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Remarks by Treasury Secretary Henry M. Paulson, Jr. before the Economic Club of Washington

March 1, 2007

WASHINGTON, DC—Thank you very much, Vernon. Thank you all.

I'd like to start with a brief comment on the economic numbers released yesterday. For a number of months now I have believed that the U.S. economy is successfully transitioning to a moderate and sustainable rate of growth, and yesterday's data supports that view. The economy grew at a 3.3% pace last year, with GDP growth of 2.2% in the fourth quarter. This is up from 2% growth in the third quarter. Recent data suggest that economic activity slowed in December and January, particularly in manufacturing.

It is important to take a broad view of the economy and not to rely on a single number or even data for a month or two in forming a judgment. I am watching developments carefully, and I believe that the U.S. economy is healthy. Labor markets are firm; unemployment is low; consumer confidence is rising; inflation is easing; exports are growing and they contributed about one percentage point to the fourth-quarter GDP number; and of particular importance to me, working families are now benefiting from this expansion, with real wages up 2.1% over the last year.

When I came to Washington in July, I noted that in certain respects our economy resembled the economy of the mid-1990s, and that with high productivity growth, moderate inflation, and a tightening labor market, workers' wages would rise. I'm pleased that in the months since those comments, we've seen exactly that. America's impressive productivity growth is enhancing the long-term strength and competitiveness of the U.S. economy and improving the economic well-being of Americans.

In my previous job in the investment banking industry I spent a great deal of time working with corporate clients, governments, and in financial markets around the world. It was very clear to me that a major lesson of the last three decades is that those nations that open themselves up to competition – in trade, finance, and investment – have benefited while the rest have been left behind. This personal experience – here and abroad – has made me greatly appreciate the openness of our nation, which has been one of the most important factors in the great economic success of the United States. Openness to trade and competition fuels economic dynamism and innovation, as well as the deployment of new technologies that raise productivity and ultimately our standard of living.

Despite our healthy economy and rising living standards, more and more Americans seem to doubt that trade brings greater benefits than costs. Some politicians from both parties, reflecting what they are hearing from their constituents, are moving further toward embracing protectionism. This is a worrisome trend. And it is a trend we must resist. Free trade is one of the cornerstones of our economic success as a nation. We must redouble our efforts to demonstrate the benefits of trade to our standard of living – and make clear that retreating to economic isolationism would mean fewer jobs, lower incomes, and lower standards of living in the United States and for hundreds of millions of people around the world.

I understand that our dynamic economy, while generating wealth and opportunities for advancement and increasing our nation's standard of living, does create dislocations and anxiety. Change can be difficult, and our economy seems to be changing ever more rapidly. As one of the sources of economic dynamism, expanding trade does result in some job losses and contributes to this sense of anxiety. But making trade a scapegoat only breeds support for protectionist policies that will make us worse off. Trade and openness to competition have produced and will continue to produce benefits for our economy, our businesses, our workers, and our consumers – benefits that greatly outweigh the costs. Proven economic principles have not changed.

We must make it a priority to help workers succeed in our rapidly changing and increasingly global economy, while maintaining our commitment to open markets and the benefits that come with them. The global economy is here to stay. To keep growing and leading the world in innovation and opportunity, we must trade freely, openly, and according to the principles of the global marketplace.

Today I'll lay out the major benefits trade and openness bring to our economy, then address some of the concerns raised about trade, and close with a discussion of how we can help more Americans tap into the potential of our dynamic economy.

More than 57 million Americans are employed by businesses that engage in international trade, and the benefits reach every state in our nation. Exports alone account for nearly 22% of manufacturing jobs in South Carolina. In the state of Washington, that number is nearly 37%. And agricultural exports support nearly 400,000 jobs in the U.S. farm sector.

Globally engaged U.S. multinationals on average pay their employees about 20% above the national average. I have worked with many of these companies and observed how competition has spurred them to innovate to stay in the lead. These companies accounted for more than half of U.S. productivity growth between 1977 and 2000, and 83% of corporate investment in R&D. The resulting technological innovations make workers more productive, over time raising wages and improving living standards, while keeping inflation in check and giving rise to new products, new industries, and new high-paying jobs.

