

China 2025: Keynote II: China's Economic Outlook

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Left: Stephen Roach. Right: Elizabeth Economy

ELIZABETH ECONOMY: If we could all take our seats so we can get started. We have a jam-packed afternoon.

Let me welcome you back. I hope you all managed to get something to eat. There will be food still out there during the break if you want to replenish yourselves.

It is my very great pleasure to introduce our keynote lunch speaker today. I think you know, over the past 30 years, virtually no issue related to China's rise has captured the imagination of the rest of the world as much as its spectacular economic success. And really, as I was thinking about it, over the past three decades China seems to have encountered very few speed bumps over the course of its development in many ways. Even in the midst of this global financial crisis, it is planning to post 8 percent growth this year.

And it leads me to wonder, are the Chinese simply doing everything right while the rest of us muddle along? Or are they bartering their future economic growth for growth today? Or are there transformations in their economy that they ought to make or that they're going to have to

make to continue on this path of economic growth and economic success? And then, of course, how will China's economic choices affect the rest of the world?

I think these are questions that many of us probably find challenging to answer. Fortunately today we have Steve Roach, who, more than anybody I know, is capable of moving us along on a path of understanding better both the challenges that China faces today and the challenges the country is likely to face looking forward a decade from now, as well as the opportunities, of course, that the country already encounters and will.

Steve, as I think many of you know, was for many years Morgan Stanley's chief economist. He is now the CEO of Morgan Stanley Asia; holds a Ph.D. in economics from NYU and just came out with what I have to say is truly a terrific book. It's very engaging, very informative. It's really a collection of his writings, some testimony, some thinking over the past several years, brought very much up to date. And we will have it for sale right after this session outside of the table immediately as you exit.

And I should note that all of the royalties from the sale of the book are going to charities in China. One is the CEIBS (China Europe International Business School) in Pudong, and the other is a set of HIV/AIDS clinics in China that David Ho runs, which I think is really something special, and, even as much as the book is terrific, merits our support.

I think one of the things that I love most about Steve and his work, frankly, is that, unlike a lot of economists in our country, Steve spends a lot of time on the ground; even before he was the CEO of Morgan Stanley Asia, spent a lot of time on the ground in China trying to understand the reality of the situation, so not simply dealing with economic models and what should or ought to be or what he might read here, but actually getting to know all the players in China, understanding the problems of central-provincial-local relations, and all the real intricacies of China's economic system. And I think that is, in good measure, what makes him so illuminating, so special.

So let me turn to Steve, and he'll speak for about 20-25 minutes, and then we'll have a discussion. (Applause.)

STEPHEN S. ROACH: Thank you. Thank you very much, Liz. And it's terrific to be here. I do travel a lot, so if it's Monday, it must be Washington, right? I hope. And 2049, I look forward to coming back on that year with all of you in this room -- (laughter) -- and celebrating the 100th anniversary of the People's Republic of China.

Liz sort of set this up, I think, very nicely. Yes, China is going to hit its growth target - a target that is so important to the nation's leaders and to its people this year. Moreover, China will hit its target even in the face of a serious, or I should say terribly serious, global crisis and recession.

So if you judge China on the basis of hitting its target, all seems well on the surface. And it's not just that China is achieving its own aspirations, but, by growing close to 8 percent, it'll play a very important role in providing a broad impetus to the overall economy in Asia and it will play, obviously, an important role in providing impetus to an otherwise very sluggish global economy.

So on that surface, you can say that China has arrived, not just as an engine of Asian growth, but also as a powerful engine of global economic growth.

The story does not stop there, though. You have got to dig beneath the surface in assessing the role of China as an autonomous source of growth in and of itself, as well as a source of growth for Asia, and as a source of growth for the broader world economy.

The best assessment of this conundrum has been provided by China's own premier, Wen Jiabao, when, a little over two and a half years ago, at the conclusion of the National People's Congress in Beijing, at a press conference that he held right after that congress was over, the premier stated categorically that, while China looks strong on the surface in terms of GDP growth, in terms of employment growth, beneath the surface, he, the premier, was worried about a Chinese economy that, at the time, was increasingly unstable, unbalanced, uncoordinated, and ultimately unsustainable. And he was dead right.

