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# VIEWPOINT

A Stephens Inc. Economic and Financial Commentary

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How is the U.S. economy doing versus our major global competitors after the recent painful recession and now emerging recovery? Economists and analysts have heavily focused on U.S. historical comparisons within the context of our economy to assess America's current economic and financial condition. This decidedly geocentric approach largely disregards our position in the global economy and may mask the intrinsic qualities of our economic strength.

Some specific global-competitive questions to consider are:

- Is the recovering United States in a strong competitive position compared to the world's major industrialized countries such as Japan, Germany, France, and the United Kingdom?
- Are we able to compete effectively with China, the rapidly growing behemoth?
- Is the United States headed into a Japanese style economic malaise — with little growth and real price deflation?
- Does our large trade deficit indicate a lack of global competitiveness?
- Should the U.S. have an assertive policy toward countries that have large trade surpluses with this country, such as China?

## U.S. Domestic Economic Update

Before delving into these questions it is useful to provide an update as to where the domestic U.S. economy is at the present time. The economy is on the mend with a real, tangible recovery, even if it is lackluster. The economy is approximately in the same relative condition as it was in late March 2010. Following is a brief update:

- **Real Gross Domestic Product**: Real GDP is growing at a modest rate of 3.0% according to first-quarter GDP estimates — true progress but still subpar for the early phase of a U.S. economic recovery. The areas of strength in the first quarter of 2010 included:
  1. Consumer spending (+2.42%, a positive contribution to first quarter 2010 real GDP)
  2. Inventory restocking (+1.65%)
  3. Business spending on equipment (+.29%)

Areas of weakness in the first quarter of 2010 included:

1. Residential housing (-.28% detraction from first quarter 2010 real GDP)
2. State and local government spending (-.49%)
3. Net exports (-.66%)

The most notable aspects of the first-quarter GDP report include the strong contribution of consumer spending on the positive side and the weakness in net exports on the negative side. Throughout the recession, net exports were a positive factor in the real GDP performance. Now they are a drag on GDP growth. Overall most analysts expect real GDP growth to continue at a 2.5% to 3.5% rate over the next 18 months.

- **Consumer Price Inflation**: The Consumer Price Index (CPI) is increasing at an annual rate of about 1.5% per year. This rate is less than the apparent Federal Reserve maximum inflation target of about 2% increase (or less) per year. The core inflation rate — which excludes food and energy prices — increased 0.6% in the first quarter of 2010, which was the lowest reading since 1959. Other measures of consumer price inflation show inflation to be well controlled. This modest inflation gives the Federal Reserve the option to keep monetary policy loose without the fear of incipient inflation. The most recent minutes of the Federal Reserve's Open Market Committee indicated that it expects annual core inflation to be under 1.7% through 2012.
- **Commodity and Producer Price Inflation**: Commodity prices increased at a rate of about 30% in the past 12 months, led by rising energy prices. Prices for finished producer goods were up 6.0% in the past 12 months, intermediate goods were up 7.7%, and unfinished or crude producer goods increased 33.4%. This price escalation from unfinished producer goods to finished producer goods suggests that price increases may be working their way through the pipeline. Although these increases are eye-popping, most economists still think these price increases will not filter through to the consumer. Large amounts of idle capacity and unemployed labor will dampen producers' pricing power. In other words, manufacturers will be forced to "eat" the producer price increases rather than passing them on to the consumer.
- **Interest Rates**: Since consumer-level inflation is currently muted by historical standards the Federal Reserve continues to hold interest rates at or near record lows. Short-term interest rates are about .5%, and 10 year U.S. Treasuries are trading in a narrow range around 3.25%. Thirty-year mortgage rates are slightly above 5%, and 15-year mortgages are between 4% and 4.5%. These relatively low rates help to support the struggling housing market.
- **Corporate Profitability**: Corporate profitability continues to rebound. Total earnings for the S&P 500 companies are expected to increase by at least 30% in 2010 and by another 20% in 2011 compared to 2010. These strong earnings provide some basis for optimism in equity markets.