Today's consumers enjoy more choices and lower prices on everything from food to cars to household goods. Products once considered luxuries have become commonplace. In 1954 it took the average American nearly three weeks of work to earn enough money to purchase a dishwasher. Last year, it took less than three days. Twenty years ago, most families could not afford a computer. Today, many families wonder how they ever lived without one. And a long distance telephone call that once cost 50 cents or more a minute can today be made almost for free, either over the Internet or on a mobile phone that fits in your pocket.

Did trade alone create these modern conveniences? No. Trade fosters the environment of competition, innovation, research, and investment that leads to better goods and services at lower prices. Some people speak about trade as if its benefits come only from exports, ignoring the positive contribution of imports. Data show that internationally traded products tend to experience lower inflation rates – even real price declines – while non-traded goods tend to rise in price. Thus trade helps Americans provide for their families. When special interests seek protection in the name of low-wage workers, we should acknowledge that limitations on imports do not benefit the vast majority of Americans. They deny people the freedom to choose from a broader array of goods and services, and impose a cruel tax on people who rely on low prices to stretch their family budgets. The cost of protectionism falls most heavily on those who are least able to afford it – the poor and the elderly.

Imports also stoke the fire of competition for American businesses and workers, and allow American manufacturers to acquire inputs at lower prices. In a global market, many American companies use imported components to make themselves more productive and more competitive—and this productivity leads to higher wages for workers and stronger growth and job creation for our entire economy.

America's openness and our embrace of change has made ours the most vibrant and dynamic economy in the world. At the same time, change does produce job losses and other temporary dislocations in particular companies, industries, and even regions – just as it creates new opportunities in others. Job losses, wherever they occur, are painful – to families and communities. We should recognize the hardships and work to alleviate them, while keeping in sight the higher living standards and new opportunities Americans enjoy as a result of economic dynamism.

American manufacturing is a good case study in change. Not unlike the revolution in agriculture Americans lived through in the 19th century, we have been living through a revolution in manufacturing. Today we have about 14 million manufacturing jobs in this country – roughly the same number we had in 1950. Then manufacturing represented about 30% of the workforce. Today it represents just 10%. Some see this as a decline in

U.S. manufacturing. On the contrary, America is the world's number one manufacturer, accounting for more than 20% of worldwide manufacturing value-added – that's more than Japan, twice as much as Germany, and more than 2.6 times as much as China. We manufacture more today than we ever have in our history – seven times as much real output as in 1950, with about the same number of workers. And a greater share of manufacturing jobs than ever before are high-skilled and high-paying. What's happened? Competition has pushed businesses to invest in technological improvements that allow workers to be more productive and earn higher wages.

I began my investment banking career in 1974 in Chicago working with Midwestern clients, many of them industrial companies and manufacturers. I have watched this transformation over three decades and it has been a radical one led by technology and automation. In the 1970s, as I walked through factory floors or assembly lines, workers were everywhere. Today, you are struck by the degree and sophistication of the automation. The increases in productivity are startling.

As manufacturing has become more productive, our robust economy has created more jobs in service industries, which account for 80% of employment in America. I know the term "service industry" can have a negative connotation – but despite what you hear from critics, our ten highest paying industries are all in the service sector – including computer systems design, management and technical consulting, and architectural and engineering services. Far from being the menial, low-wage jobs that trade opponents portray them to be, these service jobs are cutting-edge, high-paying, and skills-intensive. The evidence doesn't support the assertion that our workers are being pushed out of high-paying manufacturing jobs and into inferior service jobs. Our flexible and dynamic labor markets ensure that as the demand for services grows, our workforce grows in these high-skilled, high-paying fields.

Technologically sophisticated and specialized services are a competitive advantage for America. In fact, the United States runs a trade surplus in services – especially high-skilled services, which often represent the highest-paying jobs. Consider that one area in which we've had a multilateral free trade agreement since the founding of the World Trade Organization – information technology – is a field the United States dominates.

Critics often ask: If trade is so good for America, why do we run a trade deficit? These critics might be interested to know that the last time we ran a trade surplus our economy was in recession. We should not delude ourselves that the trade deficit comes about mainly because of other countries' trade barriers or unfair practices. We run a trade deficit because our vibrant and growing economy creates a strong demand for imports, including imports of manufacturing inputs and capital goods as well as consumer goods – while our major trading partners do not have the same growth and/or have economies with relatively low levels of consumption.