And, interestingly enough, at a large conference that Liz and I attended in Dalian in mid-September, the premier was the keynote speaker, and everybody expected him to come in and boast about China's vigorous recovery and its leadership role in Asia and the broader global economy. He said no.

The recovery is something that gratifies us, he pointed out, but it's fragile, and it reflects an economy that is increasingly, in his views, unbalanced, unstable, uncoordinated, and ultimately unsustainable.

What does he mean by that, by expressing those concerns? In terms of the imbalances, they're very clear. They reflect extraordinary distortions in the macro-structure of the Chinese economy. A couple of numbers say it all. As of right now, literally 80 percent of the country's GDP is concentrated in two sectors, exports and export-led fixed investment. By contrast, the internal private consumption share of the Chinese GDP was 35 percent last year and fell below that by the middle of this year.

It's an economy that is, as a result, more about supply than about internal demand, an economy that directs an increasing portion of its production to external markets rather than one that is supported by internal markets. This is a key and critical issue that I'll come back to in a couple of moments.

By unstable, the premier was referring to China's inordinate and increasingly intensive use of energy and other scarce resources such that the commodity intensity of the Chinese GDP - namely, resources per unit of GDP is more than double that of the typical economy in developing Asia and more than four times that of the typical developed economy.

So China has a seemingly insatiable demand for natural resources - prompting it to turn increasingly aggressive in its outward-bound foreign direct investment in trying to acquire strategic resources in Australia, in South America, and in Africa, in the commodity-producing area. And, of course, this insatiable demand for commodities has played an important role in driving the prices of these very commodities that a resource-inefficient China needs more and more of to source its economic growth.

By uncoordinated, the premier was referring to the well-known and longstanding fragmentation of the Chinese structure of governance, corporate control, and the financial system. There's an old Chinese proverb that says, "The mountains are high and the emperor is so far away." And it's emblematic of a China that has a control problem in Beijing.

And beyond the confines of Beijing, the provinces and municipalities, in many respects, still today do pretty much what is in their best interest -- rather than what is in the best interest of the nation as a whole. This lack of coordination certainly undermines the cohesion that any national economy needs to accomplish broad objectives. And the unsustainability that the premier was referring to -- and these are sort of my interpretations, but these are interpretations that he himself has fleshed out somewhat in subsequent speeches -- the unsustainability is right up Liz Economy's alley - in that it refers to the pollution-intensive character of China's economic growth and how ultimately this puts a stranglehold on the world's largest population mass.

So the interesting thing is that here's a leader of this vast nation that has experienced the most phenomenal progress that any of us have seen in our lifetimes with respect to economic development, and he's sending repeated warnings about these four "uns," as we call them, that draw into serious question as to whether or not China can stay the current course.

And I think that is a really good place to start in trying to get an assessment of what lies ahead in China. I also think it's a framework that also sheds an awful lot of light on what the broader economies of developing Asia face as well in the years ahead. That's because China does not have a monopoly on an economy that's unstable, unbalanced, uncoordinated and unsustainable. In many respects, these characteristics personify many of the other economies in developing Asia, although I hesitate and I caution all of you against painting Asia with one brush.

The interesting thing about the success of the stimulus package that has been put in place in China to deal with economic crisis and recession, is that on the surface has had such seemingly spectacular results in the first half of 2009. Yet, paradoxically, it actually compounds the very imbalances that Premier Wen is so worried about and has expressed so eloquently on several occasions.

The government enacted early last November a RMB 4 trillion fiscal stimulus plan funded by an absolutely massive and unprecedented binge of bank lending in the first six months of this year.

And if you pick apart the RMB 4 trillion and we've done that, about 72 percent of it is concentrated in infrastructure, and that includes about RMB 1 trillion that were directed at reconstruction after the Sichuan earthquake of a year and a half ago. And surprise of surprises or actually no surprise at all, when a centrally directed system orders the banks to lend and to funnel the proceeds of those loans to municipal governments who take the infrastructure projects off the shelves, you get growth. It's not like, you know, in the United States where we do middle income tax cuts and people have the discretion as to how they want to dispose of the funds. They have a GDP dial in central planning headquarters at the NDRC in Beijing and when they want eight, they'll give you eight.

