the parts were made in Canada, the other half in the United States.

Take one look at that drawing (which is quite typical—it could have been made of any other assembly that goes into cars made in North America) and you realize there is no American or Canadian auto industry. There is a North American auto industry. And dig into each one of those individual parts, and you will find chemicals, metals, castings, coatings and other products from plants in jurisdictions throughout the continent. It is not just the auto industry but the entire continental production process that is increasingly integrated.

The business community got this long ago. NAFTA did not create economic integration in North America. The business community did that over many decades, in response to strategic and economic imperatives. NAFTA was a crude and belated effort to cre-

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ate a legal and institutional framework for an economic relationship that had outgrown national institutions.

If you want to see what North America looks like from the point of view of business, have a look at a map of the continent depicting, say, oil production, pipelines, the rail network or truck traffic. In each case I defy you to spot the border in the business decisions that have shaped these maps. The economic energy of North America surges in all directions, and is increasingly unconstrained by considerations of political jurisdiction—unless, of course, jurisdictions forcefully intrude, as in the case of, say, the Keystone XL pipeline or “Buy America.”

There’s the rub. Politicians respond only to national voters, and so live in a closed political system. Alas, that closed polity is superimposed on an open economy. Government policies that result cannot truly encompass the interests of North Americans, but only of Americans and Canadians separately. Hence we get border thickening in the post-9/11 world and post-recession protectionism in the United States. Canadians’ vulnerability is that we live in another country, but not another economy.

National policy mismatches inevitably show up at the border. An inefficient border is an annoyance in a trading bloc. But in a production bloc, it is disastrous.

To understand why, think again about the rear-wheel assembly. It required that parts be brought across the border in different directions and at different stages of production. The car industry says a North American car crosses the border five or six times in the course of its production — likely an underestimate. A thick border causes our integrated production process to stumble every time the border must be crossed. We lose time and efficiency.

In thinking about what comes “after NAFTA,” we must be imaginative to create institutions that overcome political divisions that scar our economic efforts while preserving our national sovereignty.

By contrast, a foreign car exported to North America enters our territory only once. Since the car is already made, our border controls don’t disrupt production. Our own production crosses the border innumerable times. Every inefficient or obstructive contact there is in effect a tax that our international competitors do not pay.

North Americans are in this together, building a relationship that is virtually without precedent for its breadth and depth. In thinking about what comes “after NAFTA” we must be capable of imagination to create institutions that can overcome the political divisions that scar our economic efforts while preserving our national sovereignty.

On Dec. 7, Canadian Prime Minister Stephen Harper and President Barack Obama announced their “Beyond the Border” initiative to respond to exactly these practical realities at the border. The intentions are good, but the language is vague and tentative, and a U.S. election year is not a propitious moment to advance the idea of more economic openness. Nevertheless, the United States is committed to an agreement in principle that points in the right direction. It is now our responsibility to make sure we move from pretty words to a workable border regime. Our continental competitiveness and prosperity depend on it. ■

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Russia Joins the WTO

Why this is good for the United States

By Daniel Griswold and Douglas Petersen

On December 16th, the World Trade Organization's 153 members unanimously approved Russia's accession as a member. This will solidify Russia's transition from a closed communist economy to a full participant in the global marketplace. The only question is whether the United States will embrace Russia as a fellow WTO member or forfeit the benefits for the sake of an outdated policy rooted in the Cold War.

Russia's petition to join the WTO dates back to 1993. Since that time it has negotiated accession agreements with all major WTO members, including the United States, committing to open its economy further and to accept WTO rules on nondiscrimination, dispute settlement, intellectual property, and a range of other trade-related issues. To enjoy the enhanced access to Russia's market, the U.S. government will need to grant permanent normal trade relations (PNTR) to the Russian Federation.