Moreover, the U.S. has strong investment opportunities, but Americans do not save enough to finance all the worthwhile projects in our country. Foreign capital helps increase our capital stock and improve labor productivity, resulting in higher wages for our workers. Other countries save far more than they invest and the excess liquidity comes to the United States because our strong economy offers attractive opportunities. The trade deficit and the associated capital flows are fundamentally a reflection of our own and other countries' economic choices.

Narrowing the trade deficit without harming our economy requires a reversal in the underlying causes: The United States has to save more and be able to fund our own investment, and other countries have to grow faster and rely to a greater extent on domestic demand. Two of our biggest trading partners, Japan and Europe, have positive recent growth, and it is in our mutual interest that they continue to pursue pro-growth economic and labor reforms.

Our largest trade deficit is with China. China is growing at a 10% rate, but its developing economy has structural issues which are the major cause of its trade surplus with the United States. That surplus totaled approximately $233 billion in 2006, or 28% of our total trade deficit. This gross number is misleading in that much of China's exports to the United States are low value-added products for which China is the last stop in the assembly process and the importer of record, but materials and components are first imported into China from other countries in Asia and throughout the world. Our exports to China, for the most part high value-added manufacturing products and agricultural products, totaled $55 billion in 2006, growing at a rate of 32% last year, and 360% over ten years, making China one of our fastest growing markets for U.S. exports.

We are dissatisfied with the speed with which China is appreciating its currency, the value of which is not market determined, and with China's intellectual property protections. We are addressing these issues in our Strategic Economic Dialogue with China, along with China's need to accelerate the process of opening its economy to U.S. products and services. And in my judgment, the greatest risk to the economic well-being of our two nations is not that China will move too quickly, but that they will move too slowly in reforming their economy.

We expect that as China moves forward with its economic reforms, increasingly opening its economy to competition, this will benefit both of our nations. Stronger growth in all of our trading partners will sustain our own growth and contribute to a narrower trade deficit.

Trade, of course, means more than trade in goods. Capital flows across borders more quickly than ever. The back and forth movement of financial assets is 100 times greater than trade in goods. The McKinsey Global Institute estimates that since 1990, cross-border capital flows have risen nearly 11% a year, well above the 3.5% annual growth in world GDP and the 5.8% annual growth in foreign trade. In my previous job I didn't need a study to tell me about the increasing velocity and the magnitude of global capital flows. It is clear to me that these are functions of high levels of global liquidity and the imbalances created by significant differences in savings rates, economic growth rates, and the structure of different economies around the world.

The tremendous growth of capital flows benefits the United States. We excel at putting capital to its most productive uses. Foreigners don't just put their money into U.S. assets; they put it into American hands to invest on their behalf, both here and abroad. The United States has a comparative advantage in financial services. In my judgment it benefits our nation tremendously to have a number of global leaders in financial services headquartered in this country. One clear benefit is our financial services trade surplus of nearly $28 billion. Growth in global capital flows creates great opportunity for American companies and American workers. Employment in the financial services industry has increased by about a million jobs, or approximately 20%, over the last 10 years.

A great deal of foreign capital – nearly $800 billion last year on net – flows into the United States. These capital flows are a mirror image of our trade deficits: capital comes to the United States because the U.S. is the best economy in the world. In order to make that investment, they give us their goods in return. We have deep and liquid capital markets and a growing economy that provides opportunities for foreign investors to earn an attractive return on their capital. In turn, foreign investment benefits the United States by fostering economic growth and job creation. Investment has been a vital component of our economic growth, accounting for 20% of our growth since the middle of 2003.

Foreign investment in the United States comes from a diverse group of countries and finds its way into a diverse range of assets. Last year, foreigners purchased nearly $100 billion in U.S. equities and $500 billion of private sector bonds, and took ownership stakes of $180 billion in American companies. These capital inflows help keep U.S. interest rates lower than they would be otherwise, which in turn means that government borrowing costs are lower and companies can invest more and create more jobs. Capital inflows also contribute to the U.S. economy when foreign companies buy and operate existing companies or when they build new facilities here. These businesses employ more than five million Americans, and these jobs pay nearly 30% more than the U.S. average.