So they had 7.1 percent average growth in the first half of this year, and it will be like nine percent, you know, give or take a tenth of a point in the second half of the year and it will miraculously average to eight. But of the 7.1 percent growth that they had in the first half of the year, no surprise to me, 88 percent of it was concentrated in fixed investments -- 88. Go back and look at the GDP contributions of investment to China over the past ten years. The average over that ten-year period was 43 percent. There's never been such an outside investment contribution of GDP growth in modern China's history.

The Chinese leadership was very determined to achieve this outcome because the economy actually was in much, much worse shape late last year than the government let on to believe. They report their GDP growth on a year-over-year basis. If you believe the numbers and that's always a debate and an issue in China, the growth rate slowed sequentially to 6.4 percent late last year.

However, if you calculate growth on a sequential quarter-to-quarter basis, the 6.4 was a number close to zero. And for an economy with a vast reservoir of surplus labor, that's unacceptable and intolerable. In fact, the Chinese government admitted late last year that fully 20 million migrant workers had lost their jobs in export-sensitive Guangdong Province. That means there was an awful lot of labor related distress in the face of a complete reversal of China's most powerful sectoral growth driver exports. The sector had been growing plus 25 percent as recently as the middle of 2008, went to a minus 25 in the spring of '09.

And so with growth and the economy hitting a wall, the government was determined to attack the shortfall head-on and use the combination of state-directed bank lending and infrastructure spending much more aggressively than we've ever seen in the past.

Now here's where it gets interesting. If you look at the stimulus, it's a classic Chinese countercyclical stimulus action. They have words for these things in China, slogans, and they call this their "proactive fiscal stimulus." Such a policy impetus always consists of two pieces. First, there is the jump start to fixed investment, and they did that beautifully. And then there are increased tax incentives for exporters such that when the investment stimulus begins to fade and it will begin to fade around the middle of 2010, then the export machine comes on line and takes over where the investment stimulus leaves off.

There's a big problem with that approach. While it worked brilliantly a few times in the past especially after the Asian financial crisis of '97-'98, then again after the global recession of 2000 and 2001, it's not going to work this time. The investment delivered, but the export machine won't not because of export competitiveness issues in China but because external demand courtesy of what is likely to be, I think, a multi-year shake out from the over-extended American consumer, external demand is not going to snap back.

And so the second piece of the proactive fiscal stimulus is going to be disappointing. That underscores the likelihood of another slowdown in Chinese economic growth around the middle of 2010. And as was the case late last year when the economy slowed down and unemployment mounted, I think you can fully expect the Chinese to once again go back to the well with another round of bank-directed investment spending that will further exacerbate the imbalances, the structural imbalances of the Chinese economy.

So the premier had it right. Focus on imbalances. They're getting worse. They're not getting better, and the odds are that given that the global climate and the external underpinnings of this export led economy that the imbalances are going to continue to get worse in the years ahead. In the end, there's only one way out for China, and this is the subject of my new book, *The Next Asia*. The next Asia is one that's driven by a more balanced Chinese economy that moves away from the export model to one that's supported by internal private consumption. It is actually an exciting and very appealing and attractive story for China and for the rest of Asia.

There are a lot of theories about what it's going to take to stimulate internal private consumption in China. While there is no silver bullet, the point that I focus on the most is in transforming the savings culture of the society away from the excesses of fear-driven precautionary saving toward a more normal savings rate. The missing link in this equation is the lack of a social safety net in China.

China has failed to invest in social security, private pensions, medical care, and unemployment insurance. They tell you they have these institutions in place. But again you've got to dig beneath the surface. Just a couple examples: China's national social security fund currently today has U.S. \$82 billion of assets under management. Do the math. That's \$90 per worker of lifetime social security benefits.

Medical insurance. They did a big package -- big in quotes -- earlier this year. It was RMB 850 billion over three years. Again, do the math: this amounts to just \$30 a person for three years. So these are not even baby steps. China really needs to commit massively to these types of programs. If they do, I think they can then be surprisingly successful in a relatively short period of time in drawing down the excesses of precautionary saving.

