# THE EFFECT OF FOREIGN CURRENCY MANIPULATION ON SMALL MANUFACTURERS AND EXPORTERS

## HEARING

BEFORE THE

## COMMITTEE ON SMALL BUSINESS
## HOUSE OF REPRESENTATIVES

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APPENDIX

# THE EFFECT OF FOREIGN CURRENCY MANIPULATION ON SMALL MANUFACTURERS AND EXPORTERS

**WEDNESDAY, JUNE 25, 2003**

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS
*Washington, D.C.*

The Committee met, pursuant to call, at 2:09 p.m. in Room 2360, Rayburn House Office Building, Hon. Donald Manzullo [Chairman of the Committee] presiding.

Present: Representatives Manzullo, Chabot, Graves, Schrock, Beauprez, McCotter, Velazquez, Napolitano, Bordallo, Majette and Sanchez.

Chairman MANZULLO. Good afternoon, and welcome to this hearing of the Committee on Small Business. Especially welcome to those who have come some distance to participate and attend this hearing.

Last June, we looked at the effect the overvalued dollar had on our manufacturers and exporters. A year later the dollar has declined measurably, but not significantly against Asian currencies. We do appreciate Treasury Secretary Snow's redefinition of a strong dollar. It has immensely helped many manufacturers as they compete with Europe and Canada.

The currency overvaluation problem remains primarily with most of Asia. The U.S. manufacturing base was the hardest hit by this recession. The U.S. has lost over 2.7 million manufacturing jobs. For 34 straight months, the United States has lost manufacturing jobs. In the past 12 months, it has averaged 53,000 manufacturing jobs per month. I want you to think about that.

The 16th District of Illinois, which I represent, has been severely hurt by the downturn in manufacturing. Plants have been closed. People have been put out of work. Ingersoll Milling & Machine Company has been the latest company in Rockford to declare bankruptcy.

During this period, our Asian trading partners have implemented a strategy of currency undervaluation in order to gain a competitive advantage for their experts by making them cheaper. It is estimated that the actions by China, Taiwan, South Korea and Japan have essentially given their exporters a 20 to 40 percent reduction. This in turn acts as a tax by the same percentage on U.S. manufacturers and exporters.

Since 1949, the Chinese government has kept its currency pegged at 8.21 yuan to the dollar. I am sorry. Since 1994. China has experienced economic growth, gains in productivity, a large export sector and increased foreign investment, all factors that would cause its currency to appreciate if it were allowed to freely move. It is estimated by many economists that the yuan is undervalued by as much as 40 percent.

Japan has systematically intervened in the currency markets to reduce the value of their yuan. Manipulation of exchange rates for the purpose of achieving an unfair competitive advantage is illegal under international protocols. This manipulation of the currency market costs U.S. jobs.

Trade is vitally important to this country and was part of the reason for the economic expansion of the 1990s. It is also critically important to the small business sector. Small businesses export their goods overseas, and currency manipulation has squeezed their profit margins from those least able to absorb it.

The competitiveness abroad has dramatically decreased because of currency fluctuations and exchange rates that affect their prices. The impact has not just been felt abroad. The overvalued dollar has caused the U.S. to be flooded with cheap imports. Import penetration has caused domestic manufacturers to lose market share against foreign products that have a temporary price advantage.

The effect of this interference is to artificially inflate the dollar in a blatant attempt to manipulate the market. The market needs to be determined at a currency rate value. Government intervention only skews the market and invites artificial rates that are not reflective of reality. We need to insure that U.S. firms have a level playing field in the global market and not be at a competitive disadvantage.

[Mr. Manzullo's statement may be found in the appendix.]

Chairman MANZULLO. I now yield for an opening statement by my good friend and colleague, the Ranking Member, Mrs. Velazquez of New York.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Today, the increasing number of imports/exports crossing over our borders illustrate the dominance of the international trade market in the global economy. While many factors affect our ability to participate in the new global economy, exchange rates play a crucial role. The value of the country's dollar determines its competitiveness within the international market. A weak dollar can make a nation's products cheaper in foreign markets and foreign products more expensive domestically, therefore, benefiting exporters.

Just the opposite is true for the strong dollar. Products become more expensive abroad, and foreign products are cheaper domestically. Unfortunately, U.S. manufacturers have recently been suffering from these effects, therefore making it more difficult for the U.S. to successfully compete in markets overseas.

Sadly, over 2,000,000 manufacturing jobs have been lost over the last few years, and U.S. exports across the Atlantic have fallen by $17.6 billion, accounting for half of the total decline in exports. On top of this, our manufacturers are struggling with a huge surge in imports, and U.S. economists predict the market share for market share for imports to increase even further in 2003.

The effects have been detrimental to U.S. exporters and small business. Small business dominates the international commerce, accounting for 97 percent of all U.S. exporters. The U.S. manufacturing sector and exporters are the ones who bear the brunt of the nation's overvalued dollar. While the dollar has, fortunately, begun to weaken among most major currencies, it still has not depreciated as much as it should have.

One of the major contributors to this problem has been the exchange rate policies of some of our trading partners who manipulate currency for competitive purposes. Among these countries are China and Japan. China's current fixed rate has created significant hardships for U.S. manufacturers and exporters. Despite China's substantial economic growth, its exchange rate remains the same as it did when it was set in 1995.

Many economists estimate that China's currency is undervalued by 40 percent. This has contributed to our nation's large trade deficit and the relocation of thousands of U.S. jobs to foreign countries. In addition, Japan, who operates on the floating exchange rate, frequently intervenes in the foreign exchange markets, weakening Japan's yen against the U.S. dollar.

The exchange rate practices of these two countries has put U.S. manufacturers and exporters at a clear disadvantage. However, while pointing out that these policies are creating hardship for their success, many U.S. corporations are relocating affiliates to these countries in order to take advantage of the low costs. By using these foreign locations versus U.S. exports to deliver the products to foreign markets and setting up export facilities in China, these businesses play into the growing trade deficit. This results in the loss of U.S. jobs. It is fair to say that they may be contributing to the problem, too.

As the foreign trade market continues to grow and expand, it is crucial that we do all we can to protect our nation's exporters and manufacturers. Actions such as Secretary Snow's recent support for the market based floating exchange rate for China are a step in the right direction. We must continue to engage these countries in an effort to prevent them from manipulating these policies.

The U.S. cannot afford to lose out on the benefits of the new global economy, but our manufacturers cannot afford to continue carrying the weight of these unfair policies. The prosperity and success of not only the U.S., but also of its trading partners, depend on fair policies that seek to balance the needs of our country with our leading role in the world economy.

Thank you, Mr. Chairman.

[Ms. Velazquez's statement may be found in the appendix.]

Chairman MANZULLO. Thank you. Before we get to our witnesses, we welcome the newest Member of the Small Business Committee, Thaddeus McCotter from Michigan.

Thaddeus, why not take 90 seconds and tell us about yourself. You can get your name out in 90 seconds.

Mr. MCCOTTER. Yes. Thaddeus McCotter, Michigan 11. Mr. Chairman, Members of the Committee, I say to you the same thing I said to my wife on our twelfth wedding anniversary. I am just happy to be here. Thank you.

Chairman MANZULLO. And we are glad that you are here. That is pretty brief.

The rules are there is a light in the middle of the table, and when it is green you are fine, when it is yellow you are on thin ice, and when it is red you have fallen through the ice. We will ask if you could follow that. You do not have to read word for word. The statements of all the witnesses will be made part of the record.

Anybody else who wants to make a statement made part of the record here are the rules. It cannot exceed two pages in single type. It has to be at least 10 point type. No attachments or anything because these are printed at government expense. If you want to have anything put into the record just get it to our staff, and we will be all set here. Staff will take care of it.

Our first witness is Fred Bergsten, Director, Institute for International Economics. We look forward to your testimony.

You might have to pull that mike up a little bit closer there.

**STATEMENT OF FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS**

Mr. BERGSTEN. Thank you, Mr. Chairman. I thought my comparative advantage, since you have lots of experts that will tell you about the plight of small business with the dollar, is to lay out the overall situation and suggest some policy changes that might help deal with them.

The facts first. From 1995 until about 16 months ago, the dollar rose by a trade weighted average of 35 to 50 percent, depending what index you used. The rule of thumb is that every one percent rise in the average exchange rate of the dollar leads to an increase in our trade deficit of about $10 billion with a two-year lag, so a rise of 40 percent or so in the dollar explains the great bulk of our existing trade and current account deficits of $500 billion and rising rapidly.

This, incidentally, comes on top of a net foreign debt position of the United States that has already hit $3 trillion and is rising very rapidly. To finance our current account deficit and our own foreign investments, we have to import $4 billion of foreign capital every working day. It is clearly a unsustainable situation.

Fact two. As a result, I believe, the dollar has, therefore, begun to come down as you mentioned. Over the last 16 or 17 months, it has come down, but by a trade weighted average of only 10 to 20 percent depending on again what index you use, so the run up of the previous six and a half year bull market in the dollar, the reversal has only accounted to something like one-third to at most one-half of the earlier run up.

There have been no noticeable adverse effects of that dollar decline on the U.S. Inflation is at very low levels. Interest rates are at 50 year lows. It has been very smooth, very gradual, very orderly, i.e., those who feared a decline of the dollar have nothing to worry about. However, as I say, it has only gone one-third to one-half of the previous run up.

Now, at my institute we do extensive analysis of all this, and we have concluded that the U.S. current account deficit, to be sustainable, would have to be cut in about half from where it is now. Instead of $500 billion to $600 billion, $250 billion to $300 billion.

That is still a big deficit. We think that would be sustainable, but that would require a decline of the dollar of 25 to 30 percent from where it started, again leading to the conclusion that it has only come down by about one-half what is needed.

I want to leave you with conclusion number one. The current account deficit needs to be cut in half. The dollar exchange rate is moving in the right direction, but it has only gone about halfway.

The other crucial point is that the decline of the dollar so far has been very unbalanced. The dollar has come down 30 to 40 percent against the euro, only 15 percent against the yen, zero against the Chinese renminbi, so it has been quite unbalanced, and one could expect the Europeans to start screaming, and rightly so, if that pattern continued in the second half of the dollar decline.

My punch line, therefore, is that not only does the dollar have to go down another 10 or 15 percent on average, but the composition needs to change. It needs to come down particularly against the Asian currencies of which the two most important are the Japanese yen and the Chinese renminbi.

Now the problem with Japan, as you mentioned, is that they are resisting the necessary adjustment very vigorously. They put, depending how you define it, $33 billion to $43 billion of intervention into the market in the month of May alone to keep the yen from rising further and contributing to the adjustment.

I asked one of my close Japanese friends, the former Vice Minister of Finance, “Mr. Yen,” Eisuke Sakakibara, last week where he thought the yen would be in the absence of that intervention. He said at least 10 yen higher, 10 percent higher, closer to 100, which is the eventual level that I think it needs to rise to. There is a lot of debate as to whether this Japanese intervention is effective. Mr. Yen thinks it has been. I think it has been. I would leave that for you.

Secretary Snow has been very clear. Every statement he has made indicates the exchange rate should be set by the market. The huge Japanese intervention obviously distorts that, so my suggestion to the Secretary is that he should tell the Japanese that in the future for every dollar they buy to keep the dollar strong he should tell them he will sell a dollar to offset it, to neutralize the intervention’s effect and thereby to revert the exchange rate outcome to the market, which is his stated policy.

There is even a theory called the theory of the second best in economics that says when there is one governmental distortion that distorts a market a second governmental intervention to offset that is theoretically called for and justified, so I would suggest offsetting U.S. intervention to make sure the rate is set by the market.

I believe, frankly, that if we let the Japanese know we were contemplating that they would cease and desist, the yen would rise, and that part of the adjustment would be supported.

The second big issue is the Chinese currency.

Chairman MANZULLO. You have a red light there, Fred.

Mr. BERGSTEN. Can I give you one more minute?

Chairman MANZULLO. Okay.

Mr. BERGSTEN. The Chinese peg to the dollar is important not only because it averts adjustment vis-á-vis China itself, but because I believe it blocks currency adjustment in the rest of Asia.

The reason is that all the Asian countries fear competition from China above everything else, but if the Chinese currency is riding the dollar down as the dollar declines, China is becoming even more competitive, worsening the situation and making it even harder for Korea, Taiwan, even Japan, to let their currencies go up and accept adjustment against those, so the Chinese fix is of crucial importance not just for China, but for the whole region.

Therefore, Secretary Snow again has said the right thing. China should let the currency appreciate. I believe that is crucial. That should be the second key pillar of our policy going forward to achieve both the rest of the needed adjustment and do so in a balanced and, therefore, much more feasible way.

Thank you.

Chairman MANZULLO. Thank you.

[Mr. Bergsten's statement may be found in the appendix.]

Chairman MANZULLO. Our next witness is Dr. Robert Blecker, Professor of Economics at my alma mater, American University, and a research associate at the Economic Policy Institute.

You did not know that, did you?

Mr. BLECKER. No, I did not.

Chairman MANZULLO. Yes. Are you not impressed?

Mr. BLECKER. It is good to be before your Committee.

Chairman MANZULLO. There you are. Good to be here. We look forward to your testimony.

**STATEMENT OF ROBERT A. BLECKER, PROFESSOR OF ECONOMICS, AMERICAN UNIVERSITY, AND RESEARCH ASSOCIATE, ECONOMIC POLICY INSTITUTE**

Mr. BLECKER. Thank you very much, Mr. Chairman and Members of the Committee. I do appreciate the invitation to testify here.

Chairman MANZULLO. Could you pull the mike closer to you?

Mr. BLECKER. I do appreciate the invitation to testify here this afternoon.

Mr. Chairman, there has been much attention in the last few months to the falling value of the dollar. However, while attention has been focused on the dollar's fall relative to the euro and a few other major currencies, less attention has been paid to the fact that the dollar has fallen much less or not at all compared with many other currencies of our other important trading partners.

Especially, the dollar has not fallen nearly as much relative to the Japanese yen and has a fixed or managed exchange rate with the Chinese renminbi, the Taiwanese dollar and certain other Asian currencies due to the currency manipulation practiced by their governments. As a result, the dollar has not fallen nearly enough overall to undo the damage caused by its overvaluation for the past several years.

According to my statistical estimates, the rise in the dollar up to 2002 caused the following damage: First, a loss of three-quarters of a million U.S. manufacturing jobs; second, a decline in profits on U.S. manufacturing operations of about $100 billion per year; and, third, a reduction in capital expenditures at U.S. manufacturing plants of over $40 billion at an annual rate and, second, as Fred

Bergsten has already testified, a major contribution to the enormous U.S. trade deficit.

Although my statistical analysis does not distinguish U.S. manufacturing businesses by size, I believe that small businesses are likely to be disproportionately hurt by the overvalued dollar because small businesses tend to be less multinational in scope and, hence, have less of an ability to produce or source products overseas. If small businesses do shift production or outsource abroad as they are often forced to in this currency environment, the result is still a loss of American jobs that can devastate local communities.

Furthermore, the fact that the high dollar has led American manufacturers to cut back their investment spending portends slower growth and reduced technological innovation in these industries in the future.

For all these reasons, the recent decline in the dollar to a more reasonable level relative to the euro, the British pound, the Canadian dollar and a few other currencies gives a ray of hope for the U.S. manufacturing sector to begin a recovery. However, this ray of hope is significantly dimmed by the partial nature of the dollar's decline to date.

The countries that have let their currencies rise the most, chiefly the Europeans and Canadians, account for less than half of U.S. trade overall and much less than half of our trade deficit. Even in regard to those currencies, the dollar has lost only part of the value it gained between 1995 and 2002. However, the situation is worse with Japan and other East Asian countries that actively manipulate their currency values, yet account for more than half of the U.S. trade deficit.

The dollar has fallen only about 12 percent versus the yen since February 2002, compared with about 27 percent versus the euro. China, Taiwan and many other developing nations maintain pegged exchange rates, thus preventing their currencies from rising to market determined levels.

The major East Asian countries have amassed reserves of well over $1 trillion U.S. dollars in their efforts to keep their own currencies undervalued and maintain artificial competitive advantages in the U.S. market. Such intervention has grown in intensity in the past few months as the dollar has fallen relative to the other currencies.

In response to these policies, the United States needs to take strong measures to pressure our leading trading partners in East Asia to abandon their currency manipulation and allow their currencies to rise to market levels. The Secretary of the Treasury should use his authority under U.S. law to investigate foreign currency manipulation and negotiate with trading partners that obtain chronic trade surpluses with us by undervaluing their currencies.

I believe we also need to make the maintenance of realistic equilibrium exchange rates a condition for trade liberalization and market opening agreements. I would urge that all future trade agreements include prohibitions on currency manipulation and that this issue be given a priority role in future trade negotiations such as in the WTO and proposed FTAA.

Of course, the United States should not be indifferent to the fact that rising currency values can threaten economic prosperity in other countries, but the right solution to this problem is to encourage our trading partners to stimulate their own domestic economies rather than to keep the dollar overvalued and let them achieve export led growth at our expense.

Thank you very much, and I would be happy to answer any questions.

Chairman MANZULLO. Thank you.

[Mr. Blecker's statement may be found in the appendix.]

Chairman MANZULLO. Our next witness is Steve Yagle. Steve is president of Reliable Machine. He is my constituent and comes from Rockford, Illinois. I have known him since he was about 14 or 15. He has grown up.

Steve represents the Rockford Area Chamber of Commerce Manufacturing Council and the 250 manufacturers that are part of the Chamber's membership, as well as the 1,200 manufacturers in the four county region of Winnebago, Boone, Ogle and Stephenson Counties in northwest Illinois. We look forward to your testimony.

**STATEMENT OF STEVE YAGLE, PRESIDENT, RELIABLE MACHINE COMPANY**

Mr. YAGLE. Thank you, Mr. Chairman and Members of this distinguished Committee. I am pleased to be here to testify before you today, and I thank you for the opportunity to discuss issues relating to trade with Asia. I applaud your efforts to gather information and data regarding currency valuation.

Again, my name is Steve Yagle. I am president of Reliable Machine Company in Rockford, Illinois. We employ 50 hardworking individuals, and we consider ourselves a neighborhood manufacturer. I am here today representing the Rockford Area Chamber of Commerce, which I am the chairman of the Manufacturing Council, and 250 manufacturers that are part of the Chamber's membership, as well as 1,200 manufacturers in the four-county region of Winnebago, Boone, Ogle and Stephenson Counties in north-central Illinois.

Even as we battle to reduce our costs and to keep our skilled employment base, we are faced with challenges from our global competitors. Today, I am here to discuss the effect of Asia's practice of currency valuation and its effect on manufacturers in our region.

The Chinese Government manipulates the value of its currency to maintain a trade advantage over American companies. This artificially lowers the prices of Chinese goods in the U.S., allowing foreign competitors an unfair advantage in the U.S. market. This practice has placed Rockford area manufacturers at a serious disadvantage, and unless these trends are reversed more damage will be done to the livelihoods of the Rockford area working families and to the nation's economy.

From 1998 through 2002, the Rockford area lost more than 8,000 manufacturing jobs. Currently, the City of Rockford unemployment rate exceeds 10 percent, while the rate in Illinois is 6.2 percent, and the U.S. rate is 5.5 percent. Our region can no longer afford to continue losing manufacturing jobs.

An Illinois Manufacturing Extension Center study reported that over 60 percent of those surveyed are experiencing competition from China and have lost market share. Moreover, 46 percent of all Respondents said they expected competition from China to reduce their sales by an average of about 16 percent in 2003, with more losses expected in the next few years. All are losing sales overseas or find they can no longer compete against Chinese imports into the U.S. market.

Many of the manufacturers are reducing their work forces. Others say they will close their plants. Bill Orman, who is the president of Rockford Fastener, a long-time family business, predicts large numbers of small and mid-size Rockford area manufacturers will be closing down permanently due to foreign competition as orders in his industry have shrunk from millions of pieces per order to 50,000 to 60,000 pieces.

Rockford Products, another fastener manufacturer, is sourcing some parts from Asia to remain competitive. These parts were once manufactured in Rockford. In fact, the Rockford area was once the largest geographic area for fastener manufacturing in the world. Today, China holds that distinction.

My own business was affected when a business opportunity worth up to $750,000 annually, which would have created jobs in my factory, tax revenue for local, state and federal governments, vanished as a big box retailer decided to source product in China instead of Rockford and Wisconsin. My company will survive. My potential customer, a father and son business of 30 years, will most likely be bankrupt by the end of this year.

I have a question. As manufacturing jobs continue to disappear, what is going to take their place?

Also, weakness in the manufacturing sector hurts the service sector. The loss of high paying manufacturing jobs translates into lower sales for businesses of all types. Wealth is created when we manufacture goods. United States manufacturers are the most efficient on the globe. We offer world class benefits to our employees. We invest in the newest and best safety features. We are responsible to our environment, and we take responsibility for the products that we produce.

What we are asking for is a level playing field with fair trade. Manufacturers in the Rockford area can compete in price, quality, on time delivery and service with any competitor in the world.

As you consider the situation that American manufacturers face, please consider these options. We must enforce International Monetary Fund articles of agreement that explicitly prohibit currency manipulation; number two, impose tariffs on those countries that utilize currency manipulation to gain advantage in the U.S. marketplace;

Number three, institute tax credits for domestic production, both for those who produce and for those who purchase from U.S. domestic manufacturers; and, number four, establish a U.S. national policy that recognizes that manufacturing is crucial for the maintenance and potential growth of our work force and manufacturing business sector.

Thank you very much for allowing me to speak today.

[Mr. Yagle's statement may be found in the appendix.]

Chairman MANZULLO. Thank you, Steve, for coming here. I understand you have a meeting and may have to leave here prior to the Committee adjourning. If that is the case, you can just excuse yourself and leave any time you want.

Mr. YAGLE. Thank you, Mr. Chairman.

Chairman MANZULLO. You are welcome.

Our next witness is Jay Bender. Jay is speaking on behalf of the National Association of Manufacturers. He is also the president of Falcon Plastics, Inc. We look forward to your testimony.

**STATEMENT OF JAY BENDER, PRESIDENT, FALCON PLASTICS, INC., NATIONAL ASSOCIATION OF MANUFACTURERS**

Mr. BENDER. Good afternoon, Mr. Chairman and Members of the Committee. Thank you for allowing me to be here today.

My name is Jay Bender, and I am president of Falcon Plastics, a manufacturer of custom plastic molded components, assemblies and tooling located in Brookings, South Dakota. I am pleased to discuss the effect of foreign currency manipulation, especially the undervalued Chinese currency.

I am also pleased to be speaking on behalf of the National Association of Manufacturers, the NAM, which represents 14,000 members, including 10,000 small and medium sized companies.

Falcon Plastics has been in business for 28 years. The company was founded by my father, Don Bender, in 1975. We employ 200 people and have three production facilities, two in South Dakota and one in Tennessee. We sell custom molded plastic products to the agricultural, appliance, automotive, business machine, electronics and medical industries. We have shipped our products to 28 states and export around the world.

We can and do work hard to stay competitive by incorporating up-to-date equipment and production methods, but we cannot compete when the deck is stacked against us. The situation in American manufacturing today is serious and in some sectors critical. Over the past several years, American manufacturing has lost almost 2.5 million. Mr. Chairman stated 2.7 million. Falcon Plastics has gone from 300 people to just 200 people.

Mr. Chairman, let me stress that. We have lost one-third of our work force. At the same time, imports from China have surged, and the U.S. trade deficit with China has ballooned to over $100 billion. The NAM projects that if our trade deficit with China continues its 20 year trend, in five years it will exceed $300 billion.

This problem must be addressed or American manufacturing will lose more jobs, and pressures to retreat from our global trade commitments will become irresistible. We have many strengths in America. We are innovative. We have some of the best workers in the world. We have the benefit of a free and open society in which to do business.

We cannot compete when the currency of a major trading partner like China is so undervalued that it produces an overwhelming competitive advantage. The NAM has seen estimates that China's currency is up to 50 percent undervalued.

How do we know their currency is undervalued? Economic institutes, the World Bank and brokerage houses have all come out with estimates, but this one is my favorite. The Economist magazine's Big Mac index has been a pretty good indicator. Since 1986, economists have been using a comparison of the price of Big Macs around the world to gauge if currencies are at their market level. This has been among the most accurate currency indicator for about 20 years. According to the Big Mac index, the Chinese yuan is undervalued by, with all due respect to the golden arches, a whopping 56 percent.

Let me illustrate what is happening. One of my top customers recently got bids from a Chinese producer that were 26 percent lower than mine. My customer is going to stay with us for now because we are able to customize our orders and make quick deliveries, but I am not sure how long that is going to last.

If the yuan were 20 to 30 percent higher, this would solve my pricing problem, and I could hold onto my customers. The move to a realistic exchange rate could make a huge difference for my company. Until that happens, I see my customers purchasing more and more offshore, especially from China.

These products here tell another story. We mold each of the halves of these fishing lure bodies, and we also mold the packaging that they fit into. Our customer is a large producer of fishing lures. They decorate them and then attach the hooks to complete the lure. They have made the decision to move all of this production to China because they can save 50 percent over the cost of producing it here in the U.S.

Generally, fishing lures are made by small, family-owned companies, but they will not be for long with a 50 percent price difference. If China did not deliberately undervalue its currency, many of these family businesses might be saved.

The situation as it currently exists is just unfair. Does anyone believe that with all the growth in Chinese production increased productivity, product quality and exports the yuan is not worth any more now than it was in 1994?

There are other factors as well. I can produce a particular mold for one of my former customers for $25,000. That is a very competitive price. They purchase a similar Chinese mold for under $3,000. For that particular mold, 20 percent of my price is materials and components sourced on the world market. These numbers tell me that something here just does not add up. Something is wrong.

Our government must ensure that China is not subsidizing or dumping its products, which it is obliged not to do now that it is a member of the WTO. In addition to obtaining reform of China's currency practices, we ask Congress to look closer to home to address rising production costs.

These are issues addressed in the NAM strategy for manufacturing growth and renewal, and they are essential to the health of U.S. manufacturing. They include the runaway cost of litigation, energy and health care——.