To be sure, we need to increase national saving by addressing our long-term fiscal situation and by removing disincentives for American families to save. As this happens, and as our trading partners increase their domestic consumption and further open their markets, our exports will increase and world capital flows will rebalance. This will take time. For this rebalancing to take place smoothly, it is essential that we maintain our strong economy and make sure the United States remains an open and attractive destination for investment.

We are engaged in a wide range of bilateral and multilateral efforts to bring down barriers to U.S. exports – both by reducing tariffs and by urging our trading partners to undertake structural reforms. Under President Bush's leadership, we have negotiated 10 new free trade agreements with 15 countries – and our exports to FTA partners are growing twice as fast as our exports to the rest of the world. We are also working to make sure that existing trade agreements are honored and that intellectual property rights are respected. Thanks to increased openness both here and abroad, our global exports are at an all-time high. The trade deficit will take some time to correct itself, but for the last four quarters, America's exports have grown at a faster rate than our imports.

The lesson is clear: If we want to improve our balance of trade, the answer does not involve more barriers, the answer involves more trade – with open markets here at home and more open markets abroad for our exports. My job is to fight for open markets and structural reforms that will benefit American manufacturers, farmers, and service providers. Along with my Cabinet colleagues, I am pursuing that vigorously.

As a global economic leader, the United States also has a special role to play in expanding opportunity and prosperity around the world. This is both a moral issue and a practical issue. Countries that are more open economically and work cooperatively with the global community contribute to stability, security, and peace. And as nations grow wealthier, they are more likely to adopt stricter environmental and labor standards that bring them in line with developed economies.

The best way to alleviate poverty and raise living standards is through greater openness, so more people can benefit from the expanding global economy. The share of the world population living in poverty fell from 20% in 1970 to only 7% in 2000. And the most important driver was the rapid growth of developing countries that opened to trade, China and India in particular. Closer to home, Mexico's poverty rate fell by more than 20% and its rate of extreme poverty fell by more than 30% between 1994 and 2005 – the years following the passage of NAFTA.

Mexico has much more to do, particularly in their efforts to make social and economic changes that nurture their middle class. But Mexico is on the right path – and other nations in Latin America are poised to take similar steps. Right now, free trade agreements with Peru and Colombia are waiting for Congressional approval. And the Andean Trade Preference Act, which established duty-free benefits for Colombia, Peru, Ecuador, and Bolivia that will expire in June, is up for renewal. For the benefit of our workers and businesses, for the economic progress of our neighbors to the South, and to advance our goal of reduced global poverty and enhanced stability in our region and around the world, Congress needs to approve these measures.

I understand the case for trade is not clear-cut for most Americans. They worry about job losses and dislocations that occur as our economy evolves and adapts, and much of their concern is focused on trade. A recent Pew study indicates that only a third of Americans think free trade agreements benefit our economy. Close to half believe they have a negative effect on jobs and wages. People understand that trade produces benefits, but they believe the benefits are not shared equally, either among countries or among people within our country.

We have only recently reached the point in the business cycle when benefits from our expanding economy are reaching middle-class families. And we've seen the income distribution in the U.S. widen for three decades. Far from feeling like essential drivers of the world's best and most powerful economy – which they are – many American workers fear they won't be able to compete. And this fear is breathing life into anti-trade and anti-globalization elements. Protectionists use the trade deficit as a shorthand criticism of free trade policy. They try to convince workers and families that we're getting a raw deal when it comes to trade. At best, that's bad economics; at worst, it's demagoguery.

Policymakers must address the dislocations that arise from our dynamic economy. But not by trying to turn back the clock and hurting America and American workers. We will be sorry indeed if we try to eliminate dislocation by lashing out at trade.

There is a solid consensus that the rapid pace of technological change has been a major driver in the decades-long widening of the income gap in the United States. And my personal experience working 32 years in the private sector with many companies in many economies has convinced me that the experts are right when they conclude that technology is a much bigger driver of that process than global integration or trade in goods.

There is no question that technology has made many jobs obsolete, even as it has brought efficiency and convenience to our daily lives. But we don't hear many voices calling for an end to the Internet. It would be no more beneficial to try to turn back the clock on global integration than it would be to turn back the clock on technological advancement. And in my judgment, it would be no more realistic. Trade is essential to the future strength and dynamism of the American economy – to creating more and better job opportunities for American workers.

