"Crouching Tigers": Emerging Challenges to U.S. Entertainment Supremacy in the Movie Business

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Abstract

This manuscript analyzes the dynamic change that globalization is bringing to the international knowledge society and the businesses related to this economic sector. Over the past twenty years the American economy has made its final transition from the industrial age to the information age, and if one looks at the export sector it shows that large media, software and pharmaceutical firms dominate the American export economy. While conventional wisdom assumes that the economies of scale that benefit classic manufacturers will also enhance the competitive position of firms that deal in the more intangible outputs of ideas, creativity and soft power, the author of this article argues that there are several countervailing forces that might slow the dominance of American firms in the world knowledge economy. The first is the rise of potent knowledge economies in Asia, Russia and Europe. The second relates to the devolutionary force of Internet Protocol technologies that provide new avenues of distribution for knowledge exports. Focusing on the Movie Business, the author examines to what extent these forces slow one of the major areas of American export success at a time of great global economic imbalances and increasing U.S. internal and external deficits, and also shows why these countervailing factors must be a source of great concern to policy makers.

Introduction

This paper will analyze the dynamic change that globalization is bringing to the International Knowledge Society and the businesses related to that economic sector. Over the past twenty years the American economy has made its final transition from the industrial age to the information age. To look at the export sector, the dominance of the Knowledge Economy is even more striking. Large Media, Software and Pharmaceutical firms dominate the American export economy. The conventional wisdom assumes that the economies of scale that benefit classic manufacturers will also enhance the competitive position of firms that deal in the more intangible outputs of ideas, creativity and soft power. However, there are several countervailing forces that might slow the dominance of American firms in the world knowledge economy. The first is the rise of potent knowledge economies in Asia, Russia and Europe. The second relates to the devolutionary force of Internet Protocol technologies that provide new avenues of distribution for knowledge exports. To the extent that these forces slow the one area of American export success, at a time of great global economic imbalances and increasing U.S. internal and external deficits, these countervailing factors must be a source of great concern to policy makers.

This is not just speculative. Already we are seeing resistance to American intellectual property policy. In India, local pharmaceutical companies have reverse-engineered U.S. AIDS drug molecules and sold them for 20% of the U.S. price on the Indian and South African market. China and Brazil have officially embraced Linux as the “correct” software platform to build large applications on. This has led Microsoft, for the first time in its history, to open its source code to the Chinese government in order to compete there. In the media business we have seen a continued rise in the incidence of piracy of U.S. entertainment product combined with reluctance on the part of the media conglomerates to adjust prices in local markets to combat piracy. To make matters worse for American media giants, the low cost of digital production tools is allowing foreign TV producers to make huge inroads in their local TV schedules. While U.S. special effects driven motion pictures still perform well around the world, American TV series are increasingly scarce on foreign networks. The issue of the relative weakening of American dominance in the culture sphere has two components. The first is the pure economic aspect of whether the export of entertainment and software (currently the leading US export having passed aviation two years ago) will decrease in the next ten years, buffeted by the twin headwinds of foreign competition and piracy. The second and more subtle question revolves around the soft power role that U.S. entertainment exports play in defining our societal values to a potentially hostile world.

Instead of trying to review the whole of U.S. knowledge exports, we will focus on the media sector. Our purpose is to understand if U.S. domination of global entertainment is at a turning point. We have used the motion picture business as a proxy for global popular cultural influence for two reasons. First, because the movies have been the traditional way the US speaks to the world about its culture and has been the way foreigners understand day-to-day life in America. Second, because the movie business starts with public exhibition in theaters, the ability to track the relative popularity of various films and genres over time is greatly enhanced. We believe that there are indeed strong global media forces being developed in regions of Asia, Russia and to a lesser extent in Latin America that will eventually challenge US domination of world motion picture distribution. We will try to provide both a timetable and a rationale for this shift in the course of the paper.

Historical Background

The notion that the United States has always dominated the world cinema is a mistaken notion. There have been periods where other actors were prominent and even periods when the cultural influence of foreign cinema in the US was quite powerful. To understand this dynamic, it is necessary to return to the early years of the motion picture business from 1900-1917. Although Thomas Edison is generally acknowledged to be one of the pioneers of early cinema, there is ample evidence to assert that the Melies Brothers in Paris, France were equally important in the early years of cinema development. The fact that both Edison and Melies endorsed a single “gauge” for motion picture film stock so that projector technology was quickly standardized around the world is their most important cooperation. Whereas the early pictures out of the Edison studios in New Jersey were more focused on telling very simple stories, the Melies Brothers were experimenting with special effects and more elaborate storytelling from the start. By 1903, Gaston Melies had opened a distribution office in New York, and Charles Pathe, the other dominant power in early French Cinema, followed him two years later. Edison had formed the Motion Picture Patents Corporation and seemed more interested in protecting his patents than in finding good storytellers. He regularly sued rival picture producers who refused to pay him royalties, and so his pursuit of monopoly control of the motion picture trade stifled early creativity in American movies. The French were more than willing to fill the vacuum, and by 1910, the French films were gaining significant share in the American market. Since a silent film only needed English titles to transform itself, the cost of producing an English version of a French Film was insignificant. This development was denounced both by the Patents Trust members as well as local politicians ever eager to play on fears of “foreign influence” over unsophisticated US moviegoers. Much of the worry was directed towards the possibility that the sophisticated (read sexual) influence of the French Cinema might inhibit the integration of the huge European immigrant influx into the moral norms of Protestant American society.

The influence of the European cinema (the Italians and Germans had both started importing films in 1910) came to a crashing halt in 1917 with the advent of World War I. All three of the dominant European cinemas stopped any significant production and the American companies rushed to fill the vacuum. The timing was perfect in that the influence of Edison’s Patent Trust was waning. Many producers had fled to California to escape the enforcement efforts of the Trust and slowly the diverse group of former garment makers who made up the production ranks was coalescing into a few stronger companies that were to become the core of the Hollywood Studio System. By 1920 Paramount, Metro, Warner Bros., Universal and Fox had been incorporated and a group of banks (primarily led by A.P.Giannini’s Bank of America) had begun to lend money for production. Thus began the golden age of Hollywood. This domination of the world motion picture business by Hollywood continued unabated through two world wars until 1946. The domination was based on a vertically integrated film business in which all aspects from script and talent development, through production and distribution and ending in complete ownership of the exhibition business allowed the studios to maintain a consistent flow of high quality product to feed the dominant home market while building distribution branches in most major foreign markets. While the cultural influence of foreign cinema production such as the German and Russian Cinema of the late 1920’s and early 1930's was powerfully felt in the writing and directing community in Hollywood, the box office of foreign films never threatened Hollywood's lock on the international movie going imagination.

