IMPACT ANALYSIS
Issues Impacting Global Business

A Publication Serving Orlando and the Region July-August 2011

Dear Friends:

Due to a number of trends, manufacturing may increase in the United States as a result of less offshoring and more backshoring: returning previously offshored production to the U.S. Consequently, for many firms, it's worth re-evaluating their global production and supply chain strategy (p1-2).

If imitation is the sincerest form of flattery, then the U.S.-China relationship should be brimming with good will. In this case, however, only one country can benefit—and it's not the United States (p3-4).

Free trade agreements not only promote economic integration and enhance competitiveness, they also strengthen security. It's time for Congress to align U.S. economic and national security interests and pass the pending FTAs (p5-6).

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

Sincerely,

Byron Sutton
President and CEO
World Trade Center Orlando

Shifting Manufacturing Trends and the Rise of "Backshoring"

Changing realities require new strategies

By John Manzella

U.S. manufacturing employment has declined from a high of 19.5 million workers in 1979 to 11.7 million in May 2011. For many policymakers and much of the media, this is believed to be the result of offshoring: moving U.S. production to low-cost countries in search of cheap labor. In turn, many say the American manufacturing sector has been "hollowed out." Although supporting arguments are persuasive, they're not accurate.

Much of the decline in manufacturing employment, no doubt, is attributable to offshoring. But the primary cause is American innovation and automation, which boosted manufacturing productivity to an annual average rate of 3.9 percent from 2000-2007, considerably higher than productivity in the non-farm sector, at 2.6 percent.

The successful implementation of new technologies has empowered fewer workers to churn out more products quicker. What is the result?

From 1979—when there were nearly 70 percent more workers employed in the manufacturing sector—through 2010, American value added output more than tripled, from $545 billion to over $1.7 trillion. We've seen these trends before. In 1940, 9.5 million U.S. workers were employed on farms. By 2010, this number fell to 2.2 million. Yet, U.S. agricultural output skyrocketed.

The implementation of new technologies also has caused labor costs, as a percentage of a product's total cost, to decline to 20-30 percent on average, according to Boston Consulting Group, a business management firm. Susan Helper, a professor of Economics at Case Western Reserve University, says in most manufacturing facilities, it's more likely between

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10-20 percent. What is the impact? As the labor component declines, the incentives to offshore also decline.

Investment Decision Realities

When companies decide where to invest abroad, labor costs are only one of many factors examined. Other considerations, which often are more important, include the availability of skilled workers, productivity levels, the quality of local infrastructure, political stability, rule of law, proximity to key markets, and ability to repatriate profits. That's why the U.S. remains on top.

With the exception of the year 2003, the United States continues to be the world's largest recipient of foreign direct investment. And nearly 40 percent goes into manufacturing, according to the Organization for International Investment, a business association in Washington D.C.

But when cheap labor is vital—typically in the production of labor intensive, low-tech products that are relatively difficult to automate—companies have tended to offshore the manufacturing activities to the next low cost country. This trend, which began with the advent of industrialization, observed low-tech production moving from Britain to the U.S., then to Japan, Taiwan, and S. Korea, and more recently to China and other developing countries.

America, which now successfully specializes in higher technology production, began offshoring labor intensive, low-tech production in the 1970s. But a number of new factors are influencing this dynamic.

The Rise of "Backshoring"

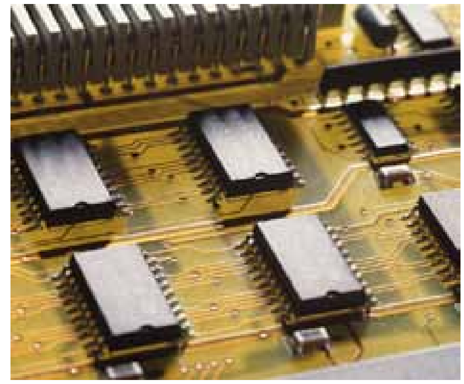
In recent years, China has absorbed much of the United States' and the developed world's low-tech production. But if U.S. consumers are the primary market destination of this production, as opposed to Chinese or other Asian consumers, the Middle Kingdom may no longer be the attractive manufacturing location it once was. Why?

For several years, Chinese labor rates have increased 17 to 18 percent annually. If sustained, this, combined with a slow appreciation of China's currency, could result in employment cost increases of 20-25 percent per year, analysts say.

Plus, ever-increasing fuel costs and expenses related to global supply chain logistics and long distance management, as well as capital outlays associated with longer lead times and larger inventories, further reduce China's low cost advantage. In addition, costs of engineers, purchasing managers and quality control staff traveling to China add up.