Let me give you an example of how saving continues to move up in China. The best estimates I've seen of household savings in China put the overall savings rate for the household sector at 27.5 percent in the year 2000 - and then rising to 37.5 percent in the year 2008. There's a lot of fear and uncertainty amongst Chinese families about job and income prospects, and it makes a lot of sense to increase rather than decrease savings in that climate. However, I think China can do a lot in altering that sense of insecurity with some aggressive social safety net initiatives.

Let me just conclude with just some comments on the major benefits of a rebalanced Chinese economy. I'll also end with just a few challenges that this trend might pose for the broader world economy. There are five benefits that I would highlight here in terms of shaping the medium to longer term outlook in China.

Number one, dealing with Premier Wen's concerns on macro sustainability. If you shift the structure of the Chinese growth model from supply to demand, you have a much better chance of a sustainable rather than increasingly unbalanced outcome. Secondly, by broadening out the support for consumer demand, you can begin to address some of the income disparities -- not just those in urban but also in rural China. It takes a lot more to address income disparities than a shift in the macro structure, but it's an important step in the right direction.

Thirdly, more of a pro-consumption model will reduce the nation's trade and current account surplus, and I think that will be helpful, but by no means decisive in reducing the risk of trade

tensions that arise from an economy that's going the other way on the current account and trade balance.

Fourthly, this rebalancing of China will also make an important contribution to lowering the oil and natural resource intensity of the Chinese GDP. Such structural change could result in a cleaner and greener GDP. That's because consumption-led growth, especially if it's complemented by the development of the services sector places less of a claim on the materials and energy inputs that a pure industrial production type technology would otherwise deliver.

And fifth and finally, is a very important benefit from the services piece itself. Manufacturing, industrial production and growth is very capital intensive. Services are increasingly labor intensive. China needs a better balance to its growth model in order to absorb its surplus labor. That is a critical challenge that the nation faces, and I would argue that services are an important and missing piece of the equation. The services sector is only about 40 percent of Chinese GDP making it about the smallest service sector of any major economy in the world today.

Finally, three challenges to think about in terms of what this model means for the rest of us. Number one, right here at home. Let's say that China draws down its surplus savings, puts it to work in stimulating private consumption. That means they're going to have less savings to send our way to fund our current account deficit. Who's going to do the financing?

Secondly, and this is a big challenge for China. Let's just say they make progress in pushing to more of a consumer-led society. This introduces a whole element of free choice and aspirations of Chinese households that could be at odds with the one-party model of political control in China.

And then finally, how does the rest of Asia respond to China's rebalancing? Does this divert capital that might otherwise go to the rest of Asia, or does it open up a huge market of internal consumption? Do the small populations of Korea and Japan and others who are aging now have great opportunity to tap into China with their high value added output.

Those are, again, some of the benefits, some of the challenges. As I said before, China can continue to grow at a rapid rate. We all take great comfort in the fact that they delivered. But beneath the surface, the premier nailed it. This is an economy that while it's hitting its growth target is one that is increasingly unstable, unbalanced, uncoordinated and ultimately unsustainable. For China, and I think this is the lesson in this crisis; China is no different than the rest of us.

No, China does not get special dispensation from Econ 101. Its unbalanced growth can go on for longer than a pure market economy. But in the end, China is accountable to the same rules that the rest of us are.

Thank you. (Applause.)

ECONOMY: That's great. Come sit. So let me open the floor for questions and I'm sure there will be a number.

Sure. Right here. Please identify yourself.

QUESTIONER: (Off mike.) All right. So my name is -- (inaudible) -- from -- (inaudible) -- Associates. And you mentioned -- (inaudible) -- in control now -- (inaudible) -- until money supply increased -- (inaudible) -- to three percent -- (inaudible) -- loans -- (inaudible) --

(Off mike.) How much control does Beijing have over the ramifications where that money goes -- (inaudible) --

ROACH: You can't -- even the Chinese can't control everything. So when you have liquidity injections in excess of the pace of real economic activity, they either go to repair balance sheet holes as is the case in the United States, or they spill over into other markets, which has been the case in China, with surging equity and property markets.