- **Unemployment**: The rate of unemployment remains stubbornly high, currently at 9.7%, near a post-World War II high. A broader and less frequently quoted measure of unemployment puts the rate at about 17%. In addition, first-time unemployment claims continue to average about 450,000 new claims per week. Economists generally agree that new weekly claims must be less than 400,000 to make a dent in the unemployment rate. The good news is that the unemployment rate probably peaked in October 2009 at a rate of 10.2%.
- **Housing**: Housing continues to exhibit mixed signals—high delinquency rates, stable prices, large oversupply and moderate sales of existing houses. Although a few areas of the country, such as San Francisco and San Diego, are strengthening, the broad housing situation remains in limbo. The end of government tax credits for home buyers on June 30, 2010, may more clearly reveal the intrinsic state of the housing market. One ominous sign is the foreclosure rate in large U.S. metropolitan areas, which is running 77% above last year's rate—not a sign of real stability in the housing market.

The weakness in both employment and housing are sources of great concern to many Americans. High unemployment and housing foreclosures are the major topics for the nightly news, and the source of many political speeches by leaders in Washington who are grappling with the twin problems.

Secondly, these problems are playing out against a backdrop of serious economic and financial instability in the Eurozone. One huge financial bailout will not solve that region's problems. The story of the debt-laden countries of southern Europe will be in the news for years to come.

A third concern which causes angst for many Americans is the perceived lack of American competitiveness in global economic relations, especially with regard to China. The question for many Americans is: Will we be able to compete in the 21st century?

## U.S. Global Competitiveness

These global competitive issues are important because a groundswell of support is developing among Democrats and Republicans in Washington to take draconian measures to address our perceived global trading issues. Tariffs are being proposed against countries (such as China) with "misaligned currencies"—as determined by the U.S. Government. Other harsh proposals include incremental taxes on U.S. multinational firms. Some multinationals are viewed as culpable for U.S. trade problems because they move production offshore.

This issue of Viewpoint focuses on

1. America's short-term global trade position
2. Assessment of U.S. long-term competitiveness

### Short-Term Trade Situation for the United States

The 2009 U.S. trade deficit compared to our real GDP was fairly good by recent historical standards. The United States exported approximately $1.5 trillion and imported about $1.9 trillion of goods and services, producing a trade deficit of about $400 billion or 2.8% of GDP. With the economy struggling and consumers spending cautiously, fewer goods were imported.

When growth was robust in 2006 to 2008, the trade deficit on goods and services was about 4.8% of GDP or about $700 billion. As the economy again recovers, we should expect a widening trade deficit as Americans spend more on imported goods. The trade deficit will probably increase from $400 billion to more than $500 billion in 2010 as the price for imported oil increases.

### Two Trade Imbalances

The pattern of U.S. trade with most industrialized countries is relatively balanced, with two exceptions. Imbalances exist between the United States and two trading partners: China and Canada. (*See Table 1*) One is "bad" for the U.S. and the other is "good" for the U.S.

Table 1:
Major Trading Partners of the U.S. by Import and Export Market Share (2009 data)

| Country | Share of U.S. Exports (%) | Share of U.S. Imports (%) | Net |
|---|---|---|---|
| Canada | 19.6% | 14.0% | +5.6% |
| China | 6.7 | 19.0 | -12.3 |
| France | 2.5 | 2.2 | +0.3 |
| Germany | 4.1 | 4.6 | -0.5 |
| Japan | 4.9 | 6.1 | -1.2 |
| Mexico | 12.3 | 11.3 | +1.0 |
| U.K. | 4.4 | 3.0 | +1.4 |

*Source*: Federal Reserve of St. Louis. *National Economic Trends*. April 2010, page 18.

- **China Trade Imbalance**: In 2009, 19% of all U.S. imports came from China, while the Chinese received only about 7% of U.S. exports. We exported $100 billion in goods and services to China, and it exported $350 billion to us. That gap represents a $250 billion trade deficit between China and the United States—about 1.8% of the U.S. GDP. Much, but not all, of the lopsided trade can be attributed to the U.S. importation of labor-intensive goods produced with relatively low-wage Chinese workers. Many in the U.S. view this trade imbalance as "unfair."
- **Canada Trade Imbalance**: The second significant U.S. trade imbalance is a trade surplus with Canada (*See Table 2*). The United States exports $294 billion in goods and services to Canada (19.6% of U.S. exports) and imports $259 billion (14.0% of imports). The difference of $35 billion may seem insignificant to the U.S., but for Canada that's a trade deficit of $35 billion or 2.5% of its GDP.