However, the post World War II innovations in both European and Asian cinemas did begin to mark a challenge to American movies in markets such as France, Italy, Great Britain, Japan, Sweden and India. The innovation was driven by the adoption of lighter weight cameras made in Europe (Arriflex, Aaton) that had been developed for newsreel production. Unlike the cumbersome Mitchell cameras used in Hollywood that required a mechanical crane to move, the hand held cameras allowed production on the streets with minimal crews and an absence of set-building. In Italy the movement was called Neo-Realism and in Franc it was named The New Wave. Directors in Italy like DeSica, Fellini and Antonioni began to make films that reflected the real world stories of their countrymen and featured actors who had less of the perfection of the Hollywood stars. In France by the late 50's, directors like Truffaut, Chabrol and Godard were telling romantic tales of sophistication that would have never passed the Hollywood Code of Screen Conduct. In Japan, Kurosawa began to film epics from the Samurai period that allowed him the freedom to criticize the debasement of the Imperial Household by the occupation powers without dealing with specific contemporary politics. It should be noted that other directors of note sprang up in India (Ray), Sweden (Bergman) and the U.K. (Schlesinger and Richardson). While American movie companies were busy fighting the encroachment of television on movie attendance and the efforts of the anti-trust authorities on their vertical monopolies, the Europeans and Asians were beginning to develop new story-telling techniques. Bergman and Fellini's use of surreal elements in their films (*Persona, 8 ½*), Kurosawa's ability to tell the same story from three points of view (*Roshamon*) are only a few of the outstanding examples of foreign innovation. To foreign audiences, the Doris Day comedies or the plodding biblical epics of the 50's seemed to pale by comparison with their local fare and so for a decade the Hollywood dominance of world cinema began to decline. What is more remarkable was that the European and Asian influence began to reach the American elites and the plethora of "Art Houses" began to spring up in every major city in the U.S. this cultural disconnect between what the major studios were producing and what the upscale audience was watching reached a crisis in 1969 when several of the major studios were on the verge of bankruptcy. It was at this point that a young director named Dennis Hopper, schooled on French New Wave cinema made *Easy Rider.* The film, shot for $400,000 using the hand-held techniques went on to gross over $50 million and ushered in the American New Wave.

Hopper's movie led to the hiring of many filmmakers fresh out of the premier U.S. Film Schools (USC, UCLA, NYU): Francis Coppola, George Lucas, Martin Scorsese, Steven Spielberg. These directors single-handedly revived a dying American film business and by 1977 had once again vaulted US film exports to the top of the world cinema scene. Although most of these directors started out making small personal films (*Rain*

People, THX 1138, Mean Streets, Duel) they soon were offered big budgets to make Hollywood films (*Godfather, Star Wars, New York New York, Jaws*) and the Blockbuster was born. Spielberg and Lucas are most remarkable because they understood something that very few in the Hollywood power structure grasped. The prime untapped audience for films was young males in the 14-30 age range; their contemporaries. The attraction was the unleashing of dormant Hollywood special-effects expertise. Although the first special effects films were primarily using models and matte-paintings, the craft (honed to perfection by Lucas' Industrial Light and Magic Company) developed rapidly with the introduction of massive computing power by Silicon Graphics and Sun Microsystems. These workstations developed for industrial Cad-Cam design in the automobile and aircraft businesses, soon became the core of Hollywood's "secret formula" for export success. The Lucas-Spielberg notion that young males would be repeat customers for these effects laden films proved prescient and they were able to radically elevate box office receipts past the $100 million mark. Furthermore, the advent of ancillary revenue streams from toy marketing, cable sales and then home video markets changed the profit profile for the major studios. And the increasingly powerful marketing machine made possible by simple plots that could be encapsulated into a 30 second TV advertisement allowed these same films to work in overseas markets on a scale unknown before 1975. At the very point that Hollywood had developed a new action genre, the European and Asian local producers began to experience a crisis of talent, which closely resembled the American experience of the early 60's. The inroads television was making into local cinema attendance and the talent drain going into TV and commercial production led to an artistic crisis in the late 70's across France, Italy and Japan. This created the Perfect Storm, which allowed the American Majors to totally dominate world cinema screens throughout the 80's.

Snapshot 1990

If we were to make a tour of local cinemas around the world in 1990 you would find that the films of Harrison Ford, Sylvester Stallone or Arnold Schwartzenneger would be playing almost everywhere on the globe. This was partially due to the dominance of the distribution divisions of the major studios in most foreign markets, but could also be attributed to some innovative financial strategies on the part of independent U.S. companies like Carolco. Sensing that local foreign distributors needed to compete with the US Majors, Carolco mounted several big budget films (*Rambo, Total Recall, Terminator*) that it pre-sold to local foreign distributors in each market. Needless to say if Medusa Film in Italy was putting up millions to pre-buy *Terminator*, it had less capital available for local productions and so the dominance of American Product became more pronounced. In Europe the French, Italian and Spanish production output was slowing and there was no attempt to compete on a large production scale. The old guard directors were long in the tooth and no new "auteurs" had emerged. In South Korea, American films had over 80% market share and there was almost no local production output. In Russia, the collapse of the Soviet Union with its built in-home market, led to dissolution of Mosfilm, the state sponsored film studio. In Latin America, the good money was in the production of TV Telenovelas and although the Brazilian film business continued to produce, the Mexican and Argentinean production output was at an all-time low as strapped governments cut off film subsidies. In Japan, the large capital companies like Matsushita and Sony decided to make their investment bet by buying American Film studios (Universal and Columbia) at the top of the market frenzy in the mistaken assumption that ownership of content could lead to technical standards domination for their respective consumer electronics platforms. This was a curious mimicking of Thomas Edison's mistake and Matsushita soon gave up, selling Universal to the Canadian Spirits company, Seagram's at a loss. Sony refused to admit its mistake but did write off 60% of the purchase price just five years after the acquisition of Columbia Pictures. Finally in India, the Bollywood film business had evolved a star system and a musical genre that was attracting record domestic audiences and beginning to get distribution in the Gulf States and other areas where it's curious combination of chaste romance, violence and musical dance numbers could pass local censorship barriers with ease.

The Basis For US Cultural Dominance

It is quite clear that the basis of US dominance in international film distribution rests on four pillars.

1. Although it is not the largest market in terms of admissions, the US "home market" is still the biggest source of income for all movie companies. US ticket prices are high enough to generate $9.5 billion per year in theatrical revenue, which ranks at the top of all markets per year.
2. The US development of sophisticated digital special effects has created a unique franchise that has allowed American films to amaze the world's audience. When a film like *Jurassic Park* can simulate photo-realistic dinosaurs, the need for culturally specific story-telling skills is obviated by the wonder created by the special effects. As we will see, this special effects expertise is beginning to be diffused and there is strong evidence that in New Zealand, Russia, China and France there are ample computer generated effects "shops" in place to challenge this American specialty.
3. The "cultural discount" for English language films is lowered every year as English as the world's second language infuses itself into school curriculums in most countries.
4. The US has the most mature legal copyright environment in which to exploit ancillary revenues (DVD, Video On Demand) for feature films. While Indian and Chinese films may perform well in

theaters, they generate relatively little revenue in the DVD market. Hollywood films generally generate more revenue in the DVD markets than in theatrical markets.

While all of these factors have kept Hollywood in the drivers seat (**Figure 1**) in the past, there is no reason to believe that any of these (with the possible exception of the English language cultural discount) are not undergoing profound changes in the globalization climate of today.