Chairman MANZULLO. How are you doing? How are you doing on time?

Mr. BENDER. Almost done.

Chairman MANZULLO. All right.

Mr. BENDER. Almost done. Costly and productive environmental and legal regulations and a badly-in-need-of-overhaul tax system.

If Congress fixes these problems, manufacturing costs will go down, and we will see fewer companies moving their production to China and foreign countries.

Mr. Chairman and Members of the Committee, some of the best jobs in South Dakota are in manufacturing. At Falcon Plastics we provide a safe working environment with good health and retirement benefits for our employees. We understand that we make adjustments to operate in a global environment or that we must make adjustments, and we are prepared to compete, but we must have a level playing field. We do not have five or 10 years. We need your help now.

Thank you very much, and I look forward to your question.

[Mr. Bender's statement may be found in the appendix.]

Chairman MANZULLO. Thank you. Did you wish to make that Big Mac a part of the record?

Mr. BENDER. Everyone thought it was my lunch.

Chairman MANZULLO. There it is.

Mr. BENDER. I have a good customer in Rockford, by the way, as well, Anderson Packaging, Inc.

Chairman MANZULLO. That is great. That is great.

Our next witness is George Jones, III. That is a pretty famous name. Did you leave your guitar outside?

Mr. JONES. I do not sing.

Chairman MANZULLO. You do not sing. Okay. If you could pull your mike up close to you, Mr. Jones.

Mr. JONES. Great.

Chairman MANZULLO. Mr. Jones is president of Seaman Paper Company of Massachusetts and is speaking on behalf of the American Forest & Paper Association. We look forward to your testimony.

**STATEMENT OF GEORGE JONES, III, PRESIDENT, SEAMAN PAPER COMPANY OF MASSACHUSETTS, INC., AMERICAN FOREST & PAPER ASSOCIATION**

Mr. JONES. Thank you very much. Before I start, I would like to thank all of you for caring enough to hold this hearing. It means a lot to us.

Mr. Chairman, my name is George Jones. I am the third generation owner of a 57-year-old business that manufactures decorative and industrial tissue paper. My company, Seaman Paper Company of Massachusetts, Inc., and its affiliates have approximately 500 employees, and we are the major employer in our area.

Our products include resale tissue purchased in stores for gift wrap, retail packaging tissue used by stores to package customer purchases, crepe streamers and waxed paper for floral and food service applications. We are a traditional, American-built, family-owned business. For more than 50 years we have enjoyed relative prosperity and success, but today we are facing the most severe threat to our existence in our company's history: Chinese imports.

I am here today testifying on behalf of the American Forest & Paper Association, AF&PA. AF&PA and its members have a long history of support for free and fair trade policies. Our trade policy agenda has been driven by the belief that our country's abundant fiber resources, skilled labor force and access to capital provide the

U.S. forest and paper industry with the comparative advantage to compete in the global marketplace.

However, this ostensible comparative advantage has been undermined in recent years by unfair exchange rate policies and other Chinese Government trade practices. While China's paper and paperboard consumption jumped between 1997 and 2002, the corresponding growth for U.S. exports did not materialize.

In fact, exports to China of several important paper categories have stagnated or declined because of a substantial buildup in Chinese paper and paperboard production capacity. In contrast, China's paper and paperboard exports, including converted products, greatly benefited from an artificially weak currency. Likewise, China has become a major consumer and producer of wood products.

Why have U.S. producers lost ground rather than gained ground with the Chinese market over the past five years? The Chinese Government has intentionally kept the value of its currency abnormally low to create a competitive advantage for their products at the expense of U.S. produced goods.

The Chinese Central Bank maintains the yuan's value at an exchange rate of 8.28 to the dollar by regularly intervening in foreign exchange markets. This has been done through the accumulation of large foreign exchange reserves since the mid 1990s.

Some estimates suggest that China's currency is about 40 percent lower than it would be if it had been allowed to float in line with market forces. This has the effect of a 40 percent tax on U.S. exports to China and a similar tax on U.S. manufacturers competing in the U.S. domestic market against Chinese imports.

What is the on-the-ground impact of the Chinese Government policies in communities across the country? I can tell you firsthand that it has meant the loss of significant U.S. sales for my company, $5 million in annual sales since year 2000 and growing. It has meant that I have had to lay off employees and curtail production while we have tried to replace the lost business.

Some of my U.S. competitors have not been so fortunate. In the last two years, several U.S. paper mills have either closed or are barely holding onto their businesses. This means a loss of employment, frequently in small, rural communities, and a loss of tax revenue to the towns where these companies have been located.

Unfortunately, this story is being repeated in product after product, including wood and paper products. My written testimony has specific recommendations for action, but I need to emphasize that if something is not done quickly many small businesses will not survive.

Let me tell you firsthand that the perception is that the Chinese cost advantage is based solely on labor costs. The reality is that labor costs alone cannot explain the full cost advantage in our product lines.

In the past 10 years, we have invested heavily in state-of-the-art converting equipment, which has reduced our labor cost by 90 percent for this product and 50 percent for this product, yet the Chinese imports are priced at or below our variable costs. There is no investment or other management tool that we can use to offset this Chinese cost advantage.

If you do not act and help to create a level playing field, then our long-term fate is sealed. Please help us to preserve these American jobs.

Thank you very much.

[Mr. Jones's statement may be found in the appendix.]

Chairman MANZULLO. Thank you for your testimony.

Our next witness is Edward——

Mr. TASHJIAN. Tashjian.

Chairman MANZULLO [continuing]. Tashjian. Okay. I was talking to your congressman, Cass Ballenger.

Mr. TASHJIAN. Super guy.

Chairman MANZULLO. He really is. I invited him to come to our hearing for the opportunity to introduce you personally, but he said that he just was not able to make it.

Let me announce that on the table before we break there is going to be a report that has been compiled by Congressman Gary Miller's daughter, who is working on her Master's at one of the schools in the Research Triangle.

It is a great report on the case goods imported from China that demonstrates that case goods both in household and in commercial furniture are now 30 percent of U.S. market share and growing. It is a great report. It is only about 14 or 16 pages.

Is it there yet, Phil? It is already on the table, and I would invite the panel and the members that have come here to the hearing to take a copy of that report with them.

Tashjian?

Mr. TASHJIAN. Tashjian. It is an Armenian name.

Chairman MANZULLO. Ed has come here from Hickory, North Carolina, as vice president of marketing for Century Furniture Industries, and we look forward to your testimony.

**STATEMENT OF EDWARD M. TASHJIAN, VICE PRESIDENT OF MARKETING, CENTURY FURNITURE, AMERICAN FURNITURE MANUFACTURERS ASSOCIATION**

Mr. TASHJIAN. Thank you. Thank you very much, Mr. Chairman and Members of the Committee. Thank you for the opportunity to testify.

Chairman MANZULLO. Could you pull the mike closer to you? You might want to pull it down just a little bit.

Mr. TASHJIAN. How is that?

Chairman MANZULLO. That is fine.

Mr. TASHJIAN. I am Ed Tashjian, and I am the vice president of marketing for Century Furniture, a high end residential furniture manufacturer located in Hickory, North Carolina.

It is an honor to appear before you today, and I have great personal admiration for this body, as well as an enormous appreciation for the time, talent and energy each of you dedicate to public service. You do a great job not just on this issue, but on every issue.

At the outset, let me make it clear that unlike my colleagues at the end of the table, Dr. Blecker and Dr. Bergsten, I am not a trained economist. I am not an expert on world trade and international monetary policy.

I am here today as an advocate for the 156,000 men and women who make up America's residential furniture manufacturing industry to present a small business point of view on the impact of currency manipulation and to ask you to use your common sense and good judgment to do what is in the best interest of this country.

Clearly, this is a complex subject both technically and ideologically, and there are no easy answers. At the end of my testimony, however, I hope you will conclude that the term fair trade means the enforcement of U.S. laws and international trading rules and that the continued loss of furniture manufacturing jobs to the Far East does not serve the best interests of the United States.

This hearing could not have come at a more opportune time. Thanks to the perseverance of lawmakers like you who care about domestic manufacturing, the issue of currency manipulation is now receiving the attention it deserves.

Secretary Snow's comments last week in support of a more fairly valued yuan and his belief that China is prepared to move in that direction are positive signs that the Administration is beginning to understand how this issue impacts domestic manufacturers like us who are already having a difficult time competing.

If you go into any high end furniture retail store today, you will find that roughly comparable residential wood furniture that is manufactured in China costs anywhere from one-third to one-half of furniture manufactured in the United States. The result is a lack of competitiveness and a loss of nearly one-quarter of the domestic furniture manufacturing jobs in the last three years.

As devastating as these statistics are, these figures understate the magnitude of the impact of these losses on communities like Hickory because declines in furniture production have a serious ripple effect, hurting firms that supply textiles, hardware and a range of services to our industry. There are few things more disheartening than to pick up a local newspaper and read about another plant closing.

In my view, there are five key factors that contribute to this substantial pricing variance at retail, and I mention these five to add fuel to the fire that George was talking about that, you know, currency manipulation is just one of these things, and it is the dominant one, as you will see.

The first one is low wages, and I agree with George that everybody believes that the advantage the Chinese has is predominantly low wages. For a comparable worker in China, they earn 45 cents an hour, while his counterpart in the U.S. earns $12.75 an hour. To put that in perspective, the Chinese worker makes 1/28th as much as the American worker.

The second are intellectual property rights violations. Foreign products have a much lower development cost because they are almost always based on American designs. The U.S. must press China to vigorously enforce its IPR related commitments as a new member of the World Trade Organization.

Third are lower operating costs. Many Pacific Rim competitors have no EPA, no OSHA requirements, which dramatically reduce operating costs. Now, please understand that I strongly support providing our employees with an impeccable work environment. In fact, Century goes to such great lengths to have a safe and comfortable environment that in our chair plant we have gone 1,000,000 hours without a lost time accident, which is the equivalent of an individual worker working for 500 years without a lost time accident. It is very important, and we work towards that.

Fourth, what enters into this are lower health care costs. I am not an expert on foreign health care, but I can tell you that better than eight cents of every dollar, every revenue dollar, goes towards health care at my company. The expense of this has doubled over the past five years. In fact, we spend more on health care than we spend on lumber, fabric and leather.

Fifth, and most importantly, is currency manipulation. By pegging the yuan to the dollar, an exporting nation like China has in effect undervalued its currency by as much as 30 to 50 percent. This is tantamount, as everybody here has said today, to a 30 to 50 percent tariff on U.S. products in our own marketplace. That is terrible. It is like two Olympic sprinters competing in a 100 meter dash, but one gets to start at the 40 meter mark. It is unfair.

Of these five factors, currency manipulation is by far the most serious. Many of our foreign competitors have an advantage when it comes to cheap labor, less stringent regulations and significantly lower operating costs, but the cost variance in the marketplace of products made in these countries is nowhere near what it is in countries like China where the currency is pegged.

The WTO and the IMF have stated that such currency manipulation done to gain an unfair competitive advantage is illegal in the global trading system. Therefore, it is vitally important that U.S. trade authorities monitor and enforce China's obligations in this area and insure that the timetables for action embodied by the WTO agreement are met. Free trade must also be fair trade and legal trade, and I would encourage this panel, as well as the Administration, to stand firm on the pursuit of fair valuation.

Century Furniture appreciates all this Committee has done to focus attention on the plight of manufacturing in the U.S., and we hope that you will remain engaged on this important issue.

Thank you.

[Mr. Tashjian's statement may be found in the appendix.]

Chairman MANZULLO. Thank you for your testimony.

Our next witness is a good friend, Dr. Paul Freedenberg, testifying on behalf of the Association for Manufacturing Technology. We look forward to your testimony.

**TESTIMONY OF PAUL FREEDENBERG, VICE PRESIDENT, GOVERNMENT RELATIONS DIRECTOR, ASSOCIATION FOR MANUFACTURING TECHNOLOGY**

Mr. FREEDENBERG. Thank you. Good afternoon. My name is Dr. Paul Freedenberg. I am Vice President, Government Relations, for AMT, the Association for Manufacturing Technology. Today I will be testifying on behalf of AMT, a 100-year-old trade association that represents approximately 350 machine tool builders and related product firms throughout the United States.

It should be cause for great concern that the machine tool industry is experiencing the worst conditions in its domestic market in a half a century. Orders are off more than 60 percent since their peak in 1997. Import penetration has increased more than 40 percent in the past four years due in large part to an overvalued dollar, which has only recently receded from its dizzying heights in relation to the European currency.

More than 30 machine tool companies have closed their doors in the past 18 months. Most recently, we have seen the bankruptcy of Ingersoll Milling, one of the oldest and most technologically advanced companies in the industry and one of your oldest and most distinguished constituents, Mr. Chairman. I guess one could conclude that if Ingersoll could fail, anyone in the machine tool industry is vulnerable.

Today, I will focus on a core problem that all of U.S. industry confronts. That problem is Chinese currency manipulation. For more than a year, AMT has been part of the Coalition for a Sound Dollar, and as part of this coalition we have expressed our great concern regarding the Chinese Government's strategy of undervaluing their currency in order to garner exports and foreign investment.

Last year, our nation's bilateral trade deficit with China exceeded $103 billion, the largest bilateral deficit in the world. Based on the four months of 2003, that deficit is headed for more than $120 billion this year. It is a deficit and a trend that any economist will tell you is unsustainable, yet it has continued to grow at this pace for the past decade.

Indeed, China is accumulating foreign currency reserves, mostly U.S. dollars, at a rate of approximately $6 billion per month. This is an uneven trading arrangement, and it is directly related to the distortion and the value of the two nations' currencies.

It is obvious that China's economic strategy over the past decade has been to keep the value of its currency low, boosting its exports and holding down imports. While many have observed that this is a highly successful strategy, another way of looking at it is that this is a shrewd method of exporting unemployment.

For those who will tell you that China's trade surplus is self-correcting I would point out that the United States imports from China have been growing at more than twice the rate of U.S. exports to China. Underlying all of this is the currency imbalance, and if you get rid of that currency imbalance you would more than double the offset getting rid of all of the tariffs that China imposes on U.S. goods.

I would point out that both Article 15 of the WTO and Article 4 of the International Monetary Fund prohibit the use of currency manipulation as a method of gaining unfair trade advantage. The IMF defines such manipulation as large scale and protracted intervention in one direction to gain an unfair trade advantage. The WTO prohibits currency intervention that would frustrate the intention of the provisions of the WTO agreement. An unfair trade case against China could be brought in either forum.

Parenthetically, I believe that these very same Chinese currency practices are also challengeable under Section 301 of the Trade Act, but for any of this to occur the U.S. Government has to have the political will to take these actions. This unfair currency issue is the responsibility of the Secretary of the Treasury.

It is my hope that Secretary John Snow will at the very least enter into discussions with his Chinese counterparts at the earliest possible opportunity with the objective of achieving a more reasonably priced yuan. Initially, this issue need not be the subject of a formal trade action, but Secretary Snow should not hesitate to initiate one or more of the actions I have discussed if the Chinese are unresponsive.

There is really no alternative to the immediate initiation of such discussions or ultimate trade actions if the discussions should prove fruitless. Either this debilitating trade distortion must be eliminated or we will see many industrial sectors faced with very unattractive alternatives—the prospect of losing their markets entirely or the alternative of being forced to relocate in China as the only opportunity for survival.

Thank you, Mr. Chairman.

[Mr. Freedenberg's statement may be found in the appendix.]

Chairman MANZULLO. Thank you for your testimony.

Our next witness is Mr. Cass Johnson speaking on behalf of the American Textile Manufacturers Institute. Mr. Johnson, we look forward to your testimony.

**STATEMENT OF CASS JOHNSON, SENIOR VICE PRESIDENT, AMERICAN TEXTILE MANUFACTURERS INSTITUTE**

Mr. JOHNSON. Thank you. Thank you, Mr. Chairman, Members of the Committee. Thank you for this opportunity to speak about the terrible damage that Asian currency manipulation is doing to the U.S. textile sector, one of this country's largest manufacturing employers. There is not a more important issue facing manufacturing today, and you and your colleagues are to be highly commended for holding these hearings.

My name is Cass Johnson. I am a senior vice president at the American Textile Manufacturers Institute and have worked in the textile area for 13 years. As such, I can describe what can happen to a great manufacturing industry when our government does not deal forcibly with important issues such as this one.

By way of background, in 1994, China cut the value of the renminbi by more than 40 percent. Forty percent is a number we have been hearing a lot today. The not too surprising response came three years later when China's most direct competitors, other Asian nations, saw their own economies collapse and their own currencies losing an average of 40 percent. Three years later, the U.S. manufacturing sector slid into recession, taking the U.S. economy with it.

There is an important chain of events here. First, China cuts the value of the renminbi by about 40 percent. Next, the currencies of its Asian competitors are devalued by about 40 percent, and then finally U.S. manufacturing suffers its worst recession since the Great Depression.

In the textile sector, the effect has been nothing short of devastating. As China and other Asian currencies have been devalued, prices for textile and apparel products from these countries have fallen by as much as 38 percent. With U.S. profit margins below five percent, a 38 percent drop by your competitor pretty much puts you out of business.

As a result, since 1997 we have closed more than 200 textile plants in the United States and lost more than 210,000 textile jobs. It is the worst bloodletting for this industry since the Great Depression. In fact, I can give you a whole list of companies that made it through the Great Depression, but have not survived the last years.

Let me emphasize that these were not antiquated mills using outdated equipment. On the contrary, we have been shutting down modern, highly productive textile plants and all too often shipping their state-of-the-art weaving looms and spinning frames to China.

While U.S. manufacturing and the U.S. textile industry are obviously affected by many issues, one fact stands out. During this time, Asian governments, in particular China, spent over $1 trillion to keep their currencies undervalued and their exports to the U.S. strong.

What is most tragic about this is that it could and should have been prevented. What Korea, Taiwan, Japan and China, among others, are doing with their currencies is out and out illegal. One way purchases of currency with a purpose of gaining an export advantage are specifically prohibited under both IMF and WTO rule.

Not only that; these actions are also clearly against the President's own stated policy that free markets, not export oriented Asian governments, should determine exchange rates. Not only that; these actions clearly are doing enormous damage. An excellent study by Ernie Preeg from the Manufacturers Alliance concluded that 1.5 million manufacturing jobs have been lost during the last two years because of illegal Asian currency manipulation.

Influential news organizations from around the world—the Economist, the New York Times, the Wall Street Journal, the Financial Times; the Financial Times had a story yesterday on this—all agree that Asian currency manipulation of this magnitude is not only bad for the United States, but it is also destabilizing for the entire world economy.

One might have expected that all this evidence, all this breaking of international rules and, most importantly, all these terrible job losses might have provoked some serious action by our government. In fact, many of us from the manufacturing sector, a number of them at the table here today, have spent the last year and a half trying desperately, and I want to underline desperately, to get the U.S. Government to act.

We have gone to USTR and to Commerce and to State on multiple occasions. Surely there are few issues that have a bigger trade, economic and international impact than this one. Each time we have been turned away with the proviso we cannot talk about this. Only Treasury can.

Well, we have been repeatedly to Treasury, and the problem with Treasury is that you feel this is some far away story that they do not want to bother about much. In fact, according to the Treasury Department's semi-annual report to Congress, currency manipulation is not even happening.

According to Treasury, those $1 trillion in Asian central banks do not really count for anything at all. Those 2.3 million lost manufacturing jobs? According to Treasury, illegal Asian currency manipulation did not have a thing to do with it.

On the one hand we are confronted with very aggressive Asian governments that are breaking international rules going against stated U.S. policy and along the way throwing millions of hardworking Americans out of their jobs at a time when our economy can least afford it. On the other hand, we have a U.S. Government that cannot even talk about this issue except to refer the matter to Treasury, which officially says currency manipulation does not exist.

That is one reason why our industry is so grateful that you and the other Members of the Committee are highlighting this issue. Action cannot come a moment too soon.

Thank you, and I would be happy to answer any questions.

[Mr. Johnson's statement may be found in the appendix.]

Chairman MANZULLO. Thank you very much for that excellent testimony.

The $500 billion or so trade deficit is more than that. Let me give you an example. If this item is exported and it costs $100 million—a government hammer? That is about what it costs.

[Laughter.]

Chairman MANZULLO. It goes down on the trade merchandise balance sheet as plus $100 million, even though it could contain $99 million worth of foreign parts. Before the NAFTA tariffs were completed, at least we had the bonded material and had an idea of what was coming back in terms of a reimport. Now we have something similar on the 62.5 percent content in automobiles.

You have to wonder. The stock market is going up in value. Sales are increasing. The only jobs that are being created are overseas. This is indeed a recovery, if you want to call it that, with a continuous decrease in the loss of jobs, and the problem is the fact that this city does not understand it.

I have been talking about manufacturing for 11 years because Rockford is a city that has a huge industrial base. It is about a 25 percent industrial base. Nearby McHenry County, until a few years ago, had an astonishing 36 percent industrial base. Most cities are 14 percent. Rockford led the nation in unemployment in 1982 at 24.9 percent where we lost 100 factories and 10,000 highly skilled jobs.

I am looking, Dr. Freedenberg, at page 6 of your testimony that talks about remedies. I think it is time to send a missile across the bow of the Administration. I think perhaps it is time that we send a letter saying that Congress perhaps should not entertain any more free trade agreements until the Administration begins to enforce some of the remedies that you have set forth on page 6.

What do you think about that?

Mr. FREEDENBERG. I did not come here to advocate protectionism or to stop the trade negotiations, but I think you will see that Congress—I think you are a good reflection of sentiment.

Support will be lost for free trade if we continue in this situation with the distortion that has existed with Asian currencies.

Chairman MANZULLO. I mean, this is not free trade.

Mr. FREEDENBERG. It does not amount to that.

Chairman MANZULLO. Why did Treasury come out with the statement that there was no distortion?

Mr. Johnson, you talked about that report. I was astonished when I saw it also.

Mr. JOHNSON. We have asked them that question. How can you not find distortion when literally everyone else is finding it, when other banks are finding it, when financial analysts are finding it?

Chairman MANZULLO. When McDonald's is finding it.

Mr. JOHNSON. When McDonald's is finding it.

Chairman MANZULLO. Right.

Mr. JOHNSON. The requirement to look for it, as I understand it, was put in in the 1980s when this problem emerged before and Treasury was ignoring the issue. They say well, we do not really know what the definition of distortion is.

Chairman MANZULLO. That is interesting.

Dr. Bergsten, in the midst of your testimony you had talked, and maybe I did not understand it, about imposing some type of a surcharge on those countries that send items here when the currency is being manipulated.

Mr. BERGSTEN. No, Mr. Chairman. I did not talk about a trade surcharge. I talked——.

Chairman MANZULLO. That is a new word for tariff, I thought.

Mr. BERGSTEN. No. It has been used. Remember, President Nixon put on a 15 percent surcharge——

Chairman MANZULLO. We will find a new word then.

Mr. BERGSTEN [continuing]. For all U.S. imports in 1971 for exactly this reason when the dollar was overvalued. Under those rules of the game, then you actually had to negotiate the devaluation of the dollar. He and John Connally put on an import surcharge to speed that negotiation. It was rough, but it worked.

No. What I suggested was something directly in the exchange market. Japan was my case where they are clearly intervening hugely to block the currency adjustment that the market is trying to provoke. I suggested our Treasury should counter their intervention dollar for dollar.

In fact, I suggested something even less Draconian; that the Secretary simply tell the Japanese that he was prepared to match their intervention dollar for dollar. I am quite confident that would be sufficient for them to cease and desist. I do not think we would actually have to do it, but if we got serious and threatened that counterintervention I am quite confident that would resolve the Japanese part of the problem.

The Chinese problem is more complicated. Everybody here has been beating up on China, starting with myself, but let me make one point on the other side of the debate. We have all noted that China has pegged to the dollar. Indeed, it did so from 1994 when it unified its exchange rates and did that big devaluation.

Remember, since that time, as I testified and as you know, the dollar actually rose by 35 to 50 percent against the trade weighted average of currencies we deal with. That means China rode the dollar up for six and a half years, hurting their competitive position.

Now, the fact that they have done so well and piled up so many reserves and attracted so much investment actually shows just how competitive they are because they did it despite riding the dollar up, but the point is for a long time the average exchange of the renminbi actually appreciated sharply in value. It has ridden the dollar down for the last 17 months, and I think we have to take strong action to get them to stop doing that, but in fact they did go the other way for a prolonged period of time.

With China, the issue is to get them to stop pegging to the dollar. In fact, it is in China's interest. They claim they do it to get a "stable" exchange rate, but that does not lead to a stable exchange rate. The dollar fluctuates wildly against the euro, the yen, every other currency in the world.

The Chinese peg to the dollar. They get dollar stability, but it is a minority of their trade, less than a third. They would get more stable exchange rates if they actually pegged to a basket of currency and let their exchange rate move, so it is even in their interest. That one is more complicated.

They are following another IMF rule that says any country can set its own exchange rate system, which in their case is to peg to the dollar which is perfectly legitimate. Hong Kong does it. Argentina did it, unfortunately, until recently. The issue is the price.

Since the price is clearly undervalued—we have all testified to that extent—pressure does need to be brought on China to move the rate up. They could appreciate in one step. They could let it float up. There are any number of ways to do it, but that is the issue.

Chairman MANZULLO. I saw an article in the Wall Street Journal last week that a lot of our U.S. multinational corporations that are manufacturing in China want to keep that peg, which I think is pretty bad, in order to keep the currency at an artificial rate.

Mrs. Velazquez?

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Dr. Blecker, as Asian countries' dollar holdings have been growing, so have their investment of these dollars in the safest dollar denominated assets that they can find—U.S. Treasury and agency securities. Asian central banks now hold more than $1 trillion of U.S. Treasuries alone.

What has been the effect on the United States' economy of these large scale purchases of U.S. government debt?

Mr. BLECKER. Well, the consequences are that it accounts for a large part of the estimated damage to the manufacturing sector that I spoke of earlier.