**Relative to the size of Canada's economy, it has a larger trade deficit with the United States than the U.S. has with China.** This trade imbalance could be viewed by the Canadians as "unfair."

Aside from these two situations, U.S. trade patterns with trade partners are relatively balanced — even with Japan. Recall when the rhetoric was that the Japanese manufacturing Goliath was going to crush U.S. industry? Didn't happen. Could Americans take away a lesson from this? The U.S. now imports almost twice as many goods and services from Mexico as it does from Japan.

An examination of other U.S. export destinations reveals clearly that the United States is competitive with other industrialized, high-income countries such as Germany and France. Germans receive 4.1% of total U.S. exports, and 4.6% of U.S. total imports come from Germany. A similar pattern holds for France and the United Kingdom.

Trade imbalances often do exist for very good reasons, and these imbalances may persist for long periods of time. However, trade imbalances do not necessarily call for draconian measures to equalize trade positions. Such measures can and often do lead to very negative outcomes such as when the U.S. helped to ignite a global trade war in the 1930s after passage of the Smoot-Hawley legislation.

## Composition of Trade

When analyzing trade patterns, it is important for highly developed countries like the United States to evaluate not only the balance of trade with other countries but also the composition of goods and services being traded.

- **High-Technology Goods**: Of the major economies of the world, the United States ranks near the top in high-technology exports. The largest exporter of high-tech goods and services is South Korea with 35% of its exports in that category. The U.S. is right behind at 34%, followed by the UK at 32%, Japan 28%, France 24%, Canada 19%, China 19% and Germany 18%. These statistics are consistent with the fact that South Korea, the United States and Japan have high levels of GDP devoted to research and development. For example, the United States spends 2.7% of GDP on R&D, and South Korea spends about the same amount. By contrast, China spends about one-tenth of 1% of its GDP on R&D.
- **Commercial Services**: The United States has a highly competitive position in commercial services, including intangible items such as environmental services, insurance, health services, distribution services, and computer services. In 2009, the United States exported about $500 billion in these services while importing just $330 billion. The United States is the global leader in commercial services by a wide margin over the UK and Germany.
- **Energy**: Energy represents the most significant category of trade imbalance for the United States. About 25% of U.S. imports were in the category of energy and extractive resources, more than $500 billion and twice as large as our trade deficit

with China. Clearly China and the "Asian Tiger" countries have little or nothing to do with the American energy imbalance.

The most significant sources of the American trade deficit are labor-intensive goods and energy. These weaknesses are certainly not symptomatic of a country headed toward an economic disaster. The World Trade Organization data indicates that the United States competes well in the industries considered businesses for the 21st century.

## Long-Term U.S. Competitiveness

Trade deficits are tangible measures of real and/or potential American trade problems. However, those deficits should be viewed in the context of a broader U.S. competitive analysis. A number of metrics can be used to quantify competitive issues.

### Per Capita Income

The United States still possesses one of the highest per-capita incomes in the world. Table 2 shows clearly the relative strength of our economy. Eight countries have higher per-capita income than the U.S. Several of these are small countries with significant oil and/or gas resources such as Norway, Qatar, Kuwait, and Brunei. The others are primarily small tax-haven countries, such as Luxembourg.

Table 2:
Per Capita Income (2009) and GDP for the U.S. and its Major U.S. Trade Competitors

| Country | Per Capita Income (2009) | Total GDP (In trillions) |
|---|---|---|
| U.S. | $46,443 | $14.4 |
| France | 42,091 | 2.7 |
| Japan | 39,573 | 5.1 |
| Germany | 39,442 | 3.3 |
| Canada | 39,217 | 1.3 |
| U.K. | 35,728 | 2.2 |
| Italy | 34,955 | 2.1 |
| Russia | 8,875 | 1.2 |
| Mexico | 8,040 | 1.0 |
| China | 3,566 | 5.2 (estimate) |

*Source*: International Monetary Fund. *World Economic Outlook*, 2009 and *2009 CIA Factbook*.