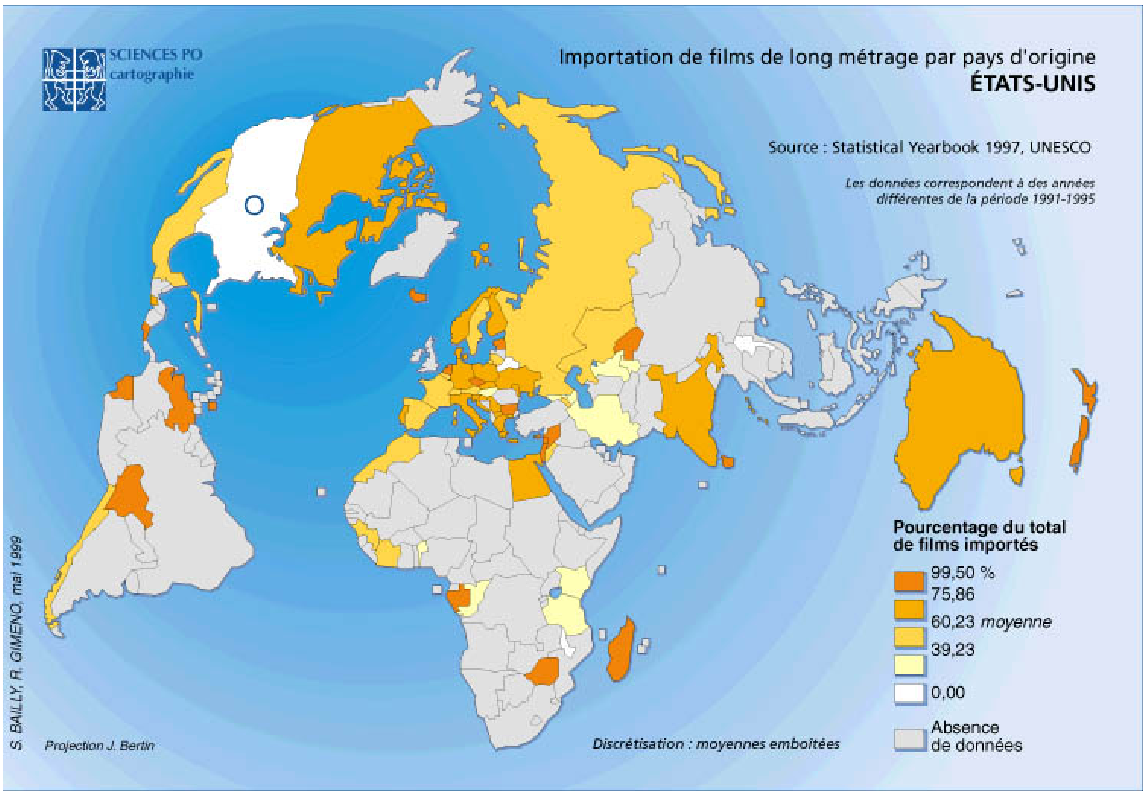

Figure 1-US Global Film Exports-Source: UNESCO

Challenges to American Cultural Dominance

In assessing the long-term dominance of Hollywood, several key factors aside from the ones previously mentioned, stand out as potential weaknesses in the American market.

1. The U.S. movie market is relatively mature with flat YOY ticket sales (**Figure 2**) for the last five years. It is clear that all the growth in film revenue is coming from outside the U.S. domestic market.
2. Even in the face of a flat domestic market, U.S. major studios have been unable to contain production and marketing costs. The MPAA recently reported that the average movie in 2004 cost $98 million to make and market.[i] Although the recent growth in DVD sales has compensated for this, we are quickly reaching market saturation in the DVD market and there is no sign that talent is willing to restrain its demands for higher compensation. A good part of this is brought on by a "Winner Takes All" mentality at the major talent agencies. Given their distrust of Studio accounting practices, major actors, directors and writers increasingly are looking for higher levels of guaranteed compensation that is not tied to the success of the film.
3. Given extremely high average production and marketing coast, Studios have fallen into "green lighting" pre-sold properties, leading to an overabundance of remakes and sequels. Although the belief that the sequel of a hit movie will generate at least 75% of the revenue of the original still holds firm in Studio boardrooms, there is increasing evidence that the public has tired of this trend (viz. *Electra, Tomb Raider II, Son of Mask*). There is also anecdotal evidence that Studio overproduction is causing marketers to spend more money to "open" a film in a competitive market where often four new films per week are opening. Second week box office declines of 50% or more are now common.

The Digital Revolution and Globalization

In studying the future of global film distribution one issue stands out as the potential "change agent" that could redraw the map: the Broadband Internet. The rapid worldwide diffusion of Broadband has the potential to create a distribution system that is no longer dominated by the five American "Majors". As the peer to peer distribution networks have already shaken the worldwide music business to its core, there is no reason to believe that Broadband and peer to peer distribution will not have a similar effect on the film business. The basic question revolves around whether the development and adoption of digital rights management (DRM) technologies can get out in front of the pirated catalogs of films already spreading over the net. Current DRM technology is much more secure than the Studios and their advocacy organizations (primarily the Motion Picture Association of American -MPAA) would like to admit. The basic piracy problem stems from two causes. First there is significant "leakage" in the studio post-production chain, with perfect digital copies of films coming out of laboratories and editing rooms. Second, the current DVD standard is not secure from a DRM point of view and an easy hack to the DVD encryption has been posted on the web for the last four years. In an ideal world, the DVD encryption standard could be rewritten to resemble the more "session-based" DRM technologies such as Microsoft's Windows Media DRM that require a "key" for each play of the movie and which separate the "key" and the player. This of course would mean a whole new generation of DVD players and there is ample evidence that Hollywood is headed in this direction. However, in a classic repeat of Edison's Patent Trust folly, the Sony Corporation is trying to use its ownership of two studios (Columbia and MGM) to advance its proprietary High Definition DVD standard (BluRay) in the face of other studios desire to use a backwards compatible High Definition DVD that would still be able to play customers existing disks as well as securing the new HD DVD's with "session-based" DRM. Whether BluRay will go the way of Sony's other Waterloo (Betamax) is still an open question. But as long as there are two competing HD-DVD platforms, the market will be frozen and the existing weak encryption DVD's will continue to be produced and copied on to the net. In early May, 2005 Executives from Warner Bros. and Sony began a series of meetings to resolve this impasse. Warner has supported the Toshiba HD-DVD standard (with quiet backing from Microsoft) and has gotten Fox and Universal on its side. Sony has announced a tentative pact with Disney to support BluRay. There is reason to believe that Sony may have to compromise and agree to a backward compatible player technology.

Assuming this technical conundrum could be overcome, the possibility inherent in legitimate broadband distribution of films is remarkable. Two scenarios can be posited from the study of the music business experience with Internet Distribution. The first posits that a great deal more content would get distribution than currently. The existing business runs on what is called the "80-20 Rule"; i.e. that 80% of the revenues are generated by 20% of the production. It is assumed that only a limited number of movies will be hits and the rest will be written off. Chris Anderson of Wired Magazine has described a new selling model called "The Long Tail", in which on-line music retailers are finding that even the most obscure content sells at acceptable levels. Although the average "Bricks and Mortar" record store might have a total of 8,000 CD's (or 50,000 individual tracks), digital music services like I-Tunes and Rhapsody currently have close to 1 million tracks in their inventory with 95% of the tracks selling at least once a month. Since the cost of adding one more movie to a server-based IP distribution system is close to zero, there is no reason to believe that the Long Tail wouldn't also apply to Broadband Internet film distribution.[ii] Already Microsoft and Intel have created to PC to TV connection with their Home Media server platform and so the IP connection to the Television is in place. The second obvious corollary of this IP-TV revolution would be that the cultural Diasporas of the major competitive filmmaking powers (China, India, Russia and Latin America) would be able to access their country's movies regardless of location. The fact that there are 20 million non-resident Indians (NRI) dispersed in western countries with little or no access to Bollywood's output is a simple case in point. These NRI's are extremely wealthy (combined net worth of over $20 billion) and retain strong cultural ties to India. However, the current film distribution system does not serve their needs. Two weeks ago I was contacted by some Indian entrepreneurs based in Minneapolis who have constructed a Beta site for the distribution of Indian films in the US. It seems like this is just the beginning of the Diaspora movement. It is clear that several Chinese companies, including a division of Phoenix TV had explored distribution possibilities for Chinese films in the US. This would seem like the next natural market development, given the size of the US Chinese Diaspora.