Trade is an especially important issue this year. The President's Trade Promotion Authority is set to expire this summer, and there is still a great deal of negotiating to be done on the Doha Round of global trade negotiations. Susan Schwab, our U.S. Trade Representative, is working hard to make progress toward a meaningful agreement, and we have made serious proposals aimed at reaching an accord.

One of the key objectives of the Doha Round is opening up economies to trade in services. Because of our advantage in providing high-end services, we have the potential to realize sizable increases in exports. Estimates suggest that if post-Uruguay Round trade barriers were removed – particularly the barriers to trade in services – the U.S. economy could eventually see as much as $500 billion in additional income each year. Without renewed TPA, the odds of reaching a successful conclusion on Doha will be greatly diminished – and an important opportunity to increase our exports in services, manufacturing, and agriculture will slip away.

To leave benefits on the bargaining table when we are so close to achieving them would do a terrible disservice to working families and would clearly leave our economy worse off.

We need to continue pushing forward on the trade agenda to keep our economy growing and to keep it competitive. At the same time, we must take action to help people thrive in a changing economy.

Increased income inequality is a fact we must confront. The way to confront it is to help average wages grow, and help people who are at the bottom of the income ladder move up. That starts with a competitive, strong, and growing economy that produces new and better opportunities for Americans.

As our economy grows, market forces work to provide the greatest rewards to those with the needed skills in growth areas. Workers with less education and fewer skills will realize fewer rewards and have fewer opportunities to advance. We should help people of all ages pursue first-rate education and retraining opportunities, so they can acquire skills to advance in a competitive worldwide environment. As Federal Reserve Chairman Ben Bernanke recently stated, "Substantial economic benefits may result from any form of training that helps individuals acquire economically and socially useful skills, including . . . on-the-job training, coursework at community colleges and vocational schools, extension courses, online education, and training in financial literacy." In fact, community colleges are a unique strength of the American educational system, offering workers an opportunity to retrain at a relatively minimal cost after they enter the workforce. President Bush is a strong advocate for working with community colleges and local businesses to tailor training to skills that are in demand.

The President has proposed a number of ideas to help workers succeed in today's economy by making benefits more portable and training more accessible. Today, losing a job means more than losing income. It often means losing health care and other benefits, which could leave a family in real jeopardy. Even though millions of Americans do move to better jobs each year, some workers feel stuck in a bad job because they can't take their benefits with them. In a rapidly growing and changing economy, the idea of obtaining all your benefits through your employer increasingly seems like an anachronism.

Through proposals to expand Health Savings Accounts and give all Americans, no matter where they work, a standard tax deduction for health insurance, the President is shifting the public policy focus of health care from the employer to the employee. The President also wants to expand opportunities for workers to save for their retirement.

Trade Adjustment Assistance is another program that could use fresh thinking. There seems to be a growing consensus among Democrats and Republicans that Trade Adjustment Assistance, the way it is structured today, does not serve people as well as it could and does not provide the right incentives. These resources can be better used in a program that has more flexibility, more options for training, and more personal ownership. The President has called on Congress to reauthorize TAA - and to improve it. And I look forward to continuing discussions toward an effective solution.

The case for trade is clear and compelling. And if we want more people to support it, we need to ease anxieties and help more people realize the benefits of trade. The alternative - raising protectionist barriers and isolating ourselves from the gains of trade - would hurt our economy. The long-term cost of protectionism - for us and for the rest of the world - is lost jobs and lost opportunity. And for some of the poorest nations, perhaps more instability. We must not heed the siren song of protectionism, trying to reduce the losses of the present by sacrificing the opportunities of the future.

For more than 60 years, the United States has been the world's leader in advocating greater openness and increased trade. Leaders of both political parties have recognized that greater engagement with the world is essential to our growth. Backing away from our commitment to openness would send a terrible signal to the rest of the world. America's message at home and abroad must be clear: The United States believes in open markets. We welcome foreign investment. And we seek partners to join us in advancing a global agenda that will help more people realize the benefits of international trade and competition.

Thank you very much.

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