As a result, The Boston Consulting Group says within the next five years, the U.S. will experience a "manufacturing renaissance" as the wage gap shrinks between China and low cost American states, such as Mississippi, South Carolina and Alabama. The production of goods that require less labor and are churned out in modest volumes, such as household appliances and construction equipment, will most likely shift back to the U.S., while labor intensive goods produced in high volumes, such as textiles, apparel and TVs, will continue to be made abroad, Boston Consulting says.

Consequently, for many U.S. manufacturers, it makes sense to "backshore" or return previously offshored lower-tech manufacturing to the United States. Mexico, a low cost alternative to China, also may become a beneficiary due to its proximity. And for U.S. producers interested in moving lower technology production abroad for the first time, it's worth a re-evaluation of their global production and supply chain strategy.



Job Trend Realities

As industrialization emerged, workers once employed in the U.S. agricultural sector began shifting to manufacturing and other emerging industries resulting in higher standards of living and a more prosperous economy. Since the 1970s, workers have been moving into the service sector where the level of sophistication has risen tremendously and corresponding wages have nearly caught up to those in manufacturing. Thus, according to the Bureau of Labor Statistics, in May 2011, average hourly earnings for all employees in manufacturing and private services were $23.68 and $22.64, respectively.

Although manufacturing may increase in the U.S. due to less offshoring and more backshoring, the number of Americans employed in the sector is unlikely to significantly change in the short term.

Overall, the vast majority of new jobs are projected to be in the service sector. And although manufacturing may increase in the United States as a result of less offshoring and more backshoring, the number of Americans employed in the sector is unlikely to significantly change in the short term. ■

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China's Rise: Are U.S. Leaders Learning the Wrong Lessons?

Industrial policy has serious problems

By Daniel Ikenson

By placing bets on particular industries, the administration is overriding a selective, evolutionary process that has undergirded the world's most successful innovation machine.

If imitation is the sincerest form of flattery, then the U.S.-China relationship should be brimming with good will. By that standard, 2010 was a celebration of mutual admiration and respect. As Chinese leaders were trying to cultivate an American mainstay—home-grown innovation, U.S. policymakers were singing the praises of industrial policy. In this case, only one country can benefit from emulating the other's policies—and it's not the United States.

The Chinese are right to turn their attention to innovation. It is essential to their next stage of development. But innovation cannot be mandated from the top down. It requires, among other important conditions, a culture that values dissent. Thus far, dissent has not featured prominently in China's economic model. Unless and until that changes, China will struggle to ascend the global value chain.

But at least China's leaders know what their economy needs, which is more than can be said of ascendant U.S. opinion leaders and policymakers. They seem determined to march the U.S. economy into the suffocating embrace of industrial policy. If it works for the Chinese, then it can work for us, seems to be the mantra of *New York Times* columnist Thomas Friedman, who wrote: "One party autocracy certainly has its drawbacks. But when it is led by a reasonably enlightened group of people, as China is today, it can also have great advantages. That one party can just impose the politically difficult but critically important policies needed to move a society forward in the 21st century."

This is a poor analogy. Just because industrial policy may have facilitated catch-up growth in an impoverished country committed to reversing the damage of a two-century slumber does not mean it is the right course for a country in the technological vanguard that owes its success to ingenuity, innovation, and entrepreneurship. Chinese leaders can learn from America's successes and failures, but the only proven model for an economy at the technological fore is one steeped in innovation and entrepreneurship.

However, with over $100 billion in direct subsidies and tax credits already devoted to green technology, President Obama disagrees. He is convinced that America's economic future depends on the ability of U.S. firms to compete and succeed in the solar panel, wind harnessing, and lithium ion battery markets. Concerning those industries, the president said: "Countries like China are moving even faster... I'm not going to settle for a situation where the United States comes in second place or third place or fourth place in what will be the most important economic engine of the future."

With all due respect, how does the president know that those will be the most important economic engines of the future? By placing bets on particular industries, the administration is overriding a selective, evolutionary process that has undergirded the world's most successful innovation machine, while reducing the chances of worthy ideas, firms and industries leading the next commercial wave.

Did President Obama's predecessors anticipate the arrival of Steve Jobs, Bill Gates or Marc Zuckerberg and the revolutionary products and services they delivered? Did Wash-

ington bureaucrats foresee the advent of specific life-extending medicines and devices, like digestible, pill-sized cameras? Had those proposing industrial policy in response to a rising Japan in the 1980s and early 1990s prevailed, much of the technology and medical advances taken for granted today would have never come to fruition.

Why the sudden turn to industrial policy last year?