These countries, if we combine the Asian developing countries led by China and Japan, account for the majority of our trade deficit, and they would account for the majority of the estimated damage to the manufacturing sector I cited, which was a $100 billion a year loss of profits for these American manufacturers, a $40 billion a year loss of investment spending, and, in my estimates, which are underestimates compared to some other people's, I had three-quarters of a million jobs lost. To make it proportional, something on the order of 60 percent of that is probably due to those countries.

Ms. VELAZQUEZ. What would happen if these countries liquidated the security holdings?

Mr. BLECKER. Well, in terms of the effect in financial markets, I do not know how big that would be, but it would start to correct some of this currency imbalance.

Ms. VELAZQUEZ. Yes?

Mr. BERGSTEN. Could I just add to that? The direct effect of that big investment of foreign dollar holdings into treasuries has been to keep U.S. interest rates much lower than they would otherwise have been.

Mr. BLECKER. Right.

Mr. BERGSTEN. That has been the argument, particularly in the previous Treasury Department, for the so-called strong dollar; that the influx of foreign investment of their export earnings has had a favorable effect on our financial markets. There is no denying that.

On your second question, if there was for some reason a massive withdrawal of foreign assets from the U.S. security markets, it would have a noticeable impact driving down the prices of Treasuries and, therefore, driving up their interest rate. That is always the horror story in this field, as a former Undersecretary of the Treasury.

If the dollar ever went into a free fall or a collapse, you would have a significant risk of inflation pressure picking up and interest rates rising. Now, I was careful to say in my statement that there is absolutely no sign of any of that over the last year and a half of dollar correction. It has been gradual and orderly.

Indeed, I think it has been the perfect time to do it because we are at a low inflation/low interest rate environment. We know the dollar has to come down. Not only does the dollar need to come down. It needs to come down now because this is the right time to do it.

Having said that, there is always the risk. If the gradual, orderly decline became a free fall, it could be trouble.

Ms. VELAZQUEZ. Thank you. Thank you.

Mr. Bender, by pursuing weak dollar policies, we run the risk of generating inflationary pressures that could lead to higher interest rates. Should we pursue a weaker dollar even if it leads to higher capital costs for businesses, or do you believe that near term deflationary pressures are enough to upset any inflationary pressures that result from the weaker dollar?

Mr. BENDER. It sounds like an economist question.

Ms. VELAZQUEZ. If any of the others——.

Mr. BENDER. Well, I guess I could just make some comments. Right now, the interest rates are lower than we have ever seen, and certainly I am enjoying that right now.

Unfortunately, for the past several years my business has been in an overcapacity situation so low interest rates really are not helping me as far as going out and purchasing new equipment or financing new capital, which I think has been one of the big issues in our U.S. economy that manufacturers have been in an overcapacity situation. There is no need to go out and invest.

Ms. VELAZQUEZ. Dr. Blecker?

Mr. BLECKER. Thank you. Until we have the disastrous scenario that Fred Bergsten just painted of the free fall and the huge hike in interest rates, which I agree is unlikely, I think any realistic rise in interest rates and capital costs would be much smaller than the savings from correcting the current competitive disadvantages that you have heard about here. These kind of disadvantages are on the order of 30 or 40 percent. If we are talking about interest rates going up a few percent, even five percent, it would pale by comparison.

There are a lot of studies that have been done of business investment in the United States, and the best studies—I would particularly commend to you Barry Bosworth's book from the Brookings Institution in 1993—show relatively little (and what we call in economics statistically insignificant) effect of interest rates and capital costs on business investment, whereas the demand factor, how much customers are purchasing from companies and what their market looks like, is really the driving factor in investment.

If these companies' business picks up because they are no longer selling at a huge, competitive disadvantage vis-á-vis these countries, they will be able to invest, even if capital costs are a little higher. The higher revenue, the demand growth and competitive situation will more than compensate.

Ms. VELAZQUEZ. Thank you.

Mr. JONES. Could I add a real life example to that too, please?

Ms. VELAZQUEZ. Sure.

Mr. JONES. Your question is would you rather have low interest rates or sales, and I think the answer is we would rather have the sales.

For years, we thought that this was all a labor thing. We invested very heavily in labor saving equipment. Now we have a machine that would put us in a competitive position on this product which is sitting idle right now because the sales went over to China.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Chairman MANZULLO. What is that product, Mr. Jones?

Mr. JONES. These are crepe streamers for parties.

Chairman MANZULLO. Okay. The next questioner would be Congressman Schrock, who has an interesting alma mater.

Mr. SCHROCK. Yes. I also am a graduate of American University.

Chairman MANZULLO. Are you not amazed that you can turn out a couple of conservatives like this in light of the reputation there?

Mr. BLECKER. We have a very diverse campus.

Chairman MANZULLO. There you are.

Mr. SCHROCK. In spite of American, I still came out a conservative.

Chairman MANZULLO. Is that right?

Mr. SCHROCK. Yes, that is right. No. It was a great experience. It really was.

Thank you all for testifying today. Each of the stories you told was very interesting. This Chairman is the one who has really peaked my interest in the loss of manufacturing jobs, and I guess all through my life I have seen it. When I was growing up in Middletown, Ohio, Armco Steel Corporation was a massive company founded by one of my neighbors, Charles H. Hook. It is now owned by the Japanese and slowly, but surely, going away.

My closest friend in college lived in Aliquippa, Pennsylvania, which was the steel Mecca of America. It is gone. When I was a student at the senior officer course at the Naval War College in Newport, Rhode Island, my wife loved to go to the outlets in Fall River, Massachusetts, where they made clothing. That is all gone now. It has all gone overseas, and it continues to get worse and worse and worse. I guess I just do not know where we stop this.

All we are looking for is a level playing field. I think Mr. Bender said that. Mr. Tashjian said—by the way, my uncle worked for Century Furniture for 30 years in Hickory, so I know your company very well. You talk about lost time accidents. The Chinese do not care.

Mr. TASHJIAN. Right.

Mr. SCHROCK. They do not have safety laws. They do not have labor laws. If somebody gets hurt, injured or killed, they just take one of their one billion people and stick them in that hole, and they do not worry about that. We do. We are a compassionate society who cares about that sort of thing. Because of that, I think we are at a terrible disadvantage. How we balance that, how we correct that, is a total mystery to me.

Mr. Johnson, I think your comment was one of the most fascinating in your testimony. You said one-way purchases of currency with the purpose of gaining an export advantage is clearly illegal under both IMF and WTO rules, and they do it and do it and do it. What do we do about it? What are we doing about it? I do not know.

Mr. JOHNSON. Nothing, right?

Mr. SCHROCK. Nothing.

Mr. JOHNSON. It is Treasury's purview.

Mr. SCHROCK. But whose feet should be held to the fire on this? Commerce's?

Mr. JOHNSON. Treasury.

Mr. SCHROCK. Treasury, I mean. Treasury, yes.

Mr. JOHNSON. You know, I think all the other agencies are sympathetic because this is causing problems for them in trade negotiations and international agreements and whatever. They sent us to Treasury. We talked to Treasury, and nothing seems to happen.

Mr. SCHROCK. What is their excuse why it is not happening?

Mr. JOHNSON. They do not believe it is happening.

Mr. SCHROCK. They do not believe it is happening. It is unfortunate.

The Secretary was invited to come here today. Is that right? He was out of the country.

Chairman MANZULLO. He would have come, but he is out of the country.

Mr. SCHROCK. He is out of the country. Yes.

Mr. JOHNSON. Can I say about Secretary Snow? He is the first one that has had positive words on this.

Mr. SCHROCK. Great. Yes.

Mr. JOHNSON. I will tell you, at the staff level my experience of them is that this is an issue they do not want to embrace.

Mr. SCHROCK. Sure, because it might jeopardize their jobs, and they are in there to keep themselves employed. They do not care how they do it. It is costing us.

Mr. JOHNSON. I think there is a serious impediment there.

Mr. SCHROCK. Yes. Mr. Blecker was the first one that talked about the currency manipulation, and I am going to ask all of you. I do not know the answer to this. I am not an economist, so I do not know.

How do you recommend we pressure East Asia, for instance, to abandon their currency manipulation? Clearly, I think we ought to be able to do something about it. I do not know what. If we can, then this body up here from the people who sit from that desk back ought to be able to try to accomplish this and make it happen.

Yes, sir, Doctor?

Mr. BERGSTEN. Well, Mr. Schrock, I would say again that I think the most direct and, therefore, appropriate route is to respond directly to their currency intervention in the currency market.

I have suggested that we could tell the countries involved—in the first instance Japan, but the same approach could be taken to China—that if they continue to distort the market, which runs directly counter to Secretary Snow's pronouncement of U.S. policy that we will simply offset that directly.

We can intervene infinitely if we wish by selling dollars. We produce dollars. We have no constraint on what we can do in that market.

Mr. SCHROCK. Do you perceive Secretary Snow wishes to do that?

Mr. BERGSTEN. He has made very clear to the Japanese, both publicly and I believe privately, that he strongly disapproves of their intervention policy. He has publicly rebuked it and indicated that they should let the rate be set by the market.

I actually think it is confrontational from the Japanese side that they have not only continued, but accelerated their intervention since he has said that. In May alone, they intervened to the tune of $43 billion in the exchange market. As I mentioned, and it is not my comment. It is the comment of the former top Japanese official in this area. The yen would be 10 percent stronger today in the absence thereof.

I think that is the direction. You can make all sorts of efforts in the trade policy area. You can talk about import surcharges. These would have all sorts of negative effects on our own economy in terms of raising cost, prices, all of that. It is a monetary problem. I think it should be dealt with in the monetary area.

Several people have mentioned that the rules of the International Monetary Fund do provide for this kind of response. U.S. law provides for this kind of response. The U.S. Treasury has been asleep at the switch. The IMF has been asleep at the switch, and I will add, as I said in my statement, the G–7 has been asleep at the switch.

The people that should really be with us in leaning on the Asian countries to let their exchange rates move up are the Europeans because if the Asian currencies do not move up, the whole decline of the dollar occurs against the euro, and the Europeans take a hit to their competitive position. With a little U.S. effort, it need not be a unilateral move. The Europeans would surely support us strongly. It could be a G–7 initiative as a whole to go to China, which is not in the G–7, or to Japan within the G–7 to make this approach. Things like this have been done before.

I mentioned the Nixon shocks. That was to achieve a sharp decline in the value of the dollar in a somewhat similar situation. Secretary Jim Baker, in 1985, in the Plaza agreement, got the G–7 to agree to drive down the dollar in exactly these circumstances. The dollar dropped by 50 percent over the next two years to correct the huge overvaluation, which actually drove the U.S. from being the world's biggest creditor country to the world's biggest debtor country in the middle of the 1980s.

This has been faced before. The problem is that the responses have only come when a real crisis emerged. In the case of the Nixon Administration, foreigners were selling dollars for gold. There was a real threat to our convertibility. We closed the gold window and negotiated a devaluation with the help of an import surcharge.

In the middle 1980s, Secretary Baker, because the Congress was threatening to go hugely protectionist at the time, and you may remember that.

Mr. SCHROCK. I do.

Mr. BERGSTEN. He got the G–7 countries to agree to bring the dollar down sharply. It worked. By 1990–1991, our current account deficit was largely eliminated, so it worked.

The problem is the Treasury of the day for the reasons mentioned, because they do not want to take aggressive actions in this area for various reasons, wait until it is very late in the day. Lots of jobs have been lost. Lots of damage has been caused. The issue here is to move sooner rather than later. Eventually they will have to do it.

Just to be clear, their hope now is that this market driven decline of the dollar over the last year and a half will continue in the gradual, orderly way I have suggested. They are hoping that their calls on Japan and China to let their rates join the process will suffice. Maybe they will, but there is no sign to that yet.

The issue is to make sure what has begun to happen, very hopefully so, will continue and, as I say, about double what we have had so far.

Chairman MANZULLO. Thank you.

Mr. SCHROCK. Mr. Chairman, I know my time has expired. Let me just say what I hear the doctor saying is that this Chairman, the Members of this Committee, need to get the Treasury officials up here and put their feet to the fire and say get this fixed because if not we are going to lose more manufacturing jobs. That will not make you happy, and it will not make me happy.

Chairman MANZULLO. The core problem is that very few people in this city understand the nature of manufacturing. There are a lot of people that believe that we could lose our entire manufacturing base, and it does not mean anything.

Mr. SCHROCK. I know.

Chairman MANZULLO. That is the big problem.

Mr. SCHROCK. And what I understand is we do not have manufacturing anymore.

Chairman MANZULLO. Dr. Freedenberg?

Mr. FREEDENBERG. If I could add just one thing?

Mr. SCHROCK. Well, not like we used to.

Mr. FREEDENBERG. In the 1980s when I was a trade official, I asked Secretary Baldridge what kind of leverage we had. He said our counterparts in Asia can add. They know which direction the surplus in the deficit is. They know who is the richest. Therefore, we have all the leverage we need.

I return to what I said in my testimony. We just have to have the political will to apply it. It is not like we do not have it. We are the most powerful there is and the richest there is. It is a matter of whether you want to do it, and that is the question; not whether you have the leverage when you want it.

Chairman MANZULLO. I can guarantee you if it involved jobs around the Beltway that the city would understand what is going on.

Somebody who lost 11,000 manufacturing jobs in one day, Grace Napolitano had the opportunity to visit her district last September in a tremendous hearing. You are still at what, 11 percent unemployment?

Ms. NAPOLITANO. It is 10.

Chairman MANZULLO. It is 10 percent.

Ms. NAPOLITANO. We are 10. We dropped one, but still thank you for being with us. Thank you.

You will find that this Committee has done a lot in bringing some of the issues that affect all business. I am particularly proud because those that are sitting on this Committee understand your pain. We cannot get the Administration to move, to look at small business, to look at the effects on small business, what is happening, and to assist small business. I hear you.

Forget economy. I know very little about it, but I can tell you that in my district——.

Chairman MANZULLO. Mrs. Napolitano, could you suspend for just a second?

Ms. NAPOLITANO. I yield to you.

Chairman MANZULLO. Please either be quiet, or I will have the police remove all of you.

[Applause.]

Ms. NAPOLITANO. That is our Chairman for you. Thank you, sir.

You understand that I actually started a small manufacturing task force in my district because there is, and mine is a small district in terms of manufacturing, in terms of industry and commercialism, but there is such a need, such a cry for my businesses, that there needs to have something happen.

I have heard the same argument from them that I have heard from you. I am listening to Mr. Blecker and Mr. Bergsten. Both of you have indicated that there needs to be some credible action taken by the agencies themselves to be able to effectively control because that is what it is going to take is some control.

Unless we can just continue having hearings—I have a ton of questions I would love to ask, but that is not going to make this any better. It is not going to stop the bleeding of our businesses, the businesses that are going under because they cannot get competitiveness when they have their trade partners abroad say well, I can get it from another country at half the price or at least undercut what their bare minimum is, given the constraints we have. They have subsidies from the government. They have all kinds of other assistance, and we are not helping our business.

You will hear the same thing over and over again. We want to be able to bring that to the front, to be able to move the agenda to help small business, but this is a Committee. We do not have the ability to tell the Administration. It is you, the business people, who need to stand up on your two hind legs—sorry about that—

and get to them and tell them that you are the ones who are going under.

You are providing the jobs in this country for the economy in this country for us to be able to get out of the slump. Without them getting your push, your work, and my suggestion is become a unified group with other small business. Talk about it. Go and visit. Go talk. Go e-mail.

The message we have sent has been heard, but you, the business people, have got to come and say vocally, strongly, openly, publicly, that you are going to go under, and so are those hundreds of thousands of jobs that we are hoping are going to come back to this country within a very short while.

Thank you, Mr. Chair.

Chairman MANZULLO. Did you have any further questions, Ms. Velazquez?

Ms. VELAZQUEZ. No, Mr. Chairman.

Chairman MANZULLO. We want to thank you all for coming. It is a little bit noisy outside. You know, if they were talking down the dollar they could go at 10 decibels more, and it would not bother me one bit.

We enjoyed the testimony very much. As I said, all of your statements will be made a part of the record.

This Committee is adjourned.

[Whereupon, at 3:38 p.m. the Committee was adjourned.]

Chairman Don Manzullo
June 25, 2003

**Foreign Currency Manipulation and its Effect on Small Manufacturers and Exporters**

Good morning and welcome to this hearing of the Committee on Small Business. A special welcome to those who have come some distance to participate and to attend this hearing.

Last June, we looked at the effect the overvalued dollar had on our manufacturers and exporters. A year later, the dollar has declined measurably, but not significantly against Asian currencies.

We do appreciate Treasury Secretary Snow's re-definition of a "strong dollar." It has immensely helped many manufacturers as they compete and Europe and Canada. But the currency overvaluation problem remains primarily with most of Asia.

The US manufacturing base was the hardest hit by the latest recession. The U.S. has lost over two and a half million manufacturing jobs during this recession.

The 16th District of IL, which I am proud to represent, has been severely hurt by the downturn in manufacturing. Plants have been closed, putting people out of work. The Ingersoll Milling Machine Company has been the latest company in Rockford, IL to declare bankruptcy.

During this period, our Asian trading partners have implemented a strategy of currency under-valuation in order to gain a competitive advantage for their exports by making them cheaper.

It is estimated that the actions by China, Taiwan, South Korea, and Japan have essentially given their exporters a 20 – 40 percent reduction. This in turn acts as a tax by the same percentage on US manufacturers and exporters.

Since 1994, the Chinese government has kept its currency pegged at 8.28 yuan to the dollar. China has experienced economic growth, gains in productivity, a large export sector, and increased foreign investment, all factors that would cause its currency to appreciate if it were allowed to freely move. It is estimated by many economists that the yuan is undervalued by as much as 40 percent.

Japan has systematically intervened in the currency markets to reduce the value of the yen. Manipulation of exchange rates for the purpose of achieving an unfair competitive advantage is illegal under international protocols.

This manipulation of the currency market costs US jobs. Trade is vitally important to this country and was part of the reason for the economic expansion of the 1990s. It is also critically important to the small business sector.

Small businesses export their goods overseas and currency manipulation has squeezed their profits margin from those least able to absorb it. Their competitiveness abroad has dramatically decreased because of currency fluctuations and exchange rates that affect their prices.

The impact is not just being felt abroad. The overvalued dollar has caused the US to be flooded with cheap imports. Import penetration has caused domestic manufacturers to lose market share against foreign products that have a temporary price advantage.

The effect of this interference is to artificially inflate the dollar in a blatant attempt to manipulate the market.

The market needs to be the determinate of currency rates and values. Government intervention only skews the market and invites artificial rates that are not reflective of reality.

We need to ensure that US firms have a level playing field in the global market and not be at a competitive disadvantage.

I now yield for an opening statement by my good friend and colleague, the Ranking Member, Ms. Velazquez of New York.

# THE CORRECTION OF THE DOLLAR AND FOREIGN INTERVENTION IN THE CURRENCY MARKETS

C. Fred Bergsten
Director, Institute for International Economics[1]

Committee on Small Business
United States House of Representatives
June 25, 2003

## The Problem

The dollar rose by a trade-weighted average of 35-50 percent (depending on which index is used) from early 1995 until February 2002. Since every one percent increase in the dollar produces an increase of $10 billion in the annual US current account deficit after a phase-in period of two to three years, this appreciation accounts for the bulk of the total deficit that now exceeds $500 billion (about 5 percent of GDP) per year. These deficits have risen by almost one full percentage point of GDP in four of the last five years (excepting only the recession year of 2001).

As a result of the external deficits of the past twenty years, the negative net international investment position (NIIP) of the United States now exceeds $3 trillion and is climbing by about 20 percent per year. To finance both the current account deficit and our own sizable capital exports, the United States must import about $1 trillion of foreign

[1] This statement draws on C. Fred Bergsten and John Williamson, editors, *Dollar Overvaluation and the World Economy*, Washington: Institute for International Economics, February 2003, a compendium of thirteen papers by leading experts on the topic and an overview by the co-editors drawn from a conference hosted by the Institute in September 2002.

capital every year or more than $4 billion every working day. The situation is clearly unsustainable.

The Correction to Date

The dollar has thus been declining in a gradual and orderly manner since early 2002. Its fall to date cumulates to 10-20 percent (again depending on which index is used). Hence it has reversed one third to one half of the runup of the previous six-and-one-half years. As a result, the annual current account deficit should decline by $100-200 billion over the coming couple of years from where it would otherwise have been.[2] There have been no noticeable adverse effects of the dollar's decline on the US economy: inflation is nowhere to be seen (and indeed deflation is the greater risk), interest rates are at fifty-year lows and the equity markets have recently surged. The Administration has wisely accepted the correction, frequently reiterating that the exchange rate should be left to market forces and discouraging any thoughts that it might intervene to interrupt the decline.[3]

Analysis at our Institute for International Economics suggests that the United States can sustain a current account deficit at about half the current level or $250-300 billion per year (2½ - 3 percent of present GDP). At this level, the ratio of the US NIIP to GDP would level off at 30-35 percent, fairly high but still short of the traditional "danger zone" of 40 percent or more. Given the relationship noted above, that every one

[2] The absolute level of the deficit could fall less if the US economy continues to grow more rapidly than its major markets abroad, which is quite likely.
[3] Media and market discussion of the so-called "strong dollar policy" is substantively irrelevant. No administration has ever defined the term nor taken steps to implement the concept. The dollar is in fact still quite strong against its historical averages while of course weaker than in the recent past.

percent decline in the dollar will produce a reduction of $10 billion in the external imbalance, our trade-weighted exchange rate needed to fall by 25-30 percent from its recent peak. Hence the depreciation of the dollar to date has probably gone about half the needed distance.

The dollar decline to date, however, has been quite unbalanced among the major trading partners of the United States. The dollar has fallen by about 30 percent against the euro but only about 15 percent against the yen. It has not fallen at all against the Chinese renminbi. This outcome is paradoxical since Japan is by far the world's largest surplus and creditor country while China is the second largest holder of foreign-exchange reserves and runs the largest bilateral surplus against the United States.

Next Steps

Two complementary steps are needed to complete the essential correction of the dollar and thus of the current account imbalance of the United States.

First, as already noted, the trade-weighted average exchange rate of the dollar needs to fall by another 10-15 percent to restore a sustainable external position for the United States. It would be highly desirable if this further adjustment occurred, over the next year or so, at a similarly gradual and orderly pace to the depreciation of the past seventeen months.

Second, this upcoming "second wave" of dollar decline should occur against a broader group of currencies and with greater corresponding appreciations in East Asia. Continued reliance on dollar correction against the euro would almost certainly produce an overvaluation of that currency, a significant further spur to trade protectionism throughout Europe that could hurt US exports, and additional political resentment on top of the acute transAtlantic tension that already exists. The Europeans would strongly (and correctly) resist such continued asymmetry of the adjustment process and almost certainly take forceful steps to prevent it, hence limiting the ultimate dollar correction.

East Asia should thus be the focal point of the currency realignments of the coming year. In particular, Japan must desist from intervening directly in the foreign exchange markets to limit the appreciation of the yen. Japan's massive purchases of dollars over the past eighteen months, which totaled over $33 billion in May alone, have probably kept the yen from rising by at least another ten percent.[4]

Secretary Snow has been very clear in stating the view of the US Government that exchange rates should be determined by market forces rather than by intervention by national monetary authorities. The Secretary should now inform the Japanese that the US authorities will sell a dollar for every dollar that the Japanese authorities buy, to offset their intervention and return the yen-dollar rate to determination by market forces. The "theory of the second best" indeed calls for governmental distortions of markets to be countered by offsetting governmental interventions in the other direction. Even a

[4] This estimate was suggested during a recent discussion in Washington by former Japanese Vice Minister of Finance Eisuke Sakakibara, known as "Mr. Yen" while in office, and conforms with my own judgment.

suggestion to the Japanese that the United States was considering this course should suffice to dissuade them from further market intervention.[5] [6]

The other major currency problem in East Asia lies in China. China pegs its currency to the dollar. Hence there has been no correction of the dollar against the world's most rapidly growing economy, which also holds the world's second largest hoard of foreign exchange reserves ($300 billion, despite its low per capita income of about $1000) and runs the largest surplus against the United States.[7]

Moreover, because of its dollar peg, the renminbi has been "riding the dollar down" and falling against virtually all other currencies along with the dollar. China is already widely viewed as the world's most formidable competitor in many sectors and this decline in its currency strengthens its competitiveness further. This deters other major countries such as Korea, Singapore, Taiwan and even Japan from letting their currencies rise against the dollar. The essentially fixed peg of the renminbi to the dollar thus blocks, or at least severely limits, all of East Asia from playing its appropriate and necessary role in the global adjustment process. Under these circumstances, it will be

[5] Some analysts of Japan believe that a weaker yen is now appropriate in light of the weakness of the Japanese economy. This view ignores the fact that Japan, despite all its problems, continues to run by far the world's largest trade surpluses (and that the surpluses are again rising, due in part to the fact that the yen is quite weak by historical standards). Moreover, exports account for less than 10 percent of Japan's GDP so Japan can only recuperate economically by addressing its wide range of severe domestic problems.
[6] It would be desirable for this counter-intervention to take place by the other major financial powers as well as the United Sates, with approval from the International Monetary Fund in furtherance of the prohibition in its Articles of Agreement of manipulation of currencies "to gain an unfair competitive advantage."
[7] The official US data are distorted by transshipments through Hong Kong. Hence the actual imbalance between the two countries is smaller than those data suggest. The number is still very large, however, and probably larger than that of second-place Japan.

very difficult to complete the required correction of the dollar and the needed adjustment of the US external imbalance.[8]

It is thus imperative that China let its currency start to rise in the exchange markets, to contribute directly to the needed US adjustment and to permit other East Asian currencies (including the yen) to rise more extensively as well.[9] Secretary Snow has recently encouraged the Chinese to move in that direction. The G-7 should promptly join the effort to convince China to let the renminbi appreciate; the countries of Euroland in particular have a huge incentive to do so because only a much greater appreciation of East Asian currencies, which will occur only if the renminbi is allowed to rise, will take the pressure off the euro to continue its disproportionate climb against the dollar.