Under the 1974 Jackson-Vanik Amendment, Congress is required annually to pass a special exemption for Russia extending it conditional access to the U.S. market. The law was originally intended to withhold normal-trade-relations status from communist countries that did not allow Jewish citizens to freely emigrate. Even after the fall of the Berlin Wall in 1989 and the dissolution of the Soviet Union in 1991, the law continued to apply to most former communist countries because of their continued status as "nonmarket economies."

As a condition of membership in the WTO, all members are expected to grant unconditional most-favored nation (MFN) status to all other members. This means each WTO member must offer the same level of market access to other members without attaching special conditions to that access. Continued application of Jackson-Vanik to Russia would be a violation of unconditional MFN status, since it depends on Congress granting renewal each year.

If Congress does not grant PNTR to Russia by repealing Jackson-Vanik, then the enhanced market-access commitments Russia has made in its accession protocol would not apply to exports from the U.S.

If Congress does not grant PNTR to Russia by repealing Jackson-Vanik, then the enhanced market-access commitments Russia has made in its accession protocol would not apply to exports from the United States. Producers in the other 150-plus members would enjoy those benefits but not producers in the United States.

The stakes are high. Russia is a major yet still underdeveloped market for a range of American exports, from poultry to aircraft. If U.S. exporters are not granted the more favorable access under Russia's accession protocol, they will face discriminatory tariffs that will put them at a disadvantage against competitors in other major trading nations. That market share, once lost, would be difficult to regain. Granting PNTR to Russia thus becomes important to promoting U.S. trade as a sustainable boost to the sputtering U.S. economy.

Expanding U.S.-Russian Commercial Relations

Russia has emerged as a major commercial partner of the United States, although the relationship remains underdeveloped relative to the size of Russia's economy and the considerable economic liberalization following the collapse of the Soviet Union. Through the first three quarters of 2011, Russia ranked 31st among nations as a market for U.S. goods exports, and 16th as a source of U.S. goods imports. In two-way trade (exports plus imports), Russia ranks as America's 23rd largest trading part-

ner, just below Thailand and Nigeria, even though it is the world's 11th largest economy in exchange-rate terms. Russia remains by far the largest economy and the only member of the G-20 group of major economies still outside the World Trade Organization. Of the 50 largest economies in exchange-rate terms, the oil-exporting Islamic Republic of Iran is the only other one that is not a member.

Trade with Russia has, however, grown significantly over the past decade. From 2000 to 2010, U.S. goods exports to Russia increased by 187 percent and U.S. imports from Russia increased by 235 percent. During the same period, total U.S. exports and imports grew 63 percent and 57 percent respectively. The growth in import value from Russia can be attributed at least partially to an increase in the world prices of natural resources such as oil and natural gas, which account for a large share of U.S. imports from Russia. Over this same time period, world prices for crude oil have increased by 183 percent.

U.S. trade with Russia is highly concentrated in a few select industries. In 2010 the top five import categories (according to the 2-digit Harmonized System) made up over 70 percent of total U.S. imports from Russia. These categories included precious stones and metals, inorganic chemicals, mineral fuels, aluminum, iron and steel, and fish and other seafood.

Examining the industry concentration of imports using the North American Industry Classification System (NAICS) produces an even greater level of concentration: just three NAICS 3-digit categories (petroleum and coal products, oil and gas, and primary metal manufacturing) made up 86 percent of imports from Russia in 2010. U.S. exports to Russia are also highly concentrated: aircraft, machinery, and meat (according to the 2-digit Harmonized System) make up about 60 percent of U.S. exports to Russia. A calculation using comparable NAICS categories yields a figure closer to 54 percent.

Russia's accession to the WTO will almost certainly result in increased U.S. exports, thereby contributing to President Obama's National Export Initiative goal to double exports from 2009 to 2014.

PNTR Key to Expanding American Exports

American producers will be in a better position to expand their exports to Russia if the United States can participate fully in Russia's membership in the WTO. And that can happen only if Congress grants Russia permanent normal trade relations.