China emerged from the Great Recession virtually unscathed and on the same 30-year-long, high-growth trajectory. At the same time, the United States continues to confront slow growth, high unemployment and a large public debt (much of it owned by the Chinese). This has fueled fear, self-loathing and self-doubt among U.S. opinion leaders, which has altered their perceptions of the bilateral relationship. Media opinions about how China has thrived at U.S. expense for too long have proliferated. And woven into stories about China's rise have been unmistakable appeals to U.S. nationalism.

In Chinese reluctance to oblige U.S. policy wishes, readers have been told that China selfishly follows a "China-First" policy. In the increasing willingness of Chinese officials to criticize U.S. policies, readers have learned of a new "triumphalism" in China. As a result, once-respected demarcations between geopolitical and economic aspects of the bilateral relationship have been blurred, with economic frictions now more likely to be cast in the context of our geopolitical differences. Columnist Robert Samuelson, a one-time proponent of the view that globalization means interdependence, now believes that "China's worldview threatens America's geopolitical and economic interests."

Simultaneously, the U.S. business community in China—long-time advocates of bilateral engagement and an important counter-balance to U.S. import-competing industries that constantly clamor for protectionism and other actions against China—began to sound the alarm about increasingly discriminatory and protectionist policies in China. They were right to complain and to enlist the support of U.S. officials to compel the Chinese government to reverse those policies.

But the firestorm over China's technology transfer and indigenous innovation policies, in conjunction with the infamous Google hacking incident, painted a picture of an increasingly adversarial China, which opinion leaders and the president were quick to embrace. After all, if the United States is going to "win the future," as the president exhorts, then somebody has to lose. When the imperative of winning the future is cast as "our generation's Sputnik moment," the president encourages the view of China as an adversary. And if we are to draw parallels between the U.S.-China economic relationship and the U.S.-Soviet Cold War rivalry, then industrial policy is to be considered a matter of national security.

China emerged from the Great Recession virtually unscathed; the U.S. continues to confront slow growth, high unemployment and a large public debt. This has fueled fear and altered perceptions.

This adversarial, zero-sum characterization of the bilateral relationship is wrong. Regrettably, it may feed increasing acrimony in the relationship, which in turn could fortify the political case for more industrial policy.

The United States is on a slippery slope. Hopefully a new batch of policymakers can reverse course before the U.S. economy and the bilateral relationship suffer further damage. ■

Daniel Ikenson is associate director of the Center for Trade Policy Studies at the Cato Institute in Washington, D.C.

Enhance U.S. Security: Pass Free Trade Agreements with Colombia, Panama and South Korea

By Ray Walser and Bruce Klinger

From the Korean War to Operation Just Cause in Panama to Plan Colombia, the U.S. has expended lives and treasure to protect Colombia, Panama, and South Korea from Communist aggression, narco-violence, insurgency, and misrule. The investment has paid off.

Today, all three are increasingly prosperous democracies and geopolitical allies with 100 million citizens and a combined gross domestic product of $2 trillion. Despite this, the White House and Democrats in Congress denigrate these valuable allies by refusing to approve pending free trade agreements (FTAs).

Not only do FTAs promote economic integration and enhance competitiveness, they also build a greater sense of security and certainty in ties between states. It is time for Congress to align U.S. economic and national security interests and pass the pending FTAs.

South Korea

Rising from the rubble of the Korean War, South Korea has built the world's 14th largest economy and become a linchpin in America's Asian security perimeter. To protect this vibrant democracy, the U.S. maintains 28,500 troops in South Korea against the multifaceted North Korean military threat and rising pressure from China. Both Pyongyang and Beijing share a common foreign policy objective to erode U.S. power and influence throughout Asia.

Passing the FTA would strengthen U.S. commercial ties and broaden the bilateral relationship with South Korea beyond the existing military alliance. It would also serve as a powerful statement of the U.S. commitment to East Asia at a time when many perceive declining American interest, presence and influence in the region.

South Korea is increasingly concerned about China's belligerent behavior and willingness to impose its growing military and economic power on smaller Asian nations. Seoul is fearful that Beijing could impose enormous political, military and economic pressure on South Korea during a future confrontation.

Approving the U.S. FTA with South Korea would constrain Beijing's ability to extend its economic and political influence over the region. Diversifying Korea's trading base would decrease its economic reliance on China and reduce the vulnerability of a key U.S. ally to pressure by Beijing. The best South Korean defense against Chinese arm-twisting is a strong security and economic relationship with the United States.

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Colombia

The gravest security challenges in the Americas are twofold. The first comes from transnational criminal organizations whose existence depend heavily upon the cultivation and delivery of cocaine. Since the 1960s, drug consumption in the U.S. has fueled narco-crime and narco-corruption in the Americas. The threat remains acute in Colombia, Mexico, and elsewhere.