Note that the U.S. per-capita income is **13 times higher than that of China**. American politicians and voters are riled about the apparent Chinese domination of the trade relationship between our two countries. Most Americans think the Chinese economy is larger than the U.S. economy. In fact, the U.S. economy is more than twice as large as China's. However, China's economic growth rate of about 10% per year gives it the potential to equal or surpass the U.S. GDP in 15 to 20 years. If that happens, the per-capita income of China will still be a small fraction of the American per capita income.

## National Productivity

Productivity is another measure of competitiveness. How does U.S. productivity compare to some of our trading partners?

According to the Organisation for Economic Cooperation and Development (OECD) data for the major industrialized countries, the United States is quite competitive with significantly higher overall productivity than most other developed countries. Table 3 shows that Germany is 24% less productive than the United States and Japan is 26% less productive. Only Norway has higher productivity (17% higher), and its advantage can largely be attributed to significant production of oil and natural gas, high value-added goods.

Table 3:
**Percentage Gap in Productivity Relative to the United States (2007)**

| | |
|---|---|
| Norway | +17% |
| Canada | -15% |
| Australia | -17% |
| UK | -22% |
| German | -24% |
| Japan | -26% |
| Korea | -45% |

*Source*: Organisation for Economic Cooperation and Development. *Factbook 2009*.

If one focuses only on **manufacturing** productivity, the conclusion about U.S. superiority is slightly less clear-cut. Japan has a well-deserved reputation for superior manufacturing efficiency, and that efficiency is reflected in unit labor-cost reduction (*See Table 4*). With the exception of Japan's significant decrease in unit labor cost in manufacturing, the United States was very competitive with its other major trading partners, decreasing manufacturing unit labor costs by 13.8% since 1994.

Table 4:
**Index of Unit Labor Costs in Manufacturing (1994 = 100)**

| | Index | Percent Change in Unit Labor Costs (Since 1994) |
|---|---|---|
| Japan | 52.9 | -47.1% |
| United States | 86.2 | -13.8 |
| Germany | 90.9 | - 9.1 |
| France | 92.5 | - 7.5 |
| Italy | 143.8 | +43.8 |
| Canada | 154.0 | +54.0 |

*Source*: Organisation for Economic Cooperation and Development. *Factbook 2009*.

The manufacturing prowess of Japan led many analysts in the 1980s to predict that Japanese productivity would ultimately “bury” the United States economically. Of course, that never happened despite its superior manufacturing efficiency. Many of the “doomsayers” of the 1980s insisted that Japanese manufacturing proficiency would decrease U.S. competitiveness and lead to a diminished global role for the United States. Many of the same “doomsayers” are now stridently warning about the Chinese dragon.

A country’s competitiveness is not just a function of manufacturing efficiency. For example, despite Japan’s manufacturing efficiency, its retail and service sectors are inefficient and undermine the country’s overall competitive position, as shown by its overall productivity.

Although labor-intensive manufacturing jobs continue to move offshore, the core of the U.S. economy remains quite competitive with its major trading partners, predominately in a broad range of goods and services. In these difficult times, it is easy to forget that the United States is the most productive major economy on the planet. Period!

### Labor-Market Flexibility

The high level of overall labor productivity in the U.S. is attributable in part to labor-market flexibility. U.S. companies can determine employment needs and then legally alter employment levels and workforce composition with relative ease. The OECD labor-market flexibility index (*See Table 5*) tracks how easily employers can terminate workers or hire temporary workers. The easier it is to hire and eliminate workers, the higher the level of productivity from a given workforce.

Table 5:
**Labor-Market Flexibility (as ranked by the OECD Strictness of Employment Protection Index in 2008)**

| Country | Rank (out of 40 countries) |
|---|---|
| United States | 1 |
| United Kingdom | 2 |
| Switzerland | 3 |
| Canada | 4 |
| Brazil | 5 |
| Japan | 14 |
| France | 27 |
| Germany | 35 |
| China | 38 |
| India | 39 |

*Source*: Organisation for Economic Cooperation and Development. Stat Extracts. Data for 2008

Of course, the corollary to that point is that employees also have few encumbrances when they decide to move to jobs with greater opportunity—and probably higher levels of productivity.