The second effect of the international dispersion of digital technology is that the US dominance of special effects technology is coming to an end. Japanese and Chinese developments in super computers as well as the software dispersion of such popular tools as Alias worldwide have begun to level the playing field in high end special effects. Already Peter Jackson's effects shop in New Zealand that did most of the Academy Award winning work on *Lord Of The Rings* has been contracted to supply the effects work for Disney's *Chronicles of Narnia* and Universal's *King Kong*, the two largest special effects pictures of the next year. The Russian special effects work in *Nightwatch* has been cited as the premiere reason it was picked up by 20th Century Fox for distribution. In addition there is growing evidence that the Computer animation competitive advantage which the US has maintained over the last 8 years is now migrating off-shore as well. Of the two great Computer Animation companies in the U.S., Pixar (*Toy Story, The Incredibles)* and Dreamworks (*Shrek*), Dreamworks has already begun outsourcing computer animation work to South Korea.

Potential Challengers to U.S. Cultural Domination

Asia

As is clear from the chart (Figure 1), the Asian market has the largest share of theatrical admissions in the film business. What is most fascinating about our research is

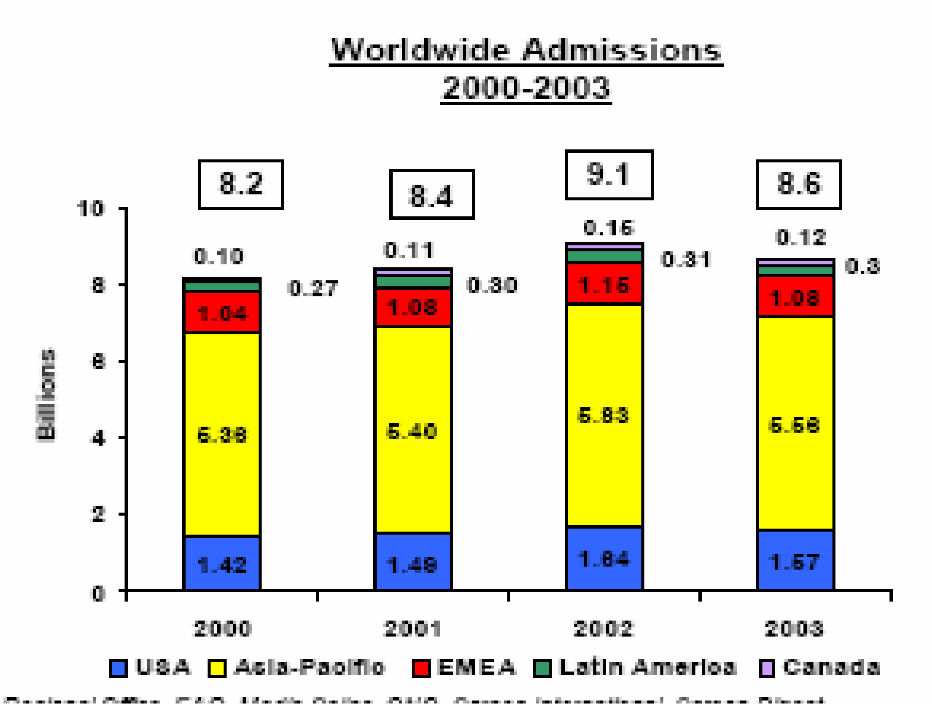

Figure 2-Global Theatrical Admissions-Source MPAA

the growing realization that this dominant position will only increase over time. With the Chinese market just beginning to add modern Multi-plex theaters, it is clear that the market will continue to expand rapidly. What is most telling about the macro view of the Asian market is the growth of Inter-Asian media trade. We are calling this the Asian Co-Prosperity Sphere. Examples abound. Japan and Korea, traditional cultural enemies for years are experiencing a rapid growth of media trade. When young Korean actor Bae Yong Joon recently flew to Tokyo to promote his film *Winter Sonata,* the police had to be called to clear the crowd of 8000 middle aged Japanese women who had mobbed Narita Airport to greet him. As 75-year-old Hisa Nomura of Tokyo told The Yomiuri Shinbun reporter, “I'm struck by a sense of nostalgia when watching South Korean dramas because I can see the ‘good old Japan’ in them. The characters hold ancestors in great veneration and respect their family members.” Strangely, this love for Korean films does not seem to be affected by recent political strains between the Korean and Japanese government over Japan's desire for a permanent seat on the UN Security Council. The attraction of the Korean films in Japan seems to be rooted in a more nostalgic desire to find role models rooted in respect for elders. But the success of Korean films in Japan is not unique. Japanese TV dramas are finding an audience in Thailand

and Chinese films beyond the Hong Kong fight genre are finding widespread acceptance throughout the region. It must be said however that in general 25 years of Japanese cultural exports to the region have not really aided Japanese diplomatic and soft power relations with its Asian neighbors. This may be a unique situation in that Korean and Chinese memories of Japanese World War II actions on their land have a staying power that no amount of Anime success can overcome.

Looking to the sub-continent, the distribution of Indian films throughout the region is still somewhat limited (**Figure 3**), there are increasing signs of India-China cooperation. Finally, and most importantly, Chinese filmmaking seems to be

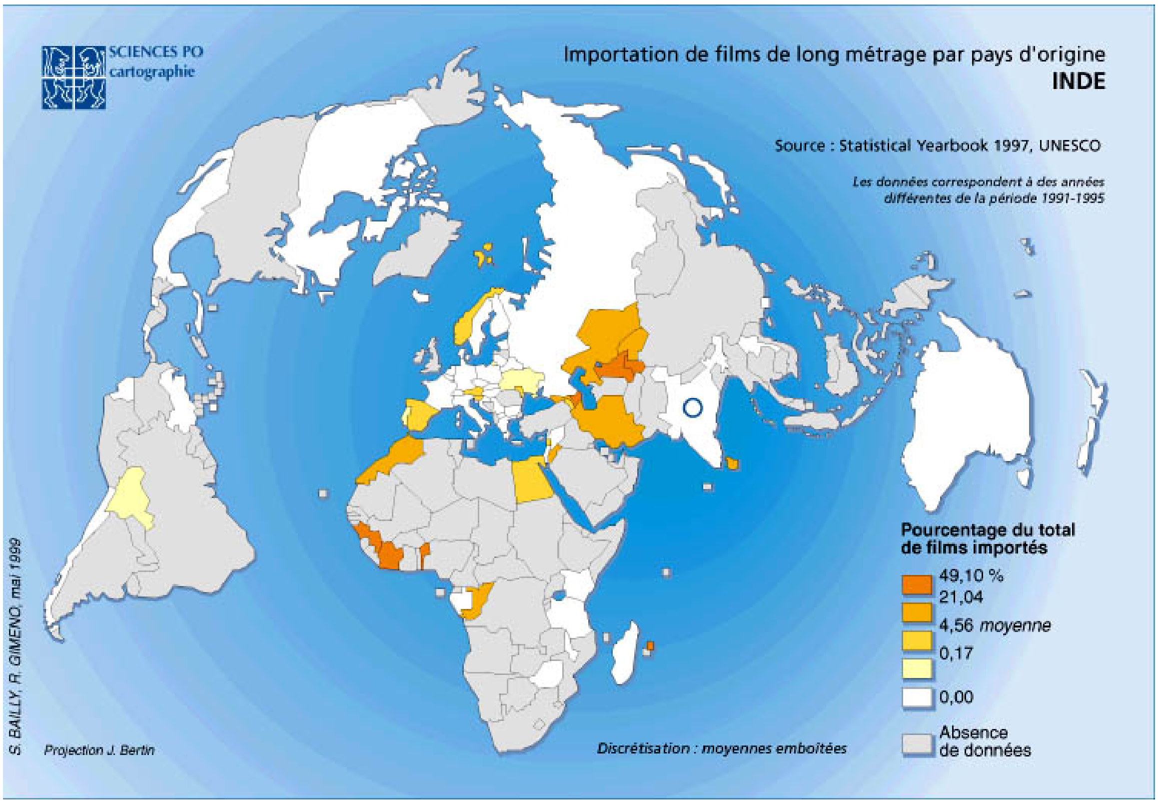

Figure 3-Indian Film Exports-Source: UNESCO

slowly escaping the bounds of heavy-handed state censorship. The ability of directors like Zhang Zimou (*Hero*) to attract worldwide audiences has created a new pride within the state film bureaucracy and a new willingness to let filmmakers expand the boundaries of genre and budget. This will only increase as China (with the help of foreign co-investors) expands its film exhibition and distribution infrastructure.