Conclusion

The first phase of the inevitable and essential correction of the exchange rate of the dollar has occurred smoothly and effectively over the past seventeen months. As a result, we can expect the US current account to improve over the next couple of years by $100 billion or so from where it would otherwise be. This is especially good news for the American manufacturing sector, which has been hit over the past three years by the

[8] A similar situation arose in the late 1980s, after the dollar had come down sharply against the other G-7 currencies after the Plaza Agreement, when the Asian NICs (Hong Kong, Korea, Singapore, Taiwan) also "rode the dollar down" and began to run huge external surpluses. The United States and G-7 then persuaded them to let their currencies appreciate and the second leg of that adjustment was successfully completed, cutting the US current account deficit to very low levels by 1990-91.

[9] China stresses the importance of maintaining "a stable exchange rate" but in fact its peg to the dollar, which gyrates so sharply against all other currencies, assures it of an unstable trade-weighted rate. China would achieve much greater currency stability by diverting the renminbi in a basket of currencies rather than the dollar (or any other single currency) and then letting the rate rise in response to market forces.

"triple whammy" of weak domestic growth, weak growth in its foreign markets (where it sells about one third of its output) and an overvalued dollar.[10]

We now need a second phase of the dollar correction of roughly equal magnitude but significantly different composition. Much of the essential further fall of the dollar should occur against the currencies of China, Japan, Korea and other countries in East Asia rather than against the euro (though some further adjustment will be needed there too). Those countries, especially China and Japan, must change their policies of competitive undervaluation to permit such realignment to occur. The United States and the G-7 should attach the highest priority to achieving this change over the coming months.

[10] See Martin Baily, "Persistent Dollar Swings and the US Economy," in Bergsten and Williamson, eds., *Dollar Overvaluation and the World Economy.*

**Statement of**

**Robert A. Blecker, Ph.D.**
**Professor of Economics, American University**
**Research Associate, Economic Policy Institute**

**House Committee on Small Business**
**June 25, 2003**

Mr. Chairman and members of the Committee, my name is Robert Blecker, and I am a professor of economics at American University and a research associate of the Economic Policy Institute here in Washington. I would like to begin by thanking you for the opportunity to testify at this hearing. I have submitted to the Committee a report I recently wrote for the Economic Policy Institute on how the overvalued dollar has affected the U.S. manufacturing sector, and I would respectfully request that this report be entered in the Record along with my written statement.

Mr. Chairman, there has been much attention in the last few months to the falling value of the U.S. dollar. However, while attention has been focused on the dollar's fall relative to the euro and a few other major currencies, less attention has been paid to the fact that the dollar has fallen much less or not at all compared with many other currencies of other important trading partners. Especially, the dollar has not fallen nearly as much relative to the Japanese yen, and has a fixed or managed exchange rate with the Chinese yuan (renminbi), the Taiwanese dollar, and certain other Asian currencies, due to the currency manipulation practiced by their governments. As a result, the dollar has not fallen nearly enough overall to undo the damage caused by its overvaluation for the past several years.

According to the statistical estimates in my EPI Briefing Paper, the rise in the dollar up to 2002 caused the following damage:

- A loss of three-quarters of a million U.S. manufacturing jobs;
- A decline in profits on U.S. manufacturing operations of about $100 billion per year; and
- A reduction in capital expenditures at U.S. manufacturing plants of over $40 billion at an annual rate.

Furthermore, as I testified to the U.S. Trade Deficit Review Commission four years ago, the high dollar has been a significant cause of the nation's large trade deficit, along with depressed economic conditions in foreign markets and a long-term shift of manufacturing production to other nations.

Although my analysis does not distinguish U.S. manufacturing businesses by size, I believe that small businesses are likely to be disproportionately represented among the companies hurt by the overvalued dollar, because small businesses tend to be less multinational in scope and hence have less of an ability to produce or source products overseas. If such businesses do manage to shift production or outsource abroad in response to a lower dollar, the result is still a loss of American jobs that can devastate local communities. Furthermore, the fact that the high dollar has led American manufacturers to cut back their domestic investment expenditures portends slower growth and reduced technological innovation in these industries in the future.

For all these reasons, the recent decline in the dollar to a more reasonable level relative to the euro, the British pound, the Canadian dollar, and certain other currencies gives a ray of hope for the manufacturing sector to begin a recovery from its current depressed state. However, this ray of hope is significantly dimmed by the partial nature of the dollar's decline to date.

The countries that have let their currencies rise the most against the dollar, chiefly the Europeans and Canadians, account for less than half of U.S. trade overall, and less than half of our trade deficit. Even in regard to those currencies, the dollar has lost only part of the value it gained between 1995 and 2002. However, the situation is even worse with Japan and other East Asian countries that actively manipulate their currency values, yet account for the largest part of the U.S. trade deficit. The dollar has fallen only about 12 percent versus the yen since February 2002, compared with about 27 percent versus the euro, due largely to Japan's intervention in currency markets to buy up dollars and keep the yen from rising. China, Taiwan, and many other developing nations maintain pegged exchange rates, and hence do not allow their currencies to rise to market-determined levels in response to their trade surpluses with the United States.

These East Asian countries have amassed reserves of well over $1 trillion U.S. dollars as a result of their efforts to keep their own currencies undervalued and maintain their artificial competitive advantages in the U.S. market, and such intervention has grown in intensity in the past few months as the dollar has fallen relative to other currencies.

In response to these policies, the United States needs to take strong measures to pressure our leading trading partners in East Asia to abandon their currency manipulation and allow their currencies to rise to market equilibrium levels in the long run. We should use the authority that the Secretary of the Treasury has under U.S. law to investigate currency manipulation and negotiate with trading partners that obtain chronic trade surpluses with us by undervaluing their currencies. Also, we need to make the maintenance of realistic, equilibrium exchange rates a condition for trade liberalization and market opening agreements. Free trade cannot bring the mutual benefits that it is supposed to provide in theory, unless the theoretically required conditions of balanced trade and full employment are met, and those conditions cannot obtain in the presence of significantly misaligned global exchange rates. I would urge that all future trade agreements include prohibitions on currency manipulation for the achievement of artificial competitive advantages and that this issue be given a priority role in future trade negotiations, such as in the WTO and the proposed FTAA.

Of course, the United States should not be indifferent to the fact that rising currency values can threaten economic prosperity in other countries, but the right solution to this problem is to encourage our trading partners to stimulate their own domestic economies, rather than to keep the dollar overvalued and let them achieve export-led growth at our expense.

Thank you very much, and I'd be happy to answer any questions.

Economic Policy Institute **Briefing Paper**

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# THE BENEFITS OF A LOWER DOLLAR

## How the high dollar has hurt U.S. manufacturing producers and why the dollar still needs to fall further

*by Robert A. Blecker*

The current decline in the dollar will provide a much-needed stimulus to the U.S. economy. The falling dollar will bring especially welcome relief to the internationally competitive U.S. manufacturing sector, which has suffered disastrous consequences—lost jobs, reduced profits, and decreased investment—as a result of the dollar's overvaluation for the past several years. However, although the dollar has come down significantly from its peak in February 2002, it has not yet fallen nearly enough to reverse the damage caused by its high value since the late 1990s.

In spite of its recent fall, the dollar has still not lost most of the value it has gained since 1995 compared to the euro and other major currencies. Moreover, the dollar has not fallen compared to the currencies of the developing nations that now account for more than half of the U.S. trade deficit. Some of these nations, especially China, maintain fixed exchange rates and intervene heavily to prevent the type of market-driven adjustment that is now occurring between the dollar and the euro. As a result, relying on financial markets to bring the dollar down is not enough. More active management of the dollar's decline—including cooperation with major U.S. trading partners and action to end foreign manipulation of currency values—is vital to ensure that the dollar falls in a comprehensive and sustainable fashion.

The high value of the dollar since the late 1990s has acted like a massive tax on U.S. exports and a huge subsidy to U.S. imports. As a result, although U.S. manufacturing firms have made substantial investments in new technologies and U.S. manufacturing workers have vastly increased their productivity, these achievements have not paid off in the face of foreign products that have been selling at deep, artificial discounts created by the overvalued dollar. Specifically, the overvalued dollar has resulted in:

- About 740,000 lost jobs in the manufacturing sector by 2002—more than one-quarter of the 2.6 million jobs lost in manufacturing since 1998.
- A decrease of nearly $100 billion in the annual profits of U.S. manufacturing companies by 2002.
- A fall in investment in the domestic manufacturing sector by over $40 billion annually as of 2002, representing a loss of 25% of U.S. manufacturing investment.

Thus far, the dollar has reversed only part of its 34% rise in overall value (in "real," inflation-adjusted terms, compared with most global currencies) between mid-1995 and early 2002. As of May 2003, the dollar is still 24% higher overall than it was at its low point in July 1995.[1] Moreover, the dollar's behavior in the last few years has varied significantly between two different groups of currencies:

- Compared with other "major" currencies (the Japanese yen, British pound, the euro and its predecessors, and a few others[2]), the dollar has fallen 16% since February 2002, after rising by 51% between April 1995 and February 2002; thus *the dollar has lost only about a third of the value it gained in the late 1990s relative to those currencies.*
- Other important U.S. trading partners, such as China and other developing nations, have fixed or managed exchange rates that do not respond to the market forces that have generated the recent decline in the dollar vis-á-vis the major currencies. *The dollar has continued to rise relative to these other currencies*, which belong to countries that now account for nearly half of total U.S. trade (and more than half of the trade deficit).

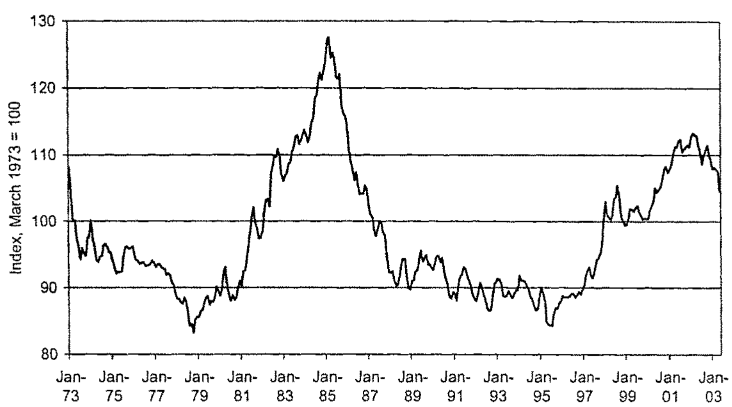
With the U.S. economy still struggling to recover nearly two years after the recession of 2001 officially ended, with the trade deficit still at record levels, and with global currency markets already forcing a downward adjustment in the U.S. exchange rate, the need to reconsider the U.S. Treasury's "strong dollar policy" has never been more clear. Although some Bush Administration officials have recently signaled a greater openness to market-driven reductions in the value of the dollar, much more needs to be done by the U.S. government—both alone and in collaboration with U.S. trading partners—to ensure a stable adjustment of the dollar to a more realistic level while promoting a recovery of growth in the global economy.

## Causes of the overvalued dollar

The U.S. dollar's sharp rise from 1995 to 2002 and its partial fall in 2002-03 are only the latest episodes in the gyrations of the dollar's value since the major industrialized nations switched to

**FIGURE 1**

**Real value of the U.S. dollar, monthly broad index, January 1973 - May 2003**




Note: Data for May 2003 are preliminary.

Source: Federal Reserve Statistical Release H.10, downloaded from http://www.federalreserve.gov/releases/h10/Summary/.

floating exchange rates in 1973. As shown in **Figure 1**, the dollar fell for most of the 1973-79 period, but then rose to new heights in the early 1980s before falling precipitously in 1985-87. After that, the dollar had a more gradual declining trend through mid-1995. In mid-1995, there was another abrupt reversal, as the dollar began rising toward a new peak in early 2002, at which point its value returned to levels not seen since the mid-1980s.

Figure 1 shows that the decline in the dollar since early 2002 has reversed only part of the increase after 1995. By this "broad" measure, which includes most other global currencies, the dollar rose by 34% from July 1995 to February 2002, and has fallen by only 8% since that time. Although the dollar briefly had a higher value in the mid-1980s, it has been more persistently overvalued in the last several years than it was during that earlier episode. Moreover, Figure 1 makes it clear that the dollar's fall thus far in 2003 has taken it only back to about where it was in 1999, not to its much lower level of the early and mid-1990s.

Although there are many reasons for the dollar's rise after 1995,[3] the most fundamental explanation is the strengthening of the U.S. economy during the "new economy" boom of the late 1990s, at a time when most of the rest of the world was relatively stagnant. The dollar's strength was, to a large extent, the mirror image of severe economic weaknesses abroad that resulted in falling values of foreign currencies. Japan's decade of stagnation, continental Europe's slow growth and high unemployment, the Asian financial crisis, and the subsequent financial turmoil in other countries from Russia to Argentina led to a massive flight of capital funds out of those countries and into the one "safe haven" in the global economy: the United States. Meanwhile, the U.S. economy had six consecutive years of relatively rapid growth with low inflation between 1995 and 2000. A robust business climate and a booming stock market helped to attract investment into U.S. financial markets, pushing up the value of the dollar.

In addition to the overall impact of U.S. economic strength relative to foreign economic weakness, several specific events provided more targeted stimuli to the appreciating dollar. In the mid-1990s, the governments of several countries, Japan in particular, intervened to halt the dollar's previous decline and to prevent their own currencies from appreciating further (Morici 1997). These interventions, which were especially large in 1994-96, effectively started the dollar on its new upward course and contributed significantly to rising U.S. trade deficits at that time. As a prominent trade economist wrote,

> In the 1990s, the Japanese, the Chinese, and other governments have dramatically increased their purchases of U.S. government securities, propping up the value of the dollar against other currencies. This has helped to sustain both their trade surpluses and U.S. deficits, even as the United States has put its fiscal house in order. In most cases, these purchases are not market-driven decisions, made in response to higher U.S. interest rates. Rather, they often reflect policy decisions to block exchange rate adjustments, and reduce internal pressures on national governments to revise protectionist trade policies and the reliance on export-led growth. (Morici 1997, p. v)

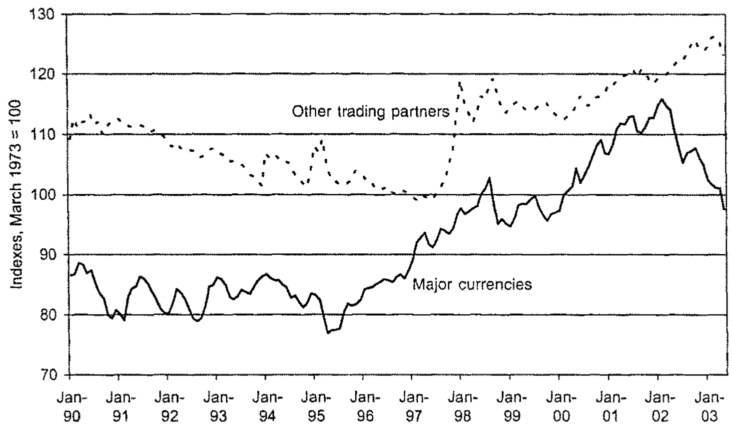
**Figure 2**, which focuses on the period since 1990, shows an important but oft-neglected fact about the dollar: how its exchange rate has varied between the "major currencies" of the other industrialized countries and what the Federal Reserve calls America's "other important trading partners," i.e., the developing nations and transition economies.[4] Compared to the major currencies, the dollar started rising in mid-1995 and continued its upward trend until early 2002, when it began a partial reversal as described above. But compared to the other (non-major) currencies, the dollar did not rise until the Asian financial crisis of 1997-98, which led to the sudden collapse or devaluation of several important currencies in Asia and elsewhere (notably the Thai baht, Taiwanese dollar,[5] Korean won, Indonesian ruppiah, Malaysian ringgit, Philippine peso, and Russian ruble) in the second half of 1997 and 1998.

As a result of the Asian crisis, the dollar jumped in value relative to the other currencies in 1997-98. Most of the Asian currencies that initially collapsed began to stabilize by 1999, but subsequent currency crises in other developing countries (such as Brazil, Turkey, and Argentina) and smaller depreciations elsewhere (e.g., Mexico) have led the dollar to *rise even higher* relative to these other currencies in the early 2000s. As of May 2003, the dollar was 24% higher against these other (developing country) currencies, compared with its low point relative to the same currencies in 1997 (see Figure 2).

The other currencies account for roughly 45% of U.S. trade with the countries included in the Fed's broad dollar index and nearly half of overall U.S. trade;[6] hence, the dollar's continued rise

**FIGURE 2**

**Real value of the U.S. dollar, monthly indexes for major currencies and other trading partners, January 1990 - May 2003**




Note: Data for May 2003 are preliminary.

Source: Federal Reserve Statistical Release H.10, downloaded from http://www.federalreserve.gov/releases/h10/Summary/.

relative to these currencies has thrust the overall value of the dollar upward and has had a notable impact in worsening the U.S. trade deficit. By 2002, the developing countries accounted for more than half of the U.S. trade deficit for goods.[7] Thus, *the dollar is still rising and not falling compared to the currencies of the countries that account for most of the nation's trade deficit.*

One reason the dollar has stayed so high relative to these other currencies is that many of their governments either peg their exchange rates (fix them relative to the dollar or other major currencies) at artificially low values, or intervene heavily to keep their currencies undervalued relative to the U.S. dollar (the latter policy is also followed by Japan, which issues a "major" currency). Such manipulative exchange rate policies are usually pursued as part of an export-led growth strategy that fosters chronic trade surpluses with the United States and therefore effectively exports unemployment to this country's traded goods sectors (mostly manufacturing). The most egregious offenders in this regard are a number of prominent East Asian countries, especially Japan, China, and Taiwan, which (not coincidentally) account for disproportionately large shares of the U.S. trade deficit.

Countries keep their currencies undervalued (and the dollar overvalued) by buying up the excess supplies of dollars that enter their countries and holding them as foreign exchange reserves.

**TABLE 1**
**Total international currency reserves (excluding gold), selected countries and years (end-of-period, in billions of U.S. dollars[a])**

| | 1990 | 1995 | 2002 |
|---|---|---|---|
| Japan | $78.5 | $183.2 | $461.3 |
| P.R. China | 29.6 | 75.4 | 291.2 |
| Taiwan | 72.5 | 90.3 | 161.7 |
| Hong Kong | 24.6 | 55.4 | 111.9 |
| Singapore | 27.8 | 68.7 | 82.1 |
| Subtotal: Four Asian NICs[b] | 154.4 | 289.7 | 646.9 |
| Euro area[c] | 290.8 | 299.1 | 246.6 |

Notes:
a. Data were converted from special drawing rights (SDRs) using the end-of-period U.S. dollar-SDR exchange rate for each year.
b. Newly industrializing countries, i.e., China, Taiwan, Hong Kong, and Singapore.
c. Data for 1990 and 1995 are the sums for the countries that later joined the European Monetary Union (EMU) in 1999. Data for 2002 are EMU totals including reserves of the European Central Bank (ECB) not counted in the individual countries' statistics.

Source: International Monetary Fund, *International Financial Statistics*, online database.

As shown in **Table 1**, several leading Asian countries have had truly prodigious increases in their international currency reserves since 1995.[8] Japan increased its foreign currency reserves by two and a half times between 1995 and 2002, reaching a world-leading $461.3 billion at the end of 2002. To put this number in perspective, Japan's reserves at that time were nearly double those of the entire euro area ($246.6 billion), even though the euro area is much larger by other economic criteria (e.g., gross domestic product) and the reserves of the future euro area countries exceeded those of Japan in 1995 and earlier.[9]

China's reserves nearly quadrupled between 1995 and 2002, and at $291.2 billion were also larger than those of the euro area at the end of 2002. The reserves of Taiwan, Hong Kong, and Singapore are also enormous for relatively small countries, and grew substantially between 1995 and 2002. These four newly industrializing countries (NICs)—China, Taiwan, Hong Kong, and Singapore—together amassed $646.9 billion of foreign reserves by 2002, more than double what they held in 1995, and more than double the level of the entire euro area. No other group of countries in the world comes close to the level of reserves accumulated by the East Asian countries shown in Table 1.

Of course, some growth of international reserves is important for sustaining global liquidity and facilitating trade, and the evidence from the financial crises of the late 1990s shows that countries with larger arsenals of reserves were more successful in avoiding speculative attacks on their currencies or contagion effects from other countries' crises.[10] But the sheer magnitude of the reserves accumulated by these East Asian countries, and the rapidity with which these reserves have increased in recent years, is *prima facie* evidence of efforts to keep their currencies undervalued

**TABLE 2**
**Average growth rates of U.S. real exports and imports of goods, 1990-95 and 1996-2002 (average annual percentage rates)**

| | Nonagricultural exports | Nonpetroleum imports |
|---|---|---|
| 1990 to 1995 | 8.9 | 8.0 |
| 1996 to 2002 | 4.4 | 9.7 |

Note: The average annual growth rates shown are the simple averages of the quarterly growth rates (measured at annual rates) for the years indicated.

Source: Author's calculations based on data in U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts, Table 4.4, downloaded from http://www.bea.gov.

and prevent their currencies from appreciating to exchange rates that would be conducive to more balanced trade relations with the United States.[11] This is outright currency manipulation of a mercantilist nature, intended to maintain those countries' trade surpluses with the United States, which by 2002 accounted for about 40% of the overall U.S. trade deficit.[12]

## How the high dollar has hurt U.S. manufacturing

The rise of the dollar since 1995 has had a devastating effect on U.S. trade performance, especially in the manufacturing sector, which accounts for the vast majority of U.S. trade.[13] A high dollar makes U.S.-produced goods less competitive compared with foreign-produced goods, putting U.S. exports at a disadvantage while encouraging imports into the U.S. market. As **Table 2** shows, the growth rate of nonagricultural exports (mostly manufactures) was *cut in half* across 1996-2002 (the period of a rising dollar) compared with 1990-95 (a period of a gradually falling dollar, as shown previously in Figure 1).[14] The growth rate of nonpetroleum imports (also mostly manufactures) increased over the same time frame.

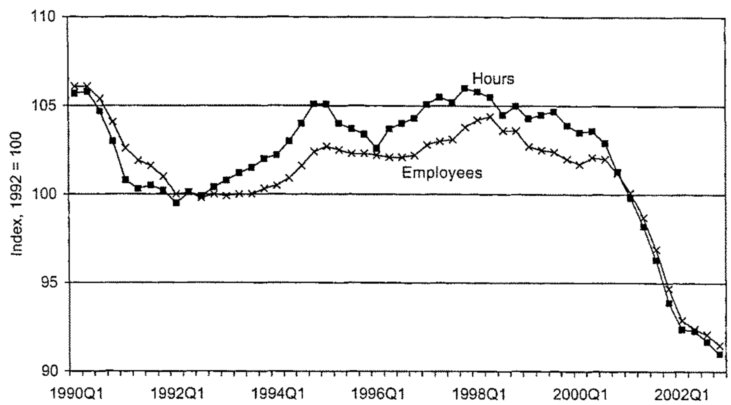
### *Job losses caused by dollar overvaluation*

Slower export growth combined with accelerated import growth implied that foreign trade had a *negative* net effect on U.S. employment during the late 1990s and early 2000s. Most of these negative employment effects were felt in the manufacturing sector, which produces the vast majority of the traded goods and services in the U.S. economy.[15] Indeed, although overall U.S. employment rose rapidly in the economic boom of the late 1990s, hours of manufacturing workers peaked in the fourth quarter of 1997, the number of manufacturing jobs peaked in the second quarter of 1998, and both trended downward thereafter (as shown in **Figure 3**), even though the recession did not begin until 2001.[16]

A large part of this falling trend in manufacturing employment since the late 1990s can be attributed to the rising trend in the dollar since 1995. According to estimates, for each 1.0% rise in

FIGURE 3

**Manufacturing employment and hours, quarterly indexes, 1990Q1 to 2002Q4**



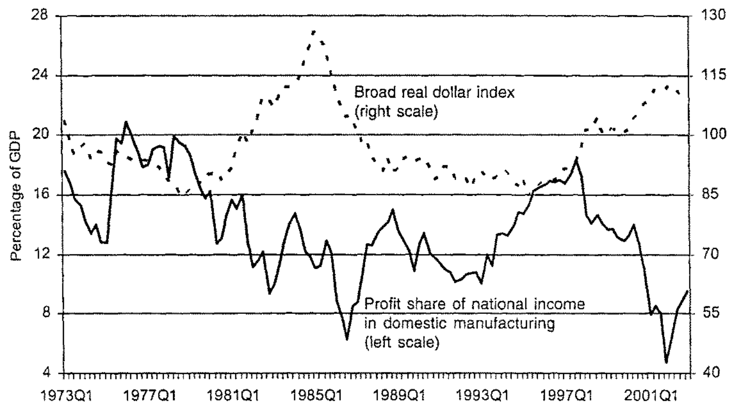

Source: U.S. Department of Labor, Bureau of Labor Statistics, Major Sector Productivity and Costs, downloaded from www.bls.gov/lpc/home.htm.

the real value of the dollar, the hours of labor employed in manufacturing fall by 0.13% and the number of workers employed falls by 0.12%.[17] Since the dollar rose by 33.5% between the second quarter of 1995 (when the dollar was at its lowest level) and the first quarter of 2002 (when the dollar peaked), the increased value of the dollar caused U.S. manufacturing workers' hours to fall by 4.4% and the number of jobs to decrease by 4.0%. These losses in hours and jobs attributed to the value of the dollar are beyond any effects of productivity growth and the business cycle downturn, i.e., the recession and slow recovery.

In terms of the actual number of workers affected, since there were approximately 18.5 million employees in manufacturing when the dollar reached its nadir in the second quarter of 1995,[18] a 4.0% reduction in employment would be equivalent to about 740,000 jobs lost[19] as a result of dollar appreciation. These three-quarters of a million lost jobs represent more than a quarter of the 2.6 million total job losses in manufacturing between the peak of manufacturing employment in the second quarter of 1998 and the employment level in the second quarter of 2003. The remainder of the job losses in manufacturing can be attributed to the effects of the recession and sluggish recovery in the United States, slow growth of U.S. export markets abroad, and continued rapid productivity growth.