So liquidity-prone China remains vulnerable to ongoing bubbles in its markets. The regulators and the policy makers are worried about it. They've expressed these concerns, and they try to manage the banks away from making loans to property speculators and in trying to discourage the excesses. In the equity market sometimes their talk works, sometimes it doesn't, but the bias is one towards instability, and this will continue to be a problem.

QUESTIONER: (Off mike.) There's been much talk about -- (inaudible) -- with that said -- (inaudible) -- namely China, -- (inaudible) --

ROACH: Look. I'm a big believer that there are no major infrastructure bubbles in developing economies, especially as large as China. I will concede that most of coastal China has now been paved. So you've probably go to be suspicious if you see roads going into coastal China. But there continue to be serious questions about the most efficient way that the banks allocate capital. While the capital allocation process remains problematic, given the massive ongoing rural-urban migration, which is just an explosively powerful trend, I'm less worried about any immediate problems in the infrastructure and the commercial real estate area.

Having said all that, I'll just say that the investment share of the Chinese GDP is now to a number north of 45 percent. No country has ever experienced a number that large and gotten away with it for long. So this is just a clear symptom of the profound build-up of macro imbalances in China.

ECONOMY: Yeah, someone with a very strong hand back there. All right.

QUESTIONER: (Inaudible) -- from -- (inaudible) -- just last month in Istanbul the -- IMF managing directors -- Mr. Strauss-Kahn was pushing this idea of global reserve pool. He was saying that countries build up reserves because they want self-assurance, but why not you keep half the money down. We will have the use of ICR and use our flexible credit line facility to lend, but you know, the result was not so many people listened to him at that meeting, but I just want your view on that. How feasible is this idea?

ROACH: Look, I'm a big believer that the global architecture is so far mainly talk and not action. Ultimately, this is, I think, a big issue in dealing with the global imbalances that are very much an

outgrowth of the integration of the world through trade flows, capital flows, information flows, and labor flows. So I am quite sympathetic in principle to what Mr. Strauss-Kahn says, although I have some questions about the actual practicality of the proposal.

But to me one of the biggest inconsistencies is of this new G20 framework is that there's broad agreement in theory, but amazing reluctance on the part of sovereign states to abdicate any power to a supranational authority. I think the managing director of the IMF is right to challenge sovereign leaders on this key point.

ECONOMY: (Off mike.) Oh, okay -- (inaudible) --

QUESTIONER: Dave Brown from SAIS. If Premier Wen is so insightful in his analysis of the weaknesses of the Chinese economy and made this assessment two years ago, why is it that the government adopts a policy to get out of this recession which, in fact, aggravates the problems and leaves China with a smaller percent of money going into his? Is it that they really have little control or is his line just something that he's saying to foreigners to make us feel happy that they've got a long-term plan that's consistent with what we'd like them to do?

ROACH: Fair point, but maybe a little bit like the pot calling the kettle black. I seem to remember on December 6th, 1996, a certain chairman of the U.S. Federal Reserve claimed the stock market was irrationally exuberant and then went on to scope the speculative fires that led to a bubble dependent U.S. economy.

Why did Greenspan do it and why does Premier Wen do it? I think it's the same disease. Seduced by the superficial successes of artificial economic growth. China experienced growth beyond its wildest expectations when the export led model delivered at a time of explosive gains in global trade, and why fix what ain't broke? In the three years ending 2007, GDP growth reported was 12 percent. In 2007, it was 13 percent. Like the rest of us, I think, China found this outcome very seductive and was willing to go with the flow rather than do the heavy lifting that these sub-structural changes require.

This crisis ironically could be China's greatest wake-up call because sends a clear signal that the external demand underpinnings of the export machine are shot. Consequently, if you stay with this model, the very imbalances that you warn about have to get worse. As everybody knows by now, the Chinese word for crisis is *weiji*, a combination of danger and opportunity.

So this is China's opportunity to really look in the mirror here and they have been seduced. They were not alone in being seduced. The world went along for the ride.