Regional Survey

China

As we have mentioned, the key to export success in any film business is a strong and growing home market. In this respect, China is poised to be the new regional power. Although its existing media infrastructure is quite large, it is clear that major changes are underway. China supports over 2,000 newspapers, 9,000 magazines and 568 publishing houses.[iii] This extensive print sector reflects the practice of every ministry and party body to have its own house organ. It is clear from recent party statements that there will be a major reduction in this sector and so far this year over 1400 periodicals have been shut down or forced to finance themselves.[iv] In the Broadcasting sector, an audience of over 700 million Chinese listens to 1000 radio stations and there are over 200 TV Stations broadcasting 2,900 channels.[v] The state cable TV franchises have over 100 million subscribers and the state has vowed to complete the shift to a digital TV platform by 2015. Most importantly there are over 87 million Internet users, many availing themselves of the Cyber Cafes in almost every city. What has been lacking in all sectors until 1998 was a vibrant advertising market. This has begun to grow and advertising spending across all channels in China last year reached $7 Billion.[vi] In the Film business investment has still lagged as China has only 800 modern Cinemas in a country of 1.25 billion people. However, this is changing rapidly as foreign investment in Multi-plexes will increase the total by 120 theaters with at least five screens each by the end of 2006.[vii] Against this background the State Administration for Radio, Film & Television (SARFT) has announced major changes in liberalizing the rules for foreign investment in China's media sector. The major effects of these are as follows:

1. Foreign Companies will be allowed to own up to 75% of any venture to "upgrade film production and projection infrastructure, technologies and equipment."
2. Foreign satellite companies will be allowed to downlink to hotels ranked three stars or above.
3. Pay TV channel operations will be opened up to private companies as long as there is a majority state owned partner.
4. Foreign co-production of content will be allowed and as of the end of 2003 SARFT had approved over 42 Sino-foreign joint venture companies to produce film and television content.
5. The number of imported films per year was increased to 70 from 50 and the maximum foreign broadcast content will be increased to 30% from 25%.
6. Censorship and script approval will be simplified, only requiring a 1000 word summary of the script. Certain regional authorities will be given permission to approve scripts shot in their regions (Shanghai, Jilin and Guangdong).

Given this sea change in state control over the media sector, we believe the Chinese film business is about to undergo a surge of productivity. The reasons for this are quite numerous.

1. China's growing urban wealth has created the conditions for a vibrant local exhibition market. Warner Bros. Has already made a large investment in Cinema construction along side a Shanghai government entity. Although China is still the most "under screened" major country, by 2009 the major cities will approach a more normal level of one screen per 15,000 people.
2. Local urban ticket prices are already beginning to climb, reflecting the citizen's willingness to pay for a better theater experience. Still, many theaters remain unimproved as the experience of one reporter entering the Hujialou Theater in east Beijing attests. "As soon as you walk in the door your senses are hit by the auditorium's damp smelly air that evokes a warehouse. Many of the seats have holes in the upholstery, food stains or are broken outright. The speakers rattle when the soundtrack hits the high notes. And the doors don't shut properly, creating streaks of light after the feature starts"[viii]
3. The growing ancillary markets in China; especially the Pay TV business could provide a secondary revenue stream for a business that has had to rely primarily on theatrical box office revenue. As a report from Coudert Bros. Recently noted "SARFT can be viewed as simply trying to catch up with a market where there is near universal access to cheap pirated digital media containing uncensored (and often untaxed) content of every kind. China's regulators and foreign media groups increasingly have shared interests in attracting audiences to cinemas and other legitimate distribution channels"[ix]
4. Artistically, the Chinese writing and directing community has matured to the point where they are the equals of the world's best. Directors like Zhang Yimou are part of China's legendary Fifth generation of filmmakers, who came out of the Beijing Film Academy in 1978, shortly after the Cultural Revolution. For years they have artfully tried to evade the heavy hand of government censorship by using allegorical stories set in China's distant past to speak to contemporary longings for freedom and heroism. As Zhang observes that while Western heroes tend to be more individualistic, fighting for themselves, "Chinese heroes are sacrificing themselves for their country or for other people. One isn't better than the other, they're just different. We're the result of thousands of years training."[x]
5. This global acceptance of Chinese film (including major film festival awards) has led to increasing Chinese exports to the major film capitals in Europe, Asia and North America. Aided by the large Chinese Diaspora, it is expected that this will only increase. Notably, Netflix (the US online DVD rental service) has increased its inventory of Chinese pictures by 200% over the past 18 months.

Our general conclusion is that China represents a strong challenge to US film exports in the Asian (including Diasporas) market. As the internal Chinese Theatrical exhibition market grows at 15% YOY, we believe that the possibility of larger budgets with more special effects will allow Chinese filmmakers to increase production values and attract more export business as well. However the import restrictions on US films into China will remain in place for some time to come. It appears for the only way for US majors to pierce the China market will be to finance Chinese language productions through Joint Venture companies. Viacom and News Corp (Fox) seem to be the most aggressive players in the JV strategy. If the quota for imported US pictures remains at 70 per year, the success of those US pictures that do get imported will remain high despite any other trade frictions that make occur between the US and China. The increasing number of first class theaters will ensure higher grosses than US pictures have earned in the past. However, the DVD market still remains problematic in that the Chinese government has not taken action against the more organized vendors of pirated DVD's. Although rumors abound in Hollywood about senior officials in the Chinese People's Army having interest in DVD duplicating plants, the question of whether a wholesale crackdown on pirated DVD's remains the biggest stumbling block to rising revenues for Hollywood in China.

South Korea

South Korea is one of the prime examples of the use of import quotas to protect and foster a local filmmaking culture. In the late 1980's, the South Korean film industry was pretty much dead. Most Korean film distributors were spending their available capital buying the Korean rights to large American blockbuster films made by US independents like Carolco (*Rambo, Terminator*). Then in 1991, the South Korean government instituted a law that mandated that every movie theater must devote 40% of its "screen days" to South Korean films. Following this move, the government also instituted a film school scholarship program in which promising Korean directors were sent abroad to European and American film schools for training. By 1993, South Korean films still only had a 15.4% share of Korean ticket sales.[xi] However, by 1999, the results of this program were beginning to show promise and for the first time South Korean films began to attract significant local audiences. That year nine of the top 20 box office draws were homegrown productions, with Kang Je-gyu's *Shiri* becoming the first Korean blockbuster with ticket sales of $26 million on 5.5 million admissions. By 2003, local product had moved to 53% market share and the first significant export business for Korean distributors was taking place at the Cannes Film Festival. That year saw Kang's Korean War Epic, *Taegukgi* gross $56 million domestically and attract an addition $12 million in foreign sale guarantees.