### Ease of Doing Business

A country's competitive position is shaped in part by ease in starting and operating businesses. Elements of the process include such factors as enforcement of contracts, ease of getting construction permits, accessibility of credit, and ability to register property. According to World Bank/IMF rankings (*See Table 6*), the United States is the third-best country in the world for a business to operate, far ahead of some of its major competitors. Asian countries such as India and China are near the bottom of the rankings.

Table 6:
**Ease of Doing Business Index for 2009 (from easiest to most difficult)**

| | |
|---|---|
| 1. | Singapore |
| 2. | New Zealand |
| 3. | United States |
| 4. | Hong Kong |
| 5. | Denmark |
| 6. | UK |
| 7. | Ireland |
| 8. | Canada |
| 9. | Australia |
| 10. | Norway |
| 12 | Japan |
| 23. | Korea |
| 25. | Germany |
| 31. | France |
| 65. | Italy |
| 83. | China |
| 122. | India |

*Source*: World Bank and IMF. *Doing Business 2009*.

Within the subcategories of the index, the United States is especially competitive in protecting investors, employment of workers and ease of acquiring credit. Where the United States is weak is in taxation and ease of trading across national borders.

## Taxation

It is surprising to many people that the United States has higher corporate tax rates than many of our major trading partners. It is almost an American article of faith that European corporate taxes are higher than American corporate taxes. Table 7 reveals the opposite. In fact, several European countries including Germany and France implemented corporate tax reductions in recent years while the U.S. rates remained largely unchanged.

Table 7:
Corporate Tax Rates (Federal Plus State) 2008 (Highest to lowest rates among OECD countries)

| Rank | Country | Corporate Tax Rate (2008) |
|---|---|---|
| 1 | Japan | 39.5% |
| 2 | USA | 39.3 |
| 3 | France | 34.4 |
| 5 | Canada | 33.5 |
| 7 | Germany | 30.2 |
| 11 | Mexico | 28.0 |
| 14 | UK | 28.0 |
| 16 | South Korea | 27.5 |
| 23 | Switzerland | 21.2 |
| 30 | Ireland | 12.5 |
| **OECD average** | | **26.6%** |

*Source*: Organisation for Economic Cooperation and Development. *Corporate Tax Rates by Country*, 2009

The only OECD country with higher Federal and state corporate tax rates than the United States is Japan. And both Japan and the United States have rates that are half again as high as the OECD average of 26.6%.

U.S. corporate tax rates are probably headed higher rather than lower. The Obama administration's ten corporate tax proposals would generate incremental tax revenues of $200 billion, much of it from American multinationals.

## Corruption

An element in the business environment that makes operating a business more or less difficult is the level of corruption. Transparency International's Corruption Perception Index shows that most of the major North American and Western European countries have relatively low levels of corruption (*as shown in Table 8*).

Many developing countries, such as China and India, have significant corruption issues that may hinder their economic development over the long run.

Table 8:
Corruption Perception Index (CPI)

| Country | Ranking |
|---|---|
| New Zealand | 1 |
| Singapore | 3 |
| Canada | 8 |
| Germany | 14 |
| Japan | 17 (tie) |
| UK | 17 (tie) |
| US | 19 |
| France | 24 |
| Korea | 39 |
| Italy | 63 |
| Greece | 71 |
| Brazil | 75 |
| China | 79 |
| India | 84 |
| Mexico | 89 |
| Russia | 146 |
| Iran | 168 |
| Somalia | 180 (last) |

*Source*: Transparency International. *Corruption Perceptions Index*, 2009.

### Technology/Patents

A measure of a country's technological strength is the patent productivity of its citizens. A common measure of that technological productivity is the number of patents per million residents (*See Table 9*). Although Japan and South Korea are at the top of the list on patentable ideas, the United States is certainly holding its own.

Invention and innovation does not guarantee economic success, nor does it prevent sustainable growth.

- Japan has a huge propensity for invention and innovation, with a significant lead over America in both patents granted and patents filed. Yet Japan's economy has languished for the past 20 years while the United States has experienced modest to average growth.
- China, on the other hand, has meager patent production, but it has one of the highest GDP growth rates in the world.