Russia's accession to the WTO will almost certainly result in increased U.S. exports, thereby contributing to President Obama's National Export Initiative goal to double exports from 2009 to 2014. Following a dip during the "Great Recession" of 2008–09, U.S. exports to Russia have rebounded strongly. The increasing economic liberalization and development of Russia in recent years has coincided with increased U.S. exports, with the growth rate of U.S. exports to Russia twice as large as the growth rate of U.S. exports to the rest of the world. By some estimates, U.S. exports to Russia could double in the five years following its accession to the WTO.

Demand within the Russian market for U.S. goods and services is significant and increasing. Moreover, that demand spans across multiple economic sectors, including agriculture, services, capital equipment, manufactures, machinery, and advanced technologies. In 2010, for example, 66 million Russians were Internet users. This number is expected to jump by 20 percent in 2011, stoking demand for U.S.-branded computer software and hardware. As a condition of its WTO entry, Russia has committed to joining the Information Technology Agreement, which eliminates duties on a wide range of IT, communication, and other high-tech hardware. Also, Russia is the 8th largest market for U.S. exports of PVC and other polymers, and exports of these goods grew 500 percent between 2008 and 2010.

Furthermore, Russia will require an estimated 960 new civilian aircraft in the next 20 years to replace its aging fleet, and a proposed reduction from 20 percent to 7.5 percent in tariffs on wide body aircraft would benefit U.S. producers significantly. Growing demand for Russia's vast natural resources—including farming, mining, oil, and energy products—drives Russian demand for heavy and complex machinery, which the United States is in an optimal position to export. Russia has committed to a bound tariff (upon entering the WTO) of 5 percent in this sector.

Meat is another area in which Russia's accession would greatly benefit the United States. Despite a temporary decline in exports to Russia due to a chemical-based ban on U.S. poultry, Russia remained one of the top 10 markets for U.S. poultry exports in 2010. As a member of the WTO, Russia would have to adhere to international standards in regulating its meat imports, ensuring greater predictability for U.S. exports.

This is also true for pork products, and U.S. pork exports increased tenfold in the five years preceding the economic crisis. Exports of U.S. beef to Russia also have risen, jumping to $102 million in 2010. Russia's agreement to bind its tariff and comply with WTO standards in agriculture will both increase the standards of meat within Russia and help to ensure and expand the market for U.S. goods.

Russia has also committed to liberalization measures in its financial sector. This has opened up Russia as a potential recipient of considerable foreign direct investment. The

U.S. financial sector is poised to gain from Russian accession commitments to allow 100 percent foreign ownership of banks and financial institutions, to liberalize financial services across borders, and to allow internal securities trading by foreign firms. Similarly, such U.S. sectors as telecommunications, professional services providers, and distribution operators would benefit from Russian liberalization of foreign investment and ownership, and several high-tech industries would benefit from Russia's adherence to the WTO's Trade-Related Aspects of Intellectual Property (TRIPs) agreement.

Russia's entry into the WTO would benefit the U.S. indirectly by spurring economic growth in Russia and institutionalizing economic reforms.

It is important politically (if not economically) to note that Russia exports mainly natural resources, energy products, and high-value goods, which typically face low to zero tariffs already. Those who misguidedly argue that increased U.S. trade with countries such as China, Mexico, and smaller, less-developed countries has had a detrimental impact on certain more labor-intensive U.S. industries need not worry that liberalized trade with Russia will produce similar results. Moreover, Russia seeks to import U.S. technologies, capital equipment, and advanced machinery. In sum, U.S.-Russia trade is significantly less competitive than it is collaborative and complementary.

Finally, Russia's entry into the WTO would benefit the United States indirectly by spurring economic growth in Russia and institutionalizing economic reforms. Although Russia remains a mixed economy with widespread government intervention, it has been liberalizing its trade regime. The average level of import tariffs in Russia has dropped from 14 percent to 8 percent, according to World Bank economist David Tarr. Membership in the WTO would help to lock in those gains. The World Bank also predicts WTO membership would increase the size of the Russian economy by as much as 11 percent in the long run, further boosting demand for U.S. exports. ■

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