One of the reasons behind the significantly higher domestic box office takes have been the growth in local screen count from 497 to 910, with most of the new theaters being multiplexes. This availability of movie theaters has boosted annual admissions from 4.8 million to 10.5 million and annual box office from $208 million to $555 million.[xii] At the same time film exports have gone from $492,000 in 1997 to $31 million in 2003 with the largest totals coming from Japan, Hong Kong and France. The success of the Japanese export market for Korea has been notable. Overcoming 50 years of cultural and political enmity, the Japanese audience has responded to Korean filmmaking in unexpected ways. The Korean TV drama *Winter Sonata* was such a success in Japan that Japanese tour operators have sold out with tours of the locations of the film and the spillover effect for both Korean films and music has been pronounced. Now the two countries have launched Japan-Korea Friendship Year 2005 and plan many cultural exchanges as well as easing visa requirements for travel between the two countries. Given that Japan has traditionally been the largest export market for American films, the increasing popularity of Korean films will probably come out of American market share given that the Japanese market is not growing overall in yearly admissions.

For the South Korean film industry the most pressing issue currently is the US effort to reduce the screen quotas. The U.S. has offered a bilateral investment treaty contingent upon Korea reducing the local screen quota to 20%. Although local filmmakers are resisting this move the Korea International Trade Association has urged the government to agree to the U.S. pre-condition.[xiii] The American push to lower screen quotas is part of the MPAA's strategy to push back into Asian markets. It is not clear if this will be successful, even if the Koreans consent. There is considerable evidence that local distributors are coming to believe that producing Korean films and owning worldwide rights can provide a better ROI than simply buying South Korean rights to American films. Given that exports of Korean films in 2004 rose to over $40 million, there is no reason to believe that the "Asian Co-prosperity Sphere" will not continue to advantage local filmmakers.

Finally it must be noted that South Korea continues to lead the world in Broadband diffusion, with almost 70% of the market having home access to 5 Mbps connectivity. This has had a dramatic effect on the massive multi-player video game market with a growth of over 65% YOY in online subscriptions and a huge surge in game production in South Korea. The effect of this lead in broadband will continue to filter into the film distribution market in the next three years as a service called Anytime begins distributing first run films (both Korean and American) to the home over broadband. Already surveys show that 60% of Korean households chose the film they plan to attend in theaters by watching the trailer over home broadband. As the US drops to number 16 in per capita broadband dispersion, it will have to watch Asian marketers take advantage of ubiquitous high speed service as a film distribution tool.

Japan

Unlike Korea and China, Japan's strength in the commercial film export trade rests on a niche strategy of animation expertise. The Anime and Manga genres developed in Japan and now spreading throughout the world represent a special level of expertise that does not seem replicable in the U.S. or even other Asian countries. Significantly, Japan has produced four of the top ten foreign language export successes: the Anime blockbusters *Spirited Away* and *Princess Mononoke*, the Manga gangster caper, *Bayside Shakedown 2* and the epic, *Antarctica* about a team of sled dogs for a Japanese scientific expedition in 1958 that survived alone for six months. Disney has bought the remake rights to *Antarctica*. As Warner Bros. Japan Managing Director Bill Ireton told Variety, "The Japanese have tired of looking to the West for all inspirations and are looking inward-into Asia, embracing that philosophy, way of life, culture."[xiv]

Like the rest of Asia, this boom in local production has been accompanied by a theater-building spree. Because of the high cost of urban land, most of the building in Japan has occurred in suburban areas and most of the theaters have been multiplexes. And similar to China, an American partnership with Warner Bros. Has spurred much of the new growth. Warner Mycal (a JV of Warner and Japanese retailer, Mycal) has built 329 screens in the last ten years. In addition traditional Japanese distributors Toei, Toho and Shochiku have all expanded their theater chains. Because of the new building boom, multiplexes now out-number one-screen theaters 1,399 to 1,286.[xv]

The other area of growth rests in remake rights purchased by American Majors from Japanese producers. The success of the remake of the Japanese horror classic *The Ring* was followed by Columbia Pictures purchase of the remake rights to Takashi Shimizu's horror film, *Jou-On*, which will be called *The Grudge* and directed in English by Shimizu. Disney is also re-making a horror film called *Dark Water* and several sequels to *The Ring* are planned by DreamWorks. As Robert Tapert, the producer of *The Grudge* told The Los Angeles Times after seeing the Japanese original, "Part of what was so scary was the lack of special effects, the lack of pyrotechnics. They don't have the resources of Hollywood movies, so they rely more on filmmaking techniques and storytelling."[xvi]

What seems clear is that in live action, the horror film genre seems to cross cultural boundaries with ease, whereas Japanese dramas and comedies have had a harder time traveling outside of Asia. In the animation field, the Japanese seemed to have established their niche and will pursue it with bigger budgets, even though it should be noted that a large Japanese animation budget is usually half of a large American animation budget. As in the case with China and South Korea, the effect on the U.S. film export industry will be mostly felt in a reduced American market share in the major Asian countries. For instance, in the week of Jan. 23, 2005, four of the top eight grossing films in Japan were Japanese productions. Contrast that to the week's results in the United Kingdom, where American films had all ten of the top box office positions.

India

By most accounts the Indian film industry is the fastest growing among the major filmmaking powers at a pace of 25% per year for the last five years. The Indian entertainment industry reported gross revenues of $4.3 billion in 2003 and is expected to rise to $7 billion by 2007.[xvii] With the "Bollywood" film industry turning out more than 800 films a year; it is clearly the most prolific film culture in the world. It must be noted that the average Indian film budget is $3 million, as opposed to the average Hollywood budget of $45 million. While for years the Bollywood industry was financed with "black money" (money laundering for criminal enterprises), it is now attracting legitimate investment funds from both television and satellite networks as well as investment funds that are being sold to non-resident Indians (NRI's) willing to finance the Indian cultural Diaspora. This is not an inconsequential group of 20 million emigrants, their combined net worth being estimated at $300 billion. This large, wealthy Diaspora population represents perhaps the most powerful asset of the Indian film industry. Although traditionally the Indian film industry madder 80% of its revenues from theatrical distribution to the more than 12,000 cinemas in India, the current breakdown of revenue is far more diverse: 9% from product placement, 9% from satellite rights, 29% from domestic theaters, 24% from music rights and 29% from international distribution.[xviii] In countries like the U.K. more than 23 satellite channels screen Indian films along with other Asian fare.

The Bollywood genre has been very restricted in its form due to the local markets insistence on sticking to the formula of chaste romance, violence and at least three major musical production numbers in each film. Attempts to vary the formula have met with strong resistance on the part of the rural Indian population and only a few "Art films" produced on small budgets do not include the mandatory musical numbers. The Indian formula has found favor in the Arab world (Figure 3) because the insistence that the romantic stars go no farther than a chaste kiss appeals to the Islamic moral code, even though one of the musical scenes usually takes place in a rainstorm in which the beautiful sari-clad female heroine might as well be undressed. Although foreign sales climbed to $335 million in 2001, we are skeptical of the Indian film industry's claim that overseas sales could reach $3 billion by 2006. This stems from our doubts on the acceptance of the musical based formula in the rest of the Asian market. Indian films to date have not fared well in China or Japan and ticket sale prices in the Arab world are so low as to cause a major disconnect between admissions and box office. (Compare figure 4 to figure 2). Ticket prices in the Indian domestic market also remain remarkably low, which accounts for large number of admissions but the relatively low box office revenues. However the ROI of the Indian film industry is clearly superior to that of the American movie business given the relatively modest budget of Indian productions. For the Indian industry to be a major challenge outside of the Indian domestic, Diaspora and Gulf regions it will have to