The second threat comes from the elected autocracy / revolutionary regime of Venezuela's Hugo Chavez. The Venezuela populist employs his nation's oil wealth to power socialism of the 21st century and fuel his anti-American Bolivarian alliance with Bolivia, Cuba, Ecuador, and Nicaragua. Chavez's Bolivarian strategy aspires to build a bloc of Latin American nations dedicated to socialism and committed to alliances—including strong military ties—with Iran, Syria and other global destabilizers.

Venezuela has become the most probable entry platform into the Americas for anti-American terrorism and a major export route for the global drug trade. Venezuela's

Russian-sustained military buildup has added fresh offensive weapons capabilities to Chavez's armed forces.

Colombia is situated at a vector point between the drug trade and Chavez. Past decades of civil conflict—fueled by government weakness, ideological conflict, and enormous drug profits—practically destroyed Colombia as a nation. By the late 1990s, Washington policymakers feared it was on the verge of becoming a failed narco-state. Starting with Plan Colombia in 1999, the U.S. invested more than $7 billion to help Colombia recover lost security control.

Under the leadership of former President Alvaro Uribe (2002–2010), Colombia beat back the threat of state capture posed by the narco-terrorists of the Revolutionary Armed Forces of Colombia (FARC) and murderous right-wing paramilitaries. Uribe's democratic security strategy restored confidence in the Colombian state and substantially reduced chronic levels of violence.

Now, under Uribe's successor, Juan Manuel Santos, Colombia is addressing festering land, labor and justice issues. Meeting these goals, however, requires expanded economic opportunities and an end to the myth that continuous U.S. denial of free trade benefits will protect and empower Colombia's small unionized sector.

Today, Colombia has, as Under Secretary of State James Steinberg observed, "gone from being a consumer of security to being a provider of security and support for others who face even greater challenges."

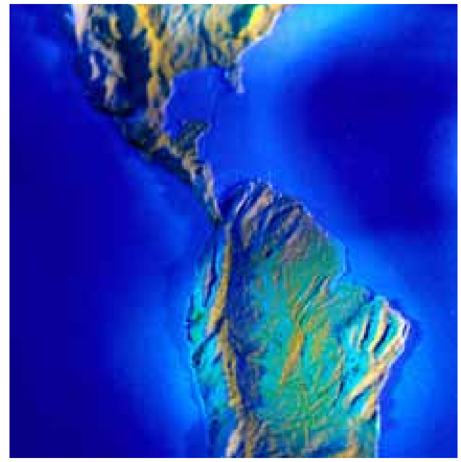
Failure to ratify the FTA will only generate more insecurity in Colombia. Since taking office, Santos has grappled with Colombia's dual isolation—perceived isolation from the U.S. because of failure to pass the FTA and isolation from the region because of close ties with the U.S. Many see Santos's new understandings with Venezuela as a species of appeasement induced by Chavez's economic pressures and by his capacity to manipulate support for FARC. Without a strong U.S. to counterbalance Chavez's bid for influence, Colombians will likely yield to an inevitable erosion of national self-esteem and security before the Chavista onslaught.

Panama

The security and free passage through the Panama Canal has been a historic must since the U.S.-built canal opened in 1914. Although its salience has diminished in the air and space age, access and free passage through the canal is still massively important to the U.S. economy and critical for its shrinking naval forces. The opening of a third set of locks in 2014 will substantially increase shipping capacity for the coming decades.

Before the negotiated transfer of sovereignty over the canal was completed, a narco-general Manuel Noriega hijacked his country and forced Operation Just Cause, which led to his removal and the renewal of democratic politics. The experience led to the abolition of the military in 1994, leaving the nation with a small police and maritime service force and reliant on U.S. support to guarantee its security.

Panama is playing an increasingly important role in cooperating and combating drug trafficking in the Central American isthmus. Failure to approve the FTA has already hurt U.S. competitiveness in Panama's recent expansion boom and will further dampen Panamanian enthusiasm to cooperate with the U.S. on security issues, especially as attention focuses



on combating money laundering in Panama's robust financial sector.

Upholding a Geo-Strategic Vision of Peace and Prosperity

The case has been made repeatedly and effectively that the FTAs are an economic win-win opportunity. Less commonly discussed is the importance of FTAs as cost-free ways to enhance U.S. security. For too long, President Obama and many in Congress have failed to listen to the advice of the Secretaries of Defense and State who are on record repeatedly in favor of passage of the FTAs. They recognize that a long-range and national interest vision of U.S. foreign and security policy includes the overdue passage of the FTAs. ■

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