**FIGURE 4**

**Inverse relation between manufacturing profit share and the real value of the dollar, quarterly, 1973Q1 to 2002Q4**




Sources : Federal Reserve Statistical Release H.10 (same as Figure 1); U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts, from http://www.bea.gov; author's calculations.

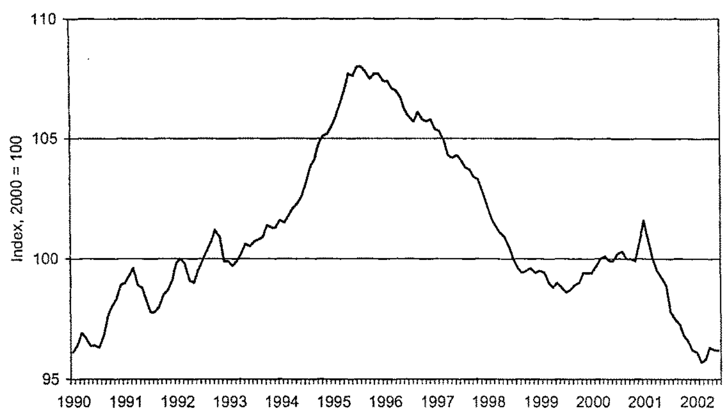
*Manufacturing profits squeezed by the high dollar*

By weakening U.S. manufacturing as a whole, the high dollar has had devastating consequences for business profits and manufacturing jobs. Starting in mid-1997, when the dollar's rise accelerated (see Figure 1), domestic manufacturers ceased to benefit from the economic boom that continued for three subsequent years in most of the U.S. economy. As **Figure 4** shows, manufacturing profits began to rebound during the economic recovery of the mid-1990s, but then peaked and tumbled in mid-1997—three years before overall economic growth slowed down in the second half of 2000 and four years before the recession of 2001.[20] This premature decline in manufacturing profits in the midst of an overall economic boom coincided with the dollar's accelerated rise during the outbreak of the Asian financial crisis. Figure 4 also shows that the cyclical fluctuations in manufacturing profits are virtually a mirror image of the value of the dollar, i.e., manufacturing profits and the real dollar index have generally moved in opposite directions throughout the past two decades.

The inverse relationship between the dollar and profits is no coincidence. On the one hand, a higher dollar brings down import prices and forces domestic firms that compete with imports to either cut price-cost margins or lose sales volume (or both). As **Figure 5** shows, import prices began to fall immediately after the dollar started to rise in 1995 and have trended downward ever since. On the other hand, a higher dollar also makes U.S. exports less competitive abroad and

FIGURE 5

Price index for all imports except petroleum, monthly, January 1990 to March 2003



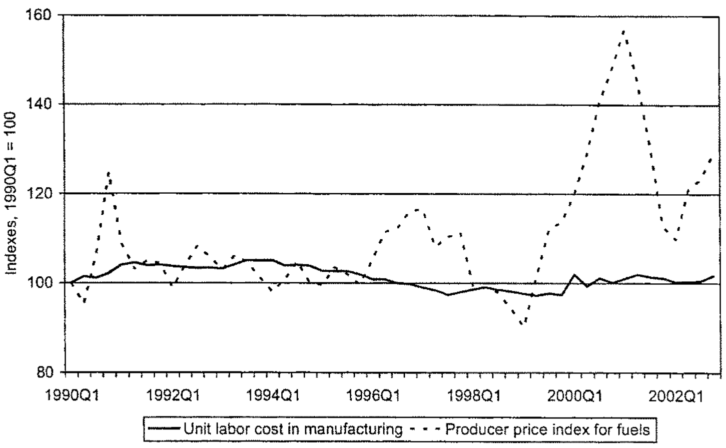

Source: U.S. Department of Labor, Bureau of Labor Statistics, downloaded from http://www.bls.gov/mxp/home.htm.

compels exporting firms to either lower their dollar prices or suffer reduced export volumes. Either way, exporting firms lose profits.[20] Thus, whether manufacturing firms compete with imports or sell in export markets, their profits are cut by an overvalued currency. Because firms that are not making profits cannot continue to employ U.S. workers, the drop in profits ultimately hurts everyone in industries that are open to foreign competition.

Of course, manufacturing profits are also affected by other factors, especially demand factors (the business cycle) and cost factors (labor, energy, and raw materials). However, none of these other factors can explain the timing of the decline in manufacturing profits starting in mid-1997. **Figure 6** shows the trends in labor and energy costs affecting the manufacturing sector since 1990. Unit labor costs in manufacturing were virtually flat throughout the 1990s and early 2000s, with only slight fluctuations, as productivity growth almost exactly matched nominal wage increases. Unit labor costs simply did not change enough to cause the wide swings in profits seen in Figure 4. Energy costs (measured by the producer price index for all fuels) have fluctuated more than unit labor costs, but the *timing* of their fluctuations does not match the trends in manufacturing profits. Fuel prices rose slightly in 1996 through early 1997, followed by a much larger increase in 1999-2000 and another increase in 2002, but these spikes in energy costs cannot explain why manufacturing profits started to decline in the second half of 1997. In fact, energy costs (i.e., fuel prices) were actually falling in late 1997 and early 1998 when the profit share began to fall (compare Figures 4 and 6).

**FIGURE 6**

**Manufacturing unit labor costs and energy prices, quarterly indexes, 1990Q1 to 2002Q4**




Note: All indexes were re-based to 1990Q1 = 100.

Sources: U.S. Department of Labor, Bureau of Labor Statistics, Major Sector Productivity and Costs and Producer Price Indexes, downloaded from http://www.bls.gov; author's calculations.

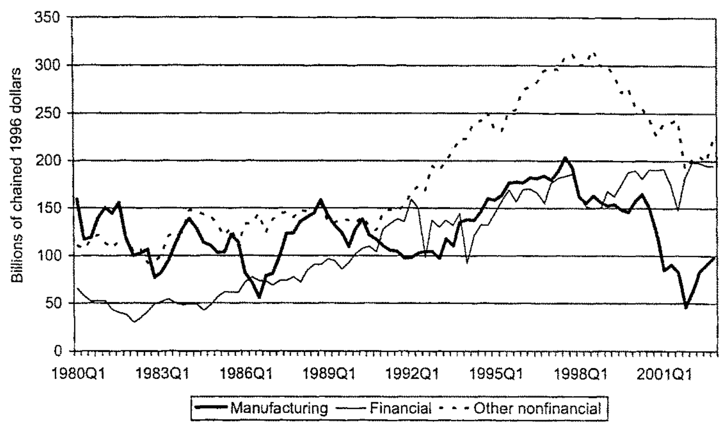
On the demand side, overall U.S. economic growth remained strong until the third quarter of 2000, three years after manufacturing profits peaked and fell. A recession occurred in the first three quarters of 2001, but this was nearly four years after manufacturing profits had begun to fall. Manufacturing profits did fall further in the last few years as a result of the growth slowdown and recession beginning in the second half of 2000, but those profits had already begun to decline while demand was still strong three years earlier. Thus, the only factor that can account for the downturn in manufacturing profits in the late 1990s was the rising dollar.

The rise in the dollar from its (quarterly) trough in the second quarter of 1995 to its peak in the first quarter of 2002 reduced manufacturing profits by $96.2 billion annually.[21] Since actual manufacturing profits were only $66.7 billion (measured at an annual rate) in the first quarter of 2002, they would have been nearly one and a half times higher (144%, to be exact) if the dollar had not appreciated.

The enormous decline in manufacturing profits after 1997 was unique among the major sectors of the U.S. economy (with the possible exception of agriculture, for which comparable statistics are not available). As shown in **Figure 7**, real (inflation-adjusted) profits in manufacturing fell earlier and more precipitously than real profits in the financial sector and other nonfinan-

**FIGURE 7**

**Real corporate profits by sector, quarterly, 1980Q1 to 2002Q4**




Note: Nominal profits were deflated by the chain-type price index for GDP.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts, downloaded from http://www.bea.gov; author's calculations.

cial sectors in the late 1990s and early 2000s. In fact, Figure 7 shows that financial sector profits were hardly affected by the recession and slow growth of the last few years. The financial sector benefits from the high dollar by continuing to attract financial inflows from foreign countries, while the goods- and services-producing sectors that have to compete with artificially cheapened foreign products are hurt. The profits of other (non-manufacturing) nonfinancial sectors also came down in the late 1990s and early 2000s—after booming more than the other sectors' profits in the mid-1990s—but did not fall nearly as fast or as far as manufacturing profits.

In spite of the losses experienced by workers and firms alike in U.S. manufacturing, it should be noted that the ultimate effects of the overvalued dollar on U.S. workers and corporations have been highly unequal. Multinational corporations (MNCs) are able to respond to the higher dollar by moving production offshore and outsourcing components abroad in order to stay competitive—eliminating jobs for U.S. manufacturing workers. Most large business firms can thus evade the negative effects of a high dollar that U.S. manufacturing workers (and smaller, national companies) cannot escape. As a result, although profits on domestic manufacturing operations fell, the profits of U.S. MNCs on their global operations were not necessarily hurt—and may even have been helped—by the strong dollar.

***Investment by domestic manufacturing firms was also reduced by the high dollar***

In addition to its negative impact on domestic employment and profitability, the overvalued dollar also hurt the domestic manufacturing sector by decreasing investment in new plants, equipment, and software (i.e., capital expenditures).[22] Since decreased investment in real, productive assets threatens the long-term viability of U.S. manufacturers, and their ability to create jobs in the future, this negative effect of the high dollar is especially alarming.

The appreciation of the dollar diminishes investment in domestic manufacturing for two reasons. First, domestic firms that either produce for export or compete with imports are likely to perceive a reduced need for production facilities in the United States when they have to compete with foreign goods that have become cheaper in dollar terms; as a result, customers switch to foreign-produced goods. For this reason, a high dollar causes both exporting and import-competing firms to reduce their planned investment at U.S. plant locations. Second, there are indirect effects of dollar appreciation on investment through the reduced profits of domestic manufacturing firms (as discussed earlier). Business firms rely on the cash flow out of current profits to finance investment, either internally (through retained earnings) or by attracting outside funds (since bank and bondholder willingness to lend depends on firms' financial health). Thus, reduced profits curtail the ability of firms to finance their investment and can result in the cancellation or delay of already planned capital expenditures.[23]

Investment in U.S. domestic manufacturing was reduced by $42.7 billion in 2002 as a result of the post-1995 appreciation of the dollar, based on an estimate that combines the two effects discussed above.[24] To put this number in perspective, note that $42.7 billion is equivalent to 24.5% of the actual level of investment in manufacturing of $174.3 billion in 2001 at current prices (sectoral investment data for 2002 were not available as of this writing). With capital expenditures thus reduced by nearly one-quarter as a result of the rise in the dollar, domestic manufacturers will find it difficult to keep up with new technologies and to maintain the pace of productivity growth that they were able to achieve in the 1990s unless the overvaluation of the dollar is soon reversed. Such a reversal will require the dollar to fall further, and in relation to more currencies, than it has fallen to date.

## Conclusions and policy recommendations

It is clear that the high value of the dollar has hurt employment, profits, and investment in the U.S. manufacturing sector. Although the value of the dollar has declined against some currencies, this partial decline has erased only a fraction of the overvaluation built up since 1995. The dollar still needs to fall further to allow the U.S. economy, and especially the manufacturing sector, to get back on their feet. This concluding section will discuss what the U.S. government can do, both by itself and in cooperation with U.S. trading partners, to encourage a further and more widespread decline of the dollar and to stabilize exchange rates at more sustainable levels.

Until recently, Bush Administration officials have generally maintained their support for a "strong dollar policy," in spite of occasional admissions (usually by either former Treasury Secretary Paul O'Neill or current Treasury Secretary John Snow) that a decline in the dollar might be a welcome corrective.[25] Since the dollar's decline accelerated in April-May 2003, Snow and some other U.S. officials have begun to adjust their rhetoric, signaling that the United States will accept a market-driven realignment of the dollar's exchange rate, but indicating no desire to manage the process or to coordinate it with other countries.[26] What remains constant in the administration's dollar policy is a hands-off, laissez-faire attitude toward currency markets (Blustein 2003b).

Although the new attitude of accepting market-driven dollar decline is a welcome shift in Bush Administration policy, no one in this administration has yet accepted the need for more active management of the dollar's decline by the United States and its trading partners. There has also been no support for an extension of the dollar's fall to encompass more currencies, especially those with managed or manipulated exchange rates. A partial decline of the dollar relative to only some currencies (mostly European) that account for less than half of the U.S. trade deficit will not suffice for reversing the damage done to the domestic U.S. economy by the dollar's broad-based overvaluation in recent years. However, there is also a risk that a decline in the dollar vis-à-vis the euro and other floating-rate currencies could trigger a panic-driven rout if the dollar collapses so fast as to threaten global financial stability.

Although the dollar needs to fall significantly further relative to the major currencies such as the euro, its fall needs to be cushioned as its value begins to reach a more acceptable level (approximately the value the dollar had in 1995 before it began its ascent). Moreover, the dollar also needs to drop relative to those foreign currencies that have been deliberately undervalued through exchange rate manipulation by their governments (especially in East Asia), so that an excessive share of the adjustment burden is not placed on those countries (mainly in Europe) that let their currencies adjust to market-determined levels. This is especially important so that the depressing effects of the falling dollar on foreign economies are not exacerbated at a time when many countries, such as those in Europe, are already suffering from slow growth and high unemployment. With the entire global economy teetering on the verge of a worldwide slowdown, the way the current realignment of exchange rates is managed will be a crucial determinant of whether that realignment helps to revive the global economy, or to sink it further.

A more effective dollar policy, therefore, has to begin by recognizing the vital distinction between the major currencies with floating exchange rates, and the currencies of the developing nations that have pegged or managed rates. For the major, floating-rate currencies (such as the euro), U.S. economic officials, in cooperation with their foreign counterparts, should announce a desire for a further decline in the dollar, but set a target range for the dollar's level in order to encourage an orderly and limited depreciation. For those countries that keep their currencies artificially undervalued by buying up large amounts of dollar reserves (primarily China, but also Japan and the other Asian countries identified in Table 1), the United States should pressure them to abandon such intervention in currency markets and allow their exchange rates to appreciate. The rest of this section explores how these twin objectives can be achieved and sustained.

***Influencing market psychology***

Given the importance of market psychology in determining the value of any financial asset, including a currency such as the U.S. dollar, statements by prominent U.S. officials have profound effects on international currency markets. Administration rhetoric in support of a strong dollar helped to brake the dollar's decline until early 2003; the recent shift toward accepting a weaker dollar has contributed to accelerating that decline. It is vital for leading economic policy makers such as the Fed Chairman and Treasury Secretary to clearly and publicly accept the need for further dollar depreciation, instead of trying to prevent the necessary correction of an unsustainable, misaligned exchange rate.

At the same time, market expectations must be stabilized in order to prevent a panic-driven collapse of the dollar, such as occurred with the Mexican peso in 1994-95 and several Asian currencies in 1997-98. Therefore, U.S. officials should not only suggest that the dollar needs to fall more, but also state a target range for the necessary dollar depreciation and suggest a floor for the dollar's level relative to the other major currencies. Even implicit suggestions of this sort proved effective in the 1985-87 period (when no specific targets were mentioned); more specific targets for sustainable exchange rates could be very effective today. The data in Figure 2 suggest that another 15-20% further depreciation of the dollar relative to the major currencies (starting from the current level in May 2003) would bring the dollar back to about where it was in 1995 (roughly an index of 80 on the scale shown in Figure 2). All such announcements would be even more credible if they were backed by the United States' major trading partners, such as through a joint announcement at a meeting of leading finance ministers or a G-8 summit.

The Federal Reserve could help to support a decline in the dollar by modifying its monetary policies to take into account the dollar's value. For example, the Fed could announce that it will not raise interest rates to prevent further dollar depreciation until the dollar reaches the new (lower) target level. The Fed could also precommit to raising interest rates modestly after the dollar has fallen to the desired target level, which would help to foster a set of self-fulfilling expectations that would encourage a significant but controlled depreciation of the dollar.

***Currency market intervention and policy coordination***

Direct intervention in currency markets—i.e., central banks or treasuries buying and selling foreign exchange in order to influence exchange rates—can also be helpful. It is often argued that the volume of currencies traded in today's global financial markets dwarfs the relatively meager foreign exchange reserves of most central banks. Although this is true, it does not mean that currency market intervention cannot be successful. If such intervention is coordinated with policy announcements and undertaken in a concerted fashion by several leading central banks simultaneously, exchange market intervention could help to shift exchange rates in a desired direction.[27] Once the dollar starts to fall, efforts by foreign countries to intervene to prevent the decline should be strongly opposed until the dollar has reached its new, lower target value.

Given the importance of foreign countries' macroeconomic policies in determining the values of their currencies relative to the dollar, it is vital for the United States to negotiate with its trading partners for the adoption of policies that would encourage a sustained appreciation of their currencies (and hence depreciation of the dollar). For the eurozone countries, Japan, and other economically depressed areas, this means above all convincing them to revive their economies through the use of *domestic* demand stimuli and structural reforms instead of relying on low currency values and export-led expansion. Such policies would also help to boost U.S. exports and prevent a global slump. In addition, foreign countries should be persuaded that allowing a realignment of currencies with a lower dollar could be helpful for resolving trade disputes with the United States, which have been exacerbated by the anticompetitive effects of the high dollar for U.S. producers (an example of this is the recent steel controversy).[28]

***Policies for currencies with managed exchange rates***

The appropriateness of pushing for countries with pegged or managed exchange rates to revalue their currencies upward depends on their economic conditions. Those countries that have recently been through financial crises and have depressed domestic economies (e.g., Argentina and Brazil) should not be pressured to revalue their currencies, and would probably be unable to do so anyway. On the other hand, those countries that are accumulating large amounts of reserves in order to artificially undervalue their currencies, such as China and the other Asian countries shown in Table 1, should be pressured to abandon such policies and allow their currencies to appreciate to market equilibrium levels.

The United States can use its political leverage to pressure such countries to stop manipulating their exchange rates. Specifically, support for future trade liberalization efforts and access to the U.S. market should be linked to the establishment of exchange rates that allow for more balanced trade relationships. It was a mistake to negotiate so many trade liberalization agreements (such as NAFTA, the WTO, and China's accession thereto) without paying attention to the need for keeping exchange rates at levels that prevent excessive trade imbalances; it is not too late to make sure that this need is addressed in future trade negotiations. The U.S. Treasury Secretary should also use his authority under the 1988 Trade Act to investigate currency manipulation by foreign governments and to negotiate with countries that are found to practice such manipulation.

***Stabilizing exchange rates at realistic levels***

Supporters of the strong dollar have raised concerns about the risks of lowering its value, including the potential harm to U.S. trading partners of their currencies appreciating while their economies are weak; the possible jeopardy to financial markets of a sudden dollar collapse; the potentially inflationary consequences of currency depreciation; and the need to keep attracting large capital inflows to finance the U.S. trade deficit. Although these are legitimate concerns, they are not insurmountable, and some are merely excuses for inaction rather than reasons not to act; for example, there is no reason why the United States needs a large trade deficit requiring significant capital inflows to finance it, or why foreign countries cannot stimulate their domestic economies.

The most significant fear[29] is that the dollar will collapse too quickly, potentially causing disastrous declines in financial markets where complicated investment positions have been created on the expectation that the dollar will remain about at its current level (see Blustein 2003a). Such fears can be mitigated, however, if the dollar's decline is managed in an orderly fashion, as advocated earlier. This problem will only get worse if U.S. officials continue to defend an indefensible "strong dollar policy" instead of encouraging investors to adjust to a new set of more realistic expectations about the dollar's future value. The question today is no longer whether the dollar needs to fall—the currency markets have already settled that question—but rather whether the U.S. government will seek to encourage and manage that fall as part of an internationally coordinated effort to promote a global economic recovery.

Looking to the future, it is important to consider systemic reforms that could prevent a recurrence of the exchange rate misalignment that the United States has experienced in the past eight years. There have been several useful proposals for stabilizing exchange rates.[30] Although it is beyond the scope of this paper to endorse any particular such plan, what is most important is to target exchange rates at levels that are consistent with more balanced trade and which allow all nations to grow at respectable rates with full employment. Countries should be prevented from undervaluing their nations' products in order to grow faster and employ more workers at the expense of their trading partners. A full and sustainable recovery of the global economy depends on all countries sharing in the growth of the world market.

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## Appendix

This Appendix presents the econometric estimates of the effects of the increased value of the U.S. dollar on the performance of the domestic manufacturing sector. Equations were estimated for the effects of the real value of the dollar (measured by the Fed's broad, inflation-adjusted index) on employment, hours, profits, and investment in manufacturing. Other variables (such as the GDP growth rate) were included in the regression equations to control for other factors (such as the business cycle) that also affect the dependent variables in these equations. A complete, detailed list of the variable definitions and sources is given at the end of this Appendix.

Because all the data are time series, all the variables were tested for the presence of unit roots or non-stationarity. Generally, all the variables had unit roots (i.e., were non-stationary) when measured in levels (or levels of logarithms[31]), according to Augmented Dickey Fuller (ADF) tests,[32] except the GDP growth rate which was stationary.[33] However, all the variables were stationary (did not have unit roots) when measured in first differences (i.e., period-to-period changes) or logarithmic differences (i.e., proportional changes). The variables used in each equation were also tested for cointegration (in levels). For those cases in which the series had unit roots and no evidence of cointegration was found, the regression equations were run with the data measured in first differences or log differences.

Although differencing the data helps to make time series stationary, it also loses information and can therefore result in less reliable estimates. In some of the equations this was not a problem, but in the equations for the profit share and the investment rate in manufacturing, differencing the data resulted in very poor statistical fits. As a result, other methods were used to estimate these two equations, while the other equations were estimated with the data in first differences or log differences. Both of the equations that didn't fit well in differences (i.e., for the profit share and investment rate) showed evidence of cointegration among the variables, although the cointegration tests were sensitive to the specification chosen. Hence, the results of cointegration analysis are reported for these equations along with more conventional estimates in levels.[34]

### *Hours and employment*

Variations in hours and employment in manufacturing are well explained by a simple specification with the variables measured in first differences of natural logarithms ("log differences," which approximate percentage changes). Log differences were used for these equations for three reasons: they were stationary (all the included variables had unit roots in logs but not in log differences); they yield good fits in the regressions; and the coefficients can be interpreted as elasticities. The variables in these equations were not cointegrated, according to standard cointegration tests, and hence it was preferred to use standard regression methods with the data series in a form that was stationary (i.e., log differences).

The model assumes that demand for workers in the manufacturing sector depends primarily on two factors: GDP growth, which determines the overall demand for manufactured goods; and the real value of the dollar, which determines how profitable it is to produce manufactured goods in the United States either for export markets or in competition with imports. GDP growth affects hours and employment contemporaneously, while the value of the dollar affects them with lags of up to four quarters due to the time it takes for imports and exports to adjust to changes in the exchange rate. This model explains a relatively high percentage of the changes in manufacturing hours and employment.

The equations for hours and employment implied by this model were estimated by ordinary least squares (OLS) using quarterly data for 1980Q2 to 2002Q1 with the following results:

$$\Delta \log \text{Hours}_t = \underset{(0.001)}{-0.01} + \underset{(0.11)}{1.14}\, \Delta \log \text{Real GDP}_t - \underset{(0.06)}{0.13}\, \Delta \log \text{Real Dollar Index} + \varepsilon_t$$

(adjusted $R^2 = 0.571$)

$$\Delta \log \text{Employment}_t = \underset{(0.001)}{-0.01} + \underset{(0.09)}{0.83}\, \Delta \log \text{Real GDP}_t - \underset{(0.05)}{0.12}\, \Delta \log \text{Real Dollar Index} + \nu_t$$

(adjusted $R^2 = 0.529$)

where the "t" subscript designates the current quarter; the numbers in parentheses are standard errors; and $\varepsilon_t$ and $\nu_t$ are random error terms. The coefficients on Δ log Real Dollar Index are the sums for 1-4 quarterly lags and the standard errors are for the null hypothesis that the sum of these coefficients equals zero using a Wald F-test. The constants and Δ log Real GDP (i.e., the GDP growth rate) are significant at the 1% level in both equations; Δ log Real Dollar Index (i.e., the percentage increase in the value of the dollar) is significant at the 5% level in both equations. The adjusted $R^2$'s are relative high for equations estimated in log differences. Note that, with the variables measured in log differences, the constant terms are equivalent to time trends. In these equations, the time trends can be interpreted as the effects of labor productivity growth, and thus the results show that both hours and employment in manufacturing fell by about 1% per quarter (approximately 4% per year) as a result of trend productivity growth (holding other factors constant).

Both hours and employment have elasticities of close to 1 with respect to GDP growth (Δ log Real GDP), but hours are slightly more elastic than employment because firms are more likely to adjust hours of existing workers than to either lay off or hire workers in responses to changes in demand for their products. Similarly, the (negative) elasticity of hours with respect to the real value of the dollar is slightly higher (in absolute value) than the corresponding elasticity of employment, for the same reason. However, the real value of the dollar clearly has a negative impact on both the hours and employment of manufacturing workers and this impact is statistically significant. The coefficients of -0.13 and -0.12 for hours and employment, respectively, were used to estimate the effects of the rise in the dollar between 1995 and 2002 reported in the text above.

### *The profit share*

The most successful way of estimating the manufacturing profit share equation was with the data measured in levels and including a lagged dependent variable to represent a partial adjustment process. This eliminated autocorrelation of the residuals, which was a problem in all other specifications tried (including using lags of the independent variables), and produced much better fits than differencing the data. With a lagged dependent variable, the estimated coefficients are estimates of the short-run effects of the other variables, i.e., how much they affect the current value of the dependent variable *relative* to its one-period lag. The effects of lags of the other independent variables are all captured in the lagged dependent variable. Estimates of the long-run effects of those variables can be obtained using the formula

$$\hat{\beta}_i\left(\frac{1}{1-\hat{\beta}_1}\right)$$

in which $\hat{\beta}_1$ is the estimated coefficient on the lagged dependent variable and $\hat{\beta}_i$ is the estimated coefficient on the $i^{th}$ variable ($i \neq 1$). Several different specifications (in terms of which other variables were included) were tried as sensitivity tests, i.e., to make sure that the estimated effects of the dollar index are robust. In addition, since the variables in this equation showed evidence of cointegration, the cointegrating equation from the cointegration analysis is also used as a further sensitivity test.[35] The results of these various estimates are given in **Table A-1**.