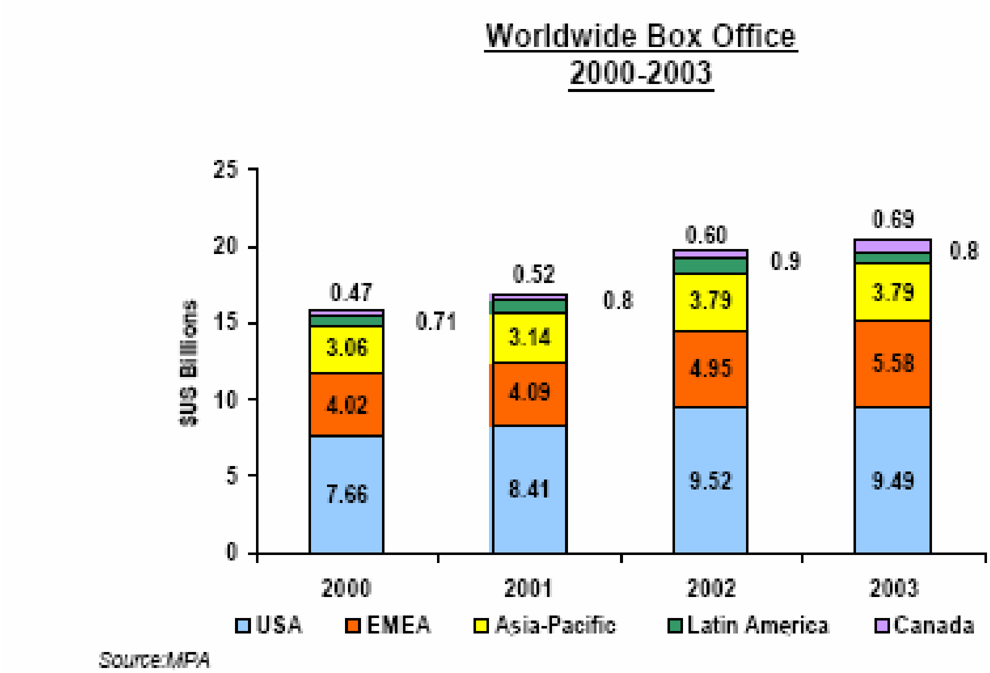

Figure 4-Worldwide Box Office Revenue-Source MPAA

Russia

Perhaps the most interesting new filmmaking power in the world is Russia. The free market reforms of the early 90 have sent the Russian film industry into a tailspin. The number of films made in Russia shrank tenfold within six years and theater attendance shrank 15 fold in the same period.[xix] At the bottom of the fall, a new generation of rich businessmen moved in to fill the cultural vacuum, but the first results were uneven to say the least. What resulted was a string of gangster pictures, full of violence and mafia chic, but utterly lacking in any of the filmmaking technique that had been the hallmark of Russian cinema since the days of Sergei Eisenstein in the 1920's. In the last four years several important changes have taken place that bode well for Russia to take its place among those countries whose domestic market can support filmmaking budgets sufficient to guarantee export success. In 2004 total grosses reached $260 million, a quantum leap from the $190 million reported in 2003.[xx] Obviously like the rest of the BRIC's (Brazil, Russia, India and China), Russia has a large, well-educated public that can support a sophisticated filmmaking industry. The second factor for success has been a considerable investment program in multiplex cinemas in both the large cities and the suburban markets. Third has been the addition of several satellite channels that buy Russian films, providing a critical ancillary market that was missing in the early 90's.Sergei Selyanov, head of St Petersburg's STV, one of Russia's leading producers recently told the Hollywood Reporter that "Russian films will be able to comfortably make a profit from domestic exhibition within a couple of years given the improvements in distribution and exhibition taking place now."[xxi]

Perhaps the most promising trend has been the application of Russian computer technological expertise to the special effects business. An indicator of the success of this initiative is the fact that 20th Century Fox recently purchased the rights to a Russian Sci-fi epic entitled *Nightwatch*, and plans to build a global blockbuster franchise out of the film and a succession of English language remakes all to be filmed in Russia by the film's original production team. Made for a mere $4 million (and earning $16 million in Russia) the film "looks like a $50 million production" according to Ray Strache, the Fox executive who acquired the film. The fact that Russian special effects teams can produce world-class effects for 20% of the U.S. cost is perhaps another example of global service outsourcing platforms that should be of some concern to U.S. policy makers. Given that the special effects business was a considerable source of U.S. comparative advantage in global film exports, we would not expect this advantage to last for long. Given the depth of writing, directing and acting talent in Russia, we would expect that *Nightwatch* represents only the first of a number of major export hits for the new Russian Cinema.

Given this early success, it is clear that the Russian government is now moving to support the filmmaking sector. The support of State run Channel One was absolutely critical to the success of *Nightwatch,* with the use of TV spots to support the theatrical opening of the film. Channel One retained TV and home video distribution rights in Russia and provides the financial backing for the smaller theatrical distribution company that released the film. The success of this TV marketing driven model is seen as the next wave of Russian movie success.

Latin America

The Latin American market continues to be a curiosity. In the television sector, "Telenovelas" (soap operas) made by Brazilian, Mexican and Venezuelan producers continue to have a very strong export market to the U.S. as well as other Latin markets. But in the film world, the balkanization of Latin culture is on display. It is the rare Argentine film that ever gets distributed in Chile. The Mexican hit *Y Tu Mama Tambien* had to be subtitled in Spain and the notion of a Portuguese film being distributed in Brazil is extremely rare. Unlike the free flow of cultural exchange that we are seeing throughout the Asian market, the Latin market is not trading media products in a similar manner. Even though we have noticed a flourishing pool of directorial talent coming out of Mexico and Brazil, it is mostly benefiting the American majors who are quick to hire directors like Alfonso Cuaron to direct their blockbusters like *Harry Potter.* In most of the Latin American countries, the distribution arms of the U.S. majors still seem to dominate the "foreign film import" business and so it is not unusual to see the American films secure 7 of the top ten slots in the local box office. Perhaps the programming needs of the enlarging Latin TV sector in the US will lead to important distribution platform for Latin American cinema in the US. Unlike the Asian and Russian immigrant populations in the US, the Latin market is well served by the existing TV infrastructure and so the need to create alternative platforms (VOD over broadband) is not as crucial for Latin filmmakers.

Implications For The United States

With all the challenges inherent in new competition from foreign film producers, it is critical to note that foreign box-office receipts for U.S. films jumped $15.7 billion last year -- a 44% rise from 2003. The growth was fueled by steep increases in ticket prices overseas. As the new head of the MPAA, Dan Glickman recently told the Theater Owners convention, "As these numbers indicate, the magic of the American movie endures, but not unchallenged." What he was referring to was the fact that domestic receipts for Japanese, Russian, Korean Indian and Chinese films rose at a similar rate as ticket prices and many new theaters opened in these countries. This of course is a short term phenomena, in that the ticket price rise was occasioned by the vast improvement in the quality of the theaters in many of the Asian markets. Now that Chinese urban ticket prices have risen to the equivalent of $7, it is clear that there will not be similar price rises on the horizon and YOY gross revenues from America's foreign export film business should flatten out. It is therefore important to try to look at a ten year time frame to assess the importance of the growth of cultural rivals to understand both the economic and "soft power" effect on this most important of American knowledge exports.