ECONOMY: Okay. We'll take three questions in quick succession--

QUESTIONER: It's Dana Marshall with Dewey & LeBouef. It seems like that this conversation is sort of like a movie that one has seen several times before, I mean, going back at least in my recollection to John Taylor and the CEA. There's been the prescription of their rebalancing their growth pattern.

The question I have for you is why if there is now even more of a recognition and as you say the crisis kind of pushing them along, why would they not take --why are they so resistant to taking the one step which many suggest would help a lot, and that's of course, on the exchange rate?

ECONOMY: Okay. Back there. The young woman. Was there a young woman -- yep?

QUESTIONER: Hi, Kelley Currie. And thank you for the compliment, Liz.

I wanted to ask you if you think about this problem of the economic imbalance in terms of it being a massive wealth transfer from the average Chinese person who lacks financial services, has to save a large amount of their income to both the state in terms of the money being reinvested in the state sector and to the West, the wealthier West, in terms of the capital outflows that grow to support our debt habits. How does this feed into the four uns? It's seems that that's one of the most unsustainable parts of the whole equation.

QUESTIONER: Thank you -- (inaudible) -- the China and I remember that you were one of the few people in the United States who opposed forcing China to appreciate -- Renminbi, but right now you are talking about it in bad economy in China, and do you change your mind right now and do you think China need to default on the currency regime more quickly or further?

Thank you.

ECONOMY: Last question.

QUESTIONER: (Off mike.) -- that's whole rebound issue that one of the potential things that's causing -- giving them pause as they try to change their economy is they're worried that by allowing the service end to grow and allowing the small and medium enterprises to have more say in what goes on in the economy, that they -- the party will have some -- (inaudible) -- questions?

ROACH: Well, those are all great questions.

No, I haven't changed my view on the currency as a mechanism for rebalancing. I think that's a red herring. It's not the way to go in solving global problems. I realize that runs against the grain of the Washington consensus who believes that currency adjustments are the answer to any major imbalances that emerge between economies. I beg to differ. I think that today's global imbalances are a manifestation of structural disparities in savings patterns, the lack of a safety net in China, and bubble-dependent American consumers. These characteristics of both economies - the U.S. and China - have very little to do with currencies.

That's not to say that it won't be politically expedient for superficial politicians, a few of which reside in this town, to focus on the currency as the foil by which they can try to assuage the complaints of their understandably disgruntled workers. In fact, I wouldn't be surprised to see another one of these crazy currency bills come out of Capitol Hill with bipartisan support. The question then arises: Is a President who laid his cards on the table a month or so ago on Chinese tire imports into the U.S., willing to say no to that type of legislation going into a mid-term election with the unemployment rate above nine percent? That's a big risk out there, and I

think, you know -- I wouldn't be surprised to see the currency lever once again become a political foil in this contentious political climate.

John, your question on the politics of rebalancing is a really important question, and all I can say is that the emergence of a consumer-led society in any nation is typically associated with more individual choice, a broadening out of aspirations across the nation, and an IT (information technology)-enabled connectivity of cell phones and Internets. That allows people on the outside to now see what's going on on the inside. If the economic gains start to spread, and that is not accompanied by political reforms to say nothing of economical reforms, there could be a new outbreak of tension. That is a very fair and important point - and an especially challenging one for China going forward.

And I have forgotten the other questions.

ECONOMY: Okay. Questions on whether their support of our debt is one of the more unsustainable elements of the -- (inaudible) --

ROACH: Well, China's support of our debt is an outgrowth of their own imbalance - namely, that they continue to derive a disproportionate share of their growth from exports. Nor do they want to take any growth risks by letting the currency work against their export competitiveness. I suspect that as China moves away from the export model then the urgency to defend the currency will begin to diminish. I also suspect, as I said in my opening comments, that China's current account surplus will begin to diminish as a share of their GDP, leaving the nation with less surplus saving to send our way in order to fund our debt.

So if we don't come to grips with our own debt issues, the -- I think the odds are that going forward the external financing is going to be more difficult to come by and especially on the very attractive terms that we have enjoyed in recent years from the world surplus savers.

ECONOMY: Well, please join me in thanking Steve for an engaging and illuminating talk -- (applause).

The Project 2049 Institute would also like to thank CFR.org for their generous assistance with the event transcript.

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