Table 9:
Patents Filed and Patents Granted by Country per Million Residents

| | Patents Granted | Patents Filed |
|---|---|---|
| Japan | 994 per million people | 2610 per million people |
| South Korea | 779 per million people | 2656 per million people |
| United States | 289 per million people | 800 per million people |
| Germany | 235 per million people | 582 per million people |
| France | 205 per million people | 239 per million people |
| United Kingdom | 82 per million people | 285 per million people |
| Italy | 13 per million people | 155 per million people |
| China | 1 per million people | 18 per million people |

*Source*: World Intellectual Property Organization. *Intellectual Property Statistics*. June 2009.

## Technological Achievement

The United States is still highly competitive as measured by its "technological achievement" even though its patent production lags behind that of Japan and South Korea. This measurement of a country's research and technology capabilities includes:

- creation of technology,
- diffusion of innovations,
- diffusion of old innovations, and
- human skills.

Using these measurements, the United States ranks second in the industrialized world in technological achievement, indicating a strong competitive standing with its trading partners. (*See Table 10*)

Table 10:
Technological Achievement by Country (for 67 countries)

| Country | Ranking |
|---|---|
| Finland | 1 |
| United States | 2 |
| Japan | 3 |
| Korea | 5 |
| United Kingdom | 7 |
| Canada | 8 |
| Germany | 10 |
| France | 15 |
| China | 40 |
| India | 58 |

*Source*: Organisation for Economic Cooperation and Development. *Handout on Constructing Composite Indicators*, 2008.

The various rankings do indicate there is a pronounced and ongoing shift in technological achievement with its epicenter shifting to East Asia and away from Europe and North America. According to *The Economist*, "Developing countries are becoming hotbeds of business innovation. ...They are reinventing systems of production and distribution, and they are experimenting with entirely new business models." These techniques generate dramatically cheaper products to service the developing world.

The United States and other Western countries are competitive, but the combination of technological prowess and management skills in Asia has and will have a strong impact on future world trading relationships.

## Final Thoughts

The current competitive record of the United States is encouraging: strong high tech and commercial services exports, strong patent position, favorable labor laws, excellent business environment, high worker productivity to name just a few strengths of the American economy.

Does this mean that the United States is in a strong position to compete for sales, economic growth and exports in the 21st century? **Absolutely not!** All the data shown in the figures above are historical and not prospective. **Past performance does not guarantee future results!**

Looking out over the next several decades is a very disquieting proposition. It is not clear that the United States is holding a winning hand.

**Quality of Competition**: The quality of our major competitors ranges from the strong (Germany and France) to the very strong (Brazil and Japan) to ferociously dynamic (South Korea and China). Conditions are changing very rapidly in global industries once dominated by the United States and European companies. Many Asian countries and their companies are now demonstrating strong technological proficiency and managerial skills.

**Governmental Resources**: The backdrop for the American economy is against a dreadful fiscal situation at Federal, state and local levels. These government fiscal deficits narrow dramatically the strategic choices the United States can and will make to address its most pressing shortcomings, such as public education. Therefore, little or nothing will be done over the next decade to significantly improve U.S. primary and secondary education.

**Immigration**: A rational immigration policy is needed to compete on a global basis. U.S. legislators need the wisdom and political guts to implement a merit-based immigration policy. The U.S. needs a policy that invites talented immigrants into the country, especially scientifically educated immigrants with the ability and resources to create new jobs for American workers. Canada and Australia have successfully implemented such a system. Sadly, wisdom and guts are in short supply among the donkeys and elephants inside the Washington Beltway.

**Free Trade Agreements:** At the present time there are three pending free trade agreements, with South Korea, Colombia and Panama, major trading partners of the U.S. These agreements were negotiated by the Bush Administration but now languish in the Congress awaiting ratification. As a result of the inaction, trade opportunities are being diverted from the U.S. to other countries including Canada, Brazil and Argentina. Given our substantial trade deficit, the situation is counterproductive for U.S. interests, especially those in the agricultural sector.