In the equations reported in Table A-1, the GDP growth rate is included to control for business cycle effects, and is strongly positive and significant. The most basic version of the equation is (1), in which the implied long-run effect of the dollar index on the profit share is -0.33, i.e., for every sustained 1 point rise in the real dollar index, profits fall by 0.33 percentage points of national income generated in domestic manufacturing. Equations (2) and (3) test the sensitivity of this result and find that it is robust when a time trend (2) or unit labor cost (3) is included. Including these variables, each of which is statistically significant when included separately (but not together), reduces the estimated long-run effect of the dollar index only slightly. (The equation was also estimated with the PPI for fuels as an index of energy costs, but this variable was not statistically significant.) The cointegrating equation (4) yields remarkably similar (long-run) coefficients for the dollar index and the time trend, although it yields a somewhat higher estimate of the growth rate effect (perhaps because of the omission of the lagged dependent variable from the cointegration

**TABLE A-1**
**Estimated equations for the profit share in domestic manufacturing (quarterly data)**

| Equation | (1) | (2) | (3) | (4) |
|---|---|---|---|---|
| Method | OLS | OLS | OLS | Cointegration[a] |
| Sample period | 1973Q1 to 2002Q1 | 1973Q1 to 2002Q1 | 1980Q1 to 2002Q1 | 1973Q4 to 2002Q1 |
| Constant | 5.47** | 7.08** | 11.03** | |
| | (1.39) | (1.45) | (3.18) | |
| Profit share (lagged 1 quarter) | 0.86** | 0.82** | 0.82** | |
| | (0.03) | (0.04) | (0.05) | |
| Real dollar index | -0.044** | -0.049** | -0.053** | -0.34 |
| | (0.012) | (0.011) | (0.013) | (0.08) |
| GDP growth rate | 0.20** | 0.21** | 0.21** | 2.09 |
| | (0.03) | (0.03) | (0.04) | (0.30) |
| Time trend | | -0.009** | | -0.06 |
| | | (0.003) | | (0.02) |
| Unit labor cost | | | -0.046* | |
| | | | (0.023) | |
| Adjusted $\bar{R}^2$ | 0.903 | 0.910 | 0.868 | |
| ***Implied long-run coefficients on:***[b] | | | | |
| Real dollar index | -0.33 | -0.27 | -0.30 | -0.34 |
| GDP growth rate | 1.48 | 1.17 | 1.19 | 2.09 |
| Time trend | | -0.05 | | -0.06 |
| Unit labor cost | | | -0.26 | |

Notes: "OLS" refers to ordinary least squares. Numbers in parentheses are standard errors. Sample periods were determined by the longest time periods for which all data (including lags) were available. Significance levels for equations (1)-(3): * 5% level, ** 1% level.

a. This is the cointegrating equation assuming an intercept and a linear deterministic trend. The Johansen trace test indicates 1 cointegrating equation at the 5% level and the maximum eigenvalue test indicates 1 cointegrating equation at both the 5% and 1% levels. Significance levels for individual coefficients are not reported.

b. See text for explanation of long-run coefficients in equations (1)-(3). The cointegrating equation (4) does not distinguish short-run and long-run coefficients.

test). Based on these equations, I take the value of -0.30 for the long-run dollar effect from equation (3) as a mid-range estimate and use that to calculate the quantitative impact of the dollar's rise on manufacturing profits discussed in the text.

### *Investment*

For the investment rate (i.e., capital expenditures as a percentage of the capital stock at the end of the previous period, both measured at current costs) in manufacturing, the best fits were obtained using the variables in levels and with certain lags. Lags are common in investment models because of the time it takes for changes in observed economic conditions to affect firms' desired investment plans, and then for firms to design and implement those plans (e.g., to order and install new equipment or to construct new facilities). The most robust variable for explaining investment is the growth rate, representing business cycle effects

**TABLE A-2**
**Estimated equations for the manufacturing investment rate (annual data)**

| Equation | (1) | (2) | (3) | (4) |
|---|---|---|---|---|
| Method | OLS | OLS | 2SLS[a] | Cointegration[b] |
| Sample period | 1975-2000 | 1975-2000 | 1975-2000 | 1977-2000 |
| Constant | 5.15** | 11.42** | 11.00** | |
| | (1.17) | (2.35) | (2.64) | |
| Profit share | 0.30** | 0.19** | 0.20** | 0.08 |
| | (0.06) | (0.06) | (0.07) | (0.05) |
| GDP growth rate (lagged one and two years)[c] | 0.24* | 0.30* | 0.30** | 0.71[d] |
| | (0.10) | (0.09) | (0.09) | (0.13) |
| Real interest rate[e] | 0.10 | | | |
| | (0.07) | | | |
| Real dollar index (lagged one year) | | -0.045* | -0.042* | -0.115 |
| | | (0.019) | (0.020) | (0.016) |
| Adjusted $R^2$ | 0.517 | 0.587 | 0.586 | |

Notes: "OLS" means ordinary least squares; "2SLS" means two-stage least squares. Numbers in parentheses are standard errors. Sample periods were determined by the longest time periods for which all data (including lags) were available. Significance levels for equations (1)-(3): * 5% level, ** 1% level.

a. The profit share was treated as endogenous; all other RHS variables were treated as exogenous or predetermined (i.e., lagged variables). The instruments used in the first stage regression were the GDP growth rate (0 to 2 lags), the real dollar index (0 to 1 lag), the profit share (1 lag), a time trend, and a constant.
b. This is the cointegrating equation assuming an intercept and a linear deterministic trend (but no time trend in the cointegrating equation). The Johansen trace test indicates 1 cointegrating equation at the 1% level and 2 cointegrating equations at the 5% level; the maximum eigenvalue test indicates 2 cointegrating equations at the 5% and no cointegrating equations at the 1% level. Significance levels for individual coefficients are not reported.
c. Coefficients are for the sum of the coefficients on the GDP growth rate lagged one and two years, except as indicated; standard errors are for the null hypothesis that the sum equals zero using a Wald $F$-test.
d. One annual lag only.
e. Prime rate charged by banks minus the inflation rate as measured by the percentage change in the GDP chain-type price index. See text and endnote 31 for discussion of alternative measures.

(known in the investment function literature as the "accelerator effect"). Many theories emphasize negative effects of (real) interest rates on investment, but empirical evidence on interest rate effects is mixed at best. Many empirical studies have found interest rate effects (or a broader measure known as the "cost of capital") to be small, statistically insignificant or to have the "wrong" sign (positive).[36]

Also, much research has shown the prevalence of financial constraints on investment, which can prevent firms from making otherwise desired capital expenditures (the classic study is Fazzari, Hubbard, and Peterson 1988). Such financial constraints are usually represented in econometric tests by cash flow or other profit measures; in the present analysis, I use the profit share. Financial constraints often operate contemporaneously rather than with lags, since they can force firms to cut back on already planned investment projects. What is innovative in the present analysis is the inclusion of the Fed's real broad dollar index to test for direct (negative) exchange rate effects on investment. Only a few previous studies have tested for (and found) such effects (see Worthington 1991, Goldberg 1993, and Campa and Goldberg 1995), and none have estimated those effects for the period of dollar appreciation since 1995.

**Table A-2** (above) reports the results of several different variants of an investment equation for the U.S. manufacturing sector. Annual data had to be used for the investment equation because the investment and capital stock data series for manufacturing are only available on an annual basis. Given the use of annual data, the number of lags that can be included is necessarily limited. The sample ends in 2000 because the investment and capital stock data for manufacturing for 2001 were not yet available at the time when these regressions were run. As noted earlier, estimates of the investment equation in first differences yielded very poor fits and therefore the equation was estimated in levels.

Equation (1) in Table A-2 is a baseline investment equation without the dollar index included. The profit share and growth rate (accelerator) variables are positive and significant, as expected, but the real interest rate variable has the wrong sign (positive) and is insignificant (and this was also true using several alternative specifications of the real interest rate).[37] Hence, the real interest rate was omitted from the other equations. Equation (2) shows the effects of including the real dollar index (but omitting the real interest rate). The real dollar index is negative and significant at the 5% level, while the coefficients on the other variables change only slightly and are still significant at the 1% level. This is strong evidence that the dollar's value has a negative effect on manufacturing investment in the United States, after controlling for other factors.

Certain econometric issues lead to the estimation of alternative equations (3) and (4) as sensitivity tests. Because the profit share is an endogenous variable, and is a function of other right-hand side variables,[38] it could be argued that equation (2) suffers from an identification (simultaneity) problem. To remedy this, equation (2) is re-estimated with two-stage least squares (2SLS), treating the profit share as endogenous, and using as instruments all the exogenous variables in the investment function plus the exogenous variables in equation (2) from Table A-1 above. The resulting estimates (equation (3) in Table A-2) are remarkably similar to those in the OLS equation (2), and the real dollar index is still negative and significant at the 5% level, lending further support to the hypothesis of significant direct negative effects of the dollar's value on manufacturing investment.[39] Equation (3) is used to estimate the effects of the rise in the dollar on investment between 1995 and 2002 as reported in the text.

Finally, the fact that the variables in this equation have unit roots suggests the need for a cointegration test, which shows evidence of at least one significant cointegrating vector and possibly two such vectors (see notes to Table A-2 for details).[40] The cointegrating equation (assuming only one cointegrating vector) is presented as equation (4) in this table. The coefficients differ somewhat in magnitude from those in equations (2) and (3), but have the same signs, and if anything the direct negative effect of the dollar on manufacturing investment is estimated to be even greater in the cointegrating equation than in the OLS and 2SLS estimates.

### *Data definitions and sources*

This section gives the exact definitions and sources for the data series used in the preceding statistical analysis.[41] Abbreviations and web sites (home pages) for the major data sources are as follows:
U.S. Department of Commerce, Bureau of Economic Analysis (BEA); www.bea.gov.
U.S. Department of Labor, Bureau of Labor Statistics (BLS); www.bls.gov.
U.S. Board of Governors of the Federal Reserve System (Federal Reserve Board or FRB); www.federalreserve.gov.

**Hours of labor in manufacturing**: index (1992 = 100), BLS, quarterly data were downloaded from www.bls.gov/lpc/home.htm under Major Sector Productivity and Costs – Create customized tables.

**Employment of labor in manufacturing**: index (1992 = 100), BLS, quarterly data were downloaded from www.bls.gov/lpc/home.htm under Major Sector Productivity and Costs – Create customized tables.

**Real GDP and growth rate of GDP**: gross domestic product in chained 1996 prices, BEA, National Income and Product Accounts (NIPAs), Table 1.2. Growth rates (percentage changes) were calculated by the author. Annual and quarterly data were downloaded from www.bea.gov/bea/dn/nipaweb/index.asp (quarterly data are expressed at annual rates).

**Profit share in manufacturing**: profit income was calculated as a percentage of national income generated in the manufacturing sector; BEA, National Income and Product Accounts (NIPAs), Tables 6.1B and 6.1C for national income by sector, and Tables 6.16B and 6.16C for profits by sector. Annual and quarterly data were downloaded from www.bea.gov/bea/dn/nipaweb/index.asp.[42]

**Real dollar index**: trade-weighted index of the real (inflation-adjusted) value of the U.S. dollar; "broad" index includes both "major" currencies and currencies of "other important trading partners, March 1973 = 100; FRB, Federal Reserve Statistical Release H.10, Foreign Exchange Rates, Summary Measures of the Foreign Exchange Value of the Dollar. Monthly data for the real broad index were downloaded from http://www.federalreserve.gov/releases/h10/Summary/ and converted to quarterly or annual time series as needed by the author.

**Unit labor costs in manufacturing**: index (1992 = 100), BLS, quarterly data were downloaded from www.bls.gov/lpc/home.htm under Major Sector Productivity and Costs – Create customized tables.

**Investment rate in manufacturing**: annual investment as a percentage of the capital stock at the end of the previous year, calculated by the author based on data from BEA, Fixed Asset Tables: investment from Table 4.7, "Historical-Cost Investment in Nonresidential Fixed Assets by Industry Group and Legal Form of Organization"; yearend capital stocks from Table 4.1, "Current-Cost Net Stock of Nonresidential Fixed Assets by Industry Group and Legal Form of Organization." Annual data were downloaded from www.bea.gov/bea/dn/faweb/AllFATables.asp.

**Real interest rate**: prime interest rate minus the inflation rate (measured by the annual percentage rate of change in the GDP chain-type price index). Prime interest rate from FRB, Federal Reserve Statistical Release H.15, Selected Interest Rates; monthly data for "bank prime loan rate" downloaded from http://www.federalreserve.gov/releases/h15/data.htm and converted to annual averages by the author. The GDP chain-type price index was calculated by the author by dividing nominal GDP (BEA, NIPAs, Table 1.1) by "real" GDP at chained 1996 prices (BEA, NIPAs, Table 1.2); annual data were downloaded from www.bea.gov/bea/dn/nipaweb/index.asp.

## Endnotes

1. This and all other measures of the value of the dollar discussed in this paper are author's calculations based on the "real" (price-adjusted) data from Federal Reserve Statistical Release H.10, Foreign Exchange Rates, downloaded from www.federalreserve.gov/releases/h10/Summary/.

2. The other "major" currencies are the Canadian and Australian dollars, the Swiss franc, and the Swedish krona.

3. For earlier analyses by this author of the dollar's overvaluation in the late 1990s and its consequences, see Blecker (1999a, 1999c).

4. Note that the "broad" dollar index in Figure 1 is a trade-weighted average of the major currency and other currency indexes shown in Figure 2.

5. Unlike the other currencies listed here, the Taiwanese dollar was not subject to a speculative attack. However, Taiwan devalued its currency in late 1997 to offset the competitive losses caused by the collapse of the Thai baht, thereby possibly precipitating some of the other Asian currency depreciations such as Korea's. I am indebted to C. Fred Bergsten for calling my attention to this point.

6. According to U.S. Federal Reserve Statistical Release H.10, Foreign Exchange Rates, Currency Weights (available online at www.federalreserve.gov/releases/h10/Weights/), the major currency countries currently have a total weight of 54.6% in the broad dollar index while the "other important trading partners" account for the other 45.4%, based on the composition of total U.S. trade with the included countries for 2001. Including a number of additional, small developing countries that are excluded from the Fed's "other important trading partners" group, total "other" (non-major) countries accounted for 47.9% of overall U.S. trade and 49.6% of U.S. imports in 2001 (U.S. Census Bureau 2002, Exhibit 13).

7. According to the data in Bach (2003, Table 2), the industrialized countries (which issue the "major" currencies) accounted for 43.9% of the U.S. trade deficit for goods in 2002, while the other countries (developing and transition economies, including OPEC members) accounted for 56.1%.

8. The data shown in Table 1 are the series for "total reserves minus gold" from the International Monetary Fund (IMF), *International Financial Statistics* (online version). These are total holdings of foreign currencies in each country shown, and do not distinguish between "official" reserves held by central banks (and presumably available to be used for currency manipulation) and private reserves held by commercial banks. The IMF does not make public the separate data for official and private reserve holdings, nor does it reveal the currency composition of the reserves. Nevertheless, most of these total reserves are likely to be official reserves of U.S. dollars, especially in the Asian countries, and they are the best indicator available of the degree to which those countries are hoarding foreign currencies in an effort to keep their own currencies undervalued.

9. The euro area countries were able to reduce their holdings of currency reserves after the switch to a single currency in 1999 because they would no longer have to intervene to maintain their parities with each other within the former Exchange Rate Mechanism (ERM).

10. See the evidence cited in Blecker (1999b).

11. For an analysis that supports this conclusion and interesting policy suggestions for inducing Japan and China to abandon their currency undervaluation, see Preeg (2003).

12. Japan, China, and Taiwan alone accounted for 39% of the U.S. trade deficit for goods in 2002, according to the data from Table 2 in Bach (2003). Hong Kong and Singapore had small surpluses with the United States, but only equivalent to 0.9% of the U.S. deficit. Adding South Korea and also netting out Hong Kong and Singapore, these East Asian countries together accounted for 40.9% of the U.S. trade deficit in 2002.

13. In 2001, manufactured goods accounted for about 80% of U.S. goods exports and 83% of U.S. goods imports. In relation to trade in goods and services combined, manufacturing accounted for 58% of total exports and 70% of total imports. See U.S. Census Bureau (2002), Exhibits 1 and 14.

14. The slowdown in U.S. export growth in the late 1980s was also exacerbated by the growth slowdown in many U.S. export markets discussed in the previous section.

15. See endnote 13 above.

16. See GDP data available at www.bea.gov and unemployment rate data available from www.bls.gov/cps/home.htm.

17. See the Appendix for details on these estimates.

18. The numbers of employees in manufacturing in this paragraph are taken from U.S. Department of Labor, Bureau of Labor Statistics, Industry at a Glance: Manufacturing, National Employment, Hours, and Earnings, series ees30000001, All employees (thousands) in manufacturing (SIC codes 20-39); downloaded from the Internet at http://www.bls.gov/iag2/iag.manufacturing_t.htm by clicking on "Back Data" for "Payroll Employment."

19. Of course, workers who lose jobs in manufacturing do not necessarily become permanently unemployed; they may find jobs (usually at lower wages and with less benefits) in other sectors such as services depending on the overall state of the economy. Needless to say, this was easier during the boom years of the late 1990s than the recession and slow-growth years of the early 2000s.

20. Shifting production to other countries can be a solution for some companies, but does not rescue the profitability of domestic export production.

21. See the Appendix for the econometric analysis underlying this estimate.

22. In this part of the discussion, the terms "capital expenditures" and "investment" (in new plants, equipment, and software) are used interchangeably.

23. The first effect of a high dollar in reducing planned investment is felt with a lag, which the estimates in the Appendix suggest is about one year. In contrast, the second (indirect) effect that operates through reduced profits is usually felt within the same year, according to those estimates.

24. This estimate is based on equation (3) in Table A-2 in the Appendix, plus the first stage regression for the profit share in manufacturing, which is an endogenous variable in the two-stage least squares procedure.

25. At his confirmation hearing before the Senate Finance Committee on January 28, 2003, then Treasury Secretary-nominee John Snow testified that "I favor a strong dollar." Barely five weeks later, on March 4, the newly confirmed Treasury Secretary kicked off a firestorm of controversy with the candid admission that he didn't "see anything troubling" with a decline in the dollar occurring around that time. By the next day, he had to backtrack, stating "let me reiterate my support for the strong dollar." See press reports in Associated Press (2003), Agence France Press (2003), Hagenbaugh (2003), Hill (2003), and Swann (2003).

26. While attending a G-8 meeting of finance ministers in France in mid-May, Snow was quoted as saying that the dollar's fall versus the euro was only "a fairly modest realignment in currencies," a statement that was interpreted by financial markets as indicating acceptance of a weaker dollar. To confuse matters, however, Snow and other U.S. officials insist that there is no change in the administration's desire for a strong dollar, but they have redefined a "strong dollar" so that the term no longer refers to the dollar's exchange rate with other currencies—the new meaning is that the dollar should be "a good medium of exchange" that "people are willing to hold" (Blustein 2003b).

27. Exchange market intervention is of limited power when it seeks to oppose rather than to support market fundamentals or is inconsistent with macro policies, but intervention in support of market fundamentals and consistent with stated policy objectives can help to shift market expectations and thus becomes more effective than one might expect from the limited amounts of foreign exchange that the authorities typically buy or sell. Since market fundamentals indicate that the dollar is overvalued and needs to fall, intervention in support of that objective should be effective. As one group of researchers concluded, "even weak signals, such as those provided by sterilized interventions, may be sufficient to coordinate agents' expectations, induce them to converge on a particular model of the economy, and pick a value of the exchange rate that is not too far from that targeted by the authorities" (Catte, Galli, and Rebecchini, 1992, p. 20). See also Dominguez and Frankel (1993) and Dominguez (2003).

28. See Blecker (2002) for an analysis of how the overvalued dollar contributed to the U.S. steel import crisis.

29. Another serious issue is the fear that dollar depreciation would spark increased inflation by raising domestic prices of imported goods. Inflation fears should be mitigated, however, if the dollar is brought down soon, while inflation is already tame due to weak demand conditions. Indeed, many economists today are more worried about possible deflation rather than inflation. Also, because goods imports account for a relatively small share of U.S. GDP (about 12%), a rise in import prices would have a relatively small impact on overall, average inflation. In the most recent instance of significant dollar depreciation, the sharp drop in the dollar in 1985-87 had no perceptible effect on U.S. inflation. Inflation rates as measured by the percentage change in the GDP chain-type price index (from U.S. Department of Commerce 2002) were 3.7% in 1984 (when the dollar was still rising), 3.2% in 1985 (when the dollar began falling), 2.2% in 1986, 3.0% in 1987, and 3.4% in 1988 (a year after the dollar bottomed out). Thus, inflation actually *fell* while the dollar was falling most rapidly in 1985-87.

30. See, for example, Williamson and Miller (1987), Williamson (1994), Davidson (1996), Grieve Smith (2001, chap. 5), and Weller and Singleton (2002). See also the discussion in Blecker (1999b, pp. 125-43).

31. "Logarithms" and "logs" always refer to natural logarithms (base-*e*) in this study.

32. The ADF tests were run in various specifications (i.e., with or without intercepts and trends and with varying numbers of lags) and the results described here were entirely robust.

33. The GDP growth rate is really a differenced variable (i.e., the proportional rate of change in real GDP); real GDP itself has a unit root and therefore it is not surprising that its rate of change is stationary.

34. It should be recalled that conventional unit root tests have low power to reject the null hypothesis of a unit root in relatively short time series, i.e., a few decades or less. Some of the variables that appear to have unit roots in the present analysis are ratios or rates that might be expected to be stationary over longer time periods (e.g., the profit share, the investment rate, and—if one believes in the hypothesis of long-run relative purchasing power parity—the real value of the dollar). These variables may appear to be non-stationary only because of the short length of the available data. Perhaps it is not a coincidence that the two equations that yielded poor fits in differences were the equations for two such variables, i.e., the profit share and investment rate, and therefore running these equations in levels may be appropriate after all.

35. A lagged dependent variable was not included in the cointegration estimates, which do not distinguish between short-run and long-run effects. Time-series econometric purists might object to this use of cointegration, because the variables included are integrated of different orders—the GDP growth rate is I(0) (stationary) while the other variables are all I(1) (have unit roots). However, other practitioners believe that variables should be expressed in whatever units make sense theoretically, and in this case it makes sense to include the growth rate of GDP (rather than its level) since all the other variables are measured as rates or percentages. In any event, the cointegrating equation is included here mainly as a sensitivity test, to show that the results of the other three equations are robust. Note especially that the coefficients on the real dollar index and the time trend from equation (4) in Table A-1 are very close to the implied long-run coefficients from equation (2), although the estimated growth effect is greater in equation (4). Since our main interest here is in the coefficient on the real dollar index, this sensitivity test confirms that our other estimates are of reasonable orders of magnitude.

36. See, for example, Fazzari (1993), Bosworth (1993), and Chirinko (1993).

37. The real interest rate used here is the prime rate minus the current inflation rate. An alternative measure, the prime rate minus the one-year lagged inflation rate (to proxy for expected inflation) was also positive and insignificant. Lags of both measures were also tried and were positive and insignificant. The real interest rate, by any of these measures, was also insignificant when the dollar index was included in the equation. When the real interest rate is omitted from equation (1), the other coefficients remain virtually unchanged.

38. Obviously, from the estimates in Table A-1, the profit share is a function of the (current) real dollar index. Less obviously, because of the lagged dependent variable in the profit share function, the profit share is also a function of lagged GDP growth rates.

39. The statistical significance of the dollar index was sensitive to the choice of instruments for the profit share. Specifically, when unit labor cost is included as an instrument, the dollar index still has a negative sign but the coefficient is smaller and insignificant. However, a better fit (as measured by adjusted $R^2$) was obtained using the time trend instead of unit labor cost. See the discussion of the profit share equations in Table A-1 for more on these variables, and note that the time trend was significant in both the OLS and cointegration estimates.

40. One could object to this cointegration test on the same ground as for the profit share equation, i.e., because the GDP growth rate is stationary while the other variables have unit roots. This objection can be answered in the same way as for the profit share equation (see endnote 36 above), i.e., that the variables should be measured in units that make sense theoretically. In regard to the investment equation, theory implies that investment should be a function of the growth rate of GDP (the so-called "accelerator effect") rather than the level of GDP, and again all variables in this equation are expressed as ratios or percentages. Also, one might question whether cointegration procedures are valid with such a small sample (only 24 annual observations could be used for this procedure, because quarterly data were not available). However, the validity of such time-series procedures depends more on the length of the time period (number of years) rather than the frequency (number of observations), and 24 years—while less than ideal—is on the borderline of an acceptable period for testing cointegration. Again (as in Table A-1), the cointegrating equation in Table A-2 is used mainly as a sensitivity test for the other estimates, not to test cointegration *per se*.

41. Only the data series used in the econometric analysis in the Appendix are included here; definitions and sources for other data series are given in the appropriate parts of the text, tables, figures, and endnotes.

42. This and other data series from the National Income and Product Accounts were taken from the BEA statistical release of June 27, 2002 (which included "final" estimates for first quarter 2002). Subsequent revisions to these data were not available in time to be incorporated into the econometrics, but were used to revise the data discussed in the text and shown in the tables and figures.

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Statement of
Steve Yagle
President, Reliable Machine
Before the House Small Business Committee
June 25 2003

Thank you Mr. Chairman and members of this distinguished committee. I am pleased to be here to testify before you today, and I thank you for the opportunity to discuss issues relating to trade with China. I applaud your efforts to gather information and data regarding currency valuation.