Although the U.S. will continue to adopt a very muscular view of our intellectual trade policy by using bilateral treaties to try to eliminate any and all import quotas for films and music in countries such as South Korea, China, India and Latin America, it is not clear that this effort will succeed. There are considerable internal pressures in these regions to support local filmmaking culture and there is even some anecdotal evidence that the trend is going the other way. Recent discussions in Russia have raised the possibility of an import quota on foreign films being imposed there and there is no reason to believe that the government will resist such a move. Although the MPAA has managed to get U.S. trade representatives to tie IP market opening to other trade issues (such as agricultural opening in Australia), it is clear that the Chinese in particular will resist such bundling. Given the strong financial power over the Treasury Bill market held by the Asian block, we doubt that any unilateral moves on the part of U.S. trade negotiators will have any immediate effect. More importantly, we believe the new found confidence of the Russian and

Asian filmmakers will be increasingly appreciated by their home audiences. While the Asian and Russian films may not penetrate the American market in any large extent, it is clear they will take local market share from the U.S. major studio export trade within the next 5 years. The new vitality of the Chinese, South Korean and Russian work in live-action along with the increasing sophistication of the Japanese work in Animation will continually challenge the rather formulaic state of the current American big-budget cinema. It is inevitable that these independent cultural movements will begin to challenge American cultural nostrums in Asia, Europe and Latin America. The initial force of these changes is rooted in the basic desire of people to tell their own stories. Despite the academic theorists idea that US Cultural imperialism would overwhelm local tastes, anecdotal evidence points to the simple desire of Asians to watch Asian characters interact on screen rather than watch blond bombshells flirt with James Bond type heroes. However, it must be pointed out that the greater issue of corporate "Knowledge Imperialism" is becoming an issue in many countries that view US multi-nationals as a stand in for more aggressive uses of US power. The same resistances that large software makers like Microsoft are feeling from the embrace of Open Source platforms like Linux, which have a political tinge to their rhetoric, will be faced by large American media firms. While the Brazilian President Lula declares that Linux will be the official software platform for all government projects, it is a distinct resistance to the "Microsoft Tax" being returned to the US. In addition, because the U.S. has been slow in the deployment of both Broadband and 3G wireless platforms, there is evidence that the development of on-line gaming software is migrating to Japan and South Korea where both advanced platforms are more diffused. As Benjamin Wallace-Wells recently wrote, "South Korea, which is first on the broadband diffusion list, is now the world's leader in developing online video games, the fastest-growing segment of an industry that's bigger than movies, and its software companies are beginning to lure top American programmers to Seoul."[xxii] More importantly for the trajectory of the next "breakout" digital imaging products, it is clear that both S. Korean and Japanese companies and government funded R & D labs are matching the U.S. step for step in High Definition 3D (HD3D) imaging and display.

Soft Power Implications

There was a general belief in the filmmaking communities of the world that the power to influence flows from the open cultural and trade strength of a country. There is not much evidence that the propaganda films of Hitler, Stalin or Mao had any effect outside of their own captive markets. The American creative knowledge economy can be the source of our strength if only hostile resistance in foreign capitals does not confront it. We recall the magic era of the 80's and 90's where the ideas of freedom flowed throughout the world, not from a gun but from a music tape. Today every American corporation selling abroad suddenly has a new issue to deal with: anti-Americanism. The global resistance to some U.S. military policies is causing pain throughout the international commercial system. The effects on the American consumer products companies have been powerful. International boycotts of Coca Cola, McDonalds, Marlboro, Ford, Procter and Gamble have caused dropping international sales at just the point when the American market is static. Retail consultant Lawrence McNaughton was quoted as saying "If you hate America, it's real easy to hate Coke or McDonald's. The two primary criteria for determining risk would be if you're in business internationally and you're a cultural icon."[xxiii] Boeing, which must compete with the European Aerobus Consortium, has lost several important contracts.

The question of whether movies or other cultural outputs have actual soft power effects can be argued, but the simple test of reading the local newspapers in a foreign capital when the Hollywood Blockbuster Premiere Circus comes to town. It is guaranteed that Tom Cruise, Brad Pitt, Angelina Jolie or their like will be on the front page of most papers and treated as a “News” event on the local TV stations. It could be argued that *Rambo* (1982), released in the first burst of Reagan’s reassertive military stance, probably did more harm to America’s image abroad with it’s largely publicized foreign run than any lovable portrait of America like *ET* (1982), released later that year, could repair. It cannot be doubted that filmmakers with the creative powers of a Steven Spielberg have power to move people around the world, given that more than 60% of the revenues for hs films have been garnered abroad. A recent commentary about Spielberg’s latest movie, *War of the World’s* by The New York Times’ Frank Rich illustrates the power of a great filmmaker to reinterpret current events even in metaphorical terms:

> "War of the Worlds" makes as many references to 9/11 as Mr. Bush did. The alien attack on America is the work of sleeper cells; the garments of the dead rain down on those fleeing urban apocalypse; poignant fliers are posted for The Missing. There is also a sterling American military that rides to the rescue…In not terribly coded dialogue, the film makes clear that its Americans know very well how to distinguish a war of choice like that in Iraq from a war of necessity, like that prompted by Al Qaeda's attack on America. Tim Robbins - who else? - pops up to declare that when aliens occupy a country, the "occupations always fail." Even Tom Cruise's doltish teenage screen son is writing a school report on "the French occupation of Algeria."

For American movie and musical artists the effects of America’s negative image abroad are demoralizing. These artists have lived for the last 40 years, confident that their words, images and music could charm the rest of the world. The “software” of America has been our most powerful export. The images and sounds were often complex and nuanced and they borrowed from every culture that came to our shores. The perception within the artistic community is that the Berlin Wall came down not because Reagan was any smarter or tougher that Gorbachev. Bruce Springsteen, George Lucas and Marvin Gaye had broken through the wall years before. America was an idea of freedom and individuality. And Gorbachev was smart enough to know a wall wasn't going to keep his people from the world they were seeing on MTV Europe. He let it fall without a fight. Of course the time when America was the world's dominant pop culture power may be ending. A moment when Michael Jackson could sell 30 million copies of *Thriller* around the world may never come again. In the music business, regional artists are already replacing the global superstar and it is possible that this balkanization of world culture will affect all audio-visual mediums. Notions that the U.S. just needs a new "branding" campaign simply neglect the deep need of all cultures to tell their own stories. Now that the technical developments of modern cinema (digital photography and special effects) are diffused around the world, it is a near certainty that the stories being told by Chinese, Russian or Indian filmmakers will reflect the basic view of their elites towards the U.S. If those views are sympathetic towards our country then U.S. soft power may be enhanced. On the other hand, if the current resistance to U.S. political, economic and cultural policies continues we do not believe that even if the next version of *SpiderMan* achieves the $1 billion worldwide gross benchmark, it would have any positive soft power effect on global views. The presence of far too many contradictory local media outlets and voices is now a fact of modern digital culture. We will never go back to the 1950's and the sooner policy makers understand that, the better.

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[i] International Herald Tribune, Mar. 16, 2005
[ii] See Taplin, The IP-TV Revolution , http://www-rcf.usc.edu/~jtaplin/IPTV.pdf
[iii] State Administration for Industry and Commerce (SAIC)
[iv] The Economist, Nov. 20,2004
[v] SAIC
[vi] The Economist, ibid
[vii] Variety, Mar. 2, 2003
[viii] Los Angeles Times, Aug. 22, 2004
[ix] Wang, Dong, et al, China Law and Practice, March 2004
[x] Los Angeles Times, Aug. 22, 2004
[xi] Variety, Oct. 4, 2004
[xii] Variety, ibid
[xiii] Asia Pulse, Nov. 17, 2004
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[xx] Variety, Jan. 9, 2005
[xxi] Hollywood Reporter, Jul. 22, 2002
[xxii] Washington Monthly, March 2005
[xxiii] Reuters, March 5, 2003