**Tax Policy:** The United States needs a corporate tax policy that fosters trade competitiveness: lower, not higher corporate taxes. The current tax proposals being vetted by the Administration and the Congress would raise taxes on the international companies, which are in the vanguard of global competition. Academic studies indicate that 80% of incremental U.S. exports are generated by U.S. firms that are currently active in exportation of American goods. Yet these firms are being singled out for adverse tax treatment. The Obama Administration claims that it wants to double U.S. exports in the next five years. If this is the case, the Administration must quickly rethink the punitive taxes being proposed for American multinational companies.

**Japan versus the United States:** The data do not indicate that the United States is headed into a Japanese style economic deflationary malaise — which lasted almost two decades. The United States is a strong, open, competitive and innovative country with a strong and productive labor force. Although its economy was damaged in the financial crisis of 2007-2009, it remains resilient. However, resiliency is a necessary, but not sufficient, condition for economic success in the 21st century.

**China versus the United States**: The United States is picking a very questionable fight on the value and potential revaluation of the Chinese yuan. This is a classic case of "be careful what you wish for, you might just get it."

- Labor-intensive jobs are not coming back to the United States from China. If the United States prevails for a stronger Chinese yuan thereby making China less competitive, the labor-intensive jobs will in time be redirected to India, Bangladesh, Vietnam, the Philippines and Indonesia.
- If these low-wage jobs were to return in significant numbers to the United States, the result would be an express train to a falling standard of living for America. A greater number of low-skill and low-wage jobs leads to a falling, not rising, standard of living for the U.S. citizenry.

- These jobs would create a magnet for low-skilled workers from the less developed countries of this hemisphere, such as Mexico. Does America really want more low skilled legal and **illegal** immigrants?
- Every 10% increase in the value of the yuan will cause the value of the $1.0 trillion Chinese investment in U.S. Treasury debt to decrease in value by about $100 billion because that investment is denominated in dollars. Does the U.S. Treasury debt deserve a triple AAA rating when you treat your creditors with such disdain? Buy our government debt. But to help us out, you need to "take a currency haircut" on your investment.
- An upward revaluation of the Chinese yuan would also make Chinese goods more expensive for lower-and middle-income American consumers — one more **stealth tax on Middle America**.
- Might it be desirable for global trade for the yuan to appreciate in a slow and orderly fashion against the dollar? Yes. Should that occur in the near future? Maybe. Will appreciation of the yuan have a significant impact on the overall U.S. trade situation and global competitiveness? **Absolutely not!**

Like it or not, America is "stuck" in the 21st century, a century which is and will be ferociously competitive. It cannot return to the "salad days" of the 1950s. All it can do is expeditiously implement thoughtful policies to enhance its global competitive position. America must fix American problems: immigration, taxation and education. Seeking scapegoats is a waste of precious time.

## Investment Consequences of the Current Global Situation

If the world is fortunate enough to avoid trade and new "shooting" wars, the current decade should be a challenging but in some cases rewarding one for global investors.

**Equity Investing**: Investors in globally-focused multinational firms should be well rewarded for their risk taking. It will require an American investor to have a truly international perspective with investments in developed and emerging economies. Size does not matter. There are great American and foreign companies of all sizes that will "win" in global competition.

**Domestic Fixed Income Investing**: The current decade will not reward domestic bondholders the way they were rewarded in the 1990s or in the first 10 years of the 21st century. Past annualized returns of 7% on Treasury bonds and 5.5% on municipal bonds are unlikely to be repeated in the current decade. The fiscal turmoil at the Federal, state and local levels could and probably will make these fixed-income investments a relatively risky asset class. The exceptions to that prediction are well-chosen municipal bonds issued by fiscally sound state and local governments. With rising marginal tax rates for individual taxpayers, well-chosen municipal bonds may become increasingly attractive.

**International Fixed Income Investing**: International bonds create a complex situation in that many Asian countries have low levels of national debt and balanced national budgets and therefore create some rewarding fixed-income opportunities. On the other hand, European governmental debt instruments issued by debt-heavy countries constitute much higher risk levels and are probably interesting only to highly sophisticated investors. Bonds issued by Greece, Ireland, Iceland, Italy, Portugal and Spain may become toxic investments in the coming years. A major governmental default by one (or more) of these countries could have complex impacts on the first two predictions. The sovereign-debt morass could turn out to be the major economic story of 2010 and 2011. The huge European government bailout is not the end of the story; it's just beginning.

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