My name is Steve Yagle, and I am President of Reliable Machine Company in Rockford, IL. I am here today representing the Rockford Area Chamber of Commerce Manufacturers Council, and 250 manufacturers that are part of the Chamber's membership, as well as 1200 in the 4 county region of Winnebago Boone, Ogle and Stephenson counties in northwest Illinois

Small manufacturers in the Rockford area grieve of competing against low-cost Chinese products. But even successful multinational corporations express concern and tell us that, unless things change, it is only a matter of time before they have to move production to the far east.

An Illinois Manufacturing Extension Center Survey reported that over 60% percent of the manufacturers surveyed reported that they are experiencing competition from China and have lost market share. Moreover, 46% of all respondents said they expected competition from China to reduce their sales by an average of about 16 percent in 2003 with more losses expected in the next few years.

All of the manufacturers surveyed are losing sales overseas or find they can no longer compete against Chinese imports into the U.S. market. Many of the manufacturers are reducing their workforces. Others say they will close their plants.

The Chinese government manipulates the value of its currency, which artificially lowers the prices of Chinese goods in the U.S. while making my products more expensive in China. This practice has placed Rockford area manufacturers at a serious disadvantage. Unless these trends are reversed, serious damage will be done to the livelihoods of the Rockford area's working families-and to the nation's economy

Bill Orman, president of Rockford Fastener, said a large numbers of small and mid-sized Rockford area manufacturers are closing down permanently due to foreign competition and manufacturing in Rockford will become extinct if competition from China continues to be intense.

Eric Anderberg, general manager of Dial Machine Inc. in Rockford, said his company recently lost work to a manufacturer in China that can fill orders at half the cost as his company.

Rockford fastener manufacturer Rockford Products must source some parts from Asia to remain competitive. Those parts were once manufactured in Rockford, when Rockford was the largest geographic area for fastener manufacturing in the world. Today, the China takes the
title.

Closer to home, a deal close to $1 million vanished from my company because a large "big box" retailer will soon source parts in China instead of Rockford and Wisconsin.

"As manufacturing jobs continue to disappear, what is going to take their place?" asked an active member of the Manufacturers Council Matthew Nelson, Plant Manager, Timken US Corporation, Rockford Plant. Weakness in the manufacturing sector also hurts the service sector, which counts on manufacturers as clients. The loss of high-paying manufacturing jobs also translates into lower sales for businesses of all types. Rockford's manufacturers are leaner, smarter and faster than ever before. Lean, smart and fast don't matter because operational excellence is no longer competitive with low-cost manufacturing.

From 1998 through 2002, Winnebago, Boone, Ogle and Stephenson counties lost 8,000 manufacturing jobs, the Illinois Bureau of Employment Security said. The city of Rockford unemployment rate exceeds 10 percent. Our region can no longer afford to lose more manufacturing jobs to China. The combination of Chinese currency manipulation and tariffs imposed on imported steel earlier last year have devastated the Rockford area's manufacturers.

In conclusion, Rockford area manufacturers are asking for a "level playing field", because, with fair trade, the Rockford area can compete in quality, speed and service better than any manufacturing region, in the world.

Thank you

**NAM National Association of Manufacturers**

# Testimony

## of Jay Bender

**President**
**Falcon Plastics, Inc.**

*on behalf of* the National Association of Manufacturers

*before the* Committee on Small Business of the House of Representatives

*on* The Impact of Chinese Currency Manipulation on
Small Manufacturers and Exporters

**June 25, 2003**

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**MANUFACTURING MAKES AMERICA STRONG**

Testimony of

Jay Bender
President
Falcon Plastics, Inc.

On Behalf of
The National Association of Manufacturers

Before the
Committee on Small Business of the House of Representatives

On

The Impact of Chinese Currency Manipulation on
Small Manufacturers and Exporters
June 25, 2003

Good afternoon Mr. Chairman and members of the Committee. Thank you for giving me the opportunity to participate in this panel. My name is Jay Bender, and I am president of Falcon Plastics Inc., a small manufacturer of custom plastic molded components, assemblies and tooling located in Brookings, South Dakota. I am pleased to have this opportunity to address the Committee on the effect of foreign currency manipulation, especially the undervalued Chinese currency, on American small manufacturers.

I am also pleased to speak on behalf of the National Association of Manufacturers (NAM). The NAM represents 14,000 members, including 10,000 small and medium-size companies.

You have a number of distinguished expert witnesses who can discuss the mechanics of Chinese currency manipulation. I am here simply to explain how Chinese currency undervaluation has significantly affected small manufacturers in the United States. I would like to describe some of our experiences at Falcon Plastics. I believe that many other small and medium sized NAM members have had similar experiences.

Falcon Plastics has been in business for 28 years. The company was founded by my father, Don Bender, in 1975. We employ 200 people and have three production facilities, two in South Dakota and one in Tennessee. We sell custom-molded plastic products to the agricultural, appliance, automotive, business machine, electronics, and medical industries.
An example of our product is a subcomponent of scoreboards for just about all sporting events at the high school, college and professional level. We have shipped our products to 28 states, South America, Asia, Mexico, Europe and Canada. We take pride in the fact that our customers can rely on us for exceptional quality, project integrity, and on-time delivery.

The custom injection-molded plastic industry is composed of primarily small businesses. Falcon Plastics has 70 molding machines and sales of approximately $20 million per year. We are considered to be on the larger size in our industry where the average company has only seven molding machines. There are a few very large companies, but then the size drops dramatically. We can and do work hard to stay competitive by incorporating up-to-date equipment and production methods. But we can't compete when the deck is stacked against us.

The situation in American manufacturing today is serious and in some sectors, critical. Over the past several years, American manufacturing has lost almost 2.5 million jobs and industrial production has stagnated. During this same period, Falcon Plastics has gone from employing over 300 people to just 200. We have lost a full one-third of our jobs.

At the same time, imports from China have surged and the U.S. trade deficit with China has ballooned to over $100 billion. The NAM projects that if our trade deficit with China continues its 20 year trend, in 5 years, it will exceed $300 billion. This problem must be addressed or American manufacturing will lose more jobs and pressures to retreat from our global trade commitments will build.

We have many strengths in American manufacturing. We are innovative and unafraid to change and improve. We have some of the best workers in the world. And we have the benefit of a free, open society in which to do business. But we cannot compete when the foreign currency of a major trading partner like China is so undervalued that it produces an overwhelming competitive advantage. The NAM has seen estimates from investment banks and the Manufacturers' Alliance that China's currency is anywhere from 15 – 50% undervalued.

On top of that, American manufacturers have to compete against Chinese companies that have access to a vast, low-wage labor pool and maintain health, environmental and safety standards that are far below that of the United States. Even without currency manipulation, this would be a significant challenge for US producers.

When is a currency undervalued? Many think that the Big Mac Index is a pretty good indicator, and the added benefit is that it's a measure we lay people can understand. Since 1986, economists have been using a comparison of the price of Big Macs around the world to gauge if currencies are at their market level. It has actually been shown to be an accurate predictor of currency value. According to the Big Mac index, the Chinese yuan is undervalued by, with all due respect to the golden arches, a whopping 56%!

I would like to offer an example of how China's undervalued currency affects us in the plastic molding business. We are losing business both here and overseas because our customers can source the product from China at a much lower price. One of my top customers recently got bids from a Chinese producer that were 26% less than what I was selling the product for. That's 26% delivered, after shipment all the way from China. My customer is staying with us for now because we offer flexibility in our ability to customize an order and make quick delivery because we are nearby. But that may not last. If my customer needs to economize to meet his competition, he may be willing to wait a little longer for his product and save 26%.

This is where the artificially low Chinese currency plays a big role in my business. If the yuan were 20 or 30% higher, this would solve my pricing problem. It may not solve every business's, but it would make a big difference to my company. If the Chinese yuan were worth what it should be, I would not have a problem holding on to my customers. The move to a realistic exchange rate could make a huge difference for my company. Until that happens, I see my customers purchasing more and more offshore, especially China.

I would like to give you another example of the effects of the undervaluation of Chinese currency. A customer of mine is a large producer of fishing lures, and they are moving all production to China because they can save 50% over the cost of producing it here. Generally, fishing lures are made by small, family-owned companies. But they won't be for long if there is a 50% price difference between those made here and those made in China. All of those companies will be forced out of business. If China did not deliberately undervalue its currency, many of these family businesses might be saved.

But, in my experience, some of the problem is larger than a fix of the currency can solve. Let me illustrate another difficulty we face. I sold a particular mold to one of my former customers for $25,000. And that's a very competitive price. They purchased a Chinese mold for under $3,000. For that particular mold, 20-25% of my price is materials and components that are sourced on the world market. I'm not an economist, but I can multiply, and these numbers tell me that something here just doesn't add up – something is wrong.

So, in addition to pressing the Chinese government to float their currency on the world market, it is essential that our government ensure that China is not subsidizing or dumping its products, which it is obliged not to do now that it is a member of the WTO.

WHAT CAN BE DONE?

For my business and many other small businesses, the single most effective thing that the U.S. government could do to level the playing field in our trade with China would be to get the Chinese government to end the practice of deliberately undervaluing their currency to gain competitive advantage. And we should do this with all trading partners engaged in this practice. The situation as it currently exists is just unfair. Does anyone believe that with all the growth in Chinese production, increased productivity, product quality and exports, the yuan isn't worth any more now than it was is 1994?

I have learned from the NAM that the Chinese are currently holding over $300 billion in their foreign currency reserves. If, instead of taking that money off the market, the Chinese government allowed its citizens to exchange yuan for dollars at a market price, that $300 billion would have driven the price of the dollar down and the Chinese yuan up, making U. S. goods and services less expensive and Chinese goods more closely reflect their true costs. We would surely have a healthier trade balance and the American manufacturing sector would be benefiting from our trade with China just as the Chinese benefit from trade with us.

In addition to obtaining reform of China's currency practices, we ask Congress to look closer to home to find out why American manufacturers and their employees are at such a disadvantage in competition with the rest of the world. These are issues addressed in the NAM's Strategy for Manufacturing Growth & Renewal, and they are essential to the health of U.S. manufacturing.

We must address:

- the runaway costs of litigation,
- soaring health care premiums that are effectively removing the possibility of coverage for some workers,
- those environmental and legal regulations which are counterproductive and not achieving the desired ends, only increasing the costs of American products,
- rising energy costs and finally,
- taxes that create disincentives for capital expenditure and growth.

If the Congress fixes these problems, manufacturing costs would go down and we would see fewer companies moving their production to China and other foreign countries.

Mr. Chairman and members of the Committee, some of the best jobs in South Dakota are in manufacturing. At Falcon Plastics, we provide a safe working environment with good health and retirement benefits to our employees. We understand that we must make adjustments to operate in a global business environment. We are prepared to compete but we must have a level playing field. I came here today to ask you to help us to be able to compete and save millions of jobs for your fellow Americans. We don't have 5 or 10 years. We need your help now.

Your hearing is an important step in this process. Thank you very much and I look forward to your questions.

George Jones III,
President, Seaman Paper Company of Massachusetts, Inc.
On Behalf of the American Forest & Paper Association
House Committee on Small Business
Wednesday, June 25, 2003

Mr. Chairman, my name is George Jones. I am the third generation owner of a 57 year old business that manufactures decorative and industrial tissue paper. My company, Seaman Paper Co. of Massachusetts, Inc., and its affiliates have approximately 500 employees, and we are the major employer in our area. Our products include resale tissue purchased in stores for giftwrap, retail packaging tissue used by stores to package customer purchases, crepe streamers and waxed paper for floral and foodservice applications. We are a traditional American-built, family-owned business. For more than 50 years we have enjoyed relative prosperity and success as a manufacturer of tissue and tissue products. But today we are facing the most severe threat to our existence in our company's history: Chinese imports.

I am here today testifying on behalf of the American Forest & Paper Association (AF&PA). AF&PA is the national trade association of the forest and paper industry, representing more than 220 companies and related associations involved in the business of growing trees and manufacturing paper and wood products. I am pleased to have this opportunity to present the industry's point of view with respect to the currency policies of the Chinese government and their impact on the paper and wood products manufacturing industries. The impacts of China's currency practices are both direct and indirect -- but the bottom line is U.S. manufactured paper and wood products are being disadvantaged in the U.S. and global marketplaces due to Chinese currency manipulation and Government subsidization of new manufacturing capacity.

AF&PA and its members have a long history of support for free and fair trade policies. We have consistently supported U.S. Government efforts to open up markets around the world and ensure a level playing field. We have supported multilateral negotiations through the GATT and then through its successor organization the WTO and more recently through bilateral and regional free trade agreements. We also supported the Congressional grant of permanent normal trading rights to China.

Our trade policy agenda has been driven by the belief that our country's abundant fiber resources, skilled labor force and access to capital provide the U.S. forest and paper industry with the comparative advantage to compete in the global marketplace. In fact, a decade or so ago, the Chinese market looked like an extremely attractive export opportunity for U.S. forest products for many years to come. This was a common view not only among industry executives, but also the view of other experts and Wall Street analysts. Why? China does not have vast forestlands, their domestic demand was on the verge of a major growth spurt, and their manufacturing facilities were small and inefficient and not able to meet environmental standards. Paper and wood products manufacturing are capital intensive -- not labor intensive -- so China shouldn't possess a natural comparative advantage.

This ostensible comparative advantage of the U.S. forest and paper industry has been undermined in recent years by unfair exchange rate policies and other Chinese government trade practices.

While China's paper and paperboard consumption jumped from 32.6 million metric tons in 1997 to some 40 million metric tons in 2002, the corresponding growth for U.S. exports didn't materialize.

In 1997, U.S. paper and paperboard exports to China were 479,000 metric tons, or $256 million (these amounts include converted paper and paperboard products). By 2002, U.S. paper and paperboard exports only increased to 577,000 metric tons with a value of $384 million. In fact, exports to China of several important paper categories have stagnated or declined because of substantial build up in Chinese paper and paperboard production capacity.

In contrast, China's paper and paperboard exports (including converted products) greatly benefited from an artificially weak currency. In 1997, these exports totaled some 45,000 metric tons with a value of $313 million. That amount jumped to 206,000 metric tons and $806 million last year. So, the U.S. trade balance with China in paper and paperboard products stood at a negative $422 million last year in a sector where China doesn't have a comparative advantage.

Likewise, China has become a major consumer and producer of wood products. Just a few years ago, for example, China imported approximately 2.5 million cubic meters of plywood -- today they are a net exporter of approximately 1.1 million cubic meters and now exports large quantities of product to South Korea, Japan and the UK -- all markets that U.S. plywood producers were previously able to serve.

**Chinese accumulation of U.S. Dollars disadvantages U.S. producers:**

Why have U.S. producers lost ground rather than gained ground with the Chinese market over the past five years? The Chinese government has intentionally kept the value of its currency abnormally low to create a competitive advantage for their products at the expense of U.S. produced goods. The Chinese central bank maintains the yuan's value at an exchange rate of 8.28 to the dollar by regularly intervening in foreign exchange markets. This has been done through the accumulation of large foreign exchange reserves since the mid-1990s.

According to figures from the Chinese central bank, China added US$74 billion to its reserves in 2002 alone, reaching $286 billion. In March 2003, the most recent month for which data are available, China had reserves of $316 billion. These huge foreign exchange reserves are far beyond the level recommended by the International Monetary Fund (IMF). Because the Chinese Central Bank has these huge U.S. dollar reserves, they don't just put the money under a mattress – they are investing it in Chinese manufacturing operations that are competing with U.S. producers. This subsidized capital expansion, along with its pegged currency, has helped the Chinese overcome their otherwise inefficient market structure and offer numerous products at prices that are less than half what we can afford to sell the same product in the U.S.

The value of the dollar has adjusted in the past year against the euro and is now back to the level at which the euro was launched in January 1999. However, the dollar remains unchanged against the currencies of major East Asian countries such as China, Japan, Korea and Taiwan. This is due to the currency policies of these countries. Each has publicly announced that their currency valuation policies are intended to boost their exports and retard imports into their markets. Mr. Chairman, I am sorry to say that their strategy appears to be working.

According to a report by Ernest Preeg of the Manufacturers Alliance, China has kept its currency exchange rate about 40% lower that it would be if it allowed it to float in line with market forces alone. This has the effect of a 40% tax on U.S. exports to China and a similar tax on U.S. manufacturers competing in the U.S. domestic market against Chinese imports. The 40% effective tax on U.S. producers competing with Chinese suppliers more than offsets the tariff reductions that China is implementing as part of its WTO accession. China, with an undervalued exchange rate, now accounts for the largest part of the U.S. trade deficits -- $103 billion in 2002, or 23% of the total U.S. trade deficit.

**Impact on U.S. small businesses:**

So what is the "on the ground" impact of these Chinese government policies in communities across the country? I can tell you first hand that it has meant the loss of significant U.S. sales for my company -- $5 million in annual sales since 2000 and growing. It has meant that I have had to lay off employees and curtail production while we have tried to replace the business. Over the past 15 years my company has invested millions of dollars in the latest technology and equipment that has kept us in the game. Right now, however, all future capital investments are on hold until we can figure out what the future is for our business. Some of my U.S. competitors have not been so fortunate. In the last two years several U.S. paper mills have either closed or are barely holding on to their businesses. This means a loss of employment, frequently in small, rural communities and a loss of tax revenue to the towns where these companies have been located. Although there are other reasons for mill closures such as high energy costs, out of date equipment and general competitiveness factors, the price deflation in our products that has occurred as a result of cheap imports has clearly been a driving factor.

In the case of the tissue market -- my company's main product line -- imports have more than doubled since 2001. In the resale tissue market, China's share of the U.S. market has grown from 6% in 1999 to a projected 42% in 2003; and in the crepe streamer market, it has grown from 5% in 1999 to a projected 37% in 2003. Chinese imports now account for 90% of the seasonal resale tissue market. The reasons are simple. The Chinese can afford to offer their products at a price that is effectively 40% lower than would be the case if their currency was allowed to float with the market. Combined with government subsidization of their capital investment -- currency manipulation for trade advantage is a double whammy to US domestic producers. While the changes we have undertaken at Seaman Paper have enabled us to stay in business, we wonder for how much longer. As cheap Chinese imports continue to flood the market, they are taking more and more market share. The perception is that Chinese products are competitive only due to low labor costs. In our product line, the reality is that our manufacturing efficiencies can offset a good portion of the Chinese labor cost advantage, so the full Chinese cost advantage is better explained by other factors like currency manipulation and Government subsidies.

Unfortunately, this story is being repeated in product after product. One AF&PA member company in rural Minnesota once supplied wood to five major blinds manufacturers. The company was forced to retool its business and change product lines, laying off 1/3 of its 24-employee workforce, after all five of those U.S. based companies closed. Each of those wooden blinds manufacturing plants was forced out of business by the import of Chinese blinds, entering the market at half the price of U.S. made products. (U.S. prices at the time were about $.17/LF while Chinese came into the market at $.08/LF.) While the company is surviving, the forced lay-offs came at a great cost to the families and communities that were impacted.

The transition from U.S. suppliers to Chinese was very rapid – from the beginning of the price reduction to the closing of the last U.S. manufacturer was only about 24 months. Most of the raw material used by the Chinese is from Russia or other Eastern European nations where environmental controls are much less stringent than in the U.S.

The furniture industry -- also a major customer of the U.S. forest products companies -- has had an experience similar to the wooden blinds business.

But the problem does not end with exports and imports of paper and wood products. Domestic demand for fiber-based packaging products, such as boxes, is much weaker than would have been the case had the U.S. manufacturing trade deficit not more than doubled from 10% of manufacturing GDP during the mid-1990s to an estimated 26% in 2002. Chinese producers of manufactured goods -- whether it is consumer electronics, toys, or apparel -- use boxes that are also made in China. Had these products been manufactured in the U.S., they would have been packaged and shipped in U.S. boxes.

**What are we recommending?**

The U.S. Government should use every means possible to urge the Chinese government to abandon its intervention in currency markets and to allow the exchange rate of the yuan to appreciate to levels consistent with market forces. Recent press reports suggest that the Chinese are considering such a move. Now is the time for a full court press from a broad range of U.S. policy makers to get China to adopt market-based rules. For example, this hearing is helpful to the public's understanding of the impact Chinese currency manipulation has on small U.S. manufacturers.

Additionally, the Congress should pursue aggressive oversight with the implementation of a provision in the Trade Promotion Authority Act of 2002, which requires consultations with governments that engage in currency manipulation. Other opportunities for Congressional oversight include the Trade Act of 1988, which requires the Treasury to analyze annually the exchange rate policies of foreign countries to consider whether countries manipulate the exchange rate of their currency for the purpose of gaining unfair advantage in international trade. Vigorous enforcement of our existing trade laws is also important to the ability of U.S. manufacturers to stay in business.

The U.S., in cooperation with other major trading countries, should use IMF and WTO rules to force China to stop manipulating currency levels to gain trade advantage. Clearly, exchange rate manipulation by China would offset any tariff reductions it agrees to in the current WTO trade negotiations.

With regard to subsidies, the early and complete phase out of Government subsidies in China and other countries for wood and paper manufacturing must be achieved and should be pursued as a priority part of the U.S. trade policy agenda. In "capacity sensitive" sectors such as ours, subsidies for additions to manufacturing capacity or for capacity maintenance create uneconomic conditions, distort global markets and reward uncompetitive producers. Eliminating these types of market distortions on a global basis is critical to the economic health of our industry. In addition, as the Administration develops a positive agenda for negotiations in this area, AF&PA urges that any discussion on this topic be approached in a manner in which developed and developing countries alike are subject to market-based disciplines.

Attention to this problem by the Congress is very important to America's small businesses. I hope through your oversight efforts, the U.S. Government can find effective ways to pressure the Chinese government into a more market-based approach for currency valuation.

**Prepared Statement of Mr. Edward M. Tashjian**
**Vice President of Marketing for Century Furniture Industries Inc.**
**Hickory, North Carolina**

**On the Impact of Foreign Currency Manipulation on U.S. Manufacturers**

**Before the House Committee on Small Business**
**June 25, 2003**

Mr. Chairman, Ranking Member Velazquez, and Members of the Committee:

Thank you for the opportunity to testify on behalf of Century Furniture, its management, and skilled workforce, on the impact of the under valuation of Asian currency, particularly the Chinese Yuan, on domestic manufacturers like us. I am Edward M. Tashjian, Vice President of Marketing for Century Furniture Industries Inc, which is headquartered in Hickory, North Carolina.

Let me make clear from the outset that I am not an economist, and I am not an expert in world trade or international monetary policy. I am here before you today as an advocate for the 156,000 men and women who make up America's residential furniture manufacturing industry, to present a human view of the impact of currency manipulation, and to ask you to use your common sense and good judgment to do what is in the best interest of our country.

This hearing couldn't come at a more opportune time. Thanks to the perseverance of Chairman Manzullo and other lawmakers, both on and off this committee, who care about domestic manufacturing, the issue of currency manipulation is now receiving the attention it warrants. We were pleased to hear Secretary Snow's comments last week in support of a more fairly valued Yuan, and his belief that China is prepared to move in that direction. The ability of U.S. manufacturers to compete with our counterparts in China hinges on such an outcome, so I urge you to keep the spotlight on this matter.

Clearly, this is a complex issue both technically and ideologically, and there are no easy answers. But, at the end of my testimony, I hope you will conclude that "fair trade" means the enforcement of U.S. laws and international trading rules, and that the continued loss of furniture manufacturing jobs to the Far East does not serve the best interests of the United States.

## Century Furniture Industries

I am privileged to work for one of the most respected privately owned manufacturers of residential furniture. Century is recognized in the industry as a design leader, ranked in the forefront for its expertise in finishing and the many details of fine craftsmanship.

Almost all of the products we sell are manufactured by us in Hickory, North Carolina. Less than ten percent of our finished product line is imported. We operate eight factories covering approximately 1.6 million square feet of manufacturing, finishing, and distribution space. Century goes to great lengths to ensure that these facilities are safe and pleasant workplaces. We are very proud of the fact that in our chair plant, we have successfully achieved 1 million manhours without a lost time accident. That is the equivalent of a person working for nearly 500 years!

Every full-time Century Furniture employee receives a comprehensive health care plan, which is a significant part of his or her compensation. This expense has doubled in cost over the last 5 years and you may be surprised to learn that last year we spent more on health care than on lumber, fabric or leather.

Many things make our company special, but two stand out. First, we make extraordinary products. From our beginning in 1947, we have been committed to the ideal of creating furniture of such impeccable quality that it brings joy not only to the people who own it, but also to the craftsmen who build it and the professionals who sell and deliver it. This is much more than a platitude. It is part of our corporate culture.

Related to that, as an ESOP (Employee Stock Ownership Plan), every employee owns a stake in our company. Each of us is dedicated to building on this tradition of excellence, because each of us shares in the growth, or materially suffers from the decline of the company. We must grow and stay profitable to support all of the employees and their families who depend on our success. Last week, our company's shareholders met to review our progress and the challenges ahead. Looking into the eyes of these dedicated, hard working and skilled people who have made a commitment to our success is both humbling and energizing. We must do our level best to protect their interests.

## The State of the Industry

It is no secret that the last few years have been the most challenging in the history of the U.S. furniture industry. Since April 2000, more than 47,000 residential furniture production workers have lost their jobs.[1] Overall, nearly 1/4 of the work force has been eliminated, but case goods workers, those who build wood furniture products, have been particularly hard hit, with a loss of 32,500 jobs or a 28.5% decline in just 3 years.

**Residential Furniture Production Workers**

| | **2000** | **2003** | **Var** | **% Var** |
|---|---|---|---|---|
| Upholstery | 89,300 | 74,300 | -15,000 | -16.8% |
| Wood | 114,000 | 81,500 | -32,500 | -28.5% |
| **Total** | 203,300 | 155,800 | -47,500 | -23.4% |

As devastating as these statistics are, this figure understates the magnitude of the impact of these losses on communities like Hickory because declines in furniture production also hurt firms that supply textiles, hardware and services to the industry. Several factory closings have been announced in just the last few weeks. There is nothing more disheartening to me than to pick up a local newspaper and read about another plant closing.

[1] Bureau of Labor Statistics **Series Id:** CEU3133712103 & CEU3133712203 Not Seasonally Adjusted, **Super Sector:** Manufacturing, **Industry:** Upholstered household furniture & Non-upholstered wood household furniture, **Data Type:** Production Workers.

Part of this unfortunate situation is attributable to the economic downturn. Furniture represents a relatively big-ticket purchase that consumers are apt to postpone during uncertain times. Manufacturers have also been hurt in recent years by the bankruptcy of major retail chains like Montgomery Wards and Heilig-Meyers.

The regulatory burdens imposed on U.S. manufacturers also impact our competitiveness. On top of already complying with numerous federal regulations – including OSHA and EPA – our industry faces the prospect of being hit with a significant and costly new federal emissions standard that could require us to install expensive controls on our wood-fired boilers. Many furniture manufacturers operate wood-fired boilers that burn scrap wood leftover from the production process as a fuel source, either to heat their facilities or to kiln-dry hardwoods before they are used in the manufacturing process.

If excessive or unrealistic emissions rules are imposed on the industry, it could force us to spend upwards of $1 million per boiler to install the proper control devices, or pay to have the materials sent off-site to a landfill, which would have little environmental value. Without modification, this proposal could impose a devastating cost on the industry. At a time when case goods plants are struggling to remain competitive, this is sure to drive additional jobs offshore.

Tax policies are also important. In order to offset the enormous advantage that Pacific Rim manufacturers have in low-cost labor, domestic plants must automate and innovate. Computer-controlled equipment allows us to handle materials, cut fabrics, and mill, bore and sand hardwoods much more efficiently. Because such state-of-the-art machinery can cost as much as a million dollars per machine, we are pleased that Congress has provided additional tax incentives to make business investment in new plant and equipment more affordable for smaller and medium-sized businesses.

## The Impact of Imports

Undoubtedly, though, the most significant factor shaping our industry today is the tidal wave of imports from low-wage nations of the Pacific Rim. The driving force is China, where the combination of two-dollar-a-day labor, lower environmental and workplace health and safety standards, less stringent protection of intellectual property rights, and artificial exchange rates has made that country the dominant producer of wood furniture in the world. Approximately half of all case goods sold in the U.S. are manufactured overseas.

I cannot stand before you today and say that all U.S. furniture manufacturers are in agreement on the nature of the problem or the appropriate solutions. Among the members of our national trade association, the American Furniture Manufacturers Association (AFMA), there is a great diversity of business models, and an equal diversity of opinion about pro's and con's of sourcing from overseas.

I'm sure you are aware that many U.S. companies are themselves bringing in product from the Pacific Rim. This is not something that they relish doing. It is done simply to keep their companies viable and to preserve as much of their domestic operations as they can. The alternative to this so-called "blended strategy" is to surrender the market to Asian-based manufacturers and to retailers who are already importing container loads of furniture directly from the Pacific Rim.

One thing I believe we can all agree on is that foreign producers should adhere to the law and to international trading norms. Below-cost selling (i.e. dumping), subsidies and design piracy do not represent free trade or fair trade. And along with those unfair practices, I would group currency manipulation.

**The Currency Issue**

Much attention has been directed recently toward the strength of the dollar relative to the currencies of our trading partners. Some analysts have recently suggested that the problem has mitigated, citing the 17 percent depreciation of the dollar against "major" currencies of the world — those that are traded on exchanges outside of their own countries. But those countries account for only 56 percent of U.S. trade. The other 44 percent reflects trade with countries whose currencies are not freely traded, such as China.[2]

China's currency has remained fixed at about 8.3 Yuan to the dollar since 1994. The stability of this currency over that period is completely at odds with economic fundamentals. China's emergence as both an export powerhouse, and a destination for foreign direct investment, should tend to exert upward pressure on the Yuan. This has been the pattern for emerging economies across the globe, and one of the factors that over time equalizes the competitive balance between trading partners.

The failure of this process to occur in China is in all likelihood due to intervention by its central banks. Essentially, the profits from China's booming manufacturing sector are used to buy and hold dollars and euros, rather than to purchase foreign goods and services. In the last few years, China has accumulated $300 billion in foreign exchange reserves – $100 billion last year alone.

Certainly, central banks enter the currency market for many legitimate reasons. However, the consistent, long-term purchase of dollars and euros can only be understood as a means of artificially depressing the Yuan. According to the International Monetary Fund (IMF), such a pattern of "protracted large-scale intervention in one direction in the exchange market" is a principal indicator of prohibited currency manipulation. [3]

As a result, there is consensus that the Yuan is substantially undervalued. Analysts at Goldman Sachs estimate the undervaluation at 15 percent, while David Gilmore of Foreign Exchange Analytics believes that allowing the Yuan to freely float could cause it to increase up to 50 percent in value.

This undervaluation contributes measurably to the trade deficit between the U.S. and China, and is a substantial factor in the competitive challenges faced by U.S. furniture producers. Domestic furniture producers are in the position of a sprinter whose opponent regularly gets a 30-50 yard head start.

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[2] Joel Popkin, *Securing America's Future: The Case for a Strong Manufacturing Base*, Council of Manufacturing Associations, 2003.

[3] International Monetary Fund, *Surveillance Fact Sheet*, April 2003.

An undervalued currency doesn't serve the interests of the Chinese people either. Their buying power and access to foreign goods are diminished. And they are blocked from the path to higher living standards that formerly low-wage nations like Japan and Korea have taken.

**Where the Buck Stops**

Let me trace the impact of currency issues and other trade factors down to level of the retail floor. The table below shows the retail selling prices of the same number of items to furnish two rooms.

Century Furniture designed both of these collections. One, Matilda Bay, is made in Hickory, the other, Chatham Glen, is made in China. The consumer pays one third as much at retail for the bedroom made in China, and one half as much for dining room. These are sold in the same channels of distribution. And while there are differences in scale and finish, the price variance is enormous. These are real numbers. These products sell at these prices in dealers across America everyday.

| | Matilda Bay Collection Made in Hickory | Chatham Glen Collection Made in China | Variance |
|---|---|---|---|
| **Bedroom King Bed, Dresser, 2 Nightstands, Mirror, Armoire** | $22,755 | $7,070 | -$15,685<br>-69% |
| **Dining Room Table, 2 arms, 4 sides, Buffet.** | $12,126 | $5,988 | -$6,138<br>-51% |

As a result, dealers sell a few more units, but at a much lower price. It costs them just as much to sell and deliver these items, regardless of where they were manufactured, because it costs the same for rent, utilities, training, insurance, and transportation, regardless of the base cost of the furniture.

But, because the selling price is so much lower, they make a much lower dollar margin on the Chinese manufactured goods. This is further exacerbated by the nature of durable goods. Unlike toothpaste or laundry detergent, which is consumed and repurchased several times a year, a consumer generally buys only one high-end dining room in her lifetime. If a manufacturer misses that purchase, he must wait several years until the consumer buys a second home, or her tastes or needs change, or possibly never sell to her again. If the retailer doesn't offer the cheaper products, his competitor across the street will, and will capture the entire margin.

This enormous price variance has so far been largely confined to case goods, but all indications are that it will spread to upholstery, a move that is sure to send new shockwaves through the domestic furniture manufacturing industry.

**Recommendations**

Adherence to global trading norms was the *quid pro quo* for China's accession into the World Trade Organization (WTO), and ultimately, access to the lucrative consumer markets of the U.S. and Western Europe. Both IMF and WTO rules proscribe currency manipulation for the purpose of obtaining a competitive advantage or to interfere with the working of trade liberalization. Article IV of the IMF Agreement, for example, requires member nations to "avoid manipulating exchange rates to gain an unfair competitive advantage."

U.S. trade authorities must monitor and enforce China's obligations in this area, and ensure that the timetables for action embodied in the WTO agreement are met. We were very encouraged to hear Secretary Snow voice his support for more market-based exchange rates, and his belief that China was agreeable to moving in that direction. Early indications are that the announcement itself moved the value of the Yuan upwards on the currency exchanges. Therefore, it is vital that U.S. policymakers stand firm in pursuit of fair valuation. We appreciate all that this committee has done to raise and highlight the importance of this issue, and we hope you will remain engaged.

**Witness Disclosure**

Finally, pursuant to House Rule XI, clause 2(g)(4), I am obligated to report to the Committee that Century Furniture has done business with the U.S. Department of State in the total amount of $589,378.16 since October 1999, which was substantially less than 1 percent of our total business in any fiscal year. Attached to my written statement is a completed witness disclosure form identifying those contracts for the past two years.

Thank you. I would be pleased to answer your questions.

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Edward M. Tashjian is currently Vice President of Marketing for Century Furniture and has responsibilities for branding, advertising, public relations, photography cataloging and price lists. Prior to joining Century, he was Vice President of Marketing for Expressions Custom Furniture, which was acquired by Century in 1997. He has a classic packaged goods marketing and advertising background, and was an Adjunct Professor of Marketing at USC in Southern California, with a specialty in geo-demographic market segmentation. He holds an MBA in Marketing from the University of Minnesota (1977) and an Undergraduate degree in Psychology from St. Olaf College (1975).

**TESTIMONY OF DR. PAUL FREEDENBERG**
**AMT — THE ASSOCIATION FOR MANUFACTURING TECHNOLOGY**
**BEFORE THE**
**COMMITTEE ON SMALL BUSINESS**
**U.S. HOUSE OF REPRESENTATIVES**
**JUNE 25, 2003**

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**TESTIMONY OF DR. PAUL FREEDENBERG**
**THE ASSOCIATION FOR MANUFACTURING TECHNOLOGY**
**BEFORE THE**
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**U.S. HOUSE OF REPRESENTATIVES**
**JUNE 25, 2003**

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## I. INTRODUCTION

Good afternoon. My name is Dr. Paul Freedenberg, Vice President – Government Relations, AMT – The Association For Manufacturing Technology. Today, I will be testifying on behalf of AMT, a 100-year-old trade association that represents approximately 350 machine tool builders and related product firms located throughout the United States

Pursuant to House Rule XI, clause 2(g)(4), I am obligated to report to you that AMT has received $219,000 in fiscal years 1997-2000 and $84,200 in fiscal year 2002 from the Commerce Department's Market Co-operator Development Program to help pay for a service and training center in China.

## II. STATE OF THE U.S. MACHINE TOOL INDUSTRY

The machine tool industry is a very small segment of our nation's manufacturing infrastructure relative to its critical importance. Significantly, machine tools should be understood as the basic building blocks for all other industries, whether those industries are automotive, defense and aerospace, electronics, or appliances. Everything made in a factory is either made on a machine tool or on a machine made by a machine tool. In fact, everything that is produced or sold by every business in America – is either made by a machine tool or by a machine that was made by a machine tool. Examples of machine tools include: cutting, grinding, forming and assembly machines; inspection and measuring machines; plus all automated manufacturing systems. Approximately 30 percent of the machine tool industry's output is exported, and, both at home and abroad, our industry competes with machine tool companies from around the industrialized world.

A strong economy depends on a strong machine tool industry. That means that the key to reversing the economic downtown we are currently experiencing and returning our nation to economic prosperity is also dependent on the maintenance of a strong and healthy machine tool industry, which is the key component of this nation's manufacturing infrastructure. Machine tools translate the dizzying advances in information technology into the design of new manufactured products and the factory floor automation that more efficiently produces those products.

It should be cause for great concern then that the machine tool industry is experiencing the worst conditions in its domestic market in a half a century. Orders are off more than 60 percent since their peak in 1997. Import penetration has increased more than 40 percent in the past four years, due, in large part, to an overvalued U.S. dollar, which has only recently receded from its dizzying heights in relation to European currency. But these same countries continue to allow anti-competitive subsidies, which further add to our competitive problems.

Another recent problem has been that we have seen increasing outsourcing by some of our largest U.S. customers. Within the past year, both Ford and General Motors have demanded that their suppliers locate in the lowest cost countries, and U.S.-based companies do not qualify under that definition, no matter how you stretch its parameters. This has pushed many parts suppliers to go off-shore in order to meet these new requirements, which further complicates market access to these companies who were once located in the United States in order to be near their customers.

The machine tool industry has also seen lost sales as a result of unfair offset conditions imposed on the aerospace industry by countries such as China, who have used their market leverage to force U.S. companies to manufacture large portions of their aircraft in the purchasing country. Particularly in the case of China, U.S. machine tool builders are unable to follow their customers, because strict enforcement of U.S. export control regulations creates an uncertainty of supply to the Chinese customer and hence provides a significant disincentive for their new aircraft parts manufacturers to buy American.

These factors, in turn, have caused further industry distress and caused banks to be quicker to foreclose on their manufacturing clients with hard assets, while allowing their service industry clients with similar balance sheets to continue to operate. These banking decisions have not been based on the long-term viability of the individual companies but rather on the value of their assets and what they could bring in at auction. This thinking has affected all manufacturers, machine tool builders as well as their customers.

More than 30 machine tool companies have closed their doors in the past 18 months. This represents nearly 10 percent of the companies in the entire industry and a much greater percentage of the industry's employment and assets. Most recently we have seen the bankruptcy of Ingersoll Milling, one of the oldest and most technologically advanced companies in the industry and one of your oldest and most distinguished constituents, Mr. Chairman. I guess one could conclude that if Ingersoll could fail anyone in the machine tool industry is vulnerable.

You may recall that a little over a year ago, Edward W. Fedor, President of Masco Machine, Inc. located in Cleveland, Ohio, testified before your Committee on the crisis facing U.S. manufacturers. Months later, Masco became a victim of the crisis about which Mr. Fedor was speaking, when the company was forced to close its doors at the end of 2002. Masco had been a member of our trade association since its creation more than twenty years ago.

Leading analysts for the machine tool industry are projecting a seven to 18 percent rebound in orders this year. But, even if this projection is accurate, 2003 orders, in real terms, will still be weaker than they have been in more than 50 years. At the very least, the manufacturing sector needs immediate relief from unfair foreign competition, which brings me to the subject of this hearing.

## III. CHINESE CURRENCY MANIPULATION

Today I will focus on a core problem that all of U.S. industry confronts. That problem is that of Chinese currency manipulation, which is the focus of the hearing today. For more than a year, AMT has been part of the Coalition for a Sound Dollar, which is a broad-based coalition of industries meeting under the leadership of the National Association of Manufacturers. As a member of this coalition we have expressed our great concern regarding the Chinese Government's strategy of undervaluing their currency in order to garner exports and foreign investment.

Last year our nation's bilateral trade deficit with China exceeded $103 billion, the largest bilateral trade deficit in the world. Based on the first four months of 2003, that deficit is headed for more than $120 billion this year. It is a deficit and a trend that any economist will tell you is unsustainable. Yet it has continued to grow at this pace for the past decade. Indeed, China is accumulating foreign currency reserves, mostly U.S. dollars, at a rate of more than $6 billion per month. This is an uneven trading arrangement, and it is directly related to a distortion in the value of the two nations' currencies.

It is obvious that China's economic strategy over the past decade has been to keep the value of its currency low, boosting its exports and holding down imports. While many have observed that this is a highly successful strategy, another way of looking at it is that this is a shrewd method of exporting unemployment. Chinese intervention, through massive purchases of U.S. dollars, has kept the Chinese yuan (also known as the renminbi) from appreciating despite large trade surpluses and investment inflows. Ernest H. Preeg, of the Manufacturers Alliance and the Hudson Institute, has estimated that the yuan is as much as 40% below the value that would be set by the marketplace. Other international economists have estimated as much as a 50 percent under-valuation. By Preeg's calculation, that undervaluation means that U.S. exports to China would be overpriced by as much as 40 percent and that Chinese goods in the U.S. would be under priced by that much. This is a critical factor in the huge U.S. trade deficit with China and in the relocation of so many U.S. manufacturing enterprises, both large and small, to China, where those same companies can benefit from what is, in effect, a tremendous subsidy. When this subsidy is added to the very substantial differential in labor costs between our two nations, this subsidy makes Chinese products almost irresistible and makes investment in Chinese manufacturing extremely attractive.

It is indisputable that there is no free market for the yuan. Despite rapid economic growth, rapidly rising productivity, soaring exports, and huge foreign investment inflows – all factors that would normally cause a currency to appreciate – China has kept its currency pegged at approximately 8.2 yuan to the dollar since 1994. The Chinese central bank sets the exchange rate by requiring companies and individuals to turn over their foreign currency earnings at the rate set by the bank. As noted, the central bank, in turn, has made massive purchases of U.S. dollars, adding these to China's foreign currency reserve accounts. China's foreign currency reserves, almost entirely in dollars, now stand at almost $300 billion. Those dollar holdings have doubled in four years, and the pace of accumulation has been increasing over the past year.

Let me repeat it again, the U.S. trade deficit with China was $103 billion last year, the largest bilateral trade deficit in the world! And for those who will tell you that China trade is self-correcting, I would point out that United States *imports from* China have been growing at more than twice the rate of U.S. *exports to* China. Underlying all this, however, is the currency imbalance. China's import tariffs currently average about 15 percent. If Preeg and his colleagues are correct and the currency is 40 percent undervalued, the **effect of a free and open currency market would be more than twice as large as the effect of eliminating every tariff that China imposes on our goods.**

The global U.S. trade deficit last year was $470 billion – up $300 billion in the last five years and now nearly five percent of the United States' GDP. The major reason is that for those five years the U.S. dollar has been significantly overvalued relative to foreign currencies. The dollar peaked in February 2002 at 30 percent above its normal level for the previous decade. Since then it has been returning to more normal levels, and in February 2003 stood at 15 percent over normal levels. Most of the adjustment has been against the euro. None could occur against the yuan, **because it is pegged to the dollar at the artificial rate of 8.2 to one.**

As two of the great trading nations of the world, the United States and China must have a healthy trade relationship, and China must take its place and assume its duties as one of the world's great trading nations. Trade barriers and distortions in any form should not be tolerated. China's World Trade Organization ("WTO") entry is helping to reduce that county's formidable trade obstacles and most of its non-tariff barriers. But the currency-related trade distortions must be ended as well.

Both article XV of the WTO and article IV of the International Monetary Fund prohibit the use of currency manipulation as a method of gaining unfair trade advantage. The IMF defines such manipulation as "large-scale" and "protracted" intervention in one direction to "gain an unfair trade advantage." The WTO prohibits currency intervention that would "frustrate the intent of the provisions of this (the WTO) Agreement." An unfair trade case against China could be brought in either forum. Parenthetically, I believe that these very same Chinese currency practices are also challengeable under Section 301 of the Trade Act. But, for any of this to occur, the U.S. Government has to have the political will to bring these actions.

This unfair currency issue is the responsibility of the Secretary of the Treasury, and it is my hope that Secretary John Snow will, at the very least, enter into discussions with his Chinese counterparts at the earliest possible opportunity with the objective of achieving a more reasonably priced yuan. Initially, this issue need not be the subject of a formal trade action. But Secretary Snow should not hesitate to initiate one or more of the actions I have discussed if the Chinese are unresponsive. There is really no alternative to immediate initiation of such discussions, or, ultimately trade actions, if the discussions should prove fruitless. Either this debilitating currency distortion must be eliminated, or we may see many industrial sectors faced with very unattractive alternatives: the prospect of losing their markets entirely, or the alternative of being forced to relocate in China as the only opportunity for survival.

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AMERICAN TEXTILE
MANUFACTURERS INSTITUTE

# The Impact of Foreign Currency Manipulation on the U.S. Textile Industry

*by*

**The American Textile Manufacturers Institute**

*before the*

**The Committee on Small Business**
**June 25, 2003**

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Thank you for this opportunity to speak about the terrible damage that Asian currency manipulation is doing to the U.S. textile sector, one of this country's largest manufacturing employers. There is not a more important issue facing manufacturing today and you and your colleagues are to be commended for holding these hearings.

My name is Cass Johnson and I am a senior vice president at the American Textile Manufacturers Institute and have worked in the textile area for 13 years. As such, I can describe what can happen to a great manufacturing industry when our government ignores issues such as these.

In 1994, China cut the value of the yuan by more than 40 percent – 40 percent is an important figure that we will hear again and again. The not too surprising response came three years later, when China's most direct competitors – other Asian nations – saw their economies collapse with their own currencies losing 40 percent of their value.

Three years later, the U.S manufacturing sector slid into recession, taking the U.S. economy with it. As NAM has pointed out, the U.S. recession was so focused on manufacturing that a manufacturing worker had a 50 times greater chance of losing chance of losing his or her job during the recession than did other workers.

There is important chain of events here – first, China cuts the value of its currency by about 40 percent, next the currencies of its Asian competitors are devalued by around 40 percent, and then finally, U.S. manufacturing suffers its worst recession since the Great Depression.

In the textile sector, the effect has been nothing short of devastating. As Chinese and other Asian currencies have been devalued, prices for textile and apparel products from these countries have fallen by as much as 38 percent.

There is no textile manufacturer in the world that can drop prices by 38 percent and survive for long, absent government assistance. As a result, since 1997, we have closed more than 200 textile plants in the United States and lost more than 210,00 U.S. textile jobs. It is the worst bloodletting since the Great Depression.

In fact, I can give you a whole list of textile companies that made it through the Great Depression that have not survived the last five years. These were modern, state of the art companies and we have been shutting them down and, all too often, selling off their weaving looms and spinning frames at cut rate prices to state-owned Chinese textile firms.

People might be interested to learn that prior to the rise of massive Asian currency manipulation in the late 1990's, U.S. manufacturing – including the textile sector – was growing and thriving. From 1991-96, U.S. manufacturing added over 400,000 jobs; U.S. manufacturing shipments increased by $719 billion, and U.S. manufacturing exports increased by over $200 billion

In the textiles sector, in 98, we had our best year in history with record shipments, exports and profits. In that year, the textile industry invested more than $2 billion in new plants and equipment in the United States.

Contrast the 1991-96 period with the last five years. During this period of time, U.S. manufacturing employment fell by 2.3 million jobs, manufacturing shipments fell by $270 billion and while manufacturing exports dropped by $81 billion. The U.S. textile industry lost almost 25 percent of its workforce.

While US manufacturing is obviously affected by many issues, one fact stands out: during this time, Asian governments spent over one trillion dollars to keep their currencies undervalued and their exports to the U.S. strong.

Looking to more recent events, over the past year and half, textiles can provide one of the more stunning examples of how powerful a weapon currencies can be if not opposed.

On January 1, 2002, China joined the WTO and quotas were removed from 29 apparel categories. Over the next 12 months, Chinese prices on these apparel items dropped an average of 46 percent - there is that 40 percent number again. Within 15 months China had an average 39 percent share of market in these products and, using present trends, China will have a 65 percent share by the end of this year.

What is most tragic about all of this is that it could and should have been prevented. What China, Korea, Japan, Taiwan, Thailand, among others, are doing with their currencies is out and out illegal. One way purchases of currency with the purpose of gaining an export advantage is clearly illegal under both IMF and WTO rules.

Not only that, these actions are also clearly against the President's own stated policy that free markets, not export-oriented Asian governments, should determine exchange rates.

Not only that, these actions clearly are doing enormous damage. An excellent study by Ernie Preeg from the Manufacturers Alliance concluded that 1.5 million U.S. manufacturing jobs have been lost during the last two years because of illegal Asian currency manipulation. The United Nations has estimates that China may be getting as much as a 50 percent price advantage because of its illegal currency peg. And the National Association of Manufacturers describes Asian currency manipulation as the biggest problem, bar none, facing U.S. manufacturing today.

Plus, influential news organizations from around the world – the *Economist*, the *New York Times*, the *Wall Street Journal*, the *Financial Times* – all say that Asian currency manipulation of this magnitude – which never before happened – is not only bad for the United States but it is destabilizing for the world economy.

One might have expected that all this evidence, all this breaking of international rules and, most particularly, all these terrible job losses might have provoked some serious action by now by our government.

In fact, many of us from the manufacturing sector have spent the last year and half trying desperately – I want to underline desperately -- to get the government to act. We have held meetings, issued reports, sent letters, talked to the media, held conferences – done everything we could think of to get some action.

We have gone to USTR, and to Commerce, and to State on multiple occasions to try and get help - - our reasoning here was simple - - surely there are few issues that have a bigger trade, economic and international impact that this one. But each time we have been turned away, often with sincere understanding, with the proviso: we can't talk about this – only Treasury can.

Well, we have been repeatedly to Treasury and the problem there is that you feel like this is some far away story that really doesn't matter much. In fact, according to the Treasury Department's semi-annual report to Congress, currency manipulation is not even happening. According to Treasury, those one trillion dollars in Asian central banks don't really count for anything after all. And those 2.3 million lost manufacturing jobs? According to the Treasury, illegal currency manipulation didn't have a thing to do with it.

So on the one hand, we are confronted with very aggressive Asian governments that are breaking international rules, going against stated U.S. policy and, along the way, throwing millions of hard working Americans out of their jobs at a time when our economy can least afford it.

On the other hand, we have a U.S. government that can't even talk about this issue except to refer the matter to Treasury which officially says it does not exist.

As you can understand, this state of things is not easy to explain to the owner of a more than 100 year old family-owned textile company that had its best year in history in 1998 and has now gone out of business.

While this gentleman could easily understand how a 40 percent price advantage could put him out of business and he readily understood that China might try to get away with something illegal like this, it was almost impossible to understand why our government wouldn't want to do something about it. It is, after all, against the government's own policies.

That is one reason why our industry is so grateful that you and the other members of the Committee are highlighting this issue. The message from the past is that if you don't highlight it and we all don't keep highlighting it, nothing will happen.

All that being said, it is way past time for this government to stop worrying about the Chinese banking system or the Japanese economy and start worrying about the manufacturing jobs that are being lost in this country.

It is time for the government to realize that unless it acts now – publicly and forcefully – that we may lose this most productive part of our economy.

So again, let me express our personal appreciation for your taking a stand on behalf of U.S. manufacturing and its workers and in combating this terrible problem. Thank you.